

Tax Expenditures: Policy Issues



Legislative Analyst's Office

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Tax Expenditures—An Alternative To Direct Spending Programs

- **What is the need for the program?**
- **What is the objective and how would that be measured?**
- **What is the cost and effectiveness of a tax expenditure?**
- **Is the goal better accomplished through the tax system or a direct spending program?**

Advantages of Using Tax Expenditures

- **Easy to administer**
 - Taxpayers do much of the work
- **Benefits are like entitlements**
 - Also available across time
- **Design can target most in need**
 - Various tools available to tailor benefits

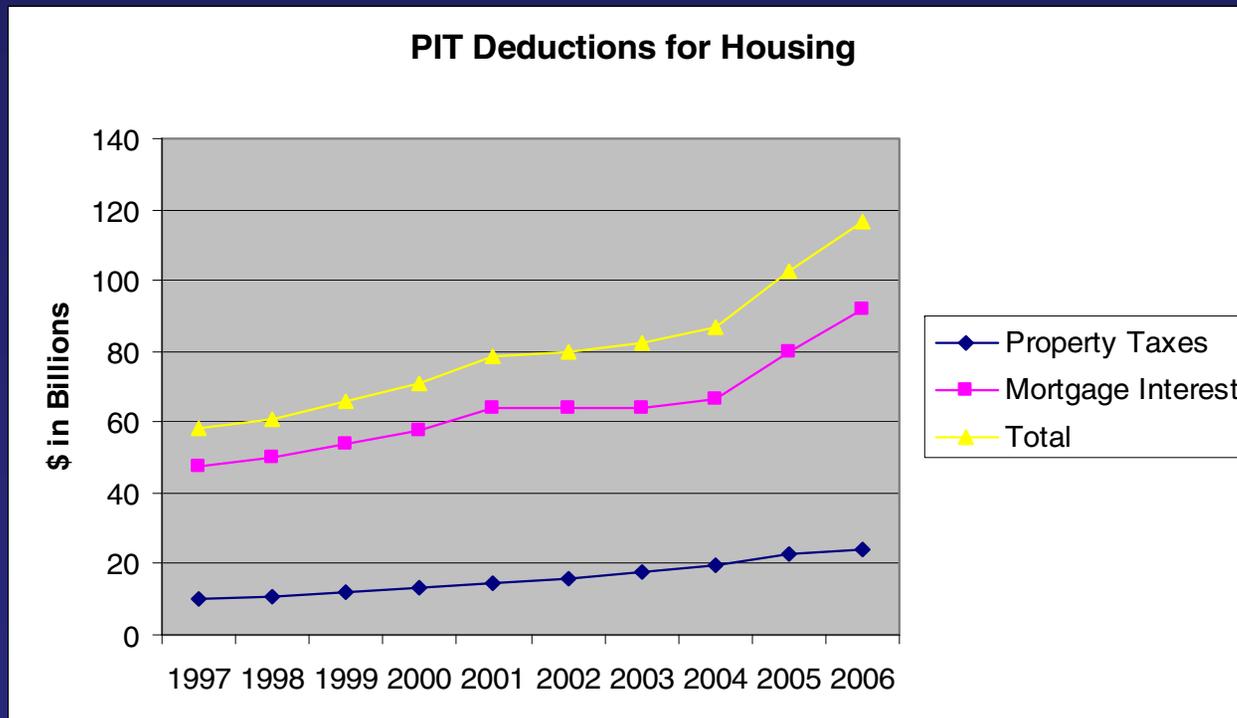
Disadvantages of Tax Expenditures

- **Process**
- **Effectiveness**
- **Administration**

Process Issues

- **Not subject to annual budget review**
 - Costs occur with little spending oversight
- **Tax policies often uncoordinated with spending policies**
 - Different committees, different perspectives
- **Majority vote to create, 2/3rds vote to eliminate or modify**

Housing Deductions Doubled Over the Past Ten Years



Effectiveness Issues

- **Goals often not clear; data not available**
- **High cost if not targeted**
- **Deductions worth more to upper-income**
 - **Itemizing; tax brackets**
- **Small tax liability can limit benefits**

Administrative Issues

- **Complicates tax system**
 - Frustrates taxpayers and increases enforcement problems
- **Data not available due to confidentiality requirements**
 - Limits ability to evaluate impacts

Tax Expenditures Represent an Evaluation Challenge

Example—federal deduction for state and local taxes

- **What is the rationale?**
 - Spillover benefits of services
 - State/local tax payments are not “income”
- **How to evaluate?**
- **What data?**

Economists Find Issues With Tax Expenditures

2005 Report to the President

- **Mortgage Interest Deduction**
 - Change into a credit equal to 15 percent of mortgage interest payments
- **Charitable Giving**
 - Deductible only if above 1 percent of income
- **State and Local Taxes**
 - Eliminates deduction

LAO Reports on Tax Expenditures

- **Manufacturers Investment Tax Credit**
 - General consensus that state-level tax credits have little effect on business decisions
- **Research and Development Tax Credit**
 - R&D have spillover benefits
 - State credits less effective than federal credits
 - State credits affect location decisions, but not overall level of investment

LAO Reports on Tax Expenditures

- **Enterprise Zone Hiring Credit**
 - Little impact on creating new jobs; some evidence it changes job location
- **Mortgage Interest Deduction**
 - Reduces cost of home ownership and increases the return on housing investment
 - Has small impact on rate of home ownership
 - May increase the size of houses purchased

Conclusion

- **Tax expenditure can be effective if well-designed**
- **Many are poorly targeted, however**
- **Eliminating or refining can help broaden the tax base and reduce distortions**
- **State needs way to monitor tax expenditures routinely**