NTA Forum

Perspectives, Ideas and News from the National Tax Association

Summer, 1992

From the Editor

It has been a quarter century since the concept of "tax expenditures" found its place in the federal budget, largely due to the efforts of former NTA President Stanley Surrey. It was a novel and puzzling concept. The term itself seemed somewhat paradoxical, and precise definition proved elusive. While many ambiguities and disagreements persist, today the economic and fiscal similarity of forgone tax collections to explicit budget expenditures is generally recognized and the term has become an accepted part of public finance jargon.

In this issue of the *NTA Forum*, Gene Steuerle introduces the parallel concept of "expenditure taxes", which (contrary to what readers might guess) refers to tax measures that are embedded in expenditure programs. While it is now accepted that a complete picture of federal expenditures must include tax expenditures, few recognize that a full picture of the effects of federal taxes must take account of those "taxes" that take the form of a reduction or phase-out of federal expenditure benefits, as in the reduction in food stamp benefits with increases in income.

These backdoor taxes are not negligible. As Steuerle points out, they often boost effective rates to levels far above what would be politically accepted if made explicit. Their effects on economic behavior should receive the same attention given to other, more explicit, taxes.

How should expenditure taxes be counted in the budget? At present they appear only as reductions in expenditures. Perhaps it would be more infor-

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Toward an Expenditure Tax Budget

By C. Eugene Steuerle

Hidden government is always costly. Some believe that it leads the public to accept a larger, more intrusive, government sector, but an equally likely result is that it leads the public to view the government as both inefficient and cumbersome. When the economic effects of government activities are not made apparent, taxpayers associate costs incorrectly with the wrong programs or with government as a whole, and public cynicism is directed toward any new program, whether well designed or not.

The tax expenditure budget is one technique for revealing some of what lies hidden in budget numbers. The tax expenditure concept is an imprecise but useful means of categorizing the placement of expenditure-like pro-

C. Eugene Steuerle

grams within the tax system. While the concept is still not widely understood by the public and arbitrary decisions must be made with respect to its measurement, it is nonetheless helpful to the budget process. Indeed, the development of this additional "budget" has placed many expenditure-like tax programs on the agenda of issues to be examined from time to time. The decade of the 1980s can be viewed historically as a time in which reduction in tax expenditures played a critical role in financing deficit reduction (1982, 1984, 1987, and 1989), tax reform (1986), and social security reform (1983).

Here I wish to propose and examine an analogous, but inverse concept: "expenditure taxes", or the placement of tax measures within expenditure programs. These expenditure taxes receive far less attention than tax expenditures, but may be far more insidious in their effects on incentives and on individual behavior. Because their effects are even more hidden than tax expenditures from normal budget processes, they have become extraordinarily popular among politicians seeking to achieve goals that could not be pursued in a less hidden accounting framework.

The Expenditure Tax Concept

How do expenditure taxes work? Expenditure taxes take back, recapture, reduce, or tax away the benefits of expenditure programs based mainly on characteristics of the taxpayer that are unrelated to the value of any additional benefits received.

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NTA Forum

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NTA Forum is a newsletter containing viewpoints, ideas and news from the National Tax Association, a nonpolitical, nonpartisan, not-for-profit organization devoted to advancing understanding of the theory and practice of taxation at all levels of government.

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In particular, benefits are reduced as income of the beneficiary's household is increased.

Expenditure taxes need to be distinguished from pure fees for government services, where additional tax is related directly to additional benefits received. A useful, although arbitrary, means of distinguishing between direct taxes and fees is that taxes are compulsory, but fees are voluntary exchanges for services rendered. Carried over to expenditure taxes, a line might be drawn between those additional fees that are given freely in exchange for some public services and those reductions in benefits that are mandatory. The definition is again partly arbitrary, as in many programs a person could technically avoid expenditure taxes by failing to apply for any program benefits.

