

STATEMENT OF
NORMAN B. TURE,
CHAIRMAN, INSTITUTE FOR RESEARCH
ON THE ECONOMICS OF TAXATION *
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Mr. Chairman, I am happy to have this opportunity to present, at last, my views on the subject of tax expenditures. My testimony is addressed to the questions of the validity and usefulness of the concept of tax expenditures and of the problems that are posed in trying to measure them. I will attempt to illustrate these conceptual and measurement problems by reference to several of the frequently cited tax expenditures.

Let me digress briefly to urge in the strongest possible terms that whatever conclusions the Committee may arrive at regarding tax expenditures, they should not be used as the rationale for net revenue increasing legislation. The last thing in the world the U.S. economy needs at this early stage in its recovery is a new layer of tax burdens. Tax increases should not be on the Congressional agenda until the recovery is assured, if not indeed complete, at which time a much less conjectural projection than those relied on in the past few years of GNP, current service budget outlays, revenues and deficits will be possible. At that time, if it appears that revenues

* The views that are presented here are my own and do not necessarily reflect the views of the Institute for Research on the Economics of Taxation. The title and the name are used for identification purposes only.

will continue to lag below expenditures, constructive decisions about the adjustments of these budget magnitudes will be possible.

Eliminating or reducing a so-called tax expenditure is a tax increase, no matter that it is done in the name of tax reform, closing loopholes, or what have you. If reform is truly the objective rather than raising revenue, then any projected revenue gains from eliminating or reducing a tax expenditure should be matched by a reduction in tax rates on the affected taxpayers.

Defining Tax Expenditures

Section 3 of the Budget Act defines tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." Upon even a moment's consideration, it must be clear that this language finesses the definitional difficulties; it does not resolve them. In short, the statutory language provides no systematic guidance for identifying which provisions are so "special" as to substitute for expenditure authorization and appropriation authority, as contrasted with "general provisions" that are strictly exercises of taxing authority.

Special Analysis G in the Budget of the United States makes a valiant but quite unsuccessful effort to make the concept of "tax expenditures" less ambiguous. The Special

Analysis G ploy is to make the term "tax expenditures" synonymous with "tax subsidies." In fact, the subsidy concept would be useful if the word subsidy were properly defined as a device which reduces the relative cost of the subsidized activity, good, or service compared to what its relative cost would be in the absence of government. Relying on this concept would produce quite a different approach to identifying tax expenditures, many of the provisions on the current list would show up as negative tax expenditures, as undue tax exactions.

The concept presented by the staff of the Joint Committee on Taxation is somewhat different from that in Special Analysis G but no less ambiguous.

To characterize any given exclusion, exemption, or deduction as "special" or to conclude that a provision affords a credit that is "special" or a preferential rate of tax or a deferral of tax, we need to have a definition of the nonspecial. Similarly, to identify a tax provision as providing economic incentives we need to be able to delineate a provision which neither inhibits nor encourages the affected activity. For this purpose, we need a rigorous definition of taxable income. It is probably unnecessary to point out that there is no consensus concerning the "correct" concept of taxable income, no more as a matter of analytical abstraction than as a practical guide to tax policy. The "correctness" of any definition of taxable income depends significantly on one's priorities with respect to tax criteria --- equity, neutrality, simplicity, adequacy, etc. --- and on

how one delineates the tax base requirements of each. All of us, of course, agree that the income tax should be fair; few of us have ever agreed on the standards of fairness. The equity standard, therefore, has never afforded a satisfactory guide to defining taxable income, hence to defining provisions of the tax law which may fairly be termed "tax expenditures."

The neutrality criterion leads to quite a different list of "tax expenditures" from that supplied in the budget document and changes the sign of many of them. A tax is neutral only if its imposition does not alter relative costs or prices. On this basis, any income tax is unneutral because it necessarily increases the cost of undertaking the activities which generate income subject to tax compared to the cost of all other activities. Even if one is willing to accept this fundamental unneutrality, one should at least seek the imposition of the tax in such a way as to alter the costs of the alternatives confronting taxpayers in the same proportion. It should raise the cost of saving in the same proportion as the cost of consuming, of working in any particular job in the same proportion as working in any other, of using one kind of production input in the same proportion as any other, etc.

Most of us have come more and more to recognize the desirability and importance of gearing tax policy more closely to the neutrality criterion than we have in the past. Past failures to do so have given us a tax system which has year by

year become increasingly punitive of saving and capital formation, of productive, market-directed personal efforts, of enterprise, risk-taking, innovation --- of the kinds of activities upon which economic progress and rising living standards depend. Enactment in 1981 of the Economic Recovery Tax Act reflected a broad-based consensus that we must move toward a tax system which conforms with the dictates of the neutrality criterion. Last year's tax legislation was, I believe, an unfortunate retreat. One must hope that that mistake will not be repeated this year and that instead we may soon regain the momentum of a neutrality-oriented tax policy.

