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Putting Corporate Tax "Loopholes" In Perspective

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Introduction

There is a popular misperception that U.S. corporations pay less in taxes than they should because of a plethora of "tax loopholes" in the tax code that allow them to minimize their tax burden. President Obama, for example, has been critical of certain tax breaks that, he maintains, allow companies to avoid U.S. tax and encourage them to "ship jobs overseas." Another campaign was launched recently by special interest groups claiming that the tax code gives billions in special, unjustifiable tax subsidies to the major oil companies each year.

Putting aside the rhetoric, it is legitimate to ask:

- What are the different types of corporate tax preferences – known as "tax expenditures" in Washington budgetary jargon – and how much do they "cost" the U.S. Treasury?
- How do corporate tax expenditures compare to the tax breaks available for individuals?
- How much do tax expenditures actually reduce the amount of tax corporations pay?

The oil and gas industry, currently in the political cross-hairs, receives just $2.8 billion in targeted tax incentives, less than 3 percent of all incentives, and far less than its smaller rivals in energy production, the renewable energy sector which receives $11.3 billion.

As is often the case in Washington, reality does not measure up to political rhetoric. According to estimates produced by the President's own Treasury staff, the special tax provisions benefiting corporations will cost the Treasury about $102 billion in 2011. The collective value of corporate tax expenditures is therefore lower than the budgetary cost of any one of the three largest tax expenditures benefiting individuals: the mortgage interest deduction, the exclusion for employer-provided health benefits, and the exclusions for pension and 401(k) contributions. Indeed, even the value of tax breaks benefiting state and local governments is almost as much as those benefiting corporations.

Moreover, a close inspection of the universe of corporate tax provisions reveals that only about 20 percent of the tax benefits are targeted to specific industries or sectors while roughly half of them are, generally speaking, available to all companies. The oil and gas industry, currently in the political cross-hairs, receives just $2.8 billion in targeted tax incentives, less than 3 percent of all incentives, and far less than its smaller rivals in energy production, the renewable energy sector which receives $11.3 billion.

Surprisingly, 22 percent of the tax benefits are targeted to aiding state and local governments or advancing charitable and social objectives, which means there are more so-called corporate tax loopholes benefiting state and local governments or social causes than targeted private industries.

How Are Tax Expenditures Calculated?

Each year, the Treasury's Office of Tax Analysis and Congress's Joint Committee on Taxation produce tax expenditure reports. While the two organizations do use different methodologies to estimate the budgetary cost of tax expenditures, they nonetheless provide a thorough accounting of the many tax provisions lawmakers have created over the years to achieve various social, economic or political objectives. For the sake of consistency, the Treasury report will be used here.

The law defines "Tax Expenditures" as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability."[1] Both organizations caution, however, that the cost estimates of tax expenditures are not the same as revenue estimates from changes in tax law.

Even if a tax expenditure is shown as having a budgetary cost of $1 billion, eliminating it will not necessarily raise $1 billion in new tax revenue because tax expenditures are interdependent.[2]

For instance, the repeal of a tax expenditure could incentivize people to take advantage of another. So while closing one "loophole" could save money in isolation, the total savings could be a wash as the cost of another tax provision increases.

Also, tax law changes affect the behavior of taxpayers. As the Treasury report illustrates, if capital gains were taxed at the ordinary tax rate, realizations would be expected to decline, which means the rate change would raise less new revenue than the full tax expenditure would indicate.

While tax preferences are certainly important to many corporations and industries, the impact on effective tax rates is modest. Indeed, while the top statutory corporate rate stands at 35 percent, IRS corporate tax return data show that, on average, U.S. companies pay an effective tax rate of roughly 27 percent, while many industries pay an effective rate above 30 percent – not much below the statutory rate.

The bottom line is that the rhetoric surrounding corporate tax expenditures far exceeds reality. However, if Washington is going to debate the future of corporate tax expenditures it should do so within the broader context of reforming the entire corporate tax code rather than attacking certain provisions in a politically charged and piecemeal process. The U.S. has one of the highest overall corporate tax rates in the industrialized world and that rate – not tax breaks – is threatening American competitiveness, wages and jobs. Lowering the corporate rate should be a top priority for lawmakers and broadening the base by closing some tax expenditures should be part of that discussion.

What Are Tax Expenditures and How Much Do Corporations Benefit from Them?

The term "tax expenditures" came into common usage after the enactment of the Congressional Budget Act of 1974. The premise is that lawmakers can use either direct spending programs or tax policies to achieve social and economic policy goals, and that there is a budgetary "cost" associated with each approach. Thus, measuring the cost of tax expenditures is a way of putting them on par with the cash outlays associated with traditional spending programs.

A list of all the major tax expenditures benefiting corporations is included in Table 1

1 Budget of the United States 2011, Analytical Perspectives, p. 207.

2 For a full explanation, see: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2009 – 2013*, January 11, 2010, p. 22, and *Budget of the United states 2011, Analytical Perspectives*, p. 207.

