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Creating Public Value with Tax and Spending Policies:
The View from Public Economics

According to the framework rooted in public economics, governments can create public value by focusing tax and spending policies on remedying market failures and addressing concerns about fairness embodied in a social welfare function. By pursuing optimal tax and spending policies, governments navigate the omnipresent trade-offs between equity and efficiency. Of course, in practice, the process by which policies are adopted does not resemble the planner’s problem in social choice theory. In addition, real fiscal policies do not look much like the recommendations that arise from the optimal tax literature. Governments operate in public choice environments that are not conducive to focused remedying of market failure, and they suffer from their own tendencies to fail to achieve their objectives. Nevertheless, many of the tools are in place to help the federal and state governments focus tax and spending in ways that can maximize public value.

The year 2011 was a low point for U.S. fiscal policy. Congress created a financial crisis by failing to raise the federal debt ceiling to accommodate growing budget deficits. A subsequent deal between congressional leaders and the White House prevented the unthinkable—default on U.S. sovereign debt—but did nothing to address the long-term deficit problem and could not prevent the unprecedented downgrading of U.S. government bonds by the credit-rating agency Standard & Poor’s. The bipartisan congressional supercommittee’s failure to propose a deficit-reduction plan triggered the threat one year later of a recession-inducing fall from a fiscal cliff. Meanwhile, across the country, experts of all stripes called for state and federal tax reform, but Congress and state legislatures did not budge. While tax and spending policy presents a prime opportunity for creating public value, few would argue that policy makers’ actions—or, more accurately, inaction—during 2011 succeeded in doing so. Moreover, the setting as I write in October 2013 is not encouraging. The country has just emerged from another budget and debt ceiling impasse, this one leading to a 16-day partial federal government shutdown. The deal that ended the shutdown funded the government and suspended the debt limit only temporarily, extending fiscal policy uncertainty into 2014.

Discouraging news about tax and spending policy, however, is mitigated by signs here and there of governments trying to make better choices about how to obtain and invest tax dollars: governments trying to do the right things and do those things right. For example, since the 1990s, Washington State policy makers have used a cost–benefit framework to identify policies that can deliver the greatest return to the state’s investments, particularly in the area of criminal justice (Pew Center on the States 2012b, 2). In early 2012, the Pew Center on the States reported that it was helping other states adopt the Washington model. The Pew Center also highlighted 13 states that had taken steps to provide legislators with high-quality assessments of the effectiveness of business tax incentives (Pew Center on the States 2012a, 1). In April 2012, the U.S. House Ways and Means Committee held hearings to “conduct a thorough review of the various targeted provisions in the [tax] Code commonly referred to as ‘tax extenders’” (2012, 1)—those tax benefits with expiration dates that are typically routinely extended with little examination by Congress. Reflecting the frustration of a witness to perhaps too many of Washington’s failings, Urban Institute resident fellow Howard Gleckman (2012) wondered whether the hearings “could be a case of Congress doing its actual job.”

Well, could they be? Are the hearings, reports, program evaluations, and cost–benefit analyses signs of governments...
moving toward better tax and spending decisions? Or will the forces that led to 2011’s and 2013’s low points continue to overwhelm efforts to rise above them? Can we take steps now to improve the prospects for evidence-based, public-value-building policies in the future?

Using the public value framework rooted in public economics, in the following section, this article will describe the ways that tax and spending policies can create public value. In the third section, I name some of the obstacles to creating public value with these policies. In the fourth section, I describe some tools that can help governments make tax and spending choices that will maximize public value.

**Tax and Spending Policies Can Create Public Value**

Mention of a product’s *value* is common in the economics literature, but the term *public value* is not. Economists tend to define the value of a good or service as its worth to the consumer or the consumer’s willingness to pay for it. Public value, however, moves us out of the marketplace and into the realm of nonmarket activity. In *Creating Public Value*, Mark Moore argues that “for a public enterprise to be judged worthwhile, … it must explain why the enterprise should be public rather than private” (1995, 43; emphasis added). Public economics addresses this challenge by identifying the conditions that call for engagement by a public sector entity, whether a government, a nonprofit, or a partnership between them. That is, economic theory holds that in cases of market failure—such as imperfect information, externalities, public goods, incomplete markets, or natural monopoly—collective action can lead to improvements in economic efficiency. A public value framework that is rooted in the principles of public economics posits that public value can be created when conditions of market failure are effectively addressed, thereby improving efficiency. In addition to prescribing when action is warranted, economic theory also argues the converse: when markets have failed, public sector intervention should be limited.

