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A Survey on Tax Expenditures

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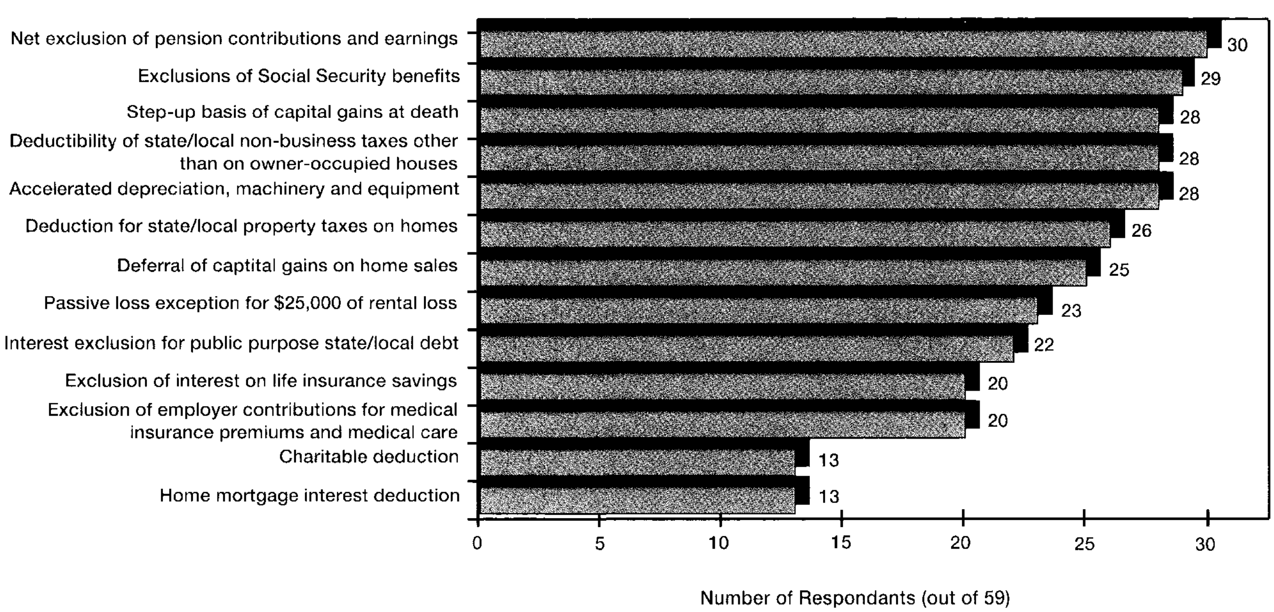
A recent General Accounting Office (GAO) report suggested, by its title, that "Tax Expenditures Deserve More Scrutiny." The GAO report may, in fact, encourage Congress to scrutinize tax expenditures more carefully. At the same time, however, the debate on tax expenditures may encourage further debate on tax neutrality and tax surcharges. In conjunction with other ongoing work in tax policy, the tax expenditure debate may also provide an important dimension of any future tax reform effort.

Tax expenditures are calculated by both the Joint Tax Committee (JTC) of Congress and by the Department of Treasury. As the GAO clearly states in its report, however, there is no consensus about what constitutes a tax expenditure. To investigate the question of what is a tax expenditure, the Tax Foundation mailed a survey to the Tax Directors, Tax Vice-Presidents, and Senior Partners of its contributing companies. This sample of America's tax practitioners includes representatives from many different businesses in many different industries and from companies of many different sizes. This report discusses some of the issues surrounding tax expenditures and presents the results of the survey.

Figure 1
Tax Expenditures as Listed by the JTC and Disputed by the Survey Respondents



Source: Tax Foundation.

Figure 2
Sample of Tax Foundation Survey on Tax Expenditures

Name ______________________ Company ______________________

1) The provisions listed below are deemed by JTC to be tax expenditures. Please circle all provisions you believe are *not* tax expenditures.

