A Review of Selected Corporate Tax Privileges

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ABSTRACT

The term *tax expenditure* is commonly used to describe both tax privileges granted to politically favored special interests and also patches to the income tax system that address economic inefficiencies. This paper focuses on the difference between tax provisions that should be labeled as tax expenditures (i.e., tax privileges) and those, if properly accounted for, that should not be counted as tax expenditures at all (i.e., those that address economic inefficiencies). The distinction is illuminated through a review of selected corporate tax expenditures, which shows that almost 65 percent of corporate tax expenditures privilege certain activities or industries while excluding others. Cataloging tax expenditures by using a consumption baseline would allow policymakers to properly contextualize these expenditures as a form of privilege, economically indistinguishable from any other government subsidy.

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The US system of taxation is fundamentally flawed: It is vulnerable to special interests and misused for social engineering. Under the current paradigm, the term *tax expenditure* is used to describe both privileges granted to politically favored special interests and patches to the income tax system that address—sometimes not very successfully—economic inefficiencies. This dual definition is fundamentally misleading because it conflates two very different phenomena and muddies policy discussions about reform.

This paper aims to illuminate the difference between tax provisions that should be labeled as tax expenditures and those that, if properly accounted for, should not be counted as tax expenditures at all. A true tax expenditure grants a privilege through the tax code. The current system wrongly labels as tax expenditures important corrections to the income tax system. This ambiguous classification system is problematic because it systematically dissolves institutional boundaries between government spending and revenue collection.[1]

The current baseline for measuring tax expenditures rests on an internally inconsistent definition of income. Without a consistent and economically efficient baseline, tax expenditure analysis will continue to be unreliable and overly subjective. To remedy this problem, tax expenditures should be measured from a consistent consumption-tax base. Others have written extensively on the benefits of using a broad-based consumption tax as a better baseline for tax expenditure accounting.[2] Our contribution will be to highlight those tax expenditures

1. Donald B. Marron, "Spending in Disguise," *National Affairs*, June 28, 2011; David F. Bradford, "Reforming Budgetary Language" (NBER Working Paper No. 8500, National Bureau of Economic Research, Cambridge, MA, October 2001); Edward D. Kleinbard, "The Congress within the Congress: How Tax Expenditures Distort Our Budget and Our Political Processes," *Ohio Northern University Law Review* 36 (2010).
2. Robert Carroll, David Joulfaian, and James Mackie, "Income versus Consumption Tax Baselines for Tax Expenditures," *National Tax Journal* 64, no. 2 (2011): 491–510; William McBride, "A Brief History of Tax Expenditures" (Fiscal Fact No. 391, Tax Foundation, August 22, 2013); Office of Management and Budget, *Analytical Perspectives: Budget of the United States Government, Fiscal Year*

that are a form of government-granted privilege through a review of selected corporate tax expenditures.

The total number of tax expenditures has grown dramatically since the 1970s, with over 225 expenditures in 2015; most of the growth has been in individual, rather than corporate, expenditures.[3] Our analysis shows that there are a total of 127 tax expenditures claimed by corporations, and almost 65 percent of them privilege certain activities or industries while excluding others. However, the remaining 35 percent of tax expenditures that do not create these privileges—such as the deferral of taxes on income earned overseas through foreign subsidiaries and affiliates, which helps reduce economic inefficiencies in the tax code—make up the large majority of expenditure dollars. Therefore, the cost of tax expenditures that grant privileges is more worrying in the context of the unaccounted-for costs of economic distortions and political favoritism. Special tax privileges should be eliminated, offset by lower tax rates to ensure that politicians are not the primary beneficiaries of this reform.

"The cost of tax expenditures that grant privileges is . . . worrying in the context of the unaccounted-for costs of economic distortions and political favoritism."

Our general analysis applies to both corporate and individual tax expenditures, although our specific examples highlight the largest and most concentrated tax benefits in the corporate tax code. Many individual tax expenditures are also problematic, but we focus on corporate privileges because the benefits are more concentrated and the politics of privilege shows up in starker contrast. However, the income tax system as a whole is fundamentally flawed in its design. Reforming the tax expenditure baseline is a decent first step toward more honest federal tax accounting.

2009 (Washington, DC: US Government Printing Office, 2008), 315–28; Jason J. Fichtner and Jacob Feldman, "When Are Tax Expenditures Really Spending?" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, November 2011).

3. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2014–2018* (prepared for the House Committee on Ways and Means and the Senate Committee on Finance, August 5, 2014).

WHAT IS A TAX EXPENDITURE?

In an overly simplistic model, a tax expenditure occurs when the government allows a taxpayer not to pay some tax that would otherwise be collected, as defined by the "normal" tax base. The term *tax expenditure* came about because this practice basically functions like any other budget allocation and thus, in a simple world, should be catalogued as such.[4]

The technical definition of a tax expenditure is enumerated in the Congressional Budget and Impoundment Control Act of 1974 as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[5] To account for tax expenditures, the Joint Committee on Taxation (JCT) and the president's Office of Management and Budget (OMB) examine deviations from what they consider the normal income tax rules or the normal baseline.[6]

The modern US income tax base is most closely defined by what is known as the Haig-Simons definition of income, also referred to as the accretion concept: consumption plus change in net worth.[7] The problem with relying on an income tax base is that it leads to double taxation of savings and investment because it does not properly account for the timing of economic profits. The result of a poorly defined base, double taxation can unintentionally distort market decisions and slow economic growth.[8]

Using the normal income tax baseline prohibits an objective accounting of tax expenditures. For example, the capital gains and dividends tax expenditure represents the lower tax rate on investment income. This is a desirable tax expenditure, necessary for the income tax system to treat economic activity more consistently now and in the future. The capital gains and dividends tax

4. The term *tax expenditure* is attributed to former Assistant Secretary of the Treasury Stanley Surrey, who first used the concept as a political move to draw attention to subsidies in the tax code and build momentum for base broadening. As a result, the US Department of the Treasury issued the first expenditure report in 1968. The Joint Committee on Taxation first produced an estimate of tax expenditures in 1972 and continues to report a similar list today. Rosanne Altshuler and Robert Dietz, "Reconsidering Tax Expenditure Estimation," *National Tax Journal* 64 (June 2011): 459–90.

5. Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, § 3(3) (1974).

6. Joshua Hall, *Tax Expenditures: A Review and Analysis* (Washington, DC: Joint Economic Committee, 1999); Congressional Budget and Impoundment Control Act of 1974, § 3(3).

7. Robert M. Haig, "The Concept of Income—Economic and Legal Aspects," in *The Federal Income Tax* (New York: Columbia University Press, 1921), 1–28.

8. Steven Landsburg has a simple and powerful illustration of why capital gains and dividends should not be classified as income. See Steve Landsburg, "Getting It Right," *The Big Questions* blog, September 14, 2010.

expenditure helps reduce the multiple taxation of investment income.[9] Properly defined, this is not a tax expenditure at all, and it is misleading to call it such. It is a patch to the flawed income tax system.

Alan Cole, an economist at the Tax Foundation, estimates that roughly 60 percent of individual and corporate tax expenditures are attempts to mitigate the income tax's bias against savings and investment and to help move the code toward a more neutral treatment of consumption and investment.[10] Many of the largest tax expenditures are intended to reduce or eliminate the multiple taxations of certain sources of income.[11] Expenditures to mitigate double taxation and deferral of income should not be counted as tax expenditures at all.

It is important to note that the term *tax expenditure* is fundamentally misleading because it equates a taxpayer's retention of his or her own money with actual government expenditure. The term *tax expenditure* assumes the government is entitled to spend the entirety of the available and arbitrarily defined tax base.[12] There is an important distinction between a tax expenditure that lets taxpayers keep more of their money and a government expenditure of money collected from taxpayers, even if the economic impact is indistinguishable.

