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Tax Expenditures and Government Size and Efficiency

Leonard E. Burman*
Syracuse University and NBER

Marvin Phaup
George Washington University

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* Leonard E. Burman, Center for Policy Research, Maxwell School of Syracuse University, 426 Eggers Hall, Syracuse, NY 13244. Email: leburman@syr.edu. Telephone: 315-443-3114. Fax: 315-443-1081. Marvin Phaup, Trachtenberg School of Public Policy and Public Administration, The George Washington University, 601K Media and Public Affairs, Washington, D.C. 20052. Email: MPhaup@gwu.edu. Telephone: 202-531-1862. Fax: 202-994-6792.

I. Introduction

It has become almost a cliché that the projected accumulation of public debt in the United States is "unsustainable." If current policies continue, the imbalance between spending and revenues will grow relative to the size of the economy until the US experiences a debt crisis. The consequence of an explicit or implicit default by the largest economy in the world would be devastating for the US and the rest of the world. (Burman, Rohaly, Rosenberg, and Lim, 2010)

Leaders of both major political parties seem to understand this. Nonetheless, controlling the debt has so far proven elusive. One reason is that two of the prime drivers of the debt—mandatory programs such as Social Security, Medicare, and Medicaid, and tax expenditures such as the tax subsidy for employer-sponsored health insurance—are very popular, not subject to the regular controls of the budget process, and growing fast.

Although mandatory spending and tax expenditures are similar in the sense that they are generally open-ended entitlements and operate outside the annual appropriations process, the costs of tax expenditures have the additional feature of being largely invisible to policy makers and citizens. Their cost is simply netted out of overall tax revenues. Perversely, for those who would like to control government spending, tax expenditures are not treated as spending at all, but as reductions in taxes. Their hidden nature has made tax expenditures irresistible to policymakers of both parties—these stealthy spending programs look like tax cuts.

The late economist, David Bradford, famously pointed out that virtually any spending program could be transformed into a tax expenditure. (Bradford 2003) To illustrate the point, he proposed a Weapons Supply Tax Credit, which would allow arms manufacturers to sell their ordinance to the pentagon in exchange for tax credits rather than cash. Instantly, the Defense Department's budget would decline by the amount of transformed spending. Tax revenues would decline by a similar amount (or more, if weapons suppliers demanded a premium on account of the complexities associated with the tax credit mechanism). But government would be doing exactly the same thing. Only the accounting would change.

A real world example is the low-income housing credit. Enacted as part of the Tax Reform Act of 1986, it was explicitly designed to mimic HUD programs that subsidized the construction and rehabilitation of affordable housing. For various reasons, the credit program is far less efficient than an equivalent grant program. (Burman and McFarlane, 2005) For example, the credits are only valuable to investors to the extent that they have tax liability, which creates uncertainty and thus causes investors to demand more in tax credits than they would a cash grant. Furthermore, since many low-income housing projects are organized by non-profits that cannot benefit from tax credits, they have to set up complex syndication schemes to reallocate credits to taxable investors, which adds to the cost of the projects. So the credit program is equivalent to a cash spending program, except that it is much less efficient.

Despite its comparative inefficiency, the tax credit approach was preferred because of the useful obfuscation of its provenance and funding. But in 2009 the veil was lifted when the financial crisis caused many low-income housing credit investors to move into a tax loss

position, making it difficult for states, which allocate the credits, to find investors willing to participate. The American Recovery and Reinvestment Act of 2009 allowed states to elect to issue cash grants in lieu of tax credits. (US Treasury 2009) This converted an estimated $3 billion of tax expenditures into cash outlays in 2009. In 2010, the veil returned and the government's finances returned to their conventionally obscured state.

Why would policymakers routinely favor tax expenditures over more efficient spending alternatives? In a nutshell, it is because sponsors of explicit spending may be attacked for favoring high taxes and big government. A similar tax expenditure program makes both taxes and spending appear lower, which offers obvious political advantages.

In this paper, we develop a simple model that illustrates incentives created by current tax expenditure accounting. In the model, voters value both direct spending and tax expenditures, and dislike taxes and deficits. Their awareness of spending is based on their own experience—i.e., they value the roads they drive on or the tax credits or deductions they claim on their tax returns—but they assess the aggregate measures based on government accounts. In this model, treating some spending as negative taxes results in (1) higher taxes and larger government and (2) an inefficient mix of spending (too many tax expenditures).

In contrast, properly accounting for tax expenditures would result in less overall spending and a more efficient allocation of spending.

Beyond the simple theoretical model, there are some challenges to properly accounting for tax expenditures. Tax expenditures are measured as deviations from a baseline "normal tax" system. The primary challenge is determining what that system should be. US government estimates use a fairly comprehensive income tax as the baseline. Conservatives complain that a benchmark based on the income tax biases policy against savings tax incentives, which would not be treated as tax expenditures if a consumption tax were the yardstick. However, many income tax expenditures are transparently spending and would be considered as such relative to any baseline. Including that subset of programs, which includes many of the largest tax expenditures, in the budget process would be a good start towards more rational budget choices.

The paper describes the current dysfunctional budget process and suggests reforms to the process that would explicitly and consistently incorporate and control tax expenditures. Beyond simply measuring tax expenditures and presenting them alongside explicit spending, the budget process could be modified to include caps on all spending—discretionary, mandatory, and tax expenditures—to facilitate tradeoffs of tax expenditures and explicit spending, and to provide incentives for policy makers to abide by the caps.

II. Tax Expenditures Defined

The term "tax expenditure" is attributed to Stanley S. Surrey who, as Assistant Secretary of the US Treasury for Tax Policy, instructed his staff to compile a list of preferences and concessions in the income tax that had the nature of expenditure programs. His goal was

straightforward: to draw attention to these items in hopes of building momentum for tax reform, which would redirect the tax system toward its core function of raising revenues.

