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AND PUBLIC FINANCE

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\$750 Billion Misspent? Getting More from Tax Incentives

Lily Batchelder, Austin Nichols and Eric Toder
Drafts of Chapters 1-3, Jan. 7, 2010

January 14, 2010
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Vanderbilt Hall-208
Time: 4:00-5:50pm
Number 1

SCHEDULE FOR 2010 NYU TAX POLICY COLLOQUIUM

(All sessions meet on Thursdays from 4-5:50 pm in Vanderbilt 208, NYU Law School)

1. **January 14** – Lily Batchelder, NYU Law School, “\$750 Billion Misspent? Getting More from Tax Incentives” (with Austin Nichols and Eric Toder).
2. **January 21** – Kimberley Brooks, McGill Law School, “Tax Sparing: A Needed Incentive for Foreign Investment in Low Income Countries, or an Unnecessary Revenue Sacrifice?”
3. **January 28** – Michael Knoll, Penn Law School, and Ruth Mason, University of Connecticut Law School, “What Is Tax Discrimination?”
4. **February 4** – Michael Devereux, Said Business School, Oxford University, “Taxation of Outbound Direct Investment: Economic Principles and Tax Policy Considerations.”
5. **February 11** – David Walker, Boston University Law School/NYU Law School, “Tax Penalties and the Legislative Process.”
6. **February 18** – Jeffrey Brown, University of Illinois Business School, “Automatic Lifetime Income as a Path to Retirement Income Security.”
7. **February 25** – Matthew Adler, Penn Law School, “Social Welfare Functions and Policy Analysis.”
8. **March 4** – Rebecca Kysar, Brooklyn Law School, “Lasting Legislation.”
9. **March 11** – David Weisbach, University of Chicago Law School, “Trade and Carbon Taxes.”
10. **March 25** – Robert Peroni, University of Texas School of Law, “Can Tax Expenditure Analysis Be Divorced From a Normative Tax Base?: A Critique of the ‘New Paradigm.’”
11. **April 1** – Douglas Shackelford, Kenan-Flagler Business School, University of North Carolina, “Capital Gains Taxes and the Return-Risk Tradeoff.”
12. **April 8** – Joel Slemrod, University of Michigan Economics Department and Business School, “Car Notches.”
13. **April 15** – Michael Schler, Cravath, Swayne, and Moore. [Title to be supplied.]
14. **April 22** – James R. Hines, University of Michigan Business School and Law School, and Edward McCaffery, USC Law School, “The Last Best Hope for Progressivity in Tax.”

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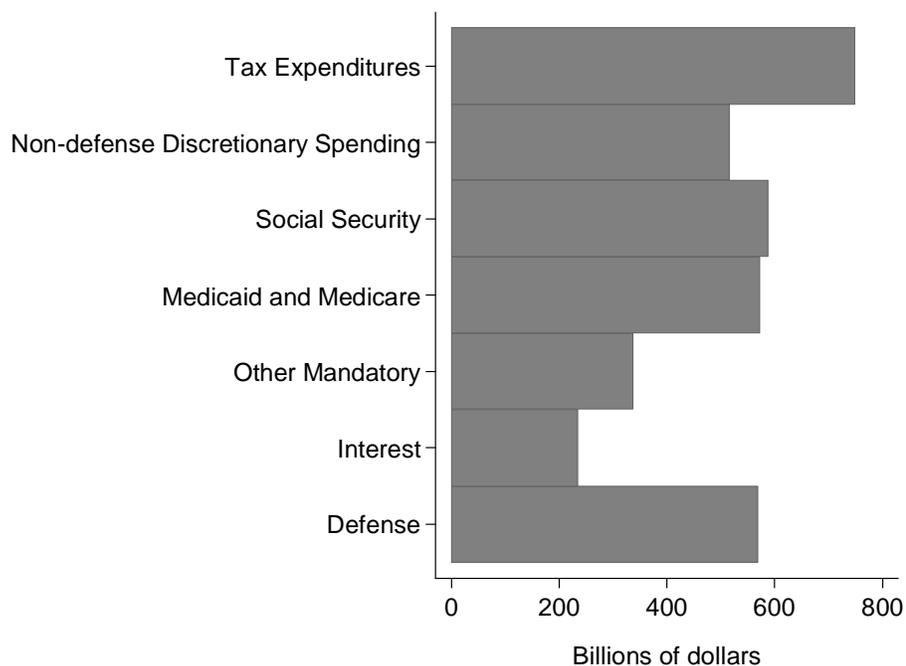
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CHAPTER 1

INTRODUCTION: SOCIAL POLICY AND THE TAX CODE

The U.S. federal government spent about three-quarters of a trillion dollars on income tax breaks for certain behavior in 2007.¹ During the same year, non-defense discretionary spending totaled about half a trillion dollars,² and the income tax raised about one trillion dollars.³ This means that if we collected the additional revenue from repealing these tax breaks and turned them into spending programs, we would increase income tax revenues by about 75 percent, and almost double the size of all domestic discretionary programs. Indeed, tax expenditures appear to be the largest category of federal spending (Figure 1.1). We vastly misconceive of the size of government when we ignore these provisions.

Figure 1.1: The Size of Government Spending Categories Compared with Tax Expenditures, 2007



Source: Burman, Geissler, and Toder (2008): OMB budget figures.

¹ The tax breaks included are listed in Table 1.

² This figure excludes \$570 billion spent on defense, \$235 billion on debt service, and \$1.5 trillion on mandatory spending programs like Social Security; total federal spending in 2007 was \$2.8 trillion (OMB figures for fiscal years 2007 and 2008, <http://www.gpoaccess.gov/usbudget/fy08/pdf/08msr.pdf>, <http://www.gpoaccess.gov/usbudget/fy09/pdf/msr.pdf>). We take “non-defense discretionary spending” as a measure of the types of direct spending that tax expenditures typically replace.

³ Throughout we refer to the individual income tax as the “income tax” and the corporate income tax as the “corporate tax.”

For the past 35 years, the Office of Management and Budget and Congressional agencies (currently the Joint Committee on Taxation) have published lists summarizing the revenue cost of tax provisions that depart from a baseline income tax and often substitute for direct spending programs. The list is referred to as the “tax expenditure budget.”⁴ It is supposed to include special tax preferences, but not provisions that are necessary for measuring income or ability to pay, such as deductions for business expenses. The baseline tax allows for personal exemptions, a standard deduction, graduated individual tax rates, different ways of taxing individuals and couples, and a separate corporate income tax. The lists of tax expenditures include many tax breaks with which we all are familiar, such as the home mortgage interest deduction, and the deduction for charitable contributions. However, these provisions are not considered when we measure the size of government by the amount of government outlays.

Tax expenditures often promote valuable social goals. But in many cases they would be designed very differently if we viewed them explicitly as spending programs and asked how well they achieve public objectives. This book seeks to do just that. It asks whether the behavior that certain tax expenditures promote merits a subsidy and, if so, whether the subsidy is effective in changing behavior. Based on these insights, it offers suggestions for how we might redesign specific tax expenditures so that they are more cost-effective—and which ones we should scrap.

The central idea to take away is that the federal income tax can be a powerful vehicle to enact and administer social policy, but only certain kinds of tax expenditures make sense. Many existing tax breaks are inferior to regulation, direct spending or governmental “nudges.” When tax expenditures for certain behavior are a good idea, a *refundable credit* is always the right method, and a uniform refundable credit should be the default absent strong evidence to the contrary.⁵ Because only a small share of such tax expenditures are structured as refundable credits, we are wasting an immense amount of money on poorly-designed tax incentives—to the tune of \$750 billion per year.

An Overview of Tax Expenditures

Before we begin, consider some basic facts about tax expenditures. Generally we will focus on *tax incentives*, by which we mean federal income tax provisions to the extent that they are associated with behavior that potentially benefits society.⁶ But we focus on the broader category of tax expenditures in this chapter because there is more data on them. Most of the tax expenditures we discuss here fall within our definition of

⁴ This concept was first popularized by Stanley Surrey (1973). For further discussion see, e.g., Howard (1999); Shaviro (2004).

⁵ This is because the incentive changes discontinuously at the point where tax liability falls to zero, but the social benefit does not, which implies that nonrefundability is associated with inefficiency. For details, see Chapter 2, this volume, and Batchelder, Goldberg, and Orszag (2006a, 2006b).

⁶ We intend to ignore tax preferences to the extent that the case for them is not based on their effects on taxpayer behavior, but rather on their distributional effects or other concerns. As discussed in more depth in Chapter 2 and throughout, some view the tax breaks discussed as justified on these other grounds but, in most cases, such arguments are relatively weak.

tax incentives, but we will explain how this is debatable for others in subsequent chapters.

Table 1.1: Non-Business Tax Expenditures in 2007, Billions \$

	TPC	OMB	JCT
Exclusions and above-the-line deductions			
Retirement plans	126.8	108.2	132.9
Health insurance	141.5	145.7	109.5
Student loan interest	1.1	0.8	0.9
Retirement benefits	23	26.9	22.4
Other	37.2	50.9	56.7
Special rates on capital gains and dividends	94.8	53.1	127.1
Itemized deductions			
Mortgage interest	92.4	79.9	73.7
Charitable contributions	43.3	47.4	41.9
Medical expenses	5.6	4.2	8.4
Other	39.4	49.5	51.5
Non-refundable credits			
Education (HOPE, Lifetime learning)	4.2	5.5	3.1
Other	3.8	3.5	3.9
Refundable credits			
Child credit	44.9	47.5	45
Earned income credit	43.7	41.8	44.7
Total, all tax expenditures	701.8	664.9	721.7
Total with interactions	760.5		

Source: Burman, Geissler, and Toder (2008). Estimates are from the Tax Policy Center (TPC), Joint Committee on Taxation (JCT), and Treasury, as reported by the Office of Management and Budget (OMB).

