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DISPARATE RACIAL IMPACT: TAX EXPENDITURE REFORM NEEDED

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Stark reminders of racial injustice in the United States — in particular, the recent killings of unarmed Black individuals by police — have increased focus on systematic racism lingering from the past of slavery and Jim Crow laws. The effects of current laws and policies on the Black community and other minorities are being reassessed, including a growing spotlight on income and wealth inequality in America. One of President Biden's first executive orders requires each agency to evaluate whether and the extent to which its "programs and policies perpetuate systemic barriers to opportunities and benefits for people of color and other underserved groups."[1]

Although U.S. federal tax laws don't have explicit differences in tax rules by race (disparate treatment), the outcomes of those facially "raceneutral" rules can have differential effects across racial groups (disparate impact). Unlike disparate treatment (intentional discrimination), disparate impact can result from laws that nonetheless disfavor a group of people. Government laws protect racial groups from disparate impacts in the areas of employment and housing,[2] but only recently have more analysts considered the potential disparate racial impacts of tax laws and tax administration.[3]

This article discusses the issues of potential disparate racial impacts of U.S. tax laws regarding government subsidy and incentive programs run through the tax system: tax expenditures. It analyzes the available data, provides normative insights, and describes eight steps to address disparate racial impacts through tax expenditures. It also calls for a heightened focus on racial injustice to be part of the broader renewed focus on equity considerations in the U.S. tax law, addressing long-standing and growing racial, income, and wealth inequalities.[4]

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[1] White House, "Executive Order on Advancing Racial Equity and Support for Underserved Communities Through the Federal Government" (Jan. 20, 2021).

[2] The Age Discrimination in Employment Act of 1967; the Civil Rights Act of 1968 (the Fair Housing Act); and the Civil Rights Act of 1991.

[3] Beverly I. Moran and William C. Whitford, "A Black Critique of the Internal Revenue Code," 1996 Wis. L. Rev. 751 (1996); Chye-Ching Huang and Roderick Taylor, "How the Federal Tax Code Can Better Advance Racial Equity: 2017 Tax Law Took Step Backward," Center on Budget and Policy Priorities (July 25, 2019); Misha Hill, "The Illusion of Race-Neutral Tax Policy," Institute on Taxation and Economic Policy (Feb. 14, 2019); and Aravind Boddupalli and Kim S. Reuben, "How Income Taxes Interact With Racial Disparities," Urban-Brookings Tax Policy Center (Jan. 30, 2020).

[4] The disparate impact of facially gender-neutral tax rules is also being considered. See Michelle Harding, Grace Perez-Navarro, and Hannah Simon, "In Tax, Gender Blind Is Not Gender Neutral: Why Tax Policy Responses to COVID-19 Must Consider Women," OECD Ecoscope (June 1, 2020); and Department of Finance Canada, "Report on Federal Tax Expenditures – Concepts, Estimates and Evaluations 2019: Part 9: Gender-Based Analysis Plus of Existing Federal Personal Income Tax Measures" (Feb. 28, 2019).

DISPARATE RACIAL IMPACT CAUSES

Disparate racial impacts of tax expenditures stem largely from the significant income and wealth inequalities in the United States, combined with the design and structure of tax benefits —that is, incentives and subsidies run through the tax code rather than as direct government expenditures. Although the United States has a progressive federal income tax structure, tax expenditures reduce the degree of progressivity in ways that favor high-income and high-wealth families. Also, state and local tax expenditures can have disparate racial impacts. While this article focuses on federal tax expenditures, its key messages and recommendations are equally applicable to the need for reform at the state and local level.