Surrey and coauthor, Paul R. McDaniel, defined the concept thus in their 1985 treatise on the subject:

> The tax expenditure concept posits that an income tax is composed of two distinct elements. The first element consists of structural provisions necessary to implement a normal income tax, such as the definition of net income, the specification of accounting rules, the determination of the entities subject to tax, the determination of the rate schedule and exemption levels, and the application of the tax to international transactions. The second element consists of the special preferences found in every income tax. These provisions, often called tax incentives or tax subsidies, are departures from the normal tax structure and are designed to favor a particular industry, activity, or class or persons. They take many forms, such as permanent exclusions from income, deductions, deferrals of tax liabilities, credits against tax, or special rates. Whatever their form, these departures from the normative tax structure represent government spending for favored activities or groups, effected through the tax system rather than through direct grants, loans, or other forms of government assistance. (p. 3)

Seven years after Treasury first published a list of tax expenditures in 1967, the Congressional Budget Act of 1974 required the Administration to publish a list of tax expenditures as part of its annual budget submission. The concept also gained widespread acceptance outside of the United States. Germany invented the concept—if not the name—more than a decade before the US and included tax expenditure analysis in its budget process. (Shaviro 2004) Both Canada and the United Kingdom started publishing lists of tax expenditures in the late 1970s, and many other OECD countries had either adopted that practice or conducted preliminary studies by 1985. (Surrey and McDaniel, 1985)

In the U.S., the President's and congressional budget documents include tabulations of tax expenditures, defined as deviations from the "normal" individual and corporate income tax bases, along with estimates of the revenue losses from each. In principal, tax expenditures could also be defined with respect to other taxes, such as payroll taxes, estate taxes, and excise taxes, but that has not been done on a systematic basis.[1] However, while explicit spending is integral to the budget presentation, tax expenditures are relegated to an appendix. They provide supplementary information to budget users, but they have no direct role in the budget process.[2]

Furthermore, tax expenditures are simply misclassified. They appear to be reduction in taxes, but they are equivalent to cash spending. A proper accounting and reporting of tax expenditures would show both government spending and taxes to be higher than is currently reported. But this is more than simply a matter of presentation. As explained below, the

[1] The US reported tax expenditures measured against a comprehensive estate and gift tax baseline until 2002. Davie (1994) discusses possible tax expenditures created by special excise tax provisions.

[2] Shaviro (2004) The Congressional Budget and Impoundment Act of 1974 required the President to annex a tabulation of tax expenditures with revenue loss estimates to each annual budget submission.

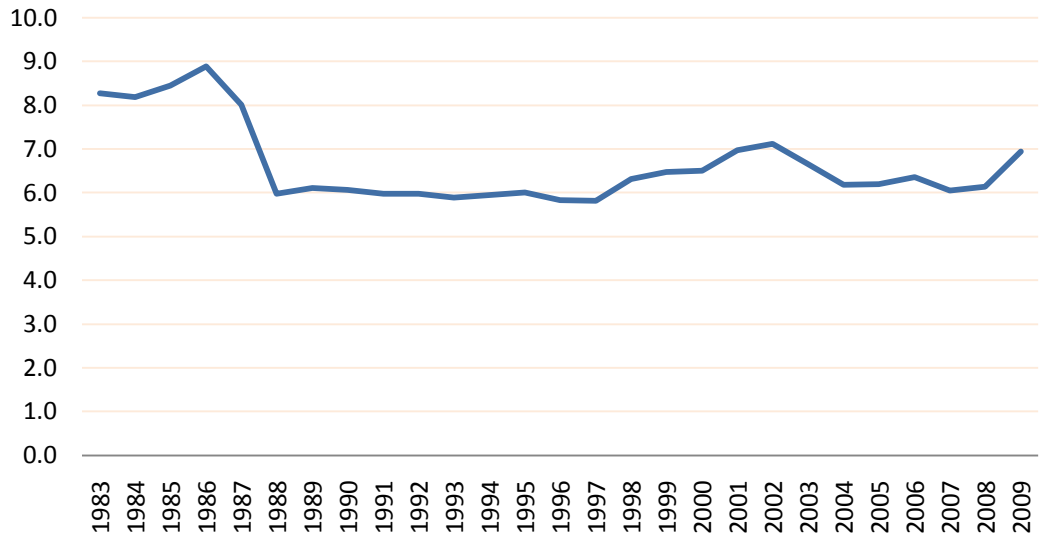
mischaracterization of tax expenditures has motivated and facilitated a shift in spending away from traditional forms and into the tax code.

A. Measuring Tax Expenditures

Each year, the Treasury Department compiles a list of income tax expenditures, which is included in the *Analytical Perspectives* volume of the Administration's Budget released in early February. The Joint Committee on Taxation prepares a similar list for Congress.[3] The purpose of the tax expenditure estimates is to raise the visibility of the cost of this use of fiscal resources.

It is not clear that these compilations have been effective in reducing the use of tax expenditures, because it is hard to tell what the level would have been absent annual revelation. Surrey and McDaniel (1985) calculated that tax expenditures grew relative to GDP and much faster than cash outlays in the first fifteen years that tax expenditure estimates were produced, between 1967 and 1982. In 1986, there was a sharp reduction in the value of tax expenditures as a result of the Tax Reform Act of 1986, which cut tax expenditures by reducing marginal tax rates (which reduces the value of deductions and exclusions) and by eliminating tax preferences. (See Figure 1.) The growth in the value of tax expenditures resumed through the 1990s because of tax rate increases at the top and introduction of some new tax expenditures such as the child tax credit (in 1997). Rate cuts in 2001 and 2003 cut tax expenditures again, but they have risen since because of new tax expenditures and the economic stimulus tax measures enacted in 2009.

Figure 1. Tax Expenditures as Percent of GDP, 1983-2009



Source: GAO analysis of OMB, Analytical Perspectives, Budget of the United States Government, Fiscal Years 1985-2011, and author's calculations.

Tax expenditures are large relative to tax revenues and other spending. (Table 1). Income tax expenditures will amount to about $1.2 trillion in fiscal year 2011 based on US Treasury

[3] This task was originally assigned to the Congressional Budget Office, but they ceded it to the Joint Committee on Taxation because the JCT was designated the official revenue estimator and was thus best prepared to estimate tax expenditures.

estimates. That is significantly larger than nondefense or defense discretionary spending. It would be about equal to total discretionary spending were it not for the extra spending enacted in an effort to boost the economy out of recession. Overall, income tax expenditures are one-quarter of total spending, or about 8 percent of GDP. Put another way, excluding income tax expenditures causes spending to be understated by about one-third.

Table 1. Income Tax Expenditures Compared with Explicit Spending, FY2011, in Billions of Dollars

	Income Tax Expenditures	Mandatory	Discretionary	Defense	Non-defense
$ Billions	**1,177**	**2,165**	**1,415**	**744**	**671**
Percent of total spending	**24.7**	**45.5**	**29.7**	**15.6**	**14.1**
% of GDP	**7.6**	**14.0**	**9.1**	**4.8**	**4.3**

Source: Budget of the United States, FY2011, and authors' calculations.

