The Corporate Investment Response to the Domestic Production Activities Deduction

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August 2015

Abstract

The Domestic Production Activities Deduction is a U.S. federal tax regulation that effectively lowers the corporate income tax rate on manufacturing income by 3.15 percentage points. To assess the impact of the deduction, this study examines the investment response to plausibly exogenous variation in effective corporate income tax rates created by the interaction of industry-level manufacturing activity and the phase-in of the deduction. Results indicate that corporate investment increased by 2.4% of installed property plant and equipment in response to the policy.

Keywords: Domestic production activities deduction, taxation, investment

JEL Classification: H25; H32; E22
1 Introduction

In the past several years, significant research efforts have been directed towards studying the impact of corporate tax reform on corporate behavior. Specifically, much attention has been given to the impacts of the “Bush Tax Cuts,” which significantly reduced the top rate on individual dividend and capital gains income, and to “Bonus Depreciation,” a policy that accelerates the deduction of new investment expenditures from taxable income. In contrast, relatively little attention has been paid to a third major corporate tax expenditure that has been in place for more than 10 years: the Domestic Production Activities Deduction (DPAD).

Implemented in 2005, the DPAD allows businesses to deduct up to 9% of income derived from domestic manufacturing activities from their taxable income. As a result, DPAD eligible firms face a 3.15% lower corporate income tax rate on domestic manufacturing income and a lower blended tax rate on all taxable income after the implementation of the deduction.

This paper quantifies the impact of the DPAD on corporate investment behavior. I find that, once fully phased in, the DPAD increased investment activity by approximately 2.4% of installed property plant and equipment. As investment is “of paramount importance for both business cycle fluctuations and long term economic growth,” these results suggest that the DPAD, and directed corporate income tax rate reductions more generally, may represent both effective short-run countercyclical levers and long-run growth stimulants to be further considered by policymakers.\(^1\)

To estimate the investment response the DPAD, I implement a differences-in-differences empirical design that exploits industry-level variation in the percentage of income that is eligible for the deduction. Firms belonging to industries that derive a large portion of income from domestic manufacturing activities (such as construction and agricultural firms) see a significant reduction in their average effective corporate income tax rate while firms residing in industries that are not domestic manufacturing intensive (such as real estate and transportation) are left essentially unaffected by the policy.

To construct this industry-level variation, I use data provided by the IRS Statistics of Income Division. The Statistics of Income Division publishes the aggregate annual dollar values of the DPAD and Net Taxable Income for businesses in 79 unique industries. Using these numbers, I derive industry-level percentages of income eligible for the DPAD, which are generally consistent over time both for the economy as a whole and for individual industries. The industry-level variation in treatment intensity and temporal variation in the DPAD deduction rate combine to create plausibly exogenous shocks which can be used to uncover the impact of the DPAD on investment.

The core empirical result of this research is that a one percentage point reduction in the effective corporate income tax rate via the DPAD increases investment by 4.1% of installed property plant and equipment (PPENT) for the average publicly traded U.S. corporation. As the DPAD decreased

\(^1\)Language taken from Goolsbee (1998).
the average firm’s effective tax rate by 1.31%, the average firm increased investment by 5.3% of installed PPENT in response to the policy. After accounting for a heterogeneous effect across firms, the analysis suggests that the DPAD induced the corporate sector as a whole to increase investment by 2.4% of installed PPENT.

The strongest critique of these results is that they are driven by industry-level trends and not by industry-level variation in DPAD treatment intensities. To address this concern, I first perform a placebo test in which a fake DPAD is implemented during similar economic conditions in the 1990s. The placebo results show no discernible pattern of divergence between high and low manufacturing intensive industries.

Next, I more directly address the concern that industry-level macroeconomic shocks are driving the estimated investment response by using macroeconomic indicators to predict industry-level investment levels in the absence of the DPAD. I use these predictions to construct a residual investment variable which is unrelated to macroeconomic trends and show that residual investment by firms in manufacturing intensive industries increases relative to investment by firms in non-manufacturing intensive industries after DPAD implementation. Finally, I include sector-by-year fixed effects and sector-level trends in the analysis. The results continue to show a significant investment response to the DPAD. Overall, the results of these robustness checks indicate that industry-level macroeconomic trends and sector trends are not driving the estimated investment response to the DPAD and may, in fact, be obfuscating the full impact of the policy.

After demonstrating the durability of the core results, I explore the interaction of the DPAD with two contemporaneous tax policies: (1) the Extraterritorial Income Exclusion (ETI), which the DPAD was designed to replace and (2) the 2004 tax holiday on repatriated earnings, which was designed to work in tandem with the DPAD to increase domestic investment. The results of these interactions show that while the ETI has no impact on investment or the elasticity of investment with respect to the DPAD, the 2004 tax holiday worked as designed; those firms which took advantage of the tax holiday were more responsive to the DPAD than firms that did not.

The findings in this research are most directly related to two concurrent working papers: Blouin, Krull and Schwab (2014) and Lester (2015). Blouin et al. (2014) examines the payout behavior of 77 firms which explicitly stated on their financial reports whether they repatriated funds in 2004 in response to the tax holiday and whether they benefited from the DPAD relative to the ETI. The authors find that the firms that benefited from the introduction of the DPAD were less likely to increase payouts, suggesting a possible investment response to the DPAD. Lester (2015) also uses financial statements to identify a subsample of firms that report receiving the DPAD. Among 767 firms that report DPAD take-up, Lester finds evidence that firms shift income across time and reclassify income to fit the DPAD definition. She also finds that firms in her subsample of the corporate population increased investment relative to firms that did not report the deduction.

This project differs from Blouin et al. (2014) and Lester (2015) in both methodology and scope.
Whereas these papers use firm-level, self-reported financial statement data to identify and study a small subset of firms, this study uses plausibly exogenous variation in the DPAD constructed from industry-level administrative data to study the investment response for all corporations listed on U.S. stock exchanges. Although Blouin et al. (2014) and Lester (2015) use different methods to examine the DPAD, results from their subsample analyses, which may suffer from selection biases, both complement and reinforce the findings presented here.

This work is indebted to and humbly contributes to another much larger literature concerning both the theoretically and empirical effects of tax policy on business investment. The theoretical foundations of this literature are provided by Hall and Jorgenson (1967), King (1977), Auerbach (1979), Bradford (1981), Summers (1981), Poterba and Summers (1985), and Desai and Goolsbee (2004). The empirical study of tax incentives and investment response is highlighted by Cummins, Hassett and Hubbard (1994), Goolsbee (1998), Edgerton (2010), Yagan (2013), and Zwick and Mahon (2014).

The remainder of the paper is organized as follows: Section 2 provides an in-depth explanation of the DPAD. Section 3 provides a simple conceptual framework that captures the effect of the policy on investment behavior, paying close attention to potential heterogeneous responses to the policy based on financial constraint and taxable status. The framework produces several testable hypotheses which are subsequently taken to the data. Section 4 discusses the data sources, construction of key variables, and descriptive statistics. Section 5 describes the empirical strategy and key identifying assumptions necessary to estimate the investment effects of the DPAD. The investment response to the DPAD is estimated and quantified in Section 6. Section 7 presents robustness checks on these estimates. In Section 8, the interaction of the DPAD and other tax policies is explored. Section 9 concludes.

2 The Domestic Production Activities Deduction

The Domestic Production Activities Deduction was enacted as part of the American Jobs Creation Act of 2004. In its simplest form, the DPAD is a federal corporate tax deduction that allows firms to deduct a percentage “Qualified Production Activities Income” from their taxable income. The DPAD effectively lowers the corporate tax rate on income derived from domestic manufacturing. Three pieces of information are key to understanding the policy: the rate of the deduction, the definition of Qualified Production Activities Income (QPAI), and other factors limiting DPAD application.

The deduction was implemented at a rate of 3% in 2005, increased to 6% in 2007, and reached its maximum rate of 9% in 2010. Figure 1 presents the DPAD rates during the phase-in period.

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2The DPAD was designed to replace the Extraterritorial Income Exclusion deduction (ETI). Discussion of the ETI and analysis of its interaction with the DPAD is reserved for Section 8.
Given a statutory corporate income tax rate of 35%, these rates reduced the effective tax rate on QPAI by 1.05% in 2005 and 2006, by 2.10% in 2007–2009, and ultimately by 3.15% in years 2010 and beyond. How much these rates affect behavior depends on the percentage of income that a firm derives from QPAI (its QPAI %). If a firm has 100% QPAI, then their effective rate drops 3.15% when the DPAD is fully phased in at 9%. Firms that claim 50% of income as QPAI see an effective rate drop of 1.575%. Effective tax rates of firms that derive no income from domestic production are completely unaffected (at least in partial equilibrium).

QPAI is equal to the excess (if any) of the firm’s Domestic Production Gross Receipts (DPGR) over the Domestic Production Gross Costs (DPGC). DPGR is defined as any income that is derived from

- Lease, rental, license, sale or exchange of goods manufactured in the United States except sale of prepared foods and energy transmission
- Construction and engineering and architectural services performed in the United States

And DPGC are defined as

- Costs of goods allocable to DPGR
- Other deductions, expenses or losses directly allocable to DPGR or
- A ratable portion of other expenses not directly allocable to such receipts

An item qualifies as produced in the United States if at least 20% of the total costs are the result of direct labor and overhead costs from US–based operations.

Finally, the deduction is limited in two ways. First, the deduction may not exceed 50% of W-2 wages paid by the firm. Second, the deduction may not exceed gross (taxable) income.

Not only is the potential 3.15% tax rate reduction a big break from the perspective of individual establishments but, the policy also constitutes a significant tax expenditure at the national
level. Figure 2 details the total taxable income deductions resulting from the DPAD and total tax expenditure on the policy during the phase-in time period (assuming a corporate rate of 35% on all income). In 2010 when the DPAD reached 9%, corporations were able to deduct more than $24 billion from their taxable income at a cost of more than $8.5 billion to US government. By 2012, expenditures on the DPAD topped $11 billion.

