

# TAX FEATURES<sup>®</sup>

July 1994 Volume 38, Number 7

## Foundation Survey on Tax Expenditures Finds Disparities With Established Definitions

A Tax Foundation survey of top tax executives at its member companies has revealed an enormous range of opinion regarding what constitutes a tax expenditure, demonstrating, according to Executive Director and Chief Economist J.D. Foster, "at the very best the difficulty involved in using the tax expenditure concept as a guide to tax policy."

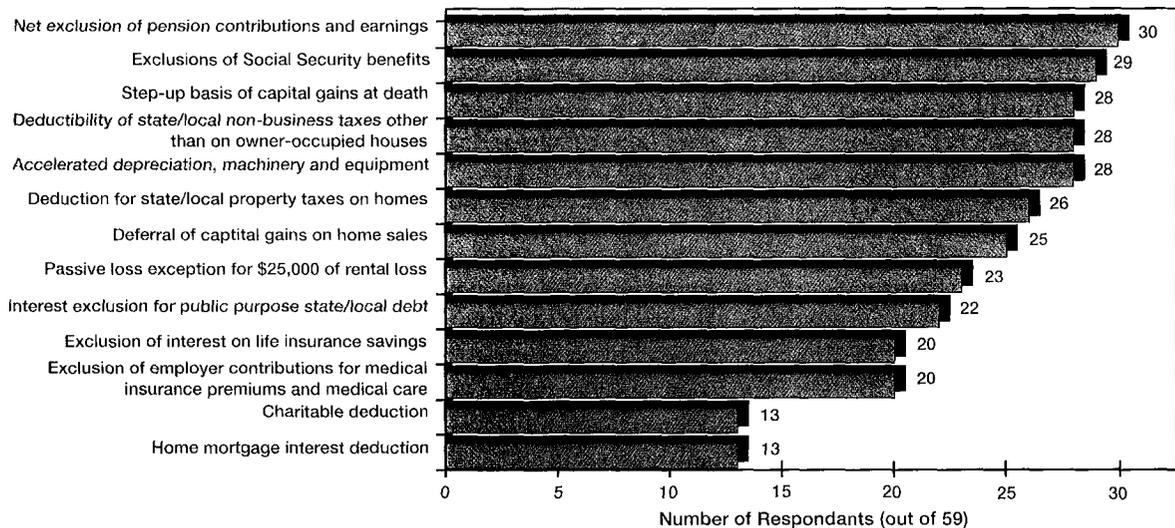
As Dr. Foster explains in a *Special Report*, titled "A Survey of Tax Expenditures," the tax

expenditure concept, developed in the 1960s, was defined by Congress in 1974 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."

Yet there is no consensus about what constitutes a tax expenditure. Dr. Foster notes that the chosen baseline is crucial to

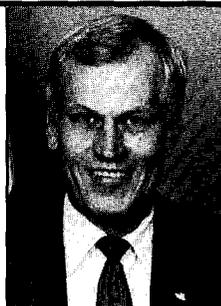
*Tax Expenditure Survey continued on page 2*

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



Source: Tax Foundation.

FRONT & CENTER



Let Congress Vote on Individual Items in Tax and Spending Bills

Rep. Charles Stenholm  
(D-Texas)

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## Tax Expenditure Survey

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the definition. The Joint Tax Committee (JTC) uses the "normal tax" structure of a comprehensive income tax as its definition of the baseline tax, which allows for personal exemptions, a standard deduction, and deductions for the expenses incurred in earning income. It also assumes the tax rate structure is part of the baseline.

On the other hand, the Treasury Department, which also calculates tax expenditures, uses the "reference law" as its baseline. While similar to the normal tax baseline, this identifies 20 fewer tax code provisions as tax expenditures.

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. 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.

### Tax Surcharges and Tax Neutrality

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 would arguably fall under this category, as might the Corporate Alternative Minimum Tax.

**Chart 2: Tax Expenditures as Listed by the JTC and Disputed by the Survey Respondents**

Tax Expenditure According to JTC	1994 Estimated Revenue Loss (\$ Billion)	No. 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.

These negative tax expenditures, or tax surcharges, ignored by the Treasury Department and the JTC, are arguably as important and conceptually valid as tax expenditures.

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.

"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," observes Dr. Foster. 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.

