

## CHAPTER FOUR

# Reduce Spending Through the Tax Code

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Each year, the tax code is used to hand out billions of dollars in subsidies to politically connected interests, picking winners and losers and distorting free markets. This spending persists without systematic review or annual appropriation. These programs operate like mandatory spending, outlays for which Congress has passed laws making permanent appropriations that it rarely reviews.

Most tax credits—the most popular way to spend through the tax code—are economically indistinguishable from direct spending. A lawmaker may want to subsidize electric vehicles because a new factory is opening in his district. Congress could propose a new program to send a \$7,500 check to qualifying purchasers of new electric cars. To meet the same goal, the same lawmaker could instead propose to cut taxes for those who purchase a new qualifying electric car by creating a \$7,500 tax credit.

In both cases, the lawmaker dedicates funding to the subsidy program in the federal budget. In the first case, the appropriations are regularly reviewed as part of the annual appropriations cycle, each cycle presenting an opportunity for a proper analysis of trade-offs between this subsidy and other federal spending priorities. Under a system of tax credits, the same outlay is considered off-budget and thereby not subject to any regular review. Congress changes how it labels the spending, and direct government spending is now called a tax cut.

### NOT ALL TAX EXPENDITURES ARE CREATED EQUAL

The concept of spending through the tax code walks a fine line that must distinguish a taxpayer's retention of his or her own money with an actual government expenditure of someone else's money. All analysis of tax expenditures, taken to its extreme, wrongly assumes that the government is entitled to spend the entirety of some arbitrarily defined tax base. However, narrowly tailored tax expenditures, which bestow concentrated benefits on select recipients, should be avoided in favor of better designed tax policy with well-defined rules broadly applied.

Further complicating the analysis of spending through the tax code, the current baseline for measuring tax expenditures as defined by the Joint Committee on Taxation and the Office of Management and Budget rests on an inconsistent definition of income, rendering tax expenditure analysis entirely subjective and unreliable. The government calculation of tax expenditures is misleading because it attempts to describe two separate phenomena. Many tax expenditures work to decrease harmful economic distortions by limiting some forms of double taxation that are built into the income tax system. True spending in the tax code (a subset of tax expenditures) is special-interest carve-outs, granting privileges to some at the expense of others.<sup>1</sup> Lawmakers should not confuse the two.

TABLE 1

## Tax Credits Suggested for Repeal

Tax Credit	10-Year Cost, in Millions
American opportunity tax credit and lifetime learning credit	\$182,385
Research and development tax credit	155,007
Low-income housing tax credit	89,298
Tax credit for orphan drug research	78,822
Energy production credit	38,097
Biodiesel credit	35,250
Credit for paid family and medical leave	25,589
Investment tax credit for energy	24,587
Credit for residential energy efficient property	19,436
Opportunity zones tax credit	16,000
New markets tax credit	13,176
Credit for employer FICA taxes on employee cash tips	12,753
Credits for clean-fuel burning vehicles and refueling property	9,415
Credit for nonbusiness energy properties	5,893
Credit for rehabilitation of historic structures	5,112
Credit for production from advanced nuclear power facilities	4,509
Enhanced oil recovery credit	4,194
Work opportunity tax credit	3,546
New energy efficient home credit	3,313
Empowerment zone tax incentives	3,208
Tax credit for certain railroad track maintenance	2,165
Credit for producing oil and gas from marginal wells	1,134
Indian employment tax credit	818
Credit for investment in clean coal facilities	747
Alcohol fuels credit	300
Disabled access credit	90
Credit for employer-provided child care	90
<b>Total</b>	<b>\$ 734,934</b>

**NOTE:** The 10-year period is from 2019 to 2028.

**SOURCE:** Author's calculations using the President's 2018 budget, Joint Committee on Taxation reports, and Congressional Budget Office alternative fiscal scenario. See Chapter 4, footnote 2, for details.

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## TAX CREDITS

A majority of tax subsidies are designed as tax credits, allowing a taxpayer to reduce his or her final tax bill by a set amount, dollar for dollar. The most numerous of these incentives are intended to encourage energy production and energy conservation.

