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CBO Report on "Tax Expenditures" Has It Wrong

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The Congressional Budget Office (CBO) released a report on the distribution of "tax expenditures"[1] that some are wrongly using to push for additional tax increases. This was inevitable because the report takes the wrong approach to the issue.

Wrongly Named. The CBO misnames "tax expenditures." Congress has explicitly inserted these provisions (routinely called "loopholes") into the tax code. Some are designed to measure income properly, some to achieve a progressive tax system, and some to lower taxes. They are better referred to as "tax preferences" to stress the fact that they are intended to achieve certain goals. Nevertheless, the CBO calls these provisions "tax expenditures"—which implies that there is a meaningful relationship between actual spending and tax reduction—and explicitly compares tax preferences to spending in its report.

There is a huge moral and economic difference between the government taxing income away from citizens and then spending it and allowing income earners to keep their money by reducing taxes through tax preferences. If tax preferences are akin to spending, then it follows that all the income Americans earn is actually the government's to begin with and that which it does not tax away and munificently lets citizens keep is really a cost to it. President Obama and Vice President Biden often frame their arguments for tax increases in this profoundly troubling way.[2]

Unsurprising Findings. The finding in the CBO report that some are using to make the case for new tax hikes is that high-income taxpayers receive the most benefit from the tax preferences the CBO considered in its analysis. For instance, Congressman Chris Van Hollen (D–MD), ranking member of the House Budget Committee, who requested the study, instantly called for Congress to eliminate tax preferences for high earners as way to raise more revenue for the government.[3]

An in-depth CBO report was not necessary to reach that conclusion, because it is wholly unsurprising. Of course tax preferences benefit high-income taxpayers more, because high-income taxpayers pay the lion's share of the tax burden.[4] It is also self-evident because it is primarily upper-middle-income taxpayers who itemize their deductions. Naturally, policies that reduce taxes lower the tax bills of those taxpayers who otherwise pay the most tax.

Includes Policies Necessary for Sound Tax Code. In the group of tax preferences the CBO analyzed, it wrongly includes policies that are necessary for establishing a sound tax code. In reality, all tax preferences are not created equal. Some, such as the mortgage interest deduction and the deduction for charitable contributions, ensure that the tax code does not interfere with economic decision making. These policies should remain in the tax code even after fundamental tax reform.

Without the mortgage interest deduction, lenders would pay tax on the interest they earn and borrowers

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on the interest they pay. Levying tax on both would create a distortion against investing in housing. The charitable deduction eliminates tax on income that taxpayers earn but do not spend. Taxing them on that income would create a bias against giving and hurt civil society by reducing donations to charities. In this case, the tax preference is not the donation but the tax-exempt status of the organizations receiving donations. Since those organizations are usually non-profits, they normally do not owe tax on their income. However, the recipients of the contributions—whether employees, suppliers, or consultants—do.

Others preferences are certainly less defensible, and Congress should abolish them through revenue-neutral tax reform. The least defensible preferences are credits—for instance, residential energy credits and credits for investing in certain designated markets.[5] Even so, these policies should not be viewed as spending.

The biggest tax preference in the CBO report is the exclusion for employer-provided health insurance. While this preference would not be part of a neutral tax code, the entanglement of health insurance and the tax code is a historical artifact that cannot be easily undone. It is problematic to include it with all tax preferences while not addressing this important fact.[6]

Leaves Out Major Tax Preferences. The CBO determines what qualifies as a tax preference by comparing the current tax code to what it believes a true income tax would look like. The problem with this method is that it is subjective. There is no textbook definition of an income tax. This means that the CBO leaves out policies that others would consider legitimate tax preferences. The CBO does address this issue in its report, but rather than attempt to identify what policies it believes are the right tax preferences, it adopts the flawed and incomplete list used by the Treasury Department and White House Office of Management and Budget.

For instance, the CBO does not include in its analysis the standard deduction or personal exemptions, even though both policies are deviations from a standard income tax and are major revenue reducers that benefit mostly low- and middle-income taxpayers. Including them would significantly shift the CBO's findings and show that tax preferences benefit low- and middle-income taxpayers more than the CBO finds in its report.