Government may, but need not, be the public-value-creating entity. Market failures can be addressed by organizations in the nonprofit, private, or informal sector or by some combination thereof, described by Benington as the “co-creation of public value jointly between civil society and the state” (2011, 39). Because this article is about creating public value with fiscal policy, I will focus on how public economics makes a case for government action.

A microeconomics-based public value framework starts with the efficiency criterion, but it does not end there. Economic theory holds that any number of outcomes may be efficient—in the sense that no resources are wasted and all Pareto improvements have been exhausted—without being equally desirable from society’s point of view. When resources are redistributed, moving us from one efficient outcome to another, some members of society will be made better off, while others will be worse off. Evaluating those trade-offs requires attention to equity—that is, society’s concern for the losers relative to the winners. It is even possible for an inefficient outcome to be socially preferable to an efficient one, if the inefficient outcome better addresses social concerns about the distribution of well-being. The goals of efficiency and equity, therefore, often must be balanced against one another.

These trade-offs—among numerous efficient outcomes and between efficient and equitable outcomes—are evaluated by a social welfare function, which describes the level of *societal* well-being generated by any distribution of well-being across the society. The social welfare function may take a range of forms, depending on society’s taste for equity. For example, if a society is indifferent to how well-being is distributed among its members, the social welfare function is simply the unweighted aggregation of individual well-being. The only way to increase social welfare is to increase the sum of total well-being, and how those additional benefits are distributed among individuals is immaterial. In this case, highly equitable distributions are no more or less desirable than highly inequitable ones.

Alternatively, a society may particularly value improvements to the well-being of certain members—the disadvantaged, for example. In this case, an additive social welfare function will include weights that vary in magnitude across types of people. Extreme concern for the disadvantaged implies a social welfare function whose value only increases when the lot of the least well-off is improved. Additional benefits to those who are already doing well have no impact on social welfare.

Whatever the form, it is through the social welfare function that the public economics framework integrates society’s preferences for equity into the government’s objective. By pursuing this objective, a government acts on behalf of collective interests, in contrast to a market-only framework governed by individual interests.

A government that aims to maximize social welfare faces a multipart social choice problem. Subject to resource constraints, the social-welfare-maximizing government must address existing market failures, such as externalities and insufficient provision of public goods. So, it must identify where, when, and how much to intervene in order to achieve efficient levels of output and consumption—that is, the point at which the additional social cost of more output or consumption outweighs the additional social benefit (where marginal social costs equal marginal social benefits). In addition, the social welfare criterion requires the government to adopt an optimal tax and transfer policy—that is, one that maximizes social welfare, thus achieving society’s redistributive (equity) goals—subject to raising enough revenue to fund the desired interventions.

Creating public value in this framework means pursuing collective equity goals under the constraint of efficiently employing scarce resources. The efficiency criterion justifies government action to effectively close information gaps, discourage negative externalities and encourage positive externalities, induce the production of public goods (whether produced by the government or not), create needed markets where none has arisen, and ensure the provision of goods whose production is characterized by large initial capital costs leading to decreasing average costs (natural monopoly). The goal of maximizing social welfare means that government intervention is
also justified by community or social concerns about fairness and justice. A proposed government action that addresses none of these criteria should be scrutinized, as unwarranted intervention unnecessarily wastes resources.