The Administration's Assault on the Manufacturing Deduction: If Oil Companies Are Too Dirty to Deserve Fair Tax Treatment, Are Other Manufacturers' Deductions Safe?

One of the so-called tax subsidies the administration has singled out to repeal for oil companies is the domestic manufacturing deduction, which tax professionals often refer to by its tax code number, the "Section 199 deduction." It was enacted in 2004 to replace a tax preference for exporters that had to be repealed after an adverse ruling by the World Trade Organization.

The new law amounts to a 32-percent tax rate on qualified activities while other firms pay 35 percent. But Congress was rather generous in defining what businesses would qualify, making it broadly available to many that wouldn't be considered "manufacturers" in plain English, and Congress opened it up to almost every category of taxpayer, be they individuals, corporations, farmers, estates, or small business owners.

"Qualified" production activities include:

- The manufacture, production, growth, or extraction of clothing, goods, food, software development, music recordings or films;
- Production of electricity, natural gas, or water in the United States;
- Construction or substantial renovation of real property in the United States including residential and commercial buildings and infrastructure such as roads, power lines, water systems, and communications facilities; or
- Engineering and architectural services performed in the United States and relating to construction of real property.

Why, suddenly, should companies that produce t-shirts, hamburgers, toys, software, or rap music be qualified to receive the tax benefit but oil companies should not be? According to the explanation in Treasury's Green Book, environmental politics account for this distortion of sound tax and economic policy. The President promised during the G-20 Summit in Pittsburgh, to "phase out subsidies for fossil fuels so that the United States can transition to a 21st century energy economy."

Treasury argues that "the lower rate of tax, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investments in the oil and gas industry than would occur under a neutral system. To the extent the lower tax rate encourages overproduction of oil and gas, it is detrimental to long-term energy security…"

To follow the reasoning of President Obama and the Treasury, the Section 199 deduction should be repealed for companies that design and build roads or those that manufacture automobiles. After all, oil companies are just producing the gasoline that powers cars down those roads. In fact, most manufacturing activities use a great deal of fossil-fuel energy. Does Section 199 contribute to the over-production and, ultimately the over-consumption, of automobiles, asphalt, tires, rubber toys, and synthetic clothing, all of these being petro-chemical based goods?

The Section 199 manufacturing activities deduction is by no means perfect tax law. The principles of sound tax policy dictate that tax laws should not favor one economic activity over another – like manufacturers over services. But neither should tax law be used to punish one type of economic activity over another. Using the tax code in this fashion is arbitrary and has led to the byzantine tax system we have today.

If such a move can be justified under environmental politics today, there is no reason the same tactics can't be justified tomorrow to exclude the makers of sugary drinks, fatty foods, alcoholic beverages, or any other firm that would seem to qualify as a manufacturer until politics determines that they are undeserving.

and ranked according to their cumulative cost between 2011 and 2015.[3] Overall, these provisions total $101.9 billion in 2011 and $618.6 billion over the five-year period.

The U.S. has one of the highest overall corporate tax rates in the industrialized world and that rate – not tax breaks – is threatening American competitiveness, wages and jobs.

The provision with the largest value is for the "deferral of income from controlled foreign corporations" which, Treasury estimates, carries a budgetary cost of $172 billion over five years.[4] The item with the second-highest budgetary cost is the "exclusion of interest on public purpose State and local bonds" which adds up to nearly $60 billion over the next five years. Third is the "deduction for U.S. production activities," also know as the manufacturing deduction or the Section 199 deduction (see sidebar) at $58 billion, while "accelerated depreciation" comes in fourth at nearly $52 billion, and the "credit for low-income housing investments" comes in fifth at $34.5 billion.

3 Provisions with costs less than $50 million are not listed, nor are provisions that may actually raise revenue. Although it is common to sum up tax expenditures as we do here, technically each score should be considered individually. The provisions interact in ways that make adding them up only the roughest approximation of their combined effect.

4 For the purposes of this estimate, Treasury assumes that controlled foreign corporations (CFCs) are "not regarded as entities separate from their controlling U.S. shareholders. Thus, the deferral of tax on income received by CFCs is regarded as a tax expenditure under this method." However, compared to current law (i.e.: the "reference law" baseline) CFCs are recognized as separate entities so deferral is not seen as a tax expenditure because "U.S. taxpayers generally are not taxed on accrued, but unrealized, income." *Analytical Perspectives*, p. 224.

In contrast to Treasury, JCT estimates a budgetary cost to deferral of $12.1 billion in 2011, $12.9 billion in 2012, and $13.5 billion in 2013. JCT's estimates don't extend further than 2013. See: JCT, p. 19, for methodology differences.

