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An Analysis of the Tax
Expenditure Budget

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Introduction

The tax code contains many provisions, commonly referred to as tax expenditures, which resemble direct spending. They provide an exception to the normal income tax by granting specific taxpayers a reduction in their tax liabilities.¹ The provisions are enacted for a variety of objectives, including “measuring income accurately, distributing fiscal benefits and burdens based on a household’s ability to pay, and promoting activities or behavior that are considered socially desirable.”² Oftentimes, the same objective can be accomplished through either a direct expenditure or a tax expenditure. This article seeks to analyze the differences between both forms of spending, including the congressional process for enacting and repealing the expenditures, the administration of the expenditures, and the legal review that the expenditures are subject to. Further, this article will discuss whether tax expenditures are an effective means of accomplishing legislative priorities and present potential reforms that would improve the use of tax expenditures.

Background

Defining Tax Expenditure

Tax expenditures arise from new tax provisions or regulations that provide a benefit to taxpayers through a reduction in their tax liabilities.³ The Congressional Budget and Impoundment Control Act of 1974 first defined tax expenditures as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction

¹ See JOINT COMMITTEE ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2015-2019 2 (2015), <https://www.jct.gov/publications.html?func=startdown&id=4857>.

² *Tax Expenditures: What are they and how are they structured?*, TAX POLICY CENTER, <http://www.taxpolicycenter.org/briefing-book/background/shelters/expenditures.cfm>.

³ JOINT COMMITTEE ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2015-2019 2 (2015), <https://www.jct.gov/publications.html?func=startdown&id=4857>.

from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.”⁴ As made clear in the definition, tax expenditures come in many different forms:

- An exclusion omits from taxation a source of income that would otherwise be taxed.⁵ Example: Municipal bond interest is excluded from taxable income.
- An exemption “reduces gross income for taxpayers because of their status or circumstances.”⁶ Example: Parents can claim an exemption for children between the ages of 19 and 23 who are full-time students.⁷
- A deduction “reduces gross income due to expenses taxpayers incur.”⁸ Example: Homeowners can take a deduction for mortgage interest paid on up to two residences.
- A credit “reduces tax liability dollar-for-dollar.”⁹ Certain tax credits are refundable, where the taxpayer receives a cash refund even where the credit exceeds the taxpayer’s liability.¹⁰ Example: The earned income tax credit is a popular refundable credit that reduces the tax liability for low-income, working individuals.
- A preferential rate lowers the tax rate for certain sources of income.¹¹ Example: Income from stock dividends and capital gains is taxed at a preferential rate.
- A deferral of tax liability “delays recognition of income or accelerates some deductions otherwise attributable to future years.” Example: Tax deferral is allowed for like-kind exchanges, where a taxpayer exchanges one asset held for trade or business or investment for another asset of like kind.

History of Tax Expenditures

In the 1960s, Stanley Surrey, then-Assistant Secretary of the Treasury, was one of the first to notice the similarities between tax preferences and direct expenditures.¹² Surrey believed there were two elements of tax expenditures, where “[t]he first element contains the structural provisions necessary to the application of a normal income tax, such as the definition of net income; the specification of accounting periods; and the determination of the entities subject to

⁴ Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, 88 Stat. 299.

⁵ *Tax Expenditures*, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, http://www.gao.gov/key_issues/tax_expenditures/issue_summary.

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

¹² *A Brief History on Tax Expenditures*, TAX FOUNDATION, <http://taxfoundation.org/article/brief-history-tax-expenditures>.

tax, the rate schedule and exemption levels” and “[t]he second element consists of the special preferences found in every income tax.”¹³ Surrey concluded that “these departures from the normative income tax structure essentially represent government spending for the favored activities or groups made through the tax system rather than through direct grants, loans, or other forms of government assistance.”¹⁴ He believed the political process could be improved if tax provisions were subject to the same reviews as spending programs.¹⁵

Surrey’s concept of tax expenditures was resisted by many from the beginning, including the Nixon administration.¹⁶ Some did not appreciate how the concept undermined political support for tax preferences, and others questioned whether tax expenditures could be accurately identified and measured.¹⁷ Additionally, some opposed the implication that all resources are property of the government, and the decision not to tax is an expenditure on behalf of the individual.¹⁸ Despite resistance, the first tax expenditure budget was published by Treasury in 1967.¹⁹ Congress further addressed tax expenditures in the Congressional Budget and Impoundment Control Act of 1974 (“1974 Act”). The 1974 Act created the Congressional Budget Office, which was directed to provide the House Budget Committees with information on the federal budget, including on tax expenditures. The mandated reports included annual reports on “the levels of tax expenditures under existing law,” five-year fiscal projections of the “estimated levels of tax expenditures by major functional categories,” and reports on proposed

¹³ Stanley S. Surrey, *The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 B. C. L. Rev. 679, 680 (1976).

¹⁴ *Id.*

¹⁵ *The End of Tax Expenditures as we Know Them?*, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION 1, <http://iret.org/pub/BLTN-84.PDF>.

¹⁶ *Id.* at 2.

¹⁷ *Id.*

¹⁸ *Id.* at 8.

¹⁹ OFFICE OF TAX ANALYSIS, U.S. TREASURY DEPARTMENT, *THE TAX EXPENDITURE BUDGET BEFORE AND AFTER THE TAX REFORM ACT OF 1986* 2 (1988), <https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/ota60.pdf>.

legislation providing an increase or decrease in tax expenditures.²⁰ Surrey viewed the equivalent treatment of tax expenditures and direct expenditures in the 1974 Act as a “major advance both for those concerned with budget efficiency and for those concerned with tax equity.”²¹

Congress attempted to rein in the number of tax expenditures in the Tax Reform Act of 1986 (“1986 Act”) by repealing some provisions and scaling back others.²² The substantial decreases in marginal tax rates further reduced the value of the tax expenditures for taxpayers.²³ The Treasury estimated the 1986 Act led to a 40% reduction in tax expenditures.²⁴ The limits on tax expenditures proved short-lived, however, as Congress began increasing the number of tax expenditures in the late 1990s.²⁵ The graph below shows that the value of tax expenditures, as a percentage of both federal revenue foregone and GDP, has trended upwards over the past two decades.²⁶ The graph utilizes data from the Joint Committee on Taxation, which did not provide estimates of tax expenditures for 2007 and 2013.²⁷

²⁰ Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, 88 Stat. 297–339 (1974).

²¹ Surrey, *supra* note 13, at 725.

²² Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085 (1986); OFFICE OF TAX ANALYSIS, THE TAX EXPENDITURE BUDGET BEFORE AND AFTER THE TAX REFORM ACT OF 1986, at 1.

²³ *Id.*

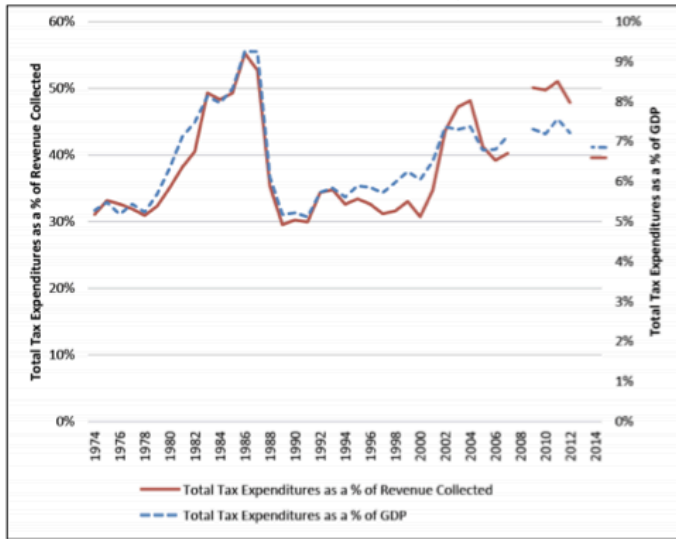
²⁴ *Id.* at 1–2.

²⁵ JOINT COMMITTEE ON TAXATION, BACKGROUND INFORMATION ON TAX EXPENDITURE ANALYSIS AND HISTORICAL SURVEY OF TAX EXPENDITURE ESTIMATES 16 (2011), <https://www.jct.gov/publications.html?func=startdown&id=3740>.

