Statement of

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I appreciate this opportunity to testify on H.R. 4882, which would incorporate limits on tax expenditures into the first and second Congressional budget resolutions. The proper treatment of tax expenditures is one of the important unresolved issues in the budget process. 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 an extensive discussion of tax expenditures and the budget process. Copies of that report have been made available to the Committee.

My testimony this morning is divided into three sections. The first discusses the importance of controlling tax expenditures, the second discusses the specific provisions of H.R. 4882, and the third deals with additional steps the committee may want to consider.

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. 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). The most recent tax expenditure budget, compiled last March, included 104 items totaling $266.3 billion for fiscal year 1982. The Economic Recovery Tax Act of 1981 added 8 new tax expenditures, expanded 22 others, and reduced 2.

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.

In many areas, the federal government exerts more influence through tax expenditures than it does through direct spending. The tax expenditures for general purpose fiscal assistance are greater than direct federal outlays, for example, and tax expenditures for housing exceed outlays by more than four to one. Table 2 shows total tax expenditures and outlays by budget function for selected years between 1967 and 1981, and compares their rates of growth.

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.

Unlike direct spending programs, however, 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 accordingly 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 2. GROWTH IN TAX EXPENDITURES AND OUTLAYS BY BUDGET FUNCTION, 1967-1981[a]

Budget Function	Amount (in millions of dollars) 1967[a]	1974	1981	Rate of Growth (Percent Increase/Decrease) 1967-1974	1974-1981	1967-1981
National Defense						
Tax Expenditures	500	715	1,755	43	145	251
Outlays	78,755	77,781	159,699	-1	105	103
International Affairs						
Tax Expenditures	290	1,685	2,720	481	61	838
Outlays	5,267	5,681	11,051	8	95	110
General Science, Space and Technology						
Tax Expenditures	500	605	2,030	21	236	306
Outlays	5,519	3,977	6,422	-28	61	16
Energy						
Tax Expenditures	1,605	2,955	6,615	84	124	312
Outlays	1,006	837	10,642	-17	1,171	958
Natural Resources and Environment						
Tax Expenditures	130	220	1,990	69	805	1,431
Outlays	2,996	5,670	13,783	89	143	360
Agriculture						
Tax Expenditures	800	1,300	1,435	63	10	79
Outlays	4,539	2,227	5,598	-51	151	23
Commerce and Housing Credit						
Tax Expenditures	12,115	36,455	98,180	201	169	710
Outlays	4,331	3,925	3,995	-09	02	-08
Transportation						
Tax Expenditures	10	970	35	9,600	-96	250
Outlays	6,301	9,172	23,312	46	154	270
Community and Regional Development						
Tax Expenditures	0	85	320	NA	276	NA
Outlays	1,381	4,134	9,265	199	124	571
Education, Training, Employment and Social Services						
Tax Expenditures	3,095	6,215	14,635	101	135	373
Outlays	7,632	12,344	30,563	62	148	300

(Continued)

TABLE 2. (Continued)

Budget Function	Amount (in millions of dollars) 1967[a]	1974	1981	Rate of Growth (Percent Increase/Decrease) 1967-1974	1974-1981	1967-1981
Health						
Tax Expenditures	2,600	5,065	19,945	95	294	667
Outlays	9,708	22,073	69,324	127	214	614
Income Security						
Tax Expenditures	9,675	13,760	52,030	42	278	438
Outlays	33,683	84,437	225,599	151	167	570
Veterans' Benefits and Services						
Tax Expenditures	550	800	1,565	45	96	185
Outlays	6,882	13,386	22,937	95	71	233
Administration of Justice						
Tax Expenditures	0	0	0	NA	NA	NA
Outlays	650	2,462	4,721	279	92	626
General Government						
Tax Expenditures	0	10	100	NA	900	NA
Outlays	1,552	3,243	4,730	109	46	205
General Purpose Fiscal Assistance						
Tax Expenditures	4,680	11,175	25,340	139	127	441
Outlays	340	6,890	6,621	1,926	-4	1,847
Interest						
Tax Expenditures	0	0	-75	NA	NA	NA
Outlays	13,751	28,032	82,590	104	195	501
Undistributed Off-setting receipts						
Tax Expenditures	0	0	0	NA	NA	NA
Outlays	-5,460	-16,651	-30,306	205	82	455
Total						
Tax Expenditures	36,550	82,015	228,620	124	179	525
Outlays	178,833	269,620	660,544	51	145	269

NOTE: NA = not applicable

a. Tax expenditure estimates were prepared only on a calendar year basis for the years 1967 to 1973. The estimate for calendar year 1967 corresponds roughly to fiscal year 1968, and is therefore compared to the outlays for that year.

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 taxpayers to use in whatever way they see fit; tax expenditures return resources to taxpayers 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 the distinction between these two ways of reducing taxes.

