

TAX EXPENDITURES— The Hidden Entitlements

Citizens for Tax Justice

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A Joint Project of Citizens for Tax Justice & the Institute on Taxation and Economic Policy

Notes on the 1996 Edition of The Hidden Entitlements

This is the second edition of The Hidden Entitlements, Citizens for Tax Justice's comprehensive analysis of the hundreds of government entitlement programs hidden in

the federal tax code. Since last year's edition, we have updated the cost estimates for "tax expenditures" to cover fiscal years 1996-2002, the same seven-year period about which the recent and ongoing battles to balance the federal budget have been fought. The updated estimates are based on the latest published information from the U.S. Treasury Department and the congressional Joint Committee on Taxation, supplemented by data from the Institute on Taxation and Economic Policy's Microsimulation Tax Model. (ITEP is a non-profit research and education organization that often collaborates with CTJ on research projects.) Using the ITEP model, we have also expanded our distributional analyses of various tax provisions, at calendar 1996 levels. We hope the new report will be useful to both policymakers and concerned citizens who care about responsible and fair federal budget policies.

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Michael P. Ettlinger, CTJ's Tax Policy Director, is also the chief architect of the ITEP Microsimulation Tax Model. His tireless efforts are responsible for most of the details in this report about the distribution of various tax expenditures.

—Robert S. McIntyre
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May 1996

The Hidden Entitlements

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TAX EXPENDITURES—

The Hidden Entitlements

PART I

An Overview of Tax Expenditures

“Addressing the problems of the poor, Gingrich asked: ‘Don’t we have to bring the poor with us? Maybe we need a tax credit for poor Americans to buy a laptop.’”

—The Washington Post, Jan. 6, 1995, reporting on House Speaker Newt Gingrich’s Jan. 5 testimony before the House Ways and Means Committee

On Thursday, January 5, 1995, his second day as Speaker of the House, Rep. Newt Gingrich (R-Ga.) suggested a new federal spending program for poor families—one that would appear to cost as much as \$25 billion. A few weeks later, Gingrich admitted his off-the-cuff idea to buy every poor American a laptop computer was “dumb.” But why would a man who usually rails against federal spending be so extraordinarily cavalier about such an expensive new program? For one simple reason: in Gingrich’s mind, he hadn’t called for more government spending, but instead had proposed a tax cut! Rather than having the Department of Health and Human Services buy computers for the poor, the checks would be written by the Internal Revenue Service. That might look like a distinction without a difference, but for Gingrich it appears to have made the potentially enormous cost of his plan irrelevant.

“Tax expenditures” is the official term used to describe the vast array of government spending programs that are implemented through the Internal Revenue Code—programs that will total \$3.7 trillion over the next 7 years. As the congressional 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.”¹

What makes tax expenditures similar to spending programs is that they are special tax provisions that are designed to accomplish some social or

¹Joint 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).

economic goal unrelated to equitable tax collection. They are like “entitlements” because they are not subject to annual budget appropriations, but are paid out to any business or individual that meets the eligibility rules, regardless of the total cost.

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, by reducing income taxes for low-income workers, including tax “refunds” for those who owe no income tax.

In fact, the government does all three of these things. 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 substantial “earned-income tax credit” to low- and moderate-income working families.

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, especially organized business interests.

Many personal income tax subsidies offer much larger benefits to well-off people than to average families, not just in dollars but even in percentage terms. A deduction for \$1,000 in mortgage interest, for example, is worth \$396 to a 39.6% top-bracket taxpayer, but only \$150 to a 15%-bracket home-owning family of four earning \$40,000. And it’s worth nothing at all to the majority of taxpayers who don’t itemize.

By law, the congressional Joint Committee on Taxation and the Treasury Department must issue reports each year listing tax expenditures and their estimated cost. (The two lists are almost identical.) These “tax expenditure budgets” are designed to be informational rather than prescriptive, so they include almost any tax provision that can plausibly be characterized as the equivalent of a direct spending program. In some cases, however, an item listed as a tax expenditure may not really be a subsidy. Instead, it might be defensible on pure tax policy grounds as a proper adjustment in computing ability to pay taxes.

For example, deductions for state and local income and property taxes are included in the official tax expenditure budgets. Some might say, however, that the state and local taxes a family pays reduce its ability to pay federal taxes, and thus that deductions for those expenses should not be considered a subsidy. In other words, it’s argued, a New York family

making \$75,000 a year in total income has a lower ability to pay federal taxes than a Texas family with the same income, because the New York family pays higher state and local taxes. The deduction for extraordinary medical expenses has been defended on similar ability-to-pay grounds, as has the charitable deduction (at least for cash donations).

These arguments are not universally accepted, however. For example, in 1984, the Reagan Treasury contended that (a) homeowner property taxes provide direct, measurable benefits to families that pay them, such as better schools, trash collection, etc.; (b) families living in areas with low property taxes get fewer of these services or must purchase them privately; and therefore (c) fairness dictates that property taxes should not be deductible. (Congress rejected Treasury's argument.) Because there is honest disagreement over whether deductions for state and local taxes, large medical costs and charitable donations are proper adjustments in computing ability to pay taxes or are instead subsidies, they are included in the tax expenditure budget for informational purposes.

Although the rule of thumb is to include in the tax expenditure budget any tax provision that is arguably a subsidy, there are some items that look remarkably like subsidies but are not included on the official tax expenditure lists. For example, the tax code allows a deduction for half of amounts spent on "business meals and entertainment." Lobbyists for restaurants, golf courses, and professional sports argue strenuously that such write-offs are not only a necessary subsidy to their industries, but are also proper deductions in computing net business income. Many people, however, wonder why the government is targeting \$6 billion a year to help pay for executives to eat at nice restaurants and attend expensive sporting events, while most people must pay for such things out of their after-tax earnings. Yet this apparent subsidy is not included in either of the official tax expenditure reports.

Despite some controversy at the margins over what should or should not be termed a "tax expenditure," most of the items on the official tax expenditure lists—from mortgage interest deductions to capital gains breaks—are generally agreed to be deviations from normal tax policy that are functionally equivalent to spending programs. These tax entitlements loom very large in the overall budget picture. In fact, the total tax expenditure budget comes to about \$455 billion in fiscal 1996. That's two and a half times as much as all means-tested direct spending programs cost. In fact, it's almost as much as the government spends on defense and interest on the national debt combined.

Size alone would seem to mandate that any serious analysis of possible ways to cut federal spending and reduce the budget deficit must

include tax subsidies within its scope. And like other spending programs, tax expenditures 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?

Before getting to the details of particular tax expenditures, 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 housing 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 fraud and inefficiency in the administration of the program. Tax-based subsidies for donations of artworks to museums, for example, have been scandal-ridden for decades. Hugely expensive business tax expenditures purportedly designed to encourage productive investment have been perverted into tax shelters and corporate "leasing" scams. Even the earned-income tax credit has been criticized over the years, both for its failure to reach many of those who are its intended beneficiaries and conversely for insufficient policing against fraudulent claims.

Another basic question about tax-based subsidies involves their "entitlement" nature. As such, they run on auto-pilot once they are put into the tax code. In contrast, so-called "discretionary" 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. Under current law, discretionary spending is subject to a hard freeze for most of the rest of this decade. In fact, under the President's proposed 1997 budget and GOP budget plans, too, such spending will be frozen at about \$540 billion a year through fiscal 2001, unadjusted for inflation or population growth, and will go up only with inflation in fiscal 2002. That means an inflation-adjusted reduction in such programs of 13% over that period and a 26%

cut as a share of the economy. In contrast, the total cost of tax expenditures is expected to rise from \$434 billion in fiscal 1995 to \$609 billion in fiscal 2002. Thus, while discretionary spending must shrink radically as a share of the economy, tax expenditures will grow by 17% in constant dollars—just about keeping pace with the economy.

If 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.

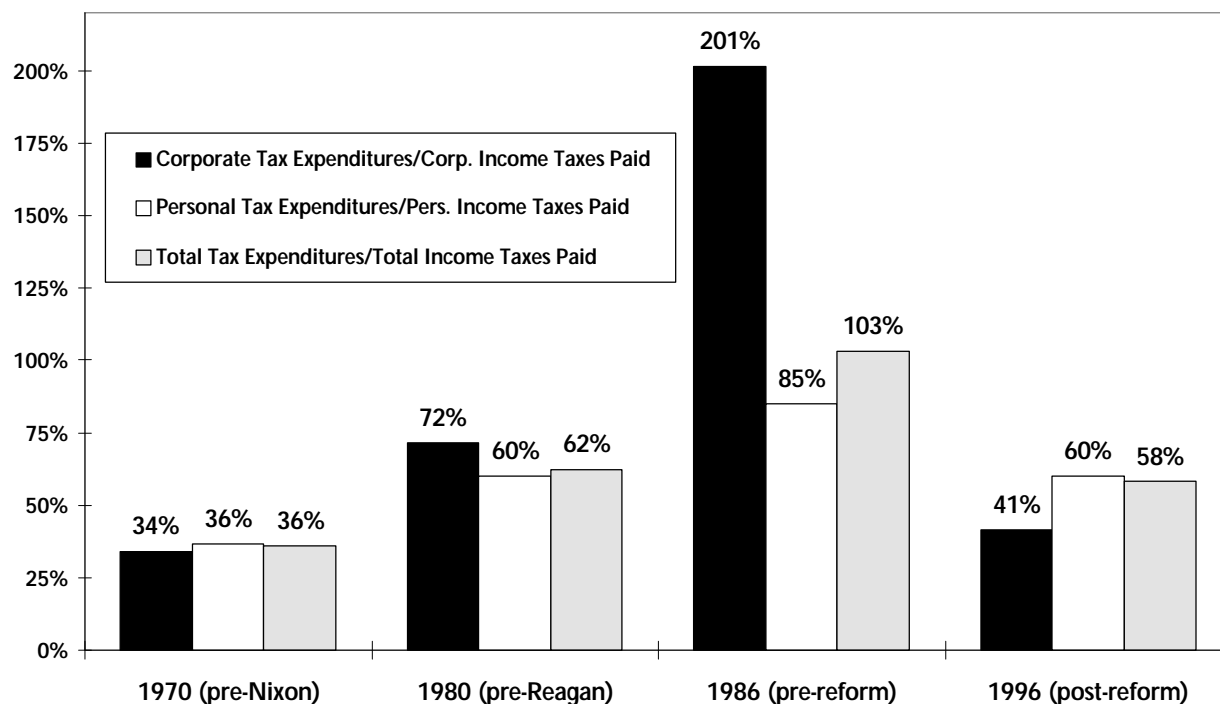
For example, when tax expenditures for Individual Retirement Accounts were expanded in 1981, the change was expected to cost only a few hundred million dollars a year. Instead, IRA subsidies were soon costing the Treasury more than \$10 billion annually. Yet the subsidies continued for 5 years until they were finally scaled back in 1986.

The 1986 Tax Reform Act illustrates, by the way, that tax expenditures are not always untouchable. The 1981 Reagan tax bill expanded tax expenditures so dramatically that by the mid-eighties our income tax system had quite literally become more loophole than tax. That is, revenues foregone through tax expenditures actually exceeded total income tax collections. Indeed, corporate tax expenditures had skyrocketed to double the amount companies paid in income taxes. In response to public outrage over corporate tax freeloading and high-income tax shelters, Congress and President Reagan closed loopholes and lowered income tax rates dramatically. As a result, today's tax expenditures as a share of income taxes paid are back to about their pre-Reagan level—although they are still higher than in 1970.

Still another fundamental question about many tax expenditures—at least those structured as personal deductions—is their “upside-down” nature. Who could imagine a direct government spending program that paid an increasing share of, say, mortgage costs as peoples' incomes

Estimated Discretionary Spending Compared to Tax Expenditures Fiscal 1995 to 2002 (\$-billions)		
	Discretionary Spending	Tax Expenditures
1995	\$546	\$434
1996	541	455
1997	542	478
1998	539	503
1999	536	530
2000	537	557
2001	548	582
2002	573	609
% change in constant \$	-12.6%	+16.8%
% change as share of GDP	-25.6%	-0.5%

Tax Expenditures as a Percent of Income Taxes Paid 1970 to the Present



rose? Yet that's exactly the effect of the current deduction for mortgage interest.

Unfortunately, lawmakers sometimes ignore the perversity of tax-deduction-based subsidies. For instance, President Clinton has proposed a new tax deduction for college tuition. This proposed tax subsidy would not benefit the truly rich, because it would be phased out between \$100,000 and \$120,000 in total income. But a family making \$100,000 could get a 28% tuition subsidy under the plan, while a family making \$40,000 could get only 15% of its tuition costs reimbursed. Thus, a family making \$100,000 sending its child to Harvard could save \$2,800 a year in taxes under the plan, while a family making \$40,000 sending its child to the state university would save only about \$600.

Even tax subsidies structured as credits against taxes otherwise due can produce strange results. Suppose a new entitlement program was proposed to give families a \$500 annual grant for each dependent child under age 18. Is it conceivable that families of four making less than \$16,900 would be made ineligible for the grant? Would anyone dare propose to limit families with two children making \$20,000 to only a \$465 grant, but to give 2-child families making \$200,000 the full \$1,000? Yet the Republican "Contract with America" proposed exactly such a new subsidy program—and President Clinton has a similar proposal—in the

form of a child tax credit that would be unavailable to lower-income families because it cannot exceed income taxes due.

Poor administration, lack of cost controls, and perverse distributional results are “features” that are far too typical of tax-based subsidies. Yet despite these obvious drawbacks, many politicians, particularly those who style themselves “conservatives,” find tax expenditures extremely attractive. One wonders: Do they actually favor the upside-down approach to subsidies? Do they think poorly administered programs are a good idea? Are they unconcerned about the impact of uncontrolled spending on the budget deficit? Or do they simply see tax subsidies as a way to earn political points with their backers and exert power over society and the economy without having their efforts show up in the official spending budget?

This last point may be the key. Because of the way the government’s budget books are kept, unscrupulous politicians can have their cake and eat it, too. To institute a new direct spending program that doesn’t increase the deficit, Congress must enact an offsetting tax increase to pay for it. Officially, this will show up in the budget as higher federal spending and higher federal taxes. But if an equivalent tax expenditure program is enacted and is paid for with higher taxes on people and/or companies not benefited, the combination will show up in the aggregate budget numbers as a wash. Neither net taxes nor spending will appear to go up in the official budget.

In their proposed “Contract,” 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.

