

RETHINKING TAX EXPENDITURES*

**Address by Edward D. Kleinbard
Chief of Staff, Joint Committee on Taxation
to the
Chicago-Kent College of Law Federal Tax Institute
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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.¹ 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.²

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, and would also be helpful in fashioning “tax reform” policies.³ 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.⁴ 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, or (in most cases) when compared to not

¹ 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, DC: Government Printing Office, 1969, p. 322.

² Stanley S. Surrey, *Pathways to Tax Reform*, Cambridge, Mass.: Harvard University Press, 1973, p. 6.

³ Excerpts from remarks before the Money Marketeers, *supra* n. 1; *see also Pathways to Tax Reform*, *supra* n.2, pp. 30-49 (describing uses of a tax expenditure budget).

⁴ *See* Surrey, *The Federal Tax System--Current Activities and Future Possibilities* (speech before Boston Economic Club, May 15, 1968). Excerpts appear in: U.S. 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*, 313 (1969).

expending government resources at all. In this way, the “expenditure control” agenda would be advanced.⁵

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 simplicity. Surrey hoped that, by rephrasing “tax incentive” proposals as “tax expenditures,” and then by analyzing the equity, efficiency and simplicity 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.⁶

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 U.S. Treasury annually to publish detailed lists of tax expenditures. (In light of the traditional expertise of the Staff of the Joint Committee on Taxation (“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, 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.

⁵ Stanley S. Surrey and Paul R. McDaniel, *Tax Expenditures*, Cambridge, Mass., Harvard U. Press, 1985, pp. 32-37.

⁶ *Id.*, pp. 25-27, 69-98.

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.⁷ 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, 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.⁸ Our 2007 pamphlet, by contrast, while employing essentially the same methodology as that of our first description 35 years earlier, listed 170 tax expenditures.⁹

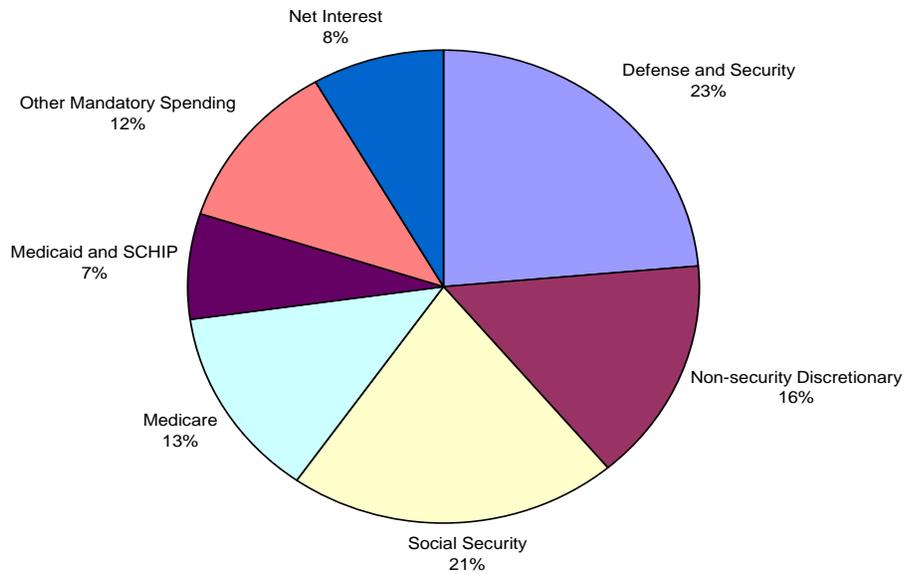
The importance of tax expenditures in dollar terms can be seen by comparing actual Federal discretionary outlays to the aggregate amount of tax expenditures. In fiscal 2009, the Federal government projects annual total outlays of more than \$3.1 trillion. Of this amount, roughly \$1.6 trillion will go 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.

⁷ See Emil Sunley, *Tax Expenditures in the United States: Experience and Practice, in Tax Expenditures—Shedding Light on Government Spending Through the Tax System* 155, 166 (Hana Pulackova Brixi, Christian M.A. Valenduc, and Zhicheng Li Swift, eds., 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.”).

⁸ Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Calendar Years 1967 through 1971* (JCS-28-72), October 4, 1972.

⁹ Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2007-2011* (JCS-3-07), September 24, 2007.

FY2009 Estimated Budget Outlays by Category



Tax expenditure calculations cannot be compared directly with these projected actual expenditures, because the tax expenditure figure calculates 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*.¹⁰

For fiscal year 2009, implementation of ten of these options, 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 account of potential interactions between the provisions).¹¹ Some of these options do not represent full

¹⁰ Congressional Budget Office Budget Options (February 2007), <<http://www.cbo.gov>>.

¹¹ 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 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

repeal; 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.

Tax expenditure analysis by itself thus has not succeeded in its first mission of “expenditure control.” That does not mean, however, that tax expenditure analysis has wholly failed, but rather that its principal utility has been as a tool of tax policy and tax distributional analysis. The rhetoric of tax expenditure analysis in fact can provide a useful mechanism to judge the fairness, efficiency and simplicity consequences of many “incentive” proposals. Policymakers further look to tax expenditure analysis to provide insight into “base broadening” and similar measures.