Dr. Foster's *Special Report* also reveals the results of the Foundation's recent survey, which was distributed to 155 members of

its Program Committee and Policy Council who represent many of America's largest corporations as well as most of the major accounting firms and many of its finest law firms. In all, 59 of the surveys (38 percent) were returned.

The survey consisted of four questions. The first question listed 13 tax provisions which are designated by Congress's Joint Tax Committee 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 (see Charts 1 and 2). 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 (that is, a

Survey continued on page 7

## Report Provides Insight Into Consequences of a VAT

### *While Not Necessarily a Money Machine, a VAT May Not Help Deficit*

A new study by the Tax Foundation shows that a value-added tax (VAT) in the United States would not necessarily turn into a "money machine" for the federal government, yet it also might not help decrease budget deficits.

In his study titled "More U.S. Revenue? An Analysis of the European Community VAT: Implications for U.S. Tax Policy," Dr. John R. McGowan—a professor at St. Louis University and an Ernst and Young Visiting Professor at the Tax Foundation—explores the consequences a VAT might have for the U.S. in terms of revenue raising and deficit reduction. To this extent, he examines the EC experience to determine whether the growth of the VAT outpaced the growth of other forms of taxation relative to Gross National Product (GNP). EC countries use a variety of sales, personal income, corporate income, and wealth taxes. This paper reports on how VAT revenues changed over time relative to these other taxes.

The paper also evaluates the so-called "money machine" problem—that is, if enacted, would a VAT become a subtle tool used by lawmakers to increase government revenue.

Based on the EC experience, Dr. McGowan cites three implications for U.S. tax policy if a VAT or consumption-based tax were to be enacted here:

- Credit-invoice VATs apparently can be implemented without becoming new money machines *if they replace other money-machine taxes.*

- Unless the VAT were implemented as a replacement of an existing tax, the U.S. tax ratio would likely increase beyond its historical level of just under 30 percent of GNP.

- The evidence suggests that a VAT would not reduce the U.S. budget deficit, particularly if enacted as a replacement tax, because of government's inclination to use any additional tax revenues to increase spending.

Dr. McGowan found that the implementation of the VAT in European countries largely replaced other existing consumption taxes, and with the exceptions of four countries, the relative tax burdens of indirect taxes re-

mained stable over this period despite the implementation of VATs. However, in those four countries—Denmark, Luxembourg, Netherlands, and Portugal—VAT increases caused total consumption taxes to increase over the period examined (1970 to 1992).

All EC countries that have adopted a VAT have adopted a credit-invoice VAT, Dr. McGowan observes. There are, however, other forms of a VAT, such as the subtraction-method VAT

and the consumed-income tax which, while having essentially the same tax base as a credit-invoice VAT, may be more similar operationally to an income tax. Only Japan currently employs a non-credit-invoice VAT.

The results reported in this paper clearly extend to the possibility of the U.S. adopting a credit-invoice VAT, but probably also shed light on the consequences of the U.S. adopting an alternative-method VAT. •

## Analysis Examines High Taxes in the Nation's Capital

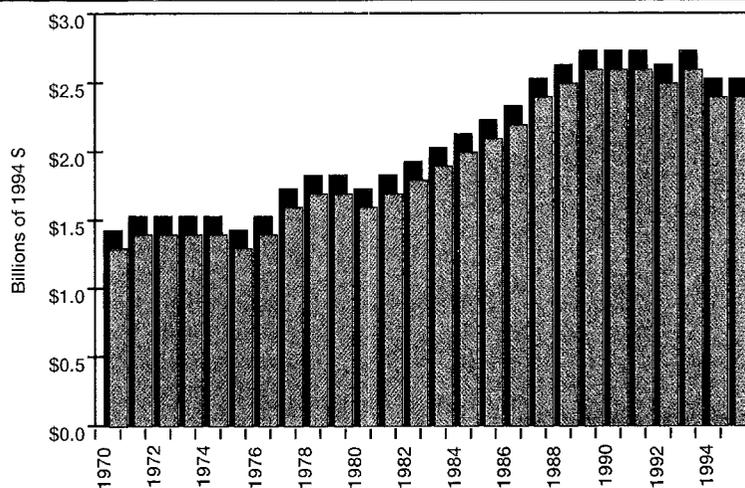
A new Tax Foundation analysis that examines the fiscal condition of the nation's capital shows that while tax revenues soared 61 percent in constant dollar terms between fiscal 1980 and 1989, the city's tax revenues have since fallen seven percent.

