

Closing the \$700 Billion Tax Loophole

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The combination of chronic budget deficits and Congress's reluctance to cut spending or raise taxes leaves many potentially productive initiatives unfunded. We must find a way to come up with new resources to meet the challenges and opportunities of the coming decades. Promisingly, there is a huge "shadow budget" that absorbs significant resources, delivers benefits poorly, and could be redirected to fund other important needs.

The federal government will spend \$2.8 trillion this year. But these figures for direct government spending do not begin to tell the tale of how budgetary resources are allocated. There is an additional \$700 billion buried in the budget that is "spent" through the tax code. This shadow budget represents subsidies disbursed by way of taxes *not* collected and is in many ways more similar to spending programs than tax cuts.

The shadow budget, which is made up of targeted tax breaks woven through the tax code, encourages and rewards everything from having children to buying vacation homes to preserving historic buildings. Most often, you can recognize tax expenditures as the tax laws that start with the word "if": If you have a child and meet certain income qualifications, you receive the child credit. If you save money in a 401(k), you receive preferential tax treatment. If you opened

up your home to someone displaced by Hurricane Katrina, you received a temporary tax break. And so on.

This fast-growing area of the budget includes the home mortgage interest deduction, deductions for many employer-provided benefits, and a slew of other exemptions, deductions, and credits that are popular with taxpayers, businesses, and politicians. But popularity does not necessarily reflect sound policy. Tax expenditures tend to be regressive, as well as extremely complex. They pay people to do what they would do anyway. And they do not receive sufficient oversight at inception or on an ongoing basis.

While the politicians who deliver these goodies are happy to market them as tax cuts—because let's face it, who doesn't like tax cuts?—in truth they are far more similar to everyday government spending programs. Take, for instance, the home mortgage interest deduction (a policy as beloved by homeowners as it is reviled by economists). It is quite simply a government program to help subsidize the housing costs of homeowners who take out mortgages. Homeowners are allowed to deduct a portion of their mortgage interest costs from their tax bill on mortgages up to \$1 million. The same goal could be accomplished by sending checks—just as we do for Social Security or other forms of welfare—to homeowners to cover a portion of their

mortgage interest costs, making the tax break a spending program. Spending programs lead to government outlays, tax expenditures to a loss of revenues for the government. Either way, the bottom line is the same: either spending has to be cut, taxes have to go up, or the deficit increases.

The political benefits of labeling a spending program a tax cut are clear. In our highly polarized and partisan political environment, agreeing on tax

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expenditures is one of the few ways that politicians of different parties seem to be able to come together to get things done. Democrats tend to like these spending programs dressed up as tax cuts because the social or economic goals they promote—helping families to save or purchase health care or invest

in education—reflect their priorities. By voting for tax expenditures, they can pursue their goals without being labeled as “big spenders.” Republicans like them because they lower the tax burden on American families—at least on the surface. And no politician of any stripe would consider crafting a spending program when the same policy could be dressed up as a tax cut—certainly not if his political advisors had a say in the matter. If, for instance, a politician wanted to develop a policy to help defray the cost of long-term care insurance, he would likely offer a tax deduction or a tax credit to the individual or employer purchasing the insurance rather than by providing long-term care directly, or by creating a voucher system to cover the costs.

Why Tax Expenditures Are a Bad Idea

Tax expenditures have a lengthy list of shortcomings.

First, they do not undergo nearly the same level of scrutiny as do spending programs. When a new government program is created or resources are directed toward a policy initiative, many questions need to be asked: Is this an important objective? Is this something the government should be doing?

Will this program be effective? Is there a better way to achieve the policy goal?

But discussions about new tax cuts tend to focus almost solely on their costs and distributional effects. Billions of targeted tax cuts for education, to encourage saving, and for health care were enacted in the past few years with little or no discussion of their cost-effectiveness in achieving stated policy goals. No wonder so many tax policies are ineffective or badly directed. If sufficient thought went into creating tax entitlements, would we have a program that subsidizes millionaires who buy second homes?

Second, once tax breaks are in place, they are rarely reviewed with the kind of rigor that should be applied to government programs. The discretionary portion of the budget requires the authorization and appropriation of funds on an annual basis, whereas entitlement programs, such as Social Security and Medicare, do not. In this sense, tax expenditures work like entitlements: once created, they continue pretty much on automatic pilot. However, entitlement programs generally have actuaries and trustees devoted to them who warn Congress when the programs need review. Tax entitlements, on the other hand, are buried in the pages of complex tax legislation and are subject to little or no oversight. Because the Senate and House tax-writing committees have virtually exclusive jurisdiction over targeted tax breaks for housing, health care, education, retirement saving, and so on, the oversight committees with substantive expertise in these areas rarely assess their cost-effectiveness.

