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tax expenditures

a primer

U.S. General Accounting Office

PAD 80-26
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PREFACE

Tax expenditures are selective tax reductions for special groups of people or for people engaged in special activities. Examples include the tax deduction for medical expenses and the tax credit for business investments in certain depreciable property. By allowing taxpayers to deduct medical costs from their taxable income or credit a part of investment costs against their tax, the Government effectively shares those expenses, no less than if each beneficiary were paid out of funds that the Congress had appropriated for the purpose.

The beneficiaries have long understood that the Federal Government was paying part of their costs. Their spokesmen regularly appear at congressional hearings to support these tax subsidies. They often record their own costs net of the tax saving. But the Federal Government itself has only recently begun viewing the tax reductions as the equivalent of direct outlays.

This paper is an introduction to the tax expenditures concept. It has been prepared for congressional staff, executive personnel, GAO's own staff, and anyone else whose work involves the Federal budget or who is interested in any of the program areas in which tax expenditures are used--or may one day be used--to influence private behavior. The paper presents criteria for identifying tax expenditures, describes the relative advantages of tax spending and direct spending, and explains how tax expenditures budgets are constructed. Appendix I contains a list of tax expenditures, with a brief explanation of each provision. An annotated bibliography in appendix II directs readers to other publications for additional information.

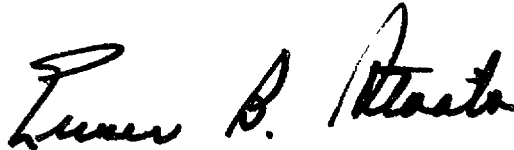
The tax expenditures concept is based on the idea that an income tax system can be divided into two parts. One part contains just the rules that are necessary to carry out the revenue-raising function of a tax on income: rules prescribing how net income is to be measured, what the tax unit is, what tax rates are to apply, and so forth. The other part contains exceptions to these rules that reduce some people's taxes but not others'. These exceptions have the same effect as Government payments to the favored taxpayers. By identifying these provisions as tax expenditures, officials are better able to determine the total amount of Government effort or influence in a program area.

The cost of a tax expenditure is the revenue that the Government did <u>not</u> collect because a particular provision was in the tax law. For example, if no tax deduction had been

allowed for medical expenses in 1978 and if tax rates and other provisions had been the same, the Government would have collected an extra $2.8 billion in income taxes from individuals. Accordingly taxpayers with medical expenses saved $2.8 billion on their 1978 taxes; or to look at it another way, the Government "spent" $2.8 billion through the tax system to help them pay their medical bills. Estimates of the costs of all tax expenditures in fiscal year 1980 are presented in appendix I.

The tax expenditures concept is still being developed and some of its features remain controversial. Many persons object to the designation of some tax provisions as "expenditures" made through the tax system. We believe that it is not necessary to agree with the budgetmakers on every line item in the tax expenditures budgets to find the concept useful. We hope that this paper will foster a wider understanding of tax expenditures and encourage those who design, administer, and evaluate Government programs to pay closer attention to the many effects of the Federal tax system.

We invite questions and comments on this paper. Please address them to Harry S. Havens, Director, Program Analysis Division.



Comptroller General
of the United States

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ABBREVIATIONS

CBO	Congressional Budget Office
DISC	domestic international sales corporation
GAO	General Accounting Office
IRC	Internal Revenue Code
IRS	Internal Revenue Service
WIN	work incentive

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CHAPTER 1

INTRODUCTION

The Federal Government sponsors many programs to promote the health of its citizens. They include such familiar examples as Medicare and Medicaid, the medical research programs of the National Institutes of Health, and the medical care provided in Veterans Administration hospitals. A less familiar program is one in which the Government forgoes $3 billion of revenue to assist one-fifth of the population to pay its medical and dental bills. This program's benefits are somewhat oddly structured; the program gives no benefits to persons unless their medical bills exceed 3 percent of their income, then pays 14 to 18 percent of the excess to low income persons, 20 to 30 percent of the excess to middle income persons, and nearly 70 percent of the excess to persons with the highest incomes. The program's best feature is administrative simplicity: the beneficiary does not have to apply to a Government office and wait for approval and payment; instead he simply reduces his income tax. Since the percentage of medical expenses above the floor that is borne by the Government is by law equal to the highest income tax rates paid by the beneficiary, and since the program applies only to persons who itemize deductions on their income tax returns, the reduction in taxes is accomplished by including medical expenses in the taxpayers' itemized deductions.

The Government's dedication of money to an activity by allowing a special reduction in taxes rather than a direct payment is called a "tax expenditure." 1/ Looking at provisions of the tax law this way emphasizes their similarity to direct expenditures and suggests that the Federal revenue losses they create could be "budgeted" the way direct expenditures are. By implication, they must be accounted for in the budget process if the total Government effort in a

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1/The term was invented by former Assistant Secretary of the Treasury Stanley S. Surrey, from whom the illustration given in the first paragraph is adapted. Strictly speaking, the term "tax expenditure" refers to the "spending" itself, the amount of revenue lost, rather than to the tax law provision that gives rise to the spending. But this distinction is seldom observed by writers on the subject, and it is common to refer to provisions of the law as "tax expenditures," as is done in this paper. Tax expenditures have also been called tax incentives, tax subsidies, tax benefits, tax preferences, loopholes, backdoor spending, and the like.

program area is to be known. This is the concept of the "tax expenditures budget," which was added to the budget-making process by the Congressional Budget and Impoundment Control Act of 1974.

The tax expenditures concept is merely one way of looking at tax provisions. The Congressmen who enacted the deduction for medical expenses probably did not think of themselves as appropriating money to pay some taxpayers' medical bills. The deduction is identified as a tax expenditure because its effect is to subsidize medical care (regardless of its original purpose).

Identifying such effects as subsidies is exactly the reason for constructing tax expenditures budgets. By lumping together the total Government support for an activity, including direct payments, loans, loan guarantees, and tax expenditures, it is possible to evaluate that support in ways that might not otherwise be apparent. One type of support may be far more (or less) effective than others, leading to a restructuring of the support. The effects of the tax expenditure may conflict with the goals of the direct payment programs, and hence one or the other should be changed. It might be that the existence of one type of program makes another redundant. Both tax expenditure and direct expenditure policies can benefit from this type of analysis.

Thinking of tax reductions as the equivalent of direct expenditures can also be useful in other analyses, such as studies of program costs. In fact, an excellent example of this use of the concept appears in a 1973 GAO report on the Navy's leasing of tankers (prepared by auditors who had never heard the term "tax expenditures"). 1/ The Navy had concluded that it was cheaper to lease certain tankers for its cargo fleet than to buy them. However, the Navy was able to lease the ships at less than economic cost because the lessors were willing to "lose" money (for tax purposes) on the contracts and make their "profit" in tax savings, by deducting the paper losses from income from other sources. GAO contended that the tax losses were just as much a cost to the Government as the direct outlays appearing in the Navy's budget and should therefore have been counted as a cost in deciding whether to lease or buy the ships. 2/ These tax costs are exactly what is meant by tax expenditures.

1/"Build and Charter Program for Nine Tanker Ships," August 15, 1973 (B-174839).

2/This example is discussed in more detail in chapter 5.

DEVELOPMENT OF TAX EXPENDITURES BUDGETS

Although the idea that special tax reductions are equivalent to direct expenditures had already been expressed several years earlier, the first tax expenditures budget in the United States only appeared in the Secretary of the Treasury's Annual Report for 1968. It was a listing of a few provisions of the Internal Revenue Code that allowed tax reductions for designated activities or specific groups of taxpayers, with an estimate of their "cost" to the Government in uncollected taxes. Several expanded versions were later prepared as the usefulness of the concept was recognized. Such budgets are now required by law in the budgets prepared by both the executive branch and the Congress. At least one State regularly prepares a tax expenditures budget for all its taxes. The concept has been much discussed in the tax literature. More than 90 tax expenditures have been identified in the Federal individual and corporation income taxes; the total revenue loss attributed to tax expenditure provisions has been estimated at over $100 billion for 1979. 1/ Proposals to create new tax expenditures are regularly presented in such policy areas as energy conservation, pollution control, and college education.

In spite of its growing use the concept is still unfamiliar to many persons, and to some people it still carries unpleasant connotations. The idea that the Government wants to "budget" uncollected tax monies suggests to some a confiscatory tax, as if the Government were entitled to all of a taxpayer's income.

This is not the meaning intended by those who originated or those who now use the tax expenditures concept. Their view is that the purpose of the tax system is to raise revenues for the Government, that there are rules for determining who is to bear what share of the tax burden, and that when those rules are bent to benefit some special group or promote some special activity, the result is the same as if the money had been collected according to the rules and returned to the special beneficiaries by direct appropriation.

1/The revenue loss estimates used in the body of this report come from Special Analyses, The Budget of the United States Government for Fiscal Year 1980 (Washington: U.S. Government Printing Office, 1979), Special Analysis G.

PURPOSE OF THIS PAPER

This paper has been prepared to introduce the tax expenditures concept to GAO personnel and others who work in Federal program areas affected by tax expenditure provisions. The tax expenditures concept is growing in importance. It is to be found today in tax reform proposals, program costs and agency budgets, surveys of alternative means of financing, or any of the multitude of areas where tax incentives are used or proposed to influence behavior (ranging from national defense to home gardens). Other countries, such as Canada, West Germany, and the Netherlands, are preparing or studying tax expenditures budgets.

Tax expenditures budgets and explanations of some aspects of them are published annually by the Office of Management and Budget, 1/ the Congressional Budget Office, 2/ and congressional committees. 3/ Tax lawyers and economists interested in the subject have published a number of detailed discussions of the concept. This paper assembles information from those sources in an attempt to provide a reasonably complete and not overly technical discussion of the topic.

Chapter 2 describes the criteria necessary to define the concept and to identify Internal Revenue Code provisions that create tax expenditures. Chapter 3 discusses how such provisions get into the law and reviews some of the arguments made for and against the use of tax expenditures. Chapter 4 covers the construction of tax expenditures budgets. Chapter 5, which brings up a few of the problems that have not yet been resolved in the definition and uses of the concept, is slightly more technical than the rest of the paper and may be omitted by those seeking only familiarization. Appendix I lists all the tax expenditures that are currently identified, presents the Congressional Budget Office's estimates of their cost for fiscal year 1980, and provides a

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1/ Special Analyses, The Budget of the United States Government (Washington: U.S. Government Printing Office, annual).

2/ Five-Year Budget Projections and Alternative Budgetary Strategies, Supplemental Report on Tax Expenditures (Washington: Congressional Budget Office, annual).

3/ E.g., U.S. Congress, House Committee on Ways and Means, Estimates of Federal Tax Expenditures, Committee Print, annual.

brief description of each one. Appendix II contains a bibliography of published tax expenditures budgets and articles discussing various aspects of the concept for those who want more information than this brief paper provides.

CHAPTER 2

IDENTIFYING TAX EXPENDITURES

The mere fact that a tax provision can be construed as serving another purpose besides determining tax liability does not make it a tax expenditure. Allowing an exemption for each child, for example, might be said to encourage large families; but it may also represent society's judgment that a family's income does not belong entirely to the person who earns it. Nor does the fact that a tax reduction could be considered the equivalent of a direct outlay make it a tax expenditure. The exemption from tax of persons earning less than a certain amount of income could be considered the equivalent of welfare payments; but it may be based on nothing more than the fact that for administrative reasons the first dollar of income is not the best starting point for an income tax. (A tax on very low incomes can cost more to collect than it brings in.) More is needed to define the concept.

