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Government Spending Undercover: Spending Programs Administered by the IRS

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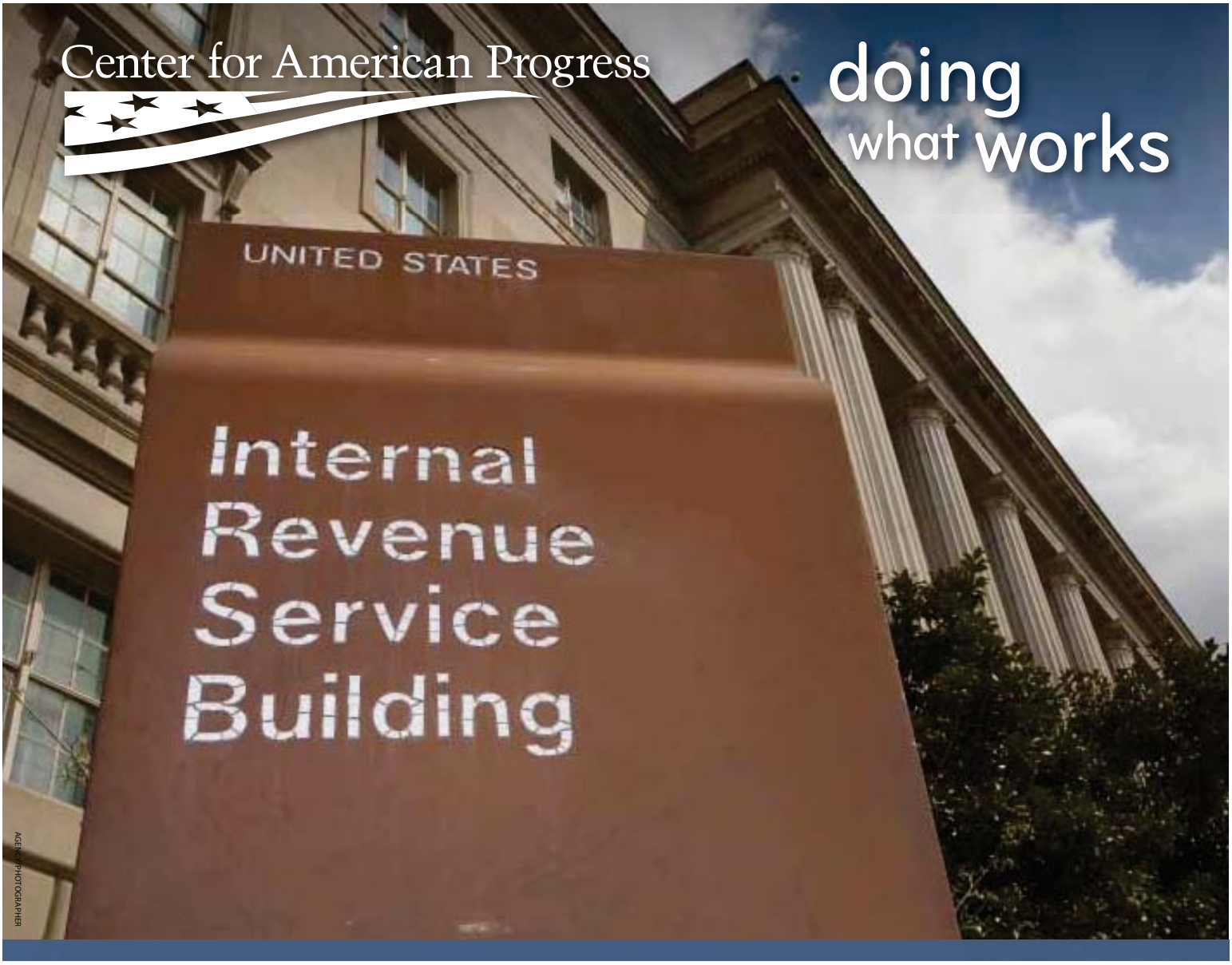

Government Spending Undercover

Spending Programs Administered by the IRS

Lily Batchelder and Eric Toder April 2010

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doing what works

This publication is a product of CAP's Doing What Works project, which promotes government reform to efficiently allocate scarce resources and achieve greater results for the American people. Doing What Works specifically has three key objectives: (1) eliminating or redesigning misguided spending programs and tax expenditures focused on priority areas such as health care, energy, and education; (2) boosting government productivity by streamlining management and strengthening operations in the areas of human resources, information technology, and procurement; and (3) building a foundation for smarter decision making by enhancing transparency, performance measurement, and evaluation. Doing What Works publications and products can be viewed at http://www.americanprogress.org/projects/doing_what_works.

Introduction and summary

When policymakers look to trim fat from the federal government they too often ignore half the problem: the vast and complicated set of spending programs administered by the Internal Revenue Service. These programs are often referred to as tax expenditures, but this report will make the case that they should be viewed just like any other type of government spending.

As Figure 1 shows, in fiscal year 2011 we will spend over $1 trillion on tax expenditures. That's more than three-fourths of all corporate and individual income tax revenues and more than one-and-a-half times the cost of all federal domestic discretionary spending. If all these programs were repealed we could cut corporate and individual income tax rates by over 40 percent and still collect the same amount of revenue.

