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Statement of

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before the

Committee on Rules

House of Representatives

on

Proposed Controls of Tax Expenditures

Mr. Chairman and Members of the Committee:

I welcome this opportunity to discuss the proposal for better controls over tax expenditures in H.R. 4882. As you requested, I will address the following four subjects:

--the nature and economic effect of tax expenditures;

--the relationship of tax expenditures to the Congressional budget process;

--the merits of setting annual ceilings in tax expenditures through budget resolutions; and

--alternative approaches to the control of tax expenditures.

THE NATURE AND ECONOMIC EFFECTS OF TAX EXPENDITURES

Tax expenditures which are sometimes referred to as tax subsidies, tax incentives, or tax preferences, are designed to grant tax relief to particular groups of taxpayers, in order to promote or subsidize certain private or business activities.

The cost of a tax expenditure is the revenue the government does not collect because of the particular tax law provision.

There is controversy over whether some tax provisions are, in fact, correctly classified as tax expenditures. For example, some argue that mortgage and consumer interest deductions should not be treated as tax expenditures, because a tax system that taxes interest income should also provide for a deduction of interest payments. The definitional problem aside, foregone revenues from tax expenditures are undoubtedly growing rapidly.

In thinking about this policy tool we need to consider whether they achieve their objectives efficiently or whether they generate unintended distortions in the allocation of resources. For example, in the case of the investment tax credit, which is intended to stimulate capital formation, increase labor productivity, and spur economic growth, we should ask if it merely subsidizes investment that would have occurred anyway. We should also ask if other policies such as direct Federal subsidies or loans would accomplish the same goals. Since the investment tax credit applies only to equipment, it distorts investment choices in favor of equipment. The distortion may induce suboptimal productivity and economic growth because the wrong types of assets are produced. The various tax expenditures subsidizing homeowners such as capital gains rollover and property tax deductions may have created incentives to overinvest in housing.

Tax expenditures must also be evaluated in terms of who receives the benefits. Tax expenditures embodied in individual income tax deductions benefit those in upper income brackets the most. The deduction allowed to individuals for casualty losses shows this affect. An individual in the top 50 percent marginal tax bracket pays only 50 cents for each eligible dollar of losses, while the individual in the 20 percent tax bracket pays 80 cents.

Tax expenditure levels may often be uncontrollable due to fluctuating economic conditions and legislative actions. Much of the recent growth in tax expenditures budgets has occurred because of inflation. Inflation affects the cost of tax expenditures not only by nominal growth in income and deductions, but also by "bracket creep." That is, as individuals move into higher tax brackets, the cost of tax expenditures rises. Changes in tax law also affect tax expenditures. The cross-the-board reduction in marginal tax rates prescribed by the Economic Recovery Tax Act of 1981 significantly reduces the cost of tax expenditures. Other features of the 1981 Act such as accelerated cost recovery of assets, expanded individual retirement accounts, and all savers certificates will, of course, increase tax expenditures.

CURRENT RELATIONSHIP BETWEEN TAX EXPENDITURES AND THE CONGRESSIONAL BUDGET PROCESS

Deliberations in the early 1970s on the Congressional Budget Act considered whether to include tax expenditures in the congressional budgetary process, but the final legislation did not contain procedures for their control. Tax expenditures were regarded as legislative actions with relatively long-term effects, and hence not appropriate for an intensive annual budget review. However, the Act does require the President to submit tax expenditures information in his budget, and the Congressional Budget Office is also required to provide Congress with long-range estimates of tax expenditures.

The Budget Act controls only the net overall effect of tax expenditures. Congress does not set specific functional targets for tax expenditures in its budget resolution as it does for direct spending programs. Nor does it allocate target tax expenditure ceilings to its tax Committees. Tax expenditures, however, are subject to one important control. After the second budget resolution sets a floor on revenues, any legislation that would bring revenues below that floor is subject to a point of order. The consequence is that any increase in that expenditure must compete with all revenue-losing provisions for the amount of the tax reduction that is permitted.

There are currently problems with estimating tax expenditures. Given the difficulties they face, the U.S. Treasury Department, the Joint Committee on Taxation, and the Congressional Budget Office do an admirable job of preparing and presenting tax expenditures budget data.

The current tax expenditure estimates provide very useful information about how the Government affects society, but tax expenditure data are admittedly incomplete and contain some unresolved conceptual problems. To put the matter simply, techniques and procedures for estimating tax expenditures are quite new, and are by no means fully developed.

At present, estimates for each tax expenditure are made by assuming the removal of only the provisions of law that entitle individuals to the tax preference. This procedure brings into question the adding up of tax expenditure estimates into a total that could be used for control purposes, because the removal of two or more tax expenditures at the same time may have a different effect than their sum when considered seperately. For example, if Congress repealed two or more itemized deductions, individual taxable income would increase. This might push some taxpayers into higher tax brackets, which would result in a greater cost of the remaining tax expenditures than originally estimated. In any event, the rise in tax rates would stop as soon as taxpayers realized that it was no longer advantageous to itemize deductions.

Moreover, in comparison to the number of people who develop data on spending programs, there are very few who are involved in preparing tax expenditure data. Stronger budgetary controls over tax expenditures should to be accompanied by the development and refinement of tax expenditure concepts and definitions, as as well as more staff to gather and analyze tax expenditure information.

MERITS OF TAX EXPENDITURE CEILINGS

In our view, H.R. 4882 would have the effect of establishing binding ceilings on tax expenditures. Because of the inherent difficulties in estimating revenue losses, we are not convinced that such a requirement should be adopted at this time. We suggest, instead, that Congress take an evolutionary approach to strengthen its control over tax expenditures, starting with improvements in the information base and scorekeeping procedures, followed by the use of non-binding targets. The Congress took such an evolutionary approach, successfully, in gradually bringing Federal credit activities under more direct control through the budget process. While the technical problems are quite difficult, we believe the same gradual approach would be appropriate in the case of tax expenditures.

ALTERNATIVES FOR CONTROLLING TAX EXPENDITURES

In addition to considering the possibility to tax expenditures controls through the budget process, Congress could also develop oversight procedures to compare tax expenditures with spending programs of similar purpose.

During the last Congress, this Committee, as well as others, thoroughly investigated several oversight reform proposals, including some that would have considered tax expenditures along with direct spending programs. Current versions of these proposals are now before this Congress. Although these proposals seek to join the review of tax expenditures with program authorization procedures rather than bringing these directly into the budget process, they would serve the purpose of strengthening oversight over tax expenditures. We have already indicated our support for the flexible approach contained in H.R. 58, which does provide for consideration of tax expenditures along with direct spending programs.

It would be possible to compare tax expenditures with spending programs more directly in the budget process. Budget committee reports could compare tax expenditures amounts with direct spending amounts in each budget function. Tax expenditures review could also be integrated with either the views and estimates process, or other aspects of congressional budget review.

I would also like to mention that we are now working to include tax expenditure information in our program inventory data base. Our tax expenditure file will be based on existing information sources, but we anticipate two major benefits. One, our inventory will bring together information that is currently dispersed in several publications. Two, our data will be automated, permitting more rapid and flexible comparison of tax expenditures with direct spending programs.