

A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS

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of the
JOINT COMMITTEE ON TAXATION



May 12, 2008
JCX-37-08

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SUMMARY

This document,¹ prepared by the staff of the Joint Committee on Taxation (the “JCT Staff”), reconsiders the utility of the JCT Staff’s current implementation of tax expenditure analysis. Tax expenditure analysis can and should serve as an effective and neutral analytical tool for policymakers in their consideration of individual tax proposals or larger tax reforms. Its efficacy has been undercut substantially, however, by the depth and breadth of the criticisms leveled against it. Tax expenditure analysis no longer provides policymakers with credible insights into the equity, efficiency, and ease of administration issues raised by a new proposal or by present law, because the premise of the analysis (the validity of the “normal” tax base) is not universally accepted. Driven off track by seemingly endless debates about what should and should not be included in the “normal” tax base, tax expenditure analysis today does not advance either of the two goals that inspired its original proponents: clarifying the aggregate size and application of government expenditures, and improving the Internal Revenue Code. The JCT Staff therefore has begun a project to rethink how best to articulate the principles of tax expenditure analysis, in order to improve the doctrine’s utility to policymakers, reemphasize its neutrality, and address the concerns raised by many commentators.

This pamphlet introduces a new paradigm for classifying tax provisions as tax expenditures. Our revised classification divides the universe of such provisions into two main categories: tax expenditures that can be identified by reference to the general rules of the existing Internal Revenue Code (not, as is the current practice, by reference to a hypothetical “normal” tax), which we label “Tax Subsidies,” and a new category that we have termed “Tax-Induced Structural Distortions.” The two categories together cover much the same ground as does the current definition of tax expenditures, and in some cases extend the application of the concept further. The revised approach does so, however, without relying on a hypothetical “normal” tax to determine what constitutes a tax expenditure, and without holding up that “normal” tax as an implicit criticism of present law. The result should be a more principled and neutral approach to the issues.

Section I of this pamphlet presents an overview. It briefly reviews the concept of tax expenditure analysis, explains the reasons for revisiting it now, and introduces the new paradigm for categorizing tax expenditures. Section II outlines the development of tax expenditure analysis and describes how that doctrine is used today by the JCT Staff and by the Treasury Department. Section III summarizes commentators’ principal objections to how tax expenditure analysis is currently implemented. Section IV responds to those criticisms by describing in detail our new taxonomy of tax expenditures. Section V explains the economic considerations that underlie tax expenditures and applies that economic thinking to our new paradigm. Finally, Section VI reviews some of the issues associated with quantifying tax expenditures under the revised definitions.

¹ This document may be cited as follows: Joint Committee on Taxation, *A Reconsideration of Tax Expenditure Analysis* (JCX-37-08), May 12, 2008. This document can also be found on our website at www.house.gov/jct.

I. OVERVIEW OF JCT STAFF TAX EXPENDITURE PROJECT

A. Original Goals of Tax Expenditure Analysis

In 1967, Assistant Secretary of the Treasury for Tax Policy Stanley Surrey introduced to U.S. tax policy discussions the phrase “tax expenditures.” Surrey used the term to refer to provisions of the Internal Revenue Code that are deliberate departures from generally accepted concepts of net income (usually by way of special exemptions, deductions, credits or exclusions) and that affect the private economy in ways that usually are accomplished by direct government spending.² In Surrey’s view:

The federal income tax system consists really of two parts: one part comprises the structural provisions necessary to implement the income tax on individual and corporate net income; the second part comprises a system of tax expenditures under which Governmental financial assistance programs are carried out through special tax provisions rather than through direct Government expenditures. This second system is grafted on to the structure of the income tax proper; it has no basic relation to that structure and is not necessary to its operation. Instead, the system of tax expenditures provides a vast subsidy apparatus that uses the mechanics of the income tax as the method of paying the subsidies.³

Surrey believed that a close analysis of tax expenditures could lead to better “expenditure control” by the Congress, through a more complete accounting for government expenditures regardless of their form. Surrey further anticipated that tax expenditure analysis would be helpful in fashioning “tax reform” policies.⁴

Surrey’s “expenditure control” theory rested on his belief that tax expenditures escaped the scrutiny applied to actual appropriations programs. Surrey hoped that the regular publication of a “tax expenditure budget” would induce Congress to abandon narrowly-constructed tax incentives and subsidies.⁵ He anticipated that, once tax expenditures were identified and clearly displayed as government spending substitutes, subsequent dissection would reveal them to be poorly targeted or inefficient, when compared either to an actual government spending program,

² Stanley S. Surrey, Excerpts from remarks before The Money Marketeers on *The U.S. Income Tax System -- the Need for a Full Accounting*, November 15, 1967, in United States Department of the Treasury, *Annual Report of the Secretary of the Treasury on the State of the Finances for the Fiscal Year Ended June 30, 1968* (Washington, D.C., Government Printing Office, 1969) at 322.

³ Stanley S. Surrey, *Pathways to Tax Reform* 6 (Cambridge, Mass., Harvard University Press, 1973).

⁴ Excerpts from remarks before the Money Marketeers, *supra*; see also *Pathways to Tax Reform*, *supra*, at 30-49 (describing uses of a tax expenditure budget).

⁵ See Stanley S. Surrey, *The Federal Tax System--Current Activities and Future Possibilities*, (speech before Boston Economic Club, May 15, 1968), in *Annual Report of the Secretary of the Treasury on the State of the Finances for the fiscal year ended June 30, 1968*, *supra* at 313.

or (in most cases) when compared to not expending government resources at all. In this way, the “expenditure control” agenda would be advanced.⁶

Surrey also saw tax expenditure analysis as playing a vital role in tax policy debates. In particular, Surrey believed that many tax expenditures violated consensus principles of tax equity, economic efficiency or ease of administration. Surrey hoped that, by rephrasing “tax incentive” proposals as “tax expenditures,” and then by analyzing the equity, efficiency and administrative consequences of those proposals as if they were spending requests, policymakers would recognize that many such proposals were inconsistent with the goal of a fair, efficient and simple income tax system.⁷

In the forty years since Surrey introduced the term to U.S. tax policy discourse, policymakers have relied on tax expenditure analysis to judge the policy implications of individual tax proposals, to gauge the overall health of the Federal income tax system, and to measure the aggregate governmental resources devoted to particular policies. Since 1974, Federal law has required the Congressional Budget Office (“CBO”) and the Treasury Department annually to publish detailed lists of tax expenditures. (In light of the traditional expertise of the JCT Staff in respect of revenue matters, and a separate statutory requirement that Congress rely on JCT Staff estimates when considering the revenue effects of proposed legislation,⁸ the CBO has always relied on the JCT Staff for the production of this annual tax expenditure publication.) Other Federal organizations (e.g., the Congressional Research Service) also employ the principles of tax expenditure analysis when analyzing Federal income tax policies.

⁶ Stanley S. Surrey and Paul R. McDaniel, *Tax Expenditures* 32-37 (Cambridge, Mass., Harvard University Press, 1985).

⁷ *Id.* at 25-27, 69-98.

⁸ P.L. 93-344 §201(g), codified at 2 USC 601(f).

B. Has the Enterprise Succeeded?

Surrey's original hope that tax expenditure analysis would have a salutary effect on budget transparency (and through that, on actual budget outlays) has not been realized, for several reasons. First, tax laws and appropriations follow completely different paths through Congress, and in particular are developed by different substantive committees. As a result, in practice one type of legislation does not substitute for the other.⁹ Second, many tax expenditures have vaguely similar distributional effects to those achieved through spending programs, but the two delivery systems are so different that in many cases each is a highly imperfect economic substitute for the other. Third, as a result of contemporary "pay-as-you-go," or "PAYGO" requirements, policymakers today typically pair tax expenditures against tax revenue-raising measures, rather than proposing them as a direct substitute for spending programs. Finally, many commentators believe that, as budget and other pressures have made it more difficult to advance policies through the appropriations process, policymakers have wholeheartedly embraced tax expenditures as a second best means of implementing their policy agendas.

In fact, Congress's use of tax expenditures has accelerated over the years. In 1972, for example, the JCT Staff's first description of tax expenditures totaled some 60 items.¹⁰ Our 2007 pamphlet, by contrast, while employing essentially the same methodology as that of our first description 35 years earlier, listed 170 tax expenditures.¹¹

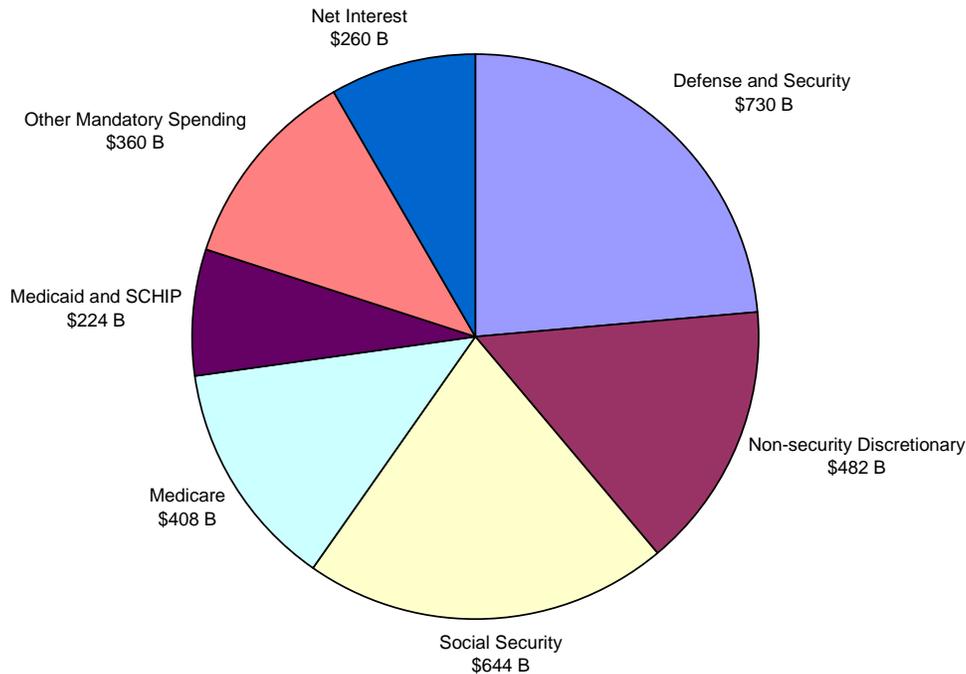
The importance of tax expenditures in dollar terms can be seen by comparing actual Federal discretionary outlays to the aggregate amount of tax expenditures. Figure 1, below, shows estimated budget outlays by spending category for fiscal year 2009. In fiscal year 2009, the Federal government projects annual total outlays of more than \$3.1 trillion. Of this amount, roughly \$1.6 trillion will go to mandatory spending programs including Social Security, Medicare and Medicaid; \$730 billion will go to defense and national security programs; and \$260 billion will go to service the national debt. This leaves a projected \$482 billion for non-defense discretionary spending of all types.

⁹ See Emil Sunley, *Tax Expenditures in the United States: Experience and Practice* 155, 166, in Hana Pulackova Brixí, Christian M.A. Valenduc, and Zhicheng Li Swift, eds., *Tax Expenditures—Shedding Light on Government Spending Through the Tax System* (2004) ("I can recall only one time when Congress traded off a tax expenditure [tax deduction for adoption expenses] for a direct spending program, and that trade-off was possible only because the tax-writing committees also have jurisdiction over welfare and income support.").

¹⁰ Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Calendar Years 1967 through 1971* (JCS-28-72), October 4, 1972.

¹¹ Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2007-2011* (JCS-3-07), September 24, 2007.

**Figure 1.—FY2009 Estimated Budget Outlays by Category
Amounts in Billions of Dollars**



JCT Staff published tax expenditure calculations cannot be compared directly with these projected actual expenditures, because our tax expenditure figures calculate the nominal revenues forgone by the existence of the rule in question, not the revenues that would be raised by repealing the rule; the two are not the same because actual repeal would have behavioral consequences that would affect post-repeal revenue collections. Moreover, tax expenditures are not additive, due to behavioral and other issues. Nonetheless, an indication of the relative magnitude of tax expenditures can be ascertained from the JCT Staff estimates contained in the CBO publication *Budget Options*, which are the revenue estimates.¹²

For fiscal year 2009, implementation of ten of these options developed by CBO, chosen for both quantitative importance and the degree to which they match up with the JCT Staff's most recent tax expenditure list, would increase revenue by about \$250 billion (without taking into account potential interactions between the provisions).¹³ Some of these options do not

¹² Congressional Budget Office, *Budget Options* (February 2007), <<http://www.cbo.gov/doc.cfm?index=7821>>.

¹³ Revenue Options 7b, 8a, 10, 13, 15, 18, 23, 28, 35, and 43. These items are, respectively: repeal of the mortgage interest deduction and conversion of the mortgage interest deduction to a credit for primary residence mortgages under \$400,000; elimination of the deductions of state and local taxes; limitation on the deductions for charitable giving to amounts exceeding two percent of adjusted gross

represent full repeal of the underlying tax expenditure; for example, the CBO revenue options list includes converting the home mortgage interest deduction to a tax credit at an effective 15 percent rate for primary residence mortgages below \$400,000, but preserves the tax benefits of home mortgage interest payments to that extent. Moreover, while these ten options are among the larger revenue raisers on the CBO list, these options do not correspond strictly to the ten largest tax expenditures contained in our most recent tax expenditure pamphlet. Yet even so, they amount to more than half of all government non-defense discretionary spending. Their magnitude illustrates the enormous importance of tax expenditures today, relative to actual non-defense discretionary appropriations.¹⁴

In sum, there is scant evidence that tax expenditure analysis has succeeded in its first mission of “expenditure control.” That does not mean, however, that tax expenditure analysis has failed, but rather that its principal utility appears to have been as a tool of tax policy and tax distributional analysis. The rhetoric of tax expenditure analysis, and the economic reasoning that underlies that rhetoric, in fact can provide a successful framework by which to judge the fairness, efficiency and administrative consequences of many “incentive” proposals. Policymakers further can look to tax expenditure analysis to provide insight into “base broadening” and similar measures.

For these reasons, as well as the practical points made earlier, we believe it appropriate to proceed on the basis that tax expenditure analysis today is most usefully described as primarily a tool of tax policy. This pamphlet in turn attempts to reinvigorate the utility of tax expenditure analysis in making tax policy decisions, by responding to the criticisms that have been leveled against it, and by describing the analytical power of its underlying economic reasoning.

income; inclusion of employer-paid premiums for income-replacement insurance in employees’ taxable income; reduction in the tax exclusion for employer-paid health insurance; elimination of the child tax credit; repeal of the expensing of exploration and development costs for extractive industries; repeal of the deduction for domestic production activities; and elimination of the source rules exception for exports.

¹⁴ We emphasize that these ten CBO options are listed simply to demonstrate the magnitude of tax expenditures today, not to suggest in any way that these particular revenue options necessarily represent desirable tax policy or should be adopted into law.

C. Why Revisit Tax Expenditure Analysis Now?

As currently applied, tax expenditure analysis is less helpful to policymakers in fashioning tax policy than might otherwise be the case, because the proponents of tax expenditure analysis generally have failed to respond convincingly to the important criticisms leveled against it. Tax expenditure analysis has always been controversial, and there is today a voluminous literature criticizing its premises and implementation as a tool of tax policy.

Many tax academics and policy experts have criticized tax expenditure analysis as resting on insufficiently rigorous foundations. These critics argue that the ideal “normal” tax system from which tax expenditures are identified does not correspond to any generally accepted formal definition of net income. Some observers further view tax expenditure analysis, in the form currently implemented, as a thinly veiled agenda for a specific form of tax reform. Under this view, the normative tax system at the heart of tax expenditure analysis is not simply an analytical tool, but is also an aspirational goal of the process. Others have questioned whether tax expenditure analysis serves any purpose at all, because the doctrine appears to these critics to rest on the unexamined premise that the tax laws should be uniquely “privileged,” through not being burdened by the political compromises and policy agendas reflected in appropriations legislation. Finally, some critics question the narrow focus on subsidies that are favorable to taxpayers, noting that there also are narrowly punitive provisions in the Internal Revenue Code. All these criticisms have gone largely unanswered.

The most important of these criticisms is the objection to the “normal” tax system.¹⁵ In current tax expenditure analysis, the “normal” tax plays three roles. First, it serves as the benchmark against which present law tax provisions are measured to determine whether they constitute tax expenditures. Second, the “normal” tax operates, at least in the view of some, as an implicit reproach to the current tax system, through being held up as an aspirational but achievable superior tax system. Third, the “normal” tax serves as the baseline from which to calculate the dollar magnitude of a particular tax expenditure.

The first two of these roles elevate the importance of the “normal” tax to a level it cannot support, because the “normal” tax is largely a commonsense extension (and cleansing) of current tax policies, not a rigorous tax framework developed from first principles. As a result, the “normal” tax cannot be defended from criticism as a series of ultimately idiosyncratic or pragmatic choices. If tax expenditure analysis is to enjoy broad support, it must be seen as *neutral* and *principled*; unfortunately, the “normal” tax satisfies these requirements only in the eyes of those who already believe that the “normal” tax accurately captures their personal ideal of a tax system.

To summarize, tax expenditure analysis can and should serve as an effective and neutral analytical tool for policymakers in their consideration of individual tax proposals or larger tax reforms. Its efficacy has been undercut substantially, however, by the depth and breadth of the criticisms leveled against it. Tax expenditure analysis no longer provides policymakers with

¹⁵ See, e.g., Boris I. Bittker, *Accounting for Federal “Tax Subsidies” in the National Budget*, 22 National Tax Journal 244 (1969).

credible insights into the equity, efficiency, and ease of administration issues raised by a new proposal or by present law, because the premise of the analysis (the validity of the “normal” tax base) is not universally accepted. Driven off track by seemingly endless debates about what should and should not be included in the “normal” tax base, tax expenditure analysis today does not advance either of the two goals that inspired its original proponents: clarifying the aggregate size and application of government expenditures, and improving the Internal Revenue Code. The JCT Staff therefore has begun a project to rethink how best to articulate the principles of tax expenditure analysis, in order to improve the doctrine’s utility to policymakers, reemphasize its neutrality, and address the concerns raised by many commentators.

D. Proposed New Approach

This pamphlet introduces a new approach to classifying tax provisions as tax expenditures. Our revised paradigm attempts in particular to respond to what we believe to be the most important consensus objections to the current articulation of tax expenditure analysis. First, in many cases, it is not possible to identify in a neutral manner the terms of the “normal” tax to which present law should be compared. Second, many observers believe that the “normal” tax has been fashioned, not simply to serve as the baseline from which to identify tax expenditures, but also to advocate the adoption of that “normal” tax into law, by presenting it as an aspirational but achievable tax system that is superior to the current Internal Revenue Code.

To address these concerns, the revised classification of tax expenditures divides the universe of such provisions into two main categories: tax expenditures in a narrow sense (as explained below), which we label “Tax Subsidies,” and a new category that we have termed “Tax-Induced Structural Distortions.” The two categories together cover much the same ground as does the current definition of tax expenditures, and in some cases extends the application of the concept further. The revised approach does so, however, without relying on a hypothetical “normal” tax to determine what constitutes a tax expenditure, and without holding up that “normal” tax as an implicit criticism of present law. The result should be a more principled and neutral approach to the issues.

Our approach to “Tax Subsidies” (that is, tax expenditures in a narrow sense) builds loosely on the work of Seymour Fiekowsky and others, by defining a “Tax Subsidy” as a specific tax provision that is deliberately inconsistent with an identifiable general rule of the present tax law (not a hypothetical “normal” tax), and that collects less revenue than does the general rule. (We refer to the converse case, of an exception that deliberately overtaxes compared to the general rule, as a “Negative Tax Subsidy.”) In practice, our conception of the compilation of general rules that together comprise our baseline for identifying Tax Subsidies corresponds closely to the Treasury Department’s “reference tax” baseline in its tax expenditure analyses.

The Tax Subsidy tax base is constructed by asking what constitutes the general rule, and what the exception, under actual present law. Our determination of Tax Subsidies in most cases thus is made, not by reference to an alternative and hypothetical “normal” tax chosen by the JCT Staff, but rather by reference to the face of the Internal Revenue Code itself (along with its legislative history and similar straightforward tools for identifying legislative intent).

We anticipate that our category of Tax Subsidies will comprise the preponderance of items that today are classified as tax expenditures. Some important provisions currently identified as tax expenditures, however, cannot easily be described as exceptions to a general rule of present law, because the general rule is not clear from the face of the Internal Revenue Code. In light of this ambiguity, such a provision cannot properly be classified as a tax expenditure (more accurately, a Tax Subsidy) in the proposed narrower sense. If the JCT Staff were to attempt to expand the scope of Tax Subsidies to address these important policy questions by arbitrarily selecting one taxing pattern or another as the general rule, the result would be the

same sort of subjective determinations that undermine the utility of a “normal” tax base in the current implementation of tax expenditure analysis.¹⁶

As an example, consider the present law’s “deferral” treatment of the earnings of foreign corporations owned by U.S. persons. To date, annual JCT Staff tax expenditure pamphlets have treated this provision as a tax expenditure, because the “normal” tax originally was defined to treat subpart F as the rule, and the deferral of “active” foreign earnings as the exception. This provision would not, however, be classified as a Tax Subsidy under our proposed definition, because present law can fairly be said to be ambiguous as to what constitutes the general rule for taxing foreign earnings.¹⁷

While they may not constitute Tax Subsidies, items like the “deferral” treatment of foreign earnings raise important tax policy issues. Moreover, present law’s treatment of these provisions can be criticized on strict economic efficiency grounds.¹⁸ Tax expenditure analysis as currently implemented identifies some of these issues, but does so by reference to the “normal” tax baseline. The result is a sterile debate as to the appropriateness of the choice of that base, which in turn obscures rather than illuminates the important economic efficiency problems that current policies embody.

Our response to the insufficiencies of an inappropriately narrow definition of tax expenditures is to create a second major category of tax expenditures alongside Tax Subsidies, which we have labeled “Tax-Induced Structural Distortions.” These we define as structural elements of the Internal Revenue Code (not deviations from any clearly identifiable general tax rule and thus not Tax Subsidies) that materially affect economic decisions in a manner that imposes substantial economic efficiency costs.¹⁹

As one example, the “deferral” treatment of foreign earnings will be classified as a Tax-Induced Structural Distortion. Another example is the differential taxation of debt and equity. The distinction between debt and equity encourages business firms to leverage their capital structures in ways that have large economic efficiency consequences, but the distinction is not a tax expenditure (Tax Subsidy) in the narrow sense, because there is no clear consensus as to what general rule of tax law, if any, the debt-equity distinction might violate.

¹⁶ See Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 Duke Law Journal 1155, 1182-1186 (1988).

¹⁷ See J. Clifton Fleming, Jr. and Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and its International Dimension*, 27 Virginia Tax Review 101, 196-197 (2008).

¹⁸ Section V.A of this pamphlet explains the concept of economic efficiency in the context of tax expenditure analysis.

¹⁹ While tax expenditure analysis can be helpful in identifying equity and ease of administration issues as well as efficiency concerns, for reasons developed in Section IV our definition of Tax-Induced Structural Distortions looks only to the last of these criteria.

We recognize that a few items that today are classified as tax expenditures may not fit neatly either as Tax Subsidies or as Tax-Induced Structural Distortions. We propose to continue to carry those items on our tax expenditure tables to preserve continuity with all of our prior work in this area. We will reevaluate this decision periodically, in light of the success (or failure) of the new approach proposed here.

Finally, the JCT Staff's revised approach to tax expenditure analysis further expands the traditional definition by identifying special provisions that increase the tax burden (above what the general rule would impose) as "negative" tax expenditures. (As previously noted, we label these provisions "Negative Tax Subsidies.") Limitations directly linked to various positive tax expenditures, the alternative minimum tax, and the limitation of itemized deductions are not classified as negative tax expenditures but instead are considered reductions in those positive expenditures.

