



**February 12, 2015**

Memorandum

To: Members of the Board  
*Wendy M. Payne*

From: Wendy M. Payne, Executive Director

Subj: **Tax Expenditures – Definitional Issues<sup>1</sup> - Tab D**

### **MEETING OBJECTIVES**

- Consider definitional issues surrounding “tax expenditures” to inform development of a project plan

### **BRIEFING MATERIAL**

Attachment 1 – October 2013 Tax Expenditure Briefing Memo and Minutes

### **BACKGROUND**

The Board rated tax expenditures a priority in 2013 and is now able to begin active discussion given progress on other priorities. This first discussion of issues will inform development of a project plan including the role and composition of a task force.

### **STAFF ANALYSIS**

#### Definitions

“**Tax expenditures**” is the term adopted in the *Congressional Budget and Impoundment Act of 1974* (the Budget Act). The Budget Act defines tax expenditures and requires annual publication of a list of tax expenditures and estimated amounts with the President’s Budget.

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<sup>1</sup> The staff prepares Board meeting materials to facilitate discussion of issues at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

Tax expenditures are:

Revenue losses attributable to provisions of Federal income tax laws which 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. (Section 3(3) of Public Law 93-344)

The general definition of tax expenditure seems to have been settled in law. Most critics focus on the definition essential to report on tax expenditures; that of “normal income tax law.”

The legislative history identifies “**normal income tax law**” as the reference for estimating tax expenditures but does not define “normal.”<sup>2</sup> The October 2013 discussion with Dr. Marron highlighted many of the judgments required in defining “normal” as well as how political views might influence some such judgments. (See Attachment 1 for minutes of the discussion.)

Official Estimates – Legislative and Executive Branches

Presently, both the Joint Committee on Taxation (JCT) and Treasury’s Office of Tax Analysis (OTA) publish annual estimates of tax expenditures. Each publication includes narrative to aid the reader in understanding the estimates. A 2011 article, Reconsidering Tax Expenditure Estimation, by Rosanne Altshuler and Robert Dietz provides insights regarding the judgments made by the two bodies. The following table from that article compares the judgments made by the JCT and the OTA (using the 2010 publications).<sup>3</sup>

<b>Table 1 – A Comparison of Baselines</b>	
<b>JCT Normal Tax</b>	<b>Treasury Normal Tax</b>
<p><b>Individual Tax</b></p> <ul style="list-style-type: none"> <li>• One personal exemption for each taxpayer and dependent</li> <li>• Standard deduction</li> <li>• Includes all cash transfer payments from the Government</li> <li>• Deductions for investment and employee business expenses</li> <li>• Prevailing tax rate schedule and tax brackets</li> <li>• Capital gains taxed upon realization</li> <li>• All employee compensation subject to tax currently               <ul style="list-style-type: none"> <li>□ Employee stock options taxed at regular rate when options exercised (with corresponding deduction for employees). Income is difference</li> </ul> </li> </ul>	<p><b>JCT normal tax with the following exceptions:</b></p> <ul style="list-style-type: none"> <li>• Includes [Alternative Minimum Tax] AMT and passive loss rules as part of the baseline</li> <li>• Includes net imputed rental income</li> </ul>

<sup>2</sup> Altshuler, Rosanne and Robert Dietz. “Reconsidering Tax Expenditure Estimation.” *The National Tax Journal*, June 2011, 64 (2, Part 2), 459-490.

<sup>3</sup> Altshuler and Dietz. 468-469. [Omitted information from the table regarding a third baseline tax – the Treasury Reference Tax.]

<p>between purchase price of stock and the market price on the day the option exercised.</p> <ul style="list-style-type: none"> <li>• All other income and transfers subject to tax <ul style="list-style-type: none"> <li>□ Social security income excluded only for the portion of retirement benefits that represent a return of payroll taxes paid during working years; Medicare benefits excluded only for the portion of HI tax contributions; public assistance benefits (food stamps, Medicaid, public housing) subject to tax; gifts excluded</li> </ul> </li> <li>• Imputed income from owner-occupied homes excluded (but not classified as tax expenditure due to administrative necessity)</li> <li>• Income tax levied on nominal not real gains in asset values (no indexing)</li> <li>• Foreign tax credit</li> </ul>	
<p><b>Business income taxation</b></p> <ul style="list-style-type: none"> <li>• Treatment of capital costs <ul style="list-style-type: none"> <li>□ Cost recovery allowances more favorable than straight-line recovery</li> </ul> </li> <li>• No indexing</li> <li>• Accounting standards <ul style="list-style-type: none"> <li>□ Accrual method of accounting, standard of “economic performance” used to determine whether liabilities are deductible, and general concept of matching income and expenses. Tax provisions that do not satisfy all three are viewed as tax expenditures.</li> </ul> </li> <li>• Prevailing carryback and carryforward periods for net operating losses</li> <li>• Top statutory rate on corporate income (no graduated rates)</li> <li>• Special tax rules for pass-through entities and nonprofit corporations exempting them from corporate income tax</li> <li>• Controlled foreign corporations (CFCs) not considered separate entities from controlling U.S. shareholders</li> <li>• Foreign tax credit</li> </ul>	<p><b>JCT normal tax with the following exceptions</b></p> <ul style="list-style-type: none"> <li>• Includes corporate AMT</li> <li>• Includes cash method of accounting for certain businesses</li> <li>• Uses economic depreciation in baseline</li> </ul>
<p>Notes: See JCT (2010) and OMB (2010) for further details.</p>	

