

# CHAPTER ELEVEN

## TAX EXPENDITURES

*Tax subsidies, like their counterparts on the spending side, reduce economic efficiency by substituting political micromanagement for routine market decisions about how capital should be allocated across the economy.<sup>a</sup>*

### A. INTRODUCTION

Tax expenditures are tax benefits used as incentives or rewards in lieu of outright payments by the government. Tax expenditures include incentive tax credits, exemptions, deductions that are not justified in computing net profit, and lower tax rates on specified types of income.

Not being outlays from the Treasury, tax expenditures are not reflected in government expenditures and are not subject to the annual Congressional appropriation process. They are not items listed in the budget and affect the budget only through tax receipts being lower than they otherwise would be.

Votes for tax expenditures have obvious political appeal for members of Congress. Some discipline in the Congressional procedure for enactment of new tax expenditures or for liberalizing existing tax expenditures has been introduced by a requirement Congress has imposed on itself that bills reducing revenues must contain offsetting revenue increases over a five-year span. Existing, ongoing tax expenditures are not affected. So-called "sunset" rules have been proposed that would terminate existing tax expenditures unless they were explicitly continued. Sunset rules have not been adopted, however.

The Budget Act of 1974 requires the Congressional Budget Committee and the President to present estimates each year of the revenue costs of existing tax expenditures. These annual cost estimates help one appreciate the magnitude of the various tax expenditures.

Although the overall concept of tax expenditures is clear, the precise definition of the term is by no means clear. Furthermore, even the basic concept has been challenged. As respects exemptions and deductions, the debate over tax expenditures merges into the debate over broadening the tax base.

The clearest examples of tax expenditures are the incentive tax credits. These reward taxpayer behavior by credits against tax liability, and are usually calculated as a specified percentage of the taxpayer's expenditure on

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a. Robert J. Shapiro, *Cut-and-Invest: A Budget Strategy for the New Economy*, PROGRESSIVE POL'Y INST. REP. NO. 23 (1995).

the rewarded behavior. The investment tax credit has been the major tax credit over the years of its off-and-on existence since its original enactment in 1962. Before the credit was sharply restricted in 1986, taxpayers making investments in tangible personal property (and some real property) for business use were permitted to offset their income tax liability by a percentage of the cost of their qualifying investments. Investment tax credits were presented as explicit incentives to invest. As initially proposed by President Kennedy, the credit would have been available only for incremental investments over the taxpayer's normal replacements of business assets, but the incremental investment approach had been abandoned by the time the credit was enacted.

The investment credit was the precursor of a flood of other tax credits. These included a credit for increasing outlays for research and development, a credit for providing low-income housing, a credit for wages paid to workers considered to be disadvantaged in some specified respects, a child care credit, a tax credit for elderly and disabled taxpayers, and an earned income tax credit for low-income taxpayers. Unlike tax credits designed to be incentives, the latter three tax credits are designed merely to provide relief from tax. The earned income credit provides actual cash supplements.

An obvious difficulty with all the tax credits (except the earned income credit) is that they benefit only persons who otherwise would owe income tax. The credits do not provide an incentive to persons whose incomes are so low that they have no tax liability or to businesses that are operating at a loss. One response to this difficulty has been to suggest making the credits "refundable"—i.e., an amount equivalent to the tax credit would be given to persons who qualify for the credit whether or not they have tax liability to apply it against. Thus, a "refund" would be made of a tax that had not been paid. So far, only the earned income tax credit is "refundable." In contrast, the wage withholding tax credit is not referred to as "refundable," because the refund is out of tax withheld from the taxpayer's compensation.

Tax exemptions and deductions from adjusted gross income also can be tax expenditures. As with nonrefundable credits, exemptions and deductions are useful only if the eligible person otherwise would owe tax. Tax deductions and exemptions of specified types of income can be of benefit by increasing net operating losses that are carried over to offset taxable income in other years.

Unlike tax credits, exemptions and deductions are tax expenditures that vary in value among taxpayers—the higher the potential tax bracket, the greater the tax expenditure. For example, a \$1,000 percentage depletion deduction is worth \$350 to a corporation with a 35 percent marginal tax rate and only \$150 to a corporation with a 15 percent marginal tax rate. If the taxpayer has exhausted the tax basis of the mineral property giving rise to the percentage depletion deduction, the tax expenditure, whether \$350 or

\$150, is an outright benefit—not merely a postponement of tax—because there is no compensating downward basis adjustment.

It is more difficult to calculate the benefit from tax expenditures that arise from accelerating deductions that a taxpayer eventually would be entitled to under "normal" rules. The value of speeding up such a deduction depends on two factors: how long it would be before the taxpayer would have received the deduction in the absence of the tax expenditure provision, and the time value of the tax deferred by speeding up the deduction. The time value to the taxpayer may be quite different from the cost to the government of postponing its receipt of tax, raising the question of what interest rate should be used to calculate the amount of the tax expenditure.

## **B. THE TAX EXPENDITURES CONCEPT DESCRIBED**

As noted above, in 1974 Congress for the first time began formally evaluating and quantifying tax expenditures. One of the leading advocates of this change was Professor Stanley Surrey, who had been Assistant Secretary of the Treasury for Tax Policy under President Kennedy. His argument for formally evaluating tax expenditures in a manner almost identical to direct expenditures, published the year before the 1974 Act, remains perhaps the best exposition of the concept. The second excerpt provides a recent example of the Office of Management and Budget's annual explanation of the tax expenditures concept in operation.

The proper classification of a given tax provision as a part of the "normal" tax structure or as a "tax expenditure" is not always clear. Does this lack of clarity matter, in the real world? In one sense, the classification is only an academic exercise—dollars saved from a lower tax burden spend just as well whether the lower tax burden results from a tax expenditure or not. On the other hand, the classification as a tax expenditure raises the political exposure of a tax provision. If the provision is viewed as part of the "normal" system, it is less subject to attack than if it is viewed as an "expenditure," which should have to compete for limited federal dollars in a political environment in which it is never possible to spend as many dollars as Congress might wish.

### **PATHWAYS TO TAX REFORM**

**Stanley S. Surrey\***

Pages 6-14, 129-41 (1973)

#### **The Tax Expenditure Budget**

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

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\*. At time of original publication, Jeremiah Smith Professor of Law at Harvard University.

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. The special provisions under which this subsidy apparatus functions take a variety of forms, covering exclusions from income, exemptions, deductions, credits against tax, preferential rates of tax, and deferrals of tax.

These special tax provisions serve ends which are similar in nature to those served in the same or other areas by direct government expenditures in the form of grants, loans, interest subsidies, and federal insurance or guarantees of private loans. The interplay is such that for any given program involving federal monetary assistance, the program may be structured to use the tax system to provide that assistance—where it will usually be called a "tax incentive"—or structured to use a direct Government expenditure. As a consequence of history, design, lack of analysis, and similar factors our present tax system is replete with these special provisions, or tax expenditures, under which many existing Government assistance programs operate through the tax system rather than the direct expenditure route.

The tax expenditure concept in essence considers these special provisions as composed of two elements: the imputed tax payment that would have been made in the absence of the special provision (all else remaining the same) and the simultaneous expenditure of that payment as a direct grant to the person benefited by the special provision. \* \* \*

The Tax Expenditure Budget \* \* \* identifies and quantifies the existing tax expenditures. \* \* \* The list of these tax expenditures here used is based on that published by the House Ways and Means Committee in June 1973, and prepared by the staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation.

The items in this Tax Expenditure Budget total between \$60 and \$65 billion—equal to around one-fourth of the regular budget. Yet most of these items seem almost to live a life of their own, undisturbed and unexamined. No agency really studies or controls them. The Office of Management and Budget largely neglects them, for the items are not in *its* budget. The executive departments likewise are usually unconcerned, for the items are not in *their* programs. The Treasury is apparently not evaluating them, but rather is adding new and indefensible items. This is no way to run a tax system and no way to run a budget policy.

These tax subsidies constitute by far the largest element in Government subsidy programs, clearly overshadowing the \$12 billion in direct cash payment subsidies, \$9 billion in benefit-in-kind subsidies, and \$4 billion in credit subsidies. \* \* \*

Tax expenditure analysis and the construction of a Tax Expenditure Budget involve some important structural aspects. Primary among these is the basic matter of definition: Which income tax rules are special provisions representing Government expenditures made through the income tax system to achieve various objectives apart from the tax, and which income tax rules constitute the basic structure of the income tax itself and hence are integral to having such a tax at all? What is required to answer this central question of definition is a normative model for an income tax structure. That normative model in turn will depend on a definition of "income" for income tax purposes. The original Treasury analysis<sup>b</sup> discussed this matter at some length. It indicated the tax expenditures there listed cover "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."

The Tax Expenditure Budget and underlying analysis drew importantly on the general acceptance of the Haig-Simons approach to the definition of "income," which essentially is based on "gain" or "accretion" and which Simons phrased as follows: "Personal income may be defined 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." This "accretion" approach and the Simons definition cast a very wide net, one reaching in a number of respects further than the coverage of modern income tax systems. The Treasury analysis, while referring to this approach when it spoke of "widely accepted definitions of income," therefore qualified reliance on it by also referring to the "generally accepted structure of an income tax." Thus, contrary to the Simons definition, the noncoverage under the United States income tax, and indeed all other income taxes, of imputed rental income on owner-occupied homes was not listed as a tax expenditure. In addition, the analysis indicated that aspects of our income tax, such as the personal exemptions, rate schedules, and income-splitting for married couples are not considered as "variations from the generally accepted measure of net income or as tax preferences, but as part of the structure of an income tax system based on ability to pay." Hence, they were not treated as tax expenditures but instead were considered as outside the scope of the Treasury study of tax expenditures.

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### **Comparison of Tax Incentives with Direct Expenditures**

The Tax Expenditure Budget thus serves to identify the tax incentives in our existing tax system and so to identify the areas in which Congress has given financial assistance through the tax system to induce desired action.

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b. The Tax Expenditure Budget for the Fiscal Year 1968, published in the Annual Report of the Secretary of the Treasury for Fiscal Year 1968, at 327, 329-30. (Eds.)

But why through the tax system? Why not through a direct expenditure program? *Given* the Congressional decision to provide the assistance, when should it be furnished through a direct expenditure program and when through a special tax program?

This section of the discussion is concerned with criteria for evaluating the use of tax incentives as compared to the use of direct Government expenditures. This evaluation does not involve the issue whether we should seek to achieve the particular goals for which tax incentives are now used or suggested. \* \* \*

There are \* \* \* a variety of ways to provide Government financial assistance—direct grants, loans, interest subsidies, guarantees of loan repayment or interest payments, insurance on investments, and so on. These methods are here called budgetary or direct expenditures. Skilled tax technicians and budgetary experts can take any tax expenditure and devise a budgetary expenditure approach to serve the same goals as a direct expenditure. For example, the British for some years used an approach under their tax law somewhat similar to our 7 percent investment credit to encourage the acquisition of machinery and equipment. The Labour Government subsequently dropped the tax technique and substituted direct cash payments. The Conservative Government then dropped the direct grants and returned to tax provisions. The existing tax incentive for charitable giving could also be structured as a direct expenditure program, under which the Government would match an individual's contribution to charity with a proportional contribution of its own to the same charity. Tax credits to an employer for manpower training could be structured as grants or contract payments to the employer. Tax benefits to the aged can be structured as cash to the aged. And so on.

