United States General Accounting Office

GAO

Report to the Honorable
William J. Coyne
House of Representatives

June 1994

TAX POLICY

Tax Expenditures Deserve More Scrutiny

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June 3, 1994

The Honorable William J. Coyne
House of Representatives

Dear Mr. Coyne:

This report responds to your request that we examine the growth of tax expenditures and alternatives for limiting their growth. It assesses the growth of federal revenues forgone through income tax expenditures and presents three options for reviewing and controlling this growth: (1) strengthening and extending techniques currently used by congressional tax-writing committees, (2) integrating tax expenditures further into the budget process, and (3) reviewing tax expenditures jointly with related federal outlay programs. The report contains a recommendation to, and matters for consideration by, Congress and recommendations to the Director of the Office of Management and Budget.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 14 days from the date of this letter. At that time we will send copies of this report to the Director of the Office of Management and Budget, the Secretary of the Treasury, appropriate congressional committees and members, and other interested parties. We will also make copies available to others upon request.

The major contributors to this report are listed in appendix V. If you have any questions concerning this report, please call either of us. Jennie Stathis can be reached on (202)512-5407, and Paul Posner can be reached on (202)512-9573.

Sincerely yours,

Jennie S. Stathis

Jennie S. Stathis
Director, Tax Policy and
Administration Issues
General Government Division

Paul L. Posner

Paul L. Posner
Director, Budget Issues
Accounting and Information Management
Division

Executive Summary

Purpose

At a time when the federal government faces hard choices to reduce the deficit and use available resources wisely, no federal expenditure or subsidy, whether it involves outlays (i.e., discretionary or direct spending) or tax revenues forgone, should escape careful examination. Congressional and executive branch processes do not subject existing tax expenditures to the same controls that apply to programs receiving appropriated funds.

Congressman William J. Coyne was concerned that a lack of attention to income tax expenditures has allowed them to increase and was interested in how they could be controlled. GAO examined a wide range of alternatives for the review and control of income tax expenditures. This report

- describes the size of increases in tax expenditures;
- examines whether tax expenditures need increased scrutiny; and
- identifies options that could be used to increase the scrutiny of and/or control the growth of tax expenditures, discussing the advantages and disadvantages of each.

Background

Tax expenditures are reductions in tax liabilities that result from preferential provisions in the tax code, such as exemptions and exclusions from taxation, deductions, credits, deferrals, and preferential tax rates. Many tax expenditures are subsidies to encourage certain behaviors, such as charitable giving. A few tax expenditures exist, at least in part, to adjust for differences in individuals' ability to pay taxes, such as deductions for catastrophic medical expenses. Some tax expenditures may also compensate for other parts of the tax system. For example, some argue the special tax treatment of capital gains may in part offset the increased taxes on capital income that result from such gains not being indexed for inflation. Congress sometimes reviews tax expenditures and has limited some tax expenditures by various means, such as by limiting the benefits as taxpayers' incomes increase.

Although widely used to describe preferential provisions in the tax code, the term tax "expenditures" is not universally accepted. Some observers believe that labeling these provisions tax "expenditures" implies that all forms of income inherently belong to the government. However, the concept was developed to show that certain tax provisions are analogous to programs on the outlay side of the budget, and it was intended to promote better informed decisions about how to achieve federal objectives. In using this term, GAO is recognizing that, as a practical matter, tax expenditures are part of the federal budget, and Congress already uses the tax expenditure concept to a limited extent in budgetary processes.

Currently, the House Committee on Ways and Means and the Senate Committee on Finance have jurisdiction over both new and existing tax expenditures. These Committees propose the mix of tax rates and tax expenditures to be used to obtain a specified amount of revenue. In reviewing tax expenditures, these Committees have used several techniques to limit individual tax expenditures or groups of them. These reviews, however, are not conducted systematically and may not explicitly consider possible trade-offs between tax expenditures and federal outlay programs and mandates.

Results in Brief

Tax expenditures can be a valid means for achieving certain federal objectives. However, studies by GAO and others have raised concerns about the effectiveness, efficiency, or equity of some tax expenditures. Substantial revenues are forgone through tax expenditures but they do not overtly compete in the annual budget process, and most are not subject to reauthorization. As a result, policymakers have few opportunities to make explicit comparisons or trade-offs between tax expenditures and federal spending programs. The growing revenues forgone through tax expenditures reduce the resources available to fund other programs or reduce the deficit and force tax rates to be higher to obtain a given amount of revenue.

The three options discussed in this report may help increase attention paid to tax expenditures and reduce their revenue losses where appropriate. First, greater scrutiny could be achieved with little or no change in congressional processes and jurisdictions by strengthening or extending techniques currently used to control tax expenditures. Ceilings and floors on eligibility, better highlighting of information, or setting a schedule for periodic review of some tax expenditures are some possibilities under this option. If controlling tax expenditures through the current framework is considered insufficient, Congress could change its processes to exert more control over them.

The second option is for Congress to further integrate tax expenditures into the budget process. One feasible approach would be for Congress to decide whether savings in tax expenditures are desirable and, if so, to set in annual budget resolutions specific savings targets. Savings could be enforced through existing reconciliation processes.

A third option is to integrate reviews of tax expenditures with functionally related outlay programs, which could make the government's overall funding effort more efficient. Such integrated reviews could be done by the executive or legislative branches, or both.

Under the Government Performance and Results Act of 1993 (GPRA), the Office of Management and Budget (OMB) plans to report information on program goals and key indicators for both outlays and tax expenditures. In January 1994, OMB designated 53 performance measurement pilot projects to begin in 1994. Implementation of GPRA provides a promising opportunity to increase the usefulness and visibility of outcome-oriented performance data.

GAO's Analysis

Tax expenditures can be a useful part of federal policy. But in some cases tax expenditures may not be the most effective, efficient, or equitable approach for providing government subsidies. For example, it might be less expensive for the federal government to provide assistance to state and local governments through direct payments than through tax-exempt bonds. Because tax expenditures represent a significant part of the total federal effort to reallocate resources, choosing the best methods for achieving objectives, including the most effective tax expenditure designs, could have significant results. (See pp. 23-32.)

Tax Expenditures Have Been Growing but Are Difficult to Measure

GAO primarily used Joint Committee on Taxation (JCT) estimates to analyze the size and growth of tax expenditures. According to these data, tax expenditures totaled about $400 billion in 1993. Their average annual percent increase in real terms for the period from 1974 to 1993 was about 4 percent, which compares to an average annual real increase for gross domestic product of about 2.5 percent. Tax expenditures are expected to continue growing; however, the rate of growth is uncertain.

As experts note, tax expenditure revenue loss estimates are not as informative as the revenue estimates made for proposed changes to the tax code. Whereas revenue estimates incorporate the changes in taxpayer behavior that are anticipated to occur as a result of the change, tax expenditure revenue loss estimates do not incorporate any behavioral effects. Furthermore, summing tax expenditure revenue losses ignores interaction effects among tax code provisions. Because of interactions with other parts of the tax code, the revenue loss from the elimination of several tax expenditures together may be greater or smaller than the sum of the revenue losses for each tax expenditure measured alone. Nevertheless, GAO believes tax expenditure revenue loss totals represent a useful gauge of the general magnitude of government subsidies carried out through the tax code.

When trends in these totals are looked at, however, care must be taken to consider the possible underlying causes. Aggregate tax expenditure magnitudes are affected by changes in tax rates, in economic activity, and in the number of tax preferences. An overall growth in aggregate tax expenditures may be due to rapid growth of a few tax expenditures—and some point to the rapid growth of health-related expenditures as a current example. However, no process currently prompts Congress to address these trends and decide whether they warrant policymaking actions.

JCT and the Department of the Treasury devote limited resources to estimating tax expenditure revenue losses because decisions are not based routinely on this information. GAO did not attempt to verify either JCT's or Treasury's tax expenditure estimates. (See pp. 33-38.)

Processes Do Not Highlight Tax Expenditures for Policymakers

Despite their significance, existing tax expenditures do not compete overtly in the annual budget process. Under budget processes, new tax expenditures must be funded as they are created. However, except for a few that are subject to reauthorization, existing tax expenditures, like most entitlement programs, can grow without congressional review. These tax expenditures are indirectly controlled primarily to the extent that revenue targets allocated to the tax committees under the budget process create pressure to decrease their growth. Although tax expenditures are listed separately in the president's budget each year, the lists are not used for making tax expenditure allocations or for comparisons with outlay programs. As a result, policymakers have few opportunities to make explicit comparisons or trade-offs between tax expenditures and federal spending programs. (See pp. 30-32.)

Options for Greater Scrutiny

Increased congressional review of or control over tax expenditures could be achieved under three general options, each consisting of several alternative approaches:

- Option 1: This option involves methods currently within the purview of congressional tax-writing committees. It includes "program" reviews of individual tax expenditures that may lead to the redesign or elimination of some that are deemed inefficient or outmoded. Currently available control techniques include placing ceilings or floors on eligibility for tax expenditure benefits, structuring tax expenditures as credits rather than exclusions or deductions, limiting the value of itemized deductions to the lowest marginal tax rate, and limiting the value of deductions and exclusions for high-income taxpayers. To promote debate on tax expenditures, additional information on them could also be highlighted using current processes. For instance, they could be merged into budget presentations with related outlay programs. The methods currently used to review and control tax expenditures also could be used in conjunction with the following two options that would alter somewhat the existing congressional procedures for overseeing tax expenditures. (See pp. 39-56.)
- Option 2: This option involves further integrating tax expenditures into budget rules. This could limit existing tax expenditures and encourage closer reviews of performance. One approach to further integration that GAO examined—placing an aggregate cap on forgone revenue—probably would not work because technical problems would be difficult to overcome. A second approach—in the form of a tax expenditure savings target—is feasible. Under this approach, in years that it wishes, Congress could specify a fixed amount of reduction in forgone revenue from tax expenditures in the budget resolution, which would be enforced through existing reconciliation processes. To promote greater public accountability, Congress could be prompted to explain in the annual budget resolution the reasons for its decision to either adopt or not adopt a savings target.

  Definitional and measurement problems, which are exacerbated by an aggregate cap, could be lessened substantially under a savings target. Technical problems would be reduced because—as is now the case in reconciliation—revenue estimates are required only for the subset of tax expenditure provisions under consideration. However, requiring a specific amount of base broadening through the budget process would involve more actors in tax policymaking, especially with respect to expanding the authority of the budget committees. (See pp. 57-70.)

- Option 3: Joint reviews of federal spending programs and related tax expenditures could be adopted to improve coordination and reduce overlap or duplication among outlay and tax expenditure programs. Joint reviews could be done in both the legislative and executive branches. Joint review of spending programs and related tax expenditures could be accomplished by having program committees hold joint hearings with tax committees. More formally, Congress could adopt sequential jurisdiction for tax expenditure subsidy "programs" or establish joint committees in functional areas. Because fewer jurisdictional hurdles would arise, the executive branch annual budget preparation process may offer a more expeditious opportunity to implement such reviews. (See pp. 71-92.)

Recent Legislation Promises Better Tax Expenditure Information

According to the Senate Committee on Governmental Affairs report on GPRA, OMB is expected to describe a framework for undertaking periodic analyses of the effects of tax expenditures in achieving performance goals in a May 1, 1997, report to the President and Congress. GPRA thus presents an opportunity to develop better information about tax expenditure performance and to use that information to stimulate discussion and oversight as well as to make determinations as to how the government can best achieve its objectives. OMB indicates that initial discussions have been held on developing output measures for key tax expenditures and that reviews of related tax expenditures and outlays will be done in the future. (See pp. 90-92.)

Recommendation to Congressional Committees

GAO recommends that the tax-writing committees explore, within the existing framework, opportunities to exercise more scrutiny over indirect "spending" through tax expenditures.

Matters for Congressional Consideration

Should Congress wish to view tax expenditure efforts in a broader context of the allocation of federal resources, it could consider the options of further integrating them into the budget process or instituting some form of integrated functional reviews.

Agency Recommendations

GAO makes several recommendations to the Director of the Office of Management and Budget intended to encourage a more informed debate about tax expenditures among executive and legislative policymakers and to stimulate joint review within the executive branch of tax expenditures and related spending programs. These recommendations should result in more informed decisions, by Congress and by the public, about the most appropriate means of achieving federal objectives. GAO envisions that in carrying out these recommendations, OMB would consult as appropriate with the Department of the Treasury and other federal agencies.

Agency Comments

In written comments on a draft of this report, OMB and Treasury's Office of Tax Analysis (OTA) expressed support for expanded federal review of tax expenditures by the executive branch or Congress. More specifically, OMB agreed, with certain caveats, that GAO's recommendations to it were reasonable and indicated that the recommendations were consistent with efforts OMB had already begun. Regarding the three options for improved oversight of tax expenditures, OMB agreed that improved information on tax expenditures was desirable and that integrated comparisons of outlay programs and related tax expenditures may provide useful insights. In its recently announced reorganization, OMB promised to undertake joint reviews of related spending and tax expenditure programs during upcoming budget cycles.

OMB and Treasury were concerned that the integration of tax expenditures into the budget process might not produce better outcomes than current processes. Treasury also expressed reservations about whether joint reviews of related spending and tax expenditure programs would provide the benefits anticipated.

OMB and Treasury's comments are discussed at the end of chapter 6. (See pp. 99-108.) OMB also suggested a number of useful technical changes, which were included.

GAO also obtained reactions on its draft report from JCT, the Congressional Budget Office, and two individuals knowledgeable about the issues discussed in the report. These organizations and individuals made observations on the report message, which are discussed at the end of chapter 6, and offered technical suggestions, which were included as appropriate.

Contents

Figures

Abbreviations

AMT	Alternative minimum tax
BEA	Budget Enforcement Act of 1990
CBO	Congressional Budget Office
CRS	Congressional Research Service
EITC	Earned income tax credit
GDP	Gross domestic product
GPRA	Government Performance and Results Act of 1993
GRH	Gramm-Rudman-Hollings
IRS	Internal Revenue Service
JCT	Joint Committee on Taxation
OBRA	Omnibus Budget Reconciliation Act of 1993
OMB	Office of Management and Budget
OTA	Office of Tax Analysis, Department of the Treasury
PAYGO	Pay-as-you-go
RCED	Resources, Community, and Economic Development Division
RIC	Regulated investment company

Introduction

The federal income tax has long been a tool for accomplishing objectives in addition to raising revenue. Tax expenditures are revenues forgone, or revenue losses,[1] due to preferential provisions of the federal tax laws, such as special exclusions, exemptions, deductions, credits, deferrals, or tax rates. Income tax expenditures fall under the jurisdiction of the House Ways and Means and Senate Finance Committees.[2]

The purposes of most tax expenditures include encouraging particular types of investment and providing economic relief to selected groups of taxpayers and consumers of tax-subsidized products (such as the alternative fuels production credit or housing financed by tax-exempt bonds). A few tax expenditures exist, at least in part, to adjust for differences in individuals' ability to pay taxes. For example, if two taxpayers have the same income, but one has a catastrophic illness and costly medical bills (or large casualty and theft losses), the other taxpayer is judged better able to pay taxes on his income. Some other tax expenditures may compensate for other provisions of the tax code. For example, advocates of capital gains tax cuts often defend the special treatment of capital gains income as, in part, offsetting assessment of taxes on the nominal, rather than the real, value of capital gains.

Aside from a few preferences provided to offset catastrophic losses and effects of other parts of the code, tax expenditures are primarily subsidies to encourage certain investment and consumption activities. It may be appropriate for the government to subsidize activities—for example, basic research and experimentation investment, health care consumption, or charitable giving—if they confer benefits on society as a whole beyond those they confer on the individual or corporation engaging in the activity. Here the operative principle is that a subsidy is needed when individuals or corporations, who do not capture all the benefits themselves, would undertake too little of the activity in the absence of a subsidy.[3]

[1]We use "losses" interchangeably with "revenues forgone" through tax expenditures throughout this report.

[2]The concept of tax expenditures extends beyond the income tax. Tax expenditure revenue losses for the estate and gift taxes, as well as for the income tax, are reported annually in the Budget. In addition, there are significant tax expenditures in both the payroll and excise tax systems. In this report, however, references to tax expenditures are limited to income tax expenditures unless otherwise noted.

[3]Some of the exceptions to normal tax law are tax disincentives that result in higher tax liabilities. Examples include limits on aggregate itemized deductions based on adjusted gross income (the Pease provision) and the individual alternative minimum tax, which removes a portion of income tax preference benefits from certain high-income taxpayers. Both are discussed in chapter 3.

Tax expenditures that exist to encourage investment have the effect of moderating the income tax base such that the income tax system takes on some characteristics of a consumption tax system. Many of the largest income tax expenditures encourage savings. For example, the tax expenditures related to pensions, social security benefits, and accelerated depreciation all encourage individuals or businesses to save and invest. To the extent that Congress addresses the size or growth of income tax expenditures and does so by restricting tax expenditures that encourage savings, it would need to consider the possible consequences for savings and investment. Of course, to the extent that current tax expenditures that encourage savings and investment could be made more efficient while also reducing their revenue cost, saving and investment incentives would be preserved.

The concept of listing tax expenditures (i.e., a tax expenditure "budget") was developed during the 1960s by Stanley Surrey, who became an assistant Treasury secretary under President Johnson, to identify and raise awareness about existing tax subsidies. The tax expenditure budget was designed to recognize the fact that many tax expenditures are very much like spending programs and to facilitate the comparison of tax incentives with these federal spending programs. Given a congressional decision to provide assistance to certain activities, Surrey asked, when should the assistance be furnished through an expenditure program and when through a tax program?[4] As Surrey and Paul R. McDaniel stated, "Those who are concerned with the growth in federal spending must also take into account the trend in tax spending."[5]

The term "tax expenditure" illustrates that government "spends" some of its revenues on subsidies to taxpayers by forgoing taxation of some of their income. If a taxpayer engages in particular types of investment and consumption activity, the federal government reduces the taxpayer's effective tax rate below the statutory rate by allowing some part of his or her income to remain untaxed or be taxed at a lower (statutory) rate.

Thus, tax expenditures interact with tax rates. When statutory rates are higher, the ability to exclude or deduct a certain portion of one's income is worth more, and, consequently, tax expenditures are larger. Likewise, when rates decrease, tax expenditures are smaller. Similarly, the value of tax expenditures like deductions or exclusions from income is greater for

[4]Stanley S. Surrey, Pathways to Tax Reform Cambridge: Harvard University Press, 1973, page 129.

[5]Stanley S. Surrey, and Paul R. McDaniel, Tax Expenditures Cambridge: Harvard University Press, 1985, page 6.

taxpayers in higher tax brackets than for those in lower brackets. Nevertheless, an individual taxpayer who does not change her or his investment or consumption patterns will pay more in tax after a tax rate increase despite the increase in the value of the deductions or exclusions.

Some observers believe that when Congress adjusts statutory tax rates it is aware that the value of tax expenditures also increases and that the statutory tax rate Congress adopts will be higher than the effective tax rate that many individuals will face. In the 1986 Tax Reform Act, Congress explicitly focused on eliminating and revising various tax expenditures so that statutory tax rates could be lowered without changing the net revenues of the federal government. If Congress again materially reduces the number or limits the scope of tax expenditures, it could also reduce the statutory tax rates so federal revenues would not change.

In keeping with Surrey's tax expenditure budget approach, the Joint Committee on Taxation (JCT) and the Department of the Treasury each annually compiles a list of income tax expenditures and estimates the government's revenue loss from each.[6] While the tax expenditures included in the JCT and Treasury lists are the same in most cases, there is still some disagreement about which provisions of the tax code should be part of the baseline structure of the income tax and which should be considered tax expenditures. For this and other reasons, the role that Surrey and others envisioned for the tax expenditure budget never materialized.[7] However, should Congress decide to control tax expenditure revenue losses directly, the tax expenditure list and its associated revenue loss estimates could take on added significance. (App. I discusses the issues pertaining to defining tax expenditures and estimating associated revenue losses.)

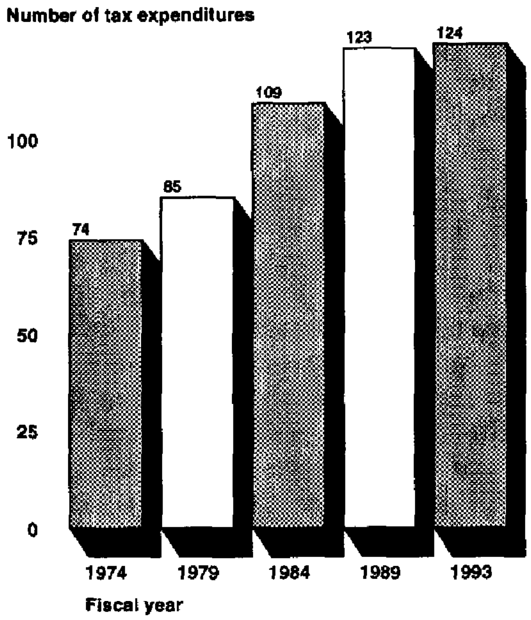
Preferential tax treatment for selected activities has existed since the beginning of the income tax in 1913. Once tax expenditures are enacted, they tend to remain in the tax code. Between 1913 and passage of the 1986 Tax Reform Act, only 13 tax expenditures had been permanently eliminated. The 1986 Tax Reform Act scaled back 30 tax expenditures directly and scaled back all but 4 tax credits indirectly through significant

[6]Treasury also includes estimates of outlay equivalents—the amount of federal spending that would be required to provide taxpayers with the same after-tax income that they receive through tax preferences.

[7]Thomas Neubig, "The Current Role of the Tax Expenditure Budget in U.S. Policymaking," in N. Bruce, ed., Tax Expenditures and Government Policy, Ontario, Canada: John Deutsch Institute, 1989, pages 244-245.

reductions in marginal tax rates.[8] Figure 1.1 shows the changes in the number of tax expenditures once JCT began listing them in 1974. In addition to reflecting newly enacted tax preferences, growth in the number of reported tax expenditures reflects increases in the number of tax code provisions JCT recognizes as giving rise to tax expenditures.

Figure 1.1: Number of Tax Expenditures Listed by JCT in Selected Fiscal Years



Source: JCT.

For 1993, JCT listed 124 separate exemptions and exclusions of income, deductions, credits, deferrals, and preferential tax rates as tax expenditures.[9]

The fact that a tax subsidy results in a loss, or even a growing loss, of federal revenues does not necessarily imply that the subsidy should be

[8]Ibid., page 242.

[9]Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 1993-1997, April 24, 1992. JCT's most recent listing (for fiscal years 1994-1998, printed April 22, 1993) added the exclusion of employer-provided transportation benefits and the exclusion of medical care and CHAMPUS health insurance for military dependents to its list of tax expenditures.

repealed or modified—just as the existence or growth of a direct outlay program does not imply that its funding should be stopped or changed. For activities the government chooses to subsidize, tax preferences are appropriate when they are more efficient, equitable, or effective than other means of funding the activities, such as direct outlay or credit programs.

The tax expenditure concept is not universally accepted. Some who object to the tax expenditure concept argue that the distinction between those tax-reduction provisions that are labeled tax expenditures and those that are not is arbitrary and that the very notion of labeling these provisions "expenditures" implies that all income could be taxed and, thus, that all income inherently belongs to the government.[10] Criticism of the tax expenditure concept essentially involves a debate over whether to view the income tax base as including the income that is not taxed as a consequence of tax expenditures or as excluding it.

Defenders of the tax expenditure concept say that it is simply a way of comparing different methods for achieving government objectives—primarily direct outlays and special provisions in the tax code—and is not meant to imply that the tax provisions should be changed. Consider, for example, targeted capital gains tax relief for investors in small businesses (enacted in the Omnibus Budget Reconciliation Act of 1993) compared to an alternative program such as below-market interest rate federal loans targeted to small businesses. Either could serve a similar purpose, and which method would be the better to use would need to be studied. To facilitate explicit trade-offs between direct outlays and tax expenditures, however, it makes sense to highlight all the resource allocations affected by government decisions. Budget symmetry can be achieved by reporting the implicit transfer delivered in the form of a tax incentive as tax revenues forgone, that is, as a tax expenditure.

We believe the tax expenditure concept, while not neatly defined or precisely measured, is a valid representation of one method that the federal government uses to allocate resources. The tax expenditure concept can be used, for example, to define that part of the income tax base that is excepted from taxation in order to carry out desired subsidies. The tax expenditure concept is intended to call attention to the fact that tax base erosion necessitates higher marginal tax rates on activities that remain taxable, and this can interfere with economic efficiency.

[10]John F. Witte, The Politics and Development of the Federal Income Tax, Madison, Wisconsin: University of Wisconsin Press, 1985, page 269.

Congress uses the tax expenditure concept, at least indirectly, in current budgeting practices. Budget Committees sometimes include recommended reductions to tax expenditures in reconciliation instructions, and pay-as-you-go (PAYGO) procedures restrict Congress' ability to expand existing tax expenditures unless offsetting funds can be raised. The tax committees consider trade-offs between reductions to existing tax expenditures and expansions of other tax expenditures and/or mandatory spending.

Tax expenditures provide benefits that are comparable to federal mandatory and discretionary spending programs.[11] For example, one goal that federal tax expenditures and discretionary outlays both seek to achieve is to increase the availability of housing for low-income persons. Thus, a credit is provided for taxpayers who invest in housing units that serve low-income tenants, while spending programs administered by the Department of Housing and Urban Development subsidize privately owned low- and moderate-income housing projects by insuring mortgages and by providing rental subsidies to low-income tenants.

From a budgetary perspective, tax expenditures are most comparable to those direct spending programs available as entitlements.[12] Eligibility for both tax expenditures and entitlements is written into law and further action is not required to provide these federal resources or subsidies. On August 4, 1993, an executive order created a budget review mechanism for entitlement programs. This order requires presidential recommendations to Congress if entitlement programs grow faster than projected. Tax expenditures are not covered by this requirement or a similar one.

The Government Performance and Results Act of 1993, which was signed into law on August 3, 1993, may enhance both the visibility and usefulness of information on tax expenditures and their likelihood of being reviewed. As discussed in the Senate Committee on Governmental Affairs' report on this act, overall federal government performance plans should include a schedule for periodically assessing the effects of specific tax expenditures

[11]One difference between spending directly versus providing a tax subsidy is that in the latter case, recipients generally are entities that earn income. Except for refundable tax credits, tax subsidies are only available to those with taxable income in some period.

[12]In its January 1992 report on The Economic and Budget Outlook, the Congressional Budget Office (CBO) defines entitlements as "programs that make payments to any person, business, or unit of government that seeks the payments and meets the criteria set in law. Congress currently controls these programs indirectly by defining eligibility and setting the benefit or payment rules, rather than directly through the annual appropriation process." Entitlement programs are categorized as mandatory spending in the budget.

in achieving performance goals.[13] The Committee expects that these annual performance reports would be used to assess the relationship and interactions between spending programs and related tax expenditures. The Director of the Office of Management and Budget (OMB) is to establish an appropriate framework for undertaking periodic analyses of the effects of tax expenditures in achieving performance goals and to describe this framework in a May 1, 1997, report to the president and Congress.

Objectives, Scope, and Methodology

In his request for this study, Representative William Coyne expressed concern that tax expenditures are not scrutinized as thoroughly as federal spending programs. Tax expenditures are only indirectly controlled under current budget processes. Representative Coyne noted that while budget processes limit discretionary spending, existing tax expenditures have generally not been subject to similar constraints.

In accordance with Representative Coyne's request, our objective was to examine whether tax expenditures need greater scrutiny and, if so, a range of alternatives for doing so.[14] Such scrutiny could result in increasing controls over tax expenditures and/or limiting their growth. Specifically, we were asked to look at the increase of revenue losses from tax expenditures and to examine the advantages and disadvantages of a range of alternatives for controlling them.

To address the question of increased tax expenditure revenue losses, we obtained estimates of these revenue losses from JCT and discussed them with JCT and Treasury's Office of Tax Analysis. We also reviewed existing studies that examined the increases in tax expenditures to determine how best to analyze tax expenditure data. We analyzed increases in estimated tax expenditure revenue losses over time. We used JCT's forecasts of tax expenditure magnitudes because they provide prospective estimates of tax expenditure revenue losses. In addition, we gathered and analyzed data on the increases in gross domestic product, federal outlays, and federal revenues to compare their growth with that of tax expenditures.

[13]Report of the Committee on Governmental Affairs, United States Senate, Government Performance and Results Act of 1993 (June 16, 1993, Report 103-58), pages 27-28.

[14]Representative Coyne's interest focused on income tax expenditures, and our report focuses on analyzing options for overseeing and controlling these tax expenditures. Tax expenditures exist for other taxes, such as estate and gift taxes, excise taxes, and payroll taxes. Although the options discussed in this report may be applicable generally to other types of tax expenditures, we have not assessed the issues related to doing so.

For fiscal year 1995, for the first time, estimates of future revenue losses were included in the income tax expenditure list published annually by the executive branch.[15] We used the fiscal year 1995 Budget data on tax expenditures to make comparisons with the results we obtained with JCT's 1993 tax expenditure data and with other measures, such as total federal revenues or spending, also contained in the 1995 Budget.

We looked at, but did not validate, the procedures JCT and Treasury use to identify tax expenditures and estimate the magnitudes of revenues forgone. We noted that each uses a somewhat different conceptual approach to identify the provisions of the tax code it labels "tax expenditures." Also, differences in their estimating models, macroeconomic assumptions, and choice of data cause their estimates of revenue losses from tax expenditures to differ somewhat. We also found that, by design, neither JCT nor Treasury devotes very many resources to estimating tax expenditure revenue losses. Tax expenditure estimates are a relatively low-priority activity because they are not routinely used for decisionmaking. Each organization devotes many more resources to making revenue estimates for proposed legislation than it does to estimating revenues forgone because of tax expenditures. JCT and Treasury tax expenditure revenue loss estimates are expected only to provide a general indication of the overall magnitude of federal effort in various budget functional categories.

To examine alternatives for increasing the scrutiny of tax expenditures, we reviewed an extensive amount of literature on the subject, including prior hearings on tax expenditures. We interviewed congressional, budgetary, and tax policy experts on the issues involved in various options to increase the scrutiny of tax expenditures and obtained their views on the desirability and practicality of these options. We also interviewed Internal Revenue Service (IRS) officials about how various options might affect taxpayers and the time required for IRS to reflect changes to tax expenditures when preparing forms and publications.

We did our work from May 1992 through August 1993 in accordance with generally accepted government auditing standards. The Department of the Treasury's Office of Tax Analysis and the Office of Management and Budget provided written comments on a draft of this report. These comments are presented in appendixes III and IV and are also summarized and evaluated at the end of chapter 6. We also obtained reactions to a draft

[15]See Budget of the United States Government, Fiscal Year 1995: Analytical Perspectives, Washington, D.C.: U.S. GPO, 1994.

of this report from JCT, the Congressional Budget Office, and two individuals with expertise related to the subject matter.

