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Abstract

Distribution of Tax Incentives

Contrary to the general belief, the great bulk -- over two-thirds -- of the dollar value of Federal tax incentives or so-called tax expenditures (often also termed "loop-holes") goes to personal taxpayers in their capacity as workers, consumers, and homeowners. In the fiscal year 1976, $61.4 billion out of a total of $91.8 billion of tax expenditures will be received by families and other personal taxpaying units. Less than one-third of the tax expenditures, the remaining $30.4 billion, will be divided among corporations, unincorporated businesses, farmers, and private investors.

An examination of the detail of the $91.8 billion of tax expenditures is also revealing. The largest items are not the ones that generally are brought up in public discussions of "loopholes", such as the controversial depletion allowances. By far, the major item of "tax expenditure" is the widely-used provision permitting federal taxpayers to deduct state and local taxes on their personal tax returns. The second largest tax incentive arises from the deductibility of interest on home mortgages. These two items together exceed the grand total of all tax aids received by corporations in the United States ($22.6 billion versus $20.7 billion).

Other items included in the $91.8 billion of "tax expenditures" which primarily benefit low and middle-income people are $3.8 billion arising from excluding unemployment insurance payments from federal taxation, $3.7 billion from excluding social security benefits from taxable income, $835 million from excluding veterans pensions and benefits, $620 million from excluding workmen's compensation payments, and $90 million from excluding welfare payments.

The $91.8 billion of "tax expenditures" does not represent an equivalent amount of "loopholes" that could readily be eliminated in order to provide additional funds for new government spending initiatives or general rate reduction, as many advocates of tax reform seem to indicate. Rather, the great bulk of federal tax incentives benefits the average consumer, worker, and homeowner. The remainder primarily serves as a spur to investment and economic growth.

THE DISTRIBUTION OF TAX INCENTIVES

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The distribution of Federal tax incentives has been a source of considerable controversy. To some these are merely "tax expenditures" and a subterfuge for direct appropriation of funds from the Treasury.1/ For others, these provisions represent simply the use of the tax system to achieve important national purposes, varying from economic growth to equity among different categories of the population.2/

A particular concern has been the contention that the bulk of these benefits has been received by business and high-bracket investor taxpayers, in contrast to the ordinary citizen.3/ Although ad hoc estimates have been made from time to time, an extremely comprehensive, official tabulation appears for the first time in the Special Analyses that accompany the Federal Budget for the Fiscal Year 1976.4/

As required by the Congressional Budget Act of 1974, the annual budget document now tabulates so-called tax expenditures. These items are defined as "revenue losses attributable to a special exclusion, exemption, or deduction from gross income or to a special credit, preferential rate of tax, or deferral of tax liability."5/ Thus, they are exceptions to the "normal structure" of the individual and corporate income tax. As the budget document notes, tax expenditures are one means by which public policy objectives are pursued by the Federal Government and, in most cases, can be viewed as alternatives to budget outlays, credit assistance, or other instruments of public policy.

Previous work of the author has classified these tax incentives or tax expenditures according to whether they are primarily aids to business, to farmers, to investors, or to individual consumers.6/ Table 1 draws on this earlier work as well as the data in the 1976 Budget to determine the current

Table 1

Estimated Distribution of Tax Expenditures, Fiscal Year 1976
(dollars in millions)

Category	Amount	Percent
Aids to individuals	$61,365	66.8
Aids to corporations	20,665	22.5
Aids to investors and unincorporated business	8,775	9.6
Aids to farmers	1,015	1.1
Total	91,820	100.0

Source: U.S. Office of Management and Budget, Special Analyses, Budget of the United States Government, Fiscal Year 1976, Washington, Government Printing Office, 1975, pp. 108-109.

distribution of these tax provisions.

