

Some Background

TAX EXPENDITURES

Why are tax expenditures controversial?

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A. To some, tax expenditures are spending items that do not belong in the tax code. To others, they are merely a way of reducing taxes, and repealing them would amount to a tax increase.

Most tax expenditures perform very much like spending programs, which means they may serve or harm the public depending on whether they serve a legitimate public purpose in the most efficient manner possible. But the identification and measurement of tax expenditures are controversial.

Subsidies and expenditures in the form of tax breaks reduce the measure of net tax revenue instead of increasing measured spending. Thus, they give the appearance of reducing government's size. For this reason, tax subsidies have strong political appeal. In fact, tax expenditures are an alternative way for government to intervene in the economy and, like direct spending, must be financed through higher taxes or reduced spending elsewhere.

Imagine, for instance, a new government program that provides tax credits for energy production at a cost of \$5 billion per year, and finances it by raising income tax rates. To pay for the energy tax credit, the government would have to raise tax rates enough to collect an additional \$5 billion—no different than what it would need to do if the subsidies for energy production were provided by a US Department of Energy grant instead of by tax credits.

Here's the conceptually tricky part: tax expenditures are defined as deviations from a baseline tax system. In the example above, it is straightforward to see the equivalence between an energy tax credit and a spending program. Often, however, the definition and estimated magnitude of tax expenditures are a matter of judgment because what belongs in the baseline tax system reflects the judgment of analysts.

Since the government began regular reporting of tax expenditures in the 1970s, the baseline against which tax expenditures are measured generally has been a version of a comprehensive income tax. But there have always been exceptions, often for income that is difficult to assess. For example, income often, but not always, has been counted only when realized, so that the deferral or exclusion from tax for unrealized capital gains is not counted as a tax expenditure, but some forms of deferral of receipts by business are. Also, the US Department of the Treasury, but not the congressional Joint Committee on Taxation (JCT), includes net imputed rental income from homeownership in its baseline used for estimating tax expenditures.

If the current income tax were replaced wholly or partly by a consumption tax, as some economists and political leaders favor, some provisions now classified as tax expenditures would no longer be regarded as such. For example, under a comprehensive consumption tax system, the tax base would be consumption, not income. Thus, the deferral of earnings contributed to retirement savings accounts and the exemption of income earned within those accounts would not be considered tax expenditures. Most other tax

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expenditures, however, including the deductibility of home mortgage interest, charitable contributions, and state and local taxes, as well as the exemption of employer contributions to health insurance plans, would still be so classified.

In other cases, estimating the size of a tax expenditure requires some judgment. For example, under an income tax, firms can recover the costs of capital investment over time with depreciation deductions that reflect the decline in the value of their assets. But what is the right measure of depreciation in an inflationary economy? For these and other items, the JCT and the Treasury use different definitions of what would be included in a normal or comprehensive income tax. Therefore, their classification and measurement of some tax expenditures differ.

In addition, estimates by the Office of Management and Budget and the JCT can differ from each other depending upon when the two estimates were prepared. A special case occurred in 2018, when the JCT estimates (published in May 2018) included the effects of the 2017 Tax Cuts and Jobs Act, while the Office of Management and Budget estimates (published in February 2018, but based on Treasury estimates first released in October 2017) did not include changes from the act.

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Further Reading

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