Greater Scrutiny of Tax Expenditures Is Desirable

As federal subsidies, tax expenditures deserve greater scrutiny for several reasons. A tax expenditure may not be the most effective way to provide federal assistance to producers and consumers. Yet all tax expenditures in effect are funded before any discretionary outlay programs because they form part of the revenue base from which appropriations are made. During 1993 budget deliberations, Congress and the executive branch focused attention on controlling entitlement spending, and the President issued an executive order intended to curb entitlement growth. Tax expenditures, which function similarly to entitlements and are treated like entitlements in the budget process, received less attention. Tax expenditure revenue losses are significant, approximating $400 billion in general magnitude. They also are expected to continue growing, but whether faster or slower than the real rate of growth in gross domestic product (GDP) is somewhat uncertain.[1]

Some Tax Expenditures May Not Be Efficient, Effective, or Equitable

In some cases, tax expenditures may not be the most efficient, effective, or equitable way to provide federal assistance to producers and consumers. Tax expenditures cause economic inefficiency if taxpayers consume or invest in otherwise unprofitable activities simply to reduce their taxes. Some tax expenditures increase the complexity of the tax system and the resources devoted to compliance. For some activities, it may be more effective (cost less) to provide a given level of government support outside, rather than within, the tax system. For other activities, a tax expenditure may be more effective than direct government payments at changing behavior. Tax expenditures can affect the horizontal and the vertical equity of the tax system.[2] Tax expenditures can make the tax system less equitable if taxpayers with similar incomes and expenses related to earning income pay different amounts of tax. Also, some tax expenditures benefit mainly taxpayers in upper income brackets because they are the taxpayers most likely to itemize and because the value of tax expenditures is generally greatest for those in higher tax brackets.

Efficiency of Tax Expenditures

Tax expenditures can cause economic inefficiency if taxpayers engage in activities they otherwise would not have chosen or unprofitable activities simply to reduce their taxes. Economic efficiency is also affected by the way tax expenditures may interact with tax rates. Some tax expenditures

[1]GDP is the value of all final goods and services produced within the borders of the United States in a given period of time.

[2]Horizontal equity in the tax system refers to whether taxpayers with similar incomes receive similar tax treatment, and vertical equity, to whether taxpayers with greater ability to pay, do pay more taxes.

may waste resources by complicating and discouraging compliance with the tax code.

Some observers and policymakers argue that tax preferences for extractive industries may encourage unprofitable and inefficient economic activity. For example, percentage depletion and the expensing of exploration and development costs for oil, gas, and other minerals allocate capital to drilling and mining that might be used more productively elsewhere. As we said in a 1990 report on oil taxes, the favorable tax treatment received by this industry provides incentives for relatively inefficient investments within the industry.[3] Some observers argue that the exclusion of employer-paid health insurance premiums from taxation as income to the beneficiary has distorted the demand for health insurance—causing overuse of the health care sector and possibly increasing health care costs.

Some policymakers argue that the continued provision of a tax preference for credit unions is inefficient as well as inequitable, since the same services now are fully taxed when provided by competing financial institutions. The retained earnings of credit unions and other mutual financial institutions were originally tax exempt, but Congress removed the exemption for savings and loans and mutual savings banks in 1951, deeming them more like profit-seeking entities than nonprofit mutual organizations. As most credit unions now resemble other financial institutions, some analysts believe they should receive the same tax treatment.[4] Supporters of the tax exemption, however, believe credit unions provide unique services that confer social benefits, justifying their exemption.

For those activities that merit a subsidy (where too little of the activity would otherwise be undertaken), subsidies through the tax code are one option. The gains and losses in economic efficiency from a particular tax subsidy would have to be compared with those of an equivalent direct subsidy (or government regulation or mandate) when a choice is made between these approaches.

The efficiency effects of tax expenditures extend to the way they may interact with tax rates. When tax rates decrease, economic efficiency improves to the extent that the incentive to engage in activities solely to

[3]Tax Policy: Additional Petroleum Production Tax Incentives Are of Questionable Merit (GAO/GGD-90-75, July 23, 1990), page 3.

[4]Credit Unions: Reforms for Ensuring Future Soundness (GAO/GGD-91-85, July 10, 1991), Appendix X.

shelter income is reduced. This was one of the concerns that led Congress to broaden the income tax base by reducing tax expenditures and lowering tax rates in the Tax Reform Act of 1986. This act repealed 14 tax expenditures and scaled back 16 others directly.

By complicating and discouraging compliance with the tax code, some tax expenditures may contribute to the inefficient use of private as well as government resources.[5] Taxpayers need to devote increasing amounts of resources to tax planning and computation in order to understand their tax obligations, pay the correct amount of tax, and yet ensure they do not pay more tax than necessary. Further, Congress has taken various steps that control the amount of benefit available through some individual tax expenditures or groups of them. These control mechanisms, such as the corporate and individual alternative minimum tax, may themselves make the tax system more complex, adding to the burden associated with income tax planning and compliance.

Effectiveness of Tax Expenditures

Tax expenditures may not be an effective way to achieve program goals when it is difficult to target them to those entities or activities that are meant to receive the benefits. Some tax expenditures may not be effective because they subsidize activities that would have been undertaken in the absence of the tax incentive. We have questioned, for example, the effectiveness of qualified mortgage bonds, which were designed to provide assistance for low- and moderate-income, first-time home buyers through below-market interest rate mortgage loans. We found that qualified mortgage bonds primarily helped buyers who could have afforded financing through a conventional mortgage and that this provision was costly and inefficient.[6] Nevertheless, this tax code provision was made permanent with the passage of the Omnibus Budget Reconciliation Act of 1993.

In addition, from a programmatic perspective the superiority of providing subsidies through the tax code has not been established for the vast

[5]Some tax expenditures simplify compliance, however, so their repeal would increase the administrative complexity of the tax system. Exclusions from taxation, such as employer-provided pension benefits, are an example because individuals do not have to report this information on their tax forms. The expensing of magazine circulation expenditures was adopted to address measurement difficulties. Without such a general treatment for circulation expenditures, it would be necessary to distinguish between expenditures for establishing or expanding circulation (which otherwise would have to be capitalized) and those for maintaining circulation (which would be deductible).

[6]Home Ownership: Mortgage Bonds Are Costly and Provide Little Assistance to Those in Need (GAO/RCED-88-111, Mar. 28, 1988); and Home Ownership: Targeting Assistance to Buyers Through Qualified Mortgage Bonds (GAO/RCED-88-190BR, June 27, 1988).

majority of tax expenditures, which may also overlap with other programs and activities financed by the government as well as unfunded federal mandates. It may cost less to provide a given level of government support outside, rather than within, the tax system. For example, many studies have shown that it would be less costly to pay interest subsidies directly to state and local governments than exempt state and local bonds from taxation. Why does providing the same level of subsidy cost the government more when it is accomplished through exempting taxpayers' bond earnings from taxation? For state and local bonds to be attractive to investors, the rate of interest on these bonds cannot fall below the after-tax rate that the lowest bracket holder of such bonds could obtain on a taxable bond of equal risk. Since the return on these bonds must be sufficient to attract the lowest bracket holder of such bonds, any investors with marginal tax rates higher than this (i.e., with more to gain from having their earnings exempted from taxation) will receive greater benefits. The revenue cost for the federal government, in the amount of this benefit to upper bracket (including corporate) investors, however, does not benefit the bond issuer. Thus, direct subsidies to issuers could reduce state and local borrowing costs at less federal cost than the existing provision.[7]

On the other hand, a tax expenditure may be a more effective way for the government to stimulate a given activity than is a direct payment. In many cases, the federal government bears the burden of designing and administering discretionary programs, and in some cases, the government would have to spend more than the estimated revenue loss to provide the equivalent total expenditure. For example, the itemized deduction for charitable contributions by taxpayers reduces federal tax revenues but may increase support of charitable activities even more. Hence, charitable organizations may gain more than Treasury loses, and each dollar forgone by Treasury generates more than a dollar in charitable giving. If, instead, the government offered a direct subsidy to charities, government spending could "crowd out" private contributions—seeing public support for charity, individuals might reduce their own. In this case, the government would have to spend more to provide the same level of aid.[8] According to Harvey Rosen, in general, whether a tax expenditure or a direct subsidy is effective depends on the amount of crowding out that takes place and on

[7] Victor Thuronyi, "Tax Expenditures: A Reassessment," Duke Law Journal, Vol. 1988, page 1,162.

[8] The charitable deduction also enables individuals to decide which charitable activities to support rather than requiring the government to make the decision.

how responsive the demand for the preferred item is with respect to its after-tax price.[9]

Tax Equity

Tax expenditures can contribute to a perception that the tax system is unfair since not all taxpayers qualify for tax expenditures, and, for those who do, the value of the tax benefit usually increases with taxable income. Tax expenditures can result in individuals with similar incomes and expenses paying differing amounts of tax depending on whether they engage in tax-subsidized activities. This different tax liability for individuals similarly situated is a violation of horizontal equity. Also, tax expenditures violate vertical equity if they cause the cost of government to be unfairly distributed among income classes. The disproportionate benefit of tax expenditures to higher income individuals may reduce the level of tax progressivity that the statutory tax rates alone would achieve.

Tax expenditures often disproportionately benefit higher income individuals. They create "upside-down" subsidies because they generally benefit only those persons with enough income to pay tax. Furthermore, those taxpayers who are eligible to itemize their deductions tend to have higher than average incomes. Finally, for exclusions as well as deductions, the value of the benefit increases with the recipient's marginal tax rate and, hence with his or her taxable income. For example, the exclusions from individual income taxes for pension contributions and earnings ($56.5 billion in 1993) and for employer contributions for medical insurance ($46.4 billion in 1993) are not restricted to those who itemize but nevertheless may benefit higher income taxpayers the most. This can result because higher income individuals are more likely to be covered and because workers in higher tax brackets receive larger tax subsidies for these benefits than other workers.

Another view is that tax expenditures are not particularly inequitable. Whether the disproportionate benefit of tax expenditures to higher income taxpayers is inequitable depends on the degree of progressivity, if any, one believes is appropriate for the income tax system or, more broadly, the degree to which net federal benefits should be greater for lower income individuals than for higher income individuals. The appropriate progressivity of the tax system and of net federal benefits to citizens are policy judgments that Congress must make. Both JCT and Treasury

[9]Harvey S. Rosen, Public Finance, 3rd edn., Homewood, IL: Irwin, 1992, page 392.

consider progressive tax rates to be part of the accepted individual income tax base.[10]

Because tax expenditures reduce the amount of taxes some taxpayers are required to pay, tax expenditures force overall statutory tax rates to be higher to obtain the same revenue.[11] Higher rates, in turn, may encourage interest groups to increase their efforts to obtain new tax expenditures. Beneficiaries of tax expenditures often strongly support these provisions, making it difficult to change or eliminate popular tax expenditures. Because each of these beneficiaries may gain a lot from a given tax expenditure, each may be motivated to organize to support the expenditure. In contrast, beneficiaries of reduced revenue losses—such as taxpayers in general—are a larger, more diffuse group. Since the group is so large, each member stands to gain little from the elimination of any one tax expenditure. Thus, taxpayers in general are unlikely to lobby against any tax expenditure with the same force as supporters of the expenditure. However, taxpayers are also unlikely to lobby against any direct outlay with the same force as the beneficiaries of the outlay lobby for it, although here, too, they provide the resources.

In some cases, a tax expenditure may be the most efficient or effective way to provide federal assistance yet may reduce tax equity, or vice versa. For example, a tax preference for medical insurance would be economically efficient if, absent a subsidy, too few workers would purchase such insurance and the tax preference encouraged workers to insure in a cost-effective manner. However, the tax expenditure for medical insurance may violate vertical equity to the extent that benefits disproportionately go to higher income taxpayers.

Tax Expenditures Have a Privileged Funding Status

Tax expenditures reduce the revenue base that is available for funding discretionary and mandatory spending programs. Because they essentially are fully funded before any discretionary programs are funded, existing tax expenditures in effect receive a higher priority. In addition, they are

[10]Both Treasury and JCT consider individual tax rates below the maximum statutory rate to be part of the income tax base, and both treat the alternative minimum tax as part of the baseline rate structure. Treasury considers corporate tax rates below the maximum statutory rate to be part of the base, but JCT recognizes and calculates a tax expenditure for the lower tax rates that apply to the first $10 million of corporate income.

[11]Although overall tax rates may be higher as a consequence of tax expenditures, Congress can choose to adjust rates for various taxpayer income classes as it determines to be most appropriate. Thus, Congress can make the tax system as progressive as it deems desirable despite the existence of tax expenditures.

not included in congressional back-stop spending controls (e.g., sequestration).[12]

Current budget rules have less effect on existing tax expenditures than on direct outlays. The Congressional Budget and Impoundment Control Act of 1974 (P.L. 93-344), as amended, requires that a list of tax expenditures be included in the budget. This list is purely informational and is presented as an appendix to the president's budget each year. Generally, budgetary decisions are not based on this list.

In 1990, the Budget Enforcement Act (BEA) subjected new tax expenditures and entitlement programs to pay-as-you-go (PAYGO) procedures.[13] BEA requires that revenue losses from new tax expenditures or spending increases from new entitlements (and initiatives that statutorily expand existing tax expenditures) be offset so there is no net increase in the deficit.[14] If offsets are not provided for new provisions, a sequester will be triggered, reducing funds for selected entitlement programs. However, unlike entitlements, tax expenditures are not subject to sequestration procedures under BEA. Tax expenditures or entitlements that are not changed statutorily, but which grow because more taxpayers take advantage of the provision, are not subject to BEA PAYGO procedures. (See ch. 4, pp. 58-60.)

Finally, under the current budget process, budget committees stipulate a floor, or minimum level, of revenues the tax committees must raise. The presence of a floor on revenues, in combination with reconciliation, could create pressure for Congress to scrutinize tax expenditures to lower or refrain from raising tax rates.[15] Under current budget rules, a reduction in tax expenditure revenue losses could be used to meet overall revenue targets or to fund increases in other tax expenditures or entitlement programs within the jurisdiction of the tax committees. Reductions in tax expenditures cannot be used to increase the amount available for

[12]Sequestration is the cancellation of budgetary resources, such as those provided through discretionary appropriations or direct spending laws.

[13]BEA restrictions apply to all tax expenditures, not just income tax expenditures. Thus, BEA restrictions apply also to excise, estate and gift, and payroll tax expenditures. The options we discuss in this report are analyzed only in relation to income tax expenditures.

[14]The effectiveness of BEA in controlling proposals with relatively small short-term but larger long-term revenue losses (beyond the 5-year period estimated for the budget) has been somewhat limited.

[15]Under the existing budget process, Congress adopts a budget resolution each year, which specifies (among other things) the appropriate level of federal revenues, i.e., the revenue floor, and the amount by which revenues must change, if any, to obtain the total level of federal revenues required.

discretionary programs. The possibility of substitution between tax preferences and tax rates can create some pressure to scrutinize tax expenditures, as it did when the Tax Reform Act of 1986 was adopted. Some policymakers, however, do not believe that revenue floors provide a sufficient incentive for scrutinizing tax expenditures because revenue floors have generally not resulted in significant changes to the level of tax expenditure revenue losses.

Budget Processes Do Not Require Regular Reviews of Tax Expenditures

Existing tax expenditures are not subject to systematic review and, thus, tend to be reviewed less frequently than discretionary outlay programs, which typically must be appropriated annually. Tax expenditures are described separately for each budget function; however, they are not included in the budget tables or added to the outlay totals. Although executive branch officials must judge how much money to request for discretionary programs each year, this is not true for tax expenditures.

Essentially, tax expenditures act as open-ended entitlement programs. Just as with entitlement programs, tax expenditures, once enacted, generally have been free to grow apace with changes in population, the economy, and taxpayer behavior and rarely have been repealed. Congress and the executive branch recently have considered new methods for exerting more scrutiny over entitlement program growth. For example, a 1993 executive order requires presidential recommendations to Congress if entitlement programs grow faster than projected.[16] Tax expenditures, however, have not received the same degree of organized attention.

This is not to say that tax expenditures are never reviewed. The tax committees sometimes have reviewed various tax expenditure provisions. This was particularly true for the relatively small number of tax expenditures that, until recently, had set expiration dates. These expenditures were reviewed in connection with their extensions. However, for the overwhelming majority of tax expenditures, a mechanism to prompt regular congressional reviews does not exist. Furthermore, occasions when revision of a wide array of these expenditures is considered, such as in the Tax Reform Act of 1986, have been rare.

Sometimes the relative obscurity of preferential tax code provisions may contribute to their being overlooked. Funding for narrow interests sometimes is camouflaged in coded jargon that can make it difficult to

[16]See Budget Control, Executive Order No. 12857, Aug. 4, 1993.

determine who benefits from a particular provision of the tax code. Some tax code provisions may be overlooked because the revenue loss attributable to each, although enduring, is small in any given year. Traditionally, JCT does not list preferential tax code provisions that result in very small revenue losses. For example, to be included in JCT's 1994 tax expenditure estimates, a tax expenditure had to have a projected total revenue loss of $50 million or more over the 5 fiscal years 1994 through 1998.

In some cases, experts have questioned whether a tax expenditure's objectives are still relevant to today's needs and conditions. According to testimony by Jane Gravelle, numerous currently existing tax expenditures were enacted in response to economic conditions that have long since changed.[17] One example she gave was the allowance for percentage depletion, which allows firms the more generous deduction associated with percentage depletion, as a substitute for recovering certain costs of acquiring mineral deposits. This specialist also stated that these existing allowances trace their roots to a temporary condition and the World War I effort, which are over 70 years in the past. (Table II.1 in app. II lists the enactment date of each tax expenditure.)

The value of reviewing the continued relevance of tax expenditures is manifested by the considerable revenues forgone and the pressing budget needs. In recent testimony, another tax policy analyst pointed out that the design of many tax expenditure policies, with built-in growth, essentially commits policymakers to enforce decisions made long ago while denying them the ability to rechannel, or reallocate, resources toward the needs of today.[18] Scrutiny of tax expenditures could include a review of each expenditure's effectiveness, equity, and efficiency. As this tax policy analyst stated, "Some tax expenditures are bad, and some are good, but all need to be examined rigorously on the same type of schedule that would apply to most other expenditures."[19]

Of the 124 tax expenditures JCT listed for 1993, about one-half were enacted before 1950. As shown in figure 2.1, the largest revenue losses stem from tax expenditures that either accompanied the enactment of the

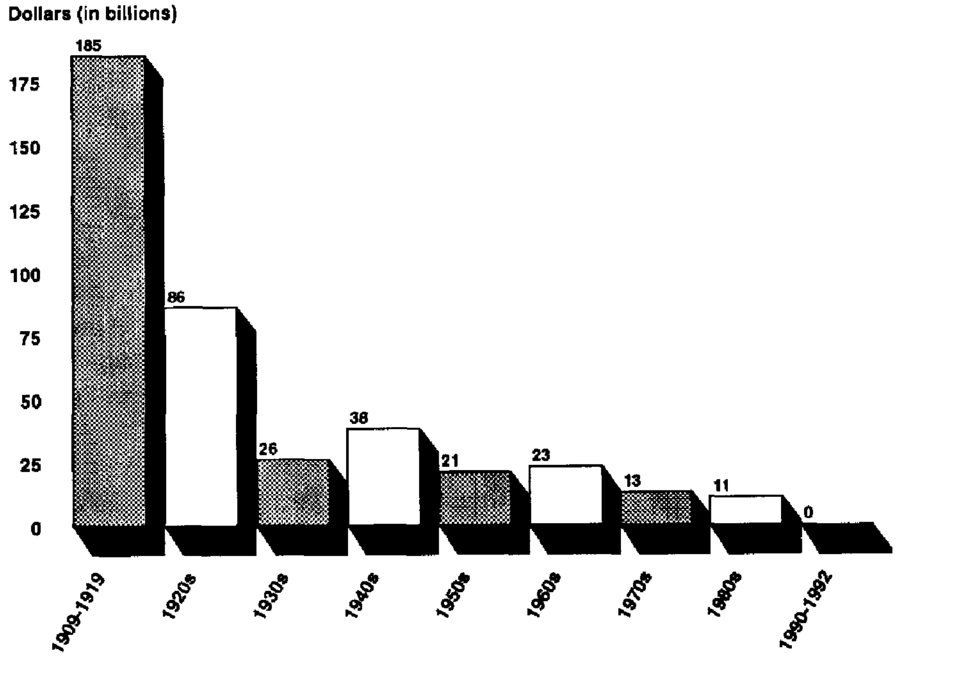
[17]Tax Expenditures, Statement of Jane G. Gravelle, Senior Specialist in Economic Policy, Congressional Research Service, before the Committee on the Budget, U.S. Senate, Feb. 3, 1993, pages 3-4.

[18]Tax Expenditures, Statement of C. Eugene Steuerle, Senior Fellow, the Urban Institute, before the Committee on the Budget, U.S. Senate, Feb. 3, 1993, page 5.

[19]Gene Steuerle, "How Much Will Tax Expenditures Grow?" Tax Notes, June 7, 1993, page 1422.

income tax or were enacted soon after.[20] Almost 85 percent of 1993 tax expenditure revenue losses are attributable to tax expenditures listed before 1950, and almost 50 percent of these revenue losses stem from tax expenditures enacted before 1920. In contrast, only 6 percent of the 1993 revenue losses are attributable to tax expenditures enacted since 1970.

Figure 2.1: Amounts of 1993 Total Tax Expenditure Revenue Losses Attributable to Years In Which the Tax Expenditures Were Enacted



Note: Total may not add to $402 billion due to rounding.

Sources: JCT, Estimates of Federal Tax Expenditures for Fiscal Years 1993-1997, April 24, 1992; CBO, Tax Expenditures: Budget Control Options and Five-Year Budget Projections for Fiscal Years 1983-1987, Washington, DC: U.S. GPO, Nov. 1982; U. S. Congress, Senate Committee on the Budget, Tax Expenditures: *Compendium of Background Material on Individual Provisions*, Washington, DC: U.S. GPO, Nov. 1992.

[20]Although the largest current revenue losses from tax expenditures come from those that either accompanied the enactment of the income tax or were enacted soon after, Congress has restricted some of these early tax expenditures. For instance, Congress has limited mortgage interest deductibility to $1 million of mortgage indebtedness. Similarly, Congress has restricted some more recently created tax expenditures, such as by better targeting mortgage revenue bond subsidies to low-income purchasers.

Revenue Losses From Tax Expenditures Are Significant

The amount and forecasted growth of aggregate tax expenditure revenue losses is determined by the tax law in effect at the time the forecast is made and the economic assumptions used when estimates are made. Changes to the tax code as a result of the Omnibus Budget Reconciliation Act of 1993 (OBRA) affected tax expenditure revenue losses. However, regardless of whether JCT's pre-OBRA 1993 estimates and economic assumptions or the fiscal year 1995 Budget's post-OBRA 1993 estimates and economic assumptions are used, aggregate tax expenditures are large. They also are expected to continue growing, but whether faster or slower than the real rate of growth in GDP is somewhat uncertain.

Neither JCT nor Treasury's Office of Tax Analysis adds tax expenditure estimates for individual tax expenditures to obtain an aggregate total. They do not because simply summing tax expenditures does not take into account possible interaction effects among the provisions. The revenue loss from each tax expenditure is estimated separately, assuming that the rest of the tax code remains unchanged. Because of interactions with other parts of the tax code, the revenue loss from the elimination of several tax expenditures together may be greater or smaller than the sum of the revenue losses for each tax expenditure measured alone. For example, the elimination of a tax expenditure that is an itemized deduction might cause more taxpayers to take the standard deduction instead of itemizing. However, the revenue loss estimate for this tax expenditure, and the other itemized deductions, does not reflect this significant interaction with the standard deduction. Eliminating several itemized deductions at the same time could cause significant numbers of taxpayers to take the standard deduction. Therefore, in this case, eliminating several itemized deductions at the same time would decrease revenue loss, but the amount would be less than the sum of the estimated revenue loss for each of the itemized deductions.

Furthermore, unlike revenue estimates made for specific tax proposals in legislation, tax expenditure revenue loss estimates do not take possible behavioral responses by taxpayers into account. The modification or elimination of tax expenditures can cause taxpayers to change their behavior, modifying first-round revenue effects. For example, when the deductibility of consumer interest was limited, some taxpayers may have shifted to interest-deductible home equity loans to continue funding consumption. This possible behavioral response would reduce the revenue gain from the elimination of the deduction for consumer interest.

Nevertheless, tax expenditure experts indicate that the aggregation of tax expenditure estimates suggests the order of magnitude of revenues forgone through tax expenditures in any one year. Aggregate tax expenditure totals may also permit policymakers to compare the relative levels of federal subsidy efforts, both those made through direct outlays and those made through the tax code. Accordingly, we summed JCT's individual tax expenditure estimates to obtain aggregate totals. We used these totals to make comparisons with other aggregate data for federal revenues and spending.

Our analysis is based on tax expenditure estimates annually published by JCT and on revenue and spending aggregates produced by the Congressional Budget Office (CBO). In particular, we relied on the most recent (April 1993) JCT estimates of tax expenditure revenue losses—for fiscal years 1994 through 1998 and on CBO's (January 1993) forecasts of GDP and federal outlays and revenues. These JCT and CBO data all rely on pre-OBRA 1993 tax law and are estimated on the basis of economic conditions prevailing at that time. Subsequent to this analysis, Treasury developed newer tax expenditure estimates and these were published by the Office of Management and Budget (OMB) in the fiscal year 1995 Budget. These estimates incorporate changes made to the tax code by OBRA 1993 and economic assumptions made in December 1993. We summed Treasury's estimates for individual tax expenditures for fiscal years 1994 through 1998 and compared them to other data from the Budget and to the JCT-derived estimates.

Regardless of the source used—whether JCT's pre-OBRA 1993 estimates and contemporaneous economic assumptions or the fiscal year 1995 Budget's post-OBRA 1993 estimates and economic assumptions—aggregate tax expenditures are large. Using JCT's estimates of 1993 tax expenditure revenue losses, we estimated that aggregate tax expenditures were about $402 billion, or 31 percent as large as the federal government's total direct outlays for 1993 (mandatory plus discretionary spending). On the basis of fiscal year 1995 Budget data, we calculated that 1993 tax expenditures totaled $391 billion.

On the basis of JCT data, we calculated that over the period from 1994 through 1998, tax expenditures could grow at an average annual real rate of about 4 percent, with 1998 revenue losses possibly amounting to $469 billion, in 1993 dollars. Using contemporaneous CBO data, this compares with projected real growth rates for GDP of about 2.6 percent, for revenues of about 3 percent, for mandatory spending of about 4 percent, and zero growth in discretionary spending.

Using the 1995 Budget data, we projected that tax expenditures could grow, in real terms, at an average annual rate of about 2 percent from fiscal year 1994 through 1998. For this period, the tax expenditure growth compares to the Budget's 2.7 percent projected growth in real GDP, 3 percent real growth in total revenue, and 4 and minus 3 percent average annual real growth for mandatory and discretionary spending, respectively.

The more recent OMB data seem to suggest that tax expenditure growth, although continuing, may be slower than that derived using JCT's 1993 data and also may be slower, rather than faster, than GDP growth. However, we did not analyze these differences because JCT's tax expenditure estimates forthcoming in the spring of 1994 will use newer economic assumptions and reflect the effects of OBRA 1993, as do the OMB estimates. Thus, the 1994 JCT estimates would provide a more comparable basis for such an analysis.

Furthermore, when trends in tax expenditure totals are looked at, care must be taken to consider the possible underlying causes. Trends in tax expenditure totals are affected by changes in tax rates and the number or generosity of tax preferences (as from OBRA 1993) and by changes in economic forecasts. In addition, an overall growth in aggregate tax expenditures may be due, in part, to rapid growth of a few large tax expenditures. For example, on the basis of recent OMB revenue loss estimates for the tax preference for health insurance, we forecast its real growth at on average about 6.2 percent annually between 1994 and 1998, assuming the tax code and the health care services delivery system remain unchanged.

Historically, aggregate tax expenditures have increased over time. On the basis of JCT revenue loss estimates, we calculated that real tax expenditure revenue losses have increased at an average annual rate of about 4 percent between 1974 and 1993. Aggregate estimated tax expenditure revenue losses have increased, in 1993 dollars, from about $226 billion in 1974 to about $402 billion in 1993. In comparison, CBO data show that the sum of real federal mandatory plus discretionary spending increased at 3 percent per year between 1974 and 1993 and average annual real growth in GDP was about 2.5 percent.

However, as can be seen in figure 2.2, aggregate tax expenditure growth has fluctuated. Although aggregate tax expenditure revenue losses declined following implementation of the Tax Reform Act of 1986, revenue losses are growing again. The level of tax expenditure revenue losses fell after 1986 primarily because of rate reductions, but also because of repeal and scale-backs of many tax expenditures.[21] In 1989, the level of aggregate real tax expenditure revenue losses was about 60 percent of the 1987 high. On the basis of 1993 JCT data, aggregate tax expenditure revenue losses of about $2.2 trillion (in 1993 dollars) are projected for the 5-year period 1994 through 1998 and by 1998 the level of tax expenditures could be about 84 percent of their 1987 high. The effect of the 1993 increase in tax rates plus economic recovery may push future estimates of the level of tax expenditures to or above their 1987 high.