Despite their big price tag, however, these programs fly under the radar of media and popular opinion for two reasons. First, almost all IRS-administered spending programs are not subject to the same annual appropriations process as discretionary spending. Just as with big entitlement programs like Social Security, Medicare, and farm subsidies, their costs depend on formulas created by Congress that once set are rarely changed. Spending on them rises automatically with increases in eligible beneficiaries and changes in economic conditions, such as health care costs or interest rates.

Second, IRS-administered spending programs appear to be tax cuts instead of spending because they transfer funds to businesses and individuals through rebates that reduce tax liability. But make no mistake: These programs are the same as spending by other agencies.

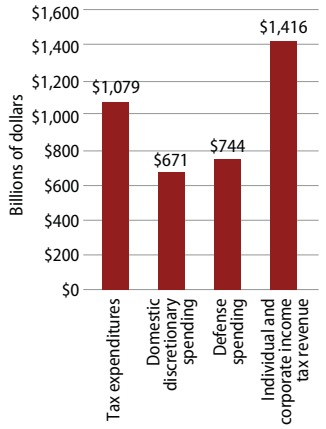
Both IRS-administered spending programs and other spending programs may promote socially desirable behavior, signal social approval of certain private activities, or help those in need. Both may also fail to achieve their objectives or outlive their usefulness, serving no clear goal other than satisfying constituencies accustomed to government aid. And both may simply respond to the concerns of hired lobbyists, representing narrow interest groups rather than the broader taxpaying public.

On one dimension, however, they do differ: IRS-administered spending programs are more likely to be ineffective initiatives or giveaways to the politically powerful than direct outlays. Advocates of IRS-administered spending programs are able to portray the pro-

FIGURE 1

Tax expenditures add up to more than three-fourths of all individual and corporate tax revenue

Estimated spending and revenue raised in different budget categories, fiscal year 2011



Source: Budget of the United States Government, FY 2011.

Notes: We discuss our views on the differences between tax expenditures and IRS-administered spending programs below. Estimates of tax expenditures do not take into account interaction effects, but Burman, Geissler, and Toder (2008) find that, for a large subset of individual income tax expenditures, ignoring interactions understates the total cost by 5 to 8 percent.

grams as tax cuts instead of spending, which makes them easier to enact and more difficult to reduce or eliminate than spending administered by other agencies. For this reason, the bar is simply lower for them. No one asks what goal a spending program dressed up as "a middle-class tax cut" serves because it seems self-evidently good to give people tax cuts. Never mind that IRS-administered spending programs do not simply cut taxes—they place innumerable conditions on what taxpayers must do to receive benefits and which taxpayers are eligible.

The last time Congress systematically reviewed and cut back these programs was 1986—almost a quarter century ago.[1] Given the mounting fiscal pressures facing the United States it is time to take a hard look at IRS-administered spending once again.

This paper explains what IRS-administered spending programs are and why they're viewed differently than spending by other agencies. It also outlines the obstacles to treating IRS spending programs the same as other government spending, which include definitional issues and measuring their cost. It then offers suggestions for beginning to work IRS spending programs into the budget process including:

- Requiring Congress, a bipartisan commission, or a designated agency to create a list of tax provisions that should be defined as "IRS-administered spending programs"
- Directing CBO to display alternative projections of federal revenue and spending that count all IRS-administered spending programs as revenue raised and then spent
- Requiring the IRS to inform taxpayers of the benefits they receive from IRS-administered spending programs
- Allowing taxpayers to claim these benefits separately from remitting tax due

Finally, the paper raises four questions that policymakers should consider in deciding which IRS-administered spending programs to keep and which ones to cut:

- What goals does the program potentially seek to achieve, if any?
- Do these goals remain worthy of taxpayer support and, if so, how much?
- Within this budget constraint is the program structured as effectively as it could be in order to achieve its objectives? Is it well targeted? And is the IRS the best agency to administer it?
- If not, how could it be restructured to maximize its effectiveness?

The answers to these questions will create an agenda for reform.

What are IRS-administered spending programs?

Any effort to overhaul IRS-administered spending programs must begin by identifying what provisions fall into this category. All tax systems initially determine how much tax residents should pay based on some measure of residents' economic status or ability to pay tax. Typically tax systems use net income, consumption, earnings, or wealth to measure how well off a taxpayer is and how much she should contribute to the cost of government relative to others. They may aggregate taxpayers into household units or measure their economic status as individuals. They then adjust the measure of well-being based on the number of people in the taxpaying unit and for expenses that reduce well-being relative to others who incur different expenses. Once policymakers have chosen a taxpaying unit and measure of well-being, they must decide what rates should apply to those deemed better off compared with those deemed worse off.

IRS spending programs are provisions in the tax code that are not necessary to measure a taxpayer's well-being or their ability to pay tax, or to allocate tax rates fairly based on this measure. For example, they are not provisions that subtract the costs of earning income from this measure, or provide lower tax rates for those with less ability to pay. Instead, these spending programs subsidize specific types of spending by individuals or corporations (even though the beneficiaries are just as well-off as others who do not benefit), or transfer funds to specific categories of individuals or corporations.[2]

It may allow a deduction from net income, exempt certain income from tax, offer a reduced tax rate, or provide a direct credit against tax liability. But in all cases, deductions, exemptions, deferral, preferential rates, and credits apply only to taxpayers with certain characteristics or to certain types of work, consumption, or investment.

