Statement of

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I appreciate this opportunity to testify on possible approaches to controlling tax expenditures. This is one of the important unresolved issues in the budget process, and I am pleased that Senator Kassebaum has taken the initiative to focus attention on it with her bill and with these hearings. In September of this year, the Congressional Budget Office (CBO) issued a report entitled "Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1982-1986," which contains extensive discussion of tax expenditures and the budget process. Copies of that report have been made available to this Committee. My testimony this afternoon is divided into three sections. The first discusses the importance of controlling tax expenditures, the second deals with possible alternative ways of controlling them, and the third focuses specifically on Senator Kassebaum's proposed "Tax Expenditure Limitation and Control Act" (S. 193).

THE IMPORTANCE OF CONTROLLING TAX EXPENDITURES

Tax expenditures have become one of the major ways in which the federal government allocates resources and affects private sector decisions. The most recent tax expenditure budget, compiled last March, included 104 items totaling $266.3 billion. The Economic Recovery Tax Act of 1981 added 8 new tax expenditures, expanded 22 others, and reduced 2.

In many areas, the federal government exerts more influence through tax expenditures than it does through direct spending. The tax expenditures for energy are greater than direct federal outlays, for example, and tax expenditures for housing exceed outlays by more than four to one.

In 1967, the first year for which an official tax expenditure budget was compiled, there were 50 items with a total revenue loss of $36.6 billion--20.5 percent of total federal direct outlays in that year and 4.4 percent of the gross national product (GNP). By fiscal year 1981, tax expenditures had grown to a total of $228.6 billion--34.6 percent of outlays and 8.0 percent of GNP (see Table 1).

Tax expenditures add to the federal deficit in the same way that direct spending programs do. They allocate resources and provide incentives and benefits in the same way that spending programs do. They are one of the ways the federal government plays a role in the economy and involves itself in the lives of its citizens.

But unlike direct spending programs, tax expenditures have low visibility in the budget process and are controlled in only a limited and indirect way. The Budget Act requires that a tax expenditure budget be compiled each year, but it is presented only for informational purposes. No direct budgetary decisions are based on it, and as a consequence it receives relatively little attention. One consequence of this low visibility is that activities that may not have sufficient support to obtain federal funding through direct outlays may be funded through the back door by tax expenditures.

Tax expenditures show up as revenue losses, and thus have an important effect on the revenue totals that are included in Congressional budget resolutions. But they are treated for this purpose as simply

TABLE 1. TAX EXPENDITURE GROWTH, CALENDAR YEARS 1967-1973 AND FISCAL YEARS 1975-1981[a]

	1967	1969	1971	1973	1975	1977	1979	1981
Tax Expenditure Totals (millions of dollars)	36,550	46,635	51,710	65,370	92,855	113,455	149,815	228,620
Percent of GNP	4.4	4.8	4.6	4.7	6.3	6.1	6.4	8.0
Percent of Federal Outlays	20.5	23.7	22.3	24.3	28.5	28.2	30.3	34.6
Percent of Federal Revenues	23.8	24.1	24.8	24.7	33.1	31.7	32.2	37.9
Federal Outlays as a Percent of GNP	21.4	20.3	20.6	19.5	22.0	21.6	20.9	23.1

a. Tax expenditure estimates were prepared only on a calendar year basis for the years 1967 to 1973. The estimates for calendar years 1967 to 1973 correspond roughly to fiscal years 1968 to 1974, and are thus compared to the GNP, outlay, and revenue figures for those fiscal years.

another form of tax cut; they are not treated as alternatives to spending programs. There is an important distinction between general tax cuts that reduce taxes broadly across the board, and tax expenditures that provide a tax cut only to those in certain specified circumstances, or who act in certain specified ways. General tax cuts return resources to people to use in whatever way they see fit; tax expenditures return resources to people only if they do what the government would like them to do, or if they are thought deserving of special help. The present treatment of tax expenditures in the budget process blurs this distinction.