Bozeman (2002) questions a definition of public value based on addressing market failures. He argues that the economic paradigm’s emphasis on efficiency gives insufficient weight to core public values, such as basic human rights. Bozeman develops an approach to addressing public policy problems called “public-value failure” that gives weight to values that he argues the market failure approach ignores. Jørgenson and Bozeman (2007) assemble an inventory and taxonomy of publicly held values, including citizen involvement, fairness, voice of the future, and human dignity. Benington argues that elected public authorities, particularly local councils, are the only organizations with a “democratic mandate to represent the interests of the whole community rather than just a fraction of the whole” and “can represent future generations as well as current customers or voters regardless of their personal or political beliefs” (2011, 38–39).

In theory, the social choice problem posited by public economics can incorporate many of the values these authors name. The social welfare function’s form embodies a community’s tastes for equity or fairness. The function’s arguments (those things that influence the magnitude of social welfare) can include not only the well-being of current society members but also that of future generations or members of neighboring societies. If a community highly values particular decision-making processes independent of the resulting policy outcomes, then constraints regarding those processes—such as democracy or openness in decision-making—can be placed in the social choice problem. Of course, the theoretical flexibility of a social welfare function to incorporate a range of social values does not imply that the actions of any particular government will reflect the values of the people on whose behalf it acts.

Bozeman describes how the market-failure model has been “particularly influential among policy makers and, increasingly, private citizens” (2002, 146) and attributes this influence to the model’s analytic precision relative to alternative models. The influence of the public economics model—extending beyond market failure and efficiency to include social welfare—has also likely been enhanced by its potential to incorporate a range of core public values.

It is not clear which direction the causation goes, but the model’s influence is surely correlated with where economists ply their trade. According to the U.S. Bureau of Labor Statistics (2012), 52 percent of jobs for economists are in federal state, or local governments. It is not surprising, then, that examples of attempts to influence public sector entities with these principles abound. Next, I briefly describe three of them.

**Legislative Analyses Evaluate Government’s Role**

The U.S. Congress and state legislatures employ researchers, legislative auditors, and committee staff—many of them making up the 52 percent of economists mentioned earlier—who often include in their analyses a discussion of whether proposed legislation meets any of the microeconomic criteria for public sector involvement. They are making cases for or against government intervention. Issue papers by nonprofit think tanks and consulting firms do the same. These analyses play a role in the legislative process by helping both proponents and opponents of tax and spending proposals frame and support their arguments. Again, unless a brief is written by an economist, it may not include the terms “externality” or “public good” or “incomplete information,” but those concepts are used as justification for government action nonetheless.

As just one of many examples, a 2008 Congressional Research Service report on the federal Research and Experimentation Tax Credit begins with what the author calls a consensus among economists that government subsidization of private sector research and development (R&D) is justified because spillover effects (positive externalities) mean that the private sector will generate inadequate amounts of research:

Most economists would also agree that private R&D investment is likely to be less than would be warranted by its economic benefits. The reason for this shortfall lies in the nature of these benefits. Firms generally cannot capture all the returns to their R&D investments, even in the presence of patents, trademarks, and other instruments of intellectual property protection, and their strict enforcement. Numerous studies have found that the average social returns to private R&D investments greatly exceed the average private returns … To remedy this failure, most economists advocate the adoption of public policies aimed at boosting or supplementing private investment in R&D, especially those investments likely to generate relatively large external benefits, such as basic research. (2008, 2)

The report goes on to summarize research on the **effectiveness** of the credit, which is very much in doubt, and to propose changes to improve its effectiveness. But regardless of whether the credit in its current form succeeds in achieving its objective of increasing public benefits from private research, the author is using public sector economics principles to make a clear case for intervention.

**Cooperative Extension Uses Public Value to Secure Public Funding**

Another example comes from the Cooperative Extension Service, a network of state outreach education organizations based at land-grant universities and funded by the U.S. Department of Agriculture, state and county governments, and, to a lesser extent, grants and user fees. As Kalambokidis (2011) explains, over the last 10 years, the Cooperative Extension Service has been using public sector economics principles to make a case for its programs’ public funding. Under continuing fiscal pressure, state and county governments have compelled state Extension Services to defend their continued receipt of public funding more rigorously than in the past. Historically, the Extension Services relied on evidence of their programs’ **private value**, or direct benefits to program participants, but this has proved inadequate in a political environment in which most of a state’s legislators are elected by people outside of the Extension Service’s traditional audiences. Instead, Extension Service employees are trying to build support for public funding by highlighting the **public value** they create: the benefits that accrue to people who have no contact with the program. As Kalambokidis (2004) explains, increasingly, Extension Service organizations are communicating their programs’ public value by showing how they address one or
more market failures, such as encouraging public benefits (positive externalities) and discouraging public costs (negative externalities).

