Increasing Transparency and Accountability for Tax Expenditures

Jason Furman[1]
Non-Resident Senior Fellow, Center on Budget and Policy Priorities &
Visiting Scholar, New York University Wagner Graduate School of Public Service

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Mr. Chairman and other members of the Committee, thank you for the invitation to address you today. And thank you for S. 2590, the Federal Funding Accountability and Transparency Act of 2006. As Senator Coburn has said, "This public database will provide transparency to federal spending and will provide an important weapon taxpayers can use to hold the government accountable."

I urge this Committee to build upon its good work by extending the principles of accountability and transparency to what are referred to as "tax expenditures." The creation of a spending database only increases the importance of making tax expenditures transparent. Exposing spending proposals to public scrutiny, while continuing to leave the public largely in the dark about targeted tax proposals, could create an environment in which spending proposals that will not withstand scrutiny get transformed into tax proposals.

To avoid creating such an environment, this Committee may want to consider taking three steps:

1. Requiring government agencies to provide more detail about tax expenditures, including their magnitude and distribution across states, incomes, industries, and budgetary functions.[2]

2. Subjecting tax expenditures to the same performance and evaluation processes as spending proposals, including procedural reviews that apply to outlay programs.[3]

3. Extending the searchable internet database established by the Federal Funding Accountability and Transparency Act of 2006 to cover more tax expenditures, going beyond the Treasury and the Joint Committee on Taxation's (JCT) current practice of listing major entities that directly benefit from targeted tax expenditures. This information should be easily accessible through the same

[1] The views expressed in this testimony are mine alone.
[2] For more detail see the recommendations of the Century Foundation Working Group on Tax Expenditures, *Bad Breaks All Around*, Century Foundation Press, New York: 2002.
[3] For more detail see the recommendations of the Government Accountability Office, "Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined," GAO-05-690, September 2005.

internet search engine that will be established pursuant to the Federal Funding Accountability and Transparency Act of 2006.

As the Government Accountability Office recently warned, “although tax expenditures are substantial in size, little progress has been made in the Executive Branch to increase the transparency of and accountability for tax expenditures.”[4] Unless this situation is remedied, the Federal Funding Accountability and Transparency Act of 2006 will leave the public partially in the dark about the budgeting process and taxpayers will be unable to hold their government fully accountable.

In my testimony I will make five points to expand on the important of increasing transparency and accountability for tax expenditures.

<u>First, the government allocates hundreds of billions of dollars annually through “tax expenditures”</u>

One of the principal activities of government is *allocating* resources by taxing and spending. The government accomplishes this both in the process of raising revenues and in the process of spending. For example, if the government wants to allocate resources towards the production of $1 billion worth of tanks it could appropriate the money and pay a weapons supplier $1 billion in exchange for tanks. Alternatively, it could enact a $1 billion “weapons supplier tax credit” and provide it to a defense contractor in exchange for the delivery of $1 billion worth of tanks. Although our government accounting system treats these two exchanges differently – recording one as a spending increase and the other as a tax cut – they are essentially the same.

Similarly, the child tax credit could be converted into a spending program that mails $1,000 checks to families with children that meet the income eligibility requirements. Or Social Security could be converted into program that provides refundable tax credits to senior citizens and other beneficiaries. In either case, the allocation and distribution of resources would be the same as under current law even though the budget would record the child tax change as an increase in taxes and spending and the Social Security change as a reduction in taxes and spending.

In recognition of this parallelism, the United States has adopted a statutory definition of “tax expenditures” as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability.”[5] The concept of “tax expenditures” is also widely accepted among economists, lawyers and other policy analysts. For example, in testimony before the Entitlement Commission in 1994, then Federal Reserve Chairman Alan Greenspan urged the committee to address both what he called “tax entitlements” and spending entitlements in addressing the nation’s long-term fiscal problems.

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[4] GAO *op cit*.
[5] Public Law 93-344, The Congressional Budget Act of 1974.

The Office of Management and Budget and JCT regularly release itemized reports on tax expenditures. In the last budget the Treasury listed a total of $911 billion of tax expenditures in FY 2006, including $807 billion for individuals and $104 billion for corporations.[6] This total approaches the total amount of discretionary spending ($1,025 billion in FY 2006) and mandatory spending ($1,418 billion in FY 2006).

Second, like normal expenditures, "tax expenditures" require higher taxes or reduction in other government spending

If the government approves a new $1 billion spending project it will have two choices: raise taxes to pay for the project or cut other spending. (Borrowing postpones but does not alter these choices: the government will have to repay the debt by raising taxes or by cutting government spending.)