E. Subcategories of Tax Subsidies

The JCT Staff believes that it would be helpful to policymakers to divide Tax Subsidies (i.e., tax expenditures in the narrow sense) into three subcategories. Section IV explains our thinking behind these divisions in more detail.

We propose these subdivisions with some reservations, because plausible arguments can be made to categorize many items in more than one subcategory, and we would not wish for classification arguments again to rob tax expenditure analysis of its productive power. We therefore emphasize that these subcategories are meant only to help policymakers to compare Tax Subsidies of like kind to one another. Regardless of the subcategories to which we have assigned them, all Tax Subsidies rely on the same fundamental definition.

The subcategories of Tax Subsidies are as follows:

1. Tax Transfers

Tax Transfers generally are payments to persons made without regard to their income tax liability, usually because there was no income tax liability to begin with, or because the person's income tax liability was eliminated by another tax subsidy.²⁰ In contrast, Tax Subsidies other than Tax Transfers only reduce (or increase, in the case of Negative Tax Subsidies) a taxpayer's income tax liability.

The subcategory of Tax Transfers today comprises the refundable portions of the earned income tax credit, child tax credit and the 2008 rebate. These provisions usually are based on perceived need as measured by income. The provisions authorizing these payments are the clearest examples of hybrid tax/spending programs, i.e., they are essentially direct government spending programs that use the tax system for distribution.²¹

2. Social Spending

This subcategory of Tax Subsidies includes Tax Subsidies that are unrelated to the production of business income and Tax Subsidies related to the supply of labor. These Tax Subsidies often are intended to subsidize or induce behavior (for example, charitable giving) that generally is considered to be unconnected to the production of business income. Examples include the itemized deduction for healthcare expenses, Individual Retirement Account ("IRA") deductions (or exclusions, in the case of Roth IRAs), and the nonrefundable portion of the child tax credit. This category also includes the portions of the earned income credit, child tax credit and 2008 rebate that are not refundable.

²⁰ For evaluation purposes, the refundable portion of a tax expenditure is considered separately from the nonrefundable portion.

²¹ Tax Transfers are also among the tax expenditures that are close substitutes for existing direct government spending programs. For example, the refundable portion of the earned income credit and child tax credit are similar to non-tax-related government programs (both Federal and State and local) that address financial need and encourage employment of low-income persons.

In cases where a provision has potentially both business and non-business statutory incidence, we classify the provision based on a judgment about the effect and/or the intent of the provision. Thus, for example, we treat working-condition fringe benefits, which are excludible from employee income (but deductible by businesses), as Tax Subsidies in the Social Spending category rather than in the Business Synthetic Spending category (described below) because this treatment of fringe benefits is generally viewed by analysts as affecting labor supply more than general business decisions.²² By the same token, IRAs, owing to their role in capital accumulation, are Tax Subsidies that have a link to Business Synthetic Spending. Nevertheless, we classify them as Social Spending, because so much of their design, including their mandatory distribution requirements, is geared toward income support for retirement.

When legislative intent is not readily discernible, the item generally will be classified according to whether or not it is linked directly to production of business income. Thus, we will classify most education subsidies as Social Spending, while various capital income subsidies will be classified as Business Synthetic Spending (or in some cases these items will show up in the other first-order category, as Tax-Induced Structural Distortions).

Owner-occupied housing preferences can rationally be categorized either as Social Spending or in the subcategory of Business Synthetic Spending, depending on whether one views home ownership as primarily a consumption activity or as a substitute for an income-producing investment. On balance, we believe that they are better described here. Doing so acknowledges that preferences for owner-occupied housing reflect a social policy agenda that transcends the tax law. Moreover, it is more straightforward for non-economists to understand the tax treatment of housing as an exception to the general rule for personal expenditures (no deduction of interest expense or other costs) than it is to see the homeowner as forgoing the rental income that could have been obtained were the housing made available for arm's-length rental.

3. Business Synthetic Spending

This category includes Tax Subsidies intended to subsidize or induce behavior directly related to the production of business or investment income but excludes any Tax Subsidies related to the supply of labor. Examples of Business Synthetic Spending include the section 199 deduction for income attributable to domestic production activities, the completed contract method of accounting rules, various energy subsidies, the last-in-first-out method of accounting and the expensing of soil and water conservation payments.

²² The legislative and executive branch histories of enactment and implementation of these provisions also support this incidence assumption, because this tax treatment of fringe benefits primarily was considered to affect decisions about labor supply and other laborer concerns such as health and retirement.

F. Estimating the Magnitude of Tax Expenditures

The JCT Staff's current quantification methodologies for tax expenditures are not tantamount to revenue estimates, for two critically important reasons. First, our annual tax expenditure tables do not take into account the many large interactive effects that would be observed if Congress were simultaneously to repeal all the many tax expenditures that appear on our tables. Second, by tradition, tax expenditures are calculated on a static basis: that is, the behavioral consequences that would follow from repeal are ignored. By contrast, the JCT Staff's actual revenue estimates fully reflect anticipated behavioral effects of the proposal under consideration, subject only to the constraint that in the usual case we do not model any macroeconomic growth effects from the proposal.²³

While the principal thrust of the JCT Staff's revised approach to tax expenditure analysis is to deemphasize the relevance of the "normal" tax as much as possible, the new approach must still define a baseline from which to measure the magnitude of tax expenditures. As previously described, current tax expenditure analysis employs the "normal" tax as the baseline from which the JCT Staff can calculate the dollar magnitude of a particular tax expenditure.

By contrast, there is no single objective unit of measurement for determining the magnitude of all the provisions that fall within the two-pronged definition of tax expenditures recommended here. The revenues forgone by Tax Subsidies can be calculated by reference to the general rules of the Internal Revenue Code, but by definition this strategy does not work for Tax-Induced Structural Distortions, which are so classified specifically because there is ambiguity as to what is the present law general rule and what is the exception.

On balance, we believe that the most feasible approach, and the one most consonant with the original legislative history of the Congressional Budget Act of 1974 is to follow general present-law tax rules (what the Treasury Department calls its reference tax base) for Tax Subsidies. We will further supplement that information with data for those Tax-Induced Structural Distortions that today are analyzed as tax expenditures by applying our current definition of the normal tax, as reflected in our recent annual tax expenditure pamphlets, *solely* for purposes of this quantification exercise.²⁴ The end result is a bit complex, but has several practical benefits.

First, we believe that the most important benefit of tax expenditure analysis is that it provides a useful framework from which to evaluate the equity, efficiency and administrative issues raised by a new proposal or present law. For this purpose, the *categorization* of the rule in question (as a Tax Subsidy, a Tax-Induced Structural Distortion, or not a tax expenditure at all) is more important than the *quantification* of the revenue forgone by the provision. Second, unless we are to quantify the forgone revenues only of Tax Subsidies, some baseline that is more

²³ *Inside the JCT Revenue Estimating Process*, A presentation by the Chief of Staff of the Joint Committee on Taxation to the New York State Bar Association, January 29, 2008. Revised January 30, 2008, <http://www.house.gov/jct/Inside_Revenue_Estimating.pdf>.

²⁴ Section VI of this pamphlet expands on these points.

inclusive than present law is needed, and this one has been developed (and modeled) for many years. Third, as described above, the quantification of tax expenditures is not, and has never been, intended to serve any purpose beyond providing rough rank ordering of the relative importance of different tax expenditures; because the quantification of a tax expenditure has never been presented as tantamount to a revenue estimate, the use of the “normal” tax as the baseline in a limited number of cases does little practical harm. Finally, this approach preserves continuity with our quantitative presentations of tax expenditures in prior years, which we believe to be helpful to policymakers and researchers alike.

G. Outline of Subsequent Work

We envision this pamphlet as the first of several on this topic that we intend to publish in the coming months. The next pamphlet will comprise our annual list of tax expenditures, reclassified along the lines described in this document, but limited to those items that we describe herein as Tax Subsidies. That pamphlet also will discuss some of the specific reasoning that led us to classify a particular Tax Subsidy in one subcategory or another.

The subsequent document will present a preliminary discussion of selected Tax-Induced Structural Distortions. That pamphlet will not recommend any particular solutions, but instead will attempt to identify critical economic inefficiencies embedded in the current tax system, and then to describe the range of possible solutions (as well as their attendant costs). Of necessity, both the list of Tax-Induced Structural Distortions that we set out, and our analyses of them, will be preliminary in nature, and we envision substantially revising this pamphlet in particular in years to come. Subsequent pamphlets will explore important ancillary themes, like the expansion of tax expenditure analysis to excise taxes.

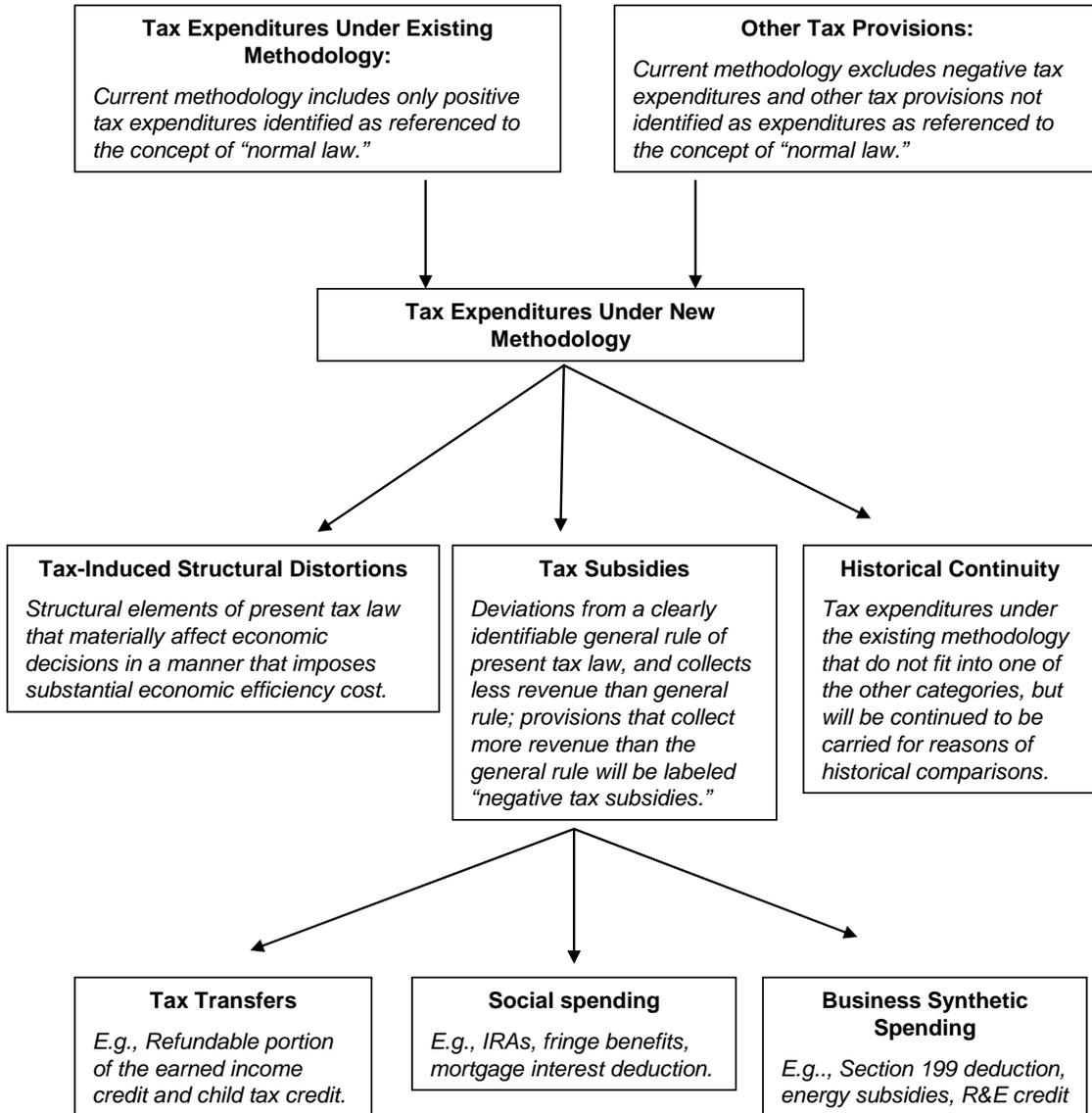
While we hope that our efforts to reduce the relevance of the idiosyncratic “normal” tax are viewed as responsive to the most serious criticisms of current tax expenditure practice, we acknowledge that no effort along the lines of a tax expenditure analysis can ever be entirely value-free. The unavoidable problem is that, by definition, tax expenditure analysis requires comparing actual rules to some hypothetical, whether that hypothetical is entirely exogenous to existing law, as in the case of the “normal” tax, or is inferred from circumstantial evidence and presented as a general rule in the law today, as advocated in our revised approach.

In this regard, we recognize that our specific implementation of tax expenditure analysis is firmly wedded to the view that the current Internal Revenue Code is at heart an income tax, because we employ that perspective when we attempt to identify what are the Code’s general rules, and what the exceptions thereto.²⁵ We believe that this approach is consistent with the language and history of the Code, as well as with the understanding of policymakers today. It of course is possible that subsequent policymakers may embrace a consumption tax as the fundamental starting point for a future Internal Revenue Code, at which point we would need to revisit many of the conclusions reached in the series of documents that we envision publishing over the next several months.

We welcome comments and suggestions on the contents of this pamphlet as well as the overall project.

²⁵ For an interesting examination of how tax expenditure analysis might change in a consumption tax environment, see Robert Carroll, David Joulfaian, and James Mackie, *Income versus Consumption Tax Baselines for Tax Expenditures*, Paper presented at NBER Conference on Tax Expenditures, March 2008.

Figure 2.—Comparison Chart of Tax Expenditure Methodologies



II. THE DEVELOPMENT OF TAX EXPENDITURE ANALYSIS

A. The Tax Expenditure Budget's Origins and Statutory Basis

The first analysis of “tax expenditures” appeared in the Treasury Department’s annual financial report for the 1968 fiscal year.²⁶ That report, prepared under the guidance of Assistant Secretary for Tax Policy Stanley Surrey, implemented Surrey’s earlier call for a “tax expenditure budget” that would encourage “expenditure control” and facilitate “tax reform.”²⁷ Surrey hoped that a formal identification of tax expenditures as substitutes for direct spending would lead to more rigorous analysis of those provisions, revealing them to be poorly targeted or inefficient when compared either to actual government spending or (in most cases) to no spending at all.²⁸ Surrey further believed that an examination of tax expenditures as if they were spending requests would demonstrate that many of these provisions are inconsistent with the goal of an equitable, efficient and simple income tax system. The 1968 Treasury Report therefore sought to identify “the major respects in which the current income tax bases deviate from widely accepted definitions of income and standards of business accounting and from the generally accepted structure of an income tax” and to provide “estimates of the amount by which each of these deviations reduces revenues.”²⁹

The 1968 Treasury Report did not include a comprehensive description of the definitions and standards, or the “generally accepted structure of an income tax,” that served as its baseline for the identification of tax expenditures. In fact, the only features that the 1968 Treasury Report explicitly included in the “accepted structure” of an income tax are the personal exemptions and graduated rates for individuals and the existence of a separate corporate tax.

²⁶ United States Department of the Treasury, *Annual Report of the Secretary of the Treasury on the State of the Finances for the Fiscal Year Ended June 30, 1968*, (Washington, D.C., Government Printing Office, 1969) (herein, the “1968 Treasury Report”). For its reports on the 1972 and 1974 fiscal years, the Treasury Department collaborated with the JCT Staff.

²⁷ Stanley S. Surrey, Excerpts from remarks before The Money Marketeers on *The U.S. Income Tax System -- the Need for a Full Accounting*, November 15, 1967, in the 1968 Treasury Report, *supra* at 322; see also *Pathways to Tax Reform, supra*, at 30-49 (describing uses of a tax expenditure budget).

²⁸ Surrey, *The Federal Tax System--Current Activities and Future Possibilities* (speech before Boston Economic Club, May 15, 1968), in the 1968 Treasury Report, *supra* at 313 (“I doubt that any of these special tax treatments could stand the scrutiny of careful program analysis, and I doubt that if these were direct expenditure programs we would tolerate for very long the inefficiencies that such program analysis would reveal.”).

²⁹ 1968 Treasury Report, *supra* at 327. Consistent with Surrey’s goal of expenditure control, the 1968 and later Treasury Reports presented tax expenditures in the same functional categories under which direct expenditures are classified in the Federal budget.

Surrey later conceded that the early Treasury Reports had relied in part on the Haig-Simons definition of personal income³⁰ as “the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.”³¹ This definition, however, provides only a general framework for analysis. As numerous critics have pointed out, the Haig-Simons definition says nothing about most of the structural issues that must be decided under any income tax law, such as the rate structure, the proper taxpaying unit and the proper accounting period. The meaning of the term “consumption” is also debatable; there is no strong consensus, for example, as to how items such as gifts, charitable contributions and medical expenses should be treated under this standard. Other features of the Haig-Simons definition, such as the inclusion of imputed income from owner-occupied housing, pose significant administrative obstacles.³²

Surrey therefore refined the Haig-Simons definition by incorporating what he described as “widely accepted” definitions and standards and “generally accepted” structural features. Thus, he treated certain items, such as the failure to tax imputed rent from owner-occupied homes, as part of the normal tax baseline “where the case for their inclusion in the income base stands on relatively technical or theoretical tax arguments.”³³ His baseline included the personal exemptions and graduated rates for individuals, on the grounds that those features were “part of the structure of an income tax based on ability to pay.”³⁴ He also included a separate corporate income tax in the baseline on the grounds that U.S. tax policy had accepted the concept, notwithstanding that strong arguments could be made that integrated taxation of corporations and shareholders would better implement the Haig-Simons definition. Numerous other structural issues were revealed only through his choices for the list of tax expenditures.³⁵

³⁰ Responding to criticism from Boris Bittker, Surrey initially denied that the Haig-Simons definition of income had served as the model for the Treasury tax expenditure project. See Stanley S. Surrey and William F. Hellmuth, *The Tax Expenditure Budget -- Response to Professor Bittker*, 22 National Tax Journal 528, 531 (1969). In later writings, however, Surrey was much more explicit about the use of Haig-Simons as the “normative tax” on which his tax expenditure analysis was based: “Tax expenditure analysis, as applied to a particular tax, requires an understanding of the normative structure of that tax in order to determine whether a provision is a part of the structural or the tax expenditure component. In the U.S. analysis of income tax expenditures, the normative concept of net income is based on the Schanz-Haig-Simons economic definition of income” Stanley S. Surrey and Paul R. McDaniel, *Tax Expenditures*, *supra* at 3.

³¹ Henry C. Simons, *Personal Income Taxation* (Chicago, University of Chicago Press, 1938).

³² See Thuronyi, *supra* at 1165.

³³ 1968 Treasury Report, *supra* at 329.

³⁴ 1968 Treasury Report, *supra* at 329.

³⁵ Some items were omitted from the list for practical reasons, such as the perceived difficulty of estimating the magnitude of the subsidy (e.g., accelerated depreciation) or the relatively small size of the subsidy.

B. The Congressional Budget Act of 1974

Congress soon embraced Surrey's concept of tax expenditure analysis in the Congressional Budget Act of 1974 (herein, the "Budget Act").³⁶ Consistent with Surrey's vision of expenditure control, the House and Senate Budget Committees (created by the Budget Act) were charged with the duty "to request and evaluate continuing studies of tax expenditures, to devise methods of coordinating tax expenditures, policies, and programs with direct budget outlays, and to report the results of such studies" to the respective chamber of Congress on a recurring basis.³⁷ To assist in that effort, the CBO (also created by the Budget Act) was required to produce an annual tax expenditure budget,³⁸ and the Executive Branch was required to include a tax expenditure budget in the annual President's Budget transmittal to Congress.³⁹

The Budget Act defines tax expenditures as "those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability; and the term 'tax expenditure budget' means an enumeration of such tax expenditures."⁴⁰ Although the Budget Act does not define the baseline to be used in identifying tax expenditures, the legislative history states that Congress assumed the use of a "normal" tax baseline.⁴¹ The legislative history does not, however, describe the components of this "normal"

³⁶ P.L. 93-344.

³⁷ P.L. 93-344 §101(c) and §102(a). These sections amended House and Senate rule, respectively. The current rules relating to the duties of the budget committees are clause 4(b)(6) of Rule X of the Rules of the House of Representatives, September 14, 2007 <<http://www.rules.house.gov/ruleprec/110th.pdf>> and clause 1(e)(2)(C) of Rule XXV of the Standing Rules of the Senate, September 14, 2007 <<http://rules.senate.gov/senaterules/Rules091407.pdf>>.

³⁸ The CBO is required to provide an annual report to Congress on "the levels of tax expenditures under existing law, taking into account projected economic factors and any changes in such levels based on proposals in the budget submitted by the President for such fiscal year." P.L. 93-344 §202(f)(1)(B). The Budget Act required that the report accompanying the first concurrent budget resolution allocate tax expenditures among major functional categories. P.L. 93-344 §301(d)(6). The report to accompany any bill or resolution reported from committee providing new or increased tax expenditures must contain a statement detailing how these will affect the levels of tax expenditures under existing law and for the following five fiscal years. P.L. 93-344 §308(a)(2) and §308(c)(3).

³⁹ The Budget Act amended the Budget and Accounting Act of 1921(P.L. 67-13) to require this. P.L. 93-344 §601.

⁴⁰ P.L. 93-344 §3(a)(3) currently codified to 2 USC 622.3.

⁴¹ Committee on Government Operations, United States Senate, *Congressional Budget and Impoundment Control Act of 1974, Public Law 93-344*, Legislative History S. 1541-H.R. 7130, (Washington, D.C., U.S. Government Printing Office, December 1974). The original Senate provision defined tax expenditures as "those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability representing a deviation from the normal tax structure for individuals and corporations." S1541. The final statutory language ended this definition after the

structure.⁴² In the absence of explicit guidance, the JCT Staff traditionally interpreted the “normal” tax in a manner consistent with Surrey’s original approach. The Treasury Department, however, has interpreted the same language to permit some significant departures.

word “liability,” as noted above. The accompanying Conference Report stated, however, that this shortening of the definition was a simplification that intended no change in meaning. Senate Conference Report NO. 93-924 to accompany H.R. 7130, Congressional Budget and Impoundment Control Act of 1974, June 12, 1974, p. 50.

⁴² Legislative History, *supra* at 1676.

C. JCT Staff Implementation of Tax Expenditure Analysis

In light of the traditional expertise of the JCT Staff in respect of revenue matters, and a separate statutory requirement that Congress rely on JCT Staff estimates when considering the revenue effects of proposed legislation,⁴³ the CBO has always relied on the JCT Staff for the production of its annual tax expenditure publication. Since 1975,⁴⁴ the JCT Staff reports have always included a description of the features of the normal tax baseline used to identify and measure tax expenditures.⁴⁵ Although the number of provisions listed as tax expenditures has grown from 70 in 1975 to 170 in 2007, the general contours of the normal tax baseline used by the JCT Staff have remained largely unchanged and are similar in essential respects to Surrey's original concept. The growth in the number of identified tax expenditures is attributable primarily to changes in law, as well as increased scrutiny of the Internal Revenue Code over time.

As explained in the JCT Staff's 2007 report, the determination of whether a provision is a tax expenditure is made on the basis of a concept of income that is larger in scope than "income" as defined under general U.S. income tax principles.⁴⁶ Under the JCT Staff methodology employed to date, the "normal" tax structure includes separate components for individuals and corporations.

The JCT Staff definition of the "normal" structure of the individual income tax includes the following major elements: one personal exemption for each taxpayer and one for each dependent, the standard deduction, the existing tax rate schedule, and deductions for investment and employee business expenses. The JCT Staff views the personal exemptions and the standard deduction as defining a zero-rate bracket that is a part of normal tax law. An itemized deduction that is not directly incurred in the production of taxable income is classified as a tax expenditure, but only to the extent that it, when added to a taxpayer's other itemized deductions, exceeds the standard deduction. Most other tax benefits to individual taxpayers are classified as tax

⁴³ P.L. 93-344 §201(g), codified at 2 USC 601(f).