**Figure 2: DPAD Deduction**

<table>
<thead>
<tr>
<th>Year</th>
<th>$(billions)$</th>
<th>$(billions) \times \tau$</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>9.332</td>
<td>3.266</td>
</tr>
<tr>
<td>2006</td>
<td>11.106</td>
<td>3.887</td>
</tr>
<tr>
<td>2007</td>
<td>21.058</td>
<td>7.370</td>
</tr>
<tr>
<td>2008</td>
<td>18.374</td>
<td>6.320</td>
</tr>
<tr>
<td>2009</td>
<td>14.198</td>
<td>4.970</td>
</tr>
<tr>
<td>2010</td>
<td>24.365</td>
<td>8.528</td>
</tr>
<tr>
<td>2011</td>
<td>27.388</td>
<td>9.586</td>
</tr>
<tr>
<td>2012</td>
<td>31.966</td>
<td>11.188</td>
</tr>
</tbody>
</table>

Notes: Source: IRS Statistics of Income. Corporate statutory rate $\tau = .35$

### 3 Conceptual Framework and Empirical Hypotheses Generation

To think about how and why firms respond to the policy and to guide the empirical analysis, this section presents a simple model of investment in the presence of the DPAD, accelerated depreciation, and financial constraint. The model presented here follows the recent work by Zwick and Mahon (2014) which combines the Neoclassical investment models of Abel (1982) and Hyashi (1982) with the Stein (2003) model of costly external finance. The model predicts that firms will increase investment response to the DPAD and produces two testable hypotheses. First, investment increases more for firms that derive a larger proportion of income from QPAI. Second, firms that are financially constrained will be more responsive to the policy. This heterogeneity of response is important in quantifying the overall impact of the policy as financial constrained firms are, on average, smaller and do less investment.
3.1 Framework Primitives

Consider a firm making a one shot investment decision. The firm begins with initial retained earnings $R_0$ and chooses the level of investment $I$ in an effort to maximize after tax profits. Future profits are increasing in $I$ according to the function, $\pi(I)$, and are taxed at the proportional rate $\tau$. The DPAD allows the firm to deduct a percentage $d$ of qualified income from its taxable income. The percentage of income that qualifies for the deduction is $\rho$. The firm discounts the after-tax profits at the risk-adjusted rate $r$; thus the firm’s discounted after tax profits can be written as

$$\frac{[1 - \tau(1 - \rho d)]\pi(I)}{1 + r}.$$ 

The after-tax price of $\$1$ of investment is $1 - \tau z$ where the parameter $z$ governs how quickly investment costs may be deducted against the firm’s taxable income. The value of the tax deduction, $\tau z$, is higher if the investment can be written off more quickly or the firm discounts the future less aggressively.$^{45}$

Investment may be additionally expensive if external financing is costly and the level of investment exceeds current cash flows. To model these financing costs, the firm faces an external finance wedge, $c(I)$, that is linear in expenses net of cash flows.

$$c(I) = \lambda[(1 - \tau z)I - R_0]$$

where $\lambda$ can be thought of as the shadow price on a borrowing constraint that may or may not bind now or in the future. Thus, a dollar of cash inside the firm is worth $1 + \lambda$ due to costly external finance.

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$^3$In this simple framework, $\rho$ is assumed to be fixed over time. One can imagine a more complicated version of the model in which firms may expend resources in an effort to increase $\rho$ by changing its business model or reclassifying earnings as qualified income. Empirically, QPAI is generally stable over time both at the population and industry level. See Figure 3.

$^4$During the last decade, the rate at which investment depreciates for tax purposes has been accelerated in an effort to stimulate investment. This largely counter-cyclical policy is known as Bonus Depreciation. Bonus Depreciation allows firms to write off a percentage of the purchase price of new capital in the first year in addition to write-offs specified in the statutory tax depreciation schedules. The empirical analysis will control Bonus Depreciation by empirically constructing $z$ and simultaneously estimating its effect of investment. Additional theoretical discussion of $z$ and bonus depreciation is left out here as it is not central the DPAD analysis. For an in depth treatment of $z$, including its construction both analytically and empirically and its impact on investment see Edgerton (2012), and Zwick and Mahon (2014).

$^5$Investment costs are assumed to be deductible at the statutory – not the DPAD adjusted – tax rate. This assumption is made because in order to receive maximum DPAD benefits from any given project, firms would optimally classify as much income and as little cost towards QPAI as possible.
3.2 Optimal Investment

The firm’s optimal investment condition is found by maximizing the firm’s objective function,

\[
\max_I \left\{ \frac{[1 - \tau(1 - \rho d)] \pi(I)}{1 + r} - (1 - \tau z) I - \lambda (1 - \tau z) I \right\},
\]

with respect to \( I \), where terms not involving \( I \) have been suppressed. Under the assumption of concave \( \pi \), the problem yields a unique interior solution characterized by the first order condition

\[
\frac{[1 - \tau(1 - \rho d)] \pi'(I^*)}{1 + r} = (1 + \lambda)(1 - \tau z).
\]

The optimal investment rule is intuitive; the firm chooses \( I \) to set the after-tax discounted future benefits of the marginal dollar of investment equal to the after tax price of investment and the cost of external finance. The DPAD increases \( d \) and thereby increases the benefits to investment. How much \( d \) increases the marginal benefit of a dollar of investment depends on \( \rho \), the percentage of income to which the DPAD applies. With fixed \( \rho \), the effects of an increase in \( d \) are only distinct from the effects of a decrease in \( \tau \) in that a decrease in the statutory rate would be mitigated to some degree by a reduction in the tax benefits to investment through \( \tau z \).

3.3 Testable Hypotheses

The DPAD increases the after-tax marginal benefit of investment and thus increases the firm’s level of investment; \( \partial I/\partial d > 0 \). From this intuitive result, two testable hypotheses may be derived. The first may be considered the baseline empirical hypothesis. The second describes heterogeneity in the baseline response based on financial constraint.\(^6\)

**Hypothesis 1.** Investment responds more strongly to the DPAD for industries that derive a larger percentage of income from QPAI; \( \partial^2 I/\partial d \partial \rho > 0 \).

When the DPAD is offered or increased, \( d \), the percentage of QPAI that may be deducted from taxable income increases. The effect of the policy is amplified by the percentage of income that may be classified as QPAI, \( \rho \). This result is intuitive – firms that are more domestic production intensive effectively receive a more generous per dollar deduction and as a result increase their investment more in response to the introduction or increase in the DPAD. This hypothesis is empirically testable because \( \rho \) varies substantially across industries. Section 4 describes the construction of industry level \( \rho \) and its variance across both the population of corporate taxpayers and across listed firms. If the DPAD does effectively stimulate investment, then firms in industries with high levels of \( \rho \) should be more responsive to the DPAD.

\(^6\)A third empirical hypothesis describing heterogeneity in response by tax status is explored theoretically and empirically in Appendix E.
The second empirically testable hypothesis concerns how investment response to the DPAD varies based on a firm’s cost of external financing or more generally its level of financial constraint.

**Hypothesis 2.** Investment responds more strongly to the DPAD for firms that are financially constrained; \( \partial^2 I / \partial d \partial \lambda > 0 \).

For both the constrained and unconstrained firms, the DPAD increases the marginal return on investment. For the constrained firm, however, the policy is doubly beneficial as it also provides for additional financial slack. Thus, the change in the optimal level of investment is larger for firms that are financially constrained if external financing is, in fact, costly. Following findings in Hadlock and Pierce (2010), the level of financial constraint that a firm faces will be represented by firm’s total assets.\(^7\) If financial constraints do affect the investment response to the DPAD, then the investment response to the DPAD should be larger among smaller firms. If, on the other hand, external financing is not more costly than internal financing, then there should be no heterogeneity in the investment response to the DPAD across firms of different sizes. The empirical analysis of this hypothesis is important in considering the overall impact of the policy; if smaller firms that do less investment are the most responsive to the policy, then the overall corporate response may be more tempered than the response to the policy by the average firm.

### 4 Data Sources, Construction, and Descriptive Statistics

In order to test the hypotheses presented in the previous section, data from several sources must be compiled. Data from the IRS Statistics of Income Corporate Tax Statistics website are used to construct the DPAD variable. Data used to construct the investment variable, control variables, and sample splitting variables are taken from the COMPUSTAT North American Annual database. Finally, data from the BEA and the IRS are used to construct a variable that captures the generosity of tax depreciation allowances, which vary during the time period examined.

The data used to construct the DPAD (the “IRS Sample”) are the 79 IRS Industries observed during the years 2005–2012. The sample used for the empirical analyses (the “Corporate Sample”) are firms contained in the COMPUSTAT North American Annual database with non-missing DPAD, investment, and control variables that are not listed in the IRS financial sector. The analysis period is 2002–2012. In total, there are 8,123 firms and 59,126 firm-year observations in the Corporate Sample.

#### 4.1 DPAD Variable

The effect of the DPAD differs across firms based on the percentage of income derived from qualified production activities (\( \rho \) in Section 3) or QPAI\%. QPAI\% can be constructed at the industry level

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\(^7\)Heterogeneity of response across the financial constraint index introduced in Hadlock and Pierce (2010) is presented in Appendix D.
using information provided by the IRS Statistics of Income Division; specifically, the data are taken from the SOI Tax Stats Table 7: “Corporate Returns with Net Income;” years 2005 - 2012. Table 7 provides information on net taxable income and the DPAD for 17 sectors and 79 more finely defined industries. Data in Table 7 are compiled from all corporations that filed a tax return during the year. The IRS sectors and industries correspond to NAICS 4-digit industries which allow IRS data to be matched to financial statement data at the industry level. QPAI% is equal to qualified income divided by total income. To find qualified income, the DPAD in total dollars is divided by the DPAD rate, which varies during years 2005-2012 as described in Section 2.

Table 1: QPAI % for IRS Sample

<table>
<thead>
<tr>
<th>Variable</th>
<th>Year(s)</th>
<th>Median</th>
<th>Mean</th>
<th>10th Pctile</th>
<th>90th Pctile</th>
</tr>
</thead>
<tbody>
<tr>
<td>QPAI %</td>
<td>2005–2012</td>
<td>9.84</td>
<td>26.42</td>
<td>0.30</td>
<td>74.02</td>
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<tr>
<td>QPAI %</td>
<td>2005</td>
<td>7.98</td>
<td>21.10</td>
<td>0.10</td>
<td>67.01</td>
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<tr>
<td></td>
<td>2006</td>
<td>9.57</td>
<td>25.49</td>
<td>0.16</td>
<td>74.92</td>
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<td></td>
<td>2007</td>
<td>9.36</td>
<td>27.59</td>
<td>0.37</td>
<td>68.32</td>
</tr>
<tr>
<td></td>
<td>2008</td>
<td>10.70</td>
<td>26.22</td>
<td>0.52</td>
<td>70.17</td>
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<tr>
<td></td>
<td>2009</td>
<td>8.59</td>
<td>27.05</td>
<td>0.31</td>
<td>77.86</td>
</tr>
<tr>
<td></td>
<td>2010</td>
<td>10.01</td>
<td>25.88</td>
<td>0.28</td>
<td>73.81</td>
</tr>
<tr>
<td></td>
<td>2011</td>
<td>12.31</td>
<td>28.41</td>
<td>0.53</td>
<td>81.89</td>
</tr>
<tr>
<td></td>
<td>2012</td>
<td>14.77</td>
<td>29.76</td>
<td>0.27</td>
<td>81.45</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Industries</th>
<th>79</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industries x Years</td>
<td>620</td>
</tr>
</tbody>
</table>

Notes: Table 1 provides descriptive statistics for the variable QPAI % for the IRS Sample – all corporations that filed a tax return during the year in question. QPAI % is defined as the percentage of taxable income that is derived from Qualified Production Activities.

Table 1 and Figure 3(A) present descriptive statistics describing the evolution of QPAI% for the IRS Sample during the years 2005-2012. The average QPAI% during all years 2005 - 2012 is 26.42%. The percentage is lowest in 2005, the first year the DPAD was available, but rises and is relatively stable at a percentage between 25.49 and 29.76 during years 2006–2012. The stability of QPAI% after 2006 suggests that firms’ domestic manufacturing vs. non-domestic manufacturing mixes are relatively fixed over time. A similar trend is apparent in Figure 4 which presents QPAI% over time for the IRS Manufacturing, Information, Retail and Real Estate Sectors. QPAI% is relatively stable over time within these sectors; high QPAI sectors like manufacturing and information report consistently high percentages of QPAI while low QPAI sectors like retail and real estate report consistently low percentages of QPAI. The stability of the trend both for the economy as a whole

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8 Appendix A provides definitions of DPAD and Net Income from the IRS Statistics of Income.
whole and at the sector level suggests that firms’ domestic manufacturing vs. non-domestic manufacturing mixes are relatively fixed. It follows directly that the theoretical assumption of fixed $\rho$ is appropriate.