Ultimately, of course, tax entitlements are not free. If all current tax expenditures were suddenly repealed, for example, the deficit could be eliminated and income tax rates could be reduced across the board by about 25%. Such a radical step is unlikely, of course, and in the case of some tax expenditures, the net change in most people’s bottom-line tax payments might not be very significant. But there are many expensive tax subsidy programs whose benefits are very heavily concentrated on the best-off people. Eliminating or scaling back 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.

Tax Expenditures, 1996-2002

Summary Cost Table

(fiscal years, \$-billions)

	1996			1992-2002		
	Corp.	Individ.	Total	Corp.	Individ.	Total
TOTAL ALL ITEMS	\$ 69.2	\$ 368.2	\$ 455.1	\$ 519.6	\$3,050.3	\$3,714.4
Total as a % of Income Taxes	41%	60%	58%	35%	62%	58%
Business & Investment						
Accelerated depreciation	\$ 28.2	\$ 10.8	\$ 39.1	\$ 188.3	\$ 71.0	\$ 259.2
Capital gains (except homes)	0.5	31.1	31.6	3.9	254.5	258.4
Tax free bonds, public*	1.7	3.3	20.0	13.9	26.9	162.8
Tax-free bonds, private*	4.0	5.9	12.7	28.4	40.7	91.7
Insurance cos. & products	4.9	8.7	13.6	50.7	153.7	204.5
Multinational	9.8	1.8	11.7	78.3	16.5	94.8
Business meals & entertainment	3.4	2.1	5.5	27.6	16.5	44.1
Low-income housing credit	0.7	1.9	2.6	6.8	17.1	23.9
Oil, gas, energy	2.4	0.4	2.8	18.3	3.2	21.5
R&D tax breaks	2.8	0.1	2.8	18.7	0.3	19.0
Timber, agriculture, minerals	0.7	0.5	1.2	6.0	4.1	10.1
Special ESOP rules	1.3	—	1.3	8.5	—	8.5
Financial institutions (non-insur.)	0.8	—	0.8	6.9	—	6.9
Installment sales	0.3	0.5	0.8	2.6	3.9	6.5
Empowerment zones	0.1	0.2	0.3	1.7	2.3	3.9
Other business & investment	7.4	1.8	9.2	59.1	13.1	72.1
Subtotal, business & investment	\$ 69.2	\$ 69.0	\$ 156.0	\$ 519.6	\$ 623.9	\$1,288.1
Pensions, Keoghs, IRAs	—	\$ 74.2	\$ 74.2	—	\$ 562.2	\$ 562.2
Total, business, investment & savings	\$ 69.2	\$ 143.3	\$ 230.2	\$ 519.6	\$1,186.1	\$1,850.3

*Totals include benefits enjoyed by state & local governments and non-profit organizations from lower interest rates.

Tax Expenditures, 1996-2002 (continued)

(fiscal years, \$-billions)

Personal (non-investment)	Individuals only	
	1996	1996-2002
Itemized deductions (net)	\$ 72.0	\$ 589.5
Employer-paid health insurance	56.7	497.8
Earned-income tax credit	24.3	202.7
Social Security benefits, etc. (exclusion)	23.0	185.8
Capital gains on homes	20.1	154.3
Other fringe benefits	12.7	106.8
Workmen's compensation, etc.	5.0	39.9
Soldiers & veterans	4.6	35.4
Child care credit	2.8	21.9
Elderly & blind std. deduction, etc.	1.6	12.8
Other personal	2.2	17.4
Total, personal	\$ 224.9	\$ 1,864.2
Addendum: Itemized deductions		
Mortgage interest	\$ 43.0	\$ 351.0
S&L taxes (w/o home property)	28.3	232.0
Property taxes (homes)	15.2	124.0
Charitable contributions	18.1	146.4
Medical expenses	3.6	33.4
Casualty losses	0.3	2.1
Total before standard deduction offset	\$ 108.6	\$ 888.9
Net Itemized Deductions	\$ 72.0	\$ 589.5

Sources: Office of Management and Budget, Budget of the United States Government, Fiscal Year 1997, Analytical Perspectives, "Tax Expenditures" (Feb. 1996). Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 1996-2000, Sept. 1, 1995. Institute on Taxation and Economic Policy Microsimulation Tax Model (April 1996).

PART II

Tax Expenditures for Business & Investment

Some analysts have claimed that our current income tax is biased against savings. They further argue that this alleged bias has caused a lower national savings rate than we otherwise would have. And thus, they conclude, we need to tilt the tax code so that it rewards saving and punishes consumption.

This is an interesting theory, but it hardly squares with reality. The truth is that the current tax code includes huge tax breaks for savings and investment. The loopholes range from no tax at all on some kinds of investment income, to outright “negative” tax rates on the profits from certain corporate investments, to industry-specific tax breaks targeted to the politically powerful. In fact, the \$230 billion annual cost of tax expenditures for savings and investment is now almost equal to the total annual amount of personal savings! The government is borrowing to cover the cost of these tax breaks, yet they have had no discernable effect on the private savings rate. As a result, the loopholes end up as a large drain on overall national savings. Thus, it seems rather apparent that if our savings rate is too low, tax breaks have been part of the problem, rather than the solution.

<u>1996-02 Cost</u>	
Corporate	\$520 billion
Individual	\$1,186 billion
Total*	\$1,850 billion

Savings and investment tax breaks are not simply a failed experiment in macroeconomic engineering. They also cause significant distortions in business decision making—to the detriment of overall economic growth. Worst of all, most savings and investment loopholes seriously undermine tax fairness. In fact, with one major exception—tax breaks for retirement savings—the current tax expenditures for savings and investment are extremely tilted toward the very best-off people in the country.

One of the key goals of the 1986 Tax Reform Act was to curb the harmful economic distortions that the “supply-side,” loophole-based policies of the seventies and early eighties had produced. As the official report on the 1986 Act notes, in the mega-loophole era “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.”

Although the 1986 reform bill did not eliminate all tax-induced investment distortions, it did make great progress—and our nation’s economy has done better as a result. Unfortunately, many in Congress today seem to want to return to the bad old days when a major share of our nation’s capital stock was diverted into tax-motivated schemes at the expense of more productive investments. But surely that’s not what our economy needs. On the contrary, the right policy for enhancing savings and investment is to reduce the government’s long-term budget deficits and to close—rather than expand—remaining economically harmful tax loopholes.

1. Accelerated depreciation

Born in scandal during the Nixon administration and the cause of many tax scandals thereafter, accelerated depreciation now is the largest of all corporate tax loopholes. Technically, accelerated depreciation lets companies write off the costs of their machinery and buildings faster than they actually wear out. In practice, that means sharply lower tax bills for corporations and individuals that can take advantage of the tax breaks.

	1996-02 Cost
Corporate	\$188 billion
Individual	\$71 billion
Total	\$259 billion

In 1970, after repeal of a large tax credit for business investment the previous year, the Nixon Treasury Department sought a new way to subsidize corporate profits. What it came up with was called the “Asset Depreciation Range” or “ADR” system. Put into place by executive fiat, it shortened depreciation periods by 20% across the board and also allowed accelerated write-off methods that concentrated deductions in the early years that equipment is used (thereby increasing their real value).

Nixon’s ADR approach was immediately challenged in court by public interest tax attorneys, who said it was far beyond Treasury’s authority under the tax code and therefore an unconstitutional giveaway to big business. But while the lawsuit was pending, a heavily lobbied Congress passed Nixon’s 1971 revenue act. That infamous bill retroactively ratified the ADR system, and reinstated the investment tax credit to boot. The combination was deadly for the corporate income tax. A sharp decline in corporate tax payments quickly ensued. Coincidentally or not, productivity growth also collapsed soon thereafter.

By the late seventies, widely publicized studies by the congressional Joint Committee on Taxation and the nonprofit Tax Analysts and Advocates were finding that many companies and even whole industries were paying effective tax rates far below those envisioned in the tax code. But worse was to come.

In 1979, Sen. Lloyd Bentsen (D-Tex.), Rep. Barber Conable (R-NY) and Rep. James Jones (D-Okla.) introduced a corporate tax cut bill. In it, they proposed to shorten depreciation periods and accelerate write-offs far more radically even than ADR. Disingenuously, Bentsen et al. claimed that their plan would cost only \$2 billion a year. That was indeed the estimated cost of the plan in its first nine months. But the sponsors knew full well, although they never mentioned, that by its fifth year the plan was expected to cut business taxes by a staggering \$50 billion annually.

Urged on by a massive corporate lobbying campaign, believing the low-cost promises of the sponsors and naively hoping to help the economy, hundreds of congressmen and Senators signed onto the Bentsen-Conable-Jones accelerated depreciation bill. In conjunction with an expanded investment tax credit, a version of the depreciation plan was eventually adopted as part of President Reagan's hugely expensive 1981 tax cut act (and made retroactive to the start of 1981).

With that, the floodgates opened. By 1983, as studies by Citizens for Tax Justice found, 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 studies found similar outrages in 1984, 1985 and 1986.

In response to public clamor, his own newfound misgivings and the disappointing economic results of the 1981 corporate tax cuts, Ronald Reagan helped lead the fight for the loophole-closing Tax Reform Act of 1986. The 1986 act repealed the investment tax credit and sharply reduced depreciation write-offs for buildings. The changes greatly scaled back corporate tax avoidance opportunities and made taxpayers out of most of the former corporate freeloaders.

While companies paid more in taxes after 1986, however, business investment flourished. To the chagrin of the supply-side advocates of corporate tax loop-

Annual Rates of Change In Business Investment in the 1980s (Real Private Non-Residential Fixed Investment)		
	1981-86	1986-89
All Business Investment	+1.9%	+2.7%
Structures	-0.7%	+0.2%
Industrial buildings	-6.8%	+8.0%
Commercial buildings	+6.8%	-1.3%
All other structures	-3.4%	-1.4%
Equipment	+3.5%	+4.1%
Industrial equipment	+0.1%	+4.0%
Computers & office equip.	+22.6%	+8.8%
All other equipment	+2.8%	+3.2%
ADDENDUM: Industrial equipment & bdgs.	-2.0%	+5.1%
U.S. Dept. of Commerce, Bureau of Economic Analysis, Mar. 1992		

holes, real business investment grew by 2.7% a year from 1986 to 1989. That was 43 percent faster than the paltry 1.9% growth rate from 1981 to 1986. Even more significant, while construction of unneeded office buildings tapered off after tax reform, business investment in industrial machinery and plants boomed. As money flowed out of wasteful tax shelters, industrial investment jumped by 5.1% a year from 1986 to 1989, after actually falling at a 2% annual rate from 1981 to 1986. 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 abuses. Even today, businesses are allowed to write off the cost of their machinery and equipment considerably faster than it actually wears out. This remaining loophole has proven much more expensive than originally anticipated by the drafters of the 1986 Tax Reform Act. In fact, accelerated depreciation tax breaks are expected to cost \$259 billion over the next seven years. Like any tax break targeted to corporations, accelerated depreciation is primarily a benefit to the very well off (who own the lion’s share of corporate stock and other capital). In fact, tax breaks from accelerated depreciation are worth an average of more than \$13,000 a year to people making more than \$200,000, but less than \$70 a year to families earning under \$50,000.

Today’s depreciation rules already reduce the effective tax rate on the profits from typical investments in machinery to about half the statutory 35% rate. One can see examples of that effect 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.

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 investments. 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.

General Electric, for example, avoided a total of \$1 billion in federal income taxes from 1986 to 1992 due to activities of its leasing subsidiary, GE Capital Services.

From 1980 to 1992, total corporate leasing deductions rose from \$92 billion to \$196 billion in constant 1992 dollars—an increase of 114% (compared to a 45% rise in total corporate receipts). As a share of total corporate receipts, corporate deductions for renting business property increased by 48%.

With its huge cost, minimal direct value to most people and sad economic record, accelerated depreciation might seem to have little going for it. Indeed, some might see curbs on excessive depreciation as a promising target for reducing the federal budget deficit. Several recent proposals, however, would vastly expand depreciation tax subsidies far beyond their current levels.

The GOP’s 1995 “Contract With America” originally included a \$30-billion-dollar a year 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 GOP presidential candidate Malcolm S. Forbes, Jr. and former Rep. Jack Kemp.²

2. Capital gains (except homes)

Capital gains are profits reflecting increased values of stocks, bonds, investment real estate and other “capital assets.” Capital gains are treated much more favorably than other types of income, especially for the highest income people. In fact, total current capital gains loopholes are estimated to cost \$258 billion over the next seven years. In terms of cost and maldistribution—and contentiousness—tax breaks for capital gains are at the top of the list.

²Under the flat tax, companies would write off their purchases of machinery and buildings immediately. The stated goal is to reduce the effective tax rate on profits from new corporate investments to zero. The Kasich plan was intended to be the mathematical equivalent of such “expensing.” It kept the current law rule that investments be written off over time, but let companies write off more than they actually invested (about \$11.5 million on a \$10 million equipment purchase, for example). For even partially debt-financed investments, effective tax rates under the Kasich plan would have been sharply negative (that is, investments would have been more profitable after-tax than before-tax).

Capital gains are not taxed at all unless and until they are “realized”—generally upon sale of an appreciated asset. And even when gains are realized, top-bracket individuals pay lower tax rates on capital gains than on so-called “ordinary” income.

As a result, investment markets that primarily service the well off are often designed to maximize the share of profits that are in the form of capital gains—both realized and unrealized. Indeed, on individual tax returns, total realized capital gains exceed stock dividends by 73%.

Which is not to say that capital gains are common for most taxpayers. In fact, only one tax return in every twelve filed reports any capital gains at all. On returns with total income up to \$75,000, stock dividends exceed reported capital gains. Interest income exceeds capital gains all the way up to \$200,000 in income. But for the highest income people—making more than \$200,000 a year—realized capital gains exceed the total amount of dividends and interest combined.

Almost two-thirds of total capital gains reported on individual tax returns go to people whose incomes exceed \$200,000. In contrast, only 7.8% of the total gains are reported by the three-quarters of tax filers with incomes of \$50,000 or less. Thus, more than any other type of income, capital gains are concentrated at the very top of the income scale.

In part because the taxation of capital gains is more important to the rich and politically powerful than the treatment of any other type of income, capital gains taxation has been extremely controversial over the years. At the onset of the income tax, realized gains were taxed at the same rates as other income—up to 77% during the World-War-I period. When the Republicans regained the White House after the war, however, the maximum capital gains rate was set at 12.5%—half the regular top rate of 25% from 1925 to 1931. The top regular rate rose to 63% in 1932, but the 12.5% top capital gains rate was briefly retained.