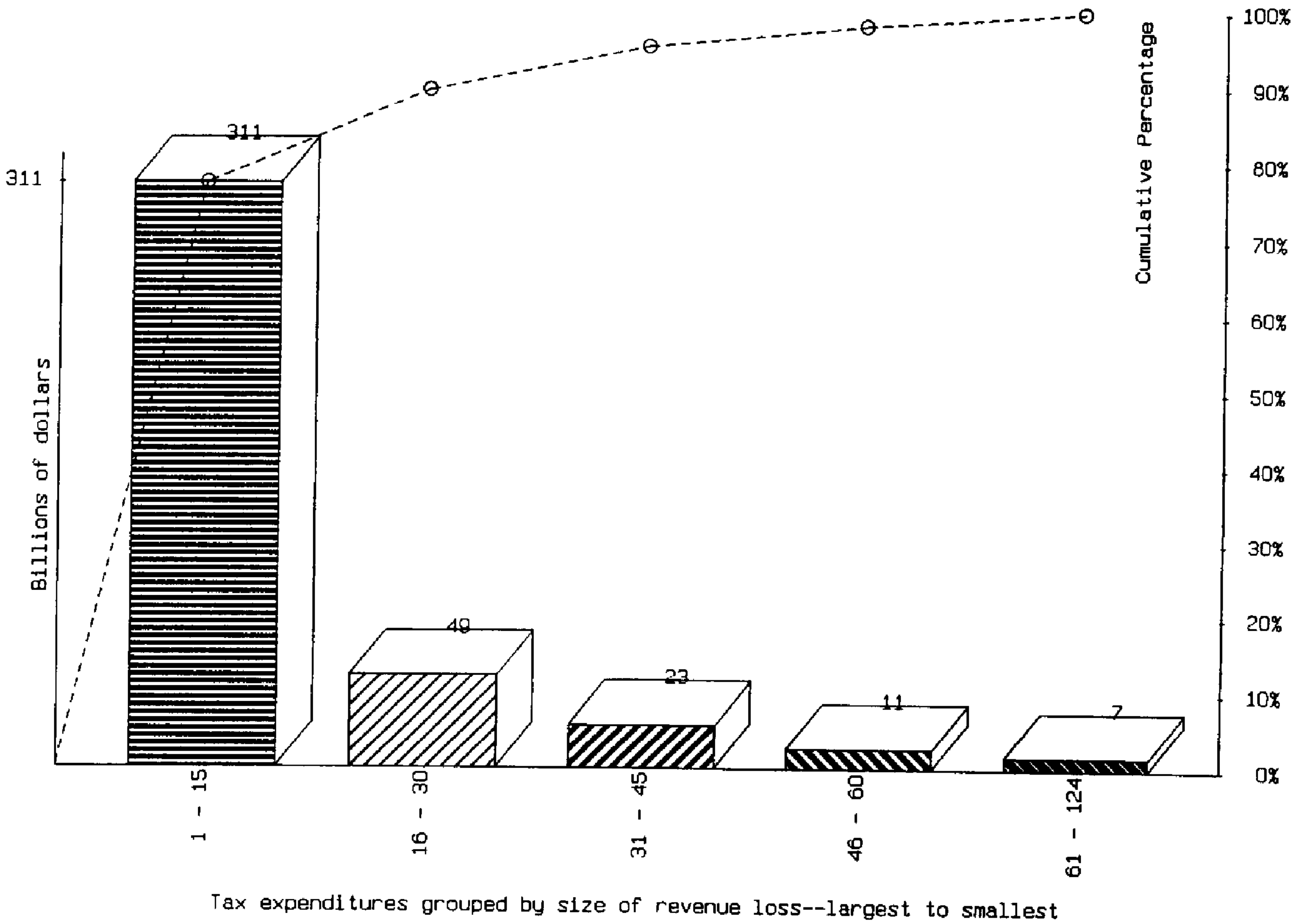
We found that the 15 largest tax expenditures, in terms of their 1993 estimated revenue losses, were responsible for $311 billion (or about 80 percent) of the aggregate tax expenditure revenue loss estimated for 1993, as shown in figure 2.3. (Table II.1 in app. II presents JCT's estimate of the revenue loss associated with each tax expenditure for 1993.)

[21]Tax expenditure magnitudes forecast by JCT peaked in 1987 because the 1987 estimate was made in 1986 based on the tax law existing in 1986 and thus did not include the changes enacted in the Tax Reform Act of 1986.

Figure 2.2: Sum of Tax Expenditure Revenue Loss Estimates Compared With Mandatory and Discretionary Spending Estimates, 1974 Through 1998

Sources: Tax expenditure estimates are based on data from JCT. Discretionary and mandatory spending estimates are from CBO, "The Economic and Budget Outlook: Fiscal Years 1994-1998," January 1993.

Figure 2.3: Tax Expenditures Ranked by Size, 1993



Note: Total may not add to $402 billion due to rounding.

Source: GAO calculations based on data from JCT, Estimates of Federal Tax Expenditures for Fiscal Years 1993-1997, April 24, 1992.

Current Methods Could Be Used to Further Limit the Growth of Tax Expenditures

Congress sometimes reviews individual tax expenditures to determine such things as whether their objectives are being achieved effectively. On the basis of these program reviews, Congress may leave a tax expenditure unaltered, eliminate it entirely, or modify it to promote its objectives in a more efficient or targeted manner.

Congress has used several techniques to limit the benefits that taxpayers may receive from individual tax expenditures or groups of them. Tax expenditure program reviews and the various control techniques fall under the aegis of the congressional tax committees and could be expanded to further control tax expenditure growth. These techniques can be used explicitly to reduce federal revenue losses, but, when applied to individual tax expenditures in conjunction with program reviews, these techniques can be used to improve the effectiveness and efficiency of tax expenditures.

Since careful oversight of any federally financed program, whether funded by discretionary outlays or tax expenditures, is desirable, if unlimited time and resources were available Congress would thoroughly examine each tax expenditure on a periodic basis, both as a part of the tax system and in terms of the objectives the expenditure serves. Such reviews could answer such questions as: What are the objectives of this expenditure? Are these objectives still valid? If so, are they being met in the best possible way? At what cost does this expenditure meet these objectives? How does it relate to other programs with similar objectives? However, since Congress faces both time and resource limits, the questions become whether, and how, feasible improvements can be made in the scrutiny Congress affords tax subsidies.

Congress has controlled the amount of revenue forgone for individual or groups of tax expenditures by adopting provisions to restrict the eligibility of taxpayers for these tax expenditures. However, to the extent that the estimated size and growth of tax expenditure revenue losses are considered undesirable, it may be that current tax expenditure program reviews and control techniques have not adequately monitored tax expenditures. If so, some way to increase the pressure to review and/or control tax expenditure growth may be needed. Providing more information on tax expenditures might better inform the public and Congress about tax expenditure provisions and might also increase pressure to reduce or limit some tax expenditures. Another way to encourage the examination of tax expenditures might be to require their periodic review (similar to a sunset process).[1] However, decreases in the overall growth of tax expenditures are likely only if substantial support for such a result emerges in Congress.

Controlling Tax Expenditures Individually or in Groups

Congress has controlled the amount of revenue forgone for certain individual tax expenditures by adopting provisions to restrict the eligibility of taxpayers for the tax expenditure. In some cases, these restrictions were adopted to better target a tax expenditure, while in other cases they were adopted primarily to reduce forgone revenues.[2] These restrictions can take many forms.

Controls on Individual Tax Expenditures

Controls on individual tax expenditures include ceilings on the amount of activity that qualifies, or the amount of benefit a taxpayer can receive from the tax expenditure in a given year. Controls can also include floors, which require the taxpayer to spend a certain amount on an activity before qualifying for the tax expenditure. Another alternative is to structure tax expenditures as credits, which can limit benefits for higher income taxpayers.[3]

Ceilings and Floors

An example of a ceiling is the $1 million cap on the total housing acquisition indebtedness for which a mortgage interest deduction can be claimed. An example of a floor is the floor on unreimbursed medical expenses paid by an individual.[4] Ceilings may limit claims by individual taxpayers, constraining revenue losses as a result, but they also reduce incentives for taxpayers to engage in the activity. Floors, on the other hand, retain the incentive, at least for those above the floor, but limit the number of taxpayers eligible for the tax expenditure, which may raise equity concerns in some cases.

[1]Two options for encouraging review of or control over tax expenditures that would alter somewhat current congressional processes are presented in chapters 4 and 5. If either option is implemented, congressional committees likely would employ methods or techniques similar to those described in this chapter when making specific changes to tax expenditures.

[2]By targeting, we mean refining the tax expenditure to help ensure benefits are provided to those Congress intends to subsidize. This could either increase or decrease the associated revenue losses, depending on the action taken.

[3]For example, a capped credit is available for child and dependent care services, providing a maximum benefit of $1,440 for two or more children. The credit rate is also reduced from 30 to 20 percent of expenses, depending on the taxpayer's income level.

[4]To the extent that these expenses exceed 7.5 percent of adjusted gross income, they may be itemized and deducted.

Under a ceiling, all taxpayers who receive benefits from a tax expenditure continue to receive benefits, but their benefits are reduced to a maximum amount for those that had activities exceeding the ceiling. Ceilings reduce the incentive effects of the tax expenditure by eliminating the marginal incentive for spending on the tax-favored activity above the ceiling. Taxpayers will not receive additional benefits for their behavior beyond the ceiling. For example, the alternative minimum tax (AMT) limits several tax expenditures for high-income taxpayers and, thus, may discourage these taxpayers from additional activity in these areas.

To the extent that ceilings affect upper income taxpayers, however, they limit the "upside down" distributional effects of some tax expenditures. (See ch. 2 for a discussion of the interrelationship between tax expenditures and income tax progressivity.) As long as it is not indexed to inflation, a fixed ceiling would increasingly limit a tax expenditure over time as inflation increased the amount spent on the targeted activity.

Floors maintain the marginal incentive effects (for those whose tax-favored activity exceeds the floor) while limiting the number of taxpayers eligible for the tax expenditure. Floors affect more taxpayers than ceilings do, because ceilings deny benefits only to those with relatively large amounts of spending on certain items, while floors deny benefits to all those whose spending is below specified levels and limit benefits received by all other eligible recipients. If the goal of an expenditure, such as the deductibility of charitable contributions, is to increase a particular type of spending, a floor may be preferable. A fixed-dollar floor (not indexed to inflation) would contribute to the growth of a tax expenditure in the presence of inflation because more and more taxpayers could exceed the floor over time. Alternatively, if the floor was related to income, as is sometimes the case, it would change in conjunction with changes in income.

A ceiling or floor mechanism could be used to limit groups of tax expenditures as well as individual ones. For example:

- A ceiling could be established as a maximum dollar amount that could be claimed, or as a percentage reduction in the total amount otherwise claimed, for a group of tax expenditures. A primary problem in implementing such an approach is the difficulty of applying a ceiling to exclusions because they generally are not reported on tax returns. A ceiling limiting a group of exclusions would be difficult to enforce, would impose additional reporting and record-keeping requirements, and would increase complexity. If a ceiling were placed on all or nearly all tax expenditures, additional problems would arise. (These are discussed under the budget options presented in ch. 4.)

- Placing a floor under all itemized deductions while refraining from raising the standard deduction is one method that could be used to limit increases in tax expenditures.[5] A fixed floor under itemized deductions would mean that some lower income taxpayers would no longer be able to itemize, and the "upside-down" distribution of tax benefits attributable to itemized deductions would remain or be exacerbated. Alternatively, a floor under the ratio of itemized deductions to adjusted gross income would mean that some taxpayers with few deductions in relation to income would no longer be able to itemize. Either type of floor would reduce the number of taxpayers who itemize, whereas establishing a ceiling to reduce, by a certain percentage, revenue losses from a group of tax expenditures might not. As with a ceiling, it would be difficult to apply a floor to exclusions. However, a floor might involve less complexity for taxpayers and IRS since the number of itemizers would be reduced.

Credits Can Be Used to Limit Revenue Losses

Structuring more tax expenditures as credits could reduce revenue losses by limiting benefits for higher income taxpayers. The value of a credit is not affected by marginal rates, so credits provide all taxpayers with the same maximum benefit per dollar of resources spent on the tax-preferred activity. For example, the investment tax credit for rehabilitation of historic structures encourages owners of historic buildings to renovate them. Taxpayers can qualify for a 20-percent tax credit if they substantially rehabilitate historic structures for use as residential or commercial property. In contrast, deductions, exemptions, and exclusions provide greater benefits to higher income taxpayers because their value is related to the taxpayer's marginal tax rate.

As stated by one economist, the choice between deductions and credits should depend at least in part on the purpose of the tax preference.[6] Deductions could be reserved for establishing net income or the net tax base (e.g., net of the costs of earning income), while credits could be used to subsidize activities. If the reason for the preference is to correct for the fact that some taxpayer condition or activity reduces ability to pay, a deduction may be appropriate. If its purpose is mainly to encourage

[5]Although raising the standard deduction would reduce aggregate tax expenditures, it could be very costly because raising the standard deduction could reduce government revenues significantly more than it reduced tax expenditures.

[6]Harvey S. Rosen, Public Finance, 3rd edn., Homewood, IL: Irwin, 1992, page 389.

certain behavior, a credit or a deduction may be appropriate depending on a taxpayer's response to the value of the tax incentive.

Suppose, for example, that taxpayers were offered a tax credit of 20 percent of their charitable contributions. The value of the incentive would be the same for high- and low-income taxpayers: 20 cents for each dollar contributed and all taxpayers with taxable income could claim the credit. But if high-income taxpayers responded by making more charitable contributions, whereas low-income taxpayers hardly increased their contributions, then the revenue forgone to provide the credit to low-income taxpayers was, in effect, wasted. A more efficient design in these circumstances would be to offer a deduction for charitable contributions. High-income taxpayers, with high marginal tax rates, would receive a larger incentive than low-income taxpayers with lower marginal tax rates. Federal revenue losses could be reduced because (1) only those low-income taxpayers who itemize their deductions would receive the deduction and (2) the value of the deduction would be lower for low-income taxpayers—15 percent under current tax law. The expected result would be more contributions made to charities for a given tax dollar forgone by offering a deduction rather than a tax credit. So encouraging a particular activity may be accomplished more efficiently either by offering a deduction or a credit, depending on whether the tax price responsiveness is substantially different or similar between high- and low-income taxpayers.[7]

Controls on Groups of Tax Expenditures

Congress has also enacted various controls on groups of tax expenditures. While adopted primarily to reduce revenue losses rather than to achieve better targeting, some of these controls may also improve the equity of these tax expenditures. As with controls over individual tax expenditures, several techniques have been used, including limits on aggregate itemized deductions based on adjusted gross income (the Pease provision), an alternative minimum tax that removes a portion of tax preference benefits from certain high-income taxpayers, and a volume cap on the amount of private-activity bonds issued by each state. Another example of a limitation on a group of tax expenditures—limiting the value of itemized

[7]There is some evidence that higher income households respond with more charitable giving, per dollar of available tax preference, than do lower income households. See Gerard M. Brannon, "Tax Expenditures and Income Distribution: A Theoretical Analysis of the Upside-Down Subsidy Argument," Aaron & Boskin, eds., The Economics of Taxation, Washington, DC: Brookings, 1980.

deductions to 15 percent (the lowest marginal tax rate)—is one of the revenue options discussed in CBO's 1993 report on reducing the deficit.[8]

The Pease Provision Limits Certain Deductions

The Pease provision limits deductions for high-income taxpayers by reducing itemized deductions by 3 percent of the excess of adjusted gross income over a certain amount.[9] In effect, this provision eliminates approximately 3 cents of itemized deductions for every dollar by which income exceeds a threshold, so when a taxpayer earns another dollar, taxable income rises by $1.03.

It is likely that at the time it was enacted, by reducing itemized deductions for higher income taxpayers, the Pease provision avoided more forceful opposition than raising rates or cutting individual tax expenditures would have involved. Some experts, however, question the wisdom of using limitations (such as the Pease provision) to raise revenues. They suggest that individual tax rates should have been directly increased instead, because such limitations increase the complexity of the tax system. These experts believe Congress should decide which activities (if any) merit subsidies by examining each tax expenditure on an individual basis.

The Alternative Minimum Tax (AMT) Limits Some Tax Expenditures Based on Taxpayers' Income Levels

The intent of the AMT is to make everyone who has high income pay at least some income tax. Given the many tax preferences available, a taxpayer can sometimes incur little or no tax liability despite such high income. The AMT is intended to ensure that each taxpayer pays some tax regardless of the tax incentives otherwise available.[10] The AMT amounts to a parallel tax system in addition to the regular tax system. Under the AMT, 1990 individual and corporate tax receipts were estimated to be almost $9 billion ($830 million and $8.1 billion, respectively) larger than they would have been in its absence. The AMT may significantly increase tax complexity for filers whose incomes could make them liable for AMT.

Both deferrals and excluded income (for example, the tax-exempt interest on private-activity bonds) are included in the lists of tax preferences that corporate and individual taxpayers must add back to taxable income to calculate the AMT. The AMT provides an example of a limit on exclusions, which could be more difficult to control than deductions.

[8]Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options, Feb. 1993, page 351.

[9]For 1993, the specified amount is $108,450 (or $54,225 if married and filing separately).

[10]The AMT provisions require the taxpayer to recalculate regular taxable income, leaving out or reducing tax preferences that can contribute to a disproportionately low tax bill. This recalculated income is then reduced by an AMT exemption and taxed.

Both the AMT approach and the Pease approach discussed above jointly reduce groups of tax preferences on the basis of the taxpayer's income level instead of reducing or refining tax expenditures singly. However, these techniques are aimed at such goals as obtaining additional revenues without engendering the political opposition that could have arisen from an attempt to raise tax rates. A similar outcome might be achieved with less administrative complexity by reducing tax preferences while at the same time eliminating the AMT.

Volume Caps Limit Issuance of Tax-Exempt Bonds

Volume caps treat tax expenditures more like appropriated programs than entitlements because the amount of benefits available is limited rather than open-ended. The Tax Reform Act of 1986 imposed a state-by-state volume cap on most tax-exempt private-activity bonds.[11] Therefore, the availability of private-activity bonds is similar to that for a closed grant program with budgetary control because the volume cap limits funding to a certain amount for each state each year. The cap on the amount of federal outlay for these tax-exempt bonds limits possible federal revenue losses while permitting flexibility for states to allocate funds among projects as they choose.[12]

Proposals to Limit the Value of Itemized Deductions

Some have proposed limiting the tax benefits of itemized deductions to a maximum rate, which could be accomplished using current congressional processes.[13] For example, Congress could limit the value of itemized deductions to the rate paid by those in the lowest tax bracket (currently 15 percent). Limiting deductions in such a manner would reduce the upside-down aspect of deductions benefitting taxpayers with higher marginal tax rates.

If Congress chose to limit the value of itemized deductions without reducing overall tax rates, the income tax would become more progressive because effective tax rates would increase for some middle- and upper income taxpayers. However, except during wartime, legislation broadening the base of the income tax usually also has included reductions in rates. Therefore, if Congress lowered tax rates simultaneously with limiting the value of tax expenditures, the overall

[11]The 1986 act combined two volume caps that existed under prior law (on mortgage revenue bonds and industrial development and student loan bonds). Beginning in 1988, the cap was set at $50 per capita or $150 million per state each year, whichever is greater.

[12]The tax credit available to developers of low-income rental housing also has a volume limit. Each state is entitled to issue credits up to a certain amount in any given year, based on the number of its residents. Developers must apply to the state housing authority for a credit allocation.

[13]Congressional Budget Office, 1993 Spending and Revenue Options; Senators Bradley and Gephardt's 1982 proposal; and recent proposals to limit the top rate for tax deductions to 31 percent.

effect on the progressivity of the tax code would depend on the rates ultimately adopted. Furthermore, depending on how any increased tax revenues were spent, government's overall spending effort might become more progressive. Whether this is desirable depends on one's judgment about how progressive, if at all, the federal tax and spending systems should be. In addition, it might not be desirable to limit revenue losses associated with itemized deductions that in part adjust for differences in ability to pay taxes. For example, some might think it inequitable to limit itemized deductions for catastrophic medical bills and for large casualty and theft losses. Finally, limiting the tax benefits of itemized deductions alone does not affect other types of tax expenditures, such as exclusions and exemptions.

Advantages and Disadvantages in Using Current Methods and Control Techniques

As with the other options we reviewed, current techniques to restrict tax expenditures have advantages and disadvantages. Using current techniques would not require changes in current budget processes or committee jurisdictions. Maintaining current jurisdictions provides the tax committees, which have expertise in the tax system, the flexibility to consider issues associated with tax expenditures, such as balancing taxpayer burden and federal revenue interests. However, if the revenue loss from aggregate tax expenditures is considered to be too high, this suggests that the use of existing techniques has not been successful at controlling this growth. Many of those we interviewed suggested that existing techniques would be adequate to control tax expenditure revenue losses if those in positions to use them will choose to do so.

Use of Current Methods and Techniques Has Advantages

An advantage of modifying tax expenditures individually is that alterations can be tailored to individual tax expenditures so that those deemed effective can be protected or increased. Use of current methods was the option most of the experts we interviewed preferred because it allows decisions to be made on the basis of the specific merits of each tax expenditure. However, even when particular tax preferences are deemed unacceptable on efficiency or equity grounds, such reviews can encounter significant political resistance from beneficiaries, causing decisionmakers to have trouble eliminating them.

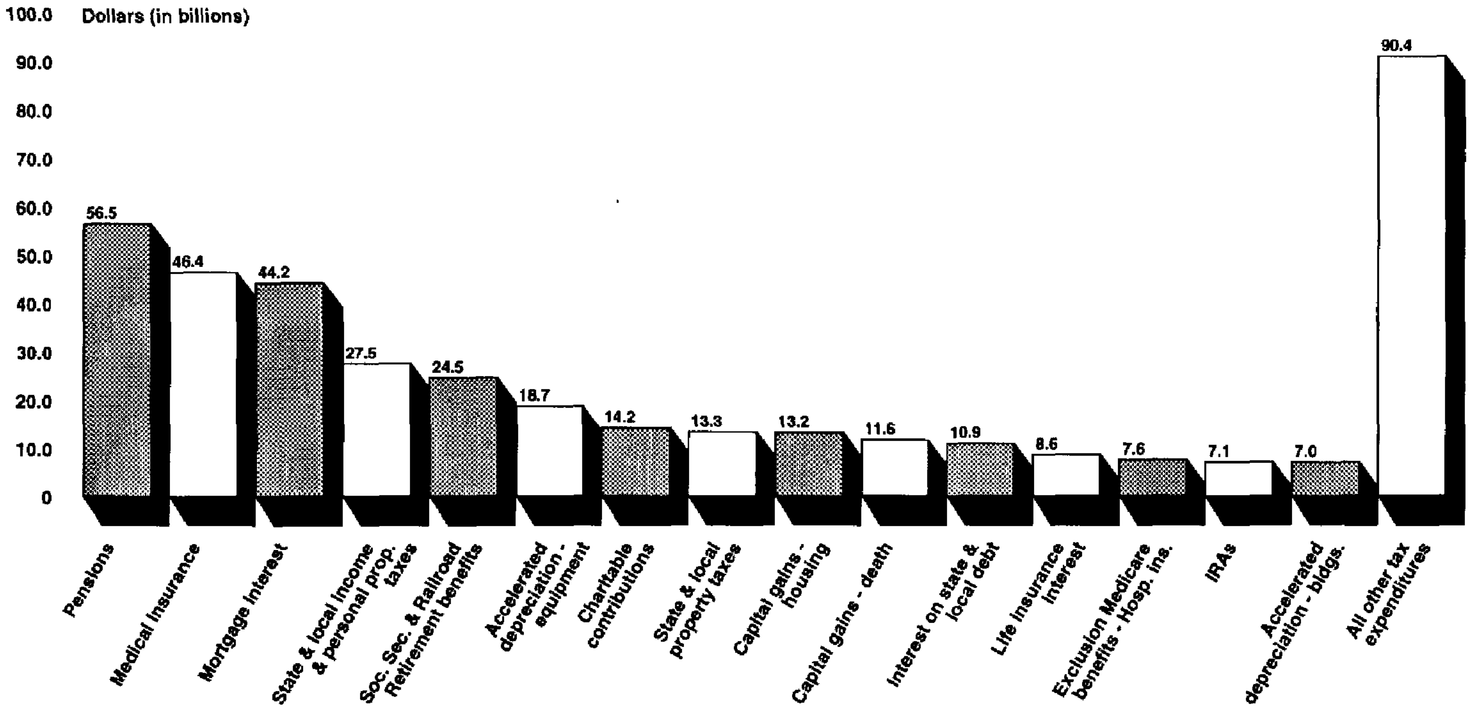
Making specific judgments on the merits of an individual tax expenditure can provide some control. Tax expenditures do not all function in the same fashion, and each may have different economic effects. Scrutinizing each tax expenditure can help Congress determine whether that tax expenditure is the best way of achieving a given goal and could also help Congress determine the optimal method to use in limiting the growth of that particular expenditure if appropriate. Relevant questions that should be considered include: Are the costs of achieving the goal minimized when it is accomplished through a tax expenditure (versus federal regulations, mandates, or direct outlays)? Are the benefits from a tax expenditure greater than its costs? Do benefits net of costs for accomplishing a goal through the tax code exceed net benefits from other approaches?

Restrictions have been adopted to better target a specific tax expenditure. For example, changes were made to the definition of expenditures under the research and experimentation tax credit by the Tax Reform Act of 1986,[14] and other changes by the Omnibus Budget Reconciliation Act of 1989, with the intent of better targeting the credit. These changes were adopted in part to increase the effectiveness of the credit in stimulating spending on research activities and, thus, increase the efficiency of resource allocation.

Grouping tax expenditures for control, rather than focusing on individual tax expenditures, may make it easier to limit revenue losses. A smaller decrease from each of several tax expenditures might encounter less opposition than a more drastic curtailment of benefits from one tax expenditure. Slightly reducing benefits from a group of tax expenditures would also enable Congress to continue promoting the objectives of these tax expenditures, but to a more limited extent. Figure 3.1 illustrates the revenue losses associated with the largest 15 tax expenditures. These 15 tax expenditures represent about 80 percent of total estimated tax expenditure revenue losses in 1993. The largest three tax expenditures (exclusions of employer pension plan contributions and earnings and of employer contributions for medical insurance premiums and medical care, and the deduction for mortgage interest on owner-occupied homes) represent about 37 percent of all revenue losses from tax expenditures in 1993. If it wanted, Congress could examine some or all of these tax expenditures and perhaps significantly reduce revenue losses by reducing their growth through better targeting their benefits.

[14]Tax Policy and Administration: The Research Tax Credit Has Stimulated Some Additional Research Spending (GAO/GGD-89-114, Sept. 5, 1989).

Figure 3.1: The 15 Largest Tax Expenditures, 1993



Source: JCT, Estimates of Federal Tax Expenditures for Fiscal Years 1993-1997, April 24, 1992.

To examine the size and growth of tax preferences overall, it is important to look at those that are largest and growing fastest. Using JCT estimates from its latest tax expenditure forecast, we calculated average annual real growth rates over the next 5 years—1994-1998—for the 15 largest tax expenditures.[15] As shown in table 3.1, the 15 largest tax expenditures in 1993, both individual and corporate, are expected to increase at different real rates. Between 1994 and 1998, at least 11 of the 15 largest tax expenditures were projected to increase faster than CBO's estimated 2.6 percent increase in GDP. The largest tax expenditure in 1993—employer pension plan contributions and earnings—could increase at an annual average rate of 3 percent in real terms during this period; the exclusion for

[15]We present these data on the largest tax expenditures for illustrative purposes. The results are based on pre-OBRA 1993 JCT estimates, and newer estimates may be different because of OBRA 1993 and changes in economic assumptions.

medical insurance, at 5 percent; and the deduction for mortgage interest, at 3 percent. In comparison, again on the basis of pre-OBRA 1993 estimates, CBO estimated that federal income tax revenues will increase annually on average at about 3 percent and GDP at about 2.6 percent, in real terms, during this period.

Table 3.1: Growth Rates of the 15 Largest Tax Expenditures (in 1993 Dollars)[a]

	Corporate			Individual		
	Billions		Percent	Billions		Percent
Tax expenditure	1993 Revenue loss	1994-98 Real revenue loss	1994-98 Average annual real increase	1993 Revenue loss	1994-98 Real revenue loss	1994-98 Average annual real increase
Net exclusion of pension contributions and earnings	b	b	b	$57	$286	3%
Exclusion of employer contributions for medical insurance premiums and medical care	b	b	b	46	199	5
Deductibility of mortgage interest on owner-occupied residences	b	b	b	44	233	3
Deduction of nonbusiness state and local government income and personal property taxes	b	b	b	28	136	4
Exclusion of untaxed Social Security and Railroad Retirement benefits	b	b	b	25	141	2
Depreciation on equipment in excess of alternative depreciation system	$15	$75	1%	4	22	2
Deductibility of charitable contributions (other than for education and health)	1	2	–3	13	67	3
Deductibility of property tax on owner-occupied homes	b	b	b	13	71	3
Deferral of capital gains on sales of principal residences	b	b	b	13	71	1
Exclusion of capital gains at death	b	b	b	12	67	5
Exclusion of interest on public purpose state and local government debt	1	20	7	10	60	7
Exclusion of investment income on life insurance and annuity contracts	c	4	9	8	42	7
Exclusion of untaxed Medicare benefits: Hospital Insurance	b	b	b	8	46	8
Exclusion of individual retirement plans (contributions and earnings)	b	b	b	7	32	4
Depreciation on buildings other than rental housing in excess of alternative depreciation system	5	24	–2	2	9	–1
All individual and corporate tax expenditures[d]	47	277	2	354	1,867	4
Gross domestic product: 1994-98 average annual real increase						2.6

(Table notes on next page)

[a]These are the 15 largest tax expenditures in 1993.

[b]Not applicable.

[c]Less than $50 million.

[d]1993 tax expenditure totals may not add to $402 billion because of rounding.

Source: Tax expenditure estimates are from JCT, and GDP estimates are from CBO. Both estimates were made on the basis of data available as of December 31, 1992.

Disadvantages of Using Current Methods and Techniques

Current methods have not necessarily reduced aggregate tax expenditure losses. These methods give recipients of tax expenditure benefits higher priority in the allocation of federal benefits than those whose benefits are derived from directly appropriated funds. This has not led to routine review of tax expenditures, such as discretionary outlays face under the annual appropriation process. Furthermore, piecemeal removal of inequitable, inefficient, or ineffective tax expenditures presents technical problems. Eliminating a tax expenditure will likely not result in raising an amount equal to the tax expenditure's published revenue loss. Curtailing benefits from or eliminating one or a few tax expenditures, while leaving others unchanged, will likely cause taxpayers to switch at least some of their spending to the still-subsidized activities.[16]

Using spending programs to achieve the same federal policy objectives may not be considered under current processes, leaving conflicts and redundancies between existing spending programs and tax expenditures. For example, conflicts exist between the federal effort to clean up lead, uranium, and asbestos in the environment and some existing tax expenditures. Federal outlays for cleaning up these substances coexist with income tax expenditures that subsidize their production. An example of overlapping programs is the federal effort to assist in the construction of low-income rental housing. The Public Housing Development Program provides direct grants from the Department of Housing and Urban Development to develop public housing. Similarly, the low-income housing tax credit can be used to provide funds for such development.

Many tax expenditures have existed for decades. Almost 85 percent of estimated 1993 tax expenditure revenue losses are from expenditures that were enacted before 1950. The exclusion of benefits and allowances to

[16]To estimate the net effect on federal revenue of any modification of the tax code, all taxpayer behavioral changes resulting from the modification, both direct and indirect, must be modeled.

armed forces personnel, for example, evolved from a 1925 court decision.[17] For some of these benefits, the rationale was a specific desire to reduce tax burdens of military personnel during wartime. Although the origins of some tax expenditures may bear little relationship to today's conditions, these tax expenditures persist either through popular support or inertia or because of their obscurity within the tax code and, under the status quo, will remain in effect.

