Cracking the Code

A Closer Look at Tax Expenditure Spending

Sima J. Gandhi March 2010

Tax expenditures are an important form of government spending. These special credits, deductions, exclusions, exemptions, and preferential tax rates provide more than $1 trillion in subsidies intended to support public objectives. They are equivalent to spending programs, yet are subject to less scrutiny than other forms of government spending. Like direct spending, tax expenditures should be measured and analyzed. If they work, they should be retained. If they are ineffective, they should be adjusted or replaced with direct spending. And if they don't work, they should be eliminated.

Just take a look at this sampling of 10 from the many tax expenditures that ought to be subject to the same scrutiny they would be if they were traditional spending programs—and the unpleasant surprises a closer look might reveal.*

1. Slam dunk for the NCAA. Millions of Americans fill out their NCAA brackets each year, and with bated breath tune in for two weeks of commercial-laden college basketball games. The NCAA basketball tournament and men's college football bowl games, such as the Rose Bowl and Gator Bowl, generated about $150 million in revenue in 2008. Yet none of this income is taxed even though a Congressional Budget Office report states that the majority of it is spent on sports programs and not on subsidizing other educational programs. And between 55 and 75 percent of this revenue stems from commercial activities such as food sales on game day and advertisements, which would be subject to tax if earned by a similar university-run business, like a restaurant. Why are sports treated differently? Former House Ways and Means Committee Chairman Bill Thomas (R-CA) posed the same question to the NCAA. The first page of their response states, "The linking of athletics with education is a uniquely American experience." Neither this nor the rest of their response justifies why large, profitable programs that generate millions in revenue (small programs are generally unprofitable and wouldn't be subject to tax anyway) benefit from taxpayer subsidies. When college sports operate like big businesses, it's not clear why they shouldn't be taxed in the same manner as a university's other commercial businesses.

2. Accelerated depreciation for horse breeders and other businesses. The American Horse Council has successfully lobbied Congress so that the tax code treats racehorses as if they live for only three years. That's clearly not true in most cases. Without going into the nitty gritty of how the subsidy works, the tax code's fiction generally treats horses as depreciating in value over three years, and this treatment entitles horse breeders to a subsidy. A Treasury Department report found the lobbyist's justification for the subsidy to be unwarranted. Yet the subsidy continues to exist, and was recently expanded. As with any program that uses taxpayer dollars to subsidize profit-making industries, the bar should be set high. Horse breeders—and all other businesses that claim the government should subsidize them when their assets depreciate over time—should have to prove why they need those subsidies. It's not clear how much racehorse breeders receive, but the overall cost of the accelerated depreciation spending program amounts to about $30 billion a year over the next five years.

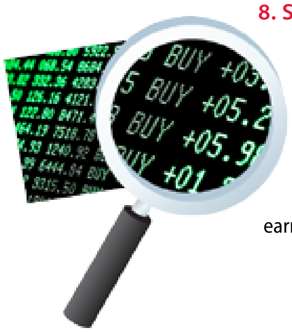
3. Section 179 tax breaks for businesses' sport utility vehicles. Section 179 of the U.S. tax code provides businesses subsidies for a variety of activities including a $25,000 tax perk for purchasing an SUV. In fact, Section 179's subsidy for SUVs used to be worth even more. President George W. Bush temporarily increased it to $100,000 in 2003. This expansion created a bonanza for car dealers and tax accounting firms. According to a *Washington Post* article, one accounting firm's flier, "Write-Off 100 percent of Your New SUV?" drew so many callers that it nearly had to shut down its switchboard. The SUV subsidy is just one of many business tax subsidies offered under the Section 179 spending program. Section 179 was originally intended to increase small business investment and simplify tax accounting. But Congress increased the cost of Section 179 over the past 15 years by boosting the amount spent on individual subsidies (like the one for SUVs) and extending the program to include medium-sized businesses. Section 179 is estimated to cost almost $500 million next year.