It is clear that, contrary to the general belief, the great bulk -- two-thirds -- of the dollar value of these tax benefits goes to individuals, $61.4 billion out of a total of $91.8 billion in the fiscal year 1976. The remaining $30.4 billion, or one-third of the total, is divided among corporations, unincorporated businesses, farmers, and private investors. As will be shown in the following section, the largest of these "tax expenditures" provide benefits to consumers, many in very low-income categories. All of the numbers in Table 1 and the tabulations that follow are taken from the Budget materials and were prepared by the U.S. Department of the Treasury. Shortcomings of this concept are discussed later.

Tax Aids to Individuals

By far the largest single category of "tax expenditures" arises from the deductibility of state and local taxes by individual federal taxpayers (see Table 2). The $16.1 billion of revenue foregone from the operation of this single provision is almost twice the estimated cost of all the tax aids to investors and unincorporated businesses. To some degree, this provision can be considered as an early form of revenue sharing, as it reduces the burden of taxation by state and local governments and thus tends to permit higher levels of such taxes than might otherwise be the case. Also, the deductibility prevents the aggregate of federal, state, and local taxation from approaching a confiscatory rate. It is interesting to note that the total of this and the related provision of deductibility of interest on home mortgages, $22.6 billion, exceeds the combined value of all tax incentives provided to all corporations in the United States ($20.7 billion).

Several of the "tax expenditures" benefit primarily low-income groups and augment the effect of the Federal Government's direct income-maintenance

Table 2

Estimated Distribution of Tax Expenditures to Individuals, Fiscal Year 1976
(in millions of dollars)

Category	Amount
Deductibility of state and local taxes	$16,070
Deductibility of mortgage interest on owner-occupied homes	6,500
Exclusion of pension contributions	5,740
Deduction of charitable contributions	5,275
Exclusion of unemployment insurance benefits	3,830
Exclusion of employer contributions to medical insurance and care	3,745
Exclusion of social security benefits	3,700
Deductibility of interest on consumer credit	3,460
Deductibility of medical expenses	2,630
Exclusion of interest on life insurance savings	1,820
Exclusion of percentage standard deduction over minimum standard deduction	1,420
Additional exemption for blind and over 65	1,265
Exclusion of veterans benefits and pensions	835
Exclusion of premiums on group term life insurance	805
Parental personal exemptions for student age 19 and over	690
Exclusion of benefits and allowances to Armed Forces personnel	650
Exclusion of workmen's compensation benefits	620
Deferral of capital gain on home sales	315
Deductibility of casualty losses	300
Exclusion of sick pay	295
Deductibility of child and dependent care expenses	250
Exclusion of scholarships and fellowships	190
Exclusion of employer-provided meals and lodging	190
Exclusion of railroad retirement system benefits	180
Exemption of credit unions	125 1/
Exclusion of certain income earned abroad by U.S. citizens	100
Exclusion of public assistance benefits	90
Exclusion of military disability pensions	85
Retirement income credit	70
Exclusion of premiums on accident insurance	50
Credits and deductions for political contributions	50
All other	20
Total, tax aids to individuals	61,365

1/ Classified on basis of status of credit union members.

Source: U.S. Office of Management and Budget, Special Analyses, Budget of the United States Government, Fiscal Year 1976, Washington, Government Printing Office, 1975, pp. 108-109.

programs. Cases in point include the exclusion of unemployment insurance benefits (with a revenue loss of $3.8 billion), of social security benefits (a revenue loss of $3.7 billion), and of public assistance benefits (a revenue loss of $90 million).

Numerous other tax provisions benefit primarily working people, notably the exclusion of workmen's compensation benefits (a revenue loss of $620 million) and the exclusion of employer contributions to medical insurance and health care (with a revenue loss of $3.7 billion). A major example of benefit to the consumer is the deductibility from taxable income of interest on consumer credit, which results in an annual revenue loss to the Treasury of $3.5 billion.

