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Regarding Unnecessary Business Subsidies
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Thank you for the opportunity to testify today on the topic of “unnecessary business subsidies,” or as it is often popularly styled, “corporate welfare.”

As is well known, the federal government provides financial assistance to businesses in a variety of ways and for a variety of stated purposes. The vast bulk of such assistance is provided through special tax abatements for businesses that engage in favored activities. As the Congressional Budget Office noted in 1995, “The federal government’s efforts to promote business are heavily weighted toward tax preferences, with spending and credit programs accounting for a smaller share of federal efforts.”¹

In fiscal 2000, the total cost of business tax preferences, including those that benefit business investors or subsidize business products, is estimated to be \$195 billion²—far, far larger than direct-spending business subsidies. One can easily calculate that personal and corporate tax rates are about 20 percent higher than they’d need to be if these tax preferences for business and investment did not exist. Or alternatively, the government could provide far more public services than it currently does at the same statutory tax rates that are now imposed. Citizens and companies that do not benefit from these tax preferences have a right to ask whether they are serving the public good.

We have organized our society to leave most decisions about what to buy and what to make to the free-market decisions of millions of consumers and businesses. Both economic theory and experience teach us that this is generally a wise choice. Of course, it takes a robust legal and political system to make these private decisions possible. Government must provide the legal system, the public infrastructure and the educational system. It must set the rules for commerce, deal with areas where markets do not work well, such as environmental protection and consumer protection, and smooth out the rough edges of capitalism to make sure that those who do not succeed are not left too far behind. It takes substantial public resources to build such a well-functioning economic and social framework, and it behooves the government not to

¹Congressional Budget Office, *Federal Financial Support of Business*, Oct. 1995.

²In its 1995 analysis of business subsidies, CBO used a rather narrow definition of business tax preferences, leaving out many of those that benefit business investors or subsidize business products, notably, most capital gains breaks, some tax-exempt bonds, and the exemption for life-insurance inside buildup. Based on the most recent figures published by the Joint Committee on Taxation, the fiscal 2000 total of business tax preferences included on CBO’s 1995 list is \$80 billion. Adding the investment tax preferences that CBO did not include, the total in fiscal 2000 comes to \$195 billion. Even this total is probably understated, particularly with regard to multinational corporation subsidies. Note that the total reported here includes an estimate for the cost of business meals and entertainment write-offs, which was excluded from the CBO list. Note also that tax breaks for retirement savings are excluded from the investment subsidies reported here.

waste its resources on usurping the role of markets where they do well on their own. “Corporate welfare” is a prime example of where government can undermine its ability to do its own job while simultaneously interfering with the private sector’s ability to do what it does best. Curbing such unwarranted interference should be high on the list of those who want a more efficient government and a strong private economy.

In my testimony today, I do not propose to offer an exhaustive critique of all the business subsidies in the tax code. Instead, I want to discuss some general principles, and then focus on a few of the more notable tax-based business subsidies. For a more extensive analysis, I refer the committee to Citizens for Tax Justice’s 1996 report, *The Hidden Entitlements* (from which portions of this testimony are adapted).

I. General Principles

Today, there are few who would challenge the notion that tax abatements designed to accomplish some social or economic goal unrelated to equitable tax collection are a form of government subsidy. Both those who lobby for such tax preferences and those who enact them understand this truism. Indeed, these tax-based subsidy programs even have an official name: “tax expenditures.” As the Joint Committee on Taxation explains:

“Special income tax provisions are referred to as tax expenditures because they are considered to be analogous to direct outlay programs Tax expenditures are most similar to those direct spending programs which have no spending limits, and which are available as entitlements.”³

For instance, suppose the government wants to subsidize wages for low-income workers. It could try to accomplish this goal in various ways. One might be by regulation, to wit, by setting a minimum hourly wage that businesses are required to pay. Alternatively, the Department of Health and Human Services could provide direct wage subsidies to eligible workers. Or a wage subsidy could be administered by the Internal Revenue Service, either by reducing income taxes for low-income workers,