Table 1

Tax Expenditures That Benefit Corporations
Fiscal Years 2009-2015
($Millions)

	2009	2010	2011	2012	2013	2014	2015	2011-15
Deferral of income from controlled foreign corporations	$31,580	$30,960	$32,720	$33,870	$34,490	$33,930	$37,130	$172,140
Exclusion of interest on public purpose State and local bonds	$4,850	$5,180	$9,690	$12,140	$12,170	$12,570	$13,200	$59,770
Deduction for US production activities	$6,930	$8,770	$10,320	$10,910	$11,570	$12,260	$12,950	$58,010
Accelerated depreciation of machinery and equipment	$23,040	$320	$(5,160)	$1,750	$11,810	$18,490	$24,770	$51,660
Credit for low-income housing investments	$3,610	$5,400	$5,860	$6,330	$7,160	$7,510	$7,630	$34,490
Alcohol fuel credit	$40	$1,190	$8,850	$10,900	$6,640	$3,590	$2,020	$32,000
Deferred taxes for financial firms on certain income earned overseas	$5,570	$5,460	$5,770	$5,980	$6,090	$5,990	$6,020	$29,850
Expensing of research and experimentation expenditures	$3,560	$3,220	$4,250	$5,390	$6,330	$6,550	$7,310	$29,830
Inventory property sales source rules	$2,420	$2,620	$2,830	$3,070	$3,320	$3,590	$3,890	$16,700
Graduated corporation income tax rate	$2,720	$2,860	$3,120	$3,070	$3,150	$3,420	$3,600	$16,360
Credit for increasing research activities	$7,620	$5,770	$3,850	$3,080	$2,460	$1,964	$1,568	$12,922
Exclusion of interest on life insurance savings	$1,530	$1,590	$1,680	$1,770	$1,860	$1,970	$2,070	$9,350
Deductibility of charitable contributions other than education and health	$1,350	$1,370	$1,430	$1,510	$1,600	$1,690	$1,790	$8,020
Special ESOP rules	$1,280	$1,250	$1,330	$1,410	$1,480	$1,550	$1,620	$7,390
Exclusion of interest on hospital construction bonds	$570	$610	$1,130	$1,420	$1,420	$1,470	$1,550	$6,990
Accelerated depreciation on rental housing	$500	$750	$890	$1,020	$1,350	$1,410	$1,480	$6,150
Energy production credit	$380	$770	$1,010	$1,230	$1,300	$1,290	$1,260	$6,090
Excess of percentage over cost depletion, fuels	$320	$560	$610	$860	$1,030	$1,060	$1,090	$4,650
Exclusion of interest on bonds for private nonprofit educational facilities	$380	$400	$750	$940	$940	$970	$1,020	$4,620
Exemption of credit union income	$650	$650	$710	$790	$880	$960	$1,030	$4,370
Excess of percentage over cost depletion, nonfuel minerals	$680	$690	$720	$730	$750	$780	$800	$3,780
Deductibility of charitable contributions (education)	$590	$610	$640	$690	$740	$780	$830	$3,680
New markets tax credit	$520	$650	$720	$730	$700	$660	$590	$3,400
Expensing of exploration and development costs, fuels	$1,370	$1,710	$990	$770	$760	$570	$290	$3,380
Special Blue Cross/Blue Shield deduction	$760	$890	$690	$660	$590	$530	$690	$3,160
Exclusion of interest on owner-occupied mortgage subsidy bonds	$200	$220	$400	$510	$510	$520	$550	$2,490
Exclusion of interest on rental housing bonds	$170	$180	$340	$430	$430	$440	$470	$2,110
Energy investment credit	$230	$430	$480	$540	$350	$330	$400	$2,100
Credit for investment in clean coal facilities	$180	$280	$480	$550	$440	$360	$250	$2,080
Tax incentives for preservation of historic structures	$330	$340	$360	$380	$400	$420	$440	$2,000
Tax credit for orphan drug research	$270	$290	$320	$350	$380	$410	$450	$1,910
Exclusion of interest for airport, dock, and similar bonds	$140	$150	$290	$360	$360	$370	$390	$1,770

Although many of the tax exclusions were created to achieve multiple policy objectives, for the sake of simplicity we've broken them down into five basic categories, summarized in Figure 1: provisions generally available to all firms regardless of industry; industry-specific or targeted provisions; tax exclusions for state and local bond activities; provisions benefiting charitable and social policy objectives; and changes to depreciation rules.

Generally Available Tax Provisions

The largest category of corporate tax expenditures, with a budgetary cost of $54.4 billion in 2011, are those provisions generally available to all firms regardless to industry. This category includes:

- Deferral of income from controlled foreign corporations ($32.7 billion);
- Deduction for U.S. production activities, which is also known as the manufacturing deduction ($8.7 billion);
- Deferred taxes for financial firms on certain income earned overseas ($5.4 billion);
- Inventory property sales source rules ($2.8 billion); and
- Graduated corporation income tax rate ($4.2 billion).

