THE INEFFICIENCY OF TARGETED TAX POLICIES

A JOINT ECONOMIC COMMITTEE REPORT

Jim Saxton (R-NJ)
Chairman

Joint Economic Committee
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Executive Summary

A number of proposals for tax relief have been introduced by members of Congress from across the political spectrum. Disagreement now lies in how the tax relief should be delivered. In his fiscal year 1998 budget, President Clinton unveiled a targeted tax-cut program which would reward tax credits to certain groups for certain activities. Many economists and policy analysts would prefer a more general, broad-based approach to tax cuts which would not single out specific activities for preferential treatment. Specifically, targeted tax policies are economically inefficient and may encourage abuse of the tax system.

Joint Economic Committee
G-01 Dirksen Building
Washington, DC 20510
Phone: 202-224-5171
Fax: 202-224-0240

Internet Address:
http://www.house.gov/jec/

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I. Targeted Tax Cuts and Standards of Good Tax Policy

Virtually all economists agree with Joseph Stiglitz, former Chairman of President Clinton's Council of Economic Advisers, that "Three main traits define a well-designed tax system: fairness, economic efficiency and simplicity."[1] Generally, targeted tax policies do not meet any of these three criteria. Furthermore, they can easily lead to abuse in the current political system.

Economic Efficiency

All taxes distort behavior and reduce economic efficiency to some extent. The goal for policy-makers is to implement tax policies which minimize these distortions. In general, broad-based tax reductions are less disruptive to the market allocation of resources than are targeted tax policies such as tax credits. Targeting adversely affects economic efficiency through three main channels: resource allocation, incentives, and administrative costs.

Resource Allocation

Targeted tax credits artificially lower prices of government-approved activities while increasing other prices throughout the economy. The distortion of relative prices alters taxpayers' behavior and disrupts the efficient operation of markets. In effect, the government, rather than the market, determines where resources should be allocated. When resources are allocated by political decisions, they are diverted from more productive uses, thus undermining economic growth.

In contrast, broad-based tax reductions minimize distortions in resource allocation because relative prices remain unchanged. In this way, the tax policy is guided by neutrality, permitting market incentives to allocate resources to their most highly valued uses. In addition, broad-based reductions in the marginal tax rates[2] imposed on working, saving, and investment would encourage these activities and increase the flow of resources into production, thus boosting prospects of long-term economic growth.

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[1] Council of Economic Advisers, *Economic Report of the President*, February 1996, U.S. Government Printing Office, Washington, D.C., p. 84.

[2] The marginal tax rate is the fraction of an *additional* dollar of income that must be paid in taxes. It is the key determinant behind individuals' decisions to work, save, and invest because it influences the relative prices of alternative activities.

Incentive Effects

Taxes affect economic behavior and decision-making, which in turn affects the economy. Economists disagree about the size of the economic impact, but the direction is clear -- *cuts in marginal tax rates stimulate economic growth.* In general, broad-based tax reductions are more conducive to economic growth because they provide incentive effects that increase the flow of resources to production.

There are two main reasons why the incentive effects of a broad-based tax reduction are superior to those of narrowly targeted tax policies such as tax credits. First, broad-based tax reductions tend to lower marginal tax rates in the economy, thus increasing the resources available for long-term economic growth. Narrowly targeted tax credits do not have this effect because they do not lower the marginal tax rate. While the effects of broad-based tax incentives on economic growth should not be overstated, it must be recognized that even modest beneficial effects on the economy are important in the long term.

Second, narrowly targeted tax measures cannot increase overall economic activity, but only rearrange it in a less efficient manner. Certain activities may be promoted, but this will be at the expense of other activities which are already operating efficiently in the market. For example, a tax credit for education may alter educational decisions to some extent, but it does not lower marginal tax rates on working, saving or investment. A tax policy heavily reliant on targeted tax credits will leave tax rates unchanged at best, or will even tend to raise tax rates in the long run. The net effect at the margin is to substitute activities favored by the government for market driven activities; to substitute less efficient for more efficient use of resources; and to exert upward pressure on tax rates that would undermine economic growth, not enhance it.