It follows that a meaningful comparison between the tax incentive technique and the direct expenditure technique must involve *similar substantive programs*. There is no point to saying that in a particular situation a tax incentive is a more useful approach because it involves no Government supervision over the details of the action to be induced, whereas a direct expenditure involves detailed supervision. To say so is not to compare a tax incentive with a direct expenditure but simply to compare a loosely controlled method of paying out Government funds with a tightly controlled method. Direct expenditures can involve loose as well as tight supervision. Once we decide which substantive program we want, then we can go on to decide which technique—tax incentive or direct expenditure—is preferable for that program.

The matter of what type of substantive program is best calculated to achieve the desired goal lies in the fields of cost-benefit and cost-effectiveness analyses. These methods are being used more and more to devise and test direct expenditures, and they should *a priori* be equally applicable to programs using a tax incentive technique. \* \* \* [T]his has [not] been true

with regard to tax incentives in the past. Far from it—and therein lie many of the problems with tax incentives. \* \* \*

A meaningful comparison between the two techniques must also be realistic. Thus, it must recognize that a tax incentive does involve the expenditure of Government funds. It is often said that a tax incentive is more useful than a direct expenditure because people do not like or will not respond to "subsidies." Such statements always assume that the direct expenditure is the "subsidy," whereas the tax benefit obtained in the tax incentive—the lower tax—is not so regarded. Perhaps we may find that this fiscal illusion has its usefulness, but we should at least be aware of what is the reality and what is the illusion.

#### Some Asserted Virtues of Tax Incentives—Falsely Claimed

Against this general background we can now consider some of the virtues and defects generally claimed for tax incentives and, on the other side of the coin, for direct expenditures. The first level of consideration relates to virtues claimed for tax incentives, but, in the light of the above background, falsely claimed.

#### *Tax incentives encourage the private sector to participate in social programs*

Frequently a tax incentive is urged on the ground that the particular problem to be met is great and that the Government must assist in its solution by enlisting the participation of the private sector—generally business. \* \* \* Thus, a tax incentive for manpower training and employment proposed in the Senate was defended in these terms:<sup>15</sup>

Tax incentives [are proposed] to encourage the fullest participation of the private sector in employment, upgrading, and training of less skilled people.

\* \* \* [I]n order to encourage business to participate in programs of this nature, Government must be willing to meet business half way. The most convenient form for subsidizing a businessman is through his income tax.

. . . [This bill] enlists the job-creating potential of private enterprise by realistically recognizing the high initial costs involved in hiring, training, and providing supportive services for low-skilled individuals.

But all this is a non sequitur; it points not to the virtue of tax incentives but to the need for Government assistance. The existence of that need has no relevance to the question whether the need should be met by an incentive or by a direct expenditure.

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15. 115 Cong. Rec. 12,875, 12,876 (1969) (statement of Senator Charles Percy).

*Tax incentives are simple and involve far less governmental supervision and detail*

A whole swirl of virtues claimed for tax incentives is summed up in the general observation that they keep Government—that is, the Government bureaucracy—out of the picture: they involve less negotiation of the arrangements, less supervision, less red tape, no new bureaucracy, and so on. The manpower proposal referred to above was supported by this argument:<sup>16</sup>

The advantages to a tax credit approach are numerous. The most important, however, is that the program can go into effect immediately upon enactment. Employment programs in the past have taken months and years to become operative. . . . Employers who participate in the program will receive a tax credit of 75 percent of the wages paid to the employee for the first 4 months of employment, 50 percent for the next 4 months, and 25 percent for the balance of the individual's first year of employment. This is an uncomplicated program with the minimum of redtape. Any employer who hires a certified employee is eligible for the tax credit—it is as simple as that.

But this merely comes down to saying: "Let's have a manpower program under which the Government pays an employer, who hires a certified employee, an amount calculated as a percentage of the employee's wage." There is nothing so far that indicates whether the payment should be by way of a tax credit or a direct expenditure. Direct expenditure programs can also be structured to pay out Government money with few administrative controls. \* \* \*

A Government that decides it is wise to pay out tax credit money via a simple tax schedule would be highly irrational if it also decided that it would be unwise to pay the same amount directly on the same basis. A dollar is a dollar—both for the person who receives it and the Government that pays it, whether the dollar comes with a tax credit label or a direct expenditure label. Nor is a new bureaucracy needed to pay out these amounts as a direct expenditure—a check-writing process is all that would be needed in keeping with the parallel to the tax credit. Nor, similarly, must there be long negotiations, complex contracts, and the like. It is not the tax route that makes the program simple—it is substantive decisions to have a simple program. In many cases, it is true, direct expenditure programs are probably overstructured and the urging of tax incentives is a reaction to, and a valid criticism of, badly designed expenditure programs. The cure lies of course in better designed expenditure programs.

It should be added, parenthetically, that the alleged simplicity of tax incentives is likely to be illusory. Thus, the argument quoted above states that "[a]ny employer who hires a certified employee is eligible for the tax

16. 115 Cong. Rec. 12,875, 12,876 (1969) (statement of Senator Charles Percy).



credit—it is simple as that." But this is not really so, because the legislation actually proposed would have required the employer to be certified by the Secretary of Labor, and to be eligible for certification an employer would have had to prove that the employment program would not impair or depress the wages, working standards, or opportunities of present employees; that the business was not affected by strike, lockout, or similar conditions; that the employees in the program would be afforded an equal opportunity for full-time employment after the expiration of the credit period; that a formal on-the-job training program would be available; and that there would be no discrimination on account of race, color, religion, or national origin. Further complexities were involved in the proposed system for determining the creditable wage base. \* \* \*

The tape is thus present in tax incentive programs and its color is red.  
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*Tax incentives promote private decision-making  
rather than Government-centered decision-making*

It is said that better progress will be made toward the solution of many social programs if individual decision-making is promoted, and that since tax incentives promote this they should be preferred to approaches that underscore Government-centered decision-making. \* \* \*

[M]any business groups who in urging tax incentives stress the virtues of private enterprise overlook the fact that they are really stressing private enterprise *plus* Government assistance. But wise or unwise, the contentions that private enterprise should be allowed free play, without Government interference, tells us nothing as to the choice between tax incentives and direct expenditures, given the same substantive program. This contention is really a variant of the previous "red tape" argument. Just as we could design a direct expenditure program that provides for reduction of red tape, so we could design one that provides more flexibility for private decision-making and less scope for Government control. For example, the deduction for charitable contributions is sometimes cited as a method of Government assistance that promotes private decision-making—the taxpayer, and not the Government, selects the charity and determines how much to give. But a direct expenditure program under which the Government matched with its grants, on a no-questions-asked and no-second-thoughts basis, the gifts of private individuals to the charities they selected, would equally preserve private decision-making. \* \* \*

It is true that many of the existing tax incentives are less structured than direct expenditure programs. But in part this reflects lack of scrutiny and foresight when the tax incentives were being planned or considered.

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### Some Asserted Defects of Tax Incentives

*Tax incentives permit windfalls by paying taxpayers for doing what they would do anyway*

It is generally argued that tax incentives are wasteful because some of the tax benefits go to taxpayers for activities which they would have performed without the benefits. When this happens, the tax credit or other benefit is a pleasant windfall, and stimulates no additional activity. With respect to most, if not all, of the existing and proposed incentives this criticism is well taken, and indeed it is often difficult to structure a tax credit system which avoids this problem without increasing complexity and introducing arbitrariness. But this also is a problem not unique to the tax incentive technique. A direct expenditure program similarly structured would be equally open to the charge. For example, grants or contract payments made to employers who hire unskilled employees as part of a manpower program may go to employers who for one reason or another would have hired those employees anyway.

It may be desirable in particular programs to tolerate this inefficiency or windfall. Or it may be desirable to attempt to eliminate it. \* \* \* The significant question is what sort of substantive program is desired.

*Tax incentives are inequitable: they are worth more to the high-income taxpayer than the low-income taxpayer; they do not benefit those who are outside the tax system because their incomes are low, they have losses, or they are exempt from tax*

This criticism of tax incentives in terms of their inequitable effects is properly levied against most of the existing tax incentives, and probably most of the proposed incentives. The existing incentives were never really carefully structured and in many instances just grew up, without serious thought ever having been given to the question whether they were fair in these terms. \* \* \*

The fact that tax benefits for the aged and the sick provide no benefits for those aged or ill who are too poor to pay income taxes was not even thought of as a difficulty, since the focus was, as in any positive tax system, on writing the rules for *taxpayers*.<sup>24</sup> The problem was sometimes thought about in the context of an individual who fell outside the tax system because of current losses, and at times a carry-forward of incentive benefits was provided. Thought was occasionally given to the fact that the deduction of

24. If we had a *negative* income tax as well as a *positive* income tax, then the direct expenditures involved in the negative income tax payments to those whose incomes were below the level of positive tax would, to that extent, provide some assistance to balance the assistance given to taxpayers through the tax expenditures contained in the positive tax system. And also, of course, direct programs in many fields presently provide assistance to nontaxpayers as well as taxpayers. But the existence of such direct programs and a negative income tax would not make the tax incentives or special tax relief equitable. The jumble of financial assistance these varied methods would provide would only by extreme happenstance provide an equitable continuum of assistance structured to provide funds to those most in need of the assistance.

mortgage interest or charitable contributions is worth more to the top-bracket taxpayer than the low-bracket taxpayer, but the disparity was generally dismissed on the grounds that all deductions had that effect. Sometimes this matter was regarded as worrisome, and a tax credit was used instead of a deduction. \* \* \*

It is clear, then, that most tax incentives have decidedly adverse effects on equity as between taxpayers at the same income level, and also, with respect to the individual income tax, between taxpayers at different income levels. As a consequence of these inequitable effects, many tax incentives look, and are, highly irrational when phrased as direct expenditure programs structured the same way. Indeed, it is doubtful that most of our existing tax incentives would ever have been introduced, let alone accepted, if so structured, and many would be laughed out of Congress. \* \* \*

This difference between the rewards of the marketplace and the rewards of tax incentive also obtains for direct Government grants. Most direct Government economic assistance for business activities is given on a *before-tax* basis and in one way or another enters as a plus in the income accounts of the person benefited. See for example: agricultural subsidies for domestic activities and exports; manpower subsidies; air carrier and maritime subsidies; land and forest conservation payments; credit subsidies (which reduce interest costs) for agriculture, exports, housing, small business, and other activities. But the tax incentives, as we have seen, do not work that way. \* \* \* The tax incentive thus produces both financial assistance and freedom from taxation. That freedom itself means much more to the well-to-do individual than to one in the lower brackets. \* \* \*

The irony of all this is illustrated by the Treasury Department's first proposing a housing rehabilitation tax incentive and then having to suggest that the incentive is a "tax preference" which must be guarded against by including it in the new minimum tax structure designed to prevent the wealthy from escaping all tax burdens. This inclusion as a tax preference under the new minimum tax<sup>c</sup> thus implicitly characterizes this tax incentive as a special tax benefit for high-bracket taxpayers. The use of the direct expenditure route would have prevented this particular undermining of the tax system.