Differences in income and wealth inequality can cause facially race-blind tax rules to have disparate effects across racial groups. Tax expenditures based on the level or types of income, wealth, and activities (for example, homeownership, saving for retirement) generally provide disproportionate benefits to some racial groups compared with others. Table 1 shows U.S. median and average income and wealth for white, Black, and Hispanic families. The median income of Black families is 58 percent of white families' median income, while the median wealth of Black families is only 13 percent of that of white families.[5]

Table 1: U.S. Family Income and Wealth by Race and Ethnicity

	White	Black	Hispanic	Black-to-White Ratio
Median family income (2018)	70.600	41.300	51.500	58%
Average family income	98.300	58.700	70.900	60%
Median family wealth (2019)	188.200	24.100	36.100	13%
Average family wealth	983.400	142.500	165.500	14%

Source: 2018 income - US Census Bureau, Current Population Survey, 2019 Annual Social and Economic Supplement, Table HINC-01; 2019 wealth - Federal Reserve Board, 2019 Survey of Consumer Finances

Many tax expenditures are "upside-down" government subsidies or incentives because their value depends on the taxpayers' marginal tax rate. Higher-income taxpayers at higher marginal tax rates get a larger benefit than lower-income taxpayers for the same level of tax-favored activity. Deductions, exemptions, and exclusions provide upside-down tax expenditures, whereby $1,000 of exempt income is worth $370 of tax savings to those in the highest tax bracket, but worth only $120 for a median-income family.

Moreover, many of the largest tax expenditures are based on the amount of wealth (for example, retirement savings, housing, corporate equities, and business assets), making their benefits disproportionately received by high-income white families. Table 2 shows that not only are white families more likely to own homes and corporate equities as well as participate in tax-favored retirement plans, but the value of the assets held by white families is also significantly greater than for Black or Hispanic families.

[5] Lisa J. Dettling et al., "Recent Trends in Wealth-Holding by Race and Ethnicity: Evidence From the Survey of Consumer Finances," FEDS Notes (Sept. 27, 2017); and Neil Bhutta et al., "Disparities in Wealth by Race and Ethnicity in the 2019 Survey of Consumer Finances," FEDS Notes (Sept. 28, 2020).

Also, 7 percent of total U.S. income tax expenditures are channeled through the corporate income tax. Congressional and Treasury economists estimate that corporate tax expenditures principally benefit capital owners, who are disproportionately high-income and wealthy, with a smaller share borne by wage earners.[6] As Table 2 shows, Black families are less likely to have direct or indirect (for example, through pensions and mutual funds) ownership in corporate equity, and those that do own significantly less in value.

Table 2: US Family Selected Wealth Components by Race and Ethnicity

	White	Black	Hispanic	Black-to-White Ratio
Homeownership (middle-aged family)	73%	51%	55%	70%
Median home value (middle-aged family)	230.000	150.000	200.000	65%
IRA/Defined contribution retirement plan participation	65%	44%	28%	68%
Median balance in IRA/Defined contribution plans	50.000	20.000	34.000	40%
Direct or indirect corporate equity ownership	61%	34%	24%	56%
Median value of corporate equity owned	50.600	14.400	14.900	28%

Source: Federal Reserve Board, 2019 Survey of Consumer Finances

So higher-income and wealthy families disproportionately benefit from tax expenditures not only because of their "upside-down" nature but also because many of the largest tax expenditures target capital income.

But tax expenditures can be designed to not favor high-income and wealthy families. Tax credits can provide an equal or even greater benefit to low- and middle-income families undertaking subsidized activity, especially if those tax credits are refundable and aren't limited to income tax liability, such as the earned income tax credit. Tax expenditures can also be targeted to low- and middle-income families through limitations and caps on the amount of the subsidized activity.

Finally, in practice tax administration can have disparate racial impacts. To the extent that participation or take-up of available tax expenditures isn't as high for lower-income households because of differences in awareness of eligibility or costs of claiming the benefits, they will be disadvantaged.

[6] Joint Committee on Taxation, "Modeling the Distribution of Taxes on Business Income," JCX-14-13 (Oct. 16, 2013).