Administrative Costs

Since tax credits can only be claimed under certain conditions, the Internal Revenue Service (IRS) must incur administrative costs to ensure the conditions are met. The more targeted the tax credit, the higher the costs incurred for record keeping, tracking, monitoring and filing. This directly reduces the benefit of a tax credit and further diverts resources away from more productive uses.

Fairness

Targeted tax policies are generally unfair because they do not apply equal tax treatment to similarly situated taxpayers. In other words, households with the same ability to pay taxes may be taxed differently depending on their composition or consumption choices. In essence, targeting is a way of using tax incentives to get Americans to do what the government wants them to do -- those who do not comply, do not receive the tax break.

Simplicity

Targeting creates a labyrinth of deductions, exclusions, and credits that complicate the tax code, raising the IRS's administrative costs and taxpayers' compliance costs. The IRS estimates that taxpayers spent 5.1 billion hours in 1995 complying with corporate and individual income tax laws.[3] These unrecorded costs, which include the time spent reading, understanding, filing, and consulting professionals, may well exceed the recorded administrative costs incurred by the IRS.

More importantly, targeting creates ample loopholes in the system, the abuse of which further increases the cost of the tax cut by lowering the government's revenue. Broad-based tax reductions, on the other hand, simplify the tax code, thereby reducing administrative and compliance costs. By eliminating the many exceptions and loopholes in the tax code, they also reduce an individual's ability to exploit the system.

Furthermore, targeting increases the power of the government by allowing the government the discretion to become increasingly involved in taxpayers' activities and spending choices. Activities more efficiently administered in the market place, thus become complicated with red tape and bureaucracy.

Potential Abuse in the Political System

Targeted tax policies may be abused if tax credits are rewarded on the basis of political clout rather than sound policy. By rewarding tax credits to a few favored groups, the government motivates others to lobby for similar preferential treatment. In this way, targeted tax credits invite powerful special interests into the political system as different groups use their money and influence to win the government's favor.

In turn, tax credits can easily be used as political handouts disguised as social or economic policy because they are easier to implement than spending increases. They are politically popular because they provide benefits to a few individuals at the expense of the rest of the taxpaying population. The ability to concentrate benefits and diffuse costs minimizes the opposition against their use.

II. Targeting Education and Employment

President Clinton recently proposed a very targeted tax-relief program in his 1998 budget. While targeted tax cuts are used on both sides of the political divide, the Administration's proposals have received widespread attention because of their size and significance. To advance two of his major goals over the next four years, President Clinton has proposed tax credits for education and for businesses who hire long-term welfare recipients.

Tax Credits for Education

The fundamental goal of President Clinton's education plan is to "open the doors of college to all."[4] The $51 billion package would refund up to $1,500 to students in each of the first two years of college provided they earn at least a "B" average. Alternatively, families with annual incomes under $100,000 could deduct up to $10,000 for each child enrolled in

[3] *Investor's Business Daily*, "Flat Tax Gains For All," January 24, 1996.

[4] President Clinton, State of the Union Address, February 4, 1997

college. The proposal also increases the size of the federal Pell Grant program by expanding eligibility and raising the maximum amount of a grant from $2,700 to $3,000. Finally, the plan allows for expanded Individual Retirement Accounts (IRAs) from which tax-free withdrawals can be made for educational purposes.

There is broad agreement that education is an important investment in human capital. However, many economists, policy makers, university officials, and even some top-ranked members of President Clinton's administration are skeptical that a targeted tax credit is the best way to boost college enrollment.