Cost of Tax Breaks for Business & Investment in Fiscal 2000

Total	\$ 194.9
Capital gains (except homes)	73.9
Accelerated depreciation	36.9
Insurance cos. & products	29.9
Multinational preferences*	13.5
Tax-free bonds, private**	9.0
Business meals & entertainment	6.6
R&D tax breaks	4.0
Low-income housing credit	4.0
Oil, gas, other energy	3.2
Timber, agriculture, minerals	1.3
Financial institutions (non-insurance)	0.9
Installment sales	0.9
Special ESOP rules	0.8
Empowerment zones	0.8
Other business & investment	9.2

*Probably substantially understated

**Excludes the \$16.5 billion cost of public-purpose bonds.

Source: Joint Committee on Taxation, Dec. 1998, except (a) figure for business meals & entertainment, estimated by Citizens for Tax Justice and (b) figure for capital gains, based on Treasury and CTJ estimates.

³Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1996–2000*, Sept. 1, 1995, p. 2. See also Congressional Budget and Impoundment Control Act of 1974 (P.L. 93–344), sec. 3(a)(3).

including tax “refunds” for those who owe no income tax, or by offering tax credits to businesses that hire low-income people.

In fact, the government follows all three approaches. First of all, of course, there is a minimum wage. Second, many low-income workers have their salaries supplemented by welfare, food stamps, unemployment compensation and so forth. And third, the tax code provides a n “earned-income tax credit” to low- and moderate-income working families and tax credits to businesses that hire certain low-income workers.

Most government spending through the tax code is not targeted toward low-income people, however. In fact, tax breaks tend to reward those with the most lobbying muscle in Washington. Organized corporate interests have been particularly successful in obtaining tax subsidies—so much so that corporate tax expenditures currently equal more than 40 percent of total corporate tax payments.

Projected Cuts in Certain Domestic Discretionary Program as Shares of GDP Under the Budget Plan Approved By Congress in 1999 (fiscal years)

Tax subsidies as entitlements:

When the Joint Committee on Taxation describes tax expenditures as similar to entitlements, it means that most of them continue without further review once they are put into the tax code. In contrast, direct spending on defense, roads, environmental protection, and other non-entitlement programs must be approved every year, and it takes an appropriation bill passed by Congress and signed by the President to do so. If a such a “discretionary” program turns out to cost more than expected, it—or something else—must be scaled back in the annual budget. But if the price tag on a tax break goes up, it continues anyway—and the process of curbing it is much more difficult.

	Percent Changes as a Share of GDP	
	1999-04	1999-09
Community and regional development	-84%	-96%
Agriculture	-60%	-72%
General government	-34%	-48%
Environment and natural resources	-25%	-39%
Science and space	-23%	-38%
Crime prevention and other justice activities	-20%	-37%
Transportation	-13%	-30%
Veterans benefits and services	-14%	-27%
Education, training, employment, social services	-3%	-15%

The budget advantages that tax entitlements enjoy over most direct spending programs is illustrated in the budget just approved by Congress, which contemplates huge reductions in most areas of domestic discretionary spending as a share of the economy over the next decade. (See table.) In contrast, tax subsidies are expected to maintain, or even expand, their claim on the economy over the same period.

Standards for evaluating business tax subsidies: Size alone would seem to mandate that any serious analysis of possible ways to improve government efficiency and curb waste must include business tax subsidies within its scope. Like other spending programs, tax subsidies ought to be evaluated on the following grounds:

1. Is the subsidy designed to serve an important public purpose?

2. Is the subsidy actually helping to achieve its goals?
3. Are the benefits, if any, from the subsidy commensurate with its cost?
4. Are the benefits of the subsidy fairly distributed, or are they disproportionately targeted to those who do not need or deserve government assistance?
5. Is the subsidy well-administered?

Few if any business tax subsidies could pass these tests.

Oversight issues: With regard to the fifth point, one might question whether the Internal Revenue Service is ever the appropriate agency to administer a government spending program. After all, the IRS's expertise is in tax collection, not construction or farming or business investment. Would we ask the Energy Department to administer the Social Security system on the side? Would we expect the Defense Department to do a good job running the food stamp program? Does anyone think the Labor Department should be in charge of securities regulation?

