Statement of Robert S. McIntyre
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Before the Senate Budget Committee
Regarding Business Tax Subsidies Administered by the Internal Revenue Service
March 9, 2011

Thank you for the opportunity to testify today. As you may know, Citizens for Tax Justice has a long history of analyzing and trying to curb unwarranted business subsidies. Our research on corporate tax subsidies, for example, has been widely credited with playing a key role in the enactment of the Tax Reform Act of 1986. We have continued our work in this area ever since.

Today is the first day of Lent, and I'd like to suggest that members of Congress consider giving something up, not just until Easter, but perhaps until the federal budget is balanced (and even thereafter). What I hope you'll give up is your enthusiasm for providing subsidies to those who don't need them, in particular, for business subsidies administered by what seems to have become Congress's favorite agency, the Internal Revenue Service.

A quarter of a century ago, President Ronald Reagan took on business tax subsidies in the Tax Reform Act of 1986. Among other things, Reagan's tax act curbed offshore corporate profit shifting, leasing tax shelters and numerous industry-specific tax breaks, and despite a reduction in the statutory corporate tax rate, increased corporate tax payments by 34 percent. Reagan also equalized the personal income tax treatment of wages and realized capital gains, and he made the tax system more progressive overall.

But lobbyists for corporations and wealthy individuals didn't give up after 1986. They worked hard to regain and expand the tax subsidies that Reagan had taken away. In the 1990s, the lobbyists persuaded the Clinton administration and the Congress to eviscerate the corporate Alternative Minimum Tax (designed to curb the huge tax advantages that go to highly-leveraged activities such as equipment leasing), adopt the so-called "check the box" and "active-financing" rules that vastly expanded offshore corporate tax-sheltering opportunities, and reestablish preferential tax rates on realized capital gains. During the George W. Bush administration, business and investment tax breaks were expanded considerably further. Both political parties are at fault in this sad repudiation of President Reagan's tax legacy.

By the early 2000s, corporate subsidies had risen so much that the average effective U.S. federal corporate tax rate paid by America's largest and most profitable corporations on their U.S. profits had fallen to only 18.4 percent — barely over half the 35 percent statutory rate.[1] Those tax subsidies have grown even larger since then.

Our complaints about business tax subsidies fall into three categories. (1) They are hugely expensive. (2) They are often economically harmful. And (3) they conflict with fundamental tax fairness.

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[1]Our study of 2001-03 corporate tax subsidies, *Corporate Income Taxes in the Bush Years*, was published in 2004.

1. The high cost of business tax subsidies

In fiscal 2011, the Treasury Department's official, but incomplete list of tax subsidies for corporations, business owners and business investors comes with an estimated annual cost of a staggering $365 billion.

These business tax subsidies are a major factor in creating the deficits that everyone agrees we need to address over the long term. We believe that eliminating or significantly reducing these subsidies ought to be a key part of any prudent deficit reduction program.

Treasury's official (but incomplete) list of tax subsidies for C corporations, business owners & business investors in fiscal 2011 ($-billion)

C corporation tax subsidies (corporate income tax)	$ 159.2
Tax subsidies for business owners & business investors (personal income tax)	205.4
Total	**$ 364.5**

Notable items	**Corporate Inc. Tax**	**Personal Inc. Tax**	**Total**
Subsidies for foreign activities & offshore profit-shifting	$ 49.5	$ —	**$ 49.5**
Accelerated depreciation and expensing of equipment	34.1	45.6	**79.7**
Energy subsidies (business)	17.7	0.8	**18.5**
Subsidies for "research and experimentation"	14.0	0.5	**14.4**
Domestic production deduction	10.5	3.3	**13.8**
Subsidies for business investors (non-industry specific)	—	132.3	**132.3**
All other business tax subsidies	33.4	22.9	**56.3**
Total	**$ 159.2**	**$ 205.4**	**$ 364.5**

Note: Figures include the effects of the biggest subsidies extended in the Dec. 2010 agreement.

