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### Senator McCain's Corporate Tax Proposals: A Critical Examination

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# Senator McCain's Corporate Tax Proposals

*A Critical Examination*

Reuven S. Avi-Yonah

April 2008

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# **SENATOR McCAIN'S CORPORATE TAX PROPOSALS**

**A Critical Examination**

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The University of Michigan

April 2008

## Introduction

Senator John McCain (R-AZ) has proposed two major changes to the corporate tax code: cutting the corporate tax rate from 35 percent to 25 percent and allowing corporations to deduct the full cost of investments in technology and equipment in the first year, an accounting process known as expensing. The first proposal aims to enhance U.S. economic competitiveness, create jobs, and increase wages. The second proposal aims in particular to boost capital expenditures and “reward investment in cutting-edge technologies.”<sup>1</sup>

Both measures, if enacted by Congress, would greatly alter the role of corporate revenues in our tax system. Corporate taxes account for a significant share of the federal government’s revenues (about 14 percent in 2007),<sup>2</sup> financing critical investments in national defense, infrastructure, and human services. The corporate tax is crucial for the overall progressivity of the tax system, prevents individuals from sheltering income in corporations, and enables some measure of regulatory control over corporations.

There are major problems with the corporate tax code, of course, such as the provisions that encourage U.S. companies to locate jobs overseas. Reforms of the tax code to address these problems—including proposals that would close loopholes and lower the corporate tax rate—are worthy of serious consideration. Some changes, however, would make these problems worse.

This paper examines Sen. McCain’s corporate tax proposals on tax sheltering, growth and competitiveness, equity, and cost. In each case this proposal raises significant concerns. Specifically:

- Allowing corporations to expense their investments in new equipment and technology, in the context of the current tax code, invites massive tax sheltering.
- Cutting the corporate tax rate to 25 percent from 35 percent would also drain the federal treasury, without improving the competitiveness of the United States as a place to do business or of its corporations in the global marketplace.
- Reducing the corporate rate will overwhelmingly benefit upper-income taxpayers.
- Combining rate cuts and expensing would be enormously expensive, reducing corporate revenues by as much as 75 percent.

# Senator McCain's Corporate Tax Proposals

## The McCain Proposals Invite a Wave of New Tax Shelters

Sen. McCain's proposals would create a new generation of tax shelters that are immune from legal challenge. Currently, companies depreciate—deduct from their corporate taxes over several years—the costs of capital investments. Sen. McCain proposes to allow a 100 percent current deduction, also known as expensing, for these capital investments, reducing corporations' taxable income dollar-for-dollar.<sup>3</sup>

In other words, rather than deducting a part of the cost of a new machine in the year of the purchase, McCain would allow companies to deduct the entire cost in that year. Basic tax classes teach the uncontroversial proposition, known as the Cary Brown theorem, that expensing for capital investments results in normal corporate profits, or profits earned in a competitive marketplace, being taxed at a zero rate. Intuitively, this means that only so-called above-normal profits (monopoly profits) will be subject to the corporate tax, and most corporations will not pay tax most of the time.

The sheltering opportunity arises because Sen. McCain proposes expensing in the context of the current corporate tax structure, including the deduction for interest when a company takes out a loan to purchase equipment. This means the company may deduct the interest on that loan. Sen. McCain's proposal would mean that a company could immediately deduct not only the interest on the money borrowed to buy a machine and part of the machine's cost, but the full cost of the machine itself.

This combination would open up almost unlimited opportunities for sheltering income. In fact, for many corporations, the proposal would result in a negative effective tax rate on many investments—rather than paying a tax on profits the corporation would get money from the government in addition to their profits.

Here's how it might work. Suppose Acme Corporation borrows \$1,000 with a 10 percent interest rate and invests it all in new equipment. Under the McCain plan, Acme can deduct its \$1,000 of investment, resulting in a reduction of its tax bill by \$250 (assuming a 25 percent corporate tax rate under the other provisions of McCain's corporate tax proposal). Acme can then invest the \$250 and earn an extra \$25 (assuming a 10 percent interest rate). Under normal competitive conditions, it will also earn \$100 (10 percent) on its \$1,000 investment, which would result in \$25 of tax, or the same amount it earns on investing the tax refund.