The same applies to a tax code that uses multiple tax rates. A standard income tax has a single tax rate applied to properly measured taxable income. Yet the CBO ignores the lower tax burden resulting from the lower tax rates paid by the majority of taxpayers. Ignoring major tax preferences that primarily benefit low- and middle-income taxpayers provides yet another reason it is hardly surprising that the CBO finds that tax preferences primarily benefit upper-income taxpayers.

Includes Polices That Are Not Tax Preferences. The CBO includes the exemption of retirement savings plans, such as 401(k)s and Individual Retirement Accounts, as a tax preference. But retirement savings plans are vital for preventing a portion of savings from unjustified multiple layers of taxation.[7] Similarly, the CBO includes lower rates

1. Congressional Budget Office, "The Distribution of Major Tax Expenditures in the Individual Income Tax System," May 2013, http://www.cbo.gov/sites/default/files/cbofiles/attachments/43768_DistributionTaxExpenditures.pdf (accessed May 30, 2013).
2. See Curtis S. Dubay, "Fairness Is in the Eye of the Beholder Vice President Biden," The Heritage Foundation, The Foundry, April 1, 2010, http://blog.heritage.org/2010/04/01/fairness-is-in-the-eye-of-the-beholder-vice-president-biden/.
3. Budget Committee Democrats, "Van Hollen Statement on CBO Report on Tax Expenditures," May 29, 2013, http://democrats.budget.house.gov/press-release/van-hollen-statement-cbo-report-tax-expenditures (accessed May 30, 2013).
4. The Heritage Foundation, "Top 10 Percent of Earners Paid Majority of U.S. Tax Percentage," http://www.heritage.org/federalbudget/top10-percent-income-earners.
5. Curtis S. Dubay, "The 2010 Tax Deal: A Chance for Congress to Lay the Groundwork for Tax Reform," Heritage Foundation *Backgrounder* No. 2569, June 13, 2011, http://www.heritage.org/research/reports/2011/06/the-2010-tax-deal-a-chance-for-congress-to-lay-the-groundwork-for-tax-reform.
6. Greg D'Angelo and Robert E. Moffit, "Health Care Reform: Changing the Tax Treatment of Health Insurance," Heritage Foundation *WebMemo* No. 2344, March 16, 2009, http://www.heritage.org/research/reports/2009/03/health-care-reform-changing-the-tax-treatment-of-health-insurance.
7. See Romina Boccia and Curtis S. Dubay, "Obama's IRA Cap: A Cap on Defined-Contribution Retirement Savings Plans," Heritage Foundation *Issue Brief* No. 3935, May 15, 2013, http://www.heritage.org/research/reports/2013/05/obama-s-cap-on-defined-contribution-retirement-savings-plans.

on capital income earned through capital gains and dividends, yet these rates are necessary to reduce the economically harmful double taxation of capital, since it is taxed first at the corporate level.

It is odd that the CBO would fail to argue that lower marginal income tax rates are tax preferences but in the same report hold that lower rates on capital gains and dividends are. If lower rates on capital income are considered tax preferences, then lower marginal rates on income must be as well. That is not to argue that lower rates on capital income should be a tax preference; rather, it reveals inconsistencies in the CBO's approach.

Not taxing contributions to retirement savings plans is not a tax preference. In fact, in a neutral tax system, such as The Heritage Foundation's New Flat Tax,[8] taxpayers would not pay tax on any of their savings—whether for retirement or for any other reason—and there would be no capital gains and dividends taxes.

CBO Hurts Tax Reform Efforts. There is broad agreement that the country needs fundamental tax reform. House Ways and Means Committee chairman Dave Camp (R–MI) is working assiduously on a plan. Retiring chairman of the Senate Finance Committee Max Baucus (D–MT) is ramping up his efforts as well.

However, by distorting the debate, this CBO report will hamper their efforts. Liberals will use it to argue for tax increases on the rich by eliminating their tax preferences without including pro-growth and revenue-neutral changes to the tax code. CBO analysis should be an asset, not a liability, when it comes to freeing the economy from the burdensome tax code.

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8. J. D. Foster, "The New Flat Tax: Easy as One, Two, Three," Heritage Foundation *Backgrounder* No. 2631, December 13, 2011, http://www.heritage.org/research/reports/2011/12/the-new-flat-tax-easy-as-one-two-three.