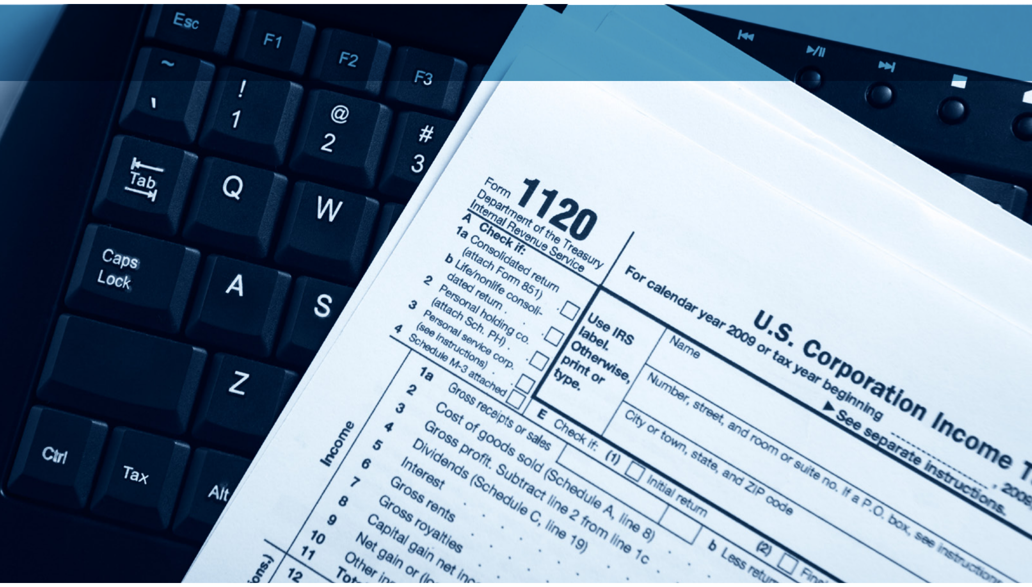
POLICY MEMO



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Anatomy of a Special Tax Break and The Case for Broad Corporate Tax Reform

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INTRODUCTION

Washington policymakers turn to broad tax reform perhaps once in a generation, and now may be such a time. Today's focus is on the corporate code, the source of most of the complexity and many of the economic problems associated with the U.S. tax system. There are many views about what aspects of the corporate code require reform and how to do it. Nevertheless, a consensus has formed that the reforms should simplify the corporate code by phasing out many special preferences and using some or all of the revenues to lower the corporate tax rate.

This consensus reflects a growing recognition by policymakers and business people of how certain features of the corporate tax code impose burdens on American competitiveness. The feature noted most often is our 35 percent marginal tax rate on corporate profits, the highest of any developed country. The impact of this high marginal rate on competitiveness is exacerbated by the worldwide character of the U.S. tax system: We apply that rate to the worldwide profits of U.S.-based companies, while all but five other nations have territorial tax systems that tax businesses only on the profits earned in their domestic markets. Finally, over many decades, policymakers have created scores of special tax deductions, tax credits and tax exemptions for designated business activities, products or industries. These provisions not only entail costly administrative and compliance burdens for the companies that use them. They also interfere with our markets' ability to allocate capital and other economic resources to their most productive uses, leaving the overall economy less efficient and productive. Phasing out special tax preferences and using all or most of the additional revenues to lower the corporate tax rate is the most reasonable response to these issues.

Here, we offer a case study of these dynamics using one of the larger and most recently-enacted special tax preferences, Section 199 of the corporate tax

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code. Since 2005, this provision has provided a special deduction for some of the profits arising from certain designated "domestic production activities." As we will see, the provision, originally designed for domestic manufacturing, now covers an estimated one-third of corporate economic activities. For example, food processing qualifies, but not retail food businesses—unless the food establishment roasts beans used to brew coffee. That exception allowed Starbucks, for example, to cut its effective tax rate by more than 2 percentage-points in 2009.[1] At the same time, the complex terms of Section 199 limit its value to most industries and companies. So, while the provision lowers the effective tax rate of those firms that can claim it – and no one faults a company for taking advantage of a badly-crafted policy -- it also induces them to channel their investment and other business decisions in the particular ways required to claim the deduction. As a result, Section 199 distorts the allocation of capital and other critical resources, including entrepreneurial activity, both within and across industries, and for the economy as a whole.