If Congress' overall goal in increasing scrutiny of tax expenditures is to reduce revenue losses, focusing on individual tax expenditures using existing techniques may not ensure that the growth of tax expenditure revenue losses would decrease. Because examining tax expenditures on an individual basis generally focuses on program objectives, revenue savings might or might not occur. Better targeting also would not necessarily result in smaller revenue losses because it could involve providing greater per capita benefits or targeting more taxpayers for benefits. In addition, if one tax expenditure is made more restrictive, taxpayers may increase their spending on activities subsidized through other tax expenditures. Thus, reducing a tax expenditure may not result in raising an amount equal to the tax expenditure revenue loss figure.

Focusing on groups of tax expenditures using existing techniques also has some drawbacks. Groups of tax expenditures could include some that are efficient as well as inefficient. Placing a ceiling on all the tax expenditures in a group could adversely affect their incentive effects. This would not necessarily be desirable if some of these tax expenditures were efficient.

In addition, tax expenditures that are more easily controlled, such as those currently reported on tax forms, may be more likely to be grouped and placed under limits. Tax expenditures that are not currently reported on tax forms could continue unaffected. Of the 45 income tax expenditures (29 individual, 6 corporate, and 10 both) that had 1993 estimated revenue losses in excess of $1 billion, 20 are either deductions, credits, or deferrals. The remaining 25 are exclusions. Exclusions, which generally are not reported on tax forms, represent over one-half (56 percent, or $214 billion) of the 1993 estimated revenue losses from tax expenditures with revenue losses in excess of $1 billion.

Enhanced Impetus to Use Existing Methods

Congress has taken steps to increase scrutiny of tax expenditures in the Government Performance and Results Act of 1993 (GPRA). According to the

[17] U.S. Court of Claims, Jones v. United States, 60 Ct. Cl. 552 (1925).

Senate Committee on Governmental Affairs' June 1993 report on GPRA, the intent of this act as it relates to tax expenditures is to direct the executive branch to (1) make more information available about tax expenditures and (2) conduct periodic reviews of tax expenditures.[18] Similarly, Congress may want to consider ways to provide more institutional impetus to increase the scrutiny of tax expenditures within the legislative branch. These techniques could correspond to executive branch efforts and resemble oversight hearings held for programs that are funded through the annual appropriation process.

More Information About Tax Expenditures Is Needed

Many of those we interviewed thought that more information should be made available about tax expenditures. Such information could include data on tax expenditures' effectiveness, distributional equity, and economic efficiency in achieving their objectives. For example, although tax subsidies for pensions, medical care, and owner-occupied housing have encouraged some taxpayers to substitute these for other forms of savings and consumption, it is unclear what the net increase in savings and consumption has been per dollar of revenue expended. Thus, it is difficult to judge the appropriateness of tax subsidies in achieving federal objectives without further information.

Greater information might make policymakers and the public more aware of the consequences of tax expenditures and their limitations, thus encouraging a more informed debate. Such information can be developed as part of the budget process and included in the president's Budget. According to the Senate Committee on Governmental Affairs' report on GPRA, information on agency program goals and key indicators for both outlays and tax expenditures is to be developed. Agencies would assess the effects of tax expenditures in achieving performance goals. Others, such as JCT, might also provide expanded information. Providing more information on the revenue losses associated with tax expenditures, the benefits provided, and a cost-benefit analysis would require that resources be devoted to this work. Improving the estimates of tax expenditure revenue losses by using a methodology more like that used for revenue estimates would require considering the behavioral effects of tax expenditures in addition to taking into account interactions between tax expenditures and other parts of the tax code.

[18]Report of the Committee on Governmental Affairs, United States Senate, Government Performance and Results Act of 1993 (June 16, 1993, Report 103-58).

Currently, sufficient resources may not be devoted to listing and estimating tax expenditures. There are many tax preferences with small revenue losses that are not listed anywhere and for which no revenue loss estimates are made, so that a truly comprehensive tax expenditure list does not exist. This lack of information may deter Congress from examining these tax expenditures. One tax policy expert has noted that while each year's budget contains detailed expenditure estimates for the changes in direct outlays proposed (by department, agency, and function), revenue loss estimates for tax expenditures are based on the tax code already enacted. Thus, revenue loss estimates do not include the proposed changes to tax rates or to tax preferences.[19] Not incorporating proposed tax law changes until the following year (after the budget has been adopted) means the budget debate each year lacks complete information.[20]

Presenting information in the president's annual budget that shows functional area totals along with amounts to be spent via both tax expenditures and outlays could increase awareness about total federal funding efforts in each area. (An example of such a presentation is shown in table 5.1 in ch. 5.) Information presented could be expanded when such information becomes available to include estimates of benefits net of costs for accomplishing various goals through direct outlays versus through the tax code to indicate the relative efficiency of alternative approaches.

In addition, tax expenditures that defer taxes and in effect provide an interest-free "loan" to taxpayers could be shown in the budget's special analysis of debt programs to give a more complete picture of the total lending effort of the federal government. For example, the depreciation on equipment in excess of the alternative depreciation system is the largest corporate tax expenditure listed by JCT, amounting to about $15 billion in 1993. Another alternative could be to retain tax preferences involving deferrals in the tax expenditure section of the budget while reporting the present value of revenues forgone through them. A table of present value estimates of revenue losses for tax expenditures involving tax deferrals was introduced in the fiscal year 1995 budget.

[19]Although each year's budget does provide revenue estimates for proposed changes to the tax code in a separate revenue proposals section, tax expenditure revenue loss estimates are made each year only for current law, not for the tax law being proposed.

[20]Gene Steuerle, "Economic Perspective: How Much Will Tax Expenditures Grow?" Tax Notes, June 7, 1993, pages 1,421-1,422.

Periodic Review of Tax Expenditures May Be Helpful

Requiring periodic reviews of tax expenditures is another approach that may encourage scrutiny of tax expenditures. OMB has been charged under GPRA with developing a framework for periodic review of tax expenditures. Congress may want to use this framework for its review and oversight of tax expenditures as well, making use of information developed by the executive branch on the effects of tax expenditures.

To the extent that periodic reviews show that specific tax expenditures are not efficient, effective, or equitable, these tax expenditures might be eliminated or redesigned, perhaps at a lower cost in forgone revenues. It is not entirely clear, however, whether periodic reviews done in the past have resulted in much change. Some experts believe that periodic reviews have resulted in improvements to individual tax expenditures. For example, changes made to better target the research and experimentation tax credit may have resulted from the need to periodically renew this tax expenditure. More congressional consideration may have been given to the expiring provisions[21] than to other tax expenditures because their design included sunsetting. Others we interviewed, however, suggested that periodic reviews can become a pro forma exercise resulting in few changes. They believe that if the political will to change a particular provision does not exist, a requirement to review it will be ineffective.

Currently, sunsets are built into some tax expenditures (which are relatively small in terms of revenue losses). These tax expenditures expire unless Congress takes specific action to extend them. Sunsetting tax expenditures also makes their treatment more similar to those appropriated programs that must be renewed each year. Tax expenditure benefits are more certain if they are not subject to sunsetting, however, because taxpayers can plan their long-range activities with more certainty about whether the sunset will be extended or not.

Under the budget rules requiring that legislative proposals be "revenue neutral,"[22] the tax committees require sponsors to find revenues to offset the costs of extending expiring tax expenditure provisions. This requirement, which could be difficult to meet, might provide the best test

[21]These provisions are 12 tax expenditures that were set to expire in June 1992. Most were extended by the Omnibus Budget Reconciliation Act of 1993. They are tax exemption for qualified mortgage revenue bonds, targeted jobs tax credit, low-income housing tax credit, qualified research tax credit, rules for allocation and apportionment of research expenses, employer-provided educational assistance, exclusion for group legal services benefits, deduction for health insurance costs of self-employed individuals, tax exemption for qualified small-issue manufacturing bonds, business energy tax credits for solar and geothermal property, tax credit for orphan drug clinical testing programs, and minimum tax exception for gifts of tangible personal property.

[22]For a more detailed description of the Budget Enforcement Act of 1990 provisions, see chapter 4.

of a tax expenditure's real worth. Because the two tax committees would have responsibility for review of all tax expenditures, as well as all other tax matters, periodic review requiring re-enactment of provisions Congress deems necessary could be very burdensome, and designing such a system would have to be done carefully.

A schedule for periodically reviewing each tax expenditure could add some regularity to congressional reviews of tax expenditures, although such a schedule might not lead to any reforms. Because some tax incentives need to be fairly long term in order to be effective, the time period between reviews of these tax expenditures should be several years.[23] For instance, an investment tax credit would need to last a number of years to have a significant effect on the nation's capital stock. The tax committees could decide what tax expenditures to sunset and how often, or Congress could develop a general rule to ensure that all tax expenditures are reviewed periodically.

[23]Alternatively, "grandfathering" could be provided for assets purchased under tax-preferred regimes. If Congress provides a transition period for changes to take effect, taxpayers who based their decisions on tax laws in force at that time are not significantly harmed by later changes. Grandfathering can be controversial, however, due to issues such as generational equity and the fact that it would limit the revenues Congress could obtain in early years.

Options for Integrating Tax Expenditures More Fully Into the Congressional Budget Process

To provide a structure that would more directly focus attention on controlling tax expenditure growth, Congress could place these expenditures under further budgetary controls. The budget process currently provides policymakers with some information about the costs of tax expenditures. However, although new expenditures and changes to existing tax expenditures are required to meet the PAYGO requirements of the Budget Enforcement Act (BEA), the current budget process has little control over existing tax expenditures—which grow because of changes in the population, the economy, and taxpayer behavior.

Placing existing tax expenditures under further budgetary controls would not be easy because of jurisdictional and technical hurdles described in this chapter. However, such obstacles are not insurmountable, depending on the value Congress places on restraining tax expenditure growth. In this regard, one approach we examined—placing an aggregate cap on forgone revenue—probably would not work. A second approach—in the form of a tax expenditure savings target—is feasible. Under this approach, Congress could be prompted to decide in each year's budget resolution whether it wishes to reduce tax expenditures by a fixed amount after it examines the economy and technical factors underlying their growth. If it decided to do so, it could specify a fixed amount of reduction in forgone revenue in the budget resolution, enforced through the existing reconciliation process. Definitional and measurement problems, which are exacerbated by an aggregate cap, could be lessened substantially under a savings target. Technical problems would be reduced because—as is now the case in reconciliation—revenue estimates would be required only for the subset of tax expenditure provisions under consideration for meeting the target. However, requiring a specific amount of base broadening through the budget process would involve more actors in tax policymaking, especially through expanding the authority of the budget committees.

The Budget Process Generates Information About Tax Expenditures

Efforts to place tax expenditures in a budgetary context began in the executive branch in 1969. It was not until 1974, however, that information about the costs of tax expenditures was officially incorporated into congressional budgeting processes. The Congressional Budget and Impoundment Control Act of 1974 created the congressional budget process to improve Congress' capacity to influence fiscal policy and better integrate expenditure and revenue decisions. The Balanced Budget and Emergency Deficit Control Act of 1985 (Gramm-Rudman-Hollings) and BEA were designed to bring greater discipline to the congressional budget process to reduce the mounting federal deficit.

Since the passage of the 1974 congressional budget act, proposals to create new tax expenditures or modify existing tax expenditures have carried a price tag—a 5-year estimate of revenues projected to be lost or gained from the change.[1] The act also authorized CBO to undertake analyses of tax expenditures, including comparisons of these and alternative subsidy programs. CBO periodically issues trend analyses and evaluations.

As noted in chapter 1, both the executive and legislative branches publish information about tax expenditures annually, including some different items on their tax expenditure lists, because they use different tax baselines. These lists, however, generally are not used for making tax expenditure allocations or comparisons with outlay programs.

The Budget Process Has Little Control Over Tax Expenditures

In developing its budget resolution each year, Congress makes a decision about the level of tax revenues required. However, determining how these revenues are to be raised—whether through modifying tax rates, imposing new types of taxes, or altering tax expenditures—is the province of the tax committees. The discretion available to the tax committees in determining how to raise revenues reduces the capacity of budgetary control mechanisms—notably the budget resolution, reconciliation directives, and sequestration processes—to directly affect tax expenditures. Moreover, although current deficit reduction enforcement mechanisms—notably PAYGO—effectively limit new tax expenditure initiatives, these mechanisms allow existing tax expenditures to grow, largely unchecked, in a manner similar to mandatory outlays.

Budget Resolutions and Reconciliation Directives Do Not Directly Address Tax Expenditures

Budget resolutions set forth spending totals for each major functional category of the budget, and these resolutions specify revenues and the amount, if any, by which revenues must increase or decrease. Because the tax committees receive only a total revenue target from the budget committees, the budget process limits existing tax expenditures only to the extent the tax committees choose to raise revenues by decreasing revenues forgone through tax expenditures.

[1]The 1994 budget resolution created a new point of order in the Senate that bars consideration of legislation that would increase the deficit in any of the next 10 years. The point of order extends the prior 5-year window for deficit neutrality to 10 years and prohibits legislation from raising the deficit in any 1 of those years, rather than over the whole period.

To achieve deficit reduction, reconciliation instructions[2] have been used in certain years to specify the aggregate amounts by which revenues and outlays must be changed to achieve budget resolution totals. As defined in the 1974 budget act, reconciliation directives instruct the tax committees to submit legislation conforming to these amounts. However, neither the budget resolution nor reconciliation directives contains special restrictions on aggregate levels of tax expenditures or requires changes in the amount of tax expenditure revenue losses. Although it is not required that reports accompany the budget resolution, if reports are prepared they are to include information about assumptions that the budget committees use to achieve their revenue totals. This guidance can—and sometimes does—assume savings from reducing tax expenditures. Although the aggregate totals for revenues and outlays specified in the resolution must be obtained, the budget committees' policy guidance is not binding on committees of jurisdiction, including the tax committees.

BEA Procedures Do Not Address Increases in Existing Tax Expenditures

By establishing a PAYGO requirement for mandatory spending[3] and receipts legislation, BEA limited the tax committees' freedom to modify or propose new tax expenditures. PAYGO requires that new direct spending[4] and tax legislation be deficit-neutral so that in the aggregate, such legislation cannot increase the deficit. Thus, under PAYGO rules, policy expansions of tax expenditure programs must be paid for through increases in revenues[5] or reductions in spending in other PAYGO-controlled legislation affecting the same fiscal year.

However, PAYGO does not control increases in tax expenditures after they have been created. In this respect, budgetary treatment of these expenditures resembles that of mandatory spending programs, which also are not subject to an annual appropriation process. Instead, the current budget process allows existing mandatory programs and tax expenditures to grow in an uncontrolled fashion, reflecting changes in the population, taxpayer behavior, and the economy.

[2]A reconciliation instruction is a provision in a concurrent budget resolution directing one or more committees to report legislation changing existing laws or pending legislation to bring spending, revenues, or the debt limit into conformity with the budget resolution. The instructions specify the committees to which they apply, indicate the appropriate dollar changes to be achieved, and usually provide a deadline by which the legislation is to be reported or submitted.

[3]Mandatory spending is spending that is not controlled through appropriations.

[4]Direct spending authority is entitlement authority, the Food Stamp Program, and budget authority provided by law other than appropriations acts. From the perspective of the appropriations process, direct spending is mandatory (not controllable through appropriations).

[5]Increases in revenues include reductions in revenue losses from existing tax expenditures.

Sequestration is the cancellation of budgetary resources provided through discretionary appropriations or direct spending laws. BEA sets forth three types of sequesters: (1) discretionary spending, (2) PAYGO, and (3) deficit reduction,[6] none of which apply to receipts (which include all tax expenditures). Most notably, if new legislation that is subject to the PAYGO requirement is passed without a deficit-neutral offset, BEA provides for a PAYGO sequestration of selected mandatory programs.[7] However, even if new or expanded tax expenditures triggered such a sequester, all tax expenditures would escape current sequestration sanctions.

Mandatory spending has received recent attention in the form of an executive order. As part of the Omnibus Budget Reconciliation Act of 1993 negotiations, the President issued Executive Order No. 12857, August 4, 1993, applying a look-back type budgetary review and control process to mandatory programs. This order created a mechanism to monitor total costs of direct spending programs and to restrain these costs if actual direct spending exceeds established targets. The targets are the current-policy estimates for mandatory programs (excluding deposit insurance and net interest). The order requires the president (as part of each annual budget submission) to compare actual or projected direct spending to the targets and to propose spending cuts and/or tax increases to make up any overage—or to explain why he thinks no action should be taken. The order does not bind Congress. However, House rules provide for consideration of the proposals in that chamber.

Budget Process Options

Budgetary processes could be used to limit revenue losses from tax expenditures. We examined two approaches Congress could use to establish limits for tax expenditure revenue losses. One approach would cap the total allowable revenue losses from tax expenditures. A second would establish tax expenditure savings targets. While an aggregate cap probably would not work, a savings target is feasible. The target could be established in the budget resolution, and reconciliation instructions could be used to enforce the reductions. If Congress desired, sequestration or

[6]The Budget Enforcement Act of 1993 effectively repealed the deficit reduction sequester.

[7]The calculation to determine whether a PAYGO sequester is required is made annually—15 days after Congress adjourns. The size of sequestration is determined by adding the impact of legislated changes on the current year's deficit to the portion of the preceding year's deficit that was not offset by an earlier sequestration. OMB determines the net deficit increase and sequesters the budget resources of certain mandatory spending programs. Programs that are sequestered have their funding levels reduced in the following fiscal year. This "look-back" into the preceding year discourages passage of legislation that increases the deficit after a sequestration report is issued.

other means of further enforcement could be added. These steps could all be taken within the overall framework of current budget procedures.

A Traditional Budget Cap Unlikely to Work for Tax Expenditures

A commonly understood spending cap would be a dollar amount that could not be exceeded. Under BEA, discretionary spending is subject to a fixed-dollar cap that is implemented through the budget and appropriations processes.[8] Budget resolutions are used to establish a total amount that can be expended for discretionary programs during the year. House and Senate Appropriations Committees subsequently allocate these totals among their subcommittees. The budget process "keeps score" of spending by tracking congressional actions. If appropriations exceed the discretionary cap, BEA provides for eliminating the overage by sequestering resources in programs that are funded in the spending category in which the breach occurred. Under discretionary caps, policymakers and program managers alike can tell with considerable precision whether spending has breached—that is, exceeded—the cap. Control is achieved because spending can be tracked through the fiscal year, and sequesters can be targeted to the programs that caused the breach. Implementation is eased because discretionary programs are not open-ended in their funding. Spending is already limited by annual appropriations.

Tax expenditures are more akin to entitlements and other mandatory programs, which are considered direct spending and not capped under BEA. Spending for entitlement and other mandatory programs is largely determined by eligibility and benefits formulas rather than fixed amounts of appropriations. Similarly, the federal government does not appropriate a fixed amount of money for tax expenditure programs. Instead, benefits are provided to all who qualify. Since this is the case, the federal government cannot know beforehand, with certainty, how much money will be "spent" through tax expenditures; it must wait for taxpayers to actually take advantage of the tax provisions. And, unlike entitlement programs, after taxpayers have taken advantage of tax expenditures the federal government still may not know, with much certainty, how much tax revenue was forgone. Data on the use of tax expenditures are generally not available for at least 1-1/2 years after a calendar year. Direct measures of use are never available for some tax expenditures (see app. I, pp. 115-117).

[8]BEA requires the president to adjust these limits only for specific reasons, including changes in concepts and definitions and designated emergencies.

The characteristics of tax expenditures and the similar features of mandatory spending programs make each difficult to subject to a spending cap such as that now in place for discretionary programs. Problems of definition and measurement, to some extent, would affect any effort to curtail revenue losses, especially efforts such as a cap that require totaling many tax expenditures or depend on future actions. (For a discussion of how definitions and measurement issues could affect the implementation of a savings target, see pp. 63-68.) Technical problems would arise because a traditional cap would set an allowable level of total revenue losses for tax expenditures. The lists of tax expenditures published by JCT and Treasury are basically informational, and these lists differ. Reliance on a spending total would raise questions about whether each provision on the tax expenditure list is properly defined as a tax expenditure. Moreover, a cap would require the aggregation of all tax expenditures for control purposes—a process confounded by interactions between tax expenditures and the standard deduction, income tax rates, and other tax expenditures.[9] Interaction effects are important sources of measurement error, because tax expenditure estimates are highly dependent on tax expenditure groupings and rankings.

A cap on tax expenditures could be breached by changes in the economy, taxpayer behavior, or tax rate changes, notwithstanding congressional policy actions. Because funding is open ended, tax expenditure revenue losses are only partly a function of congressional decisions. Under a cap, these types of problems could have significant consequences. For example, economic factors could cause tax expenditures to rise above the cap if unanticipated economic growth resulted in greater use of tax expenditures than originally estimated. Similarly, if taxpayers changed their behavior in unanticipated ways to reduce their tax liabilities, the cap also could be breached. Under the current reconciliation and PAYGO processes, estimates of direct spending and revenues are handled as adjustments to the baseline. In contrast, under a traditional cap, revenue losses would need to be further curtailed to eliminate overages above allowable amounts.

When economic and other factors drove the deficit beyond Gramm-Rudman-Hollings (GRH) targets despite congressional efforts to control spending, Congress moved away from this type of deficit reduction target. In 1990, it shifted to the current BEA framework, which implements

[9]JCT and OTA officials said that improved estimates could be developed that would be more appropriate for aggregate analyses. To provide such estimates, JCT and OTA would need to redirect effort from other duties or obtain additional resources if they are to make these improvements and also fulfill other duties.

deficit reduction through fixed-dollar ceilings for appropriated spending and prevention of new, direct spending or revenue cuts, which could take the form of new or expanded tax expenditures. Under this approach, deficit reduction is guided by ceilings controlled by policy action, not by moving targets that can be influenced by other factors.

Congress could intervene by legislatively excusing some or all of the overage caused by factors outside of its direct control. Congressional proposals to cap mandatory spending programs have included provisions to exempt certain sources of growth that are beyond the reach of policymakers—notably growth attributed to the economy or population changes. This logic could also be applied to a tax expenditure cap. By anchoring tax expenditure revenue loss reductions to economic projections at the time the target is imposed, the tax committees would be protected from having to raise more revenue than originally anticipated. Rate changes (described more fully on p. 68) could be handled in a similar fashion. Policymakers could even be held harmless for overages due to technical factors other than the economy or population—such as administrative inefficiencies, the behavior of implementing entities or beneficiaries, or new technologies. However, in these circumstances the cap would float freely upward, undermining its original purpose of holding total spending to previously agreed-to levels.

A Savings Target Could Be Administered Within the Current Budget Process Framework

Rather than capping tax expenditures, a savings target could be established in selected years, as deemed appropriate by Congress. Such a target would be a fixed amount, such as $10 billion, by which revenue losses associated with existing tax expenditures would be reduced. Both a cap and a savings target would need to include an estimated amount of revenues that the tax committees would be required to achieve. In addition, the estimates of required reductions could be the same. However, although each entails jurisdictional and technical difficulties, a savings target set according to political judgments of Congress would be more feasible. As the remainder of this chapter suggests, if the amount of savings required is specified from the beginning, a savings target's budgetary impact would be clearer. A specific amount of savings also would present a consistently measured and achievable standard. And, unlike a cap, a savings target could be implemented through existing budgetary procedures without further changes.

Savings Target Could Be Established in Several Ways

How a savings target is established, and by whom, could affect the likelihood that the target would be met. Congress could set savings targets in its annual budget resolution. This method addresses tax expenditure revenue losses by requiring a vote on whether these expenditures warrant the adoption of a savings target and—if required—what the amount should be. While annual voting builds in year-to-year flexibility regarding whether to reduce tax expenditures, it also provides opportunities to avoid action. However, even a vote not to take action would increase accountability. Moreover, the floor debate accompanying such votes could highlight important information about tax expenditures, the magnitude of revenue losses associated with them, and the rationale for Congress' decision. A second method for establishing savings targets would be through enactment of overall 5-year budget control legislation such as the BEA. As part of a deficit reduction framework, such a savings target would provide Congress a visible benchmark to measure tax expenditures' contribution to deficit reduction. This, in turn, could increase the prospect that policy actions will subsequently be taken through future budget resolutions and reconciliation bills. At the same time, increased assurance of this kind reduces Congress' flexibility to reconsider initial decisions in the event that circumstances change.

The GRH experience indicates that mechanical, formulaic approaches to cutting spending are unlikely to force Congress to take meaningful actions to reduce the deficit. These approaches may instead create an incentive to rely on questionable savings measures. On this point, CBO has concluded that budget processes work best when they enforce agreements already reached by Congress.[10]

In establishing a tax expenditure savings target, Congress could be guided by criteria, such as historical levels of revenue losses, total tax revenues, or economic growth indicators like GDP growth. However, this type of indirect approach would require totaling tax expenditures. Thus, it would pose many of the measurement and definition problems associated with a cap. Moreover, tax expenditures, like mandatory spending, grow for reasons related to the economy and other technical factors. For example, some tax expenditures, such as those related to employee fringe benefits, would tend to increase as the economy expands and employers hire additional employees. And, tax expenditures grow when tax rates are increased, as they did in 1993. Thus, in determining how much, if any, base broadening to require, it would be important to consider the sources of growth. If aggregate tax expenditures are compared with economic indicators such as GDP, these comparisons should be used only to provide

[10]Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1994-1998, Jan. 1993, page 87.

information to decisionmakers, not to mechanically establish growth limits. The quality of the information conveyed by aggregate tax expenditure data, even if estimated by current methods, might well be adequate as a guide for judgments about the appropriate size of tax expenditures.

A Savings Target Could Be Incorporated in the Budget Resolution and Enforced Through the Existing Reconciliation Process

Whatever means are used to establish a savings target, the amount of required savings could be incorporated into the budget resolution and enforced through the existing reconciliation process. Placing the savings target in the budget resolution would focus the tax committees' efforts on achieving the magnitude of change that Congress desires. Reconciliation instructions would provide a mechanism for securing legislative changes needed to satisfy the targeted revenue loss reductions. If revenue losses exceeded initial estimates because of unanticipated economic or behavioral factors, differences would be absorbed into the reestimated baseline, as is now done under reconciliation and BEA procedures. In this way, a savings target would hold policymakers accountable for actions they can control, but not for the final results.[11]

Incorporating savings targets into the budget resolution and enforcing those targets through reconciliation would place tax expenditures on a more equal status with outlays in the budget process. But, the authority of the budget committees relative to the tax committees would be increased by doing so; and, those we spoke with noted that jurisdictional conflicts would be expected. However, the Appropriations Committees currently are subject to spending targets in the budget process, although programmatic decisions remain within their jurisdiction. Similarly, the application of reconciliation instructions to tax expenditures would include others in deciding how revenue targets would be met (i.e., by requiring reductions in tax expenditure revenue losses). Although the tax committees would need to report legislation conforming to the savings target, the committees would decide how to achieve the necessary amount of reductions in revenue losses. Thus, the committees' program authority would be undiminished. If it decides to constrain the tax committees in this way, however, Congress would need to consider whether the current budget process provides sufficient authority for insuring committee action.

[11]Even though losses above original estimates that are due to economic and behavioral factors would be adjusted for, the amount of actual savings would still be affected. The open-ended character of tax expenditures and their decentralized implementation—like that of many mandatory programs—complicates the task of achieving savings through congressional policy action.

Annual and Multiyear Savings Targets

Whether to adopt a multiyear or annual target would need to be resolved. If budgetary processes to control tax expenditures result in frequent changes to tax expenditures, tax planning and administration would be made more complicated, possibly adversely affecting voluntary taxpayer compliance. Budget processes that result in meaningful reductions in the value of existing tax expenditures may have consequences such as these. However, uncertainty and disruptions also exist for those who receive benefits from outlay programs subjected to caps or budget reductions.

Thus, to the extent that Congress can limit the number of changes made annually to tax expenditures—while also achieving the reductions in existing tax expenditures it judges appropriate—tax planning and administration would benefit.[12] One technique that has been used to provide increased certainty when past tax law changes have been made is to provide a transition period for changes. For example, the Tax Reform Act of 1986 reduced and ultimately eliminated the deductibility of nonmortgage consumer interest over a 5-year period. In this respect, multiyear targets that the tax committees can plan for may be desirable so that an integrated plan could be developed for achieving the reduction goals while also phasing in any required changes.

Savings Would Be Delayed

It would be important for Congress to recognize that savings resulting from tax expenditure revenue loss targets would likely be spread out over more than a single fiscal year because of differences in calendar years, fiscal years, and tax filing timetables. For example, if actions to achieve savings were taken at the end of the congressional session in 1993, it could be difficult for IRS to develop or revise necessary tax forms before the beginning of the 1994 filing period. More time may be required for notifying taxpayers about upcoming changes. Postponing actions until the following tax year could result in a delay of 2 full fiscal years before achieving savings.[13]

[12]Tax expenditures are often intended to change taxpayer behavior by providing financial incentives. For example, the tax credit for research and development costs encourages taxpayers to increase spending on research activities by subsidizing a portion of their additional expenditures. The lack of certainty about future availability of a tax provision may discourage taxpayers from undertaking the desired behavior.

[13]According to JCT, to be most useful, estimates of tax receipts would need to be presented in a form consistent with the federal government's cash-flow accounting system. Because taxes are most often calculated on a calendar year basis, the translation of changes in calendar year tax liabilities into changes in the fiscal year receipt of taxes would be necessary. Thus, the savings realized from changes made to satisfy a savings target for existing tax expenditures would cross over differing fiscal years. However, differences in timing are currently taken into account for changes to the tax code that affect the generation of revenue.

Implementation Issues for Savings Targets

Although a savings target would be more feasible to implement than a cap, integrating existing tax expenditures into the budget process would still require Congress to make several potentially difficult decisions. As noted earlier in this report, the lists of tax expenditures published by JCT and Treasury are informational and not part of a budgetary decision process. A good design would avoid making the total tax expenditure measure part of the law. Instead, targets would be set independently—perhaps with reference to tax expenditure totals—but the only binding effect would be with respect to the savings target.

Savings targets might very well raise the measurement and definitional problems associated with a cap if they were set using total tax expenditures as a reference. However, setting a savings target without explicit reference to the total amount of revenues lost through tax expenditures would, as the Congressional Budget Office has observed, avoid some problems inherent in the ways tax expenditures are currently defined and measured. In an earlier report, CBO has concluded that these technical obstacles could be bypassed if budgetary limits focused on achieving incremental changes rather than directly addressing tax expenditure totals.[14] Achieving a $10-billion reduction in revenue losses from existing tax expenditures to satisfy a savings target would be similar to finding a $10-billion savings in existing tax expenditures to offset new mandatory spending or proposed tax expenditures under the PAYGO rules or to meet reconciliation instructions.

