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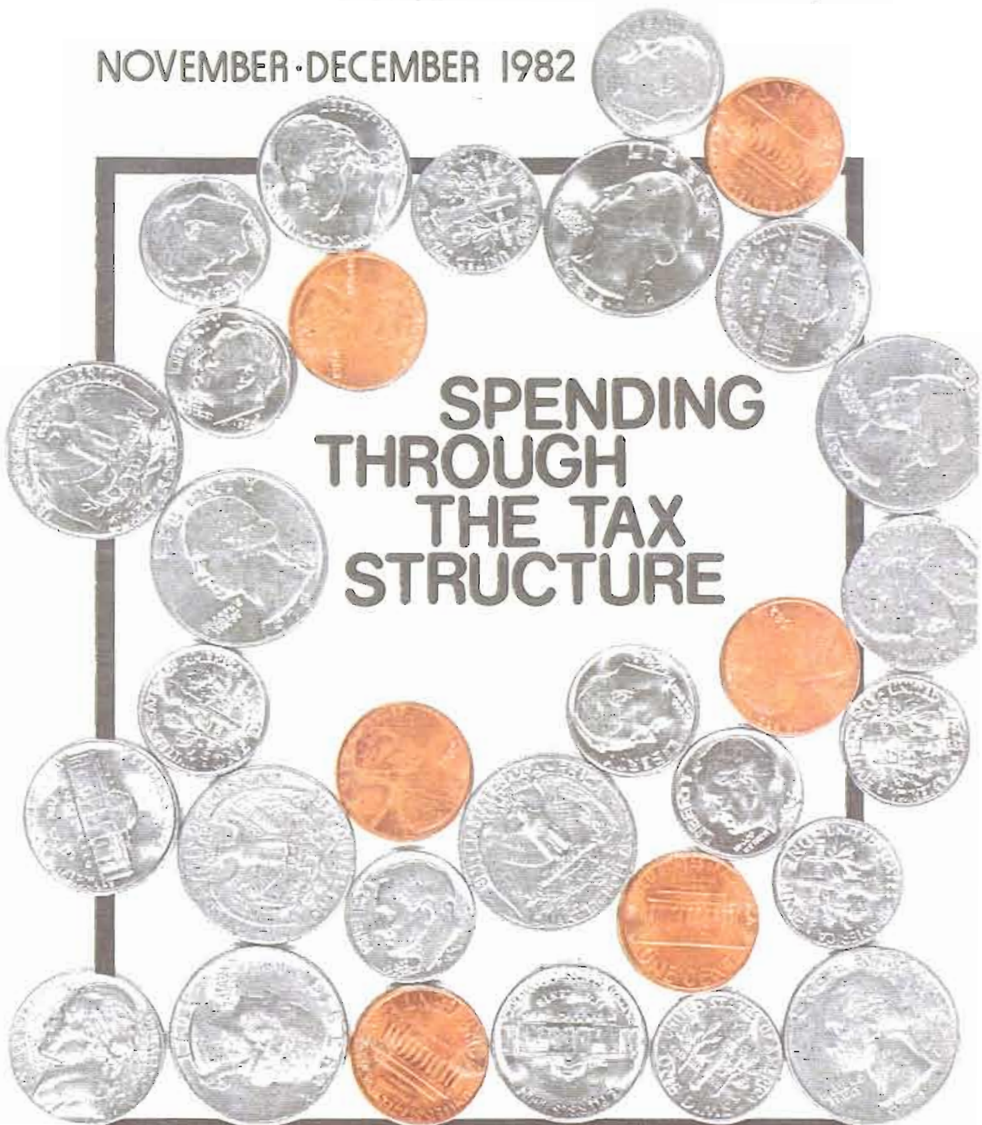

SPENDING THROUGH THE TAX STRUCTURE

Forecasting with the Index of Leading Indicators

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Spending Through the Tax Structure: Are We Taxing the Revenue System?

by Robert H. DeFina*

"The taxing power of Government must be used to provide revenues for legitimate Government purposes. It must not be used to regulate the economy or bring about social change."
—President Ronald Reagan, 1981.