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As an aside, we can here see the importance of distinguishing tax expenditures and tax incentives—so-called special tax provision—from those provisions considered a proper and necessary part of the structure of an income tax. If an item is *properly* deductible in the latter sense, it does come off at the taxpayer's top tax rate, and its benefits are confined to those who are taxpayers. Given the decision to have an income tax at all, the result is equitable, within the concept of an income tax. An income tax is a tax on *net*

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c. Sections 55-59. (Eds.)

income and not a tax on gross receipts; therefore the deductions from gross income required to produce net income base must be allowed. Those deductions, generally speaking, are the expenses and costs incurred in the process of producing or earning the gross income received by the taxpayer.

Consider, for example, the deduction for moving expenses: it is a deduction and so benefits a taxpayer (reduces his tax) in accordance with his marginal tax rate. It also benefits only taxpayers; an employee who incurs moving expense, but whose income is so low as not to leave him taxable, does not obtain any benefit or assistance. This is the correct result under a positive income tax system if the moving expense should properly be taken into account in the measurement of net income, as it should be if it is an expense in earning income rather than a personal expense. If it is the latter, the deduction is a subsidy or tax expenditure, inequitably cast, to induce labor mobility. Actually, the moving expense deduction is at the frontier of the positive income tax structure; a gradual shift is occurring, and such expenses are coming to be regarded as a factor proper and necessary to the measurement of net income.<sup>38</sup>

*Tax incentives distort the choices of the marketplace and produce unneutralities in the allocation of resources*

This criticism is in one sense always valid, because that is what the tax incentive is designed to do. Generally, the critic is also saying or implying that the distortion introduced by the particular incentive is undesirable for various reasons. In large part this criticism is true of many existing incentives for reasons earlier described. The criticism has relevance because the distorting effects of tax incentives often pass unnoticed. But the criticism is of course equally applicable to direct expenditures, some of which certainly are unwise. Again, we are not here concerned with the overall role of Government or the extent to which and under what circumstances financial assistance is desirable to induce private action different from what the marketplace would provide. This criticism thus does not per se tell us when one or the other technique should be used.

It is interesting to note that, even within the area sought to be benefited by the tax incentive, the design of the incentive may push or pull in unneutral directions, which may or may not be desirable. Thus, a tax credit for pollution control facilities focuses on expenditures for machinery as the method of control to the exclusion of other methods, such as different choice

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38. There is often a hazy line between business expenses properly deducted from gross income for the purpose of an income tax, and personal expenses, which should not be deducted. Thus, commuting expenses are personal, but the expenses of providing comfortable working conditions in an office are business; wearing nice clothes at work is a personal expense, but wearing uniforms is a business expense. The borderlines that evolve are a part of the "generally accepted structure of an income tax" that is used as a standard to identify tax expenditures. We sometimes speak of tax changes designed to provide incentives for taxpayers when what is really involved is the removal of imperfections in the design of a proper tax structure that inhibit their activities.

of materials involved in the manufacturing processes. A tax credit for businesses located in urban slums may focus concentration on monetary assistance to the neglect of the provision of technical assistance.

Further, it is difficult if not impossible to keep tax incentives within proper bounds. Tax incentives for the oil industry or the cattle industry or low-income housing or whatever soon become syndicated tax shelters for doctors, executives, actors, and others far removed from the industry itself. Their only attachment to the industry involved is that the "tax losses" which the ingenious minds can secure for them through bending the tax mechanics of the incentive to the tax shelter device. Tax incentive aid to an industry thus soon becomes a tax windfall to every doctor or other investor who is steered to that industry by tax shelter syndicators and advisers.

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*Tax incentives keep tax rates high by constricting the tax base and thereby reducing revenues*

This criticism of tax incentives states a fact that many overlook in their advocacy of tax incentives. The lack of an explicit accounting in the Federal Budget for the tax expenditures involved in tax incentives and the lack in most cases of an accounting in tax statistical data combine to cause many to forget that dollars are being spent. As a consequence, the criticism that is made against direct expenditures—that they keep our tax rates high—is often lost sight of when tax incentives are involved. \* \* \* Tax incentives are usually open-ended: they place no limit on how much tax benefit a taxpayer can earn. Hence it is difficult to foretell how much will be spent by the Government through a particular incentive. \* \* \*

In the end, the issue is whether, as to any particular area, we want direct Government provision of services or goods, Government financial assistance to encourage and assist private action to provide the services or goods, or reliance on private action unaided by the Government. If we choose Government provision or assistance, then public dollars must be spent, and whether they are dollars foregone through lost tax revenues or dollars spent directly through direct expenditures, the effect on tax rates will be the same. So also will the effect on the economy if the Government program succeeds, and the resultant effect on the revenue base and tax rates of the increased economic activity that such success may mean.

#### Summary of Asserted Virtues and Vices of Tax Incentives

This description of the virtues and vices of tax incentives yields these conclusions: the *asserted disadvantages*—waste, inefficiency, and inequity—are true of most tax incentives existing or proposed because of the way they are structured or grew up. The whole approach to tax incentives—one of rather careless or loose analysis, failure to recognize that dollars are being spent, or to recognize the defects inherent in working within the constraints of the positive tax system—has produced very poor programs. But *if* the problems were recognized and *if* care were taken to design tax

incentive programs that one would be willing to defend in substantive terms if the programs were cast as direct expenditure programs, then these disadvantages would not be involved, except to the extent that they are inherent in Government assistance itself. These are large conditions, and in most cases would be hard to bring about. For example, it would not be easy to give tax benefit assistance to groups outside the tax system but performing desired activities, such as local governments or tax-exempt organizations hiring the disadvantaged—direct payments outside the tax system would be needed. And it would not be easy to design tax incentive programs which were not inequitable as between taxpayers in high and low brackets and between taxpayers and non-taxpayers. Indeed, there is no tax incentive in existence or proposed that meets the above standards. But for purposes of comparison we are here assuming that the standards could be met under some tax incentive programs.

Similarly, the *asserted advantages* of tax incentives—greater reliance on private decision-making and less detailed requirements—to the extent that they are true in fact (and they are often only illusory) are really criticisms of the complications and supervision built into direct expenditure programs, or else a reflection of the structural weaknesses of the tax incentive program, depending on the amount of detail and supervision appropriate to the particular program. In a rational world, one should assume that if after careful study it is considered that certain complexities and details are not needed and can be left out of a tax incentive program, then they should and can simply be dropped from the direct expenditure program. This may be a more difficult condition than the description suggests, but it is probably less difficult to bring about than the conditions for repairing tax incentives, or at least no more difficult. Again, for purposes of comparison, we are also here assuming this can be done in direct expenditure programs.

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**ANALYTICAL PERSPECTIVES  
BUDGET OF THE UNITED STATES GOVERNMENT  
FISCAL YEAR 1995**

**Office of Management and Budget**

Pages 53, 57-61, 64-66 (1994)

Tax expenditures are revenue losses due to preferential provisions of the Federal tax laws, such as special exclusions, exemptions, deductions, credits, deferrals, or tax rates. Tax expenditures are an alternative to other Government policy instruments, such as direct expenditures and regulations. The Congressional Budget Act of 1974 requires that a list of tax expenditures be included in the budget.

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The Omnibus Budget Reconciliation Act of 1993 (OBRA 93) had a number of effects on income tax expenditures. The Act broadened the tax

base by reducing some tax preferences, such as the exclusion for a portion of social security income and the credit available for business income earned in U.S. possessions. Conversely, the Act narrowed the tax base, and increased tax expenditures, by creating, renewing, or expanding several other tax preferences. New provisions include empowerment zones. Certain expired provisions, such as mortgage revenue bonds and the low-income housing tax credit, were extended permanently. Others, such as the research and experimentation tax credit and the targeted jobs tax credit, were extended but not made permanent. Expanded tax expenditures include more generous expensing provisions for small business investments and increases in the earned income tax credit.

OBRA 93 also increased the revenue losses from tax expenditures by raising the top individual and corporate tax rates. As tax rates rise, the revenue losses from deductions and exclusions also increase. For example, raising the top marginal tax rate from 31 percent to 39.6 percent would increase the revenue loss from a \$1,000 exclusion in this tax bracket from \$310 to \$396.

\* \* \*

### **Tax Expenditures in the Income Tax**

#### **Tax Expenditure Estimates**

The Treasury Department prepared all tax expenditure estimates presented here based upon income tax law enacted as of December 31, 1993. Expired or repealed provisions are not listed if their revenue effects result only from taxpayer activity in years before 1993.

\* \* \*

As in prior years, two baseline concepts—the normal tax baseline and the reference tax law baseline—are considered for the estimates. For the most part, the two concepts coincide. However, items treated as tax expenditures under the normal tax baseline, but not the reference tax law baseline, are indicated by the designation "normal tax method" in the tables. The revenue losses for these items are zero using the reference tax rules. The alternative baseline concepts are discussed in detail following the estimates.

Table 6-2 reports the respective portions of the total revenue losses that arise under the individual and corporate income taxes. Listing revenue loss estimates under the individual and corporate headings does not imply that these categories of filers benefit from the special tax provisions in proportion to the respective tax expenditure amounts shown. Rather, these breakdowns show the specific tax accounts through which the various provisions are cleared. The ultimate beneficiaries of corporate tax expenditures, for example, could be stockholders, employees, customers, or others, depending on the circumstances.

\* \* \*

### Interpreting Tax Expenditure Estimates

Tax expenditure revenue loss estimates do not necessarily equal the increase in Federal revenues (or the reduction in budget deficits) that would accompany the repeal of the special provisions, for the following reasons:

*Eliminating a tax expenditure may have incentive effects that alter economic behavior*

These incentives can affect the resulting magnitudes of the formerly subsidized activity or of other tax preferences or Government programs. For example, if deductibility of mortgage interest were limited, some taxpayers would hold smaller mortgages, with a concomitantly smaller effect on the budget than if no such limits were in force.

*Tax expenditures are interdependent even without incentive effects*

Repeal of a tax expenditure provision can increase or decrease the revenue losses associated with other provisions. For example, even if behavior does not change, repeal of an itemized deduction could increase the revenue losses from other deductions because some taxpayers would be moved into higher tax brackets. Alternatively, repeal of an itemized deduction could lower the revenue loss from other deductions if taxpayers are led to claim the standard deduction instead of itemizing. Similarly, if two provisions were repealed simultaneously, the increase in tax liability could be greater or less than the sum of the two separate tax expenditures, since each is estimated assuming that the other remains in force.

*The annual value of tax expenditures for tax deferrals is reported on a cash basis in all tables except table 6-3*

Cash-based estimates reflect the difference between taxes deferred in the current year and incoming revenues that are received due to deferrals of taxes from prior years. While such estimates are useful as a measure of cash flows into the Government, they do not always accurately reflect the true economic cost of these provisions. For example, for a provision where activity levels have changed, so that incoming tax receipts from past deferrals are greater than deferred receipts from new activity, the cash-basis tax expenditure estimate can be negative, despite the fact that in present-value terms current deferrals do have a real cost to the Government. Alternatively, in the case of a newly enacted deferral provision, a cash-based estimate can overstate the real cost to the Government because the newly deferred taxes will ultimately be received. Present-value estimates, which are a useful supplement to the cash-basis estimates for provisions involving deferrals, are discussed below.

