Tax Incentives Are Always the Wrong Way to Go
By Calvin H. Johnson

In high theory, it should be okay to use the tax system to deliver subsidies or incentives. Taxpayers get a benefit equal to the dollars of revenue that the federal government gives up, and the benefit might, in high theory, accomplish something. On this earth, however, the use of tax to deliver incentives always turns out to be wrong—always. Deductions or exclusions are so overused that too little of the federal cost is passed on to the good activity. Decisionmakers, moreover, think of tax “give-ups” as free, even as a good in themselves, and they design subsidy programs without sufficient concern regarding minimizing the federal cost or maximizing the good accomplished per dollar. The cost-free fallacy always shows up as terrible design for the tax incentive.

The federal budget is the tool intended to make the government responsible for government costs. Indeed, the government takes responsibility for its costs only when the cost is on the federal spending budget. The shift from tax incentives to on-budget government spending would always improve the design of the subsidy. Apparently, only government spending is hated enough for decisionmakers to take responsibility for its costs and design the incentive with care. Congress and the administration can and do get sloppy when subsidies are taken off budget.

The lower design quality for tax incentives means that proposing a tax incentive is at this point immoral. The people who defend or propose a tax incentive rather than proposing a tax incentive is at this point immoral. The cost-free fallacy always shows up as terrible design for the tax incentive.

The tax system is so overused for incentives that too little of the federal government’s cost shows up on the site of the supposed beneficiary. Take, for example, tax-exempt municipal bonds, which provide a rare public market that displays the ugly secrets of tax incentives. Section 103 provides that interest paid by a state or municipal borrower is not subject to tax. Section 103 was once thought to be constitutionally mandated, but not now; and section 103 survives only to deliver a subsidy to a state or city that borrows.

Section 103, in high theory, could deliver a subsidy efficiently, under conditions not in effect. Assume, for example, that supply and demand in the global market for capital sets the price for renting some amount of capital at $100 interest payments per year. How much capital you can borrow for the $100 interest depends on what the going taxable interest rate is, and that varies. Whatever the interest rate, a 34 percent tax bracket investor gets only $66 from the taxable interest (see column A of Table 1 below), and he should be willing to invest the same capital in a municipal bond of the same risk and term if the city will pay him $66 and a hair:

Table 1 represents efficient delivery of the federal cost. When bonds use column B instead of column A, the federal government loses $34 worth of tax that it would have collected in column A. But when a city uses column B, it avoids the $100 interest costs it would have paid on the taxable bond market in column A. The city instead pays interest of $66+ on the tax-exempt column B, which represents a benefit to the city of just under $34. The $34 drop in the pretax interest rate in column B is sometimes called the discount or implicit tax on municipal bonds, and $34 implicit tax means the city has captured the benefit of the tax exemption. Indeed, the implicit tax is the only point of a program that is intended to deliver benefit to the city.

Both the benefit of municipal bonds and the cost of municipal bonds are measured by a comparison of column B with column A, but opportunity costs from a reasonable baseline are common, for example, underlying all time-value-of-money analyses in financial economics. Under the conditions of Table 1, the system delivers to the target city almost as much as it costs the federal government. The investor gets only a scintilla more from investing in tax-exempt bonds than he gets from taxable bonds. Only the scintilla needed to induce an investor’s move from column A to column B is lost in the vehicle moving the cost from the federal government to the benefit to the city.

Table 1 is not the state of the world, nor is it close. Investors in the 34 percent tax bracket are not willing to accept a significant implicit tax for their tax exemption, nor are they forced to accept one. They have too many opportunities to avoid tax with less than a give-up of $34.

1South Carolina v. Baker, 485 U.S. 505 (1988), stating that Pollock v. Farmers Loan & Trust, 158 U.S. 429 (1895), which had held that Congress could not constitutionally tax income derived from the states, had been overruled by later cases. The U.S. Constitution, 16th Amendment, ratified in 1913, provides that Congress can tax income “from whatever source derived.”

2With 5 percent interest rates, $100 taxable interest per year (i) will allow borrowing (B) of $2,000. With 10 percent interest, the borrowing is $1,000. The general formula is $100 = i x B or B = $100/i.
Some of the opportunities arise from sloppy congressional decisions to expand tax incentives, and some arise because accountants say they can spread magic pixie dust to make tax go away. There are also too many borrowers with access to column B who borrow too much and too many tax-advantaged investments that compete with column B. Congressmen trying to get reelected and the foxes-in-the-henhouse Treasury are even now swamping the highest brackets with too many goodies. Under those conditions, substantially all of the federal cost is wasted and never shows up as a benefit to the city.

Tax-exempt interest rates do not now reflect any significant implicit tax. A city borrowing with a AAA-rated and insured 30-year bond must now pay 4.52 percent per year, when federal 30-year bonds are yielding 4.69 percent per year interest. The implicit tax or drop is only 3.6 percent of pretax yields. The 3.6 percent is computed as (4.69 percent − 4.52 percent)/4.69 percent. Interest is only 0.19 percent lower for the city, and that 0.19 percent is only 3.6 percent of the prevailing 4.69 percent taxable interest rate.