The upshot: The corporation's effective tax rate is zero. But if Acme can also deduct \$100 of interest on its loan, the effective tax rate becomes negative. At a 25 percent rate, the company will be able to avoid paying \$25 in taxes on another \$100 in income. Of course, borrowing terms will shift over time, as will the amount of money a corporation could earn by lending out its tax savings under McCain's 100 percent depreciation proposal. But the bottom line remains an enormous tax shelter.

On its face, McCain's idea is similar to one of the proposals advanced by President Bush's Tax Reform Advisory Panel, the "Growth and Investment" tax proposal, which likewise would have allowed expensing of corporate capital investment. But the Advisory Panel proposed to ignore all financial flows, resulting in no deduction for interest.<sup>4</sup> The Panel described the elimination of the interest deduction as "essential." Specifically, the Panel said that:

"Allowing both expensing of new investments and an interest deduction would result in a net tax subsidy to new investment. Projects that would not be economical in a no-tax world might become viable just because of the tax subsidy. This would result in economic distortions and adversely impact economic activity."<sup>5</sup>

To understand the context of McCain's depreciation proposal, it is useful to review the recent history of tax sheltering. In 1981, President Reagan enacted one of the biggest effective corporate tax rate cuts by adopting super-accelerated depreciation deductions and an investment tax credit that together were equivalent to the expensing McCain is now proposing. Reagan, like McCain, did nothing to limit interest deductibility.

The result was a wave of tax shelters. Individuals borrowed heavily, used the borrowed funds to invest in ways that benefited from expensing, and deducted the interest. The combination of expensing and interest deductibility resulted in a negative tax rate for these shelters. Corporate income tax revenues plummeted to 1.5 percent of Gross Domestic Product by the end of 1985, from 2.4 percent of GDP in 1980.<sup>6</sup>

Congress brought the individual tax shelter wave to an end in 1986, limiting interest deductibility for individuals and enacting the at-risk and passive activity loss rules (which segregate losses from passive activities and prevent them from sheltering active income).<sup>7</sup> The McCain proposals invite a new round of sheltering like that of the 1980s. Taking advantage of these proposals will not require extensive legal or accounting help. The shelters will be very simple to adopt.

And once again, new loopholes in the corporate income tax could spill over into the personal income tax. In an environment in which the personal income tax rate stays at 35 percent (or higher, if Congress refuses to extend the Bush tax cuts at the highest income levels), there would be massive incentives to shift income from the individual to the corporate sector.

An important justification for maintaining a corporate tax is that individuals would otherwise be able to shelter their income in corporations and defer the individual tax indefinitely. The weapons that the Internal Revenue Service can use to combat such shifting, such as the accumulated earnings tax and transfer pricing, are hopelessly inadequate.

Thus, it is likely that the result of enacting Sen. McCain's proposal would be a

decline in not only corporate tax revenues, but in individual income tax revenues as well. In fact, President Reagan's 1981 corporate tax cuts had to be quickly reversed in the face of larger than expected revenue losses.

## Tax Changes to Promote Growth and Competitiveness Will Aid Neither

Sen. McCain justifies cutting the corporate tax rate by arguing that a rate cut will improve growth that is "essential to U.S. competitiveness." He states that "America was once a low-tax business environment, but as our trade partners lowered their rates, America failed to keep pace, leaving us with the second-highest rate among the world's advanced economies."<sup>8</sup>

The broad argument about growth is not compelling. Recent experience indicates that corporate rate cuts, like the temporary reduction in the tax rate on dividends from foreign subsidiaries from 35 percent to 5.25 percent, have resulted in increased profits for U.S. corporations but no increase in jobs or overall economic growth.<sup>9</sup> It is true that the United States now has the second-highest nominal corporate tax rate, but two facts suggest that the nominal tax rate does not diminish the competitiveness of the United States or U.S. corporations.

