

Tax Cuts or Spending— Does it Make a Difference?

***Abstract** - The use of tax incentives instead of direct spending to promote social and economic goals is growing. This paper considers whether it matters if fiscal interventions take the form of direct spending or tax breaks. Tax breaks can, and increasingly do, replace spending programs with the same effects on resource allocation and income distribution. Costs of administration may differ between them, however, depending on program design features. While the choice between the two must be made on a case-by-case basis, the increased use of the tax system for social policy raises broader concerns about political accountability.*

INTRODUCTION

While politicians and advocacy groups argue about how much of the current and projected Federal budget surplus should be used for tax cuts, commentators are focusing less attention on how much of proposed cuts are really spending in another form. Recent years have seen an increased use of tax incentives instead of direct spending to promote social and economic goals. Tax incentives serve the needs of political leaders by enabling them to appear to reduce spending and taxes, while at the same time pursuing an activist policy that promotes popular programs.

The use of the tax system as a substitute for spending is, of course, not new. Long-standing provisions of the U.S. income tax provide tax benefits for home ownership, the provision of group health insurance by employers, retirement saving, activities of state and local governments and charitable organizations, and investments in selected industries and categories of assets. Since Surrey (1973) popularized the concept, these and other tax provisions have often been referred to as "tax expenditures." The Office of Management and Budget (OMB) (2000) defines tax expenditures as "revenue losses due to preferential provisions of the Federal tax laws, such as special exclusions, exemptions, deductions, credits, deferrals, or tax rates." OMB and the Joint Committee on Taxation (JCT) publish annually lists of tax expenditures and estimates of their revenue losses.

In recent years, tax expenditures have been growing, especially those directed at social policy goals such as health, education, housing, retirement security, support for low-in-

Eric J. Toder

*The Urban Institute,
Washington, D.C.
20037*

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come families, and development of economically depressed areas. The earned income tax credit (EITC) has increased more than four-fold since 1990 and now provides as much assistance as food stamps and Supplemental Security Income (SSI) and more assistance than family support. Congress has enacted new tax credits for expenses of post-secondary education and a new child credit. It has broadened tax incentives for saving for higher education, expanded eligibility for tax-favored individual retirement accounts (IRAs), and increased tax benefits for businesses that invest in economically depressed areas and employ disadvantaged workers. Toder (1999) estimates that "social tax expenditures" have increased as a share of gross domestic product (GDP) over the past two decades, while business tax expenditures (tax benefits to promote investment or to assist selected industries) have declined.

The President's Fiscal Year 2001 budget proposes new and expanded tax incentives that reduce Federal revenues by \$81 billion over the next five years and \$264 billion over the next ten years.¹ These include expansion of the EITC and tax credits for post-secondary education, an increase in the dependent care credit, and new credits for contributions to retirement savings accounts and expenses for long-term care. Presidential candidate George W. Bush is also proposing new tax incentives. For example, Bush has proposed to expand educational saving accounts, make the research and development credit permanent, and allow non-itemizing taxpayers to deduct charitable contributions.²

By the usual standards of tax policy analysis, tax expenditures make the tax system worse according to the goals of fairness, efficiency, and simplicity. They

make the tax system less fair by enabling some taxpayers to pay less than others with the same income. They raise the efficiency cost of taxation by inducing taxpayers to substitute activities that are tax-preferred for those that would benefit them more under a neutral tax regime. They make the tax system more complicated because they require detailed rules to distinguish among transactions that do and do not qualify for special benefits. The standard rhetoric of tax reform proposals (U.S. Department of the Treasury, 1984; Bradford and U.S. Treasury Tax Policy Staff, 1984) all make the case against special tax benefits and for a tax system with low rates and a broad tax base. International agencies advising developing countries on tax policy offer similar advice (Stotsky, 1995).

Yet if these provisions are really expenditures in disguise, whether or not they violate tax policy principles is irrelevant. No general principles require that spending programs should treat all taxpayers with the same income equally or that they be neutral with respect to resource allocation. Instead, public spending programs explicitly aim to alter the allocation of resources and the distribution of income from what the market system would otherwise produce. Moreover, while costs to agencies of administering programs and to potential recipients in claiming benefits are important in program evaluation, what matters is the total cost of government programs—not whether the costs are borne by the IRS and taxpayers instead of by a spending agency and its potential beneficiaries.