The financing choices for a new $1 billion tax expenditure are identical: the government will have to raise taxes on everyone who is not specially favored by the tax expenditure or cut other spending.

To return to the earlier example, if Congress appropriates $1 billion in spending for builders of tanks, it could raise taxes to pay for this expenditure, cut spending on, say, schools, or postpone the decision by borrowing the money. If the Congress enacts a $1 billion weapons supplier tax credit the choices are identical. "Tax expenditures" are just as much "spending taxpayers money" as fiscal expenditures through the normal budget process.

In fact, if, for example, $500 billion worth of tax expenditures were eliminated that would permit a 36 percent reduction in all individual and corporate income tax rates. Economists generally presume that a tax code with a broader base and lower rates will be more efficient and conducive to economic growth.

Third, tax expenditures raise additional concerns for fiscal policy

Tax expenditures raise additional issues beyond their fiscal cost including:

- *Creating the perception or reality of unfairness*. Tax expenditures can contribute to the perception or reality of unfair discrimination between taxpayers with similar abilities to pay.

- *Adding complexity*. Tax expenditures are an important part of the reason that the Internal Revenue Code runs to more than 6,000 pages, making filing taxes an unnecessarily complicated and burdensome process;

[6] Note that these totals are indicative of the extent of tax expenditures but are not an estimate of the revenue that would be raised by repealing these tax expenditures because they ignore behavioral effects and the interaction of tax expenditures with other provisions in the tax code and other tax expenditures.

- *Disguising the true size of government.* The proper measure of the size of government is the degree to which it allocates and redistributes resources.[7] Tax expenditures are responsible for allocating and redistributing substantial amounts of resources, yet they are accounted for as reductions in government revenues rather than increases in government outlays. As a result, although tax expenditures increase the government's intervention in the market economy the most common measure of the size of government records them as a reduction in the size of government.

- *In some cases, outlays may be more efficient than tax expenditures.* As GAO explains, "In some circumstances, tax expenditures may not be the best policy choice to deliver timely benefits or reach intended populations."[8] For example, college aid may be delivered in a more timely and targeted fashion through Pell grants than through tax credits.

- *Reducing fiscal flexibility.* Tax expenditures, like entitlements, automatically provide benefits year after year. Unlike many outlay entitlements, tax expenditures do not even require reauthorization or any formal process to ensure that they are still serving their function.

Fourth, tax expenditures should receive the same scrutiny as government outlays.

Even though targeted tax expenditures have virtually the same impact as outlays on our federal budget and impose other impediments to sound fiscal policymaking, under current law they receive substantially less scrutiny than spending. Tax expenditures are not incorporated into the main budgetary tables prepared by the Office of Management and Budget (OMB) or the Congressional Budget Office (CBO). Even such basic data like the total size or distribution of tax expenditures by budgetary function is not currently available. Tax expenditures are not subject to annual budget reviews, periodic reauthorizations, or other tools of budgetary evaluation.

The Federal Funding Accountability and Transparency Act of 2006 will increase the scrutiny of government outlays still further. If the government spends $1 billion purchasing tanks, the public will have easy internet access to the names of the entities receiving the payments, the amount of the award, and other related information. If the government enacts a $1 billion weapons supplier tax credit the public has just as great an interest in knowing which entities are receiving the payment, the amount of the award and other related information, but under current law it is difficult to uncover that information.

The passage of this act *increases* the importance of extending transparency and accountability to tax expenditures. By increasing the scrutiny of spending programs the Act increases the incentive to shift spending for pet projects and entities to the tax side of the ledger. That way these projects or entities could evade the level of scrutiny that spending programs will

[7] Daniel Shaviro, "The New Age of Big Government," *Regulation*, Spring 2004.
[8] GAO, *op cit.*

receive. And if allocations for pet projects and entities is shifted to the tax side of the ledger, the tax code will grow even longer and more complicated.

Take H.R. 4520, The American Jobs Creation Act of 2004. It ran to 297 pages and included dozens of special tax breaks targeted at individual entities or small groups of entities that were not explicitly specified in the legislation. For example, the act "extended placed in service date for bonus depreciation for certain aircraft (excluding aircraft used in the transportation industry) ppisa [properly placed in service after] 9/10/01."[9] The provision, which cost more than $247 million of the taxpayers' money, reportedly was designed to benefit only one company: General Electric.