ALTERNATIVE WAYS OF CONTROLLING TAX EXPENDITURES

Tax expenditures could be controlled in the same way direct outlays are. The Budget Committees and the Congress could vote on a tax expenditure budget, broken down into budget functions and subfunctions. Tax expenditures could be limited to specified amounts, and they could then be allocated to the committees with jurisdiction over them through a "crosswalk" procedure. If they were all allocated solely to the tax committees, however, they would end up being treated in essentially the same way as they are now--as just another form of tax cut. Allocating tax expenditures jointly to the tax committees and to the committees with jurisdiction over analogous spending programs would be one way of emphasizing their relationship to spending programs. This procedure would be similar in some respects to the way spending is now allocated jointly to the appropriations committees and to the authorizing committees. Senator Kassebaum's bill contains a variant of this approach in its requirement that tax expenditures be approved by the Budget Committees and by the committees with authority over analogous spending programs.

Short of this, steps could be taken to increase the visibility of tax expenditures. The Budget Committees and the Congress could vote specifically on targets for tax expenditures, as they do now for loan programs in the credit budget. While nonbinding targets do not receive the same degree of visibility and attention as binding ceilings, this procedure would give tax expenditures more visibility than they now have. As more experience was gained with this approach, there could be gradual movement toward more binding limitations.

Alternatively, tax expenditures could be subjected to even stricter limits than are imposed on spending programs. Following the approach of the various spending limitation bills and constitutional amendments that have been introduced in recent years, total tax expenditures could be limited to some fixed percentage of GNP, federal outlays, total federal receipts, individual and corporate income tax receipts, or some other measure. Senator Kassebaum's bill, for example, would limit tax expenditures to 30 percent of total federal revenues. The growth in tax expenditures might also be limited to a fixed percentage amount, or tied to inflation, GNP growth, or some other measure. The problem with approaches that seek to use a fixed formula is that no formula can automatically take into account all of the economic and political variables that are important in budget-making. That of course is one of the attractions of fixed-formula plans for those who do not believe that budgets should be affected by all of these variables, or who worry that the Congress will not reach the proper decisions if allowed to take these variables into account. The current budget process, by contrast, is designed to allow the Congress to take into account whatever factors it considers relevant in determining budget levels.

A further problem with imposing stricter budget controls on one type of federal activity than on others is that resources will tend to flow toward the less-controlled activity. The fact that both tax expenditures and loan programs have grown more rapidly in recent years than direct outlays is an illustration of this. Ideally, the budget process should treat all forms of resource allocation the same, so that decisions are based on the merits rather than on the type of budget control.

Limitations of the Arithmetic Total of Tax Expenditures

In discussing tax expenditures we frequently use their arithmetic total, as I have done this afternoon, but arithmetic totals have limitations for budget purposes. The problem with the arithmetic totals is both a conceptual and a practical one. Tax expenditures are revenue the government does not collect, so they can never be directly observed. Instead, they must be estimated, using a somewhat artificial set of assumptions and estimating conventions. The revenue loss from each individual tax expenditure is estimated by comparing the revenue raised under current law with the revenue that would be raised if the provision had never existed. The major difficulties arise because of interactions with the standard deduction (zero bracket amount) and the income tax rate structure. If several tax expenditures that take the form of personal deductions did not exist, revenue would be higher by less than the sum of the tax expenditures, since more people would take the standard deduction. If several tax expenditures that take the form of exclusions from income did not exist, more income would be taxed at higher marginal tax rates, so revenue would be higher by more than the sum of the tax expenditures. This is spelled out in more detail in Chapter II of CBO's September 1981 report.

These interactions can be taken into account if a limited number of tax expenditures are being considered, but the calculation becomes increasingly more artificial as more items are included. Including all tax expenditures, and taking into account all of the interactions, would require constructing a wholly new tax system without tax expenditures. While this could be done, it would require making a large number of probably controversial assumptions. In the end, it would still be no more than an idealized abstraction. It would never have the reality that total budget outlays and revenues do.

Attempting to take into account all of the interactions needed to reach a theoretically correct total of tax expenditures could in fact impair the usefulness of the tax expenditure budget for one of its major purposes, that of comparing the resources being devoted to a particular activity through direct outlays and through the tax code. The revenue loss attributable to each individual component of an integrated total would vary, depending on the assumptions used to calculate the total and the order in which each item was entered into the estimating model. There would no longer be a single number for each tax expenditure that was generally comparable to the estimates for individual spending programs.