One of the most widely cited criticisms is that a targeted tax credit will mainly benefit students who would have gone to college anyway, while very little of the money will go to the poorest families who need it most. Even with the proposed increase in the size of the Pell Grant program, the value of the grant would still be 27 percent lower than it was in 1980 because of higher tuition costs. Lawrence Gladieux, executive director for policy analysis at the College Board, commented that the plan "tips the benefits so heavily to the more advantaged in our society that I have great misgivings....this is clearly an upper-income program."[5] If the fundamental purpose of the program is to boost college enrollment for the poor, Gladieux argues that it would be far more efficient to simply shift more money into Pell Grants, although this idea would be politically unpopular in the era of small government.[6]

Education analysts worry that the tax credit may distort behavior and create a range of unintended side effects. For example, the $1,500 tax credit is slightly higher than the average tuition cost at most community colleges, potentially giving colleges an incentive to raise tuition. In addition, the "B" average requirement may pressure professors into raising grades for students who are desperate to qualify for the aid. The "B" requirement may also impose a large administrative burden on the IRS by making it necessary to monitor grades.

Alternatively, a broad-based tax rate cut would provide families with additional income which could be spent on education if needed, without unfairly redistributing the benefits or introducing distortions.

Tax Credits for Employment

Another goal of President Clinton's agenda is to move an additional one million people off the welfare roles by the year 2000. To help achieve this goal, the Administration has proposed a tax credit for businesses that hire long-term welfare recipients. The plan would allow businesses to claim a 50 percent credit on the first $10,000 of wages paid to qualified welfare recipients for the first two years of employment. The plan has already sparked a great deal of criticism based on an earlier version of the program called the Targeted Jobs Tax Credit. The Targeted Jobs Tax Credit was enacted in 1978 and expired on December 31, 1994. Its poor success record has left many analysts doubting if the President's proposal will achieve its goal.

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[5] *Washington Post*, February 3, 1997, "Education Aid at What Cost?"

[6] *New York Times*, November 3, 1996, "An Economic Lesson: The Candidates' Plans for Education."

Charles Masten, the Inspector General at the U.S. Department of Labor who conducted an audit of the Targeted Jobs Tax Credit program, stated that it had "virtually no impact on employers' decisions to hire members" of these groups.[7] The audit showed that nearly 92 percent of the workers hired would have been hired anyway. Auditors estimated that the program cost $374 million a year and produced benefits of only $147 million a year, an economic loss of 63 cents for each dollar of total costs. Masten concluded that "the tax credit was a windfall for employers since the program [was] inconsequential in encouraging the employment" of welfare recipients and other groups it was intended to help.[8]

The targeted tax plan did not seem to achieve its goal, but it did encourage more lobbying activity. *The New York Times* reported that "Earlier versions of the tax credit spawned a whole industry of personnel consultants who did the paper work necessary to get the tax credit for employers. These companies became potent lobbyists for the tax credit."[9] Moreover, Linda Levine of the Congressional Research Service stated that "A number of studies found that employers did not significantly change their recruitment policies, but instead relied upon consulting firms to determine which of their newly hired workers coincidentally were members of the eligible population."[10]

Administration officials have pointed out that the new proposal was designed with criticism of the old one in mind. It is doubtful that the problems have been adequately addressed; nonetheless, the Targeted Jobs Tax Credit provides a good example of the inefficiency and potential manipulation that may arise from the use of targeted tax credits.

III. Conclusion

By artificially distorting relative prices, targeted tax rate cuts alter taxpayers' choices and disrupt the efficient operation of markets. Their inefficiency prevents policy makers from lowering the tax rate to the greatest extent possible, so that tax credits have little, if any, impact on working, saving and investing. Targeting may provide tax relief to certain groups of taxpayers, but it can actually undermine efficiency and economic growth. Furthermore, targeted tax policies can be inequitable, complicated, and easily abused.

In contrast, broad-based tax reductions minimize loopholes in the tax code, allowing for the lowest tax rates possible. The lower tax rates encourage work, saving, and investment so that more resources may be channeled toward production. Given broad-based and targeted tax rate cuts of the same size, broad-based tax rate cuts produce lower tax rates, stronger incentives, and greater economic growth.

Shahira ElBogdady
Research Analyst

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[7] *New York Times*, "Clinton Will Seek Tax Break to Ease Path Off Welfare," January 28, 1997.

[8] *Ibid.*

[9] *Ibid.*

[10] *Ibid.*