TE'S HIGH-INCOME/WEALTH BIAS

Table 3 shows the 15 largest tax expenditures, accounting for 92 percent of the total income tax revenue forgone. Only three of these are tax credits, and one of those is for research and development investments received largely by corporations. Most are deductions, exemptions, or exclusions that are upside-down in their value of the benefits because of their reduction in taxable income. Six of the largest tax expenditures are subsidies for capital investments.

Table 3: Largest 15 US Income Tax Expenditures
(in billions of dollars)

Provision	2020-29
Exclusion of employer contributions for medical insurance premiums	3.104
Favorable retirement savings plan treatment	2.871
Favorable capital gains treatment	2.519
Child credit	991
Deductibility of charitable contributions	794
Deductibility of nonbusiness State and local taxes	768
Earned income tax credit	745
Deductibility of mortgage interest on owner-occupied homes	645
Reduced tax rate on active income of US corporate foreign subsidiaries	480
Lower tax rate on qualified dividends	420
Exemption of some Social Security benefits for retirees	399
Allow 20-percent deduction to certain pass-through income	373
Exclusion of interest on State and local bonds	368
Credit for increasing research activities	238
Exclusion of life insurance death benefits	166

Source: U.S. Treasury Department FY2021 Tax Expenditures, total adjusted by author to combine similar items and include refundable credit payments.

Table 4 shows the distribution of selected income sources by income from federal tax returns in 2019. The 7 percent of tax returns with income greater than $200,000 earn 35 percent of wages and salaries, 72 percent of dividend and interest income, 79 percent of self-employment income, and 91 percent of long-term capital gains. Tax expenditures based on capital income and wealth are more regressive, benefiting high-income and wealthy families more than those based on employment compensation, such as the EITC, health insurance, Social Security benefits, or child tax credits. Wealth inequality is greater than overall income inequality, and even more than wage inequality.

The Congressional Budget Office in 2013 estimated the distribution of the largest tax expenditures by income quintiles.[7] Figure 1 shows that over one half of the value of tax expenditures benefited the highest quintile (top 20 percent). The lowest two quintiles

[7] CBO, "The Distribution of Major Tax Expenditures in the Individual Tax System" (May 29, 2013).

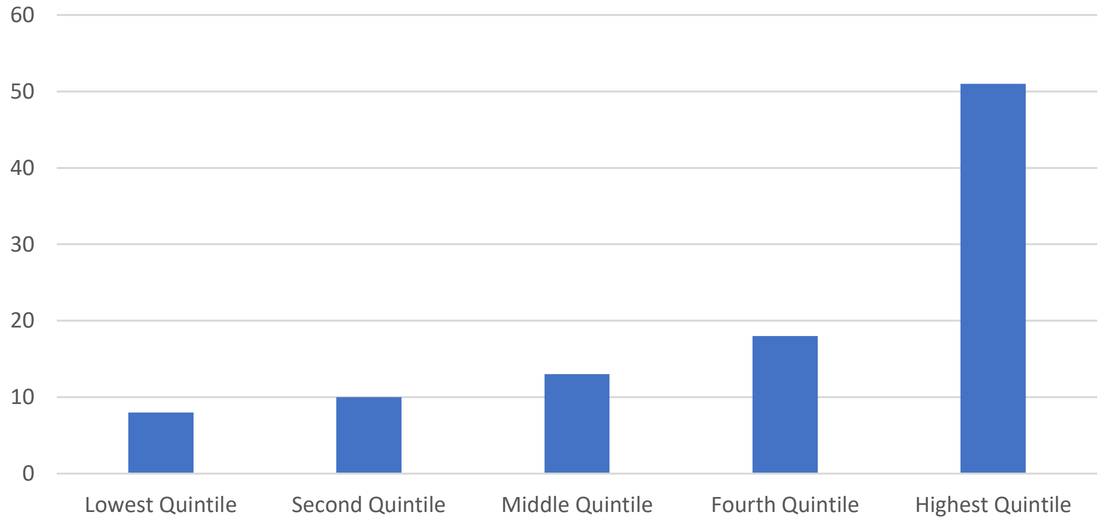
benefited from less than 10 percent of the tax expenditures. The CBO 2013 estimate is similar to a more recent estimate of the distribution of selected individual tax expenditures in 2019, which showed 59 percent benefiting the top quintile.[8]