Third, there is little impetus and no real constituency for change. While spending programs fall into well-defined categories—defense, international affairs, education, among others—tax expenditures are not classified clearly or analyzed along with the rest of the budget. The lack of transparency with respect to tax expenditures distorts the entire spending picture. Consider, for example, federal spending on housing. Most experts, looking at the federal budget, would put annual spending on housing at \$50 billion. But what they don't

take into consideration is the additional \$125 billion spent through the tax code.

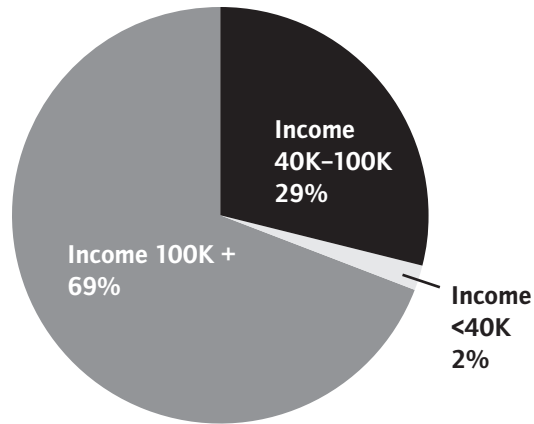
While tax expenditures are hidden in a budgetary sense, those who receive them are keenly aware of them. Come tax time, they leave many taxpayers feeling grateful to the government for giving them a way to shrink their tax bill. Just as there is a strong preference for spending on programs that send benefits directly to voters, such as Social Security and Medicare, over spending on such things as research and development or infrastructure, tax breaks that people see directly have become one of the most popular and protected areas of the budget. And politicians of course like to be on the side of helping taxpayers—no matter the effect on the rest of the budget or the ineffectiveness of the policies. With accountants, taxpayers, and politicians all on the side of targeted tax breaks, there is no rallying cry against them.

Fourth, not only are tax expenditures poorly constructed and monitored, they tend to be regressive—certainly much more so than other spending programs. In many cases, only more affluent taxpayers who itemize (rather than taking the standard deduction) realize any savings, and individuals in higher marginal tax brackets save more. A particular policy might be worth 35 cents on the dollar to a wealthy person, who is paying taxes at the 35 percent marginal rate, and nothing to someone at the bottom of the income scale, whose marginal tax rate is 10 percent or even zero. It is hard to imagine a politician trying to sell a housing program to help the rich a lot, the middle class a little, and those who can only afford to rent not at all—and yet that is exactly what the home mortgage tax break does.

The perverse effect of many of these policies is to drive up the cost of the item that is being subsidized—such as housing or health insurance—which ultimately prices out many of the poorest people most in need of help. Indeed, whenever economists propose ending or limiting the mortgage interest deduction, builders and realtors complain that home prices would plunge.

Fifth, it is tax expenditures that make the tax code an impenetrable mess. Many people mistak-

SHARE OF HOME MORTGAGE INTEREST DEDUCTIONS GOING TO TAXPAYERS IN DIFFERENT INCOME CLASSES



Source: Joint Tax Committee, U.S. Congress.

only think it is the existence of multiple tax rates that makes the tax code so complex—a misconception that has led to the popularity of “flat tax” schemes. But it is the base (what is taxed), not progressive rates, that makes the tax code so difficult to navigate. The current maze of complicated and overlapping tax breaks accounts for many of the payment errors in any given year, and compliance costs are a significant drain on the economy.

The simplifying tax reforms of 1986 dramatically reduced tax expenditures and broadened the tax base, which in turn allowed lower tax rates. But since then, politicians have not been able to resist the temptation to layer them back in: a tax break here for film and television productions, another there for railroad maintenance, another for sanctioned whaling activities, and another for motor-sport racetrack complexes. (And that was in just one year.) The Government Accountability Office found that the number of tax expenditures increased from 67 to 146 between 1974 and 2004, and that the inflation-adjusted costs of these policies increased from \$240 billion to \$730 billion. Only the smartest taxpayers, or the ones with the best accountants, can navigate this expanding and dizzying maze.

Finally, these poorly targeted programs often pay people to do what they would do anyway: having a child, buying a home, or saving for retirement. The poor targeting of hundreds of billions of dollars creates little positive behavioral or economic effect, while draining significant funds from the Treasury. In many years, the total revenue loss from tax expenditures is larger than the government's entire discretionary budget.

Hundreds of billions of dollars in potential savings can be freed up and redirected to meet the nation's most important needs.

What to Do?