Recent concern over the growth in Federal spending has led both politicians and bureaucrats to pore over the budget in search of ways to trim the fat. Thus far, their efforts have yielded unprecedented cuts. But large and growing numbers of government expenditures have managed to avoid the ax, if only because they never show up in the budget. These phantom outlays are known as tax expenditures, and they represent spending accomplished through tax relief and tax subsidies embodied in our income tax laws.

Like some direct Federal payments, such as grants or loans, tax expenditures are used to encourage certain activities and favor specified groups through financial assistance. In fact, tax expenditures can be viewed as alternatives to direct subsidies. Most policy goals that are pursued with direct assistance could, in principle, be sought with tax spending as well.

Using the tax system to meet national objectives, however, may not be a good idea. Tax spending presents substantial difficulties that do not arise with direct spending and which can seriously impair the efficiency of

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the fiscal process. Moreover, tax spending offers little advantage over direct spending to make up for its drawbacks.

In the coming years, tax expenditures are expected to increase dramatically relative to direct outlays, continuing a trend begun in the recent past. Given the difficulties associated with the use of tax spending as compared to direct spending, policymakers might want to reconsider their growing reliance on the tax system to help cure society's ills.

SPENDING THROUGH THE TAX SYSTEM

The Budget Act of 1974, which established our current budget process, defines tax expenditures as "revenue losses attributable to provisions of the 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."[1] Loosely speaking, these are tax dollars that the government purposely does not collect in order to further certain social goals (see HOW TAX EXPENDITURE PROGRAMS WORK).

In conferring the title 'tax expenditure', policymakers agree that these forgone revenues are really expenditures of Federal

[1]Implicit in the definition of tax expenditures is the notion of a benchmark tax structure from which the special provisions depart. As detailed by fiscal specialists involved with tax expenditures, these benchmark provisions (commonly referred to as the "normal tax structure") include the overall rate schedules and exemption levels, general rules as to who is subject to tax and what accounting periods should be used, and the definition of income. It may also be noted that the legislative history of the Budget Act makes clear that the classification of an item as 'special' is to be made by employing techniques that had been used by Treasury and Congressional Staff technicians in developing tax expenditure lists prior to the enactment of the Act. For a comprehensive description of and discussion of issues related to the normal structure, see Stanley Surrey, *Pathways to Tax Reform* (Cambridge: Harvard University Press, 1973).

HOW TAX EXPENDITURE PROGRAMS WORK

There are six main types of tax expenditure programs and each can be used to provide individuals with tax breaks to encourage participation in particular activities or to relieve financial hardship.

Three of these, namely *exclusions, deductions, and exemptions,* allow taxpayers to reduce their taxable income by a specified amount. The value to taxpayers of the reduction depends upon their marginal income tax bracket: the higher the bracket, the more the reduction in taxable income is worth. For instance, a one-dollar deduction is worth fifty cents to a person in the 50-percent bracket (since that is how much tax would have been paid on that dollar), while it is worth seventeen cents to a person in the 17-percent bracket. In many cases, personal deductions must be offset against the zero bracket amount (formerly known as the standard deduction) prior to subtracting it from income.

A *tax credit* permits taxpayers to deduct a certain amount directly from their tax liability. Unlike exclusions, deductions, and exemptions, the value of a credit does not depend on the marginal tax bracket because the reduction comes after the tax bill is initially calculated; however, eligibility for the credit depends upon whether taxpayers have a sufficient initial tax liability to use the credit.

Preferential tax rates let taxpayers compute their tax liability using tax rates that are lower than those normally used. The value to taxpayers, in this case, is equal to the amount of taxable income subject to the preferential rate multiplied by the difference between the preferential and regular rates.

Finally, a *deferral of tax liability* permits taxpayers to put off paying their taxes for some period of time. This benefits individuals because they can invest the tax otherwise owed and earn interest up until the time the taxes are due.

monies channeled through the tax system.[2] By reducing the tax associated with a favored activity or otherwise owed by a targeted group, the government is spending its scarce budget dollars just as it does when it makes direct payments, such as grants and loans. Whether the government first collects a dollar of tax from an individual and then sends him a one dollar check, or whether it does not collect the money in the first place, the bottom line is the same. For both the beneficiary and the government, a dollar less paid in taxes has the same effect on budgets as a dollar more directly paid out by the Treasury. The only substantive difference is how this financial assistance is delivered.