⁴⁴ The JCT Staff issued its first report on tax expenditures in 1972. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures*, October 4, 1972 (JCS-28-72). This report was issued at least in part in response to Congressional requests made in the conference report to the Revenue Act of 1971. Senate Amendment No. 74 to the Revenue Act of 1971 would have required the inclusion in the budget of estimates of "losses in revenue" from provisions of the Federal income tax laws and also estimate of indirect expenditures through the operation of the Federal tax laws. The Senate receded from its amendment in conference, as the Treasury Department indicated its willingness to supply the desired information to the relevant tax committees as requested. Conference Report No. 92-708 to accompany H.R. 10947, Revenue Act of 1971. The actual tax expenditure estimates included in this report were supplied by the Office of Tax Analysis of the Department of the Treasury.

⁴⁵ Joint Committee on Taxation, *Estimates of Federal Tax Expenditures*, July 8, 1975 (JCS-11-75).

⁴⁶ Joint Committee on Taxation, *Estimates of Federal Tax Expenditures*, Sept. 24, 2007 (JCS-3-07), available at < <http://www.house.gov/jct/s-3-07.pdf>>.

expenditures, except for certain items that are included in the baseline for reasons of ease of administration:

- The imputed income that individuals receive from the use of owner-occupied homes and durable goods is not classified as a tax expenditure, because it is administratively difficult to measure this imputed income for tax purposes.
- Capital gains are treated as taxable in full in the year realized through sale, exchange, gift or transfer at death. Thus, the deferral of tax until realization is not classified as a tax expenditure (as the Haig-Simons income definition might suggest). However, reduced rates of tax, further deferrals of tax (beyond the year of realization) and exclusions of certain capital gains are classified as tax expenditures.
- The “normal” tax base also does not provide for any indexing of the basis of capital assets for inflation, with the result that the income tax is levied on nominal gains as opposed to real gains in asset values.

Tax provisions that provide treatment less favorable than “normal” income tax law (commonly referred to as “negative tax expenditures”) have not been identified as such in JCT Staff tax expenditure reports, because listing those items was viewed as not required by the statutory definition of a tax expenditure. The individual alternative minimum tax and the passive activity loss rules are not viewed either as a part of “normal” income tax law or as separate, negative tax expenditures. Instead, they are viewed as provisions that reduce the magnitude of the tax expenditures to which they apply.

With regard to business income, “normal” income tax law is assumed to require the accrual method of accounting, the standard of “economic performance” (to test whether liabilities are deductible) and the general concept of the matching of income and expenses. In general, tax provisions that do not satisfy all three standards are viewed as tax expenditures. The normal income tax law is assumed, however, to provide for the carryback and carryforward of net operating losses, and the general limits on the number of years that such losses may be carried back or forward are also treated as part of the “normal” law on the basis of administrative convenience and compliance concerns.

The tax treatment of capital costs is acknowledged to be one of the most difficult areas in which to identify either the normal tax rule or tax expenditures, given the variety of alternative cost recovery methods available depending on the nature of the costs and the status of the taxpayer. Traditionally, the JCT Staff has classified as tax expenditures any cost recovery allowances that are more favorable than those provided under the alternative depreciation system, which provides for straight-line recovery over tax lives that are longer than those permitted under the accelerated system. For reasons of administration, the normal tax system does not take into account the effects of inflation on tax depreciation.

Finally, the existence of a separate corporate income tax is treated as a feature of the “normal” tax law, but the lower rates for small businesses are treated as tax expenditures because they are intended to provide tax benefits to small business and, unlike the graduated individual

income tax rates, are unrelated to concerns about ability to pay. Notwithstanding the general treatment of corporations as separate from their owners, the earnings of foreign subsidiaries of U.S. taxpayers are treated as currently includible by those U.S. owners. Special tax rules for passthrough entities (i.e., the absence of entity-level taxation) are not classified as tax expenditures, on the basis that those tax benefits are available to any entity that chooses to organize itself and operate in the required manner. For nonprofits, tax-exempt status is not classified as a tax expenditure because the nonbusiness activities of those organizations generally must predominate and their unrelated business activities are subject to tax.

D. Treasury Department Analysis: The Shift to a Reference Law Baseline

While the JCT Staff presentation of tax expenditures has largely remained constant, the Department of Treasury's analysis has changed significantly over time. Early reports prepared during the Ford and Carter Administrations continued the use of the "normal" tax baseline. During those years, the lists of tax expenditures produced by the Treasury Department were very similar to those produced by the JCT Staff, likely reflecting their common origin. As early as 1976, however, the Treasury Department acknowledged the arbitrariness of accepting certain features of the tax system as part of the "normal" tax structure, and noted that features of the normal tax structure should not be immune from scrutiny simply because they are not classified as tax expenditures. According to the 1976 report, many such features themselves have significant effects on economic activity and income distribution and could be replaced with budget outlays (or other policy instruments) or eliminated.⁴⁷

The Reagan Administration viewed the concept of tax expenditures with more skepticism than its predecessors. It preferred the term "tax subsidies," as it viewed most special tax provisions as more analogous to subsidies for particular activities than to direct government spending.⁴⁸ In addition, the Reagan Administration shifted to what it viewed as a more objective baseline. Thus, beginning in 1983, the Treasury Department's Special Analysis of tax expenditures sought to identify those provisions of the Internal Revenue Code that constitute basic structural features of the income tax and those that provide a special exception to the structural rules. Under this approach, a "tax expenditure" is a provision that satisfies two conditions: First, the provision is "special" in that it applies to a sufficiently narrow class of transactions or taxpayers to permit the specification of a program objective that could be assigned to an existing agency other than the IRS and be administered with appropriated funds.⁴⁹ Second, there must be a "general" rule to which the "special" provision is a clear exception. This definition relies heavily on the word "special" in the definition of tax expenditure provided in the Budget Act ("those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability"). The general, structural rules of the Internal Revenue Code became known as the "reference tax law" baseline.

⁴⁷ Special Analysis, *Budget of the United States, Fiscal Year 1976*. In this regard, the report explicitly recognized the following elements as part of the "normal" tax structure: (i) the progressive rate schedules for individuals, (ii) personal exemptions and the minimum standard deduction, (iii) separate rate schedules for filing status, (iv) deduction of business expenses, (v) exclusion of unrealized capital gains and losses, (vi) exclusion of imputed income from owner-occupied housing and other durable assets, (vii) exclusion of gifts and bequests, (viii) exclusion of the value of government services received in kind (e.g., food stamps or Medicare), (ix) foreign tax credits, (x) treatment of corporations as separate taxing entities, and (xi) the deferred taxation of earnings of foreign corporations.

⁴⁸ The 1983 budget also expressed the view that the term "tax expenditure" implied that the government has control over all resources.

⁴⁹ This condition represented a version of the substitutability criterion suggested by Seymour Fiekowsky. See Fiekowsky, *The Relation of Tax Expenditures to the Distribution of the 'Fiscal Burden,'* 2 *Canadian Taxation* 211, 215 (1980).

The reference tax law included the following components:⁵⁰ definition of a taxpaying unit, tax rate schedules, and general accounting rules for determining income subject to tax. Taxpaying units overlap in the “normal” and reference tax structures with one major exception. The reference tax law treats controlled foreign corporations as separate taxable entities whose income is not subject to U.S. tax until distributed to U.S. taxpayers. Thus, no tax expenditure arises from the deferral of tax on foreign earnings of controlled foreign corporations, because U.S. taxpayers generally are not taxed on accrued, but unrealized income. Separate rate schedules for different taxpayers are part of reference law, such that lower rates for the first several thousand dollars of corporate income do not give rise to tax expenditures under reference law as they do under “normal” law.⁵¹ General accounting rules determine that income subject to tax is gross income less costs of earning that income under reference law.

Reference law excludes gifts, defined as receipts of money or property that are not consideration in an exchange. This definition encompasses transfer payments, which are deemed gifts from the Federal government, even though “normal” law regards cash transfer payments as gross income. Depreciation under the reference tax law adopts the existing general accelerated depreciation rules as the baseline, thus they generate no tax expenditures. In contrast, “normal” law defines the difference between an approximation of economic depreciation and accelerated depreciation as a tax expenditure. In all other major respects, reference law and “normal” law are equivalent.⁵²

The Reagan Administration used the “reference law” approach exclusively for the 1983 and 1984 fiscal years. As a result, its tax expenditure lists did not fully correspond to the lists provided by the JCT Staff or by the CBO. Beginning in 1985, however, the Treasury Department provided lists of tax expenditures with respect to both its new reference tax law baseline and its historic normal tax baseline.⁵³

Essentially, the Treasury Department’s list of tax expenditures was split into two categories, a presentation that continues today. The first consists of deviations from the reference law baseline. The second category consists of more general deviations from a

⁵⁰ This discussion draws heavily on *Special Analyses, Budget of the United States Government, 1985*, “Special Analysis G - Tax Expenditures.”

⁵¹ Capital gains rates currently do not generate tax expenditures under reference law as they are structured as a maximum separate rate schedule. In 1985, the Code accomplished favorable treatment of capital gains via an exclusion, and thus such treatment gave rise to a tax expenditure even under reference law.

⁵² In 1990, the Treasury Department expanded the scope of the tax expenditure budget to include special and preferential provisions of the federal estate and gift tax laws. This addition was made possible by the use of a reference tax baseline, as no generally accepted normative tax structure exists for transfer taxes. This presentation ceased with the Fiscal Year 2003 budget, however, due to Bush Administration concerns over the lack of a generally accepted baseline and because the estate tax had been repealed by the Economic Growth and Tax Relief Reconciliation Act of 2001.

⁵³ Special Analysis, *Budget of the United States, Fiscal Year 1985*.

comprehensive normative base. Items in the second group are not treated as “tax expenditures” as such, but comprise a list of provisions subject to consideration as part of a more general reform of the existing income tax. The Treasury Department also uses a different classification of those provisions that can be considered a part of the normal base of both the individual and business income tax law.

In general, the JCT Staff methodology involves a broader definition of the normal income tax base, so that the JCT Staff list of tax expenditures includes some provisions that are not contained in the Treasury list. The cash method of accounting by certain businesses is one example. The Treasury Department considers the cash method of accounting for certain businesses to be part of normal income tax law, while the JCT Staff methodology treats it as a departure from normal income tax law that constitutes a tax expenditure.

E. Recent Treasury Department Analyses

The Bush Administration, in its FY2003 budget, expressed renewed concern with the degree of arbitrariness in the tax expenditure baseline, stating that “the meaningfulness of tax expenditure estimates is uncertain and that the ‘tax expenditure’ presentation can be improved by consideration of alternative or additional tax bases.”⁵⁴ The effort to improve the tax expenditure presentation focused on three aspects: first, the definition of an income tax or standard against which tax expenditures are identified; second, estimating “negative” tax expenditures, i.e., provisions that cause a taxpayer to pay more tax than would be consistent with the baseline income tax; and third, estimating tax expenditures relative to a hypothetical consumption tax, as well as relative to an income tax.

The FY2004 budget implemented changes in each of the three areas outlined above. It changed the way accelerated depreciation was accounted for in the baseline income tax and added an estimate of the tax expenditure associated with net imputed rental income from owner-occupied housing.⁵⁵ It also included estimates of the negative tax expenditure associated with the multiple taxation of corporate income. Significantly, it also began reporting tax expenditures relative to a consumption tax baseline.

⁵⁴ Analytical Perspectives, *Budget of the United States, Fiscal Year 2003*, Chapter 6.

⁵⁵ For consistency, the tax expenditure list should not include both the exclusion of imputed rental income and the deduction for mortgage interest as the latter is a cost of earning the former and therefore rightly deducted if the former is included in income.

III. CRITIQUES OF THE TAX EXPENDITURE CONCEPT

A. The Design of the Normal Tax Base

In current tax expenditure analysis, the “normal” tax base serves (at a minimum) as the measuring rod by which to judge whether particular tax provisions constitute tax expenditures, and also the baseline from which the JCT Staff calculates the revenues forgone by particular tax expenditures. As explained in Section II, this baseline has remained largely unchanged over the past 40 years, and therefore today is similar in essential respects to Surrey’s original concept.

In 1969, Professor Boris Bittker provided the foundation for much of the criticism that would follow by examining the subjective nature of Surrey’s “normal” tax.⁵⁶ As Bittker observed, “any system of income taxation is an aggregation of decisions about a host of structural issues that the Haig-Simons definition does not even purport to settle.”⁵⁷ For example, the Haig-Simons definition provides no guidance on the rate structure, the proper taxpaying unit, the relationship between a corporation’s income and its shareholders’ tax liability, or the proper accounting period. According to Bittker, Surrey’s silent incorporation of his own judgments on these structural elements into his “accepted concept of net income” succeeded in “bringing some issues to the fore only to conceal others.”⁵⁸ Provisions that deviated from Surrey’s “normal” tax, such as the investment credit, were classified as tax expenditures, while “a rate reduction concentrated on high bracket taxpayers” escaped that “pejorative classification” because the rate structure was treated as inherent in the “normal” tax.⁵⁹ Other items that Bittker cited as debatable choices for inclusion in the “normal” income tax included the Internal Revenue Code’s nonrecognition provisions (such as the treatment of like-kind exchanges and corporate reorganizations), straight-line depreciation for buildings (which can exceed the decline in market value) and the foreign tax credit (while the deduction of nonbusiness state and local taxes was treated as a tax expenditure). Bittker concluded that no set of tax expenditures derived from such a subjective baseline could achieve sufficient consensus to warrant inclusion in a national budget.⁶⁰

⁵⁶ Boris I. Bittker, *Accounting for Federal “Tax Subsidies” in the National Budget*, 22 National Tax Journal 244 (1969).

⁵⁷ Bittker, *supra* at 260.

⁵⁸ *Id.*

⁵⁹ Bittker, *supra* at 261. Subsequent critics have made essentially the same point. *See also* Thuronyi, *supra* at 1166 (“Surrey’s normative tax reflected his vision of what the U.S. income tax should look like, given the constraints of politics. By incorporating ‘generally accepted’ concepts, though, Surrey endeavored to shield this subjective vision behind the authority of a consensus of experts.”).

⁶⁰ Despite his concerns about the logical consistency of Surrey’s argument, Bittker nevertheless felt that the Treasury’s tax expenditure budget was “a promising exploration of [the] territory,” which might serve as a starting point for more “comprehensive estimates.” *Id.* at 260.

Since the publication of Bittker's essay, many other observers, representing a wide range of political and policy perspectives, have echoed his criticism of the "normal" tax base as a subjective compilation of judgments without a rigorous formal basis. Despite nearly uniform agreement on this point, however, no consensus has emerged on an alternative approach.

In 1980, Seymour Fiekowsky, then Assistant Director of the Treasury Department's Office of Tax Analysis, observed that "from the outset critics have perceived that the compilers of tax expenditure budgets are not as interested in more reliable accounting of the size of the uses side of the budget as they are in perpetuating the confusion between expenditure and tax structural issues in order to 'reform' the tax system."⁶¹ Fiekowsky argued instead for a more rigorous examination of the extent to which a tax provision could be replaced with a direct expenditure. He proposed a distinction between "tax subsidy programs," such as the section 103 exemption for interest on state and municipal bonds, and "tax policy, or tax-structural, issues," such as the capital gains preference and tax depreciation rules. To identify "tax subsidies," he proposed two criteria: (1) in the absence of the particular provision, existing tax law provides a general rule for determining tax liability, and (2) it is possible to formulate an expenditure program administrable by a cognizant government agency that would achieve the same objective at equal, higher or lower budgetary cost. A tax expenditure budget would include only items that met both tests, i.e., "tax subsidies," and these would be evaluated using conventional cost and effectiveness criteria.

Fiekowsky's category of "tax policy" or "tax-structural issues" included items that had important tax policy consequences but that were not "tax subsidies," either because there was no clear general rule to which they were an exception, or because it was not feasible to envision a spending program that would substitute for the tax rule. For example, neither the preferential treatment of capital gains nor accelerated depreciation methods constituted tax subsidies in Fiekowsky's view, but for different reasons. The capital gains preference would meet the first leg of the definition because, in its absence, capital gains and losses would be taxable as items of ordinary income, but not the second leg, because it would be unrealistic to imagine replacing the capital gains preference with an expenditure program. On the other hand, the Internal Revenue Code arguably contains no general tax depreciation rule that would apply in the absence of the accelerated depreciation provisions.

Fiekowsky argued that both of these items can be evaluated only with reference to "superior tax structural rules, i.e., other feasible rules to define the tax base and specify the taxable unit and rates of tax, that impose less economic welfare loss or more nearly achieve the goal of horizontal equity while raising the necessary revenue." In his view, tax expenditure analysis was not an appropriate context in which to make those tax policy choices.⁶²

⁶¹ See generally Fiekowsky, *supra* at 213.

⁶² In the same year, Michael McIntyre proposed a similarly limited approach under which tax expenditure analysis would apply only to tax provisions that were spending equivalents. To identify "tax expenditures," however, he proposed the less rigorous test that there be "a bare assertion that the tax rule under examination promotes a spending goal." McIntyre observed that tax analysts cannot always distinguish goals associated with raising revenue from goals associated with spending, since tax policy is

Other critics have argued that the definition of a tax expenditure should focus on the first of Surrey's goals – expenditure control – as a way to address their concerns regarding Surrey's normative baseline. In 1988, Professor Victor Thuronyi acknowledged the utility of the tax expenditure concept,⁶³ but argued that, by defining tax expenditures as departures from a normative tax, Surrey had “tried to cover all tax reform questions with the tax expenditure umbrella.”⁶⁴ Thuronyi proposed instead a category of “substitutable tax provisions,” defined to include any tax provision that can be replaced with a non-tax-based federal program that fulfills the tax provision's purposes at least as effectively as does the provision itself. Thuronyi believed that identification of these provisions would help policymakers treat tax and spending provisions alike for budget-making purposes and encourage replacement of tax provisions with direct spending programs where the latter would be more efficient. This approach, he argued, “does not rely on the idea of a normative tax, and thus avoids attack from those who disagree with a particular normative tax or, more generally, with the approach of defining tax expenditures as a departure from a normative tax.”⁶⁵

In 1992, Professors Douglas A. Kahn and Jeffrey S. Lehman argued forcefully that the idea of a normative tax base to which existing law should be compared “presumes that some of us should be deemed to know the answers better than others.”⁶⁶ They pointed out that a range of views exist on the ideal nature of an income tax (including that it should instead be a consumption tax), and argued that the choice among the various alternatives is “a contestable, contingent, political decision.”⁶⁷ To assist in that regard, they argued for less restrictive analyses of tax law provisions that depart from a variety of different conceptions of the appropriate tax base.

Ten years later, Bruce Bartlett argued in a similar vein that traditional tax expenditure analysis, and its “implicit assumption that there is some ideal tax system against which to judge tax preferences,” institutionalizes a particular view of tax policy that makes it difficult to make

a tool of both social and economic policy. He argued that his approach could accommodate an analysis of an argument according to both tax policy and spending policy criteria. Tax expenditure analysis would address only the latter criteria, and would say nothing about the suitability of a tax rule for promoting tax policy goals. Michael J. McIntyre, *A Solution to the Problem of Defining a Tax Expenditure*, 14 University of California Davis Law Review 78 (1980).

⁶³ Thuronyi, *supra* at 1205 (“Ever since Stanley Surrey created the tax expenditure concept, it has proven extremely useful in alerting policymakers that the tax system provides subsidies.”).

⁶⁴ *Id.* at 1181.

⁶⁵ *Id.* at 1187. Thuronyi also supported retention of Surrey's traditional definition of tax expenditures but, in recognition of its inherently subjective nature, he viewed it as a means of identifying “tax-based subsidies” that would be evaluated using criteria other than equivalence to a spending program.

⁶⁶ Douglas A. Kahn and Jeffrey S. Lehman, *Tax Expenditure Budgets: A Critical View*, 54 Tax Notes 1661, 1665 (1992).

⁶⁷ *Id.*

positive reforms.⁶⁸ Bartlett, who advocated replacement of the income tax with a consumption tax, supported what he viewed as the Bush Administration's move to "downgrade and revise the tax expenditures budget." He viewed this step as helpful in laying the groundwork for fundamental tax reform, observing that the Haig-Simons income base of traditional tax expenditure analysis "reinforces the supposed superiority of an income base and is a barrier to adoption of a consumption-based system."⁶⁹

In 2003, Leonard Burman observed that "[t]here is clearly an ideological element to the [tax expenditure analysis] debate about tax bases. People who favor an income tax also tend to favor the current method of measuring and displaying tax expenditures. Those who would prefer heavier reliance on consumption taxes would favor defining the normal tax as a broad-based consumption tax. Given that the actual income tax is a hybrid system containing many elements of income and consumption taxation, there is no objective way to resolve this dispute." Burman argued that it would be better to resolve the debate about income versus consumption tax outside the context of tax expenditure analysis. Once that issue was resolved, he suggested, the measurement and analysis of tax expenditures against the appropriate baseline would be helpful in making the tax system as neutral as possible.⁷⁰

Still other critics have responded by proposing wholly different theories of tax expenditure analysis. Professor Daniel Shaviro, writing in 2004, observed that the tax expenditure debate had gone "off the rails," not in its aim of identifying "special" provisions, but in doing so "through the identification of a supposedly canonical, yet in practice under-theorized and rightly controversial, official definition of the 'normative income tax base.'"⁷¹ Shaviro argued that the debate over the defensibility of the normative base was misdirected and too narrowly focused, and argued instead for an approach to tax expenditure analysis that would be more flexible and varied in its groupings. Shaviro restated the definition of tax expenditures as "mainly allocative rules that, as a formal matter, are found within the (ostensibly mainly distributional) tax system."⁷² Shaviro hoped that by acknowledging reasonable disagreements

⁶⁸ Bruce Bartlett, *The End of Tax Expenditures as We Know Them?*, 92 Tax Notes 413, 419 (2001).

⁶⁹ *Id.* at 421.

⁷⁰ See Leonard E. Burman, *Is the Tax Expenditure Concept Still Relevant*, 56 National Tax Journal 613, 618 (2003). While Burman saw the issue of defining the normal tax as an income tax or a consumption tax as the most contentious point of debate, he also maintained that resolution of this question was not critical to the utility of tax expenditure analysis, because even those who favor a consumption tax could find useful information in the "normal" income tax expenditure budget. Burman's theory was that tax expenditure analysis's use of the "normal" income tax base provided at least a crude measure of the nonneutralities that existed among different kinds of saving and investment under the existing hybrid tax system.

⁷¹ Shaviro, *supra* at 199.

⁷² Shaviro, *supra* at 188. This definition draws on Richard Musgrave's distinction between the allocative and distributional branches of the fiscal system. See Richard Musgrave, *The Theory of Public Finance, A Study in Political Economy* (1959).

with respect to the underlying distributional aims of any given tax system or tax base, it would be possible to focus the debate on the allocative effects (i.e., the effect on the “amount, use, and character of all assets in society”) of particular provisions. This approach, he believed, would facilitate a more effective evaluation of those allocative provisions than the traditional focus on spending equivalence.

More recently, Professors David A. Weisbach and Jacob Nussim have observed that “[t]here is no such thing as a normative tax base. The simultaneous need for a definition and the lack of grounding for any particular definition make the tax expenditure budget problematic.”⁷³ They argue instead for a theory of tax expenditures that focuses on institutional design, rather than tax policy. Under their approach, “it is entirely irrelevant whether some piece of governmental policy complies with independent tax norms.” Rather, they suggest that tax expenditure analysis should determine the best way to implement a government program – through a direct spending program or through a tax program – starting from the premise that such a program will exist.

