

## **Judging Tax Expenditures**

### **Spending Programs Buried within the Nation's Tax Code Need to be Reviewed**

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#### **Summary**

*Special tax breaks, known as tax expenditures, are generally enacted with goals unrelated to ensuring that the tax system collects revenue efficiently and fairly. Instead, these programs are designed to encourage particular activities or reward specific groups of taxpayers. Because they lack tax policy justification, tax expenditures are often described as spending programs “hidden” within the tax code.*

*Tax expenditures are exceedingly popular among lawmakers, but not for reasons of good policy. Rather, political attitudes and loose procedural rules are responsible for the excitement surrounding these provisions. This undeserved popularity can and should be reined in, at least in part, by implementing a tax expenditure performance review system. Such a system would impartially judge whether these provisions are fulfilling their stated objectives.*

*The tax expenditure review concept has a lengthy history at the federal level, although progress toward its implementation has slowed in recent years. Despite recent delays, several factors suggest that implementation is now more important and more attainable than at any time in recent memory.*

*This report discusses the merits and history of federal tax expenditure performance review, outlines reasons to be optimistic that such a system can be implemented soon, examines state-level efforts on this issue, and draws attention to several key questions that must be answered in designing a review system.*

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## I. Introduction

The recent change in presidential administrations brought with it the opportunity for an important shift in the way the federal government analyzes its effectiveness. Expanding performance review systems to consider the more than \$1 trillion of spending programs administered through the tax code could foster a more complete understanding of government, with corresponding gains in government efficiency, equity, and fiscal discipline.<sup>1</sup> The systematic review of those programs, known as tax expenditures, has for years been understood by analysts both within and outside government to be a worthwhile undertaking. This reform is long overdue.

The push to create a tax expenditure performance review system received attention within the executive branch as early as the Clinton administration, after Congress indicated its support for such a system. But despite being publicly praised and experimented with under President Clinton, the idea never gained the momentum needed for full implementation. Progress came to a near standstill under the Bush administration, which believed the entire tax expenditure concept to be of “questionable analytic value.”<sup>2</sup> Although the first budget to be drafted under President Obama offered few details regarding the new administration's plans on this issue, there are reasons for cautious optimism.

This report offers an overview of the status of tax expenditure performance review at the federal level and spells out a variety of arguments for moving more quickly than in past years toward the implementation of such a review system. In making that case, the political and procedural biases in favor of tax expenditure policy are first examined, followed by an analysis of the role to be played by performance reviews in reducing those biases. Federal experience with direct expenditure review is then given special attention. Next, an overview of the progress thus far toward implementing a tax expenditure review system is provided and is contrasted sharply with the much more ambitious (and worthy) goals laid out by the executive branch and Congress over the past 15 years. This report explains why, in the face of this lagging progress, current political and policy realities make today an ideal time to move toward implementing a review system. Then, to provide an understanding of the forms a federal review system could take, the report explores state-level efforts on this same issue. Finally, based partly on lessons from the states and partly on lessons from federal reviews of direct spending programs, concerns related to the design of an effective tax expenditure review system are discussed.

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<sup>1</sup> Using data from the Joint Committee on Taxation, the Congressional Research Service estimates that individual and corporate income tax expenditures will approach \$1.2 trillion in 2009. In reality, this \$1.2 trillion figure likely understates the true size of total tax expenditures for at least two reasons. First, the CRS method fails to account for what are known as interaction effects. Available evidence suggests that these interaction effects generally increase the overall size of tax expenditures, primarily because the successive elimination of tax expenditures would push taxpayers into higher rate brackets. Second, the CRS figures include no tax expenditures against federal payroll, transfer, or excise taxes. See CRS, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, S. Prt. 110-667, at 13; Leonard Burman, Eric Toder, and Christopher Geissler, "How Big Are Total Individual Income Tax Expenditures, and Who Benefits From Them?" (The Urban Institute, Discussion Paper No. 31, 2008), at 5-10.

<sup>2</sup> Office of Management and Budget, *Fiscal Year 2002 Budget of the United States Government: Analytical Perspectives* 61 (2001). (Hereinafter, references to the Analytical Perspectives section of the president's budget will be presented as "FYxx Budget, AP.")

## II. The Tax Expenditure Free Ride

Federal law defines tax expenditures to include special exclusions, exemptions, deductions, credits, preferential rates, and deferrals of tax liability that result in a loss of federal income tax revenue.<sup>3</sup> Rather than contributing to a broad-based, equitable, and efficient tax code, tax expenditures usually represent a direct departure from this ideal in their attempts to encourage specific behaviors or reward particular taxpayers. The mortgage interest deduction, for example, is almost invariably defended based on its perceived ability to increase homeownership.<sup>4</sup> Its complicating and slightly regressive effects on the tax code are typically of no concern.

As a result of these sorts of attributes, tax expenditures are widely understood as much more akin to spending programs than to traditional tax policy, and rightly so.<sup>5</sup> It is important to note, however, that this fact alone does not necessarily make any specific tax expenditure program a bad policy. If a particular activity is judged to be truly desirable, and if a tax expenditure is judged to be an efficient means of encouraging that activity, the lack of tax policy merit may be outweighed by the broader policy gain.<sup>6</sup> Because of the procedural and political biases in favor of tax expenditure policy, however, there is good reason to suspect that an above-average share of existing tax expenditure programs may not constitute sound policy. Those biases are discussed below.

### A. Procedural Bias: The Hidden Entitlement<sup>7</sup>

The first bias in favor of tax expenditure policy arises because most of the systems designed to oversee government spending programs have failed to recognize that spending initiatives are increasingly being written into the code. As a result, tax expenditures receive far less scrutiny in the budgeting and policymaking processes than they deserve.<sup>8</sup>

This shortcoming is partially attributable to the fact that unlike discretionary spending programs, tax expenditures are generally not subject to the appropriations process.<sup>9</sup> The most obvious consequence of this exclusion is that without a sunset provision, policymakers can in theory avoid giving a tax expenditure even a second thought after its initial enactment. Any permanent program written into the tax code is thereby allowed to continue indefinitely without

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<sup>3</sup> P.L. 93-344.

<sup>4</sup> CRS, *Tax Expenditures*, *supra* note 1, at 332.

<sup>5</sup> Hence the term "tax expenditure." For one discussion of this equivalence, see Eric J. Toder, "Tax Cuts or Spending — Does It Make a Difference?" 53 *Nat'l Tax J.* 361-372 (2000).

<sup>6</sup> One important question that must be explored under that scenario is whether a tax expenditure would be more efficient than an equivalent direct expenditure. There are indeed a variety of situations in which this may be the case. *See, e.g.*, Toder, *supra* note 5, at 368-370.

<sup>7</sup> The term "hidden entitlements" is borrowed from Robert S. McIntyre, *The Hidden Entitlements* (Citizens for Tax Justice, 1996).

<sup>8</sup> General Accounting Office, "Tax Policy: Tax Expenditures Deserve More Scrutiny," GAO/GGD/AIMD-94-122 (1994); GAO, "Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined," GAO-05-690 (2005); The Century Foundation Working Group on Tax Expenditures, *Bad Breaks All Around* (The Century Foundation Press, 2002).

<sup>9</sup> The new markets tax credit is one very rare exception. Similarly, Missouri lawmakers during their 2009 legislative session attempted to bring various tax credits under the state's appropriations process, although they were ultimately unsuccessful. *See* Tony Messenger, "Missouri Speaker Draws Line in Sand on Historic Tax Credits," *stltoday.com* (Apr. 2, 2009), *available at* <http://www.stltoday.com/blogzone/political-fix/political-fix/2009/04/missouri-speaker-draws-line-in-sand-on-historic-tax-credits/>.

formal review. As a result, any policymaker interested in reexamining those expenditures is at a disadvantage from the outset.

Perhaps even more important than the open-ended duration of most tax expenditures is their open-ended size. Rather than being limited to some appropriated dollar amount, all taxpayers who fit the criteria defined in the tax law can generally claim the expenditure's benefit. There are a few exceptions to this — such as the new markets tax credit, which is intended to encourage investment in economically distressed areas and is limited to a specific dollar amount — but the overwhelming majority of tax expenditures face no such limitation.

As a result, growth in the size of tax expenditures is almost entirely determined by changes in economics, demographics, and other characteristics of society. If, for example, the amount of research and experimentation expenses claimed by private firms begins to rapidly increase, government subsidies of those firms can be expected to swing sharply upward as research tax credit claims rise. This happens entirely independently of any conscious decision on the part of government to expend additional resources subsidizing research.

Weak procedural mechanisms leave policymakers and the people who elected them with few options for controlling spending done through the tax code. Because of tax expenditures' unlimited size and unlimited duration, many commentators have compared them with traditional entitlement programs.<sup>10</sup>

One final procedural bias leading to the overuse of tax expenditures results from the structure of the congressional committee system. Because tax expenditures can apply to virtually any area (for example, education, housing, healthcare, and commerce), members of Congress who serve on one of the taxwriting committees can legislate on almost any issue that may be of interest to their constituents, including areas in which they have little or no expertise. Unsurprisingly, that authority has often proven irresistible, and tax expenditures have proliferated as a result. Moreover, the committee structure has also been faulted with obstructing efforts to convert tax expenditures into similar, more sensible direct spending programs.<sup>11</sup> These problems are prevalent at the state level as well.

## **B. Political Bias: Tax Expenditure “Addiction”**

Procedural biases are not entirely responsible for the free ride enjoyed by tax expenditures. Even though tax expenditures may not face the same procedural controls confronted by ordinary spending programs, this does not mean that policymakers are prohibited from revisiting them. If policymakers were inclined to reexamine tax expenditures regularly, the lack of procedural mechanisms for encouraging that reexamination would be unimportant. Unfortunately, policymakers are inherently averse to properly scrutinizing tax expenditures, and the lack of formal mechanisms to force reexamination only makes that tendency worse. Typical political pressures actually encourage the overenactment of tax expenditures, and the overprotection of them once

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<sup>10</sup> For some examples, see GAO, "Tax Policy," *supra* note 8, at 94; McIntyre, *supra* note 7; Bipartisan Commission on Entitlement and Tax Reform, "Final Report to the President" (1995), at 158, 167-168, and 179; and John R. Gist, "Spending and Tax Entitlements," *Tax Notes*, Apr. 9, 2007, p. 145.