Burman, Toder and Geissler (2008) have estimated the total loss in income tax revenues from a subset of tax expenditures, which we will refer to as non-business tax expenditures.⁷ Table 1.1 lists these provisions and their estimated cost, organized by where you might see them on your tax form. Overall these tax expenditures cost about \$750 billion in 2007.⁸ Interactions among the provisions increase their cost by eight percent compared with just adding them up.⁹ Most of this increase is due to interactions across categories. For example, itemized deductions are worth more without exemptions

⁷ “Non-business” tax expenditures are those claimed by individuals, excluding those related to measurement of business (sole proprietorship), farm, or partnership income. There are a variety of payroll tax, state and local income tax, and excise tax provisions that have similar properties to the federal income tax expenditures we look at, but they are not the focus here. In many cases, the same analysis applies to both. We also ignore tax expenditures claimed by businesses, even though some have potentially large consequences for families.

⁸ Eliminating multiple tax expenditures could raise more or less revenue than the sum of the individual tax expenditure estimates for several reasons. Eliminating one tax incentive can change the estimated cost of other incentives by moving people into higher marginal tax rate brackets or inducing them to stop itemizing and switch to the standard deduction. It can also change behavior, making revenue raised less than the “static” tax expenditure estimate. Finally, providing the same incentive through a spending program sometimes would appear to cost more because the spending is “grossed up” to cover taxes beneficiaries would pay on their extra income. Until recently, Treasury provided separate estimates of these “outlay equivalent” costs. See Office of Management and Budget 286 note 2 (2007).

⁹ Burman, Geissler, and Toder (2008) also show how the individual alternative minimum tax, counter to intuition, makes costs with interactions larger, not smaller.

because abolishing exemptions would push people into higher tax brackets where deductions are worth more.

Three-quarters of these tax expenditures fall within the six categories that this book considers. Tax expenditures for health insurance and health care spending were worth about \$145 billion. Tax expenditures for retirement saving cost about \$120 billion, and those for owner-occupied housing cost over \$100 billion. Meanwhile, tax credits for work and children were worth about \$90 billion, charitable deductions about \$45 billion, and tax breaks for higher education about \$5 billion. Together, these six sets of tax breaks cost slightly more than all non-defense discretionary spending. Their estimated cost would be even larger if losses of payroll tax revenues were included.¹⁰

Between 1976 and 1986, tax expenditures grew from about 4 percent of GDP to over 6 percent.¹¹ They briefly declined after 1986, when the Tax Reform Act removed a host of special provisions. But they quickly returned to 6 percent of GDP and have been a relatively stable share of the economy ever since.¹²

Every year there are calls for new tax expenditures alongside calls for spending restraint. In the 2008 election, candidates proposed new tax expenditures for health, education, and savings, while promising to reduce deficits. In 2009, Congress enacted tax expenditures for individual taxpayers totaling \$46.5 billion as part of the stimulus package, and the Obama administration proposed about \$200 billion in new tax expenditures for individual taxpayers over the next decade in its budget. However, the administration also proposed limiting the value of itemized deductions to 28 percent of the amount deducted, which would raise \$267 billion over the next decade.¹³

Ignoring these new provisions and proposals, the value of current tax incentives is projected to grow at about the same rate as the economy, and faster than inflation, over the next several years (Figure 1.2). The composition, though, has been changing. Tax expenditures for health have been rising more rapidly than GDP, while others have been relatively stable as a share of the economy.

There are many reasons why tax expenditures represent such a large share of government, but political expediency and culture play a large role. Spending more

¹⁰ Specifically, employer contributions to fringe benefits (health insurance and pensions) are exempt from payroll tax as well as income tax. While the Social Security payroll tax adds to future benefits employees receive so there is a partial offsetting budgetary saving from excluding those revenues, the Medicare tax (2.9 percent of wages) is unrelated to future benefits of individuals who pay it

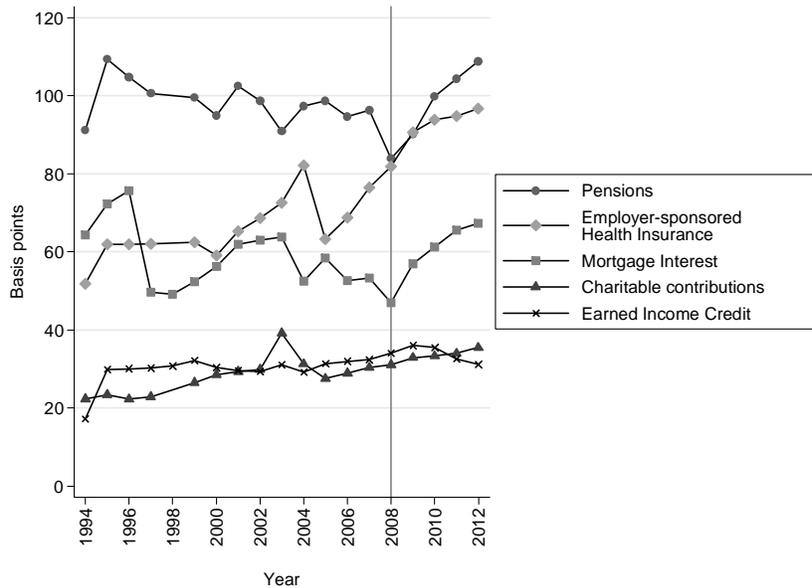
¹¹ This is an estimate by the U.S. Treasury Department and ignores interactions.

¹² Burman, Geissler, and Toder (2008).

¹³ These figures do not include the cost of the “Making Work Pay Credit”, which would allow workers to claim a refundable credit for the employee share of Social Security payroll taxes on the first \$6,400 of earnings. This provision costs \$116.2 billion in the stimulus bill and its extension in the budget will lose another \$534 billion through 2019. It is arguably, however, a change in the general rate structure of the payroll tax instead of an income tax preference, although individuals claim it on their income tax return.

money is seen as wasteful by many politicians and their constituents, while cutting taxes is seen as laudable, even if they amount to the same thing.¹⁴

**Figure 1.2: Growth in Selected Tax Expenditures as a Share of GDP
(Projections after 2008)**



Sources: Tax expenditures from Joint Committee on Taxation (2007) and comparable publications since 1994; GDP from projections by Congressional Budget Office (2009).

Who Benefits From Tax Expenditures?

Tax expenditures come in several forms, which dramatically affect whom they benefit. Most broadly, they can be deductions, exemptions, or tax credits. Deductions and exemptions have similar effects. Both subtract some amount of income before the tax calculation begins, lowering the “tax base.” For example, when an employer pays for an employee’s health insurance, the employee can exclude that payment from his or her income tax base, even though the employer gets to deduct it. Exemptions and deductions offer much larger benefits to people in higher tax brackets because their value is the amount of taxes saved. That is, it is the amount deducted or excluded multiplied by your marginal tax rate. Tax credits, on the other hand, reduce taxes due, not taxable income. Therefore, their value does not depend on whether your marginal tax rate is 10 percent or 35 percent.

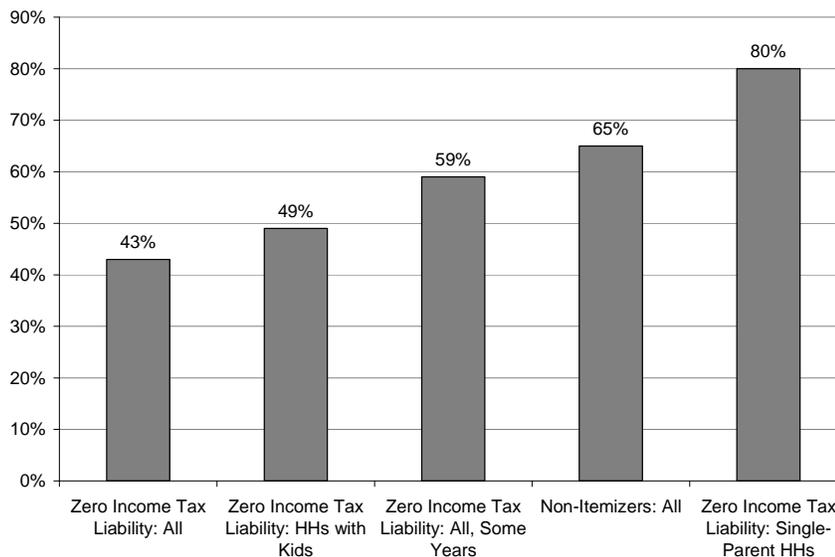
Within deductions, there is an important distinction between above-the-line deductions and itemized deductions. Like exemptions, above-the-line deductions are available to anyone. But itemized deductions are only available to those who decide to itemize as opposed to claiming the standard deduction. People who have a small sum of

¹⁴ See Shaviro (2006).

itemized deductions, for example, because they own an inexpensive home with a small mortgage, or pay relatively few state taxes, are better off taking the standard deduction. Thus, itemized deductions offer even less benefits than exemptions and above-the-line deductions for middle- and low-income households.

Tax credits also fall into two categories: refundable and non-refundable credits. Non-refundable credits are limited to a taxpayer’s income tax liability, while refundable tax credits are available even when tax liability is zero. For example, suppose a college student is eligible for a \$1,000 non-refundable credit and his parents would otherwise owe \$2,000 in income taxes. The credit will reduce their tax liability by \$1,000. If their income tax liability is \$500, it will reduce their income tax liability by \$500 instead, even if they pay a large amount of other federal taxes. But if the credit is refundable, they will receive the same benefit as other families—their income tax liability will be reduced by \$1,000 so that they will receive a net refund of \$500. Thus, refundable credits are the only type of tax expenditure that can offer the same benefit to everyone.

Figure 1.3: Percentage of Tax Units with Zero Income Tax Liability



Sources: Batchelder, Goldberg and Orszag (2006); Toder and Rosenberg (2007); TPC (2009).

The characteristics of deductions, exemptions and non-refundable credits make them much less valuable for upper-middle-income taxpayers and worthless for low-income and many middle-income taxpayers. Figure 1.3 shows that the share of taxpayers who do not itemize is still about 65 percent of all tax units.¹⁵ Itemized deductions are thus worth nothing for two-thirds of taxpayers. In addition, nearly half of taxpayers have zero income tax liability in any given year,¹⁶ and about 60 percent have zero income tax liability in some years.¹⁷ Non-refundable credits do nothing for those with no income tax

¹⁵ Toder and Rosenberg (2007)

¹⁶ According to TPC (2009), 43.4 percent of all tax units report zero or negative liability, net of credits. Over half of those have income below \$20,000.