Tax Aids to Corporations

Although depletion allowances often dominate public discussions of tax reform, they rank only fourth among the major tax aids to corporations. The largest of these tax expenditures (see Table 3) is the investment credit ($4.4 billion) which was enacted by the Congress to foster economic growth and thus create higher levels of employment and living standards. The second largest tax expenditure for corporations is intended primarily to benefit small and new business -- the exemption of the first $25,000 of a company's income from the Federal surtax of 26 percent (which reduces tax receipts by $3.6 billion a year).

The third item, the exclusion of interest on state and local debt, is the counterpart of the similar item discussed above in the category of tax aids to individuals.

Some of the items which the Federal Government has categorized as tax expenditures to corporations might appropriately be listed elsewhere. The $440 million annual cost to the Treasury which arises from the deduction of charitable contributions could be considered primarily as an aid to these non-profit

Table 3

Estimated Distribution of Tax Expenditures to Corporations, Fiscal Year 1976
(in millions of dollars)

Category	Amount
Investment credit	$ 4,420
$25,000 corporate surtax exemption	3,570
Exclusion of interest on state and local debt	3,505
Excess of percentage over cost depletion	2,610
Deferral of income of domestic international sales corporations	1,320
Expensing of exploration and development costs	1,235
Excess bad debt reserves of financial institutions	980
Capital gains	910
Expensing of research and development expenditures	660
Deductibility of charitable contributions	440
Depreciation on buildings	395
Exclusion of income earned in U.S. possessions	350
Five year amortization on railroad rolling stock	55
Exclusion of gross-up on dividends of corporations in less developed countries	55
Special rate for Western Hemisphere trade corporations	50
Deferral of tax on shipping companies	40
All other	70
Total, tax aids to corporations	20,665

Source: U.S. Office of Management and Budget, Special Analyses, Budget of the United States Government, Fiscal Year 1976, Washington, Government Printing Office, 1975, pp. 108-109.

and eleemosynary institutions.

Other Tax Aids

As shown in Table 4, the category of capital gains is the largest item of tax expenditures on behalf of investors and unincorporated business. This provision has been justified because of the desire to promote private investment and thus help to maintain a market economy.

The fourth and smallest sector of tax aids, those to agriculture, are shown in Table 5. Farmers, including corporations, may deduct certain costs as current expenses even though these expenditures were for inventories in hand at the end of the year or capital improvements. They also obtain capital gains treatment for the sale of livestock, orchards, vineyards, and comparable agricultural activities.

Shortcomings of the Tax Expenditure Concept

The foregoing analysis excludes what could be called negative tax expenditures -- exceptions to the normal structure of income taxes that result in increased tax liabilities for certain groups of taxpayers. Examples include limitations on the deductibility of losses on the sale of assets, on the carryover of business losses, and on income averaging.

The "normal" tax structure, which is the base that is used to estimate tax expenditures, focuses on the current income tax base and the rates applied to that base. Features that specify the structure of progressive rates and that exclude low-income persons from tax liability are deemed a part of that normal tax structure. Existing rates are accepted as "normal" even though there is little theoretical foundation upon which to support any particular degree of progressivity in the income tax system. The following specific features of the Federal income tax system are defined by the Treasury to be part of the normal

Table 4

Estimated Distribution of Tax Expenditures to
Investors and Unincorporated Business, Fiscal Year 1976
(in millions of dollars)

Category	Amount
Capital gains	$4,225
Exclusion of interest on state and local debt	1,260
Investment credit	950
Exclusion of pension contributions for self-employed and others	710
Depreciation on buildings in excess of straight line	635
Excess of percentage over cost depletion	445
Dividend exclusion	360
Expensing of exploration and development expenses	130
Five year amortization of housing rehabilitation	60
Total, tax aids to investors and unincorporated business	8,775

Source: U.S. Office of Management and Budget, Special Analyses, Budget of the United States Government, Fiscal Year 1976, Washington, Government Printing Office, 1975, pp. 108-109.