This paper asks whether and how it matters if fiscal interventions take the form of direct spending or tax breaks. The second section of this paper provides some illustrations of equivalence between tax cuts and spending and shows how

¹ These figures are based on estimates reported in U.S. Department of the Treasury (2000). The author classified which ones of these proposals represent tax expenditures as opposed to cuts in the "normal" or baseline income tax.

² See Office of Tax Policy Research (2000).

reclassifying tax expenditures as spending converts the net tax cut in the President's Fiscal Year 2001 budget into a small net tax increase. The third section discusses the major dimensions on which tax and direct expenditures differ. The fourth section discusses dimensions on which tax expenditures often differ from direct expenditures, but can be made equivalent by modifying design features of the tax expenditure. The fifth section of the paper reviews some criteria for choosing between tax and direct expenditures. A final section briefly concludes.

EXCEPT FOR APPEARANCE, TAX INCENTIVES AND SPENDING CAN DO EXACTLY THE SAME THING

For many expenditure programs, it is possible to design tax incentives that exactly replicate them in all features, except that the checks come in the form of tax refunds from, or reductions in tax otherwise due to, the Internal Revenue Service (IRS) instead of payments from a program agency. In principle, it would be possible to design tax provisions that eliminate most Federal spending, while keeping the actual programs intact.

Some Examples

Bradford (1989) illustrates how Congress can cut taxes and defense spending without sacrificing national security. In his example, Congress reduces spending on weapons acquisition to zero, but enacts a "weapons supply tax credit" (WSTC). To qualify for the WSTC, defense contractors deliver weapons to the Pentagon in exchange for certificates they can redeem

against income tax. (For exact equivalence to defense spending, it would be necessary to make the credit refundable or, alternatively, to allow firms without sufficient tax liability to sell their credits to other firms that can use them.)

While no one yet has proposed eliminating the defense budget, some real world examples suggest that politicians have learned to use tax incentives in creative ways. One example is the President's proposal for school modernization bonds (SMBs) to subsidize the cost of school construction. The Department of Education would administer the program and allocate funds among school districts, but payments would be in the form of tax credit certificates that would cover the interest costs of the bonds, instead of direct loan payments.³ Another example is a recent proposal by Governor Davis of California to exempt schoolteachers from California's state income tax (Purdum, 2000). The proposal initially appeared popular with legislators and the public, in part because it was perceived as a tax cut instead of an increase in spending on teachers' salaries. But one major issue was how it gets counted in various measures of fiscal policy and educational spending.⁴

Deconstructing the President's Budget

The above examples clearly illustrate how spending can be converted into an apparent tax cut. But, in other cases, identifying whether a tax provision should be called a "tax expenditure" is difficult and controversial because it requires a definition of what constitutes a "normal" or baseline tax system against which some provisions are exceptions. One relatively

³ The President's proposal expands an already existing provision for Qualified Zone Academy Bonds (QZABs) that Congress enacted in 1997. See Davie (1999).

⁴ For example, an unresolved issue, according to the *New York Times* article (Purdum, 2000a) on the proposal, was whether the estimated annual revenue loss of \$545 million would be counted in calculating per-pupil spending levels in California schools. A follow-up *New York Times* story two weeks later (Purdum, 2000b) reported growing opposition to the proposal, even by the California Teachers' Association. They feared that the proposal would alienate other public employees and undercut their traditional position in support of higher taxes to fund public education.

narrow concept (Fiekowsky, 1980) defines a provision as a tax expenditure if it meets two tests. First, there must be a general rule in the existing tax law, compared with which the specific tax provision is an exception. Second, it must be possible to formulate an expenditure program that would achieve the same objective as the tax provision.