> Section 199 is a clear case study of how special tax preferences distort business decisions.

Section 199 is emblematic of the much broader problem with the current corporate code, as a large tax preference that costs the Treasury an average of more than $16 billion a year, putting upward pressure of the corporate rate, distorts business decisions and arbitrarily favors some industries over others. Our analysis shows that while the provision was originally intended to help manufacturing, it now provides tax benefits for a number of other, selected industries, including the information industry (including film production), mining, and construction (See Table 1). At the same time, such vital areas as health care, finance and insurance, and educational services receive virtually no benefit, and neither do many labor-intensive industries such as transportation and warehousing, administration and support, retail trade, and accommodations and food services. From 2005 to 2009, for example, Section 199 provided the information and movie industry, on average, 60 times the benefits received by these other vital and job-intensive industries. And within the manufacturing sector over the same period, Section 199 provided by far the greatest benefits, relative to the size of manufacturing sub-industries, to beverage and tobacco producers, followed by chemicals, and then by computer and electronic products (See Table 2). Traditional manufacturing industries such as textiles, apparel, wood products, leather products, printing, and furniture cannot claim significant benefits from Section 199. Finally, we can find no evidence at all that the provision promotes job creation.

In the end, Section 199, like other special preferences, tends to reduce the efficiency and output of both those firms which claim the preference and those effectively unable to do so. By phasing out such preferences, policymakers could eliminate their distorting effects on investment, entrepreneurism and other economic resources. Ending this particular preference also should generate some $164 billion over the next 10 years,[2] enough to reduce the tax rate for all corporations by 1.2 to 1.3 percentage-points. Recent empirical work suggests that lowering that tax rate could produce a range of benefits. For example, it should spur overall investment by lowering the cost of capital.[3] This higher investment could raise overall productivity, which in turn could help raise wages.[4]There is also evidence suggesting that a lower corporate tax rate can encourage entrepreneurism, which in turn drives innovation and stronger long-term growth.[5] As a matter of both fairness and sound economic policy, the best course would be to phase-out section 199 along with other tax preferences which effectively favor some industries over others, and use most or all of the revenues to reduce the tax rate for all corporations.

THE PROVISIONS OF SECTION 199

Section 199 of the U.S. corporate tax code, creating a new "domestic production activities deduction" was enacted in 2004 in response to a ruling by the World Trade Organization (WTO) that a long-time U.S. corporate tax preference exempting certain income derived from export activities and foreign operations constituted an illegal export subsidy. Since the main beneficiaries of the old preference were manufacturers, Congress enacted a new preference intended also to be aimed at manufacturing, but unrelated to its exports. In essence, the new deduction allows companies to deduct from their taxable incomes a portion of the "value added" they create. To claim a Section 199 deduction, a firm takes the receipts derived from its domestic (U.S.) production activities, subtracts the costs of the goods allocable to those receipts along with other deductions, expenses and losses also allocable to those receipts, and then deducts a portion of that from its taxable income. In 2005-2006, the deductible portion was 3 percent; it increased to 6 percent for 2007-2009, and 9 percent in 2010 and thereafter. In 2008, however, the deduction for oil and natural gas-related production was capped at 6 percent.

Yet, Section 199 is not a simple tax break for manufacturing. Beyond manufacturing, its "qualified production activities" include mining, electricity and water production, film making and construction. However, the receipts which qualify for the deduction also must be derived from production property manufactured, produced, grown or extracted in the United States.

