TAX EXPENDITURE BRIEFING

D.C. TAX REVISION COMMISSION

District of Columbia

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PART I

GENERAL BACKGROUND

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Origin of Tax Expenditure Concept

- Term was coined in 1967 by Assistant Treasury Secretary Stanley Surrey to reflect “deliberate departures” from tax policy that affect the private economy in ways usually achieved by direct expenditures.
- Surrey advocated a full accounting of tax expenditures in order to promote spending control and tax reform.
- Treasury Department released first tax expenditure budget in 1968, but it was “purely hortatory.”

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Definition of Tax Expenditure

- Congressional Budget Act of 1974 defined tax expenditures as: "revenue losses attributable to provisions of the … 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."
- D.C. law, enacted in 2000, uses almost identical language (D.C. Official Code § 47-318(6)).
- Less formally, tax expenditures are sometimes called "disguised spending" – a way of allocating resources to meet public goals.

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“Normal” Tax Baseline

- Tax expenditures are measured as deviations from a baseline “normal tax” system, which generally reflects a comprehensive definition of income. But there is some dispute in defining a normal tax system.
    - For example, is a personal exemption for children a normal part of the tax system, or is it a tax expenditure?
    - JCT, OMB sometimes differ on what constitutes a tax expenditure.
- Still, there is considerable agreement on the classification of tax expenditures; disputes are usually around the margin.

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Ideological/Philosophical Considerations

- Some conservatives reject the concept of tax expenditures.
  - Primary objection is that allowing people to retain more of their income should not be seen as an expenditure; implies that government has a proprietary right to income.
  - Some also see tax expenditure concept as a thinly-veiled agenda for tax increases or narrow views of "tax reform."
- Flaw in these arguments is that tax expenditures are very selective in who benefits and are often contingent on activities that the government finds desirable.
  - Tax expenditures are not general tax cuts – they may make tax rates or public debt higher than they otherwise would be.
  - Tax expenditures can greatly extend government's involvement in social policy and the economy.

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Importance of Tax Expenditures

- Tax expenditures are like entitlements because there is no annual review. If someone meets requirements, he or she gets the benefits (in most cases). These open-ended commitments should be scrutinized.

- Tax expenditure analysis offers a fuller picture of government resource use, and promotes transparency and accountability.

- Tax expenditures affect private resource allocation.

- It is often not clear why some benefits are provided through tax system. In some cases, direct provision (through means such as grants) might be more effective.

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Political Incentives

Tax expenditures give politicians the best of both worlds: they can provide benefits and services that look like a tax cut.

Tax expenditures have been the “dominant” means of creating new federal programs since the 1990s.

Economists Len Burman and Marvin Phaup:
“Their hidden nature has made tax expenditures irresistible to policymakers of both parties – these stealthy programs look like tax cuts.”

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Strengths of Tax Expenditures

- Tax expenditures are viewed as a way to provide service without creating bureaucracy.
  - Lack of welfare bureaucracy is one reason for popularity and growth of Earned Income Tax Credit.
- Tax expenditures are viewed as a way of using incentives rather than restrictive or counterproductive “command and control” approaches.

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Weaknesses of Tax Expenditures

- Tax expenditures are "privileged" in budget process – no regular review. Costs are invisible; size of government is understated.
- Tax programs are not coordinated with spending programs addressing the same issues (social welfare, housing, energy).
- Tax expenditures may be regressive, often having "upside-down" structure in which value of exclusion, deduction, etc. rises with income.
  - Higher-income individuals spend more on items that are tax-favored.
  - Higher-income individuals are more likely to itemize their deductions.
- Tax expenditures can create economic costs – decisions are made for tax advantages rather than putting resources to best use.
- Tax expenditures can strain tax agency; turn collection agency into benefits agency. Tax benefits may not represent best way to administer programs.

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Measurement Issues

- Forgone revenue <u>does not</u> equal revenue that could be raised by repealing a tax expenditure.
- Estimates of revenue loss are static – they don't reflect behavioral changes or interaction effects.
- Tax expenditure budgets provide "ballpark estimates."

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PART II

TAX EXPENDITURES IN THE

DISTRICT OF COLUMBIA

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Statutory Requirements

- CFO is required to prepare biennial tax expenditure budget that estimates revenue loss from each tax expenditure for current fiscal year and next two fiscal years.
- Report must state the statutory authority for each provision, describe its objective, analyze whether it is meeting the objective, and discuss impact on tax burden and tax administration.