Table 4: Distribution of Selected Income Sources from Federal Tax Returns, 2019

Income (000's)	# of Returns	Wages	Long-term Capital Gains	Dividend & Interest Income	Self-Employment Income 1/
0-30	31,3%	5,6%	0,2%	1,1%	4,7%
30-50	17,7%	7,8%	0,4%	2,1%	2,2%
50-100	26,0%	20,7%	2,2%	8,6%	4,5%
100-200	17,9%	30,8%	6,1%	16,6%	9,8%
200+	7,1%	35,2%	91,1%	71,6%	78,7%
Addendum:					
$1 million +	0,4%	8,0%	71,3%	40,9%	46,0%

Source: US Joint Committee on Taxation, Overview of the Federal Tax System in Effect for 2019, JCX-9-19. Self-employment income from IRS Schedule C and E tax forms.

Figure 1: Shares of Major Tax Expenditures by Income Quintiles, 2013



Source: CBO, 2013

Table 5 shows the distribution of specific tax expenditures. Ninety-three percent of the tax reductions resulting from preferential tax rates on capital gains and dividends benefit the highest-income quintile, while 51 percent of the EITC benefits the lowest-income quintile. Thus, the nature and design of tax expenditures can greatly influence their distribution across income groups. Lower tax rates and exclusions of income from corporate equity income are highly concentrated among wealthy families. The EITC is based on employment income, targets lower-income families, and is refundable, so it is highly concentrated in the

[8] The TPC estimates from Huang and Taylor, supra note 3.

lowest two quintiles. The child tax credit isn't fully refundable, so it isn't as beneficial to the lowest quintiles.[9] One analysis finds that 75 percent of the benefit making the child tax credit refundable would go to the lowest-income quintile.[10]Although U.S. tax returns don't include racial and ethnic classifications, unlike other U.S. government data sources, the disproportionate benefits to high-income and wealthy families from tax expenditures strongly suggest that tax expenditures have a disparate racial impact. Analysts to date haven't extrapolated from income distributions by race to estimate the benefits of selected tax expenditures by race.

Table 5: Distribution of Selected Major Tax Expenditures by Income Group, Ranked by Least Progressive, 2013
(Percent)

	Quintiles					
Tax Expenditure	Lowest	Second	Middle	Fourth	Highest	All
Preferential tax rates on capital gains and dividends	*	*	2	5	93	100
Deduction of charitable contributions	*	1	4	13	81	100
Deduction of state and local taxes	*	1	4	14	80	100
Deduction of mortgage interest	*	2	6	18	73	100
Exclusion of net pension contributions and earnings	2	5	9	18	66	100
Exclusion of capital gains on assets transferred at death	*	3	15	17	65	100
Exclusion of employer-sponsored health insurance	8	14	19	26	34	100
Exclusion of a portion of Social Security benefits	3	15	36	33	13	100
Child tax credit	22	29	26	18	4	100
Earned income tax credit	51	29	12	6	3	100

** Less than 1%.*

Totals may not add to 100% due to rounding.

