United States Government Accountability Office

Accountability ★ Integrity ★ Reliability

Tax Expenditures:
Background and Evaluation Criteria and Questions

Serving the Congress and the Nation

GAO-13-167SP

TAX EXPENDITURES: BACKGROUND AND EVALUATION CRITERIA AND QUESTIONS

Tax expenditures are provisions, such as special credits and deductions, that reduce taxpayers' tax liability. If well designed and implemented, tax expenditures can provide incentives for taxpayers to engage in particular activities or adjust for their ability to pay taxes. However, tax expenditures represent a substantial financial commitment—if Department of the Treasury estimates are summed, an estimated $1 trillion in revenue was forgone for fiscal year 2011. Since 1994, GAO has recommended greater scrutiny of tax expenditures. This guide (GAO-13-167SP) describes criteria for assessing tax expenditures and develops questions, as summarized below, that Congress can ask about a tax expenditure's effectiveness.

1 What is the tax expenditure's purpose and is it being achieved?

- **What is the tax expenditure's intended purpose?**
- **Have performance measures been established to monitor success in achieving the tax expenditure's intended purpose?**
- **Does the tax expenditure succeed in achieving its intended purpose?**

2 Even if its purpose is achieved, is the tax expenditure good policy?

- **Does the tax expenditure generate net benefits in the form of efficiency gains for society as a whole?**
  - o What is the benefit to society of the activity the tax expenditure encourages?
  - o Do any performance measures established for the tax expenditure measure these benefits to society?
  - o What are the costs of the resources used to generate the tax expenditure's benefits?
  - o Do the benefits of the tax expenditure exceed its costs?
- **Is the tax expenditure fair or equitable?**
  - o Does the tax expenditure result in different benefits for similarly situated taxpayers?
  - o Do taxpayers with different abilities to pay receive different benefits from the tax expenditure?
  - o Who actually benefits from the tax expenditure?
- **Is the tax expenditure simple, transparent, and administrable?**
  - o What are planning, recordkeeping, reporting, and other compliance costs for taxpayers in using the tax expenditure?
  - o Can taxpayers understand how the tax expenditure works?
  - o What are the costs to IRS and third parties in administering the tax expenditure?

3 How does the tax expenditure relate to other federal programs?

- **Does the tax expenditure contribute to a designated cross-agency priority goal?**
- **Does the tax expenditure duplicate or overlap with another federal effort?**
- **Is the tax expenditure being coordinated with other federal activities?**
- **Would an alternative to the tax expenditure more effectively achieve its intended purpose?**
  - o Is a different tax expenditure design preferable?
  - o Is a spending or other non-tax policy tool preferable to the tax expenditure?

4 What are the consequences for the federal budget of the tax expenditure?

- **Are there budget effects not captured by Treasury's or the Joint Committee on Taxation's tax expenditure estimates?**
  - o Would eliminating or creating the tax expenditure affect revenue loss estimates for other tax expenditures?
  - o Would eliminating or creating the tax expenditure affect other federal taxes, such as the payroll tax?
  - o Would eliminating or creating the tax expenditure change taxpayer behavior in ways that affect revenue?
  - o Would eliminating or creating the tax expenditure affect the amount the government spends on other programs?
- **Are there options for limiting the tax expenditure's revenue loss?**
  - o Can the aggregate amount that taxpayers claim for the tax expenditure be capped?
  - o Can taxpayers' eligibility for the tax expenditure be restricted?
  - o For eligible taxpayers, can the value of the tax expenditure be reduced?

5 How should evaluation of the tax expenditure be managed?

- **What agency or agencies should evaluate the tax expenditure?**
- **When should the tax expenditure be evaluated?**
- **What data are needed to evaluate the tax expenditure?**

November 29, 2012

The Honorable John Lewis
Ranking Member
Committee on Ways and Means
Subcommittee on Oversight
United States House of Representatives

The Honorable Lloyd Doggett
United States House of Representatives

Tax expenditures are reductions in a taxpayer's tax liability that are the result of special exemptions and exclusions from taxation, deductions, credits, deferrals of tax liability, or preferential tax rates. Similar to spending programs, tax expenditures represent a substantial federal commitment to a wide range of mission areas. If the Department of the Treasury (Treasury) estimates are summed, an estimated $1 trillion in revenue was forgone from the 173 tax expenditures reported for fiscal year 2011.[1] Tax expenditures are often aimed at policy goals similar to those of federal spending programs. Existing tax expenditures, for example, are intended to encourage economic development in disadvantaged areas, finance postsecondary education, and stimulate research and development. For some tax expenditures, forgone revenue can be of the same magnitude or larger than related federal spending for some mission areas. The revenue the federal government forgoes from a tax expenditure reduces revenue available to fund other federal activities, requires higher tax rates to raise any given amount of revenue, increases the budget deficit, or reduces any budget surplus.

Our previous work has shown that, once enacted, tax expenditures and their relative contributions toward achieving federal missions and goals are often less visible than spending programs, which are subject to more systematic review.[2] One reason for this is that they often operate, in practice, like entitlement programs not subject to annual appropriations. Since 1994, we have recommended greater scrutiny of tax expenditures, as periodic reviews could help determine how well specific tax expenditures work to achieve their goals and how their benefits and costs compare to those of programs with similar goals. However, the Executive Branch has made little progress in developing a framework for systematically evaluating tax expenditures.[3]

[1]Treasury does not report tax expenditures that result in revenue losses of less than $5 million for each year of the 7 year period for which it reports tax expenditure estimates. Summing revenue loss estimates does not take into account possible interactions between individual provisions or potential behavioral responses to changes in these provisions on the part of taxpayers. Additionally, Treasury's revenue loss estimates include the effect of certain tax credits on receipts only and not the effect of the credits on outlays, which Treasury reports separately.

[2]GAO, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined*, GAO-05-690 (Washington, D.C.: Sept. 23, 2005) and *Tax Policy: Tax Expenditures Deserve More Scrutiny*, GAO/GGD/AIMD-94-122 (Washington, D.C.: June 3, 1994).

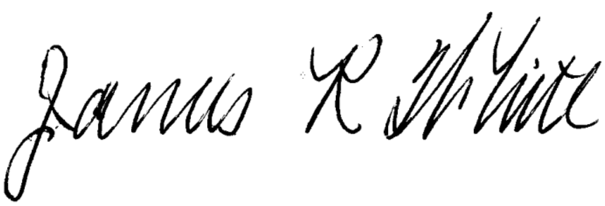
[3]GAO-05-690 and GAO/GGD/AIMD-94-122.

More recently, the Government Performance and Results Act (GPRA) Modernization Act of 2010 (GPRAMA)[4] established a framework for providing a more crosscutting and integrated approach to focusing on results and improving government performance, including for tax expenditures. GPRAMA makes clear that tax expenditures are to be included in identifying the range of federal agencies and activities that contribute to crosscutting goals. Moving forward, GPRAMA implementation can help inform tough choices in setting priorities as policymakers address the rapidly building fiscal pressures facing our national government.[5]

Given your interest in tax expenditures' effectiveness, you asked us to develop a framework that could be used to evaluate their performance. In response, this guide describes criteria for assessing tax expenditures and develops questions Congress can ask about a tax expenditure's performance.

As agreed with your offices, unless you publicly announce the contents of this guide earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to interested congressional committees, the Director of the Office of Management and Budget (OMB), Secretary of the Treasury, Commissioner of Internal Revenue, and other interested parties. In addition, the guide will be available at no charge on the GAO website at http://www.gao.gov. If you or your staffs have any questions about this guide, please contact me at (202) 512-9110 or whitej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this guide are listed in appendix II.

Sincerely,



James R. White
Director
Strategic Issues

[4]Pub. L. No. 111-352, 124 Stat. 3866 (Jan. 4, 2011).

[5]For more information on GPRAMA, see GAO, *Managing for Results: A Guide for Using the GPRA Modernization Act to Help Inform Congressional Decision Making*, GAO-12-621SP (Washington, D.C.: June 15, 2012).

Tax expenditures are tax provisions that are exceptions to the “normal structure” of individual and corporate income tax necessary to collect federal revenue.[6] These preferences can have the same effects as government spending programs; hence the name tax expenditures. The Congressional Budget and Impoundment Control Act of 1974[7] identified six types of tax provisions that are considered tax expenditures when they are exceptions to the normal tax structure, as described in table 1.

Table 1: Examples of Provisions That Are Tax Expenditures When They Are Exceptions to the Normal Tax Structure

Tax expenditure[a]	Description	Examples
Exclusion	Excludes income that would otherwise constitute part of a taxpayer’s gross income.	Employees generally pay no income taxes on contributions their employers make on their behalf for medical insurance premiums.
Exemption	Reduces gross income for taxpayers because of their status or circumstances.	Taxpayers may be able to reduce their tax liability if they have a dependent who is a child aged 19 through 23 and is a full-time student.
Deduction	Reduces gross income due to expenses taxpayers incur.	Taxpayers may be able to deduct state and local income taxes and property taxes.
Credit	Reduces tax liability dollar-for-dollar. Additionally, some credits are refundable meaning that a credit in excess of tax liability results in a cash refund.	Taxpayers with children under age 17 potentially can qualify for up to a $1,000 partially refundable, per child credit, provided their income does not exceed a certain level.
Preferential tax rate	Reduces tax rates on some forms of income.	Capital gains on certain income are subject to lower tax rates under the individual income tax.
Deferral	Delays recognition of income or accelerates some deductions otherwise attributable to future years.	Taxpayers may defer paying tax on interest earned on certain U.S. savings bonds until the bonds are redeemed.