	1994 Estimated Revenue Loss ($ Billion)
a. Net exclusion of pension contributions and earnings	58.0
b. Home mortgage interest deductions	51.8
c. Exclusion of employer contributions for medical insurance premiums and medical care	51.5
d. Step-up basis of capital gains at death	26.8
e. Deductibility of state and local nonbusiness taxes other than on owner-occupied houses	24.3
f. Exclusion of Social Security benefits	22.0
g. Deduction for state and local property tax on homes	13.9
h. Deferral of capital gains on homes	13.9
i. Charitable deduction	13.5
j. Exclusion of interest on life insurance savings	7.9
k. Interest exclusion for public purpose state and local debt	7.2
l. Passive loss exception for $25,000 of rental loss	5.9
m. Accelerated depreciation of machinery and equipment	4.4

2) Please list the most important tax provision that you believe is a tax expenditure but was not included on the list above.

____

____

3) Please list the tax provision you believe imposes the most tax in excess of what would be imposed under a neutral income tax, i.e., that provision which is essentially a tax surcharge.

____

____

4) Do you believe the Joint Tax Committee should be required to report on tax surcharges as well as on tax expenditures?

Yes __________ No __________

Tax Expenditures

The tax expenditure concept was developed in large part through the efforts of Stanley Surrey in the 1960s, who went on to become an Assistant Treasury Secretary under President Johnson. The 1974 Congressional Budget Act defines tax expenditures as "... those revenue losses attributable to provisions of the federal tax laws which allow a special credit, a preferential rate of tax, or a deferral of tax liability." It can be argued that such a definition implies that all forms of income inherently belong to the government. Nevertheless, it is probably useful to have terms defining instances in which there are negative, and positive, deviations from a baseline tax system, and it is probably useful to measure the revenues lost and gained from these provisions. The 1974 Act does not provide a definition of the baseline tax system nor a list of tax expenditures, leaving that to the discretion of the Joint Tax Committee (JTC).

Tax expenditures are revenue losses attributable to tax provisions that deviate from the baseline tax system. The chosen baseline, therefore, is crucial to the definition of tax expenditure. The JTC uses the "normal tax" structure of a comprehensive income tax as its definition of the baseline tax. Such a baseline allows for personal exemptions, a standard deduction, and deductions for the expenses incurred in earning income, and it assumes the tax rate structure is part of the baseline.

The Treasury Department, which also calculates tax expenditures, uses the "reference law" as its baseline for defining tax expenditures, which, while similar to the normal tax baseline, identifies 20 fewer tax code provisions as tax expenditures. For example, the following tax provisions are not deemed to be tax expenditures under the Treasury's reference law but are considered to be tax expenditures under the JTC's normal tax law:

- preferential rates for capital gains;
- the Earned Income Tax Credit;
- accelerated depreciation; and,
- deferral of tax received by controlled foreign corporations.

In addition to their differences in the definition of baseline tax systems, the JTC and the Treasury Department each estimate tax expenditures using somewhat different definitions, estimation procedures, macroeconomic assumptions, and data bases.

For 1993, the JTC listed 124 separate provisions as tax expenditures totaling $401 billion. For comparison, the federal government spent $542.5 billion on discretionary programs and $666.9 billion on mandatory programs, excluding depository insurance, in fiscal year 1993. According to JTC data, tax expenditures have grown at an average annual inflation-adjusted rate of 4 percent from 1974 to 1993 compared to an average annual inflation-adjusted rate of 2.5 percent for gross domestic product. Also, once a tax expenditure is enacted, it tends to remain a permanent fixture of the tax code. Between 1913 and 1986, only 13 tax expenditures had been permanently eliminated.

The JTC is careful to point out in its annual report on tax expenditures that the estimates are subject to important methodological limitations. For example, the estimates of the revenue that is lost due to a specific proposal assumes no change in taxpayer behavior would occur if the tax provision were repealed. Thus, for example, the estimate for the revenue loss from the home mortgage interest deduction assumes that if the deduction were repealed, there would be no change in individuals' preferences or financial abilities to own their homes. This contrasts with the JTC's normal revenue estimating procedures in which some modest behavioral responses are taken into account. Consequently, if the JTC were to estimate the revenues gained from repealing the home mortgage interest deduction, the estimate would likely be much less than the figure reported as a tax expenditure because of these behavioral responses.