DEFINING TAX EXPENDITURES

The original 1968 tax expenditures budget defined a tax expenditure provision as a deduction, exemption, credit, or exclusion designed to promote some objective other than the measurement of net income, such as "economic growth or a desirable expenditure pattern by taxpayers." This type of provision was contrasted to the part of the tax system designed to measure net income, which was said to conform to "widely accepted definitions of income and standards of business accounting" and the "generally accepted structure of an income tax." 1/

Similar definitions have been used in later budgets. The Special Analyses that accompany the President's budget have added references to a "theoretically pure income tax" and the "international norms" of taxation. 2/

The statutory definition was established by the Congressional Budget and Impoundment Control Act of 1974. Tax

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1/Annual Report of the Secretary of the Treasury on the State of the Finances for the Fiscal Year 1968 (Washington: U.S. Government Printing Office, 1969), pp. 326-27.

2/Special Analyses, The Budget of the United States Government for Fiscal Year 1979 (Washington: U.S. Government Printing Office, 1978), pp. 152-53.

expenditures were defined as "those 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." 1/ Committee reports said that the provisions the Congress had in mind were those that deviated from the "normal tax structure for individuals and corporations." 2/

These definitions are all nearly the same, and they establish one aspect clearly: some features of the existing income tax system reflect a widely shared view of the way a "normal" income tax should be designed to raise revenue, while some features reduce taxes on certain selected groups of persons. Therefore, a provision that reduces taxes below those required by the normal tax structure is a tax expenditure, and establishing criteria for identifying tax expenditures becomes primarily a task of defining the "normal" tax system.

THE NORMAL TAX STRUCTURE

A normal tax structure is a theoretical model embodying principles of fairness and neutrality generally agreed to underlie a nation's tax system. It is of course a pure abstraction; no such structure can be found on any nation's law books. Some ambitious persons have labored to build systems that would perfectly reflect these underlying principles, but without much success, because it is impossible to persuade all persons to agree on what features are fair and what are not.

For the same reason, no two persons are likely to agree on every detail of the "normal tax structure." Critics of the tax expenditures concept maintain that these disagreements discredit the concept. The fact is, however, that a number of remarkably consistent tax expenditures budgets have been constructed, implying broad agreement on many of the features of the normal income tax structure among those who construct the budgets. It would be overstating matters to say that there is equal agreement on the details of the structure

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1/Section 3(a)(3), Congressional Budget and Impoundment Control Act of 1974, Public Law 93-344 (31 U.S.C. 1302).

2/U.S. Congress, House, Congressional Budget and Impoundment Control Act of 1974, Conference Report No. 93-1101 to accompany H.R. 7130, 93d Cong., 2d sess., June 11, 1974, p. 50. The quotation is from the Senate version of the bill.

among tax scholars generally--tax expenditures budgets, after all, are only constructed by partisans of the concept, not by those who spurn it. But it is probably accurate to say that most of the central features of the normal tax system are not seriously in dispute. Disagreements are more common over certain peripheral features of the normal structure.

The weightiest objection to the tax expenditures concept comes from those who deny that a normal tax structure can be defined. They disclaim the existence of universal norms of taxation that can be elaborated into a complete tax structure. In their view any tax structure is inescapably arbitrary because it must contain details that cannot be derived from the original norms. These critics believe that none of the tax expenditures budgets are useful because they merely catalogue deviations from a standard that was completely arbitrary in the first place. If the standard were changed the budgets would be too.

The current view among tax policymakers is that it _is_ possible to reach broad agreement on enough features of the normal income tax structure to prepare a meaningful tax expenditures budget for the Federal income taxes. There are still other features that many scholars think should be in the normal structure; until now, however, the budgetmakers have been unable to agree upon their inclusion. Work continues on the architecture of the normal tax structure and one day more details may be added, leading to the identification of new provisions in the Internal Revenue Code as tax expenditures or the deletion of some old ones from the list.

There are a number of problems that any tax system must solve. For an income tax the normal tax structure must include a definition of income. It must provide ways of deciding who is liable for the tax, which is the same as deciding who owns the income. It needs rules for deciding how the income is to be accounted for (and for what period). It needs rules for determining allowable deductions. (Some deductions are implied in almost any definition of income, such as the cost of goods sold and other expenses of earning income.) It must have a schedule of tax rates. It must determine how to tax certain legal entities, such as corporations and trusts. And it must be applied to taxpayers operating across international boundaries.

In the following sections some of these problems will be examined and the solutions implied in the tax expenditures budgets will be used to define the "normal tax structure for individuals and corporations." 1/

Income

Income in the normal structure is intended to be as comprehensive as can be accurately determined. The starting point is the concept known as the "total accretions" definition of income, more often called the "Haig-Simons" definition, after two of the economists who developed it.

Robert Murray Haig defined income as the increases in one's economic power capable of being valued in money. Economic power means the power to satisfy one's economic wants and consists of either current consumption or the wealth available for future consumption; so, according to Henry Simons, this income is equal to the sum of consumption expenditures and changes in net wealth. Haig-Simons income, then, is the money value of all consumption in a given period, plus or minus the money value of all changes in net wealth between the beginning and end of the period.

The advantage of defining income in terms of its uses (consumption or accumulation) instead of its sources is to obviate arguments whether one dollar is different from another. It is possible to maintain that "capital gains" are not the same as "wages"; but in the hands of the recipient a dollar of one is useful in the same way as a dollar of the other. Thus anything that is useful for consumption (now or in the future) is income, and no discussion of its source is necessary.

This definition of income includes many things not usually thought of as income. Gifts are income to the recipient because a dollar received by gift is no different from any other dollar. The money value of all goods and services received is income, because a free lunch or airplane ticket represents just as much consumption as a purchased one. An

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1/One flaw in this approach is that some admitted tax expenditures are left out of the budgets for practical reasons. Some tax expenditure provisions involve revenue losses too small to be worth estimating. Other provisions that may create significant tax expenditures are omitted because the data necessary to estimate their cost are completely inadequate. The following discussions try to allow for these deliberate omissions.

increase in the value of the property one owns, such as stocks or real estate, is income in the period during which the increase occurs, because it increases the wealth available for future consumption. Similarly, a decline in value reduces income. The value of goods one produces for oneself, such as homegrown vegetables, is income because this value also represents consumption. Even the services of one's durable consumer goods, such as a house or a car, are consumption when the goods are used, and so the amount of rent one would have had to pay for them (the "imputed rental value") is income under the Haig-Simons definition.

The imputed rental value of owned assets may need further explanation. If one buys an income-producing property, such as a house to be held for rent, the price one pays reflects the present value of the income one expects to receive from the property in the future. When the rent is eventually received part of it goes to pay the expenses of owning and operating the property, and, if all goes well, something is left over as a return on the investment. The rate of this return should be at least as great as the original discount rate; that is, it is the profit one expected to get in the first place. By analogy, when one buys a house for one's own use one is buying a stream of future housing services, discounted to the present. The value of those services, less expenses (including depreciation), is income under the Haig-Simons definition, just as if one were renting from oneself and paying oneself the profit represented by the discount rate. Cars, washing machines, and other consumer durables likewise return a stream of valuable services that represents a "profit" on one's investment in them.

The Haig-Simons definition of income is recognized as being altogether too comprehensive to be a practical basis for taxation; it is intended as a tool for analyzing or a standard for judging other concepts of income. The definition of income in the normal tax structure is a substantially modified version of the Haig-Simons definition.

The appreciation or depreciation in the value of owned assets is routinely estimated for some purposes, such as constructing balance sheets or applying for credit; but until the assets are actually sold or exchanged, that value remains to some degree uncertain. Saying that one has property worth $100 is not the same as persuading someone else to pay $100 for it. So the tax law generally requires that these increases or decreases in paper values be made real ("realized") in a transaction of some sort before they are included in income or deducted as losses. This requirement is accepted as the normal one in the tax expenditures budgets. In some cases "realization" is liberally interpreted; for

example, transferring appreciated property by gift or inheritance is considered a transaction (since the owner is, in effect, disposing of accumulated, untaxed income), and a failure to tax the appreciation as income at that time is considered a tax expenditure. There are a few other ambiguous cases, but in general realization is fundamental to the definition of income in the normal system.

A similar problem surrounds the income arising from "transactions" with oneself, such as the imputed rent on owner-occupied housing. Although it can be argued that such income exists in the aggregate, it is very difficult to determine if any given individual is a recipient of such income, and even more difficult to know how it should be measured. Not all investments make a profit; in market transactions, such as renting a house, there are accounting standards for determining profit and loss, so we can know who had income and who did not. In the absence of a market transaction, we do not know whether a particular homeowner had a positive or negative "income" from his house. Homegrown vegetables present the same problem; if they are sold we know their value (the price someone was willing to pay), but if they are not sold we do not know if they had any value at all. (Farmers frequently eat what they cannot sell; the product is consumed at home precisely because it has no market value.) Thus the economists' definition of income is modified in the normal tax structure to require that it be obtained in an objective transaction. (This could be viewed not as a modification of Haig's definition, but merely as an explanation of what is meant by "capable of being valued in money.")

Gifts are also troublesome to classify. They unquestionably are income by the Haig-Simons definition; and they are definitely not income under the Internal Revenue Code. Their exclusion from taxable income is not counted as a tax expenditure item in the tax expenditures budgets. Scholarships and fellowships are specifically excluded from income under the Internal Revenue Code; they were excluded to avoid arguments over whether or not they were really gifts. The exclusion of scholarships and fellowships is considered a tax expenditure. Certain prizes and awards are likewise excluded from taxable income, but are not treated as tax expenditures, perhaps because they are thought to resemble private gifts in that the recipient does not specifically seek the prize or award. Social security payments and cash welfare payments from governments are excluded from income under the Code because the IRS ruled that they came under the

general exclusion for gifts. 1/ These exclusions are considered tax expenditures because most direct government payments do constitute income and these are in the form of cash--the most normal kind of income. Valuation difficulties may explain why several of these exclusions are not considered tax expenditures, although many persons recognize that the omission of such programs as food stamps, which have a readily determined value, calls for further examination. The treatment of gifts is discussed in more detail in chapter 5.

Taxpaying entity

In the "total accretions" income model, only individuals exist. Any income arising in corporations or other organizations should be attributed to the individuals who own or comprise the organization. In the United States, however, taxes fall on legal entities, and the structure that treats individuals (or couples), trusts, corporations, cooperatives, churches, lodges, labor unions, etc., as separate taxpaying or tax-exempt entities has been accepted as normal. Tax expenditures have been identified in deviations from a flat-rate corporation income tax for ordinary corporations, but not in the exemption from the corporate tax for tax-exempt (nonprofit) organizations or those that simply pass their taxable income through to their owners (partnerships, "Subchapter S" corporations, etc.). For the most part the existing legal structure has been considered normal in this area. (This will be brought up again in chapter 5.)

Accounting methods

The use of different accounting methods, such as cash or accrual, has not given rise to any tax expenditures; apparently any method is normal if it is consistently applied and creates no preferential distortions in income. The Internal Revenue Code does require that costs of goods included in inventories be accrued and charged off only when the goods are sold; an exception to that requirement for noncorporate farmers is considered a tax expenditure. Various ways of valuing inventories, such as last-in, first-out, have not been called tax expenditure provisions, nor have the special accounting methods for installment sales, construction contracts, etc.

1/U.S. Congress, Senate Committee on the Budget, Tax Expenditures: Relationships to Spending Programs and Background Material on Individual Provisions (Washington: U.S. Government Printing Office, 1978), pp. 138, 147.

Tax expenditures have been identified in special accounting privileges that distort the relationship between income and the costs of producing it; this topic is discussed below under "Deductions."