²⁶ Donald J. Marples, *Tax Expenditures: Overview and Analysis*, CONGRESSIONAL RESEARCH SERVICES 7, <https://www.fas.org/sgp/crs/misc/R44012.pdf>.

²⁷ *Id.*

Total Tax Expenditures as a Percentage of Federal Revenue and Gross Domestic Product (GDP), 1974 -2014



Source: CRS analysis of Joint Committee on Taxation (JCT) documents.

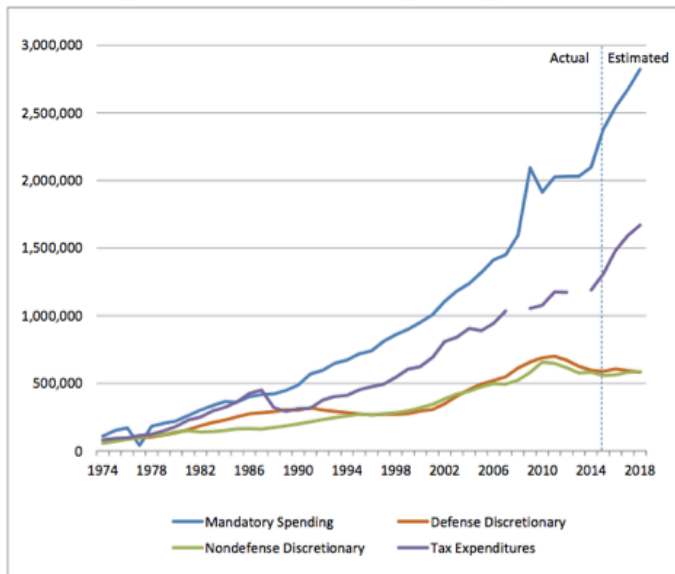
Notes: The JCT did not produce tax expenditure estimates for 2007 and 2013.

The following graph, utilizing data from both the Joint Committee on Taxation and the Office of Management and Budget, shows the value of tax expenditures since 1974 in current dollars, in comparison with the value of mandatory, defense discretionary, and nondefense discretionary spending.²⁸ Tax expenditures have increased at a rate faster than both categories of discretionary spending, but slow than that of mandatory spending.²⁹

²⁸ *Id.* at 8.

²⁹ *Id.*

Tax Expenditures and Federal Spending, 1974 - 2018



Source: CRS analysis of Office of Management and Budget (OMB) and Joint Committee on Taxation (JCT) documents.

Note: All tax expenditure figures are estimates.

Calculating Tax Expenditures

Each year, Congress’s Joint Committee on Taxation (“JCT”) and the Treasury Department’s Office of Tax Analysis publish separate tax expenditure estimates.³⁰ The Office of Management and Budget (“OMB”) utilizes the Treasury’s estimates in the Annual Perspectives volume published along with the Budget of the United States Government.³¹ The Congressional Budget Office also publishes a variety of reports incorporating estimates of tax expenditures and detailing the distribution of such expenditures among taxpayers.³²

Though tax expenditure estimates will be similar among the offices, the estimates will differ due to the judgment that is necessarily required in determining which provisions constitute

³⁰ *Tax Expenditures: What is the tax expenditure budget?*, TAX POLICY CENTER, <http://www.taxpolicycenter.org/briefing-book/background/expenditures/budget.cfm>.

³¹ *Id.*

³² *Major Recurring Reports*, CONGRESSIONAL BUDGET OFFICE, <https://www.cbo.gov/about/products/RecurringReports#15>.

tax expenditures.³³ The OMB views a tax expenditure as “an exception to baseline provisions of the tax structure that usually results in a reduction of the amount owed.”³⁴ Thus, whether something is a tax expenditure depends on what constitutes a baseline provision. The more comprehensive the definition of income is for the baseline, the more exceptions to the baseline there will be.

OMB’s tax expenditure budget identifies tax expenditures using two baseline concepts. The normal tax baseline is “a practical variant of a comprehensive income tax, which defines income as the sum of consumption and the change in net wealth in a given period of time.”³⁵ The reference tax baseline is also based on a comprehensive income tax but results in fewer tax expenditures, as “expenditures are limited to special exceptions from a generally provided tax rule that serve programmatic functions in a way that is analogous to spending programs.”³⁶ Both baselines allow for tax rates, standard deductions and personal exemptions that vary by income and marital status, deduction of expenses incurred in earning income, and a separate corporate income tax.³⁷ The normal tax baseline differs from the reference baseline in that it does not include variation in the corporate tax rate so any variances from the maximum rate constitute expenditures, it includes cash transfer payments from the government to private individuals in gross income, and it considers accelerated depreciation a tax expenditure, among other things. Expenditures from both methods, however, are included in OMB’s official listing of tax expenditures.

JCT’s method differs in some regards. For example, JCT has some additional tax

³³ OFFICE OF MANAGEMENT AND BUDGET, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2017 226,

https://www.whitehouse.gov/sites/default/files/omb/budget/fy2017/assets/ap_14_expenditures.pdf.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.* at 226–27.

expenditures as a result of the more comprehensive income tax baseline, JCT excludes expenditures that result in revenues losses below \$50 million as opposed to OMB's \$5 million threshold, and its calculations are based on the economic forecast prepared by the CBO rather than the administration's forecast.³⁸ Additionally, JCT measures each tax expenditure as the difference between the tax liability under current law and the tax liability if the law was repealed and the taxpayer takes advantage of the next best deduction.³⁹ OMB, in comparison, does not take into account the next best deduction a taxpayer could take advantage of following a repeal.⁴⁰ Lastly, since the House of Representatives adopted H.Res.5 in 2015, JCT has an obligation to incorporate macroeconomic effects when providing estimates for major tax legislation.⁴¹ OMB is not subject to a similar requirement to utilize dynamic scoring. The chart below details many of the differences between the tax expenditure budgets published by JCT and OMB.⁴²

³⁸ JCT, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2015-2019, at 18–19.

³⁹ *Id.* at 18.

⁴⁰ *Id.*

⁴¹ H.Res.5 (2015).

⁴² JCT, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2015-2019, at 18–19; OMB, ANALYTICAL PERSPECTIVES, at 225–227; *Calculating Retirement Tax Expenditures: 2010*, SCHWARTZ CENTER FOR ECONOMIC POLICY ANALYSIS 3, http://www.economicpolicyresearch.org/images/docs/retirement_security_background/Calculating_Retirement_Tax_Expenditures.pdf.

Elements of Budget	Joint Committee on Taxation	Treasury (Utilized by OMB)
Period	Covers a 5-year period, beginning with the current fiscal year.	Covers an 11-year period, beginning with the last fiscal year.
<i>De Minimis</i> Amount	Excludes provisions resulting in revenue losses less than \$50 million over 5 years.	Rounds estimates to the nearest \$10 million and excludes provisions rounding to 0.
Data Sources	Calculations based on CBO's economic forecast.	Calculations based on Administration's economic forecast.
Baseline	Normal.	Normal and reference.
Measurement	Difference between the tax liability under current law and the tax liability if the law was repealed and the taxpayer takes advantage of the next best deduction.	Difference between the tax liability under current law and the tax liability if the law was repealed and the taxpayer was prohibited from taking advantage of the next best deduction.
Examples of Variations	Tax expenditures include cash accounting by certain businesses.	Tax expenditures include exceptions to passive loss rules and imputed income from owner-occupied homes.

Though there are some variances between the JCT and OMB estimates, both agencies provide reliable and useful information on tax expenditures. This paper focuses on OMB's estimates, however, because the agency makes more data available online.

Finally, it is important to note that the tax expenditure budgets published by OMB and JCT measure only the exceptions from the federal income tax imposed on both individuals and corporations.⁴³ Because the 1974 Act only requires the inclusion of federal income tax expenditures, the various exceptions to employment taxes, excise taxes, gift taxes, and estate taxes, for example, are excluded.⁴⁴

⁴³ JCT, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2015-2019, at 3 (2015).