<sup>11</sup> See, for example, Helen F. Ladd, "The Tax Expenditure Concept After 25 Years," in Proceedings of the National Tax Association's 86th Annual Conference on Taxation, Charleston, November 1994, at 54; and CRS, "Tax Expenditures: Trends and Critiques," Report RL33641 (2008), at 9-10.

enacted. One state-level legislator went as far as to describe the political infatuation with tax expenditures as an “addiction.”<sup>12</sup>

Administering spending programs through the tax code allows policymakers to simultaneously claim that they are taking action on an important issue while also taking credit for cutting taxes, shrinking government, or deferring to the private sector. In reality, however, selectively shuffling around tax burdens leaves no less of an imprint on the economy than direct government spending. A subsidy for constructing wind farms, for example, produces the same outcome regardless of whether it is administered as a tax credit or as a government grant. Still, the rhetorical advantages to taking the tax expenditure route remain very attractive from a political standpoint.

Proper review of existing tax expenditures is also discouraged by this favorable framing. Any action designed to reduce or eliminate a tax expenditure is sure to elicit cries that those in favor of ending the provision are in support of higher taxes, even though anybody seeking to eliminate an identical direct spending program could easily receive praise from fiscal conservatives as somebody seeking to shrink the size of government.<sup>13</sup>

Politically, as well as procedurally, it truly does make a difference whether a spending program happens to be written into Title 26 (the Internal Revenue Code) rather than in some other section of U.S. law.

### **III. Counteracting the Biases**

#### **A. Potential Options**

The political and procedural biases toward conducting public policy in the form of tax expenditures have been critical in preventing policymakers from asking one simple but vital question: Are these programs working? A variety of methods have been proposed to encourage the addition of this question in the budgeting and policymaking processes. Performance review is among the most prominent of those methods. Other approaches include sunset provisions, cost savings targets, direct inclusion of tax expenditures in the appropriations process, limitations on size that trigger when growth exceeds a specified amount, and a reworking of the congressional committee system.<sup>14</sup> Each of these approaches has its merits and limitations, although an in-depth discussion of each is beyond the scope of this report. It is important to note that most of these options are not mutually exclusive and any could be used in conjunction with a performance review system.

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<sup>12</sup> Missouri state senator Matt Bartle (R) referred to himself as “a recovering tax credit addict.” See Virginia Young, “Mo. Lawmakers Try to Rein in Tax Credit Programs,” available at Missouri Senate Newsroom, <http://www.senate.mo.gov/snc/2009/02-February/021809.doc>.

<sup>13</sup> On this point there can sometimes arise a very interesting intersection between the political and procedural biases enjoyed by tax expenditures. Because Washington, for example, requires two-thirds legislative support to increase taxes, current law prevents the Legislature from eliminating tax expenditures with a simple majority vote, although identical direct spending programs would face no such obstacle. HB 2212 of the 2009 legislative session attempted to correct this asymmetry by excluding changes to tax expenditures from the definition of a tax increase, although the bill ultimately failed to make it out of committee. Other governments with similar supermajority requirements are susceptible to this same problem.

<sup>14</sup> The GAO reports on “Tax Policy” and “Government Performance and Accountability,” *supra* note 8, consider these options in the most detail. For a brief description of triggered size limitations in reference to traditional entitlement programs, see Joseph Antos et al., “Taking Back Our Fiscal Future,” at 6 (paper endorsed by various individual members of the Brookings-Heritage Fiscal Seminar, 2008). See also Edward D. Kleinbard, “The Congress Within the Congress: How Tax Expenditures Distort Our Budget and Our Political Processes,” *Tax Notes*, May 18, 2009, p. 925.

## **B. The Role of Performance Reviews**

Although there are several options worthy of serious consideration in the pursuit of a more rational tax expenditure oversight policy, the option we focus on here — performance review — is the one that is most direct in its attempt to address the effectiveness of tax expenditures.

Broadly speaking, a typical performance review requires a statement of the objectives of a program, followed by an analysis of the success of that program in achieving those objectives. In performing this analysis, both the costs and benefits of the program should be considered. Performance reviews are one of the primary means by which government can measure and report its own effectiveness.

A systematic and comprehensive performance review system can also be a valuable tool for keeping track of the wide variety of existing public policies and programs. Such a system is especially useful when it is used not only to verify that each program continues to fulfill a valued purpose, but also to verify that it fits sensibly within the context of other related programs. Federal attempts to review direct expenditure programs have been especially weak in this respect, as is outlined in the next section.

Because performance reviews are primarily informational in nature, they can help facilitate improved tax expenditure oversight either on their own or as a component of a larger effort to more closely scrutinize tax expenditures. The information provided by a performance review is of central importance to reasoned policy debate. Regardless of whether policymakers are attempting to reexamine tax expenditures under existing procedural arrangements or with the help of more aggressive tools such as sunsets or statutory limits on size, the availability of detailed and unbiased information on program effectiveness is vital to ensuring that the debate is focused on careful analysis. A comprehensive performance review framework that analyzes all notable tax expenditures within the context of related tax and spending programs is an ideal way to systematically provide this analysis.

By the same token, the lack of a tax expenditure review system has left policymakers ill-equipped for the task of scrutinizing tax expenditures. The resultant gap in information has also amplified the political biases explained above. Without official and systematic reviews of tax expenditures, policymakers must rely more heavily on anecdote and speculation. Given that most tax expenditures are enacted with what appear to be desirable goals, it is difficult to argue in favor of the elimination of any such program without evidence regarding its results. By providing direct, impartial evidence on the merit of specific tax expenditures, a review system can provide would-be tax expenditure critics the knowledge needed to counter the rampant bias in favor of tax expenditure policy.

In this environment, any effort to apply greater scrutiny to tax expenditures will see little success absent the creation of a performance review system. Performance reviews should be understood as *necessary* to good tax expenditure policy, although it remains an open question whether they are *sufficient*.

Accelerating the very gradual progress toward the implementation of a tax expenditure review system could transform discussions of tax expenditures in an extremely positive way. That reform could not come at a more crucial time, given the government's fiscal problems and the rapidly growing size of tax expenditures. The history and future of this reform are the topic of the remainder of this report.

## **IV. Lessons from PART**

Although the federal government has yet to implement a tax expenditure performance review system, it does have some experience with reviewing the effectiveness of direct spending programs. That experience comes primarily from use of the Program Assessment Rating Tool (PART), a 2002 initiative administered by the Office of Management and Budget. During PART's existence, evaluations were conducted through a questionnaire given to federal agencies covering issues of program purpose, design, planning, management, results, and accountability.<sup>15</sup> Answers to the questionnaire were used by OMB to evaluate the effectiveness of programs in achieving desired outcomes, and final results were reported as a numerical score on a 100-point scale. PART was an initiative begun solely at the behest of the Bush administration, although its roots began from a long-running struggle within the federal government to create an effective system of performance measurement. PART was used to evaluate more than 1,000 programs in its relatively short existence.

Due to a variety of flaws in PART, the Obama administration made clear in its fiscal 2010 budget that it plans to replace the tool with a "reformed performance improvement and analysis framework." This promise comes on the heels of recent surveys from the Government Accountability Office indicating that only a small minority of federal managers familiar with PART believe it to have had an impact on performance.<sup>16</sup> While the Obama administration's modifications will hopefully improve on this outcome (the precise modifications have yet to be revealed), it is also worth noting that a well-designed tax expenditure review system would avoid many of the perceived problems with PART, largely because of the differences between direct expenditure and tax expenditure review.

### **A. PART's Flaws**

One major criticism of PART was that it was overly simplistic in its use of a one-size-fits-all questionnaire. Critics contended that agencies had difficulty providing meaningful answers to the questionnaire's mostly yes-or-no questions, especially for smaller and more flexible programs. A tax expenditure review system, however, would largely bypass this problem by placing much less emphasis on the tasks performed by agencies. Rather than focusing on program planning and management, a tax expenditure review would necessarily be more concerned with an expenditure's purpose, design, and results. Because the tax law is fairly precise, these features are usually a function of the implementing legislation rather than any choice made within federal agencies. Indeed, the majority of tax expenditures require almost no agency involvement aside from the IRS's processing of claims and its investigation of suspected fraudulent claims. The unique, hands-off nature of tax expenditures is especially encouraging for the prospects of a tax expenditure review system because PART was at times criticized as requiring a substantial amount of effort by agencies. This effort was required both in completing the questionnaire itself and in explaining to OMB staff the background of the programs administered by the agency.<sup>17</sup>

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<sup>15</sup> OMB, "Program Assessment Rating Tool Guidance," Guidance No. 2008-01 (2008), at 14.

<sup>16</sup> GAO, "Government Performance: Lessons Learned for the Next Administration on Using Performance Information to Improve Results," GAO-08-1026T (2008), at 8-9.

<sup>17</sup> GAO, "Performance Budgeting: PART Focuses Attention on Program Performance, but More Can Be Done to Engage Congress," GAO-06-28 (2005), at 19.



Other PART critics contended that the goals attributed to programs were often chosen piecemeal by the administration rather than drawn from the intent behind the program's original enactment.<sup>18</sup> This type of selective analysis was made possible by the fact that the PART process was fairly insulated, especially from involvement by Congress. The GAO criticized PART's insulated nature in a 71-page report titled "PART Focuses Attention on Program Performance, but More Can Be Done to Engage Congress."<sup>19</sup> But because statutory language, not agency planning and behavior, will be the target of tax expenditure performance reviews, it is difficult to imagine an adequate tax expenditure review system that would suffer from this flaw. The easiest (indeed, often the only) way to modify a tax expenditure program is to change the tax law.<sup>20</sup> Tax expenditure reviews, by definition, will therefore be focused on sharing results with Congress. For this process to be effective, it will have to involve a back-and-forth discussion about the objectives of particular tax expenditures. Congress is unlikely to be receptive to recommendations in which it was allowed no role — as was demonstrated with PART.<sup>21</sup>

Still more critics, including OMB Director Peter Orszag, have assailed PART for focusing "too much on process and not enough on outcomes."<sup>22</sup> During Orszag's latest confirmation hearings before assuming the role of director, he noted that PART evaluations of the IRS, for example, focus on audit rates rather than on the level of compliance with the tax law. Under this construction, an IRS that wastefully pestered many honest taxpayers with audits would be rated more highly than an IRS that efficiently targeted only tax cheats. Unfortunately, defining and measuring the "outcomes" of a program is not always as easy as in this example, but a tax expenditure review framework could certainly make a better attempt to establish a meaningful definition of performance than was made under PART.