Accounting periods

The accounting period generally required by the Code and accepted as normal is an annual one. However, except in farming and a few other seasonally cyclical pursuits, a year is an arbitrary period and strict adherence to it would be unfair to individuals with extraordinarily large incomes in a particular year (because of the graduated rates) or to businesses with alternating profit and loss years (because the Government would be sharing in the profits but not in the losses). So there are provisions that reduce the effects of the annual accounting period: extraordinary increases in individuals' incomes can be averaged over a 5-year period; losses can be carried back or forward to other years. These are accepted as a part of the normal tax structure.

The preferential tax rates on capital gains are sometimes defended on similar grounds as a means of mitigating the effects of the annual accounting period and the progressive rates; gains accruing over many years might otherwise be taxed at very high rates in the year they are realized. However, the situation is not so simple with capital gains. If the tax were paid year by year as the gains accrued, it would be lower, but it would also be paid earlier; the current deferral of the tax is itself a tax advantage. Capital gains are subject to income averaging for individuals, just like any other extraordinary increase in income. And the capital gains tax rates are extremely generous and, except for the 1-year holding period, unrelated to the length of time the gains have been accruing. For these reasons the reduction in tax on capital gains income is considered a tax expenditure rather than a justified form of income averaging.

Deductions

Under the Haig-Simons concept, as under any other reasonable definition of income, income is defined net of the cost of producing it. The expenses necessary to produce income are therefore considered normal deductions by those who prepare the tax expenditures budgets. The disagreements arise over what is an expense of producing income and whether the expenses have been related to the right income.

Some expenditures serve a mixture of purposes: they produce income and also satisfy personal needs and desires. Examples are commuting expenses, which are not deductible under the Internal Revenue Code, and business lunches, which are deductible. If the personal consumption component of the deductible expenses of this type is considered inadequately restricted, they are listed as tax expenditures. Charitable deductions for corporations and the child care credit for individuals 1/ have been identified as tax expenditures because they are thought to allow tax reductions without adequately testing for the business or nonbusiness purposes behind them.

Expenditures that are accepted as necessary to produce income may nevertheless be difficult to relate to particular income. The rules followed are usually those of the accounting profession, which differ from those of the Internal Revenue Code in some cases. For tax accounting purposes, some expenses are deducted before the income they really relate to is reported (for example, the cost of drilling an oil well may be deducted before the oil is sold), and some, which are admittedly estimates to begin with, are estimated by more generous rules than normal accounting standards would permit (for example, deducting as depletion a percentage of the gross sales price of minerals instead of the prorated cost of the well or mine). These and other special tax accounting rules, such as depreciation and amortization of property at a faster rate than it really wears out or becomes obsolete, additions to bad debt reserves that are greater than those based on actual loss experience, and deductions of costs that should have been added to capital accounts, create tax expenditures because they do not relate income to expenses in a manner consistent with generally accepted accounting principles.

Other than the expenses of earning income, only one type of deduction is accepted as normal in the tax expenditures budgets. This is the portion of the individuals' incomes that is not to be taxed at all. The personal exemptions for oneself and one's dependents and the standard deduction or "zero-bracket amount" establish the threshold at which income taxation begins. This threshold varies, as do the tax rate schedules, by family status, and the deductions that make up the tax threshold are considered normal--that is, they

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1/In principle there is no difference between a credit against tax and a deduction from income. Only the mechanics of computing the tax saving are different. See the section on credits in this chapter.

are not considered tax expenditures. The extra amounts allowed for the aged and the blind, however, are considered tax expenditures, as are the itemized deductions for medical expenses, interest, taxes, charitable contributions, and casualty losses.

These distinctions are among the most controversial in the tax expenditures budgets. The argument centers on the concept of "ability to pay." Most income tax systems reflect the principle that equally situated taxpayers should pay equal amounts of tax. One of the fundamental problems a tax system must solve is deciding which taxpayers are equally situated with respect to ability to pay. If all circumstances are considered, it may be that no two taxpayers are equally able to pay. The tax system must establish classes of taxpayers within which all are presumed to have equal (or substantially similar) abilities to pay. The tax rate schedules and the tax threshold discussed above establish such classes by size of income and family status, and, in the tax expenditures budgets, these are considered the only normal classes.

Itemized personal deductions, like the extra exemptions for age and blindness, introduce some special classes into the tax system. The classes of old taxpayers, blind taxpayers, taxpayers with medical bills, taxpayers with mortgages or consumer debts, taxpayers with consumption expenditures or property subject to sales or property taxes, taxpayers in States with income taxes, taxpayers making charitable contributions, and taxpayers with uninsured damaged property are felt to be too special for the normal tax system.

There remain several technical problems in this area, and the place of proper deductions in a normal tax system is discussed further in chapter 5.

Tax rates

There are separate individual income tax rate schedules for married couples combining their incomes on one return in order to be treated as one taxpaying unit, for single individuals maintaining households for dependents, for other single individuals, and for married persons filing separate returns. Family status is considered a normal reason for varying tax liability. This is partly in recognition of the legal and moral obligations involved in family relationships, which the tax law has always allowed for; normal families really do share income, so family status is important in determining ability to pay.

The individual income tax rate schedules are "graduated" or "progressive," i.e., the rates increase as income increases. Although there are theoretical arguments for (and against) progressive income taxation, they are not reflected in the tax expenditures budgets. (It is usually said that there is no basis for deciding how much progression is normal or desirable, but that consideration of ability to pay requires some progression.) The progressive rate structure is accepted as normal because historically it has predominated in this country and most other countries with income taxes.

The corporation income tax rates are also progressive (though mildly so). But this is not considered "normal." One reason is the legislative history of the provision, which indicates that the lower tax rates on the first $100,000 of profits are a special reduction to benefit small business. Another is that, in economic theory, there is no basis for saying that one corporation has a greater ability to pay than another, because it is the position of the owners and not the corporations that determines ability to pay and there is no justification, therefore, for progressive corporate tax rates. Whatever the reason, a flat rate (proportional) tax is considered "normal" for corporations, and the revenue loss due to the lower rates on the first $100,000 is considered a tax expenditure.

In a few cases tax rates vary by source of income. There is a 50 percent maximum tax rate on the earned income of individuals and a reduced effective rate on an individual's long-term capital gains. The capital gains of corporations are also taxed at reduced rates, and there was a reduction, which is now being phased out, in the maximum corporate tax rate for income earned in foreign trade in the Western Hemisphere. All of these preferences are said to create tax expenditures.

Credits

Tax credits are dollar-for-dollar reductions in tax liability. They are simply another device for determining final tax liability; most deductions, for example, could be expressed as credits and most credits as deductions. A credit that does not vary with income (as they usually do not) is the equivalent of a deduction with a flat rate of tax (e.g., a credit of 20 percent of the cost of solar energy equipment is the same as deducting the cost of the equipment for a taxpayer whose marginal tax rate is 20 percent). A deduction is like a credit that increases as the tax rates increase (e.g., a deduction for charitable contributions is like a 14 percent credit for a taxpayer in the lowest tax bracket and a 70 percent credit for a taxpayer in the highest tax bracket.

Credits that are identified as tax expenditures (investment credit, credit for the elderly, etc.) are so classified for the reasons already discussed (i.e., they reduce tax liability for reasons that are unrelated to the revenue-raising function of the income tax).

The only normal credits that are compatible with the normal tax structure are the now-repealed general tax credit (which substituted for additional deductions or exemptions as a part of the tax threshold), those that are merely administrative devices for refunding other taxes (excess social security taxes, highway use taxes paid on gasoline not used on the highway), and those that are, or are treated as being, prepayments of income tax (including the credit for income taxes paid to foreign governments).

Conclusion

A pattern for the "normal tax structure" does emerge from the tax expenditures budgets (even if it is a little frayed at the edges). "Income" consists of all accretions to wealth or to the power to consume arising in transactions that objectively fix their value. Deductions are allowed only for the expenses of earning income and, for individuals, the amount established as the starting point for the rate schedules. The income and expenses can be determined by any generally accepted accounting method that relates the amount and timing of the expenses to the actual production of the income. The period for the determination is an annual one, except as modified by the income averaging and loss carryover provisions.

The income tax, or exemption from the tax, is determined separately for each type of legal entity. The tax liability for individuals may vary according to size of income and family status, both of which are deemed to reflect variations in the taxpayer's "ability to pay." No comparable reasons are admitted for varying the tax liabilities of corporations and no deviation from a strictly proportional rate is permitted, unless the income is simply passed through to another entity.

Anything else that reduces tax liability is a tax expenditure.

CHAPTER 3

THE INTERNAL REVENUE CODE AND TAX EXPENDITURES

If the "normal tax structure"--the consensus on the way the income tax system should be--is something different from the current Internal Revenue Code, the question arises why it is. Why are provisions enacted for nontax reasons; and, if these reasons were good ones, why does anyone object to them?

WHY ARE THERE TAX EXPENDITURES?

The "tax expenditures" label covers many different types of Code provisions, so there are many different answers to the question of why such provisions are enacted.

In some instances, the answer is simply that under the principles of taxation current when a provision was enacted it was not considered a "special" provision but a necessary part of the tax system. This is certainly the case with the consumer interest deduction, for example. All interest has been deductible during most of the existence of the income tax in this country, perhaps on the grounds that it was a reduction in "ability to pay" (income legally obligated to others was not available to pay income taxes) or on equity grounds (to avoid making a distinction between those who borrow and those who use their own money). The tax analysts who compiled the tax expenditures budgets consider these views incorrect, but the legislators who enacted the provisions presumably did not (as some people still do not--see chapter 5).

In other cases provisions now regarded as tax expenditures have arisen through attempts to treat various groups more consistently. Scholarships and fellowships, for example, were excluded to resolve disputes over whether they were non-taxable gifts or taxable compensation for services. Government transfer payments such as public welfare and social security benefits were excluded by Internal Revenue Service rulings that cause them to be treated the same as support by private gifts or welfare.

In still other cases, it is uncertain whether a provision is intended primarily to improve tax equity or to foster a social goal. Tax relief for the elderly or for persons with large medical bills, for example, is recognized as being directed to special groups, but the groups have been regarded as deserving special tax treatment, either because they are less able to pay taxes than other groups or because their reduced ability to pay all expenses could be partially

relieved by tax breaks. The latter view (a nontax reason) is accepted by most tax analysts today, but it was not necessarily the view of those who enacted the provisions.

And there is the ever-growing class of provisions that were added to the Code because they were tax expenditures. Probably the most famous, and certainly the most widely supported, such provision is the tax credit for business investments in depreciable property. When enacted in 1962, it was explicitly designed and presented as a tax expenditure (without that name) to stimulate business expansion and modernization. It was the forerunner of many other tax expenditures; a glance at the tax legislation of the next 15 years might leave the impression that the chief purpose of the tax system was to influence or control private behavior and that raising revenue was secondary. Today these intentional tax incentive provisions range from tax deferrals on income earned in international trade (DISC program) to credits for hiring welfare recipients as domestic servants (WIN program).

It is one of the little ironies of the tax expenditures concept that the proliferation of these provisions has surprised both the tax reformers who promoted the concept and those who opposed it. From the beginning, most of these reformers hoped and most of their opponents feared that highlighting tax expenditures would lead to the repeal of existing ones and an increasing reluctance to enact new ones. Instead the use of the tax system to affect social and economic behavior has expanded.