Using this narrow definition of a tax expenditure, I classify revenue proposals in the budget that are reported in U.S. Department of the Treasury (2000) into four groups—tax cuts, tax increases, cuts in tax expenditures, and increases in tax expenditures (Table 1). According to the classifications used in the Table, the budget proposes new and expanded tax expenditures of about \$264 billion over ten years.⁵ These are offset in part by cuts in other tax expenditures (mostly corporate preferences) of about \$56 billion. Other tax provisions include \$87 billion of tax cuts and \$136 billion of tax increases. Overall, the budget shows a net tax cut, but if net

new tax expenditures were counted as *net increases in spending* instead of tax cuts, the budget would display a net tax increase.

The largest tax expenditure provisions would introduce a refundable credit for new retirement saving accounts (\$53 billion), increase the lifetime learning credit for post-secondary tuition (\$30 billion), expand the dependent care credit and make it partially refundable (\$30 billion), provide credits for long-term care expenses (\$27 billion), and expand the EITC (\$23 billion). All of these provisions represent special exceptions to the general rules of an income tax and all could have been designed as direct spending programs. In comparison, the items I classify as cuts in the normal tax amount to \$87 billion. These include a proposed increase in the standard deduction for two earner couples (\$44 billion), a reduction in the alternative minimum tax (AMT) for individuals (\$33 billion), other tax simplification measures (\$8 billion), and net reductions in tariffs and customs duties (\$3 billion).⁶

TABLE 1
CLASSIFICATION OF ADMINISTRATION'S TAX PROPOSALS, FISCAL YEAR 2001
(Amounts in Billions of Dollars)

	2001	2002	2003	2004	2005	2001-5	2001-10
Increases in Tax Expenditures	-4.4	-10.4	-15.7	-22.4	-28.1	-81.0	-263.8
Cuts in Tax Expenditures	3.8	4.6	4.8	5.0	5.4	23.5	55.9
Net Changes in Tax Expenditures	-0.6	-5.8	-10.9	-17.4	-22.7	-57.5	-207.9
Tax Cuts (Normal Tax)	-1.8	-3.0	-4.0	-4.9	-7.1	-20.8	-87.0
Tax Increases	9.1	10.9	11.0	18.5	18.9	68.4	136.1
Net Tax Increase	7.4	7.9	7.0	13.6	11.8	47.6	49.1
All Tax Provisions	6.8	2.0	-4.0	-3.8	-11.0	-9.9	-158.8
Other Receipts Provisions	2.9	-1.1	-0.7	-0.6	-0.4	*	-2.6
All Proposals	9.7	0.9	-4.7	-4.3	-11.4	-9.9	-161.5

* = less than \$50 million

Source: U.S. Treasury Department (2000) and author's calculations.

⁵ Treasury (2000) displays the total budgetary effects of tax expenditures—both the non-refundable portion (reduced receipts in budgetary aggregates) and the refundable portion (which is scored as an increased outlay in budgetary aggregates.)

⁶ A portion of the cut in the individual AMT could be labeled an increase in tax expenditures because the AMT offsets the value of some items that OMB labels tax expenditures, such as the deductibility of non-business state and local income and property taxes. But the AMT also reduces the value of personal exemptions, which are not considered tax expenditures. Thus, labeling the entire AMT reduction as a cut in the normal tax may overstate the tax cut and understate the increase in tax expenditures.

The tax increase provisions are more difficult to classify between tax increases and tax expenditure reductions because many are fairly complex changes that protect the corporate income tax base, but cannot easily be characterized as a reduction in any program that substitutes for direct spending. As a first cut, Table 1 classifies all the corporate shelter provisions (\$23 billion) and provisions that broaden the base for pensions (\$3 billion) and international transactions (\$14 billion) as tax expenditure cuts and the remaining corporate provisions (\$47 billion) as tax increases. Other provisions I characterize as tax increases are increases in the tobacco excise tax (\$66 billion), reinstatement of the corporate environmental income tax (\$5 billion) and the superfund excise taxes (\$8 billion), and estate tax provisions (\$9 billion). Other receipts proposals reduce revenue by about \$3 billion.

On balance, the proposals increase the deficit by about \$162 billion over 10 years. They raise tax expenditures by an estimated \$207 billion, increase taxes (other than tax expenditure changes) by about \$49 billion and reduce other receipts by about \$3 billion.