⁴⁴ *Id.*

Current Tax Expenditure Budget

The tax expenditure budget in OMB's Analytical Perspectives for Fiscal Year 2017 includes over \$1.351 trillion of income tax expenditures for 2015.⁴⁵ In comparison, total discretionary outlays for 2015 were \$1.169 trillion and mandatory outlays were \$2.296 trillion.⁴⁶ Though the value of tax expenditures does not exceed the funding for discretionary and mandatory expenditures, tax expenditures clearly constitute a substantial portion of total expenditures.

Tax expenditures can provide benefits both to corporations and individual households. The corporate income tax expenditures amount to \$143 billion, while the individual income tax expenditures amount to \$1.208 trillion.⁴⁷ These estimates reveal that individual income tax expenditures make up over 89% of the value of all tax expenditures.⁴⁸

The largest individual income tax expenditure for 2015, totaling \$201.45 billion, was the exclusion of employer contributions for medical insurance premiums and medical care.⁴⁹ Though most benefits provided by the employer are taxed to the employee as compensation, an employer's contributions to health care on behalf of the employee are not. This results in tax savings to the employee totaling the cost of the employer contributions multiplied by the employee's marginal tax rate. The second largest tax expenditure is the exclusion of net imputed rental income, at \$97.920 billion.⁵⁰ The OMB believes that under the baseline tax system, "the

⁴⁵ OFFICE OF MANAGEMENT AND BUDGET, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2017, Tables 14-1 to 14-4 Tax Expenditures, https://www.whitehouse.gov/omb/budget/Analytical_Perspectives. Note the OMB does not total the tax expenditures in the Analytical Perspectives due to the interactive effects that the provisions may have. OMB, ANALYTICAL PERSPECTIVES, at 225. The totals were calculated, for the purposes of this paper, using the data in the Analytical Perspectives excel spreadsheet.

⁴⁶ OMB, ANALYTICAL PERSPECTIVES, at 396.

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ OMB, ANALYTICAL PERSPECTIVES, at 241.

⁵⁰ *Id.* at 239.

taxable income of a taxpayer who is an owner-occupant would include the implicit value of gross rental income on housing services earned on the investment in owner-occupied housing.”⁵¹

Because the tax code excludes the implicit rental income, the value is included as a tax expenditure. This is a more controversial tax expenditure, which JCT has not included in its tax expenditure budget for administrative reasons.⁵² Other large individual tax expenditures include the preferential rates for capital gains and dividends, deduction for mortgage interest, exclusion of contributions and earnings from retirement plans, deduction for charitable contributions, capital gains exclusion on sale of home, exclusion of interest on public purpose state and local bonds, child credit, lifetime learning credit, etc.⁵³

The largest corporate tax expenditure, totaling \$64.56 billion, is the deferral of income from controlled foreign corporations.⁵⁴ This tax expenditure is related to the provision of the tax code that allows deferral of income for foreign corporations controlled by U.S. shareholders until the U.S. shareholders receive distributions.⁵⁵ Other important corporate tax expenditures include the deduction for U.S. production activities, accelerated depreciation on certain types of property, exclusion of interest on public purpose state and local bonds, and the credit for low income housing investments.⁵⁶

Tax Expenditures vs. Direct Expenditures

Often, both direct expenditures and tax expenditures can be utilized to accomplish the same legislative goal. For example, if Congress wishes to encourage investment by state and

⁵¹ *Id.* at 252.

⁵² JCT, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2015-2019, at 5.

⁵³ OMB, ANALYTICAL PERSPECTIVES, at 238–242.

⁵⁴ *Id.* at 233.

⁵⁵ *Id.* at 246.

⁵⁶ *Id.* at 233–237.

local governments, it could either give the governments a direct grant for investment or it could subsidize the governments' borrowing costs through exclusion of municipal bond interest from taxable income. If Congress wishes to make school more affordable for students, it can provide the students or universities with direct grants, or can offer students a credit for qualifying education costs. Finally, if Congress wishes to assist low-income families, Congress can provide families with food stamps each month, or can increase the value of the earned income tax credit.

Though direct expenditures and tax expenditures can accomplish similar goals, they also differ in significant ways. Differences include the congressional process for enacting and repealing the expenditures, the administration of the expenditures, and judicial review of the expenditures. This section will discuss the positive and negative aspects of these differences between tax expenditures and direct expenditures.

Congressional Budget Process

Role of Congressional Committees

The process of drafting and enacting tax expenditures differs significantly from the process for direct expenditures. Proposals for new tax expenditures, like all tax legislation, must originate in the House Ways and Means Committee, the committee responsible for dealing with tax matters in the House of Representatives.⁵⁷ After the Committee drafts the legislation, the House votes on it.⁵⁸ Following the passage of the bill in the House, the Senate Finance Committee, responsible for dealing with tax matters in the Senate, considers and potentially revises the legislation, and then the Senate votes on the legislation.⁵⁹ Thus, the responsibility for enacting tax legislation lies with just one committee in the House and one committee in the

⁵⁷ *Writing and Enacting Tax Legislation*, U.S. DEPARTMENT OF THE TREASURY, <https://www.treasury.gov/resource-center/faqs/Taxes/Pages/writing.aspx>.

⁵⁸ *Id.*

⁵⁹ *Id.*

Senate. In contrast, direct spending programs are generally subject to a two-step process in both the House and the Senate. First, the House and Senate legislative committees, with jurisdiction over particular programs and agencies, must enact authorizing legislation that creates or continues the program.⁶⁰ Second, House and Senate Committees on Appropriations must enact an appropriations bill that provides funds for the program.⁶¹ Each appropriations committee has 12 subcommittees, with each subcommittee having jurisdiction over the funding for specific departments and agencies.⁶²

Whereas direct expenditures are considered in the legislative committees and appropriation subcommittees that have jurisdiction over specific agencies and subject-matter expertise with regard to those agencies, tax expenditure legislation is considered in committees that focus more generally on tax matters. Professor Kleinbard, referring to the tax committees as a “Congress within a Congress,” argues that the increasing use of tax expenditures has resulted in increasing power for the tax committees.⁶³ The tax committees are able to enact revenue-neutral legislation that both raises revenues through traditional taxes and then spends revenues through tax subsidies.⁶⁴ Kleinbard expressed concern that in converting direct spending initiatives into tax expenditures, the substantive committees with the subject matter expertise “do not supervise how tax subsidies are designed or spent; they do not track the efficacy of the tax programs; they do

⁶⁰ Bill Heniff Jr., *Overview of the Authorizations-Appropriations Process*, CONGRESSIONAL RESEARCH SERVICE, 1 (2012), <https://www.fas.org/sgp/crs/misc/RS20371.pdf>.

⁶¹ *Id.*

⁶² Jessica Tollestrup, *The Congressional Appropriations Process: An Introduction*, CONGRESSIONAL RESEARCH SERVICE 1 (2014), <http://www.senate.gov/CRSReports/crs-publish.cfm?pid=%260BL%2BP%3C%3B3%0A>. The 12 subcommittees are: (1) Agriculture, Rural Development, Food and Drug Administration, and Related Agencies; (2) Commerce, Justice, Science, and Related Agencies; (3) Defense; (4) Energy and Water Development, and Related Agencies; (5) Financial Services and General Government; (6) Homeland Security; (7) Interior, Environment, and Related Agencies; (8) Labor, Health and Human Services, Education, and Related Agencies; (9) Legislative Branch; (10) Military Construction, Veterans Affairs, and Related Agencies; (11) State, Foreign Operations, and Related Programs; and (12) Transportation, Housing and Urban Development, and Related Agencies. *Id.*

⁶³ Edward Kleinbard, *The Congress Within the Congress: How Tax Expenditures Distort our Budget and Our Political Processes*, 36 OHIO N. L. REV. 1, 18 (2010).

⁶⁴ *Id.* at 18.

not necessarily coordinate that spending with their own spending; and, they even have lost the ability to argue that their priorities should be preferred over those reflected in the tax legislation.”⁶⁵ Thus, the substantive appropriations committees are unable to exercise the control over spending that was arguably intended for them.