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Two Types of D.C. Tax Expenditures

- Federal Conformity: provisions of the U.S. Internal Revenue Code that are mirrored in D.C. income tax law.
  - Example: just as taxpayers can deduct home mortgage interest payments from federal taxable income, the same amount is deducted from D.C. taxable income.
  - Most states conform to many provisions of federal income tax law for simplicity, ease of administration.
- Local: provisions that are established only in D.C. law.
  - Examples: business tax credits for high-technology companies, sales tax exemptions for food and medicine; homestead exemption for real property tax.

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2012 Tax Expenditure Budget

- Provides one-page summaries of 111 federal conformity provisions and 118 local provisions.
- Builds on previous work – 2010 report was cited by Center on Budget and Policy Priorities as “drastically improved” and a possible model for other states.
- Provides greater detail on similar provisions in Maryland and Virginia.
- Cites expert analysis from sources such as CRS, CBO, and Urban-Brookings Tax Policy Center to highlight key issues.

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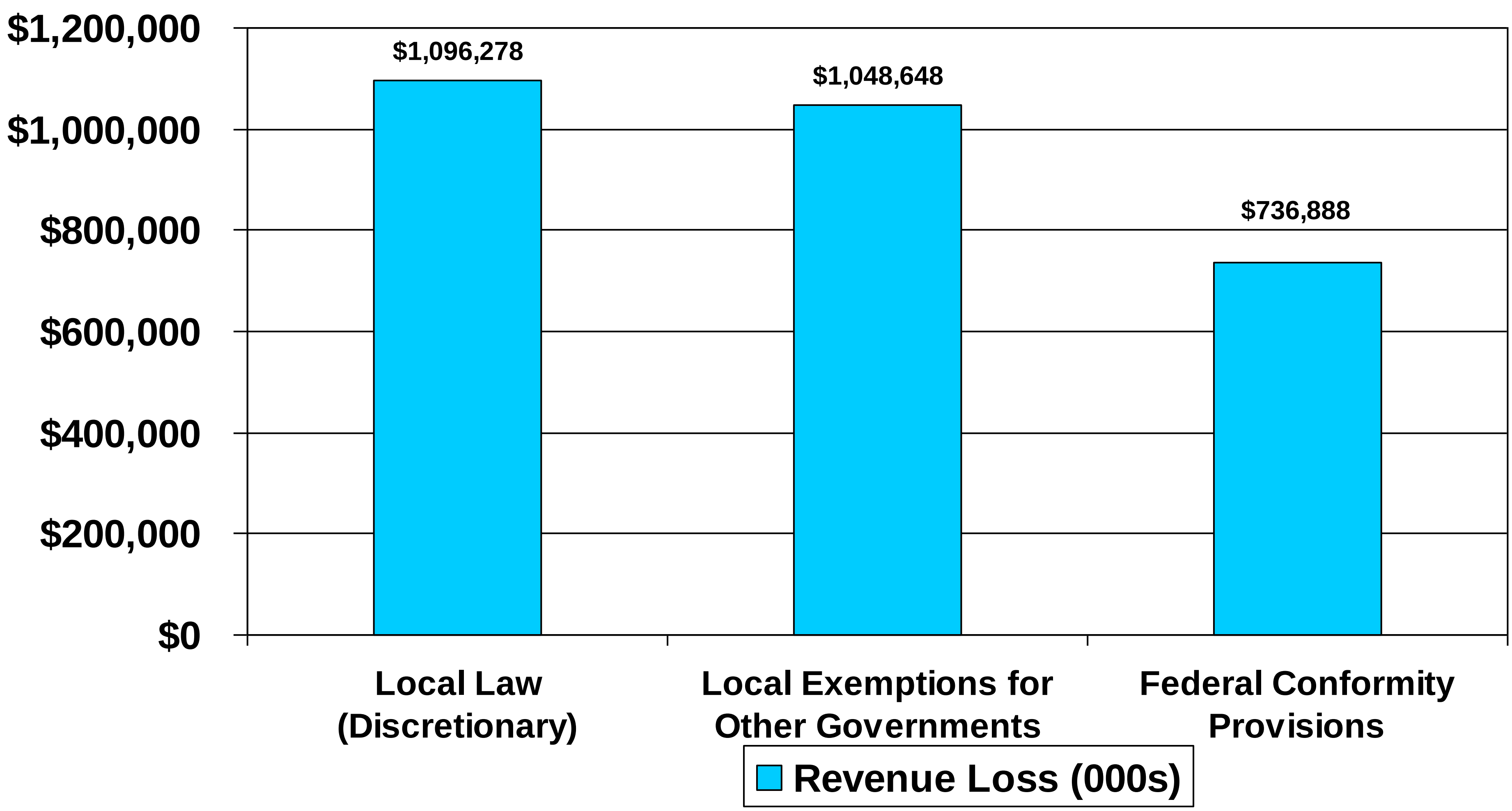
Estimated Revenue Loss by Category, FY 2012



