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Subcommittee on Federal Financial Management, Government Information, and International Security

Deconstructing the Tax Code: Uncollected Taxes and Issues of Transparency

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Mr. Chairman and Members of the Subcommittee, thank you for inviting me to discuss the concept of a tax expenditure data base and its relationship to the issue of tax transparency.

I would like first to address the issue: "What is tax transparency?" Tax transparency is an attribute of the tax system. It does not mean exposing taxpayers' incomes, business dealings, and tax liabilities to public scrutiny by publishing everyone's tax return.

Transparency means adopting a tax system based on sensible principles that are widely understood and agreed upon; that results in a measure of taxable income that corresponds to the real incomes of the taxpayers; and that permits simple, straightforward calculations of tax liabilities that are crystal clear to taxpayers and tax enforcers. A transparent tax system would be simple, would measure income correctly, and would treat all income and all taxpayers alike. It would put to rest suspicions that some people were not paying what they owed, and end the envy that one taxpayer feels when he is not eligible for a tax provision that benefits his neighbor.

Each taxpayer would have to apply that set of tax rules to his or her income, and pay the resulting tax liability. The tax returns and tax payments, however, would not be public. The tax law and tax rules would be transparent and manifest to everyone, not the incomes, business arrangements, and tax payments of the taxpayers.

Federal tax law, Section 6103 of the U.S. Code, requires that the IRS protect taxpayer privacy, and the IRS has very strict policies to enforce that legal mandate. The Statistics of Income division of the IRS compiles considerable data on incomes, filing status, and the use of various provisions in the tax code. The raw information, that is, the actual "tax file", is available only to employees of the IRS and the Treasury's Office of Tax Policy, and to employees of the Joint Tax Committee.

Tax file data is authorized by law to be shared with a limited number of other Federal agencies in a protected manner. Such data is shared only in a form that has been carefully "scrubbed" (organized in large enough subgroups or income classes) to protect the identity of the taxpayers. (See the chapter by Nick Greenia and Mark Mazur, "IRS Data, Data Users, and Data Sharing", in *Improving Business Statistics Through Interagency Data Sharing*, National Research Council of the National Academies, National Academy Press, Washington, D.C., 2006.)

Data reported in the "public use file" on the individual income tax that is made available to private sector researchers is even more carefully organized. This is done so that researchers cannot work back from the data to determine the incomes and tax filings of any individual. There is no comparable "public use file" for corporations, the data for which are reported with even fewer identifying characteristics. The far smaller number of businesses, and the availability of other public information they are required to release, would make it too easy to use disaggregated IRS data to determine information on a single taxpayer.

Would a tax expenditure data base improve tax transparency? No. Estimates of tax expenditures are already published by the Treasury, the Joint Committee on Taxation, and the Ways and Means Committee in print and on the web. The Treasury tables are also presented in the Analytical Perspectives volume of the Budget of the United States Government. These sources list tax expenditure provisions and estimate the aggregate number of users (individuals and corporations) and the dollars involved.

Could a tax expenditure data base by individual or by business be constructed? Going into more detail on tax expenditures would be expensive and difficult. It is one thing to use a sample of tax returns to estimate the use of tax provisions considered to be tax expenditures. It is quite another to examine every return and identify and publish which specific taxpayers use them and the dollar amounts saved by each filer. Such an effort would involve considerable cost for the IRS.

Furthermore, a more detailed presentation would run into serious privacy concerns. The law pertaining to taxpayer privacy, Section 6103 of the U.S. Code, would have to be revisited. Pursuant to that section, the IRS does not reveal tax information that could be traced back to an identifiable taxpayer. For example, the IRS will not release figures in any cell or class of taxpayer on deductions, exclusions, or credits unless there are at least three beneficiaries nationally or ten within a state.

The IRS relies on a high level of voluntary compliance by taxpayers to enable it to enforce and administer the tax system. A high level of compliance depends to a considerable degree on taxpayers' trust that their tax returns will remain confidential. There would be considerable and very justified resistance to removing the privacy protections by taxpayers and tax administrators.

Many provisions listed as tax expenditures involve the calculation of a deduction from taxable income, or a credit against tax. A taxpayer's worksheets are not reported on the tax returns, only the resulting adjustment to income or tax. Tracking the specific provision and amount by taxpayer would involve greatly expanded reporting requirements for individuals and businesses.

The aim of a data base would be to highlight tax provisions that are clearly unwarranted favoritism toward a small group of taxpayers. Under House and Senate rules, such "rifle shot" tax breaks are currently supposed to be identified before the bills are voted upon. Once enacted, it is difficult for the IRS to determine which taxpayers are using the provisions, unless they show up in an audit. It is really the responsibility of the Congress to avoid crafting such provisions in the first place.

A more basic question is "What is a tax expenditure?" A tax expenditure is defined in the law as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability." They achieve objectives that might otherwise have been handled by government spending or regulation.