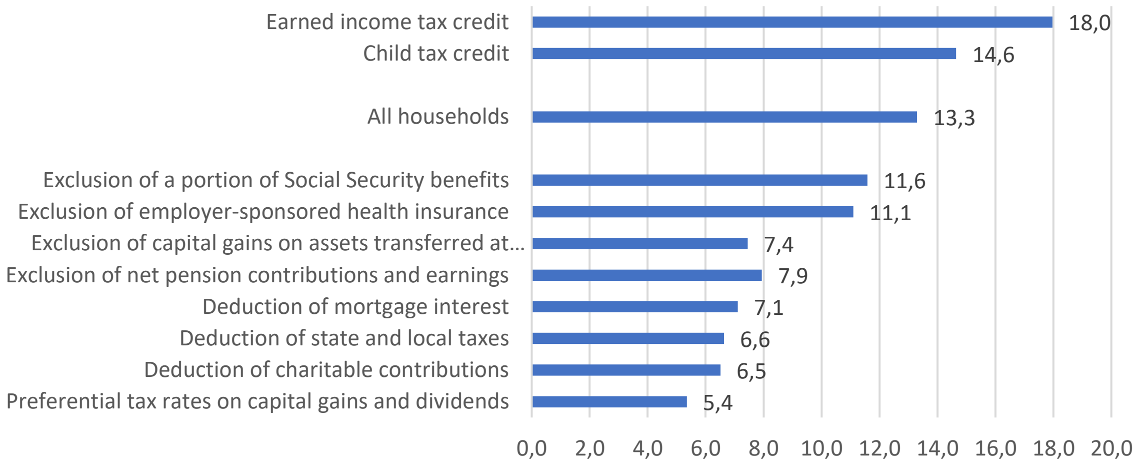
Source: Congressional Budget Office, The Distribution of Major Tax Expenditures in the Individual Tax System, 2013.

[9] Sophie Collyer, David Harris, and Christopher Wimer, "Left Behind: The One-Third of Children in Families Who Earn Too Little to Get the Full Child Tax Credit," 3 Columbia Center for Poverty and Social Policy Brief (May 13, 2019).

[10] Elaine Maag, "Expanding the Child Tax Credit: Full Refundability and Larger Credit," Forbes, May 26, 2020.

Figure 2 shows the author's calculation of Black households' share of major tax expenditures, based on the CBO's distribution of tax expenditures by income and census data on Black households' share of different income quintiles.[11] Black households have a greater share of the two tax credits than their share of total households (13.3 percent), but significantly less for itemized deductions and the preferential tax rate for capital gains and dividends (5.4 percent to 7.1 percent) because of their design and positive correlation with income and wealth. These estimates could be refined with imputations of race on tax return microdata.
Finally, one study found that Black families with the same income as white families tend to have higher tax liabilities because of differential benefits from tax expenditures.[12] Thus, tax expenditures are creating not only vertical inequality across income groups, but also horizontal inequality across racial groups within the same income class. Given differences in the "lifestyle" of white and Black families attributable to prior racial discrimination in housing, employment, and education, the financial characteristics affecting federal income tax liability result in higher tax liability for Black families than white families, even with the same income. For example, Black workers are more likely to be employed in sectors (for example, personal services) offering fewer retirement benefits, so they are less likely to benefit from retirement saving tax expenditures than white workers earning the same income in other sectors of the economy.

Figure 2: Black Households' Share of Major Tax Expenditures and All Households



ADDRESSING TE'S RACIAL IMPACTS

Recognition that facially race-neutral tax laws can have disparate racial impacts is important for identifying steps to address the disparities. Tax expenditures, to the extent that they

[11] The calculation also disaggregates the top income quintile into the top 5 percent and the 80-95 percent range, based on available CBO data.
[12] Moran and Whitford, supra note 3.

continue to favor higher-income and wealthy families, will further exacerbate the disparities in income and wealth resulting from past and ongoing injustices. Racial disparity is an additional reason why equity should have greater focus in tax policy trade-offs between equity, efficiency, growth, compliance, and administrability.