While the OTA exceptions to the JCT<sup>4</sup> approach appear to be few, they mean (1) some items are identified as tax expenditures in one case and not the other, and (2) the

<sup>4</sup> Note that the selection of the JCT normal tax as the reference point is not intended to imply a preference for one over the other.

interaction among the provisions may affect the estimated amount for individual tax expenditures. For example, whether the AMT is part of the “normal” tax system may affect the tax rates applied in estimating the value of a deduction.

Note that this paper focuses on definitional issues but estimation and presentation issues may be influenced by the definition. For example – the definition may influence how negative tax expenditures are classified and presented as well as assumptions regarding taxpayer alternatives. The JCT identifies the following six specific differences:

1. Methodology – JCT measures the tax expenditure as the difference between the tax liability under present law and the tax liability that would result if the provision were repealed and the taxpayer took advantage of remaining provisions that apply to the income or expense associated with the repealed provision. The OTA does not assume the taxpayer would take advantage of remaining provisions.
2. Definitional – JCT assumes a broader definition of normal tax than the OTA (see Table 1 above).
3. Data sources – The JCT and OTA have different sources of data as well as economic forecasts.
4. Time Period – The JCT covers the current plus four fiscal years while the OTA covers the last fiscal year, the current fiscal year, and the next five fiscal years.
5. De Minimis Amounts – Approaches to excluding small amounts differ.
6. Negative Tax Expenditures – Estimates are presented differently.<sup>5</sup>

Some raise the following broader concerns or preferences regarding the choices made in identifying a normal tax:<sup>6 7</sup>

1. Estimates use current law, including certain “sunset” provisions (such as the AMT patch and certain credits), in making normal tax projections rather than current policy. Since estimates are provided for future years, the estimates are affected by expiring provisions even where current policy implies provisions will be extended.
2. The reference (normal) tax system should be a consumption tax. Such a change would affect whether certain provisions were tax expenditures. For example, using a consumption tax as the reference law would mean exemption of contributions to and income earned in individual retirement accounts were not tax expenditures.
3. A more comprehensive measure of “income” is needed in the normal tax system. For example, unrealized capital gains could be treated as income for normal tax purposes but JCT and OTA do not. Instead, they view capital gains as normally taxed when realized (cash basis).

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<sup>5</sup> Joint Committee on Taxation. *Estimates of Federal Tax Expenditures for Fiscal Years 2014 – 2018* (JCX-97-14). August 5, 2014. Last Accessed on February 2, 2015 at <https://www.jct.gov/publications.html?func=startdown&id=4663>

<sup>6</sup> Altshuler and Dietz. 2011.

<sup>7</sup> Leonard Burman and Marvin Phaup. Tax Expenditures, the Size and Efficiency of Government, and Implications for Budget Reform. Working Paper 17268. *National Bureau of Economic Research*. August 2011.

4. Acceptance of progressive tax rates as “normal” when some argue flat rates should be “normal.” This affects what items are identified as tax expenditures. For example, creation of an income based tax credit to reduce tax liabilities would be a tax expenditure while addition of a new lower rate step in the progressive rate structure would not.
5. Tax expenditures are limited to income taxes but similar preferences exist in other tax categories (excise taxes). So, the definition leads to omission of substantively similar transactions.

### Types of Tax Expenditures

Dr. Marron’s October 2013 presentation identified six types of tax expenditures:

1. Deductions such as charitable contributions and accelerated depreciation (a timing shift – higher deductions in early years offset by smaller deductions in later years)
2. Exemption of reported income such as tax-exempt interest and credit union income
3. Exclusion such as employer health insurance and imputed rental value of home
4. Credits<sup>8</sup> such as child and research & experimentation
5. Deferral such as 401(k) and foreign income
6. Preferential rates such as capital gains and dividends

In considering the above types, remember that the same outcome can be achieved in a variety of ways. For example, same public policy purpose can be achieved through a preferential rate, a deduction, or a credit. Because a variety of approaches can be used to produce the same cash flow, the types might be viewed as administratively rather than substantively different.