First, the effective tax rates in most other countries—the rates actually paid—are now higher than here. Second, we do not currently tax U.S. corporations' foreign-sourced income—or income from outside the United States—which means reducing the corporate tax rate is irrelevant to competitiveness against foreign corporations. Both of these points merit detailed exploration.

## Comparing Tax Rates

The key determinant for competitiveness is not the nominal corporate tax rate, or the rate on paper, but rather the effective rate—the rate companies actually pay. Deductions for interest payments and investments can reduce actual taxes as a percentage of income well below the nominal rate. Companies that *actually* pay more in taxes may be less competitive, but if companies merely *appear to* pay more but do not, that that has no effect.

In the United States, companies look like they are paying more because we now have the second-highest nominal tax rate (after Japan) among the members of the Organization for Economic Competitiveness and Development.<sup>10</sup> But the underlying story is different. Other countries have indeed lowered their nominal rates over the last two decades, but their effective rates did not substantially decline between 1986 and 2008.

In fact, OECD average revenues from the corporate tax rose to 3 percent of GDP from 2 percent of GDP over this period.<sup>11</sup> In contrast, U.S. corporate tax revenue declined to between 1.5 percent and 2 percent of GDP in the late 1990s to 2003 before rebounding sharply to 3 percent of GDP from 2003 to 2006 (the last year in which complete data are available).<sup>12</sup>

Thus, the argument that we need to reduce our corporate tax rate because our trading partners have reduced theirs does not make sense. Our trading partners have reduced their nominal rate, but they have also broadened their corporate tax base by taxing more kinds of income, reducing deductions and credits, or some combination of the two. Sen. McCain's proposal to slash the corporate tax rate to 25 percent and introduce 100 percent

expensing would, in contrast, sharply reduce the corporate tax rate and narrow the base, resulting in a much lower effective tax rate in the United States than among our main trading partners.

### **The Impact of Tax Rates on Corporate Competitiveness**

The U.S. corporate tax rate is also irrelevant to the competitiveness of U.S. companies abroad because it does not apply to U.S. corporations' overseas earnings. When U.S. corporations compete with foreign corporations overseas, they can avoid paying U.S. corporate tax on their active business income by choosing to defer those taxes.

In fact, the overall tax burden on U.S. corporations' foreign operations is very low precisely because they take advantage of tax holidays and other techniques to minimize their foreign tax burden. Reducing the U.S. corporate tax rate has no impact on these operations.

Similarly, the U.S. corporate tax rate is irrelevant to operations of foreign corporate competitors in the United States because both U.S. and foreign businesses face the same tax rate—the U.S. corporate tax rate. Reducing U.S. corporate tax rates, even if it were a true cut in the effective tax rate, would have no impact on the competitiveness of foreign vs. U.S. corporations. Competitiveness is not an argument for cutting the U.S. corporate tax rate.

### **Proposals Undercut Tax Progressivity**

Who benefits when taxes on corporations are cut? The longstanding assumption of both the U.S. Department of the

Treasury and the Congressional Budget Office is that the corporate tax falls on shareholders in the short run and on all capital providers (investors in the corporate and non-corporate sectors) in the longer run because capital flows from the corporate to the non-corporate sector.<sup>13</sup> But the incidence of the corporate tax has been debated for the last 50 years.

One of Sen. McCain's economic advisors, American Enterprise Institute Senior Fellow Kevin Hassett, argues that corporate taxes are "in large part" passed on to labor through lower wages and therefore corporate tax cuts "can" increase wages.<sup>14</sup> The important word is "can." How likely is it that U.S. corporations will pass a tax cut through to their employees?

To address this question, we need to know *why* a corporate tax cut might be passed on to wage earners. The obvious answer is that because of the decline in union membership and the increase in globalization, wages have become more elastic (responsive to changes). Corporations can cut wages in response to corporate tax hikes because there are no unions to threaten a strike, and because they can credibly threaten to move jobs overseas if the workers do not accept pay cuts.

But these same factors mean that the corporations are highly unlikely to pass the benefits of tax cuts to their employees. Instead, corporations would probably accumulate increased profits. After all, U.S. corporations in recent years have boosted their cash reserves, engaged in expensive share buybacks to please shareholders, and boosted the pay of corporate executives—amid one of the least enriching business cycles for average wage earners.