As a policy tool, tax credits are poorly designed incentives; they introduce unnecessary complexity and ambiguity to the tax code and often poorly target the desired activity. Policymakers do no service to various technologies and companies by subsidizing them. Tax credits for a specific resource, technology, or narrowly described activity manipulate private-sector investment based on political agendas rather than market realities and create competition for subsidies rather than competitive companies.

Lost economic activity is greatest when the tax code, instead of being applied evenly, is applied through a corrupt political process. The government's use of the tax code to pick winners and losers has harmful economic effects on American families and businesses by limiting their access to market-determined products and generating a less dynamic economy.

Tax credits also obscure overall levels of true spending and revenue collection. The accumulation of special tax provisions increases the complexity of government activity, thereby increasing information asymmetries between government officials and citizens and allowing government budgets to expand beyond their normal democratic constraints. Tax credits contribute to a "fiscal illusion" whereby taxpayers are under the illusion that taxes are cut, shrinking government intervention. In reality, deficits increase, new market distortions are introduced, and the subsidy escapes the annual appropriations process, leading to an accumulation of market distortions that slow growth.

## TAX CREDITS TO REPEAL

The tax code contains a long list of tax credits, not all of which should be eliminated. For example, the credit for taxes paid to foreign governments on personal income earned overseas should be retained; it protects U.S. citizens from double taxation under our worldwide tax system and is a desirable feature of the tax code. Alternatively, Congress should eliminate the taxation of American citizens' worldwide income and tax only income that is earned in the United States.

With a few exceptions, however, the vast majority of tax credits are narrowly targeted subsidies and should be repealed. The *Blueprint for Balance* recommends repealing the full list of credits in Table 1, totaling \$735 billion over 10 years.<sup>2</sup> Each is subject to a variety of specific policy critiques and the more

broadly applicable critique that the tax code is not the appropriate tool for distributing subsidies even if they have political or economic benefits. The following sections highlight four major categories of spending in the tax code, followed by a full list of recommended credits for repeal and their estimated cost.

## Category 1: Repeal Tax Credits for Energy and Environment

### RECOMMENDATION

Repeal all 12 tax credits pertaining to energy production and the environment. This proposal would allow Congress to lower taxes by \$147 billion over 10 years.

### RATIONALE

Handouts to the energy industry carry a significant hidden cost to American taxpayers beyond lost revenue. Currently, 12 distinct tax credits for specific energy resources and technologies manipulate private-sector investment based on political agendas rather than market realities.

Private capital is limited. Technologies that do not receive subsidies appear to be more expensive, risky, or unpromising. By shifting the financial risk of energy projects indirectly to the taxpayer through the tax code, the government discourages private investments in projects that lack the government's blessing but may have more commercial promise. A dollar invested in a company benefiting from a tax credit cannot be invested simultaneously in another company, creating opportunity costs

where potentially promising but unsubsidized technologies may not receive investment.

Business models built around taxpayer-funded subsidies also distort the incentive that drives innovation. Preferential tax treatment reduces the necessity for an industry to make its technology cost-competitive, because the tax credit shields a company from recognizing the actual price at which its technology is economically viable.

Moreover, targeted tax credits give one technology a government-created price advantage over an unsubsidized competing technology. Companies that do not receive any preferential treatment consequently will lobby for it, demanding a level playing field. The end result is a hodgepodge of tax credits that benefit select technologies that Members of Congress support because supporting them benefits their districts or states. The only way to achieve a truly level playing field is by eliminating all sources of subsidies for all forms of energy.

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### ADDITIONAL READING

- Katie Tubb and Nicolas D. Loris, "Tax Extenders Would Make Energy Companies Dependent, Not Dominant," Heritage Foundation *Backgrounder* No. 3279, January 22, 2018.

## Category 2: Repeal the Research and Development Tax Credit

### RECOMMENDATION

Repeal the research and development tax credit. This proposal would allow Congress to lower taxes by \$155 billion over 10 years.