## **B. PART's Omission of Tax Expenditures**

As the previous section demonstrated, many of PART's flaws would not carry over to a well-designed tax expenditure review system. This is also true of PART's most serious shortcoming — its narrow perspective. By bringing tax expenditures within the umbrella of federal performance reviews, that narrow perspective could be replaced with something much broader and more useful.

As Obama insisted in his preliminary budget blueprint, released in February 2009, under his new performance review framework, "programs will not be measured in isolation, but assessed in the context of other programs that are serving the same population or meeting the same goals."<sup>23</sup> This sentiment seems to reflect a desire to remedy a problem identified repeatedly by the GAO, including as recently as 2007, when it stated that effective performance reviews "require a comprehensive perspective that crosses agencies, includes all major tools of government, and

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<sup>18</sup> OMB Watch, "New PART Scores Showcase More Contradictions of Program," Mar. 7, 2006, *available at* <http://www.ombwatch.org/node/2828>.

<sup>19</sup> GAO, "Performance Budgeting," *supra* note 17.

<sup>20</sup> Exceptions include altering Treasury regulations or IRS guidance and enforcement practices.

<sup>21</sup> GAO, "Performance Budgeting," *supra* note 17, at 42.

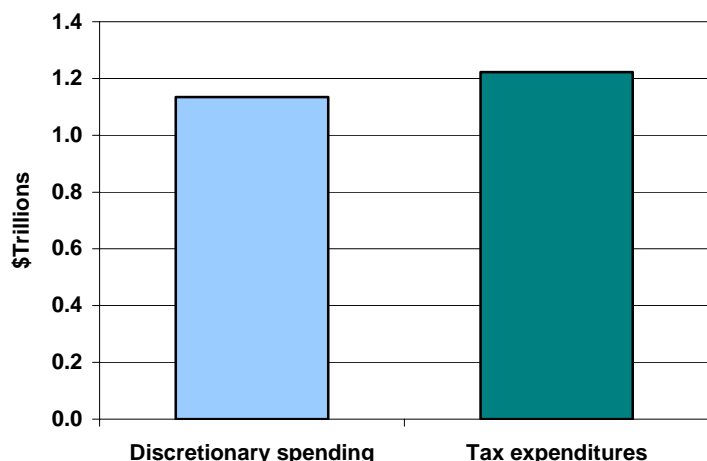
<sup>22</sup> Adam Hughes, "Orszag on PART: Exactly!" OMB Watch Blog: The Fine Print, Jan. 21, 2009, *available at* <http://www.ombwatch.org/node/9594>.

<sup>23</sup> OMB, *A New Era of Responsibility: Renewing America's Promise* (2009), at 39.

considers both spending programs and tax provisions.”<sup>24</sup> Although the language released by the Obama administration does not explicitly refer to tax expenditures, that language's parallels with the criticisms voiced by the GAO cannot help but lead one to recall the GAO's repeated insistence

that tax expenditures must be reviewed alongside direct spending programs.

**Federal Discretionary Spending Compared to Federal Tax Expenditures in FY 2008**



PART operated in a fashion directly contrary to the type of big-picture perspective articulated by the GAO and the Bush administration, as it systematically excluded upwards of \$1 trillion of programs from review simply because they were administered through the tax code.<sup>25</sup> To put that in perspective, the total size of programs excluded from PART review was equal to or larger than the entire discretionary spending budget in a typical year.<sup>26</sup>

This exclusion occurred even though the tax expenditure provisions are generally enacted with objectives that are as specific and measurable as those accompanying direct spending programs. The nearby chart shows the relative sizes of direct and tax expenditures in fiscal 2008.<sup>27</sup>

Making the omission of tax expenditures from PART especially troubling is that the case for a tax expenditure review system is even stronger than that for direct expenditures. As described earlier, direct expenditures are already reexamined as part of the regular appropriations process and are not blessed with quite the same undeserved enthusiasm in the political process that tax expenditures enjoy. While it may be easy to find a direct spending program in need of a second look, it is even easier to find a tax expenditure begging for the same. Special tax breaks for oil and gas companies, which have been allowed to continue for years despite their dubious merits, are one obvious example.<sup>28</sup>

<sup>24</sup> GAO, "21st Century Challenges: How Performance Budgeting Can Help," GAO-07-1194T (2007). See also GAO, "Government Performance and Accountability," *supra* note 8.

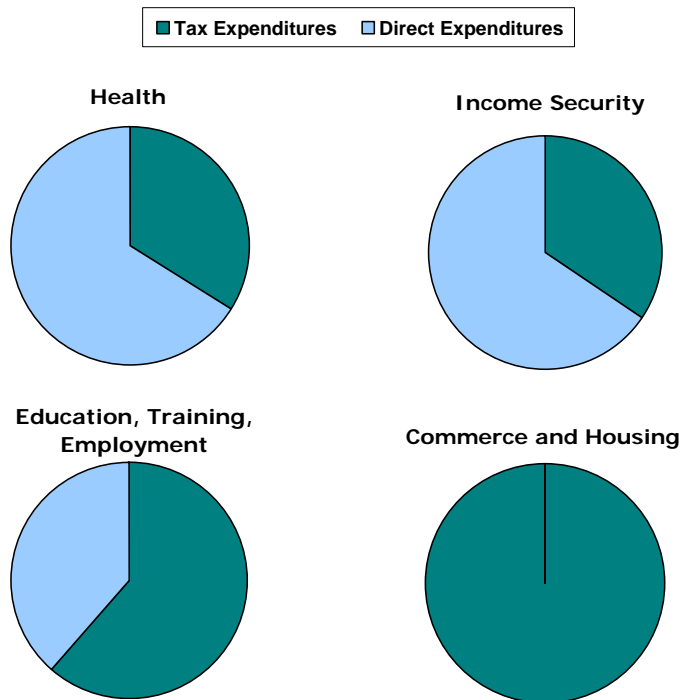
<sup>25</sup> See *supra* note 1 for an explanation of the \$1 trillion estimate. Also, it is worth noting that PART placed significant emphasis on the role of government agencies in planning, designing, and managing programs under their control. Because of the comparatively precise design of the tax law, however, tax expenditures leave relatively little room for such efforts on the part of federal agencies. Inclusion of tax expenditures in PART review would have required a significant addition to the review framework. Some type of effort along these lines would have been worthwhile, however, given both the immense size of total tax expenditures and the fact that tax expenditure review fit perfectly within PART's central mission to "assess the performance of Federal programs and to drive improvements in program performance." See OMB, "Guide to the Program Assessment Rating Tool (PART)," Guidance No. 2007-02 (2007).

<sup>26</sup> Discretionary spending is projected to stay in the \$1.1 trillion to \$1.3 trillion range annually over the next 10 years. See Congressional Budget Office, "A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook," Pub. No. 3196 (2009), at 3.

<sup>27</sup> *Id.* See *supra* note 1 for an explanation of the tax expenditure estimate.

<sup>28</sup> The Obama administration echoed a view held by many when it recently stated that "oil and gas subsidies are costly to the American taxpayer and do little to incentivize production or reduce energy prices." See OMB, *Budget of the United States Government Fiscal Year 2010: Terminations, Reductions, and Savings* (2009), at 47.

### Composition of Federal Government Support in Four Budget Categories (2007)



Ultimately, given their size and importance, the exclusion of tax expenditures from review has resulted both in a lack of their transparency and in a gap in the understanding of government's operations more generally. That gap is particularly large in several areas. According to a recent report by the Congressional Research Service, the majority of government support in the areas of commerce and housing, education, training, and employment, and general government and fiscal assistance was actually provided through the tax code in 2007.<sup>29</sup> Also, approximately one-third of health expenditures and one-third of income security expenditures were administered in the form of tax expenditures. Additional research has revealed similar patterns in other areas of federal policy.<sup>30</sup> As a result, no effort to

understand the government's overall effectiveness in these areas can hope to succeed if it neglects to consider the role of tax expenditures.

In this light, the GAO's criticisms of PART's attempts at conducting crosscutting reviews (that is, reviews covering multiple programs in the same area) are unsurprising.<sup>31</sup> PART's systematic exclusion of such a large share of government programs condemned it to fail from the start. Whatever the Obama administration's plans for its "reformed performance improvement and analysis framework," that framework will almost certainly come up short if tax expenditures are not included within its scope.

## V. Progress (Or Lack Thereof) Since 1993

The rationales for incorporating tax expenditures in a performance review system are so compelling that the Senate report accompanying one of the seminal pieces of federal performance review legislation — the Government Performance and Results Act of 1993 (GPRA) — called for precisely such a reform. The central purpose of the GPRA was to root out government "waste and inefficiency," with the understanding that "the confidence of the American people in the Government" would be eroded without that action. The act also sought to remedy the fact that "congressional policy making, spending decisions and program oversight are seriously

<sup>29</sup> CRS, "Tax Expenditures," *supra* note 11, at 15.

<sup>30</sup> Other research has shown, for example, that 63 percent of energy subsidies and 37 percent of federal expenditures on children are administered as tax expenditures. See Kleinbard, *supra* note 14, at 936; Jennifer Macomber et al., "Federal Expenditures on Infants and Toddlers in 2007," The Urban Institute and the Brookings Institution (2009), at 19.