Source: GAO.

[a]Types of tax expenditures that are identified in the Congressional Budget and Impoundment Act of 1974.

The different types of tax expenditures described in table 1 provide different levels of tax savings for different taxpayers. Exclusions, exemptions, deductions, and preferential tax rates generally provide larger tax savings to taxpayers facing higher marginal tax rates. On the other hand, credits provide the same tax savings regardless of a taxpayer’s marginal tax rate. Deferrals will generally provide larger tax savings to taxpayers who expect to face a lower tax rate in the future.

Determining whether a tax code provision meets the definition of a tax expenditure requires judgment. Provisions must be compared to a “normal structure,” or baseline, and the Congressional Budget and Impoundment Control Act did not define a specific baseline structure. As a consequence, a provision that would be considered a tax expenditure under an income tax system, under which income generally would be taxed as it is accrued, may not be considered a tax expenditure under a consumption tax system, under which income saved or invested would not be taxed until it is consumed. For example, several tax provisions that Treasury classifies as tax expenditures based on an income tax system, such as contributions

[6]The concept of tax expenditures extends beyond the income tax. Tax expenditures also exist for other types of taxes, such as excise and payroll taxes.

[7]Pub. L. No. 93-344, § 3, 88 Stat. 297, 299 (July 12, 1974), *codified at* 2 U.S.C. § 622(3).

and earnings for employer pension and 401(k) plans, would not be classified as tax expenditures under a consumption tax system.[8]

Even with an income tax, judgments must be made about what is normal and what is an exception. For example, Treasury and the congressional Joint Committee on Taxation (JCT), which both estimate revenue losses from tax expenditures, have decided that the personal exemption is part of the normal income tax and not a tax expenditure. However, the exemption for child dependents ages 19 through 23 who are full-time students is a tax expenditure. Furthermore, some provisions that limit tax liability, such as business expense deductions, are not considered to be tax expenditures—they are part of the normal income tax structure because they are costs of earning income.

Both Treasury and JCT estimate the revenue loss for each tax provision they have identified as a tax expenditure.[9] For a particular tax expenditure provision, Treasury and JCT both calculate the tax expenditure as the difference between tax liability under current law and what the tax liability would be if the provision were eliminated and the item were treated as it would be under a “normal” income tax.[10]

[8]For more detailed discussion, see appendix III of GAO-05-690 and Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2009* (Washington, D.C.: 2008).

[9]OMB, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2013* (Washington, D.C.: 2012) and Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2011-2015*, JCS-1-12 (Washington, D.C.: Jan. 17, 2012).

[10]An alternative way to measure a tax expenditure is to express its value in terms of “outlay equivalent,” or the dollar size of a direct spending program that would provide taxpayers with net benefits that would equal what they now receive from the tax expenditure. The major difference between outlay equivalents and the tax expenditure estimates is accounting for whether a tax expenditure converted into an outlay payment would itself be taxable, so that a gross-up might be needed to deliver the equivalent after-tax benefits.

Hypothetical Examples of Tax Expenditure Revenue Loss Estimates for One Taxpayer

In the case of some tax credits, such as the child tax credit, the tax expenditure estimate for one taxpayer is straightforward. A $1,000 credit claim reduces the taxpayer's tax liability by $1,000—assuming the taxpayer has a tax liability of at least $1,000 and is not subject to applicable income phaseouts—compared to what the taxpayer would have paid under the normal tax system assumed by Treasury and JCT. This $1,000 amount would be the revenue loss estimate related to this particular taxpayer's claim.

With some deductions, the comparison to a normal tax may be more complicated. Consider a taxpayer with the following characteristics.

- Tax rate: 25 percent.
- Total potential itemized deductions: $10,000.
- Amount of potential itemized deductions from charitable cash contributions: $5,000.
- Applicable standard deduction if the taxpayer does not itemize deductions: $6,000.

To maximize deductions, this taxpayer would be expected to itemize $10,000 of deductions, including $5,000 of charitable cash contributions, on his or her tax return rather than claim the $6,000 standard deduction. Estimating the revenue loss for the charitable deduction would require measuring the tax liability with and without the charitable deduction. If the provision allowing charitable deductions was repealed, to maximize deductions, the taxpayer would be expected to take the standard deduction of $6,000, since it would be greater than the taxpayer's remaining itemized deductions of $5,000. The tax expenditure revenue loss for the cash contribution deduction would be based on the $4,000 difference between the itemized deductions that include cash contributions and the standard deduction times the 25 percent tax rate, or $1,000.

Treasury and JCT calculate separately the revenue loss for each tax expenditure under the assumption that all other tax expenditures remain in the tax code. Also, they assume taxpayer behavior, such as the size of mortgages taxpayers obtain, remains constant. While, in general, the tax expenditure lists Treasury and JCT publish annually are similar, they differ somewhat in the number of tax expenditures reported and the estimated revenue loss for particular expenditures because the organizations use different (1) income tax baselines; (2) de minimis amounts, which are the minimum amount of revenue loss threshold for Treasury and JCT to report a tax expenditure; and (3) economic and technical assumptions.[11] The revenue loss estimates do not represent the amount of revenue that would be gained if a particular tax expenditure were repealed, since repeal of the expenditure would probably change taxpayer behavior in some way that would affect revenue.

[11]For more information on how Treasury and JCT estimate revenue loss, see appendix III of GAO-05-690; OMB, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2013*, (Washington, D.C.: 2012); and JCT, *Estimates of Federal Tax Expenditures for Fiscal Years 2011-2015*, JCS-1-12, (Washington, D.C.: Jan. 17, 2012).

To develop questions to consider when evaluating a tax expenditure, we brought together concepts and examples from a number of sources:

- Our previous work on results-oriented government, tax expenditures, tax reform, and program evaluation.
- Illustrative examples of tax expenditures from our previous work.
- OMB publications, including the discussion in the President's budget for fiscal year 2013 and prior years of how to evaluate tax expenditures, earlier discussion of evaluating tax expenditures, and OMB's guidance on the importance of rigorously evaluating federal programs.
- The experience of some state (Oregon and Washington) and foreign (Canada and Germany) governments that have made progress in evaluating their tax expenditures.
- Interviews with external experts in tax policy and program evaluation.

For more specific information on how we developed this guide, see appendix I. We conducted our work from May 2011 to November 2012 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for any findings and conclusions.

This guide identifies criteria and analytical questions for policymakers to consider in weighing competing priorities and evaluating the merits of a particular tax expenditure. The criteria and analytical questions can also help policymakers identify potential duplication, overlap, or fragmentation in federal mission areas and instill a more crosscutting and integrated approach to federal performance as envisioned by GPRAMA.[12] The guide focuses on evaluating particular tax expenditures, which could be part of broader discussions of tax reform. For example, such evaluations could help inform debates about how to broaden the tax base by eliminating or scaling back some tax expenditures.[13]

There is not a "one size fits all" framework for evaluating tax expenditures. Reasonable judgment must be used in adapting the general questions and concepts we discuss in this guide to evaluating a particular tax expenditure. The guide does not address more technical issues, such as the data sources or specific research designs to use in evaluating a tax expenditure. Our other publications, such as our *Designing Evaluations* guide,[14] provide more technical discussion and additional resources.

[12]For more information on our work on opportunities to reduce duplication in federal programs, see GAO, *2012 Annual Report: Opportunities to Reduce Potential Duplication in Government Programs, Save Tax Dollars, and Enhance Revenue*, GAO-12-342SP (Washington, D.C.: Feb. 28, 2012) and *Opportunities to Reduce Potential Duplication in Government Programs, Save Tax Dollars, and Enhance Revenue*, GAO-11-318SP (Washington, D.C.: Mar. 1, 2011).

[13]Tax reform discussions have raised concerns about how tax expenditures affect the fairness of the tax code, economy, and deficit. For example, see, National Commission on Fiscal Responsibility and Reform, *Report of The National Commission on Fiscal Responsibility and Reform: The Moment of Truth* (Washington, D.C.: December 2010).

[14]GAO, *Designing Evaluations: 2012 Revision*, GAO-12-208G (Washington, D.C., January 2012).

Tax expenditures have long been used as a tool for promoting social and economic objectives. While a framework for evaluating the results of outlay programs is well-established by nearly 2 decades of experience implementing GPRA, less is known about the results of tax expenditures relative to their intended purposes. Understanding progress toward achieving intended purposes can facilitate comparisons to spending programs with similar purposes as well as broader evaluations of policy effectiveness.

GPRA provides a useful framework for policy makers to use in considering whether federal programs achieve their goals by requiring that intended goals be explicitly stated and that progress towards them be measured and publically reported. As we have reported in the past, holding tax expenditures to similar requirements could help policymakers evaluate whether the government is achieving results or how the performance of tax expenditures interact with, or compare to, related spending programs.

Q What is the Tax Expenditure's Intended Purpose?