THE ECONOMIC COSTS OF SECTION 199

The Administrative and Compliance Burdens

The basic provisions of Section 199 require companies to track and identify not only the receipts derived from qualified activities but also what share of those qualified activities take place using qualified property. These complicated terms require thousands of pages of rules and regulations stipulating how to identify qualified receipts and property. If a building contractor or a software producer uses equipment made in Mexico, Germany and Nebraska, what share of its production qualifies? If a movie producer uses a multinational cast, receives royalties from U.S. and foreign markets, and produces DVDs for global markets, what share of its receipts qualify? Comparable complexities also apply in calculating the costs to be subtracted from the receipts. Under Section 199 rules, qualified costs include salaries and wages, materials and input purchases, advertising, charitable gifts, insurance, legal fees, interest payments and depreciation deductions. Just to begin, then, Section 199 imposes on companies and the economy large administrative and compliance costs associated with tracking all of those finely-defined qualified receipts and expenses, costs which come from the resources for investment and jobs.[6]

The Economic Costs for Firms, Industries, and the Overall Economy

The provision exacts larger, additional costs by impairing the efficiency and productivity of countless companies, industries, and the overall economy. Market economies are more efficient and productive than their planned or managed counterparts, because markets can channel investment and other critical resources such as entrepreneurism and skilled labor to industries, firms and activities based on their actual economic returns. A uniform tax applied equally to all industries, firms and activities leaves this market distribution of resources largely unaffected. However, tax provisions such as Section 199 artificially raise the post-tax returns of certain industries and companies and, within those industries and companies, the post-tax returns of certain activities. The result is that investment, entrepreneurism and other economic resources are no longer allocated based simply on their economic returns. By raising the post-tax returns of certain industries, firms and activities which happen to qualify for Section 199 deductions, the provision channels economic resources, on the margin, to those qualified industries, firms and activities. In so doing, it inescapably reduces the efficiency and productivity of the economy.

We can trace these effects within companies and across the economy. At a firm level, the deduction creates incentives for companies to organize and manage their activities and investments to take maximum advantage of the deduction. In this respect, Section 199 is a clear case study of how

TABLE 1. RELATIVE VALUE OF SECTION 199 DEDUCTIONS BY INDUSTRY:
SHARE OF TOTAL DEDUCTIONS / SHARE OF TOTAL REVENUES, 2005-2009

Industry	2005	2006	2007	2008	2009	Average
Mining	5.2	5.0	4.7	4.3	2.1	4.26
Information	2.7	2.7	3.0	3.1	4.1	3.12
Manufacturing	2.3	2.4	2.4	2.3	2.4	2.36
Utilities	1.2	1.7	1.9	1.2	1.6	1.52
Agriculture, forestry, fishing, hunting	0.4	0.5	0.8	1.1	1.3	0.82
Construction	0.8	0.9	0.5	0.5	0.6	0.66
Prof'al, scientific, technical services	0.2	0.4	0.3	0.4	0.5	0.36
Wholesale trade	0.4	0.3	0.3	0.3	0.3	0.32
Arts, entertainment, and recreation	0.3	0.1	0.2	0.1	0.1	0.16
Accommodation and food services	0.0	0.1	0.2	0.2	0.2	0.14
Educational services	0.1	0.0	0.0	0.1	0.4	0.12
Real estate and rental and leasing	0.2	0.1	0.1	0.1	0.1	0.12
Retail trade	0.1	0.1	0.1	0.1	0.1	0.1
Mgt of companies (holding companies)	0.1	0.1	0.1	0.1	0.1	0.10
Other services	0.1	0.1	0.1	0.1	0.1	0.10
Administrative & support & waste mgt & remediation services	0.0	0.1	0.1	0.0	0.1	0.06
Finance and insurance	0.1	0.0	0.0	0.0	0.0	0.02
Transportation and warehousing	0.0	0.0	0.0	0.0	0.0	0.0
Health care and social assistance	0.0	0.0	0.0	0.0	0.0	0.0

Source: IRS (2012), Census Bureau (2012).

special tax preferences distort business decisions. For example, since the deduction is larger when the "qualified" receipts are greater, an automaker or food processor may choose to purchase and use equipment that qualifies for the deduction but is less productive and efficient than an alternative that does not qualify. The result may be lower taxes but also lower production than might occur without the distorting effects of the deduction. Or, since the deduction is greater if the "qualified" costs are less, firms may try to shift some costs from those things which qualify to those which do not. One result, for example, may be a new incentive to hire less costly and thus less productive workers. Once again, the result may be lower taxes but also less production than could occur without the distorting effects of Section 199.