Another issue raised by some experts that we spoke with is the absence of good data on actual revenue losses for certain tax expenditures, such as exclusions and some fringe benefits (app. I discusses this issue in more detail).[15] However, at each step in the legislative process—from budget passage to enforcement—Congress relies on estimated, not actual, spending information. The following example demonstrates the impact of the budget cycle. Most fiscal year 1994 spending decisions were made in fiscal year 1993, also the year in which fiscal year 1995 budget formulation began. As a result, actuals are not available to policymakers within the relevant time frames of this—or any—budget cycle. BEA requirements must also be implemented on the basis of estimates. For example, OMB's estimates of fiscal year 1994 appropriations determine whether a breach of

[14]Congressional Budget Office, Tax Expenditures: Budget Control Options and Five-Year Budget Projections for Fiscal Years 1983-1987, Nov. 1982.

[15]JCT and Treasury officials also said that the level of effort devoted to estimating tax expenditure revenue losses would need to be increased if the estimates were used for more than informational purposes. In order to continue to meet their existing revenue estimating duties and provide improved tax expenditure estimates, these officials said that more resources would be required.

the discretionary caps has occurred, and many such determinations were made in fiscal year 1993. Moreover, while a PAYGO sequester has never been triggered, PAYGO violations (or potential violations) are also determined on the basis of estimates of direct spending.

To implement a savings target, Congress would also need to consider certain technical aspects of scorekeeping that affect the amount of revenues forgone, especially if targets were multiyear and, thus, depended on future actions. As mentioned earlier in this report, unanticipated economic and behavioral factors affecting revenue losses could be addressed under reconciliation procedures now used to implement multiyear budget agreements. However, the value of tax expenditures is tied to tax rates, with revenue losses increasing if rates rise (as in the Omnibus Budget Reconciliation Act of 1993) and decreasing if rates decline.

Thus, if rates were increased after the target was established, Congress would need to consider whether to allow the tax committees to meet the target under the new rate structure. Revenue estimates for a tax expenditure change based on new higher rates would be larger than estimates under lower tax rates (other factors being equal). Therefore, less base broadening would occur than initially anticipated when the target was set. On the other hand, if rates were reduced after the target was set, more base broadening would be required than originally anticipated.

This interaction of tax expenditures and tax rate changes is a consideration under existing congressional procedures. The revenue generated by any proposed rate change depends in part on the associated increases or decreases in the anticipated value of tax expenditures. Adopting a tax expenditure savings target could provide greater visibility to this interaction. It would also provide an opportunity for Congress to make up-front decisions concerning the appropriate mix of base broadening and rate changes. Currently, the tax committees make these decisions and Congress, as a whole, ratifies or changes those decisions when considering the legislation designed by the tax committees.

Additional Enforcement Mechanisms Could Be Added

Congress would need to determine whether reconciliation would be sufficiently fail-safe to ensure that savings targets were met. If Congress wished to increase its control beyond what is provided through the reconciliation process, it could apply sequestration rules to tax expenditures. Alternatively, Congress could impose a surtax. Although enforcement mechanisms for tax expenditures could be designed, these mechanisms likely would not affect all who benefitted from the tax expenditures that caused a savings target to be exceeded. This limitation is similar to that for the BEA sequestration process for mandatory spending.

The credibility of any tax expenditure enforcement action would likely be related to the amount of revenue loss reduction that would be needed to reach the tax expenditure savings target and the portion of taxpayers who would be affected. That is, if a large amount of revenue losses had to be curtailed from a relatively small number of taxpayers, it would be less likely that Congress would actually use the enforcement mechanism. This suggests that fairly small, fixed savings targets may be the most likely to be enforced if tax committees do not meet their tax expenditure savings targets.

Sequestration

Sequestration of tax expenditures raises many distributional and technical questions. Some experts that we spoke with in the tax community did not see how sequestration could be applied to all tax expenditures because of differences in types of tax expenditures and lack of governmental control over their use. For instance, if sequestration were applied to all or the majority of tax expenditures, the same interaction and definitional issues raised as an impediment to adopting a cap on tax expenditures would arise in implementing the sequester. Moreover, some tax expenditures—such as deferrals of income—have special timing and record-keeping characteristics that would make a sequester nearly impossible, if not impossible, to administer. In pensions, for example, the revenue losses attributable to not taxing the inside build-up in some retirement plans would be difficult to sequester because individual records are not always available, and retirement income has not yet been received. It is also difficult to envision how exclusions from income would be sequestered because they are not generally reported to IRS.

Itemized deductions that are tax expenditures likely would be the easiest tax expenditures to sequester. If tax legislation does not reduce tax expenditure revenue losses as prescribed in reconciliation instructions, an across-the-board cut (similar to the limitation of itemized deductions for high-income taxpayers enacted in 1990) could be imposed in the following year on all taxpayers who itemize. Sequestering only itemized deductions, rather than all tax expenditures, would create inequities among tax expenditure beneficiaries because those claiming deductions would have a higher effective tax rate than those receiving benefits from other forms of tax expenditures. However, this type of asymmetry exists under PAYGO rules wherein all entitlement and mandatory program spending counts in determining whether a breach has or will occur, but only certain programs are subject to sequestration. To the extent that a sequester's purpose is to motivate committees to meet their reconciliation targets, this inequitable consequence of sequestration may help achieve the underlying intent of a sequestration. In addition, because most upper income taxpayers benefit from more than one tax expenditure, Congress may view an asymmetrical sequester, which disproportionately affects upper income taxpayers, as a reasonable alternative to a more precisely targeted, but administratively complex, sequester affecting a larger number of taxpayers.

Surtax

Rather than sequestering tax expenditures, Congress could impose a surtax. The revenues obtained using either of these approaches could be similar. A surtax has advantages as well as disadvantages compared to sequestration. Most importantly, a surtax falls short, from both a tax policy and a budgetary control perspective, because it does not directly reduce revenues forgone from tax expenditures, raising taxes instead. A sequester broadens the tax base by reducing benefits, while a surtax is a statutory rate increase. Paradoxically, because a surtax would be a tax rate increase, it also would raise the value of existing tax expenditures.

An important advantage of a surtax is that it avoids the need to make certain difficult decisions to implement a sequester. For example, by choosing a surtax option, policymakers would not have to agree on a list of tax expenditures that would be subject to sequestration. Nor would they need to resolve measurement issues concerning interaction effects. If a surtax was imposed on high-income taxpayers, the additional tax generally would affect those most likely to have benefitted from tax expenditures, but also may affect some taxpayers who benefitted little or not at all. If more precise targeting for a surtax is desired, more information would be needed on who benefits from tax expenditures, which would raise issues similar to those involved in an across-the-board sequester for all tax expenditures. Finally, a simple surtax based on income could be implemented with few modifications to the current tax system, whereas a broad sequester would require collecting additional information, reporting it to taxpayers, and modifying several tax forms and publications.

Alternatives to Enhance Consideration of Trade-Offs Among Direct and Indirect Spending Programs Within Functional Areas

Benefits could be obtained from coordinating federal tax expenditures, outlays, and loans; reducing overlap and inconsistencies; and encouraging trade-offs among these instruments. For example, better targeting of all federal efforts, including direct outlays and tax expenditures, could save government and private resources and increase economic efficiency. According to tax policy expert Thomas Neubig, the concept of the tax expenditure budget implies that government intervention through the tax code should be evaluated by the same criteria as apply to, and weighed against alternative intervention through, discretionary outlays, credit programs, or regulation.[1] In addition, Neubig noted that the current information-only status of the tax expenditure budget falls far short of its potential use in making trade-offs.[2] Opportunities to increase the scrutiny of tax expenditures along with federal spending programs by function exist in both the legislative and executive branches of government.

Congressional budget and tax policy processes provide no systematic way of avoiding duplication and overlap among discretionary spending programs and tax expenditures that serve similar purposes. Current processes do not force trade-offs among tax expenditures and discretionary spending programs or promote evaluations of which is the most effective or least costly for a given purpose. Looking at the characteristics of all federal subsidies for any given functional area could help policymakers identify where resources can best be directed. Jurisdictional, budgetary, and technical impediments to joint reviews would need to be addressed.

Executive branch oversight and analysis of tax expenditures may increase in light of recent OMB initiatives and the Government Performance and Results Act of 1993. According to an August 1993 draft implementation plan, OMB planned to develop a framework for periodically assessing the effects of specific tax expenditures in achieving performance goals. These assessments were to consider the relationship and interactions between spending programs and related tax expenditures. OMB also has taken steps to increase the information available to policymakers on tax expenditures and to informally review related tax expenditures and outlay programs.

[1]Thomas Neubig, "The Current Role of the Tax Expenditure Budget in U.S. Policymaking," in N. Bruce, ed., Tax Expenditures and Government Policy, Ontario, Canada: John Deutsch Institute, 1989, page 247.

[2]Ibid., page 252.

Issues Involved in Comparing Tax Expenditures With Similar Programs

Congressional structure and budget processes treat taxes and spending as two very separate elements. Current congressional rules make the budget compartmentalized and inflexible, thereby inhibiting trade-offs between tax expenditures and discretionary spending programs. Although the tax committees have the expertise regarding the tax system, spending committee members could bring their knowledge about the mandatory and discretionary programs within their functional areas to further inform decisions about tax expenditures.

Tax expenditures that subsidize certain activities are comparable to discretionary and mandatory spending programs. Comparing tax expenditures with mandatory and discretionary spending programs may highlight the similarities and differences between these subsidies. The current budget process, however, prevents trade-offs between tax expenditures and discretionary outlays.[3] Any "savings" obtained by reducing revenue losses from tax expenditures cannot, under BEA, be used to fund discretionary programs. Congress generally does not have a process for considering related tax expenditures and outlays together.

According to tax expenditure expert Stanley Surrey, it is unlikely that some tax expenditures, with their "upside-down" distributional effects, would ever have been passed on the spending side.[4] In the health area, beneficiaries of direct budgetary expenditures tend to be lower income individuals (70 percent of this spending is directed to Medicaid programs), while the beneficiaries of tax expenditures tend to be higher income individuals.[5] Both tax expenditures and outlay programs affect the distribution of after-tax income. Therefore, judging the equity of the overall distribution, especially when budgetary resources are tight, may require consideration of the effect of all government programs in a functional area. Looking at tax and spending programs together could reduce program duplication or help ensure programs are complementary. For example, the Targeted Jobs Tax Credit and the Job Training Partnership Act of 1982 are generally not linked, providing a double incentive that may or may not induce employers to hire targeted individuals.

[3]Trade-offs can occur between tax expenditures and mandatory spending because all tax expenditures and some mandatory spending programs fall within the jurisdiction of the tax committees.

[4]Stanley S. Surrey, Pathways to Tax Reform: The Concept of Tax Expenditures, Cambridge: Harvard University Press, 1973, page 136.

[5]Tax Expenditures, Statement of Jane G. Gravelle, Senior Specialist in Economic Policy, Congressional Research Service, before the Committee on the Budget, U.S. Senate, Feb. 3, 1993, page 5.

In the 1980s, Canada tried and subsequently discontinued a formal system of integrating proposed tax expenditures into its policymaking process. This system involved the allocation of overall expenditures into nine "envelopes," with increased flexibility for program departments to make trade-offs from one spending program to another within each "envelope." The envelope system subtracted the revenue cost of any new or expanded tax expenditure from the targeted amount available for spending within the program envelope. According to Treasury officials, the envelope system may have failed in part because the finance minister had the flexibility to propose new tax expenditures, thus undermining the discipline intended by the process. However, any revenue savings from proposals to reduce existing tax expenditures in an "envelope" were not automatically allocated to that envelope. Therefore, this system did not provide an incentive to make trade-offs between existing tax expenditures and other spending programs within a given functional area.

If Congress or the executive branch adopts an integrated system for reviewing outlay programs and tax expenditures, incentives for making such trade-offs may be necessary.

Functional Reviews of Tax Expenditures Could Increase Communication Among Congressional Committees

To facilitate the comparison of tax expenditures with mandatory and discretionary spending programs that subsidize activities, Congress could broaden the scrutiny of both types of programs to include committees with program and tax expertise. Such comparative reviews might better target federal spending by reducing overlap or conflict among different types of programs. However, opening up the decisionmaking process could have both advantages and disadvantages.

Generally, the tax and spending committees are divided within Congress.[6] On some occasions, spending committees have involved themselves in tax legislation by holding hearings and issuing reports on tax expenditures within their legislative jurisdiction. The current debate on health care provides an example of informal joint consideration of an issue. The tax committees also hold hearings on how tax expenditures interact with other assistance programs. The spending committees' program expertise may help identify opportunities for making trade-offs and reducing duplication.

[6] The tax committees have jurisdiction over several outlay programs in various areas. These programs include some health programs, Social Security, and international trade.

Recognizing the problems inherent in treating federal spending and tax expenditures separately, Congress should be able to make trade-offs so that members have the flexibility to allocate spending using the most efficient programs, whether direct or indirect. For example, a member of one of the tax committees can affect tax expenditures in a certain area of interest, but cannot affect direct spending programs outside of his or her jurisdiction. Similarly, a member of an authorizing committee cannot affect tax expenditures. This division may sometimes lead policymakers to support less efficient programs (either tax expenditure or discretionary spending) because a given program might be the policymaker's only avenue for allocating resources to where the member thinks they are needed.

A broader range of expertise could be brought into the debate when reviewing existing or designing new tax expenditures or federal spending programs. Such a combination could provide benefits such as (1) evaluating how effectively a tax expenditure accomplishes its purpose as a spending program and (2) performing a tax policy analysis to evaluate its efficiency, effectiveness, and equity. The ability to make trade-offs could result in funding more efficient programs. For example, the low-income housing tax credit may be a more expensive way than the public housing program for the federal government to serve very low-income households.[7] Joint review, although it may be more complex than single committee jurisdiction, may be most appropriate when a provision has both programmatic purposes, like stimulating an activity, and tax policy purposes, like taking into account taxpayers' ability to pay taxes.

Joint review of tax expenditures could encompass a broad spectrum of changes—from program committees holding joint hearings with the tax committees to provide their views, to a more formal process with shared power by program and tax committees over tax expenditure decisions. Therefore, alternatives under this option range from requiring no formal change to the current jurisdictional structure to a major congressional reorganization. Sequential referral to committees is currently done. The House Committee on Ways and Means sometimes gets sequential jurisdiction over broad-based fees proposed by other committees, and a similar process could operate for some tax expenditures.

[7]Public Housing: Low-Income Housing Tax Credit as an Alternative Development Method (GAO/RCED-93-31, July 16, 1993), page 15.

Permanent or ad hoc joint committees could be established to oversee a certain issue, such as employee benefits or retirement income. A joint committee could develop staff expertise and work together on broad issues (including tax expenditures and mandatory and discretionary spending programs in the area).

Joint reviews could also be tied to the budget process. For example, the budget committees could set targets for each functional area. Trade-offs between tax expenditures and federal spending programs could be made as part of a joint effort to meet the functional target. If targets were more than advisory, exercising this option would require changes in congressional rules to relax or eliminate existing budget walls between tax expenditures and discretionary outlays. Such changes would also greatly increase the authority of budget committees to influence resource allocation and program decisions of other committees. (Ch. 4 contains further information about the issues involved in more fully integrating tax expenditures into the budget process.)

Another way that budget experts have suggested accomplishing congressional functional reviews is to establish an authorization process by program committees before "funding" by tax committees. This would be similar to the two-step authorization and appropriation process applied to discretionary spending programs. Each tax expenditure would receive formal review and approval by the appropriate authorizing committee.

Bringing other committees into the process of reviewing tax expenditures might be institutionally cumbersome. Two of the experts we interviewed predicted gridlock under such an approach. One cited the example of an energy bill, which had about 200 conferees. He believed there could be this many, or more, involved in any tax bill. As the number of decisionmakers increased, the difficulty of developing the consensus to make necessary decisions might also increase.

Some congressional staff and others contend that there is a healthy tension in the system as it is now. For example, one public policy theorist, Edward Zelinsky, believes that the institutions formulating and administering tax policy are less susceptible to interest group capture than those overseeing direct outlays because the former are subject to more numerous and diverse constituencies.[8] Zelinsky says that tax institutions, because of their greater political freedom (engendered by the many

[8]Edward A. Zelinsky, "James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions," Yale Law Journal, Vol. 102, No. 5, Mar. 1993, page 1,166.

countervailing constituencies of the tax system), are better positioned to design and implement policies informed by expertise than the federal institutions that control spending.

Technical Issues Would Require Resolution

Some tax expenditures do not fit into any functional area or are cross-functional (some itemized deductions fall into several functional areas). The fact that only estimates are available for tax expenditures may also pose a problem in comparing them with programs where information on dollars spent can be more readily obtained. In addition, the interactions among tax expenditures could affect all functional areas.

It could be difficult to split tax expenditures up into functional areas as tax expenditures can be characterized in different ways and fit into different "pots." It is possible that any split would be somewhat controversial. For example, the tax expenditures for accelerated depreciation and capital gains provide incentives for a wide range of different types of investment. Likewise, the tax expenditure for mortgage interest may be partly used for consumption activities unrelated to home ownership. Since a homeowner can substitute mortgage debt for consumer debt, elimination of the deduction for consumer interest has meant that money borrowed on a home mortgage is now more likely to finance spending on consumption other than housing.[9] This casts doubt on the appropriateness of classifying the entire revenue loss from the tax expenditure on mortgage interest as "spending" on housing.[10] However, similar difficulties arise in assigning mandatory and discretionary spending programs to particular budget functional areas. For example, direct outlay programs such as the food stamp program enable recipients to use some money previously spent on food for nonfood items. This casts doubt on the appropriateness of classifying the entire food stamp allocation as spending on food.

In 1982, CBO listed tax expenditures by congressional committee with authorizing jurisdiction over related direct outlays.[11] CBO pointed out that there were a number of instances in which a specific tax expenditure could easily be assigned to more than one committee.

[9]Elimination of the tax deductibility of interest expenses for many forms of consumer debt, but not mortgage debt, under the 1986 Tax Reform Act contributed to the subsequent growth of mortgage debt. (See Tax Policy: Many Factors Contributed to the Growth in Home Equity Financing in the 1980s [GAO/GGD-93-63, Mar. 25, 1993], page 1.

[10]David J. Shakow, "Tax Expenditures for Housing," Tax Notes, Vol. 59; No. 13; June 28, 1993; page 1,823.

[11]Congressional Budget Office, Tax Expenditures: Budget Control Options and Five-Year Budget Projections for Fiscal Years 1983-1987, Nov. 1982, Table B-1.

In fact, all tax expenditures would not have to be included in such a process. Rather, Congress might define a subset of tax expenditures that are similar to other programs providing subsidies. This subset could then be examined in conjunction with similar federal subsidies.

Another technical issue that generally applies to tax expenditures takes on increased importance when combining tax expenditures and mandatory and discretionary spending within functional areas. Income excluded or exempted from taxation, such as pension contributions and earnings and employer contributions for medical insurance and medical care, is generally not reported on tax forms. This makes the revenue losses from excluding or exempting this income more difficult to estimate. Of the 124 tax expenditures JCT listed for 1993, 58 exclude or exempt income from taxation. Their estimated revenue losses amount to about $222 billion—or over one-half of the aggregate estimated tax expenditure revenue loss for 1993.

In addition, the tax expenditure information provided on tax returns, such as amounts deducted, are not available until at least 1 year after the return is filed. This delay means that the government must use estimated data to control tax expenditures. The lack of precise information on tax expenditures could make it difficult for policymakers to make informed judgments about how tax expenditures compare with mandatory and discretionary federal spending programs.

Finally, if a combined target is given to authorizing committees for the spending and tax expenditure programs in their functional area, current tax expenditure estimates probably would be too imprecise. They likely would need to be replaced by more rigorous revenue estimates to increase the comparability of the sums involved for the related outlays and tax expenditures. However, providing revenue estimates could have workload implications for JCT or Treasury's Office of Tax Analysis (OTA).

In developing revenue estimates, the "stacking order" of changes would have to be considered. Changes in tax rates, standard deductions and personal exemptions, the alternative minimum tax, and other tax expenditures all affect the amount of revenue losses associated with tax expenditures. A functional ordering of tax expenditures would require Congress to decide on priorities among functions for controlling tax expenditures. For example, eliminating a tax expenditure in one functional area could affect the amount of revenues available for other functional areas.[12] Most of the interaction effects between tax expenditures could not be allocated to any specific budget function or to any one tax expenditure. One possibility could be to have all the committees develop their own recommended tax expenditure levels, ignoring the interaction effects, and then have a reconciliation process to smooth out the effects of these interactions.

The Executive Branch Could Take Steps to Integrate Review of Related Federal Efforts

The executive branch, similar to Congress, has not traditionally considered related tax expenditures and outlays together. Treasury, as well as JCT, lists tax expenditures under functional headings comparable to those of the federal budget, but this is only an informational display. Budget decisions are not made using these data. Treasury and the Internal Revenue Service (IRS) have had primary responsibility for tax expenditures, with other agencies taking little ownership in the implementation and oversight of most tax expenditure programs. The Senate Committee on Governmental Affairs' June 1993 report on the Government Performance and Results Act of 1993 calls for increasing oversight and analysis of tax expenditures by OMB and other federal agencies.

The executive branch could contribute to the debate on what is the best way to design a program—tax expenditure or discretionary spending.[13] Executive branch leadership could range from simply focusing greater attention on tax expenditures to building consensus about the need to increase their scrutiny. Such leadership has been an essential part of developing the broad-based support needed to enact major tax legislation. Highlighting the presentation of tax expenditures in the president's annual budget is one existing avenue for focusing attention. Tax expenditures could also be incorporated into the annual budget review process. OMB, in consultation with Treasury, could examine tax expenditures during its budget reviews. Incorporating tax expenditures into executive branch functional reviews could encourage clearer, more focused thinking about what should be done using the tax code versus using an outlay program. These reviews would be enhanced by linking them to agency performance assessments when the agencies begin to implement GPRA.

[12]If a deduction were eliminated, such as the deduction of charitable contributions, some taxpayers who would have itemized would no longer do so. This would result in a reduction in the revenue losses associated with other deductions that these taxpayers might have claimed.

[13]For example, Thuronyi stated that replacing some substitutable tax expenditures with spending programs will not become standard practice until the budgetmaking process forces agencies with authority over spending programs to consider such replacement seriously. See Victor Thuronyi, "Tax Expenditures: A Reassessment," Duke Law Journal, Vol. 1988, page 1,192.

It may be easier to integrate decisions about federal programs (including discretionary spending and tax expenditures) within the executive branch than within Congress. This is not to say that there would be no jurisdictional hurdles in instituting such an approach in the executive branch. "Turf battles" would likely occur in the executive branch, just as they would in Congress. For example, Treasury might have to share control of some tax-related issues with OMB and related agencies.

If the executive branch does begin doing functional reviews of tax expenditures and related outlay programs or other means of achieving federal objectives, the composition of the study teams would be important. In the executive branch, Treasury's Office of Tax Analysis traditionally has done or overseen tax-related studies, and its involvement would be critical to any consideration of changes in tax policy. On the other hand, the programmatic expertise of the agencies responsible for administering the outlay programs, or other mechanisms like regulations or loans, also would be needed to evaluate the combined functional area efforts. In addition, the studies done by other offices or agencies (such as CBO, the Congressional Research Service [CRS], or GAO) may be helpful in informing the decisions to be made. OMB's role, if any, needs to be determined but may be as a facilitator in reaching decisions.

Some recent congressional proposals were designed to enhance the president's ability to affect tax expenditures. One of these proposals is line item veto authority, which would allow the president to veto tax expenditure provisions contained in legislation before signing the bill (enacting it into law). Another proposal would give the president the authority to rescind spending for tax expenditures contained in legislation. The president would have to notify Congress within a short time after passage of the legislation that he intended to rescind that provision. Congress could disapprove the rescission by enacting a bill restoring the provision to law.

Such provisions could help the president shape the mix of tax expenditures and direct outlays in functional areas, if the president so desired. However, line item veto authority is highly controversial and might not be used to promote joint review, and veto authority would have clear implications for the balance of power between Congress and the president. Also, because few tax expenditures are subject to periodic reauthorization, there would be relatively few opportunities to affect the mix of direct outlays and tax expenditures by vetoing or rescinding tax expenditures.

Highlighting Information on Tax Expenditures Would Be Useful

Raising the consciousness of the level of resources the government is allocating to an area might lead to better policy formulation. Increasing the visibility of tax expenditures could help clarify and focus attention on the amount of associated revenue losses. This could be accomplished by revising how tax expenditures are presented in the president's budget. This revision could draw attention to the magnitudes of revenues forgone through tax expenditures by budget functional area, as well as promote comparisons of direct outlays with tax expenditures within functional areas.

Budget Example Showing Tax Expenditures and Outlays

Tax expenditures are currently listed with receipts in a separate section of the president's budget.[14] Treasury already computes outlay equivalents, which estimate how large direct outlays would have to be to place the taxpayer in the same after-tax position as would be attained under a tax expenditure.[15] Outlay equivalents facilitate the comparison of tax expenditures with federal programs for mandatory and discretionary spending. Juxtaposing data on tax expenditure revenue losses or outlay equivalents and spending program outlays in functional areas would be a useful, more accurate, and informative way of showing total government efforts in that area. Such a display would show the total federal resources devoted to a functional area and the portion in the form of outlays and tax expenditure revenue losses. An example of such a presentation is provided in table 5.1. The table follows the form of the Budget[16] and presents budget data contemporaneous with JCT's tax expenditure revenue loss estimates for fiscal year 1993.

[14]In the 1995 Budget, OMB began presenting tax expenditure estimates for the 5-year budget window as well as for the current and past years. This change may help facilitate comparisons of tax expenditures and related outlay programs.

[15]Often, the outlay equivalent is greater than the revenue loss, because in many cases outlays would have to be included in the taxable income of the beneficiaries of the program.

[16]See appendix 1, table 1-2, Budget Authority and Outlays by Function and Program, OMB, Budget of the United States Government, Fiscal Year 1993, Washington, DC: U.S. GPO, 1992.

Table 5.1: Budget Entry Example Presenting Tax Expenditure Revenue Loss Estimates Along With Federal Direct Outlays by Budget Function, Subfunction, and Program for Fiscal Year 1993 (Dollars in Billions)

Program/Budget Function				Total
HEALTH PROGRAMS				
Health	**Tax expenditures**	**Corporations**	**Individuals**	
	Exclusion of employer contributions for medical insurance premiums and medical care	[b]	$46.4	$46.4
	Supplemental health insurance credit component of earned income tax credit	[b]	0.1	0.1
	Deductibility of medical expenses	[b]	3.1	3.1
	Exclusion of interest on state and local government bonds for private hospital facilities	[c]	1.4	1.4
	Deductibility of charitable contributions to health organizations	$0.2	2.6	2.8
	Subtotal[a]	**0.2**	**53.6**	**53.8**
	Federal outlays			
	Health care services (includes Medicaid)			96.3
	Medicaid grants			84.5
	Health insurance tax credit			0.6
	Federal employees' health benefits			3.8
	Other health care services			7.4
	Health research and training			10.7
	National Institutes of Health			9.1
	Clinical training			0.3
	Other research and training			1.3
	Consumer and occupational health and safety			1.8
	Consumer safety			1.3
	Occupational safety and health			0.5
	Subtotal[a]			**108.8**
Medicare	**Tax expenditures**	**Corporations**	**Individuals**	
	Exclusion of untaxed medicare hospital insurance benefits	[b]	7.6	7.6
	Exclusion of untaxed supplementary medical insurance benefits	[b]	4.4	4.4
	Subtotal[a]	[b]	**12.0**	**12.0**
	Federal outlays			
	Medicare			130.9
	Hospital insurance			84.4
	Supplementary medical insurance			61.5

(continued)

Program/Budget Function				Total
	Medicare premiums and collections			$-15.0
	Subtotal[a]			**130.9**
Hospital and Medical Care for Veterans				
	Tax expenditures	**Corporations**	**Individuals**	
	None			
	Federal outlays			
	Hospital and medical care for veterans			14.9
	Medical care and hospital services			14.4
	Medical administration, research, and other			0.3
	Construction			0.7
	Third-party medical recoveries			–0.5
	Fees and other charges for medical services			[c]
	Subtotal[a]			**14.9**
Subtotal tax expenditures for health programs[d,g]				**65.8**
Subtotal federal outlays for health programs				**254.6**
Total federal effort for health programs				**320.4**
HOUSING PROGRAMS				
Commerce and Housing				
	Tax expenditures	**Corporations**	**Individuals**	
	Deductibility of mortgage interest on owner-occupied residences	[b]	$44.2	44.2
	Deductibility of property tax on owner-occupied homes	[b]	13.3	13.3
	Deferral of capital gains on sales of principal residences	[b]	13.2	13.2
	Exclusion of capital gains on sales of principal residences for persons age 55 and over ($125,000 exclusion)	[b]	4.6	4.6
	Exclusion of interest on state and local government bonds for owner-occupied housing	$0.2	1.6	1.8
	Depreciation of rental housing in excess of alternative depreciation system	1.0	0.5	1.5
	Low-income housing tax credit	0.1	1.0	1.1
	Exclusion of interest on state and local government bonds for rental housing	0.1	0.9	1.0
	Subtotal[a]	**1.4**	**79.3**	**80.7**
	Federal outlays			
	Mortgage credit			3.9

(continued)

Program/Budget Function				Total
	Mortgage-backed securities (GNMA)			$1.9
	Mortgage purchase activities (GNMA)			c
	Mortgage credit (FHA)			0.7
	Housing for the elderly or handicapped			0.2
	Rural housing programs (FmHA)			1.1
	Federal Housing Finance Board			c
	Subtotal[a]			**3.9**
Veterans' Benefits and Services				
	Tax expenditures	**Corporations**	**Individuals**	
	Exclusion of interest on state and local government veterans' housing bonds	c	c	e
	Subtotal[a]			
	Federal outlays			
	Veterans housing			1.2
	Loan guaranty revolving fund			0.5
	Direct loan revolving fund			c
	Guaranty and indemnity			0.7
	Subtotal[a]			**1.2**
Subtotal tax expenditures for housing programs				**80.7**
Subtotal federal outlays for housing programs				**5.1**
Total federal effort for housing programs				**85.8**
ENERGY PROGRAMS				
Energy				
	Tax expenditures	**Corporations**	**Individuals**	
	Expensing of exploration and development costs (oil and gas)	$0.2	c	0.2
	Expensing of exploration and development costs (other fuels)	c	c	e
	Excess of percentage over cost depletion (oil and gas)	0.1	c	0.1
	Excess of percentage over cost depletion (other fuels)	0.2	c	0.2
	Credit for enhanced oil recovery costs	c	c	e
	Alternative fuel production credit	0.6	$0.2	0.8
	Alcohol fuel credits	c	b	e
	Exclusion of interest on state and local government industrial development bonds for energy production facilities	c	0.1	0.1

(continued)