¹⁷ Batchelder, Goldberg, and Orszag (2006a).

liability. Instead, these incentives predominantly benefit the highest-income taxpayers who almost always have positive income tax liability and are in the highest tax brackets. The exception is non-refundable tax benefits that “phase out” as income rises, which benefit middle income taxpayers, but not those with the highest or lowest incomes..

Table 1.2 and 1.3 summarize the combined distributional effects of non-business tax expenditures by two measures. The first is the percentage decline in after-tax income if they were eliminated. As Table 2 shows, this would disproportionately hurt high-income taxpayers, implying that they benefit the most. The second measure is the dollar value of these tax expenditures. By this measure, the benefits are dramatically larger for high-income taxpayers as illustrated in Table 1.3. On average, these provisions are worth \$509 for each taxpayer in the bottom quintile, but 227 times more for each taxpayer in the top 1 percent—or an astonishing \$115,888.

Table 1.2: Distributional Effects of Eliminating Groups of Tax Expenditures: Percentage Change in After-Tax Income, by Income Quintile (2007, with AMT, with interactions)

	Bottom	Second	Middle	Fourth	Top	Top 1%	All
Exclusions from Income	-0.54	-2.99	-3.79	-3.68	-4.74	-2.9	-4.19
Above the line deductions	-0.01	-0.06	-0.09	-0.11	-0.08	-0.06	-0.08
Special rates (capital gains and dividends)	0	-0.01	-0.04	-0.12	-2.11	-5.87	-1.26
Itemized deductions	-0.02	-0.11	-0.38	-1.09	-2.91	-3.24	-1.97
Non-refundable credits	-0.05	-0.28	-0.33	-0.23	-0.06	0	-0.14
Refundable credits	-5.49	-5	-2.2	-0.99	-0.25	0	-1.14
Total: all provisions	-6.52	-8.16	-6.76	-6.79	-11.36	-13.53	-9.57

Source: Burman, Geissler, and Toder (2008)

Table 1.3: Average Value of Tax Expenditures, by Income Quintile (2007, with AMT, with interactions)

	Bottom	Second	Middle	Fourth	Top	Top 1%	All
Exclusions from Income	\$42	\$570	\$1,221	\$2,145	\$7,590	\$25,439	\$2,314
Above the line deductions	\$1	\$12	\$27	\$56	\$121	\$491	\$43
Special rates (capital gains and dividends)	\$0	\$3	\$12	\$66	\$3,115	\$50,517	\$639
Itemized deductions	\$1	\$21	\$123	\$654	\$4,386	\$24,818	\$1,037
Non-refundable credits	\$4	\$54	\$102	\$96	\$19	\$11	\$55
Refundable credits	\$428	\$953	\$697	\$525	\$386	\$10	\$597
Total: all provisions	\$509	\$1,554	\$2,168	\$3,963	\$17,356	\$115,888	\$5,109

Source: TPC estimates based on Burman, Geissler, and Toder (2008) methodology.

These dramatic differences are driven by the fact that higher-income taxpayers benefit disproportionately from exemptions, deductions, and special rates for capital gains and dividends, which account for the lion’s share of revenue foregone. Most non-refundable credits favor middle-income taxpayers the most because they phase out at higher incomes and are worthless for those with zero income tax liability. Meanwhile, existing refundable credits favor lower-income tax units. While all of the other types of

tax expenditures necessarily exclude lower-income tax units, refundable credits theoretically could benefit all equally. However, presently they do not because they phase out at middle and high incomes.

The actual distributional impact of eliminating non-business tax expenditures would depend on how the additional revenue was spent. If it were returned through a uniform percentage point income tax cut for all taxpayers,¹⁸ this would generally raise the after-tax income of low- and middle-income taxpayers. As Table 1.2 shows, eliminating tax expenditures could finance a uniform percentage point rate cut of about 10 percent of after-tax income. Because repealing these tax expenditures would cost taxpayers in the bottom four quartiles less than 10 percent of their after-tax income, they would be better-off. The top quartile would be worse-off because tax expenditures comprise more than 10 percent of their after-tax income.

Alternatively, the additional revenue could be spent on a uniform percentage change in marginal income tax rates. Then low- and middle-income households with zero income tax liability would be worse off because cutting a zero percent tax rate by any percentage results in no benefits.

Finally, non-business tax expenditures could be replaced by spending programs that benefit all tax units by the same dollar amount. Then low-income taxpayers would gain even more from eliminating tax expenditures than in the first scenario. Table 1.3 shows that repealing these tax expenditures could finance a payment of about \$5,100 to every household. Households in the bottom quintile would gain about \$4,600 on average from substituting this uniform payment because tax expenditures are worth so little to them. Households in the top quintile, however, would lose about \$12,300 on average from this substitution.

Conclusion

Federal income tax policy is a powerful agent of social policy. Individual tax expenditures provide large subsidies to support health, saving, housing, and other social goals, and many are disproportionately directed at higher-income households. These tax breaks cost more than all non-defense discretionary spending. Perhaps it makes sense to offer such large incentives to individuals to modify their behavior, and to disproportionately target them on relatively wealthy households. But we need to seriously consider whether this is the case.

In Chapter 2, we offer a framework for determining when and how we should offer fiscal incentives so that we can subject them to greater scrutiny, and in Chapter 3 we discuss issues in determining whether an incentive should be in the tax code or a direct spending program. The book then applies this framework to six major tax incentives—those for low-wage work and childrearing, higher education, owner-occupied housing, charitable contributions, retirement saving, and health insurance. In doing so, it

¹⁸ This would entail, for example a tax cut of 10 percentage points of income for all tax units with positive income tax liability, and a subsidy of 10 percentage points of income for those with zero or negative income tax liability.

suggests where and how reforms can help us get more from the dollars we spend on these tax incentives, and where we should eliminate them.

In the coming years, we face deficits of unprecedented proportions and social challenges that will demand more of our scarce resources than ever. We cannot rely solely on new taxes and raising marginal rates. We need to reconsider whether the government we *have* is focused in the right places, including both the direct subsidies that we count as government spending, and the tax subsidies that we do not.

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CHAPTER 2

WHEN AND HOW SHOULD FISCAL INCENTIVES BE PROVIDED?

Introduction

The first chapter showed that selected income tax expenditures cost about \$750 billion per year, more than all non-defense discretionary spending combined. This fact alone should make us care about whether they are being deployed wisely. Moreover, each year policymakers consider and enact new subsidies. They often do so with little or no evidence that these incentives will achieve their objectives. This chapter seeks to provide a framework for considering when we should enact or retain a fiscal incentive, and how it should be designed.

What Are Fiscal Incentives?

Before turning to the framework, we first need to explain what we mean by a fiscal incentive. Fiscal incentives are provisions that seek to induce activities or investments that may generate social benefits. They can be delivered through the tax system or as direct spending. The framework introduced here applies to both. Chapter 3 then considers whether a fiscal incentive should be delivered through the tax system or as a direct spending program.

Fiscal incentives are distinct from a number of other ways that government can intervene in the economy through taxes and transfers. In general, tax and transfer provisions have three different objectives. They can be used to pay for public goods that private markets do not adequately provide, such as roads or national defense. They can address equity concerns by providing a safety net or changing the distribution of economic gains. Finally, they can encourage individuals and corporations to make decisions based on the social benefits and costs of their choices, in addition to their own private interests.

This book is only focused on tax or transfer provisions to the extent that they are justified based on this final objective. When they do, we refer to them as *fiscal incentives*, *tax incentives* and *spending incentives*. At times, we will refer to the social costs and benefits associated with individual choices that are subsidized as *externalities*.

This definition of tax incentives maps on to the tax expenditures discussed in Chapter 1 to some degree. But the category of tax incentives is narrower than the category of tax expenditures. The tax expenditure budget historically has contained many provisions that are purely motivated by distributional or simplification concerns, such as special exemptions for individuals who are blind.¹⁹ Tax incentives only include

¹⁹ We find it conceptually incoherent to classify some distributional provisions within the Code as tax expenditures and others not. In practice, this has tended to result in deductions (such as the standard deduction) and lower rates (such as the progressive rate structure) being considered “structural” or “general” rules and excluded from the tax expenditure budget, while credits are included. Given that the tax

provisions *to the extent* that they are justified as ensuring that individuals take into account social benefits and costs when making choices. Exemptions for the blind don't fall into this category because surely no one chooses to be blind.

In practice, the distinction between fiscal incentives and those serving other objectives is often muddled. Any given tax provision or transfer program may have multiple objectives or none at all. Fiscal incentives may be historical artifacts, enacted for an objective that is no longer relevant. Or they may simply be a response to lobbying that serves no particular social goal. Still others may seek to express societal judgment of an individual's moral worth. In the tax context, provisions that some may regard as tax incentives, others may view as serving to measure income accurately, such as deductions for business entertainment expenses. As another example, the reduced rates on some capital income enacted in 2003²⁰ are categorized as tax expenditures by the Joint Committee on Taxation but not by the Treasury Department, which views them as a partial correction to the double taxation of corporate income.

Tax provisions and transfer programs may also seek to alter the distribution of income and affect incentives simultaneously. For example, the earned income tax credit increases the financial incentive to participate in the work force, but is also transfers resources to low-income workers in order to raise their living standards. As we will see in more detail in Chapter 4, this redistributive role is often hard to separate out from an incentivizing role. Reasonable, well-informed analysts may disagree.

Nevertheless, it is essential to consider whether and when fiscal provisions can be justified on the basis of the social benefits they provide by influencing individual choices—because so many are justified in this way. Where there are social benefits, we examine how they could be redesigned to influence more strongly the behaviors they are meant to affect. Where there are no social benefits or no behavioral effects, we advocate repeal. We leave it to others to consider whether these provisions can successfully be justified on other grounds and what those justifications imply. Indeed, we encourage such analysis. We can only begin seriously assessing tax breaks by considering how well they achieve each potential policy rationale.

