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RESEARCH SUMMARY

A REVIEW OF SELECTED CORPORATE TAX PRIVILEGES

The US government uses the term *tax expenditure* to describe both privileges granted to politically favored special interests and patches to the tax system that address economic inefficiencies created by the income tax code. This use of the term confuses two very different phenomena and muddies policy discussions about tax reform.

A new study from the Mercatus Center at George Mason University examines the current accounting of tax expenditures, presents case studies of some corporate tax expenditures, and proposes reforms to reduce favoritism in the tax code. The study investigates the difference between tax expenditures that privilege a particular group at the expense of others and tax provisions that, if properly accounted for, would not be counted as tax expenditures at all.

To read the study in its entirety and learn about the authors, Mercatus Senior Research Fellow Veronique de Rugy and Mercatus Program Manager Adam N. Michel, please see "A Review of Selected Corporate Tax Privileges."

BACKGROUND

A corporate tax expenditure is defined as a provision in the tax code that allows a firm or group of firms to not pay a tax which would otherwise be collected.

- The modern US tax system is built on the income tax. This system double-taxes investment and savings, distorting market decisions and slowing economic growth.
- To correct these distortions in the income tax, some special tax provisions were created to mitigate biases against savings and investment and offset other distortions.
- Current methods employed by Congress's Joint Committee on Taxation (JCT) and the administration's Office of Management and Budget (OMB) for assessing the fiscal impact of tax expenditures use the income tax as the "baseline" from which to make their count.

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- Under the current accounting methods, broadly available tax expenditures that correct for economic bias are economically indistinguishable from government-provided tax subsidies that benefit some businesses and industries at the expense of others.

- A superior tax expenditure baseline would rely on consumption, which would provide a more equal treatment of economic activity and focus attention on tax provisions that truly provide unfair advantages.

However, even by the standards of a consumption baseline, most corporate tax expenditures are unnecessary privileges that provide unfair advantages to certain industries and firms.

- Sixty-five percent of corporate tax expenditures privilege certain activities or industries while excluding others.

- The proliferation of corporate tax expenditures results in disparate effective tax rates that distort consumption and investment and motivate wasteful rent-seeking.

- The growth of tax expenditures also increases compliance costs by contributing to the lengthening of the tax code, which in the past 30 years has nearly tripled in length, from 26,300 pages in 1984 to the almost 75,000-page behemoth it is today.

This general analysis applies to individual tax expenditures as well. However, the benefits that accrue under certain corporate tax expenditures are often more concentrated, and the politics of privilege shows up in starker contrast.

- *Tax credit for orphan drug research*. This corporate tax expenditure targets the cost of researching certain favored drugs for which only a small market is initially thought to exist. This privilege redirects resources away from drugs that could benefit a broader range of people.

- *Special deduction for Blue Cross and Blue Shield*. The tax code contains special deductions for many Blue Cross and Blue Shield companies while failing to extend those privileges to their competitors.

- *Tax credit for certain railroad track maintenance*. This expenditure offsets capital maintenance costs for a limited number of qualifying railroads, driving capital investment away from its highest-value use and unfairly forcing nonqualifying railroad operators to finance their own capital maintenance.

POLICY RECOMMENDATIONS

The conversation on corporate tax expenditures is complicated by an official tax baseline that relies on a misleading definition of spending through the tax code. The following steps will help curb this problem:

- *Redefine the baseline*. The current baseline for measuring tax expenditures rests on an inconsistent definition of income, rendering tax expenditure analysis subjective and unreliable. To remedy this problem, Congress should amend the Congressional Budget and Impoundment Control Act of 1974 to redefine a common baseline around a consistent, broad-based consumption tax baseline.

- *Improve reporting*. Even without legislative action, JCT and OMB could begin reporting a second list of tax expenditures using a consumption baseline—a strategy for sounder analysis that has historical precedent in past presidential budgets.

- *Remove special provisions*. Congress should expand narrowly applied expenditures that aim to move the tax code toward a neutral base and eliminate expenditures that fail to perform this function. Until a more robust, broad-based consumption-tax system replaces the US income tax, policymakers must also resist adding additional privileges.