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A New Measure of Tax Expenditures to Support Pro-Growth Tax Policy

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The tax code is used by politicians to subsidize politically connected industries, promote charitable giving, make it easier to invest, and transfer money to families with children, among other subsidies. The current way Congress and the Administration tabulate these programs is through tax-expenditure reports, often called "spending in the tax code."

The calculation of tax expenditures is misleading because it attempts to describe two separate phenomena. First, some tax expenditures decrease harmful economic distortions by limiting some forms of double taxation that are built into the income tax system.[1] Second, many tax expenditures are true special interest carve-outs, granting privileges to some at the expense of others. For the first time since 2005, the President's budget includes a more consistent measure of tax expenditures.

A better accounting of tax expenditures would shine a light on tax-subsidy schemes, such as those included in the tax-extender bills that the House and Senate leaders continue to push.[2] It would also force policymakers to distinguish between pro-growth tax policy and other parts of the tax code. Changing the language that Congress uses for tax expenditures will make it easier to support good policies like the lower tax rate on capital gains, retirement savings accounts, and expensing for new business investments. These pro-growth reforms remove tax impediments to investments that expand economic opportunity.

Two Types of Tax Expenditures

The current baseline for measuring tax expenditures starts with a definition of a "normal law" baseline, which is similar to a comprehensive income tax. The comprehensive income tax "defines income as the sum of consumption and the change in net wealth in a given period of time."[3] Tax expenditure reports are traditionally created by the Joint Committee on Taxation (JCT) and the Office of Management and Budget (OMB). To get a normal law baseline, they begin with the income tax, and allow a standard deduction, personal exemptions, graduated individual (but not corporate) tax rates, double taxation of corporate income, and deductions for some expenses incurred in earning income.

Tax expenditures measured from an income tax base confuses two very distinct parts of the U.S. tax code. Many tax expenditures are true spending in the tax code, like tax-credit subsidies for energy production or income support through the Earned Income Tax Credit (EITC). Other parts of the tax code help to eliminate the income tax's built-in biases against savings and investment. Retirement saving accounts and lower taxes on capital gains are not spending in the tax code, for example.

In addition to mis-categorizing tax expenditures, few economists think that a pure income tax is the best tax system.[4] Instead, some form of a consumption tax that allows taxpayers to defer tax on income that is saved or invested is the most neutral treatment of income.[5] The President's 2020 budget notes that

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"comprehensive income does not necessarily represent an ideal tax base; efficiency or equity might be improved by deviating from comprehensive income as a tax base, e.g., by reducing the tax on capital income in order to further spur economic growth."[6] Calculating tax expenditures from the income tax base predisposes all tax reform debates against beneficial pro-growth features of the tax code.

Most of the Largest Tax Expenditures Are Not Spending

The President's budget analyzes the 24 largest tax expenditures, as normally calculated, under two alternative scenarios—(1) a comprehensive consumption tax base and (2) a comprehensive income tax base.

As the budget describes, both the income and consumption tax pose theoretical issues that require value judgments in order to fully determine any tax expenditure list. For example, under an income tax, should income that one immediately gives away be subject to tax? Or should charitable contributions be deductible (tax free)? Or, under a consumption tax, is a donation a form of consumption? Or should donations be deductible?

Table 1 shows how similar the government's current tax expenditure list is to a comprehensive income tax. However, under a consumption tax baseline, only eight of the 24 current largest tax expenditures would likely be counted.

If this analysis were to be completed with the full list of 172 tax expenditures, a similar trend would emerge. Pro-growth tax policies, like expensing and retirement savings accounts, would no longer be singled out as preferences. True spending in the tax code is all that would be left. This would allow lawmakers to evaluate the myriad tax credits and income exclusions on their relative merits without getting distracted by the currently mis-categorized pro-growth expenditures.