Another important limitation the JTC points out is that each tax expenditure is measured separately. If the analysis were performed for some set of tax provisions, the net estimates for revenues gained might be greater or less than the sum of the estimates for the individual provisions.

The General Accounting Office Report

The call for greater scrutiny of tax expenditures in the title of the GAO report provides a clue to GAO's recommendations in this area. In fact, the GAO presents three options for addressing tax expenditures in future budgets, including:

(1) using current methods, including regular and periodic review by the congressional tax committees to limit the growth of tax expenditures;

(2) further integration of tax expenditures into the congressional budget process to put them on a par with outlays; and,

(3) focusing on the trade-offs and overlaps between tax expenditures, discretionary and mandatory spending programs, and federal loan programs.

Other Developments

In other developments, the Government Performance and Results Act of 1993, as it relates to tax expenditures, directs the executive branch to (1) make more information available about tax expenditures, and (2) conduct periodic reviews of tax expenditures.

The Office of Management and Budget (OMB) through its OMB 2000 Review representing a comprehensive self-examination of the agency, also addressed the tax expenditure issue. An Office Memorandum to all OMB staff from Director Leon Panetta and Deputy Director Alice Rivlin noted that "OMB analyses seldom pull together both spending and tax expenditure/credit resources devoted to functional policy areas." Thus, Director Panetta agreed with the recommendation of the Steering Committee of the OMB 2000 Review that "... OMB, Treasury, and the Council of Economic Advisers (CEA) work together more closely during the budget process through a formalized mechanism for jointly reviewing tax expenditures and spending requirements." This mechanism is intended to result in "...integrated decisions and recommendations for the President."

On Capitol Hill, Senator Bill Bradley (D-N.J.) of the Senate Finance Committee has indicated his desire to see tax expenditures brought into the regular budget process for annual review and has indicated his intention to introduce legislation amending the congressional budget rules to effect this change. Rep. William Coyne (D-Penn.), a member of the House Ways and Means Committee and the

Table 1
Tax Expenditures as Listed by the JTC and Disputed by the Survey Respondents

Tax Expenditure According to JTC	1994 Estimated Revenue Loss ($ Billion)	Number of Respondents Disagreeing with JTC (out of 59)
Net exclusion of pension contributions and earnings	$58.0	30
Home mortgage interest deduction	51.8	13
Exclusion of employer contributions for medical insurance premiums and medical care	51.5	20
Step-up basis of capital gains at death	26.8	28
Deductibility of state and local non-business taxes other than on owner-occupied houses	24.3	28
Exclusion of Social Security benefits	22.0	29
Deduction for state and local property tax on homes	13.9	26
Deferral of capital gains on home sales	13.9	25
Charitable deduction	13.5	13
Exclusion of interest on life insurance savings	7.9	20
Interest exclusion for public purpose state and local debt	7.2	22
Passive loss exception for $25,000 of rental loss	5.9	23
Accelerated depreciation of machinery and equipment	4.4	28

Source: Tax Foundation.

member who requested the GAO study, has expressed concern that tax expenditures are not scrutinized as thoroughly as federal spending programs and generally are not subject to the same direct spending constraints as are discretionary spending items.

In 1991 Reps. Dick Schulze (R-Penn.) and Ed Jenkins (D-Ga.), both members of the House Ways and Means Committee, introduced legislation to force Congress and the administration to develop better revenue estimating procedures, including those procedures used for estimating revenue gains and losses for tax proposals and the procedures for estimating tax expenditures.

Tax Surcharges and Tax Neutrality

The basis for the tax expenditure concept is that some activity, good, or service receives preferential tax treatment when measured against a baseline tax system. The implication is that wherever there is a tax expenditure, some group of taxpayers are in some way undertaxed.