THE ADVANTAGES AND DISADVANTAGES OF TAX EXPENDITURES

Policymakers have seldom confronted the choice between funding a Government program through the tax system and funding it by the authorization and appropriation process. In the case of a few tax expenditures, such as the investment tax credit, policymakers may have first decided on program goals and then considered how to achieve them. But most tax expenditures have been enacted as a simple decision to reduce someone's taxes, normally with no thought given to enacting a direct spending program instead. In view of their origin it is not surprising that most tax expenditure programs have few features in common with direct spending programs. They differ because reducing taxes is a different process from establishing programs.

One difference is that reducing taxes is usually more gratifying than increasing spending. Even if the same people receive the same benefit, the tax expenditure is likely to

be viewed more favorably. This advantage may disappear if familiarity with the tax expenditures concept causes people to regard the two actions as the same.

Tax expenditures, as most of them are currently structured, are administered very simply. The beneficiary applies for the money merely by making a few entries on a tax return that would have been completed anyway. The records that must be kept to support the application are only a little different from the ones already being kept for tax purposes. Payment is prompt; in fact, it comes before the Government has even approved the application, because payment takes the form of a reduction in the tax due or an increase in the applicant's refund. If the use of the money is audited at all, it will be done by IRS agents who may already be auditing the tax return; and they will be primarily interested not in evaluating the Government's nontax objectives but in checking the accuracy of the tax computation. The taxpayer's additional paperwork and bother and the Government's additional administrative costs are likely to be negligible. The Government's interference in the applicant's business or personal life will seem minor compared to that in most direct programs.

A direct program requiring an application to the Government for a grant, a wait for approval and payment, and a justification of what was done with the money would involve far more costly and obtrusive administration. If one is to get money from the Government, the tax system currently affords a less painful way of getting it than most direct programs.

The advantage of administrative simplicity may disappear with time and attention. The investment tax credit, that bellwether of deliberate tax incentive programs, has grown in complexity with each revision and now covers some 40 pages in the Internal Revenue Code. As tax expenditure programs are increasingly regarded as the functional equivalent of direct spending programs, they may tend to become more like them in restrictiveness, red tape, and Government interference.

Tax expenditures by definition can only benefit those who owe taxes, or who would owe them without the tax expenditure provision. This restriction could be an advantage in programs that are designed to benefit corporate businesses because it provides a built-in test of efficiency. The corporation must earn enough profit to owe taxes before it receives any benefit, so a highly inefficient business, too unprofitable to survive, will not be subsidized. (But unincorporated businesses or organizations that are suffering losses can pass their tax reductions to owners who have

taxable income from other sources.) This advantage is lost if the tax expenditure is made "refundable," i.e., payments through the tax system are supplemented by direct payments to those who do not owe enough tax to get the full benefit.

Because they are a part of the tax system, tax expenditures tend to be more widely publicized than most Government programs. Nearly all of the population is aware of the income tax system. Probably no other Government activity directly affects so many people. A program highlighted on a tax return or in an IRS publication reaches a far wider audience than do any but the most highly publicized direct-spending programs.

Funding Government programs by tax expenditures rather than by direct authorization and payment also has disadvantages. Many of the characteristics cited as advantages above can also be cited as disadvantages.

The perception that tax expenditures are not a use of Government funds may make it easier to obtain support for a program initially, but it often makes it harder to review, evaluate, and terminate the program later. If a tax provision is not regarded as a Government program, it is difficult to justify evaluating its effectiveness as if it were. As noted above, however, this perception seems to be changing and more and more tax expenditures are being reviewed as Government activities even by those who dislike the name "tax expenditures."

A related disadvantage is that tax expenditures have usually been subject to less administrative and congressional review. Most direct programs come up for annual appropriations and often for renewed authorization; tax provisions tend to be enacted and forgotten except by IRS auditors, the taxpayers who benefit, and their lobbyists. With the increasing attention paid to the tax expenditures budgets and the tax system generally, this disadvantage is disappearing.

The structural differences that give tax expenditures administrative simplicity, lower costs, and minimal Government involvement arise mostly from the fact that they really are not administered at all; IRS processes the tax expenditure payments, but no one is responsible for checking the program itself to see whether its objectives are being accomplished. If careful administration is a good management practice, if strict qualification requirements, advance approval, effectiveness reviews, and fraud investigations are necessary for directly funded programs, it seems that they should also be required for tax expenditure programs.

In other words, the administrative structure should depend on the nature of the program, not on the source of the funding.

The lower administrative costs are no doubt offset to some extent by the costs involved in learning about and taking advantage of tax expenditure provisions. Fees for lawyers, accountants, and tax practitioners are an obvious component of these costs; the taxpayers' own searches for tax reductions are less obvious but possibly more costly in total. Tax expenditures did not create the tax planning industry, of course, but more time will be spent searching the more likely it seems that the search will be rewarding.

Some disadvantages arise because the system for funding programs is also the system for raising revenue. For example, many tax expenditures take the form of reductions in taxable income (exclusions, deductions, etc.). Because the individual income tax rates are progressive, the programs have an "upside-down" effect: the wealthier the taxpayer, the more the Government contributes. A subsidy program designed to pay nothing at all for casualty losses suffered by the very poor and up to almost 70 percent of the losses suffered by millionaires would not stand much chance if it were proposed as a directly funded program. It has this structure because the casualty-loss deduction necessarily follows the structure of the progressive income tax.

To avoid this effect, tax expenditures are now often structured as flat-rate credits against tax rather than deductions from income. A credit makes the Government payment the same percentage of the expense for everyone--at least, everyone who owes enough tax to use the credit. Credits still provide no benefit to those who owe no tax, so some, such as the earned income credit and a few of the energy credits, have been made refundable, meaning that direct payments are made when the credit exceeds tax liability.

Since tax expenditure programs are embedded in the tax law, the amount of the benefit they provide depends on the rest of the tax system. A nonrefundable credit for home insulation, for example, may be intended to benefit persons down to a certain income level. If the tax threshold is increased for an unrelated reason (to adjust tax burdens for inflation, for example), some intended beneficiaries will be excluded because they will no longer owe enough tax to use their credits. If marginal tax rates are changed, the size of the benefit a taxpayer receives will also be changed.

Tax expenditures also affect the rest of the tax system. If Government receipts are held constant, a tax reduction for one person means a tax increase for someone else. Each of the revenue losses caused by tax expenditure provisions is made up by higher taxes on everyone else. Thus funding a program through the tax system makes the system look more inequitable, as though it were a system for conferring privilege. (The result, of course, is the same as if the taxes were distributed equitably and the inequity were in the distribution of the direct expenditures.) Since the public's perception of the fairness of the tax system is important, this is a serious disadvantage. Tax rates are higher than would be necessary without tax expenditures; if there were fewer tax expenditures, the tax base would be broader and the same amount of revenue could be raised with lower rates. Tax expenditures also add greatly to the complexity of an already overly complicated tax system and burden the congressional tax committees and IRS with responsibility for numerous nontax programs.

TAX EXPENDITURES AND TAX REFORM

The disadvantages of tax expenditures, and especially their effect on the revenue-raising function of the tax system, have led many analysts and political figures to generally oppose their use to fund Government programs. Some of these persons have argued that the curtailment of tax expenditures should be a major goal in any effort to reform the tax system.

Tax reform has certainly been an important aim of many proponents of the tax expenditures concept. The original tax expenditures budget was little more than a catalogue of Code provisions regarded as ripe for reform. Some persons regard the present, more comprehensive lists in the same way. Some of those who dislike the concept also suspect that the principal purpose of a list of tax expenditures is to prepare the way for tax reform. Because of this view, judgments as to what are and what are not tax expenditures are sometimes clouded by the conviction that including a provision in the budget means targeting it for repeal.

But tax reform is essentially irrelevant to the concept. If a careful analysis concluded that every line item in the tax expenditures budget is the best possible use of Government funds, the concept would still have proved its value. The purpose of the budgets is to facilitate such a review, as is done (or should be done) with all Government programs.

CHAPTER 4

THE TAX EXPENDITURES BUDGET

After provisions of the Internal Revenue Code have been identified as tax expenditures, two more steps are necessary to compile a "tax expenditures budget." The cost of each provision must be estimated and it must be classified in the budget functional category in which it would appear if it were a direct expenditure program.

THE COST OF TAX EXPENDITURES

Estimating costs

According to the model presented in chapter 2, the cost of all tax expenditures is the difference between the revenue raised by the normal tax structure and that raised by the existing structure. The cost of any particular tax expenditure is its contribution to that total cost.

In the real world these costs cannot be determined directly. No one knows what revenue the normal tax structure would raise. The present system creates incentives for people to alter their behavior and so presumably influences the way they act. They would probably act differently under another system, with consequent effects on revenue, but there are too many unknowns to estimate the differences.

The approach actually taken in estimating the revenue lost by tax expenditure provisions is to consider each provision in isolation and determine how total taxes would change if it were repealed and all else, including taxpayer behavior and the rest of the tax system, remained the same.

The estimating technique varies according to the type of tax expenditure. The cost of a tax expenditure that takes the form of a tax credit, such as the investment credit, is just the amount by which the tax liabilities are reduced (as reported on tax returns). The cost of tax expenditures that take the form of a reduction in taxable income--a deduction, exclusion, exemption, or deferral--depends on the way the reduction is distributed by taxpaying entity and tax class. Information about this distribution is gathered from tax returns or other sources, the tax for each class of taxpayers is recomputed on reported income plus the reduction, and the difference between that computation and the actual tax is the amount of the tax expenditure. For example, information on the ownership of tax-exempt State and local government securities is obtained from the Federal Reserve Board or

other financial sources; the amount of tax-exempt interest is distributed by tax class based on this information and added to each class's taxable income; a new tax is computed for each class; and the differences between the new tax and the reported tax for all classes are summed to obtain the cost of this tax expenditure.

This approach cannot be generalized to produce a reliable estimate of the total cost of all tax expenditures. Earlier in this paper, "over $100 billion" was mentioned as the total cost. This figure is merely the sum of the costs of the individual provisions, estimated as described above. Although it is common to make such a summation, the figure is of limited usefulness.

The reason is that removing two or more provisions at the same time will often produce a different amount of revenue than the sum of the revenues estimated to be lost by each provision separately. For example, repealing all itemized deductions would produce a different revenue gain from the sum of the costs of each deduction by itself. As each deduction were repealed, taxable income would increase and push the affected taxpayers into higher tax brackets; however, because the "zero-bracket amount" effectively places a floor under each taxpayer's deductions, a point would come when the repeal of further deductions produced little or no additional revenue.

This example illustrates an important difference between an estimate of the cost of a tax expenditure and an estimate of the cost of a direct spending program. Tax expenditure costs should always be estimated incrementally, i.e., by assuming that only a single provision were removed, while the rest of the tax system remained unchanged. Otherwise the cost would depend on what other provisions were being removed at the same time--perhaps would even depend on the order of their removal. Cost estimates for direct spending programs require no corresponding assumptions about other spending programs.

Estimating secondary effects

The "other-things-being-equal" approach to estimating costs has attracted criticism. Business interests, for example, maintain that the investment tax credit does not cost the Government revenue but creates it. They estimate how much employment and profits have increased in response to the investment credit and conclude that the increased taxes on wages and profits are greater than the direct costs of the credit. If secondary and "ripple" effects are taken

into account, such arguments could be made about many or most of the tax expenditure provisions. Those who defend the estimates reply that these effects are even more conjectural than the assumptions in the tax expenditures budgets. It is still unclear, for example, whether the investment credit has significantly boosted total investment spending.