Under GPRA, a key first step of agencies' performance measurement efforts is establishing strategic goals that explain the purposes of the agencies' programs and the results they are intended to achieve.[15] Likewise, identifying the tax expenditure's purpose is a necessary first step in determining how the tax expenditure's performance should be assessed. For some tax expenditures, the intended purpose may be clear from the legislative history; for others the purpose may not be clear and may need to be inferred. The Congressional Research Service (CRS) regularly compiles information on tax expenditures, including what is known about their purpose or purposes.[16] The following are various examples of broad purposes for tax expenditures.

- To encourage taxpayers to engage in particular activities. Some tax expenditures are geared toward encouraging investing in basic research; hiring; saving; or producing or purchasing energy efficient vehicles, housing, or appliances.
- To adjust for differences in individuals' ability to pay taxes. Taxpayers who had large out-of-pocket medical expenses or theft losses may deduct some of these expenses.
- To adjust for other provisions of the tax code. Advocates of reduced rates on capital gains often explain the special treatment of capital gains income as offsetting, in part, the effect of inflation on the value of capital gains.

[15] GAO, *Executive Guide: Effectively Implementing the Government Performance and Results Act*, GAO/GGD-96-118 (Washington, D.C.: June 1996).

[16] U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, S. Prt. 111-58. Prepared by CRS (Washington, D.C.: December 2010).

- To simplify tax administration. The provision that generally allows taxpayers to exclude from their income part or all of the capital gains from the sale of a principal residence may simplify income tax administration.

An example of a tax expenditure that may have multiple purposes is the mortgage interest deduction. According to CRS, the mortgage interest deduction dates back to a time when all interest payments were deductible and home mortgages were less prevalent, but it is now justified as encouraging homeownership and residential construction. In our 2005 report on tax expenditures, we noted that various justifications have been offered for the mortgage interest deduction, including encouraging home ownership, stimulating residential construction and maintenance, and encouraging families to save and invest in a major financial asset.[17]

Q Have Performance Measures Been Established to Monitor Success in Achieving the Tax Expenditure's Intended Purpose?

Performance measurement is the ongoing monitoring and reporting of program accomplishments, particularly progress toward preestablished goals. It focuses on measureable performance standards. Performance measures may address the type or level of program activities conducted (process), the direct products and services delivered by a program (outputs), or the results of those products and services (outcomes). A "program" may be any activity, project, function, or policy that has an identifiable purpose or set of objectives, including tax expenditures.[18] Also, we have suggested previously that performance measures need to be responsive to multiple priorities.[19] For example, if a tax expenditure has multiple goals, then performance measures should recognize these different priorities.

Performance measurement is typically conducted by program or agency management. As will be discussed further in the final section of this guide on how tax expenditure evaluations should be managed, it may not be clear which agency is the "manager" of a tax expenditure. The Internal Revenue Service (IRS) administers and supervises the execution and application of the internal revenue laws or related statutes, including tax expenditures. However, IRS is not responsible for managing federal housing, energy, or any of the many other policies to which tax expenditures may contribute.

[17] GAO-05-690.

[18] GAO, *Performance Measurement and Evaluation: Definitions and Relationships (Supersedes* GAO-05-739SP*)*, GAO-11-646SP (Washington, D.C.: May 2, 2011). We have also identified characteristics of successful performance measures. See GAO, *Agencies Annual Performance Plans Under the Results Act: An Assessment Guide to Facilitate Congressional Decisionmaking*, GAO/GGD/AIMD-10.1.18 (Washington, D.C.: February 1998).

[19] GAO/GGD/AIMD-10.1.18.

Q Does the Tax Expenditure Succeed in Achieving Its Intended Purpose?

Performance measures can provide some information about whether a program, including a tax expenditure, has achieved its intended purpose. Such performance measurement, because of its ongoing nature, can serve as an early warning system to program management and as a vehicle for improving performance and accountability to the public. Information about the extent to which an intended purpose is being met can also contribute towards broader evaluations, discussed in the following section, of how well a program is working and actions that could be taken to improve results.

Even if a tax expenditure succeeds in achieving its intended purpose, broader questions can be asked about effects beyond that purpose. In our publication, *Understanding the Tax Reform Debate*,[20] we described how several long-standing criteria—economic efficiency, equity, simplicity, transparency, and administrability—can be used to evaluate tax policy. The same criteria can be applied to tax expenditures. The criteria may sometimes conflict with one another and some are subjective. As a result, there are likely trade-offs between the criteria when evaluating a particular tax expenditure.

Q Does the Tax Expenditure Generate Net Benefits In the Form of Efficiency Gains for Society as a Whole?

Resources are used most efficiently when they provide the greatest possible benefit or well-being. Specifically, an economy is efficient if its resources, including peoples' time, capital goods, and natural resources, are used to produce the combination of leisure, consumer goods, health, environmental quality, and so on that gives the most benefit to society. The concept of economic efficiency recognizes that when resources are not underemployed, decisions about their use involve tradeoffs. Getting more of something means giving up something else. Often, private markets can produce outcomes that are considered economically efficient. Self interest is assumed to motivate buyers and sellers to ensure that resources are used where they produce the greatest value. On the other hand, private markets can produce inefficient outcomes when market prices do not reflect the true costs and benefits of the goods produced and resources used.

A shift of resources from one use to another would improve efficiency if the benefits forgone by giving up the former use are outweighed by the benefits gained from the new use; in other words, the shift produces a net gain in benefits. A gain in economic efficiency means that our average standard of living is higher. Conversely, when shifting or failing to shift resources reduces net benefits, the economy is less efficient than it could be. Economists refer to these inefficiencies as "deadweight losses" because they represent opportunities for a net gain that are left unexploited.[21]

Q What Is the Benefit to Society of the Activity the Tax Expenditure Encourages?

Tax expenditures that provide incentives may produce economic benefits if they reduce inefficiencies that would otherwise exist. Spillovers, or what economists call externalities, are a case of such inefficiencies. A tax expenditure can generate efficiency benefits if it changes

[20]GAO, *Understanding the Tax Reform Debate: Background, Criteria & Questions*, GAO-05-1009SP (Washington, D.C.: September 2005). These criteria are also applicable to analyzing other government programs, such as spending programs or regulations.

[21]For a fuller discussion of economic efficiency and deadweight loss, see GAO-05-1009SP.

incentives in a way that reduces spillover costs or increases activities that produce spillover benefits. Pollution is an example. Because polluters do not bear the full costs of the pollution they produce, the polluting activity may be over produced in a private market, as shown in the text box below. Consequently, a shift in resources away from the polluting activity could produce a net gain to society. Tax expenditures, like credits for production of renewable energy or energy efficient housing, have been designed to shift resources towards energy efficiency investment.

Hypothetical Example of How a Spillover Can Result in Economic Inefficiency

Suppose the following scenario involving a business that makes a product.

- Business's production costs: $75.
- Product's market price: $100.
- Pollution costs to society from production: $50.

All else equal, the business will choose to make the product because the market price exceeds the production costs. However, the total costs to society, which include the production and pollution costs, exceed the market price, or the value to society. As such, the business's decision is economically inefficient, from society's perspective. The business is using up resources with a total value of $125 to produce something valued at $100.

An example of spillover benefits is when businesses investing in research and development produce knowledge that enters the public realm and is freely available to others. In this case, the research provides benefits, or positive externalities, to other people who are unrelated to the investors. Economists widely agree that some government subsidy for basic research, such as the research tax credit, may be justified because the social returns from research exceed the private returns that investors receive. In the absence of a subsidy, the amount invested in research would be less efficient from society's standpoint.

Q Do Any Performance Measures Established for the Tax Expenditure Measure These Benefits to Society?

The benefits to society described earlier can be difficult to measure on an ongoing basis. For example, increased investment in energy efficient equipment does not measure the value that society places on reduced pollution. Likewise, increased research spending does not measure the spillover benefits from the additional research. Estimating such benefits may require using a broader range of information than is feasible to monitor continuously with performance measures.

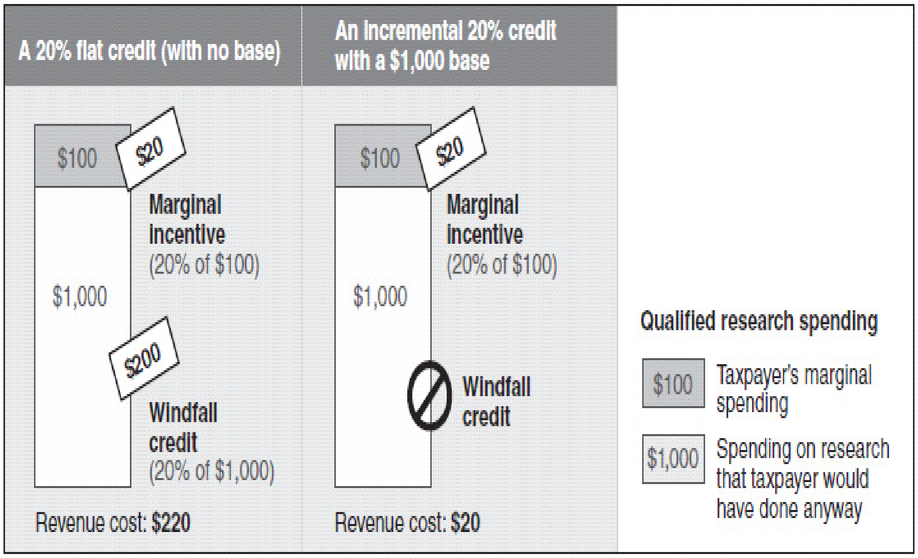
Another challenge can be measuring whether a tax expenditure actually changes behavior. If the tax expenditure has no effect on taxpayer behavior, the taxpayer gets a windfall—tax savings for activity that would have been done without the tax expenditure. In such a circumstance, no efficiency gain to society is possible because resources are not reallocated.

