2 Tax Expenditures
Some Effects & Considerations

I. Why Should You Care About Tax Expenditures (Preferences)?

There are many reasons to care about tax expenditures. For example, they carry out important public policies, influence individual behavior, affect the integrity of the tax system and have great impact on fairness. Tax expenditures operate more stealthily than direct spending because fewer people pay attention to discussions about specific tax laws—they find taxes too complicated or just too boring. But this ignorance is dangerous:

Much of government spending occurs via the tax code. The total cost of all federal income tax expenditures exceeds $1 trillion a year—most goes to individuals but billions of it go to corporations. This cost is more than the cost of defense spending or the cost of social security.

In 2017, the exclusion for employer health insurance premiums—the largest tax expenditure—by itself was just over $200 billion dollars. The Treasury estimates that over 10 years, the cost for this health benefit will be over $3 trillion. That's a lot of money! In 2018 employers spent almost $6,000 for the insurance for an employee who chose just individual coverage for themselves and almost $20,000 for an employer who chose a family plan. Employees usually pay deductibles and co-pays out of their own pockets—and that can be a lot. Still, they are getting tax-free the equivalent of thousands of dollars for insurance that people who don't have employer-provided health care aren't getting.

II. Tax Expenditures (Preferences) Influence Behavior

People often prefer goods and services that have a tax preference. For example, if I rent the house I live in for $2,000 a month, all of that money comes out of my after-tax income. In other words, if I am in the 10% tax bracket, I have to earn $2,222.22 to have $2,000 after I pay my 10% tax ($222.22) left over for rent. On the other hand, if I own the house I live in and pay in a monthly mortgage of $2,000 in mortgage payments, I don't have to earn so much before taxes. This is because federal tax law allows deductions for the interest on home mortgage loans. Let's assume that all the mortgage payment is in fact interest, which is often the case. Then, I only have to earn $2,000 to pay the mortgage, not $2,222.22. I have saved $222.22.

What does that mean in terms of my behavior? Well, let's say that I have a choice of renting a place for $2,000 a month or buying one with a mortgage of $2,000 a month. I might—in the absence of the preference—prefer to rent. For example, I like not having to take care of a house and lawn and I can pick up and move more easily if I don't own. It might also be better for me to rent for financial reasons such as I won't have to put so much of my savings into one asset (the house) and I'll have money for emergencies and also to just enjoy other things like a new car or traveling. It might even make sense for me to rent so that if a better job comes up in another location, it would be easier for me to move and so I'd be more likely to accept the job.

But the tax preference does not just affect me, it affects producers of the goods and services and ultimately the size of the economy. For example, too many people might invest their savings in housing rather than putting more of it in stocks or starting a business. This might lower the investment from their savings, or it might hurt them more drastically if the housing market crashes.

Overinvestment in housing can hurt the economy generally. The preference means more people want to buy houses so more money is invested in housing and that leaves less investment money for other productive parts of the economy (e.g., factories) and businesses have trouble hiring needed workers who are reluctant to move out of the area where they own a home.

Many experts think that one of the reasons health care cost are too high is that there are tax preferences for health insurance which leads to people getting more health insurance and health care than they really prefer. For example, let's say BigCo offers its employees $1,000 cash or $1,000 of health insurance. Some employees, like Eddie, really want and need only $900 worth of health insurance and $100 cash to buy other things. Eddie, for example, would buy some new clothes with the cash. Unfortunately, that can't happen under the two options BigCo is offering.

If Eddie chooses the $1,000 cash, he must pay tax on it. If his income tax bracket is 10%, he pays $100 tax and is left after-tax with $900. He'd have to use all of that to buy his health insurance and having nothing left over to buy the clothing.

If Eddie chooses the health insurance, he gets $1000 of health insurance because there is no tax on that. Although this choice gives Eddie more health insurance than he needs, he'll probably choose it because at least he is getting something with this option. With the other, choice he still doesn't get his clothing and he only gets $900 worth of insurance.

The tax preference for health insurance means there is a misallocation of funds in the economy—too much is spent on health insurance (which contributes to rising health care costs because of overuse of the health care system) and not enough on other things that people really want.

