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TAXPAYERS THREATENED BY PROPOSAL TO SUBJECT "TAX EXPENDITURES" TO "PERFORMANCE BUDGETING"

The House Budget Committee recently convened a hearing on performance budgeting. Performance budgeting refers to efforts to compare the amounts spent on government programs with the programs' goals and measured results. At the hearing, Chairman John Spratt (D-SC) provided a good summary of why performance budgeting, if properly implemented, is desirable, "Given the daunting challenges that face us budgetarily, we need more than ever to put the taxpayer dollars to the wisest possible use."[1]

Performance budgeting, with its emphasis on identifying government programs' goals and assessing their results, is not a new concept. However, many earlier efforts to implement it, such as the Planning, Programming, and Budgeting System (PPBS) in the 1960s, Management by Objectives in the early 1970s, Zero-Based Budgeting (ZZB) in the later 1970s, and Reinventing Government in the 1990s, had little impact, notwithstanding the claims of some supporters that they would transform government.

Currently, the Government Performance and Results Act of 1993 (GPRA) requires government agencies to develop performance plans and report their results yearly, with the hope that the information will be useful to managers within the agencies and will assist the legislative and executive branches in assessing government spending programs.[2] In addition, the Bush Administration has developed its own Program Assessment Rating Tool (PART), which attempts to systematically and consistently grade each government program based on its purpose, planning, management, and results.[3] A study by the U.S. General Accounting Office (GAO) in 2004 found that the Administration's assessment tool is beneficial, although the GAO saw room for improvement.[4]

Realistically, performance budgeting has the potential to slightly sharpen the focus of government programs and make them somewhat more results oriented, but it is unlikely to transform government. Two general obstacles are that the incentives within government are often unrelated to programs' effectiveness and that legislators and Presidents often pay scant attention to effectiveness when pushing for programs they want. In addition, performance budgeting is not good at evaluating the basic questions of whether a particular program is a legitimate function of government, whether the government can carry out the activity better than the private sector, and whether the payments made by the program and the taxes financing the program create perverse incentives that hurt the economy. Further, measuring results is often difficult. These problems are noted not to deny that performance budgeting has value – it is a highly desirable effort to combat waste, fraud, and abuse in government – but to caution against its potential benefits being oversold.

A proposal to conduct reviews of taxes not levied as though they were spending programs.

Chairman Spratt said at the start of the Budget Committee hearing, "Our question today is whether or not there are ways that we can improve the tools we use to measure government performance and effectiveness to see that we gain the most bang for our buck."[5] Two witnesses, Comptroller General David Walker, who heads GAO, and Peter Orszag, who is the Director of the Congressional Budget Office (CBO), testified that performance budgeting, which is designed to monitor government spending programs, should be extended to taxation.

Naively, one might imagine that the heads of GAO and CBO are looking at the staggering complexity of the tax system, and wondering whether there are sensible ways to improve the tax system's performance by simplifying the tax code to reduce the enormous paperwork costs that complexity imposes on taxpayers. In fact, however, the heads of GAO and CBO are not talking about that at all. They want performance budgeting to be applied on the tax side to so-called tax expenditures.

Mr. Walker testified, "Tax preferences—which are legally known as tax expenditures—result in foregone revenue for the federal government due to preferential provisions in the tax code..."[6] He described tax expenditures as "government subsidies carried out through the tax code." According to Mr. Walker, "Excluding tax expenditures from program reviews is especially problematic because tax expenditures represent such a substantial investment in such a wide range of policy goals." He observed with regret, "PART ... has generally not been applied to tax expenditures."

Mr. Orszag laid out the argument as follows:

> "Tax expenditures comprise various exceptions to the general tax rules ... and total several hundred billion dollars per year. Those exceptions are often designed to encourage the tax-favored activities (such as home ownership). Tax expenditures ... are effectively equivalent to collecting taxes at ordinary rates on the full potential tax base and then subsidizing the preferred behavior through outlays. Because selective tax reductions are like expenditures for specific economic activities, they can and should be evaluated in the same way as spending programs are. Applying performance budgeting to tax expenditures would therefore involve assessing whether they were achieving their purposes and whether they were doing so in a cost-effective manner."[7]

As the quotations indicate, the heads of GAO and OMB claim the items on the tax expenditure list are deviations from a standard, objectively-determined tax system, and that their presence in the tax code is therefore suspect.