One benefit, however, of this changing power dynamic is that the tax committees may develop tax legislation that serves a broader interest than legislation developed by a specific substantive committee.⁶⁶ Moreover, the tax committees may develop higher quality legislation if they are not captured by private interests to the extent the substantive committees are.⁶⁷ Despite these potential benefits, Kleinbard recommends reforming the legislative process so “that the tax-writing committees not be permitted to take up a tax subsidy measure without referral from the relevant authorization committee with substance-matter jurisdiction.”⁶⁸

Structure of Tax Legislation

Direct expenditures can be structured as discretionary spending, in which all programs are subject to the annual appropriations process, or mandatory spending, in which the programs are automatically funded without being reviewed each year.⁶⁹ The majority of spending programs are discretionary and thus must be reviewed annually.⁷⁰ Tax expenditures, in contrast, are typically enacted through permanent legislation.⁷¹ Like mandatory spending, tax expenditures are generally not subject to the yearly appropriations process or annual reviews.⁷² Additionally,

⁶⁵ *Id.* at 19.

⁶⁶ *Id.* at 25.

⁶⁷ *Id.* at 26.

⁶⁸ *Id.* at 29.

⁶⁹ George K. Yin, *Temporary-Effect Legislation, Political Accountability, and Fiscal Restraint*, 84 N.Y.U. L. REV. 174, 183 (2009).

⁷⁰ *Id.*

⁷¹ Allen Schick, *The Federal Budget: Politics, Policy, Process* 172 (3d ed. 2007).

⁷² *Id.*

as is the case with mandatory spending, tax expenditures usually do not have a fixed cost.⁷³ Tax subsidies are typically open to all individuals that meet the eligibility requirements, meaning the cost of the expenditure is dependent on both the number of eligible individuals and the amount of revenue forgone by each.⁷⁴ This feature of tax expenditures could make it difficult to identify and constrain the costs of the benefits in the future, especially in comparison to discretionary spending which is reconsidered annually.

Tax expenditures enacted through permanent legislation will remain in place unless Congress alters them through reconciliation or ordinary revenue legislation.⁷⁵ Due to the permanent nature of tax expenditures though, JCT has found that once they are enacted, they tend to remain in place.⁷⁶ Demonstrating this point, of the 128 tax expenditures reported for 1998, 100 of those tax expenditures were still in effect in 2006.⁷⁷ The permanent nature of tax expenditures could be a benefit where the expenditure is effective. The problem arises where a tax expenditure is ineffective, yet difficult to repeal. Professor Yin argues for enacting more temporary-effect legislation, that is reviewed annually or contains a sunset provision, for example, rather than permanent legislation, in order to promote greater political accountability and potentially increased fiscal restraint.⁷⁸ The Government Accountability Office has also expressed concern about the lack of scrutiny applied to tax expenditures, and has recommended periodic reviews to ensure tax expenditures are effectively accomplishing the goals for which they were created.⁷⁹

⁷³ Yin, at 184.

⁷⁴ *Id.*

⁷⁵ Schick, at 172.

⁷⁶ JCT, BACKGROUND INFORMATION ON TAX EXPENDITURE ANALYSIS AND HISTORICAL SURVEY OF TAX EXPENDITURE ESTIMATES, at 16.

⁷⁷ *Id.*

⁷⁸ Yin, at 253.

⁷⁹ U.S. GOVERNMENT ACCOUNTABILITY OFFICE, TAX EXPENDITURES: BACKGROUND AND EVALUATION CRITERIA AND QUESTIONS 1 (2012) <http://www.gao.gov/assets/660/650371.pdf>.

Finally, when tax legislation is drafted, it must be structured in accordance with general budget rules. For example, tax legislation is subject to PAYGO rules, which require any legislation that reduces revenues to be offset by reductions in spending or increases in revenue.⁸⁰ Kleinbard commented that the tax committees are easily able to satisfy PAYGO for the tax expenditures, by simply pairing the expenditures with the taxes that were otherwise going to be enacted.⁸¹ Schick found that PAYGO offset requirements lead to debate over how macroeconomic factors affect the cost of tax legislation and incentivize Congress to structure tax legislation so that the bulk of the revenue losses occur after the scoring period ends.⁸² As with all legislation, politicians will attempt to use budget rules and processes to their advantage when structuring tax expenditures.

Politics Surrounding Tax Expenditures

Tax expenditures are criticized both by liberals and conservatives. Liberals are concerned about the regressive nature of tax expenditures, while conservatives take issue with the concept's implication that an individual's income is the government's property.⁸³ Despite critiques on both sides of the aisle, tax expenditures remain a major component of federal spending. Perhaps this is a consequence of the procedural benefits discussed above, or the administrative and judicial benefits discussed below. In addition to those benefits, however, politicians are likely more apt to support tax expenditures because they can describe themselves as tax-cutters, while still providing a benefit to their constituents.⁸⁴

⁸⁰ Schick, at 167.

⁸¹ Kleinbard, at 18–19.

⁸² Schick, at 169–171.

⁸³ Schick, at 172.

⁸⁴ *Tax Expenditures: Spending By Another Name*, INSTITUTE ON TAXATION AND ECONOMIC POLICY 1, <http://www.itepnet.org/pdf/pb4exp.pdf>.

Administration

After the expenditures are enacted, differences exist between the ways in which direct expenditures and tax expenditures are administered. Direct federal spending programs are generally administered, in accordance with federal law, by the executive agency that received the appropriation for the specific program.⁸⁵ For example, the Supplemental Nutrition Assistance Program, a direct spending program that provides nutrition assistance to low-income individuals, is administered by the United States Department of Agriculture.⁸⁶ Head Start, a federal program that provides grants to organizations that provide schooling for children under the age of five, is a direct spending program that is administered by the U.S. Department of Health and Human Services.⁸⁷ In contrast, tax expenditures are general administered by the Internal Revenue Service (IRS), a bureau within the Department of Treasury, that is primarily responsible for collecting tax revenue.⁸⁸ For instance, the IRS is tasked with administering the individual mandate, including calculating the value of the health care subsidy that each individual receives, under the Affordable Care Act (“ACA”) of 2010.⁸⁹ The IRS must also implement the Foreign Account Tax Compliance Act of 2010 (“FATCA”), which targets noncompliance by U.S. taxpayers with money in foreign accounts through reporting requirements for individuals and foreign financial institutions.⁹⁰ As a final example, the IRS is responsible for administering and regulating the

⁸⁵ See Michelle D. Christensen, *The Executive Budget Process: An Overview*, CONGRESSIONAL RESEARCH SERVICE 6–7 (2012), <https://www.fas.org/sgp/crs/misc/R42633.pdf>.

⁸⁶ See *Supplemental Nutrition Assistance Program*, U.S. DEPT. OF AGRICULTURE, <http://www.fns.usda.gov/snap/supplemental-nutrition-assistance-program-snap>.

⁸⁷ See *Office of Head Start*, U.S. DEPT. OF HEALTH AND HUMAN SERVICES, <http://www.acf.hhs.gov/programs/ohs>.

⁸⁸ U.S. GOVERNMENT ACCOUNTABILITY OFFICE, *TAX EXPENDITURES: IRS DATA AVAILABLE FOR EVALUATIONS ARE LIMITED 1* (2013) <http://www.gao.gov/assets/660/654273.pdf>.

⁸⁹ Chuck Marr, Joel Friedman, & Brandon Debot, *IRS Funding Cuts Continue to Compromise Taxpayer Service and Weaken Enforcement*, CENTER FOR BUDGET AND POLICY PRIORITIES (2015), <http://www.cbpp.org/research/federal-tax/irs-funding-cuts-continue-to-compromise-taxpayer-service-and-weaken-enforcement>.

⁹⁰ *Id.*

nonprofit sector, as qualifying nonprofit organizations are exempt from corporate income tax.⁹¹ Naturally, the more Congress utilizes the tax code to accomplish legislative priorities, the greater the role the IRS will play in administering federal programs.