However important these questions may be in appraising the costs and benefits of tax expenditures, they do not discredit the tax expenditures budget. Secondary and "ripple" effects become a part of the budgeting process only after initial costs have been established. The U.S. Budget does not record the costs of the social security programs net of the welfare payments that might be required if there were no such programs. The budget of the Public Health Service is not presented net of the taxes on the wages of the workers its programs have kept healthy enough to work. These are important in deciding whether to undertake or continue a program, but they are not relevant to the question of how many resources the program consumes. The same is true of tax expenditures.

Projecting cost estimates

Estimating future revenue losses from tax expenditures, especially new ones, raises some additional problems. Tax expenditures are like entitlement programs with permanent appropriations: every beneficiary who establishes that he belongs to a class entitled to the benefit receives it automatically, and the amount of the Government's obligation depends entirely on the actions of private individuals and whatever limits may be built into the program. This means that analysts who are estimating future costs cannot avoid making assumptions about the way behavior will be affected.

For existing tax expenditure programs, it is usually assumed that everyone will go on doing whatever he has done in the past. Future costs can be projected based on past relationships of the factor being estimated (the medical deduction, for example) to economic and demographic indicators (age and income distributions, for example) or other variables that can be projected into the future. For new or drastically changed tax expenditures, however, some effects must be estimated or assumed in order to estimate costs. For example, to estimate the cost of a tax credit for home insulation, it is necessary to estimate how many homeowners in each tax bracket will insulate their homes each year thereafter and how much they will spend. Analysts are reluctant to simply project historical data into the future, because that is the same as assuming that

the credit will have no effect at all. So the estimate must be based on some guess about how much more insulation will be installed in response to the credit, and the accuracy of the estimate will depend on the accuracy of the guess.

A directly funded entitlement program has the same defects. If the Government set up an office to pay 15 percent of any bill for home insulation that was presented to it, estimating the future costs of the program would be as difficult as estimating the costs of the future tax expenditure; the cost would depend on the program's effect. Even for directly funded programs with specific limits there are spending shortfalls and cost overruns, and the "limits" are frequently breached by supplemental appropriations, so the tax expenditures budgets are not very different from the direct spending budgets in this respect.

BUDGET FUNCTIONAL CATEGORIES

Since one of the principal reasons for constructing a tax expenditures budget is to facilitate comparisons between tax and direct expenditures, the budgets are organized according to the same functional categories that appear in the direct outlays budget. Tax expenditure provisions are fitted into the regular budget categories dealing with the same subject. For example, the Code provisions that exclude from taxable income some of the benefits received by members of the armed forces are shown as additional costs in the budget function "National Defense," subfunction "Military Personnel." Members of the armed forces do not pay taxes on some of their combat pay, on mustering-out payments, on the value of free meals and lodging, or on subsistence payments in lieu of meals and lodging. These special tax benefits are the same as additional compensation to military personnel, so the revenue lost from them is the equivalent of an additional budget outlay for national defense of an estimated $1.4 billion in 1979.

CHAPTER 5

SOME TECHNICAL ISSUES

The tax expenditures concept is still in its early childhood, if not its infancy. Many aspects of it have not been sufficiently researched or discussed. Problems remain in definition, scope, presentation, analysis, and many related issues. Most such problems may be peripheral concerns that do not much impair the usefulness of the tax expenditures budgets; a few seriously limit some uses of the concept. Several problems of varying seriousness are discussed below.

A NORMAL OR AN IDEAL TAX SYSTEM?

Tax expenditures are defined in terms of the "normal tax structure." Everyone can agree that "normal" means conformity to a norm or standard, but not everyone agrees on the standard. In ordinary usage, that standard is the average, the commonly agreed on, the usual. To most of the economists (and some of the lawyers) who write about tax matters, however, the standard is an ideal one, derived from the Haig-Simons definition of income and other concepts from economic theory (a "theoretically pure income tax," in the words of Special Analysis G of the President's 1980 Budget).

If "normal" were accepted at its ordinary meaning of "usual" or "agreed on," there would probably be no tax expenditures budgets; the Internal Revenue Code is the nearest thing we have to an agreed-upon tax structure. 1/ If "normal" were to be taken to mean the economist's ideal, the tax expenditures budget would be very different; some of the differences were discussed in chapter 2. In this paper, we have taken the position that the existing tax expenditures budgets measure deviations from the normal and therefore indirectly establish what is meant by normal. This definition is somewhere between the above two meanings; essentially, "normal" in this paper means the standards established by the two most influential groups of tax analysts in the Federal Government, the tax staffs of the Treasury Department and the Joint Committee on Taxation, who have constructed the official budgets in consultation with each other.

This definition of normal leaves some areas where the principles followed are not completely clear. The tax staffs

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1/Several tax analysts hold this view; see, e.g., the articles by Boris Bittker and Walter Blum listed in the bibliography.

are obviously influenced strongly by the ideal concepts of the economists and seem reluctant to stray too far or too openly from them in creating their definition of "normal." In a number of areas, confusion may arise because the ideal and the normal do not match.

Gifts

Under the Internal Revenue Code, transfers of value for which no value is received in return are not income. Such unrequited transfers are income under the Haig-Simons definition. What they are under the normal tax structure of the tax expenditures budgets is not clear.

From the published budgets and explanations, the treatment of unrequited transfers is as follows:

1. Cash transfer payments from governments (social security and welfare) are income and their exclusion from taxable income creates a tax expenditure.

2. In-kind transfers from government (school lunches, public housing) are income but are not included in the tax expenditures budgets because their value is too difficult to estimate, or they are like other government services and therefore are not taxable income in the normal system.

3. Transfers from private institutions (soup kitchens) are not included because they are mostly in-kind transfers, and government in-kind transfers are not included.

4. Gifts between individuals are not income because they are usually between related parties, often within families, because they are too difficult to estimate, perhaps because they are not deductible by the donor, and because they may be subject to the separate tax on transfers (estate and gift tax).

5. Scholarships and fellowships are income and their exclusion creates a tax expenditure (perhaps because they are not really gifts, since something is expected in return for them).

6. Prizes and awards are not mentioned in the budgets, perhaps because little revenue is lost by their limited exclusion.

7. Life insurance proceeds that are excluded under the Code are not income, presumably because they are either

returns of previously taxed income, the earnings of this income (whose exclusion from current taxation is a tax expenditure), or bequests.

8. Bequests and inheritances are not income, presumably for the same reason or reasons that gifts are not.

These classifications may be ad hoc decisions not much related to one another, or they may result from the application of consistent principles that we could not discern. The classifications almost imply the principle that gifts should be taxable to the recipient when received from a tax-exempt source; but they do not quite follow this principle and the implication may be accidental. The existence of separate estate and gift taxes apparently has something to do with the ad hoc decisions, 1/ although it is not clear why it should.

Personal deductions

The provisions in the Internal Revenue Code that allow taxpayers to deduct medical expenses, interest, taxes paid, nonbusiness casualty and theft losses, and charitable contributions, have consistently been designated tax expenditure provisions by those who prepare tax expenditures budgets. They have been so designated because they are not costs of earning income; therefore, in the view of those who construct these budgets, they must be personal consumption expenditures. Since the Haig-Simons definition of income is the sum of consumption and changes in net worth, the personal expenses for which deductions are allowed do not alter income and hence in the normal income tax system have no effect on one's tax liability.

This reasoning is countered by critics who maintain that no personal expense is consumption unless the expenditure is voluntary. Expenditures for medical care and supplies are, in a manner of speaking, involuntary if the alternative is to remain ill, at peril to one's life. Taxes too are said to be involuntary, in the sense that few people willingly pay taxes; nor does anyone willingly suffer a casualty or theft loss. Charitable contributions are conceded to be voluntary; but are they consumption themselves or transfers of consumption power? The latter, say those who believe that the charitable deduction creates no tax expenditure. (Few of them draw the

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1/Special Analyses, The Budget of the United States Government for Fiscal Year 1980 (Washington: U.S. Government Printing Office, 1979), p. 187.

logical conclusion that such contributions must therefore be income to the recipients and the failure to tax them creates a tax expenditure.)

How convincing are these arguments? Proponents of the tax expenditures budgets reply that even if some personal expenditures are truly involuntary, the tax system allows for a normal level of such expenditures by exempting a certain amount of income--the so-called "zero-bracket amount"--from tax.

More serious is the question of how to know which expenditures were voluntary and which were not. In truth, most expenditures must lie within a spectrum ranging from "wholly voluntary" at one extreme to "wholly involuntary" at the other. There must be few at the latter end. Medical expenses include many payments for services that are not strictly necessary for the preservation of life or health. Taxes, which are payments for government services, are not much less voluntary than any payment for a good or service. Is the annual payment of a property tax on a person's house distinguishable from the same person's mortgage payments by the willingness with which it is paid? Casualties and thefts create losses that are purely involuntary; but the decision to carry insurance is not, in those cases where insurance is available.

The interest deduction is called a tax expenditure by nearly all those who embrace the concept, apparently on the grounds that the payment of interest is essentially a personal consumption expenditure that differs little from other such expenditures. A payment for the use of money, they say, is essentially no different from a payment for the use of, say, shelter, clothing, or transportation. If it is inappropriate to allow a deduction for these expenditures in determining a person's true income, no deduction for interest payments is appropriate either.

This reasoning is so widely accepted that the interest deduction has been a relatively noncontroversial item in all tax expenditures budgets. But there are a few dissenters who maintain that a deduction for interest payments must be allowed if horizontal equity--the equal treatment of persons in substantially equal circumstances--is to be accomplished. They point out that if one person finances current consumption by selling income-earning assets from his portfolio, at a cost measured by a loss of future income, the Government "shares" the cost in the form of forgone taxes on that future income; but the forgone revenues are not called a tax expenditure. Another person finances the same consumption not by selling assets but by borrowing cash. Both persons are in

substantially the same economic position after these transactions; but unless the Government allows the borrower a deduction for the interest he pays, the seller of assets will in future pay less taxes. Both persons have effectively done the same thing: financed current consumption out of future income. Both should therefore pay the same taxes.

The disagreement over the proper treatment of the interest deduction raises some complicated issues that have been omitted from the illustration above. The subject is important enough to warrant serious examination in a separate report.

Expenses of earning income

In principle the costs of earning income should be subtracted from gross income in order to define the net income taxable base. The principle is clear, but in practice it is often difficult to distinguish personal consumption expenditures from expenses incurred for the purpose of earning income. Many expenses have the characteristics of both. The standards for an ideal tax system that have been developed by tax scholars offer little or no guidance for deciding which expenditures should be deductible as business expenses and which should not. The makers of tax expenditures budgets have therefore been forced to decide for themselves, aided by legal and accounting principles, whether the deductions for business expenses that are allowed by the Internal Revenue Code belong in a normal income tax.

The expenses of earning wage income illustrate the difficulties. Some fringe benefits that employees enjoy, such as reimbursement of their own travel and entertainment expenses, are not taxed as income to them but nevertheless are deductible from their employers' gross income as ordinary and necessary business expenses. The deductions are not labeled tax expenditure provisions. On the other hand, the budgetmakers have been strict about designating as tax expenditures the few provisions in the tax law that either allow wage earners to deduct certain expenses of earning income (the child care expense deduction) or afford wage earners tax relief partly on the grounds that the law grants them few opportunities to deduct some expenses of earning income (the maximum tax provision). A great deal of work remains to be done in this area to provide clearer standards for budgetmakers and enable them to be less arbitrary in their decisions.

The corporation income tax

In the world of ideal tax systems corporations do not exist. Only individuals exist; and if they happen to band together to create a business enterprise, the profits and losses should be attributed to the individuals. In that case there would be no need for a corporation income tax. The individual who owned a share of corporate stock would be taxed on his portion of the corporation's profits.