In economic terms, tax expenditures are government spending like any other explicit outlay, except they are obfuscated by the complexities of the tax code. Each tax expenditure, as it reduces expected revenue, will require an offset of increased taxes or decreased spending (either now or in the future).[13] Tax expenditures easily obscure the true nature of government policy through what Princeton economist David Bradford calls "arbitrary institutional labeling." Paraphrased by Donald Marron, Bradford demonstrates the illusion of the tax expenditure label:

9. In the case of dividends, corporate profits are taxed first at the entity level through the corporate income tax and again at the individual level when profits are distributed to shareholders in the form of dividends.
10. Alan Cole, "Corporate vs Individual Tax Expenditures" (Special Report No. 218, Tax Foundation, April 2014).
11. Hall, *Tax Expenditures*.
12. The FY 2002 budget of President George W. Bush explains that tax expenditure calculations assume "an arbitrary tax base is available to the Government in its entirety as a resource to be spent." Office of Management and Budget, *Analytical Perspectives: Budget of the United States Government, Fiscal Year 2002* (Washington, DC: US Government Printing Office, 2001), 61; Hall, *Tax Expenditures*.
13. Kleinbard explains that taxes will increase in the economic sense in one of four ways: (1) raise taxes now, (2) raise taxes in the future, (3) inflate your way out of it, which is a tax in a more general sense, or (4) borrow and default, which is both bad policy and a tax on debt holders. Kleinbard, "The Congress within the Congress."

> Suppose that policymakers wanted to slash defense procurement and reduce taxes, but did not want to undermine America's national security. They could square that circle by offering defense firms a refundable "weapons supply tax credit" for producing desired weapons systems. The military would still get the weapons deemed essential to national security, defense contractors would get a tax cut, and politicians would get to boast about cutting both taxes and spending. But nothing would have changed meaningfully.[14]

Tax expenditures obscure both spending and revenue collection, contributing to what economists have termed "fiscal illusion."[15] Increasing the complexity of government activity increases information asymmetries between government officials and citizens, allowing government budgets to expand beyond their normal constraints. Through the opacity described in Bradford's example, citizens are under the illusion that taxes and spending are both reduced, while in reality the only change is increased complexity.

Former Chief of Staff of the JCT Edward D. Kleinbard explains that "tax expenditures augment fiscal illusion, and fiscal illusion in turn drives poor policy."[16] Said another way, tax expenditures make government seem more efficient, which in turn permits the government to expand beyond its means.

THE TAX BASE

The problem of distinguishing economically efficient reforms from privileges and the resulting fiscal illusion is the consequence of using income as the legally defined tax base and baseline from which we measure spending in the tax code. Without an economically consistent baseline, the accounting of tax expenditures is an inherently subjective activity with questionable analytic value.[17]

A broad-based consumption tax would provide an economically consistent baseline. In fact, it is the most desirable baseline. A consumption tax would also require fewer tax expenditures because it is designed to be neutral

14. Marron, "Spending in Disguise."
15. "This view of fiscal illusion is typically attributed to Puviani ([1903] 1973) and was rediscovered by Buchanan (1960, 1967). A clear articulation of this intellectual history can be found in Da Empoli (2002)." Justin M. Ross, "The Effect of Property Reassessments on Fiscal Transparency and Government Growth: Evidence from Virginia" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, June 2015), 4n2.
16. Kleinbard, "The Congress within the Congress," 21.
17. OMB, FY 2002 Federal Budget, 61.

across all forms of economic activity. A neutral, broad-based consumption tax is applied only to the portion of income used for consumption (or income minus investment and savings). A main principle of good taxation—that consumption and savings are treated equally—is most closely captured by a consumption tax. Because of its neutrality, many economists have concluded that a broad-based consumption tax is superior to an income tax base.[18]

The US economy would be better served by defining the tax base in terms of final consumption, thus eliminating the confusion and misinformation conveyed in current accounts of tax expenditures. Although political constraints make it unlikely that the entire tax base will be redefined, an intermediate solution would be to redefine the baseline used to account for tax expenditures by the JCT and OMB. A consumption tax baseline would force government subsidies out of the shadows and onto an explicit government balance sheet for everyone to see, allowing a more honest and transparent accounting of true tax expenditures.

Eliminating the corporate income tax would also be a good first step toward a broad-based consumption tax. However, this paper acknowledges the political constraints of tax reform and instead focuses on a solution using the consumption tax as the baseline to better account for the irregularities in the tax code. In this paper we take for granted that the government is going to tax income, including corporate income. From this premise, we try to describe how this can be done in a way that corresponds as closely as possible to economic efficiency and horizontal equity.

THE EXPENDITURE ILLUSION: GOVERNMENT PLANNING AND RENT-SEEKING

The coordinating process of the market allows firms to allocate scarce resources to competing ends. This process utilizes dispersed information not available to a central authority. To improve the market process, policymakers must presuppose that they have a superior mechanism of discovering and using the proper information to better allocate scarce resources. This task seems unrealistic in light of Nobel laureate F. A. Hayek's observation that useful knowledge is dispersed in

18. For a review of the "key economic issues involved in deciding whether and how to adopt a consumption tax," see Alan J. Auerbach, "The Choice between Income and Consumption Taxes: A Primer" (NBER Working Paper No. 12307, National Bureau of Economic Research, Cambridge, MA, June 2006); Joseph E. Stiglitz and Michael J. Boskin, "Some Lessons from the New Public Finance," *American Economic Review* 67, no. 1 (1977): 295–301.

the economy and held by billions of economic actors around the world.[19]

Even if policymakers somehow discover this useful knowledge and decide that the government should subsidize some activity through the tax code, there are other costs to consider. Each new tax expenditure signals to businesses that the tax code is increasingly open to political tailoring for additional special interests.

The existence of special carve-outs in the tax code opens the system up to special-interest lobbying. Political economist Randall Holcombe notes that businesses that "are being taxed continually lobby to have their taxes reduced or eliminated, and even if a group is not currently being taxed, it needs to keep an active lobbying presence to guard against taxes that might be placed on it in the future."[20] In his seminal book, law professor Fred McChesney characterized such lobbying to guard against future taxation or regulation as spending "money for nothing."[21] The easier it is to manipulate the tax code, the more firms are required to spend on lobbyists to ask for special tax subsidies or to prevent harmful new taxes.

Corroborating Holcombe's assertions, a growing body of literature shows that when the tax code is open to political tailoring, firms allocate scarce resources away from productive investments and into the political process.[22] Political expenditure or "rent-seeking" is the result of firms changing how they invest their profits with the expectation of gaining political privilege.[23] Firms rent-seek

"When the tax code is open to political tailoring, firms allocate scarce resources away from productive investments and into the political process."

19. F. A. Hayek, "The Use of Knowledge in Society," *American Economic Review* 35, no. 4 (September 1, 1945): 519–30.
20. Randall G. Holcombe, "Tax Policy from a Public Choice Perspective," *National Tax Journal* 51, no. 2 (1998): 360.
21. Fred S. McChesney, *Money for Nothing: Politicians, Rent Extraction, and Political Extortion* (Cambridge, MA: Harvard University Press, 1997).
22. Seth H. Giertz and Jacob Feldman, "The Costs of Tax Policy Uncertainty and the Need for Tax Reform," *Tax Notes* 138, no. 8 (2013).
23. The concept of rent-seeking was developed by Gordon Tullock in 1967, and Anne Krueger introduced the term in 1974. See Tullock, "The Welfare Costs of Tariffs, Monopolies and Theft," *Western Economic Journal* 5, no. 3 (1967): 224–32; Anne O. Krueger, "The Political Economy of the Rent-Seeking Society," *American Economic Review* 64, no. 3 (1974): 291–303.

by spending money on political campaigns, advertising to politicians, altering hiring or contracting decisions, and using various other ways of currying political favors. Rent-seeking expenditures can be either higher or lower than the value of the privilege, but they are always costly for the economy as a whole.[24]

Tax expenditures make the tax code unnecessarily vulnerable to special-interest manipulation. Heralded as a monumental removal of loopholes and tax shelters, the Tax Reform Act of 1986 was little more than a temporary political success in decreasing the number of tax expenditures.[25] The reform did temporarily reduce the dollar value of expenditures, but it left the system of tax expenditures in place, removing only the most politically vulnerable privileges.[26] Since 1986, tax expenditures have grown in both value and size, although most of the growth has been in individual tax expenditures.[27] The Tax Reform Act of 1986 stands as a testament to the ability of special interests to exploit institutional weakness in the tax code for private benefit. A relatively recent example—a temporary tax holiday provision for repatriated earnings in the American Jobs Creation Act of 2004—was shown by three economists to have a $220 return for every $1 spent on lobbying, or a 22,000 percent return on lobbying.[28]

Lost economic activity is greatest when the tax code is not evenly applied. Various deductions, exemptions, and credits create an uneven tax environment. The proliferation of special tax rules through the tax expenditure system results in disparate effective tax rates, which distort consumption and investment.[29] To the extent that the tax code must interfere with economic decisions, it should be done in a way that minimizes distortions and rent-seeking.

