

Tax Expenditures: Spending By Another Name

Lawmakers often provide targeted tax cuts to particular groups of individuals or corporations. These special tax breaks are sometimes called “tax expenditures” because they are essentially government spending programs that happen to be administered through the tax code. However, tax expenditures are usually less visible than other types of public spending—which makes it harder for policymakers and the public to evaluate these hidden tax breaks. This policy brief surveys the difficulties created by tax expenditures, and describes options for reform.

The Concept of Tax Expenditures

Tax expenditures are similar to regular spending programs in that they are intended to achieve public policy objectives that have little or nothing to do with the fair collection of tax revenues. The main difference between tax expenditures and regular government spending is that under the tax expenditure approach, instead of the government sending out a check to the recipient, the recipient pays less in tax. For example, a government could create a direct spending program to subsidize windmill construction. Or, instead, it could offer a tax expenditure that lets companies building windmills reduce their taxes by exactly the same amount. In theory, it doesn’t matter whether a government uses direct spending or a tax expenditure to achieve a policy goal. In either case, the windmill subsidy program will (in theory) have to compete with other government spending priorities when the government makes its budget decisions.

A Privileged Type of Spending

As a practical matter, however, tax expenditures usually do not have to compete on a level playing field with other public spending. Tax expenditures are evaluated differently from other spending areas in some very important ways:

- Unlike most government spending programs, tax expenditures are usually open-ended: they often have no built-in cost limits, and generally there is no annual appropriations or oversight process. Anyone who meets the statutory criteria for eligibility can get the subsidy.
- Direct spending usually requires a government agency to weigh the worthiness of an application from any potential beneficiary. In contrast, most tax expenditures require no action other than the filing of a tax return—which means that the benefits of these tax breaks may inadvertently be extended to beneficiaries who might otherwise be deemed unworthy or ineligible.
- Tax agencies typically have no incentive to ensure that tax-expenditure programs are working as they were hoped to. By contrast, government agencies tend to look closely at the effectiveness of their direct spending initiatives.
- Basic facts about who benefits from tax expenditures—and what they do with their subsidies—are often hidden behind the cloak of tax return secrecy, while the beneficiaries of conventional spending programs are usually easy to identify.

As a result of these flaws, tax expenditures often turn out to be very expensive subsidy programs for which there is little oversight and review. Once a tax expenditure is put into the law, it usually stays there indefinitely. And little is known about what the public is getting—if anything—for the expenditure. Indeed, in some states, there is no way even to

determine how much is being spent on tax expenditures: because they are administered through the tax system, tax expenditures are usually not given a line item in the state's budget. Of course, tax collections are lower than they otherwise would be, but exactly how much lower is left a mystery.

Tax Expenditure Reports

In recognition of this problem, many states and the federal government now publish tax expenditure reports. A tax expenditure report is simply a listing of the tax breaks that reduce tax revenues. The federal government publishes an annual tax expenditure report which serves as a laundry list of individual and corporate tax breaks: the most recent report lists 151 corporate and individual tax expenditures, with an annual estimated cost (in fiscal 2004) of \$774 billion.

In recent years, a growing number of state governments have followed the federal government's lead by publishing tax expenditure reports of variable quality. The best reports include the following:

- A **complete list of all exemptions** from taxes (and tax credits) allowed by a state. This means looking not just at the income and sales tax base but at smaller taxes as well. It also means identifying exemptions that are not explicitly written into the tax code. For example, most states exempt personal services (such as haircuts and car repairs) from their sales tax unless they are specifically taxed. These implicit exemptions cost states hundreds of millions of dollars annually—but are usually not visible in the tax code. A good tax expenditure report will identify all such implicit exemptions.
- **Estimates of the annual revenue loss** from each tax expenditure, including estimates of how much the tax break has cost in recent years and how much it is projected to cost in the future. The impact (if any) on local tax revenues should be estimated as well.
- Many state tax expenditures are inherited indirectly by state linkage to federal tax codes. Separately **itemizing these indirect federal tax breaks** will give policy makers a clearer understanding of the extent to which the federal linkage reduces state revenues.
- A written **evaluation of the effectiveness of each tax expenditure** will help policy makers to understand why each tax break was originally enacted—and how well it currently achieves its stated goals.
- A **regular publishing schedule** that coincides with the state budgeting process. State policy makers should be able to evaluate tax expenditure side-by-side with conventional spending—and this requires good, current estimates of how much each tax break costs. Tax expenditure reports that are published every five years are likely to be insufficient as a source for updated cost estimates.

The Goal: Regular Oversight of Tax Expenditures

The important insight provided by the tax expenditure concept is that a law that lowers a citizen's tax liability has no different effect than a law that requires a direct payment to the citizen. And if a tax break is designed to accomplish a public policy goal other than the equitable collection of tax revenues, then it should be evaluated according to the standards by which we evaluate spending laws, not the standards by which we evaluate tax laws.

Almost all states currently fall short of this goal—including many that require some form of tax expenditure reporting. But a regular, detailed tax expenditure report can help ensure that policy makers have the information necessary to achieve regular oversight of tax expenditures.

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