A quick tax expenditures glossary

Tax deduction, exclusion or exemption: A reduction in the amount of income that is subject to a tax. A taxpayer with $60,000 in income for the year who is eligible for a $10,000 deduction, exclusion or exemption will only pay taxes on $50,000.

Preferential rates: A reduction in the tax rate that applies some forms of income, such as capital gains and dividends.

Tax deferral: A provision allowing taxpayers to delay paying their taxes. For example, taxpayers can delay paying taxes on income they contribute to an IRA until they withdraw those amounts. This delay, in effect, provides an interest-free "loan" to the taxpayer.

Tax credit: A direct reduction in the amount of taxes owed. A taxpayer who originally owed $10,000 but receives a tax credit for $3,000 will only owe $7,000 in taxes. If a tax credit is refundable, a taxpayer who originally owed $1,000 but receives a tax credit for $3,000 will receive $2,000 on net from the government.

Existing IRS-administered spending programs subsidize spending on everything from oil drilling to hybrid cars to higher education to ceiling fans. Some examples include immediate deductions for the costs of certain equipment, tax credits for renewable energy investments, and the exemption for health insurance premiums paid by employers. They also transfer funds to taxpayers as various as the elderly, the blind, and military families.

Many do not think of these provisions as spending programs because the funds are delivered by reducing the amount of taxes due or increasing taxpayers' refunds rather than providing a check from a government agency with direct responsibility for a substantive program area. But the IRS turns out to be the agency that administers the largest spending programs in the country. Its programs provide more aid to homeowners than all of the Department of Housing and Urban Development's programs combined. They channel billions of dollars in assistance each year to nonprofit organizations and state and local governments. And they provide more support for health insurance for working families than any program administered by the Department of Health and Human Services.

Perhaps people would start thinking of IRS-administered spending programs as spending if the IRS delivered the funds to another agency, which then spent the money on beneficiaries in the same manner. Suppose, for example, that the funds used for the hybrid car tax credit were instead transferred to the Department of Energy, which used the money to send people a check when they purchased a hybrid car. That looks like a spending program. But just because tax law directs the IRS to spend some of the money it raises through a tax break without using another agency as an intermediary does not mean that the government is not running a spending program or that government is any smaller.

Obstacles to viewing and treating all spending programs identically

Although IRS-administered spending programs are often no different from other spending programs, they are treated very differently in the budget process and portrayed very differently in the press. Congressional and budget scorekeeping rules do not treat them as spending unless the amount paid out exceeds a taxpayer's income tax liability, and the press typically refers to them as tax cuts. As a result, it is easier to enact these programs and harder to repeal them.

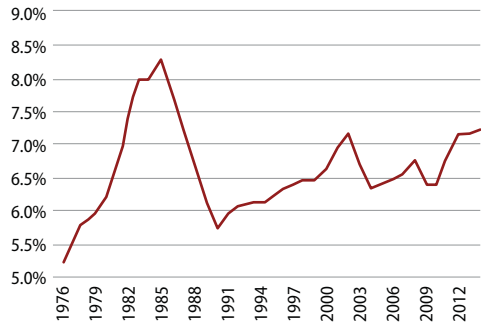
These programs enjoy three key advantages. First, they do not require annual reauthorization through the appropriations process, although a select number of them contain sunset provisions and require occasional congressional reauthorization. Second, they do not have to compete against the other spending priorities of the relevant congressional committee. For example, the congressional committees with jurisdiction over housing do not balance the value of the home mortgage interest deduction against other housing programs within some agreed-upon budget for housing programs. Finally, these spending programs give the appearance of reducing the size of government, rather than increasing it, which they do.

Because these spending programs enjoy such special protections they have flourished over the past two decades since they were last cut back in 1986 (see Figure 2). Government spending has gone undercover, masquerading as tax cuts.

FIGURE 2

Spending programs administered by the IRS make a strong comeback after cuts in 1986

Tax expenditures as percentage of GDP, 1976-2014



Sources: Budget of the United States Government, FY 2011; Budget of the United States Government, FY 2010; Steuerle (2004), 43.

Notes: See Figure 1.

The obvious response is to view and treat IRS spending programs as identical to spending programs administered by other agencies. There are several obstacles to doing this, however, which we review next. Luckily, these obstacles are at least partially surmountable. But they do illustrate why it will take effort and strong political leadership to change perceptions so that IRS-administered spending and other spending programs begin to both receive the same level of scrutiny.

Which tax provisions are spending programs?

First, it can be hard to tell which tax provisions are actually spending programs. As discussed, IRS-administered spending programs are tax benefits that are not necessary to measure a taxpayer's well-being or ability to pay, or to allocate tax rates fairly based on that measure. Many IRS spending programs take the form of tax deductions or exclusions, but not all deductions or exclusions are spending programs. Instead some are clearly necessary for measuring a taxpayer's ability to pay.