There are both pros and cons of the IRS administering federal programs rather than the executive agencies that have the subject-matter expertise. An important benefit of administering expenditures through the tax code is that the federal government does not need to create a new structure through which to disburse benefits.⁹² Individuals and business entities already report detailed financial information to the IRS annually, so the IRS can utilize this information to ensure the expenditure is benefiting only those individuals and entities that meet the statutory requirements.⁹³ Not only is this less burdensome and more cost-efficient for the government, but it could also be less burdensome for the taxpayers who can report the necessary information to just one agency, once annually. Moreover, it is possible that administering the benefits through the tax code could have the dual effect of incentivizing greater compliance with the tax code for those who are aware of the benefits, and enabling the benefits to reach more individuals than would otherwise be aware of them. For instance, some individuals may file a tax return in anticipation of receiving the earned income tax credit, while others will file without knowledge of the credit but will receive the benefit regardless. A final benefit of the IRS administering expenditures is that the IRS is an incredibly effective organization. The Treasury estimates that for every additional dollar that the IRS spent on enforcement, the IRS could increase revenue by

⁹¹ See *Tax Information for Charitable Organizations*, IRS, <https://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations>.

⁹² CONGRESSIONAL BUDGET OFFICE, *THE DISTRIBUTION OF MAJOR TAX EXPENDITURES IN THE INDIVIDUALS INCOME TAX SYSTEM 9* (2013) https://www.cbo.gov/sites/default/files/113th-congress-2013-2014/reports/TaxExpenditures_One-Column.pdf.

⁹³ See *id.*

\$4.⁹⁴ The agency's enforcement expertise could potentially lead to less abuse of the federal benefits.

There are also significant costs associated with the IRS administering federal expenditures rather than the executive agencies. First, the administrative agencies are far more specialized than the IRS and their subject-matter expertise could enable them to more easily administer and oversee the program.⁹⁵ As an example, the IRS currently oversees and audits the use of the mortgage interest deduction, which allows taxpayers to deduct the mortgage interest paid on up to two residences, with some limitations.⁹⁶ An argument could be made that the U.S. Department of Housing and Urban Development, which works to promote homeownership and increase access to affordable housing,⁹⁷ would be better suited than the IRS to subsidize the cost of home ownership for individuals or to audit individuals to ensure the reported interest deduction is in line with the value of their homes.

⁹⁴ Marr, *IRS Funding Cuts Continue to Compromise Taxpayer Service and Weaken Enforcement*, CBPP.

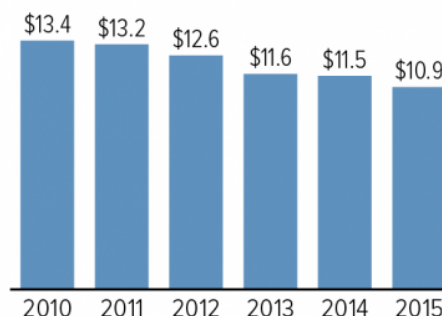
⁹⁵ CBO, *THE DISTRIBUTION OF MAJOR TAX EXPENDITURES IN THE INDIVIDUALS INCOME TAX SYSTEM*, at 9.

⁹⁶ See *Deducting Home Mortgage Interest at a Glance*, IRS, <https://www.irs.gov/Credits-&-Deductions/Individuals/Deducting-Home-Mortgage-Interest>.

⁹⁷ See *Hud's Vision*, U.S. DEPT. OF HOUSING AND URBAN DEVELOPMENT, <http://portal.hud.gov/hudportal/HUD?src=/hudvision>.

Another concern with the IRS administering federal expenditures is that the IRS may lack the resources to effectively administer the benefits and audit their use.⁹⁸ The IRS is currently faced with both increased responsibilities and decreased funding. Since 2010, the IRS has been tasked with implementing both FACTA and the ACA, managing the 5% increase in individual tax returns filed, dealing with the 700% increase in identify theft cases, and more.⁹⁹ Yet over the same period, IRS funding has been cut by 18%, as seen in the graph to the right.¹⁰⁰ These funding cuts have significantly impacted IRS operations, as demonstrated by the 14% decline in employees, slow call response times, and outdated information technology equipment.¹⁰¹

IRS appropriated funding in 2015 dollars, billions



Source: CBPP calculations based on Congressional Budget Office, Office of Management and Budget, and Bureau of Labor Statistics data

In November 2015, seven past IRS commissioners wrote a letter to the Committee on Appropriations in which they voiced concern over the past and proposed funding cuts to the IRS.¹⁰² The commissioners expressed frustration that over the last 25 years, Congress has “repeatedly added more and more socio-economic incentives to the tax code and called upon the IRS to administer these new socio-economic programs, including healthcare, retirements, social welfare, education, housing, and economic stimulus programs, none of which is related to the principal job of the IRS to collect revenue.”¹⁰³ These new programs have increased the workload for IRS employees and shifted the focus of the agency. Exemplifying this shift, both individual and business audit rates have fallen over the past decade and the enforcement staff has decreased

⁹⁸ CBO, THE DISTRIBUTION OF MAJOR TAX EXPENDITURES IN THE INDIVIDUALS INCOME TAX SYSTEM, at 9.

⁹⁹ Marr, *IRS Funding Cuts Continue to Compromise Taxpayer Service and Weaken Enforcement*, CBPP.

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² Letter from Former Commissioners of IRS to House and Senate Committees on Appropriations 1 (Nov. 9, 2015), <http://taxprof.typepad.com/files/former-irs-commissioners-letter-on-agency-budget.pdf>.

¹⁰³ *Id.* at 2.

by over 20% since 2010.¹⁰⁴ Presumably the IRS has less time to audit individuals and businesses as they are tasked with more federal spending programs to administer.

A final concern is that the each additional tax expenditure increases the complexity of the tax code. Not only does this added complexity place a substantial burden on the IRS, but it also is burdensome for individual taxpayers who must navigate the tax code each year when filing returns. Moreover, many of the tax expenditures, such as the deductions for mortgage interest, charitable contributions, and medical expenses, require taxpayers to retain detailed records throughout the year.¹⁰⁵ The previous commissioners' letter noted that over 80% of all individual taxpayers now use paid consultants or software to complete their income tax returns due to the complexity of the tax system.¹⁰⁶ The IRS, in light of the funding constraints, is unable to adequately assist these taxpayers, and in FY 2015 over 60% of individual taxpayers who called the IRS for assistance on a tax return were unable to reach an IRS assistor.¹⁰⁷ Without greater resources to assist taxpayers in navigating the tax code, the complexity could counteract some of the benefits of tax expenditures.

In summary, the burden for administering direct spending programs generally lies with the specialized federal agencies, while the administrative responsibility for tax expenditures lies with the IRS. There are both pros and cons to each method of administration, and the best method will likely depend upon the nature of the spending goal at hand.

Judicial Review

A further difference between direct expenditures and tax benefits is the constitutional standard that is applied when the courts review them. The Constitution grants Congress the

¹⁰⁴ Marr, *IRS Funding Cuts Continue to Compromise Taxpayer Service and Weaken Enforcement*, CBPP.

¹⁰⁵ CBO, *THE DISTRIBUTION OF MAJOR TAX EXPENDITURES IN THE INDIVIDUALS INCOME TAX SYSTEM*, at 8.

¹⁰⁶ Letter from Former Commissioners of IRS, at 2.

¹⁰⁷ *Id.*

“power to lay and collect taxes, duties, imposts and excises, to pay the debts and provide for the common defence and general welfare of the United States.”¹⁰⁸ The 16th amendment grants Congress further authority to “lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.”¹⁰⁹ Though Congress’s power to both tax and spend has been interpreted broadly by the Supreme Court,¹¹⁰ when other constitutional rights are also at stake, direct regulation, taxes, and tax cuts are often subject to different constitutional standards.

A primary argument for applying the same constitutional analysis to direct expenditures and tax expenditures is that they are often economically equivalent.¹¹¹ In other words, the government can either directly subsidize an activity or organization or grant a tax subsidy of the same value for that activity or organization, and the economic effects of both are the same.¹¹² The Supreme Court has at times expressed an awareness of the similarities, and treated tax expenditures as it would direct expenditures. In 1983, in *Regan v. Taxation with Representation*, Taxation with Representation claimed that the prohibition of substantial lobbying for 501(c)(3) organizations, to which charitable contributions are deductible, is unconstitutional under the First Amendment and the equal protection component of the Fifth Amendment.¹¹³ The Court reasoned that “[a] tax exemption has much the same effect as a cash grant to the organization of the amount of tax it would have to pay on its income,” and held Congress is not obligated to provide organizations with public money with which to lobby.¹¹⁴ Then, in 1989, in *Texas Monthly, Inc. v. Bullock*, the Court held Texas’s sales tax exemption, exclusively for publications advancing

¹⁰⁸ U.S. Const. art. I, § 8, cl. 1.