### Governmental Accounting Standards Board’s Tax Abatement Proposal

The GASB proposes to require disclosure of tax abatements. They tentatively define tax abatements as follows:

...a tax abatement results from an agreement between one or more governmental entities and a taxpayer in which (a) one or more governmental entities promise to forgo revenues from taxes for which the taxpayer otherwise would have been obligated and (b) the taxpayer promises to take a specific action after the agreement has been entered into that contributes to economic

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<sup>8</sup> Note that refundable tax credits (those such as the earned income tax credit that are paid even if they exceed the amount owed by a taxpayer) are presently reported as costs in the statement of net cost. Tax revenue is increased by the amount of the credit that reduced the taxpayer’s required payment. Cost is reported for the full amount of the refundable credits (that is, the amount offset against taxes owed and the portion in excess of any taxes owed).

development or otherwise benefits the governments or the citizens of those governments.<sup>9</sup>

GASB summarized the disclosure requirements as:

- General descriptive information, such as the tax being abated, the authority under which tax abatements are provided, eligibility criteria, the mechanism by which taxes are abated, provisions for recapturing abated taxes, and the types of commitments made by tax abatement recipients
- The number of tax abatement agreements entered into during the reporting period and the total number in effect as of the end of the period
- The dollar amount of taxes abated during the period
- Commitments made by a government, other than to abate taxes, as part of a tax abatement agreement.

The GASB contracted for a user needs survey in advance of developing the exposure draft. The website identifies the following results.

The survey of users ....[conducted by the academics awarded the Gil Crain grant]... was administered to staff and members of citizen groups, municipal bond analysts, and county board members.

One portion of the survey offered statements about tax abatement programs drawn from the literature and asked respondents to rate their agreement or disagreement with the statement. The statements specifically relevant to financial reporting were:

- a. Governments should report annually on tax abatement agreements outstanding.
- b. Legislators (for example, county commissioners or county board members) involved in granting tax abatements should receive timely reports comparing expected performance to actual performance.
- c. Citizens and other interested parties should have access to annual reports comparing expected performance to actual performance for all tax abatement agreements outstanding.
- d. Information about taxes recovered through recapture provisions should be reported to legislators who grant tax abatements.
- e. Information about taxes recovered through recapture provisions should be accessible to citizens and other interested parties on an annual basis.

Overall, the level of agreement in each of the three groups of users was very high on all five of these statements. Citizen group members and staff particularly agreed with statements a, b, and c. The highest level of agreement among county board members was with statement b. Municipal bond analysts most strongly agreed with a, c, and d.<sup>10</sup>

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<sup>9</sup> GASB. *Proposed Statement of the Governmental Accounting Standards Board: Tax Abatement Disclosures*. October 20, 2014. Par. 4.

<sup>10</sup> [http://www.gasb.org/jsp/GASB/GASBContent\\_C/ProjectPage&cid=1176160019928](http://www.gasb.org/jsp/GASB/GASBContent_C/ProjectPage&cid=1176160019928) – Last accessed February 2, 2015.

GASB researchers considered whether there were statutory requirements in place to report on tax abatements. Six states were identified as having such requirements.

A cursory review of the more than 200 comment letters to the GASB ED revealed:

- a. Taxpayers and advocacy groups (such as teachers associations and non-profits) express a strong interest in tax abatement information and preferential tax treatment in general.
- b. Concerns that structural or administrative differences in agreements may permit similar arrangements to go undisclosed. For example, diversions of employee income tax withholdings to the employer were viewed as not meeting the proposed definition but as having the same effect.
- c. Some expressed the view that the benefits of the tax abatement should be measured as well so that the net tax revenue effect is revealed. For example, a tax abatement that leads to greater employment and economic growth may produce greater tax revenue rather than less.
- d. Concern with placement – that is, as a disclosure versus as RSI.

## DISCUSSION ITEMS

Members' views regarding existing definitions of tax expenditures and the normal tax system would be helpful in developing the project plan and forming a tax force. The scope and complexity of the project expand significantly if the Board envisions developing a unique set of definitions.

Options for the project include:

- a. **Rely on Existing Definitions to Develop Primarily Narrative Reporting-** Accepting the existing definitions and focusing on how existing information might inform financial statement users. The task force would develop narrative requirements to aid the user in understanding the role of tax expenditures in federal activities. Such an effort would improve understanding and awareness of tax expenditures without directly requiring presentation of amounts.
- b. **Rely on Existing Definitions to Develop Narrative and Potentially Identify Amounts for Presentation** - In addition to option a, the task force should consider whether amounts should be presented for all or some types of tax expenditures.
- c. **Develop a Framework for Reporting** – Develop a framework including terms, recognition and measurement guidance, and disclosure requirements for use in federal financial statements. For example, choices among terms such as tax expenditure vs. tax preference as well as measurement options would be considered.