**Figure 3: QPAI Percent**

(A) QPAI Percent 2005-2012

(B) QPAI by Sector

(C) Manufacturing Industries

(D) Information Industries

Note: Figures 3(A) - 3(D) present percentages of Qualified Production Income as a percentage of total income. QPAI percentage is calculated as the Domestic Production Deduction divided by Income Subject to Tax as defined by the IRS Statistics of Income Division. Panel (A) presents QPAI averaged across all corporations for years 2005 - 2012. Panel (B) presents QPAI for each major production section averaged across all years 2005 - 2010. Panel (C) presents QPAI for each major industry in the manufacturing sector averaged across all years 2005 - 2012. Panel (D) presents QPAI for each major industry in the information sector averaged across all years 2005 - 2012.
Note: Figures 4(A) - 4(D) present percentages of Qualified Production Income as a percentage of total income for during years 2005-2010 for the four largest sectors IRS sectors. QPAI percentage is calculated the Domestic Production Deduction divided by Income Subject to Tax as defined by the IRS Statistics of Income Division.

While QPAI% is stable over time, Panels (B)–(D) of Figure 3 show that it also varies significantly across sectors and within sectors at the IRS industry level. The most QPAI intensive sector is construction followed closely by agriculture, information, and manufacturing. While the construction and agricultural sectors report approximately 60% of their income as QPAI, eight sectors including real estate, healthcare, and finance report less than 10% of their income as QPAI. In the manufacturing sector, the majority of industries report more than 50% of income as QPAI, but several industries including oil and gas, apparel, and leather manufacturing reports less than 30%
of income as QPAI. In the information sector, QPAI % varies from just over 80% QPAI to less than 20%. The within-sector variation is especially appealing if one is concerned about identification in the presence of sector-level shocks because it allows the impact of the DPAD to be identified even when sector fixed effects or trends are included in the analysis.

The **DPAD** variable that is used in the empirical analysis is constructed directly from QPAI%. DPAD which equal to the effective percentage point reduction in the corporate income tax rate that results from the DPAD is generated by multiplying QPAI% by the deduction percent and the statutory corporate income tax rate (DPAD = dρτ in Section 3). DPAD varies across industries due to variation in QPAI% and over time due to variation in the deduction percentage. The QPAI% used to construct the DPAD is the average of the three highest annual observations of QPAI% reported within each industry during the years 2005–2012. This high-three QPAI construction is chosen to avoid effects of the 2008 financial crisis and potential under reporting of domestic production activities in 2005.\(^9\)

Table 2 reports average QPAI% and DPAD for the Compustat Sample both over all years 2005-2012 and for each year 2005 to 2012. The average QPAI % is significantly higher for the Compustat Sample than in the IRS Sample because firms in the Compustat sample are more concentrated in high QPAI % industries than the general population of corporate tax filers. The mean effective corporate income tax rate reduction generated by the DPAD increases from 0.45 to 0.89 to 1.30 percentage points as the deduction rate increases from 3% to 6% to 9% .

### Table 2: QPAI, DPAD %; Corporate Sample

<table>
<thead>
<tr>
<th>VARIABLE</th>
<th>YEARS</th>
<th>MEDIAN</th>
<th>MEAN</th>
<th>10th PCT</th>
<th>90th PCT</th>
</tr>
</thead>
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<tr>
<td>QPAI%</td>
<td>2005 - 2012</td>
<td>44.826</td>
<td>41.747</td>
<td>3.246</td>
<td>76.293</td>
</tr>
<tr>
<td>DPAD</td>
<td>2005 - 2012</td>
<td>0.868</td>
<td>0.911</td>
<td>0.075</td>
<td>1.931</td>
</tr>
<tr>
<td>DPAD</td>
<td>2005 - 2006</td>
<td>0.458</td>
<td>0.450</td>
<td>0.045</td>
<td>0.760</td>
</tr>
<tr>
<td>DPAD</td>
<td>2007 - 2009</td>
<td>0.916</td>
<td>0.892</td>
<td>0.089</td>
<td>1.471</td>
</tr>
<tr>
<td>DPAD</td>
<td>2010 - 2012</td>
<td>1.374</td>
<td>1.296</td>
<td>0.134</td>
<td>2.203</td>
</tr>
</tbody>
</table>

Firms 8,132

Firms x Years 59,126

Notes: Table 2 presents QPAI % and DPAD for years 2005-2012 for the Corporate Sample. QPAI % is the percentage of income derived from qualified production activities and eligible for the domestic production activities deduction. DPAD is equal to the effective income tax rate reduction generated by the DPAD.

\(^9\)Estimates are robust to various QPAI% formulations including (1) an average over all years 2005-2012, (2) the highest, and (3) the lowest reported percentage.
4.2 Investment, Control, and Sample Splitting Variables

The dependent variable in all regressions is **Investment Percent** which is equal to capital expenditure in the current year scaled by the lagged value of property plant and equipment. The **HP Index** as constructed in Hadlock and Pierce (2010) is used to control for financial constraint. Marg Q and Cash Flow as constructed by Kaplan and Zingales (1997) and later used in Edgerton (2010) are used to control for investment opportunities and cash flow. Construction of these variables is detailed in Appendix B.

Three variables are used to split the Corporate Sample into smaller groups of interest. The first, **Dec Fiscal Year**, is an indicator equal to 1 if the firm’s fiscal year ends in December and equal to 0 if the firm’s fiscal year ends in another month. The second split is based on whether firms are **Domestic** or **Multinational**. If a firm reports positive foreign income during years 2002–2004, then they are classified as a Multinational. If a firm reports no foreign income, they are classified as Domestic. The final sample splitting variable is **Total Assets** which is equal to a firm’s average total assets in the years 2002–2004.

All variables based on financial statement data are Winsorized at the 1st and 99th percentiles to limit the effects of misreported data. All results are robust to both more aggressive Winsorizing at the 5% level and to the absence of Winsorizing.

Table 3 provides descriptive statistics for the investment, control, and sample splitting variables. Of note, the mean value of Investment Percent is 0.432, meaning that for the average firm capital expenditure is equal to 43% of the value of installed property, plant, and equipment. The skew of this variable is consistent with lumpy investment behavior; firms engage in large investment projects, but not every year.

4.3 Tax Depreciation Allowances

During the sample period, another tax policy which potentially affects investment, Bonus Depreciation, must be controlled for in order to accurately estimate the effects of the DPAD. Bonus depreciation works by accelerating the depreciation of capital investments for tax purposes. Bonus depreciation is controlled for by including the **Z Tax Term**, the present value of tax depreciation allowances available on $1 dollar of investment. See Edgerton (2012) and Zwick and Mahon (2014) for a discussion of the construction of this variable. The average value of the Z Tax Term for the investment sample is 0.917.

---

Investment Percent is chosen as the dependent variable, in part, so that results are directly comparable to prior research on investment behavior among Compustat firms (Cummins et al. (1994), Desai and Goolsbee (2004), Edgerton (2010)).
Table 3: Additional Descriptive Statistics; Corporate Sample

<table>
<thead>
<tr>
<th></th>
<th>Median</th>
<th>Mean</th>
<th>10th pctile</th>
<th>90th pctile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment Percent</td>
<td>0.187</td>
<td>0.432</td>
<td>0.039</td>
<td>0.787</td>
</tr>
<tr>
<td>Z Tax Term</td>
<td>0.923</td>
<td>0.915</td>
<td>0.875</td>
<td>0.952</td>
</tr>
<tr>
<td>Marg Q</td>
<td>1.523</td>
<td>3.974</td>
<td>.864</td>
<td>5.165</td>
</tr>
<tr>
<td>Cash Flow</td>
<td>0.190</td>
<td>-9.195</td>
<td>-9.183</td>
<td>1.915</td>
</tr>
<tr>
<td>HP Index</td>
<td>-4.356</td>
<td>-4.253</td>
<td>-6.711</td>
<td>-1.677</td>
</tr>
<tr>
<td>Dec Fiscal Year</td>
<td>1.000</td>
<td>0.690</td>
<td>0.000</td>
<td>1.000</td>
</tr>
<tr>
<td>Domestic</td>
<td>1.000</td>
<td>0.646</td>
<td>0.000</td>
<td>1.000</td>
</tr>
<tr>
<td>Multinational</td>
<td>0.000</td>
<td>0.354</td>
<td>0.000</td>
<td>1.000</td>
</tr>
<tr>
<td>Total Assets</td>
<td>267.231</td>
<td>7,680.593</td>
<td>4.439</td>
<td>7,086.547</td>
</tr>
</tbody>
</table>

Firms: 8,132
Firms x Years: 59,126

Notes: Table 3 reports the mean, median, 10th percentile, and 90th percentile statistics for the outcome variable (Investment Percent), control variables (Z Tax Term, Marg Q, Cash Flow, and HP Index), and sample splitting variables (Dec Fiscal Year, Domestic, Multinational, and Total Assets) for the Corporate Sample. Total Assets is measured in millions of dollars.

5 Empirical Design and Identification

A differences-in-differences (DD) estimation strategy is implemented to test Hypothesis 1 and measure the investment response to the DPAD. The DD estimation strategy is carried out using standard OLS regression techniques and compares investment by firms in high QPAI industries to investment by firms in low QPAI industries at different DPAD rates. The DD OLS specification is

\[
\frac{I_{it}}{K_{i,t-1}} = \beta_0 + \beta_1 DPAD_{jt} + \sum_{s=2}^{n} \beta_s \text{Control}_s + \eta_i + \gamma_t + \epsilon_{it}
\]

where \(i\) indexes firms, \(j\) indexes industries, and \(t\) indexes time. \(\eta\) and \(\gamma\) are firm and year fixed effects. In this DD specification, \(\beta_1\) is the treatment effect and describes the increase in Investment Percent that results from a one percentage point reduction in a firm’s effective income tax rate generated by the DPAD. To see the identifying variation upon which \(\beta_1\) is estimated, recall that \(DPAD_{jt} = \rho_j d_t \tau\). \(\rho\) varies at the industry level and describes how strongly any particular industry is “treated,” and \(d\) varies over time and describes the level of “treatment.” \(\beta_1\), then, is estimated by comparing investment by firms in high \(\rho\) industries to investment by firms in low \(\rho\) industries when the policy, \(d\), is implemented and subsequently increased.
Given that $\beta_1$ is identified by industry-by-year variation in DPAD, the key identifying assumption is that DPAD is independent of other industry-by-year shocks. Although this assumption cannot be directly tested by estimating $\beta_1$ while including industry-by-year indicators in the regression, the analysis in Section 7 addresses the concern by performing placebo analyses, controlling for macroeconomic industry-level trends, and estimating $\beta_1$ in the presence of sector-by-year fixed effects and sector-specific time trends in regression.

To test Hypothesis 2, that more financially constrained firms are more responsive to the DPAD, coefficients from (1) are estimated for subgroups of firms based on their total assets. The $\beta_1$ coefficient is then compared across the groups of firms. This technique implements a differences-in-differences-in-differences (DDD) strategy; the DD coefficient is again differenced across groups that potentially respond heterogeneously to the policy. This DDD implementation is more flexible and therefore preferable to simply including a DDD term ($DPAD \times$ group) and cross terms in the regressions because it allows for controls to have different coefficients in each sample.