Mr. Orszag wants period assessments of whether each tax expenditure furthers public policy as effectively as either alternative tax rules or direct spending programs. His aim is to replace or eliminate some of those not measuring up. Mr. Walker in his testimony places tax expenditures in the context of what he believes is the nation's need for higher taxes to finance growing government spending. He warns that rising federal spending, especially on "the 'big three'—Medicare and Medicaid and to a lesser extent, Social Security," will create a "long-term fiscal imbalance".[8] He contends that the government must respond on both the spending and tax sides. In his words, "It will be necessary to work on several fronts at once. In fact ... *all* major spending and revenue programs and policies need to be subject to periodic reviews... [Emphasis in original.]"[9] He views tax expenditures as a good place to look for tax increases.

The eight largest tax expenditures reported in the federal budget are, in order of estimated size, the tax exclusion for employer-provided health insurance, the mortgage interest deduction, accelerated depreciation of machinery and equipment, the charitable deduction, capital gains tax treatment, tax deferral on 401(k) retirement plans, tax deferral on traditional (defined benefit) pension plans, and the tax exclusion for homeowners' imputed net rental income (the extra income homeowners would report if they pretended to rent from themselves and paid themselves rent).[10] The deduction for state and local taxes would be in fourth place except that it is divided into two separate items. Clearly, the "tax expenditure" label is being applied to a wide variety of tax features with very diverse characteristics. (Congress's Joint

Committee on Taxation also prepares a tax expenditures report.[11] Its presentation has many similarities with the one in the budget but differs in some respects.)

Congressman Ryan responds.

Representative Paul Ryan (R-WI), the ranking member of the House Budget Committee, was troubled by the push to equate tax expenditures with spending programs and subject them to the same program reviews. He said, "I bristle at the notion or the term 'tax expenditure'. It ... more or less assumes that this is the government's money unless we benevolently expend it back to people."[12]

Congressman Ryan concern is fully justified. One problem is that some provisions of the tax system are accused of being tax expenditures even though they are consistent with sound tax principles. Several examples will be mentioned later.

Another problem with the term "tax expenditures" is that it automatically places taxpayers on the defensive by equating the decision not to impose a tax, or not impose it at a higher rate, with a government spending program. As a matter of arithmetic, not imposing virtually any conceivable tax, irrespective of the tax's merits or lack thereof, can be portrayed as a government outlay. Suppose, for instance, that someone suggests levying a 15% income tax surcharge on everyone whose name begins with the letters "a", "b", or "c". That would clearly be a capricious, unfair, and distortionary tax, at odds with basic tax principles. Nevertheless, not imposing the tax is mathematically equivalent in its net budget effect to levying the tax and then offsetting the tax with government payments to everyone whose name begins with "a", "b", or "c". In that peculiar sense, not placing a special, discriminatory tax on everyone whose name begins with "a", "b", or "c" is a spending program. (Of course, the alternatives would be very different in terms of administrative costs and enforcement issues.) Nobody would ever place this particular item on the tax expenditures list. The danger is that if the criteria for identifying tax expenditures are flawed, some other tax features that are consistent with sound tax principles may falsely be labeled as tax expenditures. Once that happens, the onus shifts to innocent taxpayers to defend the government payments they supposedly receive.

How "tax expenditures" are determined.

The potential for abuse is especially great because the process for identifying "tax expenditures" is subjective and biased, as can be seen by comparing what tax expenditures are purported to be and what they really are. IRET has previously published two in-depth studies that do just that.[13]

Throughout the history of the income tax, there has been vigorous debate about which exemptions, deductions, credits, and rates represent special preferences and which do not. In the 1960s, Stanley Surrey, a Harvard law professor working in the U.S. Treasury, sought to catalog those items he regarded as income tax preferences.[14] Because Surrey regarded the items on his list as subsidies to particular activities or taxpayers that are paid for with foregone tax dollars (and also because he wanted a catchy name), he called them tax expenditures. In the waning days of the Lyndon Johnson Administration, Treasury Secretary Barr drew attention to tax expenditures in testimony before the Joint Economic Committee. Several years later, Congress enacted the Congressional Budget and Impoundment Control Act of 1974 (P.L. 93-344), which requires the Administration to include a report on tax expenditures in every year's federal budget.

