

EXTERNAL APPENDICES TO CHAPTER 12

Appendix X-12.1 HIDDEN EXPENDITURES IN THE FEDERAL BUDGET

This appendix deals with three types of hidden expenditures: tax-expenditures, off-budget expenditures, and inter-governmental transfers.

A. Tax-Expenditures

The tax system can serve as an important substitute for government expenditures since any tax exemption granted to a particular group acts, in effect, as a subsidy; and for understanding the operations of government it should be considered as such.¹ Subsidies, however, are easy to spot and open to political attack. For two reasons it is politically easier to benefit a particular group through a tax-expenditure: Their magnitude much more difficult to estimate. Further, as noted in the text, their beneficiaries are more difficult to determine, which makes it easier to target quietly such measures to benefit certain upper-income groups who are the major contributors to political campaigns. For instance, in 1981 the top 30 percent of income earners (those earning over \$50,000 in 1998 dollars) obtained roughly 72 percent of the benefits of 17 major tax-expenditures.²

Estimates of federal tax-expenditures, as shown in Panel A of Table X-12.1, are large and amount to somewhat more than 5 percent of the GDP. Although it would also be useful to present tax-expenditures of state and local governments, such estimates have, unfortunately, not yet been calculated. Several

¹ The classical discussion of these tax-expenditures is by Surrey and McDaniel (1985); and the politics underlying them are analyzed sensitively by Howard (1997). Forman (1986) has a useful discussion of their estimation for the U.S. and the OECD (1984, 1996-b) has a similar discussion for many other industrialized countries.

² The Congressional Joint Committee on Taxation made estimates for 17 major tax-expenditures, which are cited by Surrey and McDaniel (1985), pp. 72 - 5.

characteristics of federal tax-expenditures are worth noting:

Table X-12.1: Federal Government: Trends in Off-Budget Spending and Tax-Expenditures

Panel A: Tax-Expenditures

ViFedExp = visible, federal expenditures (that is, expenditures shown in the published budget)

TotEx = ViFedExp + tax-expenditures

TE = tax-expenditures (expenditure equivalent)

	ViFedExp as Percent of GDP		TE as percent of GDP		TE as percent of TotEx	
	1968	1997	1968	1997	1968	1997
Total (except intergovernmental transfers)	22.4%	22.1%	5.1%	6.7%	18.4%	23.2%
Administrative, international and domestic security, interest	13.0	8.0	0.1	0.2	1.0	2.3
Education, welfare, health of which:	7.4	12.5	2.0	3.8	21.5	23.4
Education and science	0.5	0.4	0.2	0.1	25.9	20.3
Health, medical care	1.2	4.2	0.4	1.2	26.1	22.1
Retirement	3.2	4.8	0.8	1.7	19.8	26.3
Disability	0.4	0.7	0.0	0.1	4.5	11.2
Labor training, unemployment, other services	0.5	0.4	0.0	0.0	7.2	0.4
Welfare, other income subsidies	0.6	1.5	0.5	0.7	46.1	31.5
Veteran benefits, services	0.9	0.6	0.1	0.0	6.5	6.1
Housing, community development expenditures	0.2	0.4	0.5	1.3	73.0	75.7
Other expenditures for the economy	1.9	1.1	5.0	2.4	55.1	54.4

Panel B: Off-Budget Expenditures

	Total off-budget expenditures As percent of total federal on-budget expenditures (fiscal year calculation)		As percent of GDP (calendar year calculation)	Net off-budget expenditures (surplus = +) as percent of total federal on- budget expenditures (fiscal year calculation)
1950-59	5.7%		1.0%	2.1%
1960-69	15.1		2.5	0.5
1970-79	24.4		3.6	0.4
1980-89	23.7		4.3	1.3
1990-97	23.1		4.0	5.0

Notes: In Panel A 1968 data are for fiscal 1968, while data for 1997 are for the calendar year. The TE data were rearranged to correspond to the expenditure categories. The 1968 data represent only rough estimates, because the original source gave only the revenue impact, so that the expenditure equivalents were estimated by using the 1997 ratios of revenue loss to expenditure equivalents. For both years, inter-governmental transfers or expenditures for the Postal Service are not included in either the TE or the ViFedExp. For 1968 the calculated tax-expenditures representing the standard deduction in the income tax are also omitted, since in 1997 they were not considered a TE.