The beneficiaries of any corporate tax cuts would be corporate management,



who would be able to further boost their pay packets drawing from larger piles of cash, and shareholders. In fact, using increased profits to raise wages when there is no economic compulsion to do so would contradict corporate management's obligation to increase value for shareholders.

The argument that cutting the corporate tax rate will lead to wage gains is also inconsistent with the standard argument for the recent tax cuts on dividends and capital gains that Sen. McCain would retain. The standard argument for these tax cuts is that the corporate income underlying dividends and capital gains has already been taxed at 35 percent at the corporate level. If Sen. McCain and his advisers are right that the cost of corporate taxes to companies is mostly shifted to labor, then what is their justification for taxing dividends and capital gains at 15 percent, less than half of the rate for ordinary income? If labor pays most of the corporate tax, then owners of capital should be taxed on both dividends and capital gains at or near the full individual rate.

## The Cost to the Federal Budget

Sen. McCain's chief economic adviser, former Congressional Budget Office director Douglas Holtz-Eakin, estimates that the reduction of the corporate tax rate by itself would cost the Treasury \$100 billion a year. This figure, however, is probably low because it does not take into account the sheltering activity that is made possible by the combination of expensing and interest deductibility.

Len Burman, co-director of the Tax Policy Center, estimates that the rate reduction and expensing together would cut corporate tax revenue for the federal government in half, an estimate that he says is "probably conservative."<sup>15</sup> Another approach to the estimate is to use the 2003 revenues. That is when the most recent corporate tax shelter movement was at its height. In 2003, corporate tax revenues were only \$132 billion. Against that benchmark, the McCain rate cut would amount to a 75 percent reduction in corporate tax revenues.<sup>16</sup>

The problem with such deep cuts in revenues is, of course, that if we want to avoid an exploding deficit—and McCain has promised to erase the deficit by the end of his first term—then he needs to find spending cuts to offset the revenue reductions. McCain has indicated he would consider eliminating the Section 199 tax credit for "manufacturers" (defined broadly to include software writers, construction firms, and architects), the low-income housing credit, and unspecified tax breaks for life insurers, credit unions, and exporters.<sup>17</sup>

Each of these programs, however, boasts strong lobby groups, and some have problematic distributive consequences. For example, trading the low-income housing credit for a corporate tax reduction seems particularly egregious. Thus, it seems highly unlikely that a President McCain could or should be able get all of these tax revenue enhancing measures past Congress. Even if he could, these provisions would raise only a fraction of the revenues needed to pay for his tax cuts.

## Conclusion

Corporate taxes are a critical source of revenue for the nation. They provide a barrier against massive personal income tax avoidance. And they are part and parcel of our nation's progressive tax traditions. Sen. McCain's corporate tax proposals shatter each of these important attributes of the U.S. corporate tax system without providing much at all in the way of increased U.S. corporate competitiveness or wider economic prosperity.

Instead, Sen. McCain's proposals would mark the beginning of a new wave of tax shelters, contribute little to growth and competitiveness, heavily benefit higher-income taxpayers, and lead to unaffordable losses in revenue.

The U.S. economy performed quite nicely in the 1990s, with record growth in productivity and a decrease in income inequality. There is no credible evidence that restoring the tax rates that prevailed in that era (39.6 percent for individuals, 35 percent for corporations, with the full individual rate applying to corporate dividends) would impede U.S. economic growth or competitiveness. The result would be a much more equitable distribution of the tax burden, and a real chance to eliminate the current federal budget deficit.