According to Foundation Economist Chris Edwards, the rapid growth in District tax revenues during the 1970s and 1980s was remarkable considering that the D.C. population dropped from 755,000 in 1970 to 638,000 in 1980 to 601,000 by 1990 (and by 1993 stood at just 578,000).

Considering this drop, Mr. Edwards projects that city spending must meet the new (smaller) tax collection and population realities evident in Mayor Sharon Pratt Kelly's fiscal year 1995 budget. Property tax collections, income tax collections, and general sales tax collections all are down from peak years.

"An obvious focus for D.C. government efforts must be to attract residents and businesses back into the city," concludes Mr. Edwards. "Taxpayers will not move back if they continue to read about . . . further tax hikes in the city." •

Total D.C. Tax Collections in Constant 1994 Dollars



Source: Tax Foundation.

## Let Congress Vote on Individual Items in Tax and Spending Bills

Rep. Charles Stenholm  
(D-Texas)

It's no wonder taxpayers grow frustrated and cynical.

They read about congressional approval of an emergency spending bill for earthquake victims in southern California, only to learn the bill includes \$10 million for a new Amtrak station in New York. They hear claims about how federal programs are being slashed, but find there are no cuts, just smaller increases. Even those taxpayers accustomed to congressional doubletalk on federal spending see these and other shenanigans and ask,

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***We need to bring greater accountability to the appropriations process so that individual appropriations may be considered on their individual merits. The current rescission process does not make the president or Congress accountable.***

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"Can't Congress level with us when they spend our money?"

We think leveling with taxpayers is the least Congress should do. The current budget process is enormously confusing and strongly biased in favor of the status quo and deficit spending. That is why Reps. Tim Penny (D-Minn.), John Kasich (R-Ohio), and I were pleased to offer in July a substitute amendment to H.R. 4600, the Expedited Rescissions Act of 1994.

Expedited rescission legislation embodies an idea for which many members, both Democrats and Republicans, have fought hard. Then-Senator Dan Quayle first introduced expedited rescission legislation in 1985. Reps. Tom Carper and Dick Armev did yeomen's work in pushing this legislation. On the Democratic side, Reps. Tim Johnson, Dan Glickman, Tim Penny, and L. F. Payne have spent the past several years as particularly

effective advocates of this legislation. Thanks to the efforts of these and other members, the House overwhelmingly passed expedited rescission legislation in the 102nd Congress.

We need to bring greater accountability to the appropriations process so that individual appropriations may be considered on their individual merits. The current rescission process does not make the president or Congress accountable. Congress can ignore the president's rescissions, and the president can blame Congress for ignoring his rescissions. I believe that it is appropriate to strengthen the president's ability to force votes on individual budgetary items.

According to data compiled by the General Accounting Office, Congress has approved barely one-third of the individual rescissions submitted by presidents of both parties since 1974. Congress has ignored \$48 billion in rescissions submitted by presidents under the existing process without any vote at all on the merits of the rescissions.

My colleagues on the Appropriations Committee correctly point out that Congress has passed more than \$60 billion in rescissions of its own since 1974, but I do not believe that the fact that Congress has approved more spending cuts than the president has submitted is a justification for not voting on the president's rescission proposals. The public is fed up with the finger-pointing, in which each side argues that the problem is really the other side's fault. When we are faced with deficits in the \$200 billion range, we cannot afford to ignore any proposals to cut spending.

Forcing votes on individual items in tax and spending bills will have a very real cleansing effect on the legislative process and will take a step toward reducing the public cynicism about the political process. That is why we offered our substitute to the Expedited Rescissions Act of 1994. It struck a balance which grants the president the authority to force votes




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***In essence, this amendment will give Congress and the president an additional tool for fiscal responsibility and improve accountability in taxing and spending legislation without disrupting the Constitutional balance of power.***

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on individual tax and spending items without disrupting the Constitutional balance of power.

Our amendment would allow the president to propose to cut or eliminate individual spending items in appropriations bills throughout the year. The president could place some or all of the savings from proposed rescissions in a "Deficit Reduction Account." In addition, the president would be able to propose to repeal targeted tax breaks which benefit a particular taxpayer or class of taxpayer within 10 days of signing a tax bill.