To be sure, handing a program to the IRS to run has advantages. The bureaucratic overhead may be fairly low, since the IRS will inevitably devote most of its attention to its main mission of collecting taxes. But the price for that lack of attention may well be inefficiency in the administration of the program. In particular, hugely expensive business tax expenditures purportedly designed to encourage productive investment usually operate with little or no oversight as to whether they are actually achieving their goals. If a direct spending program is failing to achieve its goals, the agency in charge of the program will usually be held accountable. But no one thinks to blame the IRS if the tax-based programs it "administers" prove too costly or fail to work.

Why do many lawmakers find tax subsidies attractive? Poor administration, lack of cost controls, and unhappy distributional results are "features" that are far too typical of tax-based subsidies. Yet despite these obvious drawbacks, many politicians, at both the federal and state levels, find tax expenditures extremely attractive. One wonders: Do they think poorly administered programs are a good idea? Are they unconcerned about the impact of uncontrolled spending on the budget? Are they unconcerned about the adverse effects on taxpayer confidence in the tax system that tax-subsidy abuses can create? Or do they simply see tax subsidies as a way to exert power over society and the economy without having their efforts show up in the official spending budget?

This last point may be the most important. Because of the way the government's budget books are kept, politicians can have their cake and eat it, too. A direct spending program shows up in the official budget as federal outlays and the taxes that pay for the program as revenues. But if an equivalent tax expenditure program is enacted, paid for with taxes on people and/or companies not benefitted, the combination shows up in the aggregate budget numbers as a wash. Neither net taxes nor spending will appear to go up in the official budget. In recent years, this has made tax subsidies the tool of choice for many lawmakers.

For example, in their 1994 “Contract with America,” GOP leaders in Congress talked a lot about cutting spending. But among the most significant specific expenditure changes they proposed in 1995 were more than \$100 billion a year in increased tax-based spending programs. Ironically, these huge new tax entitlements—mostly targeted to large corporations and the wealthy—were designed to show up in the budget not as additional spending, but as tax cuts. Likewise, in recent years, many of President Clinton’s program initiatives have been styled as tax cuts rather than spending.

Ultimately, of course, tax entitlements are not free. As was noted earlier, if all current tax business and investment tax expenditures were suddenly repealed, for example, income tax rates could be reduced across the board by about a sixth. Such a radical step is unlikely, of course. But eliminating or scaling back even some of these kinds of tax entitlements could make a very significant difference in improving tax fairness and easing most people’s tax burdens. Such steps would also be likely to improve economic growth to boot, by curbing wasteful tax-sheltering activities and thereby increasing productive market-driven investment.

Most corporate tax subsidies are pure waste. If you think for a minute about how these subsidy programs came into being, then this is quite obvious. Businesses do not lobby the government to tell them what to do. They lobby for subsidies for doing what they already do, and would continue to do anyway. Thus, companies that buy lots of equipment want subsidies for buying equipment. Companies that do lots of research want subsidies for research. Companies with international operations want subsidies for operating internationally. And so forth.

As the House Ways and Means Committee noted in its report on what became the Tax Reform Act of 1986,

“Proponents of massive tax benefits for depreciable property have theorized that these benefits would stimulate investment in such property, which in turn would pull the entire economy into more rapid growth. The committee perceives that nothing of this kind has happened.”⁴

To say that most business subsidies pay companies for doing what they would do anyway does not mean, of course, that they have no effect at all. For one thing, their cost means that other taxpayers must pay higher taxes or get lower government services. For example, if the price of business subsidies is less government investment in education, we may all suffer the adverse consequences. Likewise, businesses that get lower subsidies than their competitors may find themselves unfairly disadvantaged in the marketplace.

⁴Ways and Means Committee Report on H.R. 3838, the Tax Reform Act of 1985 (which became the Tax Reform Act of 1986), pages 145-46.

In addition, even though businesses may not always realize it, subsidies do tend to have at least marginal effects on behavior. But if one believes in free markets, rather than central planning, these tax-induced economic distortions usually tend to be detrimental rather than helpful. As the official report on the 1986 Tax Reform Act notes, in the loophole-ridden era from 1981 to 1985,

“the output attainable from our capital resources was reduced because too much investment occurred in tax-favored sectors and too little investment occurred in sectors that were more productive but which were tax-disadvantaged.”⁵

In rarer cases, business subsidies can be so large that they cause large economic shifts. That was the case from 1981 to 1986 in the real estate industry, where lavish tax subsidies caused a huge wave of excess office construction around the country. As the Bush Treasury Department noted in a letter in August of 1991:

“Neutral taxation promotes the efficient allocation of investment resources, while the ability to use numerous tax incentives available for real estate prior to the 1986 Act had the opposite effect, the result of which was substantial overbuilding, one of the primary causes of the savings and loan crisis.”