I recommend the Board pursue **option a**. Resolving long-standing definitional issues would be time consuming and controversial. Further, unique definitions (option c) would likely prevent reliance on existing estimates. The outcome would be (1) added cost for a third set of estimates, (2) delay in issuing reporting requirements due to extensive research and deliberation, and (3) burden on knowledgeable users of existing estimates to analyze additional differences.

While option b appears similar to the GASB approach, I believe the added time and controversy of identifying amounts, resolving challenges associated with data sources, timing, and aggregation of amounts will be significant. The delay is unlikely to significantly improve the information already available through other sources. In contrast, option a would leverage existing sources of information so that readers of financial statements gain a better understanding of the economic or full cost of government sooner rather than later.

## **QUESTIONS FOR DISCUSSION**

**Do members agree that option a is the right basis for the project plan?**

Please contact me as soon as possible to convey your questions or suggestions. Communication before the meeting will help make the meeting more productive. You can contact me by telephone at 202-512-7362 or by e-mail at [valentinem@fasab.gov](mailto:valentinem@fasab.gov) with a cc to [paynew@fasab.gov](mailto:paynew@fasab.gov)

# October 18, 2013 Memo to the Board

Memorandum

To: Members of the Board

From: Wendy M. Payne, Executive Director

Subj: Tax Expenditures <sup>1</sup> –

## MEETING OBJECTIVE

- Educational session so that members are better prepared to assess a draft tax expenditures project plan in February 2014

The Board identified tax expenditures as a high priority project earlier this year. While we are not able to staff the project yet, we can begin developing an understanding of the information used by policy makers and others. Donald Marron will be joining us to provide an introduction to tax expenditures and answer members' questions.

Dr. Marron is the Director of Economic Policy Initiatives, Institute Fellow, Urban Institute; Director Emeritus of the Tax Policy Center. He previously served as a member of the President's Council of Economic Advisers, as acting director of the Congressional Budget Office (CBO), and as executive director of Congress's Joint Economic Committee. Before his government service, he taught economics and finance at the University of Chicago Graduate School of Business and served as chief financial officer of a health care software start-up. Dr. Marron was also a visiting professor at the Georgetown Public Policy Institute. Also, during his tenure at CBO, he was a member of FASAB.

## BRIEFING MATERIALS

This memo provides a brief overview of the topic. Attachments provide additional information that would be useful as you consider questions you may wish to ask. The Appendix provides you with the most recent report on tax expenditures from the President's Budget. In addition to explanatory material, it presents estimates and descriptions of tax expenditures.

Attachments:

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1. Marron, Donald. **Spending in Disguise**, *National Affairs* - <http://www.taxpolicycenter.org/UploadedPDF/1001542-Spending-In-Disguise-Marron.pdf>
2. Marron, Donald and Toller, Eric. **Tax Policy and the Size of Government**, Urban Institute and Urban-Brookings Tax Policy Center, *National Tax Association Proceedings*, 104<sup>th</sup> Annual Conference on Taxation. <http://www.taxpolicycenter.org/UploadedPDF/412850-tax-policy-size-of-government.pdf>
3. Marron, Donald. **How Large are Tax Expenditures: A 2012 Update**, *Tax Facts from the Tax Policy Center* - <http://taxpolicycenter.org/UploadedPDF/1001602-TN-How-Large-Are-Tax-Expenditures-2012-Update.pdf>

Appendix: *Analytical Perspectives*: Federal Receipts – Tax Expenditures – pages 241-277 -

<http://www.whitehouse.gov/sites/default/files/omb/budget/fy2014/assets/receipts.pdf>

## Background<sup>2</sup>

The Congressional Budget Act of 1974 defines tax expenditures as “revenue losses attributable to provisions of the federal tax laws which 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 liability.”

Tax expenditures may take the form of credits, deductions, special exceptions and allowances, and reduce tax liability below the level implied by the baseline tax system. The normal tax baseline is patterned on 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. The normal tax baseline allows personal exemptions, a standard deduction, and deduction of expenses incurred in earning income. It is not limited to a particular structure of tax rates, or by a specific definition of the taxpaying unit. The normal tax baseline allows several major departures from a pure comprehensive income tax. For example:

- Income is taxable only when it is realized in exchange. Thus, the deferral of tax on unrealized capital gains is not regarded as a tax expenditure. Accrued income would be taxed under a comprehensive income tax.
- There is a separate corporate income tax.

Considerations and explanatory comments include:

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<sup>2</sup> The following is largely a summary of the appendix - *Analytical Perspectives*, Federal Receipts, Tax Expenditures (pages 241-277).