A Profile of Tax Expenditures. At present, a substantial amount of Federal assistance is delivered through the tax system in pursuit of a variety of goals (see A SUBSTANTIAL AMOUNT. . .overleaf). All told, the government is estimated to have incurred almost $254 billion in tax expenditures during fiscal year 1982—close to 35 percent of scheduled direct Federal outlays—for the operation of over 100 tax-based programs.

The lion's share of tax spending accrues to individuals, providing them with aid and incentives in their capacities as homeowners, donors, savers, and so on. For example: the tax exclusion of employer contributions to employee pension plans ($25.8 billion) fosters saving by workers for their retirement; deductions of charitable contributions from taxable income ($9.7 billion) reward people who join the ranks of philanthropists; and deductions of mortgage interest on owner-occupied homes ($23.0 billion) encourage citizens to pursue the American dream of owning a home. Tax expenditures are also used to nudge corporations toward socially desired activities: the investment tax credit ($15.0 billion) defrays the costs of new capital purchases in order to stimulate investment, while the special treatment of oil and gas exploration and development costs ($2.7 billion) promotes energy development.

In many cases, the objectives sought through tax expenditures are also pursued with direct spending programs. Designated groups in the labor force have been helped both with the CETA grant program (direct spending) and the jobs tax credit; individuals receive assistance with their medical expenses both through direct medicare payments and through medical expense deductions from taxable income; and business financing costs are lowered both with direct interest subsidies and through business use of tax-exempt bonds. Such instances of common purpose clearly show that tax expenditures and direct outlays are alternative policy instruments.

In principle, most policy objectives that require financial assistance can be addressed with either spending mechanism. As a recent study of tax expenditures by the Congressional Budget Office notes, almost any of the structural details included in direct assistance programs could conceivably be incorporated into tax-based programs:

> Providing tax [expenditures] in the form of credits rather than deductions, and including the credit in taxable income can assure that the value of the tax subsidy is the same as that of an equivalent direct grant. Making the credit refundable . . . can extend the subsidy to non-taxpayers . . .. Providing the subsidy in the form of a deferral of tax liability makes it the equivalent of a loan pro-

[2] Some people have interpreted the concept of tax expenditures as implying that the Federal government is entitled to one hundred percent of everyone's income, and that any portion that taxpayers are allowed to keep is theirs only by special permission. This view is inaccurate. Tax expenditures are defined as special departures from a benchmark or normal tax structure. Thus, for the interpretation in question to be correct, the benchmark tax structure would have to tax one hundred percent of all income. However, the normal provisions of our income tax fall far short of such complete taxation.

A SUBSTANTIAL AMOUNT OF FEDERAL ASSISTANCE IS DELIVERED THROUGH THE TAX SYSTEM IN PURSUIT OF A VARIETY OF GOALS

Selected Special Provisions	Tax Expenditures (Fiscal year 1982, millions of dollars)		
	Individual	Corporate	Total
Exclusions			
Employer contribution to pension plans	$25,765		$25,765
Employer contributions for medical insurance premiums and medical care	15,330		15,330
Dividend and interest	2,185		2,185
Interest on general purpose state and local debt	1,925	$3,905	5,830
OASI benefits for retired workers	9,980		9,980
Interest on state and local industrial development bonds	315	1,295	1,610
Deductions			
Interest on consumer credit	7,585		7,585
Mortgage interest on owner-occupied homes	23,030		23,030
Property tax on owner-occupied homes	10,065		10,065
Charitable contributions*	9,705	895	10,600
Medical expenses	3,925		3,925
Nonbusiness state and local taxes other than on owner-occupied homes	20,395		20,395
Exemptions			
Parental personal exemption for student age 19 or over	995		22,995
Additional exemption for elderly	2,355		2,355
Tax Credits			
Investment tax credit, other than Employee Stock Ownership Plans, rehabilitation, reforestation, and leasing	3,475	14,970	18,445
Credit for child care and dependent care expenses	1,350		1,350
Earned income credit	555		555
Energy conservation credit	415	315	730
Preferential Tax Rates			
Capital gains (other than agriculture, timber, iron ore, and coal)	18,315	1,495	19,810
Expensing of exploration and development cost for oil and gas	1,350	2,720	4,070
Tax Deferrals			
Deferral of income of domestic international sales corporations		1,560	1,560
Deferral of tax on shipping companies		65	65

*Represents the sum of the estimates of deductions of charitable contributions for education, health, and purposes other than education and health.

