ECONOMIC ANALYSIS

Winners and Losers in Corporate Tax Reform

By Martin A. Sullivan — martysullivan@comcast.net

I want to lower the corporate rate and eliminate these loopholes to pay for it so that it doesn't add a dime to our deficit.

— President Obama, Feb. 7 remarks to U.S. Chamber of Commerce

Many of our CFOs had meetings with Secretary Geithner last week . . . revenue neutrality, we asked to take that off the table for now.

— Robert McDonald, Procter & Gamble CEO, Jan. 20 at a House Ways and Means hearing

More and more, the feeling here inside the Beltway is that the U.S. corporate tax rate should be about 25 percent. That's a nice idea. In fact, it is a critical step for promoting America's competitiveness — now made obvious by Japan's pending 5 percentage point cut in its corporate tax rate. But there is no chance our bumbling Congress — prone to gridlock, laden with debt, swarming with lobbyists — can get the job done.

Why so pessimistic? We'll let the numbers tell the story, which has two parts.

Part 1: Funding Is Tight

In December 2007 the Bush Treasury Department published the table on the following page. It shows the major corporate tax breaks and their revenue costs: the domestic production deduction ($210 billion over 10 years), the research credit ($132 billion), and the excess depreciation allowance ($356 billion).

Treasury estimated that if Congress eliminated all major corporate tax expenditures except accelerated depreciation, it would provide enough revenue to reduce the corporate rate to 31 percent. If accelerated depreciation were eliminated, the rate could be 28 percent.

Well, there you have it. Put everything on the table and you only get to a 28 percent rate.

But even the disappointing 28 percent rate is a dream because not everything will be on the table.

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The domestic production deduction, first enacted in 2004, is probably the most vulnerable to the chopping block. (The president and many congressional Democrats already want to eliminate it for the oil industry.) Reducing the depreciation allowance to some degree may also be possible. (Europeans have done this to pay for some of their rate cuts.) But after that the political flak grows very thick. The research credit, the low-income housing credit, and the charitable deduction for businesses are so firmly entrenched that it would take an upheaval equivalent to a Martian invasion to get Congress to consider repeal.

So although it may be only a small and obvious first step down the long road of building a more productive economy, even getting to a 30 percent rate would be a giant leap for Congress.

If not reductions in corporate tax expenditures, what about other funding sources for rate cuts?

Congress could raise individual taxes to pay for a corporate rate cut. But that would be about as politically appealing as reinstating the draft. To secure passage of the Tax Reform Act of 1986, Congress did the exact opposite: raised taxes on corporations to pay for tax cuts for individuals.

Congress could easily afford large corporate rate cuts if it adopted a VAT. Trading more consumption taxation for less corporate tax is the wave of the future. That is where the rest of the world is headed. But our nation's political leaders are simply unwilling to consider a VAT at this time. Republicans fear the creation of a "money machine." Democrats fear an unfair burden on working families.

Finally, Congress could simply cut corporate rates without an offsetting tax increase. Undoubtedly, supporters would invoke the Laffer curve to claim the rate cut would pay for itself. But

the public and most economists — including the official estimators in Congress and Treasury — won't buy into that wishful thinking. Unfunded rate cuts — like the unfunded Medicare prescription drug benefit passed in 2003 — might have been possible once. But with federal debt on a trajectory to disaster, those days are long gone.

Part 2: Factions Will Fight

The tax breaks highlighted in Table 1 disproportionately benefit manufacturing and technology sectors. Corporations in these industries have lots of equipment that gets accelerated depreciation, conduct lots of research that gets section 41 credits, and do a lot of domestic manufacturing that qualifies for the section 199 production deduction.

Table 1. Tax Expenditures That Substantially Narrow the Corporate Tax Base

Tax Provision	FY 2008-2017 Revenue (in billions)
Deduction for U.S. production activities	$210
Research credit	$132
Low-income housing tax credit	$55
Exclusion of interest on life insurance	$30
Inventory property sales source rules	$29
Deductibility of charitable contributions	$28
Special ESOP rules	$23
Exemption of credit union income	$19
New technology credit	$8
Blue Cross/Blue Shield deduction	$8
Excess of percentage over cost depletion	$7
Other business preferences	$27
Total	**$576**
Accelerated depreciation/expensing provisions	$356
Total revenue from business preferences	**$932**

Source: Treasury Department, "Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century," Dec. 20, 2007.

Rate cuts disproportionately benefit financial firms and retailers. Because these companies' tax breaks are small compared with their profits, they generally would much prefer rate cuts to the status quo.

Unless Congress adopts some complex and unnatural changes to tax law, it is hard to see how broad-based business coalitions like the Business Roundtable and the U.S. Chamber of Commerce can ever support revenue-neutral tax reform. Large swaths of their membership would lose more from repealed tax benefits than they would gain from lower rates.