*Repeal of some provisions could affect overall levels of income and rates of economic growth*

In principle, repeal of major tax provisions may have some impact on the budget economic assumptions. In general, however, most changes in



**B. THE TAX EXPENDITURES CONCEPT DESCRIBED**

**TABLE 6-2. CORPORATE AND INDIVIDUAL INCOME TAX REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES (In millions of dollars)**

	Revenue Loss					
	Corporations			Individuals		
	1995	1996	1997	1995	1996	1997
<b>National Defense:</b>						
Exclusion of benefits and allowances to armed forces personnel .....	—	—	—	2,030	2,020	2,015
<b>International affairs:</b>						
Exclusion of income earned abroad by United States citizens .....	—	—	—	895	945	1,000
Exclusion of income of foreign sales corporations	1,400	1,500	1,600	—	—	—
Inventory property sales source rules exception	1,300	1,400	1,500	—	—	—
Interest allocation rules exception for certain financial operations .....	95	95	95	—	—	—
Deferral of income from controlled foreign corporations (normal tax method) .....	1,700	1,800	2,000	—	—	—
<b>General science, space and technology:</b>						
Expensing of research and experimentation expenditures (normal tax method) .....	2,345	2,515	2,685	45	45	55
Credit for increasing research activities .....	1,240	730	315	30	10	—
Suspension of the allocation of research and experimentation expenditures .....	270	—	—	—	—	—
<b>Energy:</b>						
Expensing of exploration and development costs:						
Oil and gas .....	105	75	45	35	25	15
Other fuels .....	15	15	15	5	5	5
Excess of percentage over cost depletion:						
Oil and gas .....	775	790	800	260	265	265
Other fuels .....	85	85	90	15	15	15
Alternative fuel production credit .....	820	850	840	150	150	150
Exception from passive loss limitation for working interests in oil and gas properties .....	—	—	—	50	50	50
Capital gains treatment of royalties on coal .....	—	—	—	15	15	15
Exclusion of interest on State and local IDBs for energy facilities .....	70	70	70	105	105	105
New technology credit .....	65	70	75	*	*	*
Alcohol fuel credit <sup>1</sup> .....	5	5	5	30	40	45
Tax credit and deduction for clean-fuel burning vehicles and properties .....	55	55	55	10	10	10
Exclusion from income of conservation subsidies provided by public utilities .....	85	110	120	60	65	70
<b>Natural resources and environment:</b>						
Expensing of exploration and development costs, nonfuel minerals .....	45	45	45	5	5	5
Excess of percentage over cost depletion, nonfuel minerals .....	165	165	170	30	30	30
Capital gains treatment of iron ore .....	—	—	—	*	*	*
Special rules for mining reclamation reserves .....	45	45	45	5	5	5
Exclusion of interest on State and local IDBs for pollution control and sewage and waste disposal facilities .....	250	245	240	375	370	360
Capital gains treatment of certain timber income	—	—	—	15	15	15
Expensing of multiperiod timber growing costs .....	415	435	460	160	165	175

# CHAPTER 11. TAX EXPENDITURES

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	Revenue Loss					
	Corporations			Individuals		
	1995	1996	1997	1995	1996	1997
Investment credit and seven-year amortization for reforestation expenditures . . . . .	20	20	20	15	20	20
Tax incentives for preservation of historic structures . . . . .	40	40	35	85	85	85
<b>Agriculture:</b>						
Expensing of certain capital outlays . . . . .	10	10	10	60	55	55
Expensing of certain multiperiod production costs . . . . .	10	10	10	75	70	70
Treatment of loans forgiven solvent farmers as if insolvent . . . . .	—	—	—	10	10	10
Capital gains treatment of certain income . . . . .	—	—	—	140	145	145
<b>Commerce and housing:</b>						
<b>Financial institutions and insurance:</b>						
Exemption of credit union income . . . . .	380	420	465	—	—	—
Excess bad debt reserves of financial institutions . . . . .	40	40	45	—	—	—
Exclusion of interest on life insurance savings . . . . .	245	265	280	8,485	9,120	9,810
Special alternative tax on small property and casualty insurance companies . . . . .	5	5	5	—	—	—
Tax exemption of certain insurance companies . . . . .	110	115	120	—	—	—
Small life insurance company deduction . . . . .	135	140	145	—	—	—
Exemption of RIC expenses from the 2% floor for miscellaneous itemized deductions . . . . .	—	—	—	690	810	925
<b>Housing:</b>						
Exclusion of interest on owner-occupied mortgage subsidy bonds . . . . .	715	705	680	1,070	1,070	1,035
Exclusion of interest on State and local debt for rental housing . . . . .	365	345	320	555	525	490
Deductibility of mortgage interest on owner-occupied homes . . . . .	—	—	—	54,800	57,985	61,420
Deductibility of State and local property tax on owner-occupied homes . . . . .	—	—	—	14,655	15,545	16,425
Deferral of income from post 1987 installment sales . . . . .	235	240	245	700	710	720
Deferral of capital gains on home sales . . . . .	—	—	—	14,620	15,195	15,620
Exclusion of capital gains on home sales for persons age 55 and over . . . . .	—	—	—	4,960	5,155	5,300
Exception from passive loss rules for \$25,000 of rental loss . . . . .	—	—	—	5,775	5,680	5,625
Accelerated depreciation on rental housing (normal tax method) . . . . .	730	765	815	370	385	405
<b>Commerce:</b>						
Cancellation of indebtedness . . . . .	—	—	—	110	70	35
Permanent exceptions from imputed interest rules . . . . .	—	—	—	150	150	155
Step-up basis of capital gains at death . . . . .	—	—	—	6,920	7,045	7,120
Carryover basis of capital gains on gifts . . . . .	—	—	—	28,305	29,480	30,265
Ordinary income treatment of loss from small business corporation stock sale . . . . .	—	—	—	130	135	140
Accelerated depreciation of buildings other than rental housing (normal tax method) . . . . .	—	—	—	30	35	35
Accelerated depreciation of machinery and equipment (normal tax method) . . . . .	2,415	2,605	2,845	765	820	895
	18,720	18,140	17,965	4,490	4,410	4,365

# B. THE TAX EXPENDITURES CONCEPT DESCRIBED

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	Revenue Loss					
	Corporations			Individuals		
	1995	1996	1997	1995	1996	1997
Expensing of certain small investments (normal tax method) . . . . .	595	470	345	965	765	560
Amortization of start-up costs (normal tax method) . . . . .	100	105	105	100	105	110
Graduated corporation income tax rate (normal tax method) . . . . .	3,890	4,140	4,340	—	—	—
Exclusion of interest on small issue IDBs . . . . .	210	160	125	335	260	200
Deferral of gains from sale of broadcasting facilities to minority owned business . . . . .	290	305	320	*	*	*
Treatment of Alaska Native Corporations . . . . .	30	20	15	—	—	—
<b>Transportation:</b>						
Deferral of tax on shipping companies . . . . .	15	15	15	—	—	—
Exclusion of reimbursed employee parking expenses . . . . .	—	—	—	1,930	2,015	2,100
Exclusion for employer-provided transit passes . . . . .	—	—	—	40	50	65
<b>Community and regional development:</b>						
Credit for low-income housing investments . . . . .	680	780	885	1,585	1,820	2,060
Investment credit for rehabilitation of structures (other than historic) . . . . .	25	25	25	55	55	55
Exclusion of interest on IDBs for airports, docks and sports and convention facilities . . . . .	335	350	370	495	520	545
Exemption of certain mutuals' and cooperatives' income . . . . .	30	30	30	—	—	—
Empowerment zones . . . . .	95	130	155	235	310	355
<b>Education, training, employment, and social services:</b>						
<b>Education:</b>						
Exclusion of scholarship and fellowship income (normal tax method) . . . . .	—	—	—	875	920	965
Exclusion of interest on State and local student loan bonds . . . . .	120	115	110	185	180	165
Exclusion of interest on State and local debt for private nonprofit educational facilities . . . . .	300	310	315	450	460	470
Exclusion of interest on savings bonds transferred to educational institutions . . . . .	—	—	—	5	5	10
Parental personal exemption for students age 19 or over . . . . .	—	—	—	535	545	565
Deductibility of charitable contributions (education) . . . . .	670	700	740	1,560	1,640	1,720
Exclusion of employer provided educational assistance . . . . .	—	—	—	85	—	—
<b>Training, employment, and social services:</b>						
Targeted jobs credit . . . . .	320	270	50	75	55	10
Exclusion of employer provided child care . . . . .	—	—	—	725	775	830
Exclusion of employee meals and lodging (other than military) . . . . .	—	—	—	550	580	610
Credit for child and dependent care expenses . . . . .	—	—	—	2,820	2,975	3,145
Credit for disabled access expenditures . . . . .	130	130	135	30	30	30
Expensing of costs of removing certain architectural barriers to the handicapped . . . . .	15	15	15	5	5	5
Deductibility of charitable contributions, other than education and health . . . . .	840	880	930	14,240	14,950	15,700
Exclusion of certain foster care payments . . . . .	—	—	—	30	35	35
Exclusion of parsonage allowances . . . . .	—	—	—	290	320	355

	Revenue Loss					
	Corporations			Individuals		
	1995	1996	1997	1995	1996	1997
<b>Health:</b>						
Exclusion of employer contributions for medical insurance premiums and medical care . . . . .	—	—	—	56,265	61,675	67,345
Credit for child medical insurance premiums <sup>2</sup> . . .	—	—	—	—	—	—
Deductibility of medical expenses . . . . .	—	—	—	3,560	3,870	4,195
Exclusion of interest on State and local debt for private nonprofit health facilities . . . . .	600	615	635	895	920	950
Deductibility of charitable contributions (health)	420	450	470	1,600	1,680	1,760
Tax credit for orphan drug research . . . . .	15	—	—	—	—	—
Special Blue Cross/Blue Shield deduction . . . . .	125	140	100	—	—	—
<b>Income security:</b>						
Exclusion of railroad retirement system benefits . . . . .	—	—	—	400	405	410
Exclusion of workmen's compensation benefits . . .	—	—	—	4,455	4,740	5,065
Exclusion of public assistance benefits (normal tax method) . . . . .	—	—	—	585	605	640
Exclusion of special benefits for disabled coal miners . . . . .	—	—	—	100	95	95
Exclusion of military disability pensions . . . . .	—	—	—	130	130	130
Net exclusion of pension contributions and earnings:						
Employer plans . . . . .	—	—	—	55,540	59,010	59,490
Individual Retirement Accounts . . . . .	—	—	—	5,290	5,275	5,175
Keogh plans . . . . .	—	—	—	3,875	4,130	4,400
Exclusion of employer provided death benefits . . .	—	—	—	35	35	40
Exclusion of other employee benefits:						
Premiums on group term life insurance . . . . .	—	—	—	2,880	3,020	3,170
Premiums on accident and disability insurance . . .	—	—	—	140	145	150
Income of trusts to finance supplementary unemployment benefits . . . . .	—	—	—	35	35	35
Special ESOP rules (other than investment credit) . . . . .	1,760	1,635	1,545	—	—	—
Additional deduction for the blind . . . . .	—	—	—	45	45	50
Additional deduction for the elderly . . . . .	—	—	—	1,555	1,570	1,585
Tax credit for the elderly and disabled . . . . .	—	—	—	65	70	70
Deductibility of casualty losses . . . . .	—	—	—	230	230	230
Earned income credit <sup>3</sup> . . . . .	—	—	—	5,100	5,795	6,435
<b>Social Security:</b>						
Exclusion of social security benefits:						
OASI benefits for retired workers . . . . .	—	—	—	16,525	17,370	18,140
Disability insurance benefits . . . . .	—	—	—	1,905	2,105	2,320
Benefits for dependents and survivors . . . . .	—	—	—	3,730	3,940	4,150
<b>Veterans benefits and services:</b>						
Exclusion of veterans disability compensation . . .	—	—	—	1,920	1,855	1,885
Exclusion of veterans pensions . . . . .	—	—	—	75	70	70
Exclusion of GI bill benefits . . . . .	—	—	—	65	70	75
Exclusion of interest on State and local debt for veterans housing . . . . .	35	30	30	50	50	45
<b>General purpose fiscal assistance:</b>						
Exclusion of interest on public purpose State and local debt . . . . .	4,955	5,095	5,255	7,395	7,595	7,830