ON SOME DIMENSIONS, TAX EXPENDITURES CANNOT REPLICATE DIRECT SPENDING

While a tax expenditure can have the same effect on the allocation of resources and the distribution of income as a corresponding tax increase, there are always some differences between tax and spending programs. The most obvious is the one discussed in the previous section—the difference in how tax and direct expenditures are displayed in budgetary accounts and communicated to the public. But there are some other differences as well.

A second (and also obvious) difference is that tax expenditures always require

some level of involvement by the IRS, while direct expenditures do not. Tax expenditures affect the total amount of tax paid or refund due on April 15 and can affect withholding schedules and estimated payments. Individuals claim benefits, subject to audit by the IRS, but may in some circumstances also be required to submit documentation supplied by other agencies.

A third difference is that the costs of administering direct expenditures are more transparent than the costs of administering tax expenditures because they are typically revealed in the budgets of program agencies. In contrast, there is no specific accounting for the administrative costs of tax expenditures. Tax expenditures do raise the cost of providing a given level of enforcement and taxpayer service, but the IRS budget does not display incremental costs attributable to specific provisions.⁷

A fourth difference is the time period used for determining and paying benefits. The income tax uses an annual accounting period as the basis for calculating and assessing tax liability, although tax payments are made more frequently through withholding and estimated taxes. In contrast, spending programs do not necessarily use a one year time period to determine the amount of benefit payments a person or family receive and may pay benefits on a monthly or quarterly basis instead of annually. Eligibility for benefit programs may be based on the stock of assets, on income flows within a year, or on income or earnings over multiple years. For example, Social Security retirement benefits are determined by a formula based on average indexed monthly earnings over 35 years. The use of an annual accounting period places some limitations on how tax incentives can be designed.⁸

⁷ The IRS budget does not display costs of compliance either, but then neither do budgets of spending programs.

⁸ For example, many tax benefits (IRAs, tuition credits, the child credit) are phased out as a taxpayer's AGI increases. But some taxpayers with a high permanent income can nevertheless receive the benefit if their income in any single year is low enough to qualify them.

ON OTHER DIMENSIONS, TAX EXPENDITURES OFTEN DIFFER FROM DIRECT SPENDING, BUT NEED NOT DO SO

This section discusses dimensions on which tax and direct expenditures often differ, but need not do so. In recent years, as the discussion suggests, the trend has been to design new tax expenditure proposals in ways that make them closer substitutes for direct spending programs.

Relationship of Benefits to Tax Circumstances

Most tax benefits in the Federal income tax are not refundable—that is, taxpayers cannot claim benefits in excess of income taxes paid. This renders them of little or no value to low-income individuals and unprofitable corporations with little or no tax liability. In addition, many tax expenditures provide a larger percentage rate of subsidy for the tax-preferred activity to higher income taxpayers. This is the case for provisions that reduce taxable income by providing special exemptions, deductions, or deferral of income recognition and reflects the fact that a cut in taxable income is worth more to a taxpayer in a high marginal rate bracket than to a low rate bracket taxpayer. (Provisions that take the form of itemized deductions in the individual income tax provide no benefit to the over 70 percent of taxpayers, mostly with lower and middle incomes, who use the standard deductions.) In contrast, spending programs do not have this “upside-down” subsidy feature.

Tax expenditures need not, however, provide a larger per-unit subsidy to high-income than to long-income taxpayers. They can provide the same subsidy rate to all qualifying taxpayers if they are designed as credits against tax liability instead of reductions in taxable income and if they are refundable.