### RATIONALE

Capital investments, including research and innovation, are important for a flourishing economy, and tax policy should establish a framework in which such investment is not discouraged. However, tax expenditures should aim to promote neutrality

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rather than, by their design, give some firms or sectors an advantage over others.

The research credit permits a tax credit of up to 20 percent of qualified research expenditures in excess of a base amount and has a small and uncertain ability to increase private research spending, amounting to a dollar-for-dollar increase in private R&D for each dollar of tax subsidy. Government-incentivized research does not significantly increase measures of innovation and may even reduce the quality of research.<sup>3</sup> Low-quality research stems from imprecise definitions of qualified research set by bureaucrats in Washington. It is nearly impossible for governments to target socially beneficial R&D successfully: The best mechanism for development

of cutting-edge technologies is the free market, not government bureaucrats.

Because the credit cannot be precisely defined, businesses are incentivized to spend large amounts of time and money lobbying Congress and tax regulators to ensure that the credit is tailored to suit their specific interests. Taxpayers claiming the credit and administrators enforcing it spend large amounts of time and money trying to interpret, litigate, and follow the law. The complex rules and formulas are used chiefly by the largest corporations, leaving smaller competitors at a disadvantage.<sup>4</sup> A better and more neutral way to encourage innovative business investment is to allow all businesses to expense all of their expenditures.

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#### ADDITIONAL READING

- Jason J. Fichtner and Adam N. Michel, “Can a Research and Development Tax Credit Be Properly Designed for Economic Efficiency?” Mercatus Center at George Mason University, *Mercatus Research*, July 2015.

### Category 3: Repeal the Tax Credit for Low-Income Housing

#### RECOMMENDATION

Repeal the Low-Income Housing Tax Credit. This proposal would allow Congress to lower taxes by \$89 billion over 10 years.

#### RATIONALE

The Low-Income Housing Credit Program (LIHCP) is intended to encourage the provision of low-income rental housing. It achieves its goal poorly and primarily benefits special-interest groups and investors.<sup>5</sup>

Taxpayers making equity investments in eligible housing projects that offer low-income housing can access a tax credit for a 10-year period. The annual credit is 4 percent of the project cost (a 30 percent subsidy) for projects using tax-exempt bonds and 9 percent for other projects (a 70 percent subsidy). More than two-thirds of the subsidy is captured by investors and parties other than low-income tenants.<sup>6</sup>

The LIHCP is a complex system that requires developers to expend a considerable amount of energy in order to adhere to all of its construction, occupancy, and administrative rules and regulations. LIHCP projects cost 20 percent more per square foot than medium-quality market housing projects and are less cost-effective than other direct subsidy programs.<sup>7</sup> The program is widely abused by tenants occupying housing for which they are not eligible, by developers who inflate their costs to receive excess tax credits, and by government officials using their discretionary powers to award credits for personal gain.

The LIHCP should be eliminated, and efforts should be made to increase the supply of affordable housing by reducing the considerable government-imposed barriers to construction.

## ADDITIONAL READING

- Adam N. Michel, Norbert Michel, and John Ligon, “To Reduce Corporate Welfare, Kill the Low-Income Housing Tax Credit,” *Heritage Issue Brief* No. 4832, March 28, 2018.

## Category 4: Repeal Tax Credits for Higher Education

### RECOMMENDATION

Repeal the American opportunity and lifetime learning tax credits. This proposal would allow Congress to lower taxes by \$182 billion over 10 years.

### RATIONALE

The American opportunity tax credit (AOTC) and lifetime learning credit (LLC) are subsidies for higher education tuition and other qualifying expenses. Federal policy should not subsidize any one post-secondary education or training option.

The AOTC is a \$2,500 credit, available for the first four years of higher education. If one has a zero tax liability, up to \$1,000 of the credit is “refundable,” meaning that it becomes a direct transfer payment. The LLC is a nonrefundable \$2,000 credit. Taxpayers cannot claim both credits in the same year, and

each has income thresholds at which the benefits phase out.