Because the corporate income tax is considered an anomaly in the ideal tax system, little thought has been devoted to the structure of a normal income tax for corporations. If it is normal to have a tax at the corporate level on corporate profits, some additional ways in which corporations escape or defer the tax are candidates for the tax expenditures budgets. A partial list would include such provisions as those allowing tax-free reorganizations and mergers, special tax computations for insurance companies, investment companies, etc., tax-exempt and tax passthrough organizations, and even the deduction for intercorporate dividends. 1/

Foreign income

The place of national boundaries in the ideal system is apparently as uncertain as it is in the real one. The United States taxes the worldwide income of its own citizens. (It is one of the few countries in the world to attempt to tax nonresident citizens on the income they receive outside their countries' borders.) It also taxes all income generated within its jurisdiction received by anyone (with a few specific exceptions). But it allows the exclusion of some income earned by nonresident individual citizens, deferral of tax on the unrepatriated earnings of some foreign subsidiaries of U.S. corporations, credits against U.S. taxes for income taxes paid to foreign governments, and a number of special arrangements based on treaties with specific countries.

Of these exceptions, the limited exclusion of the foreign earnings of individual citizens is considered a tax

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1/The courts allowed a tax on corporate profits before the passage of the 16th Amendment, based on the argument that the Government had the right to tax the privilege of doing business as a corporation and that net income was a reasonable measure of the value of that privilege. According to this view, intercorporate dividends could appropriately be taxed at a higher rate than the other elements of corporate profits, because the right of one corporation to own stock in another is an additional valuable privilege.

expenditure by everyone, the deferral of tax on unrepatriated earnings is considered one in all the budgets now but was not considered one in the President's budgets before 1979, and the foreign tax credit and the preferences granted by treaty are not considered tax expenditures by anyone. The President's 1978 and earlier budgets omitted the deferred income and foreign tax credits on the stated grounds of "the international norms of taxation," which are not further explained. 1/

OTHER TAXES

The tax expenditures concept is not necessarily limited to the income tax. Tax expenditures could arise in deviations from a normal tax structure for wealth transfer (estate and gift) taxes; excise taxes; State and local sales, property, and income taxes; or even social security taxes (the exemption of government employees, perhaps). But the tax expenditures budgets ignore these tax systems, mostly because little effort has been devoted to establishing the normal structures for these taxes.

A tax expenditures budget has been prepared for the Federal estate and gift taxes by private researchers. 2/ It establishes the normal structure, by analogy with the income tax, as a tax on all transfers of net wealth for which adequate compensation is not received (except for some transfers between husband and wife). Provisions that deviate from this norm and so create tax expenditures are the special valuation of real property and deferral of tax payments for bequests of farms and closely-held businesses, the deduction for charitable contributions, the exclusion of some annuities and life insurance proceeds, the failure to tax all generation-skipping transfers, the preferential taxation of gifts made more than three years before death, the orphans' exclusion (a small

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1/Special Analyses, The Budget of the United States Government for Fiscal Year 1978 (Washington: U.S. Government Printing Office, 1977), p. 124. The foreign tax credit is sometimes defended as a protection against double taxation. This principle does not apply domestically, however: taxation of the same income by two political units (the Federal and State governments, for example) or even twice by the same unit (income subject to Federal income and social security taxes) is considered normal.

2/Stanley S. Surrey, William C. Warren, Paul R. McDaniel, and Harry L. Gutman, Federal Wealth Transfer Taxation (Mineola, N.Y.: Foundation Press, 1977), pp. 882-87.

deduction for bequests to certain minor children), the exclusion of gifts to political organizations, the credit for State death taxes, and the redemption at face value of Government bonds currently selling at a discount and presented in payment of estate taxes ("flower bonds"). The total revenue loss attributed to these provisions was estimated at more than $2.5 billion for 1978.

State and local property taxes are another obvious area for tax expenditure analysis. Large cities especially have begun considering the cost of exempting nonprofit organizations, churches, Federal Government property, and the like from property taxation. A type of tax expenditure analysis is already in use in this area.

The other taxes may be further away from useful tax expenditure analysis. Sales taxes are exceedingly complex, and standards are difficult to decide on. Federal excise taxes involve relatively little money and would probably not be worth the trouble. The social security tax allows so few deductions that it would probably not be worth the effort either.

USES OF TAX EXPENDITURES BUDGETS

The tax expenditures budgets are admittedly incomplete. They do not account for all the differences between Haig-Simons income and the income tax base; they do not identify all the discrepancies between the Federal income tax structure and a "theoretically pure income tax." Some omissions are due to unresolved conceptual problems, such as the handling of transfers or the corporate profits tax; some are due to inadequate data, such as the value of government services received or imputed rents on owner-occupied housing; some are aspects of the tax system that have not been sufficiently studied, such as the relationship of accounting standards to the normal tax structure.

The principal uses of the budgets are not much impaired by these omissions. One can still see that certain activities are supported indirectly through the tax system instead of or in addition to directly through the appropriations process; that certain groups of taxpayers have saved taxes at the expense of other taxpayers; and that the Government's influence is much larger than is commonly supposed.

But because the budgets are incomplete, they are of limited help in comparing the burdens borne by different taxpayers. To make such comparisons more information is needed than appears in the tax expenditures budgets.

Scholarships and fellowships offer an example. Two university students, one receiving a scholarship for his tuition costs and the other attending a tuition-free university, appear for all practical purposes to be in the same position. But the first is said to be receiving a tax expenditure and the second is not. Obviously, tax equity would not be improved by taxing the scholarship.

Or consider the tax burdens borne by homeowners and renters. Tax expenditure provisions said to subsidize home ownership are the deductions for mortgage interest and property taxes, the deferral of capital gains on exchanges of houses, and the exclusion of capital gains on homes sold by older persons. In addition, a small part of the tax expenditure due to capital gains is attributable to the sale of private homes. For the rental market, the only subsidies shown are the two deductions for rapid amortization and depreciation, the expensing of construction period taxes and interest, and an indeterminate amount also included under the capital gains heading. For 1978, these were estimated to total about $11 billion worth of subsidies for homeowners and only about $0.5 billion for the rental market, not all of which had to be passed on to the renters, of course.

But there is more to the renters' story. On its tax returns the real estate rental industry has reported net losses for decades. For 1976 (the latest statistics available) the industry as a whole reported $4.4 billion in profits, but $6.1 billion in losses. Tax return statistics for residential property are not published separately from those for commercial property, but rental housing is a well known tax-loss industry. Rental housing developments are marketed as tax losses, promising that a small investment will produce a large tax saving and some tax-free cash flow for investors in high tax brackets. This suggests that the rents charged do not cover all expenses and a profit for the owners (as in the Navy ship example in chapter 1); in other words, renters are also receiving a tax subsidy. And some of this subsidy is not in the tax expenditures budgets.

Rental housing is depreciated by the straight-line method in the normal tax system; accelerated depreciation methods are considered tax expenditure provisions. However, it is possible to achieve a tax profit using only straight-line depreciation. This is because the building is usually increasing in value the first few years of its life, not depreciating. If the property is rented for just enough to cover operating expenses and debt service, the depreciation deduction becomes a loss to be deducted from income from

other sources. If the building is sold for even as much as was paid for it (and it often will actually have appreciated in value) the depreciation previously deducted becomes a part of the profit on the sale, which is taxed at capital gains rates. Deducting depreciation on a building that is not declining in value thus allows the investor to defer taxes for some years and pay at the capital gains rates when the tax is finally paid.

In the tax expenditures budgets capital gains on the sale of rental housing are not shown as a separate estimate and the deferral due to depreciation deductions is not shown at all. In some circumstances it is also possible for the investor to defer even the capital gains tax by a tax-free exchange; tax-free exchanges of rental housing are not in the budgets. Real estate investment trusts and limited partnerships have the advantages of corporations in accumulating large funds for investment in rental housing, but do not pay corporate profits taxes; this is not in the tax expenditures budgets. Deferral of tax through installment sales reporting is not in the budgets; it is useful for deferring taxes on sales of either owner-occupied or rental housing, but presumably is more useful to landlords than to homeowners, who have other tax breaks that are even more useful. The failure to tax the imputed rental value of owner-occupied housing is also not in the budgets (see chapter 2), but this failure looks a little different when the full picture is considered. From the published statistics it appears that the net rental value of <u>rental</u> housing is not taxed either.

As a final word on incomplete budgets the Navy ship example cited in chapter 1 should be mentioned. The specific tax expenditure involved in this example has not been identified earlier because it is not in the tax expenditures budgets. The tax losses in the example were due mostly to accelerated depreciation of the ships, which allowed the lessors to defer taxes for some years. Accelerated depreciation of ships is considered normal because ships, like automobiles and other machinery, really do lose value faster when new. But the ships in this example were leased for fixed amounts for their entire depreciable lives; repairs, inoperable periods, etc., were at the Navy's expense, not the lessors'. So the declining value of the property was irrelevant to determining the income of the lessors; that income continued no matter what happened to the ships. The lessors' income was properly measured by amortizing the value of the <u>lease</u>, not depreciating the leased property. This situation is not in the tax expenditures budgets, presumably because of the difficulty of estimating excess depreciation on leased property (which depends in part on the terms of the lease). But the Navy

ship report is nevertheless an excellent example of a proper use of the tax expenditures concept; and it suggests that the real usefulness of the concept does not depend on how complete the budgets are.

ANNOTATED LIST OF TAX EXPENDITURES

This list includes all the tax expenditures listed in the most recent tax expenditures budgets published in the Special Analyses of the U.S. Budget and by the Congressional Budget Office. The list, like the tax expenditures budgets, is organized by the functional categories used in the direct expenditures budget. The authority for and descriptions of most entries were adapted from Tax Expenditures: Relationships to Spending Programs and Background Material on Individual Provisions (U.S. Senate Committee on the Budget, 1978). Descriptions of tax expenditures added or substantially modified since that publication are based on the committee reports on the Revenue Act of 1978, the Energy Tax Act of 1978, and the Foreign Earned Income Act of 1978. Cost estimates are taken from Five-Year Budget Projections and Alternative Budgetary Strategies for Fiscal Years 1980-1984, Supplemental Report on Tax Expenditures (U.S. Congressional Budget Office, June 1979).

Tax expenditure	Estimated cost Fiscal Year 1980 ($ millions)	Authority	Description
-NATIONAL DEFENSE-			
Exclusion of benefits and allowances to Armed Forces personnel	1,470	Internal Revenue Code (IRC) secs. 112, 113; Internal Revenue Regulation (IR Reg.) 1.61-2; court decisions	Military personnel are not taxed on quarters and meals provided, allowances given in lieu of quarters and meals, mustering-out payments, combat pay, and a few other such benefits.
Exclusion of military disability pensions	130	IRC secs. 104(a)(4), 104(b)	Military pensions based on disability are often not subject to income tax.
-INTERNATIONAL AFFAIRS-			
Exclusion of income earned abroad by U.S. citizens	555	IRC secs. 911-913	U.S. citizens and legal residents living and working in other countries may reduce their foreign earned income in one of several ways. Persons required to live in work camps under hardship conditions may exclude a portion of their income. Others (except U.S. Government employees) may deduct certain excess foreign living expenses, such as the cost of schooling for their children and housing costs in excess of U.S.

			housing costs. U.S. Government employees may exclude certain housing and other allowances and benefits.
Deferral of tax on income of domestic international sales corporations (DISCs)	1,260	IRC secs. 991-997	Corporations established to export U.S.-made products may defer indefinitely the corporate tax on a part of their profits.
Deferral of tax on income of controlled foreign corporations	445	IRC secs. 11(d), 882, 951-964	The profits of foreign subsidiaries of U.S. corporations are generally not taxed by the U.S. until the money is returned to this country, permitting indefinite deferral of the U.S. tax.
Special tax rate for Western Hemisphere trade corporations	5	IRC secs. 921, 922	Formerly, the law allowed profits earned in trade with Western Hemisphere countries to be taxed at a reduced rate. This provision is being phased out and will be eliminated by 1980.
-GENERAL SCIENCE, SPACE, AND TECHNOLOGY-			
Expensing of research and development expenditures	1,780	IRC sec. 174	Research and development costs may be deducted as current expenses in the year incurred instead of being capitalized and charged against the income they produce as it is earned.