# B. THE TAX EXPENDITURES CONCEPT DESCRIBED

	Revenue Loss					
	Corporations			Individuals		
	1995	1996	1997	1995	1996	1997
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	—	—	—	25,640	27,130	28,740
Tax credit for corporations receiving income from doing business in U.S. possessions	2,630	2,680	2,735	—	—	—
<b>Interest:</b>						
Deferral of interest on savings bonds	—	—	—	1,250	1,310	1,380
<b>Addendum—Aid to State and local governments:</b>						
Deductibility of:						
Property taxes on owner-occupied homes	—	—	—	14,655	15,545	16,425
Nonbusiness State and local taxes other than on owner-occupied homes	—	—	—	25,640	27,130	28,740
Exclusion of interest on:						
Public purpose State and local debt	4,955	5,095	5,255	7,395	7,595	7,830
IDBs for certain energy facilities	70	70	70	105	105	105
IDBs for pollution control and sewage and waste disposal facilities	250	245	240	375	370	360
Small issue IDBs	210	160	125	335	260	200
Owner-occupied mortgage revenue bonds	715	705	680	1,070	1,070	1,035
State and local debt for rental housing	365	345	320	555	525	490
IDBs for airports, docks, and sports and convention facilities	335	350	370	495	520	545
State and local student loan bonds	120	115	110	185	180	165
State and local debt for private nonprofit educational facilities	300	310	315	450	460	470
State and local debt for private nonprofit health facilities	600	615	635	895	920	950
State and local debt for veterans housing	35	30	30	50	50	45

Note: Provisions with estimates denoted "normal tax method" have no revenue loss under the reference tax law method.

All estimates have been rounded to the nearest \$5 million.

\* 2.5 million or less.

1 In addition, the partial exemption from the excise tax for alcohol fuels results in a reduction in excise tax receipts of \$675 million in 1995.

2 The figures in the table indicate the effect of the child medical insurance premium credit on receipts. The effect on outlays in 1994 is \$395 million.

3 The figures in the table indicate the effect of the earned income tax credit on receipts. The effect on outlays in 1995 is \$15,795 million.

particular provisions are unlikely to have significant effects on macroeconomic conditions.

### Present-Value Estimates

Discounted present-value estimates of revenue losses are presented in table 6-3 for certain provisions that involve tax deferrals or similar long-term revenue effects. These estimates complement the cash-based tax expenditure estimates presented in the other tables in this chapter.

The present-value estimates represent the revenue losses, net of future tax payments, that follow from activities undertaken during calendar year 1994 which cause the deferrals or related revenue effects. For instance, a 1994 pension contribution in 1994 would cause a deferral of tax payments on wages in 1994 and on pension earnings on this contribution (e.g., interest) in later years. In some future year, however, the 1994 pension contribution and

accrued earnings will be paid out and taxes will be due; these receipts are included in the present-value estimate. In general, this conceptual approach is similar to the one used for reporting the budgetary effects of credit programs, where direct loans and guarantees in a given year affect future cash flows.

The discount rate used for the present-value estimates is the interest rate on comparable maturity Treasury debt. \* \* \*

\* \* \*

### Tax Expenditure Baselines

A tax expenditure is a preferential exception to the baseline provisions of the tax structure. The 1974 Congressional Budget Act does not, however, specify the baseline provisions of the tax law. Deciding whether provisions are preferential exceptions, therefore, is a matter of judgement. As in prior years, this year's tax expenditure estimates are presented using two baselines: the *normal tax baseline*, which is used by the Joint Committee on Taxation, and the *reference tax law baseline*, which has been used by the Administration since 1983.

The normal tax baseline is patterned on a comprehensive income tax, which defines income as the sum of consumption and the change in net wealth in a given period of time. The normal tax baseline allows personal exemptions, a standard deduction, and deductions of the expenses incurred in earning income. It is not limited to a particular structure of tax rates, or by a specific definition of the taxpaying unit.

The reference tax law baseline is closer to existing law. Reference law tax expenditures are limited to special exceptions in the tax code that serve programmatic functions. These functions correspond to specific budget categories such as national defense, agriculture, or health care. While tax expenditures under the reference law baseline are generally tax expenditures under the normal tax baseline, the reverse is not always true.

Both the normal and reference tax baselines allow several major departures from a pure comprehensive income tax. For example:

*Income is taxable when realized in exchange*

Thus, neither the deferral of tax on unrealized capital gains nor the tax exclusion of imputed income (such as the rental value of owner-occupied housing or farmers' consumption of their own produce) is regarded as a tax expenditure. \* \* \*

*There is a separate corporation income tax*

Under a comprehensive income tax corporate income would be taxed only once—at the shareholder level, whether or not distributed in the form of dividends.

*Values of assets and debt are not adjusted for inflation*

A comprehensive income tax would adjust the cost basis of capital assets and debt for changes in the price level during the time the assets or debt are

**TABLE 6-3. PRESENT VALUE OF SELECTED TAX EXPENDITURES FOR ACTIVITY IN CALENDAR YEAR 1994 (In millions of dollars)**

Provision	Present Value of Revenue Loss
Deferral of income from controlled foreign corporations (normal tax method)	1,640
Expensing of research and experimentation expenditures (normal tax method) . . . . .	2,035
Expensing of exploration and development costs - oil and gas . . . . .	275
Expensing of exploration and development costs - other fuels . . . . .	35
Expensing of exploration and development costs - nonfuels . . . . .	90
Expensing of multiperiod timber growing costs . . . . .	235
Expensing of certain multiperiod production costs - agriculture . . . . .	65
Expensing of certain capital outlays - agriculture . . . . .	80
Deferral of capital gains on home sales . . . . .	15,605
Accelerated depreciation of rental housing (normal tax method) . . . . .	1,140
Accelerated depreciation of buildings other than rental housing (normal tax method) . . . . .	670
Accelerated depreciation of machinery and equipment (normal tax method)	22,105
Expensing of certain small investments (normal tax method) . . . . .	3,995
Amortization of start-up costs (normal tax method) . . . . .	165
Deferral of capital gains from sale of broadcasting facilities to minority-owned businesses . . . . .	230
Deferral of tax on shipping companies . . . . .	10
Credit for low-income housing investments . . . . .	2,055
Exclusion of pension contributions and earnings - employer plans . . . . .	40,500
Exclusion of IRA contributions and earnings . . . . .	1,735
Exclusion of contribution and earnings for Keogh plans . . . . .	2,710
Exclusion of interest on State and local public-purpose bonds . . . . .	16,140
Exclusion of interest on State and local non-public purpose bonds . . . . .	8,780
Deferral of interest on U.S. savings bonds . . . . .	655

Note: Provisions with estimates denoted "normal tax method" have no revenue loss under the reference tax law method.

held. Thus, under a comprehensive income tax baseline the failure to take account of inflation in measuring depreciation, capital gains, and interest income would be regarded as a negative tax expenditure (i.e., a tax penalty), and failure to take account of inflation in measuring interest costs would be regarded as a positive tax expenditure (i.e., a tax subsidy).

While the reference law and normal tax baselines are generally similar, areas of difference include:

*Tax rates*

The separate schedules applying to the various taxpaying units are included in the reference law baseline. Thus, corporate tax rates below the maximum statutory rate do not give rise to a tax expenditure. The normal tax baseline is similar, except that it specifies the current maximum rate as the baseline for the corporate income tax. The lower tax rates applied to the first \$10 million of corporate income are thus regarded as a tax expenditure. Similarly, under the reference law baseline, preferential tax rates for capital gains generally do not yield a tax expenditure; only capital gains treatment of otherwise "ordinary income," such as that from coal and iron ore royalties and the sale of timber and certain agricultural products, is considered a tax expenditure. The alternative minimum tax is treated as part of the baseline rate structure under both the reference and normal tax methods.

*Income subject to the tax*

Income subject to tax is defined as gross income less the costs of earning that income. The Federal income tax defines gross income to include: (1) consideration received in the exchange of goods and services, including labor services or property; and (2) the taxpayer's share of gross or net income earned and/or reported by another entity (such as a partnership). Under the reference tax rules, therefore, gross income does not include gifts—defined as receipts of money or property that are not consideration in an exchange—or most transfer payments, which can be thought of as gifts from the Government.<sup>2</sup> The normal tax baseline also excludes gifts between individuals from gross income. Under the normal tax baseline, however, all cash transfer payments from the Government to private individuals are counted in gross income, and exemptions of such transfers from tax are identified as tax expenditures. The costs of earning income are generally deductible in determining taxable income under both the reference and normal tax baselines.

*Capital recovery*

Under the reference tax law baseline no tax expenditures arise from accelerated depreciation. Under the normal tax baseline, the depreciation allowance for machinery and equipment is determined using straight-line depreciation over tax lives equal to mid-values of the asset depreciation range (a depreciation system in effect from 1971 through 1980). The normal tax baseline for real property is computed using 40-year straight-line depreciation.

*Treatment of foreign income*

Both the normal and reference tax baselines allow a tax credit for foreign income taxes paid (up to the amount of U.S. income taxes that would

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2. Gross income does, however, include transfer payments associated with past employment, such as social security benefits.



otherwise be due), which prevents double taxation of income earned abroad.  
\* \* \*

### **Other Considerations**

Additional tax expenditure analysis may be helpful to policy makers. For example, information on the programmatic and economic effects of tax expenditures could be useful. The outputs and efficiency of tax expenditures could then be compared more systematically with direct outlay programs.

In addition, the tax expenditure analysis could be extended beyond the income and transfer taxes to include payroll and excise taxes. The exclusion of certain forms of compensation from the wage base, for instance, reduces payroll taxes, as well as income taxes. Payroll tax exclusions are complex to analyze, however, because they also affect social insurance benefits. Certain targeted excise tax provisions might also be considered tax expenditures. In this case challenges include determining an appropriate baseline.