## Endnotes

- 1 "Economic Stimulus Plan." [www.johnmccain.com/Informing/Issues](http://www.johnmccain.com/Informing/Issues).
- 2 Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2008 to 2018* (2008), [http://www.cbo.gov/ftpdocs/89xx/doc8917/01-23-2008\\_BudgetOutlook.pdf](http://www.cbo.gov/ftpdocs/89xx/doc8917/01-23-2008_BudgetOutlook.pdf)
- 3 While Sen. McCain's expensing proposal only applies to tangible property, investment in intangibles is research and development. R&D is already subject not only to expensing, but also to a tax credit that Sen. McCain proposes to expand and make permanent.
- 4 Currently, interest is fully deductible but dividends are not. This distinction gives corporations a tax incentive to finance their investments through borrowing, rather than ownership equity. This bias is increasingly difficult to defend in a world with derivatives, where advanced financial instruments have blurred the line between debt and equity by adopting some of the characteristics of each.
- 5 The President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," (Government Printing Office, 2005), p. 164, [http://www.taxreformpanel.gov/final-report/TaxReform\\_Ch7.pdf](http://www.taxreformpanel.gov/final-report/TaxReform_Ch7.pdf). The McCain proposals differ from the Panel proposal in a second major respect as well. The Advisory Panel proposed to change the U.S. corporate tax to something closer to a Value Added Tax by exempting foreign source income and exports, and imposing the tax on imports. While this proposal raises other issues, it has the merit of aligning the United States with our trading partners, all of which have a destination-based VAT. Sen. McCain's proposal keeps in place the current corporate tax regime, in which exports are taxed and imports are deductible.
- 6 "The Budget for Fiscal Year 2008, Historical Tables," <http://www.whitehouse.gov/omb/budget/fy2008/pdf/hist.pdf>, table 2.4.
- 7 Between 1993 and 2003, another wave of corporate tax sheltering occurred. This time corporations used sophisticated techniques developed by investment banks and accounting and law firms to shelter their income from tax. This resulted in another sharp dip in corporate tax revenues. The wave was brought to an end by a series of measures aimed at curbing the intermediaries (the accounting and law firms) and by IRS victories in the courts. By 2006, corporate tax revenues had recovered to the pre-1993 level.
- 8 "Economic Stimulus Plan," [www.johnmccain.com/Informing/Issues](http://www.johnmccain.com/Informing/Issues)
- 9 Joann M. Weiner, Effects of the Dividend Repatriation Tax Holiday on Domestic Reinvestment, 2007 TNT 224-2 (Nov. 20, 2007).
- 10 Chris Atkins and Scott A. Hodge, "U.S. Still Lagging Behind OECD Corporate Tax Trends," The Tax Foundation, July 24, 2007, <http://www.taxfoundation.org/news/show/22501.html>.
- 11 See the data in Reuven Avi-Yonah and Kimberly Clausing, "Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment," The Hamilton Project, Brookings Institution (2007); also in 2007 TNT 114-38 (June 13, 2007).
- 12 The U.S. has the fourth lowest corporate tax rate, as a percentage of the economy, among the 30 OECD countries. Jason Furman, Lawrence S. Summers, and Jason Bordoff, "Achieving Progressive Tax Reform in an Increasingly Global Economy," Hamilton Project, June 2006.
- 13 Congressional Budget Office, *Historical Effective Federal Tax Rates: 1979 to 2005* (2007), <http://www.cbo.gov/ftpdocs/88xx/doc8885/EffectiveTaxRates.shtml>; Office of Tax Policy, U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century* (2007), [http://www.ustreas.gov/press/releases/reports/hp749\\_approachesstudy.pdf](http://www.ustreas.gov/press/releases/reports/hp749_approachesstudy.pdf).
- 14 Kevin Hassett and Apama Mathur, "Taxes and Wages," American Enterprise Institute for Public Policy Research, Working Paper No. 128 (June 2006).
- 15 Len Burman, "On Taxes, McCain Calls Bush and Raises, Big Time," Urban Institute and Brookings Institution, February 25, 2008, [http://taxvox.taxpolicycenter.org/blog/\\_archives/2008/2/25/3544475.html](http://taxvox.taxpolicycenter.org/blog/_archives/2008/2/25/3544475.html)
- 16 Ibid.
- 17 Bob Davis, "McCain's Economic Platform: Big Tax Cuts, With Caveats," *The Wall Street Journal*, March 3, 2008.

# Center for American Progress Action Fund



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