4. Fertilizing big agriculture. Farmers get tax subsidies for doing things they'd do anyway, like buying fertilizer, clearing brush from land, and planting windbreaks that protect crops. The weakness in these subsidies have been known since at least 1984 when the Treasury Department issued a report arguing for Congress to eliminate these subsidies because they benefit big profitable farmers. Some of these wasteful subsidies were removed over time, but many still continue to exist. These subsidies will cost nearly $1 billion in 2011.

5. Footing the bill for oil and gas companies. It's hard to believe that oil companies need taxpayer handouts with their prices so high. Yet the government spent nearly $4 billion on oil and gas companies in 2008. Some of these subsidies date as far back as 1919. The specific tax subsidies and how they work have changed over time, but what remains constant is their price tag. Spending taxpayer dollars on already profitable and mature industries doesn't make sense. Eliminating tax expenditure spending for oil and gas companies would save the government nearly $3 billion next year.

6. The timber (negative) tax. The government pays timber companies to make money. A preferential tax rate for timber sales, together with other special timber tax breaks results in a negative tax rate on the timber industry. This means that timber companies benefit more from tax breaks than they actually pay in taxes. Government resources are scarce. Policymakers should think hard about chopping subsidies that benefit industry at the expense of valuable taxpayer dollars. This subsidy will cost nearly half a billion in 2011 alone.

7. Subsidies for mansions and vacation homes. The government uses a tax expenditure to help people afford the expenses of home ownership. Promoting home ownership may be good public policy, but this spending program also provides subsidies for second homes, which makes it an enormous benefit for people with vacation homes. And it provides larger benefits to people with higher incomes. More than 75 percent of the $100 billion in subsidies will be enjoyed by taxpayers earning more than $100,000. The cost is a whopping $104 billion next year. That's enough to pay off California's entire budget deficit plus the budget requests for the U.S. Department of Labor, the Department of Agriculture, and the Department of Treasury.



8. Subsidy for capital assets? The government provides subsidies to people who invest in stocks, property, and other types of capital assets. This government spending is supposed to increase investment, but it's not clear that it actually does that—or that the investments it subsidizes are necessarily the best ones for the economy. What it does do is create a boon for the wealthy. Recent Internal Revenue Service data shows that the top 400 earners, who took home an average of $345 million in 2007, make about two-thirds of their income in capital gains. The top 400 taxpayers had an average income of $344.8 million in 2007, up 31 percent from their average $263.3 million income in 2006. Thanks in large part to the tax break on capital gains, these top 400 earners had a federal effective tax rate of only 16.6 percent, which is less than the 27.5 percent paid by the top 10 percent of earners. If the government wants to encourage people to invest and save, there may be a more efficient and effective way than subsidizing investments in capital assets. This subsidy will cost $50 billion in 2011. Cutting this subsidy would cover the U.S. Department of Education's entire budget, plus more.

9. Debt windfall for the wealthy. The federal government helps state and local governments raise money for infrastructure projects, school construction, and other activities that benefit the public. The federal government does this by giving tax subsidies to investors who buy debt from state and local governments. The subsidy is intended to make it cheaper for state and local governments to raise money. It does accomplish this goal, but the system's current design is inefficient with wealthy investors capturing 20 percent of the subsidy's value. The subsidy's poor design means a portion of this $40 billion spending program for state and local delivers an $8 billion windfall to the wealthy.

10. Murky stock ownership incentives. The Employee Stock Ownership Plan or ESOP is a spending program that's intended to encourage workers to own stock in their employers' companies. It does this by offering a variety of subsidies. One of them increases the value of an employee's retirement income if he or she participates in an ESOP. A few other subsidies encourage companies to offer ESOPs by making it cheaper for them to raise money for investments. Increasing employee ownership can have positive effects, but whether ESOPs do more good than harm is open for debate. When companies collapse, like in the case of Enron and Lehman Brothers, employees stand to lose both their jobs and a large share of their retirement savings. And according to a recent Congressional Research Service report, money raised through an ESOP doesn't actually increase investment. Policies that support small businesses and encourage people to save for retirement are sound government policies, but whether these policies should be enacted through ESOPs is not clear. The government will spend nearly $2 billion on its ESOP program in 2011.

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*Except as otherwise noted, all estimates reflect fiscal year 2011 estimates as provided in the president's FY 2011 budget.