6 The Effect of the DPAD on Corporate Investment

6.1 Hypothesis 1; Baseline Empirical Results

Table 4 presents estimates of coefficients from Equation (1). These baseline specifications, as well as all other estimates, include year and firm fixed effects. Standard errors are clustered at the industry level.

Overall, the Table 4 results support Hypothesis 1 and indicate a statistically and economically significant impact of the DPAD on corporate investment. Specification (1) estimates the impact of the DPAD on investment percent when no control variables are present. Without controls, estimates suggest that the average firm increases investment by 3% of installed property plant and equipment for every DPAD-induced percentage point reduction in their effective corporate income tax rate. In Specification (2) (the “baseline” specification), when industry-level controls for bonus depreciation and firm-level controls for financial constraint, cash flows, and investment opportunities are added, the impact increases to 4.1%. The impact of the DPAD is even larger – 4.7% – in Specification (3) when the sample is limited to corporations with December Fiscal Years – those firms whose fiscal years are temporally aligned with changes in the DPAD deduction rate.

In Specifications (4) and (5), Equation (1) is estimated separately for domestic firms and multinationals. The results suggest investment activity by multinationals is relatively more responsive to the DPAD. For multinationals, a one percentage point decrease in their effective U.S. corporate income tax rate via the DPAD increases investment by 4.2% of installed PPENT. Domestic

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11 Because the DPAD produces industry-by-year shocks, two-way clustered standard errors by industry and year is the most appropriate clustering choice from an economic perspective. However, standard errors that are clustered at the industry-level are presented because they are larger and therefore a more conservative choice.
corporations only increase investment by 2.8% of PPENT.\textsuperscript{12} The real difference in investment responsiveness between domestic and multinational firms is most likely even larger. Financial statement data for multinationals is aggregated across all subsidiaries worldwide. Thus, assuming the estimated response is driven only by U.S. investment and understanding that a large majority of investment is not done in the U.S., the responsiveness of only U.S. investment by multinationals would be larger than the observed 4.2%.

Several additional ways to interpret these results can increase understanding of the investment response to the DPAD. The first is as an elasticity of investment with respect to the net-of-tax rate, \(\mathcal{E}\{I\%, (1 - \tau_{pd})\}\). Using estimates from the baseline specification, this elasticity is \((1 - \tau_{pd})\), is 6.02.\textsuperscript{13} This estimate is 16% smaller than the 7.2 elasticity estimated by Zwick and Mahon (2014) and indicates that, on average corporate investment is slightly less responsive to the DPAD than is business investment is to accelerated depreciation, perhaps owing to the temporary nature of early bonus depreciation incentives. For domestic firms, the elasticity of investment with respect to the net of tax rate is equal to 4.49 while for multinationals, the elasticity is equal to 6.64. Section 8.2 investigates whether this divergence in responsiveness is at least in part due to the contemporaneous 2004 Repatriation Tax Holiday which potentially stimulated U.S. investment by multinational corporations.\textsuperscript{14}

A second way to interpret the baseline results is to estimate the investment response to the policy for the average firm in the corporate sample. The average firm in the sample derives 41.7% of its income from domestic production activities. As a result, when the DPAD was fully phased in, the average firm received a 1.313\% (3.15 x .417) decrease in their average effective income tax rate. Based on these numbers and the Specification (2) estimates, the average corporation increased their investment 5.3\% of installed PPENT in response to the DPAD. The average increase for a domestic firm was 3.6\% and the average multinational increased investment by 5.5\% of PPENT.

These estimates suggest a substantial investment response to the DPAD for the average firm. However, if heterogeneity exists in the investment response across firms facing varying levels of financial constraint, then these average firm estimates may not describe the economy-wide effect of the policy. If financially constrained firms are more responsive but also do less investment than larger, less constrained firms then these estimates overstate the overall impact of the DPAD.

\textsuperscript{12}Lester (2015) estimates this same number as 2.2\% by comparing self-reporting DPAD firms to a matched sample of firms that do not mention the DPAD in their financial reports. The divergence in the two estimates suggests that firms in Lester’s control group may be increasing investment in response to the DPAD but are not reporting their take-up of the deduction, leading to downward biased estimates.

\textsuperscript{13}This estimate is based on a mean investment percent of 0.43 and at a net of tax rate half way between 0.65 and 0.6185. 0.65 is the net of tax rate with no DPAD and 0.6185 is the net of tax rate with a full 9\% DPAD. The statutory tax rate, \(\tau\), is assumed to be 0.35.

\textsuperscript{14}Appendix C presents estimates using data averaged at the industry-level in an effort to alleviate concern that outliers may be driving estimates of the investment response to the policy. Results indicate a slightly smaller investment response across all firms; \(\mathcal{E}\{I\%, (1 - \tau_{pd})\} = 5.76\). Using the industry-averaged data, point estimates indicate that domestic firms are more responsive to the policy than multinationals.
## Table 4: Investment Response to the DPAD

<table>
<thead>
<tr>
<th>Specification</th>
<th>Investment Percent</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)</td>
</tr>
<tr>
<td>DPAD</td>
<td>0.030**</td>
<td>0.041***</td>
<td>0.047***</td>
<td>0.028*</td>
<td>0.042***</td>
</tr>
<tr>
<td></td>
<td>(0.012)</td>
<td>(0.012)</td>
<td>(0.014)</td>
<td>(0.016)</td>
<td>(0.014)</td>
</tr>
<tr>
<td>Z Tax Term</td>
<td>0.140</td>
<td>0.352</td>
<td>0.269</td>
<td>-0.208</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.164)</td>
<td>(0.256)</td>
<td>(0.202)</td>
<td>(0.193)</td>
<td></td>
</tr>
<tr>
<td>HP Index</td>
<td>-0.168***</td>
<td>-0.166***</td>
<td>-0.186***</td>
<td>-0.114***</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.019)</td>
<td>(0.025)</td>
<td>(0.021)</td>
<td>(0.016)</td>
<td></td>
</tr>
<tr>
<td>Marg Q</td>
<td>-1.1 × 10^{-4}</td>
<td>-3.9 × 10^{-4}</td>
<td>4.0 × 10^{-5}</td>
<td>0.002</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.001)</td>
<td>(0.001)</td>
<td>(0.001)</td>
<td>(0.002)</td>
<td></td>
</tr>
<tr>
<td>Cash Flow</td>
<td>-0.004***</td>
<td>-0.004***</td>
<td>-0.004***</td>
<td>-0.005***</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.000)</td>
<td>(0.000)</td>
<td>(0.000)</td>
<td>(0.001)</td>
<td></td>
</tr>
</tbody>
</table>

### Notes:
Specifications (1) through (5) present coefficients from regressions of the form

\[
\frac{I_{it}}{K_{i,t-1}} = \beta_0 + \beta_1 DPAD_{jt} + \sum_{s=1}^{n} \beta_s \text{Control}_s + \epsilon_{it}.
\]

In specifications (2) – (5), controls for bonus depreciation, financial distress, marginal Q, and cash flows are included. In specification (3) the analysis is limited to firms with fiscal years that end December 31st. In specification (4), analysis is limited to Domestic Firms. In specification (5), the analysis is limited to Multinationals. All specifications include firm and year fixed effects. Standard errors are clustered at the industry level. *** indicates statistical significance at the 1% level, ** at 5%, and * at 10%.
6.2 Hypothesis 1; Graphical Analysis

Before moving on to Hypothesis 2 and the economy-wide impact of the DPAD, the analysis presents graphical evidence of the effect of the policy. Figure 5 presents a visual implementation of the difference-in-difference research design described in Section 5 and empirically estimated in Section 6.1. To create these graphs, first, firm-level investment percent is regressed on firm-level control variables in each year 2002–2012. Residuals from these regressions are then averaged for the treatment and the control group. Firms are considered treated if they operate in an industry where more than 40% of income is derived from qualified production activities. The residual group means are then added to average investment percent in each year then equalized in the pre-treatment period to ease comparison of trends. The adjusted group mean residuals are then plotted. The visuals that result from this procedure match the fixed-effects regressions with firm-level covariates presented in Table 4. The increase in the residual treatment group mean residual relative to the control group mean residual after the DPAD is implemented can be interpreted as a visual difference-in-difference estimate.

On the whole, the graphical evidence complements the baseline empirical analysis and suggests that the DPAD has a strong and lasting impact on corporate investment. Panel (A) presents the graphical corollary to the baseline specification (Specifications (2), Table 4). This panel shows similar investment behaviors between the treated and non-treated groups in years 2002–2004 followed by a sharp increase in investment by the high QPAI firms relative to the low QPAI firms after the policy is implemented. This divergence occurs immediately in 2005 and steadily grows through 2012. There are no discernible sharp increases in the effect of the DPAD in 2007 or 2010 when the DPAD rate increases to 6% then to 9%, suggesting firms gradually ramped up investment perhaps in anticipation of – rather than in response to – increases in the deduction.

Panels (B), (C), and (D) limit the graphical analysis to firms with December Fiscal Years, Domestic Firms, and Multinationals. These panels correspond to Specifications (3), (4), and (5) from Table 4. Like Panel (A), Panels (B), (C), and (D) show similar investment patterns between control and treatment groups in 2002–2004. Then in 2005, while investment stays steady for the control group, investment by firms in the treatment industries increases substantially. The divergence increases over the years 2005–2007 then stays stable during years 2008–2012 except for in the Multinational panel where investment behaviors between the control group and treatment group are nearly identical in 2008 and 2009, during the heart of the worldwide financial crisis.

Overall, the graphical and empirical difference-in-difference analysis supports Hypothesis 1; firms in high QPAI industries increase investment by more than firms in low QPAI industries after the DPAD is implemented and as the deduction rate increased. The analysis now proceeds to Hypothesis 2 and quantification of the overall effect of the policy.
Figure 5: Investment Response Graphical Diff-in-Diff

(A) All Firms

(B) December Fiscal Year Firms

(c) Domestic Firms

(d) Multinationals

Notes: Figures 5(A) - 5(D) plot the mean investment percent over time for groups sorted according to their industry-based treatment intensity. The Treatment Group (Control Group) is defined as firms within industries in which more than (less than) 40% of income is derived from Qualified Production Activities. The treatment years are years 2005-2012 as the DPAD increases from 0 to 3 to 6 to 9% in 2005, 2007, and 2010. The averages plotted here are derived through the following procedure: cross-sectional regression of investment percent on controls for tax depreciation allowances, cash flows, and financial constraint are run in each year. Residual group means for the treatment and control group are then calculated and added to the mean investment percent for each year. Finally, group means prior to implementation are equalized to ease comparison of trends. All means are count weighted.
6.3 Hypothesis 2; Financial Constraint Heterogeneity

Hypothesis 2 predicts that more financially constrained firms will be more responsive to the DPAD because they benefit from financial slack generated by the policy in addition to the policy’s investment incentive. Table 5 and Figure 6 split the sample according to total assets and estimate the investment response for each group. Specification (1) and (2) repeat the baseline empirical specification for firms in the top 3 quartiles and the bottom quartile of total assets. Point estimates suggest that smaller firms, which are more likely to be financially constrained, are the most responsive to the DPAD. Firms in the bottom quartile of the asset distribution increase their investment by 6.4% of PPENT while firms in the top three quartiles increase investment by only 1.8%. Although these point estimates are economically very different, as the Equality Test suggests, they are not statistically different with any real confidence. Specifications (3) and (4) limit the heterogeneity analysis to Domestic Firms. Specifications (5) and (6) focus on Multinationals. These estimates show little heterogeneity among Domestic Firms but statistically significant differences in response for Multinationals of different sizes.

