TAX EXPENDITURES AND TAX REFORM: ISSUES AND ANALYSIS

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INTRODUCTION

Tax reform is once again in the headlines. On November 1, the President's Advisory Panel on Federal Tax Reform (2005) presented two options for restructuring the tax system – a reformed income tax with a significant amount of capital income of individuals exempt from tax (The Simplified Income Tax Plan or SIT) and a consumption-based tax with some residual taxation of capital income of individuals (The Growth and Investment Tax Plan or GIT). The panel claims both plans would promote the major goals of a good tax system by reducing complexity, improving fairness, and promoting economic growth. The plans would reform the basic structure of the income tax and also reduce many tax benefits that favor some activities and taxpayers over others – provisions often referred to as tax expenditures. In the words of the Tax Reform Panel (Executive Summary, p. xiii),

> "Tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers create complexity and instability, impose large compliance costs, and can lead to an inefficient use of resources. A rational system would favor a broad tax base, providing special treatment only where it can be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies higher taxes paid by all taxpayers."

The term "tax expenditure" was first used by Stanley Surrey (Surrey 1967) and the Treasury tax policy staff under his direction produced the first tax expenditure list in 1968. The Congressional Budget Act of 1975 requires that both Executive Branch and Congressional agencies publish annual lists of tax expenditures.[i] It defines tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability." (Sunley 2004. p. 156)

Many other countries also publish tax expenditure reports (Brixi, Valenduc, and Swift 2004).

Tax expenditure reports provide data that are useful for two overlapping, but distinct agendas – expenditure control and tax reform. As the label “tax expenditure” implies, they provide information on backdoor spending through the tax code that might otherwise be accomplished with direct outlays. But tax expenditure lists also display revenue losses from provisions that have no clear analogue in a spending program, but do depart from a practical comprehensive income tax base. This paper assesses the relationship between the tax expenditure lists, tax reform, and expenditure control.

DEFINING AND MEASURING TAX EXPENDITURES

Tax expenditures must be measured as exceptions to some benchmark or baseline income tax. But there is no bright line that reveals what provisions in a tax system are part of the baseline or normative tax system and what provisions are special exceptions. Tax experts in the United States and overseas have divergent views on whether the tax expenditure lists should be narrowly defined to focus on backdoor spending through the tax law or broadly defined to display the costs of departures from an ideal tax base.

Tax Expenditures in the United States

In the United States, the “normal” tax baseline in tax expenditure presentations is meant to represent a practical and broad-based income tax. As in other countries with tax expenditure presentations, the U.S. baseline departs from a truly comprehensive base that taxes all real income once. The normal tax baseline in the United States excludes some income (imputed rent[ii], accrued capital gains), includes some items that are not income (inflationary gains) and allows for a separate corporate income tax in addition to the tax individuals pay on corporate dividends and capital gains on sales of corporate stock.

Beginning in 1982, OMB (but not the JCT) began publishing two tax expenditure baselines – the normal tax and the "reference" tax, with the reference baseline closer to current law. Some items that are listed as tax expenditures under the normal tax are not tax expenditures under the reference tax.[iii]

During the 1980s, there was a lively debate within the Treasury Department on what ends the tax expenditure list should serve (Neubig 1989). Some analysts argued that a tax expenditure list should include only tax provisions that substitute for potential spending programs (Fiekowsky 1980), while others rejected the idea of distinguishing between "tax expenditures" and "departures from ideal income measurement" and termed the reference tax base "highly idiosyncratic … and inconsistent with the statutory definition in the Congressional Budget Act" (Surrey and McDaniel 1985. p. 195).

More recently, OMB has also been displaying tax expenditure lists against a comprehensive income base and a comprehensive consumption base (U.S. Office of Management and Budget 2005) and Treasury staff has changed the methods of estimating some tax expenditures under the normal income tax. For example, the tax expenditure estimates for accelerated depreciation have declined significantly (and for machinery and equipment turned negative for the years 2006-10) because Treasury changed the normal tax baseline depreciation schedule. It should be noted, however, that many tax expenditure items in the OMB list are the same under all the tax law baselines.[iv]

Tax Expenditures in other OECD Countries

Generally, other countries that list tax expenditures in their budget presentations also define them to be departures from a benchmark tax structure. But benchmark tax structures differ among countries, so provisions that might be considered tax expenditures in some countries' budget presentations are part of the benchmark structure in others. Countries differ as to whether they use a broad or narrow definition of tax expenditures and whether the definition of tax expenditures should be limited to selective benefits to favored activities or taxpayers or to provisions that substitute for a spending program.