<sup>31</sup> GAO, "Performance Budgeting," *supra* note 17, at 20.

handicapped by insufficient attention to program performance and results.”<sup>32</sup> The GPRA enjoyed broad bipartisan support. In the words of the Senate report:

*To increase significantly the oversight and analysis of tax expenditures, the Committee believes that the annual overall Federal Government performance plans should include a schedule for periodically assessing the effects of specific tax expenditures in achieving performance goals. ... The Committee expects that annual performance reports would subsequently be used to report on these tax expenditure assessments.*<sup>33</sup>

Among the most important outcomes of the GPRA was the eventual creation of a set of annual performance plans prepared by each federal agency.<sup>34</sup> These plans are constructed with the guidance of instructions handed down to those agencies by the OMB. Even though the language urging the creation of tax expenditure performance plans was included only in the Senate report (as opposed to the legislative language of the GPRA itself), the OMB decided as a result of the GPRA to supplement the portion of its instructions discussing the review of tax expenditures. A passage from the 2009 version of those instructions states:

*In general, tax expenditures are subject to the same degree of performance evaluation as spending and regulatory programs. ... You should be prepared to furnish, upon request, problem analyses, estimates of economic effects, and other materials that will provide explicit quantitative information on the relationship of existing or proposed tax expenditures to proposed budget expenditures. See Part 6 [of these instructions] for guidance on inclusion of tax expenditure data in annual performance plans.*<sup>35</sup>

Unfortunately, despite compelling reasons to implement the reforms contained in the GPRA report and in the OMB's instructions to federal agencies, they have not been put to use.<sup>36</sup> Rather than being performed regularly, tax expenditure studies are at best done piecemeal, often without the careful focus on governmentwide efficiency brought by a systematic review process.<sup>37</sup>

The failure to implement tax expenditure review has also been reflected to some extent in the evolution of the OMB's instructions. The reference to “Part 6” in the quote above, for example, appears to be only a relic from earlier versions of the instructions. Recent revisions have removed all mention of the term “tax expenditure” from Part 6 — the section explaining the preparation of performance plans and reports. Previous OMB instructions, in line with the sentiment of the GPRA Senate report, included numerous discussions of the proper handling of tax expenditures in performance plans and reports.<sup>38</sup>

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<sup>32</sup> GPRA of 1993, P.L. 103-26.

<sup>33</sup> "Government Performance and Results Act of 1993: Report of the Committee on Governmental Affairs," S. Rep. No. 103-58 (1993).

<sup>34</sup> Robert D. Lee Jr. et al., *Public Budgeting Systems* (Sudbury: Jones and Bartlett Publishers, 2008), at 161.

<sup>35</sup> OMB, "Preparation, Submission, and Execution of the Budget," Circular No. A-11 (2009), section 33-6.

<sup>36</sup> The Century Foundation Working Group on Tax Expenditures, *supra* note 8, at 28-29; GAO, "Government Performance and Accountability," *supra* note 8, at 65.

<sup>37</sup> For a partial list of tax expenditure studies, see Leonard E. Burman, "Is the Tax Expenditure Concept Still Relevant?" 56 *Nat'l Tax J.* 624-625 (2003).

<sup>38</sup> For some examples, see OMB, "Preparation, Submission, and Execution of the Budget," Circular No. A-11 (2000), sections 210.5(c), 210.8, 220.5(d), 220.10(c), 220.11(b), and 232.2(f).

The GPRA Senate report and past OMB instructions are by no means the only evidence that consideration has been given to systematic tax expenditure performance review at the federal level. In fact, for more than a decade the OMB has repeatedly promised, in line with the directions contained in the GPRA Senate report, to coordinate a review of the performance of tax expenditures. The first indication that the executive branch was considering reviewing tax expenditures was a brief mention of the idea in the fiscal 1995 budget.<sup>39</sup> That budget was released in early 1994 — barely six months after the GPRA was signed. And by 1997 the OMB was already formulating a fairly precise schedule for creating a comprehensive tax expenditure review system. According to one OMB report to Congress, the OMB's position was that:

*It is anticipated that Treasury and other Administration departments and offices will work together, as appropriate, on determining a set of useful measures and in developing quantitative and other estimates of [tax expenditures'] impacts. ... The expectation is that a schedule of additional evaluations of tax expenditures will be included in the governmentwide performance plan that will be published as part of the President's Fiscal Year 1999 Budget.*<sup>40</sup>

Nearly identical language was included in both the fiscal 1997 and fiscal 1998 budgets that were released in the months leading up to that OMB report.<sup>41</sup> Further, the fiscal 1998 budget, as well as the 1997 report to Congress, suggested that these evaluations would involve direct comparisons of tax expenditures with other methods available for achieving the same goals — most notably, direct spending programs and regulations.<sup>42</sup>

But when the long-awaited fiscal 1999 budget was released, it was lacking the promised level of detail. The document included very brief overviews of three “pilot studies” conducted by Treasury, meant to be the first steps in determining the methods and data needed to create a full tax expenditure performance review system.<sup>43</sup> Aside from those overviews, however, the most noteworthy language on this subject was the promise to complete additional studies in the next year to acquire the data needed to conduct these reviews.<sup>44</sup> Those studies, as well as the analyses based on the data procured from them, would then be improved over the “next few years” and “next several years,” respectively.<sup>45</sup> Contrary to the goals laid out in the fiscal 1999 budget, however, the fiscal 2000 budget provided no additional substantive detail and simply expanded the time horizon for completing these studies.<sup>46</sup>

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<sup>39</sup> The fiscal 1995 and 1996 budgets were the first to include language describing the merits of judging the performance of tax expenditures. Both documents stated: “Information on the programmatic and economic effects of tax expenditures could be useful [to policymakers]. The outputs and efficiency of tax expenditures could then be compared more systematically with direct outlay programs.” See FY95 Budget, AP, at 65; FY96 Budget, AP, at 52.

<sup>40</sup> OMB, “The Government Performance and Results Act: Report to the President and Congress From the Director of the Office of Management and Budget,” (1997), Section IV.

<sup>41</sup> FY97 Budget, AP, at 73-74; FY98 Budget, AP, at 85-87.

<sup>42</sup> FY98 Budget, AP, at 87; OMB, “The Government Performance and Results Act,” *supra* note 40, at Section IV.

<sup>43</sup> FY99 Budget, AP, at 105, 108-110, and 117.

<sup>44</sup> *Id.* at 105.

<sup>45</sup> *Id.* at 108.

<sup>46</sup> FY00 Budget, AP, at 121 and 124.

OMB and Treasury's plans for obtaining the data they needed became somewhat more concrete in the fiscal 2001 budget, and by fiscal 2002, the announcement was made that Treasury's Office of Tax Analysis and the IRS had begun to work together on creating a panel sample that would follow the same taxpayers for at least 10 years, beginning with tax year 1999.<sup>47</sup> Somewhat troubling, however, was the qualification that this sample was intended primarily as a method for evaluating *only* those tax expenditures designed to increase savings. Only a vague reference was made to "other efforts" related to data acquisition that would continue over the next several years. Obviously, this left open the question of what exactly was being done in preparation for conducting reviews of the multitude of tax expenditures unrelated to savings. The fiscal 2003, 2004, 2005, 2006, and 2007 budgets offered no additional detail regarding progress made toward creating a tax expenditure performance review system.

The fiscal 2008 and 2009 budgets did add some more emphasis, at least cosmetically, to tax expenditure performance review by creating a separate appendix in the "Analytical Perspectives" section titled, "Performance Measures and the Economic Effects of Tax Expenditures."<sup>48</sup> In terms of actual substance, however, very little changed and the section continued to serve merely as an illustrative discussion of potential criteria that could be used to evaluate tax expenditures at a later date.<sup>49</sup> Even the OMB continued to admit that its discussion of the topic was "incomplete, omitting important details both for the provisions mentioned and the many that are not explicitly cited."<sup>50</sup> Ultimately, the most to come out of the fiscal 2009 budget on this issue was the 11th promise in 11 years to review, "over the next few years," the data issues facing tax expenditure review.<sup>51</sup>

## VI. Interpretations of Executive Branch Inaction

The GAO highlighted these delays in a 2005 report, pointing out that "since their initial efforts to outline a framework for evaluating tax expenditures and preliminary performance measures, OMB and Treasury have largely ceased to make progress and have retreated from setting a schedule for evaluating tax expenditures."<sup>52</sup> The GAO blamed this failure on the difficulties associated with coordinating the efforts of the OMB, the IRS, Treasury's Office of Tax Analysis, and other agencies in the manner needed to accomplish a successful review of tax expenditures.

However, one respected former Treasury official explained the problem differently:

*Clinton's Treasury Department, of which I was a part from 1998 to 2000, was unenthusiastic about performing these evaluations, reasoning that a comprehensive evaluation of tax expenditures would necessarily raise serious objections to the measures enthusiastically advanced by the Administration. The result would either be a waste of staff time, as a credible analysis would never be published, or a whitewash that would damage the credibility of Treasury staff. Although the menu of favorite tax expenditures changed*

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<sup>47</sup> FY01 Budget, AP, at 124-127; FY02 Budget, AP, at 77-80.

<sup>48</sup> FY08 Budget, AP, at 324-327; FY09 Budget, AP, at 325-328.

<sup>49</sup> FY08 Budget, AP, at 325; FY09 Budget, AP, at 327.

<sup>50</sup> FY08 Budget, AP, at 327; FY09 Budget, AP, at 328.

<sup>51</sup> FY09 Budget, AP, at 328.

<sup>52</sup> GAO, "Government Performance and Accountability," *supra* note 8, at 58.

*when President Bush took office, the Office of Management and Budget has not published any new tax expenditure analyses as part of GPRA, suggesting that the same concerns still hold sway.*<sup>53</sup>

In reality, both characterizations of the delay likely contain some truth. Although the coordination difficulties pointed to by the GAO are certainly not trivial, it is also unlikely that those difficulties are so insurmountable that they alone could cause the 15-year delay detailed above. Rather, much of the delay must be attributed to the types of political concerns articulated in the quote above, and earlier in this report. But as the next section shows, today may be a more opportune time to break from those tendencies than at any point in recent memory.

## **VII. The Future of Review**

In May 2009 Obama's OMB released the first full proposed budget written under the new administration. Unfortunately, the subsection covering tax expenditure performance review is virtually unchanged from the fiscal 2009 version.<sup>54</sup> This lack of revision is likely attributable, at least part, to the accelerated timetable faced by OMB as a result of the president's brief tenure thus far. And, to be sure, the president and his administration have had no shortage of other issues to address.<sup>55</sup>

At the same time, Obama's policy proposals have hardly been a reprieve from the prolonged flood of federal tax expenditures. On the campaign trail and in the Oval Office, the president has advocated new or expanded tax expenditures for families with children, low-income workers, the elderly, students, homeowners, and businesses. This is not to suggest that the president is indifferent to whether these programs perform efficiently, but it does make clear that the political pressures faced by past presidents have by no means evaporated.