As a result of contemporary “PAYGO” requirements, policymakers today typically pair tax expenditures against tax revenue-raising measures, rather than proposing them as a direct substitute for spending programs. In light of this reality, and the fact that tax expenditure analysis can provide a successful framework for addressing tax equity, efficiency and simplicity issues raised by a new proposal or the tax system as a whole, we believe it appropriate to proceed on the basis that tax expenditure analysis today exists primarily as a tool of tax policy, rather than budget expenditure control.

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.

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.¹² 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 an aspirational 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

¹² See, e.g., Boris I. Bittker, *Accounting for Federal “Tax Subsidies” in the National Budget*, 22 Nat’l Tax J. 244 (1969).

credible insights into the equity, efficiency, and simplicity 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

In a forthcoming pamphlet we will introduce 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. 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. (We refer to the converse case, of an exception that deliberately overtaxes compared to the general rule, as a “Negative Tax Subsidy.”)

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).

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.¹³ The Treasury Department also has

¹³ Seymour Fiekowsky, *The Relation of Tax Expenditures to the Distribution of the ‘Fiscal Burden’*, 2 Can. Tax’n 211, 215 (1980); see also OMB, *The Budget of the United States Government, Fiscal Year 1983 -- Special Analyses G-5* (1982); Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 Duke L.J. 1155, 1187 (1988) (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).

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 but ultimately 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, we believe that experience has shown that tax expenditure analysis is 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.

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. 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.¹⁴

Present law’s “deferral” treatment of the 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. On the one hand, deferral is consistent with the general rules under which the Internal Revenue Code taxes corporations (including its definition of corporate residence). On the other hand, deferral arguably is a departure from the Code’s general approach of imposing current tax on business income, wherever earned.¹⁵

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. 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,

¹⁴ See Thuronyi, *supra* at 1182-1186.

¹⁵ See J. Clifton Fleming, Jr. and Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and its International Dimension*, 27 Va. Tax Rev. 101, 196-197 (2008).

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 efficiency costs.

An example of a Tax-Induced Structural Distortion, beyond that already given of the “deferral” of foreign earnings, 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 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.

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 the current “deferral” tax treatment of the earnings of foreign subsidiaries as raising two important efficiency concerns: (i) U.S. firms have an incentive under present law not to repatriate “active” foreign earnings to the United States; 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 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. Each solution in turn raises issues of its own that policymakers should be aware of. 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 equity and simplicity issues as well as efficiency concerns, our definition of Tax-Induced Structural Distortions looks only to the last of these criteria. 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 simplicity) 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.

It is instructive to compare the two-pronged definition outlined above to the Treasury Department’s current two-layer approach to the issue. 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.¹⁶

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 what the Treasury Department does today, because it does not invoke a "normal" tax base at all. Instead, our definition of "Tax-Induced Structural Distortions" relies entirely on an objective inquiry into efficiency considerations. The two legs of our proposed definition thus are intended to be more transparent and objective than is the alternative.

The above discussion arguably overstates the practical differences among the different definitions. 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.¹⁷ While the JCT Staff's list of tax expenditures historically has included more items than 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 phase-out of itemized deductions are not classified as negative tax expenditures but instead are considered reductions in those positive expenditures.¹⁸

¹⁶ Office of Management and Budget, *Analytical Perspective, Budget of the United States Government, Fiscal Year 2009*, Chapter 19. p. 297.

¹⁷ 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.

¹⁸ The phase-out of itemized deductions, also known as the "Pease" limitation after former Representative Donald Pease, is allocated on a pro rata basis for quantitative presentation.

E. 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).¹⁹

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.

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, 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. 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 simplicity 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 foregone by the provision. Second, unless we are to quantify the forgone revenues only of Tax Subsidies, some baseline that is more 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

¹⁹ *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>.

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 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.

Consistent with current JCT quantitative presentations, we do not envision presenting “outlay equivalents.” 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.

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. Finally, tax expenditure calculations historically have not been made on an outlay equivalent basis (Treasury itself has stopped using outlay equivalents); a change in methodology would hinder comparisons over time, while a presentation of both outlay equivalents and the more traditional revenue loss calculations could be distracting.

F. 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.

The subcategories of Tax Subsidies are as follows:

1. Tax Transfers

These 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 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 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, IRA deductions (or exclusions, in the case of Roth IRAs), and the nonrefundable portion of the child care 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 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 foregoing 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 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.

In summary, we hope that our division of Tax Subsidies into these 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 fairness. The three

²² The legislative and executive branch histories of enactment and implementation of these provisions also support the 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.

subcategories can be useful, however, to suggest that these factors 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 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.

G. Outline of Subsequent Work

In our forthcoming pamphlet, we will outline the development of tax expenditure analysis, describe how that doctrine is used today, summarize commentators' principal objections to how tax expenditure analysis is currently implemented, and respond to those criticisms by proposing in detail a new paradigm for categorizing provisions of the Internal Revenue Code as tax expenditures. I have summarized the gist of this new paradigm for you today. Finally, our forthcoming pamphlet will review some of the issues associated with quantifying tax expenditures under our revised definitions.

We envision our forthcoming pamphlet as the first of several on this topic that we intend to publish in the coming months. The next pamphlet will be 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 in more detail 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 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. 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 this project.