In recent years, the trend has been to expand *tax credits* more than deductions or exclusions. As noted above, there has been a large growth in the past decade in the EITC, a new child credit, and two new credits for expenses of post-secondary education. The President’s budget proposes new and expanded tax credits that will cost an estimated \$233 billion over 10 years—almost 90 percent of the cost of all increases in tax incentives. In contrast, most of the long-standing and biggest tax incentives in current law are deductions or exclusions instead of credits. For example, the four largest tax expenditures in current law are all deductions or exclusions. They are: exclusions of pension contribution and earnings (\$92 billion in 2001) and employer contributions for medical insurance premiums and medical care (\$81 billion), and deductions for mortgage interest on owner-occupied homes (\$61 billion) and non-business State and local taxes, other than on owner-occupied homes (\$42 billion).⁹

Refundable tax benefits are still rare, but the budget is proposing full or partial refundability for a number of provisions. Prior to 1997, the EITC was the only refundable tax benefit in either the individual or corporate income taxes. The child credit enacted in 1997 is partially refundable for qualifying taxpayers with three or more children. New or enhanced refundable or partially refundable tax benefits in the President’s budget are the EITC, new tax credits for taxpayers with long-term care needs and for workers with disabilities, and an expanded child and dependent care credit, which is currently non-refundable.

Determination of Eligibility

Tax expenditures are often viewed as less bureaucratic alternatives to direct spending programs. This is because tax

⁹ Office of Management and Budget (2000).

incentives frequently operate by reducing the relative price of favored goods and services to some or all taxpayers. In so doing, they rely on market responses to determine how much additional production and consumption of the favored output actually occurs. Eligibility for benefits depends on characteristics of taxpayers (such as income level or number of children) or their economic behavior (such as annual investment in qualifying assets) that are specified in legislation.

In contrast, eligibility for benefits under many outlay programs depends on choices of program administrators, based on broad criteria. This gives administrators a direct role in determining the allocation of resources.

But some tax expenditures also rely on decisions of administrators. An example is the low-income housing credit under which State and local housing authorities allocate a fixed dollar value of credits among applicants who submit proposals that qualify for the subsidy. Another example is the proposal in the budget for public school construction bonds. These and other existing and proposed incentives use the tax system to replicate a key feature of discretionary Federal spending programs—allocation of budgeted amounts among projects by public officials, based on broad legislative guidelines.

Nature and Degree of Enforcement

Taxpayers self-report eligibility for tax benefits. Typically, the IRS reviews eligibility only after the fact, either in the process of an audit or through checks of calculations on returns and their consistency with information returns supplied by third parties. Audit coverage is typically higher for returns with greater income potential, which means the IRS has historically targeted its enforcement efforts

on high-income individual tax returns and large corporations. In contrast, outlay programs often require potential beneficiaries to file claims and sometimes require people to appear in person before an administrator before they receive a check. Self-reporting on tax returns deters fewer people from claiming benefits than outlays that require administrative approval before benefits are paid.

Subsidies cleared through the tax system, however, need not involve less enforcement. Some benefits do require pre-certification by program agencies. For example, recipients of the low-income housing credit, as noted above, must first receive approval of their applications by State and local housing authorities. In addition, if the public and politicians worry that too many benefits from a particular tax incentive are paid to ineligible recipients, IRS can tighten enforcement. For example, in recent years, the IRS has conducted detailed studies to investigate excess claims of the EITC and increased its monitoring of EITC claims.¹⁰

Budgeted Benefits or Entitlements

Typically, tax incentives resemble entitlement spending in the sense that everyone who qualifies receives benefits. Total federal budgetary costs depend on program rules, economic conditions, and behavioral responses of individuals and businesses. In contrast, the cost of discretionary spending programs is determined annually by Congressional appropriations.

Tax incentives, however, can be and sometimes are subject to caps on total revenue losses. (Again, the low-income housing credit is an example.) To make the caps effective, there must be some method of rationing limited budgetary resources among otherwise eligible claimants. Usually, this involves empowering some

¹⁰ McCubbin (forthcoming) examines recent evidence on over-claims of the EITC, based in part on these IRS studies.



public agency to choose among applicants for benefits.

Required Frequency of Review

Many tax expenditures are "uncontrolled" in the sense that they are permanent features of the tax law, unlike appropriations that must be approved annually, and can increase in cost without any explicit decision by the Congress to expand them. But entitlement spending programs, such as Social Security, Medicare, and food stamps, share this same feature of most tax expenditures.