Comparable or even greater economic costs follow from the terms of Section 199 which concentrate its benefits in certain industries and economic activities. From 2005 to 2009, manufacturing firms, as expected, claimed the major share of the provision's total tax benefits, with 65 percent of Section 199 benefits for all corporations (See Table 1).[8] Next, however, was the information industry, which by a special amendment also includes film production for Section 199 purposes. Information industry companies received nearly 13 percent of Section 199 benefits, followed by the mining industry with less than 6 percent of those benefits. By going beyond manufacturing, the authors of the provision (and its congressional rewrite editors) have created a sprawling deduction that leaves many industries less efficient.

These data show, for example, that Section 199 provided information and movie industry companies four times the tax benefits as all American corporations in health care, education,

TABLE 2. RELATIVE VALUE OF SECTION 199 DEDUCTIONS BY MANUFACTURING INDUSTRY:
SHARE OF TOTAL DEDUCTIONS BY MANUFACTURING / SHARE OF TOTAL REVENUES BY MANUFACTURING, 2005-2009

Industry	2005	2006	2007	2008	2009	Average
Beverage and tobacco products	2.1	2.1	2.7	2.9	3.7	2.70
Chemicals	1.1	1.3	1.6	1.5	1.7	1.44
Computer and electronic products	1.0	1.2	1.1	1.6	2.0	1.38
Miscellaneous	1.0	1.2	1.0	1.3	1.6	1.22
Primary metal	1.1	1.4	1.2	1.5	0.4	1.12
Food	1.1	1.4	0.9	0.9	1.2	1.10
Paper	0.9	0.9	0.9	1.0	1.4	1.02
Machinery	0.6	1.0	1.2	1.2	0.8	0.96
Nonmetallic mineral products	1.4	1.4	0.9	0.5	0.4	0.92
Petroleum and coal products	1.4	1.1	1.0	0.7	0.2	0.88
Fabricated metal products	0.8	0.9	0.9	0.9	0.8	0.86
Electrical equip., appliances, components	0.7	0.7	0.6	0.9	0.7	0.72
Transportation equipment	0.7	0.5	0.7	0.6	0.7	0.64
Furniture and related products	0.9	0.7	0.5	0.2	0.3	0.52
Printing and related support activities	0.5	0.5	0.5	0.3	0.5	0.46
Textile mills and textile product mills	0.5	0.5	0.4	0.3	0.3	0.40
Plastics and rubber	0.4	0.4	0.4	0.3	0.5	0.40
Wood products	0.5	0.4	0.2	0.1	0.2	0.28
Apparel	0.1	0.1	0.1	0.2	0.1	0.12
Leather and allied products	0.0	0.1	0.1	0.2	0.1	0.10

Source: IRS (2012), Census Bureau (2012).

transportation and warehousing, administration and support, real estate, accommodation and food services, agriculture, finance and insurance, and retail trade. Similarly, while the job-intensive construction industry could claim substantial tax benefits from Section 199, equally job-intensive areas such as accommodation and food services, administration and support, and transportation and warehousing do not. As the Congressional Research Service has concluded, "[e]conomic efficiency could be enhanced by repealing the Section 199 deduction and using the additional revenues to offset the cost of reducing corporate tax rates.[10]

Within manufacturing, the distribution of Section 199 benefits across the various sub-industries is also very uneven and inefficient. To compare different sub-industries within manufacturing, we adjust for their varying sizes: We use each sub-industry's share of all Section 199 deductions by manufacturing firms, divided by each sub-industry's share of all revenues from manufacturing. Using this ratio to adjust for the sizes of sub-industries, we found that over 2005-2009, beverage and tobacco producers were by far the greatest beneficiaries of Section 199 across manufacturing, followed far back by chemical producers and then by computer and electronic product makers (See Table 2).