Given tight fiscal conditions and the urgent unfunded needs of the country, the tax expenditures area of the federal budget is ripe for reform.

1. **Streamline, simplify, consolidate, and eliminate.** A thorough review of all tax expenditures is long overdue. Tax breaks for dependents, education, and saving, among other things, should be consolidated. In the category of education alone, we find the exclusion from normal taxation of scholarship and fellowship income, the HOPE tax credit, the Lifetime Learning tax credit, Education Individual Retirement Accounts, the deductibility of student-loan interest, the deduction for higher education expenses, favorable treatment of education-related bonds, the parental personal exemption for students aged 19 or over, the exclusion of employer-provided educational assistance, and the discharge of student loan indebtedness. Surely a streamlining of these policies is in order.

Tax expenditures that are not achieving their purpose or have become outdated should be eliminated. Others should be dramatically scaled back and more precisely targeted to the people who need them the most or to those who are most likely to change their behavior in response to incentives. Many existing breaks should be capped and/or turned into credits—a change that could save hundreds of billions of dollars a year while

instantly increasing the progressivity of the tax code. For instance, the home mortgage deduction could be reduced significantly without a negative impact on homeownership. (More fundamentally, it is not clear we should be encouraging homeownership to the extent that we do.) Deductions for health and pension benefits could be turned into refundable credits, to both save money and help promote universal health insurance and retirement saving. Education and family tax breaks could be better targeted to provide benefits for those who most need them. Finally, many business tax breaks that amount to little more than corporate welfare should be eliminated.

2. **Fully integrate tax programs with the rest of the budget.** Not only should these tax policies be reformed, but how they are treated in the budget needs to be addressed. Tax programs should be better integrated with the rest of the budget. They should be clearly classified using the same categories as spending programs, and there ought to be a comprehensive budget showing the entirety of spending on housing, education, commerce, etc. Such a presentation should also make clear how much of the budget is discretionary and subject to the appropriations process, and how much is on automatic pilot.

3. **Classify spending as spending.** In addition, where appropriate, budget conventions should be changed so that tax expenditures that are clearly spending programs are recorded as such. Scoring certain tax expenditures as government outlays would better reflect the true size of government and the amount of resources going to different policy objectives. It would also end the bias that comes with running spending programs through the tax code. At present, attempts by lawmakers to reform or reduce tax expenditures can generally be derailed simply by labeling them as “tax increases.” If the same reforms were put forward as spending cuts, which is a better description of what they are, they would be more likely to be considered on their merits.

4. Improve oversight. Finally, along with improving the transparency of the tax side of the budget, Congress should integrate better oversight mechanisms into the annual appropriations process to monitor tax programs. Specific congressional committees should be made responsible for ensuring that these programs are operating as intended, and outside experts should be consulted as to their effectiveness. In many instances, the total resources spent on tax programs should be capped, just as with discretionary spending programs, to comply with budget restrictions.

5. Redirect the revenue. Making these changes could free up hundreds of billions of dollars annually. Redirecting even half of the revenue lost from tax expenditures would be sufficient to fund affordable universal health care coverage, a universal 401(k) retirement saving plan, and an asset-building account for every child at birth—three proposals detailed elsewhere in this volume. This is particularly feasible since existing, but poorly targeted, tax expenditures for employer-sponsored health insurance and pension saving plans alone cost the federal government more than \$250 billion annually. Thus, critical national needs could be addressed primarily by redirecting revenue already being spent less effectively for the same general purpose.

Under past reform efforts—notably in 1986—the trade-off was a cleaning up of the tax base in re-

turn for a lowering of tax rates. This time around however, there are other competing claims on resources. Reducing the \$250 billion federal budget deficit should come before further tax cuts. In 1986, many of the tax breaks that were removed were corporate and individual loopholes. Today, exemptions and deductions are often linked to specific social and economic policies—illustrating that much of the expenditure budget now falls on the tax side of the ledger. Reforming this area of the budget should be seen as spending reform as much as tax reform, and redirecting resources to where they are needed most should be a central part of the exercises. For example, redirecting the savings from eliminating or reducing the exclusion of employer-provided health care from taxation could be used to help cover the uninsured. Consolidating and eliminating many of the overlapping saving incentives could provide resources to help cover the cost of Social Security reform.

If Congress were to take the courageous step of cleaning up the haphazardly constructed tax base, the ensuing debate over the best use of the freed-up resources could return us to fiscal prudence and engender an honest budgetary debate with various options competing on equal footing. The result would be a more coordinated budget with resources allocated more sensibly, fairly, and transparently—as well as the freeing up of a significant funding stream that could be directed toward the country's most urgent needs.❖