Some tax expenditures in current law, however, do have legislated expiration dates. Examples are the research and experimentation (R&E) credit, the work opportunity credit, the exclusion for employer-provided education assistance, and the tax credit for "orphan" drugs (drugs that treat rare physical conditions or rare diseases). These "sunset" provisions require Congress to make explicit choices about extending the tax benefits. While sunset would appear to promote better budgetary control of tax expenditures, that is not always the case. In some instances, including an expiration date for a provision creates the illusion that its long-term costs are lower than those of permanent provisions, when in fact the provisions are so popular that Congress will never allow them to end. For example, the R&E credit has been a temporary feature of the tax law since 1981, although arguably sunset may have contributed to revisions and improvements in the credit over the years.

TAX INCENTIVES MAY BE PREFERABLE TO DIRECT SPENDING, BUT OFTEN ARE NOT

The discussion in the previous section suggests that *specific design aspects* of a proposal matter much more than whether recipients claim benefits when they file a tax return with the IRS or receive a check

from a program agency. These specific design questions include whether it is a matching subsidy or direct grant, whether or not there are budgetary ceilings and expiration dates, the criteria for eligibility of beneficiaries, and requirements for certifying eligibility. Nonetheless, on administrative grounds, there may be reasons for preferring either a tax incentive or a direct spending program.

Maximizing Access vs. Minimizing Fraud

There is often a trade-off between maximizing access for eligible beneficiaries and minimizing erroneous claims, including those that are deliberately fraudulent, by people who are ineligible for a benefit. In general, although not always, it is easier and less costly for people to self report benefit claims on a tax return than to apply for and receive benefits from agencies that require prior evidence of eligibility before making payments. Given that most individuals and businesses already file tax returns, a new tax incentive, even though it makes the *tax law* more complex, also has the advantage of not requiring a new point of contact between a citizen and a government agency.

Therefore, tax incentives are often preferable when it is more important to maximize the number of eligible individuals or businesses who use the incentive or receive a benefit than to minimize excess claims. In contrast, if there is a relatively greater concern about the potential for abuse, an outlay program or a tax incentive that requires pre-certification from an agency other than the IRS may be preferable. It is of course possible for the IRS to devote extra resources for enforcement of selected tax incentives. But a decision for non-revenue related reasons to audit returns with one type of tax preference more intensively than others contradicts a general policy of allocating audit resources across taxpayers to maximize the total yield from enforcement and raises issues as to whether taxpayers so targeted are being treated fairly.

Desired Degree of Administrative Discretion in Setting Priorities

Tax incentives may be preferable if the goal is to encourage more of a clear and broadly defined activity by reducing its net price. If clear and objective eligibility criteria can be established (such as a subsidy that depends on the dollar value of home mortgage payments), tax incentives have an advantage. There is no point in establishing a new funding agency when potential subsidy recipients are already settling an annual balance with the IRS. Often, however, the best use of budgetary resources requires that program experts determine how funds should be spent (as in the case of grants for scientific research, for example). In those circumstances, direct spending is typically less costly than tax incentives because the latter unnecessarily requires the use of two agencies—a program agency to allocate funds and the IRS to make the payment. Moreover, the IRS may still need to ensure that the taxpayer has supplied the appropriate documentation from the program agency.

Use of Tax Return Data for Eligibility Criteria

Tax incentives are a better subsidy mechanism than direct spending if eligibility criteria are linked to data already reported on tax returns. For example, in recent years, Congress has limited the use of a number of tax incentives to individuals with income below certain legislated thresholds. Tax incentives with income limits include individual retirement accounts, the child credit, the earned income credit, tax credits for expenses of post-secondary education, and the child and dependent care credit. Although income

phase-outs of benefits may have adverse effects on incentives by raising marginal tax rates in the phase-out range, these adverse incentives would apply equally to tax or spending programs with the same income limits and phase-out rates.