Consider a retailer who sells $100,000 of electronics each year for which she pays $80,000, and a painter who sells $100,000 worth of paintings for which he requires $1,000 of painting supplies. The retailer and the painter both have gross income of $100,000 though the retailer incurs much more expenses to make that income. If we taxed gross income, both individuals would owe the same amount of taxes even though the painter is better off than the retailer. Income taxes account for this difference in ability to pay by basing tax liability on net income or gross income minus costs of earning income. Thus, both the retailer and the painter get to deduct their business expenses and the retailer pays tax on $20,000 of net income while the painter pays tax on $99,000. As another example, if you invest in stock and later sell it, you are only taxed on how much it has appreciated, not on the sale price.

There are many other deductions and exclusions, however, that no one argues measure ability to pay. One that is not related to ability to pay is the tax exclusion for interest earned on state and local bonds. Some favor this exclusion because it lowers the cost to state and municipalities of providing public services. But no one argues that interest receipts from municipal bonds affect a taxpayer's well-being any differently than interest payments they receive from federal or corporate bonds, both of which are taxable as ordinary income.

The fact that provisions measuring ability to pay (like the business expenses described above) and many spending programs administered by the IRS (like the tax exclusion for interest on municipal bonds) both take the form of reductions in taxable income does create some confusion in determining which is really government spending. But it does not mean that one is synonymous with the other.

More substantive problems arise when one considers provisions that are more difficult to categorize because they may arguably measure ability to pay. For example, deductions for medical expenses may be appropriate when measuring well-being if the expenses reflect differences in health status. After all, one would rather not be sick and incur the associated medical costs. But such deductions may not help in measuring well-being if they reflect different choices about medical care among people with the same health status. Instead, they would then subsidize those who prefer to spend their money on more and better medical care relative to those who do not.

Another example is the reduced tax rates for dividends and capital gains. Some argue that dividends and capital gains are no different from other sources of income such as wages and interest receipts, and should be taxed in the same manner. Others argue that the corporate income tax results in corporate investment returns being taxed too highly—once at the corporate level and again at shareholder level. Under this view, the lower tax rates for capital gains and dividends partially mitigate this overtaxation. Presently the Joint Committee on Taxation implicitly adopts the former view, while for several years the Treasury Department adopted the latter.[3]

These definitional disputes can and have kept some of us in policy wonk heaven arguing about which provisions in the tax code are spending in disguise and which are necessary for measuring well-being. Indeed, these disputes have undermined prior efforts to subject IRS-administered spending programs to the same level of scrutiny as other types of spending through tax expenditure budgets.[4] Some have seen these efforts as masking a hidden agenda to promote a particular definition of net income as the best measure of well-being and ability to pay.

But more importantly, they have distracted policymakers and commentators from the more fundamental issue of how to treat provisions in the tax code that clearly are spending programs administered by the IRS. We should not let allow these gray areas deter us from beginning to view and treat clear-cut cases as identical to all other spending programs. Moreover, when a provision can be seen in two ways, both as a spending program and as a measure of well-being, policymakers and the public should at least have the information to assess its merits from both perspectives.

Measuring the cost of spending programs

A second obstacle to treating spending programs administered by the IRS in the same manner as other spending programs is the question of how to measure their cost. With other spending programs the administering agency receives a clear amount of funds. But IRS-administered spending programs are typically self-funded. That is, the IRS implements the program by reducing the amount of revenue it collects in the present or the future. Because the absence of revenue is ostensibly harder to measure than the receipt of revenue from another agency the cost is not directly apparent.

In reality, the difference between these two methods of spending is largely a mirage. The degree of precision in estimating a program's costs depends on the nature of the program, not whether it is funded through a tax rebate or a direct outlay. It is, for example, straightforward to predict the cost of a discretionary outlay program with a fixed budget. But it also straightforward to predict the cost of a tax incentive, such as the low-income housing tax credit, for which Congress sets a ceiling on the value of tax benefits that taxpayers may claim.

It can be trickier to measure the exact cost of other programs. If the programs are entitlements their estimated cost is often based on complicated and debatable assumptions regardless of whether they take the form of tax concessions or traditional spending programs. For example, budget projections for entitlement programs like Social Security require assumptions about demographic and economic trends and about how people will respond to incentives created by the system. Budget projections for student loan programs require assumptions about how much of the loans will repaid in the future.

Determining the cost of IRS-administered spending programs is no different. Estimating the cost of tax incentives for retirement saving requires assumptions about how people will respond to the incentives, how quickly the economy will grow, and whether the funds will be spent before retirement. Cost estimates for a tax deduction that allows insolvent borrowers to pay less in taxes requires assumptions about how many there are.

For some IRS-administered spending, however, there are unique measurement problems because it is difficult to estimate how much revenue the tax law would raise absent the provision. Most would agree that allowing a business to claim an immediate deduction for a capital investment with a long life, such as a machine, is an IRS-administered spending program. Because such investments are still valuable at the end of the year, economically the only expense incurred during the current year is the decline in the present value of the future output from the machine. But measuring this decline in value is often difficult. As a result, the difference between the revenue raised when the entire cost of the machine can be deducted immediately and the amount raised when only deductions for economic depreciation are allowed is difficult to measure precisely.