How Should Fiscal Incentives Be Structured?

Suppose tomorrow someone finally develops a vaccine for the common cold.²¹ The common cold is rarely life-threatening and not one of the leading horrors of life. But

expenditure budget was initially created to cast light on provisions that proponents of the concept generally opposed (see, e.g., Surrey (1973), this practice tends to discourage the use of credits to pursue distributional objectives. It also tends to discourage pursuing distributional objectives overall, at least beyond a certain point, because there are limits on the amount of redistribution that can be accomplished through exemptions and progressive rates, but not through credits. However, we leave this issue for another day.

²⁰ Joint Committee on Taxation (2008).

²¹ This example is purely for illustrative purposes. In reality, the ideal vaccination program is considerably more complicated than the hypothetical scenarios outlined here and may not be a fiscal incentive. For example, aggregate demand may be highly inelastic because of feedback effects (when the price falls, individual demand may decrease because more people get vaccinated and the disease becomes less

it is an unpleasant nuisance with huge economic costs in terms of lost work hours and low productivity among those who work while not feeling well.

Suppose also that, based on scientific trials, it has been determined that the vaccine reduces the chances of catching a cold by 95 percent but has bad side effects for some people. Moreover, the vaccine is not cheap to produce and its cost varies. For most people, an annual vaccination that provides a year of protection costs about \$100. But some people only respond to a more potent version that costs \$1,000, with the cost averaging out to \$200 per person. The characteristics of the people who experience bad side effects or require the more expensive vaccine are not known precisely.

Given these considerations, some people choose to get vaccinated on their own. Healthy workers are willing to run the risk of the side effects, and high-wage workers are happy to pay either amount to avoid catching a cold. But others do not. For those who are less healthy, or have less money to spare, the vaccine is not worth the cost.

This decision not to get vaccinated affects other people because colds are contagious and the vaccine is not 100 percent effective. Each person's risk of getting a cold is significantly reduced if those with whom he or she comes in contact have been vaccinated.

Health officials are understandably delighted by the development of the new vaccine and want to ensure that as many people as possible receive it. But Congress may only be willing to commit limited budgetary resources to a vaccination program. Policymakers designing the new program need to figure out whether to do anything, and how to get the most "bang for the buck," given the resources Congress is willing to divert from other programs or collect from additional taxes.

To do so, they need to address seven questions, summarized in Figure 2.1.

Issue #1: Do individual choices result in social benefits or costs?

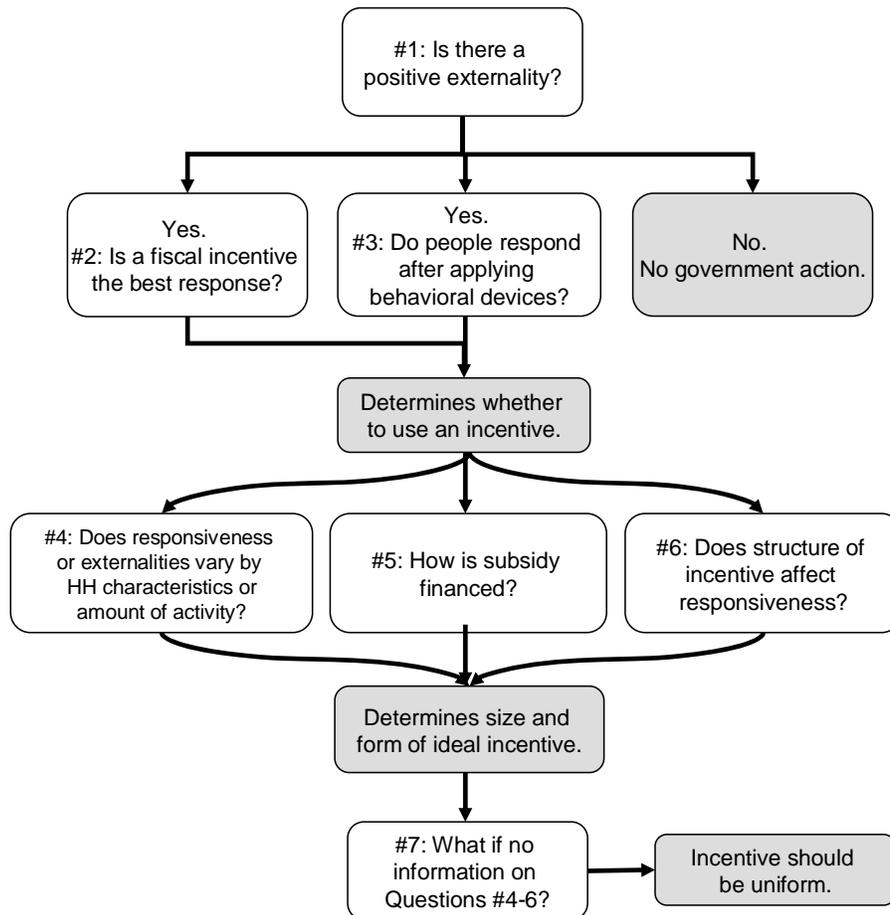
The first threshold question is whether individual choices in the area give rise to social or personal benefits or costs that the individual does not take into account. Presumably many people value getting vaccinated themselves because they would rather not spend the winter sniffing and sneezing. But if getting vaccinated requires initiative, lots of paperwork, and long waits, they may fail to do so. They may keep putting it off until it is too late, even though their "true" preference is to get vaccinated, putting these costs aside. Moreover, there are social benefits if people value other people getting vaccinated because colds are contagious and the vaccine doesn't always work. The difference between the private benefits and overall social benefits that are associated with each person's vaccination are the amounts by which everyone else in society gains.

The existence of such benefits to oneself and others does not always mean that the government should intervene. One alternative is simply to make it easier to get

prevalent). See, e.g., Geoffard and Philipson (2001). As discussed below, fiscal incentives may not be justified when demand is fairly unresponsive to price changes.

vaccinated and then let the market do its work. This might be effective in a small group. For example, if people could only catch colds from their co-workers, a person who hated having a cold could get vaccinated and pay a small amount to each of his co-workers if they do so as well, equal to the value he places on them getting vaccinated. If everyone made these payments, the ideal number of people would get vaccinated because each person's decision whether to do so would take into account the benefits that others would receive. In a small group, people might also rely on other mechanisms to achieve cooperation, such as nagging or complaining. While we will focus on *positive incentives* or subsidies, this illustrates that there are often equivalent negative incentives available.

Figure 2.1: Framework for When and How Fiscal Incentives Should Be Offered



In many cases, however, individual choices affect large numbers of people. Then markets and private negotiations do not always reach the best social outcome. Free riders become a problem because it is hard to monitor whether individuals have actually engaged in the desired behavior. Then there is a strong case for government intervention. Our hypothetical example of a cold vaccine certainly fits within this category. It unlikely people could or would voluntarily negotiate with their fellow subway passengers to pay the amount they value each other getting vaccinated.

A related threshold question is whether there are multiple social benefits involved and, if so, what precise decisions give rise to them. For example, many people might be willing to pay the average cost of \$200 to get vaccinated in our example. But far fewer might be willing to get vaccinated given that it could cost up to \$1,000. Insurance against needing the more expensive version of the vaccine (by guaranteeing a price of \$200) could therefore induce more people to participate.

In such a case, purchasing a vaccine with price protection insurance generates a second set of social benefits, potentially meriting further government intervention. All insurance tends to become cheaper as more people participate in the insurance pool. Therefore, each vaccine purchased at a guaranteed price simultaneously benefits those who would like the purchaser to get vaccinated, and those who would like to purchase a vaccine with a guaranteed price themselves but cannot afford to until the purchasing pool becomes larger.

Issue #2: Is a fiscal incentive the best response?

Once our hypothetical policymakers address the threshold question of whether government intervention into a specific individual choice is justified, they next need to consider whether a fiscal incentive is the best approach. A fiscal incentive provides each person who gets vaccinated (or who purchases a price-protected vaccine) with an amount equal to the value others place on them doing so. Essentially it takes the place of the private payments described above. But there are other options. In particular, our policymakers could mandate that certain groups get vaccinated, or that everyone does.

Mandates make sense in some cases. For example, they might make sense if individuals subject to the mandate in our example interact frequently with particularly vulnerable populations, or if there is a severe risk of a deadly epidemic if the virus survives in any form. But in many cases mandates are problematic.²²