More on Tax Benefits and Behavior

Tax benefits affect both individual behavior and the economy, but not always in predictable ways. Assume that the legislator wants to encourage people to drink milk. There are many ways it could do this. It could enact some type of price control to limit the cost of milk to the consumer. Or it could enact some direct spending laws that for example, give people coupons (or rebates) for every quart of milk they buy. It could give money to dairy farmers or others involved in getting the milk to market. Or the government could enact a tax benefit that would give the money indirectly to the consumer or the producer by lowering their taxes.

All of these ways affect behavior. Price controls might increase demand for milk but decrease the supply of it because milk producers can't get the profit they want. Direct and indirect spending through the tax law both can lower the cost of producing and consuming milk. Some consumers may buy more milk at the lower price than they otherwise would have, but others would have bought it anyway—even if the cost did not decrease. To that extent the government is spending money without having any impact. If the government is subsidizing milk production, then some investors and businesses may decide it is more profitable to be in the milk business and switch their investments to growing fruits and vegetables (for example).

III. Are Tax Expenditures (Tax Preferences) a Good Idea?

The tax-free health insurance example shows that even a tax preference designed to promote a worthwhile goal like better health may have downsides. But is it worse that a program that directly spends money on healthcare by offering $1,000 to buy health insurance, for example? In other words, is it better for the government to spend money directly or through the tax system?

Here are just a few arguments for and against using tax expenditures to spend government money through the tax laws.

Enacting Good Policies and Visibility (Transparency) Arguments.

Direct government spending puts real money in people's hands (or bank accounts) but tax expenditures save people money only by reducing their taxes. This makes tax expenditures less visible (or transparent) to people than direct spending. Some people think this transparency is good because it allows Congress to enact policies that are good for the country but would be hard to get enacted because they are politically controversial. As an example, some people say that Congress could never have enacted a direct welfare program that is as generous as The Earned Income Tax Credit (EITC).

On the other hand, some people claim that tax expenditures are bad because the public are not interested in tax issues and are often confused by them. Therefore, the public is generally less aware of tax expenditures than direct expenditures by the government. This mean it is easier for the legislature to enact and maintain policies that the public does not support. For example, many people would object to the government sending rich hedge fund managers checks for thousands of dollars but in effect, that is what happens under a technical tax rule for something called "carried interest" which lowers the amount of taxes the hedge fund managers have to pay.

Some people also say that using the tax system to implement public policies hides the extent to which the government is spending money. That is why the federal government and many states are required by law to publish a list of their tax expenditures and their costs.

Administrative and Efficiency Arguments.

Some people believe that the tax system is the most efficient way to administer policies instead of using direct spending for a variety of reasons. For example, they argue tax expenditures are less costly because no new agencies have to be created and most people already file tax returns. Other people argue that indirect government spending through the tax laws is bad because, for example, it complicates the tax laws, or because IRS officials are not the best people to administer laws that are promoting policies beyond their expertise such as housing, education, or welfare.

Integrity of the Tax System

There are two major concerns when discussing tax preferences and the integrity of the tax system.

1 **What is a tax expenditure?**

Some people say the whole concept of tax expenditures makes no sense and should be abolished because it is impossible to accurately define what a tax expenditure is. In fact, two branches of government (the legislative and executive branches) produce different estimates of tax expenditures. The definition of an income tax expenditure hinges on a definition of income and people do not completely agree. For example, some people think the exclusion of gifts from income is a tax expenditure while others think that the definition of income does not include gifts.

Other people think that the concept of tax expenditures is valid. They say that although there is disagreement over a few items, most people agree about the vast majority of tax preferences.

2 **Effect of tax expenditures on compliance**

Tax expenditures may weaken compliance in at least two ways. First, since they complicate the tax laws, it may make it harder for some people to accurately determine what their tax liabilities are. This means they may inadvertently either over or underpay their taxes. Because the law is more complicated, it may also increase frustration with the tax system.

Second, some people may be less likely to pay their taxes because they feel that the effects of tax expenditures make the tax laws unfair. For example, they may be more likely not to report some income when they hear in the news about all the tax breaks the wealthy get that they don't. Or they may think it unfair that their friend who has the same amount of income they do pays less in taxes because of tax expenditures.