Current treatment in the budget process

The final obstacle to viewing all spending programs as identical is of course the fact that IRS programs are treated very differently in the budget process at present.[5] This is a key problem that needs to be addressed. The Joint Committee on Taxation, or JCT, and the Office of Management and Budget, or OMB, estimate the cost of many spending programs administered by the IRS in their annual "tax expenditure budgets."[6] But only a tiny portion of these "tax expenditures"—the portion that exceeds income tax liability but not payroll or other tax liability—are then treated as spending in the budget. This distinction makes no sense. Spending programs are not defined by whether the beneficiary has received more from the government than she has contributed. And they certainly aren't defined by whether the recipient has received more than she paid in one kind of tax.

All IRS-administered spending programs should instead be treated in the same manner as other spending in the budget process. Until then, many will not view them as spending in general. They will continue to fly under the radar, benefitting from a lower level of public scrutiny. And as a result they will continue to be less effective than direct spending programs on average.

Reforming the budget treatment of IRS-administered spending programs

Four key reforms could begin to address the budget problem. For starters, Congress could direct the JCT, the Congressional Budget Office, or a bipartisan commission like the base closure commission to develop rules for identifying which tax provisions are clearly spending programs. The OMB and JCT do publish annual lists of provisions they identify as tax expenditures. But these lists define tax expenditures as departures from a "normal" income tax or general rules in the income tax, which not all tax experts or legislators accept as the ideal tax base.[7] If the goal is to bring IRS-administered spending programs within overall budgetary controls, it will be necessary to develop a less controversial list that garners widespread support among members of Congress.[8]

One possibility for determining which tax provisions are spending programs is to look at the statements of Congress members themselves.[9] If those supporting the provision described its merits in public documents, press quotes, or the legislative history as rewarding certain behavior or helping specific groups or industries deserving aid, it would generally be treated as a spending program in the budget process. The only exception would be for provisions also widely characterized as a way of measuring how well-off certain taxpayers are relative to others or allocating tax rates on this basis. This might create a productive tension where legislators couldn't advocate for a provision in terms similar to a spending program and then turn around and argue that it should not be treated as a spending program for budget purposes.

Second, once a list of spending programs is established, Congress could direct the Congressional Budget Office, or CBO, to display alternative projections of federal spending and revenues that treat IRS-administered spending programs as if the revenue foregone was actually raised and then spent. This would reveal these provisions for what they are—programs that expand the size of government rather than shrinking it. CBO and OMB already count the portion of tax expenditures that exceeds income tax liability—but not payroll or other tax liability—as if it was direct spending in the budgetary process. This portion is referred to as the "refundable" part of "refundable tax credits." But counting only the refundable portion of credits as spending in the budget process creates a bias against the use of refundable credits, which does more harm than good.

Almost all IRS-administered spending programs are currently structured as deductions, exclusions, or nonrefundable credits, though in recent years the number of refundable credits has grown. As explained below, almost all IRS-administered spending programs would be more effective if delivered as some form of refundable credit. It is highly unlikely that any

well-structured spending program would offer benefits that always change precisely at the points where marginal tax rates change for a household of that size, as all deductions, exclusions, and nonrefundable credits do. (Provisions measuring ability to pay, by contrast, should almost always be deductions or exclusions.) Thus, budget scoring conventions currently single out for heightened scrutiny a feature of some IRS-administered spending programs that actually makes them more cost effective.

A third possibility is to require the IRS to send an annual mailing to all households summarizing the benefits they have received from IRS-administered spending programs and perhaps the average benefit received by all households. Corporate taxpayers could receive a similar summary. Such a mailing could increase public awareness and scrutiny of these programs. It would also reveal to citizens how much they are really paying in tax each year and how much they are getting back through IRS-administered spending.

Most taxpayers have no idea what these amounts are. They receive a refund each year and do not try to calculate how much of the refund was attributable to different provisions, which often would be very difficult. As a result, they frequently believe that they benefit from an IRS-administered spending program when they don't (for example because they don't itemize) or that they benefit more from a program than they do in fact.

Finally, a larger step to increase the salience of IRS-administered spending programs would be to allow or require taxpayers to claim these benefits separately so that there is a clear distinction between taxes owed to the IRS and IRS-administered spending. This would be easier to accomplish if more benefits were in the form of refundable credits. Moreover, though it would entail some additional administrative costs, it would not require as sweeping a change in tax forms as one might imagine. Page 1 of Form 1040 currently looks very much like the "taxes owed" part of the transaction, while Page 2 (with some exceptions) includes many of the "benefits" from IRS spending programs and the bottom line. The United Kingdom tax system uses this type of approach, with the Inland Revenue Department administering both taxes, which are collected through withholding, and social benefit programs, which are paid out separately.[10]

These suggestions focus on ways to make IRS-administered spending programs more transparent in the budget process and for individual taxpayers. A more ambitious goal would be to develop better institutional arrangements for controlling their growth. This could take the form of new spending caps or "freezes" that include IRS-administered spending with direct spending.[11] It could also involve changes in Congress's organization to give committees beyond the tax-writing committees more control over IRS-administered spending within their jurisdictions. For example, Congress could require that energy conservation tax incentives pass the Energy and Commerce Committee as well.

Taking these more ambitious steps, however, would require first developing a broader consensus on what should be counted as IRS-administered spending and how it should be measured for budget control purposes.