For example, in Australia, tax expenditures are defined as "concessions designed to provide a benefit for a specific activity or class of taxpayer." (Brown 2004). Similarly and even more narrowly, Belgium defines a tax expenditure (Valenduc 2004, p.71) as a provision that "lowers tax revenue, results in a deviation from the benchmark tax system, aims to *encourage a specific behavior* favoring economic, social or cultural activities, and *could be replaced by a direct spending program (italics added).*

In contrast, Canada defines a tax expenditure under its income and value added taxes as any provision that departs from the benchmark structure, where "only the most fundamental elements of each tax system are considered part of the benchmark." (Seguin and Curr 2004, p.98). Similarly, the Netherlands defines tax expenditures as "government spending in the form of a loss or deferment of tax revenue that is due to a tax provision insofar as that tax provision is not in accordance with the benchmark structure of the tax law." (van den Ende, Haberham, and den Boogert 2004, pp. 134-135). In 1987, a working group in the Netherlands concluded that *reduction in tax revenue and deviation from the benchmark structure* is sufficient to characterize a tax expenditure item and that a limitation to provisions that reflect *non-fiscal policy goals, are convertible into direct expenditures, and apply to a limited group of taxpayers* should not be part of the tax expenditure definition.

Other Classification and Measurement Issues

Beyond the broad conceptual issues, there are numerous specific issues that analysts must confront in determining whether a provision is part of the baseline tax or a tax expenditure item. These issues include determining whether benefits to spouses based on family size are tax expenditures, whether exceptions to provisions that are themselves not part of a comprehensive base (for example, exceptions to limitations on deductibility of passive losses) are tax expenditures, how to treat provisions that provide general or selective relief from corporate double taxation, and what baseline to use for capital recovery deductions, among others. Different tax expenditure presentations in the United States both over time and across agencies have defined specific items in different ways, as do different tax expenditure budget presentations in other countries.[v]

TAX REFORM VERSUS EXPENDITURE CONTROL

Choices among tax system design issues have major consequences for economic efficiency, fairness, and complexity, but do not lend themselves readily to comparisons with direct spending programs. The first question that must be addressed is what is the overall tax base – income, consumption, or some combination. A number of the major tax reform proposals of recent years have sought to replace the income tax with a consumption tax (Bradford and U.S. Treasury Tax Policy staff 1984; Bradford 1986; Hall and Rabushka 1995). The main difference between an income and consumption tax is that the latter exempts the normal return from savings. But so many provisions in the current income tax exempt returns to savings wholly or in part that our current tax base is best described as a hybrid between a consumption base and an income tax base. By some estimates, a significant share of capital income currently escapes tax. (Slemrod 2005; Gordon, Kalambokidis, Rohaly, and Slemrod 2004). Some of the largest tax expenditures in the current U.S. income tax are preferences for capital income, including the net exclusion of pension and earnings from tax-deferred retirement plans, tax preferences for capital gains, exclusion of interest on public purpose State and local bonds, exclusion of interest on life insurance savings, and expensing and deferral of some forms of business income. These items would not be tax expenditures relative to a consumption base.

Issues Within Both and Income or Consumption Tax Base.

Broad structural design issues that must be determined for either an income or consumption tax base include: the structure of individual and corporate tax rates, the definition of the taxpaying unit (individual or couple), adjustments for family size and how they are made (exemptions, credits, definition of a dependent), definition of what constitutes consumption, including definition of what constitutes a cost of earning income (meals, travel expenses, home office deduction), adjustments for "non-discretionary" spending items (medical costs, health care), and whether to tax consumption of "public" goods (donations to charitable organizations, taxes paid to sub-national governments), definition of an employee (independent contractor rules); and enforcement mechanisms (withholding, information reporting, required record-keeping).

Treatment of some of these items may be considered tax expenditures if they depart from the basic norms of the tax system, but in many cases the principles for determining a tax expenditure item are unclear. For example, with regard to the taxpaying unit and adjustments for family size, the U.S. tax expenditure presentation counts personal exemptions as part of the baseline tax system (as an adjustment for family size), but counts the child credit as a tax expenditure item. Belgium counts provisions of individual and family taxation as part of the baseline because the tax unit is a mix of family and individual taxation, but Australia includes a dependent spouse rebate as a tax expenditure item because the individual is the tax unit in the baseline tax.

Issues in an Income Tax.