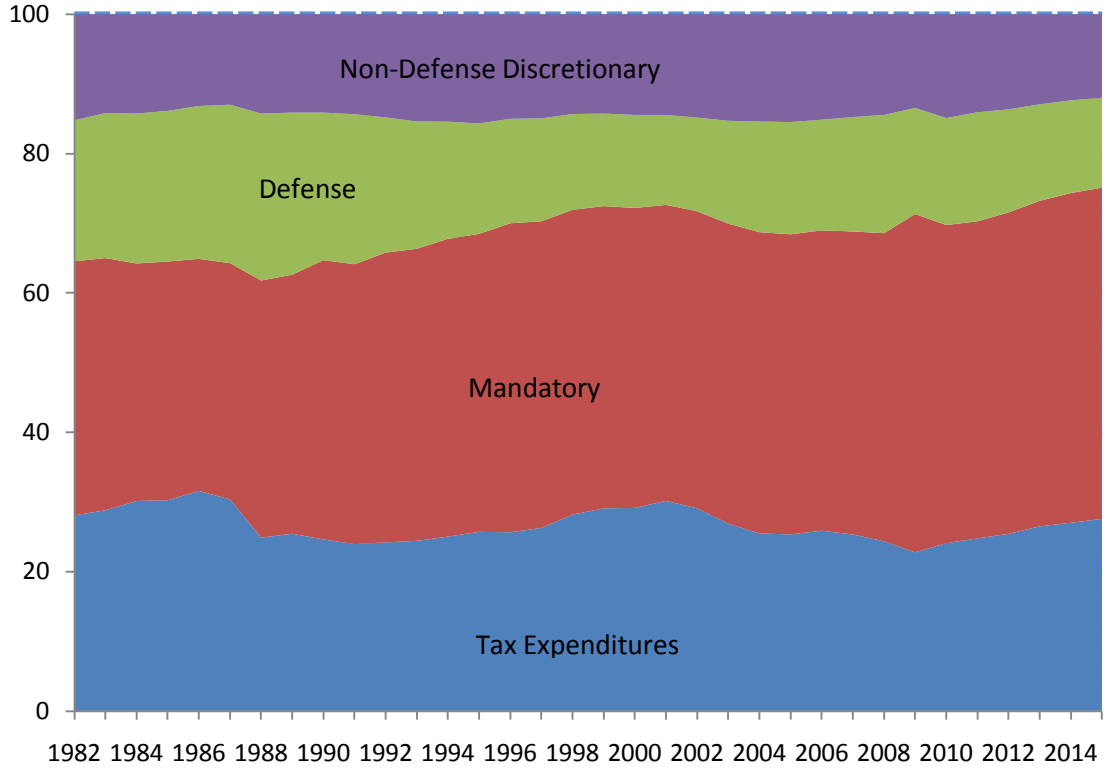
Income tax expenditures are also large relative to other taxes (Table 2). In 2011, they exceed the collections from the individual income tax, which is the largest single source of revenue. This is somewhat anomalous because income tax revenues have been depressed by the recession and temporary tax incentives enacted as part of economic stimulus. Eliminating income tax expenditures could allow income tax rates to be cut by more than half with no loss of net tax revenues, could eliminate all or most of projected budget deficits for the next 20 years, or could finance a combination of rate reduction and deficits reductions (this was basically the approach of President Obama's debt reduction commission). (National Commission on Fiscal Responsibility and Reform, 2010)

Table 2. Income Tax Expenditures Compared with Explicit Taxes, FY2011, in Billions of Dollars

	Income Tax Expenditures	Net Individual Income Tax	Corporate Income Tax	Payroll Tax	Other
$ Billions	**1,177**	**1,121**	**297**	**935**	**214**
Percent of total revenues	**31.4**	**29.9**	**7.9**	**25.0**	**5.7**
% of GDP	**7.6**	**7.2**	**1.9**	**6.0**	**1.4**

While the relative importance of tax expenditures depends on income tax rates, and thus the magnitude has waxed and waned somewhat with changes in rates, overall they have remained a significant component of overall spending (Figure 2). Meanwhile, mandatory programs have been inexorably growing. Defense has also proven difficult to control, ostensibly because of national security concerns, but also because defense is a highly popular public jobs program.

Figure 2. Shares of Total Non-Interest Spending, Including Tax Expenditures, FY 1982-2015



Source: GAO, FY 11 Budget, and authors' calculations.

B. Difficulties in measuring tax expenditures

For various reasons, measuring tax expenditures is challenging. A tax expenditure estimate reflects the amount by which tax liability is reduced due to a particular tax provision, but it does not measure the revenue that would be gained by eliminating that provision for two reasons. First, the estimate does not include any behavioral response, which would be incorporated in a revenue estimate. Thus, for example, if the American opportunity tax credit—a tax credit for the first two years of post-secondary education—were eliminated, many taxpayers who would have used that credit would instead opt for the less generous lifetime learning tax credit or other tax subsidies aimed at higher education. In consequence, the revenue savings to the Treasury would be only a fraction of the amount of American opportunity tax credits allowed.[4]

In addition, government estimates of tax expenditures do not account for losses in tax revenues from other revenue sources, most notably payroll taxes. For example, Burman, Khitatrakun, Rohaly, Williams, and Toder (2008) estimate that the loss in payroll tax revenues from the tax exclusion for employer contributions to health insurance—the largest tax expenditure in 2011—is more than half of the income tax revenue loss alone. Thus, the total

[4] The same problem could occur in the measurement of the savings from eliminating spending programs. For example, if the government were to eliminate Pell grants, which subsidize higher education, outlays for the subsidy cost of direct student loans would increase.

income plus payroll tax expenditure could be at least $265 billion compared with the estimate for the income tax expenditure alone of $177 billion. (See Table 3.)

Table 3. Largest Tax Expenditures in FY 2011, In Billions of Dollars

Provision	Amount
Exclusion for employer-sponsored health insurance	177.0
Mortgage interest deduction	104.5
401(k) plans	67.1
Deduction for state and local taxes other than property taxes	46.5
Step-up basis of capital gains at death	44.5
Lower rate on capital gains	44.3
Charitable deduction (other than ed and health)	43.9
Pensions	44.6
Exclusion of net imputed rental income	37.6
Capital gains exclusion on home sales	31.3
Tax-exempt bonds	28.7
Property tax deduction	23.7
Source: US Budget, Analytical Perspectives, FY2011	

Another apparent problem in attempting to gauge the importance of tax expenditures over time is that the cost of a group of tax expenditures is likely to differ from the sum of the individual estimates. For example, the cost of the deduction for home mortgage interest—the second largest tax expenditure on Table 3—and the deduction for state and local taxes—the sixth largest—is less than the sum of the two estimates. If either tax preference were eliminated, fewer taxpayers would itemize deductions, making the value of the second tax preference significantly smaller.[5] However, Burman, Toder, and Geissler (2007) estimated the error caused by summing tax expenditures and concluded that the cost of all individual tax expenditures is larger than the sum of the individual tax expenditures by about 6 percent.[6]

The Century Foundation Working Group on Tax Expenditures, a bipartisan group convened to evaluate current tax expenditures and make recommendations about how to improve monitoring and reporting, recommended a number of changes in the way tax expenditure information is reported. (Toder, Wasow, and Ettlinger, 2002) These include: annual estimates of the cost of all tax expenditures together and grouped by budget category; historical estimates of total tax expenditures based on a consistent methodology; and detailed information about the distribution of tax benefits as well as an assessment of how well the tax expenditures work.