IV. Are Tax Expenditures Fair?

To better understand arguments about fairness, let's consider two taxpayers: Pat and Terry each have $50,000 of income and are subject to a 10% income tax. They each pay $5,000 of income tax. The government has $10,000 which it uses to provide the goods and services the legislature enacted.

Now, let's say that under a new tax preference passed by Congress, Pat gets a $1,000 tax benefit and pays only $4,000 in taxes. Terry still pays $5,000. Some people say this is fair because the government isn't really spending money; it is just letting Pat keep Pat's own money. But why is this different than the government collecting $10,000 and giving $1,000 to Pat? How do we know that the $1,000 comes from Pat and not Terry? Note, also, that the government now only has $9,000 to provide the $10,000 worth of goods and services that the laws require. Where is it going to get that money?

Consider Pat and Terry who both have taxable income of $45,000 which they earn by working as electricians but for different companies. They both also have health insurance that costs $6,000, but Pat's employer provides theirs while Terry must purchase it themselves. Terry has to earn $7,500 dollars, pay 20% tax on it ($1,500) and then use the remaining $6000 dollars to buy the insurance. The tax preference for employer-insurance excludes the $6,000 value from Pat's income. As a result, Pat's taxable income remains $45,000 even though Pat is really receiving economic income of $51,000 ($45,000 salary + value of the insurance).

Some people say that tax preferences are not fair because two taxpayers with the same income often end up paying very different amount of taxes—like Pat and Terry after Congress passed the tax preference. Others say since the tax expenditure is no different than direct spending, the situation is no different than direct spending. In both, two people—each with the same income—may receive different benefits from the government. Those against tax expenditures on fairness grounds respond that spending through the tax laws creates tax burdens that look very unfair and make people distrust the government which will, in turn, make them less willing to pay their taxes.

Some people also say that the tax preferences are unfair because they actually help the rich more. Studies show that richer taxpayers benefit more than lower income taxpayers from many tax benefits—such as the home mortgage interest deduction and the exclusion from taxes of employer health insurance premium.

Another fairness criticism of tax expenditures is based on equity issues of race and gender. For example, studies show that minorities as a whole get fewer benefits from tax expenditures for homeowners than whites and women get fewer business-related tax benefits than men. Document 6, *Distribution of Tax Benefits*, contains several questions that allow the reader explore some fairness issues.

V. Summary: Major Points to Remember

1 Indirect spending is huge part of government expenditures.
Repealing a $100 tax expenditure would not bring in exactly $100 of revenue for a variety of reasons. For example, changes in tax laws affect people's actual behavior. Even so, the amount of government spending through the tax laws is so enormous that it's impossible to rationally think about government spending without thinking about tax expenditures or benefits.

2 Tax preferences do not simply return a taxpayer's own money; they give other taxpayers' money to the taxpayer who gets the benefits.

3 Tax expenditures affect individual behavior and also the behavior of the economy as a whole.

4 Tax expenditures have positive and negative aspects. Some people think they should be removed from the tax laws; others think they are a good idea. Can you identity some?

5 Some people think tax expenditures are unfair because they treat some people with the same amount of income differently from other people with the same amount of money.

6 Tax expenditures are not distributed evenly across taxpayers. There are gender, racial and wealth disparities.

VI Some Resources You May Want to Look At

Estimates of Federal Tax Expenditures for Fiscal Years 2018-2022 (2018) *JCX-81-18 at* https://www.jct.gov/publications.html?func=startdown&id=5148 , 35 - 40, *Table 3 Distribution by Income Class of Selected Individual tax Expenditure Items* [$ in millions; returns in thousands]. [government source]

https://www.cbpp.org/research/federal-tax/policy-basics-federal-tax-expenditures [left of center source]

https://taxfoundation.org/corporate-individual-tax-expenditures-2017/ [right of center source]

Anna Wilde Mathews, "Employer-Provided Health Insurance Approaches $20,000 a Year" *Wall St. J* Oct. 4, 2018 https://www.wsj.com/articles/employer-provided-health-insurance-approaches-20-000-a-year-1538575201?mod=searchresults&page=1&pos=3

https://home.treasury.gov/policy-issues/tax-policy/tax-expenditures