Appropriateness of Annual Accounting Period

Because the tax system uses an annual accounting period, it is less suitable than direct spending if the best program design would use time periods less than or greater than one year in determining benefit eligibility, benefit levels, or timing of payments. This would typically arise in two situations. For many programs for low-income families who have cash flow constraints, timely payments are important. While in principle people can claim tax benefits before the end of the year by changing their withholding, in practice many low-income families may be unwilling to run the risk of claiming advance benefits and then being compelled to pay tax on April 15 if the IRS rejects their claim.¹¹ In other situations, an accounting period of one year would be inappropriate for computing either benefit eligibility or the amount of benefits an individual receives. As noted above, the formula for Social Security retirement benefits is an example where benefits depend on a multiple rate formula based on the highest 35 years of earnings of workers, spouses, and former spouses.

Helping Low-Income Families and Individuals

Tax incentives that are not refundable do not provide much or any help to the many low-income families that pay little or no Federal income tax. In principle,

¹¹ The EITC has an advance payment (negative withholding) option that is available to employees who sign up for the option with their employers. Although the Clinton Administration made an effort in the early 1990s to promote advanced payment of the EITC as a way of getting benefits to recipients on a timely basis, the take-up rate on the advanced payment option was very low.



more tax credits could be made refundable. The President's Fiscal Year 2001 budget, as discussed above, would expand refundability to some existing and new tax credits. But the Congress to date has been reluctant to make tax credits refundable, except for the EITC and a portion of the child credit that goes to families with three or more children. This reflects both a concern with difficulties IRS might have in administering refundable credits and a reluctance on the part of the tax-writing committees to enact tax cuts that would be scored as spending in budgetary aggregates and that would need to be reviewed by other Congressional committees.¹²

CONCLUSIONS

In recent years, there has been a growing use of the tax system to meet social and economic objectives and especially to advance social policy goals such as education, housing, health care, support for low-income families, and retirement security. Tax incentives fit the need of political leaders to satisfy the demand for new and expanded social programs, while appearing to keep spending and tax burdens down.

Tax expenditures often have very different features than direct outlay programs. But many of the tax expenditures that Congress has recently enacted and the President is proposing are much closer substitutes for direct spending programs than long-standing tax expenditures. These newer tax expenditures are more likely to be credits providing equal subsidy rates to all who qualify, instead of deductions or exemptions that provide more benefits to taxpayers in high rate brackets. They are less likely to be limited to taxpayers using itemized deductions.

An increasing number of tax expenditure proposals have budgetary ceilings and require allocation decisions by program agencies. Finally, proposals for refundable tax benefits are becoming more frequent.

These new tax incentives make the tax system worse according to the usual tax policy criteria of fairness, efficiency, and simplicity. Some may also be wasteful or inequitable forms of expenditure. But many tax expenditures promote important social goals, which are worthy of support in some form, if not through the tax code. In addition, using the tax system as a payment mechanism can sometimes be more cost-effective than developing a new spending program. Both the substantive merits of proposed new programs and the choice between making it a tax benefit or direct outlay must be evaluated on a case-by-case basis.

But the expanded use of tax incentives raises substantial concerns on political and process grounds. Their contributions to the size of government are obscured by budgetary presentations and press reports that portray them as "tax cuts" instead of new spending. The additional costs they impose on tax administration are not revealed in budgetary presentations. They reduce the credibility of the tax system by making it more complex and seemingly less even-handed in its treatment of taxpayers with equal incomes. Because their effects on the burden of government are not fully recognized in public discourse, it may be easier to enact unnecessary or ineffective programs through the tax system than as direct expenditures.

The prospective Presidential nominees of both political parties are promoting new and expanded tax incentives. The combination of high-level political support, the lessening of budget restraints in an era of budget surplus, and the absence

¹² In the 1970s, it was agreed that the EITC would be solely within the jurisdiction of the tax-writing committees. It is not clear, however, that Congress would allow other refundable tax provisions to escape the jurisdiction of Committees with oversight responsibility for the relevant spending programs that the refundable credit is displacing.

of any articulate and powerful political support for traditional tax reform makes it a good bet that the trend towards increased spending through the tax code will continue.

So does it make a difference whether we cut taxes or spend? My answer is a qualified yes. Tax breaks may differ little, if at all, from new spending programs that can be designed to produce the same effects on income distribution and resource allocation. But the choice of whether to place a program on the tax or spending side of the budget still has important consequences both for political perceptions and for the costs of administering government programs.

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