Table 1 (continued)

Tax Expenditures That Benefit Corporations
Fiscal Years 2009-2015
($Millions)

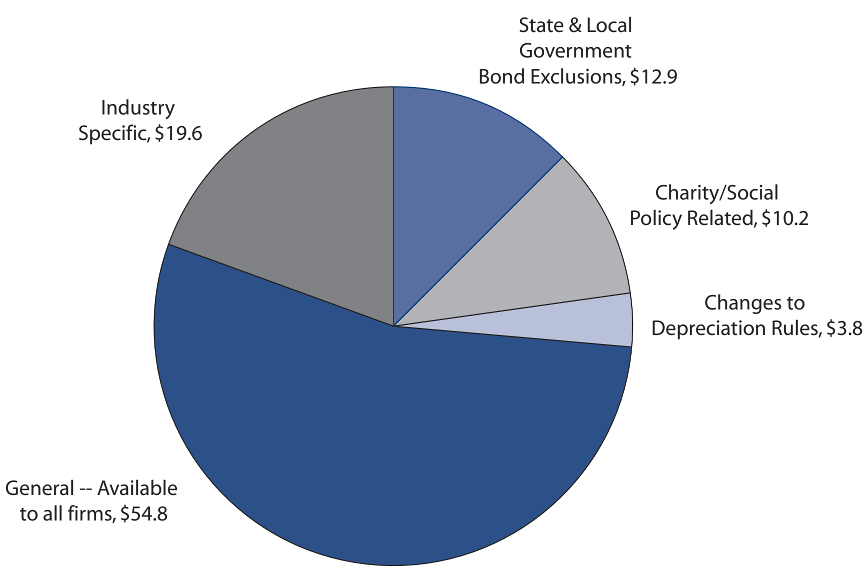
	2009	2010	2011	2012	2013	2014	2015	2011-15
Work opportunity tax credit	$680	$700	$620	$440	$230	$110	$50	$1,450
Credit for holders of zone academy bonds	$190	$220	$260	$290	$280	$250	$230	$1,310
Temporary 50% expensing for equipment used in the refining of liquid fuels	$770	$1,140	$930	$760	$630	$(300)	$(790)	$1,230
Exclusion of interest on student-loan bonds	$90	$100	$190	$230	$230	$240	$250	$1,140
Deductibility of charitable contributions (health)	$180	$180	$190	$200	$210	$230	$240	$1,070
Tax exemption of certain insurance companies owned by tax-exempt organizations	$190	$200	$200	$210	$210	$220	$220	$1,060
Tax credit and dedution for clean-fuel burning vehicles	$80	$180	$220	$120	$160	$210	$340	$1,050
Qualified school constrution bonds	$10	$40	$90	$170	$240	$260	$260	$1,020
Expensing of multiperiod timber growing costs	$130	$170	$180	$180	$210	$200	$200	$970
Exclusion of interest on bonds for water, sewage, and hazardous waste facilities	$70	$80	$140	$180	$180	$190	$200	$890
Tribal economic development bonds	$-	$50	$130	$160	$160	$170	$180	$800
Amortize all geological and geophysical expenditures of 2 years	$30	$120	$190	$190	$150	$110	$70	$710
Exclusion of interest on small issue bonds	$50	$60	$110	$140	$140	$140	$150	$680
Empowerment zones and renewal communities	$270	$140	$80	$110	$130	$150	$140	$610
Exemption of certain mutuals' and cooperatives' income	$110	$110	$110	$110	$120	$120	$120	$580
Natural gas distribution pipelines treated as 15-year property	$80	$110	$120	$110	$90	$80	$80	$480
Expensing of exploration and development costs, nonfuel minerals	$50	$90	$90	$100	$100	$100	$100	$490
Total	$107,320	$89,830	$101,920	$117,840	$126,930	$130,884	$141,188	$618,762

Source: Office of Management and Budget

Most of these provisions, such as deferral and sales source rules, are key components of the U.S. international regime that determine when and where multinational firms pay taxes on income earned abroad and how they allocate the expenses they incur while selling abroad. President Obama has been particularly critical of the deferral rules for incentivizing the offshoring of jobs. However, as Tax Foundation economists have written extensively, allowing companies to defer paying U.S. tax on income earned abroad until it is repatriated puts American companies on a level play field with their foreign competitors.[5]

Figure 1

Composition of $102 Billion in Corporate Tax Expenditures in 2011 (Billions of dollars)



The other major provision in this category is the deduction for domestic manufacturing activities. This provision was put into the tax code in 2004 after the World Trade Organization ruled against a previous U.S. tax provision benefiting domestic manufacturers who export abroad. The new provision allows any exporting manufacturer to deduct the portion of their taxable income that is attributable to domestic production. This provision has the effect of lowering the statutory rate from 35 percent to roughly 32 percent for manufacturers, or from 34 percent to 31 percent if the firm has less than $10 million in taxable income.