Program/Budget Function				Total
	Expensing of tertiary injectants	[c]	[c]	[e]
	Subtotal[a]	**$1.1**	**$0.3**	**$1.4**
	Federal outlays			
	Energy supply			4.0
	Research and development			3.6
	Petroleum reserves			–0.3
	Federal power marketing			–0.3
	Tennessee Valley Authority			1.2
	Uranium enrichment			–0.1
	Nuclear waste program			0.3
	Nuclear waste fund receipts			–0.4
	Subsidies for nonconventional fuel production			0.1
	Rural electric and telephone			–0.1
	Isotopes			[c]
	Energy conservation			0.5
	Emergency energy preparedness			0.4
	Energy information, policy, and regulation			0.2
	Nuclear Regulatory Commission			[c]
	Other energy programs			0.2
	Subtotal[a]			**5.1**
Subtotal tax expenditures for energy programs				**1.4**
Subtotal federal outlays for energy programs				**5.1**
Total federal effort for energy programs				**6.5**
TRANSPORTATION PROGRAMS				
Transportation				
	Tax expenditures	**Corporations**	**Individuals**	
	Deferral of tax on capital construction funds of shipping companies	0.1	[b]	0.1
	Exclusion of interest on state and local government bonds for mass transit commuting vehicles	[c]	[c]	[e]
	Exclusion of interest on state and local government bonds for high-speed inter-urban rail facilities	[c]	[c]	[e]
	Subtotal[a]	**0.1**	[e]	**0.1**
	Federal outlays			
	Ground transportation			21.8
	Highways			17.3
	Highway safety			0.4

(continued)

Program/Budget Function				Total
	Mass transit			$3.5
	Railroads			0.6
	Regulation			[c]
	Offsetting receipts			[c]
	Air transportation			9.7
	Airports and airways (FAA)			8.6
	Aeronautical research and technology			1.1
	Air carrier subsidies and other			[c]
	Offsetting receipts			[b]
	Water transportation			3.4
	Marine safety and transportation			3.3
	Ocean shipping			0.3
	Panama Canal Commission			[c]
	Offsetting receipts			–0.2
	Other transportation			0.4
	Miscellaneous programs			0.4
	Offsetting receipts			[c]
	Subtotal[a]			**35.3**
Community and Regional Development				
	Tax expenditures	**Corporations**	**Individuals**	
	Exclusion of interest on state and local government bonds for private airports and docks	$0.1	$0.6	0.7
	Subtotal[a]	**0.1**	**0.6**	**0.7**
	Federal outlays			
	None			
Subtotal tax expenditures for transportation programs[f]				**0.8**
Subtotal federal outlays for transportation programs				**35.3**
Total federal effort for transportation programs				**36.1**
BUSINESS PROGRAMS				
Commerce and Housing				
	Tax expenditures	**Corporations**	**Individuals**	
	Bad debt reserves of financial institutions	0.1	[b]	0.1
	Merger rules for banks and thrift institutions	0.6	[b]	0.6
	Exemption of credit union income	0.4	[b]	0.4
	Exclusion of investment income on life insurance and annuity contracts	0.4	8.2	8.6

(continued)

Program/Budget Function			Total
Exclusion of investment income from structured settlement amounts	c	b	e
Small life insurance company taxable income adjustment	$0.1	b	$0.1
Special treatment of life insurance company reserves	1.9	b	1.9
Deduction of unpaid loss reserves for property and casualty insurance companies	1.0	b	1.0
Special alternative tax on small property and casualty insurance companies	c	b	e
Tax exemption for certain insurance companies	c	b	e
Special deduction for Blue Cross and Blue Shield companies	c	b	e
Maximum 28 percent tax rate on long-term capital gains	b	$3.5	3.5
Depreciation on buildings other than rental housing in excess of alternative depreciation system	5.1	1.9	7.0
Depreciation on equipment in excess of alternative depreciation system	14.6	4.1	18.7
Expensing up to $10,000 of depreciable business property	0.1	0.1	0.2
Exclusion of capital gains at death	b	11.6	11.6
Carryover basis on gifts	b	1.3	1.3
Amortization of business start-up costs	c	0.2	0.2
Reduced rates on first $75,000 of corporate taxable income	3.1	b	3.1
Permanent exemption from imputed interest rules	c	0.2	0.2
Expensing of magazine circulation expenditures	c	c	e
Special rules for magazines, paperback book, and record returns	c	c	e
Deferral of gain on nondealer installment sales	0.1	c	0.1
Completed contract rules	0.2	c	0.2
Cash accounting, other than agriculture	c	c	e
Exclusion of interest on state and local government small-issue bonds	c	1.2	1.2
Deferral of gain on like-kind exchanges	0.3	0.2	0.5
Exception from net operating loss limitations for corporations in bankruptcy proceedings	0.2	b	0.2
Gain from sale or exchange to effectuate policies of FCC	0.2	b	0.2
Exemption of RIC expenses from miscellaneous deduction floor	b	0.6	0.6
Subtotal[a]	**28.4**	**33.1**	**61.5**

(continued)

Program/Budget Function				Total
	Federal outlays			
	Postal service			$1.5
	Payments to the Postal Service fund			0.2
	Postal Service			1.3
	Deposit insurance			75.8
	Resolution Trust Corporation Fund			32.5
	Bank Insurance Fund			38.0
	FSLIC Resolution Fund			6.4
	Savings Association Insurance Fund			–1.0
	National Credit Union Administration funds			–0.2
	Other mandatory			[c]
	Discretionary			0.1
	Other advancement of commerce			2.3
	Small and minority business assistance			0.6
	Science and technology			0.6
	Economic and demographic statistics			0.4
	International trade and other			0.7
	Subtotal[a]			**80.3**
Subtotal tax expenditures for business programs				**61.5**
Subtotal federal outlays for business programs				**80.3**
Total federal effort for business programs				**141.8**
INCOME SECURITY PROGRAMS				
Income Security				
	Tax expenditures	**Corporations**	**Individuals**	
	Exclusion of workers' compensation benefits	[b]	$3.2	3.2
	Exclusion of special benefits for disabled coal miners	[b]	0.1	0.1
	Exclusion of cash public assistance benefits	[b]	0.4	0.4
	Net exclusion of pension contributions and earnings	[b]	56.5	56.5
	Individual retirement plans (exclusion of contributions and earnings)	[b]	7.1	7.1
	Keogh plans	[b]	2.7	2.7
	Exclusion of premiums on group term life insurance	[b]	2.3	2.3
	Exclusion of premiums on accident and disability insurance	[b]	0.1	0.1
	Exclusion for employer-provided death benefits	[b]	[c]	[e]
	Additional standard deduction for the blind and the elderly	[b]	1.8	1.8

(continued)

Program/Budget Function			Total
Tax credit for the elderly and disabled	b	$0.1	$0.1
Deductibility of casualty and theft losses	b	0.4	0.4
Earned income tax credit	b	1.2	1.2
Supplemental young child credit component of earned income tax credit	b	c	e
Subtotal[a]	b	**75.9**	**75.9**
Federal outlays			
General retirement and disability insurance (excluding social security)			5.5
Railroad retirement			4.4
Special benefits for disabled coal miners			1.4
Pension Benefit Guaranty Corporation			–0.5
Other			0.2
Federal employee retirement and disability			60.0
Civilian retirement and disability programs			35.4
Military retirement			25.6
Federal employees workers' compensation (FECA)			0.2
Federal employees life insurance fund			–1.2
Unemployment compensation			27.6
Housing assistance			21.7
Subsidized housing			14.9
Renewal of Section 8 contracts			2.3
HOPE grants			0.1
Public housing operating subsidies			2.3
Low-rent public housing loans			0.1
Transitional housing and emergency shelter for the homeless			0.1
Home investment partnerships program			0.3
Shelter plus care			c
Other housing assistance			1.6
Food and nutrition assistance			34.3
Food stamps			22.7
Aid to Puerto Rico			1.1
Child nutrition and other programs			10.5
Other income security			47.6
Supplemental security income (SSI)			21.3
Family support payments			15.5
JOBS training program for welfare recipients			0.9
Earned income tax credit			7.9

(continued)

Program/Budget Function				Total
	Refugee assistance			$0.3
	Low income home energy assistance			0.7
	Payments to states for day-care assistance			0.8
	Other			0.2
	Subtotal[a]			**196.7**
Social Security				
	Tax expenditures	**Corporations**	**Individuals**	
	Exclusion of untaxed social security and railroad retirement benefits	[b]	$24.5	24.5
	Subtotal[a]	[b]	**24.5**	**24.5**
	Federal outlays			
	Social security			302.1
	Old-age and survivors insurance			269.8
	Disability insurance			32.3
	Interfund transactions			[b]
	Subtotal[a]			**302.1**
Subtotal tax expenditures for income security programs				**100.4**
Subtotal federal outlays for income security programs				**498.8**
Total federal effort for income security programs				**599.2**

[a]Subtotals may not add to totals due to rounding.

[b]Not applicable.

[c]Less than $50 million.

[d]Figures for health-related tax expenditures do not include any effects upon payroll taxes.

[e]Not available.

[f]Does not include tax preferences for employer-provided parking or transit passes.

[g]Does not include tax preferences for medical care and CHAMPUS health insurance for military dependents.

Sources: OMB, Budget of the United States Government, Fiscal Year 1993, Washington, D.C.: U.S. GPO, 1992; JCT, Estimates of Federal Tax Expenditures for Fiscal Years 1993-1997, Apr. 24, 1992.

Some tax expenditures (i.e., deferrals, such as accelerated depreciation) can be thought of as loans. CRS, in its 1992 compendium on tax expenditures, described deferrals as resulting either from (1) postponing deduction of expenses. For example, depreciation on equipment in excess of alternative depreciation system is the largest corporate tax expenditure listed by JCT—estimated at $14.6 billion in 1993.[17] Adding deferrals to debt program information would provide an idea of the total lending effort of the federal government. For example, the existing special analysis of debt programs could be expanded to include tax expenditure "loans." However, if combining forgone revenues from tax expenditures with credit reform data would prove confusing, the treatment of deferrals begun in the fiscal year 1995 Budget—reporting their present value—might be an alternative.

In presenting tax expenditures in the Budget, the same disagreements about their definition and measurement that have discouraged policymakers from including tax expenditures in spending reduction plans would be encountered. (See app. I for a discussion of tax expenditure definition and measurement issues.) Some tax expenditures are quite comparable to discretionary spending programs. Others are similar to mandatory programs, mandates, or regulations. Policymakers should recognize that information currently provided on tax expenditures is intended only to reflect the general magnitude of these federal subsidies. Comparing the magnitudes of tax expenditures with other outlays can inform decisionmakers about the level of federal involvement in an area.

Additional information about who benefits from these programs would also be useful for decisionmakers. For some tax expenditure programs, for example, distributional information could prompt questions about the rationale for providing larger subsidies to upper income taxpayers. In addition, as the executive branch develops data on the effects of tax expenditures, presenting this information in the budget would be desirable.

Including Tax Expenditures in Annual Agency Budget Reviews

Although some prior executive branch guidance called for agency consideration of tax expenditures, annual agency budget reviews conducted by OMB generally have not included tax expenditures.[18] From the agency perspective, tax expenditures have amounted to "free" resources that come out of someone else's budget. Further, since Treasury and IRS have responsibility for the administration of income tax

[17]According to the Senate Committee on the Budget's November 1992 report on tax expenditures, because depreciation methods faster than straight-line allow for larger depreciation deductions in the early years of the asset's life and smaller deductions in the later years, and because an asset's shorter useful life allows quicker recovery, accelerated depreciation results in a deferral of tax liability.

[18]Circular No. A-11: Preparation and Submission of Budget Estimates, Executive Office of the President, OMB, July 1992.

expenditures, other agencies have had little incentive to get involved. A former Treasury official told us that some Treasury and OMB personnel attempted to incorporate tax expenditures into OMB's budget reviews during the late 1970s. The Treasury official said that the agencies resisted such an approach, and he thought that leadership would be necessary to overcome this problem by emphasizing that there is money going into these programs, by whatever mechanism.[19]

Joint reviews of direct outlays and related tax expenditures could be conducted routinely for those budget subfunctions with tax expenditures. Or, to reduce the burden and focus policymakers' attention, several functional areas could be selected each year where tax expenditures would be considered jointly with outlays. Agencies can consider whether related federal efforts (achieved either through outlays or tax expenditures) could be better coordinated to increase the effectiveness and efficiency of the government's total effort in that area. Such a system might help ensure that priorities and program design are consistent with the policy objectives in each functional area.

Tax policy would be an important consideration when reviewing tax expenditures because, as part of the tax code, tax expenditures affect many elements of the overall tax system. For example, adding new tax expenditures, or adding limits to existing tax expenditures could (1) increase the complexity of the tax code, (2) make administration more difficult, and/or (3) increase taxpayer burden and compliance costs. As tax policy analyst Daniel Weinberg noted, "Many tax expenditures are interdependent because they mutually affect marginal tax rates or the incentive to itemize deductions."[20] Changes in tax expenditures also affect horizontal and vertical equity of the tax system, determining whether people with similar incomes are treated similarly and whether taxpayers with greater ability to pay, pay more taxes. Accordingly, it would be important for Treasury to be involved in reviewing agency submissions with OMB.

Including tax expenditures in OMB's budget reviews could be facilitated by GPRA. According to the Senate Committee on Governmental Affairs' report on GPRA, OMB is expected to describe a framework for undertaking periodic analyses of the effects of tax expenditures in achieving performance goals

[19]Agencies could also be required to identify the effect regulatory policy changes have on receipts. For example, some regulations clearly cost Treasury revenues, but they are not listed anywhere.

[20]Daniel H. Weinberg, "The Distributional Implications of Tax Expenditures and Comprehensive Income Taxation," National Tax Journal, Vol. XL, No. 2, page 237.

in a May 1, 1997, report to the president and Congress. While inclusion of tax expenditures in budget reviews need not be delayed in accordance with GPRA time frames, when implemented, GPRA could provide a link between budget reviews and an assessment of how well tax expenditures and outlay programs meet agency performance goals.

According to the Senate Committee on Governmental Affairs' report, agency GPRA assessments are to consider the relationship and interactions between spending programs and related tax expenditures. This could provide an opportunity to improve program coordination. As specified in the Senate Committee's report on GPRA, the Director of OMB is to establish an appropriate framework for periodic analyses of the effects of tax expenditures in achieving performance goals. Establishing such a framework would involve identifying and resolving which tax expenditures and outlay programs are related and should be jointly considered. The roles of OMB, Treasury, and agencies with outlay programs would need to be established to most effectively assess tax expenditures' performance, as well as their interaction with related spending programs.

Since the OMB Director's report on a framework for analyzing tax expenditures is not due until May 1, 1997, actual analyses are not likely to begin until that time or later. GPRA requires agency pilot tests during 1994, 1995, and 1996—before full-scale implementation of strategic planning and performance measurement begin. However, OMB's initial plans did not indicate any pilot tests or case studies for tax expenditure analyses, although OMB could use the results to develop an optimal reporting framework. As stated in the Senate Committee's report, "Focusing on doing it right in a handful of programs—often learning on a trial-and-error basis—maximizes the likelihood of ultimate, government-wide success."[21] Most agencies have had little experience in assessing tax expenditures.

The Director of OMB has discretion in determining the best manner and useful form for submitting the federal government performance plan for the overall budget. According to the Senate report, this plan could be integrated with other budget estimates, be presented in a separate section of the main budget document, or be submitted separately. As discussed earlier in this chapter, we believe that juxtaposing data on tax expenditures and program outlays would be a useful, more accurate, and informative way of showing the total government effort in the area.

[21]Report of the Committee on Governmental Affairs, United States Senate, Government Performance and Results Act of 1993 (Report 103-58), June 16, 1993, page 20.

Presenting information in a separate section of the budget, or in a separate document, could reduce the visibility of the information presented.

OMB plans to integrate its management and budget staffs, which is intended to enable more consideration of complex matters—including performance measures and issues such as the interactions between tax expenditure and outlay programs. OMB has announced its intention to initiate joint reviews of tax expenditure and outlay programs. These reviews will involve OMB, Treasury, and Council of Economic Advisers' staff. Also, OMB has had initial discussions with Treasury and other agencies about developing output measures for key tax expenditures.

Conclusions and Recommendations

In its struggle to reduce the federal deficit, Congress has been exerting ever tighter control over the allocation of federal resources. Federal discretionary and entitlement spending—but not existing tax expenditures—are subject to some form of direct budgetary control or review. Most recently, this control includes an executive order addressing entitlement program growth. New or expanded tax expenditures are subject to Budget Enforcement Act of 1990 PAYGO controls, and pressure for the tax committees to obtain a specific level of revenue may help Congress control indirect "spending" through existing tax expenditures. Nevertheless, aggregate tax expenditure revenue losses are substantial and are projected to continue increasing over the next 5 years, albeit at a somewhat uncertain rate. The revenues forgone through tax expenditures reduce the resources available to fund other programs or to reduce the federal deficit, or they require tax rates to be higher to raise a given amount of revenue.

Tax expenditures may be the most appropriate means to further some federal objectives. However, studies we and others have done have raised concerns about the effectiveness, efficiency, or equity of some tax expenditures.[1] As with other subsidy programs, it is difficult to design tax expenditures so that they do not at least, in part, reward people for what they would have done otherwise. In general, tax expenditures tend to provide relatively greater benefits to higher income taxpayers, who also face higher tax rates. The current process does not prompt policymakers to directly address this issue.

Moreover, unlike discretionary programs, tax expenditures do not overtly compete in the annual budget process. Because of this and because most are not subject to periodic reauthorization or review, tax expenditures may be less likely than discretionary spending to be modified to meet changing circumstances. Recently, Congress has been grappling with how to improve its controls over entitlement programs. Tax expenditures share many characteristics with entitlement programs and present similar challenges to those who wish to design improved controls over their growth.

[1]See, for example, Home Ownership: Mortgage Bonds Are Costly and Provide Little Assistance to Those in Need (GAO/RCED-88-111, Mar. 28, 1988); Targeted Jobs Tax Credit: Employer Actions to Recruit, Hire, and Retain Eligible Workers Vary (GAO/HRD-91-33, Feb. 20, 1991); Tax Policy: Insufficient Information to Assess Effect of Tax Free Education Assistance (GAO/GGD-89-76, June 23, 1989); The Cost-Effectiveness of the Low-Income Housing Tax Credit Compared With Housing Vouchers (CBO Staff Memorandum, April 1992); or Targeted Jobs Tax Credit Program, State of Alabama, October 1, 1990-September 30, 1991 (Department of Labor, Office of Inspector General, Aug. 20, 1993).

Providing more information on tax expenditures might help better inform the public and Congress about tax expenditure provisions. Useful information about tax expenditures could include their effectiveness, distributional equity, and economic efficiency in achieving federal objectives. Expanded and improved tax expenditure information could be developed by Treasury for the president's budget or by others, such as JCT. Many of those we interviewed thought that more information should be made available about tax expenditures to increase policymakers' and the public's awareness about their effects and limitations, thus encouraging a more informed debate. Recent revisions by OMB to the presentation of tax expenditure information in the federal Budget are a step in this direction. OMB has also begun considering what additional information could be provided in the Budget to better inform policymakers about tax expenditures and their relationship to other federal efforts.

We believe that greater scrutiny of tax expenditures is warranted. The three options we discussed in this report should help increase the amount of attention paid to tax expenditures and could reduce their revenue costs. The options include (1) using current methods to further limit the growth of tax expenditures, (2) integrating tax expenditures more fully into the congressional budget process, and (3) enhancing consideration of trade-offs among direct and indirect spending programs within functional areas. Regardless of which approach or blend of approaches Congress may adopt to review and control tax expenditures, budget and tax policy experts believe that significant changes to tax expenditures will not occur unless Congress has a strong will to do so. However, a well-designed process may enhance Congress' ability to act once a consensus for change exists.

Using Current Methods

Greater scrutiny of tax expenditures using current processes may lead to better control of associated revenues forgone if Congress finds that some tax expenditures have outlived their usefulness or could be targeted more narrowly while still accomplishing their goal of providing needed subsidies for production and consumption activities. Greater scrutiny could be achieved with little or no change in current congressional processes and jurisdictions. In addition, several techniques, such as ceilings and floors on eligibility, have already been employed by Congress to control the growth of tax expenditures. These techniques could be strengthened or extended to additional tax expenditures. Congress could provide more impetus for executive and legislative branch policymakers to scrutinize tax expenditures by requiring better highlighting of information about them.

Better highlighting of tax expenditures could be achieved by requiring a legislative organization, like JCT or CBO, to publish information about the effectiveness, distributional equity, and economic efficiency of tax expenditures. Congress also could establish a schedule for reviewing tax expenditures, perhaps concentrating on those with the largest revenue implications.

If Congress considers that controlling tax expenditure growth through the current framework is insufficient, Congress could change its processes to exert more control over the amount of federal resources allocated through tax expenditures. Congress could consider options like further integrating tax expenditures into the budget process or jointly reviewing tax expenditures along with federal mandatory and discretionary spending programs in functional areas. In implementing either of these options, Congress could, and likely would, make changes to specific tax expenditures or groups of tax expenditures using the methods and techniques that have been employed under current review processes.

Further Integrating Tax Expenditures Into the Budget Process

The integration of tax expenditures into budgetary processes would put these subsidies on a more equal footing with outlays and could contribute to a more balanced approach to deficit reduction. But full integration would not be easy. Depending on the design of the approach, integrating tax expenditures into the budget process also could encourage greater congressional and executive branch scrutiny of the performance of individual tax expenditures.

If all federal expenditures are to be on the table for deficit reduction, we believe revenues forgone through tax expenditures should not be immune from a similar degree of review and sacrifice to that now borne by many other parts of the Budget. Definitional, measurement, and other technical problems are clearly significant issues for further integration. Because of these problems, one approach we examined—an aggregate cap on tax expenditures—likely would not work. However, a tax expenditure savings target is feasible, depending on the value Congress places on further control. In developing the annual budget resolution, Congress could be prompted to decide whether tax expenditures warrant such a target. Jurisdictional hurdles would need to be overcome because a savings target expands to some extent the number of legislators that would be involved in revenue decisions. However, the constraints and conventions used in defining and measuring tax expenditures under a savings target need not differ from those now used in reconciliation or other tax legislation.

Enhancing the Consideration of Trade-Offs Within Functional Areas

Benefits could be obtained from the (1) coordination of mandatory and discretionary federal spending programs with tax expenditures, (2) reduction of overlap and inconsistencies among all federal subsidy programs, and (3) encouragement of trade-offs among tax expenditures, outlays, and loans. Better targeting by Congress and the executive branch of all federal spending and subsidy programs, for example, could save resources and increase economic efficiency. The concept underlying the tax expenditure budget is that government intervention through the tax code should be evaluated by the same criteria as and weighed against such alternatives as discretionary outlays, credit programs, or regulation. Although tax expenditures are displayed in the Budget in comparable terms with outlays, the budget process does not prompt decisionmakers in either Congress or the executive branch to consider them when reviewing related spending programs. Integrated reviews of tax expenditures with functionally related outlay programs could help achieve efficiencies.

Should Congress attempt functional integration of tax and direct subsidies, problems would arise similar to those that occur when merging tax expenditures into the budget process. For example, definitional and measurement problems would need to be addressed. Depending on the design of integrated functional reviews, congressional jurisdictional changes could be substantial. Another potential problem is that some of the reallocations of resources across budget categories that integrated reviews of spending programs and related tax expenditures might identify as desirable would not be possible under current budget rules.[2] As with budgetary integration, these problems could be overcome if Congress decides to improve the effectiveness of overall federal spending, whether through outlays or tax expenditures.

Integrated reviews are perhaps most easily done in the executive branch. OMB, in consultation with Treasury, could develop a process to annually review selected tax expenditures in conjunction with the budget review process for related spending programs. In the next section we discuss the Government Performance and Results Act of 1993 (GPRA), which provides an impetus to do so.

[2]We previously commented on the impediment that budget categories impose on effective investment in long-term economic growth. See our letter to the Chairman of the House Committee on Government Operations, Letter to the Honorable John Conyers, Jr. (B-247667), dated May 19, 1993.

Government Performance and Results Act of 1993 Holds Promise for Enhanced Executive Branch Reviews

The Government Performance and Results Act of 1993 provides a promising opportunity for the executive branch to develop useful information about tax expenditures. As specified in the Senate Committee on Governmental Affairs' report on the act,[3] the Director of OMB is to establish an appropriate framework for periodic analyses of the effects of tax expenditures in achieving performance goals. We believe such analyses, particularly if they consider the equity, efficiency, and effectiveness of the tax expenditures in achieving their intended purposes, could be useful in promoting improvements in tax expenditures.

In addition, the Committee's report established an expectation that these performance analyses should consider the relationship and interactions between outlay programs and related tax expenditures. This approach is akin to that outlined in our third option, wherein (1) the total federal effort in a functional area would be examined, (2) effective means of achieving federal objectives could be identified and promoted, and (3) ineffective or inconsistent means could be curbed.

The OMB Director's report on a framework for analyzing tax expenditures is not due until May 1997, according to the Committee's report. Consequently, actual analyses may not begin until that time or later. Under GPRA, agency pilot tests are required for outlay programs before full-scale implementation of strategic planning and performance measurement begins. The results of these tests are intended to assist the executive branch in assessing the benefits and identify any significant difficulties before expanded implementation begins governmentwide. Similarly, pilot tests in the tax expenditure area, preferably occurring before the required report to Congress, might also assist OMB, working with Treasury, in designing and implementing a framework for analyzing tax expenditures.

According to OMB, initial discussions have been held with Treasury officials on developing output measures for key tax expenditures. In addition, informal reviews of tax expenditures and related outlay programs have begun, and Treasury is also involved in these efforts. These initial efforts could lead to the use of performance measures for the comparison of tax expenditures and related spending programs on a periodic basis. These measures could help support the joint review of tax expenditures and spending we are calling for. In this regard, we are encouraged by OMB's recent announcement of its intent to initiate such reviews as part of its reorganization. These reviews, which appear to be

[3]Report of the Committee on Governmental Affairs, United States Senate, Government Performance and Results Act of 1993 (June 16, 1993, Report 103-58).

similar to the pilot tests required under GPRA for outlay programs, should provide a sound basis for proposing a framework for tax expenditure performance reviews in OMB's March 1997 report. Routinely comparing the benefits provided through tax expenditures to those provided through related spending programs would require resources. Therefore, pilot tests should include an assessment of the level of OMB, Treasury, and executive agency resources that may be needed.

Recommendation to Congressional Committees

The tax-writing committees should explore, within the existing framework, opportunities to exercise more scrutiny over indirect "spending" through tax expenditures.

Matters for Congressional Consideration

Should Congress wish to consider tax expenditure efforts in a broader context of the allocation of federal resources, it could consider further integrating them into current budget processes. Providing for congressional consideration of a savings target as part of the annual budget process could ensure that Congress addresses tax expenditures periodically. Alternatively, options to integrate consideration of related outlay and tax expenditure efforts could promote a more thorough review by the legislative and executive branches of alternatives to achieving federal objectives.

Recommendations to the Office of Management and Budget

The Director of OMB, in consultation with the Secretary of the Treasury, should revise the budgetary presentation of tax expenditure information to highlight for the public and policymakers the fiscal and other consequences associated with tax expenditures. A revised presentation should include the combined federal resources allocated in functional areas, including both outlays and tax expenditures and, to the extent possible, information that could be used in assessing their effectiveness, distributional equity, and economic efficiency.

To the extent that it is practical, OMB should incorporate tax expenditures into the annual budget review process. OMB, consulting as appropriate with the Department of the Treasury and other federal agencies, should use information on outlay programs and tax expenditures to determine and make recommendations to the president and Congress about the most effective methods for accomplishing federal objectives.

OMB, working with Treasury, should design and test the basic structure for tax expenditure performance reviews before OMB develops a framework for governmentwide use by May 1997. This could help ensure that a practical and effective framework is developed for analyzing the effects of tax expenditures in achieving performance goals under the Government Performance and Results Act of 1993. Design considerations should include determining

- which tax expenditures and outlay programs are related or interact and, therefore, should be jointly considered; and
- the roles of OMB, the Department of the Treasury, and departments or agencies with outlay program responsibilities in assessing the performance of tax expenditures and their relationship and interaction with related spending programs.

Once these initial determinations have been made, OMB, along with Treasury, should conduct case studies of the proposed performance review process to, among other things, identify (1) successful methods agencies devise for reviewing tax expenditures' performance, (2) how best to report the results of these reviews, and (3) how to ensure that adequate resources are available for such reviews. This would enable OMB and Treasury to gauge how well the proposed framework for measuring and reporting on tax expenditure performance might function.

Once tax expenditure performance data are developed, OMB also should consult with Treasury in considering how to portray tax expenditure performance information in the Budget. To complement the intent of the reviews, the tax expenditure performance information should be combined with related outlay information to demonstrate the relative efficiency, effectiveness, and equity of federal outlay and tax expenditure efforts within a functional area. Such a presentation could be used to show the relative effectiveness of federal spending programs funded through both outlays and tax expenditures.

Agency Comments and Our Evaluation

We obtained written comments on a draft of this report from OMB and Treasury. We also obtained reactions to a draft of this report from JCT, CBO, and two individuals with expertise related to the subject matter.

In written comments on a draft of this report, OMB and Treasury's Office of Tax Analysis supported expanded federal review of tax expenditures by the executive branch or Congress. OMB generally agreed that our recommendations to it were reasonable and indicated that the recommendations were consistent with efforts OMB had already begun. For example, OMB has announced plans to begin reviews of related spending and tax expenditure programs. Treasury shared GAO's concern that tax expenditures be given greater review by the executive and legislative branches, basically as outlined in GAO's first option. OMB and Treasury had reservations about whether integrating tax expenditures into the budget process would produce better outcomes than current processes. Treasury also expressed reservations about whether joint spending and tax expenditure reviews would provide the benefits anticipated. OMB and Treasury's comments as well as those of the other parties who reviewed our draft report are discussed in more detail in the following pages.

OMB's Comments

OMB said that the recommendations to the OMB Director in our draft were, with certain caveats, reasonable and consistent with efforts that the administration had already initiated.

Specifically, OMB agreed that a revised budget presentation that would contain some tables with both tax expenditure and related outlay data would be reasonable. OMB said that technical and conceptual problems with the measurement of tax expenditures could indicate limited, as opposed to full, integration of tax expenditures into the budget. OMB suggested that two new features of the fiscal year 1995 Budget were consistent with our recommendation. These features are (1) the Budget presents estimates of tax expenditures over the full 5-year budget window as well as for the current and past year and (2) present-value estimates are reported for tax expenditure provisions that involve deferrals and similar long-term revenue effects.