Some structural issues within an income tax are: whether there is a separate corporate tax and, if so, what provisions if any are provided for relief of double taxation of corporate-source income, the treatment of capital gains (definition of a realization event, special rates, loss limitations, indexing, treatment of gains transferred at death), inflation adjustment in measuring income, capital recovery rules, and international rules, including taxation of foreign-source income (worldwide with credit or territorial, extent of deferral if worldwide) and rules for allocating income and expenses between domestic and foreign-source.

Tax expenditure presentations do not apply a consistent baseline to these rules. For example, the U.S. Treasury recently changed its baseline for computing the tax expenditure from accelerated depreciation from straight-line depreciation on a historical cost basis to an accelerated depreciation method based on replacement cost using depreciation lives from the U.S. National Income and Product Accounts. By using replacement costs as the baseline, Treasury is implicitly saying that inflation adjustment of income measurement (at least for depreciable assets) is part of the baseline tax. For another example, OMB now does not consider the special tax relief on dividends to be a tax expenditure item because it is considered an offset to the corporate double tax, even though some dividend payments may be from tax-exempt corporate income and thus arguably are receiving special treatment.

Issues in a Consumption Tax.

A consumption base tax need not address issues of measurement of capital income, but must address other structural questions, including the point of collection (retail sales, value-added of all businesses, an X-tax base on wages plus business value-added less wages, individual taxpayers' income less net saving), the treatment of financial transactions (excluded as in an R-base tax, included as in an R+F base tax, or subject to special rules), the mechanism for relief of low-income taxpayers (if any), whether the tax is origin or destination-based; and rules for taxing old capital (sometime referred to as transition rules).

The Treasury Department has recently developed a list of tax expenditures that would apply if the baseline tax were a consumption tax. The assumption that income from capital is tax-free in the baseline eliminates many items from the list, but there are still items that may or may not be included. For example, the Treasury lists the exemption of imputed rent on owner-occupied homes as a tax expenditure item against a consumption baseline because housing services would be taxable under a comprehensive consumption base. But if housing services were taxable, the purchase of a home would be tax-deductible as an investment, which it is not under current law. Without knowing exactly how taxation of owner-occupied housing would be implemented under a consumption tax (deduction with taxation of imputed rent or prepaid with no taxation of the return), it is hard to know whether the exemption of imputed rent would be a tax expenditure because it exempts consumption of housing from tax or the proper consumption tax treatment because the tax has been pre-paid.

Expenditure Issues – Substitution of Tax Benefits for Direct Spending

Many items in the tax code have no relationship to general tax structure considerations and would be tax expenditures under practically any definition. For them, policy analysis should be similar to analysis of direct expenditures. The first question is whether there is a market failure that requires correction through government intervention. (Century Foundation 2002, chapter 1). If the answer is affirmative, a second question is whether the incentive is designed properly to increase the output or outputs the society wishes to increase in the most cost-effective way.

A final question is whether to pay the subsidy or transfer through a tax allowance or a direct outlay from a program agency. Toder (2000) provides examples of how direct outlays and tax incentives can be designed to have exactly the same effects on income distribution and resource allocation and cites circumstances under which either the tax code or direct spending may be the preferred method of payment.

Tax Reform vs. Expenditure Policy

The goals of good tax policy – fairness, efficiency, and simplicity – are often in conflict with each other. More steeply graduated tax rates, for example, may arguably promote a fairer distribution of after-tax income, but adversely affect incentives to work and save. All the goals of good tax policy, however, can be invoked on behalf of limiting the use of narrowly targeted tax incentives. These incentives make the tax system less fair because they cause people with the same ability to pay (measured either by income or consumption) to pay different amounts of tax. They reduce efficiency by distorting relative prices and causing too much production of the subsidized output or too much use of the subsidized input in production. They make the tax system more complex because they require distinctions between the subsidized and unsubsidized activities and by so doing raise taxpayer compliance costs and IRS costs of administration and contribute to lower compliance rates.

But an expenditure policy perspective may result in a different viewpoint. The goals of government expenditures are to re-allocate resources or redistribute income either because there are social costs and benefits not captured by market prices or because the political system does not always accept market outcomes. If a tax expenditure item is repealed and a spending program installed in its place, the tax system will become simpler and appear fairer, but there may be no net budgetary saving or lower tax rates. Moreover, any reduction in tax complexity could be offset by an increase in the cost of complying with regulations set by the program agency, leaving the overall cost to the citizen of dealing with government bureaucracy unchanged or even increased.