Many true tax subsidies do not make the top 24 list because narrowly tailored privileges are often small in dollar value compared to other more widely available provisions, but they also tend to be more numerous. By one count, true corporate subsidies make up about 65 percent of corporate tax expenditures, but only account for 17 percent of corporate tax-expenditure dollars.[7]

Spending in the Tax Code

Properly measured from a consumption tax base, tax expenditures are economically indistinguishable from direct spending. To subsidize electric vehicles, Congress could propose a new program to send a $7,500 check to qualifying purchasers of new electric cars. To meet the same goal, Congress could cut taxes for those who purchase a new qualifying electric car by creating a $7,500 tax credit.

By changing how it refers to the spending, Congress can relabel direct government expenditures as a tax cut. When the spending is appropriated through the regular process, the program is reviewed and subject to other competing priorities. Under a system of tax credits, the same outlay is considered off budget, and is similar to mandatory spending which Congress rarely reviews.

It Is Still Our Money. 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

1. Irving Fisher, "Income in Theory and Income Taxation in Practice," *Econometrica* (January 1937); Irving Fisher, "The Double Taxation of Savings," *American Economic Review*, Vol. 29, No. 1 (March, 1939); Norman B. Ture, "Supply Side Analysis and Public Policy," in David G. Raboy, ed., *Essays in Supply Side Economics* (Washington, DC: Institute for Research on the Economics of Taxation, 1982), http://iret.org/pub/SupplySideBook.pdf (accessed April 8, 2019); and Norman B. Ture, "The Inflow Outflow Tax—a Saving-Deferred Neutral Tax System," Institute for Research on the Economics of Taxation, 1997, http://iret.org/pub/inflow_outflow.pdf (accessed April 8, 2019).
2. Adam Michel, "Reintroducing Tax Subsidies That Benefit Only a Few Americans Is a Terrible Idea," The Daily Signal, February 6, 2019, https://www.heritage.org/taxes/commentary/reintroducing-tax-subsidies-benefit-only-few-americans-terrible-idea.
3. Office of Management and Budget, *Analytical Perspectives: Tax Expenditures*, Fiscal Year 2020, p. 172, https://www.whitehouse.gov/wp-content/uploads/2019/03/ap_16_expenditures-fy2020.pdf (accessed March 27, 2019).
4. Consumption taxes tend to be favored in the theoretical and empirical literatures. George R. Zodrow, "Should Capital Income Be Subject to Consumption-Based Taxation?" *Taxing Capital Income*, 2007, pp. 49–81, https://scholarship.rice.edu/bitstream/handle/1911/91720/rp_2006_002.pdf?sequence=1&isAllowed=y (accessed April 8, 2019).
5. David R. Burton, "Four Conservative Tax Plans with Equivalent Economic Results," Heritage Foundation *Backgrounder* No. 2978, December 15, 2014, http://thf_media.s3.amazonaws.com/2014/pdf/BG2978.pdf.
6. Office of Management and Budget, *Analytical Perspectives: Tax Expenditures*, p. 219.
7. Veronique de Rugy and Adam N. Michel, "A Review of Selected Corporate Tax Privileges," Mercatus Center at George Mason University, October 2016, https://www.mercatus.org/system/files/mercatus-de-rugy-corporate-tax-privileges-v1.pdf (accessed April 27, 2018).

TABLE 1

Consumption Tax: Fewer Large Tax Expenditures

	TAX EXPENDITURES		
	Normal Law	**Income Tax**	**Consumption Tax**
Exclusion of net imputed rental income on owner-occupied housing	Yes	Yes	Yes
Exclusion of workers' compensation benefits	Yes	Yes	Yes
Deductibility of mortgage interest on owner-occupied homes	Yes	Probably	Probably
Deductibility of nonbusiness state and local taxes other than on owner-occupied homes	Yes	Probably	Probably
Exclusion of Social Security benefits for retired workers	Yes	Probably	Probably
Child credit	Yes	Probably	Probably
Earned income tax credit	Yes	Probably	Probably
Exclusion of veterans death benefits and disability compensation	Yes	Yes	Probably
Exclusion of employer contributions for medical insurance premiums and medical care	Yes	Uncertain	Uncertain
Deductibility of charitable contributions, other than education and health	Yes	Uncertain	Uncertain
Deductibility of state and local property tax on owner-occupied homes	Yes	Probably	Uncertain
Deductibility of medical expenses	Yes	Uncertain	Uncertain
Deductibility of self-employed medical insurance premiums	Yes	Uncertain	Uncertain
Credit for low-income housing investments	Yes	Yes	Uncertain
Defined contribution employer plans	Yes	Yes	No
Lower rates on capital gains (except agriculture, timber, iron ore, and coal)	Yes	Yes	No
Reduced tax rate on active income of controlled foreign corporations	Yes	Yes	No
Capital gains exclusion on home sales	Yes	Yes	No
Exclusion of interest on public purpose State and local bonds	Yes	Yes	No
Defined benefit employer plans	Yes	Yes	No
Self-employed plans	Yes	Yes	No
Step-up basis of capital gains at death	Yes	Probably	No
Individual retirement accounts	Yes	Yes	No
Exception from passive loss rules for $25,000 of rental loss	Yes	No	No