¹⁰⁹ U.S. Const. amend. XVI.

¹¹⁰ See, e.g., *United States v. Butler*, 297 U.S. 1, 65–66 (1936).

¹¹¹ Linda Sugin, *Tax Expenditure Analysis and Constitutional Decisions*, 50 HASTINGS L.J. 407, 408 (1999).

¹¹² *Id.* at 410.

¹¹³ *Regan v. Taxation with Representation*, 461 U.S. 540, 542 (1983)

¹¹⁴ *Id.* at 551.

tenets of a religious faith, unconstitutional under the establishment clause.¹¹⁵ The Court acknowledged that “[e]very tax exemption constitutes a subsidy that affects nonqualifying taxpayers, forcing them to become indirect and vicarious donors.”¹¹⁶ The Court clarified that where a “subsidy is conferred upon a wide array of nonsectarian groups as well as religious organizations in pursuit of some legitimate secular end,” unlike the Texas sales tax exemption, “the fact that religious groups benefit incidentally does not deprive the subsidy of the secular purpose and primary effect mandated by the Establishment Clause.”¹¹⁷ In this case, it seems the tax subsidy mirrored too closely a direct expenditure that would have proven unconstitutional.

Economic equivalence, however, does not necessarily mean legal equivalence, and there are a variety of reasons why the Supreme Court has declined to adopt a tax expenditure analysis in which the same legal standard applies to direct expenditures and tax expenditures. In 1970, in *Walz v. Tax Commission of the City of New York*, the Court upheld a New York City property tax exemption for real or personal property of religious organizations, along with other nonprofit organizations operated for charitable or educational purposes, against an establishment clause challenge.¹¹⁸ Unlike in *Texas Monthly*, the Court found that the legislative purpose was “not aimed at establishing, sponsoring, or supporting religion,” but rather, the exemption applied to a broad class of groups that fostered moral or mental improvement in the community.¹¹⁹ In questioning whether the end result was excessive government entanglement with religion, the Court determined “[t]he grant of a tax exemption is not sponsorship since the government does not transfer part of its revenue to churches but simply abstains from demanding that the church

¹¹⁵ *Texas Monthly, Inc. v. Bullock*, 489 U.S. 1, 5 (1989).

¹¹⁶ *Id.* at 14.

¹¹⁷ *Id.* at 14–15.

¹¹⁸ *Walz v. Tax Commission of the City of New York*, 396 U.S. 664, 666–667 (1970).

¹¹⁹ *Id.* at 672–74.

support the state.”¹²⁰ Here, the Court found the distinction between directly contributing funds and abstaining from collecting revenue to be significant. The Court maintained this argument in *Camps Newfound/Owatonna v. Town of Harrison* in 1997, where it refused to equate a discriminatory tax exemption to what would have been a constitutional discriminatory subsidy, and deemed the tax exemption impermissible.¹²¹

In more recent cases, the Roberts Court has continued to distinguish direct spending, taxes, and tax expenditures.¹²² First, in *Arizona Christian School Tuition Organization v. Winn* (*Arizona Christian Schools*), decided in 2011, the Court rejected an establishment clause challenge against an Arizona law providing tax credits for contributions to School Tuition Organizations (“STO”) that provide scholarships to students attending private schools, some of which are religious.¹²³ The Court held that taxpayers lacked standing based on a distinction made by the Court between tax credits and governmental expenditures:

“[T]ax credits and governmental expenditures do not both implicate individual taxpayers in sectarian activities. A dissenter whose tax dollars are “extracted and spent” knows that he has in some small measure been made to contribute to an establishment in violation of conscience. In that instance the taxpayer's direct and particular connection with the establishment does not depend on economic speculation or political conjecture. The connection would exist even if the conscientious dissenter's tax liability were unaffected or reduced. When the government declines to impose a tax, by contrast, there is no such connection between dissenting taxpayer and alleged establishment. Any financial injury remains speculative.”¹²⁴

The Court then reasoned that because those contributing to the STO are donating their money rather than the money the state collected from the taxpayers, the taxpayers have not alleged an

¹²⁰ *Id.* at 675.

¹²¹ *Camps Newfound/Owatonna v. Town of Harrison*, 520 U.S. 564, 588–589 (1997).

¹²² See Linda Sugin, *The Great and Mighty Tax Law: How the Roberts Court has Reduced Constitutional Scrutiny of Taxes and Tax Expenditures*, 78 BROOKLYN L. REV. 777, 777 (2013).

¹²³ *Arizona Christian School Tuition Organization v. Winn*, 563 U.S. 125, 129 (2011).

¹²⁴ *Id.* at 142.

injury.¹²⁵ Professor Sugin believes that in characterizing the tax credit as the government “declin[ing] to impose a tax,” the Court mistakenly conflated tax cuts, which reduce burdens on individuals and tends to decrease the size of the government, with expenditures in the tax law, which target government resources for particular purposes and tend to increase government involvement in the economy.¹²⁶ She argues that tax expenditures share more in common with direct expenditures than tax cuts, and should be reviewed accordingly.¹²⁷ Sugin’s fear is that after *Arizona Christian Schools*, the economic equivalence of tax expenditures will no longer be considered when determining the legal standard for tax expenditures, and that tax expenditures will be immune from legal review.¹²⁸

The following year, the Roberts Court similarly appeared to limit the constitutional scrutiny applied to taxes in *National Federation of Independent Business v. Sebelius* (“*NFIB*”).¹²⁹ The Court upheld the shared responsibility payment in the Affordable Care Act, which had been characterized in the legislation as a penalty for those who did not purchase health insurance, as a valid exercise of Congress’s taxation power.¹³⁰ The majority admitted that “the breadth of Congress's power to tax is greater than its power to regulate commerce.”¹³¹ The same payment, therefore, was deemed unconstitutional when characterized as regulation by way of penalty, but deemed constitutional when characterized as a tax.¹³² Thus, both *Arizona Christian Schools* and *NFIB* seem to incentivize Congress to preference legislation through the tax code over direct spending bills.

Though recent cases have tended to distinguish more sharply between direct expenditures

¹²⁵ *Id.* at 142-143.

¹²⁶ Sugin, *The Great and Mighty Tax Law*, at 821–822.

¹²⁷ *See id.* at 822.

¹²⁸ *Id.* at 792–793.

¹²⁹ *See id.* at 777–778.

¹³⁰ *National Federation of Independent Business v. Sebelius*, 132 S. Ct. 2566, 2600 (2012).

¹³¹ *Id.* at 2601.

¹³² *Id.* at 2608.

and tax expenditures, the proper legal standard is far from clear and appears to depend on the facts and circumstances of each particular case. Professor Zelinsky has proposed considering tax benefits and direct expenditures as two-overlapping bell-shaped curves.¹³³ He believes tax benefits and direct expenditures should be analyzed on a case-by-case basis, with special emphasis on three factors: permanence, eligibility, and quantity.¹³⁴ Zelinsky argues that where a tax expenditure is subject to annual appropriations, as opposed to being a permanent part of the code, it more closely mirrors direct spending and should be reviewed accordingly.¹³⁵ Further, where a tax provision is targeted at particular recipients, rather than open to all eligible persons, the tax provision appears more similar to a direct expenditure.¹³⁶ Finally, where a tax benefit is capped at a specific quantity, as opposed to having no ceiling on the potential revenue loss, the tax benefit more closely mirrors a direct appropriation with a specific funding allocation.¹³⁷ Zelinsky would argue the more characteristics the tax benefits have in come with direct expenditures, the more closely the legal analysis should align with that of direct expenditures.¹³⁸ Only time will tell if the Court decides to adopt such an approach for review of tax expenditures.

Value of Tax Expenditures

There are clearly benefits to pursuing legislative priorities through tax expenditures, as discussed in the previous section, but some question how valuable the resulting tax expenditures are. This section examines the arguments for and against the value of tax expenditures.