Thus, most business tax subsidies are at best pure waste, and even worse, can sometimes cause perverse economic effects.

II. Four Examples of Corporate Welfare in the Tax Code

Let us now turn to a few of the many notable examples of business subsidies in the tax code. I’ve picked four items to illustrate various “features” of business subsidies:

- # Tax breaks that don’t work (accelerated depreciation).
- # Tax breaks with perverse results (multinational tax preferences).
- # Tax breaks with little oversight (R&E credit).
- # Tax breaks with virtually no justification at all (business meal deductions).

I should emphasize that all of these share common defects with one another.

1. Accelerated Depreciation

Accelerated depreciation rules allows businesses to write off their purchases of machinery, equipment and buildings for tax purposes faster than the assets actually wear out. Special tax breaks for business capital outlays entered the tax code in the sixties, and were enlarged in various ways thereafter. The process reached its

⁵Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (May 4, 1987), p. 98.

apotheosis in the major expansion of depreciation write-offs included in President Reagan's 1981 tax cut act.

With the 1981 act, the tax-shelter floodgates opened. By 1983, studies by Citizens for Tax Justice found that half of the largest and most profitable companies in the nation had paid no federal income tax at all in at least one of the years the depreciation changes had been in effect. More than a quarter of the 250 well-known companies surveyed paid nothing at all over the entire three-year period, despite \$50 billion in pretax U.S. profits. General Electric, for example, reported \$6.5 billion in pretax profits and \$283 million in tax rebates. Boeing made \$1.5 billion before tax and got \$267 million in tax rebates. Dupont's pretax profits were \$2.6 billion; after tax it made \$132 million more. CTJ's findings were similar in 1984, 1985 and 1986.

In response to public clamor, his own newfound misgivings and the disappointing economic results of the 1981 corporate tax incentives, President Reagan helped lead the fight for the loophole-closing Tax Reform Act of 1986. The 1986 act greatly scaled back depreciation and other tax breaks for business property. The changes curbed corporate tax avoidance opportunities and made taxpayers out of most of the former corporate - non-payers.

While companies paid more in taxes after 1986, however, business investment flourished. As former Reagan Treasury official, J. Gregory Ballentine, told Business Week: "It's very difficult to find much relationship between [corporate tax breaks] and investment. In 1981 manufacturing had its largest tax cut ever and immediately went down the tubes. In 1986 they had their largest tax increase and went gangbusters [on investment]."

Despite its advances, the 1986 Tax Reform Act did not end corporate depreciation subsidies. Even today, businesses are allowed to write off the cost of their machinery and equipment considerably faster than it actually wears out—a subsidy estimated by the Joint Committee on Taxation to cost \$37 billion in fiscal 2000.

Moreover, when equipment is purchased with borrowed money, the current tax system produces outright "negative" tax rates—making such investments more profitable after tax than before tax! As a result, corporate buying and selling of excess tax breaks through equipment "leasing" deals have remained widespread. Indeed, leasing tax shelters received a substantial boost from legislation enacted in 1993 and 1997. These acts substantially gutted the 1986 reforms that had curbed excess depreciation of debt-financed capital outlays (as in common with leasing). As is well-known to tax professionals, the combination of debt-financing and accelerated depreciation typically produces negative tax rates. To curb such tax shelters, the 1986 act set lower depreciation write-offs under the Alternative Minimum Tax. Unfortunately, the 1986 AMT depreciation reforms have been repealed.

One can see examples of the sometime startling effects of the accelerated depreciation rules by a quick perusal of corporate annual reports. For example, in 1995,

Eastman Kodak paid an effective federal tax rate of only 17.3%—less than half the 35% statutory corporate tax rate—mainly because of \$124 million in tax subsidies from accelerated depreciation. Accelerated depreciation was one of the key reasons why American Home Products paid only a 15.6% tax rate on its \$4.2 billion in U.S. profits from 1992-94. Allied Signal got \$51 million in accelerated depreciation tax breaks in 1995, helping it pay a tax rate of only 10.7% on its \$3.4 billion in U.S. profits over the past four years. And General Motors received tax refunds totaling almost \$1.4 billion dollars in 1995 and 1996, despite reported U.S. profits of \$5.2 billion, apparently in large part due to depreciation tax breaks generated by its leasing activities.

