Steps for Integrating Tax Expenditures into the Budget Process and Increasing Transparency

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Tax Expenditures Are Spending

Tax expenditures are a form of government spending that are implemented through the tax code. They may feel a bit different than direct spending, but for the most part, bear close resemblance to mandatory and discretionary spending. Integrating tax expenditures into the budget process and increasing transparency of tax expenditure spending is critical for more accountable spending.

The following steps outline a possible framework for incorporating tax expenditures into the budget process.

- **Categorization.** A key part of integration would be categorizing tax expenditure spending like direct spending into discretionary and mandatory spending categories.

- **Length of sunsets could reflect the category.** Tax expenditures that are subject to sunsets resemble discretionary and mandatory non-entitlement programs, depending on the length of the sunset. Those that are subject to annual sunset are most similar to discretionary programs, while those that are subject to longer term sunsets are more like mandatory non-entitlement programs (however, unlike mandatory programs, spending amounts are not capped). Tax expenditures that are not subject to sunset resemble mandatory entitlement programs—both are uncapped and insulated from the authorization as well as appropriation process.

- **Integration.** Discretionary tax expenditures would be subject to annual authorization (which automatically triggers appropriation), and worked into the appropriation process under the budget rules (specifically, the § 302(a) allocation specified in the Congressional Budget Act of 1974). Mandatory tax expenditures would not be authorized annually, but may be subject to reauthorization in a given year.

Tax Expenditures and Transparency

Tax expenditure spending should also be more transparent. The IRS collects a vast amount of useful information that can inform analysts and policymakers both inside and outside of government. However, meaningful data on the distributional and economic impacts of tax expenditure spending is limited. This makes assessment of tax expenditure spending challenging. Overcoming obstacles posed by the IRS' confidentiality rules, scope of data, and research capacities, will be key to developing a central system that can inform analysts and policymakers both inside and outside of government.

- **Data Collection.** Tax data is universal – all individuals and businesses must file tax returns. This means the tax system captures important data beyond traditional tax concepts. Important measures, like firm entries and exits as well as employment totals are compiled through employment tax returns filed by businesses. Other useful data points include socioeconomic measures such as marital status, education expenditures, major medical expenses; disability status; charitable contributions; home ownership patterns; family demographic information; and so on.

- **Electronic Filing.** Electronic filing provides the potential for improved data quality since it reduces error associated with transferring data from hardcopy tax returns to an electronic format. Currently, select data from hardcopies is recorded electronically, which leaves vast amounts of potentially informative data inaccessible. The existence of e-file data increases the potential for generating more information, and for manipulating data in ways that can shed light on the distribution and effectiveness of tax expenditures.

- **Confidentiality Rules.** Federal tax information is treated homogenously because of the IRS' confidentiality rules. These rules do not allow the IRS to distinguish among types of data, even with regards to age. This means that information about all taxpayers, whether an individual's gross income or a large corporation's financial information, receive the same type of protection. These rules impact how the IRS, which is required to regularly produce statistical information, aggregates and organizes publicly released data. Variations on this data, including different classification categories or special studies, can be requested by outside users but resource limitations limit the IRS' ability to fulfill these requests. Additional data beyond what is released can only be accessed by an outside entity, including a Federal agency, if a statute provides such entity explicit authorization.

  However, new technology coding systems may make it possible for the IRS to protect taxpayer anonymity while also providing data for assessment. The current standard for confidentiality requires that data be released in a manner that prevents outsiders from using "reasonable means" to identify a taxpayer. It does not specify how such data be released. New systems for data sorting would ideally take advantage of the flexibility allowed for presentation, without requiring the IRS to change its confidentiality rules. For example, coding microdata with various levels of confidentiality may prevent identification of a taxpayer while also preserving data relations at a micro level which are important to producing analysis useful for decisionmakers.

- **Coordinated Research Center.** A coordinated center for assessing and inputting data might be critical to maintaining the balance between taxpayer privacy and data utility. This could potentially be housed in the IRS, since IRS employees have access to raw tax information under the confidentiality rules.