The onset of the Great Depression and public disillusionment with stock speculation of the Roaring Twenties, however, led to increased capital gains tax rates in the 1930s. For a short period, realized gains were taxed under a complicated schedule that taxed gains

1996-02 Cost

Corporate	\$4 billion
Individual	\$255 billion
Total	\$258 billion

Average Capital Gains, Dividends & Interest in 1996

Income Group	Capital Gains	Dividends	Interest
\$0-10,000	\$ 20	\$ 40	\$ 185
\$10-20,000	40	130	520
\$20-30,000	135	265	885
\$30-40,000	215	425	1,145
\$40-50,000	325	440	1,340
\$50-75,000	640	755	1,655
\$75-100,000	1,370	1,330	2,725
\$100-200,000	4,305	3,290	6,005
\$200,000+	66,240	22,740	39,205
All Families	\$ 1,245	\$ 750	\$ 1,630

Source: Institute on Taxation and Economic Policy Microsimulation Tax Model, 1996.

from very short-term investments in full, but excluded as much as 70% of gains from sales of assets held for more than 10 years. This system was widely criticized as unwieldy and complex, and in the early 1940s it was scrapped. For the next 25 years, taxpayers had the option of excluding half of their capital gains or paying a maximum rate of 25% (useful to those whose regular tax brackets exceeded 50%).

In the late 1960s, the special 25% maximum rate was repealed. In conjunction with other tax changes, the top capital gains rate rose to about 39% by the mid-1970s. Then in 1978, congressional Republicans joined by a substantial minority of Democrats pushed through a major capital gains tax cut. Reluctantly signed by President Carter, it lowered the top rate to 28%, by excluding 60% of realized capital gains from tax. The 1981 cut in the top regular tax rate on unearned income reduced the maximum capital gains rate even further, this time to only 20%—its lowest level since the Hoover administration.

In conjunction with sharply increased depreciation write-offs in 1981, the 1978 and 1981 capital gains tax cuts caused a proliferation of tax shelters. Unneeded, unprofitable and often empty office buildings sprung up all across the country in response to the new tax subsidies (helping set the stage for the savings and loan crisis later in the decade). Esoteric capital-gains-based tax shelters in items like collectibles, freight cars and llama breeding abounded. Tax-shelter “losses” reported on tax returns jumped from about \$10 billion a year in the late seventies to \$160 billion a year by 1985. And since the goal of most of the shelters was not only to defer taxes, but to convert ordinary income into lightly-taxed gains, reported capital gains jumped as well.

Proponents of low capital gains tax rates like to argue that a surge in capital gains after 1978 and 1981 proves that capital gains tax cuts cause the well off to cash in far more unrealized gains, thereby mitigating or even eliminating the apparent revenue loss from a special low capital gains tax. To be sure, reported gains (before exclusion) did increase rapidly in the late seventies and early eighties. In nominal terms, they rose from \$45 billion in 1977 to \$80 billion in 1980 to \$176 billion by 1985. Adjusted for the growth of the economy, this represents a 90% increase in reported gains from 1977 to 1985. Even if all the increase in capital gains realizations could somehow be attributed to the tax cuts, these figures would still indicate that the tax cuts lowered revenues, since the capital gains tax rate was cut about in half between 1977 and 1985. But much of the increase in reported gains simply reflected the stock market’s recovery from the oil-price shocks of the seventies—and thus would have happened even absent the tax changes.

Moreover, a very large share of the increased capital gains in the first half of the eighties represented tax-shelter conversions of ordinary income into gains. This kind of tax-induced surge in reported gains actually means a pure revenue loss. If, as Michael Kinsley has noted, we cut taxes in half for people named “Newt,” then we surely would find that Newts reported much more income on tax returns. Indeed, total taxes paid by people named Newt might even go up. But that would merely reflect millions of people changing their names to Newt to avoid taxes, not some magical supply-side effect on Newts’ incentives to work, save and earn money. The same is true of tax breaks for income called “capital gains.”

So do lower tax rates on capital gains cause people to cash in more gains than they otherwise would (not counting tax-shelter effects)? The answer is probably yes, but the long-term magnitude of such induced realizations is probably quite low. A recent study by Congressional Budget Office economists Leonard Burman and William Rudolph compared capital gains realizations by a sample of particular taxpayers over time. They found large transitory effects when a taxpayer’s individual circumstances changed and when the federal government made major revisions in capital gains taxation.³ But on a long-term basis, the study found very little correlation between the tax code’s treatment of capital gains and levels of realizations. In fact, in technical terms, the study found that “[t]he permanent elasticity is not significantly different from zero.”⁴

Despite all the debate over how much reduced capital gains taxes might affect the level of asset sales, it’s really a side issue. The heart of the case for a capital gains tax break is that it supposedly encourages savings, investment, jobs and economic growth. And that case is astonishingly weak. Just look at what happened when capital gains taxes were cut in the past.

The 1978 Revenue Act, enacted in November of 1978, cut the maximum capital gains tax rate from 39% to 28%. Over the 12 months prior to enactment of that change, the real GDP grew by 5.8%. But after the 1978 capital gains tax cut was approved, the economy faltered. In fact, the GDP dropped by 1% over the next year and a half. The annual growth rate for the two years following the 1978 capital gains tax cut was only 0.3%—5.5 percentage points lower than the growth rate prior to the cut.

³Most notably, in Sept. 1986, Congress approved the Tax Reform Act of 1986, which increased the top capital gains tax rate from 20% to 28%, effective Jan. 1, 1987. This caused a rush by investors to cash in capital gains before the old 20% rate expired.

⁴Leonard E. Burman and William C. Randolph, “Measuring Permanent Responses to Capital-Gains Tax Changes in Panel Data,” *THE AMERICAN ECONOMIC REVIEW*, Sept. 1994.

In August of 1981, another capital gains tax cut was enacted, this time cutting the top rate to 20%. Over the 12 preceding months, the economy

Capital Gains Tax Changes & Economic Growth (Changes in Real Gross Domestic Product)			
Date Enacted	Growth in Prior Year	Annual Growth Rate Over Next 2 Years	Change in Growth Rate
Capital gains tax cuts:			
Nov. 6, 1978	+5.8%	+0.3%	-5.5%
Aug. 14, 1981	+3.5%	+1.0%	-2.5%
Capital gains tax increases:			
Oct. 4, 1976	+3.9%	+5.2%	+1.3%
Oct. 22, 1986	+2.2%	+3.8%	+1.6%

NOTE: Growth rates are from date of enactment of the capital gains changes.
Source: U.S. Dept. of Commerce. Compiled by Citizens for Tax Justice, 1992.

had grown by 3.5%, but in the 12 subsequent months the GDP fell by 2.8%. In the two years after the 1981 capital gains tax cut was enacted, the annual growth rate was only 1% —2.5 percentage points below the growth rate prior to the cut.

Contrary to the assertions of capital gains tax cut proponents, capital gains tax cuts have

never led to improved economic performance. Tax laws that have increased the capital gains tax, however, typically have been followed by increased growth. After capital gains taxes were increased in the 1976 Tax Reform Act, for example, the economy's growth rate jumped from 3.9% in the preceding year to 5.2% over the next two years. Likewise, following enactment of the 1986 Tax Reform Act, the growth rate rose from 2.2% in the previous year to 3.8% over the next two years.

The record of capital gains tax cuts when it comes to jobs is equally dismal. In fact, the unemployment rate rose sharply after both the 1978 and 1981 capital gains tax cuts. Conversely, the jobless rate fell notably after the 1976 and 1986 capital gains tax hikes were enacted.

History belies the claims that low capital gains taxes stimulate the economy. The long-term economic case against capital gains tax loopholes is even stronger. In essence, capital gains tax cut proponents seem to believe that free markets don't work, that the government needs to

Date of Capital Gains Tax Cut	Jobless Rate	Two years later	Change
November 1978	5.8%	7.3%	+1.5%
August 1981	7.3%	9.3%	+2.0%
Date of Capital Gains Tax Hike	Jobless Rate	Two years later	Change
October 1976	7.6%	5.7%	-1.9%
October 1986	6.8%	5.2%	-1.6%

Source: U.S. Dept. of Labor, Bureau of Labor Statistics.

step in with subsidies designed to override the signals the market sends about the level and allocation of capital. But this idea that the government should be making investment decisions for business is terrible economics.

The truth is that paying people and corporations to make investments that otherwise make no business sense undermines economic growth. Capital

gains tax breaks and other supply-side loopholes of the first half of the 1980s inspired construction of tens of thousands of unneeded office buildings and led to myriad other dramatic and wasteful misallocations of American capital and effort. But they completely failed to produce increases in total savings or investment.

Details on existing capital gains tax breaks:

28% maximum rate: One of the greatest achievements of the 1986 Tax Reform Act was to tax realized capital gains at the same rates as wages, dividends or other income. (Previously, realized capital gains had been 60 percent tax-exempt). But in 1990, Congress reinstated a small capital gains preference, by capping the capital gains rate at 28% while setting the top regular income tax rate at 31%. In the 1993 budget bill, this capital gains preference was greatly expanded to provide what amounts to a 30% capital gains exclusion for top-bracket taxpayers (the difference between the new 39.6% top regular tax rate and the continuing 28% maximum capital gains rate). The 1993 act provided an additional 50% capital gains exclusion for profits from certain “risky” investments that are considered likely to fail. Ninety-seven percent of the tax savings from the current special maximum capital gains tax rate for individuals goes to the best off one percent of all families.

Benefits of Current Law's Special Lower Rate On Capital Gains in 1996				
Income Group (\$-000)	% with Capital Gains	% of All Capital Gains	Average Tax Break (all returns)	% of Total Tax Break
\$0-10	1.0%	0.3%	\$ —	—
\$10-20	1.9%	0.7%	—	—
\$20-30	4.8%	1.7%	—	—
\$30-40	6.5%	2.0%	—	—
\$40-50	7.6%	2.3%	—	—
\$50-75	11.4%	6.8%	—	—
\$75-100	17.6%	5.7%	2	0.2%
\$100-200	27.2%	13.6%	44	2.4%
\$200+	44.0%	66.5%	5,660	97.4%
All	6.8%	100.0%	\$ 73	100.0%

Source: ITEP Microsimulation Tax Model, 1996.

Indefinite deferral of tax on unrealized capital gains: Capital gains are not taxed until assets are actually sold. As a result, investors can put off tax on their gains indefinitely. (They can also avoid tax on realized gains by selectively realizing losses on other investments in the same year.) This deferral is unavailable, of course, to other kinds of income such as savings account interest, even if the money is left in the bank. Multibillionaire Warren Buffett, for example, has structured his investment company so that it hasn't paid a dividend since 1966. Instead, Buffett's \$14 billion or so in accrued capital gains remain unrealized and thus untaxed.

Capital gains tax breaks for gifts and inheritances: Currently, heirs can sell inherited property and pay no tax on capital gains that accrued prior to the time they inherit. In other words, capital gains taxes on inherited property are completely forgiven.

In the case of gifts, the recipient takes over the giver's "basis" in the donated property—generally the cost when the property was first acquired. That carryover of basis—instead of taxing the gain—allows a continued deferral of unrealized capital gains.

Special additional industry-specific capital gains tax breaks: Historically, favorable capital gains treatment has normally been limited to profits from the sale of investments (stocks, bonds, etc.). But several industries have succeeded in getting part of their normal business profits treated as capital gains. Special capital gains treatment is currently available for sales of timber, coal, and iron ore and for certain agricultural income.

Other special capital gains breaks include:

Indefinite tax deferral for so-called "like-kind exchanges" of real estate. Normally, when someone sells appreciated property he or she must pay tax on the capital gain. But someone who sells rental real estate and purchases other rental property can put off paying capital gains taxes on the sale indefinitely by pretending to have "exchanged" the properties with another investor.

The refinancing loophole. Owners of investment assets that have gone up in value can cash in their capital gains without tax by borrowing against the appreciation. This is an enormous tax shelter for, among others, wealthy real estate speculators (although it doesn't make the official tax expenditure lists).

An exception from the normal \$3,000 annual limit on capital loss deductions, for losses on the sale of certain "small business corporate stock." Except for a \$3,000 a year de minimis rule, realized capital losses can only be used to offset realized capital gains. Otherwise, investors with a portfolio of winners and losers could realize losses to wipe out taxes on their wages and other income, even though their total capital gains position (realized and unrealized) was positive. But for certain "small business corporate stock" investments, up to \$100,000 in losses can be deducted. This subsidy is presumably designed to ease the pain of backing money-losing operations, and thereby encourage wealthy investors to invest in businesses that are unlikely to succeed.

Recently proposed capital gains tax changes:

A large reduction in the capital gains tax was the centerpiece of the Republican “Contract with America” tax program that was vetoed by President Clinton at the end of 1995. The GOP hoped to replace the current 28% maximum capital gains tax rate with a 50% exclusion (thus a 19.8% maximum rate), plus indexing the basis of assets for inflation. In the final bill approved by Congress, capital gains cuts constituted about three-quarters of the plan’s \$10,500 average annual tax cut for the best off one percent. CTJ estimated that the GOP capital gains changes, if enacted, would cost \$113 billion over the next seven years—mostly benefiting the very rich.⁵ Going even further, the Armev-Forbes “flat tax” plan would entirely eliminate taxes on capital gains.

In contrast, in his fiscal 1997 budget, President Clinton has proposed several revenue-raising reforms in capital gains taxation. They are basically directed at narrowing the definition of what qualifies for preferential capital gains treatment.

Although capital gains taxation has become an increasingly partisan issue in recent years, that was not always the case. The Revenue Act of 1978 that sharply reduced capital gains taxes was passed with significant Democratic support in Congress and signed by Democratic President Jimmy Carter. In contrast, it was Republican President Ronald Reagan who signed the Tax Reform Act of 1986 (drafted and passed by the GOP-controlled Senate led by Sen. Bob Dole) that for a time taxed capital gains at the same rates as other kinds of income.

The reason why economic conservatives might worry about special tax breaks for capital gains was aptly summarized in testimony by the

⁵CTJ’s estimate included the plan’s proposed reduction in the maximum corporate capital gains rate from the current 35% to 28%.

The Contract’s combination of indexing and a 50% capital gains exclusion would on average have excluded about two-thirds of all capital gains from taxation. For assets held for relatively short periods of time before sale, the exclusion would have been larger, while it would generally have been lower for gains from sales of long-term holdings. (If an asset is going up in value by, say, 8% a year, while inflation is 3%, then indexing alone would cut the tax by 35% on the sale of the asset after one year. But if the asset is held for 20 years, indexing alone would cut the tax due by only 20%. When the GOP’s proposed 50% exclusion is added on as well, the total exclusion for the one-year asset would have been almost 70%, compared to 60% for the 20-year asset.)