Despite the long standstill on this issue, there are at least six compelling reasons significant progress toward enacting a tax expenditure review system should be made soon. This progress could come in the form of legislation either creating a review system from scratch or mandating that the OMB follow through on the directions contained in the GPRA Senate report. The more likely outcome, however, is that the administration will simply direct the OMB and other relevant agencies to finally begin taking meaningful steps toward bringing tax expenditure performance review to fruition. The reasons that progress on this issue should and very well could be made soon are detailed below.

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<sup>53</sup> Burman, *supra* note 37, at 624.

<sup>54</sup> In fact, a side-by-side comparison reveals only two nongrammatical changes. First, the fiscal 2010 version removes reference to the "income-transfer objectives" of tax expenditures, instead referring to their ability to address "socioeconomic disparity." Second, the fiscal 2010 version wisely deletes a sentence suggesting that "spending programs also require resources to be raised via taxes, user charges, or Government borrowing, which can impose further costs by diverting resources from their most efficient uses." See FY10 Budget, AP, at 327.

<sup>55</sup> On the OMB blog, Orszag says, "Putting together the President's Budget is no easy task — in a transition year, it's particularly challenging. Work that is usually done in six or eight months is done in six or eight weeks. That we were able to put together a budget — while also working on the enactment and initial implementation of the Recovery Act — is a reflection of the dedication and quality of OMB's career staff." Peter R. Orszag, "The Budget Director's Bottom Line: Thank You," OMB Blog (June 2, 2009, 2:04 PM), available at <http://www.whitehouse.gov/omb/blog/09/06/02/TheBudgetDirectorsBottomLineThankYou/>.

## **A. New Data on the Horizon**

The 10th year of panel data gathered by Treasury, described in the fiscal 2002 budget as necessary to review the performance of savings-related tax expenditures, should have been collected some time after the close of the 2008 tax year. Because lack of sufficient data has for years been cited as the primary reason for delay, this development should open up possibilities for analyses that the OMB has so far described as being out of reach.

Oddly, after first announcing the details of this panel sample in the fiscal 2002 budget and later describing its importance in the fiscal 2003 through 2007 budgets, reference to the sample was removed from the fiscal 2008, 2009, and 2010 budgets without explanation. The author's conversations with officials at the IRS confirm, however, that the sample is still being drawn. Its importance both as a tool for conducting meaningful reviews and as a catalyst for bringing about the creation of a review system should not be underestimated.

## **B. Replacing PART**

Although the section of the fiscal 2010 budget that discusses the review of tax expenditures offers little new information, the section describing the administration's intentions regarding PART does provide some interesting detail.<sup>56</sup> In light of a variety of perceived flaws, the Obama administration plans to replace the PART framework with a “reformed performance improvement and analysis framework” that will attempt to “break down silos” by ensuring that “cross-program and cross-agency goals [will] receive as much or more focus as program-specific ones.”<sup>57</sup> The fiscal 2010 budget reiterates that the administration intends to establish a “comprehensive program and performance measurement system that shows how Federal programs link to agency and Government-wide goals.”<sup>58</sup>

If followed to their logical conclusion, these promises require that some consideration of tax expenditures be included under the new framework. Because a large share — indeed, often a majority share — of government effort toward some key policy goals takes the form of tax expenditures, any effort to examine the achievement of cross-program, cross-agency, or governmentwide goals will be impossible without a careful review of tax expenditures.

Despite these realities, the section of the budget describing PART's replacement does not refer to tax expenditures. As the OMB's first-ever chief performance officer and his team begin their work of improving government efficiency over the coming months, the administration's intentions on this matter should become clearer.

## **C. Fulfilling the Transparency Promise**

Subjecting tax expenditures to a performance review system falls squarely under the category of reforms advocated by the Obama administration in its repeated calls for improved government transparency. At present, a lack of transparency exists as a result of tax expenditures not being subject to appropriation or formal review of any kind. Further, the fairly complex way in which many of these programs distribute benefits, in large part because of their interaction with other

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<sup>56</sup> FY10 Budget, AP, at 9-10.

<sup>57</sup> *Id.* at 9.

<sup>58</sup> *Id.*



components of the tax code, suggests that these items are worthy of special attention. Spelling out the objectives and results of these hidden spending programs in a systematic fashion could make the federal government's influence on the economy, and on society more broadly, far more transparent.<sup>59</sup>

#### **D. The Tax Expenditure Breaking Point**

The huge and continually growing size of tax expenditures suggests that a political breaking point may be somewhere on the horizon. As one knowledgeable observer recently noted, tax expenditures, whether measured as a share of GDP or as a share of income taxes, have crept up to levels not seen since just before the Tax Reform Act of 1986, which drastically reduced tax expenditures.<sup>60</sup> If history can provide any clues for the future, perhaps the number and size of the holes poked in the tax base may finally be approaching the level required to inspire the political confidence needed for base-broadening tax reform.

#### **E. Deficit Reduction and Pay-Fors**

The growing need to reduce the nation's unprecedented budget deficit will require creative thinking regarding the operations of government on both the tax and spending sides of the budget. As an underscrutinized area of policy in limbo between these two categories, tax expenditures represent an obvious target for this type of thinking. Their lack of review and reform up to this point has occurred not for reasons of good policy, but because of political and procedural obstacles. To the extent that the increasing urgency of the budgetary situation will require policymakers to overcome these obstacles, a review of tax expenditures could become increasingly well received. More specifically, if conducting official and systematic reviews of these programs can draw attention to their high costs and ineffectiveness, political opportunities for deficit-reducing reform that have thus far been off the table could begin to materialize.

Alternatively, even if outright deficit reduction fails to garner the support that many believe it warrants, the search for pay-fors could create a political landscape in which tax expenditure review would be welcomed. Pay-fors are policy changes (either spending cuts or tax increases) used to offset the costs of new spending programs or tax cuts. Pay-fors are especially sought after in difficult budgetary times because they allow policymakers to pursue favored objectives without worsening an already gloomy budget outlook. At the very least, systematic tax expenditure review could highlight opportunities in which government action could be efficiently reprioritized.

In any case, a performance-focused review system could help reconceptualize these provisions in the minds of policymakers, the media, and the public as spending substitutes rather than simply as tax cuts. If this is the case, at least some of the political bias in favor of enacting and protecting

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<sup>59</sup> The frequency with which tax expenditures are described within the literature as hidden programs should be evidence enough of their lack of transparency. As the former head of the JCT once said, "once implemented, [tax expenditures] are essentially unmonitored by any arm of Congress, and simply disappear below the surface into the mainstream of baseline revenues." See Kleinbard, *supra* note 14, at 934. For more examples, see McIntyre, *supra* note 7; Gist, *supra* note 10, at 146; Jeffrey P. Owen, "Tax Expenditures and Direct Expenditures as Instruments of Social Policy," in *Comparative Tax Studies* (ed. Sijbren Cnossen, North Holland Publishing Co., 1983), at 171-197; Christopher Howard, *The Hidden Welfare State: Tax Expenditures and Social Policy in the United States* (Princeton Univ. Press, 1997); Joann M. Weiner, "Tax Expenditures and the Federal Budget," *Tax Notes*, Feb. 4, 2008, p. 586.

<sup>60</sup> Kleinbard, *supra* note 14, at 931.

tax expenditures could be eroded. Given the enormity of existing and projected budget deficits, this factor is likely the most important of those outlined in this section.

## **F. Experiments in the State Laboratories**

Finally, the implementation of tax expenditure reviews at the state level has increased this issue's visibility and provided lessons from which the federal government can learn. As the next section demonstrates, California, Delaware, Nevada, Oregon, Rhode Island, and Washington have all taken steps beyond what the federal government has done to review the performance of their tax expenditures. The issue has also received significant attention in other states, such as Connecticut, Florida, Michigan, and Wisconsin, although with less success than in those just listed.<sup>61</sup>

## **VIII. Lessons from the States**

State-level efforts to enact and implement meaningful tax expenditure review systems have produced extremely varied results. Some state governments' attempts to create review systems have endured a fate similar to that seen at the federal level. In 2005 Connecticut passed a law creating a Business Tax Credit and Tax Policy Review Committee, designed to annually review the performance of all tax credits offered under the state's corporation business tax.<sup>62</sup> Unfortunately, despite the legal requirement that the committee provide its first round of findings to the Legislature no later than January 1, 2006, the committee has yet to be formed. Wisconsin faces a similar situation, whereby a statutory requirement mandating the review of each state tax expenditure has so far been ignored.<sup>63</sup>

The halfhearted efforts on display in these two states are unfortunately symptomatic of a larger problem. Although there are policymakers who genuinely support the implementation of a rigorous tax expenditure review system, state and federal experiences thus far have also revealed a tendency for lawmakers' support to be much more enthusiastic in public speeches than in the actual policy process. Being able to claim that one has at least attempted to make government more transparent is no doubt good politics. In this light, a degree of skepticism is appropriate when examining proposed and enacted tax expenditure review systems, although there are states that have made significant strides toward implementing very useful systems.

For instance, one recent study found that a handful of states publish evaluations of the effectiveness of many tax expenditures in their regular tax expenditure reports.<sup>64</sup> California and

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<sup>61</sup> Florida's most direct experience with this issue was with the FAIR Amendment, which was struck from the 2004 ballot for technical reasons by the state's supreme court. Michigan's experience came in the form of reviews and recommendations on tax expenditures in the state's fiscal 2006, 2007, and 2008 budgets — although that section of the budget has since been discontinued. Connecticut's and Wisconsin's experiences are described in the next section.

<sup>62</sup> 2005 Conn. Acts 251 (now Conn. Gen. Stat. ch. 208, section 12-217z).

<sup>63</sup> Jason Levitis, Nicholas Johnson, and Jeremy Koulisch, "Promoting State Budget Accountability Through Tax Expenditure Reporting" (Center on Budget and Policy Priorities, 2009), at 28.

<sup>64</sup> Here the term "tax expenditure report" refers to a document that lists and measures the size of each tax expenditure. The federal government and 41 states produce those reports. *Id.* at 41.