It is widely recognized that the personal income tax is fundamentally biased against saving and in favor of consumption, in view of the fact that it levies both on the amount of current income which is saved and also on the future income produced by the current saving. Neutrality requires either that saving be excluded from current taxable income while all of the gross returns on the saving are included or that saving be included in current taxable income while all of the returns are excluded. These are perfectly equivalent and assure that the tax raises the cost of saving in the same proportion as it raises the cost of consumption. To the extent, and it is substantial, that the present income tax fails to follow either of these alternatives, it imposes a negative subsidy on saving. Any provision which abates the tax on saving or on the returns on saving should be treated as a reduction in a negative subsidy.

In the light of this criterion, consider the designation as a tax expenditure of the net exclusion of pension contributions and earnings, the largest single tax expenditure in Special Analysis G and in the Joint Committee Staff's listing. Against the basic test of tax neutrality between saving and consumption, these exclusions should be seen as major ameliorations of the anti-saving tax bias, of the tax expenditure in favor of consumption. They have no place in a listing of exceptions from the normal, if normal is interpreted, as it should be, as leaving the relative costs of saving and consumption the same as they would be in the absence of the tax.

Just as difficult to justify is the inclusion of "accelerated depreciation on equipment" or the depreciation on buildings in excess of straight line in the Joint Committee staff listing. The neutrality criterion calls for true expensing of the costs of any and all capital facilities. This means that these costs must be effectively deductible as they are incurred against all of the taxes which apply to the returns on these facilities. The Accelerated Cost Recovery System (ACRS) falls short of satisfying these requirements; ACRS allows capital recovery deductions only beginning in the taxable year in which the facilities are placed in service which often is several taxable years after some of the costs for acquiring the facilities are first incurred. The ACRS deductions, moreover, are not generally allowed against all of the taxes bearing on the income produced by the facilities;

if the facility is owned by a corporation, for example, the ACRS deduction does not offset the individual shareholder's tax liability on the dividends he receives, paid out of the income produced by the facilities. And the deductions may well exceed income and have to be carried forward, so that their present value falls short, possibly substantially so, of their nominal value. So-called accelerated depreciation should be seen as a negative tax expenditure insofar as the actual present value of those deductions is less than the present value of true expensing.

It has been shown elsewhere ^{1/} that a substantial additional deduction or investment tax credit would have to be added to ACRS deductions to provide equivalence with the true expensing called for by the neutrality criterion. For this reason, neither accelerated depreciation nor the investment credit belong on a list of tax expenditures. ^{2/}

1/ Cf. Norman B. Ture, New Directions for Federal Tax Policy for the 1980's, American Council for Capital Formation, Ballinger Publishing Company, Cambridge, MA, forthcoming.

2/ Presumably the justification for including these provisions is that they afford capital recovery deductions at a faster rate and in greater amount than so-called "economic depreciation." Economic depreciation is an abstraction which cannot be applied in any real life situation; indeed, it is inherently so ambiguous as to be of little if any use even for abstract analyses. Cf. Ture, op. cit.

Against the standard of neutrality, any tax on capital gains is a negative tax expenditure; any reduction in that tax should be seen as reducing an extraordinary tax penalty. A capital gain is the capitalized value of an expected increase in the income to be produced by the asset; since that income will be taxed as it arises, taxing the capital gain is taxing the same income flow twice. In the case of corporate stock, capital gains generally reflect the corporation's retention of earnings. Since those earnings have already been taxed to the corporation, taxing the gains realized on such stock compounds the multiple taxation of the returns on capital.

These examples of misidentification of tax expenditures can be extended far beyond the limits of the Committee's time. To cite only a few of the items which certainly are not tax expenditures in the light of tax neutrality, the \$100 dividend exclusion and the exclusion of interest on life insurance savings surely do not belong on any tax expenditure list. Nor should the exclusion of interest on any state or local bond, whether general purpose debt, small issue industrial revenue bonds, mortgage revenue bonds, etc., be treated as tax expenditure unless it could be shown that the income used to purchase these bonds was itself excluded from the income tax base.

Unfortunately, those compiling tax expenditure lists are uninhibited by any rigorous conceptual requirements. The ambiguity of concept in these lists is revealed by the facts that the lists change from time to time and that lists offered

by different compilers often differ. The Joint Committee Staff compilation includes 17 items which are not included in Special Analysis G, but no explanation of the reasons for the differences in listings is provided.

Some of the items on one or another list elude any justification. The Joint Committee staff list, for example, includes "Reduced rates on the first \$100,000 of corporate income" as a tax expenditure. There is a wide consensus that the entire corporate income tax is a negative tax expenditure, one of the principal violations of tax neutrality, and a major source of distortion in the use of capital and labor production resources. To treat corporate tax rates less than the top marginal rate as a tax expenditure defies reason. Should one infer that there is some inherent correctness in 46 percent as the rate at which income generated in corporate business is correctly taxed? If so, were prior rates of 48 percent and 52 percent, by any such implied criterion, negative tax expenditures? What logic dictates that taking only 15 percent from a company which earns \$24,999 is to provide that company a subsidy --- the equivalent of a government expenditure of funds in the form of a \$7,750 grant to that company?

