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CBO GROSSLY OVERSTATES BUSINESS TAX SUBSIDIES

The Congressional Budget Office has issued a deeply flawed report, *Federal Financial Support of Business* (June 1995), that purports to catalog federal subsidies to business. If done properly, such a study could help the Congress in its efforts to downsize government by exposing for scrutiny wasteful or otherwise inappropriate business-assistance programs. While some business-aid programs may be meritorious, others ought to be eliminated because they provide meager benefits, are excessively costly, or do not serve a compelling national interest.

The CBO erroneously claims that most federal aid to business comes from tax subsidies, not from federal spending or credit programs. The CBO conclusions are based on a tax standard that is virulently biased against saving and investment. Actually, most of the tax provisions that the CBO brands as "federal aid to business" reduce, but do not eliminate, tax biases against saving and investment. Compared to a neutral tax system, these provisions at most moderate tax penalties; they do not "assist business financially." If the CBO's tax standard ever became law, it would sharply increase tax disincentives against saving and investment — thereby worsening government barriers that hold back economic growth.

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In categorizing taxes, the CBO study relies on list of so-called tax expenditures that appears in federal budget documents each year. The staffs of both the U.S. Treasury Department and the Congressional Joint Committee on Taxation compile a listing of how much special assistance supposedly is provided to taxpayers by various tax code provisions. According to the CBO, for a provision in the tax code to be categorized as a tax expenditure, "it must be a special exemption from a general rule, and it must provide a subsidy." In its report on federal aid to business, the CBO includes those so-called tax expenditures that it regards as primarily directed towards "taxpayers who engage in commercial or business-related activities."

By uncritically accepting the concept of tax expenditures and the methods the government uses to compute them, the CBO has conditioned the validity of its results on the validity of the tax expenditures paradigm. The CBO breezily assures its readers that they can rely on the tax expenditures listing, "Tax analysts generally agree on which provisions constitute tax expenditures, with few exceptions." Whether this CBO assertion is valid, theoretical and operational difficulties plague the whole notion of tax expenditures.

The most basic problem is that tax expenditures should be measured as preferential deviations from a baseline that defines a neutral tax, one that does not alter the price relationships that would be cast up by the market system operating free from government intrusion. The government, however, has selected as its baseline a version of the income tax that tax analysts generally recognize as weighing more

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heavily on saving and investment than on immediate consumption. This version of an income tax generates an anti-saving bias because it taxes both the amount of current income that is saved and the returns on this saving; in contrast, when income is used for immediate consumption, it taxes only the initial earnings. Thus, it taxes income that is saved multiple times but income used for consumption only once, thereby placing a relatively heavier tax burden on funds used for saving and investment than on funds used for immediate consumption.

As a consequence of penalizing savers and investors, this type of income tax reduces the quantity of saving and investment to below the economically desirable level. The cost is a less productive and vigorous economy.

The CBO report fails to acknowledge this damaging bias. Instead, the CBO report claims it has identified tax provisions which it describes as "business support," "federal assistance," "federal support through tax benefits", "a subsidy," "favorable tax treatment," etc. If the report is going to use such terms, it should start from a baseline that is evenhanded towards saving and investment. Because the terms imply that the starting point is one of neutrality, the CBO report is grossly deceptive in using them to describe deviations from a baseline that is stacked against saving and investment.

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Aggravating the anti-saving bias, the official tax expenditures baseline includes both the individual and corporate income taxes. That subjects people's investments in corporations to two different federal income taxes, one on top of the other. Whereas the CBO report tries to minimize this issue, federal budget documents admit that placing two income taxes on the same income is wrong and call it one of "several major departures from a pure comprehensive income tax" in the tax expenditures calculations. With a pure income tax, all income should be imputed to individuals; the corporate income tax should not exist. Thus, if tax expenditures are calculated relative to a pure model income tax, no corporate income tax provisions should be listed as tax expenditures because the corporate income tax does not belong in the tax system. Indeed, the corporate tax provisions should be counted as the opposite of tax expenditures, what might be called negative tax expenditures or overtaxation. Nevertheless, budget documents and the CBO count many corporate tax provisions as tax expenditures, further tilting tax expenditure calculations against taxpayers.

As a specific example of where the CBO analysis goes wrong, consider accelerated depreciation, which the CBO erroneously categorizes as taxpayer assistance. According to the CBO report, accelerated depreciation is the largest pro-business tax incentive on the books, larger than all direct spending and credit programs combined aimed at assisting business.

The CBO's position is that accelerated depreciation is a subsidy because it usually lets investments be written off faster than they wear out economically. The CBO insists that to avoid subsidizing investment, an investment's tax write-off must be stretched out over the investment's life, with each year's tax deduction based on the investment's loss of value that year. Any departure from that write-off pattern the CBO counts as a tax subsidy.

In reality, to avoid penalizing investments, capital costs need to be expensed, that is, written off when they occur (or an equivalent adjustment made.) The reason is that an income tax is supposed to measure revenues minus costs; the difference is income. Further, because time has value, the costs must be deducted when they occur if income is to be measured accurately over time. Suppose, for instance, that people apply a 10 percent yearly discount rate to future receipts and outlays.

Suppose, also, that a $1,000 investment is made this year but the investment has to be depreciated in 10 even installments over the next 10 years. This stretched out write off, which the CBO report would portray as close to correct, actually has a present value of only $676. In present value terms, it understates business expenses over the 10-year period by $324 ($1,000 - $676), thus, overstates income by the same $324, and, hence, leads to overtaxation.

Accelerated depreciation, which the CBO report labels a multi-billion dollar tax subsidy, somewhat mitigates this bias but does not eliminate it. If the asset in the example qualifies for, say, 7-year cost recovery under current law, its stream of write offs has a present value of $794, which understates actual costs by $206 ($1,000 - $794). Thus, accelerated depreciation <u>penalizes</u> investments; it does <u>not</u> subsidize them. The depreciation scheme the CBO report touts would, of course, greatly increase that penalty.

Allowing the investor in the example to write off the $1,000 this year would remove the bias. So, too, would the neutral cost recovery system (NCRS), which is included in a somewhat weakened form in the tax bill passed by the House of Representatives. NCRS stretches out the write off period but grosses up the nominal deductions so that their present value equals the investment's cost.

It is astonishing that the new CBO director would have allowed her agency to issue a report with such serious analytical deficiencies. Surely, she must recognize the flaws in the tax expenditures model. The study was a carryover from last year, essentially done before she came on board. Nevertheless, she could have held the report back until it drew on a more objective analysis.

The CBO report as it stands is worse than useless. By and large, the tax "favors" that it asserts a generous government is bestowing on business activities are seen to be tax penalties when measured against a baseline that is not biased against saving and investment.

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Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.