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Tax Expenditures: Using Tax Credits and Deductions as Policy Tools

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Any provisions in the tax code to favor certain groups of taxpayers, or certain kinds of activities, results in a loss of revenue. The amount of revenue lost depends on the tax rate and how many people respond to the opportunity created by the tax provision. Economists consider the revenue foregone as equivalent to a direct expenditure on the same purpose. These revenue-reducing provisions are known as tax expenditures.

Many tax expenditures favor charitable organizations. The revenue lost from the federal income tax deduction for charitable contributions alone is estimated at $47 billion in 2008. Some states, not including South Carolina, exempt these nonprofits from paying sales taxes, and all states exempt them from local property taxes. Saving for retirement, creating jobs, owning a home, adopting a child, and preserving wildlife habitat are just a few of the many kinds of activities that can result in a lower tax burden on the individual and lower revenue to the government.

Tax expenditures are used to encourage certain kinds of positive actions. Those actions could also be encouraged by direct spending, but it may be less expensive to do so with a tax break, and this approach leaves the decision in the hands of the individual rather than the legislature. Because of the emphasis on citizen choice, tax expenditures are a very popular policy tool, but they are not always the best way to attain a particular goal at the lowest possible cost.

Tax expenditures are less visible than direct spending, and don't usually come up for annual review, so they stay in place for long periods of time. They also develop strong lobbying constituencies, like the auto dealers who defend the sales tax cap on cars in South Carolina. They can be put into effect more quickly than direct expenditures and do not create an administrative bureaucracy, although they do increase the cost of tax administration.

One drawback to using tax expenditures is that they create tax relief for activities that were already ongoing or would have been undertaken anyway. So the revenue loss does not result in much of an increase in retirement saving, job creation, or home owning as tax writers might think.
Among the tax expenditures that have come up for the most scrutiny in South Carolina are sales tax exemptions. In addition to the $300 sales tax cap on cars, boats, and airplanes, there are a host of

other sales tax exemptions, including groceries and most kinds of services. Some of those exemptions were not intended to encourage a particular activity. The elimination of the sales tax on food was intended to provide relief for low-income households, and the exemption of most services dates from an earlier era when most household spending was for tangible goods. In fact, most of the tax expenditures that are aimed at encouraging particular kinds of activities rather than providing relief for designated groups are those found in the state's individual and corporate income taxes, not in the sales tax.

The South Carolina corporate income tax offers a number of deductions or credits related to job creation that is intended to encourage economic development. Many of the tax expenditures in South Carolina's individual income tax are carryovers from the Federal income tax, but The state also has some of its own. South Carolina offers highly favorable treatment of retirement income. Social Security benefits are completely exempt from state income tax, and a large share of pension income is excluded also. So is income from serving in the military reserve, which is taxed at the federal level.

A number of recent changes in the South Carolina individual income tax encourage certain kinds of home improvements that reduce energy use or increase safety—the fire sprinkler credit and the energy efficient mobile home credit, for example. Others relate to children and education—the extra exemption for children under six and contributions to a pre-payment college education plan.
All of these, and other provisions, support worthwhile public policy goals. But it is important, when funds are scarce and needs are many, to count the cost, and to weigh these programs against others that are short of funds. Is it more important to invest in our children's college funds or to invest in our public colleges? The extra exemption for children under age six may be of little value to a poor family that owes no tax, and would benefit more from early childhood education programs for those children. Tax expenditures are one useful tool among many in making tax policy that makes South Carolina a good place to live. Like any tax policy tool, they need to be used thoughtfully and reviewed regularly to make sure that the benefits justify the cost.

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