For the regular research credit, we estimated in 2009 that more than half the amount claimed by taxpayers was a windfall.[22]

The Research Tax Credit and Windfalls

The credit is an incremental subsidy in that taxpayers earn the credit only for qualified spending that exceeds a defined threshold, known as the base spending amount. The credit's design is most cost-effective when the base spending amount accurately reflects the amount a taxpayer would have spent in absence of the credit. The figure below compares the effects of a hypothetical incremental credit with a perfectly accurate base to a flat credit, which has no base spending amount. The flat credit gives the taxpayer 20 cents for every research dollar spent while the incremental credit gives 20 percent for only the amount above what the taxpayer would have spent anyway.

A Comparison of an Incremental Credit with a Flat Credit



Source: GAO.

Both types of tax credit provide the same 20 percent reward for each additional dollar of qualified spending. In each case, that incentive encourages the taxpayer to increase spending for research by $100. However, the flat credit is less cost-effective for the government because it also gives the taxpayer a $200 windfall for conducting research that would have been done anyway.

The difficulty in designing a cost-effective incremental credit is computing the base spending amount. The base should represent what the taxpayer would have spent anyway (in the absence of the credit) but it is very difficult to design rules to measure that.

[22]We suggested Congress consider making changes to the credit to reduce excessive revenue costs and economic inefficiencies. As of November 2012, Congress has not made any changes to the credit. For more information, see GAO, *Tax Policy: The Research Tax Credit's Design and Administration Can Be Improved*, GAO-10-136. (Washington, D.C.: Nov. 6, 2009).

Q What Are the Costs of the Resources Used to Generate the Tax Expenditure's Benefits?

The costs of the tax expenditure include the resources devoted to the subsidized activity and any associated administrative and compliance costs. The resource cost of the tax expenditure is, in part, the value of these resources had they been used in other activities. These costs are opportunity costs in the sense that they represent the value of lost product or output (and the corresponding lost income and consumption opportunities) due to the shift of resources. Other resource costs include any administrative and compliance costs, which will be discussed in more detail later in this guide.

Q Do the Benefits of the Tax Expenditure Exceed Its Costs?

A tax expenditure makes society better off, in an efficiency sense, if its benefits exceed its costs. In applying this rule, there are complications to consider. First, as already noted, is that costs should be comprehensive, including administrative and compliance costs. Second is that reasonable alternatives must be examined. Even in cases where benefits exceed costs, a particular tax expenditure may not be the best solution.

Another complication relates to the economic effect of the higher tax rates that result from a narrower tax base. Holding debt constant, tax expenditures require a higher tax rate to raise the same amount of revenue. In general, higher tax rates distort economic decision making, resulting in efficiency costs. For example, OMB guidance[23] suggests using a rule of thumb—the efficiency cost of a tax increase is equal to 25 percent of the incremental tax revenue.[24] According to OMB, this additional efficiency cost from higher tax rates should be included in total costs of a program when comparing benefits to costs. We discussed these costs in more detail in our *Understanding the Tax Reform Debate* publication.[25]

---

[23]OMB, *Circular A-94* (Washington, D.C.: 1992).

[24]A rule of thumb is useful because the efficiency costs of individual tax expenditures and their offsetting revenue increases are difficult to estimate. However, the efficiency costs from rate increases are not likely to be the same in all circumstances. For example, the revenue loss from accelerated depreciation could be offset by an increase in the corporate tax rate. To the extent that the revenue from an increase in the corporate tax rate would, particularly in the short term, stem from increased taxes on already existing corporate assets, the corporate tax rate increase would have a limited effect on incentives to invest and in this regard not add to efficiency costs.

[25]GAO-05-1009SP.

Q Is the Tax Expenditure Fair or Equitable?

Equity is a subjective criterion. There are differing views on what an equitable tax system should look like, which can affect judgments on the fairness of a particular tax expenditure. Determining who benefits from the tax expenditure, and how those benefits affect equity, can be more complicated than simply identifying which taxpayers claim the tax expenditure. However, there are several questions that can inform judgments about the fairness of the tax expenditure.

Q Does the Tax Expenditure Result in Different Benefits for Similarly Situated Taxpayers?

One view on equity holds that taxpayers who have similar abilities to pay taxes should receive similar tax treatment. Tax expenditures can affect the equity of the tax system because they may favor certain types of economic behavior over others by taxpayers with similar financial conditions. For example, two taxpayers with the same income, net worth, and identical houses may be taxed differently if one owns his or her house and the other rents, because mortgage interest on owner-occupied housing is tax deductible.

Q Do Taxpayers With Different Abilities to Pay Receive Different Benefits From the Tax Expenditure?

Subjective judgments about equity are reflected in debates about the overall fairness of tax rate structures. These judgments, reflecting the view that people with different ability to pay should pay different rates or percentages of their income in taxes, are often based on how progressive the tax system is. Although the statutory rate structure of the tax system is progressive—tax liability as a percentage of income increases as income increases—some tax expenditures may affect progressivity because of their relationship to income. Depending on their design, tax deductions can be more valuable, in terms of the dollar value of the reduction in tax liability, to taxpayers in higher tax brackets. However, these deductions' effect on progressivity is less certain because the effect on effective tax rates depends on the deduction's share of a taxpayer's income.[26] Other effects on the distribution of benefits include those due to tax credits that only provide a benefit to taxpayers who otherwise have a tax liability (unless the credits are refundable). Similarly, reducing or disallowing tax expenditure benefits with ceilings or other limits for higher income taxpayers can affect progressivity. For example, progressivity may be increased when credits and deductions designed to help taxpayers pay for college are reduced or unavailable for taxpayers above certain income levels. Whether this is fair and appropriate is a subjective judgment. However, analytical tools such as distributional analysis, which shows

[26]If the deduction represents a greater share of the income of lower income taxpayers, the tax rate reduction may be greater for these taxpayers then for taxpayers with larger incomes. In this case, the deduction could increase progressivity.

tax burden by differing income groups, can be used to measure how the tax expenditure affects taxpayers with varying ability to pay and inform judgments about fairness. Like any analysis, a distributional analysis can be influenced by assumptions such as the analysis's time horizon (1 year or longer), the incidence of the tax (who ultimately bears the burden of the tax), and how income is defined (e.g., are employer-provided fringe benefits included).[27]

Q Who Actually Benefits From the Tax Expenditure?

A tax expenditure intended to benefit a particular activity, industry, or class of people may wind up benefiting others not targeted by the tax expenditure by changing prices and incomes. For example, one rationale for the mortgage interest deduction is that it encourages home ownership. To the extent that the deduction is effective, it increases housing demand, which may raise the price of housing. Today's homeowners purchased their houses at prices that reflected the existence of the mortgage interest deduction. The benefit of the tax expenditure is said to be capitalized in this higher price of housing, particularly in the short term.[28] Depending on how much the deduction increases housing demand, some of the benefits of the tax expenditure will flow in the form of higher prices and incomes to other parties such as home builders, mortgage lenders, and real estate agents.

Q **Is the Tax Expenditure Simple, Transparent, and Administrable?**

Simplicity, transparency, and administrability are desirable features of a tax system and a tax expenditure. As we have previously reported, there is considerable overlap between these three concepts, but they are not identical.[29]

Q What Are Planning, Recordkeeping, Reporting, and Other Compliance Costs for Taxpayers in Using the Tax Expenditure?

Simple tax expenditures can impose less compliance burden on taxpayers in terms of the need to learn about requirements, plan, keep records, prepare and file tax returns, and respond to IRS notices and audits, than complex tax expenditures. Compliance burden represents a cost to

[27]See GAO-05-1009SP for more discussion of distributional analyses.

[28]The extent to which the deduction is capitalized also depends on how responsive the supply of housing is to increases in its price. If housing supply is very responsive, at least in the long run, the price increase from the mortgage interest deduction could be mitigated or even eliminated.

[29]GAO-05-1009SP.

society because it drains resources from other uses solely for the purpose of complying with the tax code. One potential effect of increased compliance burden is that fewer taxpayers claim the tax expenditure. For example, we found that complex rules and the time needed to claim the small employer health insurance tax credit may have discouraged its use.[30] Some tax expenditures may reduce the compliance burden for taxpayers. For example, parking expenses paid for by employers are excluded from an employee's taxable income, up to a certain amount. Determining the fair market value of this fringe benefit might be difficult for some taxpayers.

Q Can Taxpayers Understand How the Tax Expenditure Works?

A transparent tax expenditure is one for which taxpayers can easily calculate how their tax liabilities will be affected, understand lawmakers' reasoning, and be aware of the extent to which others comply with its requirements. Transparency can allow taxpayers to more accurately predict their future tax liabilities and contribute to confidence in the fairness of the tax system. Tax expenditures that are not transparent can present challenges for taxpayers. For example, we found that families paying for college did not always select from the multiple higher education tax expenditures in a way that maximized their potential benefits, possibly because they were unaware of their eligibility or were confused about how to use the available tax credits and deductions.[31] On the other hand, as discussed earlier, tax expenditures as a policy tool tend not to be transparent in that they can mask the true size of federal spending in a given mission area and are generally not subjected to systematic performance measurement.