In the last 30 years the tax code has nearly tripled in length, from 26,300 pages in 1984 to an almost 75,000-page behemoth in 2014.[30] The tax code grows as politicians include special carve-outs for privileged firms and activities. Each

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24. Matthew Mitchell, *The Pathology of Privilege: The Economic Consequences of Government Favoritism* (Arlington, VA: Mercatus Center at George Mason University, 2012).
25. Tax Reform Act of 1986, Pub. L. 99-514 (1986). It is incumbent upon us to note, however, that reforms to marginal tax rates under the act were more lasting.
26. Jason J. Fichtner and Jacob M. Feldman, "Lessons from the 1986 Tax Reform Act: What Policy Makers Need to Learn to Avoid the Mistakes of the Past" (Mercatus Working Paper No. 11-23, Mercatus Center at George Mason University, Arlington, VA, April 2011).
27. McBride, "A Brief History of Tax Expenditures."
28. Raquel Meyer Alexander, Stephen W. Mazza, and Susan Scholz, "Measuring Rates of Return for Lobbying Expenditures: An Empirical Case Study of Tax Breaks for Multinational Corporations," *Journal of Law and Politics* 25, no. 401 (2009).
29. Jason J. Fichtner and Jacob M. Feldman, *The Hidden Cost of Federal Tax Policy* (Arlington, VA: Mercatus Center at George Mason University, 2015), 19–24.
30. "Federal Tax Law Keeps Piling Up," *CCH Standard Federal Tax Reporter* (Wolters Kluwer, 2014), http://www.cch.com/wbot2014/Chart_TaxLawPileUp_(16)_f.pdf.

new provision is written by legislatures, interpreted by regulators, and litigated in court—often adding little clarity to the law. Interpreting and complying with each page of the tax code is a complex and unforgiving task requiring armies of lawyers and accountants and a specialized tax court. The Internal Revenue Service's (IRS) own taxpayer advocate, Nina Olson, calls the length and complexity of the tax code "the most serious problem facing taxpayers."[31]

It is difficult to separate the compliance cost of tax expenditures from other tax compliance costs, but with so many expenditures on the books, they undoubtedly account for a nontrivial share of total compliance costs. According to a study presented by George Contos et al. at an IRS-sponsored research conference, corporate tax compliance costs are more than 20 percent of the cost of expenditures and about 18 percent of collected corporate tax revenue.[32] Ironically, compliance costs are in part driven by the complexity of tax expenditures, many of which are vestiges of privilege, produced by rent-seeking and obscured through fiscal illusion.

WHEN TAX EXPENDITURES ARE PRIVILEGES

Not all tax expenditures are spending through the tax code. Additionally, not all tax expenditures that privilege some firms over others should be removed. Instead, they should be expanded to promote neutrality. Some privileges in the tax code actually promote consumption-savings neutrality, but they are only available to a limited number of firms. For example, the expensing of research and experimentation expenditures privileges research-intensive sectors. A neutral tax system would grant expensing of all capital expenditures to all businesses, not just those in the R&D sector.[33] When discussing tax expenditure reform, it is important to distinguish between privileges that should be eliminated and those that should be expanded.

Specifically, we will examine tax expenditures in the corporate income tax, those claimed directly by corporations. We chose corporate tax expenditures

31. Nina Olson, "The Complexity of the Tax Code," in *2012 Annual Report to Congress—Volume 1* (Washington, DC: Taxpayer Advocate Service, 2012).
32. Authors' calculations are from Office of Management and Budget, *Table 1.2—Summary of Receipts, Outlays, and Surpluses or Deficits (−) as Percentage of GDP: 1930–2021*, Historical Tables, https://www.whitehouse.gov/omb/budget/Historicals; Congressional Research Service, *Tax Expenditures: Compendium of Background Material on Individual Provisions* (prepared for the Senate Committee on the Budget, December 2014), 13; George Contos et al., "Taxpayer Compliance Costs for Corporations and Partnerships: A New Look" (Internal Revenue Service, June 21, 2012), 11.
33. Jason J. Fichtner and Adam N. Michel, "Options for Corporate Capital Cost Recovery: Tax Rates and Depreciation" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, January 2015).

because the benefits are often more concentrated and the politics of privilege more obvious than in individual tax expenditures.

Many of the privileges claimed by individuals are also ultimately corporate subsidies. The home mortgage interest deduction is usually thought of as a privilege for middle- and high-income homeowners, but it is mainly a subsidy for the real estate industry that correlates with larger home sizes—and larger commissions on home sales—because the tax gains to homeowners are largely offset by increases in home prices.[34] Subsidies for college tuition are also largely passed on to colleges and universities because of the tuition increases made possible by the subsidies.[35] Every individual tax expenditure is subject to similar problems of corporate welfare. The individual tax code contains the lion's share of both the number and the dollar value of tax expenditures. However, benefits in the individual income tax tend to be more diffuse and are often targeted at social support programs such as the earned income tax credit.[36] Therefore, we will focus on tax expenditures and privilege in the corporate income tax.[37]

Using the following rubric, we classify the JCT's reported tax expenditures into one of three categories:

- *Category 1.* Expenditures that correct for double taxation and the timing of taxation (consumption-saving neutrality and temporary deferral of taxation).[38]

34. Jason Fichtner and Jacob Feldman, "Reforming the Mortgage Interest Deduction" (Mercatus Working Paper No. 14-17, Mercatus Center at George Mason University, Arlington, VA, June 2014).
35. David O. Lucca, Taylor Nadauld, and Karen Shen, *Credit Supply and the Rise in College Tuition: Evidence from the Expansion in Federal Student Aid Programs* (Staff Report No. 733, Federal Reserve Bank of New York, July 2015).
36. The largest tax expenditure is the exclusion of employer contributions for medical insurance premiums and medical care. Additionally, even if a tax expenditure is targeted at low-income individuals, it may not be the best policy option. For a brief discussion, see Chris Edwards and Veronique de Rugy, "Earned Income Tax Credit: Small Benefits, Large Costs" (Tax and Budget Bulletin No. 73, Cato Institute, October 2015); "Tax Expenditures, FY 2016," Resource Center, US Department of the Treasury, accessed June 26, 2016, https://www.treasury.gov/resource-center/tax-policy/Pages/Tax-Expenditures.aspx.
37. A majority of US businesses file as pass-through entities under the personal income tax, so an analysis of the corporate income tax leaves these businesses out. Kyle Pomerleau, "An Overview of Pass-Through Businesses in the United States," *Tax Foundation*, January 21, 2015.
38. There are also a limited number of arbitrary apportionment decisions that are not easily classified. One example is the Inventory Property Sales Source Rule Exception. The normal US tax base includes worldwide corporate income, permitting a credit for foreign taxes paid. The credit for foreign taxes paid is limited to the amount of US taxes that would otherwise be due. Unused or excess credits can be used only on other foreign-source income. The Inventory Property Sales Source Rule Exception allows firms to shift income from the United States to foreign operations. It treats certain inventories as having a divided source for taxation purposes and allows "up to 50 percent of

- *Category 2.* Expenditures that are not evenly applied to all firms, but if they were expanded without constraint, they would meet the criteria in category 1.
- *Category 3.* Expenditures that privilege certain activities or industries while excluding others. These do not correct for economic distortions in the income tax.[39]

Our analysis relies on a combination of the JCT expenditure report and the Congressional Research Service (CRS) report on tax expenditures, which includes the description, impact, rationale, and assessment for most JCT expenditures.[40] The CRS report is used to classify expenditures as corporate or individual and to determine the value and category of each. There are 24 corporate expenditures that cost under $50 million over 10 years, which are not included by the CRS but are included in our analysis from the JCT report.[41]

Our classification criteria are subject to a number of critiques that apply to tax expenditure analysis in general. A note in the FY 2008 budget from OMB applies broadly to all tax expenditure accounting; the budget explains that outlay equivalents for expenditures are often "judgmental and hard to apply with consistency across time and across tax expenditure items."[42] We attempt to follow the contours of a broad-based consumption tax analysis, but without a consistent benchmark in the JCT and OMB reports, any measure of expenditures will be arbitrary to a certain degree.