Delaware are two examples of states that conduct meaningful reviews in this fashion. Other states using this method have been less than meticulous in their evaluations.<sup>65</sup>

Rhode Island has also recently taken action on the tax expenditure review front. Although the state does not publish formal reviews of tax expenditures, legislation enacted in 2008 requires the release of information that could be used in conducting reviews of six categories of corporate tax credits. The names of credit recipients, amount of credit received, jobs created or retained, and employee wages and benefits are among the results of the credits that must be made public.<sup>66</sup> Many other states release similar information crucial to reviewing the effectiveness of their business tax expenditures.<sup>67</sup>

Nevada voters in November 2008 took the tax expenditure review concept a bit further, approving a constitutional amendment prohibiting the enactment of any tax exemption unless its benefits are found by the Legislature to exceed its costs.<sup>68</sup> However, because the amendment provides no criteria for making this finding, there is reason to be concerned that the Legislature's reviews may lack sufficient rigor or impartiality.<sup>69</sup>

Nevada's constitution also now requires that all tax exemptions enacted after November 2008 be saddled with a sunset provision.<sup>70</sup> The goal of this requirement is to force lawmakers to periodically reexamine tax exemption performance by mandating legislative action to continue an exemption beyond a specified number of years. Oregon adopted a similar practice in August 2009, enacting legislation that applied sunsets to the vast majority of its tax credits and set the standard that tax credits enacted in the future be designed to expire after six years.<sup>71</sup> Although sunset techniques possess the same focus on review that is emphasized in this report, they differ from typical performance reviews in that they are designed to provide additional information *and* to alter the actual policy process. The linkage between sunsets and performance reviews is revisited briefly in Section IX.D.

But arguably the most thorough and transparent review system to be implemented is Washington's 10-year performance review cycle created in 2006.<sup>72</sup> The Washington system relies on a combination of efforts from nonpartisan legislative auditing staff, elected officials, appointed

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<sup>65</sup> California, Delaware, Iowa, and Oregon are identified as the states including those evaluations in their tax expenditure reports. Louisiana officially performs a similar exercise, although only in an opaque manner with questionable usefulness. *Id.* at 28, 41.

<sup>66</sup> Unfortunately, despite an October 2008 deadline, information regarding job creation, wages, and employee benefits resulting from the credits has yet to be released. The names and addresses, as well as the amounts of credit received, have been published for fiscal 2008 and 2009, however. See "Tax Incentive Disclosure and Accountability," Tax Facts, Sept. 2009 (The Poverty Institute at the Rhode Island College School of Social Work), available at [http://www.povertyinstitute.org/matriarch/documents/FY2009%20Tax\\_Incentive\\_Disclosure\\_and\\_AccountabilityFINAL.pdf](http://www.povertyinstitute.org/matriarch/documents/FY2009%20Tax_Incentive_Disclosure_and_AccountabilityFINAL.pdf).

<sup>67</sup> See Philip Mattera et al., "The State of State Disclosure: An Evaluation of Online Public Information About Economic Development Subsidies, Procurement Contracts, and Lobbying Activities," Good Jobs First (rev. Nov. 2007). A very cursory examination of the sources referenced in Mattera et al. reveal at least nine states that disclose some amount of information on the recipients of at least one tax expenditure (Connecticut, Florida, Indiana, Iowa, Maryland, Missouri, New Jersey, Pennsylvania, and Vermont). A more thorough examination would doubtless reveal many more.

<sup>68</sup> Nev. Const. art. 10, section 6.

<sup>69</sup> Nicole M. White, John Buhl, and Karen Setze, "State Tax Ballot Battles Brewing," *State Tax Notes*, Nov. 3, 2008, p. 263.

<sup>70</sup> Nev. Const. art. 10, section 6.

<sup>71</sup> HB 2067, 2009 Or. Leg. Reg. Sess.

<sup>72</sup> Many of the details of this system can be found on the Web site of the Citizen Commission for Performance Measurement of Tax Preferences available at <http://www.citizen taxpref.wa.gov/>.

citizens, experts, and ordinary state residents.<sup>73</sup> This design helps mitigate some of the difficulties that can arise from mandating that one agency understand the intricacies of policies ranging from education to agriculture, transportation, healthcare, and others.

Washington's review cycle begins when a commission of politically appointed citizens — the Citizen Commission for Performance Measurement of Tax Preferences — establishes the 10-year schedule for evaluating most tax expenditures contained in Washington's tax code.<sup>74</sup> The commission is also given some discretion in determining which expenditures will be reviewed.<sup>75</sup> That schedule is submitted to the nonpartisan staff of the Joint Legislative Audit and Review Committee (JLARC), which is required by statute to follow GAO auditing standards.<sup>76</sup> The JLARC evaluates the expenditures based on their objectives, beneficiaries, effectiveness, unintended consequences, the impact of their repeal, and a variety of other important dimensions.<sup>77</sup> Ultimately, recommendations are made to either continue, modify, reexamine, or terminate the preference, and those recommendations and the accompanying report are passed back to the citizen commission for comment. Before commenting, the commission hears public testimony on the provisions, which adds another source of information to the process beyond what was considered by the JLARC. Then, on consideration and comment from the citizen commission, the recommendations are forwarded to a joint hearing of the legislative fiscal committees for consideration, thereby ensuring that they receive at least some attention in the actual policy process.

So far, the Washington system has been used to conduct 75 tax expenditure reviews. Two-thirds of those reviews have resulted in a recommendation from the JLARC that the tax expenditure be allowed to continue.<sup>78</sup> When considering this figure, it is important to note that a recommendation that a tax expenditure be continued signifies only that the expenditure is fulfilling the JLARC's understanding of its intended purpose. Whether that purpose is desirable and can be achieved at a reasonable cost is not typically considered in the recommendation.<sup>79</sup> The JLARC has also recommended that the Legislature reexamine a tax expenditure (17 times), allow a tax expenditure to expire (5 times), or terminate the tax expenditure (3 times). Reexaminations are typically recommended when the JLARC cannot determine with certainty the intended purpose of the provision or when the available data do not allow for an adequate measurement of the

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<sup>73</sup> *Id.* See also the description of the Joint Legislative Audit and Review Committee study process, available at <http://www.leg.wa.gov/JLARC/StudyProcess/>.

<sup>74</sup> Several significant tax expenditures are exempted from review, including those required by constitutional law; sales and use tax exemptions for machinery and equipment for manufacturing, research and development, or testing; the small-business credit for the business and occupation tax; sales and use tax exemptions for food and prescription drugs; property tax relief for retired persons; and property tax valuations based on current use. Also, the citizen commission can exempt other expenditures from review if it judges them to be a "critical part of the structure of the tax system," and expenditures costing less than \$10 million every two years can be subjected to a simpler, "expedited review." See Wash. Rev. Code section 43.136.045 (1).

<sup>75</sup> *Id.* Further, the commission decided that personal and professional services should be excluded from review because they are not "part of the original tax base." See Citizen Commission for Performance Measurement of Tax Preferences, "Meeting Minutes: November 1, 2006," available at <http://www.citizen taxpref.wa.gov/documents/minutes/Minutes%2011-1-06%20Final.pdf>.

<sup>76</sup> *Supra* note 74.

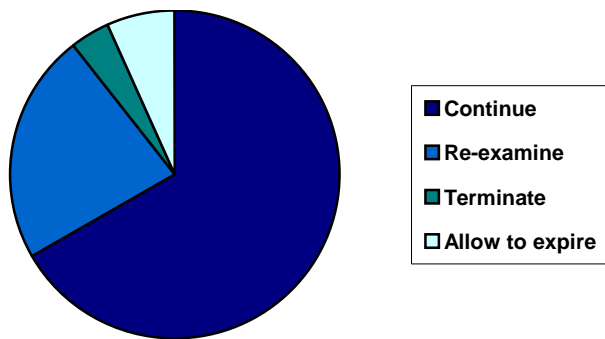
<sup>77</sup> For the complete list of criteria, see the table later in this report, or see Wash. Rev. Code section 43.136.055.

<sup>78</sup> These figures include the 2009 preliminary reviews. Totals are calculated based on information from the JLARC report summaries, available at <http://www.citizen taxpref.wa.gov/reports.htm>.

<sup>79</sup> This point is discussed further in the Section IX, Building a Review System.

provision's effects. As indicated in the chart above, the JLARC has recommended the elimination (either by termination or expiration) of only a small fraction of all tax expenditures — a little over 10 percent. The vast majority of the JLARC's recommendations have been endorsed by the citizen commission.

**JLARC Recommendations for Legislative Action on Reviewed Tax Expenditures**  
(out of 75 reviews thus far)



More than a dozen bills introduced in the 2009 session proposed to implement JLARC recommendations.<sup>80</sup> Final, direct action was taken by Washington policymakers on only one of the JLARC recommendations: changing the structure of the state's tax expenditures for alternative energy.<sup>81</sup> Another JLARC recommendation was adopted by default when a tax expenditure for beef processors, related to mad cow disease restrictions, was allowed to expire.<sup>82</sup> And, of course, many other JLARC recommendations have been implicitly adopted by policymakers' decision to allow various tax expenditures to continue unchanged.

Admittedly, the Washington system's rate of success during its short existence has been fairly modest. As more tax expenditures are reviewed each year, however, the opportunities for successful policy change will continue to grow. Further, this author's conversations with policy advocates in the state have revealed a feeling on the ground that the probability of implementing the JLARC's recommendations could be improved substantially if advocates and organizers expended greater effort to publicize its results. This is unsurprising, because tax expenditure battles often come down to a well-organized minority versus the largely indifferent majority. Performance reviews can be understood as a tool with which to reduce the majority's indifference, although it is up to advocates and policymakers to use that tool.

The Washington system also suffers from the fact that a variety of significant tax expenditures are immune from review, largely as a result of the political compromises needed to enact the system.<sup>83</sup> Further, the 10-year cycle on which the review process operates leaves each tax expenditure unexamined for significant periods between reviews, although limitations on staff resources and legislator time likely do require some type of multiyear schedule.

The order of reviews is also arguably flawed. Rather than allowing for the reviews to be undertaken in order of size, importance, magnitude of public interest, or some other relevant factor, the citizen commission is instructed to create the review schedule based first and foremost on each expenditure's date of legislative enactment.<sup>84</sup> This chronological ordering also limits the

<sup>80</sup> Data provided by the JLARC.