[5] Taxpayers can take advantage of itemized deductions only to the extent that the total of all those deductions exceeds a standard deduction, which varies by filing status. Almost two thirds of tax returns in 2008 could not benefit from the deduction for charity, for example, because their deductible expenses were less than the standard deduction. (Internal Revenue Service 2010)

[6] This occurs primarily because eliminating tax expenditures pushes some taxpayers into higher marginal tax brackets, which raises the value of remaining tax expenditures.

C. The implication of ignoring tax expenditures in the budget

Ideally, tax expenditures would be fully incorporated into the budget. Kleinbard (2010) recommends that open-ended tax expenditures (most of them) should be treated as mandatory spending while those few tax expenditures that are subject to appropriation limits (like the low-income housing credit) be included in the budget with discretionary spending. But currently, tax expenditures are simply subtracted from overall tax revenues and excluded from spending totals altogether. New tax expenditures reduce reported revenues while leaving reported spending unchanged when, in fact, they should be added to spending while leaving total revenues unchanged.

Why does this matter? For measuring the deficit, it doesn't. Since the deficit is spending minus revenues, the difference will be the same whether tax expenditures are recorded as positive spending or negative revenues. If policymakers and the public were omniscient, presumably budget choices would be unaffected by the accounting.

In fact, the accounting for tax expenditures introduces substantial biases. Taxpayers may like government spending programs, but dislike paying for them. In that light, an increase in spending and higher taxes now or in the future is much less attractive than an increase in spending that is exactly offset by a "tax cut"—taxpayers get benefits along with the illusion that they are costless. Tax expenditures make government appear smaller while providing more benefits. This creates the illusion of policy efficiency when, in fact, tax expenditures are often less efficient than alternative cash programs.

D. A simple model of tax expenditure distortions

To illustrate how miscounting tax expenditures biases budget decisions, consider this simple model of political choice. Policy makers choose taxes, cash outlays, and tax expenditures to maximize votes, which are a function of the representative (or median) voter's preferences. The representative voter is aware of and values cash outlay programs and tax expenditures. She benefits from new roads, national defense, courts, medicare, social security, etc., as well as the tax deductions, credits, and exclusions that apply to her. However, she assesses the cost of government based on reported budget totals for revenues. All else equal, she prefers smaller government and lower taxes. And she favors a smaller deficit.[7]

Define the amount of cash outlays as X and tax expenditures as E, and the total level of revenues (before subtracting tax expenditures) as T. For generality, define the fraction of tax expenditures that is excluded from reported taxes and spending as α. $\alpha=1$ corresponds to current practice where tax expenditures are netted out of spending and taxes; $\alpha=0$ would correspond to correct accounting (where tax expenditures are treated the same as cash outlays).

The vote function is defined as $V(X, E, T-\alpha E, X+E-T)$. We assume that $V_1 > 0$, $V_2 > 0$, $V_3 < 0$, and $V_4 < 0$. That is voters value cash and tax expenditures and are averse to taxes and deficits.

[7] The channel by which the deficit affects voters may be direct or indirect. Deficit spending may raise interest rates and crowd out private investment (Gale and Orszag, 2004), which would affect the voter and through macroeconomic channels. Or the rising deficit may be perceived as portending higher future taxes or even a debt crisis. We subsume all of these factors in a simple aversion to deficits.

Assume further that $V_{ii} < 0$ for all *i*. Interpreting *V* as a kind of utility of government function, this means that the median voter has diminishing marginal utility for expenditures and increasing marginal aversion to taxes and deficits. To keep things very simple, assume further that the vote function is separable in each argument, so $V_{ij} = 0 \text{ for } \mathrm{i} \neq \mathrm{j}$.

Maximizing *V* with respect to *X*, *E*, and *T* yields the following first-order conditions (assuming an interior solution):

(1) $\frac{\partial V}{\partial X} = V_1 + V_4 = 0$

(2) $\frac{\partial V}{\partial E} = V_2 - \alpha V_3 - V_4 = 0$

(3) $\frac{\partial V}{\partial T} = V_3 - V_4 = 0$

In the full disclosure case, α=0. The first-order conditions produce the intuitive result:

$$V_1 = V_2 = -V_3 = -V_4$$

That is, the marginal utility of cash and tax expenditures are equal to each other and to the marginal disutility or taxes and deficits. $V_3 = V_4$ simply means that taxpayers equate the marginal utility loss between current taxes (*T*) and future taxes (deficits).

In this very stylized model, amounts of cash and direct expenditures will depend on how much value each delivers per dollar spent.

The second case corresponds to current practice: α=1. That is, tax expenditures are subtracted from net taxes collected. Nothing else changes. Substituting α=1 into the first-order conditions and substituting equation (3) into equation (2) produces this striking result: $V_2 = 0$. That is, tax expenditures will be produced until the marginal value is zero. This happens because their cost is obscured from voters. The other condition, similar to in the full disclosure case, is:

$$V_1 = -V_3 = -V_4$$

That is, the cash spending programs will equate marginal benefit to marginal cost. Comparing this case with the α=0 (efficient) case, tax expenditures will unambiguously rise and total government spending will also rise. Cash spending programs may increase or decrease depending on the shape of *V*.

A special case is one where taxpayers are indifferent between an additional dollar of current taxes or deficits—basically Ricardian equivalence. In that case, the vote function may be written as $V\big(X, E, (T - \alpha E) + (X + E - T)\big) = V(X, E, X + (1 - \alpha)E)$. *T* drops out of the function. The only cost that matters is the portion of current spending that voters understand that they have to pay for. They don't care whether payment is now or later.

In this case, with full disclosure (α=0), the vote function is $V(X, E, X + E)$ and the first order conditions are:

$$V_1 = V_2 = -V_3$$

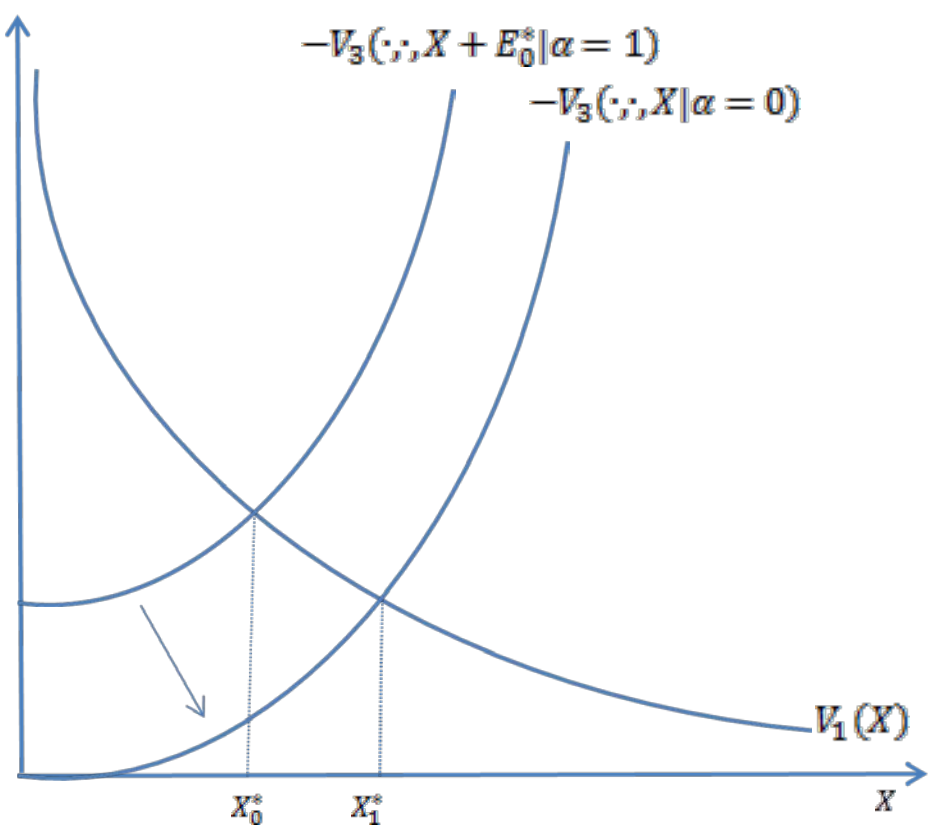
The marginal value of cash and tax expenditures are equated to the marginal disutility of taxation.

When α=1, however, the vote function is $V(X, E, X)$ and the first-order conditions become:

$$V_2 = 0$$
$$V_1 = -V_3$$

In this case, since voters do not perceive that they have to pay for tax expenditures, they demand both more tax expenditures *and more cash outlays*. To see why, denote X_α^* and E_α^* as the values of *X* and *E* that maximize *V* given α. Obviously $E_1^* > E_0^*$. But $V_3(\cdot,\cdot,X_0^*) > V_3(\cdot,\cdot,X_0^* + E_0^*)$, which implies that X_1^* must exceed X_0^* to solve the first-order conditions.[8] This is illustrated in Figure 3.

Figure 3. Cash Outlays Increase when Tax Expenditures are Excluded from Revenue Totals



[8] We may ignore the first two arguments of V_3 because of the separability assumption.

The economic interpretation is that voters wrongly perceive their tax burden to be lightened by the existence of many tax expenditures and thus have a greater willingness to pay taxes for other government programs.

Obviously, this model oversimplifies reality. For example, taxpayers may notice that their marginal tax rates are higher because the cost of many tax expenditures must be offset so at least partially perceive a connection between tax expenditures and true tax burdens. But the implication of the model comports generally with intuition. Excluding tax expenditures from budget aggregates causes taxes (current or future), overall spending, and tax expenditures to increase. Government is not only too big, but the allocation of spending between cash outlays and tax expenditures is inefficient. Making taxes seem artificially low may also, surprisingly, cause the level of cash outlays to increase compared with the efficient (full disclosure) case.

Beyond the implications for efficiency and the size of government, the miscounting of tax expenditures has implications for tax reform. For example, the president's debt commission proposed eliminating most tax expenditures, significant spending cuts and reductions in marginal income tax rates. That proposal prompted a prominent conservative group to claim that the Bowles-Simpson plan would violate a pledge many legislators had signed promising never to raise taxes.[9] In fact, if properly accounted for, the Bowles-Simpson proposal would cut taxes significantly and make larger cuts in total spending than reported.

E. The problem of baseline

The most serious challenge in measuring tax expenditures is in defining the "normal income tax." Surrey and McDaniel (1985) argue that it should be a comprehensive Haig-Simons measure of income with adjustments to reflect problems of administration. As vague as that guideline is, the actual choice is even more nebulous. Surrey and McDaniel are agnostic about fundamental issues, such as whether the normal income tax should be indexed for inflation. Their basic view is that a fixed relatively comprehensive baseline should be chosen and it would serve as a useful measuring rod against which to gauge progress or lack thereof in improving the tax system.

There are some peculiar consequences of this approach. Expensing and accelerated depreciation of investments are treated as tax expenditures, whereas the taxation of capital gains on a realization basis, rather than as they accrue, is treated as part of the normal tax.[10] Those provisions all convey tax benefits through a similar mechanism—taking advantage of the time value of money. Accelerating deductions and deferring income are two sides of the same tax-minimization strategy, but only the deduction is counted as a tax expenditure. An even more stark contrast is with the treatment of savings bonds, on which the interest income is

[9] Americans for Tax Reform, which administers the "taxpayer protection pledge," opined, "Simpson-Bowles is a massive tax hike masquerading as tax reform." (Ellis 2010)

[10] Haig-Simons income would include accrued capital gains, but the normal tax measures capital gains on a realization basis. Three factors drove this decision: historical precedent (gains have always been taxed for most individuals on a realization basis); the widely held belief that accrued but unrealized gains are not income; and the administrative difficulty of taxing gains when the sale price is not observable. Surrey and McDaniel (1985) seem ambivalent on this choice, deeming it as appropriate as of 1985, but one that should be reexamined over time.

deferred until the bond is cashed in, *which is identical to the treatment of capital gains.* But the former is considered a tax expenditure, because accrual taxation of bond interest is straightforward (and the norm for most bonds), whereas accrual taxation of gains is not.

The normal income tax contains a classical corporate income tax with no offset for double taxation, even though corporate income should only be taxed once, on an accrual basis at the shareholder's tax rate under an ideal income tax. Thus, under an economic income baseline, the taxation of dividends (as well as part of the tax on capital gains) may be represented as a negative tax expenditure.[11]

The most contentious issue is whether to define the normal tax as an income tax or a consumption tax. If the income tax is considered the norm, then savings tax incentives—such as tax-exemption for individual retirement accounts and pensions, and preferential tax rates for capital gains—are tax expenditures. The FY2003 Budget argued that the growing prevalence of tax-free savings vehicles might suggest a change in norm. "...[T]he growing presence of tax-deferred savings vehicles in the tax code suggests that these may today be part of the 'normal' income tax circa 2002." (US Office of Management and Budget, 2002, p. 96)

If a consumption tax is taken as the norm, then the taxation of interest and dividends are negative tax expenditures—that is, taxation in excess of the norm—and tax-exempt pensions and individual retirement accounts are part of the normal tax and thus not worthy of note. Against this baseline, preferential tax rates on capital gains constitute a negative tax expenditure because they exceed the benchmark rate of zero. In contrast, against the income tax baseline, the failure to tax realized capital gains at full rates is the sixth largest tax expenditure. (See Table 3.)