⁷³ David A. Weisbach and Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 *Yale Law Journal* 955, 976 (2004).

B. The “Normal” Tax as a Tax Reform Agenda

Closely related to the criticism that the “normal” tax is not rigorously specified is the charge that the proponents of tax expenditure analysis use that tool to promote its “normal” tax as the goal of a tax reform agenda. Under this view, the “normal” tax does not simply serve as the baseline from which to identify tax expenditures, but also is consciously presented as an aspirational but achievable tax system that is superior to the current Internal Revenue Code, and that therefore should be enacted into law.

Critics who see the adoption of the “normal” tax as the goal of tax expenditure analysis are thus inclined to see any tax expenditure analysis as a politically charged process. In this vein, Surrey’s insistence that his goal was merely expenditure control is dismissed as disingenuous. According to Professor Shaviro:

Tax reform, defined as broadening the base of the income tax so that high-income taxpayers would pay more, had long been a personal cause. For Surrey, the tax expenditure budget was a tool of tax policy, not just budget policy. It was meant to serve as a hit list, identifying tax provisions that should be repealed and either disappear altogether or else reappear as direct spending, and not just placed on par with direct spending whenever budgetary balance was evaluated.⁷⁴

Similar criticism has been directed toward proponents of alternative baselines. For example, Professor Linda Sugin has suggested that the Reagan Treasury Department manipulated tax expenditure analysis by changing from a “normal” tax base to a reference tax law baseline (as outlined above) in order to skew the tax expenditure budget in favor of social spending while embedding business incentives into the tax’s normal structure.⁷⁵

⁷⁴ Shaviro, *supra* at 201; *see also* Fiekowsky, *supra* at 213 (“Indeed, from the outset critics have perceived that the compilers of tax expenditure budgets are not as interested in more reliable accounting of the size of the uses side of the budget as they are in perpetuating the confusion between expenditure and tax structural issues in order to ‘reform’ the tax system.”).

⁷⁵ *See* Linda Sugin, *Tax Expenditure Analysis and Constitutional Decisions*, 50 *Hastings Law Journal* 407, 425 (1998-1999). Sugin, who acknowledges that tax expenditure analysis “provides relevant information” and is “well suited” to legislatures, is concerned about the potential judicial application of tax expenditure analysis to cases involving the equal protection or establishment clause, “because of the theoretical impossibility of [tax expenditures’] definition.” *Id.* at 419.

C. Tax “Exceptionalism”

A third line of criticism is the argument that tax expenditure analysis embodies “tax exceptionalism,” that is, an unrealistic insistence on “keeping the tax laws clean of tax preference provisions henceforth and forever.”⁷⁶ This criticism has more typically been directed toward advocates of a “comprehensive” income tax base, who are viewed as seeking to treat the tax system as “separate from the rest of government,”⁷⁷ and spending programs in particular, in order to keep it free of tax subsidies or preferences. By implication, however, any analysis that seeks to identify and evaluate tax subsidies or preferences is susceptible to a similar charge.

Professors Weisbach and Nussim, for example, argue that tax exceptionalism is a mistake. In their view, the tax system should not be privileged, rather it should be seen simply as another political tool, and the decision to implement a nontax program through the tax system should be “solely a matter of institutional design.”⁷⁸

D. The “Last Penny” Argument

Finally, some critics have suggested that tax expenditure analysis is based on the “sinister premise . . . [that one should] think of all income as virtual state property, and forbearance to tax away every last penny of it as itself a tax expenditure.”⁷⁹ The argument has also been phrased in terms of tax expenditure analysis serving an agenda of “egalitarianism,” by which apparently is meant using the tax system to level the wealth of all members of society.⁸⁰

E. Analysis of the Criticisms

The proponents of traditional tax expenditure analysis have failed to respond convincingly to the criticisms of the “normal” tax as underspecified and (whether consciously so designed or not) as an implicit goal of a tax reform agenda. In current tax expenditure analysis, the “normal” tax plays three roles. First, it serves as the benchmark against which present law

⁷⁶ See Kyle Logue, *If Taxpayers Can't be Fooled, Maybe Congress Can: A Public Choice Perspective on the Tax Transition Debate*, 67 *University of Chicago Law Review* 1507, 1525 (2000).

⁷⁷ See Weisbach and Nussim, *supra* at 968. Logue, who originated the term “tax exceptionalism” used it to criticize Daniel Shaviro on this basis. See Logue, *supra* at 1525.

⁷⁸ Weisbach and Nussim, *supra* at 957.

⁷⁹ Charles Fried, *Whose Money Is It?*, *Washington Post*, January 1, 1995, page C-7. Cited in Shaviro, *supra* at 187; see also Joint Economic Committee Study, *Tax Expenditures: A Review and Analysis* 1 (1999) (noting that the tax expenditure concept relies on an expansive definition of income; as a result, “provisions that shield components of this broad definition of income are viewed as depriving the government of its rightful revenues; these lost revenues are regarded as properly belonging to the federal government.”).

⁸⁰ Bartlett, *supra* at 419 (“[A]dvocates of the tax expenditure concept prefer to argue their case as a matter of principle. Yet a closer examination of their arguments suggests that egalitarianism, rather than good tax policy, is the true motive.”).

tax provisions are measured to determine whether they constitute tax expenditures. Second, the “normal” tax operates, at least in the view of some, as an implicit reproach to the current tax system, through being held up as an achievable and superior alternative tax system. Third, the “normal” tax serves as the baseline from which to calculate the dollar magnitude of a particular tax expenditure.

The first two of these roles elevate the importance of the “normal” tax to a level it cannot support, because the “normal” tax is largely a commonsense extension (and cleansing) of current tax policies, not a rigorous tax framework developed from first principles. As a result, the “normal” tax cannot be defended from criticism as a series of ultimately idiosyncratic or pragmatic choices. If tax expenditure analysis is to enjoy broad support, it must be seen as *neutral* and *principled*; unfortunately, the “normal” tax satisfies these requirements only in the eyes of those who already believe that the “normal” tax accurately captures their personal ideal of a tax system.

In part, the large body of criticism on these points can be explained as an academic preference for logically rigorous presentations derived from objective first principles. As summarized above, many academic writers have concluded that a “normal” tax base that cannot be specified in an objective manner simply represents the personal tastes of the proponent, and therefore cannot form the basis for separating core principles from exceptions.⁸¹

More fundamentally, however, the depth and breadth of the criticism can be seen as evidence that, in contrast to the prevailing view 40 years ago, there no longer is a near-universal consensus view as to the ideal tax system. Much academic work since the time Surrey first published his proposal for tax expenditure analysis has been devoted to arguing for the superiority of a consumption tax system over an income tax. Other academic writers have developed the argument that the current tax law hews much less closely to income tax ideals than was once commonly supposed, and further have sought to demonstrate that consumption taxes and income taxes are not (or can be designed so as not to be) as different in their economic and distributive effects as they might at first appear. Finally, other academic observers have argued

⁸¹ Bittker, for example, preferred a “more limited accounting” that would confine itself to estimating the cost of departures from the Haig-Simons definition, without attempting to account for the cost of structural provisions (such as the joint return, rate schedules, taxable periods and tax exemptions) for which that definition provides no normative model. Bittker, *supra* at 260-261. Bittker argued that “such calculations could provide information that would be helpful in applying our political, economic and ethical criteria in making policy judgments about the income tax system.” He further believed that these estimates would “help to show whether the departures of existing law are skewed in a particular direction, and whether some departures counterbalance rather than reinforce others--matters of much importance for the person who acknowledges that some departures are unavoidable, but who wants nevertheless to approach as closely as possible to the Haig-Simons ideal.” *Id.* at 261.

that a practical income tax can never come close to satisfying income tax ideals, and in the resulting world of “second best” choices, that unachievable ideal can be a misleading goal.⁸²

Whether these criticisms are correct is less important for this purpose than is the observation that they are prevalent. Tax expenditure analysis is useful to policymakers only if its conclusions are widely agreed to be neutral, in both a political and an economic sense.⁸³ The breadth and depth of the criticism of the present “normal” tax base suggests that such agreement, if it ever existed, cannot be obtained in the current environment. In light of these realities, the JCT Staff believes that it is appropriate to revisit our tax expenditure methodology, in order to refashion it in a manner that will generally be viewed as more neutral and more principled than the current implementation.

There also is merit to the argument that tax expenditure analysis reflects tax “exceptionalism” – the belief that the tax system ordinarily ought not to be burdened with the sort of *ad hoc* political compromises reflected on the face of much spending legislation. In the view of the JCT Staff, however, that “exceptionalism” is largely justified.

Unlike most spending programs, the tax system affects every individual and every economic transaction. The same is not true of most spending legislation. Because virtually every adult American must wrestle with the Internal Revenue Code, and because our system ultimately relies on self-assessment, it is important to reduce the compliance burden and to reinforce the view that the tax system is equitable. A taxpayer who reads 87 pages of instructions for a tax return⁸⁴ that detail a host of special exemptions, credits, and deductions incurs substantial compliance costs (in time or money), and may come away from the experience with the belief that the tax system contains numerous special provisions that are available to others, but not to him. Both the mistakes that may result and the perception of a system riddled with special provisions undercut in an important way the success of the self-assessment system.⁸⁵ For these reasons, the JCT Staff believes that there is merit in a presumption in favor of a tax system that is as simple and as easy to administer as possible.

⁸² See Diane Lim Rogers, *Federal Income Tax Policy: Issues of Distribution and Equity*, in W. Bartley Hildreth and James A. Richardson, eds., *Handbook on Taxation* 586 (1998) (summarizing the shifts in academic thinking about tax design between the 1960s and 1980s).

⁸³ Cf. Thomas Neubig, *The Current Role of the Tax Expenditure Budget* 239, 243, in Neil Bruce, ed., *U.S. Policymaking, in Tax Expenditures and Government Policy* (1988) (“Since its original development, the purpose of the tax expenditure budget, the appropriate conceptual baseline, and the measurement of tax expenditures, have become questions without consensus resolution. Without such resolution, differences in and unresolved questions about the tax expenditure budget have become excuses for ignoring or minimizing its role in the budget.”).

⁸⁴ The general instructions for IRS Form 1040 in 2007 were 87 pages long.

⁸⁵ See Robert V. Beaudry, *The Flat Rate Tax: Is It a Viable Solution to the Crisis Facing the Internal Revenue Code?*, 9 Oklahoma City University Law Review 219, 250 (1984), quoted in Edward A. Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 Texas Law Review 973, 1027 at fn. 106 (1985-1986).

Finally, the JCT Staff believes that the “last penny” argument is wholly without merit. In a recent article, Professors J. Clifton Fleming, Jr. and Robert J. Peroni point out that this argument makes sense only if tax expenditure analysis “can be fairly understood as asserting that Congress has a normative obligation to adopt a generally applicable income tax and that 100% is the normatively correct rate for such tax.”⁸⁶ Tax expenditure analysis does not, however, require the enactment of an income tax, and does not prescribe any particular level of income taxation as normatively correct.⁸⁷ Moreover, tax expenditure analysis is agnostic as to the extent to which any income tax system is progressive: today’s implementation of tax expenditure analysis, for example, treats individual marginal tax rates that are lower than the maximum marginal rate (at whatever rates they happen to be from year to year) as part of the “normal” tax base, not as tax expenditures.

⁸⁶ J. Clifton Fleming, Jr. and Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 *Virginia Tax Review* 101, 156 (2008); *see also*, Thuronyi, *supra* at 1178 (“This criticism, of course, misses the point. Tax expenditure analysis does not assert that the federal government has a right to tax away everyone’s income. Rather, it asserts that the government taxes to the extent of the normative tax, but gives back a substantial amount of this tax revenue through various tax-based spending programs.”).

⁸⁷ *Id.*

IV. REVISED TAX EXPENDITURE TAXONOMY⁸⁸

A. Introduction

This Section IV introduces a new approach to classifying tax provisions as tax expenditures. Our revised paradigm attempts in particular to respond to what we believe to be the most important consensus objections to the current articulation of tax expenditure analysis, as summarized in Section III. First, in many cases, it is not possible to identify in a neutral manner the terms of the “normal” tax to which present law should be compared. Second, many observers believe that the “normal” tax has been fashioned, not simply to serve as the baseline from which to identify tax expenditures, but also to advocate the adoption of that “normal” tax into law, by presenting it as a realistic goal of a tax reform agenda.

To address these concerns, the revised classification of tax expenditures divides the universe of such provisions into two main categories: tax expenditures in a narrow sense, which we label “Tax Subsidies,” and a new category that we have termed “Tax-Induced Structural Distortions.” The two categories together cover much the same ground as does the current definition of tax expenditures, and in some cases extend the application of the concept further. The revised approach does so, however, without relying on a hypothetical “normal” tax to determine what constitutes a tax expenditure, and without holding up that “normal” tax as an implicit criticism of present law. The result should be a more principled and neutral approach to the issues.

B. Tax Subsidies

Our approach to “Tax Subsidies” (that is, tax expenditures in a narrow sense) builds loosely on the work of Seymour Fiekowsky and others, by defining a Tax Subsidy as a specific tax provision that is deliberately inconsistent with an identifiable general rule of the present tax law (not a hypothetical “normal” tax), and that collects less revenue than does the general rule.⁸⁹ (We refer to the converse case, of an exception that deliberately overtaxes compared to the general rule, as a “Negative Tax Subsidy.”) In practice, our conception of the compilation of general rules that together comprise our baseline for identifying Tax Subsidies corresponds closely to the “reference tax” baseline that the Treasury Department uses in its tax expenditure analyses.

The Tax Subsidy paradigm is constructed by asking what constitutes the general rule, and what the exception, under actual present law. Our determination of Tax Subsidies in most cases thus is made, not by reference to an alternative and hypothetical normal tax chosen by the JCT

⁸⁸ This Section IV is an expanded version of the summary of our new approach presented in Section I.

⁸⁹ Fiekowsky, *supra*, at 215; *see also* OMB, *The Budget of the United States Government, Fiscal Year 1983 -- Special Analyses G-5* (1982); Thuronyi, *supra*, at 1187 (advocating a two-step classification scheme that (1) identifies a provision’s significant purposes and (2) determines whether a nontax program can serve those purposes at least as well).

Staff, but rather by reference to the face of the Internal Revenue Code itself (along with its legislative history and similar straightforward tools for identifying legislative intent).

This definition does not require the kinds of normative judgments that go into the construct of the current “normal” tax, but it is nonetheless not automatic in application. First, there will be occasional uncertainty as to whether there is a clear general rule of current tax law. Second, the system itself is at risk of producing different results through different names for economically similar preferences.

For example, the Treasury Department, in its comparable implementation of a “reference” tax base, does not list capital gains as a tax expenditure, because the capital gains preference is implemented as a different tax *rate*. In 1985, by contrast, the Internal Revenue Code provided preferential treatment for capital gains through an *exclusion*; the Treasury Department treated the exclusion as giving rise to a tax expenditure even under its “reference” base. The JCT Staff will be mindful of the importance of continuity from one period to the next as it develops the detailed implementation of the concept of Tax Subsidies in the future.

Fiekowsky and others would go further than we propose to do, by classifying a tax provision as what we call a Tax Subsidy only if that provision could be replaced by a direct expenditure program in a reasonably administrable manner. The Treasury Department also has adopted this “spending substitute” leg to its definition; we understand, however, that the Treasury Department does not currently exclude any prospective tax expenditure on the grounds that a spending program could not be designed as an effective substitute.

In practice, many Tax Subsidies will satisfy this second test as well, but in the end we believe it better not to add this second test to our definition, for two reasons. First, in some cases the test will lead to new and often fruitless debates about whether a hypothetical spending program could be designed to accomplish the same distributional effects as does a particular tax provision. Second, as explained earlier, our experience has shown that tax expenditure analysis has been most successful when applied as a tool of tax policy, rather than budget transparency. In our view, the “spending substitute” leg of the Fiekowsky definition points too much in the direction of the second agenda, by requiring that a Tax Subsidy be convertible into a straightforward spending substitute.⁹⁰

Some important provisions currently identified as tax expenditures cannot easily be described as exceptions to a general rule of present law, because the general rule is not clear from the face of the Internal Revenue Code. In light of this ambiguity, such a provision cannot properly be classified as a tax expenditure (more accurately, a Tax Subsidy) in the proposed narrower sense. Instead, we propose a second category, described below, for those provisions.

⁹⁰ In Section VI we discuss outlay equivalence, which is a byproduct of this spending test.

C. Tax-Induced Structural Distortions

As indicated above, some important provisions currently identified as tax expenditures cannot easily be described as exceptions to a general rule of present law, because the general rule is not clear from the face of the Internal Revenue Code. Those provisions therefore cannot properly be classified as Tax Subsidies in the narrower sense described above. If the JCT Staff were to attempt to expand the scope of Tax Subsidies to address these important policy questions by arbitrarily selecting one taxing pattern or another as the general rule, the result would be the same sort of subjective determinations that undermine the utility of a “normal” tax base in the current implementation of tax expenditure analysis.⁹¹

The opportunity for taxpayers to elect to defer inclusion, for income tax purposes, of certain “active” earnings of foreign corporations owned by U.S. persons is one example of a provision that today is treated as a tax expenditure, but that would not be classified as a Tax Subsidy under our proposed definition, because present law is ambiguous as to what constitutes the general rule for taxing foreign earnings.⁹²

Items like the deferral treatment of foreign earnings raise important tax policy issues. Moreover, present law’s treatment of these provisions can be criticized on strict economic efficiency grounds.⁹³ Tax expenditure analysis as currently implemented identifies some of these issues, but does so by reference to a “normal” tax baseline. The result is a sterile debate as to the appropriateness of the choice of that base, which in turn obscures rather than illuminates the important economic efficiency problems that current policies embody.

Our response to the insufficiencies of an inappropriately narrow definition of tax expenditures is to create a second major category of tax expenditures alongside Tax Subsidies, which we have labeled “Tax-Induced Structural Distortions.” These we define as structural elements of the Internal Revenue Code (not deviations from any clearly identifiable general tax rule and thus not Tax Subsidies in our classification) that materially affect economic decisions in a manner that imposes substantial efficiency costs.

The “deferral” of certain foreign earnings thus is one example of a Tax-Induced Structural Distortion. Another example is the differential taxation of debt and equity. The distinction between debt and equity is a Tax-Induced Structural Distortion, because it encourages business firms to leverage their capital structures, but it is not a Tax Subsidy (a tax expenditure in the narrower sense), because there is no clear consensus as to what general rule of tax law, if any, the debt-equity distinction might violate.

We identify and present Tax-Induced Structural Distortions by considering their economic efficiency costs, not by invoking any normative tax system. For example, we analyze

⁹¹ See Thuronyi, *supra*, at 1182-1186.

⁹² See Fleming and Peroni, *supra* at 196-197.

⁹³ Section V.A. below discusses the concept of economic efficiency.

the current deferral tax treatment of the earnings of foreign subsidiaries as raising two important efficiency concerns: (i) U.S. firms may have an incentive under present law not to repatriate “active” foreign earnings to the United States;⁹⁴ and (ii) deferral also implies a conditionally different tax rate on foreign active business income than the rate that applies to domestic income, and this difference may affect the type and location of business investment when compared either to a wholly domestic enterprise, or to a wholly foreign one.

One possible solution to these efficiency concerns is to adopt a territorial tax regime; another is the first solution’s polar opposite, that is, to adopt a “full inclusion” tax regime. (Other hybrid solutions may also exist.) Each solution in turn raises issues of interest to policymakers. Our tax expenditure presentation of this and similar cases, however, will not prejudge the issue (as current tax expenditure analysis arguably does), by holding up one solution or the other as the “normal” tax system.

While tax expenditure analysis can be helpful in identifying efficiency, equity, and ease of administration issues, as well as the design issues discussed in Section V, our definition of Tax-Induced Structural Distortions looks only to the substantive criterion of efficiency. There are at least three reasons for this decision. First, efficiency is an inherently more neutral construct than is equity (and possibly simplicity), and our overriding objective in rethinking tax expenditures is to move to a system that most observers can accept as neutral and principled. Second, most tax expenditures that are particularly troubling for equity (or other) reasons will be described as Tax Subsidies. Finally, most of the important structural ambiguities in the Internal Revenue Code today relate to the taxation of capital income (that is, business or investment income); efficiency goals loom largest in this context.

D. Comparison to Treasury Department Approach

It is instructive to compare the two-pronged definition outlined above to the Treasury Department’s current two-layer approach to tax expenditure analysis. The Treasury Department employs two concentric tax bases: a “normal” tax that is similar to that currently employed by the JCT Staff, and a “reference” tax base that (like our proposed tax base for identifying Tax Subsidies) constitutes a compilation of the general rules of the Internal Revenue Code and that can be visualized as a subset of the normal tax base.⁹⁵

The Tax Subsidy component of the two-pronged approach advocated here is determined in a manner generally similar to the Treasury Department’s reliance on its reference tax base, except that the definition proposed here does not add an incremental judgment (albeit one that has not figured heavily into the current construction of the Treasury Department’s list) as to whether a spending program could substitute for the tax provision in question. The definition of a “Tax-Induced Structural Distortion,” by contrast, is very different from our understanding of

⁹⁴ A taxpayer whose foreign tax credit position leaves it vulnerable to U.S. residual taxation may refrain from repatriating income back to the United States.

⁹⁵ Office of Management and Budget, *Analytical Perspective, Budget of the United States Government, Fiscal Year 2009* at 297.

what the Treasury Department does today, because it does not invoke a “normal” tax base at all.⁹⁶ Instead, our definition of “Tax-Induced Structural Distortions” relies entirely on an objective inquiry into efficiency considerations. The two categories that of our proposed definition of tax expenditures thus are intended to be as transparent and objective as possible.

E. Subcategories of Tax Subsidies

The JCT Staff believes that it would be helpful to policymakers to divide Tax Subsidies (i.e., tax expenditures in the narrow sense) into three subcategories. We propose these subdivisions with some reservations, because plausible arguments can be made to categorize many items in more than one subcategory, and we would not wish for classification arguments again to rob tax expenditure analysis of its productive power. We therefore emphasize that these subcategories are meant only to help policymakers to compare Tax Subsidies of like kind to one another; regardless of the subcategories to which we have assigned them, all Tax Subsidies rely on the same fundamental definition.

As a starting point, we have assumed that the following definitional provisions are in accordance with the general rules of current law and therefore are not Tax Subsidies:⁹⁷ (i) the personal exemption and standard deduction, because these items generally are offered to all taxpayers; (ii) filing status options, because these options are deemed to reflect an attempt to achieve parity across heterogeneous taxpayer units; and (iii) the nominal tax rate structure, which reflects a societal preference about how tax liability should vary by taxable income.⁹⁸

⁹⁶ In contrast to Fiekowsky, we view Tax-Induced Structural Distortions as firmly part of tax expenditure analysis, because the same economic reasoning and design parameters apply to them as apply to Tax Subsidies.

⁹⁷ As discussed earlier, one of Boris Bittker’s criticisms of Stanley Surrey’s approach was that the decision about what definitional items constituted tax expenditures, including the choice of rates and filing units, seemed subjective. While it is true that judgments are necessary in any tax expenditure analysis, the JCT Staff attempts here to identify rationales such as universality (the personal exemption and standard deduction), equity (filing status), and pragmatism (the rate structure itself) for identifying certain items as general rules rather than as Tax Subsidies. Specifically with respect to the rate structure, one difficulty in treating the rates themselves as tax expenditures stems from the decision about what the “general” rate would be (Zero? The top marginal rate? Some average rate that results in revenue neutrality? A uniform rate that maximizes revenue, or maximizes efficiency, or maximizes equity?). Attempting to present whatever negative or positive tax expenditures would result from treating the rate structure itself as a tax expenditure is also difficult in the context of a more comprehensive tax expenditure analysis that relies largely (with the exception of tax credits) on the effective marginal rates faced by taxpayers under present law to value tax expenditures. An interesting alternative presentation that treats part of the rate structure as a tax expenditure can be found in Rosanne Altshuler and Robert D. Dietz, *Reconsidering Tax Expenditure Estimation: Challenges and Reforms*, Paper presented at NBER Conference on Tax Expenditures, March 2008.