Industry-Specific Provisions

Over the years, lawmakers have enacted a number of tax provisions that largely benefit specific industries or groups. The budgetary cost of these provisions will be $19.6 billion in 2011. The largest items in this category include:

- The alcohol fuel credit ($8.85 billion);
- The credit for increasing research activities ($3.8 billion);
- The exclusion of interest on life insurance ($1.68 billion);
- Special ESOP rules ($1.3 billion);
- The energy production credit ($1 billion);
- The exemption of credit union income ($710 million);
- The special Blue Cross/Blue Shield deduction ($690 million);

Table 2

Composition of Corporate Tax Expenditures
Fiscal Years 2009-2015
$Millions

	2009	2010	2011	2012	2013	2014	2015	2011-15
Bond exclusions	$6,330	$6,850	$12,860	$16,170	$16,270	$16,820	$17,670	$79,790
Charity/Social Policy Related	$7,800	$9,680	$10,220	$10,740	$11,550	$11,960	$12,160	$56,630
Depreciation Changes	$30,530	$8,880	$3,810	$11,860	$23,210	$29,050	$35,300	$103,230
General -- Available to all firms	$49,220	$50,670	$54,760	$56,900	$58,620	$59,190	$63,590	$293,060
Direct “Subsidy” -- Industry specific	$13,050	$13,310	$19,610	$21,370	$16,490	$13,094	$11,588	$82,152

Source: Office of Management and Budget

5 Robert C. Carroll, “The Importance of Deferral and a Lower Corporate Rate,” Tax Foundation *Special Report No. 174*, February 19, 2010.

- The energy investment credit ($480 million); and
- The credit for investment in clean coal facilities ($480 million).

The majority of these industry-specific provisions, some $11 billion in total, benefit companies engaged in renewable energy activities. The biggest single tax provision is the alcohol fuel credit. The energy production credit is also significant in this category.

Lawmakers have also carved out special preferences for non-profit organizations – such as credit unions and non-profit health and life insurers – who provide commercial services like many taxable businesses.

If Washington is going to debate the future of corporate tax expenditures it should do so within the broader context of reforming the entire corporate tax code rather than attacking certain provisions in a politically charged and piecemeal process. The U.S. has one of the highest overall corporate tax rates in the industrialized world and that rate – not tax breaks – is threatening American competitiveness, wages and jobs.

Aid to State and Local Governments

In 2011, corporate tax expenditures aimed at benefiting state and local governments will total $12.9 billion, largely through the exemption of bond interest from tax. The largest items in this category include:

- The exclusion of interest on public purpose state and local bonds ($9.7 billion);
- The exclusion of interest on hospital construction bonds ($1.13 billion);
- The exclusion of interest on bonds for private non-profit educational facilities ($750 million);
- The exclusion of interest on owner-occupied mortgage subsidy bonds ($340 million);
- The exclusion of interest for airport, dock, and similar bonds ($360 million); and
- The credit for holders of zone academy bonds ($290 million).

When most people think of aid to state and local governments, they think of traditional programs such as Community Development Block Grants, federal highway funds, and Medicaid assistance. However, the tax code contains nearly $110 billion per year in preferences aimed at aiding state and local governments, and the corporate provisions are only a small part of that.

The vast majority of the tax code's benefits to state and local governments are found in the individual tax code. For example, the deductibility of property and income taxes carries a budgetary cost of more than $70 billion while the tax exemption for bond interest carries a budgetary cost of roughly $26 billion, bringing the total cost of the individual preferences to $96 billion.

Provisions Aimed at Charity and Social Policy Objectives

In 2011, the budgetary costs of corporate tax expenditures benefiting charities and specific social policy objectives total $10.2 billion. The largest of these charitable and social policy provisions include:

- The credit for low-income housing investments ($8.85 billion);
- The new markets tax credit ($720 million);

- The tax incentives for preservation of historic structures ($360 million);
- The tax credit for orphan drug research ($320 million); and
- The work opportunity tax credit ($620 million).

Compared to the tax provisions available to individuals, these corporate provisions are very small. Treasury estimates the budgetary cost of individual charitable deductions alone at more than $51 billion in 2011. Similarly, the value of the incentive for preserving historic structures is twice as much for individuals as it is for corporations.

The new markets tax credit is a special credit for taxpayers who "make qualified equity investments in a community development entity (CDE), which then makes qualified investments in low-income communities."[6] This is in addition to the tax benefits available to businesses who invest in empowerment zones and "renewable communities."

The work opportunity tax credit is intended to incentivize employers to hire people "who are certified as members of various targeted groups" such as those who have been on welfare.[7] These individuals will also likely be eligible for the Earned Income Tax Credit program which gives out more than $50 billion in refundable tax credits to low-income workers who don't have an income tax liability.

Table 3

Returns of Active Corporations: 2007 Tax Year (In $Billions)

Net Income (less deficit)	$ 1,836.7
Statutory special deductions including net operating losses and dividends paid	$ 649.6
Income Subject to Tax	$ 1,248.3
Total income tax due before credits	$ 437.1
Foreign tax credit	$ 86.5
General business credit	$ 15.7
Prior year minimum tax credit	$ 3.2
Total income tax after credits	$ 331.4

Source: IRS http://www.irs.gov/pub/irs-soi/07coccr.pdf, Table 20.