Thus, we think that President Obama is seriously off track in proposing to devote all the savings that can be gained from curbing business tax subsidies not to deficit reduction, but rather to lowering the statutory corporate tax rate.

Imagine if, despite our deficit problem, someone called for big cuts in direct spending programs, but then proposed using all the money to cut tax rates. Most of us would call that crazy. But it seems just as crazy to do so when it comes to cracking down on subsidies that happen to be administered by the IRS.

2. Misallocation of capital and exporting jobs

High cost is not the only problem with business tax subsidies. They also often hurt our economy.

To be sure, to a large degree, business tax subsidies are simply an economically useless waste of resources. That's because companies don't ask for subsidies that would force them to change their behavior. Why would they? Instead, they ask for subsidies to reward them for doing what they would do anyway.

- Take for example, Boeing. This fine American company was just awarded a $35 billion contract to build new airborne tankers for the Air Force. That seems all well and good. After all, the contract was subject to competitive bidding, and Boeing won. And for its $35 billion, the Pentagon will get the planes it says it needs. But on top of that lucrative contract, Boeing gets a bonus. Over the past three years, Boeing reported $9.7 billion in pretax U.S. profits. But instead of paying the 35 percent corporate tax rate on those profits, Boeing received $3.5 billion in tax subsidies. As a result, it paid no federal income tax at all over those three years. But Boeing doesn't need such subsidies to build planes. It just needs someone who wants to buy them, such as occurred with the tanker deal.

Over the years, my group has done numerous studies on corporate tax subsidies and their effect on corporate investment behavior and job creation. In all of these studies, we found no positive correlation between the amount of subsidies that companies received and their investment and jobs performance.[2] That's not shocking. After all, corporate executives (as opposed to their lobbyists) often insist that tax subsidies are not the basis for their investment decisions. Other things, they say, usually matter much more, including infrastructure, wage levels, access to markets, the quality of the workforce and so forth.

a. Misallocation of capital

Useless waste is bad enough. But sometime tax subsidies, if they're big enough, do influence business decisions. And when they do, they generally cause harm, by reducing productivity, jobs, and economic growth. At least that's what one would conclude if one believes that market forces are usually a better way to allocate business capital than government "incentives" to do something else.

The range of effective corporate tax rates across different industries is striking. Periodically, my group analyzes the U.S. profits and U.S. taxes of a large sample of major American corporations. We expect to have a new report out this coming summer. Until then, we can look at our most recent report, which covered 275 highly profitable corporations over the 2001-03 period. During those three years, federal effective corporate tax rates on the 275 companies' domestic profits ranged from a low of 1.6 percent for aerospace and defense companies up to a high of 27.7 percent on retail and wholesale trade firms. Without doubt, such wide disparities continue today.

Effective Corporate Tax Rates for 275 Major American Corporations 2001-03, by Industry

$-millions	2001-03 Totals		
Industry & Company	**Profit**	**Tax**	**Rate**
Aerospace & defense	$ 17,684	$ 285	1.6%
Transportation	14,309	619	4.3%
Industrial and farm equipment	6,489	406	6.2%
Telecommunications	73,203	5,465	7.5%
Electronics, electrical equipment	47,023	5,095	10.8%
Petroleum & pipelines	42,530	5,652	13.3%
Miscellaneous services	61,378	8,855	14.4%
Utilities, gas and electric	53,794	7,767	14.4%
Computers, office equip, software, data	74,904	11,949	16.0%
Metals & metal products	7,814	1,362	17.4%
Financial	285,589	56,222	19.7%
Chemicals	5,424	1,129	20.8%
Pharmaceuticals & medical products	71,010	15,339	21.6%
Miscellaneous manufacturing	27,319	6,043	22.1%
Health care	25,432	5,674	22.3%
Publishing, printing	11,103	2,551	23.0%
Motor vehicles and parts	6,097	1,418	23.3%
Food & beverages & tobacco	74,024	17,589	23.8%
Household & personal products	19,354	4,688	24.2%
Retail & wholesale trade	132,558	36,692	27.7%
ALL INDUSTRIES	**$ 1,057,038**	**$ 194,799**	**18.4%**

At least on the margin, such a wide range of effective corporate tax rates among industries has to have some bad effects in misallocating America's capital resources. The same is true for the range of effective tax rates among corporations in the same industry.