To measure tax preferences objectively and accurately, one needs to know how a tax system with no special preferences would look. Two candidates for the reference tax are a pure income tax and a pure consumption tax.[15] With an income tax, a further question is which of several possible definitions of income to use. Although the official U.S. National Income and Product Accounts (NIPA) rely on one definition of income, another definition, known as the Haig-Simons concept of income, is frequently used in tax discussions.[16] Tax theorists who favor aggressive income redistribution through the tax system tend to prefer a broad-based Haig-Simons income tax.[17] However, because such a tax has a strong bias against saving and in favor of immediate consumption and because a tax based on Haig-Simons income is inherently extremely complicated[18], many tax theorists believe a better choice in terms of simplicity and saving-consumption neutrality is a broad-based consumed income tax. The actual federal income tax system is a hybrid, with some elements of the income base, some of the consumption base, and some not consistent with either base.

Surrey and his collaborators, however, rejected using a theoretically consistent tax model as their reference point. Instead, they chose a "normal" tax: a hypothetical tax comporting with their notion of how the tax system ought to look and loosely based, with many exceptions, on a redistributional Haig-Simons income tax. Even some members of Surrey's staff were troubled by the ad hoc nature of their "normal" tax. For instance, the personal exemption is clearly a departure from a tax based solely on comprehensive income, albeit a deviation that most people view as desirable and reasonable. Surrey, however, insisted it is part of the "normal" tax and refused to include it in the tax expenditure budget.[19]

Today, the tax expenditure budget continues to reflect Surrey's view of the "normal" tax, although some of the items on the list have changed over time.

Some cases in which the tax expenditure listing goes wrong.

The subjective process through which items are categorized as tax expenditures suggests that one should be cautious about accepting the list at face value. At the very least, one should test whether the results are plausible by looking carefully at various tax features and deciding whether the tax expenditure report handles them properly. Regrettably, one finds that the tax expenditure listing often gives incorrect results and is not a reliable guide.

Consider several examples.

■ The personal exemption deliberately foregoes taxing several thousand dollars of the average taxpayer's income. It removed $840 billion from the tax base in 2005, according to IRS data. Whether one's benchmark is a comprehensive income tax or a comprehensive consumed income tax, the personal exemption takes a large bite out of the potential tax base. Hence, a very strong case can be made that the personal exemption is a tax expenditure, notwithstanding its desirability. (Just because something is a tax expenditure does not mean it is bad.) Nevertheless, as mentioned above, the personal exemption is kept off the official tax expenditure list.

■ By similar reasoning, the standard deduction also should be counted as a tax expenditure, but it is not. Inconsistently, although the standard deduction is not on the tax expenditure list, many itemized deductions are.

■ Should differences in tax rates be treated as a preference item? This is a difficult issue to resolve, but an analogy is that most consumers would see it as an advantage if they could pay a below-average price for a product but a disadvantage if they had to pay an above-average price. Further, although it is a matter of law rather than economics, the 1974 Budget Act says that tax expenditures are to include "revenue losses attributable to ... a preferential rate of tax..." Nevertheless, the individual income tax's graduated rates are explicitly omitted from the tax expenditure list; the low rates in the first few brackets and the high rates in the last few brackets are not counted as positive and negative tax preferences, respectively. Inconsistently, however, the tax expenditure report categorizes all corporate tax rates below the top rate as tax preferences. (The corporate income tax has a graduated rate schedule, but corporations with more than a small amount of income are in the top rate bracket.)

■ The tax expenditures report provides estimates of the revenue costs of the various items on the list. In almost all cases, though, repealing an item would collect less revenue than estimated because people would alter their behavior in response to the tax change.

■ Corporate income is taxed at the corporate level by the corporate income tax and then at the individual level by the individual income tax.