Principles for reforming IRS-administered spending programs

Regardless of whether Congress begins to treat IRS-administered spending programs as spending under budget procedures, it is time to take a hard look at the substance of these provisions once again. They have flourished since they were last cut back in 1986. And as discussed, IRS-administered spending programs benefit both from their exclusion from the traditional budget process and from their ability to masquerade as tax cuts that shrink the size of government. It follows that they should be the preferred vehicle for poorly designed spending programs and giveaways to narrow, politically powerful constituencies.

Once policymakers and commentators begin to analyze IRS-administered spending programs as the spending that they are, they will likely come to the conclusion that many of these programs should be reformed or eliminated. They should consider four questions as they go about their analysis.

The first is whether the activity or group that benefits from the program should be receiving subsidies at all. Most goods and services in the economy benefit the purchaser and making them more accessible and less costly would help those who consume them. But absent market failures, private entrepreneurs will generally produce the most efficient mix of goods and services given people's preferences. Government intervention is only potentially needed when goods and services produce public benefits that the purchaser does not take into account or when we believe that some groups merit government aid, perhaps because they are less well-off.

We can distinguish between two types of such public benefits—those where certain kinds of consumption or behavior by an individual benefits others and those where it benefits the individual herself. Examples of the former are public education, basic science research, and public health measures. Many people benefit from living in an educated, healthy, and technologically advanced society. We refer to these goods as producing "externalities." Examples of the latter include watching less television or saving for retirement. People might wish they could cut back on television watching or save more but have trouble acting on those preferences. We refer to these situations where a choice produces benefits to the decision maker that she does not take into account as producing "internalities."

Many IRS-administered spending programs do not appear to produce any particular social benefits. For example, it is questionable whether subsidies to oil companies for oil drilling and exploration produce any external benefits. In other cases, such as internalities, the

Once policymakers and commentators begin to analyze IRS-administered spending programs as the spending that they are, they will likely come to the conclusion that many of these programs should be reformed or eliminated.

social benefits are controversial. People might be better off if they watched less television. But many will think that taxpayer dollars shouldn't be used to interfere with choices that have no effect on others and that these choices should instead be left to the individual.

Others think that internalities may merit government intervention only where the individuals may be especially poorly equipped to make choices. An example is retirement savings decisions, which require sophisticated financial calculations and do not provide people with an opportunity to observe the consequences of their choices—that they have saved too little for retirement, for example—and change their choices in response.

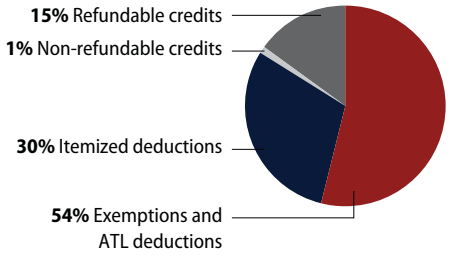
If an activity or group does merit incentives or support the second question to consider is whether subsidies, libertarian paternalism, regulation, or direct government provision is the best approach. In many cases, subsidies may be a better approach than regulation or direct government provision because they rely on market mechanisms. But even then libertarian paternalism should also be considered because it requires little or no revenue.

This approach uses behavioral devices such as rules that "default" people into retirement savings plans to nudge people in a certain direction. Defaults have been shown in some experiments to be very effective in changing behavior while at the same time reducing costs to taxpayers (if they substitute for subsidies) and allowing individuals to retain freedom to opt out of the program.[12] They are not costless, however. The person who is nudged may be worse off because he is no longer acting upon his preferences. But their benefits may outweigh their costs, especially in the case of internalities where they may nudge the decision maker in the direction of acting in her own best interests.

FIGURE 3

Most tax expenditures claimed on individual returns are exemptions and deductions that disproportionately benefit higher-income individuals.

Form of major nonbusiness tax expenditures, 2008



Source: Burman, Geissler, and Toder (2008) excluding special tax rates.

In cases where subsidies are deemed appropriate, the third question to consider is how to get the most bang for the buck. The answer will turn on several factors. When the subsidy seeks to assist people or businesses meriting government aid, it generally should be targeted on those most deserving or in need. When the goal is to change behavior, the subsidy should be targeted to those for whom changes in behavior would produce the most social benefits and those who are most likely to respond.

But regardless of how they are targeted, IRS spending programs should be structured as some kind of refundable credit in virtually all cases. Unfortunately, Figure 3 illustrates that presently the vast majority of nonbusiness tax expenditures—those claimed on individual income tax returns that do not relate to business income—are structured as deductions or exclusions. (The same is true for tax expenditures for businesses.) These types of tax benefits provide larger subsidies to higher-income individuals because the value is the amount deducted or excluded times the marginal tax rate.

Many deductions are itemized deductions, which provide no subsidy to the 65 percent of mostly low- and middle-income tax filers who do not itemize deductions on their tax returns.[13] And all deductions and exclusions provide no subsidy at all to people with no income tax liability—even though they may pay payroll taxes, federal excise taxes, and state and local taxes—despite the fact that they comprise about 43 percent of all tax units.[14]

It's hard to believe that it is more important to subsidize activities like homeownership and health insurance for higher-income individuals, which is what many of these exemptions and deductions do. After all, such individuals are less likely to respond to such subsidies because they typically already own their homes and have health insurance. Similarly, there is no reason why higher-income tax units should receive larger incentives to buy hybrid cars or invest in state and local bonds, because the benefits of such investments to the climate and state and local finances do not vary with the investor's income.