Because the GOP plan would have given capital gains tax breaks to corporations as well as individuals, large timber companies and certain other industries that are allowed to treat a large portion of their profits as capital gains could have ended up paying little or nothing in income taxes if the plan had been enacted—as was the case prior to the Tax Reform Act of 1986.

Treasury before the House Ways and Means Committee in January 1995 concerning the Republican “Contract”:

“Increasing the preferential treatment of capital gains would create economic efficiency losses and make the tax system more complex by encouraging taxpayers to convert ordinary income into capital gains.”

Numerous economists, including some very conservative ones, have echoed Treasury’s serious concerns about the GOP’s proposed capital gains tax cuts. They note that capital gains are already the lowest taxed form of capital income (due to deferral and preferential rates), and they fear the likely waste of capital resources from new tax shelters.⁶

3. 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.

<u>1996-02 Cost</u>	
Corporate	\$78 billion
Individual	\$17 billion
Total	\$95 billion

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. The same loopholes that foreign companies use are also 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.

⁶These are among the reasons why indexing, although it might seem attractive at first glance, is particularly inappropriate in the case of capital gains. In fact, indexing any type of capital income for inflation (whether interest, dividends, or whatever) is inappropriate unless interest deductions are also indexed downward. The tax-sheltering potential of the Republican capital gains breaks is very large. Investments in depreciable property that actually lose money before tax could become highly profitable after tax under the plan.

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 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 May 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.

Recently, 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.

Another of the classic tax avoidance games that multinational companies play is illustrated by a tax break that goes to the many drug companies and electronics firms that have set up subsidiaries in Puerto Rico. They assign “ownership” of their most valuable assets—patents, trade secrets and the like—to their Puerto Rican operations, and then argue that a very large share of their total profits is therefore “earned” in Puerto Rico and therefore eligible for the tax break. Reforms in 1986 tried to scale back this tax dodge, but it still costs more than \$3 billion annually. Although encouraging jobs in Puerto Rico might be a nice idea (although perhaps not at the expense of

mainland employment), it has been estimated that many of the Puerto Rican jobs cost the Treasury upwards of \$70,000 a year each because the tax break is so abused.

The official list of tax expenditures in the international area—totaling \$95 billion over the next seven years—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 and research expenses, “source” rules that treat certain kinds of U.S. profits as foreign, and the Puerto Rican “possessions tax credit.”⁷

Fixing these problems in the current system would be a good idea. But even better 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. 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 \$15-20 billion annually.

Not listed in the official tax expenditure budget, but a major tax break nonetheless is the tax exemption for interest earned in the United States by foreigners. Such interest (on loans to American companies and the U.S. government) was exempted from U.S. tax under the Reagan administration in 1984. At the insistence of the proponents of the change, this interest income is not reported to foreigners’ home governments, and as a result, tax evasion is said to be the norm. As a result, the United States has become a major international tax haven. There is evidence that not only foreign tax cheats, but also Americans posing as foreigners have been taking advantage of this loophole. Reinstating the tax has been proposed, with a waiver of the tax if a foreign lender supplies the information necessary to report the interest income to the foreign home government.

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 proposes \$6.3 billion in international tax reforms over the 1997-2002 period, while congressional tax plans call for about a quarter that much. In addition, both sides want to scale back the \$3 billion a year tax break for corporations in Puerto Rico by about half a billion dollars a year.

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.

4. Tax-exempt bonds

Individuals and corporations that lend money to states and localities pay no federal income tax on the interest they earn. This allows states and cities to pay reduced interest rates—what in today’s jargon might be called a “funded unmandate.” But not surprisingly, the money that state and local governments save in lower interest payments is considerably less than the cost of the tax break to the federal government—which is expected to be \$255 billion over the next seven years.

1996-02 Cost

Public	\$163 billion
Private	\$92 billion
Total	\$255 billion

Over the past year or so, interest rates on long-term state and local tax-exempt bonds have averaged about 5.8%. That’s about 1.8 percentage points—or 24%—lower than the taxable interest paid on comparable Treasury and corporate bonds, which have paid about 7.6%.⁸ Most interest on state and local bonds, however, goes to lenders in federal tax brackets considerably higher than 24%. That means that the federal tax subsidy for state and local bond interest costs the federal government considerably more than state and local governments save in interest payments. In fact, since about a third of the tax breaks for tax-exempt bonds go to 35%-bracket corporations (banks and so forth), and almost 90% of the remaining tax subsidies go to individual taxpayers making more than \$100,000, about a quarter of the federal subsidy ends up as a windfall to well-off investors.

For example, a top-bracket individual would pay about \$40,800 in federal taxes on \$100,000 in interest earned from investing in taxable bonds. But if the person invests in tax-exempt bonds instead, the federal government loses the \$40,800 while the state or local government issuing the bond saves only about \$24,000 in reduced interest expense. Thus, two-fifths of the federal tax subsidy ends up as a windfall to the investor.

Tax Breaks from Tax-Exempt Bonds			
Income Group (\$-000)	% with Pers. Tax Break	Average Tax Benefit (all families)	% of Total Tax Benefit
\$0-10	—	\$ —	—
\$10-20	0.3%	1	0.3%
\$20-30	1.0%	7	1.2%
\$30-40	2.1%	7	0.9%
\$40-50	3.3%	9	0.9%
\$50-75	5.2%	27	4.0%
\$75-100	9.3%	86	5.1%
\$100-200	18.0%	325	14.5%
\$200+	35.0%	5,155	72.9%
All	3.1%	\$ 88	100.0%

Tax benefits include personal and corporate income tax savings and corporate interest savings, net of reduced personal and corporate interest received. They exclude benefits from lower interest paid by state and local governments, non-profit organizations and individuals. Source: ITEP Microsimulation Tax Model, 1996.

⁸For long-term corporate bonds, the 7.6% figure is net of state income taxes on pretax interest of 8%. Interest on federal bonds, at 7.6% on 10-year-plus bonds, is exempt from state taxes.

Likewise, a bank or other 35% bracket corporation that invests \$100,000 in tax-exempt bonds gets a federal tax subsidy equal to about \$35,000. Since the local government saves only \$24,000 on the interest it pays, however, the bank's windfall is equal to \$11,000—about a third of the cost of the subsidy to the federal government.

Bond Yields Before & After Taxes (examples based on \$100,000 in pretax interest on taxable bonds)		
Top-Bracket Individuals:		
	Interest before Federal Tax	Interest After Tax
Taxable bonds	\$100,000	\$59,200
Tax-exempts	\$75,800	75,800
Federal Interest Subsidy		\$40,800
S&L Interest Saving		24,200
Windfall to Investors		\$16,600
% Windfall		41%
Banks & Other Corporations:		
	Interest before Federal Tax	Interest After Tax
Taxable bonds	\$100,000	\$65,000
Tax-exempts	\$75,800	75,800
Federal Interest Subsidy		#35,000
S&L Interest Saving		24,200
Windfall to Investors		\$10,800
% Windfall		31%

Why is the market for tax-exempt bonds so inefficient? The apparent reason is that, while most tax-free bonds are held by high-bracket individuals and corporations, on the margin states and localities find it necessary to make their bonds attractive to taxpayers in lower brackets—primarily the 28% rate. In addition, because the subsidy is tax-bracket dependent, states have to provide a cushion for bondholders who might fall into a lower bracket in a given year.

It's bad enough that the federal subsidy for tax-exempt bonds is so inherently inefficient and wasteful. But on top of that, in many circumstances, private companies and individuals can "borrow" the ability to issue tax-free bonds from state and local governments. Thus, states and cities have extended the right to borrow tax free to businesses building airports, rental housing and electric plants, to individuals taking out mortgages and student loans, and on and on. Indeed, before reforms in the mid-eighties, there was almost no limit on what states could authorize tax-exempt financing for—and since the federal government was picking up the bill, there was

no internal fiscal constraint on the states' going hog wild. Reforms now generally limit the total amount of such private misuse of tax-free financing—through a state-by-state volume cap—but it still remains a major drain on the federal Treasury. In fact, \$92 billion or more than a third of the \$255 billion total tax expenditure for tax-exempt bonds, stems from tax-free non-governmental bonds used to finance private projects. This not only seems like an inappropriate use of scarce federal resources, but by increasing the quantity of tax-free bonds, it probably

drives up the interest rates that states and cities have to pay on their normal public-purpose bonds.⁹

In the late seventies, the Treasury Department suggested replacing the tax exemption for state and local bonds with a direct federal subsidy for state and local interest payments. If that subsidy were set at, say, 25% of the interest paid, both the federal government and state and local governments would come out ahead. Indeed, the value of the subsidy to states and cities would increase by 3 percent, while the cost to the federal government would fall by almost a quarter.

A 25% Direct Federal Subsidy for State & Local Bond Interest Compared to the Current Tax Exemption (Assumes 32.4%-bracket bondholders)				
	Current System	25% Subsidy	Change	% Change
Pretax interest	\$75,800	\$100,000		
S&L interest cost	75,800	75,000	\$-800	-1%
S&L interest saving	24,200	25,000	+800	+3%
Federal cost of subsidy	32,400	25,000	-7,400	-23%
Bondholders, after-tax	75,800	67,600	-8,200	-11%

States and cities resisted this proposed reform, despite its apparent benefits to them, for two major reasons.

- # First, they feared the loss of the “entitlement” nature of their current interest subsidy. That is, they worried that future Congresses might find it easier to scale back a direct subsidy for interest than a tax entitlement, however inefficient the latter might be.
- # Second, states and cities wondered whether their much-criticized, but politically attractive practice of “lending” their tax exemptions to private businesses could survive under the heightened scrutiny that applies to direct federal spending programs.

With governments at all levels in dire financial straits today, however, it might be time for a second look at federal subsidies for tax-exempt bonds. Making these subsidies more efficient and limiting them to truly public borrowing could save governments tens of billions of dollars and make the federal tax code fairer at the same time.

⁹Overall, we calculate that only 46% of the total tax subsidy for tax-exempt bonds goes to state and local governments in the form of lower interest rates on their public-purpose borrowing. Twenty-seven percent of the tax subsidy goes to individual lenders and borrowers, 18% to corporate lenders and borrowers, and the remaining 9% to nonprofit hospitals and schools.

5. Business meals and entertainment

It's a fundamental (and usually honored) income tax principle that personal outlays, whether for a family car, a house, food or entertainment, should not be deductible in computing net income.¹⁰ On the contrary, these are precisely the things that net income is used to buy. If the income tax laws generally allowed people to deduct their personal expenses, there would be little or nothing left to tax (except savings).¹¹

1996-02 Cost	
Corporate	\$28 billion
Individual	\$17 billion
Total	\$44 billion

Note: Not included on the "official" tax expenditure lists.

To be sure, when taxpayers assert that some of their apparently personal outlays also have a business purpose, the issues are not always clear cut. Although the tax code ostensibly allows deductions only for "necessary" business expenses, this rule is liberally interpreted when a business purpose clearly predominates. The law does not limit deductions for office furnishings, for example, to the cheapest available.

But when the personal element of an outlay dominates, the tax code should not (and usually does not) allow a deduction. For example, although someone could reasonably say that he or she needs a place to live in order to survive (and be able to work), normal housing costs have no particular linkage to earning income, and are thus not deductible as business expenses. Likewise, commuting costs may make it possible to get to work, but they are properly treated as stemming from personal decisions about where to live, rather than being primarily business-related, and are thus not deductible.

It's hard to imagine any outlays that are more quintessentially personal than those for meals and entertainment. Everyone has to eat, no matter what their profession or trade (if any). Entertainment, by definition, is designed to provide personal satisfaction and enjoyment.

Current law recognizes that eating and entertainment expenses are personal when a person makes such outlays solely on his or her own behalf. The fact that someone may read a business journal over lunch or think about marketing strategies during a football game does not transform those meals and entertainment outlays into deductible business

¹⁰Section 262 of the Internal Revenue Code states this principle explicitly.

¹¹A few personal outlays, most notably mortgage interest, are allowed as itemized deductions in computing individual taxable income. But the mortgage interest deduction is not defended on tax policy grounds as a proper deduction in computing net income (or ability to pay taxes), but rather as a government subsidy for housing. A reasonable case on ability-to-pay grounds can be made for most other itemized deductions, such as state and local taxes, cash charitable gift and extraordinary medical expenses.

expenses. Strangely, however, when a meal or recreational activity is shared with a business associate or a potential client or customer, the tax law generally allows half of the amount spent to be written off.

Specifically, meals that bear a “reasonable and proximate relationship to a trade or business” are 50% deductible if they occur under circumstances that are “conducive to a business discussion.” There’s no requirement that business actually be discussed, either before, during or after the meal. Entertainment outlays are 50% deductible if the taxpayer has more than a general expectation of deriving income or a specific trade 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 as a business meal). 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. For example, a freelance writer may discuss virtually everything he writes with his wife, often over dinner. Indeed, most of their meals together may be “conducive to a business discussion” about writing projects. Should this couple be deducting the cost of those meals? If they go to a play or a sporting event after one of their “business meals,” should their entertainment costs also be deductible? Would they be on firmer ground if they talked at an expensive restaurant about the wife’s small-business projects, on which the husband often gives constructive advice?¹²

¹²Probably, none of these “business meals” and related entertainment should be deductible even under existing law, but the current rules are sufficiently vague that the answer is not certain. Ironically, the case for deductibility would improve if the couple ate at more expensive restaurants than they would normally frequent. Their chances also would improve if they kept their excursions to a “reasonable” number per year. It might also help if they were willing to claim that they didn’t really like the meals they ate. And it would clearly assist their claim if they brought a potential purchaser (albeit a friend) to dinner with them. As the Court of Appeals for the Seventh Circuit put it in *Moss v. Commissioner* (1985):

“The taxpayer is permitted to deduct the whole price [of a ‘business meal’], provided the expense is ‘different from or in excess of that which would have been made for the taxpayer’s personal purposes.’ ... [T]he Internal Revenue Service has every right to insist that the meal be shown to be a real business necessity. This condition is most easily satisfied when a client or customer or supplier or other outsider to the business is a guest.... But it is different when all the participants in the meal are coworkers.... They know each other well already; they don’t need the social lubrication that a meal with an outsider provides—at least don’t need it daily.... It is all a matter of degree and circumstance Daily—for a full year—is too often, perhaps even for entertainment of clients The case might be different if [business necessity required the taxpayers] to eat each day either in a disagreeable restaurant, so that they derived less value from the meal than it cost them to buy it ..., or in a restaurant too expensive for their personal taste But so far as appears, they picked the restaurant they liked most.”

The fundamental problem is that no matter what the technical rules, the deduction for meals and entertainment is itself an abuse of good tax policy. Personal outlays of this sort simply should not be deductible in computing net income.