**Some Economists Propose Redistributive Tax Policy**

The form of a social welfare function embodies tastes for equity or fairness. Which function is used in optimal tax and spending analysis, therefore, will influence recommendations for redistribution. In 2012, the Occupy movement and the presidential election combined to bring an unprecedented awareness to U.S. income inequality. Against this backdrop, one particular example of social welfare analysis received attention in the blogosphere and media. In a 2011 paper, economists Peter Diamond and Emmanuel Saez posit an additive social welfare function that weighs individuals’ well-being in inverse proportion to their consumption. So, the more you consume—the better off you are—the less society values making you even better off. It is a version of social welfare that values equity in consumption. Given observations of the current income distribution and measures of the responsiveness of taxpayers to changes in their tax rates, they use this social welfare function to estimate an optimal income tax schedule for the United States. Diamond and Saez conclude that very high earnings should be subject to rising marginal tax rates and higher rates than current U.S. policy—as high as 50 percent to 70 percent. Had they used a social welfare function embodying different values—for example, one that did not value equity in consumption—the authors would have estimated different optimal tax rates. This approach leads Diamond and Saez to argue, in effect, that the U.S. government could create public value—increase social welfare—by increasing top income tax rates and subsidizing the earnings of low-income earners.

Despite the presence of economic rhetoric and analysis in legislation and policy debates, the fiscal policies we observe do not appear to be the result of an exercise in maximizing economic efficiency and social welfare. Tax and spending policies are usually shaped by other than economic considerations, and moving from the theory of optimal public expenditure and optimal tax policy to action is complicated by innumerable obstacles. I discuss some of them in the next section.

**Creating Public Value with Tax and Spending Policies Faces Obstacles**

**Taxes and Transfers Cause Distortions**

To preserve the economic efficiency that microeconomic theory predicts will arise from individuals’ pursuit of their own interests, optimal tax and transfer policy prescribes that revenue be raised and redistributed with the least impact on individual behavior. So as not to influence taxpayer choices about how much to work or invest, for example, taxes should be levied and transfers paid in amounts that do not vary with those choices. In practice, such so-called lump-sum taxes and payments are rarely an option because charging everyone the same amount of tax (or transferring the same amount of benefits) is seen as unfair. Therefore, governments must balance revenue and redistribution objectives against the distortions caused by the remaining instruments, such as taxes on earnings derived from work or investment. In public sector economics, employing these distorting options is called a second-best solution.

Economic analyses usually recognize this limitation and account for the distortions caused by second-best solutions. For example, Diamond and Saez (2011) recognize that high-income taxpayers might react to increases in tax rates by reducing work or investment efforts and consider those responses in their analysis. Studies of taxes meant to discourage environmental damage, such as pollution levies, recognize that the efficiencies resulting from reducing negative externalities will be mitigated by distortions arising from the tax’s impact on, for example, work effort. Nevertheless, having to incorporate these distortions complicates the analyses and sometimes makes policy prescriptions less clear.

**How the Government Should Best Intervene May Be Unknown**

A prescription for government intervention does not tell us what type of intervention is best. Knowing that greenhouse gas emissions should be reduced to ensure the health of future generations is not the same as knowing which level of government in which country should act and what, precisely, it should do. In the presence of an externality, efficient outcomes can, in theory, be achieved by any number of approaches, including regulation, taxes, subsidies, redefining property rights, or tradable emissions rights. Ideally, the recognition that an intervention is warranted would be followed by an analysis of the range of possible policies, including their expected impacts and costs. Cost–benefit analysis could then help policy makers choose the preferred intervention. In practice, though, high-quality cost–benefit or social return on investment analyses require resources, making timely results rarely available.