SOURCE: Estimates of Federal Tax Expenditures for Fiscal Years 1982-87, prepared by the Staff of the Joint Committee on Taxation (March 8, 1982).

> gram. While no interest is normally charged on tax deferrals, it could be if Congress wished. . . . Congress can make tax subsidies look and work as much or as little like direct spending . . . as it chooses.[3]

Once it has been decided that a particular subsidy is desirable, both spending options—tax expenditures and direct outlays—are usually open to policymakers as a potential means of providing the assistance.

Reliance on Tax Spending Is Increasing. Although direct outlays have traditionally been the primary form of financial assistance from the Federal government, tax expenditures are growing in relative importance. In 1976, for instance, the ratio of tax spending to direct spending was about 1:4; by 1981 it had risen to 1:3. And while tax spending more than doubled since 1976, growing at a rate of about 18.6 percent annually, direct outlays grew by 12.5 percent a year. The differential was most pronounced over the past two fiscal years when tax spending increased at a 24-percent yearly rate, compared to the 15.7-percent annual growth of direct spending. The future promises a continuation of this trend: over the next five years, tax expenditures are expected to grow by three-quarters, while direct outlays are estimated to rise only by one-third. As a result, by fiscal year 1987, the ratio of tax spending to direct spending is expected to jump to about 1:2.

Despite the apparent popularity of tax expenditures, there are reasons why using the tax system to deliver financial assistance may not be the best idea. Tax spending has certain practical difficulties not shared by direct spending which can have adverse consequences for our fiscal process. Furthermore, tax spending offers little benefit over direct spending to compensate for its adverse effects.

TAX EXPENDITURES OFFER LITTLE ADVANTAGE OVER DIRECT ASSISTANCE

Those who applaud the use of tax spending see in it a major advantage over direct assistance—a greater compatibility with the philosophy of private decisionmaking and individual initiative. As Murray Weidenbaum, former Chairman of the Council of Economic Advisors, wrote:

> The choice between tax incentives and direct Federal expenditures turns out to involve more than the selection among technical financing mechanisms. The choice involves altering the balance between public and private power in our society.[4]

Promoters of tax spending argue that, all too often, direct payment programs involve an endless maze of rules, regulations, and eligibility requirements that needlessly restrict individual choice. This government influence, they feel, hampers progress toward reaching a program's stated objective. In contrast, tax expenditures are viewed as placing most of the decisionmaking process with the beneficiary: the incentive is created, and the individual is left to respond. Tax expenditures, they allege, help get government off our backs.

There is not much validity, however, to the assertion that tax expenditures are necessarily more compatible with private choice

[3]Congressional Budget Office, *Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1982-1986* (September 1981), pp. 46-47.

[4]Murray L. Weidenbaum, "The Case for Tax Loopholes," Center for the Study of American Business, *Reprint Series*, No. 21 (St. Louis: Washington University, September 1978), p. 12. For similar views, see the remarks of Senators Packwood, Roth, and Domenici in Joel Havemann, "Tax Expenditures — Spending Money Without Expenditures," *National Journal*, December 10, 1977, pp.1908-1911.

than is direct spending. The extent of any intrusion into the free market—that is, the amount of administrative control, bureaucracy, and red tape involved—is a matter of program design. And a program's design is determined by the preferences of policymakers, not by the particular policy instrument (in this case, tax spending or direct spending) chosen to implement the program. Indeed, the choice of direct spending or tax spending as the means of providing financial assistance comes after the determination of a program's eligibility requirements and regulations. If direct assistance programs are more complex, as proponents of tax spending lament, the reason lies not in the fact that direct payment mechanisms are used to provide the incentives; rather, it lies in the policymakers' decisions to structure the underlying programs in particular ways. And both tax spending and direct spending programs can be designed with as much or as little red tape as is desired.