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combined income from export manufacture and sale" to be effectively exempt from US taxes. See Congressional Research Service, *Tax Expenditures*, 56.

39. In our categorization, we placed provisions that specified accelerated depreciation into category 3. Manipulating a depreciation time horizon is distinctly different than offering 50 percent expensing or full expensing. While shortening depreciation schedules may have marginal economic benefits, it further complicates the tax code. See our discussion below in the section entitled "Seven-Year Recovery Period for Alaska Natural Gas Pipeline."

40. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2014–2018*; Congressional Research Service, *Tax Expenditures*.

41. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2014 –2018*; Congressional Research Service, *Tax Expenditures*. To the extent possible, we relied on analysis included in OMB, FY 2009 Federal Budget, Appendix A. Our full categorization should be understood as a rough breakdown. Any consistent accounting between the income and consumption baselines requires evaluations that could be considered differently under different assumptions. For a more detailed discussion of some of these difficulties, see Office of Management and Budget, *Analytical Perspectives: Budget of the United States Government, Fiscal Year 2009*, 315–25. The authors' full list of 127 classified expenditures is available upon request.

42. Office of Management and Budget, *Analytical Perspectives: Budget of the United States Government, Fiscal Year 2008* (Washington, DC: US Government Printing Office, 2007), 286.

“It is . . . important to remember that the dollar value is only part of the story; the numerous distortions from each privilege result in unaccounted-for and often unseen costs.”

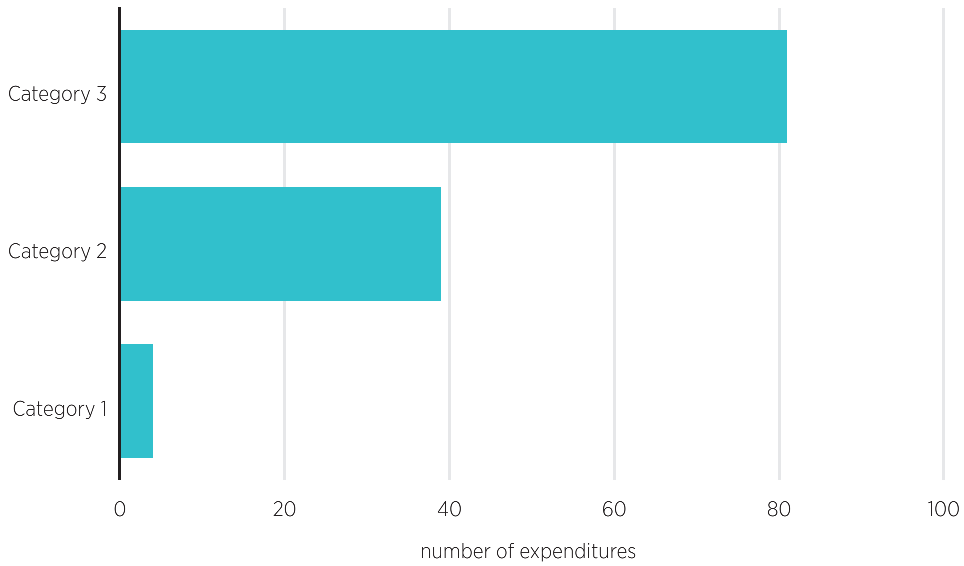
In 2015 the JCT counted 225 total tax expenditures, 127 of which are claimed by corporations.[43] Figure 1 shows that only four corporate expenditures fall into category 1, which includes expenditures that correct for double taxation and deferral and that are broadly available to all corporations. Thirty-nine corporate expenditures fall into category 2. These expenditures are corrections similar to those in category 1, but they are not broadly available to all corporations and thus favor certain firms or industries. The remaining 81 tax expenditures—almost 65 percent—privilege certain activities or industries while excluding others.

We have primarily focused on the number of tax expenditures because each unnecessary carve-out adds additional complexity. The dollar value of the different categories of expenditures shows that the largest ones would not be expenditures at all if properly defined.[44] Figure 2 shows that category 1 expenditures, while small in number, account for 53 percent of the dollar value of corporate expenditures. Category 2 accounts for 28.4 percent, and category 3 only accounts for 17.2 percent.[45]

A defining feature of narrowly tailored privileges is that they are often small in dollar value compared to other more widely available provisions. As expected, the more narrowly tailored category 3 expenditures have a lower total dollar value. However, the impact of a privilege on

43. Three additional expenditures were issues of apportionment that do not fall within any of our three categories: the Apportionment of Research and Development Expenses for the Determination of Foreign Tax Credits, the Inventory Property Sales Source Rule Exception, and the Interest Expense Allocation.
44. The summation of the dollar value is imprecise for various reasons. Most notably, the individual expenditures estimates don’t account for interaction effects with other provisions or changes in taxpayer behavior. Additionally, positive tax expenditures of less than $50 million are not assigned a value and are thus excluded from this analysis.
45. Our estimates are similar to those performed by the Tax Foundation, originally by William McBride (”A Brief History of Tax Expenditures”) and then updated by Alan Cole (“Corporate vs Individual Tax Expenditures”). In 2014 the estimate was $44,837 million in corporate welfare. Our pure corporate welfare estimate (category 1) is smaller at $27.3 million. Our category 2 expenditures are estimated at $45.4 million. Our results complement other estimates and help add granularity to the issue of unevenly applied tax rules.

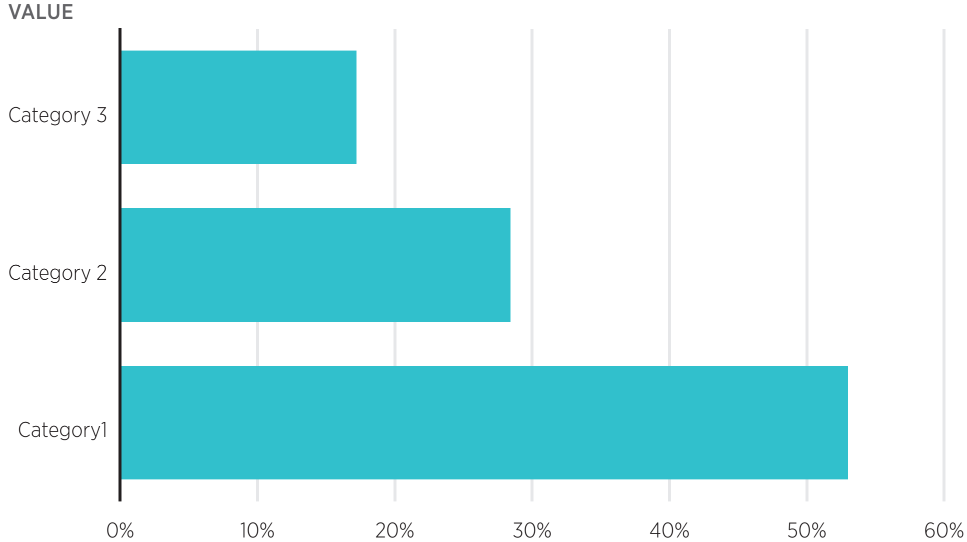
FIGURE 1. CATEGORIES OF CORPORATE TAX EXPENDITURES BY COUNT



Note: Three uncategorized expenditures (discussed above in footnotes 38 and 43) are not included in this figure.

Source: Authors' calculations are based on Congressional Research Service, *Tax Expenditures*; Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2014–2018*.

FIGURE 2. CATEGORIES OF CORPORATE TAX EXPENDITURES BY PERCENTAGE OF TOTAL DOLLAR VALUE



Note: Values do not sum to 100 percent because three uncategorized expenditures are not included in this figure; they account for 1.4 percent of the total dollar value (see footnotes 38 and 43). Positive tax expenditures of less than $50 million are not assigned a value and are thus excluded from this analysis.

Source: Authors' calculations are based on Congressional Research Service, *Tax Expenditures*.

a small number of firms is comparatively larger, even if the category 3 dollar amount seems relatively small. The broadly applied and universally used category 1 provisions have a higher dollar value precisely because they are not privileges. It is thus important to remember that the dollar value is only part of the story; the numerous distortions from each privilege result in unaccounted-for and often unseen costs.