TAX EXPENDITURE LIMITATION AND CONTROL ACT (S. 193)

S. 193 seeks to control tax expenditures by making two major changes in the Budget Act:

1) Budget resolutions would be out of order "if the level of revenue loss from tax expenditures contained in the resolution exceeds 30 percent of the recommended level for net revenue set forth in such resolution."

2) New tax expenditures, or modifications of existing tax expenditures, would have to be approved by the committees having jurisdiction over the activity that the tax expenditure affects, and by the Budget Committees, as well as by the tax committees. New or modified tax expenditures would also have to be reported by the May 15 deadline that applies to spending authorizations.

The second of these changes could lead to major improvements in the way tax expenditures are dealt with in the budget process. Before discussing this, however, I would like to talk briefly about the first part of the proposal.

Limiting Tax Expenditures to 30 Percent of Total Revenues

As my testimony so far has indicated, any limit on the total amount of tax expenditures must confront the fact that the total itself is a somewhat artifical number. In addition, as discussed earlier, limiting tax expenditures by the use of a fixed formula would impose on them a discipline that is more strict and rigid than that which now applies to spending programs. The better approach is probably to try, insofar as possible, to subject all forms of resource allocation to the same kind of budget control.

There are also some special problems in tying tax expenditures to total revenues rather than to some more general measure, such as the gross national product. Increases in excise taxes or a windfall profit tax on decontrolled natural gas would increase overall revenues, and thus permit an increase in tax expenditures--whether or not this was the desired result. An increase in income tax rates or a postponement of the scheduled rate reductions would also increase overall revenues, but in this case there might not be more room for tax expenditures, since the revenue loss from tax expenditures as now measured would increase along with the increases in marginal tax rates.

Approval by Other Committees

In my view, limiting tax expenditure totals is less important than trying to devise ways to require the Congress to consider seriously the trade-offs between tax expenditures and spending programs on a case-by-case basis. The requirement in S. 193 that new or modified tax expenditures be approved by the non-tax committees with jurisdiction over analogous spending programs and by the Budget Committees would be an important step in that direction. It would enable the Congress to treat tax expenditures as more than just another kind of tax cut. They would be treated as what they are--an alternative to spending programs. By involving the committees that are responsible for allocating scarce resources to particular program areas, a better overall accounting of the resources going to these areas could be achieved, and end runs around the limitations of the budget process could be minimized.

The non-tax committees are likely to have more expertise in the program areas involved than the tax committees, and thus may be better able to give tax expenditure proposals a critical evaluation. They could also determine more readily whether a tax expenditure would duplicate or overlap with similar spending programs, and might be able to suggest ways of coordinating the administration of the tax expenditure with that of similar spending programs. The Budget Committees, for their part, could determine whether the total of resources being devoted to a particular purpose through tax and spending programs was consistent with overall budgetary priorities.

One way of strengthening the incentive for the non-tax committees to take the review responsibility provided in S. 193 more seriously would be to provide that their spending allocation be reduced commensurately every time they approved a tax expenditure that fell into their area of jurisdiction. This would give the non-tax committees a real stake in whether or not tax expenditures in their area were increased, and would force them to make the difficult trade-offs that are inherent in budgeting. It would also relieve sane of the burden on the Budget Committees, which would no longer have to stand alone in seeking to impose the discipline of the budget process on tax expenditures.

This of course would represent a significant reallocation of authority and responsibility among committees in the Congress, just as the Budget Act itself did. If the Congress took this step for itself, it might also want to extend the same principle to the executive branch by providing that each department's spending allocation be reduced whenever tax expenditures in the same area were increased.

CONCLUSION

As I always seem to say when I appear before the Budget Committees, none of the options you have are easy ones. Any attempt to impose more control over tax expenditures will be resisted by those who benefit from them, just as control over spending programs is resisted by their beneficiaries. Any change in the budget process itself will encounter resistance within the Congress. But the gains in terms of greater control over the allocation of scarce resources, and a fuller awareness of all the ways in which the federal government influences private decisions, would also be substantial. Whether the gains would outweigh the costs is, as always, for you to decide.