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5. TAX EXPENDITURES

Tax expenditures are revenue losses due to preferential provisions of the Federal tax laws, such as special exclusions, exemptions, deductions, credits, deferrals, or tax rates. They are alternatives to other policy instruments, such as spending or regulatory programs, as means of achieving Federal policy goals. Tax expenditures are created for a variety of reasons, including to encourage certain activities, to improve fairness, to ease compliance with and administration of the tax system, and to reduce certain tax-induced distortions. The Congressional Budget Act of 1974 (Public Law 93-344) requires that a list of tax expenditures be included in the budget.

The largest tax expenditures tend to be associated with the individual income tax. For example, tax preferences are provided for employer contributions for medical insurance, pension contributions and earnings, mortgage interest payments on owner-occupied homes, capital gains, and payments of State and local individual income taxes. Tax expenditures under the corporate income tax tend to be related to the rate of cost recovery for various investments; as is discussed below, the extent to which these provisions are classified as tax expenditures varies according to the conceptual baseline used. Charitable contributions and credits for State taxes on bequests are the largest tax expenditures under the unified transfer (i.e., estate and gift) tax.

Because of potential interactions among provisions, this chapter does not present a grand total revenue loss estimate for tax expenditures. Moreover, past tax changes entailing broad elimination of tax expenditures were generally accompanied by changes in tax rates or other basic provisions, so that the net effects on Federal revenues were considerably (if not totally) offset. Nevertheless, in aggregate, tax expenditures have revenue impacts of hundreds of billions of dollars, and are some of the most important ways in which the Federal Government affects economic decisions and social welfare.

Tax expenditures relating to the individual and corporate income taxes are considered first in this chapter. They are estimated for fiscal years 1997-2003 using three methods of accounting: revenue loss, outlay equivalent, and present value. The present value approach provides estimates of the revenue losses for tax expenditures that involve deferrals of tax payments into the

future or have similar long-term effects. Tax expenditures relating to the unified transfer tax are considered in a section at the end of the chapter.

The section in this chapter on Performance Measures and the Economic Effects of Tax Expenditures presents information related to assessment of the effect of tax expenditures on the achievement of program performance goals. This section was prepared under the Government Performance and Results Act of 1993 and is a part of the government-wide performance plan required by this Act (see also Sections III, IV, and VI of the *Budget* volume). Tax expenditures are also discussed in Section VI of the *Budget*, which considers the Federal Government's spending, regulatory, and tax policies across functional areas.

Performance Measures and the Economic Effects of Tax Expenditures

Under the Government Performance and Results Act of 1993 (GPRA), Federal agencies are directed to develop both strategic and annual plans for their programs and activities. These plans set out performance objectives to be achieved over a specific time period. Achieving most of these objectives will largely be the result of direct expenditures of funds. However, tax expenditures may also contribute to goal achievement.

The Senate Governmental Affairs Committee report on this Act⁴ called on the Executive branch to undertake a series of analyses to assess the effect of specific tax expenditures on the achievement of the goals and objectives in these strategic and annual plans. As described in OMB's May 1997 report on this Act,⁵ Treasury in 1997 initiated pilot studies of three specific tax expenditures in order to explore evaluation methods and resource needs associated with evaluating the relationship between tax expenditures and performance goals. Tax expenditures were selected in each of the three main areas—individual, business, and international taxation—within the Office of Tax Analysis. The specific provisions considered were: the tax exemption for worker's compensation benefits; the tax credit for nonconventional fuels; and the tax exclusion for certain amounts of income earned by Americans living

⁴ Committee on Governmental Affairs, United States Senate, "Government Performance and Results Act of 1993" (Report 103-58, 1993).

⁵ Director of the Office of Management and Budget, "The Government Performance and Results Act," Report to the President and the Congress, May 1997.

abroad. The results of these studies are summarized in the context of the three specific provisions in the section that follows, which provides provision descriptions.