Table 5

Estimated Distribution of Tax Expenditures to Farmers, Fiscal Year 1976
(in millions of dollars)

Category	Amount
Expensing of certain capital outlays	$ 650
Capital gain treatment of certain income	365
Total, tax aids to farmers	1,015

Source: U.S. Office of Management and Budget, Special Analyses, Budget of the United States Government, Fiscal Year 1976, Washington, Government Printing Office, 1975, pp. 108-109.

tax structure in estimating tax expenditures:7/

1. The progressive rate schedules for the individual income tax.
2. Personal exemptions and the minimum standard deduction.
3. Separate rate schedules for single and married taxpayers, married taxpayers filing separately, and heads of households.
4. Deduction of business expenses.
5. Exclusion of unrealized capital gains and losses.
6. Exclusion of imputed income from owner-occupied housing and other sources.
7. Exclusion of the value of government services received in kind, such as food stamps, rent supplements, and Medicare.
8. Foreign tax credits.

Another important shortcoming of the tax expenditure concept arises from the implicit assumption that there are no indirect effects from the operation of each of these special tax provisions. In practice, eliminating many of the tax expenditures would alter taxpayer behavior and economic conditions; they also might require offsetting changes in Federal expenditure programs or in other aspects of the tax system. Thus, eliminating the investment credit would likely result in direct government expenditures or other tax incentives to maintain economic growth and employment.

Another shortcoming of the tax expenditure approach relates to the problems of aggregation. The official tabulation of these items does not contain any totals. The justification given is that in some cases the revenue gain resulting from the deletion of two or more tax expenditure items would be greater than the sum of the individual estimates, and in other instances the gain could be lower.8/

For example, if interest income from state and local government securities were made taxable and capital gains were taxed at ordinary rates, many individuals would be pushed into higher tax brackets than if just one of these sources of income became fully taxable. The combined effect on revenue would be greater than the sum of the two separate estimates. Over the long run, however, investors would shift to higher yield taxable bonds and state and local governments would have to overcome the loss of the tax exemption by offering more competitive rates.

Conclusion

The great bulk of the dollar value of Federal tax incentives or "tax expenditures" goes to personal taxpayers in their capacity as workers, consumers, and homeowners. The largest of these special tax provisions are not the ones that generally are brought up in public discussions of so-called loopholes. By far, the major tax expenditure is the widely-used provision that permits federal taxpayers to deduct state and local taxes from their taxable personal income. The second largest tax incentive arises from the deductibility of interest on home mortgages. These two items exceed the total of all tax expenditures in behalf of corporations.

The composition of the "tax expenditure" total also includes other items not generally considered by tax reformers, such as excluding social security and unemployment compensation from taxable income. It would appear that the $91.8 billion of "tax expenditures" does not quite represent the equivalent amount of "loopholes" that might easily be closed in order to provide additional funds for new government spending initiatives or general rate reduction, as many advocates of tax reform seem to indicate.

Footnotes

1/ Stanley Surrey, "Tax Incentives As a Device for Implementing Governmental Policy: A Comparison With Direct Government Expenditures," Harvard Law Review, Vol. 83, 1970, p. 705.

2/ Bruce F. Davie and Bruce F. Duncombe, Public Finance, New York, Holt, Rinehart and Winston, 1972, pp. 289-291.

3/ Philip M. Stern, "Uncle Sam's Welfare Program For the Rich," in Annual Editions, Readings in Economics, '74-'75, Guilford, Connecticut, Dushkin Publishing Group, 1974, pp. 75-83.

4/ U.S. Office of Management and Budget, Special Analysis, Budget of the United States Government, Fiscal Year 1976, Washington, Government Printing Office, 1975, pp. 101-117.

5/ Ibid., p. 101.

6/ Murray L. Weidenbaum, "The Outlook for Changes in Federal Taxation," Federal Reserve Bank of St. Louis Review, December 1972, p. 12.

7/ U.S. Office of Management and Budget, op. cit., pp. 102-104.

8/ Ibid., pp. 106-107.