Table 2, with the almost 90 percent waste, is also not a temporary condition. The implicit tax has been under 10 percent since 2000. The current administration is merely making a bad situation worse. More and more people are getting access to the bath water in column B, the more people who use the same bath water on a Saturday night, the less clean everyone gets. We are approaching the point at which the tax exemption for municipal bonds will be wasted entirely: All money is lost to Treasury and no benefit is passed on by the investor to the borrowing city.

There is no reason to think that municipal bonds are any less wasteful than any other tax incentive. At the margin, municipal bonds compete in a whole sea of alternative tax-favored investments. Two or three investments removed, the $96.40 competes with every investment. Because all investment returns reach the same sea level after tax, the implicit tax on bonds is a thermometer measuring what is happening throughout the system. Accelerated depreciation is no more efficient than tax-exempt bonds, and indeed, accelerated depreciation is probably worse because it does not even have a tax expenditure budget to monitor the waste. Charitable deductions are intended, it is said, to be passed on and not retained for the benefit of the donor, but for many charitable deductions the beneficiary and the donor are identical, so the value of the charitable deductions can’t be passed on to anybody else. We can compute the pass-on rate for municipal bonds because there is a public market for municipal bonds. There is no reason to think the situation is any better in the dark recesses of tax incentives where the disinfecting rays of sunlight never reach.

The 3.6 percent implicit tax also marks the maximum tax rate that the system is able to impose on profits, even those consumed by the citizens best able to bear tax. Try to impose a real tax higher than 3.6 percent on capital yield devoted to frivolous luxuries and investors can flee to municipal bonds instead.

The subsidy for municipal borrowing is usually a terrible idea in the first place. It encourages cities to undertake capital projects that should be done by the presumably more efficient private sector. The private sector must borrow under column A, however, and gets no subsidy. Column B also induces cities to undertake projects that could not bear the cost of fair interest, viewing the overall global market for taxable bonds as the measure of what capital really costs. Cities also borrow to give lavish benefits to current voters, with the borrowing to be repaid by future, even unborn, citizens who do not vote. Local politicians trying to get reelected are already perfectly willing to be irresponsible about the future. But why should the federal government incentive such grasshopper behavior? One does not avoid the basic stupidity of a government subsidy just because it is effected off budget through the tax system.  

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Anything stupid in a government spending program will show up when a tax vehicle is used instead, with all the extra inefficiencies inherent in the tax vehicle.

Replacing a deduction or exclusion for a subsidy with a tax credit improves matters, but not by enough. The grown-ups who are supposed to be responsible for government costs do not take tax incentives seriously even for tax credits. For example, the report by the President’s Advisory Panel on Federal Tax Reform recommended that the deduction of home mortgage interest should be replaced with a tax credit of 15 percent of mortgage interest, cut off for interest exceeding that on the average-priced house in each area. President Bush himself has stopped the suggestion from going forward. Still, a 15 percent credit is a better idea than a deduction — why should the federal government be giving a benefit worth 34 percent of the interest a million-dollar borrowing to homeowners in the 34 percent tax bracket, a lesser benefit to those in lower brackets, and none at all to the more than one half of the country that does not itemize?

Yet even an across-the-board 15-percent-of-interest-paid credit is a wasteful subsidy. The benefit of any subsidy program is only for the extra or added houses that it gets people into. Giving a benefit to those who would own a house anyway is a waste of money. If the subsidy were thought of as real money, it would be focused on the marginal case of someone who would be homeless without the subsidy, but gets into a house solely because of the subsidy. Ownership of homes does give externalities in benefits to a neighborhood, but perhaps the neighbors, who are the primary beneficiaries of the externalities, are the proper people to bear the full cost of any subsidy that is given. Only when the government is trying to be cheap is it possible for it to design a subsidy that is efficient; that is, that tries to get the very lowest cost for the most benefit. The political system apparently tries to reach efficiency only for costs that are part of government spending.

It is possible to design a government spending system that is free of government bureaucracy. One could simply send up a jet to 35,000 feet and throw out dollars while flying up and down the coasts. The system would have a certain random element, but it would not have any desk officers or forms. Indeed, the major purpose of bureaucracy is to limit the federal cost and focus the costs on the greatest good. I suspect that one counts absence of bureaucratic control as a positive value only if one considers the dollars thrown out as if they were free and does not try to focus or account for them.

If we do not expect anyone to do anything for their tax benefits, there is no waste. Thus, we do not need to do any cost benefit analysis for the standard deductions, earned income credit, or personal exemptions. Their purpose is to leave taxpayers with privileged waste, free to spend their own money however they want. There is no government cost because there is no public responsibility for what is done for the money. Deductions for theft losses, casualty losses, and business expenses similarly are not giving incentives, but only calculating the taxpayer’s net standard of living. Only when the government is trying to get something accomplished is it appropriate to ask for a cost benefit analysis and careful account of the costs. But if the government has a cost that it needs to account for, the federal spending budget is the best general way to ensure that the cost is not wasted. Tax incentives are off budget to avoid the best cost controls and ensure waste.