1. Deciding whether a provision of tax law is an exception to the normal tax baseline is a matter of judgment.
2. A grand total for the estimated tax expenditures is not provided in Analytical Perspectives because each tax expenditure is estimated assuming other parts of the Tax Code remain unchanged. The estimates would be different if tax expenditures were changed simultaneously because of potential interactions among provisions.
3. Estimates should be regarded as approximations. The individual estimates do not necessarily equal the increase in Federal revenues (or the change in the budget balance) that would result from repealing these special provisions because:
  - a. eliminating a tax expenditure may have incentive effects that alter economic behavior, and
  - b. tax expenditures are interdependent even without incentive effects.
4. Estimates are provided for the cash (current revenue) effect and the present value effect for the period 2012 through 2018. The present value effects are important because deferrals will reverse in later years. (Note that new deferral provisions may result in expenditures for which later reversals are wholly outside the time period of the estimate.)
5. Estimates are based on tax law in effect at December 31, 2012 and assume that any provisions scheduled to expire will expire (for example, alternative minimum tax relief).
6. Estimates are grouped by functional categories including:<sup>3</sup>
  - a. National defense (exclusion of benefits and allowances to armed forces personnel)
  - b. International affairs (exclusion of income earned abroad by U.S. citizens)
  - c. General science, space, and technology (credit for increasing research activities)
  - d. Energy (energy investment credit)
  - e. Natural resources and environment (Income averaging for farmers)
  - f. Agriculture (Income averaging for farmers)
  - g. Commerce and housing (carryover basis of capital gains on gifts)
  - h. Transportation (exclusion for employer-provided transit passes)
  - i. Community and regional development (investment credit for rehabilitation of structures)
  - j. Education, training, employment, and social services (HOPE tax credit)
  - k. Health (exclusion of employer contribution for premiums)
  - l. Income security (exclusion of workers comp benefits)
  - m. Social security (exclusion of social security benefits)
  - n. Veterans benefits and services (exclusion of veterans pensions)
  - o. General purpose fiscal assistance (exclusion of interest on state and local bonds)
  - p. Interest (deferred interest on savings bonds)
  - q. An addendum for aid to state and local governments (deductibility of property taxes on owner-occupied homes)
7. Tables present total revenue effects that arise under individual and corporate income taxes separately. The reader is cautioned that labeling does not imply that individuals and corporations “benefit from the special tax provisions in proportion to the respective tax expenditure amounts shown. Rather, these breakdowns show the form of tax liability that the various provisions affect. The ultimate beneficiaries of corporate tax expenditures could be shareholders, employees, customers, or other providers of capital, depending on economic forces.”

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<sup>3</sup> One example tax expenditure item is included parenthetically for each functional category. See the appendix for a complete list. Note that no functional totals are provided.

8. Tax expenditures can arise in other than income taxes (for example, excise taxes) but these generally are not included in reports on tax expenditures.

Analytical Perspectives (see Appendix) describes 169 tax expenditures. The top ten, based on total FY2014-2018 revenue effect (Table 16-3), are:

<b>Appendix Ref #</b>	<b>Provision</b>	<b>2014 (in millions)</b>	<b>2014-2018 (in millions)</b>
128	Exclusion of employer contributions for medical insurance premiums and medical care	\$ 212,820	\$ 1,206,260
59	Deductibility of mortgage interest on owner-occupied homes	101,470	640,180
146	Defined contribution employer plans	79,720	477,870
63	Exclusion of net imputed rental income	75,520	436,680
71	Capital gains (except agriculture, timber, iron ore, and coal)	46,690	331,020
145	Defined benefit employer plans	53,060	308,390
168	Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	51,560	292,140
77	Accelerated depreciation of machinery and equipment (normal tax method)	17,850	273,730
62	Capital gains exclusion on home sales	45,870	263,200
124	Deductibility of charitable contributions, other than education and health	44,060	259,910

### Performance Measures

Consideration of tax expenditures is now included in performance management efforts.

Congress updated the statutory framework for performance management in the federal government, the Government Performance and Results Act of 1993 (GPRA), with the GPRA Modernization Act of 2010 (GPRAMA). Both acts require agencies to set goals and measure and report the performance of their programs. GPRAMA introduced a more integrated and crosscutting approach to performance measurement that cuts across organizational boundaries. The act requires that OMB, in coordination with agencies, develop long-term crosscutting priority goals to improve performance and management of the government. OMB is to coordinate annually with agencies to develop a federal government performance plan which establishes performance indicators for achieving these goals. Moreover, GPRAMA requires that this plan identify the tax expenditures that contribute to each crosscutting priority goal. As we noted in a recent report,

sporadic progress has been made along these lines. **OMB Circular A-11 guidance directs agencies to list tax expenditures among the various programs and activities that contribute to the subset of performance goals that are designated as agency priority goals.** [footnotes omitted]<sup>4</sup>