Of the ten largest corporate tax expenditures, only three should be eliminated completely based on tax neutrality (all in category 3). These three are the US production activity deduction, the tax credit for low-income housing, and the reduced rates on the first $10 million of corporate taxable income. Each privilege favors certain activities or industries while excluding others.

The deduction for US production activities under section 199 of the Internal Revenue Code (IRC)[46] allows all taxpayers a deduction of up to 9 percent on qualified domestic production activities. The authorizing legislation, the American Jobs Creation Act of 2004, explicitly states that its goal is to "make our manufacturing, service, and high-technology businesses and workers more competitive and productive both at home and abroad."[47] Through the deduction, businesses are made more profitable by providing a taxpayer-supported subsidy to qualifying US manufacturing firms.[48] This deduction is strongly supported by both the National Association of Manufacturers (NAM) and the US Chamber of Commerce. The Chamber of Commerce spends more on political lobbying than any other organization; at $124 million in 2014, it spent more than double the amount of the second-place National Association of Realtors.[49] The production activity deduction is a special-interest tax favor that should be eliminated from the tax code.[50]

The tax credit for low-income housing is intended to encourage the private development of affordable rental housing for low-income individuals. It has been shown in both academic research and government reports that the credit does not

46. I.R.C. § 199 (2014).
47. American Jobs Creation Act of 2004, Pub. L. No. 108-357 (2004).
48. Jeremy Horpedahl and Brandon Pizzola, "A Trillion Little Subsidies: The Economic Impact of Tax Expenditures in the Federal Income Tax Code" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, October 25, 2012), 25.
49. NAM spent $12 million in 2014, ranking 23rd of out 2,871 organizations. Center for Responsive Politics, "Profile for 2016 Election Cycle: National Association of Manufacturers," opensecrets.org, accessed September 14, 2016, http://www.opensecrets.org/orgs/summary.php?id=D000054156&cycle=2014.
50. This recommendation is supported by a recently released report from a House Republican task force, which recommends removing the deduction in favor of rate reductions. Report by the Speaker's Tax Reform Task Force, *A Better Way: Our Vision for a Confident America,* US House of Representatives, June 2016, http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf.

significantly increase the stock of low-income housing, as many of the projects that receive credit would have been completed even without the subsidy. This body of research has also found that other housing support programs, such as vouchers that empower recipients with choice, may be more cost effective for reaching the same goals of helping low-income households with their housing costs.[51] This tax credit is a special privilege that primarily provides benefits to the construction industry without reaching the stated policy goals; it should be eliminated.

The US corporate income tax includes reduced rates on the first $10 million of taxable income. The common justification for a graduated corporate income tax lies in the popular belief that small businesses are the fountainhead of job creation and the engine of economic growth. However, there is little economic justification to conclude that small businesses are more deserving of government favor than big companies.[52] Instead, corporate taxes should be equally applied to firms of all sizes.

TAX EXPENDITURES WITH HIGHLY CONCENTRATED BENEFITS

Next we discuss five expenditures with unusually concentrated benefits (see table 1). The first, tax-exempt bonds, covers a broad category of expenditures. There are two tax credits, one deduction, and an accelerated depreciation election; these four are more narrowly focused than the first. These five expenditures were not chosen systematically; they are instead a small sample of the different types of privileges that exist in the tax code and stood out to us in our research.

Tax-Exempt Bonds

One way state and local governments finance spending above the level of annually collected taxes is to borrow from the savings of corporations and individuals by issuing bonds. When governments borrow, they pay interest over the life of

51. Lan Deng, "The Cost-Effectiveness of the Low-Income Housing Tax Credit Relative to Vouchers: Evidence from Six Metropolitan Areas," *Housing Policy Debate* 16, no. 3–4 (January 2005): 469–511; Stephen Malpezzi and Kerry Vandell, "Does the Low-Income Housing Tax Credit Increase the Supply of Housing?," *Journal of Housing Economics* 11, no. 4 (December 2002): 360–80; Congressional Budget Office, "The Cost-Effectiveness of the Low-Income Housing Tax Credit Compared with Housing Vouchers" (CBO Staff Memorandum, April 1992), https://www.cbo.gov/sites/default/files/102nd-congress-1991-1992/reports/doc09b.pdf.
52. Veronique de Rugy, "Are Small Businesses the Engine of Growth?" (Working Paper No. 123, American Enterprise Institute, December 8, 2005); Jane G. Gravelle, "Federal Tax Treatment of Small Business: How Favorable? How Justified?" (100th Annual Conference Proceedings, National Tax Association, November 15–17, 2007), 152–58, http://www.ntanet.org/images/stories/pdf/proceedings/07/017.pdf.

TABLE 1. FIVE TAX EXPENDITURES WITH HIGHLY CONCENTRATED BENEFITS (BILLIONS OF DOLLARS)

Type of Tax Expenditure	Individual	Corporate
Tax-exempt bonds (category 2)	$31	$11.9
Tax credit for orphan drug research (category 3)	*	$0.7
Tax credit for certain railroad track maintenance (category 3)	$0	$0.2
Special deduction for Blue Cross and Blue Shield companies (category 3)	$0	$0.4
Seven-year MACRS Alaska natural gas pipeline (category 2)	$0	$0

Note: * = positive tax expenditures of less than $50 million. Expenditures under $50 million are not included in totals.

Source: Congressional Research Service, *Tax Expenditures*.

the bond to compensate the lender for the alternative uses of the money. The private sector has similar debt instruments of various types that pay interest, pay dividends, or increase in value over time to compensate for the temporary use of private savings. Private gains from lending and investing are taxed, while gains from lending to state and local governments are most often tax exempt.

First adopted in 1913, the original income tax base explicitly exempted income earned from lending to state governments—a departure from the standard inclusion of both active income (i.e., from a job) and income earned from investments (i.e., interest).[53] This exemption persists today.

When income from government bonds is exempt from taxation, the real costs for governments to borrow are reduced. Investors who are not required to pay tax on interest income will be willing to accept a lower interest rate than they otherwise would. Investors should be indifferent between a government bond and a corporate bond of identical risk, given similar tax treatment. However, a tax-exempt bond with a 6.5 percent rate of return is equivalent to a taxable bond with a 10 percent rate of return (most interest income is taxed at the taxpayer's top marginal rate, here assumed to be 35 percent).[54] This tax exemption therefore allows state and local governments to finance debt spending at interest rates well below those of the private sector.

The two main types of tax-exempt bonds for this paper's purposes are government bonds and qualified private-activity bonds.[55] Government bonds

53. Dennis Zimmerman, "Tax-Exempt Bonds," originally published in *NTA Encyclopedia of Taxation and Tax Policy* (Congressional Research Service, 1999), 443.
54. Steven Maguire and Jeffrey M. Stupak, *Tax-Exempt Bonds: A Description of State and Local Government Debt* (Congressional Research Service, January 9, 2015), 2.
55. The CRS describes several other ways to categorize bonds that are less instructive for our purposes. Ibid., 5–10.

are most often issued to finance traditional government projects such as roads, bridges, schools, and public buildings. Qualified private-activity bonds are subject to additional restrictions, but they can be used to fund investments whose chief beneficiary is a private corporation or individual.[56]

The JCT categorizes qualified private-activity bonds separately, based on budget function. For our analysis of expenditures with concentrated benefits, we will combine the JCT's 15 categories of tax-exempt bonds, as shown in table 2. At a total combined cost of more than $42.9 billion, corporations claim about a quarter of tax-exempt bond expenditure dollars.

Tax-exempt bonds lower the cost of government capital investment and increase state and local capital formation above what would naturally occur without the tax preference. There are certain theoretical spillover benefits from local investment that are realized by the country as a whole. The federal tax subsidy is justified as increasing local investments that are under provisioned.[57] This same justification is often provided for the federal deduction of state and local taxes from the federal personal income tax.[58]

The tax privileges for state and local bonds produce three types of inequities that inefficiently distort investment and economic activity. If the goal is to promote local investments, the tax subsidy is poorly tailored and indiscriminate. As such, the first inequity creates a bias toward the government provision of investments that would have otherwise been carried out by the private sector. Second, the federal subsidy is in reality a wealth transfer from citizens in states with low public investments to those in states with high public investments. State and local governments that choose to remain relatively small and allow the private sector to provision a larger share of goods and services are harmed. Lastly, high-income corporations and individuals reap most of the benefits.