H.R. 4882

H.R. 4882 would incorporate limits on tax expenditures into the budget process by requiring that the first and second budget resolutions include a recommended level for total tax expenditures as well as for total revenues, and specify the amount by which both tax expenditures and revenues should be increased or decreased. It would also subject tax expenditures to the point-of-order discipline of Section 311 of the Budget Act, thereby making out of order any legislation that caused the recommended level of tax expenditures to be exceeded.

H.R. 4882 would thus sharpen the distinction between general revenue-reducing measures, such as rate cuts and increases in the standard deduction (zero bracket amount) and personal exemptions, and special-purpose tax provisions that seek to provide incentives for certain kinds of activities, or relief to those in special circumstances. This would enable the Congress to achieve more comprehensive control over the federal government's resource allocation activities. It would be harder for those programs or activities that are unable to obtain support on the direct spending side of the budget to obtain it through the back door of tax expenditures. And it would be easier to avoid the duplication and overlap that can now occur when similar programs are supported through both direct spending and tax expenditures.

Possible Definitional and Measurement Problems

As the CBO report I referred to earlier discusses in more detail, there are some problems in defining and measuring tax expenditures. These problems affect mainly the current total of tax expenditures--the base from which H.R. 4882 would begin. Under H.R. 4882, however, decisions are only required on relatively small additions to or subtractions from that base. The definitional and measurement problems with respect to these incremental decisions are minor.

Definitional Problems. Tax expenditures are defined in the Budget Act as the revenue losses attributable to provisions of the tax law that allow "a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." In general, tax expenditures are provisions that have some special purpose beyond simply defining taxable net income. Provisions that are part of the normal structure of the tax code--general rate schedules and exemption levels, general rules on who is subject to tax and what accounting periods should be used, and deductions for the costs of earning taxable income--are not classified as tax expenditures.

Inevitably there are some problems with borderline provisions. The just-enacted deduction for two-earner married couples, for example, is treated as a tax expenditure. But if the Congress had adopted a broader approach and allowed married couples to be taxed separately at the lower rates applicable to single persons, the change would probably have been regarded as a modification of the basic tax structure rather than as a tax expenditure. The newly enacted Accelerated Cost Recovery System of depreciation is another example. It could plausibly be argued that this is such a fundamental restructuring of business taxation that it represents a new tax system rather than a special incentive or tax expenditure designed to encourage business investment.

Despite these uncertainties at the margin, however, there has been almost complete agreement over the years between the Congress and the Administration on which provisions of the tax code are "special" enough to be termed tax expenditures. In any event, disagreements over past classification decisions need not affect the decisions the Congress would have to make under H.R. 4882. If the budget resolution required that tax expenditures be cut by $5 billion, for example, and if there was any question about whether a provision that would be cut or eliminated was a tax expenditure, the Congress could make that decision for itself at the time. It would be no more difficult than a whole host of budget classification decisions that must be made all the time on the spending side of the budget.

<u>Measurement Problems.</u> As I discussed in detail in my testimony on November 24 before the Senate Budget Committee, there are certain difficulties in estimating the arithmetic total of all tax expenditures. Each individual tax expenditure estimate represents a good approximation of the revenue that would be gained if that provision did not exist and nothing else changed. But to estimate what total revenues would amount to if no tax expenditures existed would require, in effect, the construction of a whole new tax system. The resulting tax increases would be so large that they would produce fundamental changes in the economy that would themselves have dramatic effects on revenue collections. Such an estimate could be made, but it would be so sensitive to the assumptions made about the economic effects that the assumptions would largely determine the results.

Again, however, this problem with the arithmetic totals is generally not important as long as decisions are based only on incremental changes to the total. If the budget resolution specifies that tax expenditures shall be reduced by $5 billion, the only question is whether the legislative changes in question will have that effect.

One question to be decided is how to treat changes in overall tax rates or the standard deduction (zero bracket amount) in budgeting tax expenditures. A reduction in income tax rates would reduce the revenue loss from all tax expenditures that take the form of deductions, exemptions, or exclusions from income, since the revenue loss is measured by multiplying the amount excluded by the relevant marginal rate.

Similarly, increases in the standard deduction would reduce the revenue loss from all tax expenditures that take the form of itemized deductions. The Congress could, of course, decide that this kind of reduction in tax expenditures should not count for budget resolution purposes. The argument against such a rule is that reducing tax rates does in fact reduce the resource allocation effects of tax expenditures, and therefore account should be taken of this in the budget process. The problem does not seem intractable, however. It is probably one of those cases where the particular rule you choose is not as important as simply having a rule.

ADDITIONAL STEPS

As my testimony so far has indicated, I believe that H.R. 4882 represents an important and workable step toward improved control of tax expenditures. The Committee may want to consider some additional steps, however.