<sup>81</sup> Engrossed Senate Substitute Bill 6170 of the 2009-2010 legislative session. For the JLARC recommendation on this issue, see State of Washington Joint Legislative Audit and Review Committee, "2008 Full Tax Preference Performance Reviews," Report 09-3 (2009), at 211-232.

<sup>82</sup> State of Washington Joint Legislative Audit and Review Committee, "Tax Preference Performance Review: Beef Processors," Report 07-7 (2007).

<sup>83</sup> See *supra* notes 74 and 75.

<sup>84</sup> Wash. Rev. Code section 43.136.050 (1).

commission's ability to schedule similar tax expenditures for concurrent review, although some flexibility is allowed in this regard.

On the whole, however, Washington's system is preferable to the status quo in which tax expenditures tend to continue for years with little attention, protected from the appropriations process by procedural rules, and protected from all other scrutiny by political calculations. The federal government, as well as the other 49 states and the District of Columbia, would do well to study the efforts of Washington.

## **IX. Building a Review System**

The previous section touched on a variety of issues related to the design of a tax expenditure review system. Like the 13 budgets preceding it, the fiscal 2010 federal budget points out the difficulties of creating an effective review system: "Developing a framework that is sufficiently comprehensive, accurate, and flexible to reflect the objectives and effects of the wide range of tax expenditures will be a significant challenge."<sup>85</sup> The following subsections examine some of the factors that should be taken into consideration when designing such a framework. This discussion purposefully raises more questions than it answers and leaves many others unexplored. The intent is only to draw attention to some of the key details that must be addressed before implementing the type of review system discussed more generally throughout this report.<sup>86</sup>

### **A. Who Conducts the Reviews?**

#### **1. Federal reviews**

At the federal level, deciding on the appropriate body to head up a tax expenditure review system is no easy task. The OMB's control of the direct spending performance review process may, at first glance, appear to make the agency a natural choice for conducting tax expenditure reviews. But tax expenditure reviews are substantially different from direct spending reviews. While direct spending reviews require working with numerous agencies with varying policy focuses (a task with which the OMB is familiar), an effective tax expenditure review process focuses primarily on examining the tax law and relevant data. These are not tasks for which the OMB is better suited than other potential candidates for coordinating the review process.

Also, while direct spending programs can be made more effective through changes in agency behavior, meaningful tax expenditure reform almost always has to be effected through changes to the tax law. This implies that the organization in charge of tax expenditure review must be responsive to, and viewed as credible by, lawmakers. Unfortunately, the OMB's track record on working with lawmakers in Congress is not very promising in this regard.<sup>87</sup>

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<sup>85</sup> FY10 Budget, AP, at 329.

<sup>86</sup> Methods for integrating tax expenditure and direct expenditure review systems are not discussed in the following sections. To evaluate all government programs within the proper context, examinations of these two types of expenditures must be coordinated in some way. The following sections do not attempt to describe the appropriate form of that coordination, and instead focus primarily on questions unique to the evaluation of tax expenditures. Issues of coordination represent an excellent opportunity for future research.

<sup>87</sup> GAO, "Performance Budgeting," *supra* note 17.

As a result, tax expenditure reviews may be best handled by a body better suited to working closely with Congress, such as the GAO, the Joint Committee on Taxation, or a new congressional joint committee modeled after Washington's JLARC. For tax expenditure review, the ability of these organizations to work with Congress is a far greater asset than the OMB's experience in dealing with executive agencies.

Before implementing a tax expenditure review system, the creation of a presidential advisory panel tasked with working out the details of such a system could be very useful. Because the presidents' budget for the past 14 years has lamented that the creation of a tax expenditure review system will be a significant challenge, a thorough and transparent investigation into the appropriate design of that system is a reasonable first step.

The panel's work should be narrowly focused on only the design of a tax expenditure review system, which should make reaching a productive consensus much easier than when panels have been tasked with more daunting, big-picture tasks. By making the panel's deliberations public and opening up the process to outside comments, the review system produced will be viewed with greater legitimacy in the eyes of both Congress and the president. Moreover, holding a public discussion on this issue by means of the panel's work could also help inform state-level efforts toward implementing review systems and would provide policy advocates and other interested parties with the information needed to productively scrutinize the work of the panel.

The advisory panel should be chaired by the OMB's chief performance officer, and would ideally involve key officials from the JCT, Treasury's Office of Tax Analysis, and the IRS's Statistics of Income Division. The inclusion of officials from the GAO and the Congressional Budget Office as well as staff or members from the congressional taxwriting committees could also benefit the panel's work. Additional seats for outside experts could be made available at the president's discretion. Including individuals from a broad range of agencies would help counteract the insular tendencies that have dominated direct spending reviews in years past, although care must be taken to keep the panel from growing too large to be effective.

## **2. State reviews**

At the state level, assigning a body to coordinate tax expenditure reviews is also a difficult task. Given the variability in state governmental structures, no single design will be appropriate for every state.

One common misconception worth noting, however, is the belief that state revenue agencies are the natural bodies to perform those reviews. Performance reviews are substantially different from tax law enforcement or revenue estimation and measurement. Even though a revenue agency may be skilled at administering a tuition tax credit, for example, it may still lack the tools and expertise needed to judge the educational outcomes of that credit. Program evaluation training and the ability to coordinate between lawmakers, agencies, experts, and other interested parties across policy areas are much more important than an intimate familiarity with the tax law. Revenue agencies undoubtedly must be involved in the reviews, but whether they should be in charge of them is another question entirely.

### **B. When Should the Reviews Occur?**

As discussed above, Washington conducts its performance reviews on a 10-year cycle. This schedule allows for the reviews to be done by a smaller staff and with greater detail than would be possible on a more accelerated schedule. It also has the added benefit of not overwhelming

policymakers by requiring that they review recommendations on hundreds of tax expenditures simultaneously. Especially because of this second reason, a multiyear review schedule may make sense even at the federal level, although a 10-year cycle is likely much longer than is either necessary or desirable.

Using a multiyear review schedule raises the question of how to order the reviews. A variety of techniques could be used. Conducting the reviews in order of size would ensure that the largest and most important provisions do not slip by without proper scrutiny for any longer than necessary. Alternatively, less complex or less controversial analyses could be conducted at the outset as a way to test the review framework and allow time for public comment before the more significant reviews occur.<sup>88</sup>

Another option would be to allow for discretion regarding which provisions are likely to be politically relevant in the near future. Preferential tax rates for capital gains income represent an obvious starting point, as those rates are scheduled to increase under current law at the end of 2010. This would not be a viable long-term strategy for structuring the review process, although it would ensure that the process produces the most useful performance information upfront.

Also, the timing of the review process should be calibrated in a way that takes into consideration the policymaking schedules of the legislative and executive branches. Releasing the results of these reviews in a manner that allows committee hearings and broader debates to occur soon afterward would help maximize their effect on the policy process.

Arguably, the most important timing issue is ensuring that related tax expenditures are reviewed simultaneously. The mortgage interest deduction, for example, is best viewed in the context of the many other tax expenditures that subsidize housing.

Ideally, these reviews would also occur alongside a review of direct spending programs operating in the same issue area. The additional perspective on government's broader purposes that could be provided by conducting reviews in this way would be quite valuable. Admittedly, aligning reviews of tax expenditures and direct expenditures will involve a substantial amount of effort (especially if these two types of reviews are coordinated by different organizations), but the potential payoff of this effort would also be substantial.

### **C. What Should the Reviews Include?**

The most important design issue is determining what the reviews should contain. This involves deciding both the provisions to be reviewed and the methods used to review them.

#### **1. Which taxes, and which tax provisions?**

Ideally, all significant taxes should be included in the analysis — personal income taxes, corporate income taxes, payroll taxes, transfer taxes, and excise taxes being the most relevant at the federal level. Each type of tax brings its own challenges in conducting tax expenditure reviews, but overcoming those obstacles is necessary for a truly comprehensive perspective.<sup>89</sup> Most notably,

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<sup>88</sup> This approach could also help prevent the further stalling of review implementation by delaying the debate over which provisions qualify as tax expenditures. As the GAO points out, "any effort to more systematically oversee tax expenditures . . . initially could concentrate on those tax expenditures upon which agreement already exists" that they are in fact tax expenditures. See GAO, "Tax Policy," *supra* note 8, at 105.

<sup>89</sup> For example, the fiscal 2001 budget said: "Payroll tax exclusions are complex to analyze . . . because they also affect social insurance benefits. Certain targeted excise tax provisions might also be considered tax expenditures. In this case challenges include determining an appropriate baseline." Further, the fiscal 2003 budget, in its elimination of transfer tax (*i.e.*, estate and gift tax) analyses, asserted that "there is no generally accepted normal baseline for transfer taxes." Some analysts, however, have



when controversy arises over which provisions truly are tax expenditures (as opposed to ordinary components of the tax law), the review system should err on the side of inclusiveness by examining the provisions.<sup>90</sup> After all, the purpose of a review is to provide additional information — and in any case, any adequate review will pay ample attention to the purely tax-policy-based reasons a provision may exist.

The reviews should also include all types of tax expenditures — including exclusions, exemptions, deductions, deferrals, credits, and preferential rates, for example. Oregon's focus on only tax credits and Nevada's attention to only tax exemptions are two examples of states failing to live up to this standard.

## 2. What criteria?

Washington's review system offers a useful starting point for discussion of the factors worth considering during the course of review. The 10 required factors listed in the table below are taken directly from Washington's revised statutes.<sup>91</sup> Other factors can be considered at the reviewers' discretion, and it is hardly a challenge to imagine other criteria worth contemplating during the course of a tax expenditure review.

The negative consequences (intended or otherwise) of tax expenditures on individuals, organizations, and industries are one example worth adding to the list. Also, item 7 in the table could be expanded to require considering means testing as a method of reducing tax expenditure costs. An especially intriguing factor worth adding would be a requirement that the review consider why the tax code was chosen as the vehicle for administering the expenditure and whether converting the tax expenditure to a direct spending program would be both feasible and desirable.