The disparities in effective U.S. tax rates among industries just cited are largely due to tax subsidies that are supposed to encourage domestic investment and job creation. As noted above, our research has found these domestic subsidies to be either ineffective or economically harmful.

[2] In fact, we found that the opposite was true. See, e.g., *The Failure of Corporate Tax Incentives* (1985); *Money for Nothing* (1986), and *Corporate Income Taxes in the Bush Years* (2004).

But whatever you think of these kinds of subsidies, there is another category of corporate tax subsidies that are even worse: ones that tilt the playing field to favor foreign activities over U.S. investment and jobs.

b. Offshore profit shifting and export of jobs

A major way that business tax subsidies hurt our economy and jobs is that some of the largest subsidies encourage corporations to shift profits, and sometimes jobs, offshore.

Let's start with some background. The primary goal of our international corporate tax rules should be to assure that profits earned in the United States are subject to U.S. corporate income tax — whether those profits are earned by American-based or foreign-based corporations. A secondary, but still important goal, should be to avoid creating a tax advantage for corporate investments abroad versus domestic investments. To avoid double taxation of corporate overseas profits, our tax rules provide a tax credit for taxes paid to foreign governments on foreign earnings.

But our system has a key defect. It allows corporations to indefinitely "defer" reporting on their tax returns profits earned, or ostensibly earned, by their foreign subsidiaries. This means that corporations can avoid paying U.S. taxes, and often *any* taxes, on profits that they can persuade the IRS are "foreign." To compound this problem, the rules allow corporations to reduce their U.S. taxable income by some of their costs of earning foreign profits. The Treasury Department estimates that its short list of offshore corporate tax subsidies will cost the government $50 billion in fiscal 2011 alone. Many analysts believe that the real cost is much higher when offshore subsidies not on Treasury's list are taken into account.

(1) Offshore profit shifting
Companies with valuable intellectual property, such as high-tech companies, drug companies and the like, often are able to use complicated tax schemes to move, for tax purposes, what are actually profits earned in the United States to offshore tax havens where those profits go untaxed. Meanwhile, these companies often can deduct some of the cost of earning these so-called "foreign" profits to reduce their remaining U.S. taxable income.

There are many parts to these complicated tax shelters, including mispricing of intracompany transactions to shift deductions into the United States and revenues outside the United States. But the key to making these schemes work is the fact that U.S. corporations do not have to report the profits of their foreign subsidiaries on their U.S. tax returns. Ending this "deferral" privilege would eliminate most of this kind of tax sheltering activity.

(2) Incentives to move jobs out of the United States
In some cases, our tax system encourages companies to shift actual investment and jobs away from the United States. Of course, there are many reasons why American companies may want to do business outside of the United States. There may be opportunities to sell products or to obtain cheap labor, for example. But our tax code can magnify those advantages by making it more profitable, after taxes, to create jobs in low-tax countries. This violates what should be the second goal of our international corporate tax system: to avoid favoring foreign investment over U.S. investment.

Of course, corporate lobbyists are not lacking in arguments about why it's somehow a good idea to tilt the tax playing field in favor of foreign investment. And, of course, they don't phrase their arguments that way, preferring instead to claim that foreign investment is actually good for U.S. jobs. But our experience with the notable shift in jobs away from the United States over the past decades strongly indicates that these claims don't hold water. We have written about this topic in depth in reports on our website (www.ctj.org), but here is just one prominent example:

- In 2004, Congress enacted the "American Jobs Creation Act," which added more than $200 billion in new corporate tax subsidies over 10 years. It was a bill that the General Electric Company helped write and in which GE gained billions of dollars in new subsidies, particularly for its offshore activities. GE promised, of course, that these new subsidies would be good for our economy and U.S. jobs. But six years later, GE had cut its American workforce by 32,000 jobs, a 19 percent drop, while increasing its foreign jobs by 8.5 percent. In 2004, 54 percent of GE employees were in the United States. By 2010, that had dropped to only 46 percent.