\* \* \*

### **Notes and Questions**

1. How does a reduction in income tax rates affect tax expenditures?
2. Is the tax expenditures concept merely a way of framing the issue as to what should be included in the income tax base?
3. If a credit against tax is allowed for purchase of a depreciable asset, should the tax basis of the asset thereafter be the full price paid for it or its cost reduced by the tax credit?
4. Did Professor Surrey make a valid point when he wrote that it was difficult to keep tax incentives within "proper bounds" and prevent them from being used as tax shelters by "doctors, executives, actors, and others far removed from the industry itself"?
5. Professor Surrey argued that almost any tax expenditure could be duplicated, in substantive effect, by a direct expenditure program. Is this correct? What difference would it make? Would direct expenditures be more closely scrutinized? Would direct expenditures exclude as potential beneficiaries those with so little income that they paid no income tax, as tax expenditures routinely do?
6. Would charities be indifferent if Congress ended the tax deduction for charitable contributions and substituted, as Professor Surrey suggested, "a direct expenditure program under which the Government matched with its grants, on a no-questions-asked and no-second-thoughts basis, the gifts of private individuals to the charities they selected"? Would such a direct expenditure be constitutional if the charity were a church?

7. From the government's point of view, there are important differences between direct expenditures and tax expenditures. Direct expenditures are more closely administered, which means higher administrative costs. However, tax expenditures may cost more because they are likely to benefit an unnecessarily broad class of taxpayers.

Lobbying Congress to adopt a tax expenditure is easier than lobbying for an appropriation for a direct expenditure. Once a direct expenditure program is in place, however, the government agency administering it is likely to lobby for its continuation. In contrast, the Internal Revenue Service will not lobby to sustain a tax expenditure that it has to administer.

8. Why does Professor Surrey not regard the moving expense deduction as a tax expenditure?

9. The structure of a tax expenditure is important. Prior to the Tax Reform Act of 1986, taxpayers over the age of 65 and blind taxpayers were allowed an additional personal exemption, which had the effect of a deduction for all such taxpayers. The 1986 Act, in addition to reducing the amount of the benefit, changed its structure—rather than a personal exemption available to all aged and blind taxpayers, it was restructured as an increased standard deduction, of value only to those who utilized the standard deduction.<sup>d</sup> What policy choices, or what views of the effects of age or blindness, justify one structure as compared to the other? What different decision would be reflected by converting the tax advantage to a "refundable" credit?

10. Why does Congress give a tax advantage to taxpayers who are elderly or blind, and not to taxpayers with other afflictions, such as paraplegia?

11. Professor Douglas Kahn has suggested informally that some personal deductions (such as the medical expense deduction and the additional standard deduction for the aged and the blind) should be regarded not as tax expenditures, but as attempts to refine the very rough utility curve in the progressive tax rate structure to bring it closer to an ideal of equality of sacrifice.

12. In order to identify a tax expenditure, one must have a norm, or reference point. The Office of Management and Budget distinguished between two versions of the normal tax structure—the "normal tax baseline" and the "reference tax baseline." In general terms, what is the difference between the two? What is an item that would be regarded as a tax

d. Section 63(f).

expenditure when compared to the normal tax baseline, but not to the reference tax baseline?

13. Tax expenditures arising from deferral of tax liability have been significant over the years, but have attracted relatively little political opposition. The advantages of tax deferral are better understood by the beneficiaries than by the general public. Moreover, such tax expenditures are politically defended on the grounds that the tax is "merely" being postponed.

Tax expenditures arising from deferral are difficult to quantify because the cost to the government depends not only on the amount and length of deferment, but also on the interest rate assumed in computing the time value of money. In measuring these tax expenditures, the Office of Management and Budget uses as a discount rate "the interest rate on comparable maturity Treasury debt." Is this appropriate, or should we look to what the typical taxpayer would have to pay to borrow money?

### C. THE TAX EXPENDITURES CONCEPT CHALLENGED

Unless carefully confined, the premise of the tax expenditures concept might be ridiculed by *reductio ad absurdum*: any portion of a taxpayer's income that the government allows the taxpayer to keep would be a tax expenditure. In a slightly less extreme form, under a progressive income tax rate structure, any revenue lost by failure to tax everyone at the top bracket rate might be considered a tax expenditure. The excerpts in Subchapter B are careful to define tax expenditures in such a fashion as to exclude such interpretations. The more limited view of tax expenditures requires the application of normative standards, but these standards are open to challenge, as is demonstrated by the two excerpts, one recent and one written in opposition to the concept of the tax expenditures idea during its pre-1974 gestation.

#### EXPENDITURE BUDGETS: A CRITICAL VIEW

Douglas A. Kahn\* & Jeffrey S. Lehman\*\*

54 Tax Notes 1661, 1661-63 (1992)

The various tax expenditure budgets prepared in the legislative and executive branches purport to carry out a straightforward task. They claim to identify those situations in which Congress has departed from the "normative," "normal," or "correct" tax rule in a way that is equivalent to the appropriation of public funds. Or, as it is sometimes put, they expose circumstances in which Congress has chosen to subsidize certain activities indirectly, through the Internal Revenue Code.

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Yet, the very statement of the task exposes its Achilles heel. It assumes the existence of one true, "correct," "normative" rule of federal income taxation that should be applied to any given transaction. The collection of all such rules stands as a kind of Platonic Internal Revenue Code, an implicit reprimand to the flawed efforts of our mortal Congress.

We believe that questions of tax policy are more complicated than that. An ideal Internal Revenue Code makes no more sense than an ideal Environmental Protection Act or an ideal Penal Code. An income tax stands inside, not outside, the society that enacts it.

The particular contours of our federal income tax serve to reaffirm public values that are "normative" in every sense of the word except the one used by advocates of tax expenditure budgets. The disallowance of a deduction for illegal bribes confirms that we think they are naughty. Similarly, the limitation on losses from wagering transactions shows that we do not consider them to be an appropriate foundation for a career. Conversely, the exclusion from income of tort recoveries is an expression of public compassion. And our refusal to tax people when their neighbors help them move furniture, or (as some have suggested) when they enjoy a few moments of leisure, suggests a shared sense of a private domain in which even the tax collector will respect people's right to be left alone.

Experts can help to clarify the implications of one tax policy choice over another. They can show how one choice favors one particular set of moral, political, or economic commitments over another. They can argue for greater consistency in the way tensions among such commitments are resolved. They can estimate the differences in the amount and distribution of revenues that would be collected under different regimes. But, the ultimate choice must rest with the citizen and not the oracle.

### **The Choice Among Utopias**

Let us describe a series of perspectives that are frequently presented concerning the ideal nature of an income tax:

(1) For some observers of the tax scene, any tax that alters citizen behavior is terribly unfortunate. Such observers decry any tax that alters individuals' economic incentives from what they would have been in a world with no taxes and a perfect marketplace. They would prefer that the government raise its revenues exclusively by taxing (a) activities that generate negative externalities, and (b) goods for which the demand is entirely inelastic. Since no income tax can pretend to be nondistortional, such observers view all income taxes as tainted by a kind of "original sin."

(2) Other, more practically minded observers, worry that the taxes that would satisfy perspective (1) would not generate enough revenues for the government to finance its current level of operations. They believe that Nicholas Kaldor had it right almost 40 years ago, when he argued that the proper income tax system is what we now call a consumption tax. Such observers are willing to accept the fact that a consumption tax biases

taxpayers' choice between labor and leisure. They console themselves with the observation that at least a consumption tax avoids biasing the choice between savings and current consumption.

(3) Another set of commentators objects that a consumption tax that would satisfy perspective (2) ignores the new economic power reflected in congealed, unconsumed, newly acquired wealth. They contend that all such economic power should be reckoned in the tax base, perhaps as a proxy for an (ideal) wealth tax. For such observers, the touchstone of income taxation must be the sum of consumption and wealth accumulation—what is commonly known as Haig-Simons income.

(4) Still other commentators find fault with the pure Haig-Simons approach endorsed under perspective (3). It would offend such commentators' notions of privacy to tax citizens on unrealized asset appreciation and on imputed income from services or durable goods. Or, at least, it would require a preposterous expenditure of administrative resources in an ultimately futile quest. These observers would prefer that we tax Haig-Simons income to the extent it is realized through market interactions.

(5) Yet another set of commentators finds fault with even the market-delimited, realization-qualified version of the Haig-Simons approach suggested by perspective (4). They believe that such an approach unacceptably distorts investor incentives, leading them to overconsume and undersave, to indulge in too much leisure and not enough work. While they are in sympathy with the political vision that would allocate the tax burden according to accumulating economic power, they favor qualifications to that vision whenever the cost to productive incentives appears to jeopardize economic growth.

(6) Finally, one finds the United States Congress. It apparently believes that even the approach dictated by perspective (5) would leave the American economy in the wrong place. Not enough research and development, not enough low-income housing, not enough money in the hands of working families with children, not enough money in the hands of churches and museums, too many renters and not enough homeowners, etc., etc., etc.

If one is prone to depression, one can view the foregoing list of perspectives from (1) to (6) as identifying a kind of linear decline. Each is one step further from the Garden of Eden of distortion-free taxation. We view them differently. We prefer to see each perspective as emphasizing different elements in a basket of normative values—efficiency (in the neoclassical economic sense), consumption/savings neutrality, privacy, equity, administrability, charity, pragmatism, etc.

What is disturbing about the language of tax expenditures is its tone of moral absolutism. The tax expenditure budget is said to distinguish "normal" tax practice from that which is deviant. Sometimes it is said to distinguish provisions that are "normative" (?) from those that are (presumably) nonnormative (?!). This language is doubly confusing. First, it suggests that

provisions that fit *within* the implicit baseline of the tax expenditure budget are somehow pure, safe, and good. They should not be changed because "neutral" principles have blessed them. Conversely, the language suggests that provisions that fall *outside* the implicit baseline of the tax expenditure budget (tax expenditures) are somehow corrupt, dangerous, and evil. They should be changed as soon as possible to conform with the "neutral" position. To flirt with them is to call one's probity into question.

This is, of course, a bit of an overstatement. But, it captures the rhetorical direction of the tax expenditure budget. And that rhetorical direction is grossly misleading. The tax expenditure budget's conception of an appropriate tax base has no legitimate claim to establishing the terms of political debate. \* \* \*

### **The Illusion of Value-Free Precision—An Example**

The reference point for construction of the tax expenditure budget is a measure of taxable income that is close to position (4) above, with some variations. That may be some people's Platonic Internal Revenue Code, but it is obviously not everyone's. The choice among perspectives is a contestable, contingent, political decision. Thus, while the several existing tax expenditure budgets give an appearance of being the products of a highly sophisticated, expert, neutral examination of the tax system, they could just as accurately be characterized as exercises in mystification. They create only an illusion of value-free scientific precision in a heavily politicized domain.

Consider two features of our tax system. First, it grants a form of accelerated depreciation. Second, it does not tax unrealized gains. The first feature appears in tax expenditure budgets. Moreover, as the *Tax Notes* discussion over the past few months has made clear, many proponents of tax expenditure budgets view that as a good thing because they believe that accelerated depreciation is not "normative." Yet the second feature—the refusal to tax unrealized gains—does not appear in any tax expenditure budget.