For the next year, the Administration's plan is to complete additional studies that will focus on the availability of the data needed to assess the effects of selected significant tax expenditures. In addition, summarized data on the beneficiaries and other economic properties of such provisions will be developed where feasible. This effort will complement information published by the Joint Committee on Taxation and the Senate Budget Committee on the rationale, beneficiaries, and effects of tax expenditures.⁶ One finding of the pilot studies is that much of the data needed for thorough analysis is not currently available. Hence, assessment of data needs and availability from Federal statistical agencies, program-agency studies, or private-sector sources, and, when feasible, publication of data on selected tax expenditures should prove valuable to broader efforts to assess the effects tax expenditures and to compare their effectiveness with outlay, regulatory and other tax policies as means of achieving objectives.

Comparisons of tax expenditure, spending, and regulatory policies. Tax expenditures by definition work through the tax system and, particularly, the income tax. Thus, they may be relatively advantageous policy approaches when the benefit or incentive is related to income and is intended to be widely available.⁷ Because there is an existing public administrative and private compliance structure for the tax system, the incremental administrative and compliance costs for a tax expenditure may be low in many, though not all, cases. In addition, tax expenditures may help simplify the tax system, as where they leave certain income sources untaxed (e.g., exemptions for employer fringe benefits or exclusions for up to \$500,000 of capital gains on home sales). Tax expenditures also implicitly subsidize certain activities, which benefits recipients; the beneficiaries experience reduced taxes that are offset by higher taxes (or spending reductions) elsewhere. Regulatory or tax-disincentive policies, which can also modify behavior, would have a different distributional impact. Finally, a variety of tax expenditure tools can be used—e.g., deductions, credits, exemptions and deferrals; floors and ceilings; and phase-ins and phase-outs, dependent on income, expenses, or demographic characteristics (age, number of family members, etc.). This wide range means that tax expenditures can be flexible and can have very different distributional and cost-effectiveness properties.

Tax expenditures also have limitations. In some cases they can add to the complexity of the tax system, which can raise both administrative and compliance costs; for

example, various holding periods and tax rates for capital gains can complicate filing and decisionmaking. Also, the income tax system does not gather information on wealth, in contrast to certain loan programs that are based on recipients' assets and income. In addition, the tax system may have little or no contact with persons who have no or very low incomes, and incentives for such persons may need to take the form of refunds. These features may reduce the effectiveness of tax expenditures for addressing certain income-transfer objectives. Tax expenditures also generally do not enable the same degree of agency discretion as an outlay program; for example, grant or direct Federal service delivery programs can prioritize which activities are addressed with what amount of resources in a way that is difficult to emulate with tax expenditures. Finally, tax expenditures tend to escape the budget scrutiny afforded to other programs. For instance, a program funded by a tax expenditure does not increase government outlays as a share of national product and it may even decrease receipts as a share of output. However, the effective government compensation to a service provider can be identical to that of a spending program under which the outlay (and possibly the receipts) share of GDP may increase.

Outlay programs, in contrast, have advantages where direct government service provision is particularly warranted—such as equipping and providing the armed forces or administering the system of justice. Outlay programs may also be specifically designed to meet the needs of low-income families who would not otherwise be subject to income taxes or need to file a return. Outlay programs may also receive more year-to-year oversight and fine tuning, through the legislative and executive budget process. In addition, there are many types of spending programs—including direct government provision; credit programs; and payments to State and local governments, the private sector, or individuals in the form of grants or contracts—which provides flexibility for policy design. Regarding limitations, certain outlay programs—such as direct government service provision—may rely less directly on economic incentives and private-market provision than tax incentives, which may reduce the relative efficiency of spending programs for some goals. Spending programs also require resources to be raised via taxes, user charges, or government borrowing. Finally, spending programs, particularly on the discretionary side, may respond less readily to changing activity levels and economic conditions than tax expenditures.