⁹⁸ Because the personal exemption is phased out (“PEP”) on the basis of a definition of gross income, a concept that is almost as general as taxable income, this phase-out also is treated as reflecting a societal preference about progressivity; thus PEP (like the nominal tax rate structure) is not treated as a negative tax expenditure.

Limitations directly linked to various Tax Subsidies, the alternative minimum tax, and the phase-out of itemized deductions are not classified as negative tax expenditures but instead are considered reductions in tax expenditures

The subcategories of Tax Subsidies (including two examples of Negative Tax Subsidies presented in the third subcategory) are as follows:

1. Tax Transfers

A Tax Transfer is a payment made to a person without regard to the person's income tax liability, because there was no income tax liability to begin with, or because the person's income tax liability was eliminated by another Tax Subsidy.⁹⁹ Unlike Tax Transfers, other Tax Subsidies only reduce (or increase, in the case of Negative Tax Subsidies) a taxpayer's income tax liability.

The subcategory of Tax Transfers today includes the refundable portions of the earned income tax credit, child tax credit, and the Recovery Rebates as enacted in the Economic Stimulus Act of 2008. These provisions usually are based on perceived need as measured by income. The provisions authorizing these payments are the clearest examples of hybrid tax/spending programs, i.e., they are essentially direct government spending programs that use the tax system for distribution.¹⁰⁰

2. Social Spending

This subcategory of Tax Subsidies includes Tax Subsidies that are unrelated to the production of business income, and Tax Subsidies related to the supply of labor. These Tax Subsidies often are intended to subsidize or induce behavior (for example, charitable giving) that generally is considered to be unconnected to the production of business income. Examples include the itemized deduction for medical and dental expenses, IRA deductions (or exclusions, in the case of Roth IRAs), and the nonrefundable portion of the child tax credit. This category also includes the portions of the earned income credit, child tax credit, and 2008 rebate that are not refundable.

In cases where a provision has potentially both business and non-business statutory incidence, we classify the provision based on a judgment about the effect and/or the intent of the

⁹⁹ For evaluation purposes, the refundable portion of a tax expenditure is considered separately from the nonrefundable portion.

¹⁰⁰ Tax Transfers are also among the tax expenditures that are close substitutes for existing direct government spending programs. For example, the refundable portion of the earned income credit and child tax credit are similar to non-tax-related government programs (both Federal and State and local) that address financial need and encourage employment of low-income persons. The Tax Transfer category is not intended to be the exclusive listing of provisions targeted as financial relief for, or employment of, low-income persons, as other nonrefundable provisions may have the same or overlapping goals, but means-tested refundability is a clear demarcation for preventing Tax Transfers from being overinclusive as a category.

provision. Thus, for example, we treat working-condition fringe benefits, which are excludible from employee income (but deductible by businesses), as Tax Subsidies in the Social Spending category rather than in the Business Synthetic Spending category, described below, because this treatment of fringe benefits is generally viewed by analysts as affecting labor supply more than general business decisions.¹⁰¹ By the same token, IRAs, owing to their role in capital accumulation, are Tax Subsidies that have a link to Business Synthetic Spending. Nevertheless, we classify them as Social Spending, because so much of their design, including their mandatory distribution requirements, is geared toward income support for retirement.

When legislative intent is not readily discernible, an item that appears to qualify for more than one category will be classified according to whether or not it is linked directly to production of business income. Thus, we will classify most education subsidies as Social Spending, while various capital income subsidies will be classified as Business Synthetic Spending (or in some cases these items will be placed in the other first-order category, Tax-Induced Structural Distortions).

Owner-occupied housing preferences can rationally be categorized either as Social Spending or in the subcategory of Business Synthetic Spending, depending on whether one views home ownership as primarily a consumption activity or a substitute for an income-producing investment. On balance, we believe that these housing preferences are better described as Social Spending. Doing so acknowledges that preferences for owner-occupied housing reflect a social policy agenda that transcends the tax law. Moreover, it is more straightforward for non-economists to understand the tax treatment of housing as an exception to the general rule for personal expenditures (no deduction of interest expense or other costs) than it is to see the homeowner as forgoing the rental income that could have been obtained were the housing made available for arm's-length rental.

3. Business Synthetic Spending

This category includes Tax Subsidies intended to subsidize or induce behavior directly related to the production of business or investment income (but excludes any Tax Subsidies related to the supply of labor). Examples of Business Synthetic Spending include the section 199 deduction for income attributable to domestic production activities, the completed contract method of accounting rules, various energy subsidies, the last-in-first-out method of accounting, and the expensing of soil and water conservation payments.

Negative Tax Subsidies are those special provisions of the law that increase the normal tax burden above what the general rules would impose. Two examples of Negative Business Synthetic Spending items are the two-percent floor on the deductibility of itemized investment expenses, and the disallowance of a deduction for employee remuneration in excess of \$1 million.

¹⁰¹ The legislative and executive branch histories of enactment and implementation of these provisions also support this incidence assumption, because this tax treatment of fringe benefits primarily was considered to affect decisions about labor supply and other laborer concerns such as health and retirement.

4. Utility of Tax Subsidy subcategories

We hope that our division of Tax Subsidies into the above three subcategories will facilitate consensus on the principles that are relevant to the evaluation of a particular Tax Subsidy. All tax subsidies raise questions of equity, efficiency and ease of administration. The three subcategories can be useful, however, to suggest that these factors may have different weights across the different subcategories.

For example, targeting and incentive effects are likely to be most important in the evaluation of a Tax Transfer intended to aid low-income persons. Effects on income distribution may be less important, however, to the evaluation of a Social Spending provision than is its efficacy in achieving a specific societal goal. For an item in the Business Synthetic Spending subcategory, concerns regarding certainty and economic efficiency may be more relevant than for items in the other two subcategories. Tradeoffs among competing goals are a necessity in the design of any tax provision. The subcategories of Tax Subsidies are intended simply to assist in making and understanding these tradeoffs.

F. Miscellaneous Considerations

The above discussion arguably overstates the practical differences among the different definitions of tax expenditures. The Treasury Department, for example, lists some 152 items as tax expenditures under its “reference tax” baseline. In the Treasury Department’s analysis, employing the “normal” tax as the baseline adds only nine additional items.¹⁰² While the JCT Staff’s list of tax expenditures historically has included more items than has the Treasury Department’s, we nonetheless anticipate that our category of Tax Subsidies will comprise the preponderance of items that today are classified as tax expenditures.

We recognize that a few items that today are classified as tax expenditures may not fit neatly either as Tax Subsidies or as Tax-Induced Structural Distortions. We propose to continue to carry those items on our tax expenditure tables to preserve continuity with all of our prior work in this area. We will reevaluate this decision periodically, in light of the success (or failure) of the new approach proposed here.

Finally, the JCT Staff’s revised approach to tax expenditure analysis further expands the traditional definition by identifying special provisions that increase the tax burden (above what the general rule would impose) as “negative” tax expenditures. (As previously noted, we label these provisions “Negative Tax Subsidies.”) Limitations directly linked to various positive tax expenditures, the alternative minimum tax, and the limitation on itemized deductions are not classified as negative tax expenditures but instead are considered reductions in those positive expenditures.¹⁰³

¹⁰² These additional items include: certain accelerated depreciation deductions, the current expensing of research and experimentation expenditures, and the “deferral” of active income earned by foreign subsidiaries of U.S. taxpayers.

¹⁰³ The limitation on itemized deductions, also known as the “Pease” limitation after former Representative Donald Pease, is allocated on a pro rata basis for quantitative presentation.

V. ECONOMIC CONSIDERATIONS IN TAX EXPENDITURE ANALYSIS

A. Introduction to the Economic Evaluation of Tax Expenditures

1. Overview

Analysts generally apply three principal economic criteria when judging the merits of any tax system: Does that tax system increase or decrease equity across taxpayers? Does it increase or decrease economic efficiency (that is, the extent to which market decisions are free of distortions introduced by the tax)? And can that tax system be easily administered? Tax expenditure analysis can apply these same criteria to evaluate the efficacy of any proposed tax expenditure, which reflects the status of a tax expenditure as both an exception to a general rule of tax law and as part of the fabric of the overall tax system.

The next several subsections therefore explain how economists use the terms “equity,” “efficiency” and “ease of administration,” and the application of these terms to tax expenditure analysis.¹⁰⁴ These concepts may sound subjective, but in fact economists have made a great deal of progress over the last several decades in expressing them in objective terms. By providing relatively robust answers to the questions suggested above, tax expenditure analysis can offer useful insights to policymakers called on to decide, for example, whether a proposed new tax expenditure is worth the revenue cost.¹⁰⁵

The ultimate goal of economic analysis is to provide guidance to policymakers in order to improve welfare – that is, the overall well-being of the members of a society. As a first-order approximation, economists often use wealth (or income, or sometimes consumption) as a proxy

¹⁰⁴ See *The Structure and Reform of Direct Taxation: Report of a Committee Chaired by Professor J. E. Meade* (George Allen and Unwin, London, 1978); James Banks and Peter A. Diamond, *The Base for Direct Taxation* (March 20, 2008), MIT Department of Economics Working Paper No. 08-11. These are not the only goals that might explain tax expenditures. The Meade Report and Banks and Diamond expand these categories by including international and transition goals, but the categories presented here are inclusive enough to cover a variety of aims. In addition, efficiency may also include concerns about competitiveness (a justification often offered for the foreign earned income exclusion under section 911) or national security (the income tax exclusion for certain military benefits), while equity concerns may include tax expenditures justified on the basis of common (or even international) law or treaties.

¹⁰⁵ The issues of equity, efficiency and ease of administration are equally relevant when applied to the non-tax mechanisms generally available to policymakers to intervene in the economy by subsidizing (or penalizing) one activity above others: direct spending and mandates (i.e., regulation). In many cases, there may be only minor differences in the equity or efficiency analysis of a proposed subsidy couched alternatively as direct spending or as a tax expenditure. (The relative ease of administration may, however, differ materially between the two.) Because the issues are the same, regardless of the type of intervention, policy analysts generally recommend that all three mechanisms (direct spending, tax expenditure and, where relevant, regulation) be considered before adopting one approach over the others. The nature of the legislative process, however, does not readily permit such comparisons always to be made.

for welfare, but they fully realize that this is an imperfect measure.¹⁰⁶ Given a fixed revenue constraint (i.e., a need for a fixed amount of tax revenues), analysts usually will conclude that a system that is more equitable in distributing the burden of taxation, more efficient (or less distorting) with respect to economic decision making, and easier to administer will result in increased welfare, including through increased productivity and increased wealth. Economists usually believe that the ordinary operations of the marketplace do a better job of allocating resources and opportunities than does a more regulated system. They accordingly believe that competitive markets are likely to improve welfare, by maximizing economic efficiency and productivity.

As a very general matter, therefore, economists ordinarily are skeptical about the value of tax expenditures and begin with the presumption that in most cases tax expenditures will diminish economic efficiency.¹⁰⁷ Economists recognize, however, that the welfare of society encompasses more than efficiency goals. As a result, if the tax expenditure has other redeeming attributes, then on balance it may enhance welfare. For example, a tax expenditure that diminishes economic efficiency may improve equity (or some other societal value) in ways such that the overall welfare of society is enhanced, notwithstanding the detriments to efficiency.¹⁰⁸ Ultimately, such decisions can only be resolved through the political process, because that is the vehicle that resolves competing and otherwise incomparable preferences of a society.

To take a well-known example, the Federal income tax today contains several large subsidies (incentives) for home ownership. Most economists would agree that these tax subsidies are welfare-diminishing. The tax expenditures can be described as introducing inequality of after-tax treatment between otherwise similarly-situated home owners and home renters. The incentives can also be seen as introducing inequities in another sense, by virtue of what Stanley Surrey called their “upside down” design – that is, the fact that these tax expenditures, by being structured as tax deductions, give proportionately greater government subsidies to taxpayers with higher incomes (because the value of a tax deduction is determined by the taxpayer’s marginal tax rate). Housing tax subsidies can also be viewed as inefficient, in at least three respects. First, they encourage private capital to be diverted into the housing sector from other investments that would have been made in a world without such incentives, thereby raising the cost of capital for the rest of the economy. Second, the revenues forgone by providing these tax subsidies must be made up by raising marginal tax rates, and those higher tax rates by themselves introduce

¹⁰⁶ Critics sometimes mistakenly argue that economists, by using wealth as a first-order proxy for welfare, ignore public goods like environmental protection. In fact, economists recognize that wealth should include measures of assets like the environment. Such assets will be inefficiently priced (undervalued) in market transactions and may justify government intervention to correct such mispricing. Economists have suggested ways to deal with these “externalities,” some of which are discussed in more detail below.

¹⁰⁷ Subsection V.A.3, below, briefly discusses the application of the theory of the second best in this context.

¹⁰⁸ Some tax expenditures, like savings incentives, may actually increase economic efficiency, by mitigating structural distortions inherent in an income tax, as described below.

distortions in behavior. Finally, current law's housing incentives certainly add significant complexity to our tax system.

Nonetheless, the political process has concluded that subsidizing home ownership is desirable. This conclusion can be explained as reflecting factors other than efficiency – for example, “externalities” such as the possible advantages to society of having its citizens feel more “invested” in their communities, and committed to the larger political system, that might stem from home ownership. Moreover, a simple application of tax expenditure analysis along the lines summarized above might be criticized in this context (when one is reviewing a longstanding tax expenditure) for assuming a world where decisions had not been distorted for many decades by these incentives; the technical analysis of what to do with those tax expenditures in light of that past history, or in light (in this case) of the market dislocations that this sector of the economy currently is suffering, might be completely different from the analysis that would be applied to a completely new proposed tax expenditure.

To conclude this example, tax expenditure analysis can shed helpful light on the costs (in the broad sense, including, as noted above, environmental costs and similar externalities) of tax subsidies associated with owner-occupied housing, or can propose ways of rethinking the subsidies that might reduce their costs (for example, the replacement of housing-related tax deductions with tax credits). The ultimate decision as to the net societal welfare to be gained by subsidizing home ownership, however, can only be resolved through the political process.

The remainder of this Subsection V.A. amplifies the above themes, by describing in more detail the principal economic criteria used to evaluate tax systems or tax expenditures: equity, efficiency and ease of administration. These are the criteria by which economists would argue that the desirability of most tax expenditures should be judged.

Subsection V.B. is a higher-level presentation that grounds the economic considerations of tax expenditure analysis in contemporary economic research literature. This subsection requires some background in academic economics.

Subsection V.C. then poses and answers a related but slightly different question: once a decision has been reached to implement a tax expenditure, how can that expenditure be designed so as to minimize its equity, efficiency, and administrative deficiencies? This subsection introduces three analytical criteria to help with that design question: transparency, targeting and certainty.

Finally, Subsection V.D. applies the principles developed in Subsections V.A. and V.B. to this pamphlet's new paradigm for categorizing tax expenditures.

2. Equity

Equity denotes a concept of fairness, particularly as relates to the distribution of wealth or the burden of taxation.¹⁰⁹ Equity includes the notions of horizontal and vertical equity.

¹⁰⁹ Another concept of equity relates to the choice of business organizational form. That is, tax provisions should treat businesses in different organizational forms the same. *See* Roger H. Gordon and

Horizontal equity is the idea that taxpayers who are similarly situated with respect to their ability to pay taxes should pay similar amounts of tax. That is, "taxes should bear similarly upon all people in similar circumstances."¹¹⁰ Vertical equity suggests that taxpayers with different abilities to pay should be treated differently, or those with a greater ability to pay should pay more.¹¹¹ Together, these two ways of looking at equity suggest that "the ideal tax base should be equivalent to whatever is determined to be the appropriate measure of ability to pay."¹¹² In practice, of course, difficulties arise in determining when taxpayers are similarly situated—that is, what constitutes the correct measure of ability to pay.

The concept of vertical equity by itself does not answer the question of whether the tax system should be used to reduce income inequality in society. A “proportional” income tax – a flat tax imposed at a single specified rate on taxable income – would, for example, collect five times as much revenue from a taxpayer with \$100,000 of taxable income as from one with \$20,000, and to that extent would honor the principle of vertical equity. That flat income tax would also leave intact the pre-tax inequality in income between the two taxpayers (because the after-tax incomes of each would still be in a ratio of 5:1).

In reality, the Federal income tax has always been used to address income inequality in society, through its “progressive” rate structure. Economists define a progressive tax as one in which the *average* tax rate rises with income.¹¹³ An average income tax rate is the taxpayer's total income tax liability divided by his total income. Mechanically, this is accomplished by applying higher *marginal* tax rates as incomes increase. A marginal income tax rate is the rate of tax imposed on an additional, or marginal, dollar of income earned by the taxpayer.¹¹⁴

Jeffrey K. MacKie-Mason, *Tax Distortions to the Choice of Organizational Form*, 55 *Journal of Public Economics* 279-306 (1994).

¹¹⁰ Henry Simons, *Federal Tax Reform* 8 (University of Chicago Press, 1950).

¹¹¹ Richard Musgrave, *The Theory of Public Finance* (McGraw Hill, 1959).

¹¹² Diane Lim Rogers, *Federal Income Tax Policy: Issues of Distribution and Equity* 579-607, in *Handbook on Taxation*, eds. W. Bartley Hildreth & James A. Richardson (Marcel Dekker, Inc., 1999).

An alternative view of equity suggests that taxes should be paid in proportion to the benefits received. See Adam Smith, *Wealth of Nations* (1776). The property tax may also embody this concept of equity in which the taxpayer gets what he pays for and pays for what he gets. There are efficiency advantages as well to this construction of equity. See James R. Hines, Jr. *What is Benefit Taxation?*, 75 *Journal of Public Economics* 483-492 (2000).

¹¹³ Louis Kaplow, *Taxation and Redistribution: Some Clarifications*, 60 *Tax Law Review* 58 (2007).

¹¹⁴ Statutory tax rates in the Code are marginal tax rates. While the current Federal tax system has both rising marginal and rising average tax rate rates, a tax may be progressive, even if marginal rates are declining at higher levels of income.

For example, if a hypothetical income tax imposed a tax rate of 20 percent on the first \$50,000 of taxable income, 30 percent on the next \$50,000 of income, and 40 percent on all income beyond that, then a taxpayer who had precisely \$50,000 of taxable income would have an *average* tax rate of 20 percent (because the taxpayer's tax bill would be \$10,000), but would face a *marginal* tax rate on his next dollar of income of 30 percent. Similarly, a taxpayer who earned \$100,000 in taxable income would pay tax at an *average* rate of 25 percent (not 30 percent, because the first \$50,000 of income was taxed at only 20 percent), and would face a *marginal* tax rate on her next dollar of income of 40 percent.

While any particular level of progressivity is a matter for society to judge, economic analysis can provide measures of progressivity to inform this political process. One way to measure progressivity is to measure the difference between pre-tax and after-tax income inequality. One common tool that public policy economists have employed to measure income inequality (whether pre-tax or after-tax) is the "Gini coefficient." The Gini coefficient summarizes the characteristics of how society's aggregate income is distributed among its members in a single number. This measure equals 1.0 when all income in an economy is attributable to one taxpayer (that is, the system is as unequal as possible), and 0.0 when all income is equally distributed among the members of the society. The Gini coefficient by itself, however, does not provide information about the equity of the tax system.¹¹⁵

Tax expenditures interact with the notion of equity in various ways. Some tax expenditures may be designed to provide a better measure of what Congress deems to be the correct measure of "ability to pay," and thereby improve horizontal equity. For example, the deduction for medical expenses in excess of 7.5 percent of adjusted gross income may reflect a determination that two taxpayers with the same gross income are not similarly situated if one has high medical expenses and the other does not.

Tax expenditure design also can have a significant effect on vertical equity. For example, tax expenditures formulated as deductions will generally reduce the progressivity of the tax system, by reducing average tax rates more for higher marginal rate taxpayers than for lower marginal rate taxpayers. (This is what Stanley Surrey termed the "upside down" subsidy effect of tax expenditures structured as deductions.) In contrast, tax expenditures structured as credits would generally increase the progressivity of the tax system. A credit will create uniform incentives and provide uniform benefits to all individuals if it is structured as a refundable credit.¹¹⁶ Gini coefficients and similar tools can be used to compare the after-tax income inequality (i.e. tax progressivity) consequences of complex trade-offs among different packages of tax expenditures and/or tax revenue raising provisions.

¹¹⁵ See Michael J. Graetz, *Paint-by-Numbers Tax Lawmaking*, 95 Columbia Law Review 609, 620-624 (1995), for a more detailed discussion of uses of the Gini coefficient to evaluate tax laws. For example, a tax system may be judged by comparing pre-tax and post-tax Ginis. Changes in tax laws may be assessed by comparing post-tax Ginis before and after a tax change.

¹¹⁶ Lily L. Batchelder, Fred T. Goldberg, Jr., Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 Stanford Law Review 52-57 (2006).

3. Efficiency

To an economist, the “efficiency” of a tax does not relate to the ease with which it is collected. Instead, a tax system is more “efficient” if it does not distort, or if it actually improves, the economic decisions that individuals and businesses make. A tax system is perfectly efficient if individuals and firms make the same decisions in the presence of the tax as they would if the tax did not exist, subject only to the fact that they are less wealthy by virtue of paying the tax. (That is, even an efficient tax that is not immediately returned to the taxpayer in the form of government services reduces a taxpayer’s wealth – otherwise it would not be a tax.)

No practical tax system can be wholly efficient, because distortions in behavior will follow whenever the taxpayer’s actions can determine the base on which he is taxed.¹¹⁷ For example, confronted with an income tax cost to working more and earning more money, some taxpayers will choose (untaxed) leisure instead. The result, to an economist, is a distortion, because the taxpayer has chosen, in light of the imposition of taxes on his wages, to work less than he would in a world without such taxes.¹¹⁸ These non-neutralities can cause taxpayers to

¹¹⁷ Joel Slemrod, *Which is the Simplest Tax System of Them All?* 355, in Henry J. Aaron and William G. Gale, eds., *Economic Effects of Fundamental Tax Reform* (Brookings Institution 1996). Thus, the usual example of a perfectly efficient tax is a “poll” tax, i.e., one imposed at the same rate on every individual, regardless of wealth or other distinguishing feature. Such a tax cannot be avoided, and therefore does not change behavior. It is also plainly inequitable, and in the United States at least suffers from Constitutional infirmities.

¹¹⁸ As described in the text below, it is well known among economists that any income tax—even an “ideal” income tax — introduces two important economic inefficiencies. First, an income tax, like any tax measured by effort or output (including a consumption tax), distorts an individual’s decisions with respect to how to divide his time between labor and leisure. Second, an income tax distorts an individual’s choice as to whether to consume his after-tax earnings currently, or to postpone that consumption for the future. (This second distortion follows from the fact that an income tax generally taxes the returns earned by the individual from investing his after-tax earnings pending his future consumption of them.)

Economists also have developed what is referred to as the “theory of the second best.” As applied to taxation, this important theory argues that, where a tax (like an income tax) itself creates economic inefficiencies, actions to *partially* correct those inefficiencies (in some cases, but not others, for example) may actually compound the problem, not mitigate it. Instead, the theory argues, the total economic effects of the tax system before the proposed correction must be compared to the total effects afterwards.

The theory of the second best has direct relevance to the examination of tax expenditures, because it implies that a particular tax expenditure might not be as detrimental from an economic efficiency perspective as might at first appear to be the case (or, theoretically, might actually improve matters). For example, when Congress provides investment incentives for some types of capital investment but not others, that legislation will distort the allocation of capital, when compared to an income tax that treated all capital investment identically, but might possibly reduce the income tax’s aggregate distorting effects on savings. Such legislation thus might (or might not) lead to a net welfare gain.

