Pitfalls in the Construction and Use of Tax Expenditures

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Disclaimer: Any views expressed are my own and not necessarily those of the U.S. Department of the Treasury.

Does the "ideal" Haig Simons (H-S) baseline provide clear guidance?

Sometimes thought that H-S baseline is a firm concept that provides unambiguous guidance, although their might be practical issues with implementing it.

- This is not true.
- One set of problems is that income is not a clear, scientific concept. There are ambiguities about how to treat such items as:
  - Leisure and household production
  - Human capital
  - Consumer interest
  - Childcare expenses
  - Work related expenses
  - Gifts and bequests
  - Charitable contributions
  - Medical expenses
  - Non-money benefits from working

Ambiguities in the "ideal" Haig Simons (H-S) baseline (continued)

Tax credits.

- Taken literally, H-S deals with the income base, and so does not say anything about credits.
- Nonetheless, the logic of a broad-based, uniform, income tax makes many tax credits look like tax expenditures.

Tax rate/tax rate schedule.

- Is a graduated rate schedule consistent with a broad-based uniform tax system? Should the lower rates be a tax expenditure?
- What tax rate or tax rate schedule should be used to measure revenue in the baseline tax system?
    - Repealing the tax expenditures typically raises revenue. Should the baseline system have a lower tax rate? How/where should that be accounted for?

Ambiguities in the "ideal" Haig Simons (H-S) baseline (continued)

Corporate profits can be taxed twice, once under the corporation income tax and again under the individual income tax, when distributed as a dividend or realized as a capital gain.

Both Treasury and JCT have the corporate tax as part of their baseline tax system, but does this make sense? Is this double tax consistent with a Haig Simons tax base or a H-S inspired broad based tax system?

- H-S income itself is silent on the matter.
- A H-S inspired broad-based tax system that did not differentiate tax paid according to the form or manner in which income is earned would not allow for a separate level of tax on corporate profits.

Should the corporate tax be a huge "negative tax expenditure"?

Should preferential individual income tax rates on dividends and capital gains from the sale of corporate stock be considered a tax expenditure?

Should one adjust for outlay equivalents?

Want to have tax subsidies and direct spending programs measured in a comparable way: a dollar of tax subsidy is the same as a dollar of direct spending.

Tax subsidies are generally not taxable. Direct spending programs often give benefits that are taxable.

To make (untaxable) tax subsidies equivalent to taxable direct spending programs, use the "outlay equivalent": in simplest form, ax subsidy/(1-tax rate).

- Treasury used to do this, but no longer does.
- Making the adjustment required judgments that were felt to be difficult: which equivalent spending programs would be taxed? How would the equivalent spending program be designed?
- Not clear that outlay equivalents lead to a net improvement in budget measurement: cost of spending programs are not measured net of tax payments; asymmetric to adjust only the tax programs measure.

Can tax expenditure estimates be used as revenue estimates?

Can't use tax expenditures estimates as proxies for revenue estimates for an actual proposal:

- Interactions between provisions ignored
- Behavior ignored
- Other taxes ignored
- Timing is incorrect: tax expenditures compare fully phased in policies. Especially important for policies with big timing effects, e.g., changing depreciation allowances.

Having tax expenditure estimates "on the shelf" is of limited help in evaluating the revenue effects of policy changes.

Can tax expenditures allow one to get to a "grand budget"?

Grand budget - sums up the total effect of government action on the economy.

Not an attainable goal.

- The list of tax expenditures is not exhaustive, even given the baseline (e.g., deferral of tax on capital gains is not a tax expenditure).
- There are an infinite number of tax expenditures because tax expenditures are things not done or revenues not collected.
- Nothing uniquely correct about a "total tax expenditure" calculation as a measure of government involvement in the economy; e.g., the total would be different for a different baseline.
- Negative tax expenditures often are ignored.
- Taxes other than income taxes have to be considered.
- Regulations have to be considered.

Do we need to worry excessively about the baseline?

No.

The proper interpretation of tax expenditures is as a comparison of of alternative policies: compare one policy, existing law, with another policy, whatever the baseline provides.

Could do a different comparison; have a different baseline.

Baseline does not specify the “best” tax law.

Best to focus on the positive aspects, rather than the normative aspects.

Purpose is to illustrate that there are different ways to accomplish the same ends: tax subsidy have the same allocational and distributional effects as a spending program.

Should one have a tax expenditure "budget"?

Having a budget can create the (incorrect) impression that the baseline is the proper or ideal tax system.

Adds to the political contentiousness of doing a tax expenditure exercise.

So might want to call it a "list" or "selected tax expenditures."

Emphasize that the items on the list and the measurement of them are just ways of illustrating policy choices. Focus on the positive rather than the normative dimensions.

Are tax expenditures a "hit list" for tax reform?

Pretty clear that many think that they are a "hit list"– that they are "bad" policies.

Less clear that they are bad or should constitute a "hit list".

Have to evaluate each item on its own merits and opinions will differ.

Some tax expenditures arguably represent desirable economic or social policy.

- EITC
- Accelerated depreciation/investment tax credits

Others are widely (but not universally) considered to be poor policy.

- Deduction of home mortgage interest.
- Exclusion for ESI

Others reflect administrative concerns/problems.

- Exclusion of imputed rent and capital gains on owner occupied housing.
- Lot of smaller ones: exclusion of fringe benefits, of conservation easements, of assistance for foster children.

Is distributional analysis of tax expenditures helpful?

Sometimes, sometimes not. Care should be taken here.

If tax expenditures really are spending programs, then it might not make sense to look at their effect on the distribution of the tax burden – on the burden imposed by having to fund what the government does.

Bradford's tank example:

- Pay for tanks made by Chrysler with (a) direct spending or (b) tax credits.
- No one would be appalled that Chrysler or its shareholders were paid directly for the tanks they produced and no one would say that they received an inappropriate benefit from producing the tanks.
- Yet many politicians and others would be appalled by Chrsyler's low tax burden if the payment were made via tax credits, and would argue that Chrysler, and its shareholders were paying an unfairly low tax burden. In reality, tax burdens (and spending benefits) throughout the economy are the same as if Chrysler were paid directly for the tanks.

This can lead to ill placed concerns about taxpayers not paying their fair share of taxes, and to policies that complicate the tax code in what might be an inappropriate attempt to limit tax benefits. The AMT is one potential example of such a policy.

Distributional analysis (continued)

Sensible to look at who benefits from government spending and to look at net benefits from the combined effects of taxes and spending programs.

Not clear that the distribution of the benefits from military spending would match the distribution of corporate taxes, even in a careful model.

This concern probably is more important for "business" economic incentives (investment credits, accelerated depreciation, production deduction, low tax rate on dividends), than for "individual" social incentives (EITC, child tax credit).