In our amendment, within 10 legislative days after the president sends a rescission package to Congress, a vote shall be taken on the rescission bill. The bill may not be amended on the floor, except that 50 House members can request a vote on a motion to strike an individual rescission from the package. If a majority of members vote in favor of the individual item, it would be struck from the bill. If approved by a simply majority of the House, the bill would be sent to the Senate for consideration under the same expedited procedure.

Any appropriations or tax item that was submitted by the president would be, in effect, suspended until Congress acts on the president's package. If Congress avoids a vote, the funds would continue to be withheld from obligation or the tax provision would continue to be deemed to be repealed. Unlike current law, Congress could not

force the president to spend the money by ignoring the rescissions. If a simple majority in either the House or Senate defeats a rescission proposal, the funds for programs covered by the proposal would be released for obligation in accordance with the previously enacted appropriation, or the tax provision would take effect. If a bill rescinding spending or repealing tax benefits is approved by the House and Senate, it would be sent to the president for his signature.

Our amendment would, we believe, improve the base text of the Expedited Rescissions Act in several ways:

- The president would have the option of earmarking savings from proposed rescissions to deficit reduction in anticipation of lockbox legislation which the House of Representatives will consider later this year. Under the base bill, the savings from rescissions automatically would be available to be spent on other programs.
- The president would be able to single out narrowly drawn provisions in tax bills which are added to tax bills at the behest of large corporations or wealthy taxpayers. Congress would have to vote on these rifle shot tax provisions on their merits.
- The president would be able to submit a rescission package for expedited consideration at any point in the year. The base bill would restrict the president to submitting rescissions

during a limited window after signing an appropriations bill.

- The new expedited rescission authority would be established permanently instead of being limited to the few remaining months of the 103rd Congress as the base bill would do.

- If 50 members of the House or 15 members of the Senate request a separate vote on an individual item, they would have the opportunity to convince a majority of the House to strike that item from the package before the vote on the overall package. Under the base bill, members could be placed in a position of being compelled to oppose the entire package because of one item included in the package even though they supported virtually all rescissions in the package.

- Our substitute would not lay out a cumbersome new procedure for consideration of an Appropriations Committee alternative as the base bill does. Contrary to some suggestions, our substitute does not prevent Congress from considering an alternative rescission package.

In essence, this amendment will give Congress and the president an additional tool for fiscal responsibility and improve accountability in taxing and spending legislation without disrupting the Constitutional balance of power.

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*The views expressed in Front & Center are not necessarily those of the Tax Foundation.*

## OPINION

## Moving Toward Tax Neutrality (Continued)

Many discussions of tax neutrality appear to accept an erroneous assumption that has plagued tax policy debate in recent decades—namely, that the comprehensive accrual notion of income is the appropriate and only standard to be used in defining the income tax base, tax neutrality, and consequently, tax expenditures. To often, debate seems to ignore or reject the alternative (and, in my opinion, more appropriate) standard of consumed income which excludes saving and investment from the annual income tax base.

As a result of what I believe is a conceptual error, many analysts make the dubious assumption that an income tax is or can be “neutral” even if it postpones the deductibility of certain business expenditures (e.g., capital investments) and allows for the deductibility of other expenditures. Under the consumed-income standard, immediate deductibility of all business investment is required to achieve neutrality; current deductibility is not a tax expenditure under such a standard while postponing deductibility is a form of double taxation.

No one seriously argues that a taxpayer should be required to postpone the deductibility of business expenditures such as advertising, training and research. The correct reason for that current deductibility has nothing to do with the red herring analysis of the economic life of the expenditures. (Those expenditures do not have a zero economic life). The correct reason that such expenditures are deductible is that they are not for personal consumption (which may properly be taxed on an annual basis) but are investments for the future which should not be included in the annual tax base.

Advertising, training and research expenditures would not be undertaken if they had no economic life beyond the end of the year. They clearly have continuing value and will generate future income. The expenses are deductible currently because the benefit of that



*James Q. Riordan, Esq.  
Former Chairman,  
Tax Foundation*

income will be taxed when it is realized. To include the investment itself as well as the future benefits in the tax base is double taxation compared to the way we tax consumption.