In the practical context of considering pending legislation, however, analysts (including the JCT Staff) tend not to emphasize the relevance of the theory of the second best, for several reasons. First, most tax expenditures on their face introduce new and very narrow incremental inefficiencies on top of the

make decisions that result in an inefficient use of their own and the economy's resources. By reducing taxpayer welfare, these distortions diminish the performance of the economy, and the welfare of society as a whole.¹¹⁹

Economists use the term “deadweight loss” as a synonym for the distortions in economic decision-making caused by taxes. Thus, the “deadweight loss” of a tax is the welfare cost to society of the tax, beyond the actual cash payments made to the government, that are attributable to hours not worked, investments not made, or the like, because of the tax burden that would be imposed on those affirmative acts.

No practical tax, whether a consumption tax or an income tax, can avoid the deadweight loss associated with distorting taxpayers’ preferences for how they would divide their time between work and leisure in the absence of taxes. In addition, an income tax, by taxing both wage income and any return on the wage-earner’s after-tax savings, decreases the present value of future consumption compared to present consumption. This in turn creates a bias against saving. (On the other hand, by taxing investment returns from savings, income taxes can have lower marginal and average tax rates than an otherwise comparable consumption tax, which may have compliance or other economic advantages.)

Distortions to the decision to save rather than to spend thus are an inevitable consequence of choosing an income tax. It follows that many savings incentives should be classified as tax expenditures, in the sense that they are exceptions to the general income tax rule, but at the same time these tax expenditures may actually increase economic efficiency.

Importantly for tax expenditure analysis, the concept of deadweight loss also includes the welfare costs to society of affirmative decisions to change behavior (whether of consumption, or investment, or other acts), to avoid or reduce tax burdens. That is, tax expenditures may create distortions (deadweight loss) by influencing the allocation of resources.

systemic inefficiencies of an income tax, and it is highly likely that a more sophisticated analysis would lead to the conclusion that these highly targeted provisions in fact lead to an increase, rather than a mitigation, of existing systemic inefficiencies. Second, it can be argued that the practical goal in general of economic analysis of income tax proposals, in the absence of some conscious decision to the contrary, should be to preserve the known systemic inefficiencies of the income tax, and measured from this baseline (as opposed to the ideal of a perfectly efficient world), the theory of the second best has less relevance. Finally, it is much easier to determine the direct distortion of a new provision than its indirect effects on pre-existing distortions. As a consequence, most policy analysts addressing practical legislative proposals invoke second-best considerations only when the effects are clear.

¹¹⁹ An additional consideration for efficiency is the extent to which a tax system promotes overall economic growth. See Richard Abel Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice* (Fifth ed., McGraw Hill, February 1989). Designing a tax system that encouraged economic growth was one of the primary objectives of the Treasury Department’s study of fundamental tax reform in 1984. See Treasury Department, Office of the Secretary, *Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President, Vol 1: Overview* (1984). If capital is allocated more efficiently across sectors of the economy, the result will be more productive investment and growth will accelerate.

Thus, imagine that a taxpayer on a limited budget today prefers peanut butter to cream cheese, and a subsidy then is created for production of the latter through the adoption of tax expenditures aimed at cheese makers. In light of the now-lower subsidized price of cream cheese, the taxpayer (and others like her) may choose to switch some of her peanut butter consumption to cream cheese. Proponents of the cheese tax expenditure would point to the surge in cream cheese production and consumption as demonstrating that an untapped need had been filled, but economists apprised of the facts would conclude that the concomitant decline in peanut butter consumption told a sadder story of deadweight loss, in which peanut butter fanciers distorted their pretax preferences to reduce their tax liabilities.

As another, and weightier, example, income from investments in corporate equity generally is subject to a corporate-level tax when earned and to individual-level tax when distributed, while interest from certain State and local securities is exempt from tax. This creates a bias against corporate equity investment and a bias in favor of investment in State and local debt securities. Such non-neutralities may distort investor decisions, thereby reducing the efficiency of capital markets in allocating capital to its most highly valued uses. Similarly, the exclusion of employer-provided health benefits from taxable income may lead employees to consume more health care and less other goods than they otherwise would.

Progressive tax structures may increase vertical equity, but they also increase the distorting effect of taxes on the work-leisure decision, by imposing ever-greater tax burdens as taxpayers earn more money. In general, as marginal tax rates become higher, the deadweight losses (the distorting effects of taxes) imposed on society increase, because the higher marginal rates impel stronger taxpayer reactions. As a result, in designing a tax system or a tax expenditure there frequently is a direct tradeoff between equity and efficiency goals.

For a fixed government revenue constraint (that is, for a fixed amount of taxes that need to be raised), the introduction of tax expenditures necessitates higher marginal rates to raise the same amount of revenue. As a result, and in addition to whatever direct effects they may have, tax expenditures will amplify the distortions attributable to imposing higher marginal tax rates. It is important to remember both these direct and indirect consequences when measuring the deadweight loss attributable to a tax expenditure.

Some taxes may actually improve economic efficiency if they correct a market “externality.” Externalities are factors (positive or negative) that are not traded in any market or that influence any party not involved in a particular economic transaction. The best-known example of an externality is environmental degradation, which causes a real decline in all of society’s welfare, but which, in the absence of some mandate (regulation) or tax might not be reflected in the economic calculus of the parties causing that degradation. In response, economists might propose a “Pigouvian” tax, named for economist Arthur Pigou, who developed the concept of economic externalities.¹²⁰ In this case, a tax actually improves economic efficiency, by assuring that private marginal costs of an activity will equal (after consideration of

¹²⁰ Arthur C. Pigou, *A Study in Public Finance* (Third Edition, Macmillan, 1947).

the Pigouvian tax) society's marginal costs. To improve efficiency, not only must the externality exist, but also the tax must effectively discourage the targeted activity.

Just as there are Pigouvian taxes in the real world, so too there can be Pigouvian tax expenditures – that is, tax expenditures that, by compensating for an externality, actually improve economic efficiency. For example, one rationale for the research and experimentation credit is that a private firm may find it difficult to capture the full benefits from its research and prevent its competitors from using such benefits. Thus the firm will conduct too little research and experimentation relative to the full benefits such activity would provide to society as a whole. If this is so, then a Pigouvian subsidy in the form of a tax expenditure for such research is compatible with optimal resource allocation.¹²¹

4. Ease of administration

One of the common complaints about the current income tax system is that it is difficult to administer and extremely complex. The complexity leads to the use of resources to learn the rules of the tax and to prepare returns for the collection of the tax. Individuals, businesses, and the government all use resources in the process of collecting the tax revenue. Researchers have estimated the compliance burden at between \$90 billion¹²² and \$265 billion per year.¹²³ Expenditures by the government show up in the staffing and budget requirements. For fiscal year 2008, the Internal Revenue Service had a budget of more than \$10.8 billion, with over 91,000 full-time equivalent employees.¹²⁴ During fiscal year 2007, the IRS processed 235 million returns.¹²⁵ The IRS also processed 1.8 billion information returns in the course of its document-matching program.¹²⁶ These information returns relate to items such as wage, dividend, and interest receipts and are matched against individual income tax returns to identify income reporting discrepancies, unsubstantiated deductions, and nonfiling of returns. There were

¹²¹ See William J. Baumol, *On Taxation and the Control of Externalities*, 62 *American Economic Review* 307-322 (1972). A similar argument can be made for addressing negative externalities, such as pollution, with negative tax expenditures. In this case individuals may not fully incorporate the environmental costs they impose on society by certain activities, and thus indulge in them too much. A negative tax expenditure that raised the private cost of such activities to reflect the full social cost could enhance economic efficiency.

¹²² John L. Guyton, Adam K. Korobow, Peter S. Lee, and Eric J. Toder, *The Effects of Tax Software and Paid Preparers on Compliance Costs*, 58 *National Tax Journal* 439-448 (September 2005).

¹²³ Scott J. Moody, Wendy P. Warcholik, and Scott A. Hodge, *The Rising Cost of Complying with the Federal Income Tax*, Tax Foundation, Special Report No. 138, December 2005.

¹²⁴ Internal Revenue Service, *The Budget in Brief, Fiscal Year 2009* at 6.

¹²⁵ IRS Data Book, Fiscal Year 2007 (Pub. 55B), March 2008, Table 2 (hereinafter, "IRS Data Book").

¹²⁶ IRS Data Book, Table 14.

over 179 million income, estate, gift, and partnership returns filed in 2006. The IRS examined 1.5 million of those returns, for an audit rate of 0.86 percent.¹²⁷

Tax expenditures generally contribute to the compliance burden of the income tax. Some have suggested that not only do they make the tax system more complex because they require distinctions between subsidized and unsubsidized activities, but also they raise compliance costs, IRS costs of administration, and rates of noncompliance.¹²⁸ To the extent that individuals and businesses must devote resources to tracking tax-preferred activities due to tax expenditures, this raises compliance costs. Refining tax expenditures by better targeting them to their intended beneficiaries may have the unintended consequence of also increasing complexity.¹²⁹ Tax expenditures also increase the length of instructions and the time required to complete tax returns.

Some tax expenditures, however, particularly exclusions, may simplify administration of the tax system. For example, the exclusion from taxable income of *de minimis* working condition fringe benefits (e.g. employer-provided coffee) simplifies administration of the income tax.

¹²⁷ IRS Data Book, Table 9.

¹²⁸ Eric Toder, *Tax Expenditures and Tax Reform: Issues and Analysis*, in *Proceedings of the National Tax Association Ninety-Eighth Annual Conference* (2005) at 475.

¹²⁹ For a detailed discussion of these issues in the health context, see Janet Holtzblatt, *The Challenges of Implementing Health Reform through the Tax System*, Paper presented at the conference on Taxes and Health Insurance: Analysis and Policies, organized by the Tax Policy Center and the American Tax Policy Institute at Brookings Institution, February 29, 2008.

B. Theoretical Economic Research on Tax Expenditures

Some results from theoretical economic analyses of income taxes and tax expenditures have implications for the analysis of how tax expenditures fare in meeting the substantive goals of equity, efficiency, and ease of administration.¹³⁰ This research often is referred to as “optimal income tax” and “optimal tax expenditure” literature. This brief discussion emphasizes some of the consensus results of this theoretical research. This summary of the theoretical literature does not attempt to survey the important applied research on either the income tax or on tax expenditures, because of the volume of such studies and the difficulty in finding consensus results that would be useful at this stage of our reexamination of tax expenditures.¹³¹

Optimal income tax theory suggests that provided that equity and revenue generation issues are identical, one income tax structure is preferable to another income tax structure if it minimizes (1) potential negative labor supply response,¹³² and (2) the number of tax brackets. Optimal income tax theory also favors the imposition of transparent non-increasing tax rates over large ranges of income. With respect to this last result, these theoretical studies suggest that, again, if equity and revenue issues are somehow ameliorated, generally it would be better to have

¹³⁰ F. P. Ramsey, *A Contribution to the Theory of Taxation*, *Economic Journal* 47-61 (March 1927); James A. Mirrlees, *An Exploration in the Theory of Optimum Taxation*, 38 *The Review of Economic Studies* 175-208 (1971); A. B. Atkinson & J. E. Stiglitz, *The Design of Tax Structure: Direct versus Indirect Taxation*, 6 *Journal of Public Economics* 55-75 (1976). These theoretical studies broadly have focused on commodity and individual income taxes because at the theoretical level there is little justification for separate business or corporate income taxes once an individual income tax has been established.

¹³¹ The empirical research on tax expenditures largely focuses on specific questions about tax expenditures (e.g., the particular tax and income elasticities, substitutability or complementarity between the tax-subsidized activity and direct government provision), while our focus here is more general. Indicative of this applied research are the many empirical studies of specific tax expenditures, some recent (Altshuler and Dietz, *supra*) and some not so recent (e.g., L. C. Fitch, *Taxing Municipal Bond Income* (1950)). In particular, the tax treatment of charitable giving and tax-exempt charities (given great momentum by The Commission on Private Philanthropy and Public Needs, *Research Papers*, 5 Volumes, published by the Department of the Treasury (1977) and many studies over a long period of time by others, e.g., Burton A. Weisbrod, *The Nonprofit Economy*, Harvard University Press, Cambridge, MA, (1980), as well as earlier econometric studies, e.g., Michael K. Taussig, *Economic Aspects of the Personal Income Tax Treatment of Charitable Contributions*, 20 *National Tax Journal* 1-19 (1967); Martin S. Feldstein and Charles T. Clotfelter, *Tax Incentives and Charitable Contributions in the United States: A Microeconomic Analysis*, 5 *Journal of Public Economics* 1-26 (1976), and issues related to Federalism (particularly the tax treatment of interest from municipal bonds) have received empirical attention over the years (e.g., D.J. Ott and A.H. Meltzer, eds., *Federal Tax Treatment of State and Local Securities* (Washington, D.C., The Brookings Institution, 1963); Roger H. Gordon and Joel Slemrod, *A General Equilibrium Simulation Study of Subsidies of Municipal Expenditures*, 38 *Journal of Finance*, AFA Papers and Proceedings 585-594 (1983).) In addition, these two items, charitable giving and municipal bonds, were and are often used as examples in the general discussion of tax expenditures.

¹³² This result affirms the similar efficiency result discussed above in subsection V.A.3.

a tax rate structure composed of *decreasing* tax rates as income rises.¹³³ In practice, of course, the goals of equity and revenue generation make this unobtainable. Also, all else being equal, optimal income tax studies suggest that income that is less responsive to taxation should bear a relatively higher tax burden.¹³⁴

Economic studies of optimal tax expenditures focus on many questions that bear on the issues of efficiency and equity.¹³⁵ One such example is the nature of the activity that is being encouraged; this literature analyzes how private activity interacts with the form in which the government provides the encouragement in question (direct government provision of the good or service, tax expenditures, or other forms of both governmental intervention, such as regulation,

¹³³ The efficiency principle that it is better to have non-increasing marginal rates as income rises applies to the generation of business and labor income, and not to the treatment of expenses not directly related to the generation of this income. For example, a taxpayer's ability to deduct (rather than claim as a credit, or not obtain a tax preference at all) various Social Spending tax expenditures, such as the charitable contribution deduction, can be described as moderating the progressivity of the effective rate structure. Nonetheless, optimal tax theory would hold that this reduction in progressivity cannot be justified on the basis of the efficiency principle described in the text, because the rate reduction is achieved by non-business or non-labor related expenses and not solely as a result of the generation of more income. The fact that a moderation or decrease in marginal rates is achieved through the non-work-related expense deduction side muddles in a classic second-best sense the justification for the application of the non-increasing marginal rate principle.

¹³⁴ This optimality of the inverse relationship between tax rates and behavioral elasticity also applies to commodity and consumption taxes.

¹³⁵ The mathematical exploration of the general theoretical properties of tax expenditures logically followed from the interest in optimal taxation. Feldstein presented a theoretical model of charitable giving that was augmented by a stylized representation showing that the present law income tax deduction was economically efficient. Martin Feldstein, *A Contribution to the Theory of Tax Expenditures: The Case of Charitable Giving*, in Henry J. Aaron & Michael J. Boskin, eds., *The Economics of Taxation, Essays in Honor of Joseph Pechman* (Washington, D.C., The Brookings Institution, 1980) at 99-122. Driessen questioned this result, and Feldstein responded in defense of his result. See Patrick A. Driessen, *A Qualification Concerning the Efficiency of Tax Expenditure*, 33 *Journal of Public Economics* 125-131 (June 1987); Martin Feldstein, *The Efficiency of Tax Expenditures: Reply*, 33 *Journal of Public Economics* 133-136 (June 1987). For extensions of this theoretical research focused primarily on the tax expenditure for charitable giving, see Russell D. Roberts, *A Positive Model of Private Charity and Public Transfers*, 92 *Journal of Political Economy* 136-148 (1984); Theodore Bergstrom et al., *On the Private Provision of Public Goods*, 29 *Journal of Public Economics* 25-49 (Feb. 1986); and James Andreoni, *Impure Altruism and Donation to Public Goods: A Theory of Warm Glow Giving*, 100 *Economic Journal* 464-477 (June 1990). Saez updated the earlier research and generalized the results to extend beyond charitable giving. See Emmanuel Saez, *The Optimal Treatment of Tax Expenditures*, 88 *Journal of Public Economics* 2657-2684 (2004).

Some optimal income tax studies consider both income and other taxes including consumption and wealth taxes, e.g., Atkinson and Stiglitz (1980). Even within a framework restricted to income tax, the consideration of the differential treatment of capital and income can be explored. See Banks and Diamond, *supra*, provide a recent summary of results on this differentiation). The JCT Staff approach, following the narrow direction of the Budget Act, currently is restricted to the income tax.

mandates, or delegation). Sometimes direct government provision of a good or service and a tax expenditure may be very similar, as with the direct government provision of Temporary Assistance for Needy Families and a tax expenditure like the refundable earned income credit (both have work constraints and involve cash remission, although there are differences in eligibility and other areas).¹³⁶

Other tax expenditure issues concern the substantive goals of general tax policy that were noted previously.¹³⁷ For example, as subsidy instruments, tax credits are generally preferable to tax deductions on equity grounds.¹³⁸ Efficiency concerns alone suggest that the preferred subsidy rate is only by chance likely to be the same as the marginal income tax rate faced by a taxpayer; as a result the tax expenditure subsidy rate should not be linked to income but rather to something else such as specific consumption. Revenue generation concerns favor a tax system that limits the cost of subsidies and minimizes savings, investment, and labor supply distortions. Also, tax subsidies should be greater when targeted at more responsive positive behaviors,¹³⁹ and interactions with direct government spending and/or tax expenditure-induced behavior should be considered.

Thus in evaluating a tax expenditure, among the issues that one should consider are the societal preferences for the subsidized activity,¹⁴⁰ the substitutable or complementary relationship of direct government provision and other government policy options with the tax expenditure, the responsiveness of the favored activity to subsidy, the responsiveness of labor supply to any increases in marginal tax rates necessitated by the existence of the tax expenditure, the relative efficiency of private provision of the activity that the government seeks to encourage, including targeting and fundraising costs, the overall effects that the tax expenditure has on the societal preferences for income distribution, any participation benefits (“warm glow”) or costs (e.g., learning and compliance, envy) to the taxpayer of undertaking or others’ undertaking the subsidized behavior linked to the tax expenditure,¹⁴¹ and the interaction

¹³⁶ The earned income credit is discussed in detail in Section V.D.

¹³⁷ There are also some theoretical studies of tax and tax expenditure design, including Martin Feldstein, *On the Theory of Tax Reform*, 6 *Journal of Public Economics* 77-104 (July 1976).

¹³⁸ Therefore unless an expense is directly connected to the generation of business or labor income, for equity reasons it generally should be formulated as a credit rather than a deduction. In this regard, although Saez, *supra*, finds that the ideal subsidy a priori should not be linked to the income tax rate structure, he also finds that this linkage seems to detract surprisingly little from overall efficiency. The potential harm from linkage is limited largely because his area of focus, what we term Social Spending in this pamphlet, represents a relatively small part of overall economic activity, at least within the stylized model that Saez sets up.

¹³⁹ The targeting of tax subsidies to behaviors most susceptible to change is analogous to the Ramsey rule of inverse taxation. See Ramsey, *supra*.

¹⁴⁰ The propriety of the mechanisms for determining societal preferences, which are subjects of public choice and other schools of research, are beyond the limited scope of this inquiry.

¹⁴¹ J. Andreoni, *supra*.

of the tax expenditure with other private and government programs (including other tax expenditures).¹⁴²

¹⁴² Saez, *supra*, mathematically presents many of these and other results.

C. Evaluating the Design of Tax Expenditures

1. Overview

The previous two subsections addressed the substantive question of when, or whether, a tax expenditure might improve social welfare, as measured through the economic principles of equity, efficiency and ease of administration. Economic analysis also can help, however, to improve the design of any tax expenditure, regardless of its substantive merits in the eyes of economists.

Economists have developed a number of consensus principles that can help policymakers in designing a proposed tax expenditure. These principles take into account both the popular and academic analyses of tax expenditures over the years, including the variety of approaches taken in the study and presentation of tax expenditures. These design principles generally can be seen as applications of the substantive goals of equity, efficiency, and ease of administration presented in Section V.A. above.

Adherence to these design principles generally does not rely on any particular normative view about an income tax. Regardless of whether a particular income tax norm can achieve consensus, it is likely that those interested in the betterment of an income tax would agree that these non-exclusive general attributes presented below would be desirable in any tax expenditure.¹⁴³ Even when a provision has consensus support for its substantive aim, design problems may erode its value, as when a provision that society agrees should aid one group or encourage one type of behavior instead significantly compensates another group or encourages another type of behavior. Thus, to the extent that a tax expenditure has been created in an effort to achieve some combination of substantive goals, all parties likely would prefer that this tax expenditure be *transparent* in its application, that it be *targeted* narrowly to those taxpayers or activities that are the object of the expenditure, and that taxpayers will enjoy *certainty* in realizing the tax advantages through which the expenditure's goals are to be achieved.

2. Transparency

Transparency in the tax expenditure context refers to many design and measurement issues that affect both government oversight and taxpayer acceptance and usage of a tax expenditure. Perhaps the most commonly cited transparency concern is the degree to which the revenue costs of a tax expenditure are identifiable and publicized, and the identity of the provision's beneficiaries is clear. In addition, it is important for the potential benefits and possibly non-governmental costs of a provision to be ascertainable. A complex tax expenditure also can affect the use or "take-up" of the provision, and increase compliance costs associated

¹⁴³ Of course, someone who is opposed to any income tax, or any kind of tax, may not find these principles compelling.

with the provision. Similarly, obscure or interacting phase-outs may undermine both a provision's intent and taxpayer confidence.¹⁴⁴

The transparency of a tax expenditure to a taxpayer is enhanced by consistency in content and availability, the absence of confusing alternatives, and recurring taxpayer participation. For example, Congress first enacted the Hope Credit more than a decade ago. While that provision has been relatively consistent in content, the Hope Credit has at least one close substitute (the Lifetime Learning Credit) and another potential substitute (the tuition and fees deduction.)¹⁴⁵ The Hope Credit also requires a potential user to learn about eligible expenses, whether a student is or can be claimed as a dependent, and how the credit interacts with other higher education financial programs. In addition, Hope Credit participation is likely to be cyclical or discontinuous for taxpayers – for example, the Hope Credit may require a parent's or student's attention for as little as one or two tax return years and then never again affect that taxpayer. By contrast, the home mortgage interest deduction typically is relevant for a continuous and long-term period, once a taxpayer purchases his first primary residence.

Transparency also is affected by issues of framing and advertising. Framing includes tax expenditure design issues such as the naming of a provision, Internal Revenue Code and tax form placement, and possible cross-referencing among forms. Naming a provision may seem mundane, but taxpayers and others may have a different reaction to something called, for example, the Earned Income Credit rather than the Earned Income Tax Credit, or it may be a surprise to some taxpayers that section 199, the deduction for “domestic production activities,” applies to certain income from services. Even with the pervasive use of tax software and paid return preparers, taxpayers often need to educate themselves about the existence of various provisions and the mechanics of how to claim them. Public and private advertising and promotion therefore increase tax transparency for taxpayers. While the outreach programs of the Internal Revenue Service are important, the advertising of the Hope Credit by educational institutions likely has contributed to the take-up of that credit in the same way that a vigorous publicity campaign undertaken by private financial entities may have increased Individual Retirement Account participation in the last 25 years.

In some cases transparency of costs and benefits for participants may conflict with another important goal – taxpayer confidentiality. For example, full identification of who uses

¹⁴⁴ See Thomas A. Barthold, Thomas Koerner, & John F. Navratil, *Effective Marginal Tax Rates Under the Federal Individual Income Tax: Death by One Thousand Pin Pricks?*, 51 National Tax Journal at 563 (1998) and Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001 at 88.