The deduction for charitable contributions provides a useful illustration of this point about program design since it is frequently touted as an unrestrictive Federal program that enlists private support for the public interest.[5] According to the guidelines of this deduction, individuals decide, free of government direction, both the recipient charity and the size of the donation. But the same objectives could be accomplished through a direct spending program as well. Private contributions could be matched, for instance, by Federal grants, with individuals determining both the beneficiary and the amount of the contribution. As this example shows, neither compatibility with private initiative nor the simplicity of a program's structure hinges on the choice between tax and direct spending. These are questions of program design, and they are independent of the expenditure mechanism.[6]

[5]This and other examples are discussed in Stanley Surrey, *Pathways to Tax Reform*.

Some observers of the fiscal policy process take a more cynical view concerning the benefits of using tax expenditures rather than direct payments. They note that the main attraction of tax spending may be that it does not show up on the expenditure side of the government's budget; that is, it allows spending without the appearance of spending.[7] Whether or not this aspect of tax spending has contributed to the relative growth of tax expenditures in recent years is uncertain. What is clear, however, is that, from society's perspective, this feature does not provide any substantive benefits. A dollar spent through the tax system represents the same use of Federal monies as a dollar spent through a direct outlay, regardless of how it is accounted for. Some political gains well may result from using tax expenditures if the electorate does not recognize that funds are spent through the tax system; however, such benefits should not be an important consideration when choosing between tax and direct spending mechanisms.

Although tax expenditures do not appear to provide any meaningful advantages over direct spending, the choice between the two remains consequential. In particular, spending through the tax system complicates the workings of the fiscal process in ways that are not encountered with the direct provision of assistance.

TAX SPENDING HAS ADMINISTRATIVE PROBLEMS NOT SHARED BY DIRECT SPENDING. . .

Some of these complications occur at the administrative level. Tax expenditure pro-

[6]The same argument holds true against claims that direct spending programs force uniformity on the recipients of the aid while tax expenditures do not and that tax expenditures allow regional diversity while direct programs do not.

[7]For a representative view, see Charles Davenport, "Impact of the Congressional Budget Process on Tax Legislation," *National Tax Journal*, September 1979, pp. 262-269.

grams are administered by the Internal Revenue Service rather than by the executive agency normally involved with the policy objective being addressed. As a result, the knowledge, insight, and resources of that executive agency are neglected. And the IRS, despite its limited resources, is called upon to administer programs that it may be ill-equipped to handle and that are unrelated to revenue raising.

Administrative Responsibilities Are Inappropriately Assigned. Tax expenditures involve an inappropriate assignment of administrative responsibilities for spending programs. This issue was discussed by Jerome Kurtz, a former Commissioner of the IRS:

> Each of the tax expenditure programs is, in effect, a non-revenue related expenditure program written into the tax law. Each entails its own special set of issues, definitions, and limitations . . .. Because of these provisions, I find myself, a Commissioner of Internal Revenue, administering programs of many other agencies. If these programs were parceled out to those agencies, the concentration of programs would be diffused and the tax law and administration would be vastly simpler.[8]

Indeed, the staffs of the various executive agencies and other Federal departments have accumulated a large stock of expertise and experience in particular areas: the Department of Housing and Urban Development specializes in housing, the Department of the Interior in conservation and wildlife, the Department of Labor in employment and unemployment, and so forth. As a consequence, the trained personnel of these departments are much more adept than IRS agents at gauging the effectiveness of particular spending programs or program features, and they are more skilled in making judgements regarding eligibility. Furthermore, the executive agencies are better positioned and equipped than the IRS to deal with program problems that might arise. Yet when spending programs are built into the tax system (and, hence, are administered by the IRS), the resources and detailed knowledge of the different government agencies are largely ignored. Such a division of responsibilities is counterproductive, and it needlessly diminishes the potential success and efficiency of these programs.

By the same token, this awkward arrangement also substantially compounds the problems of tax administration, impeding the smooth functioning of the tax system. Rather than concentrating on their primary job of efficiently collecting taxes, IRS agents must devote considerable time and effort to writing regulations, verifying eligibility, and pursuing litigation for over one hundred programs that are unrelated to revenue raising. The recent controversy over the legality of the tax-exempt status of racially discriminatory schools clearly illustrates how tax expenditures can embroil the IRS in issues that have nothing to do with revenue raising.