Regulations have a key distributional difference from outlay and tax-expenditure programs in that the immediate distributional burden of the regulation typically falls on the regulated party (i.e., the intended actor)—generally in the private sector. While the regulated parties can pass costs along through product or input prices, the initial incidence is on the regulated party. Regulations can be fine-tuned more quickly than tax expenditures, as they can generally be changed by the executive branch without legislation. Like tax expendi-

⁶ Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 1998–2992," JCS–22–97, December 15, 1997; and Committee on the Budget, United States Senate, "Tax Expenditures: Compendium of Background Material on Individual Provisions," prepared by the Congressional Research Service (S. Prt. 104–69, December 1996).

⁷ While this section focuses upon tax expenditures under the income tax, tax preferences also arise under the unified transfer, payroll, and excise tax systems. Such preferences can be useful when they relate to the base of those taxes, such as an excise tax exemption for certain types of meritorious consumption.

tures, regulations often largely rely upon voluntary compliance, rather than detailed inspections and policing. As such, the public administrative costs tend to be modest, relative to the private resource costs associated with modifying activities. Historically, regulations have tended to rely on proscriptive measures, as opposed to economic incentives, which can diminish their efficiency, though this feature can also promote full compliance where (as in certain safety-related cases) policymakers believe that trade-offs with economic considerations are unnecessary. Also, regulations generally do not directly affect the Federal budget and outlays and receipts as a percentage of national output. Thus, like tax expenditures, they may escape the type of scrutiny that outlay programs receive. However, most regulations are subjected to a formal type of benefit-cost analysis that goes well beyond the analysis required for outlay and tax-expenditure programs. To some extent, the GPRA requirement for performance evaluation will address this lack of formal analysis.

Tax expenditures, like spending and regulatory programs, have a variety of objectives and effects. These include: encouraging certain types of activities (e.g., saving for retirement or investing in certain sectors); increasing certain types of after-tax income (e.g., favorable tax treatment of social security income); reducing private compliance costs and government administrative costs (e.g., favorable treatment of certain employer-provided fringe benefits); and promoting tax neutrality (e.g., accelerated depreciation in the presence of inflation). Some of these objectives are well suited to quantitative measurement, while others are less well suited. Also, many tax expenditures, including those cited above, may have more than one objective. For example, favorable treatment of employer-provided pensions might be argued to have aspects of most, or even all, of the goals mentioned above. In addition, the economic effects of particular provisions can extend beyond their intended objectives (e.g., a provision intended to promote an activity or raise certain incomes may have positive or negative effects on tax neutrality).

Performance measurement is generally concerned with inputs, outputs, and outcomes. In the case of tax expenditures, the principal input is usually the tax revenue loss. Outputs are quantitative or qualitative measures of goods and services, or changes in income and investment, directly produced by these inputs. Outcomes, in turn, represent the changes in the economy, society, or environment that are the ultimate goals of programs.

Thus, for a provision that reduces taxes on certain investment activity, an increase in the amount of investment would likely be a key output. The resulting production from that investment, and, in turn, the associated improvements in national income, welfare, or security, could be the outcomes of interest. For other provisions, such as those designed to address a potential inequity or unintended consequence in the tax code, an important performance measure might be how they change effective tax rates (the discounted present-value

of taxes owed on new investments or incremental earnings) or excess burden (an economic measure of the distortions caused by taxes). Distributional effects on incomes may be an important measure for certain provisions.

An overview of evaluation issues by budget function. The discussion below considers the types of measures that might be useful for some major programmatic groups of tax expenditures. The discussion is intended to be illustrative, and not all encompassing. However, it is premised on the assumption that the data needed to perform the analysis are available or can be developed. In practice, data availability is likely to be a major challenge, and data constraints may limit the assessment of the effectiveness of many of the provisions for some time. In addition, such assessments can raise significant challenges in economic modeling, which has inherent uncertainties. For these reasons, and related time, staffing, and resource constraints, the evaluation process is likely to take a number of years and to include qualitative assessments and estimated ranges of effects, in many cases, as opposed to point estimates.