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Local Tax Expenditures by Policy Area

- Economic Development: 24 items with revenue loss of $323.6 million in FY 2012 (sales tax exemptions for professional services, transportation, and communication services account for most of revenue loss).

- Social Policy: 14 items with revenue loss of $223.8 million (such as property tax exemption for churches, sales tax exemption for food)

- Housing: 26 items with revenue loss of $135.3 million (such as homestead deduction, assessment increase cap)

- Tax Administration and Equity: 9 items with revenue loss of $111.9 million (almost entirely utilities and motor fuel sales tax exemptions).

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Top 5 Local Provisions (Revenue Impact)

- Sales tax exemption for professional and personal services -- $250.5 million. (FY 2012)
- Real property tax exemption for educational institutions -- $102.0 million.
- Sales tax exemption for public utility companies -- $89.8 million.
- Real property tax exemption for churches -- $59.5 million.
- Sales tax exemption for groceries – $56.3 million.

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Local Exemptions for Other Governments

- Real property tax exemption for federal government property -- $823.4 million. (FY 2012)
- Sales tax exemption for federal and D.C. governments -- $182.6 million.
- Real property tax exemption for embassies of foreign governments -- $41.1 million.

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Federal Conformity Provisions by Policy Area

- Health: 11 items with revenue loss of $180.9 million in FY 2012 (such as employer contributions for medical care)

- Income Security: 15 items with revenue loss of $170.5 million (such as employer pension contributions, workers' comp.)

- Housing: 6 items with revenue loss of $126.3 million (mostly mortgage interest deduction, plus capital gain on sale of principal residence and deduction of state & local property tax)

- Economic Development: 27 items with revenue loss of $79.6 million (such as R&D exemption, acceleration depreciation of buildings and equipment).

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Top 5 Federal Conformity Provisions

1. Employer contributions for medical insurance and medical care -- $109.4 million. (FY 2012)

2. Employer pension contributions and earnings plans -- $90.7 million.

3. Home mortgage interest deduction -- $87.0 million.

4. Charitable contributions -- $54.5 million.

5. Capital gains on assets transferred at death -- $39.9 million.

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Trends and Patterns

- Number of local tax expenditures grew from 114 in 2010 to 118 in 2012 – four created, none repealed.

- Many local tax expenditures are forgotten or unused – 16 local provisions have not been used in recent years; others have very low utilization.

  - Examples: housing relocation assistance; local economic development zone incentives for business; credits for brownfield revitalization; preservation of section 8 housing; creation of single-room occupancy housing.

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Local Tax Expenditures for Housing

D.C.'s array of tax incentive programs for housing is very broad:

Income tax: deduction for housing relocation assistance; credits for employer-assisted home purchase assistance and long-term homeownership; property tax circuit-breaker.

Real property tax: abatements for improving low-income housing, preserving section 8 housing, rehabilitating vacant rental housing, single-room occupancy housing, new residential developments, NOMA residential development; exemptions for owner-occupied housing, resident management corporations, cooperative housing for low- and moderate-income households; credit for senior citizens and disabled; deferrals for low-income homeowners; cap on assessment increases.

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PART III

EXPERT ANALYSIS

AND RECOMMENDATIONS

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Tax Reform Panels

Recent tax reform panels have recommended consolidating tax provisions and expanding the use of credits.

President Bush's Advisory Panel on Tax Reform, 2005

- Proposed family credit to replace personal exemption, standard deduction, and child tax credit
- Would limit mortgage interest deduction to 15% of interest paid
- Would consolidate 15 different tax provisions into three saving plans for work, family, and retirement.

