

THE TAX EXPENDITURE BUDGET—THE NEED FOR A FULLER ACCOUNTING

GEORGE F. BREAK*

IMAGINE for a moment that you are playing a game of trivial pursuit and are asked: What famous book begins "This is the scene: It is September 1967 . . ." In this audience especially many will already know the answer. By way of a few clues for those who don't, the scene in question had three main features:

- a growing federal budget deficit that needed to be controlled,
- lively Congressional debate over the mix in the fiscal control package between expenditure reductions and tax increases, and
- considerations of potential expenditure reductions that ignored the implicit tax subsidies and incentives in the Internal Revenue Code even though the discussion took place in the House Ways and Means Committee.

Now you may think that I simply have the date wrong, and that it is in fact May 20, 1985. There are, indeed, some remarkable similarities between the two dates. All three elements of the 1967 scene are present now, though in different degrees. The deficit problem is worse, discussions of expenditure reductions are relatively more important now, but there still seems to be distressingly little connection between the spending cuts proposed and the tax subsidies that may exist in the same functional area on the revenue side of the budget. As I'm sure you all know by now, the title of the book is *Pathways to Tax Reform*.

One distinctly non-trivial result of that September 1967 scene was the development in this country, by Stanley Surrey and Henry Aaron, of the tax expenditure budget. The basic ideas were first presented by Surrey in a November 1967 speech entitled, "The United States Income Tax System—the Need for a Full Accounting." They were developed by the

Treasury Department tax staff and a group of consultants and were published in the Annual Report of the Secretary of the Treasury for Fiscal 1968. The first comprehensive listing of government subsidies, including those on the tax as well as the expenditure side of the budget, was apparently in the Federal Republic of Germany, at first in 1959 on an informal basis and then beginning in 1967 on a legally-required biennial basis. Much has happened since those early pioneering efforts. By 1983 comprehensive tax expenditure or tax relief accounts were in use in eleven countries and under serious study in at least five others.¹

A particularly interesting use of the tax expenditure budget has been in Canada in recent years. In 1979 the Canadian government introduced both its first official tax expenditure budget and a new Policy and Expenditure Management System. Under that system all expenditure programs are divided into a number of broad policy area groups called "envelopes." Ministers then receive spending targets for each envelope which they cannot exceed, and all new tax expenditure proposals are integrated into this budgetary planning process. That means that all proposals for new tax expenditures, or for expansions in existing ones, are debited against each Minister's allowable envelope spending limit. There is, however, one important exception. Tax expenditures proposed by the Minister of Finance for general fiscal purposes do not affect envelope targets.² Clearly included under this exception would be any proposed increase in an investment tax credit that was part of an anti-recessionary policy. Less clear, perhaps, would be the adoption of a general investment tax credit to stimulate productivity and economic growth.

In his 1967 speech Stanley Surrey described, in his usual succinct fashion, both the promise resulting from, and the problems to be encountered in, the develop-

*University of California, Berkeley.

ment of a tax expenditure budget: "The approach would be to explore the possibility of describing in the Federal Budget the expenditure equivalents of tax benefit provisions. We should not, of course, overlook the difficulties of interpretation or measurement involved here."³ The promise is already well established, and though some important problems remain unresolved, there is much that could be accomplished by a fuller accounting in tax expenditure budgets of the main conceptual and mensural difficulties. We already have a textual discussion of these problems that accompanies the annual tabular presentations of federal tax expenditures, but the difficulties dealt with in the text could be given greater visibility, I believe, by dividing the tabular listing of tax expenditures into three, or more, broad categories. This would serve to highlight the fact that there is not one generally-agreed-upon basic structure for an income tax. At any given time views about what is in fact the "best attainable income tax" (BAIT), as I called it a few years ago,⁴ are bound to differ to some extent, and changing circumstances are likely to alter those views over time. A multi-part tax expenditure budget would be designed to bring these disagreements more into the open, and by doing so, to minimize misuses of official tax expenditure estimates.

To illustrate the points I have in mind here I have drawn up, in Table 1, a three-part federal tax expenditure budget from the fiscal 1986 revenue loss estimates of the Joint Committee on Taxation.⁵ Needless to say, not everyone will agree with the specific allocations made in Table 1. Its purpose is not to obtain agreement on these choices but rather to stimulate interest in the development of a multi-part tax expenditure budget and in its uses for policy purposes.