Q What Are the Costs to IRS and Third Parties in Administering the Tax Expenditure?

IRS incurs costs through processing tax returns, ensuring that only eligible taxpayers receive tax benefits, and providing assistance to taxpayers in claiming these benefits. In addition, for some tax expenditures, other government agencies incur costs.[32] Third parties, such as banks or employers, can incur costs if required to track and submit to IRS information on taxpayers' income and transactions. We previously reported that certain activities may be cheaper and

---

[30]GAO, *Small Employer Health Tax Credit: Factors Contributing to Low Use and Complexity*, GAO-12-549 (Washington, D.C.: May 14, 2012).

[31]GAO, *Higher Education: Improved Tax Information Could Help Families Pay for College*, GAO-12-560 (Washington, D.C.: May 18, 2012).

[32]For example, the Department of Labor and state agencies assist IRS in administering the work opportunity tax credit, which allows employers to claim credits for hiring workers from certain disadvantaged groups. In addition, we have reported that the administration of many community development tax expenditures involves other federal agencies as well as state and local governments. For example, the National Park Service oversees preservation standards for the 20 percent historic rehabilitation tax credit. For more information, see GAO, *Community Development: Limited Information on the Use and Effectiveness of Tax Expenditures Could Be Mitigated through Congressional Attention*, GAO-12-262 (Washington, D.C.: Feb. 29, 2012).

simpler to administer through the tax code.[33] For example, the incremental administrative and compliance costs to deliver the credit for child and dependent care expenses may be relatively low compared to the costs of setting up a separate system for processing child care applications and sending vouchers to those eligible. Other tax expenditures might reduce such administration costs. For example, the provision that generally allows taxpayers to exclude from their income part or all of the capital gains from the sale of a principal residence may simplify income tax administration.

[33] GAO-05-690.

Many tax expenditures exist alongside other federal programs that have similar goals. For example, many spending programs and tax expenditures seek to improve energy efficiency or provide financial assistance for higher education.[34]

Q Does the Tax Expenditure Contribute to a Designated Cross-Agency Priority Goal?

GPRAMA requires OMB, in coordination with agencies, to select a limited number of long-term, outcome-oriented crosscutting priority goals for the federal government, [35] which the administration is calling cross-agency priority (CAP) goals. On an annual basis, OMB is to identify the federal agencies, organizations, program activities, tax expenditures, regulations, policies, and other activities that contribute to each goal, along with crosscutting performance measures and quarterly performance targets. GPRAMA also requires that OMB—with the agencies—develop a federal government performance plan defining the level of performance to be achieved toward the crosscutting goals.[36] Concurrent with the President's budget for fiscal year 2013, the administration announced 14 interim crosscutting federal priority goals in February 2012. Several of the goals specifically identify tax expenditures as contributing programs.[37] OMB and agencies are required to consult with Congress when establishing or adjusting government-wide and agency goals, which can provide Congress with opportunities to encourage further incorporation of tax expenditures into the goals. Consultations also provide Congress an opportunity to better understand challenges confronting particular programs, such as any data limitations and methodological issues in measuring and assessing a tax expenditure's performance.[38]

[34]GAO-12-560; GAO-12-342SP; GAO, *Energy Conservation and Climate Change: Factors to Consider in the Design of the Nonbusiness Energy Property Credit*, GAO-12-318 (Washington, D.C.: Apr. 2, 2012); and GAO-11-318SP.

[35]31 U.S.C. § 1120(a)(1). OMB is to update or revise the goals at least every 4 years. The goals are to be published concurrently with the President's Budget in the first full fiscal year following the commencement of the presidential term of office.

[36]31 U.S.C. § 1115(a).

[37]CAP goals that identified tax expenditures are: (1) veteran career readiness, (2) entrepreneurship and small business, (3) energy efficiency, and (4) job training. See, GAO, *Managing for Results: GAO's Work Related to the Interim Crosscutting Priority Goals under the GPRA Modernization Act*, GAO-12-620R (Washington, D.C.: May 31, 2012).

[38]GAO-12-621SP and GAO, *Managing for Results: Opportunities for Congress to Address Government Performance Issues*, GAO-12-215R (Washington, D.C.: Dec. 9, 2011).

Q Does the Tax Expenditure Duplicate or Overlap with Another Federal Effort?

Tax expenditures, if well designed and effectively implemented, can be an effective tool to further federal goals. However, tax expenditures can contribute to mission fragmentation and program overlap, thus creating the potential for duplication. For example, in a recent report on federal assistance for higher education we analyzed seven large spending programs and eight large tax expenditure programs that provide such assistance. In another example, we found that the federal government supported domestic ethanol production through two duplicative tools: (1) a tax credit and (2) a renewable fuel standard.[39] We determined that the tax credit was not needed because the fuel standard was at a level high enough to ensure that a market for domestic ethanol production existed. In other words, the tax credit was no longer necessary to stimulate additional ethanol production. As such, we suggested that Congress consider revising the tax credit or phasing it out. Congress let the credit expire at the end of 2011.[40] Coordinated reviews of tax expenditures with related federal spending programs—which are consistent with GPRAMA requirements—could help policymakers reduce overlap and inconsistencies and direct scarce resources to the most effective or least costly methods to deliver federal support.

Q Is the Tax Expenditure Being Coordinated with Other Federal Activities?

Achieving results for the nation increasingly requires that federal agencies work together to identify ways to deliver results more efficiently and in a way that is consistent with limited budgetary resources. For example, tax expenditures where administration is fragmented across multiple agencies, like those for the 23 community development tax expenditures we studied, may require coordination to identify the data needed to measure and assess use of the tax benefits and associated outcomes.[41] Coordination would also be critical to determining cost-effective means of collecting, analyzing, and reporting such data. GPRAMA established a framework for taking a more crosscutting and integrated approach to focusing on results and improving government performance. Likewise, to address the potential for overlap and fragmentation among federal programs, previously we have identified collaborative practices agencies should consider implementing in order to maximize the performance and results of federal programs that share common outcomes.[42] These practices include defining common outcomes; agreeing on roles and responsibilities for collaborative efforts; establishing

---

[39]GAO, *Biofuels: Potential Effects and Challenges of Required Increases in Production and Use*, GAO-09-446 (Washington, D.C.: Aug. 25, 2009).

[40]GAO, *Follow-up on 2011 Report: Status of Actions Taken to Reduce Duplication, Overlap, and Fragmentation, Save Tax Dollars, and Enhance Revenue*, GAO-12-453SP (Washington, D.C.: Feb. 28, 2012).

[41]GAO-12-262.

[42]GAO, *Managing for Results: Key Considerations for Implementing Interagency Collaborative Mechanisms*, GAO-12-1022 (Washington, D.C.: Sept. 27, 2012) and *Results-Oriented Government: Practices That Can Help Enhance and Sustain Collaboration among Federal Agencies*, GAO-06-15 (Washington, D.C.: Oct. 21, 2005).

compatible policies and procedures; and developing mechanisms to monitor, assess, and report on performance results. For example, the Department of Housing and Urban Development has collaborated with IRS to attempt to measure the use of Empowerment Zone/Renewal Community employment credits.[43] For higher education tax expenditures, based on our recommendation, IRS and the Department of Education have agreed to collaborate to help ensure individuals who are eligible to claim a higher education tax expenditure are aware of their eligibility and the benefit they may receive.[44]

Q Would an Alternative to the Tax Expenditure More Effectively Achieve Its Intended Purpose?

There are different types of tax expenditures and they often have the same effects as spending programs. Therefore, there are usually choices for how to deliver the desired federal assistance.

Q Is a Different Tax Expenditure Design Preferable?

Tax policy discussions sometimes include proposals to convert one type of tax expenditure, such as a deduction, to another, such as a credit. The different types of tax expenditures—exclusions, exemptions, deductions, credits, preferential rates, and deferrals—have different revenue, distribution, efficiency and other effects. For example:

- exclusions, exemptions, and deductions are worth more to taxpayers in higher tax brackets;
- itemized deductions cannot be claimed by taxpayers who take the standard deduction;
- exclusions may also reduce payroll taxes;
- credits can be made refundable; and
- deferrals shift the timing of payments.

Understanding such design differences may help policy makers select a type of tax expenditure that best accomplishes their goals.

[43] We noted that the Department of Housing and Urban Development and IRS efforts represent a step in the right direction for agency collaboration; however the two agencies have faced data challenges. For more information, see GAO-12-262.

[44] GAO-12-560.

Illustration of the Use of Two Different Types of Tax Expenditures to Achieve the Same Goal

Both Canada and the United States offer tax subsidies for public transit use.

- Canada uses a non-refundable credit for individuals who purchase public transit passes.
- The United States uses an exclusion—the value of transit passes provided directly by employers can be excluded from employees' income, subject to a monthly limit.

These different tax expenditure designs most directly affect distribution, compliance burden, and administrative costs.

- With Canada's credit, the benefit does not change due to a taxpayer's marginal tax rate (provided the taxpayer's tax liability exceeds the value of the credit), while the effective value of the United States' exclusion is greater for higher income individuals.
- Canadians must file their tax returns to receive the benefit, which may increase the compliance burden for individual taxpayers, while U.S. employers provide transit passes to their employees, which may increase third parties' administrative costs.