However, not even a Haig-Simons income tax, with its aggressive bias against saving, approves of taxing the same income at both the corporate and individual levels. Under a Haig-Simons income tax, the corporate tax should not exist, and the same is true if the tax base is consumed income. Accordingly, the corporate income tax can be viewed as an extra layer of tax. Far from acknowledging this extra layer of tax, though, the tax expenditure report declares that the corporate income tax is part of the "normal" tax, and actually categorizes as tax subsidies many of the features that have been added to the tax to mitigate its impact.

■ A number of items involving saving and returns to saving, such as accelerated depreciation, IRAs, 401(k) plans, and the tax treatment of life insurance, appear to be tax expenditures when measured against the Haig-Simons baseline or the tax expenditure report's subjective "normal" tax, but they are not tax expenditures – they are proper tax treatment – when measured against the consumed income baseline. In fact, some provisions related to saving and investment that are recorded as preferences in the tax expenditures report constitute overtaxation according to the consumed income standard. Hence, the tax expenditure list is wrong in all these cases if one uses the consumed income benchmark. As noted earlier, a Haig-Simons tax favors income redistribution while a consumed income tax is preferable in terms of economic efficiency and simplicity.

■ The tax code contains some provisions that bear unusually lightly on certain activities and taxpayers, and other provisions that bear unusually heavily. (The particular provisions in each class depend, of course, on which tax benchmark one uses.) To provide a balanced perspective, both sides should be reported. The tax expenditure list, however, includes only positive tax preferences; it ignores negative preferences. That is like a referee at a sporting event vigorously calling fouls against one team while ignoring fouls by the other team. The one-sidedness of the tax expenditures list helps explain why it is sometimes accused of being a hit list for tax increases.

Not ready for prime time.

To the credit of the Office of Management and Budget and the U.S. Treasury, the tax expenditures report in the federal budget includes a thoughtful and intellectually honest discussion of these problems and others.[20] Unfortunately, many of those who discuss tax expenditures incorrectly dismiss the problems as minor and erroneously treat the tax expenditures list as being scrupulously objective and highly reliable.

Norman Ture, who was an early critic of the tax expenditures list (and the founder of IRET), concluded that the list was more likely to mislead than to inform. He wrote:

> Although identifying and measuring "tax expenditures," as tax provisions that are believed to have the same effects as government outlays, is appealing in the abstract, in practice the identification and measurement of tax expenditures are seriously flawed. The limitations are so severe that the desirability of continued listing of tax expenditures in the federal budget should be subjected to the closest scrutiny."[21]

The recommendation by the heads of GAO and CBO that the items on the tax expenditures list ought to be subject to performance budgeting is an example of what Ture was warning against. The list contains too many inaccuracies and biases to be a useful tool in the formulation of public policy. To be blunt, it would be a case of garbage in, garbage out. A number of tax features that are consistent with good tax policy and are not preferences at all would erroneously be treated as tax subsidies and evaluated as though they were government spending programs. The result would be deeply prejudicial to taxpayers, as Rep. Ryan perceptively observed, and it might lead to the removal from the tax code of many features that belong there.

A distraction from proper oversight of spending programs.

A danger of thinking of and reviewing tax provisions as though they are government outlays is that doing so would provide an excuse to spend less time examining actual government spending programs. If that happens, it would become easier for inefficient government programs to dodge scrutiny and less likely that government outlays will provide good value for taxpayers' dollars.

Although monitoring the effectiveness of spending programs is important, the work is not glamorous (unless there are scandals). Moreover, spending programs often build up powerful constituencies of government employees and program beneficiaries would want their programs to be left alone or expanded; they do not want their programs' effectiveness not be questioned too closely. If performance budgeting were extended to so-called tax expenditures, it is virtually certain that these groups would quickly argue that spending programs receive too much oversight and criticism and taxpayers not enough.

Hence, if the recommendation of the heads of GAO and CBO were to be followed, it is virtually certain that the oversight of spending programs would suffer. Ironically, performance budgeting, which is intended to lead to better use of taxpayers' dollars, would be transmuted to some degree into a device for extracting more dollars from taxpayers.

A more reasonable approach.