IRS administration of these spending programs also neglects the crucial role of objectives and incentives in program management. Direct spending programs involve their administering agencies from the standpoint of stated department goals: the particular program aims are assigned to be compatible with those agency objectives. In contrast, the IRS has aims that are separate from those of the spending programs it administers. The IRS's overriding concern is the efficient collection of revenue, and not, for instance, the stewardship of the country's natural resources or the caretaking of our nation's elderly. As such, IRS personnel have no institutional incentive to accomplish the goals

[8]Cited in Stanley Surrey and Paul McDaniel, "The Tax Expenditure Concept: Current Developments and Emerging Issues," *Boston College Law Review*, January 1979, pp. 278-279.

of the many tax-spending programs. They instead treat these programs like any other provision of the tax code: emphasis is placed on assuring technical compliance with the rules governing the special tax treatment, with no effort expended to publicize the program's availability, to promote its use, to monitor its effectiveness, and so on. Incompatibility between the overall objective of the IRS and the aim of individual tax expenditure efforts makes it more difficult for such programs to succeed.

Providing Aid and Incentives to Nontaxpayers Is Harder. Providing nontaxpayers with incentives and relief is harder to accomplish through the tax system than through direct payment schemes. Unlike direct outlay programs, tax expenditures cannot be extended directly to individuals and organizations that do not pay tax. Instead, some auxiliary arrangement used in conjunction with a tax spending program is required if nontaxpayers are to be reached.[9]

The complex leasing rules that have been written into the tax code exemplify such arrangements; they represent an effort to extend tax incentives for investment to firms without enough tax liability to take advantage of the subsidies. (According to the new leasing rules, a business with inadequate tax liability is permitted to lease equipment from another concern that has sufficient liability to be eligible for the tax breaks. In this way, the low-tax firm can receive some of the tax incentive indirectly through lower lease payments to the high-tax firm).

Although schemes of this sort might ultimately channel program subsidies to nontaxpayers, they needlessly complicate the tax code and use the resources of the IRS inefficiently. To continue with the leasing example, tax administration efforts must be devoted to processing and verifying details of the transactions such as the term of the lease, the interval between the date property is leased and the date it is acquired, and the amount of investment the lessor risks throughout the term of the lease. All this has little to do with revenue raising. Futhermore, the time and money of the private sector are wasted in locating leasing partners, arranging meetings, negotiating the final agreements, and explaining it all to the IRS. Compared to the direct payment alternative, in which the appropriate government agency deals directly with the targeted beneficiaries, such makeshift tax spending arrangements seem inferior.[10]

In sum, the administration of spending programs will always entail costs, regardless of whether these programs are formulated as direct payments or tax expenditures. How-

[9]In the case of most tax spending programs, there is little reason why nontaxpayers should be excluded. If these schemes were recast as direct payment programs, it is very doubtful that individuals and organizations would be ineligible for incentives simply because of a lack of taxable income. The fact that many tax expenditure programs do not include nontaxpayers does not reflect a prudent policy decision; rather, it points to an inadequacy of the tax spending technique. Exclusion of nontaxpayers is automatic and largely arbitrary and, hence, limits the potential success of tax spending programs.

[10]There are other, more direct, tax approaches such as making tax credits refundable even to nontaxpayers, but these, too, are costly and burdensome and are very likely to be ineffective. This point is discussed in the Congressional Budget Office's tax expenditure study: "People whose incomes are so low they do not have to pay taxes usually do not have to file tax returns, so the IRS may have no record of their existence. It is thus hard to inform them of their possible eligibility for a subsidy. Once they learn about the subsidy, they may have difficulty with the forms and paperwork necessary to establish their eligibility, and the IRS has relatively few resources to provide them with assistance. Many low-income nontaxpayers also have considerable fear and skepticism about dealing with the IRS, and may thus be reluctant to apply for an IRS-administered subsidy. It may also be a hardship for them to have to wait until tax returns can be filed to obtain the subsidy. While attempts have been made to have the earned income tax credit reflected currently in withholding, there have been administrative problems with this approach." Congressional Budget Office, *Tax Expenditures,* p. 48.

ever, the administrative dollars are bound to be spent less efficiently when the tax expenditure route is traveled.