It is even harder to believe that any IRS-administered spending program should be a deduction or exclusion. These types of provisions change the amount of the subsidy at the precise point where income tax brackets change. Even if an IRS-administered spending program should rise with net income there is no reason why it would rise in this particular manner. Instead such programs should be refundable credits, which can be structured to rise or fall with income as policymakers see fit.[15]

Moreover, in many cases an IRS-administered spending program should not only be structured as a refundable credit but should also provide the same benefit irrespective of income. Specifically, if a provision's goal is to address externalities or internalities and policymakers have little or no information about relative differences in responsiveness and social benefits, a uniform subsidy is generally the most efficient approach.[16] Because policymakers frequently do not have such information this default can be tremendously important.

When policymakers look at how to get the most bang for the buck from a tax subsidy intended to influence behavior they should consider several additional factors. One is whether the subsidy can be more narrowly targeted on the activity producing social benefits. Subsidies for structured settlements and life insurance, for example, are ostensibly designed to promote annuities and life insurance but frequently subsidize contracts with few insurance elements.[17]

Another is whether aspects of the program's structure may affect responsiveness to it. There is some evidence that people respond more to subsidies that are framed as matches rather than refunds,[18] and that are uniform.[19] They may also respond more to financial incentives delivered at the time the consumption decision is made rather than in the future.[20]

The fourth and final question is whether the IRS or another agency should administer the subsidy. The IRS may be the most appropriate administrator in some cases. If a program is based on annual income and other data currently reported on tax returns it probably

makes mores sense to let individual and businesses claim the benefits on their tax returns rather than to set up a new program bureaucracy. Because the IRS generally scrutinizes benefit claims less carefully than other program agencies, one might also want to use the IRS if one is more concerned about the possibility of eligible recipients underclaiming benefits than other households overclaiming them.[21]

But the IRS may be a poor choice for administering other programs. If agency discretion is required to determine benefit eligibility it is better to house programs in agencies with specific programmatic expertise in the area. If policymakers want to base the subsidy on economic status measured over a longer or shorter period than one year—as, perhaps, with Social Security and Food Stamps respectively—the IRS may not be the best administering agency.

To sum up, policymakers should keep in mind four broad principles when evaluating the effectiveness of IRS-administering spending programs:

- Deductions, exemptions, and different marginal tax rates should continue to be used to determine differences in ability to pay tax among taxpayers and allocate tax rates based on this measure. Other provisions that do not produce any broader social benefits or transfer funds to groups that merit government aid should be repealed.

- Programs that try to encourage people to act more rationally based on their long-term interests—rather than taking into account spillover benefits for others—may often accomplish policy objectives just as effectively if replaced with behavior devices such as defaults, and at a lower cost to the taxpaying public.

- IRS-administered subsidies should be structured as some kind of refundable credit. If the program seeks to influence taxpayer choices, it should be structured as a uniform refundable credit absent evidence that the choices of some groups produce larger public benefits or that the group will respond more to the subsidy.

- Designating the IRS as the administrator of a spending program sometimes makes sense, especially if eligibility ideally depends on data already reported on tax returns and little else. But the IRS should not administer programs that require administrative discretion in allocating benefits or programs for which eligibility does not depend on an annual measure of well-being.

Conclusion

Policymakers should consider reforming or repealing many spending programs administered by the IRS as they seek to control budget deficits. These programs are often called "tax expenditures" and will cost more than $1 trillion in fiscal year 2011. But because they appear to be tax cuts instead of direct outlays, they are often overlooked in discussions of how to control the growth of federal spending. This paper argues that IRS-administered spending programs should be subject to the same level of scrutiny and the same budget procedures as spending programs administered by other agencies.

The last time Congress systematically reviewed and cut back on IRS-administered spending programs was 1986—a quarter century ago. Since then, these programs have ballooned, now representing more than 7 percent of GDP. There are certainly obstacles to ensuring equal treatment for them, such as calculating their cost and determining whether the relevant provision is a spending program or measuring ability to pay. But these obstacles should not deter policymakers from giving these programs the critical evaluation they deserve.

In conducting such a systematic review this paper argues that policymakers should consider whether each spending program administered by the IRS furthers any public goals and, if so, whether it is structured as effectively as possible to achieve its objectives. If a program seeks to encourage consumers to act in their own interest, policymakers should consider replacing or supplementing it with default rules and "nudges" that facilitate better decisions.

If a program seeks to encourage consumers to make choices that benefit others, policymakers should target its subsidies on the choices that benefit others the most and the taxpayers who are most likely to respond. When a financial subsidy is appropriate to encourage socially beneficial choices, policymakers can often increase responsiveness by offering the same subsidy to everyone, framing the subsidy as a match, or delivering it earlier in time. More fundamentally, such subsidies should not depend on the claimant's marginal tax rate or itemizing status. This implies that spending programs administered by the IRS should almost always be delivered in the form of refundable credits instead of nonrefundable credits, deductions, or exclusions.

In addition to taking a hard look at the merits of existing IRS-administered spending programs, policymakers should move toward incorporating these programs into the budget process so that there is no bias in their favor going forward.

