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spotlight

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End All Tax Biases

Report on Tax Expenditures Misses Half the Story

SUMMARY: **North Carolina's tax code distorts economic activity. It penalizes the investment, savings, and entrepreneurship needed for economic growth. But the latest report on taxes from the Department of Revenue only looks at ways the tax code does not bring in as much money as it could. The General Assembly should seek fundamental reform of the tax code to make it simple and fair. Short of this ideal, it should acknowledge that tax biases work up as well as down and seek a truer picture of bias than the current tax expenditure report.**

In 1992, the General Assembly called for a biennial report on provisions in the North Carolina tax code that reduce "the amount of revenue that would otherwise be available to the state."[1] Following the federal example, the law called these provisions "tax expenditures."[2] The North Carolina Department of Revenue published the first Biennial Tax Expenditure Report in October 1992 and published its second report thirteen years later, in November 2005.[3] There are, however, a number of theoretical problems with the concept of tax expenditures and more problems with the application of the concept in the Department of Revenue's report.

No Rational Rationale

According to Harvard Law School Professor Charles Fried, the concept starts from "the subtle disposition to think of all income as virtual state property, and forbearance to tax away every last penny of it as itself a tax expenditure."[4] While not as pervasive in the Department of Revenue's report itself, this disposition is clear in the law's wording — "A 'tax expenditure'… reduces the amount of tax revenue that would otherwise be available to the State" — in the ease with which discussion moves from "expenditures" to "loopholes," and in reports and criticisms of the report's findings from think tanks[5] and the press.[6]

Second, one must specify a valid baseline tax structure for a tax expenditure to exist. As an example of how difficult this can be, the U.S. Treasury Department removed a number of provisions from the list of tax expenditures

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in 1992, because it decided that they were not deviations from, but part of, the baseline tax. The North Carolina report assumes the existing tax structure as the baseline, without a philosophical or methodological or economic reason. For example, corporate income arguably should not be taxed. Because they are merely a legal entity, corporations cannot "pay taxes." They can only collect taxes from their employees through lower wages, from their customers through higher prices, and from their investors through lower returns. They then pass that money to government. Despite this, corporate taxes are part of the existing code, so exemptions and deductions from this questionable tax are considered tax expenditures.

In some cases, the tax expenditure may help fund government in other ways, such as the tax exemption for interest on municipal, state, and federal bonds. In other cases, the expenditure may be reasonable in every sense except by the arbitrary definition of tax expenditures. One example is whether sales tax should be paid on capital investment and business inputs. The North Carolina Department of Revenue noted: "It is arguable whether purchases of machinery, fuel or similar inputs used in production of final goods should be taxed. Since there is no consensus on this point, we include estimates of tax exemptions on machinery [as tax expenditures in this report]."[7]

Further, there is no distinction between useful expenditures and wasteful expenditures. For example, tax exemptions on corporate purchases of machinery are just as much tax expenditures in the report as the tax incentives provided to Dell Corporation or those to new and expanding companies for job creation, worker training, or technology commercialization under the William S. Lee Act. Yet, the latter do little more than transfer wealth to a few businesses from other businesses and individual taxpayers, while the former are legitimate production costs.

Nor is there an attempt to identify those areas of the tax code that require certain taxpayers to pay more than the baseline. These negative tax expenditures, or tax surcharges, are simply ignored. For example, fortified wines are taxed at a 24 percent rate, higher than the 22 percent rate on unfortified wines. Not only does the treatment of fortified wines create a tax surcharge; the treatment of wine in general is biased compared to other consumer goods

How Income Taxation Penalizes Saving, Investment, and Entrepreneurship

The easiest way to see the penalty on economic growth is to first note that the broad choice facing an individual with a certain amount of after-tax income is to either spend that after-tax income or to save and invest it. Under the typical income tax system, the returns to saving, for example interest income, are taxed while the rewards to consumption, which relate to personal satisfaction and are non-pecuniary, are not. The tax system, therefore, will penalize saving and investment by reducing the returns to those activities relative to consumption.

Using the traditional terminology, income taxation "double taxes" saving relative to consumption. That is, it reduces the returns to saving twice, while reducing the returns to consumption just once. This can be demonstrated with a simple example. Start with an individual who has $1,000 of pre-tax income. In the absence of taxation this means that this person has $1,000 available for either saving or consumption, i.e., the purchases of goods and services. If the interest rate is a simple 10 percent per year, then the person can decide whether he prefers to spend $1,000 or save the $1,000 and have $1,100 available for spending a year from now (Figure 1). The decision will be based on his needs and desires and the needs and desires of those who depend on him.