Much like other federal subsidies for higher education spending, such as federally subsidized loan programs, the AOTC and LLC have contributed to the precipitous rise in the cost of a college degree. The myriad sources of federal funds for higher education has removed any incentive for colleges and universities to keep tuition costs low. The significant increase in college tuition rates only increases student reliance on loans and tax incentives to finance higher education.

Eliminating the AOTC and LLC will help to put pressure on colleges and universities to manage tuition costs and will streamline the tax code by eliminating a source of unnecessary complexity.

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## ADDITIONAL READING

- Mary Clare Reim, “Private Lending: The Way to Reduce Students’ College Costs and Protect America’s Taxpayers,” *Heritage Foundation Background* No. 3203, April 27, 2017.
- Mark J. Warshawsky and Ross Marchand, “Dysfunctions in the Federal Financing of Higher Education,” *Mercatus Center* at George Mason University, *Mercatus Research*, January 2017.

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## ENDNOTES

1. Veronique de Rugy and Adam N. Michel, "A Review of Selected Corporate Tax Privileges," Mercatus Center at George Mason University, *Mercatus Research*, October 2016, <https://www.mercatus.org/system/files/mercatus-de-rugy-corporate-tax-privileges-v1.pdf> (accessed April 27, 2018).
2. Author's calculations based on expenditure reports from the President's 2018 budget, various JCT reports, and CBO alternative fiscal scenario revenue projections. Credit values from before TCJA reduced by 10 percent, however the economics of each individual credit, and how they interact with one another, will vary significantly. Office of Management and Budget, "Analytical Perspectives: Tax Expenditures," Fiscal Year 2019, [https://www.whitehouse.gov/wp-content/uploads/2018/02/ap\\_13\\_expenditures-fy2019.pdf](https://www.whitehouse.gov/wp-content/uploads/2018/02/ap_13_expenditures-fy2019.pdf) (accessed May 3, 2018); Joint Committee on Taxation, various reports (JCX-3-17, JCX-67-17, JCX-46-17, JCX-4-18, <https://www.jct.gov/publications.html> (accessed May 3, 2018); Congressional Budget Office, "Revenue Projections, by Category," April 2018, <https://www.cbo.gov/sites/default/files/recurringdata/51138-2018-04-revenueprojections.xlsx>, (accessed May 3, 2018).
3. Christof Ernst, Katharina Richter, and Nadine Riedel, "Corporate Taxation and the Quality of Research and Development," FZID *Discussion Paper* No. 66-2013, University of Hohenheim, Center for Research on Innovation and Services, 2013, <https://www.econstor.eu/bitstream/10419/69739/1/736810501.pdf> (accessed April 27, 2018).
4. Jason J. Fichtner and Adam N. Michel, "Can a Research and Development Tax Credit Be Properly Designed for Economic Efficiency?" Mercatus Center at George Mason University, *Mercatus Research*, July 2015, <https://www.mercatus.org/system/files/Fichtner-R-D-Tax-Credit.pdf> (accessed April 27, 2018).
5. Chris Edwards and Vanessa Brown Calder, "Low-Income Housing Tax Credit: Costly, Complex, and Corruption-Prone," Cato Institute *Tax and Budget Bulletin* No. 79, November 13, 2017, <https://www.cato.org/publications/tax-budget-bulletin/low-income-housing-tax-credit-costly-complex-corruption-prone> (accessed April 27, 2018).
6. Ed Olsen, "Does Housing Affordability Argue for Subsidizing the Construction of Tax Credit Projects?" March 24, 2017, revised July 26, 2017, prepared for presentation at a conference on housing affordability at the American Enterprise Institute, April 6, 2017, <http://eoolsen.weebly.com/uploads/7/7/9/6/7796901/olsenaehousingaffordabilityconferencepanel12rev.pdf> (accessed April 27, 2018).
7. Michael D. Eriksen, "The Market Price of Low-Income Housing Tax Credits," *Journal of Urban Economics*, Vol. 66, No. 2 (September 2009), pp. 141-149, (accessed April 27, 2018).