Analytically, the proper taxpayer in the case of meals and entertainment benefits should be the person who is fed or entertained. Thus, the theoretically correct treatment of such benefits would be to tax the recipients on the value of the benefits they receive. Denying deductions to payers, however, would produce roughly the same result, and would be considerably easier to administer.

Of course, in the case of self-employed people, denying a deduction for meals and entertainment personally enjoyed gives exactly the same answer as taxing the benefits. For employees, the issue is only slightly more complicated. Businesses can, of course, deduct the wages they pay their employees, whether paid in cash or in non-cash compensation. But the employees are supposed to report those wages, cash or in-kind, as income on their personal tax returns. Thus, theoretically, employer payments to employees in the form of meals and entertainment could be deductible by employers and taxable to the employees. But a more workable solution is simply to deny the deductions to the employer. Because the relevant marginal tax rates on individuals and businesses are roughly the same, this approach gives about the same result as taxing the benefits to the employees.¹³

Customers of a business who receive meals and entertainment are in a similar position to employees. That is, the customers also receive in-kind income. Denying business deductions to the payer for those in-kind payments is a good, workable alternative to taxing those benefits directly to the recipients.

A perusal of testimony before the House Ways and Means Committee shows little effort by the proponents of the business meals and entertainment deduction to defend it on tax policy grounds. (Instead, they primarily talk about the need of their industries for government subsidies, a topic discussed below). But when a tax policy defense is raised for meals

¹³The lowest marginal federal income and payroll tax rate on wages is about 28% (the 15% income tax and 15.3% Social Security payroll tax, less interactions). Because the cross-over points for hitting the 28% income tax bracket and exceeding the wage cap on the Social Security tax (not counting the 2.9% effective Medicare tax) are about the same (for one-earner married couples), the marginal rate generally remains at just over 30% at higher income levels. On the highest earners, the rate on wages is 43% (the 36% top rate, the 10% surtax, the itemized deduction disallowance and the 2.9% Medicare tax, less interactions). The top corporate marginal tax rate is 35% (although it's less for smaller companies). Thus, except for very high earners and smaller businesses, marginal tax rates for companies and employees are roughly the same.

and entertainment write-offs, it usually comes down to arguing about the proper valuation of the benefits to the recipients.

In particular, defenders of the write-offs have asserted that the value of meals and entertainment received by self-employed people, employees, customers, spouses, etc. in a business context is often much less than the dollars spent. A salesman might not like fancy meals very much. Or a customer might not really be a hockey fan. Or a businessman might actually detest golf. They engage in these allegedly somewhat disagreeable activities, it is argued, only because of business necessity.¹⁴

This argument seems terribly weak. After all, the point of feeding and entertaining customers is to make them happy. Dragging customers to restaurants or stadiums that they abhor would hardly be a sound business practice. Likewise, those paying for meals and entertainment (or their employees) have substantial discretion in choosing where they eat or play.

As noted, defenders of write-offs for business meals and entertainment generally do not focus on tax policy issues. Instead, they attempt to defend the \$6 billion annual cost of these deductions as 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 buying business people jewelry or furs would rank even lower.) How can we possibly justify higher taxes on the general public or bigger budget deficits to fund such a peculiar entitlement program?

Proponents of a federal subsidy for meals and entertainment also maintain that it is a "jobs issue."¹⁵ But from a national perspective, the argument that cutting the government subsidy for meals and entertainment would cost jobs is wholly without merit. Essentially, there

¹⁴See, e.g., "Statement of Marvin Leffler, Chairman of the Board, Nat'l Council of Salesmen's Organizations," before the Ways and Means Comm., March 31, 1993 ("When [a salesman] entertains a customer, he naturally eats a more expensive meal, but not for self-gratification—he would rather be home.")

¹⁵See, e.g., "Statement of George A. Wachtel, Director, Research and Government Relations, The League of American Theatres and Producers," before the House Ways and Means Committee, Mar. 31, 1993 ("Theatre and performing arts budgets are extremely labor intensive.... We should be promoting policies that ensure the further development of the arts in America"); "Statement of Darryl Hartley-Leonard on behalf of the American Hotel & Motel Association," before the House Ways and Means Committee, Mar. 31, 1993 ("In the final analysis, what really matters is how many working Americans you will displace from their jobs"); "Statement of Chip Berman on behalf of the National Restaurant Association," before the House Ways and Means Committee, Mar. 31, 1993 ("it all boils down to jobs").

are two possible economic results that could occur if the subsidy for meals and entertainment is eliminated. Either:

a. Not much will change. Business people will continue to eat, attend sporting events, and so forth at about the same rate as they do now. This may seem the most likely outcome, particularly in the case of meals, since eating will remain a human necessity and eating well, a pleasure. The record since 1986 confirms that curbing write-offs is likely to have little impact on dining and recreation.¹⁶

b. Or alternatively, some of the money that now goes to buy meals and entertainment will be shifted to other purchases.

The important point from a national jobs perspective is that it doesn't matter which of these two results occurs. If less money is spent on meals and entertainment, then more money will be spent on other things, creating jobs in other areas.¹⁷ Thus, there is no reason to expect any net effect on total American jobs from ending the subsidy for business meals and entertainment.

6. Mergers and acquisitions

The deductibility of corporate interest payments, even in the case of “junk bonds” and other types of debt that are more like stocks than real borrowing, helped fuel a wave of leveraged buyouts and other debt-for-stock transactions in the 1980s. From 1985 to 1990, more than \$1 trillion in new corporate indebtedness was incurred, accompanied by \$54 billion in corporate stock retirements—a combination that costs the federal Treasury some \$20-30 billion a year in lost corporate taxes. The deals that were struck then cannot be undone, but strict curbs on interest deductions on debt used to finance acquisitions and other limitations on companies' ability to characterize equity as debt could help keep this problem from resurfacing and making the revenue hemorrhage even

¹⁶The 1986 Tax Reform Act cut the meals and entertainment write-off by 20%, the corporate tax rate by 26% and the top personal tax rate by 44%. Yet despite this combined 40% reduction in the meals and entertainment subsidy, there was no noticeable reduction in business eating or entertaining. (Nor, by the way, did sports stars see a decline in their earnings as a result of the withdrawal of a substantial portion of the government subsidy for entertainment.) The 1993 deficit reduction act reduced the write-off from 80% to 50% (although it also raised top tax rates), with no noticeable effect on eating and playing.

¹⁷There is one other possible outcome: that people would actually save more. Since the goal of deficit reduction is to increase national savings, however, that rather unlikely result is not to be greatly feared. Of course, one could argue against deficit reduction itself on the ground that it can cost jobs in some circumstances, but defenders of the business meals deduction typically profess to favor cutting the deficit.

worse. In particular, interest on debt incurred to purchase stock (perhaps in excess of, say, \$5 million) could be made nondeductible, thereby curbing a perverse tax incentive for corporate debt.

In addition, many companies that made acquisitions in the eighties took extremely aggressive positions on their tax returns in an attempt to write off what they paid for “goodwill” and similar “intangible” assets (like brand names) that generally don’t decline in value over time. Unfortunately, the 1993 budget act essentially ratified this practice, which may encourage future acquisitions. Repealing that 1993 change and clarifying the law to make crystal clear that no goodwill write-offs are allowed would remove a significant bias in the tax law in favor of economically unwarranted mergers and acquisitions.

Tax subsidies for mergers and acquisitions are not included in the official tax expenditure budget, but they do impose significant costs on the Treasury and the economy.

7. Insurance companies and products

Insurance companies enjoy a wealth of federal tax breaks, both at the corporate level and for their customers. In total, these tax expenditures are expected to cost \$204 billion over the next seven years. All of them ought to be reevaluated to determine if any important public purpose can justify that large cost. The tax subsidies include:

Interest on life insurance savings. Interest and other investment income earned on accumulated life insurance premiums is not taxed either as it accrues or when received by beneficiaries upon the death of the insured. In recent years, many corporations have taken advantage of this tax shelter by borrowing against insurance policies on their employees, and deducting the interest while the policy earns tax-free income. (Both President Clinton and Congress have proposed to curb this abuse.)

Small property and casualty insurance companies. Insurance companies that have annual net premium incomes of less than \$350,000 are exempt from tax; those with \$350,000 to \$2,100,000 of net premium incomes may elect to pay tax only on their investment income.

Deduction of unpaid property loss reserves of property and casualty companies. Property and casualty insurance companies can deduct not only claims paid, but also “loss reserves” that exceed actual claims expenses.

Special treatment of life insurance company reserves. Likewise, life insurance companies can deduct “reserves” that exceed claims actually paid. Insurance companies also aren’t taxed on investment income stemming from so-called “structured settlement amounts.”

Insurance companies owned by tax-exempt organizations. Generally, the income generated by life and property and casualty insurance companies is subject to tax,

	1995-99 Cost
Corporate	\$51 billion
Individual	\$154 billion
Total	\$204 billion

albeit by special rules. Insurance operations conducted by fraternal societies and “voluntary employee benefit associations,” however, are tax-exempt. Some of the leading “non-profit” fraternal society insurers write tens of billions of dollars in insurance coverage—and pay their top executives princely salaries (as much as \$900,000 per year). Treating these high-powered insurance activities as tax-exempt is an abuse of non-profit status. The tax exemption ought to be repealed (as the Treasury Department suggested back in 1984).

Blue Cross and Blue Shield. Although these organizations do not qualify as tax-exempt charities, they get exceptions from normal insurance company income tax accounting rules that effectively eliminate all their taxes.

8. Oil, gas and energy tax breaks

Oil and gas companies are allowed to write off many of their capital costs immediately, and many can take deductions for so-called “percentage depletion”—which has no connection with actual expenses. The purpose of these tax subsidies is to encourage domestic oil and gas production—and apparently consumption.

1996-02 Cost	
Corporate	\$18 billion
Individual	\$3 billion
Total	\$21 billion

Having provided these subsidies, Congress then has recognized that it is not in the national interest to encourage oil and gas consumption. But rather than repealing the oil and gas tax breaks, it has instead provided additional, conflicting subsidies for alternative fuels and conservation. To make matters even more confusing, one of the largest alternative fuel subsidies is for gasohol, which some argue may use almost as much fuel to produce as it ostensibly saves. In total, the conflicting tax breaks for oil, gas and energy are expected to cost \$21 billion over the next seven years.

Exploration and development costs. Normally, businesses can write off their investments in plants and equipment only as those investments wear out. Oil companies, however, can write off their so-called “intangible drilling costs,” that is, much of their investments in finding and developing domestic oil and gas wells, immediately, even for successful wells.¹⁸ (Major, integrated oil companies can immediately deduct only 70% of such investments and must write off the remaining 30% over five years.) A similar tax break is granted for the costs of surface stripping and the construction of shafts and tunnels for other fuel minerals.

Percentage depletion. Independent oil and gas (and other fuel mineral) producers are generally allowed to take so-called “percentage depletion” deductions rather

¹⁸Such “intangible drilling costs” include wages, the costs of using machinery for grading and drilling, and the cost of unsalvageable materials used in constructing wells. For most businesses, costs such as these would normally be written off over the useful life of the assets created.

than writing off actual costs over the productive life of the property based on the fraction of the resource extracted. Since percentage depletion deductions are simply a flat percentage of gross revenues, unlike depreciation or cost depletion, percentage depletion deductions can greatly exceed actual costs! Percentage depletion rates are 22% of gross income for uranium, 15% for oil, gas and oil shale, and 10% for coal. The deduction is limited to half of the net income from a property, except for oil and gas, where the deduction can be 100%. Production from geothermal deposits is eligible for percentage depletion at 65% of net income.

Oil and gas exception to passive loss limitation. Although owners of working interests in oil and gas properties are subject to the alternative minimum tax, they are exempted from the “passive income” limitations. This means that the “working interest-holder,” who manages on behalf of himself and all other owners the development of wells and incurs all the costs of their operation, may use oil and gas “losses” to shelter income from other sources.

Alternative fuel production credit. A credit of \$3 per barrel (in 1979 dollars) of oil-equivalent production is provided for several forms of so-called “alternative fuels.” (It is available as long as the price of oil stays below \$29.50 in 1979 dollars). Alternative fuels include shale oil, natural gas produced from hard-to-access places and garbage, and synthetic oil and gas produced from coal. Production of many of these fuels has been criticized as environmentally detrimental.

Alcohol fuel credit. Manufacturers of gasohol (a motor fuel composed of 10% alcohol), get a tax subsidy of 54 cents per gallon of alcohol used.¹⁹ This enormous subsidy has produced big profits for Archer-Daniels-Midland, the nation’s chief gasohol producer. But although the subsidy is designed to encourage substitution of alcohol for petroleum-based gasoline, it’s not clear that it has actually saved much if any oil consumption. That’s because production of the corn used to make the alcohol is itself quite energy intensive.

New technology credits. A 10% credit is available for investment in solar and geothermal energy facilities. In addition, a credit of 1.5 cents is provided per kilowatt hour of electricity produced from renewable resources such as wind and biomass. The renewable resources credit applies only to electricity produced by a facility placed in service before July 1, 1999.

Credit and deduction for clean-fuel vehicles and property. A 10% tax credit is provided for purchases of electric vehicles. There also is a tax deduction for other clean-fuel burning vehicles and their refueling facilities.

Exclusion of utility conservation subsidies. Subsidies by public utilities for customer expenditures on energy conservation measures are excluded from the gross income of the customers.

¹⁹Technically, gasohol is exempt from 5.4 cents of the 18.4 cents per gallon federal gasoline tax. (There is a corresponding income tax credit for alcohol used as a fuel in applications where the gasoline tax is not assessed, such as farming.) Since the alcohol-content of gasohol is 10%, the subsidy works out to 54 cents per gallon of alcohol used.

9. Timber, agriculture, minerals

Timber, agriculture and mineral extraction have long been favored by the tax code over other industries. Besides the capital gains breaks that apply to these industries (loopholes that the Republican “Contract” tried to expand), these tax expenditures include:

<u>1996-02 Cost</u>		
Corporate	\$6 billion	Exploration and development costs. As is true for fuel minerals, certain capital outlays associated with exploration and development of nonfuel minerals may be written off immediately rather than depreciated over the life of the asset.
Individual	\$4 billion	
Total	\$10 billion	

Mining reclamation reserves. Taxpayers are allowed to establish reserves to cover certain costs of mine reclamation and of closing solid waste disposal properties. Net increases in reserves may be taken as a deduction against taxable income.

Expensing multi-period timber growing costs. Generally, costs must be capitalized when goods are produced for inventory. Timber production, however, was specifically exempted from these multi-period cost capitalization rules, allowing immediate deductions and therefore deferral of tax.