Provisions that Modify Depreciation Rules

In 2011, the corporate tax provisions with the least budgetary costs are the changes to the rules dictating how much and how quickly corporations can depreciate assets and investments. The largest of these changes to depreciation rules include:

- The accelerated depreciation of machinery and equipment (2009 cost of $23 billion but raises $5.1 billion in 2011 due to timing shifts);
- The expensing of research and experimentation expenditures ($4.25 billion);
- The accelerated depreciation on rental housing ($890 million);
- The excess of percentage over cost depletion, fuels ($610 million);
- The excess of percentage over cost depletion, nonfuel minerals ($720 million);
- The expensing of exploration and development costs, fuels ($990 million); and
- The expensing of multi-period timber growing costs ($180 million).

As Treasury frames the issue, "under an economic income tax, the costs of acquiring machinery and equipment are capitalized and depreciated over time in accordance with the decline in the property's economic value due to wear and tear or obsolescence."[8] However, many economists believe that it would be better for the economy if capital investments were expensed as they are made rather than depreciated over a period of years somewhat arbitrarily determined to be the useful lifetime of the asset.

6 *Analytical Perspectives*, p. 233.

7 Ibid. p. 235.

8 *Analytical Perspectives*, p. 231.

Over the years, lawmakers have enacted numerous changes to the standard depreciation rules in order to incentivize firms to invest in activities that were thought to be underinvested. The majority of these provisions benefit companies engaged in oil, gas, minerals, and renewable resource activities. For example, the value of benefits available to oil and gas firms is about $2.8 billion while the value of benefits available to mining and timber firms is less than $1 billion.

How Do Corporate Tax Expenditures Compare to Individual Tax Provisions?

The number and budgetary cost of corporate tax expenditures is modest compared to the vast number and cost of the tax expenditures in the individual tax code. Indeed, as Figure 2 shows, the $102 billion in budgetary costs of all corporate tax expenditures is smaller than the budgetary costs of the mortgage interest deduction ($104 billion), the exclusions for pension and 401(k)s ($142 billion), and the exclusion for employer-provided health insurance ($177 billion).

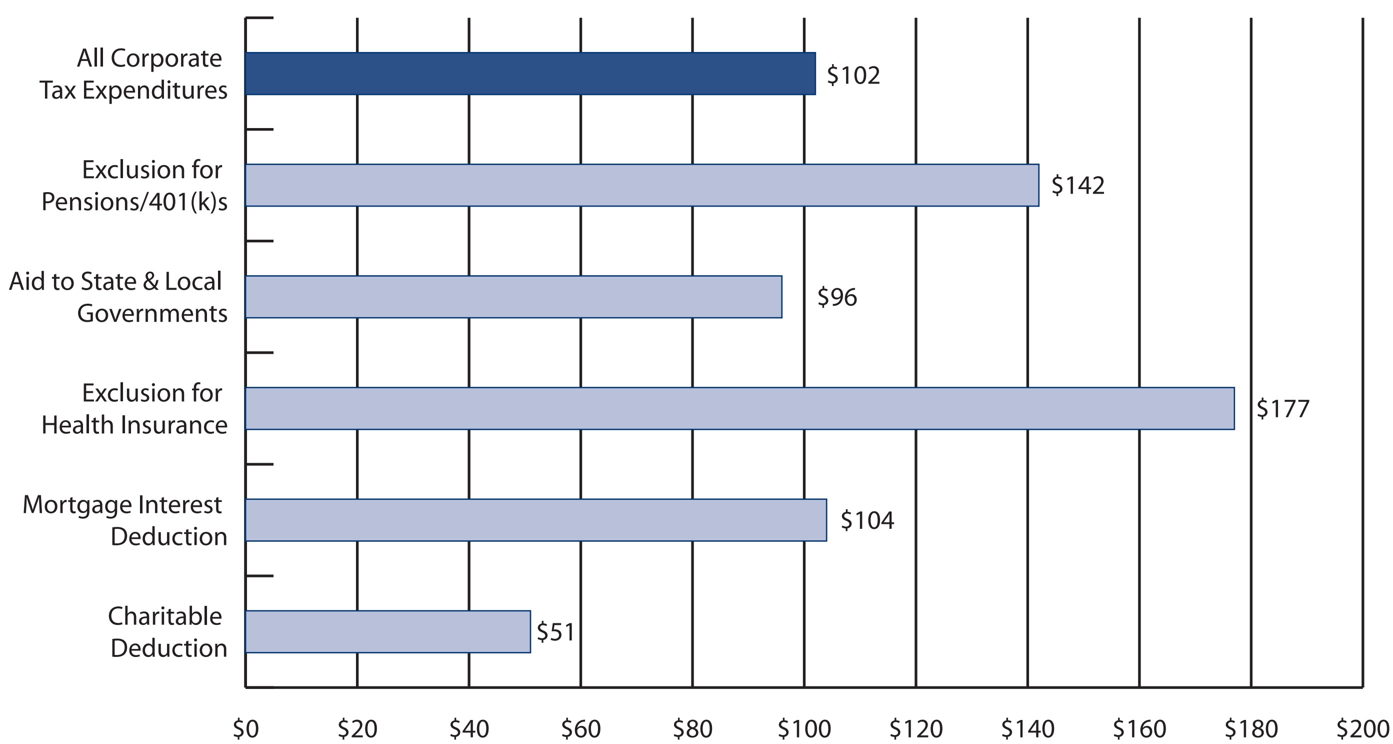
Moreover, the total value of the tax expenditures for corporations is only slightly greater than the $96 billion in preferences aimed at aiding state and local governments – such as the deductions for property and income taxes and the exclusion of bond income.