Now assume that the individual faces a 10 percent income tax. His $1,000 is reduced to $900. This reduces the amount available for

Figure 1: No Tax

		Consume	Save
Year 1	Income	1,000	1,000
	Saving	0	1,000
	Tax (0%)	0	0
	Net Income	1,000	1,000
	Spend	1,000	0
Year 2	Interest (10%)	0	100
	Tax (0%)	0	0
	Spend	0	100
	Saving Penalty	0.0%	0.0%

Figure 2: Current Income Tax

		Consume	Save
Year 1	Income	1,000	1,000
	Saving	0	900
	Tax (10%)	100	100
	Net Income	900	900
	Spend	900	0
Year 2	Interest (10%)	0	90
	Tax (10%)	0	9
	Spend	0	81
	Saving Penalty	0.0%	9.0%

taxed at the general retail sales tax rate of seven percent.

Also, because of the convoluted way that tax expenditures are defined, calculations of the revenue loss they cause may rise or fall even if there is no real effect on state finances. For example, funeral expenses up to $1,500 were exempt from the sales and use tax in 1992, creating a tax expenditure that was calculated to be between $3 million and $4 million that year.[8] A change in the tax code now separates services, which are not taxed, from goods that are taxed, such as the casket, grave, marker, and other goods. So the calculated expenditure has disappeared even though the actual impact of the change on state revenues is negligible.

As noted, the current tax structure is arbitrarily accepted as the baseline for all expenditures. But there is no economic justification for this. Indeed, the current tax system is the problem. It distorts behavior in a number of ways beyond those measured in the tax expenditure report. The system is complicated, and it distorts economic decision-making by systematically penalizing investment, entrepreneurship, and economic growth.

A Better Approach

Instead of combing the tax code for "tax expenditures," the goal of tax policymakers should be to search equally hard for aspects of the tax code that favor some kinds of economic activities over others. This is most easily done by eliminating those aspects of the system that create a bias against different forms of economic activity over others.

The current tax system is heavily biased against saving, investment, and entrepreneurship. Economists generally agree that a consumed-income tax would help to eliminate this bias.[9] Such a system would treat all saving and investment as if it were an IRA, but with no penalty for early withdrawal. That is, so long as income is deposited in some form of saving or investment vehicle, it is untaxed. Income is taxed only when it is withdrawn from saving and spent. This approach eliminates the current tax system's bias against saving and investment (see "How Income

consumption by 10 percent and, likewise, it reduces his returns to saving by 10 percent. If the $900 is saved his interest income is reduced to $90. In the absence of further taxation his choice is between spending $900 now or waiting a year and having the opportunity to spend $990. But under an income tax, the returns to saving get hit again. The $90 in interest gets taxed by 10 percent also. The return to saving is reduced to $81. The tax reduces these returns twice: first, from $100 to $90 when the initial $1,000 is taxed and second, from $90 to $81 when the interest is taxed. The return from consumption is only reduced once, from the level of satisfaction that could be obtained with $1,000 to the level that could be obtained with $900 (Figure 2). The tax on interest or other returns to investment, including the taxation of dividends and capital gains, biases the decisions against saving, investment, entrepreneurship and business expansion and in favor of consumption spending.

Under a consumed-income tax, the return on investment would return to 10 percent, as it would be without taxes (Figure 3).

Figure 3: Consumed-Income Tax

		Consume	"Traditional IRA" Save	"Roth IRA" Save
Year 1	Income	1,000	1,000	1,000
	Saving	0	1,000	900
	Tax (10%)	100	0	100
	Net Income	900	1,000	900
	Spend	900	0	0
Year 2	Interest (10%)	0	100	90
	Tax (10%)	0	10	0
	Spend	0	90	90
	Saving Penalty	0.0%	0.0%	0.0%

If we were to apply North Carolina's top marginal rate and look at its actual impact on investment returns, including interest, dividends, and capital gains, we discover that while reducing the rewards to current consumption by 8.25 percent it reduces investment returns by about 16 percent. If we apply North Carolina's second highest marginal rate of 7.75 percent it would be equivalent to a rate of about 15 percent when applied to the returns to saving and investment.

By taxing saving and investment, North Carolina has a strong anti-productivity bias in its tax code, which stifles entrepreneurship and ultimately job creation.