Budgetary data on off-budget expenditures come from Executive Office of the President, Office of Management and the Budget (annual, various issues). Data on tax-expenditures for fiscal 1968 come from Stanley Surrey (1969, pp. 322-40); 1997 data come from Executive Office of the President, Office of Management and the Budget (1998, pp. 91-103). Data on explicit federal expenditures and GDP come from national accounts data from Department of Commerce, Bureau of Economic Analysis (1998, pp. 3, 197) and from the BEA website.

* As a percent of visible expenditures, tax-expenditures were unimportant in the category of “general governmental expenditures” (expenditures for administration, international and domestic security, and interest payments). Furthermore, most of these tax-expenditures were various types of tax credits for investment abroad, which for unknown reasons the government classifies under “external security.”

* Tax-expenditures amounted to somewhat less than one fourth of total federal expenditures for education, health, and welfare; somewhat more than half of those for “other expenditures for the economy;” and somewhat more than three-quarters of those for housing and community development. In the first category tax-expenditures were relatively low for such functions as disability and veteran benefits, because the visible expenditures (subsidies) for these purposes have had strong political support, so that no hidden subsidies have been necessary. By way of contrast, politically more questionable subsidies, such as those for housing and for the rest of the economy, have been hidden in the form of tax-expenditures. The housing and community development tax-expenditures have consisted primarily of exemption of mortgage interest payments from the federal income tax; a large share of the economic tax-expenditures have been for certain alternative fuel sales.

* Tax-expenditures as a share of the GDP or as a share of total visible federal expenditures revealed a strong tendency to grow. The pattern, however, was irregular: the ratio of such expenditures to the GDP (TE/GDP) almost doubled between 1967 and 1982, and then was cut back by the tax reform act of 1986.³ The proliferating tax-expenditures, of course, increased the complexity of the tax code, but

³ This statement is based on CBO data cited by Surrey and McDaniel (1985), p. 34. On p. 51 they cite somewhat different time-series data for the 1975 - 85 period. The data for early years raise

in the middle and late 1990s, many of those advocating tax reform focused their primary attention on the rate structure, rather than the necessity to cut back such “corporate welfare.”

In certain nations, such as Canada, the legislature is required to consider tax-expenditures and visible expenditures together so that conscious trade-offs between the two forms of expenditures can be made (discussed by Howard, 1997). Although the Canadian approach also seems likely to dampen the rise in subsidies through tax-expenditures, it does not seem likely to me that this budgetary device will be implemented in the U.S. for many years to come. Most importantly, the U.S. Congress appears to have acted in recent years under the assumption that the short-run political gains achieved by raising tax-expenditures were greater than those to be expected either of giving them a visible subsidy or of reducing taxes. In particular, tax-expenditures have proven themselves a politically less painful method of boosting governmental aid to particular upper income groups than a budget line reading “subsidies for the rich.”

The upper limit to such tax-expenditures is reached when the tax code becomes totally unfathomable. But it takes many years to reform a tax structure so that a new cycle of increasing tax-expenditures and tax complexity can begin. Given the cyclical nature of the process, long range forecasts are impossible to make.

B. Off-Budget Expenditures

Off-budget expenditures include those of a variety of federal trust funds and federally-owned entities like the Postal Service. Such entities can spend a great deal of money, but, if able to offset some or all of these by various types of revenue, only the difference between receipts and expenditures may

questions and must be used cautiously: the CBO data for tax-expenditures in fiscal 1967 are considerably lower than the Treasury Department data for fiscal 1968 used in Table 3.

appear as a line in the federal budget. Of course, for almost all of these entities, for instance, the Postal Service or the Railway Employees Retirement Fund, only this difference between expenditures and receipts has important policy implications.