In many cases, tax expenditures are quite similar in purpose to spending or loan programs. The purpose of both the targeted jobs tax credit and the Job Corps, for example, is to provide jobs for hard-core unemployed youth. For residential energy conservation there are tax credits, grants, and loans. The Interior Department provides direct grants for historic preservation and also helps administer the tax incentives for historic preservation. Both the Export-Import Bank and the Domestic International Sales Corporation (DISC) tax provisions subsidize U.S. exports.

The Committee may therefore want to explore ways of involving the committees with jurisdiction over analogous spending and loan programs more directly in the control of tax expenditures. These 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 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 tax expenditures with that of similar spending programs. They might also help to prevent those who are unable to obtain federal assistance through grant or loan programs from making end runs around the budget process and obtaining it through tax expenditures.

The Rules of the House recognize the value of this kind of review by providing that:

> Each standing committee of the House shall have the function of reviewing and studying on a continuing basis the impact or probable impact of tax policies affecting subjects within its jurisdiction . . .
> (Rule X 2.(d))

The difficulty with this rule is that the non-tax committees have no real incentive to examine tax expenditures. Additional tax expenditures cost them nothing, and reductions in tax expenditures gain them nothing. If the budget process could be revised to make the involvement of these committees in decisions on tax expenditures more meaningful, Congressional control over tax expenditures could be substantially enhanced.

Greater Involvement of Spending Committees

One way of doing this would be to break the tax expenditure budget down into separate budget functions, as is done with spending programs. The tax expenditures in each function could then be allocated to the various committees with jurisdiction over analogous spending programs, by means of the same kind of "crosswalk" procedure that is used for spending allocations.

The Budget Act could be amended to require that all legislation providing for new or increased tax expenditures must be referred to the committee or committees with jurisdiction over analogous spending programs, after being approved by the House Ways and Means or Senate Finance Committee. The spending committee could recommend approval, approval with modifications, or disapproval. Its recommendation would then accompany the bill to the floor. This would be analogous to the procedure set out in Section 401 of the Budget Act for review by the Appropriations Committees of bills providing new spending authority.

In order to make the review function serious, however, it would be important to ensure that the decision had real consequences. One way to provide an incentive for serious review would be to tie a spending committee's spending allocations to the actions it takes on tax expenditure allocations. Its spending allocation could be reduced, for example, if the committee approved a tax expenditure that was referred to it. Or the spending committee could be permitted to recommend to the tax committee that a tax expenditure included in the spending committee's allocation be reduced or eliminated, and if the tax committee agreed, the spending committee's spending allocation could be increased. Spending committees faced with the need to reduce spending on programs within their jurisdiction might recommend that tax expenditures allocated to them be reduced instead. The energy committee, for example, might recommend that the home insulation tax credit be reduced in order to provide additional funding for grant and loan programs for home insulation. The public works committee might recommend that tax-exempt industrial revenue bonds be limited in order to provide more funding for Economic Development Administration programs. The banking committee might recommend that the new tax provisions allowing more rapid depreciation for commercial and residential real property be scaled back in order to provide more funding for low- and moderate-income rental housing.

At a time like the present, when strict budget discipline is needed in all aspects of the federal government's activities, this procedure for forcing trade-offs between tax expenditures and direct spending could help to assure that the discipline is applied more uniformly to all forms of resource allocation and that the same careful review is given to tax expenditures that should be given to all forms of federal resource allocation and intervention in the economy.

Initial Experimentation

The jurisdictional and other questions that may arise with any new procedure of this kind suggest that it be tried in a limited and experimental way for a period of time before being fully implemented. The experience over the last few years with a credit budget may be a useful guide. The Budget Committees and the Congress have voted on a separate nonbinding credit budget as part of budget resolutions for the last two years. As experience has been gained, and as more attention has been devoted to the analytic and practical problems that are involved, the Congress has reached a point at which firmer and more binding controls over the allocation of credit can be implemented.

The same procedure could be followed with tax expenditures. The Congress could start with the controls over aggregate tax expenditures provided in H.R. 4882, perhaps supplemented with function-by-function breakdowns for informational purposes, and nonbinding allocations to the spending committees. The Congress might then experiment with the referral of new or increased tax expenditures to spending committees that have very closely analogous spending programs within their jurisdiction. Approval might or might not entail reduction in the committees' spending allocations.

CONCLUSION

Experience with the budget process has shown that it is adaptable to changing circumstances, even without formal amendment. I think we know enough already to say that the amendments included in H.R. 4882 would be workable and useful. The Congress could experiment further with additional controls over tax expenditures, just as it has with controls over credit. As more experience and knowledge is gained, and a consensus begins to form, the new procedures could be formally institutionalized by amendments to the Budget Act. The important thing, however, is to start. Tax expenditures are too important a part of the federal activities to be left free from direct control under the budget process.