Figure 6 reinforces the financial constraint heterogeneity. Panel (A) presents DPAD coefficient estimates from baseline regressions performed on each asset decile. Panel (B) presents the same coefficient estimates with 95% confidence intervals. The figure shows the response to the DPAD is concentrated among firms in the bottom 20% of the asset distribution.

The heterogeneous effect of the policy across firms of different sizes has implications for the macroeconomic impact of the DPAD. The average firm in the bottom quartile of the asset distribution reports average PPENT of $5.56 million while firms in the top three quartiles of the asset distribution report average PPENT of $1.98 billion. The firms that are most responsive to the policy constitute less than 1% of the total corporate stock of PPENT. By weighting the Table 5 Specification (1) and (2) results by PPENT and multiplying this weighted average by the 1.313% effective corporate income tax rate that the DPAD created, I estimate that the corporate sector increased investment by 2.37% of installed PPENT in response to the DPAD.

The heterogeneous effect could also indicate that response to the policy is driven primarily by the additional financial slack instead of the investment incentive created by the policy. To test this possibility, one can compare the additional financial slack created by the policy to the investment response. Focusing on those firms in the bottom quartile of the asset distribution with positive pretax income, the DPAD increases after tax income by approximately $90,000 annually once the policy is fully implemented (DPAD of 1.6% and pretax income of $5.64 million). These same firms increase investment by just over $500,000 annually in response to the policy (6.4% of $7.89 average PPENT). Thus, the financial slack generated by the policy accounts for only about 20% of the investment response among the potentially most financially constrained firms. These calculations suggest that the DPAD policy works mostly by increasing the incentive to invest – not just the amount of cash with which to invest.
Table 5: Heterogeneity of Investment Response to the DPAD

<table>
<thead>
<tr>
<th>Specification</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
<th>(6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Firms</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top 75%</td>
<td>0.018*</td>
<td>0.064*</td>
<td>0.018</td>
<td>0.025</td>
<td>0.005</td>
<td>0.117**</td>
</tr>
<tr>
<td>Low 25%</td>
<td>(0.010)</td>
<td>(0.039)</td>
<td>(0.015)</td>
<td>(0.046)</td>
<td>(0.009)</td>
<td>(0.056)</td>
</tr>
<tr>
<td>Domestics</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top 75%</td>
<td>0.018</td>
<td>0.025</td>
<td>0.005</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Low 25%</td>
<td>(0.015)</td>
<td>(0.046)</td>
<td>(0.009)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Multinationals</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top 75%</td>
<td>0.117**</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Low 25%</td>
<td>(0.056)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Equality Test

<table>
<thead>
<tr>
<th>Firms</th>
<th>P = 0.225</th>
<th>P = 0.881</th>
<th>P = 0.025**</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firms</td>
<td>5,030</td>
<td>1,969</td>
<td>3,417</td>
</tr>
<tr>
<td>Firm x Years</td>
<td>41,193</td>
<td>13,689</td>
<td>27,100</td>
</tr>
</tbody>
</table>

Notes: Specifications (1)–(6) present coefficient estimates from baseline regressions run on different subsamples of firms according to mean assets in years 2002–2004. All Specifications include firms and year fixed effects and controls for bonus depreciation, cash flow, investment opportunities. The equality test measures whether the DPAD coefficient is equal in specifications in adjacent specifications; p-values are presented. Standard errors are clustered at industry level and are robust to heteroskedasticity.

Figure 6: DPAD Heterogeneity by Asset Deciles

(A) DPAD coefficients with fitted line

(B) DPAD coefficients with 95% CI

Notes: Figure 6 presents DPAD coefficient estimates from baseline regressions by asset deciles for firms with > $5 million in assets. Panel (A) present coefficient estimates with a fitted quadratic line. Panel (B) presents DPAD coefficient estimates with 95% confidence intervals.
The evidence has thus far shown strong support for Hypothesis 1; firms in high QPAI industries increase investment in response to the DPAD more than firms in low QPAI industries. The evidence is less clear regarding Hypothesis 2; point estimates suggest smaller firms are more responsive to the DPAD than larger firms, but the difference is not statistically significant. Despite the lack of statistical power, the heterogeneity is economically large enough that it cannot be ignored when estimating the overall impact of the policy.

7 Robustness of Baseline Results

The strongest critique of the analysis thus far is that the estimated impact of the DPAD may be driven by industry-by-year shocks that are correlated with the DPAD. Unfortunately, the usual solution to this critique – adding industry-by-year fixed effects to the regression analysis – is not an option here as the DPAD varies only by industry and year. The analysis can however, address the industry-by-year concerns if the shocks are driven by the macroeconomic factors and concerns that sector-by-year shocks are responsible for the estimated response.

7.1 Investment Placebo Tests

One potential issue with using industry-level time series data to estimate the impact of the DPAD policy is that different industries may respond differently to the business cycle and these different responses may produce spurious results. The simplest way to explore this potential issue is to explore how high and low QPAI industries have responded to past business cycles. Figure 7 follows the exact procedure outlined in Section 6.2 to compare high and low QPAI industries during the years 1990–2000. In all four panels of Figure 7, no sharp and lasting divergence between high and low QPAI industries appears, suggesting that high and low QPAI industries do not respond differently to the business cycles.

To create Figure 7, investment levels were equalized in 1994. This equalization, in essence, assumes that a placebo DPAD policy is implemented in 1995. This year was chosen because business cycle conditions were comparable around 2005 and around 1995; like years 2003–2006, the economy was expanding during the years 1993–1996. Thus, a second interpretation of Figure 7 is that a placebo policy introduced in 1995 does not produce similar graphical DD results to analysis of the real DPAD.

This 1995 placebo may also be explored empirically. Table 6 presents estimates from the same baseline regression models as in Table 4 but now assumes the DPAD was implemented at a rate of 3% in 1995 and subsequently increased to 6% and 9% in 1997 and 2000. The Table 6 results show no statistically significant effect of the placebo policy on investment and echo the visual DD placebo.
FIGURE 7: INVESTMENT RESPONSE PLACEBO 1990-2000

Figure 7(A) - 7(D) plot the mean investment percent over time for groups sorted according to their industry-based treatment intensity. The Treatment Group (Control Group) is defined as firms within industries in which more than (less than) 40% of income is derived from Qualified Production Activities. The placebo policy is “enacted” in 1995. The averages plotted here are derived through the following procedure: cross-sectional regression of investment percent on controls for tax depreciation allowances, cash flows, and financial constraint are run in each year. Residual group means for the treatment and control group are then calculated and added to the mean investment percent for each year. Finally, group means in the 1994 are subtracted from all observations, and the overall mean investment percentage is added to ease the comparison of trends before and after the placebo policy is implemented. All means are count weighted.
### Table 6: Investment Response to 1995 DPAD Placedo

<table>
<thead>
<tr>
<th>Specification</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>DPAD</td>
<td>0.005</td>
<td>0.012</td>
<td>0.013</td>
<td>0.021</td>
<td>-0.038</td>
</tr>
<tr>
<td></td>
<td>(0.034)</td>
<td>(0.038)</td>
<td>(0.050)</td>
<td>(0.026)</td>
<td>(0.077)</td>
</tr>
<tr>
<td>HP Index</td>
<td>-0.163***</td>
<td>-0.170***</td>
<td>-0.128***</td>
<td>-0.204***</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.017)</td>
<td>(0.021)</td>
<td>(0.019)</td>
<td>(0.020)</td>
<td></td>
</tr>
<tr>
<td>Marg Q</td>
<td>0.004**</td>
<td>0.004</td>
<td>0.003*</td>
<td>0.005**</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.002)</td>
<td>(0.002)</td>
<td>(0.002)</td>
<td>(0.002)</td>
<td></td>
</tr>
<tr>
<td>Cash Flow</td>
<td>-0.019***</td>
<td>-0.019***</td>
<td>-0.016***</td>
<td>-0.022***</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.001)</td>
<td>(0.001)</td>
<td>(0.001)</td>
<td>(0.001)</td>
<td></td>
</tr>
</tbody>
</table>

- **December Fiscal Year**: ✓
- **Domestic Firms Only**: ✓
- **Multinationals Only**: ✓

<table>
<thead>
<tr>
<th>Firms</th>
<th>12,815</th>
<th>12,815</th>
<th>8,648</th>
<th>6,415</th>
<th>6,400</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm x Years</td>
<td>118,269</td>
<td>118,269</td>
<td>74,953</td>
<td>64,497</td>
<td>53,772</td>
</tr>
</tbody>
</table>

Notes: Specifications (1) through (6) present coefficients from regressions of the form

\[
\frac{I_{it}}{K_{i,t-1}} = \beta_0 + \beta_1 DPAD_{jt} + \sum_{s=1}^{n} \beta_s Control_s + \epsilon_{it}.
\]

where DPAD is a placebo policy initiated in 1995 and phased in over years 1995-2000. In specifications (2) – (6), controls for financial distress, marginal Q, and cash flows are included. In specification (3) the analysis is limited to firms with fiscal years that end December 31st. In specification (4), analysis is limited to Domestic Firms. In specification (5), the analysis is limited to Multinationals. All specifications include firm and year fixed effects. Standard errors are clustered by industry. *** indicates statistical significance at the 1% level, ** at 5%, and * at 10%. 

25
7.2 Correcting for Industry-Level Investment Cyclicality

To further address potentially confounding industry-level investment responses to the macroeconomy, one can attempt to control for such cyclicality while estimating the investment impact of the DPAD. To do this, a two-stage procedure is followed to eliminate business cycle effects from the investment outcome variable. First, for each of the 79 IRS industries, firm level annual Investment Percent is estimated as a function of the annual percent change in GDP using data from the years 1980–2000 as in the following equation:

\[
\text{Investment } \%_{it} = \alpha_j + \beta_j [\% \Delta \text{GDP}_t] + \gamma_j [\% \Delta \text{GDP}^2_t] + \epsilon_{it}. \tag{2}
\]

Second, from the regressions, industry-level estimates of \(\alpha\), \(\beta\) and \(\gamma\) are recovered and used to predict an expected investment (Investment \%) for each industry during each year 2002–2012. Panel (A) of Figure 8 plots (Investment \%) over the levels of \%\Delta GDP observed during 2002–2012 for both High QPAI and Low QPAI industries. The plot demonstrates that different industries do, on average, respond differently to the business cycle. When the economy is expanding, High QPAI industries are predicted to invest slightly more than Low QPAI industries. When the economy moves into a recession, however, High QPAI industries are predicted to invest significantly less than Low QPAI industries. Therefore, as shown in Panel (B), in absence of the DPAD, High QPAI industries are predicted to invest similarly to Low QPAI industries in years 2002–2007 and in years 2010–2012 but significantly less than Low QPAI industries in 2008 and 2009.