This paper has suggested four reforms that could further this goal:

- Requiring Congress, a bipartisan commission, or a designated agency to create a list of tax provisions that should be defined as "IRS-administered spending programs"
- Directing CBO to display alternative projections of federal revenue and spending that count all IRS-administered spending programs as revenue raised and then spent
- Requiring the IRS to inform taxpayers of the benefits they receive from IRS-administered spending programs
- Allowing taxpayers to claim these benefits separately from remitting tax due

All of these potential reforms would make IRS-administered spending more transparent and salient. More importantly, they could lay a foundation for more fundamental reforms, such as including IRS-administered spending within future spending caps and giving non-tax committees with relevant policy expertise more authority over such programs.

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Endnotes

1 The Tax Reform Act of 1986 reduced IRS administered spending both directly, by eliminating a number of tax preferences, and indirectly by reducing individual and corporate marginal tax rates, which lowered the value of tax deductions and exemptions that remained in the tax law. See Congressional Budget Office, "The Effects of Tax Reform on Tax Expenditures" (1988).

2 This distinction between provisions that allocate tax rates based on well-being and those that transfer funds on this basis may be difficult to maintain theoretically. See Daniel Shaviro, "Rethinking Tax Expenditures and Fiscal Language," Tax Law Review 57 (2) (2004): 187.

3 The Treasury Department has now reverted to its previous position and lists the special rate on qualified dividends as a tax expenditure line item.

4 See, e.g., Robert Peroni "Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base? A Critique of the "New Paradigm" and Its Denouement." (Forthcoming); Joint Committee on Taxation, "A Reconsideration of Tax Expenditure Analysis (JCX-37-08), May 12, 2008," available at http://www.house.gov/jct/x-37-08.pdf; Stanley Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (Cambridge: Harvard University Press, 1973).

5 For a history of the relationship between tax expenditures and the budget process, see Edward Kleinbard, "Tax Expenditures Framework Legislation" USC Law Legal Studies Paper No. 10-1 (2010).

6 OMB and JCT only consider the individual and corporate income taxes, thereby missing spending programs embedded in the payroll tax, excise taxes, estate and gift taxes, and a variety of other taxes that make up more than 40 percent of federal revenue, although probably are lesser amount of tax expenditures. For a discussion of how tax expenditure estimates for federal excise taxes might be constructed, see Bruce Davie, "Tax Expenditures in the Federal Excise System," National Tax Journal 47 (1) (1994): 39-62.

7 Peroni, "Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base?" (2010).

8 For further proposals to bring tax expenditures into the budget process, see Kleinbard, "Tax Expenditures Framework Legislation" (2010)

9 Michael McIntyre advocated a somewhat similar approach in Michael J. McIntrye, "A Solution to the Problem of Defining a Tax Expenditure," U.C. Davis Law Review 14 (1980).

10 Stuart Adam and James Browne. "A Survey of the UK Tax System" (London: Institute of Fiscal Studies, 2009)

11 This approach is advocated in Leonard Burman, Christopher Geissler, and Eric Toder, "How Big are Total Individual Income Tax Expenditures and Who Benefits from Them?" (Washington: Urban-Brookings Tax Policy Center, 2008).

12 See, e.g., Brigitte C. Madrian and Dennis F. Shea, "The Power Of Suggestion: Inertia In 401(k) Participation And Savings Behavior," Quarterly Journal of Economics 116 (4) (2001): 1149-1187.

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15 Lily L. Batchelder, Fred T. Goldberg, Jr., and Peter R. Orszag, "Efficiency and Tax Incentives: The Case for Refundable Tax Credits," Stanford Law Review 59 (23) (2006).

16 Ibid.

17 See, e.g., Jeremy Babener "Structured Settlements and Single Claimant Qualified Settlement Funds: Regulating in Accordance with Structured Settlement History," *NYU Journal of Legislation and Public Policy* (2010); Michael Graetz and Deborah Schenk, *Federal Income Taxation: Principles and Policies, 6th Edition* (New York: Foundations Press, 2009).

18 See, e.g., Catherine C. Eckel and Phillip J. Grossman. "Subsidizing Charitable Contributions: A Natural Field Experiment Comparing Matching and Rebate Subsidies." *Experimental Economics* (Forthcoming); Emmanuel Saez, "Details Matter: The Impact of Presentation and Information on the Take-up of Financial Incentives for Retirement Saving," *American Economic Journal: Economic Policy* 1 (1) (2009): 204-228.

19 See, e.g., Paul Burnham and Larry Ozanne, "Individual Retirement Accounts." In Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle, eds., *The Encyclopedia of Taxation and Tax Policy, 2nd Edition* (Washington: Urban Institute Press, 2005)

20 See, e.g., Sima J. Gandhi, "Viewing Education Loans Through a Myopic Lens" (Washington: Brookings Institution Hamilton Project, 2008); Erica Field, "Educational Debt Burden and Career Choice: Evidence from a Financial Aid Experiment at NYU Law School," *American Economic Journal: Applied Economics* 1(1) (2009): 1-21.

21 For a thoughtful discussion of this choice in the context of the Earned Income Tax Credit and welfare programs, see Lawrence Zelenak, "Tax or Welfare: The Administration of the Earned Income Tax Credit," *UCLA Law Review* 52 (2005): 1897.

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