

ECONOMIC BRIEF NO. 14

Tax Incentives: A Mixed Blessing

It's difficult to design a tax break to reach the poor. Suppose South Carolina gave a \$1,000 income tax deduction for disabled family members. A high-income family would save \$70 while a low-income family might save \$30 to \$40. Families not filing—likely to include severely disabled persons—might not get any benefit at all.

Want to help the disabled? save the farmers? encourage small town merchants? reward people who hire welfare clients? lure new industry? Give them a tax break!

For the last decade or two, a tax break was the economic equivalent of "take two aspirin and call me in the morning." No matter what the complaint, it could be remedied with another exclusion, deduction, or tax credit on the income tax, sales tax or property tax.

When used properly, a tax break is an incentive to which taxpayers can choose to respond or not. An income tax deduction for mortgage interest, for example, has made owning a home more attractive than renting and investing in other assets. This tax break has given the United States one of the highest rates of home ownership in the world.

Tax credits and deductions are very attractive to those who place a high value on economic freedom and prefer choices to rules and private producers to government. Consider the tax deduction for contributions to charity. Studies show that this deduction is very effective in inducing citizens to support charities. Many charities provide services and activities that government might otherwise have to provide. The charitable deductions can be viewed as a matching grant program partly funded by government and partly by citizens. The key is volun-

tary choice and private production.

Tax breaks have some drawbacks, however. First, deductions, credits and exemptions make administering and complying with the tax law more complex. A relatively simple tax break, such as the exemption of Bibles from sales tax, can lead to difficult decisions for buyers, sellers, tax administrators, and the courts. Is a Bible calendar or a Bible tape covered? Does this exemption violate separation of church and state? Do sellers have to report Bible sales separately to claim the exemption? Multiply this example by hundreds or thousands and soon an army of tax administrators, accountants, and lawyers is interpreting and applying tax law.

Second, each tax break creates a revenue loss that must be made up by increasing taxes on everyone else or by cutting services. Property tax breaks for new firms mean higher property taxes on established firms and homeowners. The governor's proposal to give an income tax credit for preschool children means a loss of income tax revenue that will have to be made up by cutting state services and programs or raising taxes somewhere else.

Third, a tax break intended as an incentive will include people who would have taken the desired action anyway. Some families may enhance their homes to

get a property tax rebate for beautification. Others would have enhanced their surroundings anyway, but now get a tax break bonus. The amount of revenue lost may be high relative to the increase in the desired activity.

Finally, unless a tax break is carefully crafted to reach the poor, it is likely to benefit the rich more than the poor. Income tax breaks benefit itemizers in higher tax brackets and don't benefit non-itemizers or nonfilers. It is possible to design tax breaks aimed at the poor, but usually they are more complicated to administer.

The poor are often used as an excuse to create tax breaks that go disproportionately to higher income families. Exempting food from sales tax is suggested as a way to reduce the tax burden on the poor. However, the very poor who buy food with food stamps already pay no sales tax. While such an exemption would bring some small improvement in the situation of the near-poor with incomes just above the food stamp level, the 85 percent of the population that is not poor would get most of the benefit. So the state revenue lost per dollar gained by the poor is very high.

Tax breaks have a role to play in the revenue structure, but overusing a good tool means eroding the tax base and complicating the tax system, often without reaching the intended people or objective.

Available from the Strom Thurmond Institute by subscription: *The Economic Situation*. Authored by Bruce Yandle, Senior Fellow of the Institute, this quarterly newsletter provides commentary on national, regional and state economic trends affecting South Carolinians. It is designed to help the reader make a personal economic forecast. Price: \$10.00; make checks payable to Clemson University.