We believe the new presentations in the fiscal year 1995 Budget are consistent with the intent of our recommendation to better highlight for the public and policymakers the fiscal and other consequences associated with tax expenditures. We believe, and OMB agrees, that tables similar to those presented in chapter 5 that display related tax expenditure and outlay efforts would also be useful. We also agree that technical and conceptual problems with the measurement of tax expenditures may inhibit the full integration of tax expenditures into functionally related budget presentations. In this regard, we believe OMB's apparent intention to begin with presentations that seem most feasible and elaborate on them or develop additional presentations as more information becomes available is a logical approach.

Concerning our recommendation that OMB take steps to incorporate tax expenditures into the annual budget review process, OMB reported that such steps have been initiated. OMB has announced its intent to start joint reviews with Treasury and Council of Economic Advisers staff. Also, the integration of OMB management and budget staffs, which OMB will begin implementing on May 1, is intended to enable OMB to give more consideration to complex matters, such as performance measures and the interactions between tax expenditures and outlay programs. Again, these steps seem to be consistent with our recommendation.

On our recommendations that focus on analyzing the effects of tax expenditures in achieving their performance goals and using performance information in the Budget, OMB also indicated that initial work has begun. OMB reported having discussions with Treasury and other agency officials on developing output measures for key tax expenditures that would be consistent with the goals of the Government Performance and Results Act of 1993. OMB believes that although such measures involve a number of information-related challenges, they will serve as a good foundation for more widespread reporting on tax expenditures.

Such initial discussions are promising. We believe, however, that the basic structure for tax expenditure performance reviews must be designed and tested in a systematic manner to increase the likelihood that OMB will be successful in applying GPRA to tax expenditures. Therefore, we encourage OMB to design and test a structure for tax expenditure performance reviews as soon as practical.

In addition to commenting on our specific recommendations to the Director of OMB, OMB provided some comments on the three basic options for more systematically overseeing tax expenditures that were presented in our draft. On the option of making greater use of methods currently within the purview of the tax committees, OMB suggested that the use of ceilings, floors, or similar measures for limiting tax expenditures presents important tax policy issues that merit evaluation. We agree that these mechanisms for limiting tax expenditures have important tax policy implications and have summarized the principal policy considerations related to using them.

OMB suggested that additional mechanistic constraints on the budget process could be a blunt instrument for guiding tax and budget policy and that it is not clear such an option would ultimately produce better outcomes than the current approach. OMB also said that budget constraints on tax expenditures could add additional uncertainty to the tax code and that this uncertainty could deter precisely the types of activities that some provisions are designed to promote.

As discussed in the report, we believe that a savings target approach to further integrating tax expenditures into the budget process is one feasible approach to prompting greater scrutiny of tax expenditures. If a savings target were adopted, design decisions like multiple-year budget agreements adopted by Congress as a whole could help minimize but not eliminate most problems associated with further integrating tax expenditures into the budget process. Regarding uncertainty, any congressional attempt to more closely scrutinize tax expenditures is likely to increase uncertainty. Although steps can be taken to decrease the adverse effect of additional controls or targets, if Congress judges that tax expenditures need to be better controlled or targeted, then inherently some change is implied, and some uncertainty will result. Overall, we believe that tax expenditures deserve greater scrutiny and believe that each option presented is a feasible means of achieving it but that implementing each option also calls for careful design decisions.

OMB said that we should consider updating our data on tax expenditures because the data included in the fiscal year 1995 Budget takes into account changes introduced by OBRA 1993 and revised economic assumptions. Where we discuss comparisons of tax expenditures and other measures, such as GDP, entitlement spending, revenue growth, or discretionary spending, we have included results based on the Budget to show the overall effect that OBRA 1993 and recent economic changes may have had on tax expenditure levels. We did not use Budget data in various tables in the report that list individual tax expenditures. Some individual tax expenditures could be affected materially by OBRA 1993 or new economic assumptions. However, without extensive analysis that was beyond the scope of our effort, we would not have been able to determine whether specific tax expenditure amounts changed due to these circumstances or perhaps other factors, such as differences in estimating conventions used by JCT and Treasury's Office of Tax Analysis. We judged that for illustrative purposes the 1993 JCT data were adequate.

OMB also said that the draft report should recognize that in principle, the tax expenditure concept applies to other taxes, such as estate and gift taxes. We have done so. Finally, OMB offered various technical comments concerning the accuracy, completeness, or balance of certain items in our draft, and we made appropriate changes on the basis of those comments.

Treasury's Comments

In commenting on our draft report, Treasury agreed that a more comprehensive periodic review of tax expenditures would be useful. In particular, Treasury supported the idea that tax expenditures should be given greater review by the administration and the tax-writing committees of Congress. This view concurs with our first option.

However, Treasury was not convinced that further integration of tax expenditures into the budget process (our second option) or combined outlay-tax expenditure reviews by the administration or Congress (our third option) would provide the benefits anticipated by our report. Concerning further integration of tax expenditures into the budget process, Treasury said that conceptual and measurement problems with tax expenditures are likely to be quite serious if tax expenditures were to be explicitly integrated into the budget process. Among the problems Treasury cited with tax expenditure estimates are that (1) the determination of which tax provisions are tax expenditures is not an inconsequential problem, (2) projections of future tax expenditures are more uncertain than estimates of future tax receipts or outlays, (3) tax expenditure estimates are not intended to indicate the increased revenues that might result if one or another tax expenditure is repealed, and (4) interactions among tax expenditures would affect revenues raised if tax expenditures are modified but that OTA and JCT do not take these interactions into account.

Treasury said that given additional resources, OTA and JCT could provide revenue estimates for tax expenditures that would be more appropriate for implementing our second or third options than current tax expenditure estimates. However, Treasury concluded that policymakers and the public would be better served if increased resources were used to better elucidate the effectiveness of tax expenditures and outlays in achieving their policy objectives.

In general, we agree that studying how well tax expenditures and outlays achieve their policy objectives is critical to improving government operations. Nevertheless, Congress and the executive branch use various processes to guide decisionmaking. Whether policymakers and the public would be better served by using any increased resources to determine the effectiveness of tax expenditures or to support decision processes like those described in our second and third options is a policy judgment.

Concerning the various other issues raised by Treasury, we recognized and discussed them in the draft report. Although such problems exist, we concluded that they could be overcome or that processes could be designed that minimize their adverse effects. For example, despite the conceptual difficulties of defining tax expenditures and the different approaches that JCT and OTA use in determining which tax law provisions constitute tax expenditures, JCT and OTA tax expenditure lists are quite similar. Any effort to more systematically oversee tax expenditures, including the three options we present, initially could concentrate on those tax expenditures upon which agreement already exists.

In our draft report, we also presented the measurement limitations with current tax expenditure estimates. These limitations were a key factor in our conclusion that subjecting tax expenditures to an overall cap on allowed revenue losses likely would not be feasible. However, we concluded that setting a target, not a binding cap, for reducing tax expenditures would significantly mitigate measurement and interaction difficulties. A savings target mitigates these difficulties primarily because it focuses attention on achieving a defined reduction in revenue losses. The savings target approach involves processes similar to those tax committees can face under current PAYGO rules whenever changes to tax expenditures are considered.

The setting of the level of a savings target, if any, could raise measurement and interaction issues if the aggregate level of tax expenditures is used mechanistically in determining the savings target level. For example, if a tax expenditure savings target was set as a 5-percent reduction in total revenue losses, measurement of total revenue losses would be important. If, however, targets were set less rigidly, current estimating practices may be sufficient. Treasury indicated that the current tax expenditure estimates are sufficient to provide guidance to policymakers on the order of magnitude of revenues lost. If policymakers judge this order of magnitude to be too large or if they judge that the revenue system would be improved through fewer tax expenditures, they could judgmentally select savings targets to reduce tax expenditures over time. This would be conceptually similar to the decision Congress made in designing the Tax Reform Act of 1986 to broaden the tax base and reduce rates.

Treasury raised various specific concerns with the option of further integrating tax expenditures into the budget process. However, Treasury's concerns appeared to be focused on a system that would attempt to cap tax expenditures, which we concluded was unlikely to work.

In our draft, we discussed concerns Treasury expressed about difficulties that would result from the application of sequestration rules to tax expenditures and the adverse effect that uncertainty about tax expenditure provisions could have on financial planning. In summary, such concerns must be weighed in the decision of whether to implement a budget-based method for controlling tax expenditures. Problems associated with sequestration and uncertainty can be lessened, although not eliminated. Ultimately, Congress must judge whether further efforts should be made to scrutinize or control tax expenditures and whether the benefits of such efforts will outweigh the imperfections that are attendant to the options we discuss or that likely would apply to other options that could be devised. In making this judgment, it may be useful to consider whether budget controls over outlay programs have similar imperfections. For example, citizens who receive federal assistance through discretionary programs that were capped in BEA have experienced uncertainty or reductions in that assistance.

Treasury also was concerned that a system to control tax expenditures, which would reduce budgetary flexibility, would also make the federal government much less responsive to changing economic conditions. This is a possible consequence of a restrictive system. However, a budget option does not have to reduce Congress' budgetary flexibility significantly. For instance, the savings target approach to integrating tax expenditures, in essence, makes one key change to current budget processes: It provides Congress the opportunity to decide whether the targets should be met in part through base broadening as it sets revenue targets. Budget flexibility continues, but the locus for decisionmaking is moved. In addition, the controlling of tax expenditures through any option could arguably increase flexibility. One of the significant impediments to budgetary flexibility is the substantial portion of federal spending that is locked in unless Congress explicitly revises statutes. Entitlement programs, tax expenditures, and interest payments on the deficit decrease the ability of Congress to respond to changes in the economy—either cyclical changes such as recessions or structural changes such as the replacement of manufacturing by service sector employment. Thus, budgetary flexibility to respond to economic change is multifaceted.

Treasury also linked its concerns regarding measurement problems associated with tax expenditures to our third option, which suggests reviewing functionally related tax expenditures and outlay programs together. Our draft described a range of approaches to achieving such reviews. Approaches could vary from joint hearings involving tax committees and authorizing committees to jurisdictional and budgetary changes, which would give authorizing committees a formal role in determining the level of revenue losses for tax expenditures related to their functional expertise. Giving authorizing committees a formal role related to tax expenditures could include the assignment of combined "targets" to the committees for total "spending" on related tax expenditures and outlay programs.

This latter approach might require that tax expenditure estimates be replaced with more rigorous revenue estimates. Both Treasury and JCT officials believed that they would need to redirect their efforts from other areas or that they would need additional resources to meet such a requirement if they were also to continue fulfilling their other responsibilities. We recognize this consequence explicitly in this report. In addition, OTA and JCT may need some time to develop methodologies to provide revenue estimates rather than the current tax expenditure revenue loss estimates. Approaches to doing functional reviews not tied to "spending" targets would be less affected by tax expenditure measurement issues.

In reference to the option of reviewing functionally related tax expenditures and outlays, Treasury said that Canada's experience with linking functionally related tax expenditures and outlays in its budget process was not encouraging. Treasury pointed to the ability of the Canadian finance minister to institute new tax expenditures as undermining the discipline intended by the process and leading to its collapse. This possible cause of the Canadian system's failure has been added to our report. However, as our draft indicates, the system did not provide an adequate incentive to make trade-offs within functional areas, because savings from reduced tax expenditures were not automatically available for other efforts in the functional area. We observed that such an incentive may be necessary if a similar system is tried in the United States.

Comments From JCT, CBO, and Experts

JCT, CBO, and two individuals with expertise related to tax expenditures and federal budgeting reviewed a draft of the report. All provided various technical comments that related to such things as (1) the reliability and use of current tax expenditure data, (2) the accuracy of certain data or passages in the draft, or (3) the ability of additional information to provide a fuller perspective for readers on certain issues. Where appropriate, we made changes to this report on the basis of these comments.

Two of the commenters, CBO and one of the individuals, expressed reservations about whether tax expenditures could be subjected to budgetlike controls. CBO's reservations centered primarily on using growth trends for aggregate tax expenditures to support policy judgments. CBO noted that year-to-year changes in aggregate tax expenditure levels could be due to such underlying factors as changes in the tax law, in tax rates, or in economic data used to derive the tax expenditure estimates. We have revised the report to clarify that budgetary restrictions, if any, on tax expenditures should not be mechanically linked to tax expenditures' growth. Rather, Congress should assess the magnitude and trends in tax expenditure revenue losses and be prompted to decide whether these warrant action in the form of a savings target.

CBO also commented that tax expenditures are identified differently by JCT and OTA within Treasury because they use differing definitions of what a normal income tax system would include in order to identify deviations from it—that is, tax expenditures. In addition, CBO said that although the aggregation of tax expenditures in any 1 year roughly suggests an order of magnitude, the sum has limited analytical value for purposes of budgetary and tax policy because it does not account for interactions between tax expenditures.

We discuss these concerns in the report. We also analyze how the options to increase scrutiny of tax expenditures can be designed to minimize the effect of these problems. For the option of further integration of tax expenditures into the budget process, we concluded that using aggregate tax expenditure totals in any mechanistic manner to trigger congressional action would be unadvisable. Making incremental changes to tax expenditures through the use of a savings target, when deemed appropriate by Congress, would substantially decrease problems related to the identification of tax expenditures and the measurement of aggregate totals.

One of the individual commenters said that the draft report assumed that tax expenditures should be budgeted as substitutes for direct expenditures but that this was inappropriate. The commenter said that tax expenditures were an analytic tool that should not be transformed into an accounting and decisional rule.

This commenter suggested that Congress currently considers tax expenditures in the broader context of their interaction with tax rates. In this view, Congress seeks to achieve a set of effective tax rates that is the result of both statutory tax rates and tax expenditures. Addressing tax expenditures alone would, in his view, tend to distort decisions. Congress would likely accompany any major change in tax expenditures with a corresponding shift in tax rates to achieve the desired effective tax rate goal.

This view effectively reflects the way that tax expenditure decisions are made under current processes—tax committees have autonomy to decide the appropriate levels of tax expenditures in the context of their interaction with rates and other tax policy goals. While we agree that the savings target would limit somewhat the tax committees' freedom to make tax policy decisions, our proposal does not preclude the tax committees from adjusting tax rates and tax expenditures together. Under existing PAYGO rules, tax rates still could be changed as long as the changes do not increase the deficit. In addition, other national concerns are or should be considered when reviewing tax expenditures besides their interactions with tax rates. As we have noted in this report, these include how well tax expenditures achieve their objectives and tax expenditures' interrelationships with other tools used by the federal government to achieve broad related objectives—a concern shared by authorizing or appropriating committees. Moreover, tax expenditures can be an important part of any broad-based effort to reduce the federal deficit, which is an important national concern that involves the entire Congress.

The options of further integrating tax expenditures into the budget process or reviewing related tax expenditures and spending programs together would help shift the context for tax expenditure decisions to prompt the involvement of other actors or committees with a vital interest in their outcomes. However, tax committees would continue to play a key role. For example, if the budget resolution provided for a tax expenditure savings target, the tax committees would decide how to meet such a target through specific changes in tax expenditures. Commensurate tax rate adjustments could be made as long as sufficient offsets were included to avoid raising the deficit.

Definitional and Measurement Issues Relevant to Efforts to Control Tax Expenditure Revenue Losses

Individual and corporate tax expenditures have been enumerated and their revenue losses estimated annually since the mid-1970s. However, the purpose of the tax expenditure list, the appropriate conceptual baseline for defining tax expenditures, and tax expenditure measurement practices are still subject to debate. Discussions about which provisions of the tax code should be classified as tax expenditures stem from different views about what should be included in the income tax base. For example, a few tax expenditures, such as accelerated depreciation and special treatment for capital gains, do not fit neatly into budget categories. Since 1983, Treasury's list of tax expenditures has distinguished between those that can be put into budget functional categories according to their various purposes, and those that do not fall into specific budget categories.[1] However, the Joint Committee on Taxation's (JCT) list does not differentiate between them.

There also are different views about how to estimate tax expenditure revenue losses and whether the current estimates are good enough to serve as a basis for controlling their growth. Some have suggested that uncertainties about the definition and measurement of tax expenditures discourage policymakers from including them in spending reduction plans. These uncertainties, however, need not preclude all policies to control tax expenditure revenue losses or to scrutinize this type of "spending" carried out through tax code provisions.

What Constitutes a Tax Expenditure Could Be Subject to Controversy

Central to the tax expenditure concept is the idea that the income tax system consists of two parts: (1) the structural provisions of the tax code necessary to implement taxes on individual and corporate net income and (2) a system of tax expenditures under which governmental financial assistance programs are carried out through special tax code provisions rather than through other government spending. Provisions of the tax code that simply define and measure net income subject to tax are considered baseline provisions. Tax expenditures are provisions of the tax code that reduce tax liability but are not considered part of the income tax baseline. These provisions are designed to further social and economic goals (e.g., more health care, more capital investment) that are not intrinsically related to the tax system.

There is no precise legal definition of the income tax baseline or of exceptions to it. Section 3(a)(3) of the 1974 Congressional Budget Act

[1]Beginning with the fiscal year 1987 Budget, Treasury has reported tax expenditure estimates with respect to both the "normal" and the "reference tax law" baselines.

defines tax expenditures as "those 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 tax liability...." Since the budget act does not list the items that meet this definition, JCT and Treasury each compiles a list. There is some disagreement between them about which provisions of the tax code should be part of the baseline structure of the income tax and which should be considered tax expenditures. However, although each uses a different definition of the income tax baseline, there is considerable overlap in the tax preferences on the JCT and Treasury lists.

There are many proposals to redefine the income tax base and exceptions to it in accord with some particular purpose for the tax expenditure list. Several tax policy researchers have constructed their own lists in conjunction with proposals for classifying, evaluating, or limiting income tax expenditures. Many of those we talked to suggested that if the tax expenditure list were used to control aggregate tax revenue losses, or even to target some tax expenditures for periodic review, the appropriate baseline to use in selecting the items to be listed could become more controversial.

JCT's and Treasury's Tax Expenditure Lists Generally Agree

Although JCT and Treasury currently use different rules to identify baseline provisions of the tax code and tax expenditures, there is substantial overlap in the tax code provisions they designate as tax expenditures. JCT's tax expenditure list is derived from a comprehensive definition of income, which defines income as the sum of consumption and the change in net wealth in a given period of time. Treasury's list enumerates provisions of the tax code that serve specific budget functions. Four differences between these lists concern tax rates, income subject to tax, rules for capital recovery, and treatment of foreign income.

In large part, JCT and Treasury agree on the tax code provisions they classify as part of the baseline structure of the income tax and those they consider exceptions, or tax expenditures. For example, both JCT and Treasury treat the structure of tax rates—with higher income individuals taxed at a higher rate than those with lower incomes—as part of the structure of the income tax base. JCT uses the "normal tax" structure, or baseline, patterned on a comprehensive income tax to define tax expenditures. The normal tax baseline allows personal exemptions, a standard deduction, and deductions of the expenses incurred in earning income. Since 1983, Treasury has used the "reference law" structure to define tax expenditures. The reference law tax baseline also permits personal exemptions, a standard deduction, and deductions of the expenses incurred in earning income. However, it identifies fewer other tax code provisions as tax expenditures than does the normal tax baseline.

Although tax expenditures under the reference law baseline are generally considered tax expenditures under the normal tax baseline, the reverse is not always true. For example, in contrast to the normal tax structure, under the reference tax baseline the following are not considered tax expenditures:

- corporate tax rates below the maximum statutory rate and preferential tax rates for capital gains generally (because the reference tax baseline includes a separate schedule for each of these sources of income);
- cash transfer payments from government to private individuals, e.g., transfer payments such as public assistance and the earned income tax credit (because the reference tax baseline's definition of income does not include gifts—receipts of money or property that are not part of an exchange);
- accelerated depreciation (because under the reference tax baseline the general tax depreciation rules are the Accelerated Cost Recovery System rules rather than straight-line depreciation); and
- deferral of tax on income received by controlled foreign corporations (because under the reference tax baseline this income is not considered realized until it has been repatriated to the U.S. parent firm as dividends or other income).

Unlike the normal tax baseline, under the reference law baseline, tax expenditures are limited to special exceptions in the tax code that are targeted to specific groups and that could be administered by an executive agency other than Treasury. Reference law tax expenditures correspond to specific budget categories, such as national defense, health care, or farm subsidies. For example, the reference law system does not classify accelerated depreciation and the special tax treatment of capital gains as tax expenditures because these tax code provisions are not targeted to specific groups or activities but provide incentives for a wide range of different types of investment. And those tax code provisions are not assigned to functional areas of the budget or meaningfully associated with particular executive agencies other than Treasury.

The differences between the two tax expenditure lists amount to less than 20 items out of approximately 125 tax expenditure provisions. Recently the lists have become more similar because Treasury has included in its list revenue loss estimates for selected tax expenditures, defined using a normal tax baseline.

Treasury also publishes a list of tax expenditure outlay equivalents. The outlay equivalent measure allows a comparison of the cost of the tax expenditure with that of a direct federal outlay for the same purpose. The outlay equivalent is an estimate of the amount of federal outlay that would be required to provide the taxpayer with the same after-tax income as he or she receives through the tax preference. On the basis of outlay equivalent magnitudes, some mistakenly claim that a subsidy provided through outright funding costs the government more than an equivalent subsidy provided through a tax expenditure. The government's net receipts are actually about the same under either funding mechanism. The portion of the funding outlay for the outright subsidy that represents funds to cover taxes owed would be returned to the government as tax receipts.

Tax Expenditure Lists Are Used for Many Different Purposes

In the two decades since Stanley Surrey developed the concept of tax expenditures, several lists of income tax expenditures have been constructed.[2] In addition to the lists of the congressional and executive branches of government, tax policy researchers have devised their own lists in conjunction with various proposals for classifying, evaluating, or reducing tax expenditures.

Sometimes the tax expenditure list has been used to identify tax code provisions that could be potential revenue sources. For example, the Congressional Budget Office's (CBO) list of policy options for reducing the deficit, JCT's list of revenue raising options,[3] the "Pease cap" on itemized deductions, and tax preference items subject to the alternative minimum tax are all partially drawn from a tax expenditure list.

Treasury uses its list to enumerate tax code provisions that could be carried out through discretionary or entitlement spending, credit programs, or regulations administered by executive agencies other than

[2]For a discussion of the alternative income tax structures that could be used as the standard for identifying tax expenditures, see OMB, Budget of the United States Government, Fiscal Year 1987, Special Analyses, pages G-2 through G-5.

[3]CBO, Reducing the Deficit: Spending and Revenue Options, Feb. 1993; JCT, Description of Possible Options to Increase Revenues, Prepared for the Committee on Ways and Means, June 1987.

the Internal Revenue Service (IRS). Treasury's list of tax expenditure outlay equivalents complements its list of tax expenditure revenue losses by allowing the cost of a tax expenditure to be compared with that of its equivalent federal outlay.

Others, seeking to emphasize the degree to which our income tax discourages savings and capital accumulation, would use the tax expenditure list to enumerate the current income tax's deviations from a consumption tax.[4] All tax expenditures that encourage saving and capital investment would be absent from their list. Under this approach, for example, the exclusion of pension contributions and pension earnings would no longer be a tax expenditure since it encourages savings for retirement, while subsidies for current consumption, such as exemptions for nonretirement fringe benefits, would remain tax expenditures.

JCT uses its tax expenditure list to identify those provisions of the income tax code that represent deviations from an ideal comprehensive income tax. JCT's tax baseline is an ideal comprehensive income tax with certain compromises for administrative practicality, such as not including inflation adjustments and not taxing all accrued income (for example, the implicit rental income from owner-occupied housing).

Others would use a tax expenditure list to enumerate all tax structure deviations from an ideal income tax baseline such as Haig-Simons' economic income.[5,6] Such a list of tax expenditures would attempt to pinpoint all provisions in the tax code that deviate from an ideal tax baseline and thus cause distortions in the economy. Thus, tax code provisions, such as the standard deduction, personal exemptions, the deferral of tax on unrealized capital gains, and the exclusion of imputed income (such as the rental value of owner-occupied housing and farmers' consumption of their own produce), might be considered tax expenditures, that is, exceptions to a "generally accepted definition of income." A major problem with this approach is that there are many "generally accepted definitions" of the normal income tax baseline.

Because of the potential for disagreement on the division of tax code provisions into baseline provisions versus tax expenditures, it might be

[4]See discussion in Victor Thuronyi, "Tax Expenditures: A Reassessment," Duke Law Journal, Vol. 1988, pages 1,167-1,170.

[5]Ibid., page 1,167.

[6]The Haig-Simons' definition of income over a fixed period is the money value of the net increase to an individual's power to consume during that period.

easier to get agreement if different tax expenditure lists were compiled for various purposes. For example, a list to be used in limiting the growth of tax expenditure revenue losses could differ from a list designed to comprehensively enumerate all tax expenditures.

Revenue Loss Estimation Issues

Both Treasury and JCT annually estimate revenue losses for each tax expenditure on their respective lists. Revenue loss estimates measure the revenue cost of each tax expenditure separately. A tax expenditure's revenue cost is the difference between tax liability under current law and the tax liability that would result if taxes were recomputed without that tax expenditure. Revenue cost estimates assume (1) economic behavior does not change and (2) all other tax expenditures remain in the code unchanged. The limitations of tax expenditure estimates have been cited as a reason for not using them to make policy decisions. In contrast to the revenue estimates made for proposed legislation, tax expenditure revenue loss estimates are made only to provide information about the general magnitude of federal "spending" through tax code provisions.

No major legislative or budget outcomes are dependent upon estimates of the magnitudes or growth rates of tax expenditure revenue losses, and less effort, therefore, goes into making these estimates than goes into making revenue estimates for proposed changes to tax laws. Current estimates are intended to provide only general information about the overall magnitude of government subsidies in various budget functional areas. Although revenue estimates for proposed tax legislation do include interactions among tax expenditures, as well as behavioral changes triggered by the legislation, tax expenditure estimates do not. If controls or some other policy decisions were based on these estimates, existing resources might have to be reallocated, or more resources might be needed to better estimate tax expenditure magnitudes and growth rates. However, some argue that estimating aggregate tax expenditure revenue losses accurately is not a necessary precondition for reviewing and possibly limiting revenue losses attributable to tax preferences.[7]

In all cases, tax expenditure revenue loss estimates depend on the assumptions, models, and data used. For deductions and income specifically identified on tax returns, losses are estimated by analyzing a sample of tax return data. For exemptions, exclusions, and other income

[7]John F. Witte, "The Tax Reform Act of 1986: A New Era in Politics?" American Politics Quarterly, Oct. 1991, page 441; Thomas Neubig, "The Current Role of the Tax Expenditure Budget in U.S. Policymaking," in N. Bruce, ed., Tax Expenditures and Government Policy, Ontario, Canada: John Deutsch Institute; 1989, page 246.

not readily identifiable, estimation of tax expenditure revenue losses depends on data other than that found on tax returns, such as special studies or other government data sources. There are differences in the economic assumptions and models Treasury and JCT use to estimate tax expenditure revenue losses. For example, revenue loss forecasts depend on estimates of taxable income and thus on the estimated future state of the economy. For its information on the future state of the economy, JCT uses macroeconomic forecasts provided by CBO, while Treasury's forecasts are prepared by the Office of Management and Budget (OMB), Treasury itself, and the Council of Economic Advisers. The estimates depend on the particular models and data used and on assumptions about the economy at a point in time. This sensitivity to changes in economic conditions, as well as to changes in tax law, makes meaningful comparisons of year-to-year revenue losses for a given tax expenditure difficult.

Because changes to tax expenditures have behavioral effects and because tax code provisions interact, the sum of individual tax expenditure revenue losses is not equal to the combined effect on revenues of all tax expenditures. Behavioral responses to tax expenditure changes and interactions among code provisions are such that aggregate tax expenditure revenue losses might be greater or less than the sum of the parts.[8] The sum of all tax expenditure revenue losses should only be used to illustrate orders of magnitude, not total revenue effects. Recognizing this, neither JCT nor Treasury totals the tax expenditure amounts they list. Because comparisons of the sum of tax expenditures over time are more questionable than comparisons of single tax expenditures, we use these data only to illustrate orders of magnitude, not to report precise values or revenue effects.

Some have suggested it might be desirable to devote more resources to estimating revenue losses from tax expenditures.[9] For example, tax expenditure interaction effects could be modeled rather than ignored, as they currently are. However, estimating aggregate tax expenditure revenue losses simultaneously by netting out all the relevant interactions would involve more work than is currently performed. Whether the use made of these improved estimates would justify the additional work involved should be considered.

[8]For example, if several itemized deductions were repealed, more people would take the standard deduction, and government's revenue gains would be smaller than the sum of the individual revenue loss estimates. Conversely, the progressive rate schedule makes the value of several income tax exclusions larger than the sum of the individual exclusions.

[9]For example, see Neubig, pages 252-253.

Some with whom we talked thought that ignoring tax expenditure interaction effects would not be a major problem, at least if tax expenditure revenue loss estimates were used only for general guidance in controlling tax expenditures' growth. They pointed out that budget figures for mandatory and discretionary spending also depend on estimates and have interactions among them. As CBO has noted, shifting the focus from controlling the total of tax expenditures to controlling incremental changes to that total lessens the concern about aggregate revenue loss estimation weaknesses.[10]

Furthermore, controlling the aggregate growth in tax expenditure revenue losses might involve changing only a few relatively large or fast-growing tax expenditures. JCT and Treasury routinely account for interaction effects when making revenue estimates for proposals to change only a few specific tax expenditures.

[10]CBO, Tax Expenditures: Budget Control Options and Five-Year Budget Projections for Fiscal Years 1983-1987, Nov. 1982, page xv.

Tax Expenditure Dates of Initial Authorization and 1993 Revenue Losses

About 10 percent (14 tax expenditures) of the 124 income tax expenditures present in 1993 were authorized by either the Payne-Aldrich Tariff Act of 1909 (which established the corporate income tax) or the Revenue Act of 1913 (which established the individual income tax) and thus have been part of the current income tax system since its inception. The Internal Revenue Code is also the result of thousands of incremental decisions compiled in about three dozen major bills enacted since 1913.

Table II.1 presents JCT's revenue loss estimates for each of the 124 tax expenditures it listed for 1993. This table also shows the year each tax expenditure was first enacted and the enabling legislation.