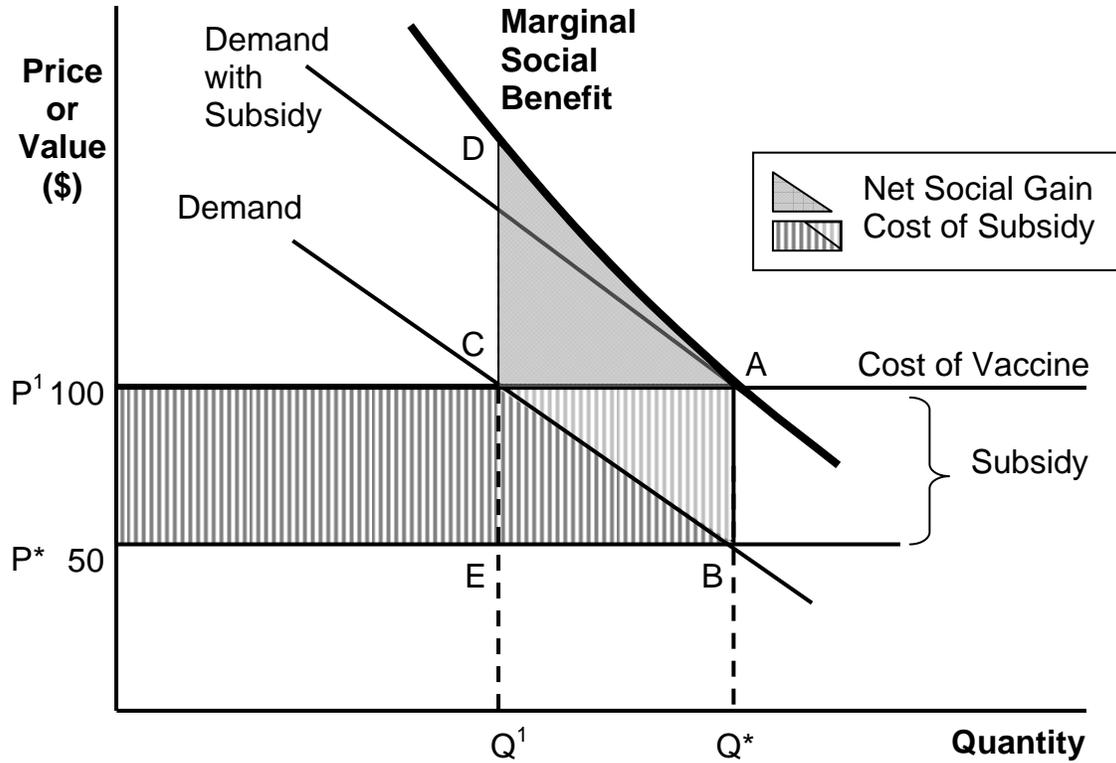
Some people may bear extraordinary burdens from complying with mandates. Some social benefits also do not depend on everyone complying. For example, we might eradicate the common cold if only 90 percent of people got vaccinated. Or the vaccine might kill some people if the side effects are severe enough. When the benefits of the mandate do not uniformly exceed its costs, a fiscal incentive is generally the better approach.

The benefits of a fiscal incentive are illustrated in Figure 2.2. Suppose the cost of the new vaccine is always \$100 and demand for it is illustrated by the Demand line. Some people value getting vaccinated very highly; others value it less. The number of vaccines ultimately sold without any government intervention would then be the point, Q1, where the last person purchasing a vaccine values it exactly as much as its cost. But if others also benefit from each person's decision to get vaccinated, the real benefits from selling each vaccine are much greater—the value the vaccinated person *and* all other people get from each vaccine sold, or the Marginal Social Benefit line. Society would

²² Depending on the penalties for non-compliance, mandates could effectively be equivalent to a negative fiscal incentive, i.e., a “tax”, on failure to undertake the desired behavior.

therefore be better off if the number of vaccines sold were Q^* . At this point, the sum of private value and value to others of the last vaccine purchased equals the vaccine's cost.

Figure 2.2: Social Benefits of a Subsidy



Fiscal incentives are a way to ensure that we can reach this point. The ideal fiscal incentive would give each new person who gets vaccinated a subsidy equal to the amount others benefit from his or her decision to do so (the excess of the marginal social benefit over the demand line), which would mean subsidizing only those people along the line segment CB in Figure 2.2. However, typically it is very difficult to distinguish between people who would get vaccinated absent the incentive and those who would not. A more common means of reaching the ideal number of vaccinations, therefore, is to offer a subsidy that pays every person who gets vaccinated the amount by which the benefits to others exceed the private benefits at the optimal level (the height of line segment AB). Suppose this excess benefit and the related subsidy is \$50. Then demand for the vaccine would become the Demand with Subsidy line, and the ideal number of vaccines would be sold. The grey triangle ACD in Figure 2.2 illustrates the amount that society would benefit from this incentive.

This net gain to society can be understood by considering all of the costs and benefits generated by the subsidy. The cost to taxpayers who finance the subsidy is \$50 times the number of vaccines purchased, or the vertically-lined rectangle BAP^1P^* . At the same time, three groups of people benefit. Everyone who would have gotten vaccinated anyhow is better off by \$50 (the rectangle ECP^1P^*) because, once the subsidy is in place, the cost of getting vaccinated falls from \$100 to \$50. In addition, those who decide to get

vaccinated in response are better off to the extent that getting vaccinated is worth more than \$50 to them (triangle CBE). Together, these two groups gain by the trapezoidal shape CBP^*P^1 (with the darker vertical lines). Finally, society at large benefits from each person's decision to get vaccinated. Their benefits exceed \$50 (the subsidy) times the number of additional vaccines sold, and are illustrated by the shape ABCD.²³ If one subtracts the costs to government from the benefits to these three groups, the net social gain is the gray triangle ACD.²⁴

Issue #3: Do people respond after applying behavioral devices?

Let's say our policymakers have now determined that a fiscal incentive is a better response than a mandate or doing nothing. The next question they must consider is whether there are any other ways that they can induce just as many people to get vaccinated, but with less cost. In recent years, economists have discovered that many people's choices are profoundly influenced by non-financial considerations, such as inertia, financial education, myopia, and signals that they interpret as recommendations.²⁵ For example, some studies have found that when employers change the default for 401(k) plans so that employees have to opt out if they don't want to participate (instead of opting in if they do), participation in the first year increases from 37 to 86 percent.²⁶ Others have found that people's decisions are affected by financial education,²⁷ the salience of benefits and costs,²⁸ and the extent to which benefits are in the present and costs in the future,²⁹ even if the options are economically equivalent. In light of this evidence, it is possible that applying "behavioral devices" or "nudges" to the decision of whether to get vaccinated would have the same effect on people's choices as a fiscal incentive, or an even larger one.

Our policymakers could, for example, first try requiring primary care doctors to suggest that each patient consider getting vaccinated as part of his annual check-up, while explaining the potential side effects. Patients would get vaccinated on the spot as long as they did not refuse. Perhaps everyone for whom the personal and social benefits of getting vaccinated exceeded the personal costs would get vaccinated in response. Then a fiscal incentive would be unnecessary.

In general, policymakers should try behavioral devices first to the extent that the intervention is motivated by *internalities*. Internalities arise when an individual is unable to act in line with their "true" preferences because their choices are heavily influenced by factors such as which choice is the default, the most salient, or provide benefits sooner in time. Relatively disadvantaged individuals tend to be influenced the most strongly by

²³ The benefits exceed the area ABEC in this example only because the benefits to others of each marginal vaccine sold is greater than the subsidy up until the ideal level.

²⁴ Adding in extra social costs of raising government revenue to cover the cost of the subsidy complicates the analysis somewhat, but the essential point is clear without this complication. See Broadway and Tremblay (2008); Kopczuk (2003); Cremer, Gahvari and Ladoux (1998); and Sandmo (1975).

²⁵ See, e.g., Duflo et al (2006); Saez (2009).

²⁶ See Madrian and Shea (2001).

²⁷ See, e.g., Chetty and Saez (2009).

²⁸ See, e.g., Finkelstein (2009); Chetty et al (forthcoming).

²⁹ See, e.g., Field (2009).

these factors, and to respond the most strongly to behavioral devices.³⁰ In such cases, it makes no sense to offer a fiscal incentive if behavioral devices have a comparable effect. Fiscal incentives cost taxpayers money. As long as individuals are, on net, being nudged towards their “true” preferences, behavioral devices impose no net costs.³¹

When policymakers justify intervention on the ground that the overall social benefits associated with individuals making a certain choice exceed the overall private costs, however, the issue is more complicated. Then behavioral devices may impose net costs on the individual decision makers by distorting their choices away from their “true” preferences. This is the case even if no additional taxes and spending programs are enacted. Policymakers must then weigh the costs imposed on the decision makers by behavioral devices against the benefits gained by others. Because these costs may not be uniform, fiscal incentives may be a more efficient approach.

Issue #4: Does the responsiveness or the magnitude of social benefits vary by household characteristics or the amount of activity?

Suppose our policymakers have now determined that a fiscal incentive is worth the cost even after applying any relevant behavioral devices. The final decision they face is how best to structure the incentive. Ideally the subsidy should equal the average amount by which others now benefit from each person’s decision to get vaccinated. But this is just an average. It is possible (and likely) that the ideal subsidy would actually vary from person to person and group to group. This ideal also doesn’t take into account budget constraints. As a result, our policymakers need to consider several further questions in order to determine how to get the most bang for their buck with the resources they have.

First, they need to consider whether the magnitude of social benefits varies by different demographic characteristics or the amount of the activity. If so, this variance should determine who is eligible for the incentive and how large an incentive they should receive. For example, suppose that the social benefits arising from toddlers getting vaccinated are relatively large. They roll around a lot, and forget to blow their noses and wash their hands, so spread germs quickly. All else equal, vaccines for toddlers should then be eligible for a relatively large incentive. Or perhaps the vaccine only works if one receives it twice. Then people should only be able to claim the subsidy when they get vaccinated a second time.

Second, our policymakers need to consider whether responsiveness to the incentive varies along these dimensions. If so, such variance should also determine who is eligible for the subsidy and in what amount, if there are budget constraints. For example, suppose scientists are unusual in that almost all get vaccinated regardless of whether they are subsidized. A minority doesn’t, and is highly responsive to fiscal incentives. Unless policymakers can find a way to separate out these two subgroups or have an unlimited budget, it may make sense to exclude scientists from the subsidy

³⁰ See, e.g., Madrian and Shea (2001); Dohman et al (2009).

³¹ Some nudges, like financial education, can entail costs but they are typically minor compared to the cost of a fiscal incentive.

entirely. Otherwise a large number of scientists would claim the incentive even though they would have purchased the vaccine anyways. This is sometimes referred to as the problem of “buying out the base.” It means that scientists are relatively unresponsive to fiscal incentives to get vaccinated as a group, even though they may be very responsive in individual cases.

In general, policymakers should allocate funds spent on fiscal incentives among different groups to the point where the net social benefits generated by spending an additional dollar on each group are the same. As the example of “buying out the base” illustrates, this may imply excluding some groups entirely if there are budget constraints. But it may also imply floors on some fiscal incentives. For example, suppose getting vaccinated a second time generates equal social benefits as doing so the first time. Most scientists get vaccinated once but not twice. Then it might be efficient to offer scientists an incentive for their second vaccine, while offering everyone else a subsidy for both. This way, money is not wasted subsidizing scientists’ decisions to get subsidized once, which most would do anyways.