## Considerations for the Board

When the project plan is developed, we will want to consider questions such as:

1. Should issues be considered from a “blank slate” or should we work with the framework for existing reports such as Analytical Perspectives? This will impact:
  - a. Definitions
  - b. Measurement and presentation guidance
    - i. Normal tax
    - ii. Consideration of tax provisions that expire but are routinely extended
    - iii. Projected and/or historical amounts
    - iv. Present value over a period of time (to address reversing provisions)
2. Which of the various means of categorization (functional, tax expenditure type, related agency (goal or program)) are needed? (Is it necessary and/or appropriate to provide sub-totals?)
3. What explanatory information is needed to help users understand the estimates?
  - a. Nature of these estimates
  - b. To the extent that tax expenditures substitute for spending, what – if any - options exist to relate the tax expenditure information to net cost information and to performance measures?
  - c. Changes in law and prior projections
4. What placement in the financial reports (MD&A, financial statements, notes or required supplementary information) is needed to meet reporting objectives within the overall constraint of cost-beneficial requirements? (Note: presentation in a variety of places is possible.)
5. Is reporting only at the government-wide level or also at agency level?

At the meeting, Dr. Marron will address questions you may have regarding tax expenditures.

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<sup>4</sup> GAO-13-479 Data for Tax Expenditures

## MINUTES OF THE OCTOBER 2013 MEETING

- **Tax Expenditures**

Mr. Allen welcomed Donald Marron, the Director of Economic Policy Initiatives, Institute Fellow, Urban Institute; Director Emeritus of the Tax Policy Center. He previously served as a member of the President's Council of Economic Advisers, as acting director of the Congressional Budget Office (CBO), and as executive director of Congress's Joint Economic Committee. Before his government service, he taught economics and finance at the University of Chicago Graduate School of Business and served as chief financial officer of a health care software start-up. Dr. Marron was also a visiting professor at the Georgetown Public Policy Institute. Also, during his tenure at CBO, he was a member of FASAB.

Dr. Marron explained that people often view taxation as the way the government raises money. This is true but misses the fact that the government makes policy through the tax code. There is a debate about whether such policy is the moral equivalent to spending; in his opinion it often is. He explained that incentives are created and resources are reallocated. Either spending or tax policy can be used for these purposes.

Dr. Marron gave examples of tax provisions that substitute for spending programs. Following the economic distress in 2008-2009, some existing tax provisions stopped working. For example, the absence of profits caused some tax incentives to cease to work well. These tax incentives were converted to spending programs temporarily to provide incentives. In health reform, a large component of the subsidies is structured as a tax credit. In stimulus proposals, some stimulus could be provided through Social Security but this would not reach all seniors. For those not reached through Social Security, a tax credit was proposed that was economically equivalent to spending.

As a policy analyst, Dr. Marron expressed concern that tax preferences may not get the same attention and transparency as spending. Many tax provisions are permanent and do not get the annual attention that spending receives. There are rarely head-to-head comparisons between spending programs and tax policy. (He noted that he refers globally to 'tax preferences' because most but not all are equivalent to spending (expenditure) and others not. Using 'tax expenditures' as the global reference prejudices the question of whether a provision is equivalent to spending.)

There is no universal agreement regarding what provisions are tax preferences. To reach such an agreement one would need to identify a benchmark tax system. Given an ideal or benchmark system, tax preferences (expenditures) are deviations from that system. Judgments are inevitable in reporting on tax expenditures.

There is annual reporting on tax expenditures though. The Joint Committee on Taxation (JCT) and the Treasury have chosen to consider a broad-based individual income tax and a separate corporate income tax as normal. They have also incorporated as normal a progressive structure. These choices have affected what provisions are identified as 'tax expenditures.'

For example, the tax brackets allowing lower income earners to pay a lower rate than higher income earners are not identified as a preference. However, there are analysts who argue that this progressive rate structure is a preference rather than a feature of the normal tax system. The vast majority of analysts accept the progressive structure as normal.

Double taxation of corporate earnings, once through corporate taxes and again through individual taxes on dividends or capital gains, is also assumed to be part of the “normal tax system.” The U.S. system has features intended to ameliorate double taxation. Because our normal tax system is identified as separate systems for individual and corporate taxation double taxation is “normal.” Thus, features such as lower rates on dividends and capital gains are identified as tax expenditures and some would argue they are not (that is, a normal tax system would not tax earnings twice).

Political views influence judgments regarding the normal tax system. Because classification as a tax expenditure implies that the feature is ‘spending’ or a ‘loophole’, individuals on the right of the political spectrum have objected to reporting the lower rates on dividends and capital gains as tax expenditures.