It should be noted, however, that while individuals may appear to be the intended beneficiary of preferences such as the mortgage interest deduction, the exclusion for employer-provided health insurance, or even the state and local tax deduction, the ultimate beneficiaries of these preferences are the housing sector, the health care sector, and state and local governments.

The economic distortions caused by the housing and health preferences are well

Figure 2

Corporate Tax Expenditures Compared to Major Individual Tax Expenditures in 2011 (Billions of dollars)



Source: Office of Management and Budget: 2001 Budget of the United States documented. The mortgage interest deduction, for example, is not only capitalized into the price of homes – which benefits builders, not purchasers – but it can incentivize people to purchase more expensive homes than they could otherwise afford – which benefits lenders.

The exclusion for employer-provided health insurance also distorts the market by disconnecting consumers from the actual cost of medical care, which can drive up costs and cause an over-consumption of medical services. Patients don't perceive the true cost of health care because employers and insurers are typically paying the bills. Thus, they will tend to demand more services irrespective of the price. This is not the case with most consumer goods – such as home electronics – where competition and consumer choice tend to drive down prices.

The tax exclusion for state and local bonds allows these governments to borrow money at lower rates than private sector borrowers which, some argue, encourages an over-investment in public works projects compared to private projects. Similarly, many economists argue that the tax deduction for state and local income and property taxes allows local governments to pass along the cost of higher taxes to Uncle Sam, which may actually lead them to tax and spend more than taxpayers would otherwise condone.

How Much Do Tax Expenditures Lower Corporate Taxes?

Despite the often-repeated rhetoric that corporations are paying less than they should because of the excessive loopholes in the tax code, IRS data suggest that the various tax provisions are modestly lowering the amount or effective tax rate that companies pay. Indeed, U.S.

Table 4

Returns of Active Corporations: Tax Year 2007

Sectors	Income Subject to Tax (Thousands of Dollars)	Total Income Tax after Credits (Thousands of Dollars)	Share of All Corporate Income Subject to Tax	Taxes as a Percentage of Income (Effective Tax Rate)	Share of Total Corporate Tax Burden
All Sectors	$1,248,285,457	$331,374,445	100.0%	26.5%	100.0%
Agriculture, Forestry, Fishing,and Hunting	$2,991,030	$858,753	0.2%	28.7%	0.3%
Mining	$49,186,831	$10,244,230	3.9%	20.8%	3.1%
Utilities	$41,839,176	$12,701,975	3.4%	30.4%	3.8%
Construction	$17,534,953	$5,446,848	1.4%	31.1%	1.6%
Manufacturing	$451,981,627	$94,833,468	36.2%	21.0%	28.6%
Total Wholesale & Retail Trade	$166,344,658	$54,261,459	13.3%	32.6%	16.4%
Wholesale Trade	$82,475,916	$26,964,882	6.6%	32.7%	8.1%
Retail Trade	$83,868,656	$27,296,564	6.7%	32.5%	8.2%
Transportation and Warehousing	$18,688,592	$5,805,573	1.5%	31.1%	1.8%
Information	$94,879,442	$27,973,736	7.6%	29.5%	8.4%
Finance and Insurance	$203,564,815	$62,490,442	16.3%	30.7%	18.9%
Real Estate and Rental and Leasing	$19,146,611	$6,468,771	1.5%	33.8%	2.0%
Professional, Scientific, and Technical Services	$21,308,146	$5,872,038	1.7%	27.6%	1.8%
Management of Companies (Holding Companies)	$117,659,456	$32,370,753	9.4%	27.5%	9.8%
Administrative and Support and Waste Management and Remediation Services	$10,278,649	$3,013,718	0.8%	29.3%	0.9%
Educational Services	$1,780,133	$593,787	0.1%	33.4%	0.2%
Health Care and Social Assistance	$9,118,841	$2,926,868	0.7%	32.1%	0.9%
Arts, Entertainment, and Recreation	$2,039,482	$622,306	0.2%	30.5%	0.2%
Accomodation and Food Services	$17,322,325	$4,177,411	1.4%	24.1%	1.3%
Other Services	$2,618,658	$712,011	0.2%	27.2%	0.2%

*Source: IRS

9 IRS data for 2008 showed that taxpayers earning over $250,000 paid an effective rate of 23.1 percent.

companies end up paying a higher effective rate than even the wealthiest 1 percent of individual taxpayers even though they both face the same top statutory rate of 35 percent. [9]

It is instructive to walk through the most recent IRS data for the tax returns of active corporations in 2007. As is shown in Table 3, these firms had net income of just over $1.8 trillion. After subtracting various deductions allowed under the code – such as for net operating losses and dividends paid – these firms had taxable income of roughly $1.25 trillion.