That may look simple, but tax expenditures are harder to deal with in practice than the definition might suggest. I have offered as a written submission IRET Policy Bulletin 84, *The*

End of Tax Expenditures As We Know Them?, by Bruce Bartlett, which we published in 2001. It discusses the history of tax expenditures, the difficulty in measuring them, and the conceptual problems of determining what is and what is not a tax expenditure when there is widespread disagreement on the nature of the ideal tax system. I have also made available to the Subcommittee copies of IRET Fiscal Issue 6, *Tax Expenditures: A Critical Appraisal*, which favors using a saving-consumption neutral tax as the baseline (a.k.a. consumed-income, or consumption-based tax).

The concept of what is a tax expenditure varies with one's view of the ideal tax system. What constitutes "special" treatment, and what is or is not a tax expenditure, depends critically on what is regarded as regular treatment under the tax system. The Analytical Perspectives report tax expenditures under two income tax baselines. Since the Fiscal Year 2004 Budget, it has also provided a very different list of tax expenditures as measured against a neutral or consumed-income tax concept.

Let me give some examples. In the pure "Haig-Simons" income tax, there would be no double taxation of corporate income, which would be attributed to the shareholders. Anything now listed as a corporate-related tax expenditure would disappear under that definition, and the corporate tax itself would become a "negative" tax expenditure. Capital gains and the imputed income from owner-occupied housing would be taxed as accrued. Deferral of the tax on capital gains would be considered a tax expenditure. However, inflationary gains and the inflation element of interest would be excluded from interest income and from interest deductions, and depreciation would be inflation-adjusted. Failure to adjust for inflation, as in the current tax system, would result in "negative" tax expenditures on the inflation component of capital gains, interest income, and depreciation, and a tax subsidy on interest deductions.

The income tax we have today deviates from the original Haig-Simons precepts. The Treasury reports tax expenditures under the "normal tax baseline" and the "reference tax law baseline". Each accepts the corporate income tax and the deferral of taxes on unrealized capital gains as normal, and not, respectively, as either a negative or a positive tax expenditure. The reduced tax rates on dividends and capital gains offset some of the double taxation of corporate income, and are part of the move toward a more neutral consumption-based system; they are not considered tax expenditures by the Treasury.

The normal baseline brands more provisions as tax expenditures, because the reference tax law accepts as a natural starting point some of the features of the tax law that deviate from the purer version of the income tax. The normal baseline counts the lower tax rates applied to married versus single filers as tax expenditures, while the reference baseline does not. The normal baseline counts the lower than maximum corporate tax rates as a tax expenditure, while the reference baseline does not. The normal baseline regards accelerated depreciation beyond "economic depreciation" as a tax expenditure, but the reference baseline does not. Exemption of government cash transfer payments is a tax expenditure under the normal baseline, but not under the reference baseline.

The personal exemption and the standard deduction are considered normal in both methods, and are not listed as tax expenditures. The exclusion of income from owner-occupied housing is not considered a tax expenditure, but, as a consequence, the deduction of mortgage interest is. The exclusion of health care premiums on employer-provided insurance is considered a tax expenditure. The arbitrary nature of these assumptions is obvious. The Joint Tax Committee classifies a few items differently from the Treasury.

The differences are even greater when compared to a consumption-based tax. Pension arrangements and IRAs are considered tax expenditures under the income tax baselines. Under a consumed-income or saving-consumption neutral tax, all saving would normally receive pension or IRA treatment. In that system, the extra tax on ordinary saving under the income tax would be regarded as excess taxation, and would be branded a "negative" tax expenditure.

Treasury reports other differences under a consumption-based concept. In my view, it is a much superior table, but not perfect. Treasury regards state and local government services as consumption, and calls the deduction of state and local taxes a tax expenditure. Yet most state and local outlays are either investment in human capital (education) leading to higher taxable income for individuals, or transfer payments to persons who should be subject to tax. These ought to be deductible by the taxpayers.

These examples only scratch the surface of the differences one finds as concepts of the ideal tax system vary. Another issue relates to measurement. As the Special Analyses chapter points out, any change in the tax law regarding the tax expenditure provisions would lead to substantial changes in taxpayer behavior. In addition, the presence of many tax expenditure provisions means that the revenue associated with any one of them is affected by the existence of the others. The numbers also vary whenever the level of the basic tax rates is altered. The present value of a tax expenditure, considering its pattern over time, may be very different from the current year figure. All the numbers associated with these provisions must be taken with a grain of salt.

In conclusion:

Tax expenditures are generally fairly broadly available. They are not typically the "rifle shot" special interest benefits that would be comparable to earmarks on the spending side of the budget. (I offer no support to the rifle shot provisions.)

Tax expenditures are often deliberate and well-crafted offsets to the relatively heavy tax burden imposed by the income tax on income from capital. They are partial steps toward a consumption base. There is nothing wrong with moving in that direction. In fact, the income base is so detrimental to capital formation, productivity, and wages that many economists regard the neutral tax base alternatives as clearly superior.

Some tax expenditures are bad tax policy, but listing all tax expenditures by beneficiary, even if it were possible to do so, would offer no guidance as to which ones ought to be repealed.

Tax expenditure provisions are part of the tax code. Using them is not tax evasion. The provisions are not part of the "tax gap" from non-compliance.

A tax expenditure data base akin to the earmark and grant data base is not a sound concept, nor a workable idea.