From Panel B of Table X-12.1, we can draw three quick conclusions: First, although the importance of these expenditures (measured either as a share of GDP or of expenditures at various levels of government) increased dramatically between 1950 and 1980, since that time they have leveled off. Second, although the ratio of such off-budget expenditures amounted to a significant portion of on-budget expenditures, the ratio of such expenditures to the GDP was relatively small. Third, over the second half of the 20th century, such off-budget entities actually spent less revenues than they received and used their surplus to purchase Treasury bonds, thereby building up the internally held federal debt.

In sum, off-budget expenditures do not appear out of control nor do they appear to have served, in the last few decades of the 20th century, as a surreptitious means to increase governmental expenditures. We have no obvious reason to expect them to have a dramatic impact on the future U.S. economy either, excepting, of course, the Social Security and Medicare Trust Funds.

C. Inter-Governmental Transfers

Up to now, all discussion in this section has concerned expenditures directly made by the federal government. It is worth considering briefly expenditures made by state and local governments that are partially or totally financed by either visible federal grants or federal tax-expenditures that benefit these lower levels of governments. As an example of the latter, exemption from the federal income tax of interest income from certain bonds issued by state and local governments allows them to sell these bonds at a lower interest rate than bonds without such a tax advantage.

Table X-12.2: Transfers from the Federal Government to State and Local Governments

Panel A: Decade Averages

FedViDiEx = visible, direct expenditures of the federal government

ViFedTr = visible, direct federal transfers to state and local governments

SLViDiEx = visible, direct expenditures of state and local governments

	<u>As ratio to the GDP</u>			<u>ViFedTr as percent of:</u>	
	<u>FedViDiEx,</u> <u>excluding</u> <u>ViFedTr</u>	<u>ViFedTr</u>	<u>SLViDiEx</u>	<u>FedViDiEx,</u> <u>excluding</u> <u>ViFedTr</u>	<u>SLViDiEx</u>
1952 through 1959	19.5%	0.9%	8.7%	4.7%	10.2%
1960 through 1970	18.8	1.6	11.0	8.7	14.7
1970 through 1979	19.2	3.0	13.7	15.9	22.2
1980 through 1989	21.9	2.5	12.8	11.4	19.5
1990 through 1997	20.9	2.7	14.1	13.1	19.4

Panel B: Federal Tax-expenditures (TE) Aiding State and Local Governments

	<u>Fiscal</u> <u>year 1968</u>	<u>Calender</u> <u>year 1997</u>
Federal TE acting as grants-in-aid to state and local governments		
As percent of GDP	0.8%	1.0%
As percent of visible direct federal expenditures	4.3	5.0
As percent of visible direct state and local governmental expenditures	7.0	6.9
As percent of visible federal transfers to state and local governments	42.2	34.8

Note: For the tax-expenditures the 1968 figures represent rough estimates, since the expenditure equivalents were estimated by applying the ratios of expenditure equivalents to revenue loss for 1997 to the 1968 data.

Data on decade averages come from Department of Commerce, Bureau of Economic Analysis (1998) and BEA website, Tables 3.16 and 3.17. Data on tax-expenditures come from sources detailed in Table 3. Federal tax-expenditures acting as grants-in-aid to state and local government include tax exemption on interest from various types of state and local governmental bonds and deduction of certain state and local taxes from income taxed by federal government.

Panel A of Table X-12.2 shows that such federal transfers to state and local governments hit a high point during the 1970s, when measured either as a share of direct federal expenditures, of direct state and local governmental expenditures, or of GDP. Further, cutting back on these intergovernmental transfers in the 1980s and 1990s partially financed the increased visible, direct federal expenditures replacing these transfers, so that the Congress did not need to raise federal taxes.

Panel B of Table X-12.2 shows that these visible federal transfers were accompanied by tax-expenditures that increased the total transfers by more than a third. From another perspective, such tax-expenditures amounted to 0.8 to 1.0 percent of the GDP during the last 30 years of the century. It is noteworthy, however, that as a percent of visible transfers to state and local governments, these tax-expenditures declined between 1968 and 1997, a phenomenon that would have appeared even more dramatic if data were presented for a year during the 1970s when the percentage to the GDP of these federal transfers to the states had reached its peak.

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