Table 2A quantifies all this. It shows the percentage changes in corporate tax liability that would result from a corporate rate cut to 30 percent paid for by an elimination of the three largest corporate tax expenditures. The big winners are securities, insurance, credit intermediation, retail trade, and bank holding companies. (See the notes for a more complete description of the industry classifications.) The big losers are electrical products, transport equipment, computers and electronics, technical services, and agriculture.

Table 2B is similar to 2A, except the results are presented in dollar terms (instead of percentage changes). The loss of the section 199 domestic production deduction would come mainly at the expense of the oil, gas, and coal industries. The loss of the research credit would come mainly at the expense of the chemical (including pharmaceutical) and computer industries.

Individual Results May Vary

Tables 2A and 2B provide a useful starting point for exploring the political dynamics of corporate tax reform, but no one set of numbers can tell the whole story.

For example, looking at Table 2A, you might think retailers would be huge supporters of tax reform. Well, of course they want lower rates, but don't expect them to expend too much political capital pushing for change. Their overriding concern is preventing the imposition of a VAT in the United States. Their worst nightmare is that interest in lowering the corporate rate becomes so great that a consensus develops that a VAT is necessary to pay for tax reform.

You might think, based on Table 2A, that financial companies would be rabidly in favor of reform. But as explained in the end notes, these simulations are based on 2005-2007 — years of soaring profitability for Wall Street. If profits do not return to pre-crisis levels, the gains from tax reform for financial firms will not be so great.

> ***Retailers' worst nightmare is that interest in lowering the corporate rate becomes so great that a consensus develops that a VAT is necessary to pay for lower corporate rates.***

The case of the financial companies illustrates a more general point about tax reform: The attractiveness of revenue-neutral reform grows with profitability. For example, suppose biotech companies become fantastically profitable in the future. In this case, the value of most tax benefits becomes relatively small relative to the value of rate cuts. If, on

Table 2A. Percentage Change in Tax Liability From a Revenue-Neutral Corporate Tax Reform						
Industry	Slower Depreciation	Repeal Domestic Production Credit	Repeal Research Credit	Rate Reduction to 30%	Net Overall Tax Effect	
1. Securities	1.8%	0.1%	0.1%	-14.3%	-12.3%	← WINNERS
2. Insurance	1.9%	0.1%	0.4%	-14.3%	-11.9%	
3. Credit intermediation	3.6%	0.2%	0.4%	-14.3%	-10.2%	
4. Retail trade	3.5%	0.4%	0.2%	-14.3%	-10.1%	
5. Bank holding companies	3.7%	0.2%	0.3%	-14.3%	-10.1%	
6. Real estate	5.9%	0.3%	0.2%	-14.3%	-7.9%	
7. Accommodations	5.8%	0.9%	0.8%	-14.3%	-6.9%	
8. Other services	7.5%	0.5%	0.4%	-14.3%	-5.8%	
9. Wholesale	6.1%	2.6%	1.5%	-14.3%	-4.1%	
10. Mining	4.1%	9.1%	0.2%	-14.3%	-0.9%	
11. Construction	7.6%	6.8%	0.2%	-14.3%	0.3%	
12. Oil and coal products	4.1%	11.1%	0.3%	-14.3%	1.2%	
13. Food manufacturing	6.1%	9.1%	1.5%	-14.3%	2.5%	
14. Utilities	12.9%	6.4%	0.5%	-14.3%	5.5%	
15. Other manufacturing	8.7%	8.9%	3.5%	-14.3%	6.8%	
16. Publishing	3.4%	10.7%	7.0%	-14.3%	6.8%	
17. Chemicals	5.4%	7.4%	8.8%	-14.3%	7.3%	
18. Metal, minerals, and machinery manufacturing	7.9%	9.3%	4.5%	-14.3%	7.3%	
19. Transportation	23.3%	0.1%	0.2%	-14.3%	9.3%	
20. Internet	17.6%	4.1%	2.7%	-14.3%	10.2%	
21. Agriculture	24.4%	6.0%	0.7%	-14.3%	16.8%	
22. Technical services	9.9%	2.9%	19.0%	-14.3%	17.5%	
23. Computers and electronics	11.4%	10.0%	25.9%	-14.3%	33.0%	
24. Transport equipment	34.4%	10.5%	17.4%	-14.3%	48.1%	
25. Electrical products	48.3%	18.3%	17.3%	-14.3%	69.7%	LOSERS →

the other hand, biotech turns out to have low profits, then research credits and accelerated depreciation allowances are more valuable than rate cuts. Similarly, oil company profits would soar if — heaven forbid — the price of oil goes to $200 a barrel. If that happened, the oil industry would care little about depreciation allowances and only about the corporate rate.

Deferral?