Although we require consumption to be paid for the with after-tax dollars, we don't impose double taxation on consumption because we do not include the benefits of consumption in the annual tax base. While income used for consumption is included in the tax base, the benefits of consumption are not taxed. One buys a painting with after-tax income but no tax is imposed on the benefit of enjoying it. One builds a porch with after-tax dollars, but we don't collect an annual income tax on the benefit of rocking on it. Since we tax the future benefits from the investment in business equipment we should not also include the initial investment in the annual tax base.

Neutrality between investment and consumption and among different kinds of investment requires that all corporate business expenditures should be immediately deductible (e.g., the purchase of computers as well as the training of employees to use them) from the annual income tax base. It is the simplest way to reduce the anti-investment bias in the current law and move toward a truly neutral income tax system.

*The views expressed in Opinion are not necessarily those of the Tax Foundation.*

## Study Suggests Tax Integration Lowers Corporate Leverage

The results of a new study by the Tax Foundation suggest that nations that adopt an integrated tax system—integrating the corporate and personal income taxes—can reduce corporate financial leverage. The findings also indicate that this effect is diminished by increased taxes on gains realized through stock appreciation.

The paper, “Effects of Tax Policy on Corporate Financing Decisions: Integration of the Corporate and Personal Income Tax,” was prepared by Professors Keith F. Sellers, Deborah W. Thomas, and Craig T. Schulman of the University of Arkansas, as part of the Tax Foundation's Ernst & Young Visiting Professor program.

The authors' conclusions are significant for the United States, which is considering both integration and the reintroduction of preferential tax treatment of capital gains.

In their research, the Ernst & Young Visiting Professors examined whether the adoption of an integrated tax system in New Zealand, Canada, and Australia altered corporate financing decisions. Each of these countries had previously used a classical tax system similar to that employed in the U.S., and in each case the country integrated its corporate and personal income taxes so as to eliminate the double taxation of corporate earnings.

Evidence from both New Zealand and Canada indicate that tax integration is a significant determinant of corporate capital structure and contributed to decreased levels of financial leverage. In Australia, no link could be established between the adoption of integration and the debt-to-equity ratios of domestic firms.

The study noted that high-dividend firms are most influenced by integration. In addition, the results confirm that the “benefits” of tax integration may be offset by changes in capital gains taxes. These findings also indicate that firms should not be considered homogeneous in their reactions to tax policy changes. ●

## Tax Expenditure Survey

*Continued from page 2*

tax surcharge). The final question asked whether the respondent believed the JTC should be required to report tax surcharges as well as tax expenditures.

As the results in the two charts 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 with the JTC; and, overall, about 40 percent of the time the respondents disagreed with the JTC's assessment.

Another survey question asked 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.

Dr. Foster concludes that 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 suffer from a clear lack of consensus. "As demonstrated by the Foundation's survey," Dr. Foster says, "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." ●

## FOUNDATION MESSAGE

## Speeding Down the Wrong Track to Reform

Every major legislative battle sets the stage for the battle to follow. Thus it is unfortunate President Clinton did not heed Senator Moynihan's call earlier this year for the president to put welfare reform before health care reform.

One can only guess at what motivated the chairman of the Senate Finance Committee to urge the president to switch priorities in this way. One possibility, of course, is that Senator Moynihan's decades of study of the welfare system led him to believe we have some important lessons to learn from this well-intended but now widely discredited attempt at social engineering, and that we need to learn these lessons before going on to the next great feat of engineering.

Federal welfare programs provide a case study in the law of unintended consequences. We try to give people a safety net when they are down, and it turns it into a hammock. We try to give single mothers financial support commensurate with their family size, and they come to see babies as profit centers.



*J.D. Foster  
Executive Director and  
Chief Economist*

Welfare reform, which may have greater political support than health care reform, will offer a tremendous opportunity to see what has worked and what has not. Above all, it will provide the opportunity to debate the role of government in society, not just in terms of problems that need to be fixed but in terms of solutions that need to be abandoned.

It is unfortunate that welfare reform did not precede health care reform because what is needed first is a debate about the proper role of government. Absent this preparatory debate, the health care debate has proceeded largely as though the only options are a greater or a better role for government in the market for health care services and health insurance.

President Clinton complains that he would be willing to consider alternatives to his managed care approach, but that none is forthcoming. On the contrary, there are strong, viable alternatives such as the Medical Savings Account (MSA), which essentially would allow each of us to purchase health care insurance and health care services through a savings account much like the old Individual Retirement Account. The MSA can be the centerpiece of a health care reform that would effectively address the problems defined by the president, and it would do so without employer mandates, without a reduction in a patient's choice of doctors, without getting caught in the quagmire of abortion, without another government bureaucracy, and without expanding the government's role in health care.

