

The New Old Tax Expenditure Debate, Part 2

C. Eugene Steuerle

**"Economic Perspective" column reprinted with permission.
Copyright 2002 TAX ANALYSTS**

Document date: June 10, 2002

Released online: June 10, 2002

The nonpartisan Urban Institute publishes studies, reports, and books on timely topics worthy of public consideration.

The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders.

© TAX ANALYSTS. Reprinted with permission.

Increasingly over the past few decades the tax code has become the tool of choice for those who would use the government to try to influence private behavior. Budget principles call for making transparent the resources that are used in this government involvement in the economy. Requiring the government to account for its actions is one means of achieving this transparency and really should be considered neutral as to whether policy choices are good or bad.

Once budget numbers are displayed, however, they are only seldom used in a neutral manner. Almost any government policy has some costs involved with it, and opponents of those policies will continually point to those costs -- just as advocates will point to the benefits. Indeed, budget identification of costs has always been opposed by those who want to hide what is going on, and are, in this respect, not different from tax subsidies direct expenditures. By the same token, those who oppose programs often mention budgetary costs as one reason for their opposition.

The recent attack on tax expenditures is partly over substance, but it is also partly a reaction to the way that they were used in tax and budget battles early in the history of their development. The income tax, it must be remembered, grew along with the size of government in the first half of the 20th century. Proponents of what was then called progressive policy tended to push simultaneously for both more government and higher levels of income tax collection. Opponents of larger government often found themselves opposed to larger income tax collections.

This early history and division into pro- and anti-government camps still dominates thinking about the income tax, even though it belies later history and the developments over the past few decades. In particular, the growth in government in almost every industrial state over the past half century is not associated with further growth in income taxes, but rather the growth in flat rate taxes like the Social Security tax and the value-added tax.

The tax expenditure concept came into fruition between this early stage of income tax growth and the later stage of relatively flat income tax collections. The idea of tax expenditures was not entirely new but followed from a long-running economic critique of government. That critique, accepted by both conservative and liberal economists, suggested that special tax breaks tended to cause tax rates to be too high, thereby creating distortions both as taxpayers moved toward preferred activities and as they reacted negatively to the higher tax rates that resulted from the erosion of the tax base. But when used in the early period by those with liberal tendencies, the critique was applied almost solely to the first type of distortion. That is, the liberal critics accepted the argument that tax breaks often distorted choices in favor of preferred items of consumption or investment, but they seldom suggested that the elimination or paring of tax breaks should be used to finance tax rate reduction. Instead, the hint was that the additional revenues could be used to support some other expenditure programs.

Stanley Surrey is given much of the credit for bringing tax expenditures explicitly into the federal budget. Surrey, who was Assistant Secretary of the Treasury for both Presidents Kennedy and Johnson, favored terms like "normal" tax to refer to the tax base from which deviations would be measured. He believed that if an income tax was to tax income, then that is what it should do -- and not allow exceptions to that tax base (other than what was effectively a zero rate bracket created by personal exemptions and standard deductions). In a sense, he thought that each tax had its own normal base -- for the corporate tax, for instance, it was corporate income.

Early in my career I wrote an article on tax expenditures for health care and made the observation that if

government wished to tax individuals on the basis of their ability-to-pay, a case could be made for defining the tax base to be something like income less extraordinary medical expenditures. Like many others who dared mention any deviation from what he considered to be a pure income tax, I received a letter from Surrey indicating that exceptions like this did not belong in the tax code.

Surrey got around some more difficult issues through his concept of what was "normal." Thus, his tax expenditure list did not include all exceptions to what economists would view as a tax base that represented real economic income. For instance, the return from owning (as opposed to renting) durable goods and housing was never counted as a tax expenditure, but only the interest deductions and property taxes associated with such items. This is not to suggest that it makes sense to tax that income, only that economists would say there is non-taxable income derived from ownership of housing and durable goods, regardless of whether there was any debt owed on those assets. Surrey would say it wasn't part of the "normal" tax base. I found it hard simply to engage him on issues like extraordinary medical expenses and income from durable goods because he really did imply that "normal" was a norm.

But none of these limitations denies the soundness of the intuition that it is possible to account for tax provisions that resemble direct expenditures. Surrey's agenda, indeed, was in many ways a conservative one -- good budget accounting and opposition to expenditures, albeit expenditures put into the tax system. But he served the Kennedy and Johnson administrations, which had an expansionist view of government. Hence, when proponents of tax expenditure accounting opposed various tax expenditures, it was often to raise revenues to finance other parts of government. However, let's not attribute too much consistency to political developments in the 1960s. The Kennedy and Johnson administrations often supported new tax expenditures, including the investment tax credit that was adopted as part of what was argued to be a Keynesian stimulus package.

One additional factor tended to identify early opposition to tax expenditures with a liberal agenda. A few decades ago tax expenditures were much more likely to reduce business and capital income taxes than today. Moreover, on the individual side of the ledger, they were largely in the form of deductions or exclusions rather than credits. The amount of deduction or exclusion taken by taxpayers usually rises with the income of the individual, as does the tax rate that is avoided. Hence, tax expenditures came to be viewed as reducing progressivity. One can again debate this point: on the direct spending side, items like Social Security are not viewed as regressive simply because larger amounts are paid to higher income taxpayers. After all, those taxpayers still can pay more in tax than they get in benefits. But forget about theory; at the time, tax expenditures were often argued to be regressive.

The arguments developed in this blooming stage of the tax expenditure budget have been fought over and over again like the verbal battles over the Civil War that stretched well into the 20th century. As we shall see, however, history would soon play its usual tricks on advocates on both sides.

Other Publications by the Authors

- [C. Eugene Steuerle](#)

Usage and reprints: Most publications may be downloaded free of charge from the web site and may be used and copies made for research, academic, policy or other non-commercial purposes. Proper attribution is required. Posting UI research papers on other websites is permitted subject to prior approval from the Urban Institute—contact publicaffairs@urban.org.

If you are unable to access or print the PDF document please [contact us](#) or call the Publications Office at (202) 261-5687.

Disclaimer: *The nonpartisan Urban Institute publishes studies, reports, and books on timely topics worthy of public consideration. The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders. Copyright of the written materials contained within the Urban Institute website is owned or controlled by the Urban Institute.*

Source: The Urban Institute, © 2012 | <http://www.urban.org>