The purpose of measuring these taxes is not to label them as bad or good per se. Many would contend that expenditure taxes allow the benefits of programs to be more progressively distributed. Others would argue that they improve the targeting of program benefits and reduce the number of participants. My point here is neither to degrade nor endorse expenditure taxes. Instead, I simply want budgets to recognize and policymakers to note that expenditure taxes have a real impact on individual decision-making, on the economy, and on the operation of government programs.

A similar dispute over merit of programs, rather than need to measure what is being done, unfortunately has succeeded on occasion in sidetracking the discussion of tax expenditures. Like expenditure taxes, tax expenditures are inherently neither good nor bad. At one point in history, any reduction in tax expenditures was viewed suspiciously by some as an attempt to raise revenues that might be spent on other direct expenditure programs. As it turned out, the reduction in tax expenditures that accompanied TRA-86 went in just the opposite direction. It significantly pared the size of government — both by cutting back on "expenditures" (in the Tax Code) and by lowering the "taxes" or higher tax rates necessary to support these expenditures. Similarly, a reduction in expenditure taxes might lead to either a decrease in benefits or an increase in the extent to which a program has to be supported by more progressive direct taxes. The political response to better information cannot be predicted in advance.

The difficulty with current measures is that hidden taxes appear in the budget only as negative expenditures. Increased taxes on work and marriage show up merely as a decrease in benefits. Note again a type of symmetry with tax expenditures, where the budgetary effect of increasing tax expenditures is to lower the budget figures for taxes collected.

A Simple Example

Many expenditure taxes are limited categorically to those who qualify for certain program benefits, e.g., food stamps. Perhaps the easiest way to visualize expenditure taxes is to imagine some expenditure that is made available universally, then is phased out as income increases. Such a program of expenditures and expenditure taxes is shown in Figure 1.

This example is not simply hypothetical. Take the case of national health insurance proposals that provide for health care benefits that would phase out as income increases. President Bush, for instance, has recently advocated a tax credit or voucher for individuals with incomes below the poverty line, with the credit to be phased out between 100 percent and 150 percent of the poverty income level. In essence, everyone (or almost everyone, if those already receiving Medicare are excluded) would be eligible for the benefit and made subject to the phase-out of benefits.

Our hypothetical program in Figure 1 has a very similar design. Suppose that $2,500 worth of health benefits are phased out between $10,000 and $15,000 of income. Take someone in this proposed program at $12,500 of income with gross expenditures for medical insurance initially equal to, say, $2,500 and expenditure taxes equal to $1,250. Does this person behave similarly to someone with $1,250 in medical benefits? Hardly. The $2,500 health insurance policy is still required, and the taxpayer may be expected to respond to the $1,250 in taxes and the effective tax rate on additional work just as would a taxpayer with a similar marginal rate of tax.

In fact, for a program that is universal, the additional expenditure tax is superfluous and unwieldy relative to an adjustment of the statutory rate schedule in the income tax. If the expenditure tax reduces benefits by, say, 50 cents for each dollar of income between $10,000 and $15,000, why not simply add 50 percentage points to the income tax rate schedule in that income range? The latter method is simpler and neater. It has the same incentive effect on taxpayers and beneficiaries. Yet it would show up in the budget quite differently! If viewed explicitly as the tax that it is, it would show up as an increase in tax revenue. As an implicit tax, it appears as a reduction in spending.

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Of course, not only would the view of the budget change with explicit recognition of such expenditure taxes, so also would our perception of the progressivity of the tax system and the structure of marginal tax rates. Figure 1 shows that the implicit marginal tax rate is 50 percent for this program alone. When added to income tax rates, social security tax rates, phase-outs of earned income tax credits and other implicit tax rates, combined marginal tax rates reach 90 percent, 100 percent, or even more — exorbitant rates that are quite familiar to students of welfare program.

Alternative Methods of Accounting for Expenditure Taxes

How might expenditure taxes be counted? At a minimum we ought to count the reduction in benefits for those participating in programs. That is, program benefits should be counted gross of the tax that is paid, and then the tax should be calculated in order to arrive at the net payment. This simple method would give us a much clearer picture of the benefits and taxes of the population of participants in programs.