The MSA has not received the attention it deserves because it is regarded, correctly, as an attempt to instill greater market discipline into the health care market. Without having had the welfare debate first, the Congress and the American people remain distrustful of relying on the private sector and comfortable with increased government involvement in our personal lives. The welfare debate, and the ensuing distrust in government it will surely engender, would prepare the ground well for more free market approaches to health care reform. If health care reform stalls this year, and if welfare reform gets a chance in the next Congress, we may yet have a chance to debate the efficacy of free markets and free choice in health care versus postal service-quality health care.

# Goldberg Foresees Dangerous Trend

*Tax Features* (ISSN 0883-1335) is published monthly by the Tax Foundation, an independent 501(c)(3) organization chartered in the District of Columbia. Annual subscriptions to the newsletter are \$15.

*Co-Chairman and Distinguished Fellow*  
The Honorable Bill Frenzel

*Co-Chairman*  
Dominic A. Tarantino

*Executive Director and Chief Economist*  
J.D. Foster

*Counsellor*  
James C. Miller, III

*Administrator and Director, Foundation Development*  
Gaye Bennett

*Adjunct Fellow*  
Charles E. McLure, Jr.

*Tax Counsel*  
Lynda K. Walker

*Special Tax Counsel*  
J. Dwight Evans

*Director, Corporate Development*  
Renee Nowland

*Editor and Communications Director*  
Stephen Gold

Tax Foundation  
(202) 783-2760 Tel  
(202) 942-7675 Fax

In an address to the Tax Foundation's Program Committee July 21, Fred Goldberg—former Internal Revenue Service Commissioner, Executive Director of the Kerry-Danforth Commission on Entitlement and Tax Reform, and a member of the Program Committee—painted a stark picture of the nation's fiscal state for the near future.

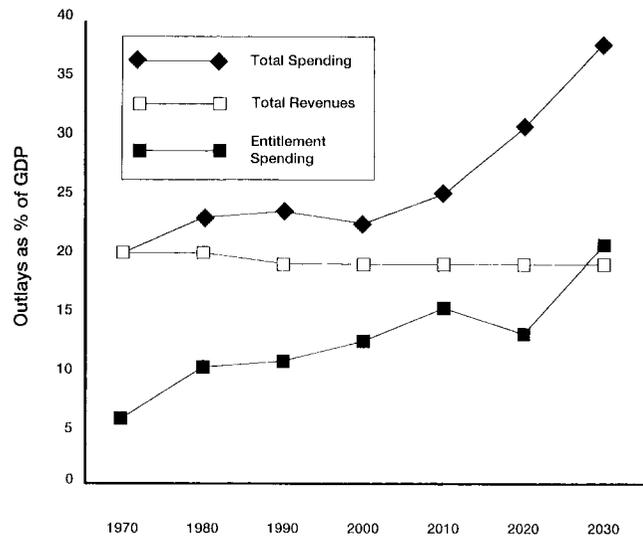
Based on current projections, Mr. Goldberg noted that total federal spending would easily outpace federal revenues over the next 36 years. Through

the use of graphs, he showed that this was primarily the result of rapidly climbing federal entitlement spending. The graph accompanying this article shows that entitlement spending alone will outpace total revenue by the year 2030. In addition, the drain on net national saving due to the federal budget deficit is projected to be enormous "as far as the eye can see," as a noted Washington insider was known to say a few years back. Another graph, not shown, indicated how private saving has declined from about eight percent of gross national product to about five percent, indicating that while government borrowing is projected to increase, the level of private saving is

insufficient to fund this borrowing and to provide the capital necessary for even a modest level of domestically financed investment.

Two other graphs Mr. Goldberg presented painted an equally dark picture, showing how the trust fund that covers Medicare outlays and the Social Security Trust Fund each go bankrupt in about seven and 35 years, respectively. To avoid this outcome through tax increases, Mr. Goldberg observed, would require a payroll tax of almost 33 percent.

**Forecast on Federal Entitlement Spending, Total Spending, and Total Revenues**



Source: Presentation by Fred Goldberg to Tax Foundation Program Committee, July 21, 1994.

Tax Foundation  
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Suite 750  
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