To incorporate these predictions into the baseline DPAD analysis, a residual investment variable is created where

\[
\text{Residual Investment } \%_{it} = \text{Investment } \%_{it} - \hat{\text{Investment } \%}_{jt}. \tag{3}
\]

For the empirical analysis, Residual Investment \% is normalized to increase its interpretability. Residual Investment \% represents only the portion of a firm’s annual investment activity that is unrelated to the responses of its industry to the macroeconomy. When this new outcome variable is used instead of Investment \% as the outcome variable in DPAD analyses, concerns of confounded estimates due to differences in industry-level responses to the business cycle are eliminated.

Table 7 presents coefficients from regressions of Residual Investment \% on DPAD. Specification (2), which mirrors the baseline specification, suggests that a one percentage point decrease in a firm’s effective corporate income tax rate via the DPAD increases Residual Investment \% by 0.08 standard deviations. The effect of the DPAD on Residual Investment \% remains strong when the analysis is limited to firms with December fiscal years, domestic, and multinational firms. Overall, the results of this robustness check demonstrate that industry-level movements generated by macroeconomic conditions are not responsible for the estimated impact of the DPAD on corporate investment.
Figure 8: Predicting Investment Percent

(a) Predicted Investment Percent

(b) Predicted Investment Percent Over Time

Notes: Figure 8(A) plots the predicted investment percent for treatment (> 40% QPAI) and control (< 40% QPAI) industries. Figure 8(B) plots the Predicted Investment Percent % for treatment and control industries over the years 2002–2012.

Table 7: Residual Investment Response to the DPAD

<table>
<thead>
<tr>
<th>Dependent Variable:</th>
<th>Residual Investment %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Specification</td>
<td>(1)</td>
</tr>
<tr>
<td>DPAD</td>
<td>0.079***</td>
</tr>
<tr>
<td></td>
<td>(0.029)</td>
</tr>
<tr>
<td>Additional Controls</td>
<td>✓</td>
</tr>
<tr>
<td>December Fiscal Yr</td>
<td>✓</td>
</tr>
<tr>
<td>Domestic Firms Only</td>
<td></td>
</tr>
<tr>
<td>Multinationals Only</td>
<td></td>
</tr>
<tr>
<td>Firms</td>
<td>8,040</td>
</tr>
<tr>
<td>Firm x Years</td>
<td>57,574</td>
</tr>
</tbody>
</table>

Notes: Specifications (1) through (5) present coefficients from regression of Residual Investment % on DPAD as in Equation 1 where Residual Investment % is defined in Equation 2. All specifications include firm and year fixed effects. Specifications (2)–(5) control for bonus depreciation, financial distress, marginal Q, and cash flows. Standard errors are clustered at the industry level. *** indicates statistical significance at the 1% level, ** at 5%, and * at 10%.
Figure 9 presents the graphical implementation of the DD research design using Residual Investment % as the outcome variable. Two interesting patterns are immediately apparent. First, the Residual Investment in all four subplots for both the treatment and control groups now follow counter-cyclical trends. The counter-cyclical movement of Residual Investment demonstrates that macroeconomic trends in investment, which follow the business cycle have been effectively eliminated as was the goal of this exercise. Second, Residual Investment % in years 2002–2004 are nearly identical for the treatment and control groups. In the baseline graphical analysis, pre-trends were similar but not to the same degree observed here. The tightening of the pre-trends provides more evidence, as Figure 8 first demonstrated, that macroeconomic forces did differentially affect treatment and control industries. More importantly, the tightening shows that the procedure that generated the Residual Investment % variable effectively eliminated any differential effect of these macroeconomic forces.

In most other ways, the four subplots are similar to those presented in the previous graphical DD analysis. Upon DPAD implementation in 2005, Residual Investment % by firms in high QPAI industries increases relative to low QPAI industries. The difference in Residual Investment % increases through 2008 for the full sample and all three subgroups but then decreases in the Domestic and Manufacturing subgroups. The diminished effect among the Domestic and Manufacturing firms suggests a more short-run response to the DPAD for these groups. Overall, these visual results (1) suggest that the residual investment procedure works and (2) reinforce the empirical residual investment analysis. Differences in how certain industries respond to the macroeconomic shocks do not seem to be responsible for the estimated impact of the DPAD on corporate investment.

7.3 Robustness to Sector Fixed-Effects and Trends

The analysis in Sections 7.1 and 7.2 demonstrate that industry-level co-movements with the macroeconomy do not confound estimates of the effect of the DPAD on corporate investment. The analysis now turns to addressing shocks and trends at the sector level. By controlling for sector-level trends and shocks, this section attempts to eliminate any concerns that differences in investment by High and Low QPAI sectors are responsible for the observed response to the policy. Furthermore, if industry-level shocks are correlated with sector-level movements then the following analysis further allays concerns that industry-level shocks are responsible for the observed investment response.

Specification (1) of Table 8 presents estimates of Equation 1 using firms only in the manufacturing sector. As these firms all experience the same sector-level shocks, the year-fixed effects provide effective control and allow the impact of the policy to be estimated in the absence of such shocks. The Specification (1) DPAD estimate suggests a large investment response to the DPAD among manufacturer firms. However, the coefficient is not statistically significant.

15I have chosen to present a Manufacturing panel instead of a December Fiscal Year panel because this is the only graph in which the DPAD impact seems to significantly dissipate over time.
Notes: Figure 9 plots the mean residual investment over time for groups sorted according to their industry-based treatment intensity. The Treatment Group (Control Group) is defined as firms within industries in which more than (less than) 40% of income is derived from Qualified Production Activities. The treatment years are years 2005-2012 as the DPAD increases from 0 to 3 to 6 to 9% in 2005, 2007, and 2010. The averages plotted here are derived through the following procedure: cross-sectional regression of residual investment percent on controls for tax depreciation allowances, cash flows, and financial constraint are run in each year. Residual group means for the treatment and control group are then calculated and added to the mean investment percent for each year. Finally, group means in year 2002 are subtracted from all observations and the overall mean investment percentage is added to ease the comparison of trends. All means are count weighted.
In Specification (2), sector-by-year fixed effects are added to the regression for the full sample of firms. With sector-by-year fixed effects, the impact of sector-level annual shocks to investment are eliminated and identification of the impact of the DPAD on investment comes from how investment by firms in industries with varying levels of QPAI within a sector responds differently to the DPAD. The point estimate is larger than in the baseline model, indicating that sector-by-year shocks, like macroeconomic conditions, may, in fact, obscure the impact of the DPAD policy.

Specifications (3) and (4) report results from regressions that include sector-level linear and quadratic time. In both regressions, the DPAD is estimated to have a large and statistically significant effect. While these time trends are less flexible than the fixed effects, they eliminate any concerns that different trends in High and Low QPAI sectors generate the estimated investment response to the DPAD.

Overall, the results presented in Table 8 suggest that baseline estimates are robust to sector-level time trends and sector-level shocks which potentially differentially affect Low and High QPAI sectors.

**Table 8: Robustness to Sector FE, and Sector Trends**

<table>
<thead>
<tr>
<th>Dependent Variable:</th>
<th>Investment Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Specification</td>
<td>(1)</td>
</tr>
<tr>
<td>DPAD</td>
<td>0.101</td>
</tr>
<tr>
<td></td>
<td>(0.073)</td>
</tr>
<tr>
<td>MANUFACTURING ONLY</td>
<td>✓</td>
</tr>
<tr>
<td>SECTOR x YEAR FE</td>
<td>✓</td>
</tr>
<tr>
<td>SECTOR LINEAR TIME TRENDS</td>
<td>✓</td>
</tr>
<tr>
<td>SECTOR QUAD TIME TRENDS</td>
<td>✓</td>
</tr>
<tr>
<td>FIRMS</td>
<td>3,931</td>
</tr>
<tr>
<td>FIRM x YEARS</td>
<td>27,253</td>
</tr>
</tbody>
</table>

Notes: Specifications (1) through (4) present coefficients from regressions of the form

\[
\frac{I_{it}}{K_{i,t-1}} = \beta_0 + \beta_1 DPAD_{jt} + \sum_{s=1}^{n} \beta_s \text{Control}_s + \epsilon_{it}.
\]

All specifications include firm and year fixed effects and controls for bonus depreciation, financial distress, marginal Q, and cash flows. Specification (1) presents estimates using only data from the manufacturing sector. Specification (2) includes sector x year fixed effects. Specification (3) includes sector specific linear trends. Specification (4) includes sector specific quadratic time trends. Standard errors are clustered at the industry level. *** indicates statistical significance at the 1% level, ** at 5%, and * at 10%.
8 Interactions with Contemporaneous Tax Policies

Having demonstrated that the baseline empirical results are not driven by macro-economic factors or sector trends, the analysis now proceeds to investigate the interaction of the DPAD with two contemporaneous tax policies, the Extraterritorial Income Exclusion, which the DPAD was designed to replace, and the 2004 tax holiday on repatriated earnings, which was implemented in tandem with the DPAD.

8.1 The Extraterritorial Income Tax Incentive

Before 2004, Extraterritorial Income Exclusion (ETI) allowed firms to deduct a percentage of income from exports from their taxable income.\(^{16}\) The ETI was abandoned because, in 2002, the World Trade Organization (WTO) definitively ruled that the ETI was an export subsidy that violated international free trade agreements. As a result, the WTO gave trade partners permission to apply sanctions to U.S. goods. In the face of pressure from members of the European Union, U.S. lawmakers discontinued the ETI but sought a cost neutral replacement that created similar advantages for U.S. manufacturers without violating WTO standards. The DPAD was this replacement.

The mechanics of the ETI are similar to those of its replacement. While the DPAD allowed firms to deduct a maximum of 9% of income derived from domestic manufacturing activities, the ETI allowed firms to deduct 15% of income derived from domestic manufacturing and exporting activities. Thus, the ETI offered a higher statutory deduction rate but a narrower base than the DPAD.

8.1.1 ETI Data

As in the DPAD analysis, industry-level ETI treatments can be constructed and used to investigate the repeal of the ETI. The impact of the policy on various industries is captured by Export Percent, the percentage of income derived from domestic exporting.\(^{17}\) To calculate Export Percent, industry-level gross export receipts from USA Trade Online\(^{18}\) are divided by industry-level total receipts from IRS tax data.\(^{19,20}\) Like QPAI Percent, Export Percent is multiplied by the statutory

---

\(^{16}\) Products could qualify as exports only if they were manufactured or significantly altered (more than 50% of values added) in the U.S.

\(^{17}\) The income on which the ETI applies: “income derived from the export of domestic produced or altered goods.”

\(^{18}\) USA Trade Online is the official source for U.S. merchandise trade data. Industry-level export values are constructed from census export data.

\(^{19}\) USA Trade Online does not record exporting data on every NAICS 3-digit industry. Data is not recorded for many industries because they produce zero or a negligible amount of products for export. Examples of industries that do not appear in the USA Trade Online data are transportation, healthcare, and real estate. For the purposes of estimating the impact of the ETI on investment, these industries are assigned an Export Percent of 0.

\(^{20}\) The ETI applies only to the net income from exporting activities. However, only data on gross exports are available. If net income from exporting activities were available, it could be divided by (net) taxable income in order.
deduction rate (0.15) then the corporation income tax rate (0.35) to transform it into an industry-
level measure of the percentage point reduction in the corporate income tax rate via the ETI (denoted \textbf{ETI}).