Of course, corporate lobbyists will relentlessly tell Congress that businesses need tax subsidies from the government in order to be successful. They promise more jobs if they get the subsidies, and threaten economic harm if they are denied them. A central claim in the lobbyists' arsenal of falsehoods is the assertion that their clients need still more tax subsidies to compete because U.S. corporate taxes are much higher than foreign corporate taxes.

To evaluate this claim, we recently took a look at the corporations in our 2001-03 study cited earlier. Of the 275 companies in that study, 106 reported significant foreign profits. Here's what we found about their effective tax rates:

- Three-quarters of the 106 corporations paid higher foreign tax rates on their foreign profits than they paid to the United States in federal and state income taxes on the U.S. profits.
- On average for all 106 corporations, the effective foreign tax rate on their foreign profits was 29.3 percent. That was more than a third higher than the 21.3 percent U.S. federal and state rate they paid on their U.S. profits.[3]

Effective tax rates:
US federal & state tax rates on U.S. income vs. foreign income taxes on foreign income for 106 U.S. companies with significant foreign profits

	2001-03 total ($-billion)		
	Profit	Tax	Rate
US fed & state	$ 562.6	$ 121.0	21.5%
Foreign	304.7	89.3	29.3%
Foreign / US			136%

We have not yet compiled comprehensive recent data on U.S. versus foreign effective tax rates, although we doubt that things have changed very much since the early 2000s. We can, however, point to a few recent examples:

- Over the 2006-10 period, General Electric's U.S. federal tax rate on the $26.3 billion in pretax U.S. profits it reported to its shareholders was a negative 15.8 percent (GE enjoyed a net of $4.2 in tax rebates from Uncle Sam). In contrast, GE's foreign tax rate on its $67.7 billion in reported foreign profits was 19.6 percent.

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[3] The profits referred to here are the U.S. and foreign pretax profits that companies report to their shareholders. These profit figures are often quite different from the geographic profit allocations that companies report to the IRS, because of tax schemes that shift what should be taxable U.S. profits to offshore tax havens. At least in 2001-03, corporations generally seemed to be more accurate in reporting to their shareholders than to the IRS.

- In 2009, ExxonMobil says it paid a 49.2 percent effective foreign tax rate on its foreign profits. But on its U.S. profits, it paid no federal income tax at all, but instead got a rebate of $0.8 billion.

We can also point out that a 2007 study by the Bush Treasury Department also concluded that the effective U.S. corporate tax rate is lower than the average corporate effective tax rate imposed by our major competitors.[4]

3. Tax fairness

Since the mid-1990s, expanded business subsidies have sharply reduced taxes on capital income, so that such income is now taxed at far lower rates than workers pay on their wages. That's unfair in and of itself. In addition, because capital income is so concentrated on high-income people, the tax subsidies for capital income also undermine the progressivity of our tax system.

Subsidies that reduce federal income taxes on C corporations:
If one looks at the tax subsidies for C corporations on Treasury's official list for fiscal 2011 and compares that to what corporate income tax payments would be without the subsidies, one finds that in the current fiscal year, tax subsidies are expected to reduce corporate income taxes by a staggering 44 percent. But that's not the full story, because some corporate tax subsidies are not included on Treasury's list. As I noted earlier, we're working on a new comprehensive study of the taxes paid or not paid by America's biggest and most profitable companies, and our preliminary results so far suggest that corporate tax subsidies are now larger than corporate taxes paid.