If we can find any such justification, why don't we include in this list of tax expenditures all bracket rates in the individual income tax less than the present top 50 percent? But why set 50 percent as the "normal" rate? Why not set

100 percent as the standard and treat all exactions from taxpayers at lesser rates as the equivalent of the government giving them money?

The conceptual frailties of tax expenditures argues strongly against relying on any listing as departures from "normal," "standard," or what have you, still less as the equivalent of budget outlays. Many of the usually listed items could be justified as tax subsidies or tax expenditure only if one believes that the "right" tax should discriminate against saving, in favor of consumption. Others require some as yet unavailable delineation of the "right" rate or rates of tax or the "right" timing of tax liability or the "right" taxpaying unit. In short, the usual lists should be regarded as arbitrary and capricious, at the least, and in large part counter to an emerging consensus in favor of neutrality as the principal criterion of tax policy.

Measuring Tax Expenditures

Even if the imprecision and ambiguities of defining tax expenditures are disregarded, enormous difficulties are confronted in attempting to measure them. Presumably the amount of any given tax expenditure is the revenue which the government doesn't collect because the specific provision of the law differs from what is the "correct" or nonspecial treatment. Whereas one can relatively unambiguously designate a specific amount to be spent on a direct government expenditure, no comparably unequivocal estimate can be provided for a tax expenditure.

The correct measure of the revenue effect of a tax expenditure is the difference between the amount of actual tax liability, on the one hand, and the tax liability which would have arisen from the composition and level of economic activity which would prevail in the absence of the tax expenditure, on the other. Unless one assumes that taxpayers' behavior would be identical with and without the tax expenditure, the measurement of the tax expenditure requires identifying and measuring the changes in the composition and volume of economic activity which occurred in response to the tax expenditure and how these changes affected tax liabilities. While this concept of "feedback" effects has become familiar and widely accepted in recent years, the limited capacity to measure them in the present state of the econometric art has forced reliance on so-called static or first-level revenue estimates for measuring tax expenditures. But these static estimates necessarily assume no economic effects are produced by the tax expenditure; they are almost certainly, therefore, wrong and are highly misleading.

Beyond these fundamental measurement problems, there are substantial mechanical difficulties to be confronted in attempting to measure tax expenditures. For one thing, it is not possible to add all tax expenditures into a meaningful total. Each tax expenditure provision must be estimated independently to avoid making the estimates depend on the sequence by which provisions are conceptually eliminated from the Internal Revenue Code in

making the estimates. As a result, tax expenditures as currently measured are not additive. For example, if two "special" exclusions were considered jointly, the elimination of the exclusions together would push individual taxpayers into higher tax brackets than if each exclusion were considered separately. The revenue loss (tax expenditure) from the provisions considered jointly is greater than the sum of the revenue losses from considering them separately, and there is no clear way to allocate the greater joint total between the two provisions. The reverse is true for itemized deductions, since considering two or more in combination would cause more taxpayers to use the zero bracket amount, or standard deduction (which has not been considered a tax expenditure) than if these deductions are considered one at a time. Again, it is not clear how to allocate the lower joint total among itemized deductions.

In addition, tax expenditure estimates differ from estimates of the potential revenue gain from repeal in that tax expenditure estimates treat provisions as if they are permanent features of the Internal Revenue Code, although many are not, and because of the timing differences between changes in tax liabilities and changes in tax receipts.

Comparability of Direct Expenditures and Tax Expenditures

The very term "tax expenditures" implies that the foregone revenue is essentially the same as a direct outlay by the government. As I have noted, it may be possible to estimate an

"expenditure equivalent," but it will rarely, if ever, be the case that a tax provision is actually equivalent to an outlay program. Direct outlays by the government for purchase of goods or services involve a direct preemption of the production inputs used to produce the goods or services the government buys. Tax expenditures never involve such a direct impact on the use of production inputs. Tax expenditures and direct subsidies have their effects through changes in relative costs and prices and the responses to these changes. However, in the case of tax expenditures, the pattern of price changes will be different from those produced by direct expenditures. Moreover, the magnitude of the change in the use of production inputs induced by the "tax expenditure" cannot always be inferred from the amount of the estimated revenue loss.

Conclusion

The preceding discussion of the conceptual and measurement frailties of tax expenditures argues against treating any listing of these items as an inventory of "special tax breaks." Constructive revision of the tax system cannot proceed on the basis of eliminating or reducing either the most quantitatively impressive or most vulnerable provisions on the list. The real and critical deficiencies in the existing income tax system arise from the continuing bias against private saving and capital formation, not from the selective amelioration of that bias. A well conceived frontal attack on the basic sources of