The tax expenditure budget baseline, which distinguishes between these two features, is "normative" in the sense that it advances a particular moral or political claim. It reflects a particular balance among the ideals of efficiency, equity, neutrality, administrability, privacy, charity, and pragmatism. But, each of the six perspectives enumerated in the prior section is "normative" in precisely the same way. And at most two of the six perspectives (perspective (4) and perhaps some versions of perspective (5)) would distinguish between these two features. The others would treat both as good or both as objectionable.

One can advance plausible arguments in favor of taxing unrealized gains. One can advance plausible arguments against granting accelerated depreciation deductions. One could also argue for the status quo with regard to each of these features. But, there is no *a priori* reason to classify one feature differently from the other, or to allocate a heavier burden of

persuasion to those who attack realization or defend accelerated depreciation than one allocates to those who defend realization or attack accelerated depreciation.

\* \* \*

**ACCOUNTING FOR FEDERAL 'TAX SUBSIDIES' IN THE NATIONAL BUDGET**

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22 National Tax Journal 244, 246-57 (1969)

Although Mr. Surrey did not address himself to the mode of presentation, his proposal implied that "tax benefit provisions" would be reported in the Budget as hypothetical expenditures, to be "classified along customary budgetary lines: assistance to business, natural resources, agriculture, aid to the elderly, medical assistance, aid to charitable institutions, and so on."<sup>5</sup>

\* \* \*

Fleshing out Mr. Surrey's proposal, the Treasury has estimated the revenue lost by virtue of "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." These estimates were published, along with a discussion of the conceptual framework governing the items selected for inclusion, in an exhibit to Secretary Fowler's final report as Secretary of the Treasury, under the title "The Tax Expenditure Budget: A Conceptual Analysis." This study should be regarded as only a first step in achieving the "full accounting" envisioned by Mr. Surrey \* \* \*

It has been a familiar exercise for many years to compute the "cost" of a proposed tax provision by estimating the amount of revenue that would be lost by its enactment; and at first blush, a "full accounting" seems to require nothing more than an aggregation of such estimates, based on existing tax concessions, rather than on proposed ones. If that were its only prerequisite, an expansion of the Treasury's estimating facilities and staff would bring us close to achieving the promise of a "full accounting." To be fully informative, of course, the estimates would have to take account of the fact that tax concessions influence behavior; since the revenue "lost" by virtue of any tax provision depends in part on its absence, its "cost" cannot be accurately measured by merely recomputing the tax liability on the return as filed. It might turn out that the revenue effects of tax incentive provisions, if they succeed in their objective of altering behavior, are especially difficult to

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5. Surrey, Taxes and the Federal Budget (speech to Financial Executives Institute, Dallas Chapter, Feb. 13, 1968), p. 13. [This was in line with Mr. Surrey's views as expressed in the text in Subchapter A. (Eds.)]

estimate—although these are precisely the provisions that are most in need of cost effectiveness studies. \* \* \*

Even if the Treasury's estimates could be refined to take into account tax-induced changes in behavior, however, a major obstacle in achieving a "full accounting" would remain, viz., the fact that a systematic compilation of revenue losses requires an agreed starting point, departures from which can be identified. What is needed is not an ad hoc list of tax provisions, but a generally acceptable model, or set of principles, enabling us to decide with reasonable assurance which income tax provisions are departures from the model, whose costs are to be reported as "tax expenditures." In this connection, it is important to note that the proposed "full accounting" is evidently intended to embrace every provision that serves as the substitute for an appropriation, including those that are solely or primarily distributive in function (e.g., the extra \$600 exemption for the blind and the aged).<sup>e</sup>

In listing the exclusion of social security benefits as a "tax expenditure" that ought to be reflected in the Federal Budget as aid to the elderly, the Treasury analysts very likely had in mind the fact that these receipts constitute income under the Haig-Simons definition. Conversely, their study accepts the deduction of business expenses under §162 as necessary to the accurate determination of net income, with the result that the revenue "lost" by virtue of this provision is not reported as a "tax expenditure" to aid private enterprise. In making this distinction, no value judgment is intended: the deduction of business expenses and the exclusion of social security benefits are not treated differently because one provision is "good" and the other "bad," but because one is helpful or necessary in defining net income, while the other distorts the computation of income. Thus, in asking that the revenue losses resulting from "deliberate departures from accepted concepts of net income and through special exemptions, deductions and credits" be reported as "expenditures," Mr. Surrey noted that these "tax benefit provisions" will have to be separated from provisions that serve to define income accurately: "We should not, of course, overlook the difficulties of interpretation or measurement involved here."<sup>9</sup> \* \* \* In the same vein, the Treasury study seeks to identify the provisions of existing law that deviate "from widely accepted definitions of income and standards of business accounting and from the generally accepted structure of an income tax."

To effect a "full accounting," then, we must first construct an ideal or correct income tax structure, departures from which will be reflected as "tax expenditures" in the National Budget. Although Mr. Surrey is not explicit on the point, his proposal has much in common with the call for a comprehensive income tax base, which similarly presupposes an ideal tax

e. Present law no longer provides an additional personal exemption for aged and blind taxpayers; they are entitled, however, to an increased standard deduction. Section 63(f). (Eds.)  
9. Surrey, *The United Income Tax System—the Need for a Full Accounting* (speech to Money Marketeers, Nov. 15, 1967), p. 5.



structure—based on the Haig-Simons definition of income—any departure from which is to be regarded as a maverick that must shoulder a heavy burden of justification.

The call for a "full accounting" does not by itself imply that repeal of all of these provisions is feasible or desirable, but only that the revenue lost by sticking with existing law should be disclosed in the Budget. At the same time, it is not insignificant that Mr. Surrey doubts the "efficiency" of these provisions and their ability to withstand public scrutiny if viewed as expenditures; after all, the purpose of the "full accounting" is to stimulate a re-examination of "tax expenditures," rather than merely to record them for economic historians or antiquarian statisticians. Unless the "full accounting" is to be limited to those provisions that the incumbent Secretary of the Treasury wants Congress to repeal, however, it will require a formidable list of tax provisions to be reflected as "expenditures" if the Haig-Simons definition is to be the criterion for judging the extent of the current Internal Revenue Code's departure from "a proper measurement of net income."

Such a comprehensive list of "tax expenditures" would include a number of items that Congress has so far shown no interest in repealing, despite the magnitude of the revenue "lost" by their preservation. Thus, the cash receipts and disbursements method of accounting for income—which conflicts with the Haig-Simons definition because it does not currently reflect changes in the taxpayer's net worth—can be described as a "tax subsidy," granted for the double purpose of simplifying the income-reporting process for taxpayers with rudimentary records and of easing the payment problem for taxpayers who have rendered services or sold property, but have not yet collected from their customers and clients. Another example of a "tax expenditure" that has hitherto been considered sacrosanct is the exclusion of unrealized appreciation from income, a "preference" that is customarily accepted by even the most confirmed advocates of a comprehensive income tax base on the ground that difficulties in valuing the taxpayer's assets make it administratively impossible to apply the Haig-Simons definition in this area.

\* \* \*

A whole-hearted enemy of "backstairs" spending might, I suppose, argue that a disclosure of the cost of the cash receipts and disbursements method of accounting or of the realization concept would be a first step to their elimination. \* \* \*

Favorable legislative action on such proposals is so remote a possibility, however, that one may be inclined to argue for reporting in the National Budget only those "tax expenditures" that Congress is likely to repeal—once they have been brought into the open. But if the "full accounting" is to be limited in this fashion, some of the prime candidates for inclusion on the "expenditure" side might fall by the wayside. I am not at all sure, for example, that percentage depletion and the immunity of state and municipal

bond interest are more vulnerable to Congressional hostility than the cash method of accounting. \* \* \*

Assuming a consistent application of the Haig-Simons definition, however, there are many other areas that would generate "tax expenditures" for inclusion in the Budget, including the exclusion from taxable income of gifts, bequests, life insurance proceeds, and recoveries for personal injuries and wrongful death; \* \* \* personal and dependency exemptions; imputed income from assets and housewives' services; the non-recognition provisions (e.g., exchanges of like-kind property, corporate reorganizations, etc.); depreciation deductions that exceed declines in market value \* \* \*; current deductions for expenditures that have value beyond the current year (e.g., research and experimental expenses, institutional advertising, and outlays for industrial know-how); special accounting privileges (e.g., installment sale reporting); the foreign tax credit<sup>15</sup> and other items. The Treasury study—perhaps because it is offered as a "minimum" rather than comprehensive list—makes a number of compromises in applying the Haig-Simons definition in these areas. Thus, it estimates the cost of excluding employers' contributions to pension plans and the interest component of life insurance savings, but not the revenue cost of excluding increases in the taxpayer's net worth resulting from other transactions. Similarly debatable lines are drawn at other points, in that the study estimates the revenue cost of excluding or deducting: public assistance, but not gifts from charitable agencies, friends, and relatives; sick pay and workmen's compensation, but not recoveries and settlements in personal injury suits; child care expenses of employees, but not their moving expenses; accelerated depreciation on buildings, but not straight-line depreciation (even though it too may exceed the property's decline in market value); the expensing of research and experimental expenditures, but not the rapid amortization of such outlays (even if their long-term value is substantial), nor the expensing of comparable outlays for good will, industrial know-how, etc.; nonbusiness state and local taxes, but not foreign taxes. \* \* \*

The revenue cost of the omitted items may have been too difficult to estimate with the data at hand when the Tax Expenditure Budget was prepared; I mention them not to criticize an admittedly "minimum" list for

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15. The foreign tax credit protects taxpayers with foreign operations against double income taxation; but of all possible ways of accomplishing this end, it is the most costly for the United States. If its cost were reflected as a "tax expenditure," Congress might decide that relief from double taxation could be procured more "efficiently" by hiring more persuasive ambassadors, speaking softly but carrying a big stick, or threatening to reduce our appropriations for foreign aid. In the alternative, Congress might decide that if a deduction is a sufficient recognition of the added burden of a state or local income tax, it is equally sufficient in the case of a foreign tax. The proper treatment of the foreign tax credit is discussed in the Treasury's Tax Expenditure Budget, Annual Report of the Secretary of the Treasury on the State of the Finances (fiscal year ended June 30, 1968) (1969), p. 331; but no estimate of its cost is made because of the complexity of the issues involved.

conforming to its self-description, but to illustrate the scope of the Haig-Simons definition. Because I have recently discussed the ramifications of a consistent adherence to this definition, I will not undertake to list here the many other provisions of existing law that, in my opinion, depart from that definition. Suffice it to say that a "full accounting" for these departures would be a formidable undertaking, comparable to Prof. Charles O. Galvin's challenging proposal for a tax model based on the comprehensive income tax base concept. There is, however, a major difference between the two projects, stemming from the fact that the Haig-Simons definition provides no guidance to many structural issues that must be decided in any income tax law. As to these decisions, the unofficial research model proposed by Prof. Galvin can experiment with alternatives, while the Treasury's "full accounting" will have to select one "correct" model against which to measure existing law. Because I see no way to select such an "official" model for these structural provisions, I am not sanguine about the prospects for a "full accounting."