**Policies May Be Poorly Understood**

Tax and spending policies and their implications can be very complex. Any group of public finance scholars will be hard-pressed to come to a mutual understanding of, for example, the impact on long-term U.S. economic growth of comprehensive health care reform or a carbon tax. When the consensus is unclear, it is hard to make a strong policy recommendation, and it is even harder to persuade policy makers to accept your recommendation. The fact that elected officials must be able to convince voters of the correctness of their positions on tax and spending proposals imposes additional obstacles. Stiglitz observes a “simplicity constraint” on policy analysts that arises because “the public has neither the background nor the patience to digest a complicated message” (1998, 14). Additionally, parties with a private interest in a particular policy take advantage of that simplicity constraint and use the media to make a case for their own position.

**Which Policies Are Adopted Depends on the Public Choice Environment**

The microeconomic model that maximizes social welfare subject to constraints presumes that some entity can act according to the model’s prescription. Economics students are sometimes asked to imagine a benevolent dictator who knows the form and arguments of the social welfare function and who cares only about creating the greatest amount of social welfare. Of course, the government is not a single-minded entity that can enact optimal tax and spending policies at will. Instead, which tax and spending policies are
adopted depends on the voting mechanisms and political structures in place and on the distribution of political power among agents. Fundamentally, collective action to produce nonexcludable public goods is hindered by individual incentives to free ride (enjoy the benefits of a good without paying for it). Olson (1965) notes that a group whose members share a common interest, yet cannot agree to compulsory taxation, will fund public goods in insufficient quantities or not at all. While a full analysis of how the public choice environment affects public finance decisions is beyond the scope of this article, such institutions as lobbying, private contributions to political candidates, and access to voting rights will affect which policies are enacted and how benefits are distributed.

The Government May Fail to Achieve Its Objective
Imagine that the existing public choice environment could lead to the adoption of optimal tax and spending policies. Public value is only created if the government’s actions in pursuit of those optimal policies are effective. Any attempt at intervention still comes with the risk that government may fail to achieve its objective, achieve it at a higher than necessary cost, or adopt a suboptimal objective. Critiquing state governments, Brandl asserts that failure to achieve objectives is the norm rather than the exception. He writes that “for much of what government does, little relationship exists between the amount of money spent and the results achieved” (1998, 29).

Government ineffectiveness can lead to a lower level of social welfare than would have arisen without intervention. Wolf calls this nonmarket failure (in contrast with market failure), and defines it this way:

Market failure provides the rationale for attempted nonmarket (that is, government) remedies. Yet the remedies may themselves fail, for reasons similar to those accounting for market failure. In both cases, incentives influencing individual organizations (“firms,” in one case, and entities acting for or constituting “government,” in the other) may lead to outcomes that diverge substantially from what is socially preferable. (1979, 112)

Some instances of nonmarket (government) failure arise because the actor is the government, which is vulnerable to such influences as well-funded special interests and public managers with competing objectives. Other failures derive from the nature of nonmarket production. For example, public goods providers do not benefit from a price signal to indicate the magnitude of goods demanded, and the absence of a profit motive can lead to unnecessarily high-cost production. Wolf also notes the difficulty of identifying the quality of public goods produced, such as the effectiveness of expenditures on education. He writes, “To monitor output quality requires precise, representative, and regularized feedback which is hard to realize for nonmarket output” (1979, 114).

Society’s Preferences for Equity May Be Unknown
A society’s taste for equity is clearly defined when its members are homogeneous in their preferences: a single member’s preferences can prescribe a redistributive policy that satisfies the social welfare function. In a pluralistic society, it is not clear whose preferences the social welfare function represents or how competing views should be weighted. Social welfare analyses such as the one presented by Diamond and Saez (2011) can be sensitive to the authors’ assumptions about how much taxpayers value redistributive policies. Surveying the general public about their values can provide insight into survey respondents’ preferences for different distributions of income, consumption, wealth, or tax burden. After reviewing the literature on taxpayer preferences for tax distribution (admittedly, only one aspect of fairness), Slemrod and Bakija conclude that “[p]ublic opinion surveys generally suggest strong support for progressivity in taxation. But the results sometimes appear inconsistent or are difficult to interpret, can differ greatly depending on how the question is framed, and in some cases seem to indicate considerable confusion about how the U.S. tax system works” (2008, 72).