Tax expenditure	Estimated cost Fiscal Year 1980 ($ millions)	Authority	Description
-ENERGY-			
Expensing of exploration and development costs	1,665	IRC secs. 263(c), 465, 616, 617, 704(d), 1254	The costs of searching for oil, minerals, etc. and bringing them to the point of production (including "intangible drilling" costs) may, for tax purposes, be deducted currently from other income; in normal accounting practice, such expenses would be capitalized and charged against the income from the property as it is produced. Most of the revenue loss relates to oil and gas income.
Excess of percentage over cost depletion	1,750	IRC secs. 613, 613A	Taxpayers are allowed to deduct as depletion each year a fixed percentage of their income from many types of mineral property rather than their prorated investment in the well or mine; the latter is considered the "normal" deduction and the extra deduction that percentage depletion produces is considered a tax expenditure. The deduction for all minerals is included here because most of it relates to fuels.

Capital gains treatment of royalties on coal	85	IRC sec. 631(c)	Lessors of coal deposits can arrange the terms of the lease so that the royalties are taxed at the lower capital gains rates instead of as ordinary income.
Residential energy credits	435	IRC sec. 44C	Tax credits are allowed for home insulation and other energy-saving features and for installing solar and wind devices as alternative energy sources in private homes.
Alternative conservation and new technology credits	390	IRC secs. 46(a), 46(c)(6), 48(l)	Credits are also granted to businesses for various energy-saving features and alternative energy sources.
NATURAL RESOURCES AND ENVIRONMENT			
Exclusion of interest on State and local government pollution control bonds	460	IRC sec. 103(b)(4)(F)	State and municipal bond interest is generally not subject to Federal income tax unless the bonds are used to build facilities leased to private businesses ("industrial development bonds"). Some types of nontaxable industrial development bonds are allowed, however; the interest on bonds used to finance pollution control facilities leased to private concerns remains exempt from Federal income tax.

Tax expenditure	Estimated cost Fiscal Year 1980 ($ millions)	Authority	Description
-NATURAL RESOURCES AND ENVIRONMENT (cont.)-			
Exclusion of payments in aid of construction of water and sewage facilities	60	IRC secs. 118(b), 362(c)	Builders and developers often pay for the water and sewage facilities for their developments. The facilities then become the property of the local private utility serving the development. The contributions are not considered taxable income to the utility.
5-year amortization of pollution control facilities	-10	IRC secs. 46(c), 169	Certified pollution control facilities may be written off over a 5-year period in lieu of being depreciated over their useful lives. This results in larger deductions early in the life of the property and no deductions later. The cost is negative in 1980 because the amortization of earlier years resulted in smaller depreciation deductions in 1980.
Capital gains treatment of certain timber income	455	IRC secs. 631(a), 631(c), 1221, 1231	In some circumstances profits from the sale of standing timber may be taxed at the lower capital gains rates instead of the ordinary rates.

Capital gains treatment of iron ore	20	IRC sec. 631(c)	Lessors of iron ore deposits can arrange the terms of the lease so that the royalties are treated as capital gains rather than ordinary income.
Tax incentives for preservation of historic structures	10	IRC secs. 167(n), 167(o), 191, 280B	The expenses of rehabilitating a certified historic structure may be either amortized over a 5-year period or treated as expenses subject to accelerated depreciation.
-AGRICULTURE-			
Expensing of certain capital outlays	505	IRC secs. 162, 175, 180, 182, 278, 447, 464, 465, 704(d); IR Regs. 1.61-4, 1.162-12, 1.471-6	Unincorporated farmers may use the cash accounting method for all expenses, even those becoming a part of inventories or producing income in subsequent years, and are thus allowed to deduct currently expenses another type of business would have to capitalize. In addition, all farmers can take current deductions for such capital expenditures as soil and water conservation and land clearing expenses.
Capital gains treatment of certain ordinary income	395	IRC secs. 1201, 1202, 1221-1223, 1231, 1245, 1251, 1252	The gain from the sale of certain farm products, such as livestock and orchards, may be treated as a capital gain and taxed at lower rates than ordinary income.

Tax expenditure	Estimated cost Fiscal Year 1980 ($ millions)	Authority	Description
-AGRICULTURE (cont.)-			
Deductibility of noncash patronage dividends and certain other items of cooperatives	365	IRC secs. 1381-1388	Earnings retained by cooperatives but allocated to members are treated as deductible patronage dividends by the cooperatives and taxed to the members. If they were subject to the corporate income tax, corporation taxes would increase by $540 million and individual income taxes would decrease by $175 million, for a net tax expenditure of $365 million.
Exclusion of certain cost-sharing payments	30	IRC secs. 126, 1255	Federal and State programs to assist landowners in conserving soil, protecting the environment, improving forests, or providing habitat for wildlife are not taxable to the landowners if they do not improve the income-producing capability of the property.
-COMMERCE AND HOUSING CREDITS-			
Dividend exclusion	450	IRC sec. 116	Individuals may exclude up to $100 of dividends received from U.S. corporations.

Exclusion of interest on State and local industrial development bonds	585	IRC sec. 103(b)	State and municipal bond interest is generally not subject to Federal income tax unless the bonds are used to build facilities leased to private businesses ("industrial development bonds"). Some types of nontaxable industrial development bonds are allowed, however, if used for such public purposes as sewage disposal plants, parking lots, airports, sports arenas, etc. Pollution control facilities and residential housing are shown elsewhere; the rest are included here.
Exemption of credit union income	100	IRC sec. 501(c)(14)	Credit unions are not subject to the Federal corporation income tax.
Excess bad debt reserves of financial institutions	855	IRC secs. 585, 593, 596, and various IRS rulings	Banks and savings and loan associations are allowed to deduct as additions to their reserves for bad debts a percentage of their outstanding loans (or, for mutual institutions, a percentage of net income). For commercial banks this deduction is slowly being phased out, and by 1988 they must compute the deduction based on their own loss experience, the way other businesses do now.

Tax expenditure	Estimated cost Fiscal Year 1980 ($ millions)	Authority	Description
-COMMERCE AND HOUSING CREDITS (cont.)-			
Deductibility of mortgage interest on owner-occupied homes	9,290	IRC sec. 163	Taxpayers who itemize deductions may deduct the interest they pay on their mortagages.
Deductibility of property taxes on owner-occupied homes	6,615	IRC sec. 164	Taxpayers who itemize deductions may deduct the property taxes on their homes.
Deductibility of interest on consumer credit	2,945	IRC sec. 163	Taxpayers who itemize deductions may also deduct the interest they pay on any other nonbusiness debt (auto loans, credit cards, etc.).
Expensing of construction period taxes and interest	700	IRC secs. 163, 164, 189	Interest and taxes paid while a building is under construction may be treated as current expenses (by corporations) or amortizable expenses (by individuals), rather than capitalized and depreciated like other construction costs.
Excess first-year depreciation	185	IRC sec. 179	Taxpayers may take a deduction for depreciation of up to 20 percent of $10,000 worth of machinery

			and equipment in the first year of use in addition to their regular depreciation for the year.
Depreciation on rental housing in excess of straight line	350	IRC sec. 167(j)	Residential rental property may be depreciated by accelerated methods for tax purposes, although straight-line depreciation is considered the normal method for buildings.
Depreciation on buildings (other than rental housing) in excess of straight line	255	IRC sec. 167(j)	New nonresidential rental property may be depreciated by limited accelerated methods for tax purposes; straight-line depreciation is considered normal for buildings.
Asset depreciation range	3,030	IRC sec. 167(m); IR Reg. 1.167(a)-11; Rev. Proc. 72-10	The Internal Revenue Service has established classes of assets with assigned useful lives to use in computing the depreciation deduction; the ADR system allows taxpayers to arbitrarily choose lives up to 20 percent shorter than the assigned lives, thus accelerating their depreciation deductions.
Capital gains (other than farming, timber, iron ore, and coal)	10,775	IRC secs. 1201-1254	Gains on the sale of capital assets held for longer than a year may be taxed at lower rates than other income. Corporations may compute their tax on all capital gains at a rate of 28 percent if

Tax expenditure	Estimated cost Fiscal Year 1980 ($ millions)	Authority	Description
- - - - - - - - - - - - -COMMERCE AND HOUSING CREDITS (cont.)- - - - - - - - - - - - -			
Capital gains (other than farming, timber, iron ore, and coal) (cont.)			this reduces their taxes; individuals accomplish the rate reduction by excluding 60 percent of their gains from taxable income.
Deferral of capital gains on home sales	1,010	IRC sec. 1034	Profits from the sale of a taxpayer's principal residence are not taxed if the money is reinvested in another residence of equal or greater value.
Capital gains at death	10,005	IRC secs. 1014, 1015, 1023	When property that has appreciated in value is transferred by gift or inheritance, the accumulated gain is not subject to income tax, as it would have been had the property been sold.
Reduced corporation income tax rates on first $100,000 of corporate income	7,075	IRC sec. 11	The normal corporation income tax is considered a proportional (single-rate) tax imposed at the highest marginal rate. The lower rates on the first $100,000 of income create a tax expenditure.

Investment credit (other than for TRASOPs and rehabilitated structures)	18,460	IRC secs. 38, 46-50	Businessmen may take up to 10 percent of the cost of machinery and equipment as a credit against their income tax. The extra credit for employee stock purchases (TRASOPs) and the limited credit for buildings are included elsewhere in this list.
Investment credit for rehabilitated structures	180	IRC sec. 48(g)	The Revenue Act of 1978 extended the 10 percent investment credit to rehabilitation expenditures for nonresidential commercial buildings at least 20 years old.
Exclusion of interest on State and local housing bonds	820	IRC sec. 103(b)(4)(A)	One type of industrial development bond on which the interest is still nontaxable is that used to finance residential construction; see the general discussion of industrial development bonds above.
- - - - - - - - - - -TRANSPORTATION- - - - - - - - - - -			
5-year amortization on railroad rolling stock	-40	IRC sec. 184	Before 1976, railway cars could be amortized over a 5-year period instead of being depreciated. Some of this equipment is still producing income; if it had been subject to normal depreciation its owners' taxes would have been higher in earlier years and would have been $40 million lower in 1980.

Tax expenditure	Estimated cost Fiscal Year 1980 ($ millions)	Authority	Description
---TRANSPORTATION (cont.)---			
Deferral of tax on shipping companies	70	46 U.S.C. 1177	Shipowners are allowed a tax deduction for deposits into a special reserve fund used to acquire additional or replacement ships.
---COMMUNITY AND REGIONAL DEVELOPMENT---			
5-year amortization for rehabilitation of low-income housing	15	IRC sec. 167(k)	Expenditures for rehabilitating low-income rental housing may be amortized over a 5-year period rather than depreciated over the useful life of the property.
---EDUCATION, TRAINING, EMPLOYMENT, AND SOCIAL SERVICES---			
Exclusion of scholarship and fellowship income	365	IRC sec. 117	Scholarships and fellowships are not included in taxable income.
Parental personal exemption for students aged 19 or over	1,020	IRC sec. 151(e)	The $1,000 personal exemption that parents are allowed for dependent children normally ends when the child reaches age 18 if the child has gross income of $1,000 or more; however, if the child is a full-time student the parent may continue to claim the exemption.