More generally, it is frequently (but not always) efficient to limit fiscal incentives to low- and middle-income individuals. This is the case because the problem of “buying out the base” tends to be larger among relatively high-income individuals who usually do not face as binding financial constraints. Alternatively, policymakers can account for the relatively weak responsiveness of high-income individuals through floors that only provide incentives once their choices or purchases exceed a certain threshold.

While “buying out the base” allows society to promote desired behavior at a smaller cost to the taxpayer, it also raises some equity concerns. Effectively, it is equivalent to giving a uniform subsidy to everyone and then imposing lump sum taxes on selected categories of taxpayers who are thought to be less responsive to the subsidy.

Issue #5: How is the subsidy financed?

So far our policymakers have considered how to get the most from their fiscal incentive purely from an efficiency perspective. This makes sense because the purpose of correcting for externalities is to improve efficiency. It is to make the pie bigger, not to change how it is divided up. Ideally, policymakers should address distributional objectives through separate, more general taxes and transfers based on people’s economic status, not on how much they consume of a specific good.³²

Nevertheless, fiscal incentives can affect the economic distribution if some groups are more likely to be eligible for them or claim them than others. As a result, policymakers need to think about how a fiscal incentive is financed when deciding how to structure it. This is a largely theoretical question because we rarely know how any tax break is funded. Most fiscal incentives are not linked to specific tax increases and, even

³² See Atkinson and Stiglitz (1976).

if they are, money is fungible. Nevertheless, it is important in the rare instances in which we do.

Ideally, a fiscal incentive should be funded through a “corrective tax.” A corrective tax is one that falls on different groups in proportion to the share of benefits they reap from the incentive.³³ For example, the tax funding our cold vaccine incentive should be allocated in the same proportion as all of the shaded areas in Figure 2 (the benefits it generates). If half of the beneficiaries are low-income and half are high-income, half of the tax should be raised from each group. It should *not* be raised only from people who claim the subsidy because the point is to provide an incentive to get vaccinated. If the tax was raised from the precise people who claim it, any incentive would essentially be taxed back immediately.

A corrective tax is the best approach because it maximizes the efficiency benefits of a fiscal incentive, given pre-existing distributional preferences. Indeed, when a fiscal incentive is enacted together with a corrective tax, it can improve fairness as well. As illustrated in Figure 2.2, the benefits generated by a well-structured fiscal incentive should exceed its cost. This excess is not necessary to keep each group in the same economic position as it was prior to the incentive, and can be used by policymakers to pursue distributional goals if they so choose.

Unfortunately, as noted, policymakers rarely, if ever, know how a fiscal incentive is financed in practice. However, if they somehow know how it is being funded but are not able to control the funding source, they may want to adjust the fiscal incentive to compensate. For example, it might be reasonable to assume that any new fiscal incentive is funded with a tax with the same distributional effects as the fiscal system prior to the incentive. If so, and if our policymakers thought the prior balance between fairness and efficiency was right, they might want to increase the incentive on fairness grounds if it produces benefits that are more progressive than the underlying fiscal system, and decrease it if it produces benefits that are less progressive.

Issue #6: Does the structure of the incentive affect responsiveness?

The final issue our policymakers have to consider when deciding how to structure the subsidy for getting vaccinated is whether there are elements of the overall structure that affect responsiveness to it. Essentially, they need to consider whether any behavioral devices can be used to increase the incentive’s impact.

One possibility is myopia. As noted, there is some evidence that people weight benefits and costs in the present more heavily than those that arise in the future even if, later on, they weight them the same.³⁴ This implies that, where possible, incentives should be provided upfront and payments for costs demanded later.

Another possibility is framing effects. There is some evidence that people respond more to a fiscal incentive that is structured as a “spending match,” than they do to one

³³ See Kaplow (1996); Kaplow (2004); Batchelder et al (2006).

³⁴ See, e.g., Field (2009).

with the same cost and effective subsidy rate that is structured as a “refund.”³⁵ For example, suppose that there is only one vaccine, which costs \$100 and the ideal fiscal incentive is \$50. This subsidy could be delivered as a refund to each person who gets vaccinated equal to 50 percent of the vaccine’s cost. Or it could be delivered as a 100 percent match for amounts spent on the vaccine. If a person pays \$50 to a vaccine provider, the government will also pay \$50 to the vaccine provider. Although these two options are economically equivalent, people seem to (irrationally) respond more strongly to the latter because a 100 percent match sounds larger. All else equal, it may therefore be better to structure a fiscal incentive as a spending match.

Finally, uniform subsidies may have a larger impact because people may find it easier to understand how a fiscal incentive works if it is the same amount for everyone. For example, suppose our cold vaccine is ineffective for people with hazel eyes. Even though it generally would make sense to exclude people with hazel eyes, doing so may affect the responsiveness of others. People with mostly brown or blue eyes might worry that the government will consider their eyes to be hazel. Because they are unsure whether they will receive the subsidy, some may decide not to get vaccinated, even though they would if they knew they were eligible.

There is some evidence that people do respond more strongly to fiscal incentives that are uniform. For example, some researchers argue that more people contributed to IRAs in the mid-1980s when everyone was entitled to contribute the same amount, either because mutual funds and banks were advertising IRAs more heavily, or because people were more confident that they were eligible. However, others dispute this conclusion.³⁶

Issue #7: What if policymakers have little or no information about issues #4-6?

Our policymakers now have before them all of the questions they need to consider when deciding how best to structure a fiscal incentive for the new vaccine. But they may still be confused. Perhaps they have little or no information about relative differences in responsiveness and social benefits, or about how the incentive will be funded. This is often the case. Policymakers are lucky if they even have clear evidence that an activity generates social benefits overall. They may therefore ask what to do if more detailed information is absent or inconclusive. In such circumstances, a uniform subsidy is generally the best response.

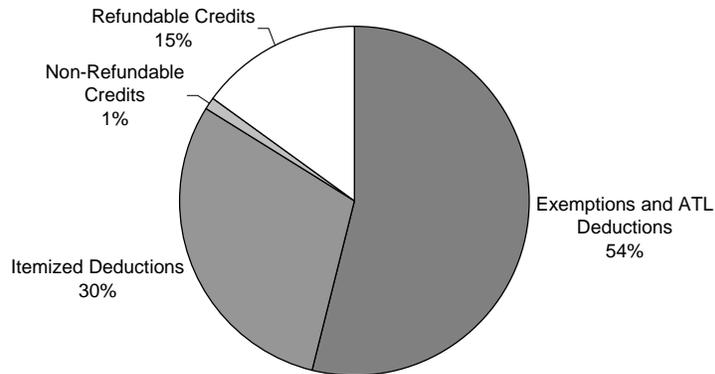
One fundamental tenet of public economics is that the efficiency losses generated by taxes generally rise more rapidly as the tax rate gets higher. The same is true when the government does not address the social benefits that arise from individual choices. The efficiency losses resulting from their failure to do so rise more rapidly as the amount of unconsidered social benefits becomes larger. For example, suppose that the social benefits associated with getting vaccinated are \$50, and subsidizing the vaccines by \$10 less than this ideal results in a \$10 efficiency loss. Providing a subsidy that is \$20 less than the ideal will result in an efficiency loss of \$40—or a loss four times as large.

³⁵ See Eckel and Grossman (forthcoming); Saez (2009).

³⁶ For a summary, see Burnham and Ozanne (2005).

This implies that a small number of big mistakes when structuring a fiscal incentive can result in greater efficiency losses than a large number of smaller mistakes, even if the total magnitude of the mistakes is the same. For example, in the above example, giving one person a \$30 subsidy (a big mistake) and one person a \$50 subsidy (no mistake) is worse from an efficiency perspective than giving two people a \$40 subsidy (two small mistakes that add up to the same amount).

Figure 2.3: Form of Major Non-Business Federal Income Tax Incentives



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

When policymakers don't have evidence of how externalities and elasticities vary across different groups, the most efficient default structure for a fiscal subsidy is therefore to give the same subsidy to everyone. This assumes (reasonably in our view) that uniform subsidies generate more small mistakes and fewer large mistakes than randomly giving different amounts to different groups.

Indeed, a uniform subsidy is also the most efficient default even if policymakers are completely mistaken and end up subsidizing a choice generating no social benefits for others, or even costs for others overall. As soon as this becomes clear, they should, of course, repeal the incentive. But until then, if they have no information about how the size of the social benefits and responsiveness vary across different groups, a uniform subsidy is likely to generate less harm than other options.

Policymakers frequently do not have reliable information about how the social benefits generated by individual choices vary across different demographic groups, or how responsiveness to incentives varies. Thus, this default is tremendously important. Nevertheless, none of our current tax incentives are uniform. The only way a tax incentive can be uniform is if it is a refundable tax credit. But only 15 percent of the major non-business income tax incentives are refundable credits (Figure 2.3). Among these, none are uniform because they tend to phase in and phase out.

The Obama Administration's recent proposal to cap the value of itemized deductions at 28 percent of the amount deducted moves in this direction. But it would

still provide dramatically larger tax incentives for high-income households. Only about 6 percent of households have enough income to deduct at the 28 percent rate,³⁷ while the 65 percent of households that do not itemize would not receive any tax incentive at all.

Conclusion

This Chapter leaves us with three major takeaways. First, to the extent that positive externalities are present, policymakers should try behavioral devices first. They should not enact a fiscal incentive unless they have information that the activity still generates positive externalities or externalities after such devices are implemented, and that people will still respond to a fiscal incentive. Second, if they do have such evidence, the ideal structure of the subsidy depends on three factors: (a) how the subsidy is financed, (b) whether the general structure of the incentive affects overall responsiveness, and (c) how different groups vary in their responsiveness to the incentive and the social benefits their choices generate. Finally, if policymakers do not have clear information about these three factors, the default should be a uniform incentive.