People who favor an income tax also tend to favor the current method of measuring and displaying tax expenditures. Those who would prefer heavier reliance on consumption taxes would favor defining the normal tax as a broad-based consumption tax.[12] Given that the actual income tax is a hybrid system containing many elements of income and consumption taxation, there is no obvious way to resolve this difference.

One option would be to consider only the tax expenditures that would be the same against any baseline. About half of the items in Table 3 are in that category. There are issues involved in excluding savings tax preferences, however. Their benefit is most skewed towards those with higher incomes (the main justification for retaining an income tax is that taxing saving improves overall progressivity). And excluding savings tax breaks could create a bias in favor of moving to a consumption tax, which might create an obstacle to bipartisan agreement.

Even those who favor a consumption tax could find useful information in the current tax expenditure tabulations. A hybrid income-consumption tax, as we have in the United States,

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[11] However, it is also true that many corporations pay little or no tax. In those cases, dividend and capital gains taxation are an indirect step towards the ideal of an integrated corporate tax. (Burman 2003) So the actual size and sign of the tax expenditure attributable to dividends and capital gains taxation under the economic income baseline is unclear.

[12] Indeed, conservative economist, Bruce Bartlett (2001) argued that the current methodology creates a "…bias in favor of liberal tax policy."

may actually do more to impair national savings than a pure income tax, because of the non-neutralities among different kinds of saving and investment. The tax expenditure list provides at least a crude measure of these nonneutralities, insofar as it shows that particular industries benefit more than others.

F. Bipartisan appeal of budgeting for tax expenditures

The most peculiar argument against the tax expenditure concept is the notion that it assumes that all income belongs to the government unless government deigns to refund it in the form of tax breaks. Interestingly, neither this argument nor the concept of tax expenditure is a new one. Brooks (1986) reports that in 1863, William Gladstone, then a Tory member of the British parliament, railed against the exemption from income tax of charitable contributions. He complained that the charitable deduction would make no sense as a direct expenditure, conflicting as it would with efforts to bring "…the whole expenditure of the State…within the control, and under the eye, of the House of Commons. If this money is to be laid out upon what are called charities, why is that portion of the State expenditure to be altogether withdrawn from view… and to be so contrived that we shall know nothing of it, and have no control over it…?"[13]

The rebuttal from Sir Strafford Northcote could be lifted from the modern ultraconservative's critique of tax expenditures: "'The right hon. Gentleman, if he took £5 out of the pocket of a man with £100, put the case as if he gave the man £95…'" (Brooks, 1985, p. 684) More than a century later, the Republican Vice Chairman of Congress's Joint Economic Committee, Jim Saxton, complained that "[t]he tax expenditure concept relies heavily on a normative notion that shielding certain taxpayer income from taxation deprives government of its rightful revenues." (Saxton 1999)

The irony of this aspect of the debate is that conservatives in other contexts object to runaway growth of government spending. Presumably it is relevant in evaluating spending on housing programs, for example, to note that the largest new construction program is not financed by cash expenditures overseen by the Department of Housing and Urban Development, but the low-income housing credit. The largest cash assistance program for low-income families is the earned income tax credit. And so on. All of these programs could be carried out with cash expenditures, and presumably fiscal conservatives would want to monitor their cost and effectiveness if they were thus transformed.

And, as shown in the previous section, the misattribution of tax expenditures causes overall government spending, taxes, and the deficit to be higher than they would be otherwise, and for government resources to be inefficiently allocated in favor of tax expenditures. The revenues lost to inefficient tax expenditures could otherwise be used to reduce the deficit or lower tax rates. Indeed, the Tax Reform Act of 1986, enacted two decades after the government began to produce estimates of tax expenditures, illustrates this trade-off. Top marginal tax rates for individuals were cut from 50 percent to 28 percent, and from 46 percent to 34 percent for corporations in a package that was designed to be revenue neutral. (Birnbaum and Murray, 1988) The dramatic rate reductions were financed entirely by eliminating or curtailing tax

[13] Cited in Brooks (1985, pp. 683-684).

expenditures.[14] Millions of taxpayers were also removed from the tax rolls. All of the recent bipartisan tax reform proposals have used some of the revenue gained from eliminating tax expenditures to lower marginal income tax rates (and some for deficit reduction).[15] They would cut taxes and spending (when tax expenditures are properly accounted for).

Reducing tax expenditures should appeal to liberals too. With the exception of the small number of refundable tax credits, tax expenditures tend to be middle- and upper-income entitlements. (Burman, Toder, and Geissler 2007) The privileged status of tax expenditures means that spending is skewed in favor of programs that favor the relatively well off. Efforts to reduce spending that ignore tax expenditures necessarily mean that the burden of deficit reduction will fall disproportionately on those with lower incomes.

And controlling tax expenditures could have the added benefit of simplifying the tax system and making it more efficient by reducing the opportunities for tax sheltering. If some of the budget savings are used to cut marginal income tax rates, the efficiency gains would grow. Moreover, to the extent that the proliferation of tax expenditures fuels perceptions of unfairness, trimming them could enhance the integrity of the income tax.

III. Budgeting for Tax Expenditures

A logical step toward increasing the visibility of tax expenditures to policy makers and the public would be to integrate tax expenditures explicitly into the federal budget process. So long as the Congress and the President exclude tax expenditures from the regular order of fiscal decisions, from the budget totals, and from the trade-offs that are the core of genuine budgeting, the U.S. budget process will remain incomplete and ineffective as a planning tool for efficiently allocating scarce resources.

A. The Current Budget Process

The current federal budget process was designed to give Congress control of federal revenues and expenditures. That statutory process includes many of the necessary elements for informed, disciplined budgeting by the legislative branch. (Phaup and Kirschner, 2010B) Those elements include a timetable for sequential action, assignment of responsibility for decisions, and a set of potentially effective enforcement mechanisms. Nonetheless, the process has fallen short of intended results.

In part this failure occurred because the Congress exercised its prerogative to ignore its own rules. That choice was facilitated by the high cost of monitoring budget decisions with opaque and incomplete budget information. We begin our effort to establish this point with a general review of the current process.

[14] There was also a shift of tax liability from individuals to corporations that some viewed as anti-growth. Nonetheless, eliminating tax expenditures made possible substantial tax rate cuts which most economists would view as efficiency-enhancing.

[15] See, e.g., National Commission on Fiscal Responsibility and Reform (2010) and Bipartisan Policy Center (2010).