Q Is A Spending or Other Non-tax Policy Tool Preferable to the Tax Expenditure?

As already noted, tax expenditures are often aimed at goals similar to spending programs, raising the question of whether a non-tax policy tool might be preferred. OMB has considered the advantages and disadvantages of various policy tools, including tax expenditures. Generally, OMB highlights diffperences across the tools in the ability to target benefits, government administrative costs, and the burden imposed on parties outside the government, as shown in table 2.

Table 2: Potential Advantages and Disadvantages of Tax Expenditures Compared to Alternative Policy Tools

Policy tool	Potential advantages	Potential disadvantages
Tax expenditure	Benefits are widely available. A benefit or incentive linked to income may be administered through IRS at a relatively low cost. May simplify the tax system's operation, (e.g., a threshold for capital gains from the sale of a residence below which taxes are not assessed). The variety of tax expenditure types allows for flexibility.	Difficult to target those without an income tax filing requirement or low tax liabilities. May add to the complexity of the tax system. Generally do not enable the same degree of agency discretion as spending programs.
Spending program	May be specifically designed for low income families that are not subject to income taxes. Better suited to funding programs when direct provision by the federal government is warranted, such as the armed forces and justice system. May receive more year-to-year oversight. Provides flexibility for policy design.	May rely less on economic incentives and private market provisions, reducing efficiency for some goals. May respond less rapidly to changing economic conditions.
Regulation	Applies directly and immediately to the regulated parties. Public administrative costs may be low because they rely largely on voluntary compliance. Regulations can be fine tuned by the Executive Branch without legislation.	Historically have relied on proscriptive measures rather than economic incentives, which can diminish economic efficiency. May impose substantial compliance costs on regulated entities. Since they generally do not affect directly outlays or receipts, may not receive as much oversight as spending programs.

Source: OMB.

Note: Analysis of Office of Management and Budget, Analytical Perspectives, Budget of the United States Government, Fiscal Year 2013 (Washington, D.C.: 2012).

In some cases, the tax expenditure may not be the most cost-effective way to achieve a policy goal. For example, we found that a grant may be more cost effective at encouraging investments in low-income communities than the New Markets Tax Credit.

The New Markets Tax Credit

Congress established the New Markets Tax Credit (NMTC) in 2000 to encourage investors to make investments in low-income communities that traditionally lack access to capital. However, we found that the complexity of NMTC appears to reduce the federal subsidy reaching low-income communities.

- Treasury awards tax credits to Community Development Entities (CDE).
- Investors then make investments in the CDEs and, in exchange, can claim tax credits on a portion of their investment.
- The CDEs, in turn, are required to invest substantially all of the proceeds they receive into qualified low-income community investments.

This complex structure reduces the federal subsidy in two ways. First, as we reported in 2010, when the demand for NMTCs was highest the tax credits sold for $0.75 to $0.80 per dollar, according to CDE representatives we interviewed. Therefore, the federal subsidy was reduced by 20 percent to 25 percent before any funds were made available to CDEs. Second, CDE and other third-party fees, such as asset management and legal fees, further reduced the subsidy.

These up-front reductions in the federal subsidy could be largely avoided in a grant program. One option would be for Congress to set aside a portion of funds to be used as grants and a portion to be used as tax credits under the current NMTC program to facilitate a comparison of the two. For more information, see, GAO, *New Markets Tax Credit: The Credit Helps Fund a Variety of Projects in Low-Income Communities, but Could be Simplified*, GAO-10-334 (Washington, D.C.: Jan. 29, 2010).

In other cases, a tax expenditure may be the most cost-effective way to achieve a goal. For example, the incremental administrative and compliance costs to deliver the tax credit for child and dependent care expenses may be relatively low compared to the costs of setting up a separate system for processing child care applications and sending vouchers to those eligible.[45]

[45] GAO-05-690.

As previously discussed, Treasury and JCT estimate revenue losses for each tax expenditure. However, these estimates are not intended to include the full effect on the federal budget of eliminating or creating a tax expenditure. A variety of potential responses by taxpayers and policy makers need to be considered to understand the full budgetary consequences.

Q Are There Budget Effects Not Captured by Treasury's or the JCT's Tax Expenditure Estimates?

Treasury and JCT both estimate revenue loss separately for each tax expenditure by comparing revenue raised under current law with the revenue that would have been raised if the tax expenditure provision did not exist, assuming that taxpayer behavior and spending provisions remain constant. However, because taxpayer behavior and spending provisions may not remain constant, Treasury's and JCT's revenue loss estimates do not necessarily represent the amount of revenue that would be gained if the particular tax expenditure were repealed.

Q Would Eliminating or Creating the Tax Expenditure Affect Revenue Loss Estimates for Other Tax Expenditures?

Eliminating or creating the tax expenditure could increase or decrease the tax revenues associated with other income tax provisions. For example, revenue losses from remaining exclusions, exemptions, and deductions could increase if eliminating the tax expenditure results in some taxpayers moving into a higher tax bracket because more of their income is subject to tax. At higher marginal tax rates, the forgone revenue from the remaining tax expenditures these taxpayers claim would be greater.

Q Would Eliminating or Creating the Tax Expenditure Affect Other Federal Taxes, Such as the Payroll Tax?

Eliminating or creating the tax expenditure could also affect the amount of revenue the government collects from payroll taxes. For example, some exclusions apply to both income and payroll taxes. Treasury estimated that the exclusion of employer contributions for medical insurance premiums and medical care reduced payroll tax receipts by approximately $105 billion in fiscal year 2011. Eliminating this particular exclusion could result in increased payroll tax receipts.[46]

[46]OMB, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2013* (Washington, D.C.: 2012).

Q Would Eliminating or Creating the Tax Expenditure Change Taxpayer Behavior In Ways that Affect Revenue?

In some situations, taxpayers might be able to alter their behavior in ways that would offset some of the increase in tax liability associated with eliminating a tax expenditure. For example, when the consumer interest deduction was phased out gradually, beginning in 1987, some taxpayers shifted to tax-deductible home equity loans in lieu of other nondeductible consumer debt.[47] Likewise, if the preferential tax rates for capital gains were eliminated, some taxpayers might delay or accelerate selling assets, thereby affecting the amount or timing of revenue the government receives.

Q Would Eliminating or Creating the Tax Expenditure Affect the Amount the Government Spends on Other Programs?

Because tax expenditures are similar to spending programs, they can be substitutes for each other. If the tax expenditure is replaced by, or replaces, a mandatory spending program, there may be no net effect on the federal budget. If the tax expenditure is replaced by, or replaces, a discretionary spending program, the net effect depends on the relative size of the revenue loss from the tax expenditure and the appropriations for the spending program. Therefore, any conclusion about the overall effect of tax expenditures on the budget depends on the assumptions about whether a spending program would be substituted for the tax expenditure and whether this would be a mandatory or discretionary spending program. Also, tax credits may affect eligibility for federal spending programs.[48]

[47]Until the Tax Reform Act of 1986, taxpayers were allowed to deduct interest paid on borrowed funds. Deductable interest could include, for example, interest expenses from credit cards, school loans, and mortgages. For more information, see GAO, *Tax Policy: Many Factors Contributed to the Growth in Home Equity Financing in the 1980s*, GAO/GGD-93-63 (Washington, D.C., Mar. 25, 1993).

[48]For example, a refund from the earned income tax credit may be considered income for purposes of determining eligibility for Temporary Assistance for Needy Families. However, since 2010, section 728 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Public Law 111–312, indicates that a tax refund should not be taken into account as income for purposes of determining eligibility for benefits or assistance under any federal programs and federally assisted programs. This provision expires December 31, 2012.

Q Are There Options for Limiting the Tax Expenditure's Revenue Loss?

Some tax expenditures are similar in many ways to "direct spending" or mandatory programs (including entitlements). The amount of spending or revenue loss is not controlled directly by Congress and the President; the spending or revenue loss is determined by eligibility criteria and any "benefit" formula or tax rate. Congress can indirectly change the spending from an entitlement program by changing eligibility or benefit rules, or both. Similarly, the revenue loss from a tax expenditure is a function of its design. A tax expenditure typically reduces taxes for all qualified claimants, regardless of how many taxpayers claim the tax expenditure, how much they claim collectively, or how much federal revenue is reduced by these claims.[49]

Q Can the Aggregate Amount that Taxpayers Claim for the Tax Expenditure Be Capped?

One option to limit revenue losses is to set a maximum amount that can be claimed in aggregate for all taxpayers for a tax expenditure. For example, Congress has authorized a maximum amount of tax credits that can be allocated for the New Markets Tax Credit and the low income housing tax credit.[50] While a cap may limit revenue losses, it requires processes for allocating the tax benefits so the cap is not exceeded, which adds administrative complexity and cost for the government and taxpayers. Also, a cap may reduce the incentive for taxpayers to engage in an activity.

Q Can Taxpayers' Eligibility for The Tax Expenditure Be Restricted?

Restricting eligibility for tax expenditures does not provide the same certainty of future revenue loss as capping the aggregate amount taxpayers can claim, since the number of taxpayers who will claim a particular tax expenditure and how much they will claim may not be known. However, we have reported on ways to restrict eligibility for tax expenditures that can limit revenue losses, as described in table 3. While these restrictions might limit the tax expenditure's revenue loss, they may also add significant complexity for taxpayers.