Economists also complain—rightfully—that accelerated depreciation often skews investment decisions away from what makes the most business sense and toward tax-sheltering activities. This can, for example, favor short-term, tax-motivated investments over long-term ones.

With its huge cost, minimal direct value to most people and sad economic record, accelerated depreciation might seem to have little going for it. Yet several recent proposals would expand depreciation tax subsidies far beyond even their current levels. The GOP's 1995 "Contract With America" originally included a \$30-billion-dollar a year super-accelerated depreciation plan promoted by Budget Committee Chairman John Kasich (R-Ohio) that would have let companies write off more than they actually spent buying new equipment. A conceptually similar increase in depreciation write-offs is a key feature of the "flat tax" proposed by Rep. Dick Armey (R-Tex.) and endorsed by presidential candidate Malcolm S. Forbes, Jr. and former Rep. Jack Kemp.

Nevertheless, curbing or eliminating accelerated depreciation should be at the top of the list for those who really believe in attacking corporate welfare and curbing government waste.

2. Tax breaks for multinational corporations

Multinational corporations, whether American- or foreign-owned, are supposed to pay taxes on the profits they earn in the United States. In addition, American companies and individuals aren't supposed to gain tax advantages from moving their operations or investments to low-tax offshore "tax havens." But our tax laws often fail miserably to achieve these goals.

For example, IRS data show that foreign-owned corporations doing business here typically pay far less in U.S. income taxes than do purely American firms with comparable sales and assets.⁶ The same loopholes that foreign companies use are also

⁶See U.S. General Accounting Office, *Foreign- and U.S.-Controlled Corporations That Did Not Pay U.S. Income Taxes, 1989-95* (March 1999). According to GAO's analysis, the 15,363 large American companies studied paid an average of \$8.1 million in federal income taxes in 1995. In contrast, the 2,767 foreign-controlled corporations paid an average of only \$4.2 million in federal income taxes that year—only half what the U.S. companies paid. This was true even though the average amount of gross receipts reported by the foreign-

utilized by U.S.-owned multinationals, and even provide incentives for American companies to move plants and jobs overseas.

The problems in our taxation of multinational companies stem mainly from the complicated, often unworkable approach we use to try to determine how much of a corporation's worldwide earnings relate to its U.S. activities, and therefore are subject to U.S. tax. In essence, the IRS must try to scrutinize every movement of goods and services between a multinational company's domestic and foreign operations, and then attempt to assure that a fair, "arm's length" "transfer price" was assigned (on paper) to each real or notional transaction.

But companies have a huge incentive to pretend that their American operations pay too much or charge too little to their foreign operations for goods and services (for U.S. tax purposes only), thereby minimizing their U.S. taxable income. In other words, companies try to set their "transfer prices" to shift income away from the United States and shift deductible expenses into the United States. A 1992 Congressional Budget Office report found that "[i]ncreasingly aggressive transfer pricing by . . . multinational corporations" may be one source of the shortfall in corporate tax payments in recent years compared to what was predicted after the 1986 corporate tax reforms. Variants on the transfer-pricing problem—such as ill-advised "source" rules and statutory misallocations of certain kinds of expenses—expand the tax avoidance opportunities.

Let's say a big American company has \$10 billion in total sales—half in the U.S. and half in Germany—and \$8 billion in total expenses—again half and half (in reality). With \$1 billion in actual U.S. profits and a 35% tax rate, the company ought to pay \$350 million in U.S. income taxes. But suppose that for U.S. tax purposes, the company is able to treat 5/8th of its expenses—or \$5 billion—as U.S.-related. If you do the arithmetic, you'll see that leaves it with zero U.S. taxable profit. Although our tax system has rules to mitigate this kind of abuse, companies still have plenty of room to maneuver.