¹³³ Edward Zelinsky, *Are Tax 'Benefits' Constitutionally Equivalent to Direct Expenditures?*, 112 HARVARD L. REV. 379, 400 (1999).

¹³⁴ *Id.*

¹³⁵ *Id.* at 401.

¹³⁶ *Id.* at 403.

¹³⁷ *Id.* at 404.

¹³⁸ *See id.* at 400.

Pros

A major benefit of federal spending through the tax code is that it allows citizens to have a greater role in determining the use of federal funds. The deduction for charitable contributions, for instance, effectively enables individuals to determine which nonprofits are to be the recipients of federal funds, and how much they will be given. A contribution to a charity lowers an individual's tax liability by the value of the contribution multiplied by the individual's marginal tax rate. The decrease in tax liability, or the amount of revenue the government forgoes, is the government's contribution to the charity. The federal government could theoretically accomplish its goal of subsidizing nonprofit organization by eliminating the deduction and spending the increased tax revenue on grants to the charities of its choice. But instead, the government gives the responsibility of finding charities to subsidize to individuals. Allowing individuals to disburse funds in this way could increase the amount of charitable giving in the United States and widen its reach, aid organizations that are beneficial for society but would not have received support from a majority of Congress members, encourage individuals to become more involved in the community, and lessen the workload for the federal government. The downside of this shift in responsibility is that it may be difficult for the government to determine which organizations the funds are going to, as well as the quality of those organizations.

A further example of the federal government shifting responsibility for disbursement of federal funds to individuals is the preferential rate for capital gains. Among other reasons, the federal government taxes capital gains at preferential rates to incentivize investment in the economy.¹³⁹ The federal government could directly invest in specific companies or industries, but instead chooses to forgo revenue where individuals invest in businesses that they believe to be

¹³⁹ *The Tax Break-Down: Preferential Rates on Capital Gains*, COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET, <http://crfb.org/blogs/tax-break-down-preferential-rates-capital-gains>.

the most promising. Shifting the responsibility for investment into the hands of the individuals can save the government both time and resources, eliminate the conflict of interest that would result if the government was investing in U.S. corporations, and incentivize individuals to save a greater percentage of their income.

Tax expenditures may not always be effective, but when they are structured properly and narrowly tailored to the purpose of the expenditure, tax expenditures can successfully incentivize certain behaviors, fix market failures, save the government time and resources, and provide relief to low-income individuals.

Cons

Regressive Structure

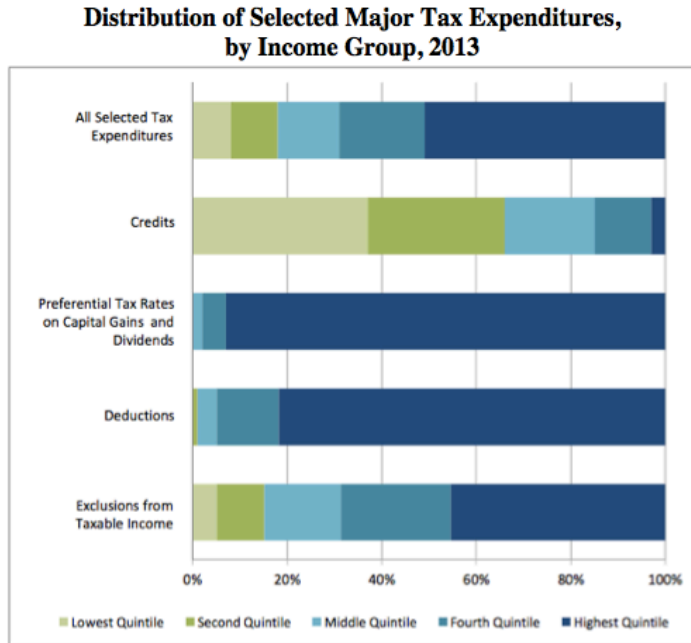
First, a common concern with tax expenditures is that they can be regressive, allowing higher-income individuals to receive a greater benefit. The Congressional Budget Office (CBO) analyzed the distribution of ten of the largest tax expenditures and found that over 51% of the benefits accrue to the highest quintile of earners, as opposed to 8% for the lowest quintile.¹⁴⁰ It is important to note, however, that while tax expenditures appear regressive when analyzing the value of the benefits accruing to individuals at each income level, they appear less so when analyzed relative to after-tax income.¹⁴¹ The CBO found the major tax expenditures as a share of after-tax income to be 11.7% for the lowest income quintile, as opposed to 9.4% of the highest quintile.¹⁴² Additionally, a regressive outcome is dependent upon the structure of the tax expenditure. This is illustrated in CBO's graph below, which details the distribution of major tax

¹⁴⁰ CBO, THE DISTRIBUTION OF MAJOR TAX EXPENDITURES IN THE INDIVIDUALS INCOME TAX SYSTEM, at 11.

¹⁴¹ *Id.* at 36.

¹⁴² *Id.* at 36.

expenditures by income group for each type of tax expenditure.¹⁴³



Regressive outcomes are common with tax expenditures that are structured as tax exclusions or deductions, in which the value of the tax benefit depends upon the taxpayer's marginal rate.¹⁴⁴ For example, the value of the exclusion of employer contributions for health insurance from income increases as a taxpayer's marginal rate increases. Because health insurance premiums are not included in taxable income, a taxpayer in the 35% marginal tax bracket is effectively receiving a 35% subsidy on the cost of insurance from the federal government. In contrast, a taxpayer in the 10% marginal tax bracket would be receiving a benefit equal to just 10% of the employer contributions. An above-the-line deduction, such as the deduction for student loan interest, functions the same way.

The value of an itemized deduction, or a below-the-line deduction, is similarly dependent on the taxpayer's marginal tax rate, but is arguably more regressive because an individual only itemizes deductions when the applicable expenses exceed the standard deduction. The

¹⁴³ Marples, *Tax Expenditures: Overview and Analysis*, CRS at 6.

¹⁴⁴ *See id.*

Congressional Research Service has found that just 32% of taxpayers itemize deductions, and the percent of taxpayers that itemize for a given income group, as well as the value of their deductions, increases along with adjusted gross income (AGI).¹⁴⁵ Just 6% of individuals with AGI between \$1 and \$20k itemize, 55% of those with AGI between \$50k and \$100k itemize, and 98% of those who make over \$1 million itemize.¹⁴⁶ Exemplifying this data, if an individual's only itemized deduction for the tax year is a charitable contribution, the individual would have to contribute over \$6,300 (the 2016 standard deduction for single individuals) to receive a benefit from the contribution. Though low-income individuals may donate a larger percentage of their income to charity¹⁴⁷, they are probably less likely to donate \$6,300 to charity each year, and thus less likely to itemize and claim the deduction.

Tax credits are less regressive than exclusions and deductions because the value of the credit does not depend upon an individual's marginal tax rate. Rather, a tax credit reduces the individual's tax liability dollar-for-dollar. For example, individuals can claim the lifetime learning credit, which allows taxpayers to directly reduce their tax liability by up to \$2,000 for qualifying educational expenses.¹⁴⁸ This credit is nonrefundable, however, so the credit is limited to the individual's tax liability.¹⁴⁹ Those credits that are refundable, meaning even those without tax liability can receive the benefit, or that include phase-outs based on income, are more progressive. For instance, the earned income tax credit provides funds to working individuals, but the benefits phase-out as the individual's income rises.¹⁵⁰ It is also refundable, so individuals

¹⁴⁵ Sean Lowry, *Itemized Tax Deductions for Individuals: Data Analysis*, CONGRESSIONAL RESEARCH SERVICE 2–3 (2014), <https://www.fas.org/sgp/crs/misc/R43012.pdf>.

¹⁴⁶ *Id.* at 3.

¹⁴⁷ *Why the Rich don't Give to Charity*, ATLANTIC, <http://www.theatlantic.com/magazine/archive/2013/04/why-the-rich-dont-give/309254/>.

¹⁴⁸ *Lifetime Learning Credit*, IRS, <https://www.irs.gov/publications/p970/ch03.html>.