A more difficult question is what to do about those who are only potentially eligible for programs. In Figure 1, for instance, taxpayers with incomes beyond the break-even could either be counted as having an expenditure level "E" and a tax level "T" equal to "E", or as having zero expenditure and zero tax.

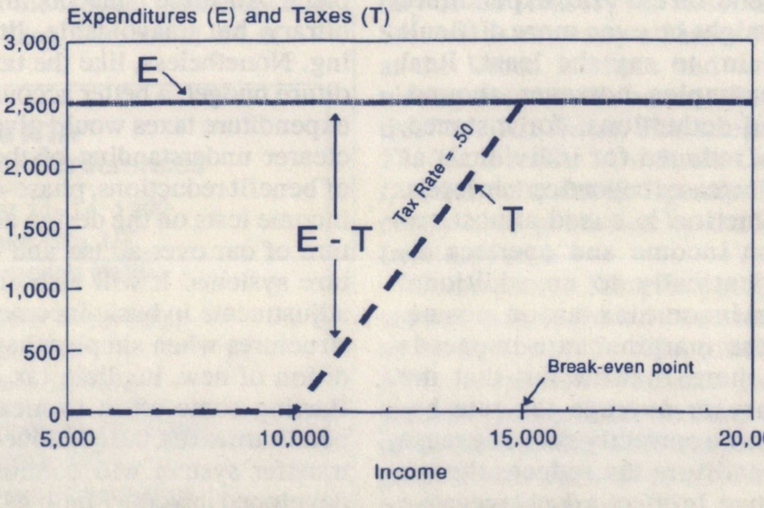
Neither solution is ideal. Economists might assert that programs should be assessed by their marginal, not average, impact. To argue that programs should be counted only when they have marginal impact, however, confuses budgetary accounting with the measurement of economic effects. Social security taxes and head taxes are recognized as having budgetary impacts even when taxpayers face marginal rates of zero on additional income.

A further complication is that households make discrete, not simply marginal, decisions. To gain or maintain participation in a welfare program such as AFDC, Food Stamps, or Medicaid, an individual faces the dilemma that full-time work or marriage often makes one ineligible. Clearly these programs send certain signals to those not in the programs. Similarly, whether or not those at higher income levels are in the system or not, they have effectively "moved" through the system in the sense of being eligible for benefits if their income had remained lower (and, perhaps, they met other conditions such as avoiding marriage.)

Nonetheless, one cannot be dogmatic on what are nothing more than rules of measurement. At a minimum, it seems to me, the benefit reductions faced by those currently in the systems should be treated as expenditure taxes. Mandatory participation in programs should also require separate accounting for gross benefits and charges, even when the two are equal.

From a political perspective, explicit recognition of expenditure taxes may be harder to achieve than tax

Figure 1
Alternative Means of Accounting for Expenditure Taxes



Which conveys a clearer economic message:
Expenditures = E - T and Taxes = 0, or Expenditures = E and Taxes = T ?

expenditures. Why? A natural conservative-liberal coalition has tended to form around the notion of reducing tax expenditures in exchange for a reduction in tax rates. With expenditure taxes, no such coalition is obvious.

Conservatives often favor hidden expenditure taxes because, relative to direct taxes, expenditure taxes are often much more regressive and make expenditure programs look smaller. Liberals often favor expenditure taxes because they allow benefits to be concentrated on the poor more than do more progressive benefit-reduction rates that extend the break-even to higher income levels. At various times, both sides have supported their stances by arguing that very high tax rates on benefit recipients have little effect on behavior. These stances are supported partly by economic studies that have found few labor supply effects from high benefit reduction rates in welfare programs.

I simply want budgets to recognize and policymakers to note that expenditure taxes have a real impact on individual decision-making, on the economy, and on the operation of government programs.