I have no personal judgment as to whether this particular provision was warranted or not. But it is my strong personal judgment that the public has a right to know about how much this provision costs and which company or companies benefit from it. I am not claiming that the $911 billion in yearly tax expenditures are all wasteful or inappropriate. I am merely saying that their costs and beneficiaries ought to be known to the public. This is equally true whether a given tax expenditure assists only one entity or thousands of entities.

<u>Fifth, attempts to increase transparency and accountability for tax expenditures should be mindful of concerns about privacy and other issues not faced by government outlays</u>

One of my main recommendations – that the reporting of tax expenditures be extended to list the entities that benefit from them – raises some complications, but no insurmountable impediments. Some of the important issues to address include:

- *Privacy*. Americans are compelled to file tax forms. They are not compelled to apply for government grants. Thus there is an asymmetry between disclosing information about tax expenditures and information about grants. But this asymmetry should not be exaggerated. Spending also faces important privacy concerns that were successfully addressed in the Federal Funding Accountability and Transparency Act of 2006 by exempting individual recipients of Federal assistance (e.g., Social Security and food stamp beneficiaries) and government employees. A similar approach could be applied to taxes. Disclosing any individual tax expenditures, like medical deductions or mortgage interest deductions, would be a gross violation of privacy that would be contrary to the public interest. But our society accepts – and often requires – a certain level of financial disclosure by businesses. Entity-level reporting could be limited to business tax expenditures. This reporting could be further limited either to: (1) provisions that target benefits to a narrowly defined class of entities, (2) only entities with benefits from tax expenditures that exceed a specific dollar amount, like $100,000, or (3) the top, say, 25 entities receiving each tax expenditure.

- *Ambiguity in the definition of tax expenditures*. There is some ambiguity in the definition of tax expenditures, whether an item represents a deviation from a broad-based tax or is part of administering that tax. This ambiguity, however, has not prevented Treasury or

[9] Joint Committee on Taxation, JCX-69-04, October 4, 2004.

JCT from itemizing tax expenditures. Moreover, most of the tax expenditures targeted specifically at individual entities or modest numbers of entities are amenable to relatively uncontroversial definition.

- *Ambiguity in the measurement of tax expenditures.* There is also some ambiguity in the measurement of tax expenditures, particularly when considering the interaction of a variety of tax provisions. These ambiguities, however, are routinely overcome in compiling aggregate tax expenditures. Moreover, the calculated benefit — tax reduction — for the entities that receive a tax expenditure represent a useful piece of information for the public, even if tax economists could argue that the total budgetary cost is somewhat different from the benefit calculated by beneficiaries.

- *Access to the information required to compute tax expenditures*. Finally, the government already has a number of systems for tracking grant recipients. The Federal Funding Accountability and Transparency Act of 2006 merely requires the government to organize these data in a form that is accessible by the public. No such system is in place for tax expenditures. Thus there could be larger difficulties in compiling these data at the entity level, including a longer lag time between the tax expenditure and its recognition and inclusion in the database by the Internal Revenue Service (IRS). The restrictions discussed to protect privacy would also reduce the burden on the IRS of compiling a database on tax expenditures.

In conclusion, the basic principle should be to treat tax expenditures like other expenditures

The basic principle that should guide policymakers in approaching tax expenditures is parallelism: whenever possible tax expenditures should be subject to the same level of scrutiny, transparency and accountability as outlays. As Senator Lautenberg has said, "the American people deserve to know who is paying less in taxes and causing them to pay more. They have a right to know who is getting benefits from Congress."

This is especially important because if one major part of the government's fiscal system remains opaque it will undermine the broader intent of the Federal Funding Accountability and Transparency Act of 2006 — ensuring that the public is able to hold government accountable for its fiscal actions.

Failure to treat outlays and tax expenditures in a parallel manner could create pressure to transform spending programs into targeted tax entitlements, which receive less oversight. This will add to the existing pressure to rely on tax expenditures, whose popularity has grown in recent years, complicating the tax code and masking the true "size of government" as measured by the extent of its interference in the economy.

But applying the principle of parallelism will require balancing privacy and feasibility. Treasury and the IRS could both play an important role in developing options for increasing the transparency of tax expenditures. Some of those steps – such as reporting more data on the extent and distribution of tax expenditures – are relatively straightforward. Others will be more complicated. But exposing the specific entities that benefit from tax entitlements to the sunshine of public scrutiny is a goal which is well worth this Committee's attention.