Credit and seven-year amortization for reforestation. A special 10% tax credit is allowed for up to \$10,000 invested annually in clearing land and planting trees for the production of timber. The same amount of forestation investment may also be amortized over a seven-year period. Without this preference, the amount would have to be capitalized and could be deducted only when the trees were sold or harvested (say, 20 or more years later.) Moreover, the forestation investment that is amortizable is not reduced by any of the investment credit that is allowed.

Expensing certain capital outlays. Farmers, except for certain agricultural corporations and partnerships, are allowed to deduct certain investments in feed and fertilizer, as well as for soil and water conservation measures. Expensing is allowed, even though these expenditures are for inventories held beyond the end of the year or for capital improvements that would otherwise be capitalized.

Expensing multi-period livestock and crop production costs. Raising livestock and growing crops with a production period of less than two years are exempted from normal cost capitalization rules. Farmers planting orchards, building farm facilities for their own use or producing goods for sale with longer production periods also may elect not to capitalize certain costs. But if they do, they must apply straight-line depreciation to all depreciable property they use in farming.

Loans forgiven solvent farmers. Farmers are granted another special tax treatment—exemption from taxes on certain forgiven debt. Normally, loan forgiveness is treated as income of the borrower. The borrower must either report the income right away or reduce his recoverable basis in the property to which the loan relates (leading to reduced depreciation deductions or a larger taxable gain when the

property is sold). In the case of bankrupt debtors, however, loan forgiveness does not result in any income tax liability (currently or in the future). Farmers with forgiven debt are treated as “bankrupt” for tax purposes (even though they are solvent), and thus are never taxed on their forgiven loans.

10. Financial institutions (non-insurance)

Before the 1986 Tax Reform Act, it was rare to find a bank (or savings and loan or credit union) that paid any significant amount in federal income taxes. Reforms have lessened the tax breaks for financial institutions (most notably limits on their ability to deduct their interest costs for carrying tax-exempt bonds). But financial institutions still enjoy substantial tax subsidies, including the ability to take phony deductions. The major breaks listed in the official tax expenditure budget include:

	<u>1996-02 Cost</u>
Corporate	\$7 billion

Bad debt reserves. Commercial banks with less than \$500 million in assets, mutual savings banks, and savings and loan associations are permitted to deduct so-called “additions to bad debt reserves” that exceed their actual losses on bad loans. The deduction for additions to loss reserves allowed qualifying mutual savings banks and savings and loan associations is 8 percent of otherwise taxable income. To qualify, the thrift institutions must maintain a specified fraction of their assets in the form of mortgages, primarily residential.

Credit union income. Unlike banks and thrifts, the earnings of credit unions not distributed to members as interest or dividends are exempt from income tax.

11. Other business and investment tax breaks

The official tax expenditure budget lists a number of other business and investment tax subsidies. Some were installed for noble purposes, but it is highly questionable whether they are achieving their stated goals, and even if they are doing some good, whether they are doing so efficiently. The list includes:

Low-income housing credit. Through 1989, a tax credit for investment in new, substantially rehabilitated and certain unrehabilitated low-income housing was allowed, worth 70% of construction or rehabilitation costs (and taken over 10 years with interest). For federally subsidized projects and those involving unrehabilitated existing low income housing, the credit was worth 30% of costs. Beginning in 1990, the credit was extended to a value of 70%, including projects financed with other federal subsidies, but only if substantial rehabilitation is done. In addition, investors are allowed to take depreciation write-offs as if they had not received this large tax-credit subsidy. The 1996-2002 cost of this credit is \$23.9 billion.

Employer Stock Ownership Plan (ESOP) provisions. A special type of employee benefit plan is tax-exempt. Corporate employer contributions of stock to the ESOP are deductible by the company as part of employee compensation. But they aren't included in the employees' gross income for tax purposes until they are paid out as benefits. Other tax breaks for ESOPs include: (1) annual employer contributions are subject to less restrictive limits (percentages of employees' cash compensation) than regular pension plans; (2) ESOPs may borrow to purchase employer stock, under an agreement with the employer that the debt will be serviced by the corporation's (tax-deductible) payment of a portion of wages (excludable by the employees) to service the loan; (3) lenders to ESOPs may exclude half the interest they receive from their gross income; (4) employees who sell appreciated company stock to the ESOP may defer any taxes due until they withdraw benefits; and (5) dividends paid on ESOP-held stock are deductible by the corporate employer.

In theory, tax subsidies for ESOPs are intended to increase ownership of corporations by their employees. In practice, they seem to have mainly enriched the companies that have utilized them, at a 1996-2002 cost of \$8.5 billion.

Real property installment sales. When a business sells a product, normal accounting (and tax rules) include the proceeds in gross income. That's true even if the seller lends the buyer the money to buy the product and the buyer pays in installments (typically with interest).²⁰ But business sellers of real estate can put off paying tax on installment sales of up to \$5 million in outstanding obligations.

Empowerment zones. Businesses in designated "economically depressed areas" will get \$3.9 billion in special tax breaks over the next seven years, including an employer wage credit, increased depreciation write-offs and tax-exempt financing. There's also a tax credit for gifts to certain community development corporations.

Reduced corporate income tax rates for smaller corporations. Smaller corporations are taxed at lower rates than the 35% regular corporate rate, with the tax savings from the lower rates phased out for larger companies. As a result, statutory corporate rates bounce around a lot. Specifically, they:

Corporate Tax Rates	
Taxable income	Rate
\$0	15%
50,000	25%
75,000	34%
100,000	39%
335,000	34%
10,000,000	35%
15,000,000	38%
18,330,000	35%

- # start at 15% of the first \$50,000 of taxable income,
- # go to 25% on the next \$25,000,
- # then go to 34% on the next \$25,000,
- # then go to 39% on the next \$235,000,
- # then go back down to 34% up to \$10 million,
- # then go up to 35% on the next \$5 million,
- # then go to 38% on the next \$3.33 million
- # and finally go to 35% on income above \$18.33 million.

Although the special lower corporate tax rates are purportedly designed to help the little guy, they are of no benefit at all to the vast majority of business owners who make less than about \$60,000. Since married business owners stay in the 15% personal income tax bracket until about that level, they get no tax advantage from incorporating and paying the lower corporate rate rather than not incorporating and simply paying taxes on their profits as individuals.

²⁰In some cases, profits on installment sales can be deferred, but the seller must pay interest to the government on the deferred taxes.

But the lower corporate rates on smaller businesses do benefit well-off business owners, who routinely split their incomes between the personal and corporate rate schedules to minimize their tax rates. For example, a business owner with \$200,000 in total income can save \$9,200 in taxes compared to what he'd owe under the regular personal income tax by paying himself a salary of \$125,000 and keeping the remaining \$75,000 in his corporation. A business owner making \$500,000 can cut his taxes by \$16,400 by arranging to have 20% of his income taxed at the reduced corporate rates. The 1996-2002 price tag for the special lower corporate rates is \$34.8 billion.

Treatment of "Alaskan Native Corporations" losses. Normally, the tax laws restrict profitable corporations from reducing their taxes by merging or buying companies with unused tax write-offs and investment credits. But "Alaska Native Corporations" have a limited exemption (15 years after the write-off or credit arose) from these restrictions (covering deductions and credits arising prior to Apr. 26, 1988). As a result, many ANCs have sold their unused write-offs and credits to profitable corporations, who use them to cut their taxes.

Cancellation of indebtedness. If someone borrows money and the debt is later forgiven, that "cancellation of indebtedness" ought to be treated as income. Otherwise, people could be paid in loans, and never pay tax on their earnings. But cancellation of certain asset-related indebtedness is not treated as income. Instead, it reduces the "basis" of the asset, so that the tax is indefinitely deferred.

Exceptions to imputed interest rules. The tax laws generally try to treat interest paid or received based on the substance of a transaction, not how lenders and borrowers might try to characterize the interest payments. Suppose, for instance, that someone borrows \$10 million and promises to pay back \$15 million in a lump sum 4 years later. The tax code would treat the interest on this loan just as if the interest payments were made annually. Thus (roughly speaking), the lender would have to include \$1.25 million of interest in income each year, and the borrower could deduct a corresponding amount.

Likewise, if a borrower promises to pay \$1 million plus interest at 10% on a one year loan—for a total repayment of \$1.1 million—but only gets \$900,000 from the lender, the tax law would treat this as what it actually is—a \$900,000 loan at 22.2% interest. (This could matter a lot if the lender is in a high tax bracket and the borrower in a low one.)

There are exceptions to these general rules for accounting for interest expense or income, however. First of all, there is a \$250,000 general exception (supposedly in the interest of simplicity). Secondly, sellers of farms and small businesses worth less than \$1 million, with a note taken back from the purchaser, are exempt. And third, "points" on mortgage loans used to purchase a home are treated as prepaid interest deductible in the year paid, rather than requiring that the interest deductions be spread out over the life of the loan.

Exemption of certain mutuals' and cooperatives' income. Profits of mutual and cooperative telephone and electric companies are exempt from tax if at least 85% of their revenues come from patron service charges.

U.S. savings bonds. Unlike, say, interest from corporate bonds, regular Treasury bonds or for that matter a savings account, interest on U.S. savings bonds is not taxed until the savings bonds are redeemed. This tax deferral is like an interest-free loan from the government.

12. Pensions, IRAs, etc.

Normally, people don't get a tax deduction for the money they save. (If they did, we'd have a consumption tax, not an income tax.) But employer contributions to pension plans and certain other kinds of personal retirement savings are excluded from individuals' adjusted gross incomes. Likewise, investment income earned by pension funds and other qualifying retirement plans is not taxed when earned. Instead, people pay tax on their retirement savings and accrued investment income only when they withdraw the funds after retirement.

1996-02 Cost

Individual \$562 billion

Limits on Tax Deferrals for Retirement Savings

Employer pensions: In general, tax deferrals for employer pension plans are limited to \$30,000 in employer contributions per worker per year. Alternatively, in the case of "defined benefit" plans, the maximum annual pension payment per worker cannot exceed about \$120,000 (indexed for inflation).

Self-employed pension plans: Self-employed persons can make deductible contributions to their own retirement (Keogh) plans equal to 25% of their income, up to a maximum of \$30,000 per year.

401(k) plans and tax-sheltered annuities: Limited amounts (\$9,240 in 1994) can be excluded from an employee's adjusted gross income under a qualified cash or deferred arrangement with the employer (known as a "401(k)" plan). A worker's own contribution of a similar amount may be excluded annually from the worker's adjusted gross income when placed in a tax-sheltered annuity.

Individual Retirement Accounts (IRAs): Workers can deduct annual contributions to an IRA of \$2,000 per year (or total compensation, if less). For couples, the maximum deduction is \$4,000 (\$2,250 if only one spouse has earned income). All taxpayers without employer-provided retirement plans are eligible for IRA deductions.

In addition, even taxpayers whose employers do provide retirement benefits can take IRA deductions if their incomes are below certain levels. For couples with employer plans, IRA deductions are phased out between \$40,000 and \$50,000 of adjusted gross income. For single people with employer plans, the phase-out is between \$25,000 and \$35,000. Beyond these income limits, taxpayers with employer plans can still make nondeductible contributions to IRAs and defer tax on investment income until retirement.

Tax breaks for employer-pension contributions were first established as an incentive for corporations to provide pensions to their workers. Similar treatment was later extended to unincorporated businesses and later to Individual Retirement Accounts for people without employer-provided pensions. (In 1981, eligibility for tax-deductible IRAs was granted even to workers with pensions, but that expanded IRA tax break was scaled back in 1986).

To further the goal of assuring that pension benefits are not limited to business owners, managers and highly-paid employees, "anti-discrimination" rules have been gradually strengthened over time. These rules are supposed to assure that pension benefits go to the rank-and-file, too.

In general under current law, pension contributions or benefits must be based on an equal percentage of salary for all eligible workers (up to the maximum contribution of \$30,000 a year). Full-time workers must gain a full right to accrued pension benefits (i.e., benefits must "vest") after five years on the job, or alternatively, benefits can vest at 20% a year from the third to the seventh year of work.

Notwithstanding these and many other salutary albeit complex rules, many employers do their best to tilt their pension benefits in favor of highly-paid workers, especially in non-unionized industries and small businesses. That practice comes on top of an intrinsic tilt in pension tax breaks: the fact that their value depends on a worker's marginal tax rate—the “upside-down” effect common to most personal tax subsidies. Top-bracket taxpayers benefit from tax deferral at about a 40% tax rate, while most workers defer tax at about a 30% rate on the initial employer contributions (counting income and payroll taxes) and at a 15% rate on the pension fund's investment earnings.

Although pension tax deferrals clearly favor the well-off in terms of their direct tax benefits, pension tax breaks have probably helped enhance retirement savings for ordinary workers (if only by encouraging workers to negotiate with their employers to take part of their pay in pensions rather than current compensation). In fact, the distribution of pension payouts to retired people is actually far more even than the distribution of income overall. For example, families with incomes below \$50,000 have 40% of total income from all sources, but get 50% of total pension income. In contrast, people making more than \$200,000 get 16% of the nation's total income, but only 5% of total pensions.

Retirement savings tax breaks, particularly IRAs, have sometimes been touted as “savings incentives.” Yet despite a major expansion in the use of these tax subsidies over time, national savings has not improved. Indeed, the abject failure of IRAs to augment savings (along with their skyrocketing cost) was one reason IRAs were scaled back in the 1986 Tax Reform Act.²¹ Unfortunately, both President Clinton and congressional Republicans have proposed to undo much of the 1986 IRA reforms by restoring IRA eligibility to better-off families with employer pensions.

Distribution of Taxable Pensions Compared to Overall Income in 1996			
Income Group	All Families		% of Pension Income
	% of Families	% of All Income	
\$0-10,000	18.6%	2.6%	1.5%
\$10-20,000	21.5%	7.9%	8.4%
\$20-30,000	15.8%	9.7%	13.1%
\$30-40,000	11.5%	10.0%	15.1%
\$40-50,000	8.7%	9.8%	11.9%
\$50-75,000	13.2%	20.0%	23.6%
\$75-100,000	5.2%	11.1%	11.1%
\$100-200,000	3.9%	12.8%	10.1%
\$200,000+	1.2%	16.2%	5.0%
All Families	100.0%	100.0%	100.0%

Source: Institute on Taxation and Economic Policy Microsimulation Tax Model, 1996.