It is regrettable that much of the tax expenditure list is opinion masquerading as fact. It would be useful, to find a more objective, less biased way to identify tax preferences, with fewer false positives. That would make it easier to highlight the features in the income tax system that actually do favor some activities or taxpayers over others.

One promising option would be to ask what features in the tax code are inconsistent with ***both*** a Haig-Simons income tax and a consumed income tax. Measuring tax provisions against a theoretically pure tax base, as opposed to an ad hoc "normal" tax, would improve objectivity. Classifying provisions as tax preferences only if both bases agree on that would reduce the number of false positives. Tax provisions that treat saving and consumption evenhandedly would no longer be categorized as tax preferences, because they are consistent with the consumed-income-tax treatment. This approach would not sidestep all the problems mentioned earlier, but it would avoid many of them.

For example, one provision that Mr. Walker singled out in his oral testimony as having undesirable, unintended consequences is the tax-free status of the compensation that workers receive in the form of employer-provided health benefits.[22] Because those benefits would be taxable under either a pure Haig-Simons income tax or a pure consumed income tax, they would also show up on the list being suggested here. Knowing that the tax-free status of this fringe benefit is at odds with two different tax bases increases one's confidence that it really is a tax preference.

Mr. Walker warned in his testimony that the number of tax expenditures is large and growing. One reaches a similar conclusion using the more objective, less inflammatory approach outlined here. Hence, it would be prudent to monitor tax provisions that appear preferential when compared to both the Haig-Simons and consumed-income tax bases. However, in order that policymakers not be distracted from their oversight of spending programs, tax preferences should be monitored separately from government spending programs. Performance budgeting should continue to focus on government outlays; it should not be extended to tax preferences.

Conclusion.

The federal budget must by law include a report on so-called tax expenditures. These are provisions in the income tax code that supposedly subsidize taxpayers. In the tax-expenditures methodology, the provisions on the list are viewed as equivalent to spending programs, except delivered through the tax system. Unfortunately the tax expenditures list is seriously flawed in concept and execution. The heads of the Government Accountability Office (GAO) and the Congressional Budget Office (CBO) now propose to raise the stakes by recommending that Congress, as part of its oversight of the federal budget, perform regular budget reviews on the items on the tax expenditures list as though they were spending programs rather than income tax features.

The recommendation from GAO and CBO should be rejected. The tax expenditures list is too inaccurate and biased to be anything but a misleading guide for policymakers. Further, if the proposal were implemented, it would be a distraction from the important work of overseeing the cost effectiveness of government spending programs and an excuse for raising taxes.

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Endnotes

1. John Spratt, Opening Statement, House Budget Committee, Hearing on "Using Taxpayers' Dollars Most Efficiently: Perspectives on Performance Budgeting," September 20, 2007, transcribed by this paper's author from the audio file posted on the Committee website at http://budget.house.gov/hearings.htm.

2. P.L. 103-62.

3. PART is one of the ways in which the Administration is trying to improve the government's performance. For more information on the President's Management Agenda (PMA), see http://www.whitehouse.gov/results/agenda/index.html. The website also provides several specific examples of why it is often so difficult to improve the effectiveness of government programs (http://www.whitehouse.gov/results/obstacles/index.html). For information specifically on PART, see http://www.whitehouse.gov/omb/expectmore/index.html.

4. U.S. General Accounting Office, "Performance Budgeting; Observations On The Use Of OMB's Program Assessment Rating Tool For The Fiscal Year 2004 Budget,"GAO-04-174, January 2004, accessed at http://www.gao.gov/new.items/d04174.pdf. GAO concluded that the information furnished by PART helps the Office of Management and Budge to better oversee the budget process, increases agency interest in program results, and improves transparency. GAO also noted some ways in which PART's design could be strengthened, recommended more input from Congress, and suggested greater coordination between PART and GPRA.

5. John Spratt, Opening Statement, *op. cit.*

6. All quotations in this paragraph are from David M. Walker, Comptroller General of the United States, "21st Century Challenges; How Performance Budgeting Can Help," before the Committee on the Budget, U.S. House of Representatives, September 20, 2007, GAO-07-1194T, pp. 7-8, accessed at http://www.gao.gov/new.items/d071194t.pdf.