1. Overview

The formulation of the U.S. budget plan for the fiscal year beginning October 1 starts in the spring of the previous year when the Office of Management and Budget begins work on the Executive's proposed budget, which is delivered by the President to the Congress in February. The release of the President's budget marks the opening of the annual financial budget cycle by the Congress which is intended to be completed before the beginning of the next fiscal year. (Table 4)

The outline of the Congressional budget is developed by the House and Senate Committees on the Budget in the form of a concurrent resolution. That resolution specifies plannedrevenues, spending, and the budget deficit or surplus for the budget year and distributes spending across 20 functional categories. Projections for 4- 9 additional years are also included, but those numbers are peripheral to most budget decisions. The primary focus is on the budget year.

In framing the resolution, the budget committees have the support of the Congressional Budget Office, especially in assessing the implications of the President's proposed budget and alternative budgets for the deficit and the macro-economy. The budget framers also take account of the plans and priorities of legislative committees and the Congressional leadership.

Once reported by the budget committees and approved by the Congress, the resolution becomes part of the rules of the House and Senate and thereby constrains subsequent fiscal action by the Congress. Discretionary spending is controlled by a specified limit on the total amount of budget authority (authority to enter into obligations that will result in outlays) allocated to the appropriations committees. Outlays of mandatory programs are determined by the number of eligible beneficiaries and by the level of benefits specified in law. Thus, outlays of mandatory spending programs must be controlled by changing the terms of the authorizing law. To that end, budget resolutions that cut mandatory spending also include instructions to the committees of jurisdiction to report legislation that would modify existing statutes to realize the planned savings.

Those instructions and the subsequent amending legislation "reconcile" policy with the spending limits in the resolution and are referred to as reconciliation provisions. Reconciliation can also be used to effect changes in tax law in order to adjust projected revenues and the deficit to the targets specified in the resolution.

Budget resolutions are not laws. Rather, they are procedural rules of the House of Representatives and the United States Senate. They are, therefore, enforced by those rules, including most importantly that any member may raise a point of order against the consideration of legislation that violates the budget resolution. To suspend the rules and proceed to consideration requires a majority vote in the House and a super-majority of 60 votes in the Senate.

Table 4: U.S. Budget Calendar

On or about 1st Monday in February	The president transmits his budget proposal to Congress.
6 weeks later	Congressional committees report budget plans and estimates to Budget Committees.
April 15th	Action completed on concurrent congressional budget resolution.
June 15th	Action on reconciliation completed (changes in authorizing legislation and tax laws to align projected spending and revenues with budget resolution).
June 30th	Action on appropriations consistent with resolution completed by Congress.
July 15th	President transmits midsession review of the budget submitted earlier in the year, with revised projections of revenues, outlays, and deficits for the current and proposed budget years.
October 1st	The fiscal year begins.

Source: Office of Management and Budget (2010). *Analytical Perspectives: Budget of the United States Government, Fiscal Year 2011.* Washington, D.C.

The budget resolution constrains the content of legislation, which also must be signed by the President. By assuring the consistency of subsequent legislation with the resolution, the statutory budget process appears to be sufficient for effective legislative budgeting. And, the possibility of a Presidential veto adds a possibly redundant "check and balance" against poor budget decisions.

2. Performance Gaps

Nonetheless many observers see the current budget process as utterly dysfunctional. Existing fiscal policies are inconsistent with the inter-temporal budget constraint as indicated by medium- and long-term budget projections that show—under fairly optimistic assumptions—federal debt growing faster than national income. Such a fiscal path is not one that can be maintained. Growth of obligations in excess of the capacity to pay implies default and loss of credibility, if not legitimacy. Put simply, current policy requires government to make commitments it cannot honor. The inevitable adverse economic, political, and social consequences of this policy are likely to be worse if the required adjustment is forced suddenly by crisis than if policymakers take measured, pre-emptive remedial action. Additionally, the longer current policies continue, the greater the adjustment is likely to be.

One of the goals of federal budgeting is to support economic stabilization. (Phaup and KIrschner, 2010A) The likelihood that current policy is destabilizing is a measure of the failure of

the current process. Another objective is to allocate scarce resources efficiently. Yet, waste, or spending that produces few social benefits, is endemic to many spending programs.

What has gone wrong with a process that appears to have many features that make it well-suited to the objectives of public budgeting?

First, Congress-and the President have ceased to accept responsibility for budgeting. Though there are many explanations for this development—polarized political views, a shift in priorities away from fiscal rectitude, a secular slowing of income growth, loss of political influence by fiscal institutions—the fact is that the statutory budget process has been abandoned. In five of the last 12 fiscal years, the Congress failed to adopt a budget resolution. In the years a resolution was enacted (or "deemed" to have been enacted to comply with the rules and to avoid having to live with the limits for the current year specified in the previous resolution), points of order were routinely waived in the House. Often those waivers were included in the rule for consideration of specific legislation as reported by the Rules Committee. Reconciliation has not been used to address structural fiscal imbalance since 1999.

Indeed, in 2001 and 2003, the reconciliation process was used to facilitate passage of large tax cuts without meaningful spending cuts.

IV. A Path for Reform

To restore and improve federal budgeting, two general types of reform are required: imposing effective limits and measuring resource costs comprehensively. We first discuss these generally and then turn to specific recommendations for recognizing this spending in the budget as outlays and to limit it with the tools for controlling other spending. We do not propose to eliminate the use of tax expenditures nor to replace them with explicit cash outlays. We seek only to subject their cost to the same salience and controls that are available to limit other federal spending.

The greatest single deficiency in the current process may be the failure to set ceilings on total federal spending consistent with long–term fiscal balance. A close second is the failure to measure commitments of resources comprehensively. By default, current spending is the sum of individual decisions made without regard to total costs. Moreover much spending, including tax expenditures, is not included explicitly in the budgets.

Federal budget decisions could be improved both in aggregate and by specific uses of resources by restoring the concept of a resource limit. That chosen limit needs to take account of the resources likely to be available to government over the medium and long terms, as well as the current state of the economy and relevant structural factors such as projected demographic change.

Adding effective limits to the budget process also requires adhering to the concept of a *comprehensive* budget--arguably the most widely-endorsed element of good budgeting. That principle is central to the seminal 1967 *Report of the President's* (Johnson) *Commission on Budget Concepts*. And, it has been endorsed by every President's budget since.

The largest single omission from the tabulation of the budget totals is tax expenditures. This spending through the tax code is off the budget table, if not technically "off-budget." Except for refundable tax credits, which are shown as outlays in the budget, the cost of existing tax expenditures appear in the budget only as an unidentified reduction in revenue.

Newly enacted tax expenditures are scored as tax cuts--reducing revenues and increasing the deficit. Tax expenditures are not limited by appropriations. Most are permanent parts of tax law and do not require periodic reconsideration or review. Growth in the year-to-year value of tax expenditures is included (as reductions) in budget baseline projections of revenues and requires no legislative action.