Category A in Table 1 is intended to include those broad groups of individual tax expenditure items that have little or no structural function and for which reasonably reliable cost estimates are currently available. The five most important groups here are:

—the investment tax credit and non-

business interest expenses, each at \$36 billion for fiscal 1986,

- employee fringe benefits, \$33 billion,
- state and local bond interest, \$29 billion, and
- charitable contributions, \$15 billion.

Altogether the ten groups included in our top category of tax expenditure items added up to \$180 billion, or 42 percent of the 1986 tax expenditure total.

Category B contains two groups also with little or no structural function but with serious measurement problems. They are:

- excess depletion and depreciation, \$35 billion, and
- financial institutions, \$10 billion.

The difficulties involved in measuring inflation-adjusted economic depreciation and the true income of financial institutions are well known and need not be discussed here. For similar reasons some might prefer to shift the capital cost expensing group from Category A to B. In any case, our two top categories together account for 53 percent of all fiscal 1986 tax expenditures.

Category C, finally, contains the groups whose usefulness on the official tax expenditure listing is, for various reasons, open to serious question. The most important, estimated at a revenue cost of \$91 billion for fiscal 1986, involves mainly the exclusion from the income tax base of pension fund contributions and earnings. This treatment of tax subsidies for retirement saving plans assumes that accrual-basis taxation is the appropriate reference BAIT. A strong alternative contender for BAIT status, however, would be a realization-basis tax that exempted all contributions to pension funds and plans and then taxed all fund earnings and benefit distributions. This alternative is superior to the accrual-basis BAIT in its treatment of defined-benefit pension plans, but its adoption would, under present circumstances, involve a complex, and undoubtedly unpopular, annual allocation of fund earnings to potential beneficiaries for tax computation purposes. Those complexities could be completely avoided under a flat-rate income tax plan, and would be considerably moderated under the

CATEGORIES OF FEDERAL TAX EXPENDITURES, FISCAL 1986

Group	Revenue Cost Estimate (\$ billions)
<u>CATEGORY A</u>	
1. Investment tax credit	36.3
2. Nonbusiness interest expenses	35.9
3. Employee fringe benefits	33.3
4. Interest on state and local bonds	29.4
5. Charitable contributions	15.2
6. Transfer payments and special personal exemptions	9.7
7. Capital cost expensing	6.8
8. Tax credits	6.4
9. Foreign source income	4.7
10. Child and dependent care expenses	<u>2.2</u>
Total	179.9
<u>CATEGORY B</u>	
11. Excess depletion and depreciation	35.1
12. Financial institutions	<u>10.0</u>
Total	45.1
<u>CATEGORY C</u>	
13. Retirement saving	90.6
14. Capital gains and losses	45.7
15. State and local nonbusiness taxes	35.2
16. Special corporation income tax features	9.9
17. Income deferral opportunities	7.7
18. Special deduction for two-earner married couples	6.8
19. Medical expenses; casualty and theft losses	3.8
Total	199.7
Grand Total	424.7

Source: "Joint Tax Committee Estimates FY '86-'90 Tax Expenditures,"
Tax Notes (April 22, 1985), pp. 401-11.

modified flat-rate tax plans now under consideration. It seems appropriate, therefore, that official tax expenditure budgets present cost estimates based on

each of the alternative BAITs just noted.⁶ Capital gains and losses are a difficult item to deal with in tax expenditure budgets for both conceptual and mensural

reasons. Even if realization-basis taxation is taken to be the appropriate BAIT model, as seems widely agreed, two conceptual ambiguities must be faced. One involves the extent to which realized capital losses should be offsettable against ordinary income, and the other concerns the level below which effective capital gains tax rates should be set to avoid excessive lock-in effects. Since there are no clear answers to these difficult questions, there is also no clear indication of the nature of the structural anomalies now present in the federal income tax. The one unambiguous item in the group is the net accrued capital gain that might be taxed at the death of capital asset owners, but even this item, estimated at \$4 billion for fiscal 1986, is mismeasured at present. The BAIT model for all capital gains and losses, as it is for capital income generally, is one based on inflation-adjusted, rather than on nominal, dollar amounts. For all of these reasons I find the capital gains listings in currently available tax expenditure budgets to be of little use.