Finally, this whole exercise has neglected international taxation. That is partly because the data make it hard to look at differential effects of international tax changes across industries. But it is also because of the fundamental difficulty in guessing what role international companies will play in tax reform.

On the one hand, business wants more relaxed international tax rules. On the other hand, the administration and many congressional Democrats want to tighten them. Around the world, countries are moving away from worldwide taxation to territorial taxation. But some territorial proposals would raise revenue, while others would lose it. At least for now, assuming a net zero impact from international rule changes inside a corporate tax reform is a reasonable approximation of what we might expect.

What if corporate tax reform included a move to the kind of territorial system that businesses want — one that gives them a tax cut? In general, manufacturers are more multinational than other business sectors. If a revenue-losing territorial system were overlaid onto the tax reform packages modeled in tables 2A and 2B, it could even out some of the disparities. For manufacturers, it might make the loss of their other tax preferences acceptable. It might be the first step down a path the business community as a whole could accept. But because it's the opposite of base broadening, it would also raise the revenue-neutral rate. It would put Congress in the absurd situation in which it will be repealing incentives for domestic investment to pay for expanded incentives on foreign investment.

Notes

To produce tables 2A and 2B, the three largest tax expenditures shown in Table 1 were distributed

Table 2B. Dollar Amount of Annual Tax Change From a Revenue-Neutral Corporate Tax Reform (in billions)						
Industry	Slower Depreciation	Repeal Domestic Production Credit	Repeal Research Credit	Rate Reduction to 30%	Net Overall Tax Effect	
1. Securities	$0.28	$0.01	$0.02	-$2.28	-$1.97	← WINNERS
2. Insurance	$0.88	$0.07	$0.16	-$6.49	-$5.39	
3. Credit intermediation	$0.67	$0.03	$0.07	-$2.65	-$1.89	
4. Retail trade	$1.29	$0.14	$0.08	-$5.22	-$3.70	
5. Bank holding companies	$1.86	$0.08	$0.16	-$7.18	-$5.08	
6. Real estate	$0.41	$0.02	$0.01	-$1.01	-$0.56	
7. Accommodations	$0.31	$0.05	$0.04	-$0.78	-$0.37	
8. Other services	$0.75	$0.05	$0.04	-$1.43	-$0.58	
9. Wholesale	$1.90	$0.80	$0.46	-$4.45	-$1.29	
10. Mining	$0.52	$1.17	$0.03	-$1.83	-$0.11	
11. Construction	$0.77	$0.68	$0.02	-$1.43	$0.03	
12. Oil and coal products	$1.10	$2.99	$0.09	-$3.85	$0.32	
13. Food manufacturing	$0.56	$0.83	$0.14	-$1.30	$0.22	
14. Utilities	$1.72	$0.85	$0.06	-$1.91	$0.73	
15. Other manufacturing	$1.56	$1.59	$0.63	-$2.56	$1.22	
16. Publishing	$0.39	$1.20	$0.79	-$1.61	$0.77	
17. Chemicals	$1.38	$1.90	$2.27	-$3.67	$1.88	
18. Metal, minerals, and machinery manufacturing	$1.57	$1.84	$0.88	-$2.84	$1.46	
19. Transportation	$2.04	$0.01	$0.02	-$1.25	$0.81	
20. Internet	$3.82	$0.89	$0.59	-$3.09	$2.21	
21. Agriculture	$0.26	$0.06	$0.01	-$0.15	$0.18	
22. Technical services	$0.70	$0.21	$1.34	-$1.01	$1.24	
23. Computers and electronics	$1.41	$1.23	$3.18	-$1.76	$4.06	
24. Transport equipment	$3.37	$1.03	$1.71	-$1.40	$4.71	
25. Electrical products	$0.98	$0.37	$0.35	-$0.29	$1.42	LOSERS →

across industries as they had been in 2005, 2006, and 2007. Shares for each tax expenditure were estimated using corporate tax return data published by the IRS Statistics of Income division, Table 12, ''Returns of Active Corporations, Other Than Forms 1120-REIT, 1120-RIC, and 1120S,'' available at http://www.irs.gov/taxstats/article/0,,id=170720,00.html.

It was assumed any depreciation revenue raiser would focus on equipment. Equipment depreciation by industry was estimated as a percentage of total reported depreciation by industry, where industry percentages were taken from the input-output table published by the Bureau of Economic Analysis of the Commerce Department, Benchmark Input-Output Accounts, Capital Flows, spreadsheet ''1997 Investment by Using Industry,'' tab ''NIPAx22Struc.''

The IRS uses the North American Industrial Classification System. The 25-industry aggregation scheme used in tables 2A and 2B tried to capture the key differences in the use of tax expenditures across industries without overwhelming the reader with detail. Additional plain-English descriptions of industries can be found at http://www.bls.gov/iag/tgs/iag_index_naics.htm. ■