Qualified private-activity bonds are often used to finance sports stadiums and other private ventures. Contrary to the popular narrative, there is little economic public benefit to building stadiums or arenas for professional sports franchises. In an empirical study of sports subsidies, economist Dennis Coates found that sports stadium "development is unlikely to make a community wealthier, and subsidizing professional sports teams may actually reduce

56. Depending on the type of qualified private-activity bond, the following restrictions might apply: the bond is ineligible for advanced refunding; interest income cannot be included in the alternative minimum tax base; or there is a yearly federal cap of total bond value issued (in 2014, the lesser of $100 per resident or $348.91 million). Ibid., 10.
57. Ibid., 4.
58. Jeremy Horpedahl and Harrison Searles, "The Deduction of State and Local Taxes from Federal Income Taxes," (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, March 2014).

TABLE 2. TAX-EXEMPT BONDS (BILLIONS OF DOLLARS)

Exclusion of interest on type of bond	Individual	Corporate
Public-purpose state and local government bonds	23.8	9.3
State and local government bonds for private nonprofit and qualified public education facilities	2.3	0.9
State and local government bonds for private nonprofit hospital facilities	1.6	0.6
State and local government bonds for owner-occupied housing	0.9	0.3
State and local government bonds for rental housing	0.7	0.3
State and local government bonds for private airports, docks, and mass-commuting facilities	0.6	0.2
State and local government small-issue qualified private-activity bonds	0.3	0.1
State and local government sewage, water, and hazardous waste facilities bonds	0.3	0.1
State and local government student loan bonds	0.4	0.1
State and local government qualified private-activity bonds for highway projects and rail-truck transfer facilities	0.1	*
State and local qualified private-activity bonds for green buildings and sustainable design projects	*	*
State and local government qualified private-activity bonds for energy production facilities	*	*
State and local government bonds for high-speed rail facilities	*	*
State and local government bonds for veterans' housing	*	*
Educational savings bonds	0	*
Total	31	11.9

Note: * = positive tax expenditures of less than $50 million. Expenditures under $50 million are not included in totals.

Source: Congressional Research Service, *Tax Expenditures*.

economic growth."[59] Federal subsidies for tax-exempt bonds make public financing of private activity less expensive, which encourages more government involvement in private enterprise. These subsidies also harm the citizens in areas that choose not to subsidize private activities with public funds.

The tax-exempt subsidy of government bonds is often captured by a private entity. In 2009 the IRS estimated that tax-exempt interest was the primary reason that 19,551 individual tax filers with incomes over $200,000 paid no federal income tax.[60] In a survey of the academic literature, a joint study by the

59. Dennis Coates, "Growth Effects of Sports Franchises, Stadiums, and Arenas: 15 Years Later" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, October 2015).
60. Justin Bryan, "High-Income Tax Returns for 2009" (Internal Revenue Service, spring 2012), https://www.irs.gov/pub/irs-soi/12insprbulhignincome.pdf.

Congressional Budget Office and the JCT found that about 20 percent of the federal subsidy simply takes "the form of a federal transfer to bondholders in higher tax brackets."[61]

Tax-exempt bonds are an inefficient means of subsidizing subnational investment for at least two reasons. First, as described above, almost a quarter of the subsidy is captured by wealthy individuals and businesses. Second, the subsidy is inefficiently tailored so that projects with minimal positive externalities are often the recipients of the funds. Former Senator Tom Coburn's 2014 Tax Decoder reports that "Anheuser-Busch, four-diamond hotels, high-end fishing boat manufacturers, and a golf course in one of the country's wealthiest neighborhoods are just some of the beneficiaries of tax-exempt bonds."[62] The report details tax-exempt bonds that financed $496 million for the Hard Rock Hotel in Hollywood, Florida; $103.8 million for SilverRock Resort in La Quinta, California; $942 million for Yankee Stadium in New York City; and $103 million for a Hilton hotel in Omaha, Nebraska.[63]

The ability of private corporations to gain financing through tax-subsidized bonds opens the door to rent-seeking and economic distortions. As described in an earlier section, firms can gain the special privilege of subsidized government financing by currying political favors through private expenditure.[64] Rent-seeking costs significantly diminish the expected benefit of the federal subsidy to local infrastructure.

The myriad distortions caused by tax-exempt interest could be remedied by exempting all interest from income taxation rather than just interest payments from the government. As described above, a neutral tax base should treat current consumption, investment, and savings equally.

"Firms can gain the special privilege of subsidized government financing by currying political favors through private expenditure."

61. *Subsidizing Infrastructure Investment with Tax-Preferred Bonds* (Joint CBO/JCT Study, October 2009), 34, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/106xx/doc10667/10-26-taxpreferredbonds.pdf.
62. Tom Coburn, "Tax Decoder," December 2014, 240, https://web.archive.org/web/20141210013518/http://www.coburn.senate.gov/public/index.cfm?a=Files.Serve&File_id=e1f80788-49ce-4bef-b30d-2c2d074a4f7e.
63. Ibid., 243–44.
64. Mitchell, "The Pathology of Privilege."

Interest is just the payment for postponing consumption. A second-best solution may be to remove the tax exemption and tax all interest equally.[65]

Tax Credit for Orphan Drug Research

Investments in drugs to diagnose, treat, or prevent qualified rare diseases and conditions are able to claim a nonrefundable tax credit. The credit is 50 percent of qualified clinical testing expenses from the development of what are commonly known as "orphan drugs." Orphan drugs are generally designated as such by the US Food and Drug Administration's Office of Orphan Products Development if the drug is used for a rare disease or condition affecting fewer than 200,000 people, or if there is a reasonable expectation of not recovering the costs of development.[66]

Since enactment of the orphan drug tax credit in 1983,[67] many have pointed to its successes. In the 10 years prior to the credit's availability, 10 orphan drugs were approved; in the 10 years after 1983, the FDA approved 88 orphan drugs.[68] Today over 400 drugs have been brought to market with the help of tax subsidies.[69] The 1983 legislation included three other incentives: federal grants, seven-year marketing exclusivity, and FDA application fee waivers.

While most researchers agree that the number of orphan drugs has increased, the magnitude of the increase is subject to debate. It is unknown how many drugs have been developed as a result of the tax credit alone because the other incentives cannot be effectively parsed out. Tax subsidies are also notorious for incentivizing firms to relabel expenditures into the favored class, thus artificially increasing both the tax benefits and the official count of qualifying drugs.[70] Lastly, orphan drugs often qualify for other federal research

65. Coburn, "Tax Decoder," 242.
66. There are other restrictions, including restrictions on nondomestic expenditures and on interaction with other research credits under IRC sections 41 and 174. See I.R.C. §§ 41(b), 45C, and 280C; Congressional Research Service, *Tax Expenditures*, 871.
67. Orphan Drug Act of 1983, Pub. L. No. 97-414 (1983).
68. Congressional Research Service, *Tax Expenditures*, 873.
69. US Food and Drug Administration, "Developing Products for Rare Diseases & Conditions," FDA.gov, accessed December 29, 2015, http://www.fda.gov/ForIndustry/DevelopingProductsforRareDiseasesConditions/default.htm.
70. This phenomenon has been documented in the Research and Development Tax credit. Bronwyn Hall and John Van Reenen, "How Effective Are Fiscal Incentives for R&D? A Review of the Evidence," *Research Policy* 29, no. 4–5 (April 2000): 449–69; Jason J. Fichtner and Adam N. Michel, "Can a Research and Development Tax Credit Be Properly Designed for Economic Efficiency?" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, July 2015).

incentive programs such as the general R&D incentives under IRC sections 41 and 174.[71]

The desirability of increasing private expenditures on drugs for a limited number of people has also been questioned. Research by Olivier Wellman-Labadie and Youwen Zhou in the journal *Health Policy* found that "the United States Orphan Drug Act has created issues which, in some cases, have led to commercial and ethical abuses."[72] The increase in private expenditures on orphan drugs shifts limited resources away from development of drugs that could benefit a broad range of people. The actual welfare tradeoff from redirecting resources away from commercially viable drugs is ultimately unknown.

It is also inaccurate to say that all orphan drugs are not commercially profitable. Using a comprehensive database of US pharmaceuticals, Wellman-Labadie and Zhou found that in 2006 a quarter of the products that reached the "blockbuster status" of earning more than $1 billion in profits that year "had one or more orphan designations. These orphan drugs brought in global sales of US$ 58.7 billion in 2006."[73] Commercially profitable products should not receive government subsidies, and the orphan drug tax credit should be eliminated. If policymakers decide subsidies are necessary for a more limited subset of unprofitable drug research, there are other policy tools to provide better-targeted support.