. . . AS WELL AS SOME LEGISLATIVE AND BUDGETARY DRAWBACKS

The shortcomings of the tax expenditure route are not restricted to the administrative level; rather, they arise at the legislative and budgetary levels as well. In particular, spending through the tax system results in an inefficient division of legislative responsibility, hinders budget planning, and makes control of the budget more difficult. Furthermore, placing spending programs in the tax structure can make for unintended shifts in the nature of the incentives provided by those programs.

An Inefficient Division of Legislative Responsibility Arises. Congress is comprised of many different committees, each of which has legislative responsibility for specified areas. For example, the House and Senate Veterans Affairs Committees oversee legislation dealing with veterans of the armed forces, while the banking committees of both houses are primarily concerned with laws affecting the country's financial system. Such division of labor permits the committees and their staffs to develop expertise in particular areas.

When tax spending is used, the purpose of the Congressional committee system is defeated and the benefits associated with that system are forgone. Because spending programs administered through the tax structure are legally part of the tax code, their legislative jurisdiction lies solely within the two Congressional tax-writing committees—the Senate Finance Committee and the House Ways and Means Committee. Thus, the tax committees have legislative responsibility for more than one hundred spending programs—not as a result of careful planning to insure that the most informed Congressional participants are involved in the programs' development and oversight, but only because of the decision to operate those programs through the tax structure. Indeed, the expertise of the tax committees is not in dealing with the nation's housing problems or in overseeing interstate commerce; rather, it is in the handling of the technical revenue-raising aspects of the tax structure.[11] The tax committees' lack of familiarity with specific expenditure areas can only work to the detriment of the spending programs placed under their control.[12]

Tax Incentives Can Be Arbitrarily Changed. Placing spending programs in the tax structure also subjects the incentives they provide to arbitrary change. These changes will occur whenever the overall rate schedules or exemption levels are revised, regardless of intent. A modification of tax rates, for whatever reason, automatically alters the value of income deductions and exclusions to taxpayers. As a result, the ac-

[11]Indeed, as Senator Edward Kennedy once remarked, "It is humanly impossible for the members of the Finance Committe and . . . Ways and Means Committee to be Renaissance men and women in employment, commerce, energy, health, education, housing, banking, state and local finance, transportation, investment, the cities, shipping, . . . , and all the other areas in which tax spending programs are now being used and in which expertise in the area is obviously required." 123 *Congressional Record* S11408, as cited in Surrey and McDaniel, "The Tax Expenditure Concept," p. 290.

[12]The tax committees might try to overcome, to some extent, their deficient knowledge and lack of insight regarding the spending programs placed under their jurisdiction, say, by consulting with appropriate legislative committees. But this sort of scheme is extremely cumbersome; it unnecessarily entangles the tax committees in deliberations with every other Congressional committee over matters that are substantively outside the tax committees' area of responsibility. And such onerous deliberations would be necessary on an ongoing basis, to handle both the continuing oversight of the more than one hundred existing programs, as well as the flow of proposed tax spending programs. Furthermore, the basic question would still remain as to why the inappropriate jurisdictional arrangement is used in the first place, given tax spending's lack of advantage over direct spending.

tivities fostered by these tax spending programs become either more or less attractive, depending upon the nature of the rate changes. Similarly, increases in the zero-bracket amount or in the level of the personal exemption can cause an unintended elimination of incentives by decreasing a taxpayer's liability below that necessary to make use of the special provisions.

A case in point is the recent Economic Recovery Tax Act of 1981 and its effect on the incentives provided by the tax deduction for charitable donations. Although the stated intention of the tax cuts embodied in the Act is to spur economic growth by enhancing work and investment incentives, those rate reductions have the inadvertent consequence of seriously diminishing the incentives offered by the charitable gift deduction. Consequently, charitable giving is expected to decline; the Urban Institute projects that the new tax law, by lowering the incentive provided by the deduction, will result in a drop of at least $18 billion in donations during the period 1981 to 1984. All this happens despite the absence of an explicit decision to alter the program.[13]

These sorts of spontaneous program adjustments, which are associated with general revisions of the basic tax code, impede the success of the individual programs. Such adjustments reflect neither an evaluation of a program's effectiveness nor a reassessment of overall expenditure priorities; instead, they are haphazard and occur for reasons unrelated to the objectives of the tax spending. Hence the incentives provided by the tax expenditure programs will no longer be appropriate for the goals being sought.[14] No such unintended and detrimental changes would occur if the spending programs were framed as direct assistance schemes.