The federal tax code is rife with provisions that reasonable men and women may argue are or are not tax expenditures. It is almost certain, however, that the tax code includes numerous provisions that raise the level of tax on an activity, good, or service above what would occur when compared to whatever a baseline tax might impose. For example, virtually all federal excises, such as the sales taxes on tobacco and gasoline, would arguably fall under this category, as might the phase-out of the personal exemption for upper-income taxpayers and the Corporate Alternative Minimum Tax. These negative tax expenditures, or tax surcharges, while ignored by the GAO in its report and by the Treasury Department and the JTC when they make their estimates of tax expenditures, are arguably as important and conceptually valid as tax expenditures.

The Treasury Department uses the reference tax law as its baseline while the JTC uses a normal tax as would be defined under a comprehensive income tax. Neither of these structures bears any necessary relation to an economically neutral tax system. Consequently, it is important to remember that a tax expenditure as currently defined may be precisely what is needed to achieve a neutral tax system—that is, a tax system which does not distort the allocation of resources among activities.

Tax neutrality, like tax fairness, is a term of art which receives near universal acclaim as a goal of tax policy, but which has not had the benefit of a generally accepted definition. An economic definition of tax neutrality is that a tax is neutral if it leaves unchanged the relative prices of goods, services, and activities that would arise if no tax were imposed.

An example of the difference between a tax expenditure as defined by the JTC or Treasury on the one hand, and a tax expenditure under a neutral tax system on the other hand, is the multiple taxation of saving. Such multiple taxation is considered part of a normal income tax by the JTC and part of the referential tax law by the Treasury Department. However, using tax neutrality as the baseline, the tax imposed on interest and dividend income, for example, is generally a tax surcharge. Using the JTC's or the Treasury's baseline, the failure to tax interest and dividend income would create a tax expenditure.

Clearly, the tax expenditure concept would have far greater meaning for the guiding of tax policy if it were tied specifically to some definition of a neutral tax system. While it may be as difficult to establish a consensus on the practical meaning of tax neutrality as it is to establish a consensus on the meaning of a normal income tax, the orientation would, at the very least, be based on sounder analytical footing.

Table 2
Other Important Tax Expenditures

Provision	Number of Times Listed
Earned Income Tax Credit	7
Research and Development Tax Credit	4
Personal exemption/standard deduction	4
Preferential capital gains tax rate (when in effect)	3
Tax rates below the top tax rate	3
Targeted Jobs Tax Credit	3
Exemption of entitlements from taxation	2
Exemption of tax-exempt organization income from taxation	2
Low-Income Housing Tax Credit	2
Interest expense on leveraged buyouts	2

Source: Tax Foundation.

Tax Foundation Survey of Tax Practitioners

Economists, accountants, and lawyers have debated the theoretical aspects of a proper federal tax system, tax neutrality, and tax expenditures for years. However, within the U.S. there is a vast army of men and women in corporate tax departments, law offices, and accounting firms with many years of practical experience in applying the federal tax code to real world situations. Many of these tax professionals are associated with the Tax Foundation. Their years of experience with the corporate and personal income taxes have given them time-tested wisdom about how the tax system should be designed and operate. Their understanding of the tax system also grants them unique insight into what constitutes a tax expenditure.

To gauge their views, the Tax Foundation mailed 155 surveys to the members of its Program Committee and Policy Council, of which 59 (38 percent) were returned completed. (A sample of the survey is provided in Figure 2.) The members of the Tax Foundation's Program Committee and Policy Council represent many of America's largest corporations as well as most of the major accounting firms and many of its finest law firms.

The survey consisted of four questions. The first question listed 13 tax provisions which are designated by the JTC as tax expenditures, along with their associated estimated revenue losses. The survey asked the respondent to indicate those provisions which the respondent believed were not tax expenditures. The second question asked the respondent to list the most important tax provision that is a tax expenditure but which was not included in the list. The third question asked the respondent to list the tax provisions that impose the most tax in excess of what would be imposed under a neutral tax system (i.e., a tax surcharge). And the final question asked whether the respondent believed the JTC should be required to report tax surcharges as well as tax expenditures.