Stiglitz observes that “[i]n practice, governments do not derive utility possibilities schedules, nor do they write down social welfare functions. But their approach to deciding whether … to undertake any particular project does reflect [social welfare concepts]” (1999, 105). He might have written more realistically that a government’s approach may reflect social welfare concepts, as he presents examples of such that certainly do not apply to every government decision. For instance, Stiglitz suggests that in practice, policy makers may focus on identifying the winners and losers of any proposal and estimate their relative gains and losses. Such an approach commonly influences tax policy, where analysts within and outside government estimate how after-tax income will change for various groups or types of taxpayers.

Stiglitz then recommends a “rough justice” version of optimal policy making: “Calculate weighted net benefits, weighting gains and losses to the poor more heavily than those to the rich according to the social welfare function” (1999, 116). Whether explicitly or implicitly (usually), policy makers will determine the relative sizes of those weights. Consequently, the system that chooses policy makers—such as a democratic process or a dictator—will determine whose preferences for equity will influence redistributive policies.

Tax Expenditures May Receive Less Scrutiny than Direct Expenditures
In cases in which government spending (in contrast to criminal penalties or regulation, for example) is prescribed to improve social welfare, governments with taxing authority often have two options: direct expenditures or tax expenditures, which are tax provisions that give preferential treatment to specific taxpayers or activities. At both the federal and state levels, direct expenditures are itemized in the government’s annual budget and only continue if Congress (or the state legislature) authorizes the spending. Tax expenditures, on the other hand, are rarely itemized in the budget—they represent revenue forgone rather than money spent—and generally need no reauthorization. Consequently, indirect spending through tax provisions receives much less evaluation and scrutiny than direct expenditures.

Exacerbating the potential for poor policy choices is the fact that legislators seem to prefer indirect expenditures. Because increases in
direct spending increase the public budget, a legislator who supports a spending proposal appears to be a supporter of government expansion, or a Big Spender. Increasing spending through the tax code, however, can be framed as cutting taxes and reducing the budget, even if the tax expenditure is funded by a revenue increase elsewhere. So, supporters of tax expenditures can be framed—or frame themselves—as opponents of government expansion, even if the tax expenditure has the same budgetary effect as a direct expenditure.

Clearly, the government, however structured, faces limitations in its quest to create public value (maximize social welfare) through optimal tax and spending policies. Despite these limitations, though, it is reasonable to urge the government to focus tax and spending policies on cases in which (1) market failures are the most costly (in terms of efficiency and social welfare); (2) taxes or direct spending are more cost effective than other possible remedies; and (3) the government has the best chance of achieving the desired outcome—that is, it is least hampered by the causes of government failure.

Some Suggestions to Maintain a Public Value Focus
To benefit from an economics-based view of public value, government decision makers need help to identify market failures and the range of options available to address them. They also need policy analysis that can forecast the expected outcome from adopting a proposed policy.

Support Policy Analysis
Once decision makers in a public organization have chosen to act, they must choose which actions to take, when to act, and how much to invest. Policy analyses, cost–benefit analyses, and estimates of social returns on investment can help them make these choices. Moreover, Wölf (1979) argues that governments need the benefit of careful monitoring of the quality of their output. Such analyses are conducted by a range of agents, both within and outside government. Legislative and executive staffs produce analyses for their respective clients, but not all of them are released to the public. For example, staff of the Congressional Research Service generate analyses at the request of members of Congress, but their reports are not made directly available to the general public (individuals may request the reports from their representatives in Congress). In contrast, many analyses produced by the Congressional Budget Office, including tax burden distribution tables, are available on that office’s website.

In Minnesota, the Office of the Legislative Auditor pursues a mission that can directly support public value generation: “The Program Evaluation Division conducts evaluations to determine the degree to which activities and programs funded by the state are accomplishing their goals and utilizing resources efficiently.”