AN EXAMPLE: THE TAX REFORM PANEL REPORT

The recent report of the President's Tax Reform Panel proposes major structural changes in the tax system and scales back a number of tax expenditures. The panel asserts the two reform proposals it outlines are in the aggregate revenue neutral, but has not released line-by-line and year-by-year estimates of revenue changes. It seems, however, that the structural reforms the panel proposes (including elimination of the individual alternative minimum tax) will lose revenue on balance and that a reduction in tax expenditures that are true spending substitutes is financing these revenue losses.

Structural Changes

Both of the panel's broad tax reform options would eliminate the marriage penalty in the individual rate structure, replace current personal exemptions and credits with new credits for taxpayers and dependents, and eliminate the standard deduction while allowing all taxpayers to claim remaining itemized deductions. Both options would eliminate the corporate and individual alternative minimum tax (AMT) and simplify savings incentives in the current tax by eliminating many separate provisions, while greatly expanding amounts that individuals can contribute in any year to two types of tax-exempt accounts.[vi]

The SIT proposal would reduce double taxation of corporate income by exempting from tax dividends from domestic corporate income and sharply reducing the tax rate on capital gains from sales of shares of domestic corporations. The SIT would also move towards a territorial system of international taxation by exempting from tax active foreign-source income of U.S. multi-national corporations, while including royalties paid by foreign subsidiaries in domestic-source income and tightening the definition of a U.S. resident corporation.

The GIT proposal would allow expensing for all business investments, but would eliminate the deductibility of business interest. It would retain a 15 percent tax on investment income of individuals accrued outside of the expanded tax-free accounts.

Some of the structural changes would not affect measured tax expenditures, but others could change them relative to the normal tax. The widening of rate brackets to eliminate marriage penalties, for example, would not create a new tax expenditure item because changes in rate structures, bracket widths, and the relative treatment of single and married taxpayers are considered changes in the normal tax base. The expanded savings exemptions would increase tax expenditures relative to the current normal tax baseline, but would raise the issue as to whether normal income tax treatment of savings is part of the reference tax. Based on recent tax expenditure presentations in the federal budget, expanded corporate double tax relief for dividends and capital gains on corporate stock would probably be part of the normal tax, as would expensing of corporate capital investments under the GIT. Exemption of foreign source income could also be in a revised normal tax baseline, but could remain a tax-expenditure, as is deferral in current law, if the normal baseline remains worldwide income of U.S.-resident corporations.

<u>Changes in Targeted Tax Expenditures</u>

The report includes many proposals affecting narrowly targeted revising tax expenditures. Some tax expenditures would be eliminated, including the deduction for non-business state and local taxes, the exclusion of interest on life-insurance saving, the deduction for U.S. production activities, all exemptions of employee fringe benefits other than for health insurance, tax benefits for college tuition, and many business tax breaks.[vii]

Other tax expenditures would be either reduced or substantially re-structured. The mortgage interest deduction would be converted to a 15 percent credit and limited to interest on maximum loan amounts that would vary by region and deductibility of charitable contributions would be limited to contributions in excess of 1 percent of income. Both deductions would become available to non-itemizers. The exclusion from income of employer-paid health insurance premiums would be capped, but employee premiums would become deductible (with the same cap). The earned income tax credit would be replaced with a new and simplified work credit. Depreciation rules for business investments would be simplified by reducing the number of asset classes, each with an open-ended account and a fixed depreciation percentage, so that taxpayers would not need to keep track of different vintages of assets.

Still other tax expenditures would be re-structured or expanded. As noted above, saving incentives for individuals would be simplified, but greatly expanded. The Panel also recommends expanded expensing of small business investments under the SIT.

Addressing Expenditure Issues in the Context of Tax Reform

Many of these proposed changes address expenditure reform-type issues and would substantially alter Federal support for housing, health care, private charitable activities, and research and experimentation, among others. The rationales in support of all these proposals are that they would make Federal support for these activities more cost-effective in promoting public policy goals.

For example, providing a capped mortgage interest credit instead of the current mortgage interest deduction for itemizers only is likely to be a more cost-effective way of promoting home ownership instead of encouraging purchases of expensive homes. Placing a floor under the deduction for charitable contributions subsidize most giving at the margin, at a reduced revenue cost. Capping the health care exclusion would arguably eliminate subsidies of “Cadillac” plans, while continuing to promote basic health insurance coverage.[viii]

These rationales have little to do with the best way to design and administer a tax system; instead, they address the best ways to design Federal assistance for housing, health, and charitable activities. The judgments the Tax Reform panel makes, although debatable in some instances, seem mostly sound to this author. But experts in tax policy, and ultimately the Congressional tax-writing committees, address these design issues only because, for historical and political reasons, the subsidies have been cleared through the tax system. Ideally, housing policy experts would design the structure of housing subsidies and health policy experts the structure of incentives to buy health insurance, both subject to overall budget ceilings that force them to consider trade-offs between incentives for home-ownership and other housing programs and between subsidies for private health insurance and other ways to increase access to health care services.