Table 1 and *Figure 1* list the 13 tax provisions, their associated estimated revenue losses, and the number of respondents disagreeing with the JTC's assessment of whether the provision is a tax expenditure.

As the results in *Table 1* show, on each provision listed a majority of the respondents agreed with the JTC in its assessment of whether the particular tax provision was a tax expenditure. However, in each case at least 22 percent of the respondents disagreed

Table 3
The Most Important Tax Surcharges

Provision	Number of Times Listed
Alternative Minimum Tax	12
Progressive tax rates	8
Double taxation of corporate income	7
Phase-out of personal exemptions/ standard deduction for upper income taxpayers	6
All instances of the disallowance of deductibility of ordinary and necessary business expenses	5
Rules on the allocation of foreign income and expense	4
Taxation of capital gains generally	3
Taxation of capital gains due to inflation	3
Limitations on capital loss deductions	3
Uniform capitalization rules for inventory	2
Restrictions on the deductibility of passive losses	2
Non-deductibility of reserves for bad debt	2

Source: Tax Foundation.

with the JTC; and, overall, about 40 percent of the time the respondents disagreed with the JTC's assessment. These results demonstrate the enormous range of opinion regarding what constitutes a tax expenditure and, therefore, the difficulty involved in using the tax expenditure concept as a guide to tax policy.

Table 2 lists the write-in responses to the second question dealing with provisions not listed in Table 1, but which the respondent believes is an important tax expenditure. Only those provisions listed by the respondents at least twice are reported in Table 2.

Table 3 lists the write-in responses to the third question dealing with the most important provisions which impose tax in excess of a neutral tax system. Only those provisions that are listed by the respondents at least twice are reported in *Table 3*.

The fourth question asking whether the JTC should be required to report tax surcharges as well as tax expenditures received a nearly unanimous response. Of the 59 respondents, 54 (92 percent) answered that the JTC should be required to report tax surcharges, while three responded that the JTC should not report tax surcharges and two responded that the JTC should report neither tax expenditures nor tax surcharges.

Conclusion

It is entirely appropriate to consider the tax and spending policies of the federal government on a consolidated basis. In some respects, government transfer programs are little different economically from negative income taxes, while tax provisions that are designed to benefit specific individuals or activities are little different from transfer programs. Similarly, many economists have argued for years that Social Security should be treated as an intergenerational tax and transfer system, while the OMB's 1995 submission of the administration's budget took this concept to the next level by considering the intergenerational income transfer implications of federal fiscal policy.

The tax expenditure concept, when considered in light of consolidated federal fiscal policies, can be a very useful tool in assessing the net effect of those policies. This tool of fiscal analysis is severely limited, however, if it is based on the wrong premise or on a premise around which there is very little consensus.

Unfortunately, the definitions of tax expenditure which are used by both the JTC and the Treasury Department suffer from a clear lack of consensus. As demonstrated by this survey, no consensus exists about whether many of the most important provisions deemed by the JTC and Treasury to be tax expenditures are really tax expenditures. It is likely, therefore, that neither of these sets of estimates are appropriate guides for purposes of developing future tax policies.

Further, in each case, the definition of tax expenditure depends on a baseline tax system established on principles that often bear little relationship to a neutral tax system. While such a baseline may be appropriate for measuring net income transfers, it is inappropriate in assessing the effects of taxation on relative prices, and thus it is inappropriate in assessing the net effect of these tax provisions on the U.S. economy. At the least, if tax expenditures based solely on income transfers are reported, then the Congress should consider requiring the JTC to report on those tax provisions violating tax neutrality, as well.

The current system of tax expenditure reporting also suffers from an asymmetry that further limits the value of the estimates as a tool of fiscal analysis. The survey results reported in this paper clearly imply support for reporting instances in which there is an excessive tax imposed, or tax surcharge, as a component of federal fiscal policies.

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