



Dear GOP: Tax Credits Are Not the Answer

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June 2017

If you like social engineering done through the tax code, you'll love the House Republicans' health care plan. It takes the refundable tax credit that Obamacare provides to most people who get their coverage through a government-run insurance exchange and replaces it with a refundable tax credit available to anyone who buys a plan on the individual market. This would make our already nightmarish Internal Revenue Code even more complicated and tax season even more painful.

Regular tax credits allow an amount to be deducted directly from income taxes owed. Unfortunately, they're often poorly designed: They introduce unnecessary complexity and ambiguity to the tax code while usually failing to properly target the desired activity or population. In addition, while tax credits can seem lucrative to their recipients, they're often counterproductive for the economy as a whole.

Take, for example, the federal credit extended to U.S. companies for research and development. It is one of the largest corporate tax carve-outs in our tax code, amounting to about \$9 billion a year. It's also an archetype for how these efforts can go wrong.

The benefits of the R&D credit are highly concentrated—the top 1 percent of American firms claim more than 82 percent of associated dollars. And because the design of the credit is so complex, companies must redirect scarce resources away from producing something of value to their customers and toward securing the handout. "Because the credit cannot be precisely defined, businesses are incentivized to spend large amounts of time and money lobbying Congress and tax regulators to ensure the credit is renewed and tailored to suit their specific interests," the Mercatus Center's Jason Fichtner and Adam Michel explained in a 2015 paper. "Significant resources are also wasted as parties attempt to interpret, litigate, and follow the law."

Despite the costs, there's no proof the R&D credit leads to significantly more or better innovations.

"Refundable" tax credits—the kind that become cash transfers from the government to people who don't owe any taxes—have all the same problems as regular tax credits, and on top of that require actual government outlays. According to a Congressional Budget Office report, the feds this year will receive \$238 billion less than they otherwise would (in 2013 dollars) because of tax credits, including needing to make some \$150 billion in direct expenditures.

The Earned Income Tax Credit (EITC), a darling of both parties, is even more lopsided. The program, which offers a wage subsidy to low-income workers, provides roughly \$70 billion in annual benefits, \$60 billion of which counts as government spending. Meanwhile, 94 percent of the current Obamacare tax credit takes the form of outlays, according to the Cato Institute's Michael Cannon, and the Republican substitute would likely be similarly expensive.

It is wrongheaded and paternalistic to use the tax code as a system of reward or penalty, as opposed to just being a means of raising revenue while introducing as few distortions as possible to the economy. The GOP's proposed health care tax credits are no better in this regard than the long-decried individual mandate, which punishes people for not buying a product Washington wants them to.

We already have a long list of tax credits meant to influence our behavior, nudging us to have more kids, save more money, drive electric vehicles, buy a house, go back to school, and more. Politicians justify the credits as either promoting good things (such as homeownership) or discouraging bad ones (such as pollution from fossil fuels). But as the economists Ed Lazear and Jim Poterba wrote back in 2005, "Such arguments are usually difficult to support with empirical evidence, and they lead to special privileges and a myriad of tax breaks that are likely, on balance, to reduce the efficiency of the tax system."

Republicans, who currently hold majorities in both the House and the Senate, regularly claim they want a fairer, simpler tax code. But the credits they seem to love are far more likely to be the product of special-interest lobbying than a careful study of social externalities.