## 3. The definition of performance.

One fundamental decision to be made in designing a review system involves setting the standards by which performance is defined and measured. Should the review simply catalogue the direct purposes meant to be fulfilled by the expenditure, and measure its ability to achieve those ends? Or should a more ambitious examination of the expenditure's underlying purposes also be undertaken? On one hand, an estimate of the number of families that purchased homes because of the mortgage interest deduction would be of significant value to the policy debate and could reasonably be understood as a useful measure of the deduction's performance. However, a review that focused only on measuring the deduction's direct results (that is, changes in the level of homeownership) would completely miss the more fundamental question of whether any resultant increases in the rate of homeownership produced significant gains for society.<sup>92</sup>

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downplayed the baseline difficulties surrounding excise and transfer taxes, and have even gone so far as to dub the elimination of transfer tax analysis from the budget as mere "political filtering." See FY01 Budget, AP, at 124; FY03 Budget, AP, at 95; Burman, *supra* note 37, at 614, 626.

<sup>90</sup> See *supra* note 88. See also Michael J. McIntyre, "A Solution to the Problem of Defining a Tax Expenditure," 14 *U.C. Davis L. Rev.* 79-103 (1980).

<sup>91</sup> Wash. Rev. Code section 43.136.055.

<sup>92</sup> Admittedly, a more thorough review of this type may at times be exceedingly difficult as a result of data constraints and technical obstacles. Quantifying the broad value to society of an incremental increase in homeownership, for example, is no easy task. The benefits (e.g., an increase in community solidarity) and the costs (e.g., loss in labor market mobility) hardly lend themselves to an easy comparison. A review that took on those questions could allow for what some would consider an uncomfortable degree of analyst discretion, although addressing only the easy or uncontroversial questions is hardly a preferable alternative. Ultimately, some attempt at this more meaningful type of review is justifiable wherever possible.

## Factors That Must Be Considered in Washington State Tax Expenditure Performance Reviews

1. The classes of individuals, types of organizations, or types of industries whose state tax liabilities are directly affected by the tax preference;  
  
Public policy objectives that might provide a justification for the tax preference, including but not limited to the legislative history, any legislative intent, or the extent to which the tax preference encourages
2. business growth or relocation into this state, promotes growth or retention of high wage jobs, or helps stabilize communities;
3. Evidence that the existence of the tax preference has contributed to the achievement of any of the public policy objectives;
4. The extent to which continuation of the tax preference might contribute to any of the public policy objectives;
5. The extent to which the tax preference may provide unintended benefits to an individual, organization, or industry other than those the legislature intended;  
  
The extent to which terminating the tax preference may have negative effects on the category of
6. taxpayers that currently benefit from the tax preference, and the extent to which resulting higher taxes may have negative effects on employment and the economy;
7. The feasibility of modifying the tax preference to provide for adjustment or recapture of the tax benefits of the tax preference if the objectives are not fulfilled;  
  
Fiscal impacts of the tax preference, including past impacts and expected future impacts if it is continued. For the purposes of this subsection, "fiscal impact" includes an analysis of the general effects
8. of the tax preference on the overall state economy, including, but not limited to, the effects of the tax preference on the consumption and expenditures of persons and businesses within the state;
9. The extent to which termination of the tax preference would affect the distribution of liability for payment of state taxes;
10. Consideration of similar tax preferences adopted in other states, and potential public policy benefits that might be gained by incorporating corresponding provisions in Washington.

This point is especially important when some may construe the purposes of the provision as directly contrary to good policy — such as a tax expenditure designed to promote an industry that typically creates few if any economic benefits for its host community (an industry with a low multiplier effect). If a special tax break serves its purpose by attracting (and enriching) an industry that does little to improve the lives of residents in the surrounding area, is it fair to say that the program performed well?

A working definition of performance is also important when considering tax expenditures that have several unintentional consequences. Should unintentional, but beneficial, consequences of the expenditure receive significant attention in the review, or should more emphasis be placed only on those results that have been identified by policymakers as being the goals of the provision? The following section explores issues of this type in greater detail.

At the very least, this discussion should make clear that a well-defined concept of performance must be included prominently in the review so the results can be put in the proper context.<sup>93</sup>

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<sup>93</sup> Further, the measure of performance chosen must be focused on some type of valued outcome. Simply counting the number of families that claimed the mortgage interest deduction in a particular year, for example, provides no information regarding the deduction's desired incentive effects. Although this may seem obvious, PART suffered from this shortcoming; see Section IV.

#### 4. Should recommendations be included?

Another important issue is whether the review process should result in explicit recommendations on what policy actions should be taken. Recommendations can add a useful bottom line to the reviews, ensuring that their results are more easily digestible, and perhaps even producing some excitement surrounding the review's release. But recommendations also come with limitations.

In its purest form, a review process designed to produce recommendations would look directly at the costs and benefits of the provision, and recommend continuation only if the resources expended by the provision could not be expended in some more efficient manner (either by spending the money in a different way or by lowering taxes more broadly). With its focus on the well-being of society and the full range of options available to policymakers, this would be the most thorough type of review from an economic perspective. But a review structured in this way would be exceedingly difficult to conduct given its immense scope, and would likely be of limited utility given political realities.

The question then becomes, barring this kind of exhaustive analysis, what threshold should be used for deciding whether to recommend that a tax expenditure be continued? A decision must be made on whether to adopt the narrower or more sweeping definition of performance, described above. The reviewers must also decide whether a tax expenditure intended to fulfill a variety of purposes should be continued even if only some of those purposes are being adequately addressed. And what of unintentional benefits, especially in cases of older tax expenditures that were enacted under very different conditions than today? Should valuable but accidental or unforeseen results of a tax expenditure count in the decision to recommend its continuation?

These are just a few of the questions that must be answered before establishing a system of providing recommendations on tax expenditure provisions.

It is worth noting that the reviewers' job might be made more manageable if, for tax expenditures with numerous or unclear purposes, they are allowed to identify in the review report key areas of uncertainty and to request that the legislature provide clarification. This is done frequently under the Washington review system. Additional insight from policymakers on what they would like to achieve through the use of specific tax expenditures is of value both in the course of conducting reviews and in encouraging policymakers to think critically about the public policies for which they are responsible. As federal experience with PART shows, legislators are more likely to be receptive to a review's recommendations if they are allowed some type of role in the review process. There are limitations to this approach, however, such as the time constraints faced by policymakers and the fact that many provisions are enacted or continued by groups of policymakers who may have very different objectives.<sup>94</sup> Further, requesting legislative reexamination, as opposed to providing an official policy recommendation, does reduce some of the potency of the recommendations. This is the cost of safeguarding against situations in which the reviewers may be forced to speculate regarding the intended purposes of the provisions they are reviewing.

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<sup>94</sup> Imagine a generic, hypothetical tax expenditure for businesses. Such an expenditure could be supported by Legislator A as a means of encouraging economic growth, by Legislator B as a way to "starve the beast," and by Legislator C as a way to reward a loyal campaign contributor. Under such a scenario, there may not be a useful "legislative intent" behind the provision. If legislators A and C are uninterested in starving the beast, for example, the reviewers will be unable to find a coherent set of objectives to focus on in making recommendations.

## **D. Action-Forcing Mechanisms**

Mechanisms for forcing policymakers to consider the results of tax expenditure performance reviews are by no means central to the reviews themselves. Still, in terms of practical effect, no issue may be more important. The authorization and appropriations processes already require that time be spent deciding whether to continue specific direct spending programs and deciding the amount of funding they will receive. Explicitly including tax expenditure reviews in the policy process could help place tax expenditures on a more equal footing with ordinary spending programs.

Requiring committee hearings to be held on performance review reports (as in Washington) represents one fairly modest option. More aggressive action could be taken by increasing the use of sunset provisions in a way that forces policymakers to take direct action to continue a reviewed tax expenditure. One analysis of sunset provisions in California found them to have greatly increased the possibility of removing or modifying a tax expenditure program, although evidence on the effectiveness of this technique at the federal level has been mixed at best.<sup>95</sup> A middle ground between these two alternatives could be a requirement that the head of the executive branch (whether a president or governor) make explicit recommendations in his proposed budget regarding each tax expenditure that has been reviewed.

In the end, finding a productive way to inject a tax expenditure performance review into the actual policy process could reduce the procedural biases that have caused observers to refer to these programs as hidden entitlements.<sup>96</sup>

## **X. Conclusion**

Federal tax expenditure performance review has the potential to direct much-needed attention to a large and often poorly understood area of public policy. Such a reform would reduce the political and procedural biases toward conducting public policy through special tax breaks. Tax expenditure review has already been contemplated or otherwise worked on to some extent by Congress, the OMB, the GAO, the IRS, and Treasury's Office of Tax Analysis. Various states have also already implemented such a practice, and others would benefit by following suit.

As outlined in this report, a variety of recent developments, including the coming availability of new data, the recently proposed replacement of PART, experiences in the states, the sheer size of existing tax expenditures, the magnitude of current budget deficits, and the administration's repeated calls for greater government transparency, all strongly suggest that the time is ripe for the implementation of a tax expenditure review system. Ultimately, the most important among

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<sup>95</sup> See Mark A. Ibele and Jon David Vasche, "Tax Expenditure Reporting in California: Lessons and Opportunities," in Proceedings of the National Tax Association's 92nd Annual Conference on Taxation, Atlanta, Oct. 24, 1999. At the federal level, the tax "extenders" package is the single area in which sunset provisions are most frequently and visibly used. The package consists of several tax expenditures that are typically renewed for no more than one- or two-year periods. Unfortunately, many believe this use of sunsets to be a result only of a desire to artificially minimize the provision's long-term cost, and politicians' desire to retain the support of lobbyists and campaign contributors. One former House Ways and Means Committee staffer tells a story of a member admitting this second point during a late night markup of the extenders bill. See Diane Lim Rogers, "The Trouble With 'Tax Extenders,'" EconomistMom.com, May 23, 2008, available at <http://economistmom.com/2008/05/the-trouble-with-tax-extendere/>.

<sup>96</sup> See *supra* notes 7 and 59.

these factors will likely be the magnitude of current and future budget deficits. It is difficult to imagine a desirable scenario under which the U.S. government could restore fiscal sustainability without taking a closer look at the more than \$1 trillion spent annually through the tax code. A performance review system would help provide that closer look.