Dr. Marron also noted there is a long-standing debate about whether it is best to tax consumption or income. The benchmark in the U.S. is an income tax. Some features of our tax system are designed to move in the direction of a consumption tax. For example, accelerated depreciation is designed to encourage investment. Therefore, there is controversy around treatment of such provisions as tax expenditures.

Payroll and excise tax expenditures are not tracked by JCT and are footnoted by Treasury. The largest income tax preference is exclusion of health care benefits provided by employers and this is exempt from payroll tax. Thus, there is a debate about whether these preferences should be included in reports.

Dr. Marron asked if members had any questions before he continued.

Mr. Allen asked whether tax expenditures could be measured in some consistent way from year to year and subject to audit. He noted that the Board rated this as an important project. He imagined there are a variety of ways to treat tax expenditures – disclosures, recognized amounts in the financial statements, or narrative in management’s discussion and analysis. He asked about Dr. Marron’s views on including the estimates.

Dr. Marron noted that the numbers currently focused on are the “net” amounts. That is, the amount the government has asserted a right to collect – perhaps 39% of total income – less the allowed deductions such as mortgage interest and charitable contributions. From a policy point of view, it is interesting to measure the size of government based on the gross actions rather than the net. He referred to the paper regarding the size of government provided in the briefing material (Marron and Toder).

Mr. Allen asked if the estimates could swing widely from year-to-year such that you would not have consistent agreement on the estimates.

Dr. Marron indicated that one decision point is whether it is a number or many numbers. There are about two hundred preferences. JCT and Treasury do not add the preferences together because of the effect of interactions and behavioral impacts. Many policy analysts do estimate them individually and then as a total. If you do all the itemized deductions together, the result is about 7% larger than if you run them individually. This difference is small and does not impact the usefulness of the discussion.

He noted a bigger issue is that the estimates may appear to represent what money you can raise by eliminating preferences. This would not be the case because of the interactions and behavioral impact if policy is changed. Behavioral responses may include decreasing charitable giving or paying down mortgage balances.

Mr. Showalter asked about the reason JCT and Treasury do not add them up. If the report is of the actual results of a prior year, is it more appropriate to total the preferences? Dr. Marron said that is a fair way to approach it but there may still be some interactions that affect estimates. He also noted that there are some differences between JCT and Treasury. One example is the value of the imputed rent you receive in income from owning a home. In concept, this is the equivalent of earnings on any durable asset you own. One set of estimates includes it and one does not. The question is whether this is a subsidy to housing and to be reported or not.

Mr. Dacey discussed a recent GAO report on tax expenditures. The report found that about half of the dollar value of reported tax expenditures comes from information that is not separately reported on line items on actual returns and he believes that they are derived statistically. There may be a challenge in auditing tax expenditures that are based on information that is not separately reported on tax forms.

Dr. Marron provided a few examples of preferences that must be estimated because they do not appear on returns. Mr. Dacey noted that some information comes from Statistics of Income reports prepared by the IRS and believes that such information is about two to three years in arrears. He thought this would pose some challenges to reporting.

Mr. Showalter asked if this would be a problem. He inquired whether we could audit at the total level rather than the individual preferences by considering total income and what the tax would be on that total. Mr. Dacey was uncertain if such an approach would be meaningful.

Dr. Marron acknowledged there is a lot of estimating that must go into this because it is not observable. He noted an additional issue this year. There was a tax law change late in calendar year 2012. Treasury was unable to estimate those changes in time for the estimates released in early 2013.

Mr. Allen asked about the value of health insurance provided by employers. He wondered how the value is reported or estimated. He thought the W-2 does not report that value. Dr. Marron noted a change brought by the Affordable Care Act is that the

value of health insurance will be on the W-2. In addition, economists are estimating the value.

Continuing with his presentation, Dr. Marron noted there are six types of tax expenditures:

1. Deductions such as charitable contributions and accelerated depreciation (a timing shift)
2. Exemption of reported income such as tax-exempt interest and credit union income
3. Exclusion such as employer health insurance and imputed rental value of home
4. Credit such as child and research & experimentation
5. Deferral such as 401(k) and MNC foreign income
6. Preferential rates such as capital gains and dividends

Mr. Allen asked about separating those expenditures that are timing differences such as accelerated depreciation. Dr. Marron noted that the appropriate tax expenditure measure is the value of the timing benefit. This becomes more complicated to measure. For firms, accelerated depreciation is of greater value in periods of higher interest rates. There are many choices made in estimating these timing differences.

Dr. Marron noted that if you measure on a flow basis companies that made investments this year have a benefit and companies that did not make investments are not getting a benefit. The net effect of these behaviors is the expenditure for the government. The amount of timing that is shifted is much larger in 401Ks. Mr. Allen also noted that the tax rates may change before 401Ks reverse.

Mr. Showalter asked if Mr. Allen was suggesting that timing differences not be measured. Mr. Allen noted that may be an option.

