



Tax Deductions and Subsidies, Big Government's New Tools

by Brad Cook

Originally developed for the purpose of reducing tax burden and creating incentives to spur the economy, tax deductions and subsidies have become a back-door tool of big government. While the intention behind many of these is well warranted, they distort the economy.

Big government consistently uses tax deductions and subsidies to choose the winners and losers in the economy. Littered throughout the tax code are numerous deductions and subsidies that are nothing but hand-wrapped gifts to special interest groups. For example, it is estimated that federal and state subsidies account for about 60 cents and 20 cents, respectively, a gallon for ethanol production.¹ Were it not for these subsidies, ethanol production would be very economically inefficient and production would either reduce or cease.

Tax deductions to individuals and businesses can also hide the real cost of certain activities from taxpayers. Many experts believe that the home mortgage interest deduction harms the economy by diverting money from business investment to residential housing. The educational tax credits are also believed to increase the costs of college as colleges increase their tuition prices to get a share of the money.²

Though both parties imply that they want to streamline the tax code, a recent tax bill, American Jobs Creation Act of 2004, is nothing but a sleigh full of early holiday gifts for special interests and big government. The 600-plus-page act rewards 200,000 manufacturers with corporate tax breaks and opens the door even wider for big government to get its meddlesome hand into our back pockets.

The Jobs Creation Act allows for state and local sales taxes to be deducted from federal income taxes, a deduction that was eliminated in the 1986 Tax Reform Act. In the lawmakers' defense, this deduction was re-enacted to make it fairer for those who live in states with sales tax but no state or local income taxes, since state and local income taxes were already deductible. Under the new law, taxpayers can deduct either their state and local income taxes or their state and local sales tax, but not both.

These deductions may be seen as a progressive tax reform, but in fact they undermine what true tax reform should be. Just as other tax deductions and subsidies support special interests and big government, these tax deductions shield taxpayers from the full burden of increased taxes at the state and local level. An individual taxpayer who is in the 25 percent federal government tax bracket may pay \$500 in either state sales or income taxes and expects \$500 worth of services. But if these taxes are deductible, his federal tax bill will reduce by \$125, and therefore his \$500 of state taxes reduces his

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disposable income by only \$375. This makes state government seem less expensive than it really is and the taxpayer will have an incentive to seek more state government.³

Though a perfect tax code, so simple that tax returns fit on a postcard, may be infeasible, a more streamlined tax code is not. A responsible tax reform would reduce the number of deductions and subsidies, thereby eliminating the many exploited loopholes that exist in the current 60,000-page tax code. True tax reform does not choose the winners and losers in the economy, nor does it create a hidden agenda for big government. Instead it seeks to make sure that everyone pays a fair and equal share of his or her debt to society, so that a millionaire (a ketchup heiress for example) cannot legally shelter so much of her income that she pays a lower rate on her income than I do.

If lawmakers can extricate themselves from special interests or their temptations to control and streamline the tax code, it can lead to monumental tax change. This can move us one step closer to the elimination of the current inequitable income tax code, or at the very least, decrease tax rates.

(Endnotes)

1 David Pimentel, "Ethanol Fuels: Energy Balance, Economics, and Environmental Impacts are Negative," *Natural Resources Research*, Vol.12, No.2, June 2003.

2 Daniel J. Mitchell, "Sales Tax Deduction Would Subsidize Bigger Government, Undermine Tax Reform," *Web Memo #520*, The Heritage Foundation, June 9, 2004.

<http://www.heritage.org/Research/Taxes/wm520.cfm> (11/4/2004)

3 Ibid.

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