Setting expenditure policy within the context of tax reform means that these expenditures are subject to a particular form of budgetary constraint. Within the context of revenue-neutral tax reform, cuts in tax expenditures finance either tax rate cuts or other structural reforms in the tax system (such as, for example, eliminating the double taxation of corporate dividends). Cuts in tax expenditures do not finance increases in other spending programs, even those with related purposes. Of course, if tax expenditures for some program areas are cut, there may be pressure for offsetting spending increases, in which case tax reform would be revenue neutral, but not budget neutral.

CONCLUDING COMMENTS

In considering how to reform the tax system, issues of tax structure and expenditure issues are often confounded. To some people, tax reform means changing the fundamental parameters of the tax system; to others it means reducing spending cleared through the tax code. These two purposes of reform are fundamentally different. Tax reform plans will inevitably combine both tax structure change and changes in the level and design of spending programs cleared through the tax code. For example, the President's Tax Reform Panel has proposed structural reforms and rate reductions that on balance lose money and pays for them by reducing spending through the tax system.

The tax expenditure lists in the United States and other countries have served over the years as both a measure of spending through the tax system and, by listing provisions that lose revenue relative to a broad income tax base, as a road map for tax reform. Even given the ambiguity in defining a baseline system, they will continue to provide a useful accounting of spending programs that are cleared through the tax code. But, given current institutional arrangements, the tax expenditure budget has not succeeded in one main purpose – to facilitate trade-offs between tax and spending programs aimed at the same policy objectives. Instead, outlay subsidies and transfer programs are balanced against other spending programs (entitlements, defense, homeland security) in competing for funds within overall spending targets and tax expenditures are balanced against tax rate changes and structural tax reforms (e.g., marriage penalty relief, relief of corporate double taxation) within whatever revenue targets the Administration and Congress choose to set. Finally, cuts in tax expenditures, not direct outlays, become the means for paying for the revenue costs of structural tax reforms.

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NOTES

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[i] In fact, the Joint Committee on Internal Revenue taxation (JCT) publishes the annual lists for Congress, not CBO. The Office of Tax Analysis in the U.S. Treasury Department prepares the tax expenditures lists that OMB produces in its annual budget.

[ii] The Executive Branch budget presentation now includes net imputed rent on owner-occupied homes as a tax expenditure (Office of Management and Budget 2005).

[iii] The major provisions that are tax expenditures compared with the normal tax, but not compared with the reference tax, are: 1) corporate tax rates below the maximum statutory rates (graduated individual rates are part of both baselines), 2) exemption of Government transfer payments received by individuals, 3) capital recovery rules that are more generous than economic depreciation (the reference tax baseline includes all widely applicable depreciation rules in the income tax), and 4) the deferral of income that U.S. taxpayers accrue in controlled foreign corporations.

[iv] Beyond the broad issues of defining the baseline for measuring tax expenditures under the income tax, Treasury staff have addressed numerous other issues in tax expenditure measurement. For example, over time, Treasury has added tables that measure the "outlay equivalent" cost of tax expenditures, which

sometimes exceeds the revenue loss, and the present value cost of tax expenditures on new saving and investment for those provisions that defer recognition of income on saving and investment. Treasury has also at times displayed the costs of tax expenditures relative to other tax bases, such as the Federal estate and gift tax and Federal excise taxes (Davie 1994). Many other countries list tax expenditures relative to other tax bases, including value-added taxes and customs duties.

[v] For a fuller discussion of some of these issues, see Toder (2002).

[vi] The increase in saving incentives does not result in much revenue loss in part because the panel is scoring its proposal relative to the Administration's budget proposal, which also proposes a vast increase in tax-free savings accounts. Relative to current law, however, the panel is proposing a large increase in contributions to tax-free savings accounts, which over time will significantly erode the base of taxing individual capital income and move the system much closer to a consumption-based tax.

[vii] The Report would eliminate 40 business tax breaks, but identifies specifically only a few of them.

[viii] A health care cap, however, might be a poor way to limit the subsidy to Cadillac plans to the extent that differences in health care costs among employer groups reflect differences in the risk pools covered instead of differences in the generosity of plans.