National defense.—Some tax expenditures are intended to assist governmental activities. For example, tax preferences for military benefits reflect, among other things, the view that benefits such as housing, subsistence, and moving expenses are intrinsic aspects of military service, and are provided, in part, for the benefit of the employer, the U.S. Government. Tax benefits for combat service are intended to reduce tax burdens on military personnel undertaking hazardous service for the Nation. A portion of the tax expenditure associated with foreign earnings is targeted to benefit U.S. Government civilian personnel working abroad, by offsetting the living costs that can be higher than those in the United States. These tax expenditures should be considered together with direct agency budget costs in making programmatic decisions.

International affairs.—Tax expenditures are also aimed at promoting U.S. exports. These include the exclusion for income earned abroad by nongovernmental employees and preferences for income from exports and U.S.-controlled foreign corporations. Measuring the effectiveness of these provisions raises challenging issues. In addition to determining their effectiveness in markets of the benefitting firms, analysis should consider the extent to which macroeconomic factors lead to offsetting effects, such as increased imports, which could moderate any net effects on employment, national output, and trade deficits. Similar issues arise in the case of export promotion programs supported by outlays.

General science, space and technology; energy; natural resources and the environment; agriculture; and commerce and housing.—A series of tax expenditures reduces the cost of investment, both in specific activities—such as research and experimen-

tation, extractive industries, and certain financial activities—and more generally, through accelerated depreciation for plant and equipment. These provisions can be evaluated along a number of dimensions. For example, it could be useful to consider the strength of the incentives by measuring their effects on the cost of capital (the interest rate which investments must yield to cover their costs) and effective tax rates. The impact of these provisions on the amounts of corresponding forms of investment—such as research spending, exploration activity, or equipment—could also be estimated. In some cases, such as research, there is evidence that the investment can provide significant positive externalities—that is, economic benefits that are not reflected in the market transactions between private parties. It could be useful to quantify these externalities and compare them with the degree of tax subsidy provided. Measures could also indicate the provisions' effects on production from these investments—such as numbers or values of patents, energy production and reserves, and industrial production. Issues to be considered include the extent to which the preferences increase production (as opposed to benefitting existing output) and their cost-effectiveness relative to other policies. Analysis could also consider objectives that are more difficult to measure but still are ultimate goals, such as promoting the Nation's technological base, energy security, environmental quality, or economic growth. Such an assessment is likely to involve tax analysis as well as consideration of non-tax matters such as market structure, scientific, and other information (such as the effects of increased domestic fuel production on imports from various regions, or the effects of various energy sources on the environment).

Housing investment also benefits from tax expenditures, including the mortgage interest deduction and preferential treatment of capital gains on homes. Measures of the effectiveness of these provisions could include their effects on increasing the extent of home ownership and the quality of housing. In addition, the mortgage interest deduction offsets the taxable nature of investment income received by homeowners, so the relationship between the deduction and such earnings is also relevant to evaluation of this provision. Similarly, analysis of the extent of accumulated inflationary gains is likely to be relevant to evaluation of the capital gains preference for home sales. Deductibility of State and local property taxes assists with making housing more affordable as well as easing the cost of providing community services through these taxes. Provisions intended to promote investment in rental housing could be evaluated for their effects on making such housing more available and affordable. These provisions should then be compared with alternative programs that address housing supply and demand.

Transportation.—Employer-provided parking is a fringe benefit that, for the most part, is excluded from taxation. The tax expenditure revenue loss estimates reflect the cost of parking that is leased by employers for employees; an estimate is not currently available

for the value of parking owned by employers and provided to their employees. The exclusion for employer-provided transit passes is intended to promote use of this mode of transportation, which has environmental and congestion benefits. The tax treatments of these different benefits could be compared with alternative transportation policies.