Further Issues

Admittedly, the expenditure tax concept could get complicated. Some expenditure taxes are even hidden within tax expenditures. "Tax expenditure taxes" might be even more difficult to explain, to say the least. Real world examples, however, abound. Itemized deductions, for instance, are now reduced for individuals as income increases beyond certain levels. The reduction is based almost entirely on income and operates almost identically to an additional marginal income tax rate on income. While the marginal rate impact is hidden, here it turns out that the budgetary or average tax rate becomes more correctly stated because the expenditure tax reduces the tax expenditure. In effect, a double negative becomes a positive.

There is little doubt that the adoption of an expenditure tax budget would encounter conflicting views on how specific expenditure taxes should be measured. The current tax expenditure budget generates a similar ongoing debate. Some believe that tax expenditures should cover only expenditures that could fall within the purview of departments of government other than Treasury. Others would constrict the tax expenditure list to exclude items related to the measurement of taxable income such as depreciation, because no expenditure department would ever be in charge of tax depreciation rules. Some want to exclude all capital income subsidies from the tax expenditure list on the argument that a consumption tax base, rather than income, should be the norm. Others want to measure all deviations from a pure income tax — including negative tax expenditures due to the double taxation of certain forms of income. And so on.

Were an expenditure tax concept to be more fully developed, similar interesting debates would surely take place. All these concepts involve arbitrary, but unavoidable, line drawing. Nonetheless, like the tax expenditure budget, a better accounting for expenditure taxes would give a much clearer understanding of the impact of benefit reductions, phase-outs, and income tests on the design and structure of our over-all tax and expenditure systems. It will also encourage adjustments in basic income tax rate structures when simpler than the addition of new, implicit, tax systems. Barring some effort to measure expenditure taxes, the combined tax and transfer system will continue to be developed in a crazy-quilt pattern that will lack coordination and direction.◆

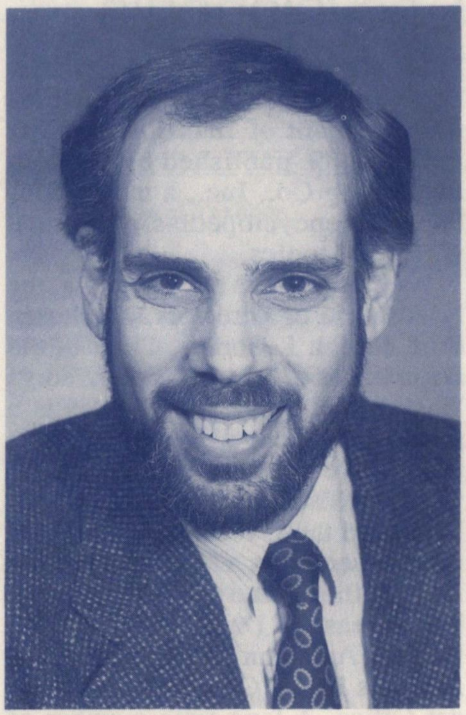
Slemrod Named Editor of *National Tax Journal*

The NTA Board of Directors is pleased to announce that Joel Slemrod, Professor of Economics at the University of Michigan and Director of its Office of Tax Policy Research, will succeed the late Daniel M. Holland as Editor of the *National Tax Journal*. He will take over the editorial duties starting June 1.

Slemrod is a most distinguished Public Finance economist and a long time member of NTA. He is a graduate of Princeton University (1973) and received his Ph.D. from Harvard in 1980. His dissertation received Honorable Mention in the NTA Outstanding Dissertation Awards for that year. In 1979 he joined the faculty of the University of Minnesota, moving to the University of Michigan in 1987. Since 1985 he has been a Research Associate at the National Bureau of Economic Research and, since 1987, Coordinator of the NBER Research Project on International Aspects of Taxation.