When applied at the 35 percent statutory tax rate, $1.25 trillion in taxable income produces a tax bill of $437 billion. However, companies can lower this burden by deducting the various credits available to them – in the same way that a family can deduct the child credit against their tax bill. The largest of these credits in 2007 was the $86.5 billion companies deducted for income taxes they paid to foreign governments. It is universally accepted that two countries should not tax the same dollar of income twice, so countries have developed various ways of protecting companies from double taxation. The U.S. allows companies to take a tax credit for taxes paid to other countries.

The other major tax credit is the general business credit, which is actually the sum of the various tax credits available to companies such as the welfare-to-work credit, research credit, new markets credit, biodiesel fuels credit, and orphan drug credit. In 2007, companies reduced their tax liability by $15.7 billion, or 3.5 percent, by using these credits.

After taking advantage of their credits and deductions, U.S. companies paid income taxes of $331 billion, or 26.5 percent of their taxable income.

Table 4, shows more detail on the income earned and taxes paid by specific industries. Manufacturing generated by far the most income subject to tax, $451 billion, and paid more in tax than any other sector at nearly $95 billion. However, because of such provisions as the foreign tax credit, accelerated depreciation, and the domestic manufacturing credit, the manufacturing industry paid an effective rate of 21 percent, the lowest of any sector.

By contrast, the finance and insurance industry generated the second-most taxable income of any sector and paid $62.5 billion in taxes, for an effective rate of 30.7 percent. Unlike manufacturers, banks and insurers have few large capital investments to depreciate nor can they take advantage of the domestic manufacturing credit so it makes sense that they would end up paying a higher effective tax rate.

The wholesale and retail trade sector generated more than $166 billion in taxable income and paid $54 billion in taxes at an effective rate of 32.6 percent. The other major sector was holding companies (those engaged in the "management of companies") who paid $32 billion on $117 billion of taxable income for an effective rate of 27.5 percent.

Conclusion

Contrary to political rhetoric and public perception, the tax "loopholes" available to U.S. companies are not as generous or as costly as is often repeated. Indeed, the budgetary costs of the popular tax preferences available to individuals – such as the mortgage interest deduction, exclusion for employer-paid health insurance, and the exclusions for pensions and 401(k)s – are all larger than the $102 billion in budgetary costs of corporate tax expenditures. Surprisingly, even the tax expenditures that benefit state and local governments are almost as costly as are those benefiting the corporate sector.

While it is true that these corporate tax expenditures are quite important to some firms and industries, they do not appear to have a major impact on lowering the overall amount of income taxes corporations pay nor the effective rate at which they ultimately pay. Recent IRS data for 2007, the most recent available, shows that U.S. firms paid an effective rate of roughly 27 percent, not too far below the statutory federal income tax rate of 35 percent. By contrast, the top 1 percent of individual taxpayers – who also face a top income tax rate of 35 percent – paid 23 percent of their income in taxes in 2008.

An important study by economists at the Organization for Economic Cooperation and Development (OECD) determined that corporate income taxes are the most harmful tax for a nation's long-term economic growth.

If lawmakers perceive that there is a problem with corporate tax expenditures, then the right way to consider them is within the broader context of corporate tax reform, not in a politically charged, piecemeal fashion. Next to Japan, U.S. companies face the highest statutory corporate income tax in the industrialized world. This uncompetitive tax rate, not corporate tax breaks, is threatening U.S. competitiveness in the global economy and the nation's long-term economic growth.

A very important study by economists at the Organization for Economic Cooperation and Development (OECD)[10] determined that corporate income taxes are the most harmful tax for a nation's long-term economic growth. Thus, lawmakers should be focused on lowering that statutory rate down to a level on par with our major trading partners – around 26 percent. Part of that strategy to lower the corporate rate could include broadening the tax base by eliminating some corporate tax expenditures. But "closing loopholes" for the sake of extracting more revenues from one industry seems punitive, arbitrary and politically motivated.

10 Asa Johansson, Christopher Heady, Jens Arnold, Bert Brys and Laura Vartia, "Tax and Economic Growth," Economics Department Working Paper No. 620. ECO/WKP(2008)28, Organization for Economic Cooperation and Development, July 11, 2008. http://www.olis.oecd.org/olis/2008doc.nsf/LinkTo/NT00003502/$FILE/JT03248896.PDF

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