However, the office completes only those analyses requested by the legislature.

Spending policies in Washington State are influenced by cost–benefit analyses conducted by the nonpartisan Washington State Institute for Public Policy (WSIPP), created by the legislature in 1983. There is evidence that WSIPP’s analyses have directly influenced how the state has spent funds for criminal justice programs, and, as mentioned in the introduction, several other states are working toward adopting the WSIPP model.

Nonprofit think tanks and consulting firms also generate policy analyses, and those with strong communications strategies can be very successful in placing their analyses and recommendations in front of policy makers and the public. If influence is a measure of success for such organizations, the most successful in the area of tax policy may be the nonpartisan, nonprofit Urban-Brookings Tax Policy Center (TPC), which generates economic and distributional analyses of nearly every serious federal tax policy proposal. Many TPC staff have spent parts of their careers in government tax research offices, such as the Department of Treasury’s Office of Tax Analysis, the Joint Committee on Taxation, and the Congressional Budget Office. They bring to TPC modeling expertise and familiarity with tax return data that allow them to produce analyses that mimic those of the within-government shops but can be publicly released. The TPC models employ public use versions of the same tax return data sets that are used for within-government analyses.

The 10 years since TPC’s founding have been marked by an unprecedented amount of transparency regarding the impact of tax proposals. Through media interviews, open-to-the-public conferences, a well-read website, and op-ed pieces and blogs, TPC analyses are very widely distributed. It is now rare for a serious debate about a proposed tax change to occur on Capitol Hill, in the media, or in the blogosphere without input from TPC.

To help public sector organizations stay focused on generating public value, the entities that generate policy analyses must be supported with the freedom to investigate even those policies that are favored by politicians in power. They should also be free to release their reports so that they can be vetted—or critiqued—by experts outside government. Whenever possible, without risking disclosure of confidential information, public data should be shared with outside investigators—as the Internal Revenue Service shares data with TPC and others—so that those entities can enrich the debate with their own analyses. At the same time, the government’s internal analysts should be supported with the resources they need to produce high-quality reports. In short, to ensure public value, the public sector must not only fund the policies but also fund the policy analysis.

Require Fiscal, Distributional, and Effectiveness Analyses of Tax Expenditures
The U.S. Office of Management and Budget and most states produce a tax expenditure budget (TEB) that lists the tax provisions (exemptions, exclusions, deductions, deferrals, and preferential rates) that (1) reduce the tax base relative to a reference baseline and (2) give preferential treatment to select activities or taxpayers. TEBs typically explain the provision and provide an estimate of the cost in terms of revenue forgone. Some TEBs also list the tax expenditure’s intended purpose and the number and types of taxpayers who benefit. Few TEBs, however, analyze the effectiveness of tax expenditures.

In 2010, under a legislative mandate, the Minnesota Department of Revenue assembled a group of public finance experts and their own tax staff to develop a process for systematically reviewing tax expenditures. According to a report by the Minnesota Department of Revenue (2011), the group recommended the creation of a Tax Expenditure Commission of policy and tax specialists to oversee the review process and make recommendations to the governor and legislature. All tax expenditures would be formally evaluated.
over eight years, with a focus on high-priority provisions early on. An evaluation would include revenue and distributional effects of the provision, as well as an assessment of its effectiveness relative to its intended purpose. Importantly, the evaluation would also include a comparison of the provision with alternative policies, including direct expenditures that have the same objective. To date, the commission’s recommendations have not been adopted, making them suggestions rather than a model of action for other states to follow.

**Incorporate Tax Expenditures into the Budget Process**
The Minnesota Department of Revenue report (2011) also recommendedremedying the inadequate scrutiny of tax expenditures by fully incorporating them into the budget process. The governor and the legislature would be required to explicitly reauthorize tax expenditures, as they do for direct expenditures. A provision would be sunset following its evaluation, and unless extended by the sunset date, it would expire. If a tax expenditure is allowed to expire, the rate for the relevant tax (e.g., personal income, sales) would be reduced to hold revenue constant, so that expiring tax breaks would not automatically generate additional revenue.