SOURCE: Office of Management and Budget, "Analytical Perspectives: Tax Expenditures," Fiscal Year 2020, https://www.whitehouse.gov/wp-content/uploads/2019/03/ap_16_expenditures-fy2020.pdf (accessed April 3, 2019).

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with an actual government expenditure of someone else's money. All analysis of tax expenditures, taken to the 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 as they distort markets, reduce output, and ultimately hurt jobs and wage growth.

Tax Extenders

Every few years Congress engages in a ritual extension of expiring tax provisions, most of which are targeted temporary subsidies.[8] Following the 2017 Tax Cuts and Jobs Act (TCJA), some observers hoped that lawmakers would keep their promise that tax extenders had been extended for the last time.[9] Many of the pre-tax reform extenders are no longer needed due to changes in the TCJA, and the rest are subsidies that should be allowed to expire.[10] However, a bipartisan group of lawmakers is again pushing to re-animate long-expired tax subsidies.[11]

Calculating tax expenditures from a consumption baseline would shine a light on corrupt subsidy schemes that exist to enrich a few well-connected industries and lobbyists. Today, these provisions can hide among the good tax expenditures like those that protect every American's retirement savings from being taxed twice.

What Can Congress Do?

To better distinguish between types of tax expenditures, Congress should amend the Congressional Budget and Impoundment Control Act of 1974 to specify that those undertaking the tabulation of tax expenditures use a comprehensive consumption tax base rather than the current normal law income tax base. Short of amending the 1974 act, the JCT should follow the lead of OMB and begin reporting a second list of tax expenditures from a consumption baseline.[12]

The current accounting of tax expenditures forces pro-growth tax reformers to continually defend each of the important policies that lower the double tax on saving. A better accounting of tax expenditures from a consumption tax base would make it easier to support and expand existing pro-growth reforms to allow for an even more robust economy that is supported by additional investment and saving.

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8. Adam N. Michel, "Stop Extending Bad Policy—Let the Tax Extenders Die," Heritage Foundation *Issue Brief* No. 4809, January 17, 2018, https://www.heritage.org/taxes/report/stop-extending-bad-policy-let-the-tax-extenders-die.
9. Kevin Brady, Naomi Jagoda, and Cristina Marcos, "House Approves $622B Tax Plan," *The Hill*, December 17, 2015, https://thehill.com/policy/finance/263590-house-approves-622b-tax-package (accessed April 8, 2019).
10. Erica York, "Recommendations to Congress on the 2018 Tax Extenders," Tax Foundation *Fiscal Fact* No. 584, April 2018, https://files.taxfoundation.org/20180416165154/Tax-Foundation-FF584.pdf (accessed April 8, 2019).
11. S. 617, Tax Extender and Disaster Relief Act of 2019, 116th Congress (2019–2020), https://www.congress.gov/bill/116th-congress/senate-bill/617/text (accessed April 27, 2019).
12. The 1974 act does not preclude producing an additional, parallel accounting of expenditures. Under President George W. Bush, the OMB set a precedent for such analysis by publishing a second list of tax expenditures and a discussion of the difference between official lists and those measured from a comprehensive consumption base.