---

[49] GAO-05-690.

[50] See GAO, *New Markets Tax Credit: The Credit Helps Fund a Variety of Projects in Low-Income Communities, but Could Be Simplified*, GAO-10-334 (Washington, D.C.: Jan. 29, 2010) and *Community Reinvestment Act: Challenges in Quantifying Its Effect on Low-Income Housing Tax Credit Investment*, GAO-12-869R (Washington, D.C.: Aug. 28, 2012).

Table 3: Options for Restricting Eligibility for a Tax Expenditure

Option	Examples
• Impose a ceiling on the benefits that can be claimed by an individual	• The mortgage interest deduction for owner-occupied homes is limited to mortgages of $1.1 million.
• Phase out benefits as income rises	• For the tuition and fees deduction, single filers whose adjusted gross income does not exceed $65,000 may deduct up to $4,000 per return. Single filers with an income of more than $65,000 but not exceeding $80,000 may deduct up to $2,000.
• Add a floor providing benefits only to taxpayers who spend above specified levels	• Unreimbursed medical expenses must be greater than 7.5 percent of adjusted gross income.
• Impose controls on groups of related tax expenditures	• Previously, itemized deductions have been limited for taxpayers with income above a certain threshold.

Source: GAO.
Note: Options are discussed in GAO/GGD/AIMD-94-122 and GAO-12-560.

Q For Eligible Taxpayers, Can The Value of the Tax Expenditure Be Reduced?

The dollar amount available to eligible taxpayers for a given tax expenditure could be reduced. For example, if the maximum amounts taxpayers could claim for the child tax credit were reduced, total tax revenue losses would decrease, all else equal. Reducing the dollar amount available for a tax expenditure may reduce the incentive for taxpayers to engage in the related activity or affect the desired adjustments for differences in individuals' ability to pay taxes.

For years we have reported on the lack of transparency and accountability for tax expenditures in comparison to spending programs.[51] GPRAMA sets a framework that can help ensure that tax expenditures are evaluated more systematically.

Q What Agency or Agencies Should Evaluate the Tax Expenditure?

GPRAMA sets the expectation that agencies should consider tax expenditures in measuring and communicating progress in achieving their missions and goals. For a tax expenditure that is part of a CAP goal, the responsible agencies identified in the related performance plan may be the logical agencies responsible for evaluating the tax expenditure. For example, the tax credit and deduction for clean-fuel burning vehicles falls under the energy efficiency goal, for which the Department of Energy, Environmental Protection Agency, and Department of Transportation are listed among the responsible agencies. Other tax expenditures not part of a CAP goal may also have logical connections to agencies—OMB guidance directs agencies to identify tax expenditures that contribute to their agency goals.[52] For both CAP and agency goals, GPRAMA requires identification of an individual, known as a goal leader, responsible for coordinating efforts to achieve the goals. Although IRS is the federal agency responsible for administering the tax laws, including those for tax expenditures, it is not responsible for the program areas targeted by many tax expenditures. For tax expenditures without logical connections to program agencies, such as those with tax administration purposes like the exclusion from income of capital gains from the sale of a principal residence, Treasury may be the most appropriate agency to conduct an evaluation. For many tax expenditures, evaluations will likely require collaboration among agencies.

Q When Should the Tax Expenditure Be Evaluated?

GPRAMA contains some guidance for when agencies could gauge the contributions of tax expenditures in achieving CAP goals. For tax expenditures that are not part of CAP goals, there are various options for selecting when to conduct evaluations.

- *Selecting on a judgmental basis*. For example, Canada's Department of Finance generally selects 1 or 2 tax expenditures per year to evaluate.[53]

---

[51]GAO-05-690 and GAO/GGD/AIMD-94-122.

[52]OMB, *Circular A-11* (Washington, D.C.: August 2012).

[53]In some years, Canada's Department of Finance analyzes a tax policy issue instead of evaluating a specific tax expenditure.

- *Selecting based on established criteria*. Examples of criteria from the state and foreign governments we reviewed included evaluating older tax expenditures first, grouping evaluations by policy focus or industry, and focusing on tax expenditures with the largest revenue losses.

- *Evaluating a new tax expenditure before it is enacted*. Policy makers would need to request the evaluation well before deciding whether to enact a new tax expenditure to allow for sufficient time to conduct the evaluation.

- *Evaluating an existing tax expenditure before it is extended*. Many tax expenditure provisions have set expiration dates; however, Congress has often extended these provisions.[54] Evaluations could be conducted before deciding on whether to extend an expiring tax expenditure provision. As with a new tax expenditure, policy makers would need to request the evaluation well before the expiration date to allow for sufficient time to conduct the evaluation.

Q What Data Are Needed to Evaluate the Tax Expenditure?

As with determining who should evaluate a tax expenditure, it is the responsible program agencies that should determine what data should be collected to evaluate tax expenditures relevant to their agency goals (or Treasury in the case of tax expenditures with tax administration purposes). Further, the data that agencies will need to evaluate a tax expenditure depends on the questions being asked about the tax expenditure. Data needed to determine if the tax expenditure is achieving its intended purpose may differ from data needed to evaluate broader issues, such as whether the tax expenditure generates net benefits for society. IRS collects some tax expenditure data reported on tax returns or other tax forms. However, to minimize its workload and the burden on taxpayers, IRS collects only the information needed to know the correct amount of taxes owed, unless it is legislatively mandated to collect additional information. As such, existing IRS data may not be sufficient for evaluating the efficiency, equity, and other effects of a tax expenditure. For example, for the Indian reservation depreciation tax expenditure, IRS did not require taxpayers to identify the reservation on which the depreciated property is located, preventing analysis that seeks to link investment to economic indicators on specific reservations.[55] Without information on where the investment is located, little progress can be made in determining how effective the tax expenditure is in promoting economic development.

[54] GAO, *Tax Policy: Factors For Evaluating Expiring Tax Provisions*, GAO-12-760T (Washington, D.C.: June 8, 2012).

[55] GAO-08-731.

IRS could be directed to collect more data that could be used to evaluate a given tax expenditure; however, such effort involves costs.[56] For example, for the Indian depreciation deduction, we suggested Congress consider requiring IRS to collect additional information, but we noted that Congress would need to weigh the associated costs of collecting and analyzing the information as well as the effects on IRS's other priorities.[57] Regardless of what type of data is collected, agencies will need to plan sufficiently so the data collected are available in time to conduct an evaluation. For general information on collecting data for evaluations, see our *Designing Evaluations* guide.[58]

[56]Likewise if entities other than IRS are to use collected data, taxpayer confidentiality and privacy provisions must be considered. Our taxpayer privacy guide provides questions for Congress to consider when assessing whether to expand disclosure of tax information. GAO, *Taxpayer Privacy: A Guide for Screening and Assessing Proposals to Disclose Confidential Tax Information to Specific Parties for Specific Purposes*, GAO-12-231SP (Washington, D.C.: Dec. 14, 2011).

[57]GAO-08-731.

[58]GAO-12-208G.

To consider how to develop evaluative questions for tax expenditures, we brought together concepts and examples from a number of sources.

1. Our previous work on tax expenditures, tax reform, results-oriented government, and program evaluation.

- Results-orientated government. The Government Performance and Results Act Modernization Act (GPRAMA) is part of long-standing efforts to improve the efficiency and effectiveness of federal programs.[59] Since the 1990s, individual federal agencies have been required to: (1) define their missions and desired outcomes, (2) measure performance, and (3) use this performance information to identify performance gaps.[60] GPRAMA enhances this framework by focusing on challenges that are not possible for any single agency to address alone, such as increasing energy efficiency and improving the coordination and delivery of job training services. It requires the Office of Management and Budget (OMB) and federal agencies to identify and assess how different federal efforts, including tax expenditures, are contributing to the achievement of the federal government's goals.[61]

- Our previous work on tax expenditures. We have issued a number of reports on tax expenditures. In 2005 and 1994, we described the substantial federal commitment tax expenditures represent, but found that little progress had been made in regularly and systematically evaluating them.[62] We have also evaluated the use of tax expenditures in achieving specific federal goals, such as helping students and families pay for higher education and in promoting community development.[63] In June 2012, we testified on factors to consider when evaluating expiring tax provisions, the majority of which are tax expenditures.[64]

- Tax Reform. Our 2005 report, Understanding the Tax Reform Debate: Background, Criteria, & Questions,[65] summarizes long standing criteria for evaluating tax policy. A good tax system should raise the amount of revenue the government needs at the lowest cost to

---

[59]Pub. L. No. 111-352, 124 Stat. 3866 (2011). GPRAMA amends the Government Performance and Results Act of 1993, Pub. L. No. 103-62, 107 Stat. 285 (1993).

[60]GAO, *Executive Guide: Effectively Implementing the Government Performance and Results Act*, GAO/GGD-96-118 (Washington, D.C.: June 1, 1996).

[61]GAO, *Government Performance: GPRA Modernization Act Provides Opportunities to Help Address Fiscal, Performance, and Management Challenges*, GAO-11-466T (Washington, D.C.: Mar. 16, 2011).

[62]GAO, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Examined*, GAO-05-690 (Washington, D.C.: Sep. 23, 2005) and *Tax Policy: Tax Expenditures Deserve More Scrutiny*, GAO/GGD/AIMD-94-122 (Washington, D.C.: June 3, 1994).