**Publicly Disclose the Recipients of Business Tax Credits**
Tax credits, which reduce taxes dollar for dollar, are fairly clear. The Minnesota Department of Revenue report (2011) argues that this lack of transparency is of particular concern in the case of business tax credits for economic development, because the recipients of grants and loans for this same purpose are made public. The argument for transparency regarding economic development grants and loans—that the recipients should be held accountable for the public benefits they have promised in exchange for the grants or loans—also holds for the beneficiaries of tax credits. Oklahoma releases the recipients of all tax credits—not only businesses—and the types of amounts of the credits and publishes them in a searchable online database.11

**Require Statements of a Law’s Purpose**
Few tax expenditure provisions in Minnesota Statute include a stated purpose. This poses a challenge for the analyst charged with estimating the provisions’ effectiveness. Against what objective are they to evaluate whether the provision has succeeded or failed? The Minnesota Department of Revenue report charges the proposed Tax Expenditure Commission with defining a clear and measurable purpose for each tax expenditure “if one is not stated in law” (2011, 34).

Of course, simply stating the purpose of a law does not ensure (1) that the purpose represents a legitimate role of government, or (2) that the law is effective at achieving its purpose at a reasonable cost. However, requiring a clear purpose for all new laws—including tax expenditures—that also states how it represents a legitimate role for government could limit provisions that are really meant to only create private benefits for a few select members of society. Additionally, requiring the purpose to be measurable, as the Minnesota Department of Revenue (2011) proposes, will provide an objective against which the provision’s effectiveness can be tested.

**Taxpayer Interest Groups Keep the Focus on Public Value**
Taxpayer interest groups have varying missions. Some favor smaller government and reduced taxes, while others promote good government or smart growth. To the extent that their objectives are consistent with generating public value, they can help the government keep its focus in several ways. They can keep tax expenditures in the spotlight and not let policy makers get away with presenting expansion of tax expenditures as limiting government. They can insist on evidence of a policy’s efficacy. If the media reports opposing versions of a program’s efficacy or impact, a taxpayer group can push back and insist on knowing why the versions differ. With enough information, informed consumers of public policy can judge for themselves which programs should be adopted and which reformed or discarded. To help support the needed policy analysis, taxpayer groups should also be willing to see public dollars fund the analysis and not frame such expenditures as bureaucratic waste.

**Conclusion**
According to the framework rooted in public economics, governments can create public value by focusing tax and spending policies on remedying market failures and addressing concerns about fairness. By pursuing optimal tax and spending policies, governments navigate the omnipresent trade-offs between equity and efficiency. Of course, in practice, the process by which policies are adopted does not resemble the planner’s problem in social choice theory, and real fiscal policies do not look much like the recommendations that arise from the optimal tax literature. As former Secretary of the Treasury William Simon said, “The nation should have a tax system that looks like someone designed it on purpose,” but at the moment, we do not, and neither do many of the states.

Governments operate in public choice environments that are not conducive to focused remedying of market failure, and they suffer from their own tendencies to fail to achieve their objectives. Nevertheless, many of the tools are in place to help the federal and state governments focus tax and spending in ways that can maximize public value, and others are available if we can muster the will to support them.

**Notes**
1. Public economics is also sometimes called public sector economics or public finance.
2. Here, a public good is defined as it is in economics: a good that is nonexcludable and nonrival in consumption.
3. Here, a natural monopoly is defined as it is in economics: an industry whose output requires large initial capital costs, leading to ever-decreasing average costs of production.
4. A summary of these criteria can be found in any public finance textbook. Bator (1958) presents an early exposition of market failure, and Samuelson (1954) describes efficient levels of public goods.
5. A Pareto improvement makes at least one person better off without making anyone else worse off. A Pareto efficient outcome is one in which no resources are wasted and all Pareto improvements have been exhausted.
6. A thorough exposition of optimal tax policy can be found in Auerbach and Hines (2002).

8. Bovenberg and Goulder (2002) provide a comprehensive summary of these second-best solutions to environmental taxes.


References