These data show, for example, that after accounting for the relative size of sub-industries, the traditional areas of textiles, apparel, leather products, wood products, furniture, printing, and plastic and rubber derived, on average, one-fifteenth of the benefits of beverage and tobacco producers. There is no economic justification for

TABLE 3. REVENUES COST OF SECTION 199 BY FORM OF BUSINESS ORGANIZATION, 2005-2012 ($ BILLIONS)

	2005	2006	2007	2008	2008	2010	2011	2012	Total
Corporate	$1.8	$2.7	$3.9	$5.5	$5.0	$7.0	$8.9	$9.3	$44.1
Other	$0.6	$0.9	$1.3	$1.8	$1.2	$2.4	$3.4	$4.1	$15.7
Total	$2.4	$3.6	$5.2	$7.3	$6.2	$9.4	$12.3	$13.4	$59.8

Source: Joint Committee on Taxation (2012).

a tax preference for manufacturing which, across sub-industries, provides beverage and tobacco producers, on average, 15 times the relative benefits that companies in such a wide range of other manufacturing sub-industries can claim.

> Section 199 has created substantial economic distortions.

At a minimum, Section 199 has created substantial economic distortions. It provides a large tax incentive for firms in those industries that can take significant advantage of its terms, to organize and manage their investments and production strategies to do so. On top of this, as suggested already, there are numerous "special cases" now part of Section 199, from film production to Starbucks coffee shops. So, those companies and industries that use Section 199 find that their effective tax burden is lower, enhancing their post-tax returns relative to companies and industries unable to claim the same tax benefits. The result is that industries such as film making and tobacco production that can claim large Section 199 benefits, especially relative to their size, can attract more capital and other resources than their actual economic returns justify. At the same time, industries such as health care, education, accommodations and food services, and textiles and apparel that are unable to claim significant Section 199 benefits may receive less capital and other resources than their economic performance would warrant.

Beyond these large issues, additional distortions arise from the fact that Section 199 deductions can be claimed by firms such as S-corps, partnerships and LLCs, which pass through their profits to their owners, as well as by corporations. The value of a Section 199 deduction depends on the tax rate of the firm claiming it, and most beneficiaries are organized as C-corporations subject to the 35 percent federal corporate tax. But about one-quarter of the revenues losses from Section 199 deductions come from owners of pass-through entities subject to the personal income tax rate of the owners (See Table 3). Since the top personal income tax rate is higher than the corporate rate, the incentive to use the Section 199 deduction varies across industries and companies based on their mode of legal organization as well as on a company's ability to take advantage of the particular terms of Section 199. Given that pass-through companies accounted for 47 percent of all business profits in 2008 but only about one-quarter of all Section 199 claims, it is apparent that those companies are concentrated in industries unable to take significant advantage of Section 199, such as finance, insurance, educational services, and health care.