The third group in Category C is state and local nonbusiness taxes (\$35 billion in fiscal 1986). Most economists regard these as the price at which governmental services are purchased and, consistent with this benefit-model interpretation, would place the group in our Category A. The general public, in contrast, regards these taxes as ability-to-pay levies whose vertical equity should be judged with reference to the progressiveness of their burdens by income class. These views, in turn, imply that in a federal system of government, such as ours, each level of government should base its income taxes on individual incomes net of the ability-to-pay taxes imposed by the other level. According to this ability-model view, then, state and local nonbusiness taxes are a necessary structural component of the federal individual income tax and do not belong in the tax expenditure budget.⁷ Given these sharply divergent views, the group should be placed in Category C.

Three other groups in Category C are less important quantitatively and need only brief comment here. The first, special corporation income tax features (\$10 billion in fiscal 1986), contains the re-

duced tax rates for small corporations, cooperative dividends, the dividend exclusion, and the reinvestment of public utility dividends. Here again there are two contrasting BAIT models, one that includes a separate corporation levy in its income tax system, under which these features are structural anomalies and hence Category A tax expenditures, and one that proposes a fully integrated corporation-individual income tax system, under which these items are not tax expenditures. The second group, income deferral opportunities (\$8 billion), contains such items as savings bond interest, income from installment sales and long-term contracts, and the bad debt reserves of nonfinancial business. As with capital gains and losses the choice here is between accrual income accounting which may lack the objectivity and liquidity qualities that good tax base measurements require and realization-basis accounting that may permit undue deferrals of tax liabilities. That choice is complex enough to place this group in Category C. The third group is medical expense and casualty and theft loss deductions (\$4 billion). Insofar as these large expenses are involuntary they clearly impair individual abilities to pay taxes, serve an important structural function, and should not be classified as tax expenditures.

A recurring theme in Category C is that there are some items that look like structural anomalies when viewed separately but are really structural accommodations when viewed in relation to other required structural features of the income tax. The special deduction for two-earner married couples (\$7 billion), for example, may be viewed as a requirement for any income tax with a progressive rate structure. Other structural accommodations may include a single, low rate on pension fund earnings when individual tax rates are progressive, a special, low rate on capital gains when they are taxed on a realization basis, and lower rates on small corporations when corporate source income is overtaxed under an unintegrated corporation-individual tax system.

In addition to these specific structural accommodations, which should not be classified as tax expenditures to the extent that

they serve to offset distortions created by other basic structural features of the tax law, there may also be some of a more general nature. Consider, for example, the investment tax credit, the leading item in Category A. The way in which that credit is structured suggests a tax law feature adopted to offset, in an economically productive way, the burdens created by excessively high business income tax rates. Both the limits placed on its deductibility from current tax liabilities and the use of carryovers rather than refundability for excess credits strongly suggest such an interpretation. An expenditure subsidy program serving the same general purpose would not have those features, but would be granted to all businesses regardless of their taxability status. There may, in short, be doubts about the proper classification of even such a widely accepted tax expenditure item as the federal investment tax credit.

These brief comments necessarily leave untouched many of the important promises and complexities of the tax expenditure budget. It was a great idea, and I expect it to continue to prosper and develop and, in the process, to keep very much alive the name of Stanley Surrey.

¹The ten countries, in addition to the United States, with comprehensive tax expenditure accounts were Australia, Austria, Canada, the Federal Republic of Germany, France, Ireland, Japan, Portugal, Spain, and the United Kingdom. Countries considering such budgets included Belgium, Finland, the Netherlands, New Zealand, and Sweden. See Congress of the United States, Congressional Budget Office, *Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1984-1988* (October 1983), and Organization for Economic Co-operation and Development, *Tax Expenditures: A Review of the Issues and Country Practices* (Paris 1984).

²Organization for Economic Co-operation and Development, *op. cit.*, p. 11.

³Stanley S. Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (Harvard University Press, 1973), p. 4.

⁴George F. Break, "Issues in Measuring the Level of Government Economic Activity," *American Economic Review: Papers and Proceedings* (May 1982), pp. 288-95.

⁵*Tax Notes* (April 22, 1985), pp. 401-11.

⁶For a discussion of these two alternatives see David F. Bradford and the U.S. Treasury Tax Policy Staff, *Blueprints for Basic Tax Reform*, Second Edition, Revised (Tax Analysts, 1984), pp. 52-54.

⁷George F. Break, "Tax Principles in a Federal System," in Henry J. Aaron and Michael J. Boskin, eds. *The Economics of Taxation* (Brookings Institution, 1980), pp. 317-26, and "Comments on the Gramlich and Inman Papers," in John M. Quigley and Daniel L. Rubinfeld, eds. *American Domestic Priorities: An Economic Appraisal* (University of California Press, forthcoming).