¹⁴⁵ An evaluation of the Hope Credit should be conducted in conjunction with an assessment of the Lifetime Credit and the tuition and fees deduction, as these provisions significantly interact. There are many other tax expenditures that also should be examined as part of a subgroup of tax expenditures that are substitutes and complements, and the grouping of tax expenditures by Federal outlay type, which we intend to continue in tandem with the new broad classifications described in Section IV, facilitates the recognition of these interactions.

what tax expenditure might have the positive effect of clearly identifying persons or businesses that are not taking advantage of tax benefits, but such identification could compromise both individual privacy or (in the case of businesses) confidential trade information.

3. Targeting

Targeting issues often are related to revenue concerns and the substantive goals of equity, efficiency, and ease of administration. Having decided to provide a certain subsidy, it is desirable to implement that subsidy by benefiting the intended parties with as little economic distortion and for as little cost in terms of forgone revenue as possible. These concerns are not limited to the specific tax expenditure provision under examination or even other governmental policies, but also include secondary consequences that may be broadly distributed. Examples of marginal, or “last dollar,” targeting include the use of thresholds (e.g., the 7.5 percent itemization threshold for medical and dental expenses) or the focus on increments above certain historic baselines (the research and experimentation credit.) While some limitations, such as historical and other threshold tests, may aid in targeting, others (e.g., the financial plan limitations under expired section 965) may be worse than no limitation because they may give the impression but not the reality of effective targeting.¹⁴⁶

One important and common targeting issue is when to use a deduction rather than a credit to deliver a tax expenditure. While as discussed in the prior section a credit generally is theoretically preferable to a deduction, a deduction is not necessarily inconsistent with good targeting. A deduction may be appropriate, for example, when the expense is directly related to the production of income, and some might argue that something like charitable giving is not entirely voluntary and therefore should be fashioned as a deduction.¹⁴⁷ However, it often is at least theoretically possible to design a tax credit that creates just as much overall incentive or relief as a deduction and that also avoids some equity issues caused by use of a deduction, although it is difficult in practice to design credit phase-outs that do not create high effective marginal tax rates.

Because of economic and demographic changes, targeting often requires adjustments that may create complexity and uncertainty. For example, the filtering function of the 7.5 percent threshold for itemizing medical and dental expenses contemplated by policymakers at the time of its enactment may take on a different meaning as the U.S. age structure changes and preferences and the need for health care spending change. Also, once a tax expenditure has been enacted, inertia, precedence, and interest group behavior may make repeal or scaling back difficult, even

¹⁴⁶ Negative Tax Subsidies also can be targeted imperfectly. For example, it is questionable how effective the \$1 million limit on executive compensation under Code section 162(m) is, as corporations appear to have responded by altering their methods of compensating executives in ways that do not seem to have greatly affected the targeted firms, investors, or executives. See Steven Balsam and David Ryan, *Limiting Executive Compensation: The Case of CEOs Hired after the Imposition of 162(m)*, *Journal of Accounting, Auditing and Finance*, September 2007.

¹⁴⁷ This is an argument by W. D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 *Harvard Law Review* 309-385 (1972).

if the original tax expenditure targeting rationale is impeached.¹⁴⁸ Additionally, electivity may cause tax expenditure targeting issues.

For example, at the time of initial enactment of the first IRA provisions, it was very difficult to predict how many taxpayers would take up the new program, in the absence of relevant prior experience. Aside from novelty, it is likely that exogenous changes (such as the advertising campaigns that financial institutions mounted when IRAs first were introduced) will affect electivity in ways that are difficult to foresee.¹⁴⁹

4. Certainty

Much attention recently has been focused on the pattern of short-term extensions of a large number of tax expenditures in a single “extenders” package. In practice, it can involve extending an expiring tax expenditure or blocking administrative action.¹⁵⁰ Many tax

¹⁴⁸ For example, part of the rationale for the additional deduction for the aged was relief for what has historically been a low-income demographic group (measured by gross, taxable, or disposable income.) While as a group the aged’s relative income standing has improved in recent decades, this longstanding tax expenditure has not been modified or repealed. Also, when an income tax structure is first imposed, a tax expenditure created at the outset may have faced less of a revenue or other test than subsequently enacted tax expenditures because incremental change tends to attract more scrutiny – this evolutionary institutional factor may be one reason to believe that not all current tax expenditures, given the timing and other difference surrounding their placement in the Internal Revenue Code, faced the same level and type of attention.

¹⁴⁹ In addition to the targeting issues raised by electivity, what could be termed secondary electivity often creates horizontal equity or business entity equity issues. If primary electivity is the decision to undertake an activity, such as investing or making a charitable contribution, then secondary electivity is the choice permitted in the Code that a person makes of how to treat the investment or charitable contribution for income tax purposes. Secondary electivity raises equity issues because it allows persons undertaking the same activity to obtain different tax results. Thus one business depreciates a capital purchase using the straight-line method while another business elects to expense under section 179, or one person itemizes a charitable deduction while another person chooses to take the standard deduction, or a U.S. investor may choose between operating overseas as a branch or controlled foreign corporation and thereby affect eligibility for deferral. Note that secondary electivity often involves a tax expenditure. This electivity, valued by taxpayers for the flexibility it permits, intentionally produces varied tax results. The Code sometimes attempts to ameliorate equity issues associated with secondary electivity by enforcing symmetry with respect to business or investment transaction (e.g., gain deferred in the disposition of an asset may result in downward basis adjustment of a replacement asset), but this remedy is often ad hoc and does not necessarily rectify the inequity arising from the secondary electivity. It is sometimes difficult to determine when secondary electivity is occurring because of the simultaneity of primary and secondary electivity. For example, some charitable giving and some investment might not occur in the absence, respectively, of the opportunity to itemize deductions and section 179 expensing, and thus it may not be possible to always isolate the equity effects of secondary electivity.

¹⁵⁰ For example, Congress temporarily blocked implementation of certain research and development allocation rules, used to calculate foreign tax credits, multiple times in the 1970s and 1980s.

expenditures that have been extended for short periods of time are relatively new.¹⁵¹ Short-term sunsets are understandable for new provisions lacking a basis for evaluation, and even older provisions are likely to need revisiting from time to time. In fact, one of the complaints about tax expenditures is that tax expenditures are not reconsidered enough, which cuts against the goal of certainty; this example demonstrates how some of the tax expenditure goals, substantive and design, can interact.

Some tax expenditures that are extended for short periods also may be perceived by some of those affected as “too big to expire” or at least expire for very long, and thus taxpayers may not be affected much by a short sunset period for those provisions, whereas taxpayer uncertainty about short sunsets for newer provisions may be warranted. Both pro- and anti-taxpayer retroactivity also reduce certainty, as do temporary tax reductions (or increases), tax holidays, tax amnesties, and sporadic enforcement of tax laws.

One indirect form of uncertainty is the fact that the value of a tax expenditure, particularly a deduction or exemption, changes whenever the general tax rates change, and also can change when other tax expenditures that interact with the first expenditure change. This type of uncertainty cannot be avoided unless Congress adjusts a wide range tax expenditures to hold taxpayers harmless every time general income tax rates change. The value of other items may change for exogenous reasons, for example, the value of the last-in-first-out method of accounting is affected by general and specific price changes. Finally, taxpayers may invite uncertainty by taking tax return positions that are either opposed, or at least not acquiesced in, by the Internal Revenue Service.

In summary, in addition to measuring how well tax expenditures fulfill the substantive goals of equity, efficiency, and ease of administration, all tax expenditures can be evaluated using the design criteria of transparency, targeting, and certainty.¹⁵² Just as the effects on substantive tax system goals of undertaking certain tax expenditures may conflict (e.g., what is equitable may not be efficient)¹⁵³ or complement each other (e.g., equity can sometimes enhance

Also, some longer term expirations or sunsets are related to parliamentary rules concerning revenue effects outside of the traditional five- or ten-year budget period.

¹⁵¹ The research and experimentation credit is a notable exception.

¹⁵² The Congressional Research Service (“CRS”) comprehensively examines tax expenditures using the normative law approach. Congressional Research Service, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, prepared for the Committee on the Budget, 109th Congress, 2nd Session, S. Per. 109-072 (December 2006). The substantive and design criteria presented here are noted in some of the CRS descriptions of individual tax expenditures, but not in a formalized manner. The criteria discussed here are the foundation for our revised approach to tax expenditures described in Section IV above, and may be useful as a companion, along with the CRS publication, to applied research on tax expenditures.

¹⁵³ An important treatise on the interaction of these two aspirations for an income tax system is Arthur M. Okun, *Equality and Efficiency: The Big Tradeoff* (Washington, D.C., The Brookings Institution, 1975).

efficiency), some of these desirable design characteristics of tax expenditures may also conflict or complement each other, and the substantive and design goals may also interact. As an example, the attributes that make a tax expenditure understandable and straightforward may inhibit attainment of other goals embodied in the Code, as when narrow targeting leads to a lack of transparency.

D. Application of Economic Analysis to Selected Tax Subsidies

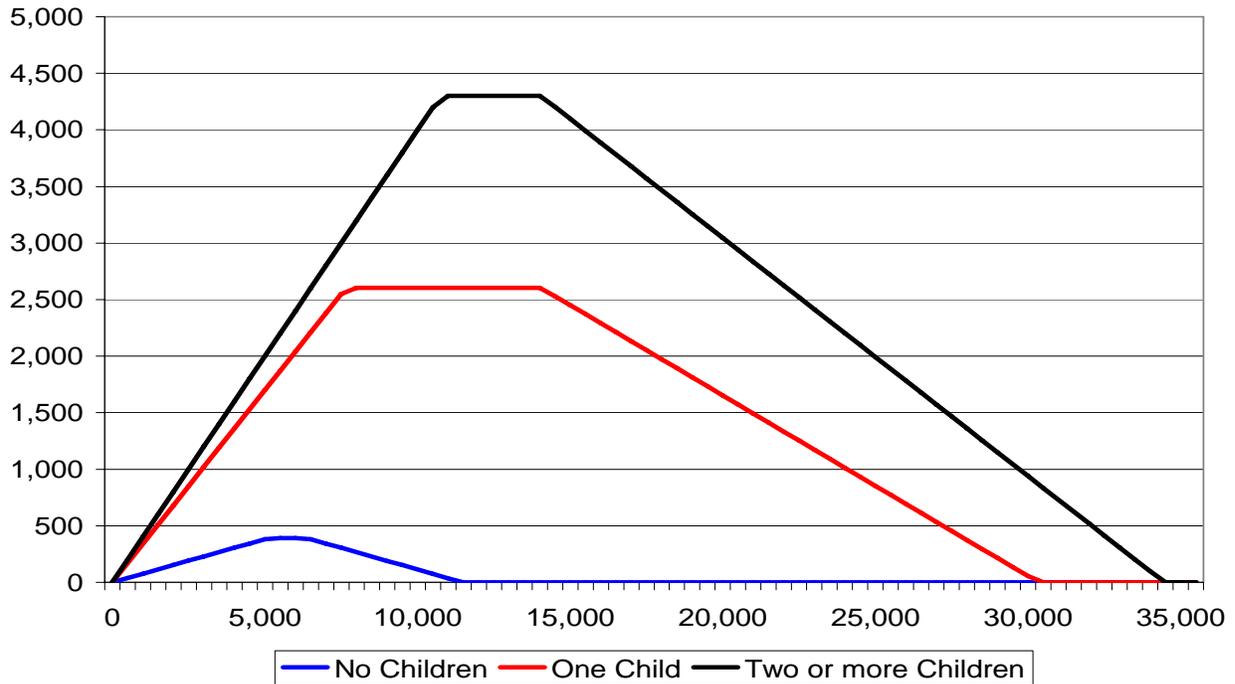
This Subsection presents some selected examples of how the economic reasoning developed earlier in Section V can be applied to some examples of Tax Subsidies.

1. Refundable earned income credit

The Earned Income Credit (“EIC”) is intended to subsidize the work effort of low-income families. We classify the refundable portion of the EIC as a Tax Transfer. Because the EIC is designed as an income support program (in addition to rewarding work effort), the two principal substantive evaluation issues of equity and ease of administration play major roles in assessing its effects.

As can be seen in the figure below, the EIC provides a credit for each additional earned dollar up to a maximum dollar amount, with the credit phased out for each dollar of earned income or adjusted gross income above a phase-out threshold. The credit rate, maximum income, beginning of the phase-out, and the phase-out rate depend on whether the taxpayer has no qualifying children, one qualifying child, or two or more qualifying children.

Figure 3.–2004 Value of the EIC by Income and Number of Qualifying Children



While not all of the EIC is received by taxpayers as a refund, a substantial majority of the revenue cost is categorized as refundable (88 percent of the EIC claimed on 2004 returns was refunded after the nonrefundable portion was exhausted by offsetting income and self-

employment taxes.)¹⁵⁴ The table below shows that the income distribution of the EIC is concentrated among low-income taxpayers, and could be considered a substitute for direct spending welfare programs.

**Table 1.—Distribution by Income Class of the Earned Income Credit
at 2006 Rates and 2006 Income Levels¹
[money amounts in millions of dollars, returns in thousands]**

Income Class ²	Earned Income Returns	Credit Amount ³
Below \$10,000	5,747	\$6,650
\$10,000 to \$20,000	6,407	16,349
\$20,000 to \$30,000	4,808	11,353
\$30,000 to \$40,000	4,067	6,446
\$40,000 to \$50,000	1,815	1,987
\$50,000 to \$75,000	534	475
\$75,000 to \$100,000	9	5
\$100,000 to \$200,000	3	5
\$200,000 and over	0	0
TOTAL	23,391	43,270

¹ Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

² The income concept used to place tax returns into classes is adjusted gross income (AGI) plus: (a) tax-exempt interest, (b) employer contributions for health plans and life insurance, (c) employer share of FICA tax, (d) workers' compensation, (e) nontaxable Social Security benefits, (f) insurance value of Medicare benefits, (g) alternative minimum tax preference items, and (h) excluded income of U.S. citizens living abroad.

³ Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

As indicated earlier, because the EIC is a Tax Transfer, its efficacy can be determined principally by reference to the two substantive criteria of equity and ease of administration. In terms of the design criteria, the EIC appears to be relatively targeted, transparent, and certain in its application when compared to other Tax Subsidies.

With regard to equity, the EIC benefits the lower portion of the income distribution as shown above. As with any program that provides income support, and particularly in the case of a program such as the EIC which attempts to reward work effort, it is important to measure over

¹⁵⁴ Internal Revenue Service, *Statistics of Income Bulletin*, Winter 2006-2007 (Washington, D.C. 2006). The portion that is refundable has varied over time as the liability otherwise owed by taxpayers has adjusted to changes in the rest of the income and self employment tax systems.

time the income mobility of current and prior participants. That is, is the EIC a catalyst or a deterrent to income mobility? One mobility measure would be the number of recipients moving out of eligibility due to an increase in earnings. A good result would be fewer people qualifying for the EIC over time because of an improvement in their employment and income situations. One study found that as many as 50 percent of EIC claimants receive the EIC for only short periods of time lasting one to three years.¹⁵⁵ While these results are not causal, the short tenure of those claiming the EIC, combined with the high participation rates, suggests that the program is reaching a fairly mobile population in terms of income.

The combination of the high dollar value of the credit (the maximum credit in 2007 was \$4,716), the high phase-out rates (about 20 percent for taxpayers with two or more qualifying children), and the earned income requirement also means that the EIC is likely to have a number of effects on the supply of labor that might have long-term equity and efficiency ramifications. In this regard, researchers have found that the EIC has a variety of effects on labor supply.¹⁵⁶

The narrowly targeted design of the EIC contributes to these equity effects. Initially the EIC was targeted only toward low-income workers with children, but it was expanded beginning in 1994 to include all low-income workers. A measure of the effectiveness of the EIC in reaching its targeted beneficiaries is the participation rate in the program. The credit appears to be fairly effective in reaching targeted beneficiaries, with some studies finding the participation rates for families with children ranging between 80 percent¹⁵⁷ and 92 percent.¹⁵⁸ These participation rates compare favorably with participation rates for other direct spending subsidies.

¹⁵⁵ Tim A. Dowd, *Distinguishing Between Short-Term and Long-Term Recipients of the Earned Income Tax Credit*, 58 *National Tax Journal* 807-828 (December 2005). Dowd also finds that there is broad usage of the EIC. For taxpayers who have a child at some point over a 15-year period, or are under the age of 65, the probability of claiming the EIC at least once is 28 percent.

¹⁵⁶ Researchers have looked at the labor supply effects of the credit. Nada Eissa and Jeffrey Liebman, *Labor Supply Response to the Earned Income Tax Credit*, 111 *Quarterly Journal of Economics* 605-637 (1996) and V. Joseph Hotz, Charles H. Mullin, and John Karl Scholz, *The Earned Income Tax Credit and Labor Market Participation of Families on Welfare*, Unpublished Working Paper, March, 2005, found that the EIC expansions of 1987 and 1994 increased labor force participation. Other studies have found that the EIC does not affect hours of work very much. Maria Cancian and Arik Levinson, *Labor Supply and Participation Effects of the Earned Income Tax Credit: Evidence from the National Survey of America's Families and Wisconsin's Supplemental Benefit for Families with Three Children*, Unpublished Working Paper, September 2003; Eissa and Liebman, *supra*. Still, other researchers have found that the EIC reduces labor force participation for married taxpayers. Nada Eissa and Hilary Hoynes, *Taxes and the Labor Market Participation of Married Couples: The Earned Income Tax Credit*, 88 *Journal of Public Economics* 1931-1958 (August 2004).

¹⁵⁷ John Karl Scholz, *The Earned Income Tax Credit: Participation, Compliance and Antipoverty Effectiveness*, 47 *National Tax Journal* 63-87 (March 1994).

¹⁵⁸ Marsha Blumenthal, Brian Erard, and Chih Chin Ho, *Participation and Compliance with the Earned Income Tax Credit*, 58 *National Tax Journal* 189-214 (June 2005).

One study, for example, found that food stamps, arguably targeted at a similar population, had a participation rate of 54 percent.¹⁵⁹

There is a significant degree of noncompliance, however, with the EIC requirements, resulting in claims by non-targeted individuals. In a recent study, the General Accountability Office found that up to 80 percent of the recipients of the advance EIC were non-compliant.¹⁶⁰ Moreover, for the program as a whole, the IRS found that for tax year 1999 as many as 32 percent of EIC claims were erroneous.¹⁶¹ The high non-compliance rates reduce the degree to which the EIC is effective at delivering benefits only to the targeted population of working poor families.

In response to the high non-compliance rate, Congress has attempted to target the credit more effectively by increasing the administrative requirements and changing the eligibility requirements.¹⁶² These efforts, however, affect the extent to which the EIC meets the second substantive goal of ease of administration. While some of the non-compliance may be due to fraud, the complex nature of the eligibility rules contributes to taxpayer confusion and non-compliance.¹⁶³ Studies have shown that the high non-compliance rates are indicative of the complex eligibility requirements for the EIC,¹⁶⁴ and this complexity reduces the extent to which the EIC is a transparent program from an administrative perspective.

On the other hand, the revenue cost of the earned income credit (“EIC”) is relatively transparent compared with other tax subsidies. The credit is entered directly on individual tax forms and has limited substitutability with other tax expenditures, and the provision’s relative complexity is somewhat tempered by its long tenure in the Internal Revenue Code and the Internal Revenue Service’s outreach program for employees and employers. For knowledgeable, qualifying taxpayers, the EIC is essentially certain. Taxpayers and firms expect that the EIC will be available every year because it has been a part of the income tax system since 1975. However, low-income and first-time filers may not be aware of, or in some cases may

¹⁵⁹ Department of Agriculture, Food and Nutrition Service, *Explaining Changes in Food Stamp Program Participation Rates* (Washington, D.C., September 2004).

¹⁶⁰ Government Accountability Office, *Advance Earned Income Tax Credit, Low Use and Small Dollars Paid Impede IRS’s Efforts to Reduce High Noncompliance* (Washington, D.C., August 2007).

¹⁶¹ Internal Revenue Service, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* (Washington, D.C., February 2002).

¹⁶² For example, in the Personal Responsibility and Welfare Relief Act of 1996, Congress required taxpayers to use Social Security Numbers for each claimed child; in the Economic Growth and Tax Relief Reconciliation Act of 2001, Congress streamlined some of the rules regarding qualifying income and children.

¹⁶³ Lindsay H. Rubel, *Complexity, Regressivity, and Income Disparity: Self-defeating Aspects of the Earned Income Tax Credit* (Washington and Lee University, School of Law, 2006).

¹⁶⁴ Janet Holtzblatt, and Janet McCubbin, *Issues Affecting Low-Income Filers*, in Henry J. Aaron and Joel Slemrod, eds, *The Crisis in Tax Administration* (Brookings Institution Press, 2004).

overestimate, the high effective marginal tax rates associated with the EIC's phase-out. This confusion about the credit reduces its certainty for taxpayers.

Finally, the EIC program's structure also is of interest to the extent that it can provide information about the merit of using the tax system (and employers) to partially or fully deliver government benefits to employees. Some researchers have argued that because of the lower EIC administrative costs and the higher participation rates for the EIC that, relative to other direct spending transfer programs, the EIC should be expanded beyond its current target population.¹⁶⁵

2. Individual retirement accounts

The principal purpose of the IRA provisions is to help ensure adequate income for retirees, and thus we classify IRAs as Social Spending (while acknowledging that their role in capital accumulation means that they share some attributes of other items that we classify as Business Synthetic Spending). The IRA provisions attempt to meet this goal of retiree income assurance in two ways: (i) IRAs provide a vehicle to which employees can roll over employer-sponsored pension assets upon separation from service; and (ii) IRAs provide those without an employer plan, or those who participate in an employer plan that provides limited benefits, with a retirement savings opportunity. The choice was made in providing IRAs that, because of the difficulty in ascertaining the retirement assets of a heterogeneous mix of taxpayers, the provision would be targeted with relatively modest caps on contributions and with income-related limitations. Over the years, however, other IRA programs (such as the Roth IRA) have been added to the Internal Revenue Code as a need for flexibility was perceived. The current IRA provisions contain many complex rules pertaining to contributions and withdrawals. Depending upon the type of IRA and the taxpayer's current circumstances, a taxpayer may at any one time be affected by an IRA's potential deductibility, deferral of taxation on inside-build-up, exemption, and a number of other Internal Revenue Code features.

As noted in Section IV, for an item in the Social Spending subcategory, efficacy in achieving a specified societal goal may be more important than its effects on equity or efficiency. In fact, both the IRA deduction and the Roth IRA exemption appear to be relatively inequitable, because their tax benefits are linked to a taxpayer's marginal tax rate. This inequity could be mitigated by converting the deduction into a credit.¹⁶⁶ However, another potential source of inequity may be the difficulty in identifying a worker's accumulated pension assets, with the result that eligibility for the IRA provisions cannot be related directly to the level of those assets. The actual extent of any inequity is difficult to determine, due to the connection between the tax treatment of the contribution to an IRA and the eventual distribution: for example, a taxpayer may obtain a deduction while facing a marginal tax rate of X% at time of contribution and then pay tax at a rate of Y% upon distribution (with the distribution including any investment gain). The tax treatments are reversed for contributions to and distributions from a Roth IRA. This connection between tax treatment of contribution and distribution requires that the equity of the

¹⁶⁵ Dennis J. Ventry, *Welfare By Any Other Name: Tax Transfers and the EITC*, 56 American University Law Review (2007).

¹⁶⁶ Batchelder, Goldberg and Orszag, *supra*.

provision be evaluated taking account of a longer period of time, perhaps with a present-value measure of equity.

The design goals of transparency and certainty are perhaps more relevant, however, in determining the extent to which IRAs achieve their societal goal of enhancing retirement income. In assessing transparency, participation (as measured by deductible contributions to IRAs) is easily gauged because of the tax form entry on Forms 1040 and 1040A, but nondeductible and Roth IRA participation is less transparent because taxpayers are not required to make a direct entry identifying Roth IRA participation on basic tax forms (although participants in nondeductible IRAs are required to complete supplementary Form 8606).¹⁶⁷ There may also be interactions between IRAs and other tax expenditures that are close substitutes, including defined contribution plans such as section 401(k) programs sponsored by employers. Calculations of IRA revenue costs, particularly on a present-value basis, are complicated by the necessity of tracking or predicting both IRA contributions and distributions, with time and taxpayer characteristics (including marginal tax rates) varying over the life of an IRA. The analysis further is complicated by the availability of Roth IRAs, and the opportunity (limited by taxpayer income level) of taxpayers to convert from traditional IRAs to Roth IRAs.