²¹The official General Explanation of the Tax Reform Act of 1986 noted: “Congress determined that since 1981, the expanded availability of IRAs had no discernible impact on the level of aggregate personal savings.” (p. 625)

PART III

Personal Tax Expenditures

1. Itemized deductions

Itemized deductions are the usual targets of various so-called “flat tax” proposals (which otherwise typically aim to expand loopholes, particularly for corporations and investment income). But while some itemized deductions lack a strong tax policy basis and can be criticized as inefficient or unfair subsidies, others can be seriously defended on tax policy grounds.

1996-02 Cost
Individual \$589 billion*
 *After standard deduction offset.

1996 Tax Savings from Itemized Deductions										
Income Group \$-000	All Deductions		State/Local Taxes		Mortgage Interest		Charitable Gifts		Medical Costs	
	% With	Average Benefit*	% With	Average Benefit*	% With	Average Benefit*	% With	Average Benefit*	% With	Average Benefit*
\$0-10	0.8%	\$ 0	0.4%	\$ 0	0.4%	\$ 0	0.6%	\$ 0	0.6%	\$ 0
\$10-20	4.0%	10	2.8%	4	2.3%	5	2.8%	2	2.3%	6
\$20-30	12.4%	52	11.7%	26	8.5%	35	10.0%	13	5.2%	19
\$30-40	24.0%	149	24.0%	85	18.9%	108	20.9%	37	6.9%	36
\$40-50	37.3%	305	37.3%	181	31.3%	233	33.7%	74	7.2%	40
\$50-75	60.6%	767	60.6%	490	52.8%	598	56.6%	190	6.7%	50
\$75-100	82.1%	1,853	82.1%	1,142	72.3%	1,317	78.3%	415	6.0%	82
\$100-200	89.7%	3,860	89.7%	2,190	76.3%	2,293	86.3%	731	4.7%	98
\$200+	93.2%	14,870	93.2%	9,725	73.2%	4,929	90.3%	3,910	2.4%	159
All	25.9%	\$ 590	25.5%	\$ 362	21.5%	\$ 339	23.7%	\$ 138	4.3%	\$ 29

NOTE: “All deductions” includes items not shown here. Details do not sum to total because of standard deduction offset.

*Average for all families in each group.

Source ITEP Microsimulation Tax Model, 1996.

Mortgage interest on owner-occupied homes. Homeowners who itemize deductions can deduct mortgage interest on their primary and secondary residences. The regular mortgage interest deduction is limited to interest on debt no greater than the homeowner’s basis in the residence, and the loan is also limited to no more than \$1 million (for debt incurred after Oct. 13, 1987). Interest on home-equity loans on debt of up to \$100,000 is also deductible, irrespective of the purpose of borrowing (provided that the debt does not exceed the fair market value of the residence).

The regular mortgage interest deduction is beloved by the real estate industry as a major federal subsidy for home purchases. The home-equity interest deduction is an exception to the general denial of deductions for personal interest that has no apparent rationale at all. Like all subsidies structured as personal tax deductions, these interest write-offs lead to “upside-down” effects: the higher a person’s income (and tax bracket), the larger the share of mortgage interest that the government subsidizes.

	<u>1996-02 Cost</u>
Individual	\$351 billion

- # If a family making \$45,000 borrows \$75,000 to buy a home, the federal government will offset about 13% of its total mortgage payments, a subsidy worth about \$81 per month. But if a family making \$500,000 takes out a \$360,000 mortgage to buy a house, the government will subsidize about 35% of its mortgage payments, worth \$1,020 a month.²²
- # In 1996, about 27 million tax returns are expected to show a deduction for mortgage interest. That compares to about 64 million home-owning families. Thus, more than half of all homeowners get no tax reduction at all from the mortgage interest deduction. Another 50 million or so families rent rather than own, and of course they get no help from the mortgage interest subsidy either. On average, mortgage interest deductions are worth almost \$5,000 a year each to taxpayers making more than \$200,000, but only \$333 a year to families earning between \$30,000 and \$75,000.²³

It seems obvious that a \$43 billion a year direct government housing subsidy program with such bizarre effects would have no chance at all of being enacted. Nevertheless, the mortgage deduction has been on the books so long and is relied on by so many people that curtailing it would have to be done slowly and gradually to avoid serious unfairness during the transition. Some reformers have suggested eliminating the home equity loan loophole and the deduction for second homes and also lowering the cap on regular mortgage loans eligible for the deduction from the current \$1 million. These are all excellent ideas, although lowering the cap on regular mortgages too much too quickly could create significant regional disparities (due to the wide range of housing costs).

²²These figures are averages for the first ten years of a 30-year mortgage at 9% annual interest. In later years, the subsidy declines because interest falls as a share of total monthly mortgage payments.

²³Almost half (46%) of the families who now itemize mortgage interest would switch to the standard deduction if the mortgage deduction were eliminated, reducing the number of itemizers by 38%. In comparison, eliminating deductions for state and local taxes would cut the number of itemizers by 34%; wiping out charitable deductions would cut the number by 11%; medical, by 6%; and casualty losses, by only 0.1%. Thus, the mortgage interest deduction is the single biggest factor in making people into itemizers.

1996-02 Cost
Individual \$351 billion

State and local taxes. Itemizers can deduct the personal income and property taxes they pay to their state and local governments. (Sales taxes used to be deductible, but no longer are, in part because it was very difficult for people to keep track of what they actually paid in sales taxes and the alternative sales-tax-deduction tables provided by the IRS weren't very accurate.) The rationale for the tax deduction for state and local taxes is that people shouldn't be taxed on income that doesn't directly benefit them personally, but that they are required to pay in taxes to serve the general good. Put another way, a New Yorker making \$50,000 is thought to have a lower ability to pay federal taxes than a Texan with the same gross income, because the New Yorker's state and local taxes are higher.

Some analysts argue, however, that deductions for state and local taxes are a subsidy for state and local services received by individuals. For example, they point out, communities with high property taxes may provide better schools and other services (e.g., trash collection, parks, etc.) than communities with low property taxes. There's no doubt that there is a strong correlation between the level of state and local taxes and the quantity and quality of public services. On the other hand, the state and local services that a particular person receives may or may not reflect the amount of state and local taxes that he or she pays.

1996-02 Cost
Individual \$146 billion
Corporate \$17 billion

Charitable contributions. Contributions to charitable, religious, and certain other nonprofit organizations are allowed as itemized deductions for individuals, generally up to 50% of adjusted gross income. Taxpayers who donate assets to charitable or educational organizations can deduct the assets' full value without any tax on appreciation. Corporations can also deduct charitable contributions, up to 10% of their pretax income.

The basic principle behind the tax deduction for charitable donations is a defensible one: people shouldn't be taxed on income that doesn't benefit them personally, but that they instead give away for the public good. (This is the same as the rationale for the deduction for state and local taxes.) In other words, if someone earns \$1,000 and gives it away to charity, it's reasonable not to tax him on that \$1,000 in earnings. The normal way it works in the case of cash gifts is that the donor includes the \$1,000 in his gross income and deducts the \$1,000 gift in computing taxable income. Net result: no tax on the income given to charity.

But there are major problems with charitable deductions, most notably in the case of donations of property rather than cash. In 1986 (the last year before the 1986 Tax Reform Act took effect), the IRS says that one out of every ten people making more than \$200,000 who paid no federal income

tax at all reported giving more than 30% of total income to charity. A few of these no-tax rich people said they donated all of their income to charity. If this looks a little fishy to you, you're right. Almost certainly, much of this apparent largesse reflected a loophole in the law that allowed these wealthy people to deduct the full appreciated value of donated property, even though the increase in value was never counted as part of their gross income.

Take someone who has \$1,000 worth of stock that she originally bought for \$100. If she sells the stock and gives the \$1,000 to charity, she'll include the \$900 gain in her gross income and get a deduction for the donation. The net tax on the income given to charity will be zero. Fair enough.

Suppose, however, that instead our taxpayer gives the stock itself directly to charity. That shouldn't end up with a different bottom-line tax result. After all, there's no real distinction. But under the regular income tax rules, there's a huge difference. Not only will she get a deduction for the \$100 in earnings originally used to buy the stock, but she'll also get a deduction for the \$900 in appreciation that is not included in her adjusted gross income. As a result, she won't have to pay taxes on \$900 of her other income that she did not give to charity.

Thus, in this example, someone in the 28% tax bracket will be \$252 better off by donating the stock directly rather than selling it and giving away the proceeds. This strange result is the equivalent of allowing someone who sells the stock and makes a cash gift to take a double deduction for the stock's increased value.

The problem can be even worse in the case of donations of hard-to-value property, such as works of art. Too often, taxpayers will assert highly-inflated "values" for donated objects, and take tax deductions for the full so-called "market value." Congenial or unscrupulous private appraisers sometimes assist in this tax avoidance.

A few years ago, for example, the curator of the Smithsonian Museum was caught cooperating in a scam in which wealthy taxpayers took huge deductions for donations of gems that were appraised at

The "Double" Charitable Deduction for Appreciated Property (Example using a 28% Bracket Taxpayer)	
Asset value at time of donation	\$1,000
Original cost	100
Sell Asset & Donate Cash:	
Tax on sale (\$900 x 28%)	\$252
Tax reduction on gift (\$1,000 x 28%)	-280
Net tax effect*	\$ -
Donate Asset Itself:	
Tax reduction on gift (\$1,000 x 28%)	\$-280
Net tax effect*	\$-252
Sell Asset & Deduct Appreciation Twice:	
Tax on sale (\$900 x 28%)	\$252
Tax reduction on gift (\$1,000 x 28% + 900 x 28%)	-532
Net tax effect*	\$-252
*Includes presumed offsetting \$28 tax on \$100 in earnings used to buy asset originally.	

thousands of times their real value. From the curator's point of view, nothing was amiss. The scheme was arranged so that occasionally the Smithsonian would get a donation with real value. But it ended up (before the fraud was exposed) that the cost to the government in lost revenues was far greater than the real value of what the Smithsonian received.

Of course, the IRS tries to police the phony-appraisal area, but with an audit rate of less than 2%, it can't deal with most cases of abuse.²⁴

Although often criticized, the loophole for donations of appreciated property was a fixture in the tax code for many years. In 1986, however, the Tax Reform Act limited these excessive charitable deductions in connection with the alternative minimum tax—which is supposed to assure that all high-income people pay at least some significant federal income tax no matter how many tax preferences they may utilize under the regular tax. After 1986, in computing taxable income under the minimum tax, taxpayers who made charitable donations of appreciated property no longer got better treatment than cash donors. Instead, they could deduct only what they paid for the donated property—be it stocks, real estate or whatever. The General Explanation of the 1986 Act explained the reasons for the reform as follows:

“Congress concluded that certain items . . . must be added to the minimum tax base in order for it to serve its intended purpose of requiring taxpayers with substantial economic incomes to pay some tax. The items . . . include . . . untaxed appreciation deductions with respect to charitable contributions of appreciated property.”

Unfortunately, in 1993 the Clinton administration persuaded Congress to restore the old tax shelter by repealing the 1986 minimum tax reform.²⁵ This tax reform substantially weakened the minimum tax and will increase the number of wealthy tax freeloaders.

²⁴Since 1969, people haven't been allowed to deduct more than the actual cost of things they create themselves. For instance, if a carpenter builds a table and donates it to a soup kitchen, he can deduct only his expenses, not the value of his time. If an artist donates a painting to decorate a soup kitchen's wall, she deducts only her costs, not the value of the painting that represents her efforts. That's simply an extension of the common sense rule that applies if someone donates time to charity. For instance, someone helping out in a soup kitchen for free does not get a tax deduction for the value of her efforts.

²⁵The idea of reopening this loophole got its start in the Bush administration's 1990 deficit reduction act, when Congress suspended the minimum tax restriction for charitable deductions of “appreciated tangible personal property.” This tax break, whose purpose was to provide a government subsidy for donations of expensive art works, was scheduled to expire in 1993, but was expanded and made permanent instead.

At bottom, the appreciated-property-donation tax break amounts to an open-ended, essentially unpoliced entitlement program for rich donors. It encourages fraud and undermines tax fairness.

In the case of donations of tangible property such as artworks, the government ends up helping pay for things that it might otherwise never have considered subsidizing. If the federal government has extra money available to subsidize art-museum acquisitions, it should appropriate the funds directly—and make sure that the funds are well spent. Meanwhile, the appreciated-property-donation loophole should be closed.

Medical expenses. Personal out-of-pocket outlays for medical care (including the costs of prescription drugs) exceeding 7.5% of adjusted gross income are deductible. The rationale for the deduction is that extraordinary out-of-pocket medical expenses reduce a family's ability to pay taxes.

	1996-02 Cost
Individual	\$33 billion

Because of the floor, only about one in twenty-three taxpayers utilizes this deduction in any given year. A family with income of \$50,000, for example, can deduct only medical expenses above \$3,750. Because of the floor (and because a third of the families who do take the medical deduction would otherwise use the standard deduction), the average subsidy rate is quite low, only about 8% of the extraordinary medical expenses claimed. About half of the total tax savings go to families making between \$30,000 and \$75,000. In this group, one out of 14 taxpayers claims the deduction. Their average medical expenses are about \$8,000, with about \$4,700 of that deductible. Their average tax saving from the deduction is \$620.

Casualty losses. People who buy property and casualty insurance can't deduct its cost. But unlucky or poor-planning families who suffer a large uninsured loss due to casualty or theft can sometimes deduct such a loss—but only if their total losses during a year are more than 10% of their adjusted gross income (and if they itemize deductions). Because of the floor, very few families take the casualty loss deduction (only 121,699 did so in 1992). The number taking the deduction and its cost to the Treasury seem to fluctuate depending on the level of natural disasters in a year.

	1996-02 Cost
Individual	\$2 billion

Although the casualty loss deduction could have some appeal on ability-to-pay grounds (similar to the deduction for extraordinary medical expenses), one can reasonably ask whether what amounts to a government back-up to the private property insurance system makes much sense.

2. Fringe benefits

Tax subsidies are available for a wide range of employee compensation that is paid not in cash, but in fringe benefits. Tax policy analysts have long complained about the disparity between cash wages and benefits. Many wonder, for example, why a person who pays cash for insurance should be taxed more heavily than another person who gets insurance as a fringe benefit (and accepts lower cash wages). Others point out that tax subsidies for certain kinds of spending may encourage it at the expense of otherwise more satisfying outlays. Yet despite these fairness and economic issues, there rarely is any political interest in changing the tax treatment of fringe benefits, in large part because the benefits are so broadly dispersed among the public. The major fringe benefit tax breaks listed in the tax expenditure budget include:

Employer-paid medical insurance & expenses. Employee compensation, in the form of employer payments for health insurance premiums and other medical expenses, is deducted as a business expense by employers, but isn't included in employees' gross income.