In the tax context, this has one further implication—whenever a tax incentive is offered, it should be some type of refundable credit. If policymakers have information about financing or how responsiveness or the social benefits vary, the ideal subsidy may rise or fall with income. But even if it should rise with income, it should still be a refundable credit. The only scenario in which the ideal incentive could be a deduction or exemption is if there were sharp changes in externalities or responsiveness exactly at the point of each tax bracket and exactly in proportion to the rate change. This is completely implausible. Thus, so long as tax incentives are offered, they should be credits, and they should be refundable.

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CHAPTER 3

WHEN SHOULD FISCAL INCENTIVES BE DELIVERED AS TAX CUTS VERSUS TRANSFERS?

Introduction

The previous chapter set out a framework for considering when fiscal incentives should be enacted or maintained, and how they can be improved. But this still leaves open the core question of whether fiscal incentives belong in the tax code, or are better delivered through the transfer system. This chapter turns to this issue. We consider and reject the traditional view that tax law should always remain uncluttered by fiscal incentives. Instead we support the more recent view that the choice between using the tax code and direct spending to deliver tax incentives should mainly be based on administrative efficiency and the likely effects on the incentive's structure. Increasingly, tax incentives can and are being designed to replicate the features of spending programs. Moving programs out of the tax law accomplishes little if the same programs reappear as direct spending.

The chapter concludes by offering some suggestions for how we might adjust to a world in which the political system continues to use the tax code as a major way of funding fiscal incentives, even if spending programs would be more administratively efficient. These proposals focus on improving transparency in budget reporting, the process for developing policy reforms, and the administration of these backdoor forms of spending.

The Traditional Tax Reform Perspective: Making the Tax Code Neutral

Traditionally a key element of nearly all tax reform proposals has been eliminating or reducing tax expenditures. Authors of these proposals typically criticize tax expenditures on multiple fronts.³⁸ They claim that these provisions make the tax system less fair by allowing some taxpayers to pay less tax than others with the same income. They argue that tax expenditures reduce economic efficiency by inducing taxpayers to choose less efficient production methods or less preferred consumption goods solely for tax reasons. They contend that these tax provisions raise administrative and compliance costs by requiring additional recordkeeping and often difficult determinations of whether an item of income or spending is eligible for a tax incentive. In addition, traditional tax reform proponents assert that tax expenditures require higher marginal tax rates in order to raise the same amount of revenue, leading to even greater efficiency losses.

But government spending programs are not meant to be neutral among activities. Frequently spending programs deliberately change the allocation of resources and the distribution of income from what an unregulated market would produce. Tax incentives

³⁸ See, e.g., U.S. Treasury Department (1984); President's Advisory Panel on Tax Reform (2005).

and other types of tax expenditures are no exception. The political process in the United States has apparently determined, for example, that it is worthwhile to spend taxpayer resources to advance objectives such as expanding private health insurance coverage and increasing access to higher education. If these types of activities are worth promoting with taxpayer dollars, are they any less appropriate if the payments are delivered through tax provisions instead of through direct outlays from program agencies?

Moreover, it is not obvious what is accomplished by “cleaning up” the tax code if the tax expenditures would simply be shifted to the spending side of the budget.³⁹ True, the tax system would be treating taxpayers with the same income more equally. But people who engage in the same subsidized activity (for example, those with health insurance) would still be favored over others with the same income (the uninsured). True, the economic distortions created by the tax system would be reduced, but if the same incentives are provided through outlay subsidies, economic efficiency would be unaffected. True, the compliance costs imposed on taxpayers and the administrative burdens on the IRS would also decline, but the costs imposed on beneficiaries of direct spending programs and administering agencies might increase even more.⁴⁰ Less revenue would be lost from tax incentives. But if direct outlays replaced them, there would be no extra money to pay for reductions in marginal tax rates.

So should fiscal incentives be in the tax code or not? The standard tax reform paradigm is inadequate to explain whether or not programs should or should not be in the tax code. Instead, a more recent view, that we support, argues that the choice between delivering fiscal incentives through the tax code or a spending agency should depend on how the choice affects the structure and administration of the program, and the relative advantages of coordination and specialization.

The New View: Choosing the Best Institutional Defaults

While direct outlays can be designed to replicate tax incentives, and vice versa, currently the design of tax incentives often differs systematically from the design of fiscal incentives administered through spending programs on at least six dimensions: income eligibility, permanency, budget limits, accounting period, enforcement practices, and specialized knowledge about eligibility criteria. These differences need not exist in theory, but because they often do, they are relevant for deciding where to house a fiscal incentive.⁴¹

First, the lion’s share of tax incentives are available only to those with positive tax liability, and most are also structured as exemptions or deductions. As discussed in Chapter 1, this results in larger subsidy rates for higher-income individuals, which are much less common among spending programs. Second, tax incentives are typically enacted on a permanent basis, as opposed to discretionary spending programs, which are appropriated annually. In addition, tax incentives are usually entitlements, with revenue losses depending on taxpayer behavior, unconstrained by budgetary limits. Many

³⁹ See, e.g., Alstott (1995); Weisbach and Nussim (2004).

⁴⁰ See, e.g., Zelenak (2005).

⁴¹ For a more detailed discussion, see Toder (2002).

discretionary spending programs are limited instead to the amount appropriated. Fourth, people almost always calculate their tax liability based on data that are annual or longer, while many spending programs base benefits on monthly or quarterly data and others like Social Security base benefits on multi-year data. Finally, the ability to claim tax incentives typically depends only on self-reported criteria, with administrative review only occurring if and when an individual is audited after receiving the benefit. By contrast, spending programs usually require pre-certification by administrators before any subsidy is issued in order to determine eligibility and benefit levels. This pre-certification is often quite onerous, requiring more information than most taxpayers have to supply when audited.⁴²

[Insert summary table]

Many of these differences in defaults could determine whether it makes sense to deliver a fiscal incentive through the IRS or a spending agency. Nevertheless, the first three are becoming smaller over time. For example, Congress is enacting more and more tax incentives with sunset provisions or budgetary ceilings.⁴³ Policymakers are increasingly proposing and enacting refundable credits, although they still constitute a small minority of tax incentives.⁴⁴ At the same time, spending programs are increasingly structured as formula-based entitlements, which do not require annual review. The share of direct expenditures dedicated to such entitlement programs is projected to grow even more dramatically in the coming years.

In short, these first three differences in the customary design of tax incentives and direct spending incentives have narrowed. As a result, the tendencies of tax incentives to rely on annual data and self-reporting are becoming more important structural considerations when choosing between the tax and transfer administration.

For example, if shorter measurement and delivery periods are desirable, this may counsel in favor of delivering a fiscal incentive through the transfer system. Timely receipt and minimal overpayments are important for some types of assistance for low-income families. Typically their consumption needs are pressing, and they have little savings to draw upon if they accidentally receive an overpayment. In such cases, annual measurement and delivery of tax benefits may be too long. While the IRS has experimented with issuing certain tax benefits more frequently, these efforts have not been terribly successful and policymakers appear to be abandoning them.⁴⁵

Similarly, the conventional enforcement practices of the IRS tend to result in more people claiming tax incentives for which they are eligible, potentially increasing the

⁴² For example, over 80 percent of IRS audits are conducted solely by mail. See Treasury Inspector General for Tax Administration (2008).

⁴³ For example, the low-income housing tax credit, qualified zone academy bonds for educational facilities, and various energy credits all face budgetary ceilings.

⁴⁴ See, e.g., the Administration's proposal for the American Opportunity Credit. More general proposals to structure tax incentives as uniform refundable credits include Batchelder, Goldberg and Orszag (2006) and Century Foundation Working Group on Tax Expenditures (2002).

⁴⁵ Specifically, the Obama Administration recently proposed repealing the advanced payment EITC.

behavioral response to the incentive that policymakers seek. At the same time, these enforcement practices can also result in more people claiming tax incentives for which they are not eligible if third party information about their eligibility (such as banks disclosing how much interest is paid on a home mortgage) is unavailable. The IRS has experimented with requiring pre-certification for some refundable credits, but has encountered strong resistance to do so. Thus, if one kind of misallocation (under-utilization versus over-claiming) is more troubling, this may also determine whether the tax or spending system is the better approach.

Finally, the merits of tax versus spending incentives may increasingly depend, not just on these structural tendencies, but on considerations grounded in administrative efficiency.⁴⁶ In particular, Weisbach and Nussim⁴⁷ argue that the choice between using the tax code or a spending agency to deliver tax incentives and other tax expenditures should depend on the relative advantages of coordination and specialization. Using the tax system allows better coordination because the tax system already collects substantial information about individuals that can be used to determine benefit eligibility. But spending programs permit more specialization. The IRS lacks expertise in administering many social programs that other government agencies possess. Where specialized knowledge is required for effective administration, they argue, it is better to use spending programs than tax provisions.

This final consideration implies that the tax system has an advantage over direct spending if the variables measured on tax returns, such as income, are important criteria for determining eligibility or the level of benefits. Providing a benefit as a tax incentive then exploits the fact that individuals already file returns with the IRS. All that is needed is some additional lines on current forms rather than a whole new program bureaucracy. On the other hand, direct spending programs have an advantage over tax incentives where administrative judgment based on other kinds of specialized knowledge is important, for example, when awarding grants for investments in energy-efficient property.

More generally, these various considerations suggest that there is no “one size fits all” answer to whether a fiscal incentive is best administered as a tax incentive or a spending program. This stands in contrast to the traditional view that virtually all tax expenditures should be eliminated or converted to direct spending programs.

A Third Perspective: Reforming Tax Administration and Oversight

Notwithstanding the rather complex issues in determining whether it make sense to use the tax system for an incentive program, political interests and public perception do favor tax incentives over direct outlays, as explained in Chapter 1. Politicians like tax incentives because they can provide the political and social benefits of spending programs, while appearing to be tax cuts that reduce the size of government instead of new spending that adds to “big government.” In 1996, President Clinton famously claimed that the “era of big government is over,” while promoting a raft of new tax

⁴⁶ For further discussion, see Toder (2002).

⁴⁷ Weisbach and Nussim (2004).

incentives at the same time. Moreover, Republican politicians are much more willing to support expansions of government that bear the “tax cut” label.