Bipartisan Policy Center, 2010 (Rivlin-Domenici).

- Proposes flat refundable child credit and refundable earnings credit to replace EITC, personal exemptions, standard deduction, and child credit.
- Proposed 15% refundable credit for charitable contributions and 15% refundable credit for retirement savings.
- Would cap mortgage interest deduction at $25,000.

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Center on Budget and Policy Priorities

- Recommends converting deductions into credits in order to promote national savings, college attendance, homeownership, while making tax code more progressive.
    - High-income families would generally buy a home, send children to college, and contribute to charities regardless of tax incentives. (thus deductions are poorly targeted).
    - Refundable tax credits ensure that low-income families are included.
- Highlights inequities and fragmentation that can result from tax expenditures.
    - Child-care programs for low-income families are not an entitlement, but the child tax credit is.

Source: Chuck Marr and Brian Highsmith, “Reforming Tax Expenditures Can Reduce Deficits While Making the Tax Code More Efficient and Equitable, April 15, 2011.

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Century Foundation

A Century Foundation working group recommended that four main questions should be used to evaluate tax expenditures:

1. Is there a need for the government intervention, and is the existing or proposed intervention effective?

2. If an existing tax expenditure is deemed unnecessary or ineffective, would there be major economic disruption from repeal?

3. Even if an intervention is justified, is it best implemented through a tax break?

4. Assuming that there ought to be a tax break, are some ways of designing it better than others?

<u>Source</u>: The Century Foundation Working Group on Tax Expenditures, *Bad Breaks All Around*, 2002.

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Other Experts

<u>Edward Kleinbard</u> (former JCT staff director).

Include fixed-dollar tax subsidies in appropriations process.

New tax subsidies should be established by authorizing committees, then referred to tax committee.

<u>Len Burman (Syracuse University) and Marvin Phaup (GWU)</u>

Add tax expenditures to revenue and expenditure sides of budget; score new tax expenditures as outlays; include tax expenditures in budget resolution targets for total spending; enforce spending caps through proportional increases to tax rates.

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PART IV

EXAMPLES FROM

OTHER GOVERNMENTS

State Examples

Iowa Tax Credit Review Panel (2010): recommended repeal of 8 tax credits; five-year sunset review of all credits; more public reporting and transparency; implement benefit-cost analysis; cap value of all credits.

Massachusetts Tax Expenditure Commission (2012): clearly articulate purpose and desired outcome for each provision; develop measures of effectiveness; five-year sunset review of all "grant-like" provisions; review all provisions at least every 10 years; include "clawback" mechanisms for "grant-like" provisions. Commission also recommended classifying tax expenditures as follows: (1) fairness, (2) economic competitiveness, (3) targeted policy priorities, (4) structural, and (5) other.

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State Examples (cont.)

Oregon: Legislation enacted in 2009 requires sunset reviews for most tax credits.

Rhode Island: Legislation enacted in 2008 requires disclosure of credit recipients, amount of credit received, jobs created or retained, employee wages and benefits.

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Washington State

- Established Citizen Commission for Performance Measurement of Tax Preferences in 2006

- 10-year schedule for evaluating most tax expenditures according to 10 criteria, including: who benefits, public policy objectives, evidence of effectiveness, unintended benefits, effects on employment and the economy, feasibility of recapturing subsidy if objectives are not fulfilled, fiscal impact, distributional impact, policies in other states.

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New Zealand

- New Zealand's Revenue Department works with other agencies to evaluate shared or related programs.

- An example is the Working for Families program, which includes work and family tax credits as well as child-care subsidies and other assistance provided by the Ministry of Social Development. The two agencies created a joint research program and a linked data set. Evaluation results led to program changes that are credited with increasing work by single parents and reducing public assistance rolls.

Source: U.S. Government Accountability Office, *Tax Administration: Information on Selected Foreign Practices That May Provide Useful Insights*, May 2011.

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Summary of Reform Ideas

- Implement performance review system.
  - Who should conduct review?
  - Review largest items first? Review all items within a program area?
- Require sunset provisions and review.
- Examine tax expenditure design.
  - Deductions or credits? Income ceilings? Outcome measures and clawback provisions? These are among the options to consider.
- Include tax expenditures in budget/appropriations process; make part of budget targets and caps.
- Increase involvement/oversight by authorizing committees.