A frequent contributor to the *National Tax Journal* and other scholarly publications, Slemrod has contributed to and edited four books: *Taxation in the Global Economy* (with Assaf Razin), University of Chicago Press and NBER, 1990; *Do Taxes Matter?: The Impact of the Tax Reform Act of 1986*, MIT Press, 1990; *Why People Pay Taxes: Tax Compliance and Enforcement*, University of Michigan Press, forthcoming; and *Taxation of Multinational Enterprises* (with Alberto Giovannini and Glenn Hubbard), University of Chicago Press and NBER, forthcoming.

Starting immediately, all manuscripts and communications for the editor should be sent to Professor Slemrod at Room 2264C, School of Business Administration, University of Michigan, 701 Tappan Avenue, Ann Arbor, MI 48109-1234.◆



Joel Slemrod

NTA Forms New Committee on International Public Finance

In recognition of the increasing significance of the international dimension of tax policies, the NTA Board of Directors has authorized formation of a new Committee on International Public Finance.

Like the other standing committees of the Association, the new Committee will present a program at its Committee meeting at the Annual Conference, as well as suggest international topics for inclusion in general or concurrent sessions. It will also identify topics that may be appropriate for special meetings and seminars under Committee sponsorship.

How does one become a member of this new Committee? Every summer the NTA office sends invitations to all members except those already serving on one of the standing committees) inviting them to indicate which committee they wish to join. Simply check the box for the International Public Finance Committee.

A Chair and Vice Chair will be named soon. It is expected that this new Committee will hold its first meeting at the Annual Conference in Salt Lake City, October 11-14.◆

Future NTA Annual Conferences

October 11–14, 1992
Salt Lake City, UT
Little America Hotel

November 7–10, 1993
St. Paul MN
Radisson St. Paul

November 13–16, 1994
Charleston, SC
Omni Hotel Charleston

From the Editor

(continued from page 1)

mative if they were reported in the same manner as other tax collections, with program expenditures grossed up by an equal amount.

Formerly Deputy Assistant Secretary of the Treasury for Tax Analysis, Steuerle is currently a Senior Fellow at the Urban Institute and writes a weekly column "Economic Perspective" for *Tax Notes*. His latest book *The Tax Decade: How Taxes Came to Dominate the Public Agenda* has recently been published by the Urban Institute Press.

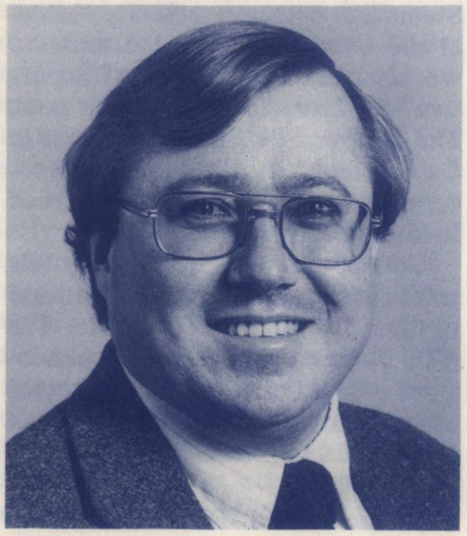
Comments on Steuerle's proposals are welcome and should be addressed to the Editor at the NTA office. The *NTA Forum* also welcomes submissions of short articles on other topics of interest to the wide range of tax professionals represented in NTA membership. ◆

NTA to Produce Encyclopedia

Plans are in place for the Association to put together a one-volume *Encyclopedia of Taxation and Tax Policy*, to be published by Garland Publishing Co., Inc., a major publisher of encyclopedias on a wide variety of topics.

As Editor of the encyclopedia, the NTA Board of Directors has chosen Prof. Joseph J. Cordes, Chair of the Department of Economics at George Washington University. Cordes is a graduate of Stanford University (1971) and received his Ph.D. from the University of Wisconsin (Madison) in 1977. He joined the GWU faculty in 1975 and has served as a Financial Economist in the Office of Tax Analysis, U.S. Treasury Department, and as Deputy Assistant Director for Tax Analysis in the Congressional Budget Office. A long time member of NTA, Cordes has appeared frequently on programs of the Annual Conference and the Spring Symposium and has published frequently in the *National Tax Journal* and other scholarly journals.