1996-02 Cost

Individual \$498 billion

Many health analysts have worried that this very large government subsidy for health insurance causes people to use more health care than they otherwise would, thus helping drive up the cost of health care. In fact, the designers of the "managed competition" approach to health care reform treated limits on tax exemptions for employer-provided health insurance as the centerpiece of their proposal. But there is surprisingly little evidence that tax-induced overuse of health care really occurs. Other nations, for example, subsidize health care to a far greater extent than does ours, but their health care costs are a far lower share of their economies.

Fortunately, the exclusion for health insurance benefits does not have much of the "upside down" subsidy effect that is typical of tax deductions. The tax break reduces both income and social security payroll taxes, and marginal tax rates on wages, including social security taxes, run at about 30% for the vast majority of working families (although the best off one percent of taxpayers are in a 40%-plus bracket). Moreover, because health insurance premiums are basically a flat amount per family, regardless of income level, the size of the health insurance tax subsidy actually declines as a share of income as income rises.

To be sure, the health insurance tax subsidy does not benefit the uninsured, who tend to be lower-income workers. No doubt, a more rational and inclusive system of government assistance for health insurance could be devised. But the last effort to do so foundered in Congress.

Tax breaks for non-health fringe benefits (excluding pensions, discussed earlier) are estimated to cost about \$107 billion over the next seven years. These are:

Other employer-provided insurance benefits. Many employers cover part or all the cost of premiums or payments for: (a) employees' life insurance benefits; (b) accident and disability benefits; (c) death benefits; and (d) supplementary unemployment benefits. The amounts are deductible by the employers and are excluded as well from employees' gross incomes for tax purposes. Whether the government ought to subsidize such purchases can be questioned. But somewhat like health insurance subsidies, the percentage benefits of these other fringe-benefit tax breaks are relatively evenhanded as tax subsidies go (although higher income employees are probably much more likely to get them).

Exclusion of employee parking expenses and employer-provided transit passes. Employee parking expenses paid for by employers are excluded from the employees' income, up to \$155 a month, indexed for inflation. (Parking at facilities owned by the employer isn't counted as a tax break.) Some environmentalists charged that this tax subsidy encourages driving at the expense of mass transit. So Congress extended the subsidy to employer-paid transit passes, tokens and fare cards (so long as the total value of the benefit doesn't exceed \$60 per month, indexed for inflation).

Other fringe benefits. Several other employee benefits are not counted in employees' income, although the employers' costs for these benefits are deductible business expenses. Such exclusions include, among other things, child care, meals and lodging, ministers' housing allowances and the rental value of parsonages.

3. Earned-income tax credit

The earned-income tax credit (EITC) is designed to supplement the wages of low- and moderate-income workers, primarily working families with children. It's available whether or not a family owes income taxes. That is, eligible workers can get a "tax refund" even if the credit exceeds what they otherwise owe in taxes.

As a result of changes adopted in 1993, in 1996 the EITC is equal to 40% of the first \$8,890 in wages for families with two or more children—for a maximum of \$3,556. It is 34% of the first \$6,330 in wages for a family with one child (maximum \$2,152). The credit is phased out between \$11,610 and \$28,490 in income for two-child-plus families and between \$11,610 and \$25,080 for one-child families. Low-income childless workers (ages 25 to 64) can get a small credit equal to 7.65% of up to \$4,220 in wages (\$323), phased out between \$5,280 and \$9,500. All these amounts are indexed for inflation.

1996-02 Cost

Individual	\$203 billion
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First initiated as a small, ostensibly temporary program back in 1974, the EITC has become one of the federal government's largest programs to assist lower-income people. At \$27 billion a year (fiscal 1997), its cost far exceeds what the federal government spends on Aid to Families with Dependent Children (\$17 billion) and equals the cost of both food stamps and Supplemental Security Income (each \$27 billion in fiscal 1997).

Because it is available only to working families (and perhaps because it is styled as a tax expenditure), the EITC has historically been beloved by Democrats and Republicans alike—at least until 1995, when congressional Republicans proposed to reduce it. Clearly, it does a great deal of good for many working Americans.

Nevertheless, the EITC has been criticized. Some of the credit's intended beneficiaries fail to take advantage of it, due to ignorance on their part and perhaps insufficient zeal on the part of the IRS in handing out subsidies. Meanwhile, others who are not eligible for the EITC file fraudulent claims. In fact, by 1990, the level of EITC fraud was so high that Congress felt forced to change the EITC rules to sanction many of the previously illegal claims. That change, which allowed more than one worker per household to claim the credit, has led in turn to enormous "marriage penalties." Under current law, for example, a two-earner, two-child couple making \$27,500 (with a 60%/40% earnings split) can save an

astonishing \$3,700 a year in federal income taxes by avoiding marriage! Almost all that anti-marriage premium stems from the 1990 changes in the EITC eligibility rules.

When it comes to incentives and disincentives for working, the EITC is a mixed bag. On the positive and probably most important side, the credit substantially increases the rewards from working for many low-wage workers. But the necessary phase-out of the EITC means that modest-income workers in the phase-out range face the highest marginal tax rates on wages of any income group. The combination of the 15% federal income tax rate, the (effectively)

14% payroll tax, state income taxes and the 21% EITC phase-out means that a two-child worker making between \$11,610 and \$28,490 keeps less than half of each additional dollar in wages earned. That's a higher marginal tax rate than even the very richest Americans face. Fortunately, however, there is little evidence that high marginal tax rates actually discourage work by people already in the workforce.

The Earned-Income Tax Credit in 1996			
Income Group	% of Total Benefits	Average Benefit	
		Fam. w/	All Fam.
\$0-10,000	26.7%	\$ 920	\$ 284
\$10-20,000	58.3%	2,020	539
\$20-30,000	14.1%	870	177
\$30-40,000	0.7%	840	13
\$40,000+	—	—	—
All Families	100.0%	\$ 1,330	\$ 199

Source: Institute on Taxation and Economic Policy Microsimulation Tax Model, 1996.

Certainly, the problems discussed in the last two paragraphs are not exclusive to the EITC. Similar issues arise with direct welfare payments. But this discussion ought to illustrate that spending money through the tax code—even for the best of purposes—is not likely to be an improvement over spending it directly. On the contrary, asking the IRS—whose normal mission is to collect money from people—to run a program to give people money goes against the grain and has inherent administrative drawbacks.

4. Other personal tax breaks

The remaining items in the tax expenditure budget are generally an inoffensive lot. Some, in fact, serve quite praiseworthy goals, but a few raise fairness questions. Although almost all of these tax subsidies could just as easily be run as direct spending programs (and a few could conceivably be dispensed with entirely), the advantages of doing so would probably be very small in most cases.

Tax-free social security benefits for retired workers. Social security benefits are essentially supplemented for most recipients by the fact that, unlike private pensions, they are mostly not subject to income tax. This tax break—estimated to cost \$186 billion over the next seven years—is phased out, however, for better-off retirees. Retired couples, for example, begin paying taxes on part of their social security benefits when their total income exceeds about \$40,000. The portion subject to tax rises gradually, and eventually reaches 85% (at about \$70,000 in total retirement income for couples). Thus, the tax code enhances the already progressive nature of social security benefits received compared to taxes paid into the fund during people’s working years. (Similar rules apply to railroad retirement benefits.)

Tax Savings from Exclusion of Social Security Benefits		
Income Group	% of Benefits	Average Benefit*
\$0-10	0.5%	\$ 20
\$10-20	17.9%	525
\$20-30	27.7%	1,425
\$30-40	23.3%	1,880
\$40-50	13.6%	1,775
\$50-75	11.8%	1,225
\$75-100	2.4%	785
\$100-200	1.9%	700
\$200+	1.0%	995
All	100.0%	\$ 880

*Average for families with Soc. Security.
Source: ITEP Tax Model, 1996.

Other tax help for the elderly and the blind. Taxpayers 65 or older and blind people get a larger standard deduction (9 out of 10 don’t itemize). The additional deduction is \$1,000 for eligible singles and \$800 per spouse for couples (that is, \$1,600 if both qualify), indexed for inflation.²⁶ The 1996-02 cost of this tax break is \$13 billion.

²⁶In addition, a very limited number of individuals who are 65 or older, or who are permanently disabled, can take a tax credit equal to 15% of the sum of their earned and retirement income. Qualified income is limited to no more than \$2,500 for single people and for married couples filing a joint return where only one spouse is 65, and can be up to \$3,750 for joint returns where both spouses are 65 or older. These limits are reduced by one-half of the taxpayer’s adjusted gross income over \$7,500 for single individuals and \$10,000 for married couples filing a joint return. The cost of this credit is very small.

Capital gains on home sales. Homeowners who sell their homes for more than they paid for them can defer capital gains tax by purchasing or constructing a home of value at least equal to that of the prior home within two years. People 55 or older can completely exclude from tax up to \$125,000 of the gain from selling a home. This once-in-a-lifetime exclusion converts prior deferrals of tax into complete forgiveness of tax (up to the \$125,000 limit). If a house is passed on at death, capital gains taxes deferred on prior increases in the home's value (like other capital gains) are completely exempted from income tax without any limit.

As a result of these provisions, the overwhelming majority of capital gains from home sales are never subject to income tax. Clearly homes are special—and ought to be treated differently from purely financial investments. But one can wonder whether any of the special capital gains tax breaks for homes should go even to sales of the most expensive mansions.

Workmen's compensation, public assistance and disabled coal miner benefits. Workmen's compensation payments to disabled workers, welfare and disability payments to former coal miners out of the Black Lung trust fund are not subject to the income tax, although they clearly are income to their recipients. The cost of these "tax expenditures" is not insignificant—\$40 billion from 1996 to 2002—mostly reflecting the exclusion of workmen's compensation. But most of the beneficiaries of these tax subsidies, especially those getting welfare payments, are rather low-income people.

Benefits and allowances to soldiers and veterans. Housing and meals provided military personnel, either in cash or in kind, are excluded from income subject to tax. Most military pension income received by current disabled retired veterans

is excluded from their income subject to tax. All compensation due to death or disability and pensions paid by the Veterans Administration are excluded from taxable income. In effect, this tax break is in lieu of paying soldiers higher pay while they are in the service. Of course, the benefits of this \$35.4 billion tax subsidy (1996-02) are considerably higher for those with the highest post-military earnings, because they depend on a person's tax bracket.

Child and dependent care expenses. Working families with children get a tax credit for a percentage of their child-care expenses. Married couples can claim the credit if one spouse works full time and the other works at least part time or goes to school. Single working parents (including divorced or separated parents who have custody of children) also can claim the credit. Child care costs (and loosely related maid-service expenses) of up to a maximum \$2,400 for one dependent and \$4,800 for two or more dependents are eligible for the credit. Unlike the "upside-down" subsidies provided by most special tax deductions and

Child Care Credits in 1996			
Income Group	% With	Average Tax Saving	
		Fam. w/	All Fam.
\$0-10	—	\$ —	\$ —
\$10-20	2.2%	390	8
\$20-30	5.4%	440	23
\$30-40	6.7%	380	26
\$40-50	8.4%	370	31
\$50-75	10.1%	400	41
\$75-100	11.2%	440	49
\$100-200	9.0%	460	41
\$200+	5.3%	510	27
Totals	5.2%	\$ 410	\$ 21

Source: Institute on Taxation and Economic Policy Microsimulation Tax Model, 1996.

exclusions, the child-care credit's percentage subsidy declines as income rises. Specifically, the credit is equal to 30% of qualified child-care costs for parents with family incomes of \$10,000 or less, phased down to 20% at \$28,000 or more in income. Oddly, the same income rules apply to both married couples and single parents, meaning that the credit can be considerably larger for couples who choose not to marry. The 1996-02 cost of the child care credit is \$21.9 billion.

Scholarship and fellowship income. Scholarships and fellowships granted to students working for an academic degree are not taxable except to the extent they exceed tuition and course-related expenses. The distinction essentially treats scholarships as non-taxable discounts on educational fees, but treats any excess amounts as taxable because they constitute payments for services (often the case with fellowships) or coverage of normal living expenses (such as room and board).

Deduction for part of the cost of self-employed health insurance. Self-employed people can deduct 30% of their health insurance costs—a scaled-back version of the 100%-exclusion workers enjoy for employer-provided health insurance. Currently pending legislation would increase the percent that can be deducted.

U.S. savings bonds for education. The general rule for interest on U.S. savings bonds is that tax is due when the bonds mature. But if savings bonds (and the interest thereon) are used to fund educational expenses, then the deferred tax on the interest is completely forgiven. (The exclusion applies only to bonds issued after 1989.) This exclusion is phased out between \$65,250 and \$96,900 of adjusted gross income for joint returns and between \$43,450 and \$59,300 for single and head of household returns (at 1996 levels, indexed for inflation). Generally, the income phase-outs effectively limit the tax subsidy to about 15% of savings bond interest used to pay for educational expenses.

Dependent students age 19 or older. Taxpayers can claim personal exemptions for dependent children age 19 or over who receive parental support payments of \$1,000 or more per year, are full-time students and do not claim a personal exemption on their own tax returns—even if the students would normally not qualify as dependents because the parents do not provide more than half the students' support. In effect, this allow students to transfer their personal exemptions to their parents—an arrangement beneficial to families in which the parents' marginal tax rate is higher than the student's marginal rate.

Foster care payments. Foster parents provide a home and care for children who are wards of a state, under a contract with the state. Foster parents are not taxed on the payments they receive for their services and their expenses are consequently nondeductible. Thus, this activity is tax-exempt. It's not likely, however, that much tax would be due if foster-parenting were treated as a business, since expenses would be approximately equal to income.

PART IV

Conclusion

The notion that many of the provisions of the Internal Revenue Code are really hidden spending programs may seem surprising to the uninitiated. But it's 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 such as aid to the poor and the elderly, 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 adds to budget deficits and 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 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.²⁷

²⁷Don't be fooled, however, by the special interests' version of tax reform—or deform. Recognizing the growing public concern about complexity and “corporate welfare” in the tax code, many conservative lobbying organizations and politicians have endorsed a so-called “flat tax.” But abandoning graduated tax rates in favor of a single flat rate has nothing whatsoever to do with tax simplification or closing loopholes. It's simply a way to increase taxes sharply on most families to pay for huge tax reductions for the wealthy. Moreover, the leading flat-rate tax plans—as proposed by House Majority Leader Richard Armey (R-Tex.) and Ways and Means Chairman Bill Archer (R-Tex.)—actually call for replacing income taxes with taxes on wages or personal consumption only. That means that rather than closing corporate loopholes, these (and other) consumption tax proposals would consolidate the tax breaks for corporations and investors into one all-encompassing loophole: complete repeal of the corporate income tax and other taxes on capital income.