SECTION 199 AND JOB CREATION

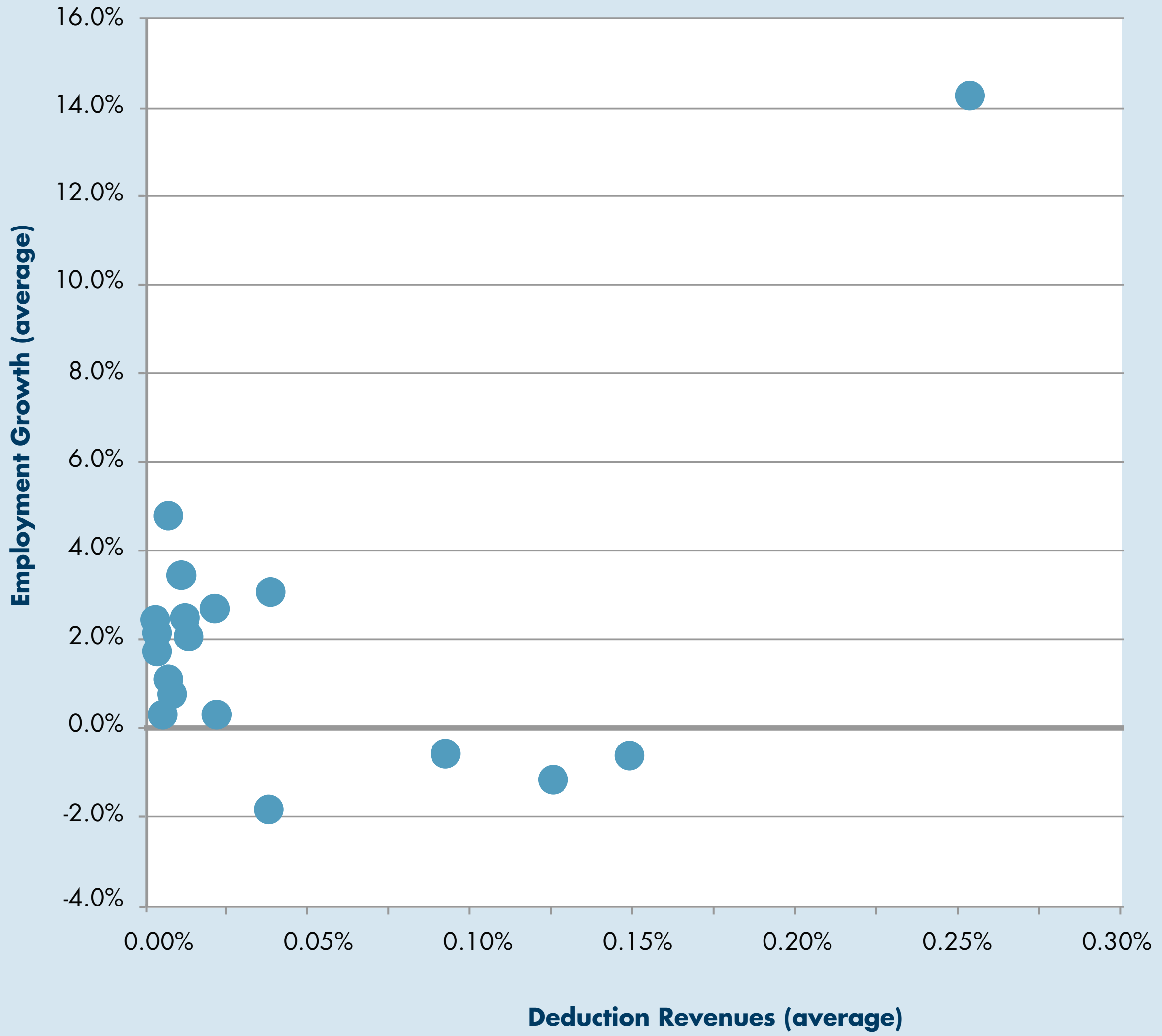
One question that remains is, for all of the distortions and inefficiencies associated with Section 199, does it promote job creation by promoting domestic production in at least selected firms and industries? To test for any employment benefit related to Section 199, we compared each industry's Section 199 claims as a share of its revenues, over the years 2005-2007, with each industry's employment growth over the same period. (We do not include 2008 and 2009, as the financial crisis and deep recession drove down employment in ways unrelated to the issues considered here.) Figure 1 suggests that there is no such correlation.

The figure shows that most industries which received little or no benefit from Section 199 recorded positive job growth over the first three years of the provision, while four of the five industries which claimed the largest benefits (information, manufacturing, utilities and agriculture) recorded job losses. The outlier is mining, which claimed substantial benefits from Section 199 and experienced the strongest job growth. Ironically, that sector also includes oil and natural gas producers, who would be excluded from section 199 under the administration proposal. On balance, however, there is no evidence that those job gains were related to Section 199.