Taxation Penalizes Saving, Investment, and Entrepreneurship" for further explanation).

To the extent that there are elements of the tax code that foster these biases, they should be sought out and eliminated. Some of what the Department of Revenue describes as tax expenditures clearly would be eliminated under this approach. A host of telephone charges would lose their exemption and the sales tax holiday would end. Movies would no longer have a preferential tax rate. Tax credits for state-sanctioned behavior such as the purchase of environmentally friendly dry-cleaning equipment, use of state ports, or constructing renewable energy equipment would also disappear.

Other items considered tax expenditures, however, would still be around and some would even be expanded. All interest and capital gains would be exempt from corporate and individual income taxes, not just the interest on federal or state bonds. Tax credits for investments in "qualified" businesses would end, but investments in any company would be exempt from individual income taxes.

Ideally the corporate income tax should be abolished. It is both a form of double taxation and a hidden tax on consumers, corporate employees, and corporate shareholders. Short of complete abolition though, all investments should be immediately expensed the year they are incurred. In other words, there should be no depreciation or amortization for tax purposes.

Conclusion

"[T]he fundamental purpose of our tax system is to raise revenues to fund government," wrote the President's Advisory Panel on Tax Reform. "[M]eaningful reform can deliver a system that is simpler, fairer, and more growth-oriented than our existing tax code."[10] Such a system is also the surest way to make government revenue collection reasonably consistent from year to year.

Special tax provisions make taxes more complex and unstable, privilege one group or behavior over another, and drive a wedge between the amount that citizens pay for government and the benefits they receive. These provisions also lead to inefficient economic decisions as individuals and corporations give more consideration to the tax effects of their choices than to the inherent worth of the choices themselves.

North Carolina should consider fundamental reform such as a consumed-income tax. Any effort short of that would only continue the disparities in the existing tax system. Even without putting such fundamental reform in practice, the General Assembly should stop looking for tax expenditures. Instead, lawmakers should enact legislation to examine the existing tax laws against a simple, neutral system, and they should report all tax biases that distort economic behavior.

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Notes

1. G.S.105-256(a)(2) as written in SL1991-10(1). "105-256(a) The Secretary of Revenue shall prepare and publish the following: … (2) At least every two years, a tax expenditure report that lists the tax expenditures made by a provision in this Chapter other than a provision in Subchapter II and, when possible to do without impairing other duties of the Secretary or the Department of Revenue, the amount by which revenue is reduced by each expenditure. A 'tax expenditure' is an exemption, an exclusion, a deduction, an allowance, a credit, a refund, a preferential tax rate, or another device that reduces the amount of tax revenue that would otherwise be available to the State."
2. "FAQs: Taxes and the Economy," United States Department of the Treasury, www.treas.gov/education/faq/taxes/taxes-economy.shtml#q5
3. "Biennial Tax Expenditure Report 2005," North Carolina Department of Revenue: Raleigh, November 2005.
4. Charles Fried, "Whose Money Is It?" *Washington Post*, January 1, 1995. Quoted in Bruce Bartlett, "The End of Tax Expenditures As We Know Them?" Institute for Research on the Economics of Taxation: Washington, D.C., June 13, 2001, page 8.
5. Amna Cameron, "Corporations Win, Low Income Families Lose," North Carolina Budget and Tax Center, Raleigh, N.C., November 11, 2005, www.ncjustice.org/media/library/526_taxbrf11102005.pdf
6. David Rice, "Businesses in N.C. don't pay excessive taxes, group says," *Winston-Salem Journal*, November 12, 2005, www.journalnow.com/servlet/Satellite?pagename=WSJ%2FMGArticle%2FWSJ_BasicArticle&c=MGArticle&cid=1128768107307&path=!localnews!economy!&s=1037645509109
7. "Biennial Tax Expenditure Report 2005," North Carolina Department of Revenue: Raleigh, November 2005, www.dor.state.nc.us/publications/NC_Tax_Expenditure_Report_05.pdf
8. "Biennial Tax Expenditure Report 1992," North Carolina Department of Revenue: Raleigh, October 1992.
9. Roy Cordato, "Liberty and Economic Growth: Principles for Reforming North Carolina's Tax System," John Locke Foundation, January 2005, www.johnlocke.org/policy_reports/display_story.html?id=52
10. Report of the President's Advisory Panel on Federal Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System, November 2005, Exeuctive Summary, p. xiii, www.taxreformpanel.gov/final-report