[63]GAO, *Higher Education: Improved Information Could Help Families Pay for College*, GAO-12-560 (Washington, D.C.: May 18, 2012) and *Community Development: Limited Information on the Use and Effectiveness of Tax Expenditures Could Be Mitigated through Congressional Attention*, GAO-12-262 (Washington, D.C.: Feb. 29, 2012). Older reports we have issued on tax expenditures are listed on pp. 127-128 of GAO-05-690.

[64]GAO, *Tax Policy: Factors for Evaluating Expiring Tax Provisions*, GAO-12-760T (Washington, D.C.: June 8, 2012).

[65]GAO, *Understanding the Tax Reform Debate: Background, Criteria & Questions*, GAO-05-1009SP (Washington, D.C.: September 2005).

society, balanced with other objectives, such as fairly distributing the burden of taxes. How a tax system is designed has important implications for the economy, the compliance burden of taxpayers, Internal Revenue Service's ability to administer the tax system, and public perceptions of its fairness and legitimacy. These criteria can be used to develop evaluative questions about specific tax expenditures.

- Program evaluation. Two of our reports—Designing Evaluations and Performance Measurement and Evaluation: Definitions and Relationships—summarize our institutional knowledge of how to evaluate federal programs.[66] Many tax expenditures can be viewed as spending channeled through the tax code. In evaluating a tax expenditure, policy makers should ask many of the same types of questions as they would ask about any other federal program.

2. Illustrative examples of tax expenditures from our previous work, which are cited throughout this guide.

3. OMB publications, including the discussion in the President's budget for fiscal year 2013 and prior years of how to evaluate tax expenditures, earlier discussion of evaluating tax expenditures, and OMB's guidance on the importance of rigorously evaluating federal programs.[67]

4. The experience of several state and foreign governments that have made progress in evaluating their tax expenditures. We used two reports by the Center on Budget and Policy Priorities[68] and the Organization for Economic Co-operation and Development[69] to identify state (Oregon and Washington) and foreign governments (Canada and Germany)[70] that have taken steps to systematically evaluate tax expenditures. We interviewed officials from these governments.

---

[66]GAO, *Designing Evaluations: 2012 Revision*, GAO-12-208G (Washington, D.C.: Jan. 31, 2012) and *Performance Measurement and Evaluation: Definitions and Relationships*, GAO-11-646SP (Washington, D.C.: May 2, 2011).

[67]OMB, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2013*, (Washington, D.C.: 2012); *Circular No. A-11: Preparation, Submission, and Execution of the Budget* (Washington, D.C.: August 2012); *Evaluating Programs for Efficacy and Cost-Efficiency*, M-10-32, Memorandum for the Heads of Executive Departments and Agencies, (Washington, D.C.: Jul. 29, 2010); *Increased Emphasis on Program Evaluations*, M-10-01, Memorandum for the Heads of Executive Departments and Agencies, (Washington, D.C.: Oct. 7, 2009); *The Government Performance and Results Act: Report to the President and Congress from the Director of the Office of Management and Budget*, (Washington, D.C.: May 1997); and *Circular No. A-94 Revised: Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs* (Washington, D.C.: October 29, 1992).

[68]Center on Budget and Policy Priorities, *Promoting State Budget Accountability Through Tax Expenditure Reporting,* (Washington D.C.: May 2011).

[69]Organization for Economic Co-operation and Development, *Tax Expenditures in OECD Countries,* (Paris, France: 2010).

[70]The reports also identify several other governments that have reportedly made progress in evaluating tax expenditures. We contacted audit officials in these governments, but they were not able to provide information in the timeframe for our report.

5. We interviewed external experts in tax policy and program evaluation to discuss how evaluations could be done for tax expenditures. These included several academics who specialize in either tax policy or program evaluation. We also interviewed experts affiliated with the Congressional Research Service, Tax Policy Center, American Enterprise Institute, the Performance Institute, and several universities. We also asked several of the experts to review a draft of this guide.

We conducted our work from May 2011 to November 2012 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for any findings and conclusions.

GAO Contact

James White, (202) 512-9110, whitej@gao.gov

Staff Acknowledgements

Staff members who made major contributions to this report include Jeff Arkin, Assistant Director; Judith Ambrose; Michael Brostek; Elizabeth Curda; Kevin Daly; Aimée Elivert; Lois Hanshaw; Susan Irving; Benjamin Licht; Robert Lunsford; Sarah McGrath; Donna Miller; Ed Nannenhorn; Michael O’Neill; Robert Robinson; Alan Rozzi; MaryLynn Sergent; Anne Stevens; and Jim Wozny.

Tax Expenditures

Community Reinvestment Act: Challenges in Quantifying Its Effects on Low-Income Housing Tax Credit Investment. GAO-12-869R. Washington, D.C.: August 28, 2012.

Tax Policy: Factors For Evaluating Expiring Tax Provisions. GAO-12-760T. Washington, D.C.: June 8, 2012.

Higher Education: Improved Tax Information Could Help Families Pay for College. GAO-12-560. Washington, D.C.: May 18, 2012.

Small Employer Health Tax Credit: Factors Contributing to Low Use and Complexity. GAO-12-549. Washington, D.C.: May 14, 2012.

Community Development Financial Institutions and New Markets Tax Credit Programs in Metropolitan and Nonmetropolitan Areas. GAO-12-547R. Washington, D.C.: April 26, 2012.

Energy Conservation and Climate Change: Factors to Consider in the Design of the Nonbusiness Energy Property Credit. GAO-12-318. Washington, D.C.: April 2, 2012.

Community Development: Limited Information on the Use and Effectiveness of Tax Expenditures Could be Mitigated through Congressional Action. GAO-12-262. Washington, D.C.: February 29, 2012.

Revitalization Programs: Empowerment Zones, Enterprise Communities, and Renewal Communities. GAO-10-464R. Washington, D.C.: March 12, 2010.

New Markets Tax Credit: The Credit Helps Fund a Variety of Projects in Low-Income Communities, but Could be Simplified. GAO-10-334. Washington, D.C.: January 29, 2010.

Tax Policy: The Research Tax Credit's Design and Administration Can Be Improved. GAO-10-136. Washington, D.C.: November 6, 2009.

Biofuels: Potential Effects and Challenges of Required Increases in Production and Use. GAO-09-446. Washington, D.C.: August 25, 2009.

Tax Expenditures: Available Data are Insufficient to Determine the Use and Impact of Indian Reservation Depreciation. GAO-08-731. Washington, D.C.: June 26, 2008.

Government Performance Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined. GAO-05-690. Washington, D.C.: September 23, 2005.

Tax Policy: Tax Expenditures Deserve More Scrutiny. GAO/GGD/AIMD-94-122. Washington, D.C.: June 3, 1994.

Tax Policy: Many Factors Contributed to the Growth in Home Equity Financing in the 1980s. GAO/GGD-93-63. Washington, D.C., March 25, 1993.

Results-oriented Government and Program Evaluation

Managing for Results: Key Considerations for Implementing Interagency Collaborative Mechanisms. GAO-12-1022. Washington, D.C.: September 27, 2012.

Managing for Results: A Guide for Using the GPRA Modernization Act to Help Inform Congressional Decision Making. GAO-12-621SP. Washington, D.C.: June 15, 2012.

Managing for Results: GAO's Work Related to the Interim Crosscutting Priority Goals under the GPRA Modernization Act. GAO-12-620R. Washington, D.C.: May 31, 2012.

Follow-up on 2011 Report: Status of Actions Taken to Reduce Duplication, Overlap, and Fragmentation, Save Tax Dollars, and Enhance Revenue. GAO-12-453SP. Washington, D.C.: February 28, 2012.

2012 Annual Report: Opportunities to Reduce Duplication, Overlap and Fragmentation, Achieve Savings, and Enhance Revenue. GAO-12-342SP. Washington, D.C.: February 28, 2012.

Designing Evaluations: 2012 Revision. GAO-12-208G. Washington, D.C., January 31, 2012.

Managing for Results: Opportunities for Congress to Address Government Performance Issues. GAO-12-215R. Washington, D.C.: December 9, 2011.

Performance Measurement and Evaluation: Definitions and Relationships (Supersedes GAO-05-739SP). GAO-11-646SP. Washington, D.C.: May 2, 2011.

Opportunities to Reduce Potential Duplication in Government Programs, Save Tax Dollars, and Enhance Revenue. GAO-11-318SP. Washington, D.C.: March 1, 2011.

Results-Oriented Government: Practices That Can Help Enhance and Sustain Collaboration among Federal Agencies. GAO-06-15. Washington, D.C.: October 21, 2005.

Agencies' Annual Performance Plans Under the Results Act: An Assessment Guide to Facilitate Congressional Decisionmaking. GAO/GGD/AIMD-10.1.18. Washington, D.C.: February 1, 1998.

Executive Guide: Effectively Implementing the Government Performance and Results Act. GAO/GGD-96-118. Washington, D.C.: June 1, 1996.

Taxpayer Privacy and Tax Reform

Taxpayer Privacy: A Guide for Screening and Assessing Proposals to Disclose Confidential Tax Information to Specific Parties for Specific Purposes. GAO-12-231SP. Washington, D.C.: December 14, 2011.

Understanding the Tax Reform Debate: Background, Criteria, & Questions. GAO-05-1009SP. Washington, D.C.: September 1, 2005.

(450895)