Here's a real-world example: In its 1987 annual report to its stockholders, IBM said that a third of its worldwide profits were earned by its U.S. operations. But on its federal tax return, IBM treated so much of its R&D expenses as U.S.-related that it reported almost no U.S. earnings—despite \$25 billion in U.S. sales that year. As a result, IBM's federal income taxes for 1987 were virtually wiped out.

A few years ago, Intel Corp. won a case in the Tax Court letting it treat millions of dollars in profits from selling U.S.-made computer chips as Japanese income for U.S. tax purposes—and therefore exempt from U.S. tax—even though a tax treaty between the U.S. and Japan requires Japan to treat the profits as American—and therefore exempt from Japanese tax! As too often happens, the profits thus became "nowhere income"—not taxable anywhere.

The official list of tax expenditures in the international area—totaling \$13.5 billion in

controlled companies was actually slightly larger than the amount reported by the American firms.

fiscal 2000—focuses on congressionally-enacted loopholes in the current “transfer pricing” approach. Thus, the list includes items such as indefinite “deferral” of tax on the profits of controlled foreign subsidiaries, misallocations of interest expenses, “source” rules that treat certain kinds of U.S. profits as foreign, and the Puerto Rican “possessions tax credit.”⁷ This list understates the total tax subsidies to multinational companies, however, because it does not challenge the basic, flawed approach to taxing multinationals that we current use.

To be sure, curbing the multinational tax breaks identified in the official list would be a good idea. But an even better approach would be to replace the current, complex “transfer pricing” rules with a much simpler formula approach that taxes international profits based on the share of a company’s worldwide sales, assets and payroll in the United States, as Senator Byron Dorgan (D-N.D.) has suggested. Exactly how much revenue could be gained by this kind of comprehensive international tax reform is unclear, but some estimates are on the order of \$20-35 billion annually.

Yet when proposals are made for even modest changes in the tax breaks for multinational corporations, Congress, in the face of overwhelming lobbying pressure from multinational companies, has resisted. President Clinton pledged major international tax reforms in his 1992 campaign, but Congress rejected even the rather timid changes he proposed in 1993. The President’s 1997 budget proposed \$6.3 billion in international tax reforms over the 1997-2002 period, but most of these were rejected as well. Likewise, when the Treasury Department discovered in late 1997 that it had itself inadvertently opened a major new multinational loophole by an ill-advised tax regulation and proposed to correct its mistake, Congress barred implementation of the correction (at least temporarily).

The very idea that our tax laws favor multinational corporations, including foreign owned ones, over purely domestic U.S. businesses should upset all of us.

3. The Research and Experimentation Tax Credit

The tax credit for research and experimentation was first enacted in 1981. It supplements the already extremely favorable tax treatment of research and development investments, which can be deducted immediately, rather than capitalized and deducted over time, as is the case with business investments in tangible capital assets.

The stated purpose of the R&E credit is to encourage business research that would otherwise not be undertaken because other investment opportunities would be more profitable. One has to wonder why Congress thinks it is appropriate to interfere with marketplace decisions in this way. In any event, up until now, the distorting effects of

⁷The official tax expenditure list also includes a tax exemption for most income earned by Americans working abroad. Although this item is treated as a personal tax expenditure, multinational companies say that it primarily benefits them by allowing them to pay lower wages.

the R&E credit have been fairly small. That's in part because, due to budget constraints, over its lifetime, the R&E credit has mainly subsidized research that was already planned or completed (that is, it has generally been extended for short periods, usually retroactively).⁸

The R&E tax credit has been modified many times over the years, in part to try to restrict its application to real scientific research (rather than, say, development of an improved Chicken McNugget). Recently, the IRS proposed a regulation to implement congressional intent in this regard by requiring, among other things, documentation of scientific purpose and methods for "research" investments to qualify. The proposed regulation has caused a firestorm of complaints from the affected companies.

Yet it is quite clear that when the government subsidizes basic scientific research (which the market arguably does neglect) through direct spending programs it explicitly requires a showing by prospective grantees that a real scientific approach and purpose will be utilized. Thus, lobbyists who argue for a looser standard for the R&E tax credit and who argue that the IRS has "little understanding of the way technology companies work"⁹ are implicitly endorsing a common defect of tax-based subsidies: the lack of oversight by a qualified agency. We would not tolerate such a lack of oversight in the case of direct spending. Why are we so tolerant in the case of a tax-based subsidy?