Tax expenditures share many features—exemption from control by appropriations, permanent authorization, growth without further action by the Congress—with mandatory spending. However, mandatory spending is included and identified in the budget and functional totals. Much of this spending has also been afforded "third rail," protected status by both political parties, especially in the last 10 years. One direct spending program, social security, has been legislatively moved "off-budget." The effect of this special classification has been diminished, however, by the budget agencies' practice of showing unified budget totals as the sum of both off-budget and on-budget subtotals.

Tax expenditures and direct spending account for over 70 percent of all federal spending. Less than a third of the budget is accounted for by discretionary spending, which is controlled directly by the appropriations process. Despite the dominance of tax expenditures and direct spending, there is nothing in the current process that forces an affirmative decision on the appropriate size of this spending. Under these circumstances, it is perhaps remarkable that the financial performance of the United States has not been worse.

A. Adding Tax Expenditures to the Current Budget Process

Increasing the functionality of federal budgeting requires major changes to current practice including:

- Enacting statutory ceilings on the budget consistent with medium- and long-term fiscal stability, short-term economic stabilization, projected demographic change and other relevant factors;
- Increasing the comprehensiveness and timeliness of resource use recognized in the budget, including current period commitments for federal pensions, social insurance, long-term insurance, and uses of non-financial resources; and
- Strengthening budget enforcement mechanisms by requiring elected officials to embrace comprehensive statutory fiscal goals, raising the barriers to waivers of points of order, making routine use of reconciliation, and—as a last resort—broad-based, automatic spending sequesters and tax surcharges to signal significant departures from enacted fiscal goals.

However, such sweeping reforms are unlikely to be adopted quickly. In the meantime, an informed consensus seems to be emerging in support of a major step in this direction: integrating tax expenditures into the current budget process. That modification to current practice would be consistent with existing budget concepts and contemplated more general reforms. It could be accomplished by treating tax expenditures in the budget as any other form of federal spending.

Specifically, this change would entail the following steps:

1. Add tax expenditures to the budget totals consistent with their equivalence to a) levying taxes and b) refunding the tax to those who meet the criteria for receiving benefits.
2. Score the cost of new tax expenditures as increases in spending and the budget deficit, rather than as a reduction in revenues
3. Include tax expenditures in the Concurrent Budget Resolution as capped amounts of budget authority and outlays allocated by function and to committee(s) of jurisdiction
4. Include tax expenditures in reconciliation instructions and omnibus legislation and subject them to points of order
5. Require the President to revise the budget accounts and functional allocations of resources to include tax expenditures fully in the executive budget..

We elaborate on these means of incorporating tax expenditures in the existing budget process below.

Add tax expenditure to summary budget totals. The current treatment of tax expenditures shows the net effect of tax expenditures on the deficit but fails to identify the amount of fiscal resources used in this way or the effect on outlays. Table 5 illustrates our proposed alternative treatment of tax expenditures in the summary budget tables. Tax expenditures, as taxes levied and refunded, do not reduce total revenues but rather change its composition and increase budget outlays.

Table 5. Example of Adding Tax Expenditures to Budget Totals

Total revenues		4.0
Cash	3.0	
Tax expenditures	1.0	
Total outlays		5.0
Cash	4.0	
Tax expenditures	1.0	
Surplus (deficit)		(1.0)
Borrowing from the public		1.0

Note that current budgeting only shows cash revenues, outlays.

Our proposed alternative discloses both the size and nature of tax expenditures. It also reduces the current accounting bias in favor of tax expenditures as shown above.

Score new tax expenditures as increases in outlays. Under current practice, cost estimates for new legislation that increases or decreases tax expenditures report the effect on cash revenues and the deficit but show no effect on outlays. Consistent with the treatment of other spending, tax expenditure legislation should be scored with its outlay effects. Table 6 provides an example for legislation that increases tax expenditures.

Table 6. Scoring an Increase in Tax Expenditures

Change in total revenues		0.0
Cash	**-0.1**	
Tax expenditures	+0.1	
Change in total outlays		**+0.1**
Cash	0.0	
Tax expenditures	+0.1	
Change in surplus (deficit)		(0.1)
Change in borrowing from the public		+0.1

Include tax expenditures explicitly in the budget resolution and committee allocations. The budget resolution sets aggregate limits on new budget authority and outlays and distributes those sums across 20 budget functions, each with numerous sub-functions. In addition, though not specified in the resolution, those totals are allocated to each of the legislative committees of jurisdiction. [These are often referred to as Section 203 allocations for the section of the Budget Act that authorizes them.]. Discretionary appropriations are allocated to the appropriations committees and direct spending to the authorizing committees. Those allocations constitute the legislative spending budgets for each committee.

Under current practice, tax expenditures are not allocated to functions or committees. They are tabulated by function, and shown in a report that supplements the budget data, but are not a part of it. We propose that tax expenditures be included in the budget resolution by function and sub-function and allocated to the committees of jurisdiction. Further, we propose that all tax expenditures be assigned to a new or existing budget account and that all new accounts be assigned to a budget sub-function

Apply reconciliation explicitly to tax expenditures and subject them to points of order. This recommendation is a small change from current policy, which neither excludes changes in tax law from reconciliation nor bars points of order against tax legislation that would violate the aggregate budget totals in the resolution. We propose only to make the inclusion of tax expenditures, per se, routine in reconciliation and in enforcement of the resolution. We also recommend extending the point of order against appropriations bills that violate the committee's spending allocation to include all legislation affecting tax expenditures.

Add tax expenditures to the President's budget For consistency between the president's budget and Congressional practice, the executive budget should move tax expenditures from supplementary material into the budget accounts, functional distributions, and summary budget totals.

V. Conclusion

Policy analysts have long recognized that much spending is hidden in the tax code. Many tax expenditures are effectively open-ended entitlement programs like Social Security or Medicare, and even harder to monitor and control because they do not show up in traditional budget tables. Political scientist Chris Howard (1997) aptly named them "The Hidden Welfare State."

This paper takes tax expenditure analysis one step forward by showing how the mischaracterization of tax expenditures systematically leads to more overall spending (bigger government), higher taxes, larger deficits, and a misallocation of resources away from cash spending programs in favor of tax expenditures. For those who favor smaller government, more efficient government, and lower taxes, this should be a source of concern. Moreover, since tax expenditures tend to benefit families with higher incomes, the misallocation of scarce resources away from traditional spending programs raises equity concerns as well.

Integrating tax expenditures into the budget process and subjecting them (and all other spending) to effective controls could improve the efficiency of government and soften the blow from the belt tightening that is necessary if we are to avoid a debt crisis. An added benefit is that reductions in tax expenditures could simplify the income tax and make it less prone to abuse, especially if part of the revenues from the trimmed tax expenditures were used to cut marginal income tax rates. That is, controlling tax expenditures might increase the chances of enacting badly needed tax reform.

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