Special Deduction for Blue Cross and Blue Shield Companies

Blue Cross Blue Shield's special tax privilege dates back to the 1930s and the beginning of the health insurance industry. In 1933 the American Hospital Association, in its capacity as the overseer of many early private insurers, required those using the Blue Cross symbol to meet certain requirements. One of these requirements was to organize as a nonprofit.[74] These early insurance plans were promoted by the managing hospitals as benefiting the public

71. Alexander Korniakov, David W. Pauls, and Tom Hopkins, "The Orphan Drug and Research Tax Credits: The 'Substantially All' Rule," *The Tax Adviser*, American Institute of CPAs website, October 1, 2014, http://www.thetaxadviser.com/issues/2014/oct/korniakov-oct14.html.
72. Olivier Wellman-Labadie and Youwen Zhou, "The US Orphan Drug Act: Rare Disease Research Stimulator or Commercial Opportunity?," *Health Policy* 95, no. 2–3 (May 2010): 216–28.
73. Ibid., 225.
74. In 1994 the requirement for Blue Cross Blue Shield insurers to organize as nonprofits was lifted by the national governing body. The special deduction cannot be claimed by for-profit Blue Cross Blue Shield companies. D. Andrew Austin and Thomas L. Hungerford, *The Market Structure of the Health Insurance Industry* (Congressional Research Service, May 25, 2010), 3, 22.

welfare, as many insurance providers at the time did not think health insurance was economically viable.[75]

During the 1930s many states deemed Blue Cross organizations charitable organizations for public welfare, exempting them from many insurance regulations and taxes.[76] Similarly, at the federal level the IRS has recognized Blue Cross organizations as tax-exempt charitable organizations since their inception.[77] In the 1950s commercial health insurers began to seriously compete with Blue Cross, eating into their previous monopoly. The rise of private health insurers began to make clear that health insurance was not a public good, as was once thought.[78]

The Tax Reform Act of 1986 was billed as removing the special Blue Cross Blue Shield tax exemptions because these organizations would now be subject to income tax. In the explanation of the 1986 reform, Congress noted that insurance activity is "inherently commercial rather than charitable," making special treatment inappropriate because it "provided an unfair competitive advantage."[79]

As Congress took away the Blue Cross Blue Shield tax exemption with one hand, they created several new tax privileges with the other hand. Explaining the 1986 reform, the JCT noted, "To ease the transition from tax-exempt to taxable status, Congress determined that it is appropriate to give such organizations relief from" certain requirements applicable to other insurers.[80] Blue Cross Blue Shield and a small number of other qualifying insurers would receive special tax status if they existed on August 16, 1986, and if they met certain other requirements.[81]

Almost 30 years later, certain nonprofit Blue Cross Blue Shield insurers are still receiving these special tax benefits. The special deduction for Blue Cross and Blue Shield companies under section 833 of the Internal Revenue Code (IRC) has three provisions. Eligible organizations are entitled to, first, treatment as "stock insurance companies," second, full deduction of "unearned premiums,"

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75. Hospitals provided the first insurance plans to maximize their profits. The system was a way both to provide a steady income to the hospital and to reduce the number of unpaid bills. Ibid., 3.
76. Many states explicitly tied tax and regulatory benefits to the provision of insurance to the uninsurable. Federal and state insurance programs now take the role of insurer of last resort. Mark A. Hall and Christopher J. Conover, "For-Profit Conversion of Blue Cross Plans: Public Benefit or Public Harm?," *Annual Review of Public Health* 27 (2006): 455.
77. Austin and Hungerford, "The Market Structure of the Health Insurance Industry," 3, 8–9; Paul Arnsberger et al., "A History of the Tax-Exempt Sector: An SOI Perspective," *Statistics of Income Bulletin* (winter 2008), Internal Revenue Service, https://www.irs.gov/pub/irs-soi/tehistory.pdf.
78. Austin and Hungerford, "The Market Structure of the Health Insurance Industry," 3, 6.
79. Joint Committee on Taxation, "General Explanation of the Tax Reform Act of 1986," May 4, 1987, 585, http://www.jct.gov/jcs-10-87.pdf.
80. Ibid., 590.
81. Congressional Research Service, *Tax Expenditures*, 319.

and third, a special deduction of "25 percent of the year's health-related claims and expenses minus its accumulated surplus at the beginning of the year."[82]

After the passage of the Patient Protection and Affordable Care Act (ACA) in 2010, the IRS released final regulations that prevented Blue Cross Blue Shield from including "quality improvement expenses" in healthcare spending medical loss requirements under the new ACA guidelines for measuring insurer administrative costs.[83] The Blue Cross Blue Shield Association lobbied that they should be subject to the same medical loss requirements as everyone else, despite their special treatment under IRC section 833.[84]

In December 2014 the omnibus budget bill, titled the Consolidated and Further Continuing Appropriations Act, 2015, gave the Blue Cross Blue Shield Association the ability to include the quality improvements for which they had asked. The last few pages of the bill, section 102, "Modification of Treatment of Certain Health Organizations," expanded the use of quality improvement expenses in medical loss ratios to section 833–eligible insurers.[85]

Congress noted during the 1986 reforms that Blue Cross Blue Shield companies were providing largely commercial services that could not be differentiated from similar services provided by other insurers. The JCT estimates that the special deduction for Blue Cross Blue Shield companies will cost taxpayers $400 million in 2014 and $2.1 billion from 2014 through 2018.[86]

Through 36 independently operated member companies, the Blue Cross Blue Shield system covers more than 105 million Americans—more, in fact, than any other insurer. Blue Cross Blue Shield also acts as an administrator of Medicare claims in many states.[87] In 2014 Blue Cross Blue Shield affiliates had the third-largest lobbying expenditures in the United States, spending more than $22.2 million.[88] Not all Blue Cross Blue Shield affiliates are eligible for the

82. Ibid., 319–20; 26 U.S.C. § 833 (2014).
83. The ACA links section 833 benefits to maintaining a medical loss ratio (MLR) of 85 percent. The MLR requirement for other insurers is 80 percent for individual and small-group businesses and 85 percent for large groups. 79 Fed. Reg. 4 (Jan. 7, 2014), 755.
84. Justine Handelman, BCBSA comment letter to IRS Commissioner Daniel I. Werfel, "Computation of, and Rules Relating to, Medical Loss Ratio [Sec. 833]," August 12, 2013, http://www.regulations.gov/contentStreamer?documentId=IRS-2013-0019-0004&attachmentNumber=1&disposition=attachment&contentType=pdf; Sara Hansard, "IRS Says Blue Cross Blue Shield Plans Can't Count Quality Expenses in MLR Calculations," Bloomberg BNA website, January 8, 2014, http://www.bna.com/irs-says-blue-n17179881207/.
85. Consolidated and Further Continuing Appropriations Act, Pub. L. No. 113-235 (2015), 201.
86. JCT, *Estimates of Federal Tax Expenditures For Fiscal Years 2014–2018*.
87. "About Blue Cross Blue Shield Association," Bcbs.com, accessed December 30, 2015, http://www.bcbs.com/about-the-association/.
88. Center for Responsive Politics, "Profile for 2016 Election Cycle: Blue Cross/Blue Shield," OpenSecrets.org, accessed September 14, 2016, http://www.opensecrets.org/orgs/summary

special deduction, as each must be organized as a nonprofit and must not have changed form since 1986.

Blue Cross Blue Shield is one of the largest and most influential businesses in American health care, serving both the private and public sectors. Healthcare scholars Mark Hall and Christopher Conover note that Blue Cross Blue Shield and its affiliates are "enormously influential in political and health policy circles: Without exaggeration, they collectively are far and away the most important group of private institutions in the nation's healthcare system."[89]

In the modern era there seems to be no justifiable reason to subsidize a select group of insurers based on their historical role in the health insurance industry. The special deduction for Blue Cross and Blue Shield companies should be eliminated.