Exclusion of employee meals and lodging	350	IRC sec. 119	Meals and lodging furnished employees on the employer's premises for the convenience of the employer are not taxable income to the employee.
Exclusion of contributions to prepaid legal service plans	20	IRC sec. 120	Employers' contributions to prepaid legal service plans for their employees and the benefits their employees receive from the plans are not included in the employees' taxable income.
Investment credit for employee stock ownership plans (TRASOPs)	450	IRC secs. 46(a)(2), 48(n)	Corporations are allowed an additional 1 or 2 percent investment credit (in addition to the normal 10 percent) if they contribute an equivalent amount of their stock to a trust for their employees. This provision was added to the law by the Tax Reduction Act of 1975; "TRASOP" stands for Tax Reduction Act Stock Ownership Plan. The official acronym is now "ESOP"--Employee Stock Ownership Plan.
Deductibility of charitable contributions (education)	1,150	IRC sec. 170	Within certain limits, individuals who itemize deductions and corporations may deduct contributions to educational institutions and organizations.

Tax expenditure	Estimated cost Fiscal Year 1980 ($ millions)	Authority	Description
------- EDUCATION, TRAINING, EMPLOYMENT, AND SOCIAL SERVICES (cont.) -------			
Deductibility of charitable contributions to other than education and health	6,405	IRC sec. 170	Within certain limits, individuals who itemize deductions and corporations may deduct contributions to charitable, religious, scientific, veteran, and amateur sports organizations and institutions; to societies for the prevention of cruelty to animals or children; to Federal, State, and local governments; and to fraternal organizations for charitable uses.
Maximum tax on personal service income	1,625	IRC sec. 1348	The maximum tax rate on "earned" income--wages and self-employment income--is 50 percent, although the statutory rate on investment and other "unearned" income can be as high as 70 percent.
Credit for child and dependent care expenses	705	IRC sec. 44A	A credit of up to $400 for one dependent or $800 for two or more dependents is allowed to individuals and couples who maintain households for dependent children or disabled dependents and must pay for their care in order to work.

Credit for employment of AFDC recipients and public assistance recipients under work incentive programs	160	IRC secs. 40, 50A, 50B	Taxpayers who employ recipients of Aid to Families with Dependent Children or other public assistance may receive a credit for up to $6,000 of wages paid to each such employee. For nonbusiness taxpayers the credit is 35 percent of the first year's wages; for business taxpayers it is 50 percent of the first year's wages and 25 percent of the second year's wages.
General jobs credit	215	IRC secs. 44B, 51-53	For taxable years 1977 and 1978, employers could claim a credit for a part of their additional payroll if they had expanded their work force.
Targeted jobs credit	480	IRC secs. 44B, 51-53, 6501(q)	Employers may take a credit for a percentage of the wages paid in the first 2 years of employment to employees from certain groups, such as public assistance recipients; disadvantaged youths, Vietnam era veterans, and convicts; vocational rehabilitation referrals; and cooperative education students.
Employer educational assistance	30	IRC sec. 127	Education provided or paid for by an employer for an employee is not included in the employee's taxable income; the tax expenditure arises from education that is not "job related."

Tax expenditure	Estimated cost Fiscal Year 1980 ($ millions)	Authority	Description
-HEALTH-			
Exclusion of employer contributions for medical insurance premiums and medical care	9,595	IRC secs. 105, 106	Neither the contributions that employers make to accident and health plans for their employees nor the benefits the employees receive from such plans are taxable to the employees.
Deductibility of medical expenses	3,120	IRC sec. 213	Individuals who itemize deductions may deduct large medical bills (generally the excess over 3 percent of their adjusted gross income) and a portion of their medical insurance premiums.
Expensing of costs of removing architectural and transportation barriers to the handicapped	Less than 2.5	IRC sec. 190	Taxpayers may treat expenses incurred in removing barriers to the handicapped as current deductions rather than capitalizing them.
Deductibility of charitable contributions (health)	1,415	IRC sec. 170	Within certain limits, individuals who itemize deductions and corporations may deduct contributions to charitable, educational, and scientific institutions and organizations concerned with health.

INCOME SECURITY

Item	Amount	Legal authority	Description
Exclusion of social security benefits:		Various IRS rulings	Social security benefits are not subject to Federal income tax.
Disability insurance benefits	735		
OASI benefits for retired workers	6,430		
Benefits for dependents and survivors	940		
Exclusion of railroad retirement benefits	305	45 U.S.C. 231m	Under the Railroad Retirement Act of 1974, most benefits are nontaxable.
Exclusion of workmen's compensation benefits	1,285	IRC sec. 104(a)(1)	Workmen's compensation benefits are nontaxable.
Exclusion of special benefits for disabled coal miners	50	IRC sec. 104(a)(1); Revenue Ruling 72-400	Payments for death or disability due to black lung disease are not taxable.
Exclusion of unemployment insurance benefits	1,935	IRC sec. 85	Unemployment compensation is generally not taxable unless adjusted gross income exceeds $20,000 for a single individual or $25,000 for a married couple filing jointly.

Tax expenditure	Estimated cost Fiscal Year 1980 ($ millions)	Authority	Description
-INCOME SECURITY (cont.)-			
Exclusion of public assistance benefits	395	Various IRS rulings	Welfare payments are not taxable.
Exclusion of disability pay	150	IRC sec. 105(d)	Retired individuals under age 65 who are permanently and totally disabled may exclude up to $5,200 a year of their disability pay. The exclusion is phased out for adjusted gross incomes of over $15,000 a year.
Net exclusion of pension contributions and earnings: Employer plans	12,925	IRC secs. 401-407, 410-415	Employees are not taxed on the amounts their employers contribute to retirement plans or on the income the contributions earn until the employee withdraws the money.
Net exclusion of pension contributions and earnings: Plans for self-employed and others	2,205	IRC secs. 219, 220, 401-405, 408-415	Self-employed individuals and employees not covered by employer-paid pension plans may deduct limited amounts contributed to their own retirement plans. The income the contributions earn is not taxed until the money is withdrawn.

Exclusion of other employee benefits: Premiums on group term life insurance	915	IRC sec. 79	Employers may buy up to $50,000 of group term life insurance coverage for an employee and the employee will not be taxed on the premiums.
Exclusion of other employee benefits: Premiums on accident and disability insurance	80	IRC sec. 106	Employer-paid premiums on accident and accidental death insurance policies for employees are not taxable income to the employees.
Exclusion of other employee benefits: Income of trusts to finance supplemental unemployment benefits	10	IRC sec. 501(c)(17)	The earnings of trusts established to finance supplemental unemployment benefits are not taxed to the employees until they receive payments from the trust.
Exclusion of interest on life insurance savings	2,720	IRC sec. 101(a), IR Reg. 1.451-2	Most life insurance policies, except term insurance, earn investment income for the policyholder, because the premiums are invested and a part of the earnings are used to pay for the cost of insurance or to increase the policy benefits. If the policyholder dies, none of the earnings are subject to income tax; if the policyholder cashes in the policy while living, the part of the earnings used to pay for insurance is never taxed and the tax on the remainder is deferred from the year the income was earned to the year the policy is redeemed.

Tax expenditure	Estimated cost Fiscal Year 1980 ($ millions)	Authority	Description
-INCOME SECURITY (cont.)-			
Exclusion of capital gains on home sales for persons aged 55 and over	535	IRC sec. 121	Taxpayers aged 55 and over are allowed to exclude from taxable income up to $100,000 of the gain on one sale of a principal residence.
Additional exemption for the elderly	1,855	IRC sec. 151(c)	An additional personal exemption of $1,000 is allowed for a taxpayer who is aged 65 or over.
Additional exemption for the blind	35	IRC sec. 151(d)	An additional personal exemption of $1,000 is allowed for a taxpayer who is legally blind.
Deductibility of casualty losses	475	IRC sec. 165(c)(3)	Individuals who itemize deductions may deduct the excess over $100 of each nonbusiness loss due to fire, storm, shipwreck, other casualty, or theft.
Tax credit for the elderly	160	IRC sec. 37	Individuals who are aged 65 or older are allowed a small tax credit, reduced if they have tax-exempt retirement income or if their adjusted gross income exceeds $7,500 a year ($10,000 for a joint return). A credit is

			also allowed to persons receiving payments from a public retirement system who are under age 65.
Earned income credit: Nonrefundable portion	350	IRC sec. 43	Wage-earners and self-employed taxpayers who maintain households for dependent children receive a tax credit equal to 10 percent of up to $5,000 of earned income, reduced as income increases until it is phased out at $10,000. The credit is "refundable," meaning that if the credit is greater than the taxpayer's liability for the year, the difference is paid directly. This item includes only the portion that reduces taxes; the "refundable" portion is a direct outlay ($1,874 million in 1980).
- - - - - - - - - - - - - - -VETERANS' BENEFITS AND SERVICES- - - - - - - - - - - - - -			
Exclusion of veterans' disability compensation	1,005	38 U.S.C. 3101	All benefits paid by the Veterans Administration are tax-exempt.
Exclusion of veterans' pensions	55		
Exclusion of GI bill benefits	170		

Tax expenditure	Estimated cost Fiscal Year 1980 ($ millions)	Authority	Description
-GENERAL GOVERNMENT-			
Credits for political contributions	100	IRC sec. 41	Individuals are allowed a tax credit of 50 percent of the amount contributed for up to $100 given to political parties and candidates.
-GENERAL PURPOSE FISCAL ASSISTANCE-			
Exclusion of interest on general purpose State and local debt	5,880	IRC sec. 103	The interest on State and local government obligations is generally exempt from Federal income tax.
Deductibility of nonbusiness State and local taxes (other than on owner-occupied homes)	12,450	IRC sec. 164	Individuals who itemize deductions may deduct State and local income, personal property, and general sales taxes. Homeowners' property taxes are included elsewhere in this listing.
Tax credit for corporations doing business in U.S. possessions	730	IRC sec. 936	Corporations doing business in Puerto Rico or other U.S. possessions, except the Virgin Islands, may credit the tax owed on any income earned in the possessions against their Federal income tax, thereby exempting such income from U.S. tax.

- - - - - - - - - - - - - - - - - - - -INTEREST- -

Deferral of interest on savings bonds	625	IRC sec. 454	Interest on U.S. savings bonds is not taxable until the bonds are cashed in.

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Two types of background materials are also included. One is articles dealing with "comprehensive income" (Haig-Simons income), included because of the importance of comprehensive income in the development of the tax expenditures idea. The other is a few articles by tax practitioners (lawyers and accountants) on methods of sheltering income from tax by the judicious use of some tax expenditure provisions.

* * *

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This report analyzes the effect of several tax expenditures on business competition.

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Wolfman, Bernard. "Federal Tax Policy and the Support of Science." University of Pennsylvania Law Review, vol. 114 (1965), pp. 171-86.

One of the earliest statements of the tax expenditures concept, which the author calls "tax preferences." He suggests budgeting them and reviewing them periodically.

Wright, L. Hart. "Carter's Projected 'Zero-Based' Review of the Internal Revenue Code: Is Our Tax Code to be 'Born Again'?" Michigan Law Review, vol. 75 (1977), pp. 1286-1317.

Contains a good discussion (pp. 1302-07) of how tax expenditures are enacted.

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