Eight steps should be considered in the reform of tax expenditures for reducing racial and income disparities:

1. Governments need to assess and report the impact of taxes on racial disparities as a key policy dimension in their tax policy analyses. Measurement matters. The U.S. tax system should collect information on racial identifiers, similar to other government surveys on income and wealth, to better assess the effects of current and potential tax policies on racial inequality.[13] The Biden administration's executive order advancing racial equity establishes an Equitable Data Working Group, including the Treasury Assistant Secretary for Tax Policy, to consider federal datasets, such as income tax returns, to be disaggregated by race, ethnicity, gender, and other key demographic variables.[14]

2. Analysis matters. Collecting race and ethnicity information on tax returns will take several years. In the meantime, government tax agencies should quickly use statistical imputations of race as part of their policy analyses of existing databases, similar to imputations they use for many non-tax-return items. The distribution of taxable income, tax liability, and tax expenditures by race and ethnicity would provide policymakers and the public with new information to assess tax fairness across additional dimensions.

3. Sunsetting current tax expenditures could force a new review of their effectiveness, efficiency, administrability, and equity/racial justice effects. A broader focus on their equity considerations is needed.

4. Proportional tax credits should replace "upside-down" tax expenditures in a revenue-neutral manner to reduce disparate racial impacts. Refundable tax credits are preferred, since they provide the same absolute benefit to low-income households as to middle- and upper income households. The Biden campaign proposed replacing the deduction of contributions to defined contribution retirement plans with a refundable tax credit.[15] Refundable tax credits are important for reducing disparate racial impacts at the bottom of the income distribution because many low-income families are below the positive income tax threshold (yet pay significant payroll and other taxes).

5. Limitations on the total amount of tax expenditures, individually or as a group, could reduce disparate racial impacts at the top of the income distribution. The recent cap on the amount of state tax deductions focused more of the benefit on middle-income taxpayers. Similarly, eligibility limitations on income or assets could target tax expenditures to lower and middle-income taxpayers. For instance, do retirement savings in excess of $5 million require tax incentives in addition to the racial disparity they create?

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[13] Jeremy Bearer-Friend, "Should the IRS Know Your Race? The Challenge of Colorblind Tax Data," 73 Tax L. Rev. 1 (Fall 2019).

[14] White House, Executive Order, supra note 1.

[15] TPC, "An Analysis of Former Vice President Biden's Tax Proposals" (Mar. 5, 2020).

6. Greater tax service assistance to low-income taxpayers could help ensure that they aren't overtaxed because of their lack of awareness of tax credit opportunities, while increased tax compliance of high wealth individuals could reduce income and wealth disparities.

7. Most published tax expenditure analyses focus on income tax expenditures, but payroll, excise, and inheritance/estate taxes also have provisions providing the equivalent of government expenditures.[16] All tax expenditures should be reviewed. To the extent that some tax expenditures are difficult to address for administrative reasons, such as the value of unrealized capital gains and defined benefit contributions, increased use of inheritance and estate taxation could limit the tax benefits from those income tax expenditures. Bequests and transfers are estimated to account for at least half of aggregate wealth[17] and explain much of the racial wealth gap.[18]

8. Revenue raised by reforming tax expenditures should be used to redesign tax expenditures and to finance improved government expenditures addressing education, health, and housing disparities amongst Americans. It is not simply taxes, but also whole-of-government efforts that are needed to address racial inequalities.

Reforming tax expenditures with the goal of reducing racial, income, and wealth inequalities can be an important first step toward a more inclusive and fairer tax system.

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[16] David P. Richardson, "Should There Be a Payroll Tax Expenditure Budget?" in 98 Proceedings, Annual Conference on Taxation and Minutes of the Annual Meeting of the National Tax Association 482 (2005); and Treasury, "Tax Expenditures Under the Estate Tax" (Oct. 20, 2016).
[17] William G. Gale and John Karl Scholz, "International Transfers and the Accumulation of Wealth," 8 J. Econ. Persp. 145 (1994).
[18] Darrick Hamilton and William Darity Jr., "Can 'Baby Bonds' Eliminate the Racial Wealth Gap in Putative Post-Racial America?" 37 Rev. Black Pol. Econ. 207 (2010).