Budget Control Becomes More Difficult... Tax expenditures make budget control more difficult because funds spent through the tax system are harder to monitor than those disbursed through direct assistance schemes. Direct spending, whether accomplished through programs with statutory ceilings or through open-ended entitlements, is highly visible. In each case, unplanned increases or decreases in expenditures for particular programs can be rapidly identified by the specific agency responsible for the payments. Desired program adjustments can then be quickly implemented.

By contrast, changes in individual tax expenditures are reflected only in fluctuations of total revenue collections. This makes such changes extremely difficult to identify. Forecasts of aggregate revenues can be wrong for a variety of reasons. It may take quite a while to associate, say, an unexpected shortfall in overall revenues with a greater-than-expected use of a particular tax expenditure program. As a result, legislators cannot respond effectively to unanticipated and undesired tax spending program developments.[15]

...And Coordination of Spending Plans Is Hindered. The use of tax expenditures

[13]See "New Tax Law Is Said To Endanger Billions in Gifts to Private Groups," *New York Times*, August 27, 1981, p. A1. The remarks of Brian O'Connell, president of the Independent Sector (a coalition of 320 leading foundations, corporations, and nonprofit organizations) are particularly pertinent to the discussion. Speaking about the effect of the tax cuts on charitable giving, he noted, "The irony in these developments is that the Administration wants to strengthen the nonprofit sector but the tax cut inadvertently undercuts the very organizations the President is counting on."

[14]It might be possible, in principle, to restructure all affected tax expenditure programs after each tax code change; however, as a practical matter, such readjustments are not feasible.

[15]The use of tax-exempt bonds to finance single-family housing provides an example of the problems that can arise. Rapid and unforeseen increases went on for months, threatening multibillion dollar annual revenue losses, before Congress finally stepped in to impose limits. See Congressional Budget Office, *Tax Expenditures* and *Tax Exempt Bonds for Single-Family Housing* (April 1979).

impedes Congressional budget-planning efforts as well. When spending programs are placed in the tax structure, they are removed from the normal budgeting process that applies to all direct outlays.[16] (For example, tax expenditures are not covered by the detailed spending targets that guide legislative consideration of direct spending options.) In this way, funds spent through the tax system are insulated, to a significant degree, from explicit competition with other spending priorities for scarce budget dollars. But this competition lies at the heart of effective budget design since it is the mechanism by which the relative values of alternative spending options are determined. Thus, running expenditure programs through the tax structure hinders Congress's ability accurately to assess the value of these programs relative to other social needs. Needless to say, this obstructs the formulation of a coordinated and consistent budget plan.[17]

TO SPEND, OR NOT TO TAX — THAT IS THE QUESTION

The practical shortcomings of tax spending bring into question the wisdom of the growing reliance on its use. At the administrative, legislative, and budgetary levels, spending through the tax system has drawbacks not shared by direct outlay mechanisms. And these drawbacks significantly encumber the efficient working of the fiscal process. Although some of these difficulties might be overcome, there seems to be little gain from trying; tax expenditures generally provide no substantive advantages over direct spending. In light of these considerations, policymakers would do well to shift emphasis away from using the tax system as a conduit for distributing Federal dollars.

[16] According to the Budget Act of 1974, outlays and revenues are subject to different budgeting procedures. Because they are considered revenue items in a legal sense, tax expenditures are treated as such for budgeting purposes despite their more appropriate substantive characterization as outlays. For a detailed description of the Congressional budget process, see Allen Schick, *Congress and Money* (Washington: The Urban Institute, 1980).

[17] The discussions of the Tax Reduction Act of 1976 in Allen Schick, *Congress and Money* and in Davenport, "Impact of the Congressional Budget Process" indicate the adverse consequences for the budget that the divided consideration of expenditures can have.