Figure 10 graphs Export Percent across NAICS 3-digit industries and Table 9 presents summary
statistics for Export Percent and ETI across the Corporate Sample. On average, 9\% of income is
derived from exporting activities translating into a corporate income tax rate reduction of 0.477
percentage points. Like QPAI, Export Percent varies widely across industries; the agricultural
industry derives more than 40\% of income from exporting activities while a significant number of
industries derive less than 10\% of income from exports.

Interestingly, the correlation between Export Percent and QPAI Percent is equal to -0.4. This
negative correlation suggests that the industries which were most hurt by the repeal of the ETI
are not the same industries that most benefited from the introduction of the DPAD. This means
that estimates of the investment response to the DPAD may be generated not by a positive invest-
ment response by high QPAI industries but rather by a negative investment response by high ETI
industries.

\begin{table}
\centering
\begin{tabular}{lcccc}
\hline
 & Median & Mean & 10th pctile & 90th pctile & Max \\
\hline
Export Percent & 0.895 & 9.068 & 0.000 & 26.937 & 45.275 \\
ETI & 0.047 & 0.477 & 0.000 & 1.414 & 2.377 \\
Firms & & & 7,104 & & \\
Firms x Years & & & & & 22,656 \\
\hline
\end{tabular}
\caption{ETI Descriptive Statistics; Corporate Sample}
\end{table}

Notes: Table 9 reports the mean, median, 10th percentile, and 90th percentile statistics for the percent of
income derived from exporting activities and ETI, the effective tax rate reduction that firms received via
the ETI.

to derive the percentage of income to which the ETI applies. Because only the gross numbers are available, they are
divided by total receipts from the IRS. Under the assumption that profit margins are the same for domestic exports
and other forms of income generation, this process yields accurate percentages of income derived from domestic
exporting activities.
The impact of the ETI on corporate investment and its interaction with the DPAD is explored empirically in Table 10. Specification (1) regresses Investment % on ETI while controlling for firm level determinants of investment and industry level bonus depreciation incentives. Specification (1) results suggest the repeal of the ETI has no impact on corporate investment. In Specification (2), DPAD is added to the regression model. When both ETI and DPAD are included, the DPAD has a positive effect on investment. The DPAD coefficient point estimate is slightly larger than in the baseline estimation. Introducing the DPAD increases the magnitude of the ETI coefficient point estimate, but it is not statistically significant. Specification (3) regresses investment on a combined DPADETI variable. When both policies are combined into a single effective tax rate reduction variable, the point estimate suggests that a 1 percentage point corporate tax rate reduction via either the DPAD or ETI increases investment activity by 0.40 or by just under 10%. Specifications (4) and (5) repeat the Specification (2) model but limit the analysis to only domestic and only
multinational firms. In both specifications the ETI coefficient is not statistically significant and the DPAD coefficient estimates are slightly larger than in baseline regressions.

Overall, several conclusions can be drawn from the combined DPAD ETI analysis. First, although the DPAD was designed to replace the ETI, the industries that benefited most from the ETI were not the same as those that benefited the most from the DPAD. Second, corporate investment behavior does not seem to be responsive to the ETI. Finally, the repeal of the ETI is not responsible for the estimated effects of the DPAD. If anything, like the industry-level cyclical investment patterns and sector-level trends, exclusion of the ETI from the DPAD analysis seems to downward bias estimates of the corporate investment response.

**Table 10: Investment Response to the ETI and DPAD**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>ETI</td>
<td>-0.001</td>
<td>0.020</td>
<td>0.019</td>
<td>0.029</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.023)</td>
<td>(0.025)</td>
<td>(0.043)</td>
<td>(0.018)</td>
<td></td>
</tr>
<tr>
<td>DPAD</td>
<td>0.047***</td>
<td>0.034*</td>
<td>0.050***</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.014)</td>
<td>(0.018)</td>
<td>(0.014)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>DPADETI</td>
<td></td>
<td></td>
<td>0.038**</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(0.016)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**December Fiscal Year**

- ✓

**Domestic Firms Only**

- ✓

**Multinationals Only**

- ✓

**Firms**

- 9,149
- 9,149
- 9,216
- 5,217
- 2,846

**Firm x Years**

- 58,849
- 58,849
- 60,209
- 37,251
- 20,512

Notes: Specifications (1)–(4) present coefficient from regressions of Investment Percent on ETI, ETI and DPAD, or DPADETI. In all specifications the dependent investment variable is Capital Expenditure scaled by lagged Property, Plant, and Equipment. All specifications include firm and year fixed effects. All specifications include controls for bonus depreciation, financial distress, marginal Q, and cash flows. Standard errors are clustered at the industry level. *** indicates statistical significance at the 1% level, ** at 5%, and * at 10%.
8.2 The 2004 Tax Holiday on Repatriated Earnings

The American Jobs Creation Act of 2004 introduced both the DPAD and the 2004 tax holiday on repatriated earnings which allowed firms to repatriate foreign earnings at an 85% reduced tax rate. The DPAD and tax holiday were designed to work in tandem to provide incentives for firms to finance new domestic investment with foreign holdings. Thus far, the analysis has shown that multinational firms were more responsive to the DPAD than domestic firms. Furthermore, the difference in investment responsiveness is most likely downward biased because multinational investment data includes investments in foreign subsidiaries which should be unaffected by DPAD. The goal of this section is to determine whether this difference in investment responsiveness is due to the tax holiday which decreased the tax costs of foreign financing for multinationals.

8.2.1 Repatriated Earnings Data

From fiscal year 2004 and 2005 financial statements, Sebastien Bradley has recorded the repatriation behaviors of all firms that reported repatriating foreign earnings as a direct result of the 2004 tax holiday. For use in this analysis, these repatriations numbers are translated into a simple indicator variable, $Repatriator$. $Repatriator$ is equal to 1 (in all years) if a firm repatriated earning as a direct result of the tax holiday and if they are defined as a multinational in the preceding analysis (reported positive foreign income in years 2002–2004). $Repatriator$ is equal to 0 if a multinational firm did not repatriate earnings in response to the tax holiday. In total, there are 100 firms that report tax holiday repatriations. These 100 Repatriators represent 4.3% of the 2,320 multinationals in the 2004 Corporate Sample.

8.2.2 Investment Responsiveness to the DPAD and the Tax Holiday

In order to determine whether the combination of the DPAD and tax holiday incentives is responsible for the larger investment response to the DPAD among multinational firms, a difference-in-difference-in-difference (DDD) empirical design is implemented. In this instance, the DDD design is preferable to a split-sample analysis because investment behavior by only the 100 Repatriator Firms is a very small sample from which to draw meaningful empirical conclusions. The DDD allows all 2000+ multinational firms to be used to estimate Repatriator vs. non-Repatriator responses to the DPAD. The DDD model can be written as

$$
\text{Investment } \% = \beta_0 + \beta_1 DPAD_{jt} + \beta_2 [DPAD_{jt} \times Repatriator_i] + \sum_{s=3}^{n} \beta_s Control_s + \epsilon_{it}. 
$$

---

21 Bradley (2013) and Bradley (2014) detail the collection of this data as well as use the data to estimate stock price responses to repatriations and uncover a “Round-Tripping” Effect of the tax holiday.
In this DDD model, the $\beta_1$ coefficient is interpreted as the Investment % response to a one percentage point decrease in the effective corporate income tax rate via the DPAD for a Non-Repatriator. $\beta_1 + \beta_2$ is interpreted as the response by a Repatriator.

Estimates from Repatriator DDD models are presented in Table 11. In Specification (1) the DDD model is estimated without any control variables. Without controls, multinationals are estimated to increase investment percent by 0.039 in response to a one percentage point reduction in the effective effective corporate income tax rate via the DPAD. Repatriating multinationals are estimated to be no more responsive.

**Table 11: Investment Response to the DPAD by Repatriating Firms**

<table>
<thead>
<tr>
<th>Dependent Variable: Investment Percent</th>
<th>Specification</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>DPAD</td>
<td></td>
<td>0.039***</td>
<td>0.039***</td>
<td>0.004</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.015)</td>
<td>(0.014)</td>
<td>(0.031)</td>
</tr>
<tr>
<td>Repatriator x DPAD</td>
<td></td>
<td>0.013</td>
<td>0.030***</td>
<td>0.040***</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.009)</td>
<td>(0.010)</td>
<td>(0.010)</td>
</tr>
</tbody>
</table>

Additional Controls ✓ ✓ ✓
Manufacturing Firms Only ✓ ✓
Multinational Firms Only ✓ ✓ ✓

Firms 2,888 2,888 1,525
Firm x Years 21,004 21,004 11,980

Notes: Specifications (1) through (3) present coefficients from regressions of the form

$$\frac{I_{it}}{K_{i,t-1}} = \beta_0 + \beta_1 DPAD_{jt} + \beta_2 [DPAD_{jt} \times \text{Repatriator}_i] \sum_{s=3}^{n} \beta_s \text{Control}_s + \epsilon_{it}. $$

All specifications are limited to the Multinational subsample and include firm and year fixed effects. Specifications (2) and (3) include controls for bonus depreciation, financial distress, marginal Q, and cash flows. Specification (3) limits the analysis to firms in the Manufacturing sector. Standard errors are clustered by industry. *** indicates statistical significance at the 1% level, ** at 5%, and * at 10%.

In Specification (2), control variables are added to the model. With control variables, investment by multinationals increases stays constant at 0.039 in response to the policy and investment by Repatriators is estimated to increase by 0.069 in response to the policy. The Specification (2) results suggest that firms that took advantage of the tax holiday were 177% as responsive to the DPAD as multinationals that did not. In terms of elasticities, the estimated elasticity of investment with
respect to the net of tax rate for non-repatriating multinationals was 6.01 (similar to the baseline multinational elasticity) while the elasticity for repatriating multinationals was an incredible 18.0. Specification (3) limits the analysis to multinationals in the manufacturing sector. Results indicate that, in this sector, non-repatriating multinationals are unresponsive to the policy, but repatriating multinationals invest in response to the DPAD.

These results reinforce the findings of Blouin et al. (2014) which demonstrate that repatriating firms that benefited from the DPAD were less likely to increase corporate payouts. Their results suggested that perhaps these manufacturing firms were using the retained funds to increase investment. The Table 11 results suggest that, indeed, those firms that took advantage of the tax and benefited from the DPAD increased investment substantially. Thus, for a small number of firms, the 2004 tax holiday on repatriated earnings and the DPAD worked in concert and as designed to increase investment in domestic manufacturing.

9 Conclusion

This paper is the first to study the corporate investment response to the Domestic Production Activities Deduction using a plausibly exogenous source of variation based on administrative tax data. To summarize the findings presented here, the DPAD generated a 1.31% effective tax rate reduction for the average corporate in the sample. The average firm increased investment by 4.1% of installed property plant and equipment. This average response, however, overestimates the overall investment response to the policy as smaller potentially more financially constrained firms were the most responsive. Taking into account the heterogeneity in response across firms of different sizes, estimates suggest that corporate investment increased by 2.4% of installed property plant and equipment in response to the policy. The estimated impact of the DPAD on investment is not generated by the repeal of the Extraterritorial Income Exclusion. A modest part of the investment response is driven by the interaction of the DPAD with the 2004 tax holiday on repatriated earnings.