The encyclopedia is planned to include 200 to 250 short essays on specific tax topics and to run some 600-800 printed pages. Authors will be drawn primarily from ranks of NTA members. The project is expected to take about three years.◆



NTA and NCSL Plan Joint Seminar

NTA, in cooperation with the National Conference of State Legislatures, will conduct a special seminar on "The Challenge of Fiscal Equalization for State and Local Government Finance". The Seminar will be held in Denver January 7, 1993. The NTA Committee on Intergovernmental Fiscal Relations is spearheading the effort.

The seminar, which will immediately precede NCSL's conference of chairs of state legislatures' fiscal committees, stems from the sense that the issue of fiscal equalization, perhaps most obvious in school finance, extends through the entire range of state and local government services. In recent weeks attention has been focused anew on the fiscal plight of urban areas and the possible responses of states and the federal government. The Seminar will examine the fundamental rationale for "equal" access to public services as well as the policies states have followed, or might follow, in providing more nearly equal access.

A joint NTA-NCSL planning committee has identified the following topics as of special concern:

- Fiscal Disparities as a Public Policy Issue
- How Fiscal Disparities Manifest Themselves in the Public Policy Arena
- Experience of the States in Dealing With Fiscal Disparities
- Innovative Approaches to Alleviating Fiscal Disparities such as:
  - —State-Local Tax Base Sharing
  - —Tax Base Sharing Among Localities
  - —Property Tax Reform
  - —Innovative Methods of Distributing State Aid

Papers presented at the Seminar will be published in some appropriate form.

Members will receive full information and registration material early in the fall. Meanwhile, mark your calendar.◆

40 Years Ago with the NTA

"The area of jurisdictional conflict and territorial multiple taxation is at once the one in which most progress has been made and the one in which most still remains to be done. Progress has been promoted by the persistent interest and efforts of organizations such as the National Tax Association. But a very large area of conflicting claims, based on situs and domicile and varying definitions of domicile, remains to be conquered.

" . . . I should like to see . . . the amount of income upon which one state claims jurisdiction on grounds of domicile and the other on grounds of situs split . . . on the assumption that each of the two interests is equal. A plan which gives the tax wholly to the jurisdiction of domicile or wholly to the jurisdiction of situs is destined to frustration because both claims are legitimate. The claims should be compromised."

Harold M. Groves, of the University of Wisconsin, speaking on "Intergovern--mental Coordination of Tax Systems" at the Forty-Fifth Annual Conference on Taxation, Toronto, Ontario, September 10, 1952.

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Cost to you, which reflects a 20% NTA discount, depends on the scope of the search and the time required. Usually it runs between $40 and $100.

For more information phone the above number, or NTA headquarters at 614-864-1221.

New Members

The Association is pleased to welcome the following new members who have joined between January 1 and April 30, 1992.

NAME	STATE OR COUNTRY
State Division of Taxation	RI
Neil Adkins	FL
David J. Alarcon	Phillipines
Michael E. Bean	MI
Ruth Beier	MI
Mary Louise Bittner	PA
Neil Bruce	WA
Norman J. Bruns	WA
Mark Buchi	UT
Fred N. Coulson	MO
James R. Davis	GA
Barry L. Dennis	DC
Marta Espasa	Spain
Martha Fabricius	DC
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Sudha Subrahmanyam	WV
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We invite you to join us in our work

APPLICATION FOR MEMBERSHIP

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I wish to become a member of the National Tax Association.

My check for $____________ is enclosed for the payment of annual dues. I understand that $50.00 of my dues ($55.00 for foreign members) covers the subscription cost of *The National Tax Journal*, and that I will receive the *Proceedings of the Annual Conference,* the *NTA Forum*, and all other publications of the Association at no additional cost.

Sustaining Member .... $500.00 or more
Corporation or Government Agency $300.00*
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Government employee, academic, or library $ 70.00
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* Allows up to three individuals in case of corporations, up to five in case of government agencies.

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