One possible response to these biases in favor of tax incentives would be to increase efforts to shift more tax incentives to the spending side of the budget. But focusing on form in this way is a relatively indirect way to improve the substance of incentive programs. In addition, given the strength of the political incentives favoring tax provision, success of such an effort is unlikely.

An alternative response would be to improve the management, oversight, and administration of tax incentives. This response would recognize that tax incentives are not likely to disappear, but that more explicit recognition that they are spending in disguise might create an environment that would improve the chances of more effective program design, better budgetary controls, and more effective program administration. Towards this alternative approach, we offer a few tentative suggestions.

Provide more and better information for the press and public

Budgetary presentations would look a lot different if certain programs were treated as spending changes instead of tax cuts. For example, if the increased tax expenditures in the President’s fiscal year 2010 budget were displayed as additional spending instead of tax cuts, proposed spending increases over the next 10 years would be about \$300 billion higher and tax cuts about \$300 billion less.⁴⁸ On the other side, the proposal to limit itemized deductions to the 28 percent rate to help pay for health reform raises \$267 billion over 10 years and could be view as a cut in spending on activities these deductions subsidize (e.g., housing, charities) instead of a tax increase. Other cutbacks in tax incentives that could be classified as spending cuts instead of tax increases would raise an additional \$55 billion.⁴⁹

Official agencies could also present more data on the total cost of tax expenditures that take account of interactions among programs⁵⁰ and of the total costs of tax incentives for specific program areas, such as health, housing, and saving, at present and over time. This would require using consistent ways of measuring these costs. But it could highlight more plainly the “true” size of government and of resources spent in

⁴⁸ The proposals we count for this calculation are: expand earned income tax credit (21.4 billion), expand refundability of the child tax credit (\$71.0 billion), expand the savers’ credit and require automatic enrollment in IRAs and 401k plans (\$59.6 billion), provide a refundable “American opportunity” tax credit for higher education (\$48.5 billion), eliminate capital gains taxation on small business stock (\$5.8 billion), make the research and experimentation credit permanent (\$74.5 billion), and expand other expiring tax incentives through calendar year 2010 (\$17.2 billion). Adding the making work pay credit to this number (which we argue could be viewed as a payroll tax cut instead of a tax incentive, even though it is refundable) would add another \$535.0 billion to this figure.

⁴⁹ The other items used for this calculation are reduction in preferences for oil and gas companies (\$31.5 billion), taxing carried interest as ordinary income (\$23.5 billion), and elimination of the advanced earned income tax credit (\$0.9 billion). If the increase in taxation of capital gains and dividends is regarded as a tax expenditure cut, as the JCT but not Treasury does, this would switch another \$118 billion from the tax increase to the spending cut column.

⁵⁰ See, for example, Burman, Toder, and Geissler (2008) and Altshuler and Dietz (2008).

separate budget functions, when one accounts for disguised spending through the tax code.

We acknowledge that developing such numbers may be a controversial and difficult process. There is no universal agreement on the baseline tax system against which departures should be measured. For example, calculations of tax expenditures would be quite different if the baseline was a broad-based progressive consumption tax instead of an income tax.⁵¹ One option would be to offer estimates based on multiple baselines. Another would be to define tax expenditures as exceptions from any general statutory rule in the tax code, as suggested recently by the Joint Committee on Taxation. Likewise, calculations of tax incentives would be quite different if items like the Earned Income Tax Credit were categorized as changes in the basic tax rate structure rather than as tax expenditures. We also suggest listing the cost of tax provisions in multiple categories where this is an issue, while noting the overlap. The purpose of disseminating such information should be to develop better measures of backdoor spending through the tax code, not a “hit list” of potential tax increases.

At an individual level, awareness could be greatly expanded by sending each tax filer an annual summary of the effects of the tax system on them once they have filed, much like the Social Security Administration sends an annual notice to each adult of how much he or she has paid into the system and how much benefits he or she has accrued. Most taxpayers have little or no idea what their marginal income tax rate or average income tax rate is.⁵² They simply see how much money is withheld from their paycheck and how much they get as a refund, leaving it to paid tax preparers to calculate their tax liability. As illustrated in Figure 3.1, such a notice could show taxpayers what their marginal and average tax rates are, separating income taxes from FICA taxes. This might help increase responsiveness to programs like the Earned Income Tax Credit and Child Tax Credit that provide net subsidies for working. Taxpayers know even less about how much they benefit or could benefit from other tax incentives. The notice could tell taxpayers the value of major tax incentives for them, and how much more they would gain if they spent more funds on subsidized goods. For example, taxpayers could learn the governmental match rate if they slightly increased their retirement savings or charitable giving.

[Insert Figure 3.1, example annual notice]

Provide for more and better institutional review of spending programs in the tax law

Currently, staffers with program expertise in health, housing, education, and other budget functions are mostly housed within executive departments other than the Treasury, and non-tax-writing Congressional committees. These staffers oversee direct spending programs, but not tax incentives. Meanwhile, Congressional and Treasury tax staffers do develop technical expertise in the program areas they oversee. But tax offices

⁵¹ Carroll, Joulfaian, and Mackie (2008).

⁵² [Cites]

generally do not reflect the same perspective and orientation of those responsible for developing and overseeing spending policies. Cabinet departments other than Treasury have an incentive to lobby for tax incentives because it helps their constituent groups without taking funds from their budgets. By contrast, the Office of Tax Policy the Treasury Department often assumes the role of defending fiscal responsibility by opposing “non-revenue” uses of the tax system. Because tax incentives are such a large and important component of social programs, there need to be institutional arrangements that provide spending program experts and tax experts with responsibility and incentives to make honest recommendations about the trade-offs between tax and direct spending programs.

One way to accomplish this goal would be to fund more subject matter experts at the IRS and Office of Tax Policy and more tax experts at other agencies, or to set up special offices to administer separate groups of programs. In recent years, the IRS has taken some steps in this direction. Under a special Congressional appropriation, it first established a separate office to administer the earned income tax credit, which was later broadened to include all refundable credits. By mandate, though, this office tends to focus more on enforcement than determining how to structure refundable credits more effectively and increase responsiveness to them. Moreover, there are no specialized groups charged with administering the majority of tax incentives that are non-refundable.

At the Congressional level, stronger institutional review could be furthered by consolidating oversight of fiscal incentives delivered through the tax code and spending programs into one committee. Frequently, efforts to streamline and reform fiscal incentives that operate through both systems are derailed by committee members who do not want to give up jurisdiction. For this same reason, though, this proposal is unlikely to attract much interest.

Include spending policy experts in future tax reform panels

Future tax reform panels should also include the input of specialists in program areas affected by tax incentives. The President’s 2005 Tax Reform Panel, for example, made important proposals to scale back tax incentives for housing and health care to pay for a proposed elimination of the individual alternative minimum tax, in addition to its broader proposals to reform the overall tax structure. But while the panel, its staff, and its expert witnesses reflected well the perspective of tax policy expertise, it did not incorporate much of the perspective of those with experience in housing policy and health policy. Regardless of the merits of the panel’s specific proposals, it seems logical to include these perspectives when developing proposals to reform back-door spending policies.

Redesign the tax reporting and payment process

Finally, policymakers might consider restructuring how individuals report and pay income taxes in recognition of the dual role that IRS now has assumed—collecting taxes to finance direct government spending and administering a large set of subsidies and transfer payments. The Form 1040 is already bifurcated into a tax form and spending

form to a large degree. Individuals generally enter their income items on the first page of the form and enter their deductions and credits on the second. If tax forms were fully bifurcated into two parts, the dual role of the income tax system might become more transparent to filers.

The system would be even more transparent if individuals could calculate their positive tax liability (minus taxes remitted earlier in the year) on Part I of the tax form and their other offsets on Part II. This calculation would be easier to design if all tax preferences were in the form of refundable credits instead of deductions, but could still work under current law. One might even go further and allow individuals to file the second page of the Form 1040 (and associated forms) and claim offsets any time during the following calendar year after filing Part I. Although individuals have an incentive to claim tax incentives as early as possible in order to accelerate receipt, the delay could ease the stress of the filing deadline by providing more time for many of the most complex and burdensome components of calculating tax liability. It would also again highlight the division between what people are paying to support government (including the tax breaks they and others receive), and what they are getting back in payments for undertaking favored activities.

Bifurcating the Form 1040 into its revenue and spending parts, combined with some other simplifying reforms, might also facilitate a move to a return-free tax filing system for most taxpayers without self-employment income. Taxpayers would still need to file a form to receive the benefits of tax incentives, but the tax portion could be collected automatically through withholding.⁵³

These ideas are not meant to be comprehensive or complete, but more suggestive of an alternative way to approach reform of tax incentives. For almost 40 years, reformers have advocated moving tax expenditures out of the tax system with little success.⁵⁴ Rather assuming that we can do so, we should consider how to measure, reform, and administer them as if they were direct spending programs.

Conclusion

Subsidies that promote social policy goals can be paid to recipients either in the form of direct payments from program agencies or tax rebates claimed on their income tax return. The choice between these two methods of payment should depend mainly on administrative efficiency and the tendency of each method to result in different design choices. Some subsidies are more suitable for administration by program agencies and others as part of the income tax. But political biases favor tax subsidies, regardless of which choice is preferable.

⁵³ The United Kingdom tax system combines a “Pay-as-You-Earn” (PAYE) withholding system that requires no tax filing for many taxpayers, along with social benefits through the tax code that individuals file forms with the tax authorities to claim. The UK system is facilitated because they have individual instead of family tax filing, withholding on interest and dividends, and most taxpayers subject to a single rate. See Adam and Browne (2009).

⁵⁴ See, e.g., Surrey (1973).

The bias towards delivering fiscal incentives through the tax code can lead to less effective design, less efficient administration, reduced transparency in measuring the size of government, and less careful monitoring of program effectiveness. Nevertheless, it is likely to continue. If the tax system will continue to be used for fiscal subsidies, we should consider ways of redesigning institutions and processes to facilitate better policy design choices and review mechanisms, make them more transparent, and reduce costs of compliance and administration.

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