THE OUTLOOK FOR SECTION 199

Despite the major economic issues and costs associated with Section 199, there are proposals to expand it. The Administration has proposed

FIGURE 1: SECTION 199 BENEFITS BY INDUSTRY (ADJUSTED FOR INDUSTRY SIZE), AND INDUSTRY JOB GROWTH, 2005-2007



Source: IRS (2012), Census Bureau (2012).

TABLE 4. REVENUE EFFECTS OF REPEALING SECTION 199, 2012-2021 ($ BILLIONS)

2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-2021
$4.3	$13.9	$14.7	$15.6	$16.5	$17.6	$18.6	$19.7	$20.9	$22.1	$163.9

Source: Joint Committee on Taxation (October 21, 2011).

to bar oil and natural gas producers as well as coal producers from claiming the deduction and use the additional revenues to provide a new 18 percent Section 199 deduction for "advanced manufacturing firms." The Administration has not yet defined what would qualify as "advanced manufacturing;" but however it were to be defined, such a large inducement for firms that are very capital-intensive almost certainly would induce some of them to organize their investments and other activities to take advantage of it. In this way, this proposal could raise the existing efficiency costs of Section 199.

Other policy analysts and advocates have proposed to phase out Section 199 and use its revenues to reduce our high corporate tax rate. In 2005, one year after the enactment of Section 199, the President's Advisory Panel on Federal Tax Reform recommended its elimination.[12] Its repeal has been included in several other broad tax reform plans, including one advanced in 2007 by Representative Charles Rangel, then chairman of the House Ways and Means Committee, and another put forward in 2011 by Senators Ron Wyden, Dan Coats and Mark Begich.[13] And in 2010, President Obama's Economic Recovery Advisory Board reported that the provision's repeal for corporations could cover a 1.1 percentage-point cut in the corporate tax rate, and its repeal for all businesses including pass-through entities could fund a 1.4 percentage-point reduction in that rate.[14]

As the Economic Recovery Advisory Board's calculations suggest, Section 199 is a very costly provision. The Joint Committee on Taxation estimates that the provision will cost the Treasury $72.1 billion over the five year period, 2011-2015, greater than all but two other provisions in the corporate code (the deferral of tax on foreign-source income, at $86.7 billion over the five years, and depreciation in excess of the alternative depreciation system at $109.0 billion).[15] Using the latest ten-year estimates, repealing Section 199 for all businesses would raise about $164 billion from FY 2012 to FY 2021.

We estimate that phasing out Section 199 for all companies would provides the revenues to cut the current corporate tax rate by 1.2 to 1.3 percentage-points. By so doing, policymakers unequivocally could increase the economy's overall efficiency and output. As part of a broader reform that would also end numerous other special corporate tax preferences and reduce the marginal tax rate by at least five percentage-points, this effort could contribute to stronger growth for the American economy.

ENDNOTES

1. Dixon, Reuters (2012)
2. Joint Committee on Taxation (October 21, 2011).
3. Hassett and Hubbard (2002).
4. Schwellnus and Arnold (2008).
5. Cullen and Gordon (2002).
6. For examples of the complex rules applied by Section 199 to different industries, see Atkinson (2007), Benko (2005), Deloitte (2005), Feinschreiber (2006), Jackel (2006) and Jenks (2006).
7. IRS (2012), Census Bureau (2012).
8. These data are based on Section 199 claims by companies subject to the corporate tax. They do not include claims by S-corps, partnerships and LLCs, which are pass-through entities taxed under the individual income tax.
9. Sherlock (2012).
10. IRS (2012), Census Bureau (2012).
11. IRS (2012), Census Bureau (2012).
12. President's Advisory Panel on Federal Tax Reform (2005).
13. H.R. 3970, "Tax Reduction and Reform Act of 2007; and S. 727, "Bipartisan Tax Fairness and Simplification Act of 2011."
14. President's Economic Recovery Advisory Board (2010).
15. Joint Committee on Taxation (January 17, 2012).
16. Joint Committee on Taxation (October 21, 2011).

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