7. Peter R. Orszag, Director, CBO, "Performance Budgeting: Applications to Health Insurance Programs and Tax Policy," before the Committee on the Budget, U.S. House of Representatives, September 20, 2007, p. 1, accessed at http://www.cbo.gov/ftpdoc.cfm?index=8642&type=1.

8. Walker, *op. cit.*, p. 2

9. Walker, *op. cit.*, pp. 2-3.

10. For the Tax Expenditures report, see U.S. Office of Management and Budget, *Analytical Perspectives, Budget Of The United States Government, Fiscal Year 2008*, pp. 285-327, accessed at http://www.whitehouse.gov/omb/budget/fy2008/pdf/spec.pdf. The table ranking tax expenditures by size (projected revenue losses over the period 2008-2012) is on pp. 296-298 of the report.

11. U.S. Congress, Joint Committee on Taxation, "Estimates Of Federal Tax Expenditures For Fiscal Years 2007-2011," JCS-3-07, September 24, 2007, accessed at http://www.house.gov/jct/s-3-07.pdf.

12. Paul Ryan, Comment during Question Period, House Budget Committee, Hearing on "Using Taxpayers' Dollars Most Efficiently: Perspectives on Performance Budgeting," September 20, 2007, transcribed by this paper's author from the audio file posted on the Committee website at http://budget.house.gov/hearings.htm.

13. See Norman B. Ture, "Tax Expenditures: A Critical Appraisal," *IRET Fiscal Issue*, No. 5, 1990; and Bruce Bartlett, "The End of Tax Expenditures As We Know Them?" *IRET Policy Bulletin*, No. 84, June 13, 2001, available at http://iret.org/pub/BLTN-84.PDF. In addition to providing more details on the problems with tax expenditures that are mentioned here, they discuss a number of additional conceptual and measurement shortcomings.

14. For a more detailed account of Surrey's role, see Jonathan Barry Forman, "Origins of the Tax Expenditure Budget," *Tax Notes*, February 10, 1986, pp. 537-545. Also see Bruce Bartlett, "The End of Tax Expenditures As We Know Them?" *IRET Policy Bulletin*, No. 84, June 13, 2001, available at http://iret.org/pub/BLTN-84.PDF.

15. While at the U.S. Treasury in the 1970s, David Bradford discussed clearly and in detail the nuts and bolts of constructing a comprehensive income tax and a comprehensive consumed income tax. See David F. Bradford and the U.S. Treasury Tax Policy Staff, *Blueprints For Basic Tax Reform* (Arlington, VA: Tax Analysts, 1984), esp. pp. 8-11, 101-128. The study was first issued by the U.S. Department of the Treasury in January 1977.

16. See Henry C. Simons, *Personal Income Taxation* (Chicago, IL: The University of Chicago Press, 1938).

17. Simons explicitly said he was looking for a definition of income supporting steep income redistribution. "Income taxation is broadly an instrument of economic control, a means of mitigating income inequality. In what follows, we shall assume that moderation of inequality is an important objective of policy and proceed to consider income taxes as devices for effecting it." (Simons, *op. cit.*, p. 41).

18. For the classic discussion of why a Haig-Simons income tax is by its nature much more complicated than a consumed income tax, see William D. Andrews, "A Consumption-Type Or Cash Flow Personal Income Tax," *Harvard Law Review*, Vol. 87, No. 6, April 1974, pp. 1113-1188.

19. See Forman, "Origins of the Tax Expenditure Budget," *op. cit.*, p. 539.

20. U.S. Office of Management and Budget, *U.S. Budget, FY 2008*, *op. cit.*

21. Norman B. Ture, "Tax Expenditures: A Critical Appraisal," *IRET Fiscal Issue*, No. 5, 1990, p. i.

22. David Walker, Oral Testimony, House Budget Committee, Hearing on "Using Taxpayers' Dollars Most Efficiently: Perspectives on Performance Budgeting," September 20, 2007, transcribed by this paper's author from the audio file posted on the Committee website at http://budget.house.gov/hearings.htm.