Useful business research is undeniably a good thing. But so are many other business activities. Research is also highly profitable, especially in our technology-dominated world. There is no reason why Congress should try to encourage such investments (at the expense of alternative investments) when they are not otherwise profitable.

4. Business Meals and Entertainment Subsidies

Under current law, spending on meals that bear a "reasonable and proximate relationship to a trade or business" and are "conducive to a business discussion" are both 50% deductible and excluded from the income of the recipients. There's no requirement that business actually be discussed, either before, during or after the meal. Likewise, entertainment outlays—for golf, hockey tickets, etc.—are 50% deductible if the taxpayer has more than a general expectation of deriving income or a specific trade

⁸Some companies that take advantage of the R&E credit admit the obvious: that they would do extensive R&E even without a subsidy. For example, Applied Materials, which is lobbying for an extension of the R&E credit, notes in a filing with the SEC: "Applied Materials' long-term growth strategy requires continued development of new semiconductor manufacturing technology. The Company's significant investment in research, development and engineering (RD&E) has generally enabled it to deliver new products and technologies before the emergence of strong competition." The semiconductor maker reports \$8 million in R&E tax credits in 1998. See "Does high-tech research require a tax break? Multi-billion dollar firms get a tax break and almost nobody is complaining," by David Bowermaster, MSNBC, Mar. 12, 1999.

⁹See BNA Daily Tax Report, Apr. 28, 1999, p. G-5.

or business benefit (other than goodwill) from the activity, or more liberally, if the entertainment is directly preceded or followed by a substantial and bona fide business discussion. Such a discussion does not have to occur on the same day as the entertainment, nor does it have to last as long.

The problem is not merely that these rules are hopelessly open to abuse—although of course they are. The fundamental problem is that no matter what the technical rules, the deduction/exclusion for meals and entertainment is considered by almost every disinterested analyst as an abuse of good tax policy. Recognizing this fact, defenders of write-offs for business meals and entertainment generally do not focus on tax policy issues. Instead, they attempt to defend the \$6.6 billion annual cost of these deductions as justifiable government subsidies to the restaurant, resort and entertainment industries.

Now if one were to make a list of government spending priorities, a subsidy for business men and women's eating, drinking and entertainment would seem to be very near, if not at, the bottom of the list. (Perhaps subsidizing business people's purchases of jewelry or furs would rank even lower.) So how can we possibly justify higher taxes on the general public or reductions in important government services to fund such a peculiar entitlement program?¹⁰

III. Conclusion

The notion that many of the provisions of the Internal Revenue Code are really hidden spending programs is a well-known fact to the special interest groups that lobby for the loopholes. Indeed, these interests usually prefer to get their subsidies through the tax laws—not only because the benefits are disguised, but because once enacted, they typically remain in the law as permanent entitlements.

At a time of intense, critical scrutiny on direct government programs, it's especially important to focus on the hundreds of billions of dollars in "hidden entitlements" buried in the tax code. Far too many of these tax subsidies amount to welfare for corporations and the rich. They often involve the government in what it usually does not do well—trying to make decisions for businesses, investors and consumers—and as a result, they harmfully distort private economic choices. Their huge cost crowds out funds for what the government ought to be doing better—building the roads, promoting education, stopping crime, protecting the environment and so forth. And

¹⁰Lobbyists for the business meals deduction have recently come up with a novel argument for actually expanding their subsidy. They maintain that if the government decides to increase the minimum wage for low-income workers, then it's only fair to do something for better-off business people, too. As the Washington Post (May 3, 1999, p. A2) reports, in connection with the proposed increase in the minimum wage, "table-service restaurants want to increase the business meal tax deduction from 50 percent to 80 percent. That change . . . would affect eateries ranging from elegant Washington bistros to hotel and chain restaurants across the country, could cost \$3 billion."

they make our tax laws much too complex.

In short, while not all “tax expenditures” are evil, many of them undermine tax fairness, impede economic growth and divert scarce tax dollars away from better uses. If we hope to “reinvent government” to make it more effective and less burdensome—in short, a better deal for ordinary American families—then scaling back wasteful and pernicious tax loopholes should be at the top of the agenda.