While this research has shown that corporate investment increased in response to the DPAD, there remains much more work to be done regarding this policy. Whether the DPAD induces multinational firms to relocate production activities to the U.S., whether firms increase their taxable income in response to the policy, whether firms alter their payout and financing strategies in response to the policy, and whether firms hire more workers as a result of the policy remain unanswered and largely unasked questions. Until these questions are answered, at the very least, one can conclude that the DPAD, and directed corporate tax deductions more generally, seem to increase investment without forcing businesses to significantly alter the way in which they operate. This result may be of great importance as policy makers as they consider the future of corporate taxation in the U.S.
References


Bradley, Sebastien J., “Investor Responses to Dividends Received Deductions: Rewarding Multinational Tax Avoidance?,” 2013.


Appendix A  Data Definitions from
IRS “Corporate Returns - Explanation of Terms”

Income Subject to Tax: This was generally the amount of income subject to tax at the corporate level. For most corporations, income subject to tax consisted of net income minus the “Statutory Special Deductions” described in this section. However, there were certain exceptions. S corporations were usually not taxable at the corporate level and so did not have income subject to tax. Some, however, had a limited tax liability on capital gains and so were included in the statistics for this item. Likewise, regulated investment companies and real estate investment trusts generally passed their net income on to be taxed at the shareholder level; but any taxable amounts not distributed were included in income subject to tax. Because insurance companies were permitted to use reserve accounting for tax purposes, insurance income subject to tax was based on changes in reserve accounts; life insurance companies could also have been allowed an additional special deduction (discussed in Statutory Special Deductions). Consolidated returns that contain life insurance subsidiaries were not allowed to offset all of the life insurance subsidiary’s gains by losses from nonlife companies, so it was possible for such a consolidated return to show no net income but still have a positive amount of income subject to tax.

Statutory Special Deductions: Statutory special deductions in the tables was the sum of the deductions for net operating loss carryovers from prior years and the special deductions for dividends and other corporate attributes allowed by the Code. These deductions were in addition to ordinary and necessary business deductions and were shown in the statistics as deductions from net income. In general, net income less statutory special deductions equaled income subject to tax. The following components of Statutory Special Deductions are shown separately in Table 20.

Domestic Production Deduction: The Domestic Production Deduction (DPD) was added as part of the American Jobs Creation Act and is available for Tax Years beginning after December 31, 2004. By keeping manufacturing and software development activities in the United States, exporters may claim a deduction for a percent of their income from qualified exports. The provision, which can be found under code section 199, was largely written to satisfy WTO objections to Extraterritorial Income (ETI) and Foreign Sales Corporation provisions. The credit is figured on Form 8903.
Appendix B  Investment Control Variables

• Marg Q
Marginal Q or Tobin’s Q is the marginal value of an additional dollar of investment. Marg Q is empirically measured as the ratio of the market value of equity plus the book value of liabilities excluding deferred taxes, divided by the book value of assets,

\[ Q_t = \frac{prcc_t \times csho_t + at_t - ceq_t + txdb_t}{at_t}, \]

Where prcc is the price of outstanding shares, csho is the number of outstanding shares, at is total assets, ceq is outstanding equity and txdbt is the differed tax liabilities.

• Cash Flow
The measure of cash flow is constructed following Kaplan and Zingales (1997). "Cash Flow/PPE" is defined as

\[ \text{Cash Flow}_t = \frac{ib18_t + dp14_t}{ppent8_{t-1}}. \]

This ratio is the income before extraordinary items plus depreciation and amortization, scaled by the capital stock at the beginning of the year.

• HP Index
Hadlock and Pierce (2010) propose a measure of financial constraint based on firm size and age.

\[ \text{HP Index} = -0.737 \times \text{size} + 0.043 \times \text{size}^2 - 0.04 \times \text{age} \]

where size = \( \min\{\text{assets in 2004 dollars, } \$4.5 \text{ billion}\} \) and age = \( \min\{\text{years on Compustat tapes, } 37\} \).
Appendix C  Industry-Averaged Estimates

Table 12: Investment Response to DPAD

<table>
<thead>
<tr>
<th>Dependent Variable:</th>
<th>Investment Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Specification</strong></td>
<td>(1)</td>
</tr>
<tr>
<td>DPAD</td>
<td>0.031**</td>
</tr>
<tr>
<td></td>
<td>(0.012)</td>
</tr>
<tr>
<td>December Fiscal Year</td>
<td>✓</td>
</tr>
<tr>
<td>Domestic Firms Only</td>
<td>✓</td>
</tr>
<tr>
<td>Multinationals Only</td>
<td></td>
</tr>
<tr>
<td>Industries</td>
<td>105</td>
</tr>
<tr>
<td>Ind. x Years</td>
<td>1,210</td>
</tr>
<tr>
<td>$\mathcal{E}{I%,(1 - \tau_{pd})}$</td>
<td>5.76</td>
</tr>
</tbody>
</table>

Notes: Specifications (1) through (5) present coefficients from regressions of the form

$$\frac{I_{it}}{K_{i,t-1}} = \beta_0 + \beta_1 DPAD_{jt} + \sum_{s=1}^{n} \beta_s Control_s + \epsilon_{it}.$$

In specifications (2) – (5), controls for bonus depreciation, financial distress, marginal Q, and cash flows are included. In specification (3) the analysis is limited to firms with fiscal years that end of December 31st. In specification (4), analysis is limited to Domestic Firms, those firms that report no foreign in years 2002–2004. In specification (5), the analysis is limited to Multinationals, those firms that report some foreign source income in years 2002–2004. All specifications include firm and year fixed effects. Standard errors are two-way clustered by industry and year. *** indicates statistical significance at the 1% level, ** at 5%, and * at 10%.
Appendix D  Hadlock Pierce Index Response Heterogeneity

Appendix D repeats the heterogeneity analysis performed in Section 6.3 but now using the HP Index to split the sample instead of total assets. The results are nearly identical. When the heterogeneous investment response is weighted by PPENT, the estimates predict the corporate sector increased investment by 2.4% of PPENT in response to the DPAD.

Table 13: Heterogeneity of Investment Response to the DPAD

<table>
<thead>
<tr>
<th>Dep. Variable:</th>
<th>Investment Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Specification</td>
<td>(1)   (2)   (3)   (4)   (5)   (6)</td>
</tr>
<tr>
<td>All Firms</td>
<td></td>
</tr>
<tr>
<td>Domestic Firms</td>
<td></td>
</tr>
<tr>
<td>Multinationals</td>
<td></td>
</tr>
<tr>
<td>HP Index Split</td>
<td>LOW 75%</td>
</tr>
<tr>
<td>DPAD</td>
<td>0.018**</td>
</tr>
<tr>
<td></td>
<td>(0.008)</td>
</tr>
<tr>
<td>Equality Test</td>
<td>P = 0.234</td>
</tr>
<tr>
<td>Firms</td>
<td>4,716</td>
</tr>
<tr>
<td>Firm x Years</td>
<td>39,455</td>
</tr>
</tbody>
</table>

Notes: Specifications (1) through (6) present coefficients from regressions of the form

\[
\frac{I_{it}}{K_{i,t-1}} = \beta_0 + \beta_1 DPAD_{jt} + \sum_{s=1}^{n} \beta_s Control_s + \epsilon_{it},
\]

run on different subsamples of firms split by the HP Index. All Specifications include controls and firm and year fixed effects. The equality test measures whether the DPAD coefficient is equal in specifications in adjacent specifications; P-values are presented. Standard errors are at industry level and are robust to heteroskedasticity. *** indicates statistical significance at the 1% level, ** at 5%, and * at 10%.
Appendix E  Tax Status Response Heterogeneity

In the theoretical framework, the DPAD may be further generalized to consider a state in which the firm is nontaxable. When the next dollar of income does not increase the firm’s tax bill, then the firm can only realize the benefit of the deduction if it is carried forward to decrease taxable income in a future taxable state. The generalized version of $d$ can be written as

$$d(\beta, \gamma) = \gamma d(\beta) + (1 - \gamma)\beta \phi d(1),$$

where $\gamma \in \{0,1\}$ is an indicator for current tax state and $\phi$ is a discounter that reflects both the expected arrival time of the taxable state and the discount rate applied to the future and subsequent periods when the firm switches. Note that for the nontaxable firm, $\beta$ applies to all future deductions; even when $\beta$ equals one, $\phi$ is less than one and the value of the deductions are lower when the firm is nontaxable.

**Hypothesis 3.** Investment responds more strongly to bonus depreciaiton for firms that expect to be taxable when income is subject to DPAD; $\partial I/\partial d|_{\gamma=1} > \partial I/\partial d|_{\gamma=0}$.

Blouin, Core and Guay (2010)’s simulated marginal tax rates are used to approximate tax status. The rates are a function of a firm’s current taxable status and the growth trajectory of other firms in its industry. The average MTR for the investment sample is 0.195 meaning the simulated tax rate on the marginal dollar of income is 19.5%. The MTRs generated by Blouin et al. (2010) are only available for years 2000-2010.

Overall, the results do not support the hypothesis. Instead, it seems firms with lower MTRs prior to DPAD implementation are more responsive to the policy. Several explanations for these results are possible. First, firms with high and low MTRs may revert toward the mean over time and therefore non-taxable firms in the present will be taxable in the future and vice-versa. Second, firms with low MTRs may be more tax-aggressive and therefore more cognizant of and reactive to tax polices. Third, firms with low MTRs may have more flexible business models that allow for the pursuit of tax avoidance activities.
Table 14: Investment Response to DPAD

<table>
<thead>
<tr>
<th>Specification</th>
<th>(7)</th>
<th>(8)</th>
<th>(9)</th>
<th>(10)</th>
<th>(11)</th>
<th>(12)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>All Firms</td>
<td>Domestic Firms</td>
<td>Multinationals</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax Rate Split</td>
<td>Low 50%</td>
<td>Top 50%</td>
<td>Low 50%</td>
<td>Top 50%</td>
<td>Low 50%</td>
<td>Top 50%</td>
</tr>
<tr>
<td>DPAD</td>
<td>0.044*</td>
<td>0.018**</td>
<td>0.035</td>
<td>0.019</td>
<td>0.050*</td>
<td>0.005</td>
</tr>
<tr>
<td></td>
<td>(0.024)</td>
<td>(0.009)</td>
<td>(0.031)</td>
<td>(0.013)</td>
<td>(0.029)</td>
<td>(0.010)</td>
</tr>
<tr>
<td>Equality Test</td>
<td>P = 0.325</td>
<td>P = 0.629</td>
<td>P = 0.185</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Firms</td>
<td>3,157</td>
<td>2,527</td>
<td>2,152</td>
<td>1,712</td>
<td>997</td>
<td>823</td>
</tr>
<tr>
<td>Firm x Years</td>
<td>22,403</td>
<td>22,444</td>
<td>14,728</td>
<td>14,757</td>
<td>7,686</td>
<td>7,676</td>
</tr>
</tbody>
</table>

Notes: Specifications (1) through (6) present coefficients from regressions of the form

$$\frac{I_{it}}{K_{i,t-1}} = \beta_0 + \beta_1 DPAD_{jt} + \sum_{s=1}^{n} \beta_s Control_s + \epsilon_{it}. $$

run on different subsamples of firms split by estimated marginal tax rates. All Specifications include controls and firm and year fixed effects. The equality test measures whether the DPAD coefficient is equal in specifications in adjacent specifications; P-values are presented. Standard errors are at industry level and are robust to heteroskedasticity. *** indicates statistical significance at the 1% level, ** at 5%, and * at 10%.