IRAs also entail a significant element of uncertainty, i.e., a taxpayer's uncertainty, noted above, about his marginal tax rate at the time of potential distribution. The difference between a taxpayer's tax rate at time of contribution and distribution or early withdrawal is a key factor in choosing among the IRA options for taxpayers who are eligible for more than one type of IRA.

IRAs appear, however, to fare well in terms of ease of administration, a substantive goal that is important to all subcategories of Tax Subsidies. IRAs appear to have minimal fraud and compliance issues, although the complexity of the mandatory distribution and early withdrawal rules noted above may offer opportunities for tax evasion.

Broader evaluation issues include the interaction of IRAs with other retirement tax expenditures. For example, the equity implications of IRAs discussed above may look different when one takes account of the effects of the Saver's Credit.¹⁶⁸ Other questions related to the substantive Social Spending goals of IRAs include whether, given society's continued desire to

¹⁶⁷ A similar distinction occurs with respect to distributions – a normal distribution from a Roth IRA will not show up on any tax return form. However, there is information reporting on all IRA contributions and distributions, and Form 8606 is required for non-deductible IRA contributions. For compliance purposes the IRS thus can use Form 8606 and information returns as well as Form 1040 or 1040A, and for research purposes the information returns easily can be linked to tax returns. This characterization of the connection between lines on Forms 1040 and 1040A, other tax forms and information returns, and the role of such information in compliance and research also generally applies to other exemptions such as the foreign earned income exclusion or the exclusion of fellowship and scholarship income, while the exemption for tax-exempt interest is required to be listed on the Forms 1040s and 1040A.

¹⁶⁸ For example one study of the Saver's Credit found that nonrefundability inhibited its effect. See Gary Koenig and Robert Harvey, *Utilization of the Saver's Credit: An Analysis of the First Year*, 58 National Tax Journal 787-806 (2005).

ensure adequate retiree income, the IRA method of encouraging retirement saving are as imperative in 2008, with the current proliferation of employee participation in such plans and the decline of defined benefit plan participation, as IRAs were when they were introduced en masse in the 1980s, a time when defined benefit plan usage was relatively more prevalent. Thus, one could test whether IRAs, in their current form or perhaps legislatively enhanced for the future by use of tax credits and other tools, are necessary to ensure retirement income security if the ongoing decline in defined benefit participation is viewed with alarm.

3. Research and experimentation tax credit

The research and experimentation (“R&E”) tax credit, which expired at the end of 2007, is a multifaceted Tax Subsidy that is intended to increase general social welfare by encouraging businesses to perform research. Its rationale thus is economic efficiency. We classify the R&E credit as a Business Synthetic Spending item because it is elected by businesses and aimed at a type of spending, research and experimentation expenses, that when targeted correctly improves general social welfare.

One fundamental question about the R&E credit relates to the externality rationale for its existence, that is, whether in a Pigouvian fashion the credit increases social welfare by inducing important research that otherwise would not occur. In this regard, consideration of other tax and outlay effects is necessary for evaluation of the R&E credit’s effect on efficiency.¹⁶⁹

As indicated by Tables 2 and 3, the R&E credit is used by businesses of varying size and industrial focus. These tables show that a heterogeneous mix of firms claim the credit, although the dollar amount of the credit is more narrowly distributed.

¹⁶⁹ See Zvi Griliches, *The Search for R&D Spillovers*, 94 *Scandinavian Journal of Economics* (1992); M. Ishaq Nadiri, *Innovations and Technological Spillovers*, National Bureau of Economic Research, Working Paper No. 4423 (1993); Bronwyn Hall, *The Private and Social Returns to Research and Development*, in Bruce Smith and Claude Barfield, eds., *Technology, R&D and the Economy* (Washington, D.C., Brookings Institution Press 1996) at 1-14. These papers suggest that the rate of return to privately funded research expenditures is high compared to that in physical capital and the social rate of return exceeds the private rate of return. Griliches concludes, “in spite of [many] difficulties, there has been a significant number of reasonably well-done studies all pointing in the same direction: R&D spillovers are present, their magnitude may be quite large, and social rates of return remain significantly above private rates.” Griliches, *supra*, at S43. Charles I. Jones and John C. Williams, *Measuring the Social Return to R&D*, 113 *Quarterly Journal of Economics* at 1120 (1998), also conclude that “advanced economies like the United States substantially under invest in R&D.”

Table 2.—Percentage Distribution of Corporations Claiming Research Tax Credit and Percentage of Credit Claimed by Sector, 2005

Industry	Percent of Corporations Claiming Credit	Percent of Total R & E Credit
Manufacturing	50.7	71.2
Professional, Scientific, and Technical Services	25.3	10.2
Information	6.7	9.8
Wholesale Trade	6.2	3.1
Finance and Insurance	1.5	1.9
Holding Companies	2.4	1.5
Retail Trade	0.9	0.7
Health Care and Social Services	1.0	0.4
Utilities	0.2	0.3
Transportation and Warehousing	0.9	0.2
Administrative and Support and Waste Management and Remediation Services	2.4	0.2
Agriculture, Forestry, Fishing, and Hunting	1.0	0.2
Mining	0.1	(1)
Real Estate and Rental and Leasing	0.1	(1)
Construction	0.2	(1)
Other Services	0.2	(1)
Arts, Entertainment, and Recreation	(2)	(2)
Educational Services	(2)	(2)
Accommodation and Food Services	(2)	(2)
Not Allocable	(2)	(2)
Wholesale and Retail Trade not Allocable	(2)	(2)

¹ Less than 0.1 percent.

² Data undisclosed to protect taxpayer confidentiality.

Source: Joint Committee on Taxation staff calculations from Internal Revenue Service, Statistics of Income data.

Table 3.–Percentage Distribution of Corporations Claiming Research Tax Credit and of Credit Claimed by Corporation Size, 2005

Asset Size (\$)	Percent of Firms Claiming Credit	Percent of Credit Claimed
0	1.4	0.7
1 to 99,999	10.1	0.1
100,000 to 249,999	5.2	0.1
250,000 to 499,999	3.8	0.2
500,000 to 999,999	8.1	0.4
1,000,000 to 9,999,999	37.5	5.4
10,000,000 to 49,999,999	18.7	6.4
50,000,000 +	15.3	86.6

Note: Totals may not add to 100 percent due to rounding.

Source: Joint Committee on Taxation staff calculations from Internal Revenue Service, Statistics of Income data.

The R&E credit has several variants. The three primary versions broadly target cross-industrial research activity and are provided on an incremental basis. Another narrower credit focuses on research undertaken by energy research consortia and is calculated as a percentage of base expenditures. Finally, a credit is available for amounts paid to certain universities and nonprofit scientific research organizations for basic research that advances scientific knowledge but does not have a specific commercial objective.¹⁷⁰

The R&E credit is a good example of a provision in which targeting creates complexity. The complexity arises from requirements to identify qualified expenditures and to track these expenditures over time. Taxpayers must also make the calculation for each variant of the credit to determine which provides the greatest tax benefit. The provision's complexity, however, may be relatively less burdensome by virtue of the sophistication of typical research credit claimants compared with EIC or IRA users. The credit's incremental targeting is designed to encourage taxpayer response similar to that provided by a conventional credit but at a substantially reduced revenue cost and, in that respect, enhance efficiency. On the other hand, the nonrefundability of

¹⁷⁰ A full discussion of this and other issues, including the connection of the R&E credit to externalities, can be found in Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2009 Budget Proposal*, March 2008 (JCS-1-08).

the credit disadvantages some potentially important start-up businesses that lack sufficient tax liability to fully use the credit.¹⁷¹

Although the R&E credit currently is not applicable because of its expiration, it has been extended many times since its introduction.¹⁷² One of the continuing issues related to the R&E credit concerns uncertainty, as the credit has been extended for short periods of varying duration numerous times over the past two decades. The credit has also been difficult to administer, resulting in audit issues and complicated recordkeeping requirements.

¹⁷¹ However, any unused credits may be carried forward up to twenty years, and in limited circumstances start-up firms with unused credits may be combined with other firms or with new business opportunities that generate tax liabilities.

¹⁷² The credit was allowed to lapse from July 1, 1995, through June 30, 1996.

VI. ESTIMATING METHODOLOGY

A. Recent Tax Expenditure Estimating Methodology

This subsection summarizes how the JCT Staff has in the immediate past identified tax expenditures and estimated the revenues forgone by tax expenditures. The description explains our recent past practice; we summarize the differences between this and our new approach later in this Section VI.

As described throughout this pamphlet, the determination of whether a provision is a tax expenditure is made on the basis of the “normal” tax, which is a broad concept of income that is larger in scope than “income” as defined under the general principles of the Internal Revenue Code. The JCT Staff has used its judgment in distinguishing between those income tax provisions (and regulations) that can be viewed as a part of normal income tax law and those special provisions that result in tax expenditures. A provision traditionally has been listed as a tax expenditure by the JCT Staff if there is a reasonable basis for such classification and the provision results in more than a *de minimis* revenue loss.

If a tax expenditure provision were eliminated, Congress might choose to continue financial assistance through other means rather than terminate all Federal assistance for the activity. If a replacement spending program were enacted, the higher revenues received as a result of the elimination of a tax expenditure might not represent a net budget gain. A replacement program could involve direct expenditures, direct loans or loan guarantees, regulatory activity, a mandate, a different form of tax expenditure, or a general reduction in tax rates. JCT Staff estimates of tax expenditures have not addressed any of these possible policy responses; this will not change under the revised methodology summarized in this pamphlet.

The JCT Staff’s methodology in the recent past did not include negative tax expenditures as a result of provisions in the Internal Revenue Code that provide special tax treatment that is less favorable than normal income tax law. Examples of such provisions include (1) the denial of deductions for certain lobbying expenses, (2) the denial of deductions for certain executive compensation, and (3) the two-percent floor on itemized deductions for unreimbursed employee expenses or personal investment expenses.

Individual income tax

Under the JCT Staff’s methodology applied in the immediate past, the “normal” individual income tax had the following components: one personal exemption for each taxpayer and one for each dependent, the standard deduction, the existing tax rate schedule, and deductions for investment and employee business expenses. Most other tax benefits to individual taxpayers were classified as exceptions to normal income tax law.¹⁷³

¹⁷³ See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2007-2011* (JCS-3-07) 9-13, September 24, 2007 (providing a detailed enumeration of the exceptions to the normal law under the previous methodology).

Business income taxation

Under the JCT Staff's methodology applied in the immediate past, regardless of the legal form of organization (sole proprietorship, partnership, or S or C corporation), the same general principles were used in the computation of taxable business income. Thus, most business tax expenditures applied equally to unincorporated and incorporated businesses.

One of the most difficult issues in defining tax expenditures for business income relates to the tax treatment of capital costs. Under present law, capital costs may be recovered under a variety of alternative methods, depending upon the nature of the costs and the status of the taxpayer. For example, investments in equipment and structures may qualify for tax credits, expensing, accelerated depreciation, or straight-line depreciation. The JCT Staff generally classified as tax expenditures cost recovery allowances that were more favorable than those provided under the alternative depreciation system (sec. 168(g)), which provides for straight-line recovery over tax lives that are longer than those permitted under the accelerated system. The JCT Staff assumed that "normal" income tax law would not provide for any indexing of the basis of capital assets. Thus, normal income tax law would not take into account the effects of inflation on tax depreciation. In estimating the tax expenditure for accelerated depreciation, the JCT Staff assumed that depreciation under sec. 168(g) is "normal" law. Our tax expenditure estimate therefore compared depreciation under sec. 168(g) with cost recovery methods actually allowable to taxpayers. Thus, all investments that would be depreciable under either sec. 168(g) or under accelerated depreciation are taken into account in deriving the tax expenditure; the tax expenditure estimate potentially includes the differential of cost recovery on investments made as many as forty years ago.¹⁷⁴

The methodology applied by the JCT Staff in the recent past used several accounting standards in evaluating the provisions in the Code that govern the recognition of business receipts and expenses. Under the JCT Staff view, "normal" income tax law was assumed to require the accrual method of accounting, the standard of "economic performance" (used in the Code to test whether liabilities are deductible), and the general concept of matching income and expenses. In general, tax provisions that did not satisfy all three standards were viewed as tax expenditures.

For example, the deduction for contributions to taxpayer-controlled mining reclamation reserve accounts was viewed as a tax expenditure because the contributions did not satisfy the economic performance standard. (Adherence to the standard would require that the taxpayer make an irrevocable contribution toward future reclamation, involving a trust fund or similar mechanism, as occurs in a number of areas in the Code.) The deductions for contributions to nuclear decommissioning trust accounts and certain environmental settlement trust accounts, by contrast, were not viewed as a tax expenditure, because the contributions are irrevocable (*i.e.*, they satisfy the economic performance standard). However, present law provides for a reduced

¹⁷⁴ The comparison of cost recovery for investments made over the last forty years is one way that the tax expenditure estimate is very different from a revenue estimate of a change in law affecting depreciable assets on a prospective basis.

rate of tax on the income of both types of trust accounts, and these tax rate reductions have been viewed as tax expenditures.

The JCT Staff assumed that “normal” income tax law would provide for the carryback and carryforward of net operating losses. The staff also assumed that the general limits on the number of years that such losses may be carried back or forward were chosen for reasons of administrative convenience and compliance concerns and may be assumed to represent “normal” income tax law. Exceptions to the general limits on carrybacks and carryforwards were viewed as tax expenditures.

Corporate income tax

The income of corporations (other than S corporations) generally is subject to the corporate income tax; the JCT Staff’s implementation of the “normal” tax treated the separate corporate income tax (and the double taxation of dividend income) as part of the “normal” tax base. The corporate income tax includes a graduated tax rate schedule. The lower tax rates in the schedule were classified by the JCT Staff as a tax expenditure (as opposed to normal income tax law) because they were intended to provide tax benefits to small business and, unlike the graduated individual income tax rates, are unrelated to concerns about ability of individuals to pay taxes.

Exceptions to the corporate alternative minimum tax were not viewed as tax expenditures because the effects of the AMT exceptions are already incorporated in the estimates of related tax expenditures.

Certain income of pass-through entities is exempt from the corporate income tax. The income of sole proprietorships, S corporations, most partnerships, and other entities (such as regulated investment companies and real estate investment trusts) is taxed only at the individual level. The special tax rules for these pass-through entities were not classified as tax expenditures because the tax benefits are available to any entity that chooses to organize itself and operate in the required manner.

Nonprofit corporations that satisfy the requirements of Internal Revenue Code section 501 also generally are exempt from corporate income tax. The tax exemption of certain nonprofit cooperative business organizations, such as trade associations, was not treated as a tax expenditure for the same reason applicable to for-profit pass-through business entities. With respect to other nonprofit organizations, such as charities, tax-exempt status was not classified as a tax expenditure because the nonbusiness activities of such organizations generally must predominate and their unrelated business activities are subject to tax. In general, the imputed income derived from nonbusiness activities conducted by individuals or collectively by certain nonprofit organizations is outside the normal income tax base. However, the ability of donors to such nonprofit organizations to claim a charitable contribution deduction is a tax expenditure, as is the exclusion of income granted to holders of tax-exempt financing issued by charities.

B. Tax Expenditure Estimates Generally

A tax expenditure for a given year is measured as the difference between taxpayers' aggregate tax liability under present law and their tax liability that would result from a recomputation of tax without benefit of the tax expenditure provision. Taxpayer behavior is assumed to remain unchanged for tax expenditure estimate purposes.¹⁷⁵

The tax expenditure calculation for a given year reflects continuing timing differences attributable to investments made in prior years. Accelerated depreciation is the best-known example of this phenomenon. Estimates for this tax expenditure are based on the difference between tax depreciation deductions under present law and the deductions that would have been claimed in the current year if investments in the current year *and all prior years* had been depreciated using the alternative (normal income tax law) depreciation system.

Neither the tax expenditure estimating methodology used in the immediate past nor the proposed methods for tax expenditures are the same as those used for revenue estimates, for three critically important reasons. First, our annual tax expenditure tables do not take into account the many large interactive effects that would be observed if Congress were simultaneously to repeal all the many tax expenditures that appear on our tables. In other words, if two or more tax expenditures were estimated simultaneously, the total change in tax liability could be smaller or larger than the sum of the amounts shown for each item separately, as a result of interactions among the tax expenditure provisions.

Second, by tradition, tax expenditures are calculated on a static basis: that is, the behavioral consequences that would follow from repeal are ignored.¹⁷⁶ By contrast, the JCT

¹⁷⁵ An alternative way to measure tax expenditures is to express the values in terms of "outlay equivalents." An outlay equivalent is the dollar size of a direct spending program that would provide taxpayers with net benefits that would equal what they now receive from a tax expenditure. The Treasury Department presents estimates of outlay equivalents in the President's budget in addition to presenting estimates in the same manner as the JCT Staff. In the early 1980s, the Treasury Department adopted the concept of "outlay equivalency" for its tax expenditure analysis. In adopting this approach, Treasury presented tax expenditures using the more traditional "revenue loss" method in tandem with the tax expenditures' outlay equivalents. Treasury calculated outlay equivalents in a manner designed to facilitate a "fair" (apples to apples) comparison between tax expenditures and direct government outlays. In calculating outlay equivalents, Treasury considered how a tax expenditure would be converted into a direct outlay and whether the outlay payment itself was likely to be taxable. To arrive at the outlay equivalent amount, Treasury then grossed up the tax expenditure amount to account for any tax liability that would be associated with a direct payment.

¹⁷⁶ The JCT Staff allows for "tax form" behavior when calculating a tax expenditure. That is, we assume the taxpayer will take the next most beneficial tax position. For example, if Congress repealed the education credits (the Hope and the Lifetime Learning Credits), we would assume that individuals otherwise eligible for these credits would avail themselves of the next best thing, for example, the tuition deduction.

The tradition of scoring tax expenditures on a static basis is an attempt to put the tax expenditure on a more equal footing with other expenditures. The tax expenditure static assumption asks the question

Staff's actual revenue estimates fully reflect anticipated behavioral effects of the proposal under consideration (subject only to the constraint that in the usual case we do not model any macroeconomic growth effects from the proposal).¹⁷⁷

Third, tax expenditure calculations are applied retroactively, in the sense that a tax expenditure calculation for a year reflects timing differences attributable to investments made in prior years. In most cases, actual revenue legislation is not designed to have this kind of retroactive effect.

Internal Revenue Service statistics from recent tax returns are used to develop projections of the tax credits, deductions, and exclusions that will be claimed under the present-law baseline. These statistics show the actual usage of the various tax expenditure provisions. In the case of some tax expenditures, such as the earned income credit, there is evidence that some taxpayers are not claiming all of the benefits to which they are entitled, while others are filing claims that exceed their entitlements. JCT Staff tax expenditure estimates are based on projections of actual claims under the various tax provisions, not the tax benefits to which taxpayers are entitled.

of what is the total effect of the provision on current Federal budgets. By contrast, a revenue estimate in part asks the question of what is the taxpayer's next best alternative; the revenue estimate contemplates that taxpayers will change their behaviors accordingly.

¹⁷⁷ *Inside the JCT Revenue Estimating Process*, A presentation by the Chief of Staff of the Joint Committee on Taxation to the New York State Bar Association, January 29, 2008. Revised January 30, 2008, <http://www.house.gov/jct/Inside_Revenue_Estimating.pdf>.

C. New Methodology

1. The baseline and presentation

While the principal thrust of JCT's proposed revised approach to tax expenditure analysis is to deemphasize the relevance of the "normal" tax as much as possible, the new approach must still define a baseline from which to measure the magnitude of tax expenditures. As previously described, current tax expenditure analysis employs the "normal" tax as the baseline from which the JCT Staff can calculate the dollar magnitude of a particular tax expenditure.

On balance, we believe that the most feasible approach, and the one most consonant with the original legislative history of the Budget Act, is to follow general present-law tax rules (what the Treasury Department calls its reference tax base) for Tax Subsidies. We will develop our presentation of the general tax rules of present law in our next tax expenditure pamphlet, which will contain estimates of the revenues forgone in respect of those tax expenditures that are classified as Tax Subsidies.

Solely for purposes of preserving continuity with past analyses, we will estimate the forgone revenues associated with those Tax-Induced Structural Distortions that in the recent past have been analyzed as tax expenditures by applying our immediately-past definition of the "normal" tax, as reflected in our recent annual tax expenditure pamphlets.¹⁷⁸ Where helpful and feasible, we will supplement that analysis with revenue or tax-expenditure style estimates, but the principal presentation of each Tax-Induced Structural Distortion will be the written analysis of the relevant economic efficiency issues associated with that tax expenditure.

Consistent with current JCT quantitative presentations, we do not envision presenting "outlay equivalents" in these subsequent pamphlets. While outlay equivalence is a useful concept for considering the budget consequences of converting a tax expenditure into a direct spending program, it is not always clear what the proper tax treatment would be for a direct payment that has been converted from a tax expenditure. Moreover, adoption of outlay equivalents would expose the lack of uniformity in accounting for appropriations, because current government accounting for direct outlays only measures what the government remits on a cash basis and does not take into account directly the taxability to a private person of a direct government payment. Thus, the imposition of outlay equivalence on the tax side alone would be asymmetric.

2. Miscellaneous methodological issues

We recognize that a few items that today are classified as tax expenditures may not fit neatly either as Tax Subsidies or as Tax-Induced Structural Distortions. We propose to continue to carry those items on our tax expenditure tables to preserve continuity with all of our prior

¹⁷⁸ In every case, however, the substantive analysis of a Tax-Induced Structural Distortion will follow the summary presented earlier in this pamphlet, by identifying the economic distortion(s) embedded in current tax law, and possible alternative structural approaches that would address those economic distortions.

work in this area. We will reevaluate this decision periodically, in light of the success (or failure) of the new approach proposed here.

Limitations directly linked to various positive tax expenditures, or to the alternative minimum tax or the limitation of itemized deductions, are not classified as negative tax expenditures. Instead, these items are considered reductions in those positive expenditures. This approach is consistent with that followed by the JCT Staff in the recent past.

3. Areas for further research and development

Moving forward, we will continue to review the methodology underlying the measurement of specific tax expenditures in light of our new taxonomy. We anticipate that the perspectives developed through our new approach will point to interesting areas for further research and development.

For instance, the measurement of tax expenditures associated with retirement savings incentives is potentially affected both by demographic changes that might prompt a revised approach and by our new methodology. As the Baby Boom generation moves fully into retirement years, it may become increasingly important to consider the present discounted value of tax expenditures in addition to their current cash costs. Individual income tax expenditures that have a deferred tax consequence will be affected due to the increasing size of the retired population. IRAs and similar provisions will see a rise in distributions to retirees that could result in an attenuation of the estimated tax expenditure on a cash accounting method. A present discounted value approach would provide a more realistic picture of the true costs of the provision.¹⁷⁹ On the other hand, it might be argued that the introduction of another method of accounting would be confusing to policymakers, particularly when it was not implemented consistently across the Federal budget.¹⁸⁰

¹⁷⁹ For a detailed discussion of the optimal budget window, see Alan Auerbach, *Budget Windows, Sunsets, and Fiscal Control*, 90 *Journal of Public Economics* 87-100 (2006).

¹⁸⁰ The Treasury Department has from time to time produced tables reporting present-value estimates of the revenue losses for tax expenditures that involved deferrals of tax payments or had similar long-term effects. The dual baseline approach was first introduced in the fiscal year 1995 budget. Analytical Perspectives, Budget of the United States, Fiscal Year 1995.