One such area is the rate structure. In 1964, income tax rates were substantially reduced, for the stated purpose of encouraging economic growth. Since an alternative method of accomplishing this objective was a federal subsidy, should the reduction have been reflected in the Treasury's "Tax Expenditure Budget?" The logic of the "full accounting" approach suggests an affirmative response, so that the cost of this effort to increase economic growth by a rate reduction would be constantly brought to public attention, thus encouraging an annual review of both the merits of its objective and its efficiency as compared with other devices and programs to accomplish the same end. \* \* \*

Once it is decided that a rate reduction may be a form of "back door spending," however, we encounter a troublesome—perhaps an insoluble—problem of measurement. The cost of the 1964 experiment in encouraging economic growth by a rate reduction might, I suppose, be ascertained by computing the difference between (a) the revenue actually collected, and (b) the amount that would have been produced if the old rates had been perpetuated. (Ideally, of course, account should be taken of the effect of the reduced rate on the volume of taxable income; but if this is not done for other "tax expenditures," presumably it would not be done in this instance either.) The aggregate cost of the tax reduction would then be allocated among income classes, to reflect the cost of the tax cut for each such group. This process could be repeated for each tax cut in our history, so that the "tax expenditure" section of the National Budget would report, separately, the "cost" of every such change, classified as an aid to investment, a device to encourage consumer spending, and so on, depending on its purpose. The aggregate to be reported for the current year would thus be the difference between the revenue produced by the rates actually in effect, and the amount that would have been produced if the highest rates in history had been preserved. The benchmark year would vary from one taxable income class

to another, of course, since the peak rate applicable to each class would be the standard for determining the "cost" of encouraging that group of taxpayers to engage in investment, consumption, or other tax-favored activity.

\* \* \*

Another problem—equally unsolved by the Haig-Simons definition, but equally troublesome to the "full accounting" approach—is the taxable unit to be used in computing the "tax expenditures" that are to be reflected in the National Budget. The problem can be illustrated by a question: should the difference between the tax liability of a married man (or a head of a household) and that of a single individual with the same taxable income be reflected on the expenditure side of the National Budget, as a subsidy to family life, in the interest of a "full accounting"? \* \* \*

It would simplify the search for a "full accounting" to accept the Code's existing classification of taxpayers, disregarding the possibility that structural decisions in this area constitute "tax expenditures." If this were to be done, however, it would seem equally appropriate to me to treat taxpayers who are blind, over 65, or otherwise "different" as appropriate taxpaying units whose exemptions or other allowances are simply devices for imposing rates appropriate to their divergent taxpaying abilities; and the same could be said of taxpayers who have minor children, support aged parents, suffer from illness, or are victimized by fire or theft. \* \* \*

A taxonomic problem that creates similar difficulties for a "full accounting" arises from the separate rate schedules that are applicable under current law to individuals and corporations. Does the fact that the individual rate is lower than the corporate rate at the \$5,000 income level mean that the difference is a "tax expenditure" to aid low-bracket individuals? Conversely, since the corporate rate is lower than the individual rate at the \$200,000 level, does *this* difference constitute a "tax expenditure" to aid corporate business? Or are the two rate schedules simply not to be compared, on the theory that we have two entirely separate income taxes, each levied on its own self-contained group of taxpayers? \* \* \*

Of course, if the Haig-Simons definition were to be applied to individual taxpayers with rigor, there would be no need to compute the income of legal entities like corporations, since the natural person's net worth computation would have fully taken the corporate activities into account. On this theory, the "tax expenditure" to be reported in the interest of achieving a "full accounting" would take account of the taxes that would be collected from individual shareholders if unrealized appreciation and depreciation on their stock entered into the computation of income. The Treasury's "Tax Expenditure Budget," however, does not attempt such a rigorous application of the Haig-Simons definition, but instead contains estimates of the revenue cost of existing provisions relating to Western Hemisphere Trade

Corporations, the excess bad debt reserves of financial institutions, and the deferral of tax on shipping companies.

The study's working hypothesis, stated without independent discussion, is "[t]he assumption inherent in current law, that corporations are separate entities and subject to income taxation independently from their shareholders." \* \* \* Yet the exemption from corporate tax that is granted to Subchapter S corporations and regulated investment companies is not treated as a "tax expenditure"; evidently it is appropriate to view these corporations as conduits rather than entities. \* \* \* [D]ifficulties in deciding whether corporations are conduits or entities suggest that there simply are no "generally accepted" principles specifying the proper relationship between a corporation's income and its shareholders' tax liability—with the result that it is difficult, if not impossible, to apply the "tax expenditure" concept in this area.

The proper classification of tax-exempt organizations presents another problem for the "full accounting" approach. Should the tax exemptions accorded to educational institutions, churches, charitable organizations, social clubs, and other non-profit institutions be reflected as "tax expenditures" to benefit education, religion, charity, and social intercourse? Or is it more appropriate to view the federal income tax as a device by which the government shares in the profits of activities that are carried on for the personal benefit of individual taxpayers, so that the activities of nonprofit institutions are not a proper subject for income taxation? So regarded, the tax exemption accorded to these institutions is an acknowledgment of, rather than a departure from, the "true nature" of the federal income tax; and hence it is not a "tax expenditure" required for a "full accounting" in the National Budget. \* \* \*

The same question—is tax-exemption an "expenditure" or not?—must be answered with respect to state and municipal governmental agencies, which are not taxed by the federal government on their income, whether derived from taxation, the sale of property or services, investments, or other sources. One might, of course, assert that the immunity from federal taxation that is enjoyed by state and local governments constitutes an "expenditure" because it accomplishes the same result as federal grants to these agencies; and that a failure to acknowledge this infusion of federal assistance understates the federal contribution to their well-being. On the other hand, one is tempted to argue that governmental agencies (even if engaged in activities that compete with private business) do not realize "income" in the Haig-Simons sense, or that, if they do, the federal income tax properly exempts them because it is concerned only with activities carried on for private profit. If this view is accepted, their exemption would not be recorded as a "tax expenditure."

If we conclude that the tax exemption accorded to non-profit organizations and governmental agencies is not a tax expenditure, however,

a doubt arises about the proper way to reflect the deductions allowed to individuals for charitable contributions and state and local taxes, as well as the exclusion from taxable income of state and municipal bond interest. To the extent that these tax provisions inure to the benefit of the individual taxpayer, they might be properly classified as tax expenditures. To the extent of the benefit inuring to the non-profit or governmental agency, however, should these exemptions be bracketed with the agency's *own* exemption, and excluded from the list of "tax expenditures"? If the purpose of a "full accounting" is to disclose the cost of all "government expenditures made through the tax system," it would seem desirable to fish or cut bait: either record the tax-exempt organization's tax benefits as "expenditures" whether they derive from its own exemption or from concessions allowed to others that are passed on to it; or disregard these benefits entirely. To pick and choose among these tax provisions, recording some but not others as "tax expenditures," is a way of compromising on a middle ground, but it falls short of a "full accounting."

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#### *Notes and Questions*

14. In criticizing the tax expenditures concept, Professors Kahn and Lehman did not mean that every provision in the Internal Revenue Code is normal because it exists, thus depriving us of any standard for judgment. They are saying, in effect, that "normal" is not a useful standard. Virtually every tax provision has political or social implications. In their view, all provisions should be reviewed on their merits, without trying for an automatic rule that will distinguish tax expenditures from normal provisions.
15. Is it fair to treat failure to adopt the Haig-Simons definition of income (discussed in Chapter Two) as a tax expenditure?
16. Are we left with a hopeless standoff between the proponents of the tax expenditures approach and its opponents?
17. Many items generally regarded as tax expenditures are also identified as items of tax preference under the alternative minimum tax provisions (sections 55-59). The AMT provisions demonstrate Congressional ambivalence about these items. Does the existence of the AMT provisions support either the proponents or the detractors of the tax expenditures concept?
18. Virtually every compilation of tax expenditures would include the deduction for home mortgage interest, as a subsidy for housing. Few would count as a tax expenditure the exclusion of imputed income from home ownership. (Even though Professor Bittker argues that consistency should

lead to imputed income being regarded as a tax expenditure, this is just an example in his broader argument that the entire tax expenditures concept is flawed and unworkable.) On the other hand, suppose we view the home mortgage deduction as essential, or at least helpful, in establishing equity in the measurement of taxable income (not, as for a classic tax expenditure, solely in the pursuit of a nontax goal), as Oliver argues:

The taxpayer with ready cash can purchase a house outright. Instead of investing his cash to earn a taxable stream of income and then paying nondeductible rent from after-tax dollars, in effect, he can receive a tax-free flow of imputed income from the personal residence. The interest deduction places the taxpayer purchasing his house with borrowed funds in a similar position. For example, suppose each of three taxpayers, A, B, and C, desires to purchase a personal residence costing \$50,000. A and B each has \$50,000 of ready cash; thus, they can purchase their residences for cash, or invest the cash and purchase the residences with borrowed funds. C has no available assets and therefore must borrow in order to purchase his residence. Assume further, and somewhat artificially, that the taxpayers can lend or borrow money at 10% interest. Ignoring the transactions described below, the three taxpayers have equal taxable income and will itemize deductions.

A uses his \$50,000 cash to purchase his house. He receives neither taxable income nor a deduction as a result of the transaction. The imputed income of the rental value of the house, of course, is not included in income.

Unlike A, B chooses to invest his \$50,000 cash at 10% interest. He borrows \$50,000, also at 10%, to purchase his house. B receives taxable income of \$5,000 from his investment, but the deduction for the \$5,000 interest paid by B will offset the interest income. B's taxable income therefore is equal to A's.<sup>184</sup> Because these taxpayers have engaged in transactions that are substantially equivalent in economic terms, their taxable income should be affected in the same way.

C, having no choice, also borrows to purchase his residence. Like B, he receives a \$5,000 interest deduction. Since C has no offsetting income item, C has \$5,000 less taxable income than either

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184. A and B may not have identical taxable incomes since B's offsetting income and deduction may affect other computations. \* \* \*

Of more importance is the assumption that all three taxpayers would itemize deductions even without the interest deduction. If this were not the case, A would be in a favored position since a portion of the interest deduction of B and C would be absorbed by the zero bracket amount, and only the excess would be deductible. See I.R.C. § 63.

These refinements, however, do not alter the basic point. The interest deduction, even in the case of interest arising from a purely personal expenditure, assures substantial equity among these three typical taxpayers.

A or B. This result, however, is precisely what we should expect. A and B each has \$50,000 of assets that, given a 10% interest rate of return, will produce \$5,000 annually.

\* \* \*

The denial of an interest deduction thus would favor those with liquid excess cash and the ability to divert it to investments producing only untaxed imputed income. It would disfavor those who borrow to purchase assets that produce imputed income. The interest deduction thus effectively allows those not having sufficient wealth and liquidity to purchase personal assets without borrowing to enjoy the benefits of untaxed imputed personal income.<sup>f</sup>

Do you agree that this analysis justifies the deduction for home mortgage interest? If so, does this mean that that deduction should not be regarded as a tax expenditure?

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