Tax Credit for Certain Railroad Track Maintenance

The 45G Tax Credit, named after the pertinent IRC section, is equal to 50 percent of all qualified railroad track maintenance expenditures paid or incurred during the tax year. The credit is limited by a multiple of owned track length and can only be claimed by the smaller class II or class III railroads (also known as regional and short line railroads, respectively) and related railroad businesses. The provision for this credit was extended through 2017 in the December 2015 Omnibus Appropriations bill.[90] In a summary of the earlier 2014 extension, the JCT estimated that a one-year extension of the credit would reduce revenues by $207 million between 2015 and 2024.[91]

The first authorizing legislation for the credit was the American Jobs Creation Act of 2004, and it has been reauthorized four times. According to the CRS, there was no official rationale for this subsidy in the 2004 legislation, but some have indicated "the purpose was to encourage the rehabilitation, rather than the abandonment, of short line railroads."[92] The CRS further notes that the

.php?id=D000000109&cycle=2014.

89. Hall and Conover, "For-Profit Conversion of Blue Cross Plans," 444.

90. Mischa Wanek-Libman, "Omnibus Bill Extends Short Line Tax Credit, Funds TIGER and Safety Grants," RailwayAge website, December 21, 2015, http://www.railwayage.com/index.php/regulatory/omnibus-bill-extends-short-line-tax-credit-funds-tiger-and-safety-grants.html.

91. Marie Sapirie, "Lessons From FATCA for Country-by-Country Reporting," *Tax Notes,* News Analysis, April 6, 2015, http://www.taxnotes.com/tax-notes-today/fatca/news-analysis-lessons-fatca-country-country-reporting/2015/04/06/13608676.

92. Congressional Research Service, *Tax Expenditures*, 550.

credit offers a substantial subsidy to qualifying railroads that "are particularly important in providing transportation of agriculture products."[93]

This credit is included in our list of tax privileges because its benefits are enjoyed by a select group of businesses. The Federal Railroad Administration estimates that there are about 560 qualifying railroads in operation, and the American Short Line and Regional Railroad Association continually lobbies for the extension of the 45G Credit. The association's 45G Subcommittee Chairman Bob Ledoux noted after the 2014 extension, "Early in 2015 we will be back at the grindstone working to ensure that small railroads can use more of the revenue we earn to enhance the quality and safety of our infrastructure."[94] In other words, the association must reinvest in lobbying infrastructure to ensure that its subsidy continues. Special subsidies to specific industries distort investment allocation and are economically inefficient, as a business should earn enough to cover the maintenance costs of its capital. The tax credit for railroad track maintenance should be allowed to expire and should not be reauthorized.

Seven-Year Recovery Period for Alaska Natural Gas Pipeline

The American Jobs Creation Act of 2004 permanently shortened the depreciation timeline for a qualifying Alaska natural gas pipeline from the statutory 22 years to only 7 years.[95] Shorter depreciation timelines increase the after-tax profitability of an asset by shifting tax payments into the future. The system of tax depreciation artificially distorts returns to investment. Despite the problems with the current system, any deviation from the standard depreciation schedule is a relative tax subsidy for a specific industry or production method.[96] A 2012 report by the JCT lists 55 similar statutory changes to depreciation periods.[97]

Although there are currently no qualifying natural gas pipelines in Alaska, the Alaska natural gas pipeline expenditure is included in our list because it illustrates how special-interest politics can work. A minor but complicated change in the tax code can deliver a subsidy to a specific firm or

93. Ibid.
94. Douglas John Bowen, "45 G Tax Credit Extended through 2014," RailwayAge website, December 17, 2014, http://www.railwayage.com/index.php/freight/short-lines/45-g-tax-credit-extended.html.
95. This change was made to the modified accelerated cost recovery system (MACRS). Qualified pipelines have a capacity of more than 500 billion British thermal units of natural gas per day. Pub. L. No. 108-357 (2004).
96. Fichtner and Michel, "Options for Corporate Capital Cost Recovery."
97. Joint Committee on Taxation, "Background and Present Law Relating to Cost Recovery and Domestic Production Activities" (prepared for hearing before Senate Committee on Finance), February 27, 2012, 20–21.

project, obscuring the cost from public scrutiny. The Alaska natural gas pipeline is currently stalled in the planning and approval stages, but this permanent statutory subsidy will remain available for the project in the future.[98] Tax economist Martin Sullivan estimated in 2003 that this provision could provide a subsidy worth as much as $300 million.[99] The benefit of the shortened depreciation schedule will accrue exclusively to the private owners of the pipeline as a windfall profit.[100]

The shortened depreciation incentive for the Alaska natural gas pipeline should be eliminated before it further distorts future investment decisions. Ideally, the tax code should eliminate tax depreciation altogether and allow all capital assets to be expensed in the tax year in which they are incurred. Such a system would eliminate Congress's ability to artificially manipulate depreciation timelines and provide other significant economic benefits.[101] The Alaska pipeline depreciation subsidy is just one of over 50 such manipulations for industries such as racehorses, green energy property, magazine circulation expenditures, research and development, and intangible drilling costs—these should all be eliminated.[102]

CONCLUSION AND POLICY RECOMMENDATIONS

The US income tax system is fundamentally flawed in its design, and hundreds of special-interest privileges have made it worse. The term *tax expenditure* is misleading because it attempts to describe two separate phenomena. First, some tax expenditures work to decrease harmful economic distortions by limiting some forms of double taxation. Second, many tax expenditure provisions are true special-interest carve-outs, granting privileges to some firms or industries at the expense of others.

The current baseline for measuring tax expenditures rests on an internally inconsistent definition of income. Without a consistent baseline, most tax

98. The Alaska legislature recently held a special session to kick-start stalled consideration of the pipeline. Associated Press, "Gas Pipeline Is Focus of Alaska Special Session," *Fuel Fix,* September 24, 2015.
99. Martin A. Sullivan, "Alaska Pipeline Subsidies Would Hurt the Fisc and the Economy," *Tax Notes*, October 28, 2003.
100. Various other federal and state subsidies have been both proposed and enacted for a future Alaska natural gas pipeline. Martin Sullivan provides a fantastic review of Alaska pipeline subsidies in his 2003 *Tax Notes piece, "Alaska Pipeline Subsidies Would Hurt the Fisc and the Economy." For a more current review of the issue, see Paul W. Parfomak, The Alaska Natural Gas Pipeline: Background, Status, and Issues for Congress (Congressional Research Service, June 9, 2011)*.
101. Fichtner and Michel, "Options for Corporate Capital Cost Recovery."
102. JCT, "Background and Present Law Relating to Cost Recovery and Domestic Production Activities," 20–21.

expenditure analysis provides unreliable and overly subjective information. To remedy this problem, the Congressional Budget and Impoundment Control Act of 1974 should be amended to use a consistent, broad-based tax base that relies on final consumption rather than gross income.

The technical definition of tax expenditures enumerated in the Congressional Budget and Impoundment Control Act of 1974 is "revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[103] Rather than using gross income as the baseline, the 1974 Act should be amended to use a tax base that relies on final consumption.

Additionally, the JCT and OMB could—without legislative action—begin reporting a second list of tax expenditures using a consumption baseline. The 1974 act does not preclude producing an additional, parallel accounting of expenditures. Under George W. Bush, the OMB set a precedent for such analysis by including a review of tax expenditure presentation and a discussion on the difference between official tax expenditures and those measured from a comprehensive consumption base. This analysis was included in budgets for fiscal years 2004–2009. Either the JCT or the OMB could refresh this analysis to provide a more comprehensive look at true privileges in the tax code.

Many major features of the US income tax system—about 60 percent of expenditure dollars—are designed to promote consumption-savings neutrality, but not all of these are equally applied. This inequality creates unintentional tax privileges.[104] Reforming the baseline that Congress uses to measure tax expenditures would provide a more honest, transparent, and simple accounting of tax subsidies. Such a reform would show the extent to which the federal government double-taxes some types of income; it would also highlight other areas of the tax code that may need to be reformed.

Policymakers should also remove all special provisions in the tax code that benefit one industry, production method, or business over another. Ideally, this reform would entail expanding many expenditures that currently are only narrowly available. Such an expansion would move the tax code toward a neutral base and eliminate all other special provisions. Until a robust, broad-based consumption tax system replaces the US income tax, policymakers must resist the constant pressures to add additional privileges.

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103. Congressional Budget and Impoundment Control Act of 1974, § 3(3) (1974).
104. Cole, "Corporate vs Individual Tax Expenditures."

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