Community and regional development.—A series of tax expenditures is intended to promote community and regional development by reducing the costs of financing specialized infrastructure, such as airports, docks, and stadiums. Empowerment zone and enterprise community provisions are designed to promote activity in disadvantaged areas. These provisions can be compared with grant and other policies designed to spur economic development.

Education, training, employment, and social services.—Major provisions in this function are intended to promote post-secondary education, to offset costs of raising children, and to promote a variety of charitable activities. The education incentives can be compared with loans, grants, and other programs designed to promote higher education and training. The child credits are intended to adjust the tax system for the costs of raising children; as such, they could be compared to other Federal tax and spending policies, including related features of the tax system, such as personal exemptions (which are not defined as a tax expenditure). Evaluation of charitable activities requires consideration of the beneficiaries of these activities, who are generally not the parties receiving the tax reduction.

Health.—Individuals also benefit from favorable treatment of employer-provided health insurance. Measures of these benefits could include increased coverage and the distribution of this coverage across different income groups. The effects of insurance coverage on final outcome measures of actual health (e.g., infant mortality, days of work lost due to illness, or life expectancy) or intermediate outcomes (e.g., use of preventive health care or health care costs) could also be investigated. The distribution of employer-provided health insurance is not readily evident from tax return information; thus, the distribution of benefits from this exclusion must be imputed using tax as well as other forms of information.

Income security, social security, and veterans benefits and services.—Major tax expenditures in the income security function benefit retirement savings, through employer-provided pensions, individual retirement accounts, and Keogh plans. These provisions might be evaluated in terms of their effects on boosting retirement incomes, private savings, and national savings (which would include the effect on private savings as well as public savings or deficits). In considering the provisions' distributional effects, it may be useful to consider beneficiaries' incomes while retired and over

their entire lifetimes. Interactions with other programs, including social security, also may merit analysis. As in the case of employer-provided health insurance, analysis of employer-provided pension programs requires imputing the benefits of the firm-level contributions back to individuals.

Other provisions principally have income distribution, rather than incentive, effects. For example, tax-favored treatment of social security benefits, certain veterans benefits, and deductions for the blind and elderly provide increased incomes to eligible parties. The distribution of these benefits may be a useful performance measure. The earned-income tax credit, in contrast, should be evaluated both for its effects on labor force participation and its distributional properties.

General purpose fiscal assistance and interest.—The tax-exemption for public purpose State and local bonds reduces the costs of borrowing for a variety of purposes; borrowing for non-public purposes is reflected under other budget functions. The deductibility of certain State and local taxes reflected under this function primarily relates to personal income taxes; property tax deductibility is reflected under the commerce and housing function. Tax preferences for Puerto Rico and other U.S. possessions are also included here. These provisions can be compared with other tax and spending policies as means of benefitting fiscal and economic conditions in the States, localities, and possessions. Finally, the tax deferral for interest on U.S. savings bonds benefits savers who invest in these instruments;

the extent of these benefits and any effects on Federal borrowing costs could be evaluated.

The above illustrative discussion, while broad, is nevertheless incomplete, both for the provisions mentioned and the many that are not explicitly cited. Developing a framework that is sufficiently comprehensive, accurate, and flexible to reflect the objectives and effects of the wide range of tax expenditures will be a significant challenge. OMB, Treasury, and other agencies will work together, as appropriate, to address this challenge. Particularly over the next few years, a significant portion of this effort is likely to be devoted to data issues. Because the compilation of data is resource intensive, and must be balanced with other objectives (including minimizing information collection burdens), careful planning will be essential. Given the challenges inherent in this work, the nature of the analyses is likely to evolve and improve over the next several years.

Other Considerations

The tax expenditure analysis could be extended beyond the income and transfer taxes to include payroll and excise taxes. The exclusion of certain forms of compensation from the wage base, for instance, reduces payroll taxes, as well as income taxes. Payroll tax exclusions are complex to analyze, however, because they also affect social insurance benefits. Certain targeted excise tax provisions might also be considered tax expenditures. In this case challenges include determining an appropriate baseline.