¹⁴⁹ *Id.*

¹⁵⁰ *A Closer Look at Refundable Tax Credits*, COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET, <http://crfb.org/blogs/closer-look-refundable-tax-credits>.

will qualify for the benefit even if they do not owe taxes. The earned income tax credit, therefore, is an example of a tax expenditure that is narrowly tailored to benefit low-income individuals. Though phase-outs are more common with tax credits, some tax deductions, including deductions for retirement contributions and student loan interest, have income phase-outs as well.¹⁵¹

Some tax expenditures appear regressive not just because of their structure, but also because of the activity that is being subsidized. Many of the subsidized activities are those that high-income individuals are more likely to partake in. For example, the preferential rates for capital gains and the exclusion of municipal bond interest from income will benefit those individuals that have enough money to invest. The deduction for mortgage interest will benefit those individuals who can afford to own a home. Lastly, the exclusion for employer contributions to health care will benefit those individuals that have employment.

Though the regressive nature of these tax expenditures can be concerning when viewed from an equitable perspective, it is also important to remember that the legislative purpose behind tax expenditures is not always to help the needy. For example, Congress may have allowed lower tax rates for capital gains and dividends as a way to incentivize investment in the economy, to encourage individuals to save their money, or to compensate for the double tax on income. Moreover, some of these tax expenditures, though they appear to be catered to the wealthy, may have secondary effects that benefit low-income individuals, though it may not be apparent on their tax return. For instance, the mortgage interest deduction could lower the costs

¹⁵¹ *Income Tax Issues: How do Phaseouts of Tax Provisions Affect Taxpayers?*, THE TAX POLICY BRIEFING BOOK, <http://www.taxpolicycenter.org/briefing-book/background/issues/phaseouts.cfm>.

of ownership for landlords, and thereby result in lower rent for the tenants.¹⁵² Similarly, the preferential treatment for capital gains could lead to greater investment in corporations, enabling the corporations to employ more individuals and increase salaries.

Whether or not the regressive nature matters depends on what one believes the proper role for tax expenditures in the tax code should be. If the goal is to maximize the benefits given to low-income individuals, however, potential reforms to make tax expenditures less regressive include eliminating subsidies for activities that high-income individuals are more likely to partake in, capping the total dollar value of benefits that individuals can claim, capping the tax rates used to calculate the benefits, increasing the use of phase-outs based on income levels, and relying more heavily on refundable credits rather than on exclusions and deductions.

Inefficient Allocation of Resources

Another concern that some have with the use of tax expenditures is that the expenditures may lead to an inefficient allocation of resources, with individuals consuming more expensive goods and services than they would otherwise consume due to the federal subsidy.¹⁵³ For example, the exclusion of employer contributions from health care could incentivize taxpayers to purchase more expensive insurance than they would if they purchased health insurance independently of employment.¹⁵⁴ Additionally, the tax benefits for particular retirement accounts could lead individuals to move their savings to tax-advantaged retirement accounts even where the economic return is not as strong.¹⁵⁵ An example of Congress effectively structuring a tax expenditure so as to not incentivize unnecessary spending is the deduction for medical and dental

¹⁵² See Larry Ozanne, *Taxation of Owner-Occupied and Rental Housing*, CONGRESSIONAL BUDGET OFFICE 2–3 (2012), https://www.cbo.gov/sites/default/files/112th-congress-2011-2012/workingpaper/11-2-2012-Taxation_of_Housing_0.pdf.

¹⁵³ CBO, *THE DISTRIBUTION OF MAJOR TAX EXPENDITURES IN THE INDIVIDUALS INCOME TAX SYSTEM*, at 7.

¹⁵⁴ *Id.* at 8.

¹⁵⁵ *Id.* at 8.

expenses. Medical and dental expenses can be itemized to the extent that they exceed 10% of the taxpayer's AGI.¹⁵⁶ Because the expenses must exceed 10% of an individual's AGI, and are itemized, an individual will generally only claim this deduction if they have incurred significant medical expenses in a given year. This limitation ensures that the expenditure will benefit those individuals with the greatest need. A person with an average amount of medical expenses would not be incentivized to consume more, and would not be required to maintain detailed records of medical expenses for tax purposes.

Unnecessary Subsidies

Additionally, some question the effectiveness of tax expenditures because they can, at times, subsidize activities that would have occurred without the federal benefit.¹⁵⁷ Many individuals would donate to charity even if they were not able to claim the charitable deduction on their tax return.¹⁵⁸ Presumably, many individuals would also continue to have children if the child credit and the exemptions for dependents were eliminated. The counterargument is that all individuals must be subsidized in order to incentivize those who would not donate at all, or as much, without the tax incentive. Further, the purpose of a tax expenditure may not necessarily be to incentivize specific behaviors, it could be to more accurately measure an individual's ability to pay taxes, in which case it would not matter that the activity would have occurred regardless of the benefit.

Higher Statutory Tax Rates

A final concern with tax expenditures is that the government must increase statutory tax

¹⁵⁶ *Topic 502 – Medical and Dental Expenses*, IRS, <https://www.irs.gov/taxtopics/tc502.html>.

¹⁵⁷ CBO, *THE DISTRIBUTION OF MAJOR TAX EXPENDITURES IN THE INDIVIDUALS INCOME TAX SYSTEM*, at 7.

¹⁵⁸ *See The Tax Break-Down: Charitable Deduction*, Committee for a Responsible Federal Budget (2013), <http://crfb.org/blogs/tax-break-down-charitable-deduction> (Of the approximately \$300 billion given to charity in 2011, \$125 billion was not deducted as a charitable contribution).

rates upon enacting them because the tax preferences decrease revenue for the government.¹⁵⁹ In other words, those who are not receiving the preferences would be subsidizing those who are through higher tax rates. This could be ideal from a progressive perspective, where higher-income individuals are subsidizing lower-income individuals, as would be the case with the earned income tax credit. However, that is not always the case. For example, because the federal government loses revenue by excluding employer contributions to health care from income, the statutory tax rates for all individuals may be increased. This means that individuals whose employers will not provide health insurance, not only will have to purchase insurance without a subsidy, but also could pay more in taxes. To avoid situations where one group of taxpayers is inappropriately burdened by a benefit to another group of taxpayers, politicians should carefully analyze where the incidence of tax expenditures falls before enacting them into law.

Conclusion

An analysis of the congressional process for enacting and repealing tax expenditures, the administration of tax expenditures, and the judicial review of tax expenditures, illustrates both significant benefits and consequences of legislating through the tax code rather than direct appropriations. There are also varying levels of effectiveness among the many tax expenditures, depending upon the goal which is to be achieved and the way in which they are structured. Thus, whether or not a legislative objective should be enacted through a tax expenditure or a direct appropriation is highly circumstantial.

The following reforms, if implemented, could help to ensure that tax expenditures are utilized only when appropriate and are structured in a way that maximizes their benefit. With

¹⁵⁹ *Id.* at 8.

regard to the budget process, the tax committees should not enact tax expenditures without obtaining approval from the authorization and appropriation committees that have the subject-matter expertise.¹⁶⁰ Moreover, Congress should implement a program through which each of the tax expenditures is annually reviewed to ensure the goals of the expenditure are being effectively achieved. This could also be accomplished by attaching sunset provisions to all tax expenditures, requiring affirmative action by politicians to retain the expenditures after the relevant time period has elapsed. Congress should also take care to structure tax expenditures in a way that benefits those who are the target of the legislation, but neither burdens those who are not the target of the legislation, nor leads to unnecessary revenue losses by aiding those who are not the target. This will require a careful analysis of the incidence of the tax legislation. With regard to the administration of tax expenditures, Congress should ensure that the IRS has the capacity and the expertise to effectively administer any tax expenditures within the agency's domain. This would likely necessitate an increase in the IRS's budget. Lastly, Congress should consider the increased complexity, for both the IRS and the individuals, that will result from additions to the tax code, and which could diminish the impact of the benefit. By increasing the scrutiny over tax expenditures, improving the structure of tax expenditures, and ensuring resources are available to administer them, these reforms would likely improve the quality of tax expenditures enacted in the future.

¹⁶⁰ Kleinbard, at 29.

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