MANHATTAN INSTITUTE FOR POLICY RESEARCH

ISSUES 2012 | No. 9 April 2012

# HOW TAX EXPENDITURES HURT THE ECONOMY—AND WHAT TO DO ABOUT IT

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As we approach the deadline for filing income-tax returns, a renewed focus has emerged on "tax expenditures." These are reductions in taxes owed, which occur when taxpayers avail themselves of provisions in the tax code such as the deductions for mortgage interest, state and local income and property taxes, and charitable contributions. Such aspects of the tax code have come under attack for disproportionately benefiting upper-income earners. Indeed, in a March 13 *New York Times* article, Eduardo Porter writes that "the $1 trillion in tax breaks mostly benefits those higher up the income ladder."[1]

There is much to question about the assumptions underlying this perspective. It is crucial to keep in mind that, in fiscal year 2009, the top half of earners paid 97.8 percent of federal income taxes, the top 10 percent paid 70.5 percent, and the top 1 percent paid 36.7 percent.[2] That is why upper-income earners get more benefits from tax expenditures. If the tax system were not as progressive as it is, upper-income taxpayers would not benefit from tax expenditures.

The wealthy are not the only beneficiaries of tax expenditures, however. Lower-income taxpayers benefit disproportionately from refundable tax benefits such as the Earned Income Tax Credit, the Refundable Child Credit, and the Making Work Pay credit. The federal government spent over $100 billion in 2011 on these refundable tax credits. In general, a family of four making $50,000 will pay no income taxes.[3]

More broadly, it is important to keep in mind that the major problem with tax expenditures is not the benefits that they provide for the wealthy, who already pay the largest share of taxes, but the ways in which they distort behavior, leading to inefficiencies in the economy.

Published by the Manhattan Institute

Consider some of the tax expenditures with the greatest cost:

Employer-provided health insurance as a tax-free benefit has prevented the development of a private market in health insurance, similar to private markets for home insurance and auto insurance. In 2011, this benefit reduced federal tax revenue by $109.3 billion.[4] This has led to the current problems with health insurance, culminating in the Patient Protection and Affordable Care Act, with its own serious implications for federal debt and deficits.

Deductions from federal taxable income for state and local taxes reduced tax collections by $42 billion in 2011 and, if eliminated, would bring in an additional $230 billion in revenue from 2011 through 2015, according to the Joint Tax Committee. Under the current system, all taxpayers are subsidizing those states with high state and local taxes and who have decided to have exceptionally large public-sector workforces.

The mortgage-interest deduction was put into place to encourage homeownership because homeowners generally keep their property in better condition than do renters. In 2011, this benefit reduced federal tax revenue by $76 billion.[5] Although intended to raise the quality of America's housing stock, this deduction was instrumental in the housing crash of 2006. Without the mortgage-interest deduction, it is likely that individuals would have purchased smaller houses—and been less likely to get in over their heads, financially.

Tax expenditures amounted to over $1 trillion in the government's 2011 fiscal year (which ended September 30). That is why many deficit reduction plans want to shrink them.[6] Those on the left of the political spectrum seek to eliminate tax expenditures as a way of raising revenue. Those on the right want to lower tax rates, keeping revenue collected by the federal government at the same level as it stands now.

What should be done? Eliminating all such deductions and credits, including deductions for mortgage interest and state and local taxes, as well as tax-free employer-provided health insurance, would be desirable as long as rates decline such that aggregate tax receipts do not initially rise. Higher government revenues mean higher taxes for families that can just barely afford to meet expenses today and may not be able to afford them tomorrow. That is bad news for the tens of millions of Americans who are struggling to work their way out of the recession.

Cuts in tax expenditures, both individual and corporate, must therefore be balanced with lower rates so that tax reform is initially revenue-neutral and not a tax increase in disguise. Then a more efficient tax system will be able to generate higher economic growth, higher tax revenues, and a lower deficit. A more efficient tax code would eliminate tax expenditures and use the revenue to lower rates, leaving the revenue collected by the government initially equal. Then economic growth would spur additional tax collections. This approach, recommended by advocates of fundamental tax reform, would leave aside specific benefits promoted by tax breaks for charitable deductions and mortgage interest but would generate increased benefits from lower rates.