Dr. Marron offered that there is a more complicated example. Income from foreign operations of multi-national firms is taxed but the tax is only paid when the income is returned (repatriated) to the U.S. So, when does the deferral become permanent?

Mr. Reger asked if that provides an incentive to not repatriate the income. Dr. Marron agreed. He referred to past "tax holidays." He also indicated there are active discussions of options to resolve this incentive. Generally, he said a net present value approach would be used but there are many choices to make regarding these estimates.

Dr. Marron noted the variety of tax credits that are available in the individual and corporate tax systems. There are both refundable and non-refundable tax credits. The refundable credits are paid even if the amount exceeds the taxpayer's liability and the non-refundable are paid up to the taxpayer's liability (that is, it only offsets taxes owed). In the budget, refundable tax credits are first offset against receipts and the amount paid to taxpayers is then recorded as spending. The total amount shows up as a tax expenditure.

Mr. Dacey asked if personal exemptions and standard deductions are treated as part of the normal tax system and not as tax expenditures. Dr. Marron indicated that they are but that is a choice and is not without controversy.

Mr. Dacey asked who the users of the data are. Dr. Marron noted that the tax reform debate includes discussion of eliminating certain tax expenditures and using the funds to lower the rate. He referred to the various deficit reduction commissions as well as the President's budget as users of the information.

Mr. Dacey asked what source CBO uses for its analyses. Dr. Marron indicated that JCT estimates are generally used.

Ms. Payne noted the discussion focused on policy makers. She asked if it is important for citizens to know about tax expenditures and, if so, all or some.

Dr. Marron noted it is important. He thought it would be useful to know about the magnitude of changes in tax law. He also thought the overall magnitude of tax expenditures in policy is important. He mentioned that the attention to tax preferences waxes and wanes. He noted that the mortgage interest deduction and Social Security are the two largest entitlements of the middle class but the latter gets much more press coverage.

Mr. Allen asked Dr. Marron's views regarding placement in the financial report – management's discussion and analysis, financial statements, note disclosures, or supplementary information. He also wondered if the information would enhance the financial report.

Dr. Marron indicated that one could simply take the Treasury numbers and report them as unaudited amounts. He was not certain that all readers of the financial statements already know that these large amounts are reallocated through the tax code. He noted it would be useful to identify the six largest programs on "auto-pilot" – whether they are spending programs like Social Security or tax policy like mortgage interest deductions. This would encourage people to weigh these policies in an equivalent manner.

Dr. Marron acknowledged you could do a gross revenue line as the first line of the income statement but he would not recommend it.

Mr. Dacey responded that he thought most people understand tax breaks. Mr. Steinberg disagreed. Dr. Marron noted that people view these breaks as "letting them keep their own money." Others view them as government money distributed through the tax system.

Mr. Reger pointed to the charts that show the projected receipts and expenditures. Those charts do not show all the revenue we are foregoing through tax expenditures since these are net revenues. Netting tends to hide aspects of the fiscal situation.

Mr. Steinberg added that reporting on tax expenditures would add information and the press might notice the information. It begins to educate the public about the budget and

tax policy. He also noted that the information about the size of government is important to people.

Mr. Allen noted that a discussion of the fiscal challenges we face is incomplete unless tax expenditures are included. He thought tax expenditures ought to be mentioned. Ms. Kearney agreed that it would be informative but we must be very thoughtful about how it is presented. Showing it as “lost revenue” would be misleading. She thought some explanation of tax expenditures with a reference to Analytical Perspectives could be helpful.

Mr. Smith agreed it is important. He thought it was more complicated than simply “gross” versus “net” revenue reporting. It may need a statement to itself. He felt it was so meaningful that it should not be in a note. It should be more than one line and we should think about the whole picture. It is out of sight and out of mind but is a policy decision. It ought to have the same level of importance.

Mr. Showalter agreed. He noted that hospitals are already reporting gross revenue and then deducting what they do not anticipate collecting from Medicare and Medicaid.

Ms. Kearney noted that it would not be possible to remove all these preferences. So, it would be misleading to present this in a manner that suggests we could collect the whole amount.

Mr. Smith noted that the fact we cannot collect them is still a decision. These are the equivalent of entitlements. We cannot eliminate Social Security but we still report it.

Mr. McCall noted that he leaned toward a special statement, note or RSI. A schedule would help people understand that there are preferences for the middle class person as well as the corporate loopholes that get so much press.

Dr. Marron agreed. No one thinks they benefit from a loophole.

Mr. Steinberg noted the complexity of this project and the importance of a great task force. He thought we should begin by determining the point we want to get across and then determine the best way to convey that point.

Mr. Allen noted that there is a great deal of interest in the project. The project plan will be presented in March.