Subsidies that reduce federal income taxes on C corporation shareholders (individuals):
Corporate profits are not only largely untaxed at the corporate level, they're also barely taxed at the personal level.

- Two-thirds of stock dividends paid to individuals, directly or into retirement plans or charitable coffers, are effectively taxed at a zero rate or less, and stock dividends that are reported on personal income tax returns are generally subject to a top tax rate 20 points below the regular rates.

- Most capital gains on corporate stock are never realized and thus are never subject to income tax, and even when such gains are realized, they are subject to a top tax rate 20 points below the regular rates.

- According to the IRS, the 400 individuals with the highest adjusted gross income reported on their tax returns now pay only 14 or 15 percent of their reported income in federal income taxes, mainly because of the low tax rate on realized capital gains (some of which "capital gains" are probably disguised wages). But when you think for a minute, you know that even that paltry 14 percent rate is a far higher rate than these extraordinarily well-off people actually pay, since a large portion of capital gains are never cashed in, and thus go untaxed.

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[4] U.S. Department of the Treasury, "Treasury Conference on Business Taxation and Global Competitiveness: Background Paper," July 23, 2007.

- It's worth noting that about 70 percent of the tax savings from the low tax rates on the small portion of capital gains and stock dividends that is subject to personal income tax goes to the best-off one percent.

The bottom line is this: When one adds up the federal income taxes paid by corporations and their shareholders, it is clear that there is no "double tax," as some corporate lobbyists and economists claim. In fact, there is not even a single tax.

In contrast, most wages are subject to both personal income tax and payroll tax. And this "double tax" adds up to a much higher effective rate on wages than the rate imposed on capital income.

This disparity between the relatively heavy taxation of wages and the light taxation of capital income is a key reason why combined federal, state and local taxes of all kinds are now virtually flat across all income groups from the middle of the income scale to the best-off one percent.[5]

Conclusion

Curbing the many ways we now subsidize businesses through the tax code is long overdue.[6] President Reagan's 1986 Tax Reform Act, along with lessons learned thereafter, can provide an excellent template for action.

On the corporate side, we need to start with a serious reform of our international tax system. Getting rid of "deferral" is the key to eliminating artificial offshore profit shifting and ending tax incentives for companies to invest abroad instead of here in the United States. Once we clean up our international tax mess, then we are likely to find it far more attractive to crack down on unaffordable and unwarranted domestic business tax subsidies as well.

With regard to business subsidies in the personal income tax, we would start by going after tax subsidies for capital gains and stock dividends, and go on from there.

More details on our reform proposals can be found on our website (www.ctj.org).

Of course, there are many non-business subsidies in the tax code. A large proportion of them, however, are means-tested in one way or another, which makes many of them praiseworthy or at least inoffensive in terms of equity. On the other hand, there's no doubt that there are personal tax subsidies that are unwarranted or far less desirable than continuation of other spending priorities.[7]

That said, we firmly believe that business subsidies are the biggest problem in the tax code today. They are distributionally harmful, which means they create even greater inequality. They should

[5]CTJ, "All Americans Pay Taxes" (April 2010).

[6]Of course, the time may not yet be ripe to do so. We may be wise to wait until the many current members of Congress who believe that eliminating virtually any subsidy administered by the IRS entails an unacceptable "tax increase" are either persuaded otherwise or move on to other careers.

[7]It would be remiss not to mention that requiring the IRS to administer so many tax-based spending programs outside its field of expertise surely interferes with the IRS's main mission: to collect taxes as fairly and as simply as possible.

have little economic appeal to anyone who believes that business investment decisions are usually best left to market forces. And curbing corporate subsidies is one of the few kinds of spending cut that enjoys wide public support.

So, as you take on the delicate task of reducing long-term budget deficits without endangering the fragile economic recovery, we urge you to make elimination or reduction of business tax subsidies your highest priority. Doing so can slash the deficit while retaining essential programs, improve economic efficiency, add jobs and make America a more equitable society.

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