However, most deficit reduction plans—such as those put forward by President Obama's deficit reduction commission, the Bipartisan Policy Center Debt Reduction Task Force, and National Bureau of Economic Research president emeritus Martin Feldstein, the distinguished Harvard economist—are not revenue-neutral. They do not lower rates enough to make up for eliminating tax expenditures, and, consequently, they raise Treasury revenues. Historically, that has raised spending and expanded government functions, leading to lower economic growth.

Advocates of curtailing or eliminating tax expenditures say that they are not raising taxes because the tax rates remain the same or fall. This is disingenuous because tax collections rise. Legislated increases in tax revenues, whether through higher rates or reduced tax expenditures, discourage economic growth. With lower rates, economic recovery and higher employment eventually would raise the ratio of revenue to gross national product, reducing the deficit.

For instance, the president's deficit reduction commission sought to lower individual income tax rates to 8 percent, 14 percent, and 23 percent and the corporate rate, now 35 percent, to 26 percent, and eliminate all tax expenditures. It sounds as though taxes would be lower, but this would raise $785 billion between 2012 and 2020.[7]

The Debt Reduction Task Force, cochaired by Alice Rivlin and Pete Domenici, proposed raising taxes by $1.9 trillion from 2012 to 2020 by scaling back many tax expenditures.[8] Their report explains that "tax expenditures misallocate resources by promoting over-investment in tax-favored industries and over-consumption of tax-favored goods and services."[9]

It is misleading to lump all tax expenditures together. The Rivlin-Domenici team tries to sort out the good from the bad. For example, they would allow everyone to save $20,000 per year free of taxes, but they would raise taxes on capital gains and dividends to ordinary income rates—even though such taxes on capital would discourage investment.

What Congress should do instead is to take an even sharper knife to spending than authors of deficit reduction plans contemplate: eliminate proposed high-speed rail, devolve infrastructure spending and gasoline taxes to the states, gradually raise the Social Security retirement age, leave the slots of retiring federal workers unfilled, and expand competitive bidding for all Defense Department contracts.

The soundest way to reduce our deficit is through fundamental tax reform, which generates the economic growth that powers our economy. This means a revenue-neutral plan to get rid of tax expenditures and to lower tax rates, without raising overall levels of taxation. Raising taxes by eliminating tax expenditures, without a commensurate decline in tax rates, will only reduce economic growth.

### Table I: Selected Tax Expenditures, 2011 (in billions)

| | |
|---|---|
| Deduction of nonbusiness state and local government income taxes, sales taxes, and personal property taxes | $42.4 |
| | |
| Deduction for mortgage interest on owner-occupied residences | $77.6 |
| Deduction for property taxes on real property | $24.3 |
| Exclusion of capital gains on sales of principal residences | $18.4 |
| ***Subtotal*** | ***$120.3*** |
| | |
| Exclusion of employer contributions for health care, health-insurance premiums, and long-term-care insurance premiums | $109.3 |
| | |
| Credit for children under age 17 | $56.4 |
| Earned income credit | $59.5 |
| Making work pay credit | $15.5 |
| ***Subtotal*** | ***$131.4*** |
| Net exclusion of pension contributions and earnings | |
| Plans covering partners and sole proprietors (Keogh plans) | $14.2 |
| Defined benefit plans | $42.7 |
| Defined contribution plans | $48.4 |
| ***Subtotal*** | ***$105.3*** |
| Exclusion of Medicare benefits | |
| Hospital insurance | $30.3 |
| Supplementary medical insurance | $21.2 |
| Prescription drug insurance | $6.1 |
| ***Subtotal*** | ***$57.6*** |

Source: Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2011–2015," U.S. Government Printing Office, January 17, 2012, http://www.jct.gov/publications.html?func=startdown&id=4385.

## ENDNOTES

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[9] Ibid, p. 37.