Table II.1: Initial Authority for Tax Expenditures and JCT's 1993 Revenue Loss Estimates

Function	First enacted: Year	First enacted: Act, court case, or regulation	Corporations: 1993 Estimate[a] (in billions)	Individuals: 1993 Estimate[a] (in billions)
National defense				
Exclusion of benefits and allowances to Armed Forces personnel	1925	Jones v. U.S. (60 Ct. Cl. 552)	[b]	$2.0
Exclusion of military disability benefits	1942	1942 Revenue Act	[b]	0.1
International affairs				
Exclusion of income earned abroad by U.S. citizens	1926	1926 Revenue Act	[b]	1.5
Exclusion of certain allowances for Federal employees abroad	1943	1943 Revenue Act	[b]	0.2
Exclusion of income of foreign sales corporations	1984	Deficit Reduction Act of 1984	$1.5	[b]
Deferral of income of controlled foreign corporations	1909	Accepted practice 1909-1962; restricted under the Revenue Act of 1962	1.0	[b]
Inventory property sales source rule exception	1921 and 1986	1921 Revenue Act and Tax Reform Act of 1986	4.0	[b]
Interest allocation rules exception for certain nonfinancial institutions	1986	Tax Reform Act of 1986	0.1	[b]
General science, space and technology				
Expensing of research and development expenditures	1954	Section 174, Internal Revenue Code	1.8	[b]
Energy				

(continued)

Function	First enacted: Year	First enacted: Act, court case, or regulation	Corporations: 1993 Estimate[a] (in billions)	Individuals: 1993 Estimate[a] (in billions)
Expensing of exploration and development costs (oil and gas)	1916	Treasury Regulation (T.D. 45, article 223) established that such costs were ordinary operating expenses. Development costs were specifically enacted in 1954 Internal Revenue Code and exploration costs in 1951 Revenue Act.	0.2	[c]
Expensing of exploration and development costs (other fuels)	1916	Treasury Regulation (T.D. 45, article 223) established that such costs were ordinary operating expenses. Specifically enacted in the 1954 Internal Revenue Code.	[c]	[c]
Excess of percentage over cost depletion (oil and gas)	1918	Depletion on a discovery-value basis accepted practice 1918-1926; 1926 Revenue Act enacted percentage over cost depletion for oil and gas.	0.1	[c]
Excess of percentage over cost depletion (other fuels)	1918	Depletion on a discovery-value basis accepted practice 1918-1926; 1932 Revenue Act enacted percentage over cost depletion for other fuels.	0.2	[c]
Credit for enhanced oil recovery costs	1990	Omnibus Budget and Reconciliation Act of 1990	[c]	[c]
Alternative fuel production credit	1980	Crude Oil Windfall Profit Tax Act of 1980	0.6	0.2
Alcohol fuel credits	1980	Crude Oil Windfall Profit Tax Act of 1980	[c]	[b]
Exclusion of interest on state and local government industrial development bonds for energy production facilities	1980	Crude Oil Windfall Profit Tax Act of 1980	[c]	0.1
Expensing of tertiary injectants	1980	Crude Oil Windfall Profit Tax Act of 1980	[c]	[c]
Natural resources and environment				
Expensing of exploration and development costs, nonfuel minerals	1951	1951 Revenue Act	[c]	[c]
Excess of percentage over cost depletion, nonfuel minerals	1918	Depletion on a discovery-value basis accepted practice 1918-1932; 1932 Revenue Act enacted percentage over cost depletion.	0.2	[c]
Investment credit and 7-year amortization for reforestation expenditures	1980	Recreational Boating Safety and Facilities Improvement Act of 1980	[c]	[c]
Expensing multiperiod timber-growing costs	1923 and 1986	A 1923 income tax ruling was the first distinguishing between what expenses might be deductible and what expenses might be capitalized. The Tax Reform Act of 1986 excepted timber from uniform capitalization rules.	0.4	[c]

(continued)

Function	First enacted: Year	First enacted: Act, court case, or regulation	Corporations 1993 Estimate[a] (in billions)	Individuals 1993 Estimate[a] (in billions)
Exclusion of interest on state and local government sewage, water, and hazardous waste facilities bonds	1968 and 1986	Exclusion of interest on state and local bonds accepted practice until 1968. Sewage and water exception was explicitly enacted in Revenue Expenditure and Control Act of 1968. Tax Reform Act of 1986 excepted hazardous waste facilities.	0.2	1.2
Investment tax credit for rehabilitation of historic structures	1976	Tax Reform Act of 1976	0.1	[c]
Special rules for mining reclamation reserves	1984	Deficit Reduction Act of 1984	[c]	[c]
Agriculture				
Expensing of soil and water conservation expenditures	1954	Expensing for agriculture accepted practice following 1916 Revenue Act. Explicitly enacted in 1954 Internal Revenue Code.	[c]	[c]
Expensing of fertilizer and soil conditioner costs	1960	Expensing for agriculture accepted practice following 1916 Revenue Act. Explicitly enacted in 1960 Internal Revenue Code.	[c]	0.1
Expensing of the costs of raising dairy and breeding cattle	1916	Expensing for agriculture accepted practice following 1916 Revenue Act.	[c]	0.1
Exclusion of cost-sharing payments	1978	Revenue Act of 1978	[b]	[c]
Exclusion of cancellation of indebtedness income of farmers	1986	Tax Reform Act of 1986	[b]	0.2
Cash accounting for agriculture	1916	1916 Revenue Act	0.1	0.3
Commerce and housing				
(Financial institutions)				
Excess bad debt reserves of financial institutions	1947	IRS ruling in 1947 (for commercial banks); 1951 Revenue Act (for thrifts)	0.1	[b]
Merger rules for banks and thrift institutions	1981	Economic Recovery Tax Act of 1981	0.6	[b]
Exemption of credit union income	1909	1909 income tax law	0.4	[b]
(Insurance companies)				
Exclusion of investment income on life insurance and annuity contracts	1913	Revenue Act of 1913	0.4	8.2
Exclusion of investment income from structured settlement amounts	1982	Periodic Payments Settlement Act	[c]	[b]

(continued)

Function	First enacted: Year	First enacted: Act, court case, or regulation	Corporations: 1993 Estimate[a] (in billions)	Individuals: 1993 Estimate[a] (in billions)
Small life insurance company taxable income adjustment	1984	Deficit Reduction Act of 1984	0.1	[b]
Special treatment of life insurance company reserves	1909	1909 income tax law	1.9	[b]
Deduction of unpaid loss reserves for property and casualty insurance companies	1909	1909 income tax law	1.0	[b]
Special alternative tax on small property and casualty insurance companies	1942 and 1986	Exemptions and reduced tax rates for mutual insurance companies, enacted in the 1942 Revenue Act, were replaced by provisions in the Tax Reform Act of 1986.	[c]	[b]
Tax exemption for certain insurance companies	1909, 1924, and 1928	1909 income tax law, insurance operations of fraternal organizations; benevolent life insurance associations were made tax exempt in 1924; and voluntary employee benefit associations were added in the Revenue Act of 1928.	[c]	[b]
Special deduction for Blue Cross and Blue Shield companies	1920s	Internal Revenue Service regulations	[c]	[b]
(Housing)				
Deductibility of mortgage interest on owner-occupied residences	1913	Revenue Act of 1913	[b]	44.2
Deductibility of property tax on owner-occupied homes	1913	Revenue Act of 1913	[b]	13.3
Deferral of capital gains on sales of principal residences	1951	1951 Revenue Act	[b]	13.2
Exclusion of capital gains on sales of principal residences for persons age 55 and over ($125,000 exclusion)	1964	Revenue Act of 1964; greatly expanded under the 1978 Revenue Act	[b]	4.6
Exclusion of interest on state and local government bonds for owner-occupied housing	1913	Revenue Act of 1913	0.2	1.6
Depreciation of rental housing in excess of alternative depreciation system	1946	Revenue ruling in 1946; enacted in 1954 Internal Revenue Code	1.0	0.5
Low-income housing tax credit	1986	Tax Reform Act of 1986	0.1	1.0
Exclusion of interest on state and local government bonds for rental housing	1937	U.S. Housing Act of 1937	0.1	0.9

(continued)

Function	First enacted: Year	First enacted: Act, court case, or regulation	Corporations 1993 Estimate[a] (in billions)	Individuals 1993 Estimate[a] (in billions)
(Other business and commerce)				
Maximum 28 percent tax rate on long-term capital gains	1921 and 1990	1921 Revenue Act first established capital gains rate at 12.5 percent. Omnibus Budget Reconciliation Act of 1990 set 28 percent rate.	[b]	3.5
Depreciation on buildings other than rental housing in excess of alternative depreciation system	1946	Revenue ruling in 1946; enacted in 1954 Internal Revenue Code	5.1	1.9
Depreciation on equipment in excess of alternative depreciation system	1946 and 1954	Revenue ruling in 1946; enacted in 1954 Internal Revenue Code	14.6	4.1
Expensing up to $10,000 of depreciable business property	1959 and 1981	Special deduction enacted in 1959. Expensing substituted in Economic Recovery Act of 1981.	0.1	0.1
Exclusion of capital gains at death	1921	1921 Revenue Act	[b]	11.6
Carryover basis on gifts	1921	1921 Revenue Act	[b]	1.3
Amortization of business start-up costs	1980	Miscellaneous Revenue Act of 1980	[c]	0.2
Reduced rates on first $75,000 of corporate taxable income	1941 and 1986	1941 Revenue Act (reduced rates on first $100,000) and Tax Reform Act of 1986	3.1	[b]
Permanent exemption from imputed interest rules	1984	Deficit Reduction Act of 1984	[c]	0.2
Expensing of magazine circulation expenditures	1950	Codified in Internal Revenue Code Section 173	[c]	[c]
Special rules for magazines, paperback book, and record returns	1978	1978 Revenue Act	[c]	[c]
Deferral of gain on nondealer installment sales	1921	1921 Revenue Act	0.1	[c]
Completed contract rules	1918 and 1986	Permitted by IRS regulations since 1918. The Tax Reform Act of 1986 codified the rules for long term contracts.	0.2	[c]
Cash accounting, other than agriculture	1916	1916 Revenue Act	[c]	[c]
Exclusion of interest on state and local government small-issue bonds	1909	Permitted since 1909. The first federal restrictions were imposed in the Revenue and Expenditure Control Act of 1968.	[c]	1.2
Deferral of gain on like-kind exchanges	1921	1921 Revenue Act	0.3	0.2
Exception from net operating loss limitations for corporations in bankruptcy proceedings	1986	Tax Reform Act of 1986	0.2	[b]

(continued)

Function	First enacted		Corporations	Individuals
	Year	Act, court case, or regulation	1993 Estimate[a] (in billions)	1993 Estimate[a] (in billions)
Gain from sale or exchange to effectuate policies of FCC	1943	1943 Revenue Act	0.2	[b]
Exemption of RIC expenses from miscellaneous deduction floor	1986	Tax Reform Act of 1986	[b]	0.6
Transportation				
Deferral of tax on capital construction funds of shipping companies	1936	Merchant Marine Act of 1936	0.1	[b]
Exclusion of interest on state and local government bonds for mass transit commuting vehicles	1981	Economic Recovery Tax Act of 1981	[c]	[c]
Exclusion of interest on state and local government bonds for high-speed inter-urban rail facilities	1968 and 1986	The Revenue and Expenditure Control Act of 1968 and the Tax Reform Act of 1986	[c]	[c]
Community and regional development				
Investment credit for rehabilitation of structures other than historic structures	1978	Revenue Act of 1978	[c]	[c]
Exclusion of interest on state and local government bonds for private airports and docks	1968	The Revenue and Expenditure Control Act of 1968 specifically excepted bond issues for airports, docks, and wharves.	0.1	0.6
Education, training, employment and social services				
(Education and training)				
Exclusion of scholarship and fellowship income	1954	1954 Internal Revenue Code	[b]	0.5
Parental personal exemption for students age 19-23	1954	1954 Internal Revenue Code and Technical and Miscellaneous Revenue Act of 1988.	[b]	0.6
Exclusion of interest on state and local government student loan bonds	1976	Tax Reform Act of 1976	[c]	0.3
Exclusion of interest on state and local government bonds for private educational facilities	1913	Revenue Act of 1913	[c]	0.4
Deductibility of charitable contributions for educational institutions	1917	1917 War Revenue Act	0.2	2.1
Exclusion of interest on educational savings bonds	1988	Technical and Miscellaneous Revenue Act of 1988	[b]	0.2

(continued)

Function	First enacted: Year	First enacted: Act, court case, or regulation	Corporations: 1993 Estimate[a] (in billions)	Individuals: 1993 Estimate[a] (in billions)
(Employment)				
Exclusion of employee meals and lodging (other than military)	1918	1918-1954 regulation; enacted in 1954 Internal Revenue Code	[b]	0.5
Employee stock ownership plans	1974	Employee Retirement Income Security Act of 1974	1.0	[c]
Exclusion for benefits provided under cafeteria plans	1974	Employee Retirement Income Security Act of 1974	[b]	2.9
Exclusion of rental allowances for ministers' homes	1921	1921 Revenue Act	[b]	0.2
Exclusion of miscellaneous fringe benefits	1984	Deficit Reduction Act of 1984	[b]	4.3
Exclusion of employee awards	1986	Tax Reform Act of 1986	[b]	0.1
Exclusion of income earned by supplemental unemployment benefits trusts	1960	Codified in Internal Revenue Code Section 501(c)(17) by P.L. 86-667.	[b]	[c]
Exclusion of income earned by voluntary employees' beneficiary associations	1928	1928 Revenue Act	[b]	0.5
(Social services)				
Deductibility of charitable contributions, other than for education and health	1917	1917 War Revenue Act	1.1	13.1
Credit for child and dependent care expenses	1954 and 1976	A deduction was enacted in the 1954 Internal Revenue Code. Credit first enacted in the Tax Reform Act of 1976.	[b]	2.8
Exclusion for employer-provided child care	1981	Economic Recovery Tax Act of 1981	[b]	0.4
Exclusion for certain foster care payments	1977 and 1982	IRS Revenue Ruling (77-280, 1977-2, CBA) Codified in Periodic Payments Settlement Act	[b]	[c]
Expensing costs of removing architectural barriers	1976	Tax Reform Act of 1976	0.1	[c]
Tax credit for disabled access expenditures	1990	Revenue Reconciliation Act of 1990	0.1	[b]
Health				
Exclusion of employer contributions for medical insurance premiums and medical care	1918	Revenue Act of 1918	[b]	46.4
Supplemental health insurance credit component of earned income tax credit	1990	Omnibus Budget Reconciliation Act of 1990	[b]	0.1
Deductibility of medical expenses	1942	1942 Revenue Act	[b]	3.1

(continued)

Function	First enacted: Year	First enacted: Act, court case, or regulation	Corporations 1993 Estimate[a] (in billions)	Individuals 1993 Estimate[a] (in billions)
Exclusion of interest on state and local government bonds for private hospital facilities	1913	Revenue Act of 1913	[c]	1.4
Deductibility of charitable contributions to health organizations	1917	1917 War Revenue Act	0.2	2.6
Medicare				
Exclusion of untaxed medicare hospital insurance benefits	1965	Exclusion has existed since the advent of Medicare in 1965; Revenue Ruling 70-341 in 1970 provided that benefits are not includible in gross income.	[b]	7.6
Exclusion of untaxed supplementary medical insurance benefits	1965	Exclusion has existed since the advent of Medicare in 1965; Revenue Ruling 70-341 in 1970 provided that benefits are not includible in gross income.	[b]	4.4
Income security				
Exclusion of workers' compensation benefits	1918	Accepted practice, enacted in 1918 Revenue Act.	[b]	3.2
Exclusion of special benefits for disabled coal miners	1972	Revenue Ruling 72-400 and Black Lung Benefits Act of 1972	[b]	0.1
Exclusion of cash public assistance benefits	1930s	Included in revenue rulings on the definition of gross income.	[b]	0.4
Net exclusion of pension contributions and earnings	1921	The earnings of stock-bonus or profit sharing plans were exempted in 1921 Revenue Act. Treatment extended to pension trusts in 1926.	[b]	56.5
Individual retirement plans (exclusion of contributions and earnings)	1974	Employment Retirement Income Security Act of 1974	[b]	7.1
Keogh plans	1962	Self-Employed Individuals Retirement Act	[b]	2.7
Exclusion of premiums on group term life insurance	1920	Administrative legal opinion (L.O. 1014, 2 C.B. 8 (1920))	[b]	2.3
Exclusion of premiums on accident and disability insurance	1954	1954 Internal Revenue Code	[b]	0.1
Exclusion for employer-provided death benefits	1951	1951 Revenue Act	[b]	[c]
Additional standard deduction for the blind and the elderly	1943 and 1948	1943 Revenue Act and 1948 Revenue Act	[b]	1.8
Tax credit for the elderly and disabled	1954 and 1976	A retirement income credit enacted in 1954 was replaced by this tax credit in the Tax Reform Act of 1976	[b]	0.1
Deductibility of casualty and theft losses	1913	Revenue Act of 1913	[b]	0.4

(continued)

Function	First enacted: Year	First enacted: Act, court case, or regulation	Corporations 1993 Estimate[a] (in billions)	Individuals 1993 Estimate[a] (in billions)
Earned income tax credit	1975	Tax Reduction Act of 1975	[b]	1.2
Supplemental young child credit component of earned income tax credit	1990	Omnibus Budget Reconciliation Act of 1990	[b]	[c]
Social Security and Railroad Retirement				
Exclusion of untaxed Social Security and railroad Retirement benefits	1938, 1941 and 1935	Administrative Rulings I.T. 3194 and 3447, and Railroad Retirement Act of 1935	[b]	24.5
Veterans' benefits and services				
Exclusion of veterans' disability compensation	1917	1917 War Revenue Act	[b]	1.5
Exclusion of veterans' pensions	1917	1917 War Revenue Act	[b]	0.1
Exclusion of GI bill benefits	1917	1917 War Revenue Act	[b]	0.1
Exclusion of interest on state and local government veterans' housing bonds	1940s	First issued by the States after World War II	[c]	[c]
General purpose fiscal assistance				
Exclusion of interest on public purpose state and local government debt	1913	Revenue Act of 1913	1.0	9.9
Deduction of nonbusiness state and local government income and personal property taxes	1913	Revenue Act of 1913	[b]	27.5
Tax credit for corporations with possessions source income	1921 and 1976	1921 Revenue Act enacted an exclusion. It was changed to a credit in the Tax Reform Act of 1976.	3.2	[b]
Interest				
Deferral of interest on savings bonds	1913	Revenue Act of 1913	[b]	1.3
Total			**47.4**	**354.3**

(Table notes on next page)

[a]JCT's 1992 estimates for fiscal year 1993 are based on the provisions in tax law as enacted through December 31, 1991.

[b]Not applicable.

[c]Less than $50 million.

[d]The number in the table shows the effect of the earned income tax credit on receipts. The increase in outlays was $9.7 billion in 1993.

Sources: JCT, Estimates of Federal Tax Expenditures for Fiscal Years 1993-1997, April 24, 1992; CBO, Tax Expenditures: Budget Control Options and Five-Year Budget Projections for Fiscal Years 1983-1987, Washington, DC: U.S. GPO, Nov. 1982; U. S. Congress, Senate Committee on the Budget, Tax Expenditures: Compendium of Background Material on Individual Provisions, Washington, DC: U.S. GPO, Nov. 1992.

Comments From the Office of Management and Budget

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

MAR 7 1994

Ms. Jennie S. Stathis, Director
Tax Policy and Administration Issues
Mr. Paul Posner, Director
Budget Issues
U.S. General Accounting Office
Washington, D.C. 20548

Dear Ms. Stathis and Mr. Posner:

Thank you for the opportunity to review the draft of GAO's report, "Tax Policy: Tax Expenditures Deserve More Scrutiny." Overall, it addresses an important topic and presents useful information.

The report contains four recommendations for the Director of the Office of Management and Budget (pp. 144-146 of the draft). We will address these recommendations before turning to other areas of the report.

First, GAO recommends that the Director of OMB, in consultation with the Secretary of the Treasury, revise the budgetary presentation of tax expenditure information. The revision would combine tax expenditure data with outlay data to give a more complete picture of Federal resources allocated to functional areas. Information would also be expanded on the efficiency, distributional, and other economic properties of tax expenditures.

Second, it is recommended that consideration of tax expenditures be incorporated into the annual budget review process. OMB, in consultation with Treasury and other agencies, would advise the President on the most effective approaches for achieving Federal policy objectives.

Third, it is recommended that OMB, with Treasury, design and test a structure for performance reviews of tax expenditures prior to May 1997. The objective would be to develop a framework for analyzing performance goals consistent with the Government Performance and Results Act of 1993. The work would involve assessing which methods are most effective for conducting such performance reviews.

Fourth, GAO recommends that following the development of tax expenditure performance data, OMB should consult with Treasury on

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how to report these measures in the budget. This information would be combined with data on outlay programs to enable better comparisons of alternative methods for achieving Federal objectives.

The recommendations are, with appropriate caveats, reasonable. To a large degree, as we have discussed in our meetings with your staff, they are consistent with efforts that the Administration has already initiated.

Regarding the first recommendation, for a revised budget presentation, it would be reasonable to present, for information purposes, some summary tables that include tax expenditure data with outlay data. The appropriate degree of this integration remains an open question, and would likely evolve as improved information becomes available. At some point, for instance, the technical and conceptual limitations of the tax expenditure measures (many of which are recognized in your draft) could argue for limited, as opposed to full, integration. Nevertheless, the general point -- that more information comparing tax and outlay measures should be made available to policymakers and the public -- is quite valid.

As part of our effort to improve analysis and reporting on tax expenditures, the Fiscal Year 1995 Budget contains two new features that should significantly improve understanding of the effects of tax expenditures over time. First, Administration estimates of tax expenditures are presented over the full five-year budget window, as well as for the current and past year. Second, present-value estimates are reported for tax expenditure provisions that involve tax deferrals and similar long-term revenue effects. The present-value estimates complement the cash-basis estimates for these provisions by providing a measure of the long-term effect of actions taken this year that generate deferrals.

The Administration has also initiated work on the second recommendation, which involves integrating reviews of tax expenditures into the budget process. In the reviews to date, this process has been informal. In keeping with the Secretary of the Treasury's role as the principal spokesman on tax policy matters, these reviews tend to lead to discussions with the Treasury, as opposed to formal OMB recommendations. In addition, our planned integration of the management and budget staffs, under "OMB 2000," will help deepen OMB's staff coverage of policy areas and departments. It is intended to enable more consideration of complex matters, including performance measures generally and issues such as the interactions between tax expenditure and outlay programs.

OMB has also initiated work related to the third and fourth recommendations, involving development of performance reviews for tax expenditures. We have had initial discussions with Treasury and other agencies about developing output indicators for key tax expenditures, consistent with the goals of the Government

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Performance and Results Act. While development of these output measures involves a number of information-related challenges, we believe that this process will serve as a good foundation for more widespread reporting on tax expenditures.

In addition to its recommendations to the Director of OMB, GAO's report considers three general policy options that deserve comment. These options are: 1) to control tax expenditures more through mechanisms available to the tax committees; 2) to implement formal budgeting constraints; and 3) to initiate joint reviews of tax expenditures and spending programs. While we support the aspect of these options calling for improved information on tax expenditures, we are cautious on some other aspects.

The first option, for example, could involve consideration of ceilings or floors or similar measures for limiting tax expenditures. These are important issues of tax policy that merit evaluation, but are otherwise difficult to comment upon in the abstract.

The second option raises the possibility of special caps or savings targets for tax expenditures. While we recognize the concerns that lead to this option being considered, we are cautious about suggesting additional mechanistic constraints on the budget process. Such constraints can be a blunt instrument for guiding tax and budget policy, and it is not clear that they would ultimately produce better outcomes than the current approach. Among other features, such constraints could add additional uncertainty to the tax code. This could deter precisely the types of activities that some provisions are designed to promote.

The third option -- for more simultaneous review of tax expenditure and spending options -- has been considered above in the context of recommendations to OMB. We concur with the view that more integrated comparison of outlay and tax expenditure programs may provide useful insights.

We have provided detailed comments on the report in an attachment to this letter. There are, however, two issues that merit noting here.

First, the draft should recognize that, in principle, the concept of tax expenditures extends beyond the income tax. The budget, for example, currently also presents information on tax expenditures in the estate and gift taxes. There are, in addition, significant tax expenditures that affect the payroll and excise tax systems. While there are conceptual challenges to measuring tax expenditures in these areas, in general analyses of tax preferences should extend beyond the income tax.

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Second, it should be noted that this year's Budget provides more recent estimates of tax expenditure figures than the draft report. In view of the changes associated with the Omnibus Budget Reconciliation Act of 1993, there could be significant differences between these estimates and the Joint Committee on Taxation estimates which consider prior law.

Again, we appreciate this opportunity to review your work. We hope that you find these comments useful.

Sincerely,

Joseph J. Minarik
Associate Director
for Economic Policy

Enclosure

Comments From the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON

March 1, 1994

Ms. Jennie S. Stathis
Director, Tax Policy and
Administration Issues
General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Ms. Stathis:

Thank you for the opportunity to review and comment on your draft report "Tax Policy: Tax Expenditures Deserve More Scrutiny".

Your report tentatively proposes three options designed to "increase attention paid to tax expenditures and reduce their revenue loss". The first option calls for greater scrutiny of the expenditures, but no significant change in budgeting and reporting procedures. The second option calls for Congress to integrate tax expenditures into the budget process through the use of tax expenditure limitations (or savings targets). The third option calls for joint reviews of tax expenditures with their functionally related outlay programs. We support your recommendation that tax expenditures be given greater review by the Administration and the tax-writing committees of the Congress (option one), but are not convinced that Congressionally mandated caps or combined outlay-tax expenditure reviews by Congress or the Administration (options two and three) will provide the benefits anticipated.

We share GAO's concern that tax expenditures be given the same critical examination as discretionary spending programs at a time when the Federal government must make painful choices to reduce the budget deficit. Tax expenditures are already subject to budget discipline. Existing expenditures cannot be increased or new expenditures introduced without a corresponding increase in tax revenues or reduction in direct spending. Conversely, the desire to introduce new entitlement programs typically generates examination of the possibilities for reduction or repeal of existing tax expenditures to satisfy these "pay-go" rules. Nevertheless, we agree that a more comprehensive periodic review of tax expenditures would be useful. Unlike tax collections or outlays, however, about which historical information is available, a tax expenditure is a hypothetical construct that can only be estimated. This leads to conceptual and measurement problems which, although not overly troublesome when the estimates are used to provide guidance to policymakers as to the order of magnitude of the revenues lost, are likely to be quite serious if tax expenditures were to be explicitly integrated into the budget process.

More specifically, a tax expenditure is defined as the difference between the revenues that might be obtained under an alternative tax system -- one that differs in certain ways from the current tax system -- and the revenues obtained under the current system. Even ignoring the not inconsequential problem of determining the appropriate alternative tax system, it is generally not

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possible to disentangle the cost of any given tax expenditure in prior years from the historical record of actual tax collections. This obviously makes projections of the future costs of tax expenditures more uncertain than estimates of future tax receipts or outlays. Moreover, the estimates provided do not (and are not intended to) indicate the increased revenues that might arise were one or another tax expenditure repealed.

Repealing any one tax expenditure can have implications for the calculation of other provisions. For example, taxpayers denied the ability to exclude employer contributions to a Keogh plan might instead increase their IRA contributions. Since approximately one hundred and twenty five tax expenditures are currently listed in the Budget, of necessity neither the behavioral reactions of taxpayers to repeal of the specific tax provision under examination nor the resulting interaction with all other tax expenditures are taken into account in the estimates presented by Treasury's Office of Tax Analysis (OTA) or the Congressional Joint Committee on Taxation (JCT). Tax expenditure estimates relating to timing differences also tend to understate the revenue gain from repeal of such differences, since they reflect both the increased liabilities under the alternative tax attributable to past activities that have "turned-around" as well as the decreased liabilities under the alternative tax attributable to current activities. (If the level of current activities is lower than the level of past activities, such tax expenditure estimates may be negative.) In contrast, tax expenditure estimates relating to exclusions from income or tax credits tend to overstate the revenue gain from repeal of the provision due to the neglect of potential taxpayer response.

Given additional resources, OTA and JCT could include revenue estimates for the repeal of the tax provision giving rise to each tax expenditure (assuming all other provisions remain unchanged) if GAO's options two or three were to be adopted. It is not apparent, however, that such efforts would be worthwhile. Both policy-makers and the public might be better served if, instead of refining the accuracy of their cost, the increased resources were instead used to better elucidate the effectiveness of tax expenditures (and outlays) in achieving their policy objectives. Moreover, because of their interactive effects, any attempt to achieve a given tax savings target by the simultaneous repeal of several tax expenditures whose estimates add up to the target could, depending on the expenditures chosen, produce highly inaccurate results.

Any legislation designed to impose broad limitations on the level of tax expenditures (as proposed in GAO's option two) must provide specific rules as to how these expenditures will be capped. For example, will specific expenditures be eliminated, or will all expenditures be rateably reduced, and if so, how? In short, limiting tax expenditures raises difficult budget issues, similar to those that would arise if entitlements were to be capped. These do not appear to be issues that can (or should) be dealt with using the blunt instruments of sequestration and restrictive legislative rules. Moreover, to the extent the caps were binding (or even close to binding), they would make the year-to-year availability of tax expenditures uncertain. This would make business and family financial planning difficult, and likely negate the incentive effects which the tax expenditures were designed to achieve.

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The Canadian experience with incorporating tax expenditures into their budget process in a manner similar to that envisioned under GAO's proposed option three is also not very encouraging. As described in an article by Satya Poddar in Tax Expenditures and Government Policy (John Deutsch Institute for the Study of Economic Policy, Ontario, Canada, 1988), Canada attempted to assign responsibility for the cost of new tax expenditures to the budget of the program minister proposing the expenditure. This system initially lead to a significant reduction in the demands for new tax expenditures by the program ministers. However, the system did not last very long, in part because of the flexibility given the Minister of Finance and the utilization of this flexibility by the government in instituting new tax expenditures. While a less flexible budgetary system in the U.S. may be better able to withstand political pressure, it may do so at the expense of making the Federal government much less responsive to changing economic conditions. Moreover, because there is no "bright line" test as to what constitutes a tax expenditure, these pressures may place OTA and JCT in the untenable position of having to defend decisions that are inherently somewhat arbitrary.

In summary, although the GAO report mentions the conceptual and measurement issues relating to the calculation of tax expenditures, GAO appears to be somewhat less concerned than Treasury about reliance in the budget process on estimates subject to the limitations noted. More importantly, GAO also appears to be less concerned than Treasury about the implications of a budget process which would generate continual excessive uncertainty about the tax system and treat important tax policy issues in a mechanical fashion. We believe that, as long as the public and policy-makers have the necessary information, it should not be necessary to resort to artificial budgetary constraints to ensure that tax expenditures obtain the attention and scrutiny they deserve.

Sincerely,

Lowell Dworin

Lowell Dworin
Director, Office of Tax Analysis

cc: Mr. Paul Posner

Major Contributors to This Report

General Government Division, Washington, D.C.

Thomas McCool, Associate Director
Michael Brostek, Assistant Director
Susan Ragland, Evaluator-in-Charge
Anne Stevens, Economist
Elwood White, Evaluator

Accounting and Information Management Division

Margaret Wrightson, Assistant Director

United States
General Accounting Office
Washington, D.C. 20548-0001

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