Tax Expenditure Policy: An Analysis of Indirect Government Spending

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Abstract

"The tax code contains a great number of special provisions which provide credits, deductions, and other tax advantages intended to achieve non-tax goals considered desirable by Congress."[i] These tax incentives allow exclusions which are deviations from the generally accepted definition of income. Stanley S. Surrey labeled these deviations as "Tax Expenditures" and proffered a new way of viewing these non-collections as indirect government spending.

The basic principle is that the Government is spending money through the credits and deductions and preferential rates. That is, the system can be viewed as if the IRS had collected the excluded amount, and then had given that amount back to the taxpayer in the form of a direct expenditure via a subsidy program aimed at some particular goal.

One of the critical issues is that the incentives are designed to accomplish non-tax goals but are reviewed only by the taxing committees of Congress. These incentives are not reviewed by the respective committees to whose substance they pertain.

Another critical issue is whether tax expenditures are better or worse than direct government spending and tax cuts as a means of accomplishing a particular goal. This issue has generally sided with direct government spending and tax cuts. However, tax expenditures may be the better method in some situations and should not be shunned. Furthermore, when viewed in light of general tax policy considerations, tax expenditures are equal to direct expenditures.

Consequently, with all due respect to Mr. Surrey, this paper draws the conclusion that tax expenditures may be preferable to direct government spending and should be considered as an option by policymakers.

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[i] Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*. 83 Harv. L. Rev. 705 (1970).

I. Introduction

A. Surrey: Who He was and Why He is Important

In 1967, Assistant Secretary of the Treasury for Tax Policy Stanley S. Surrey introduced the phrase "tax expenditures."[1] He used the term to refer to provisions of the Internal Revenue Code (IRC) that are deliberate departures from generally accepted concepts of income designed to affect the economy in ways that are usually accomplished by direct government spending.[2] After Graduating from Columbia Law, Surrey delved into the income tax and its enigmas.[3] He soon went to work at the Treasury where he spent some time.[4] However, Surrey went on to teach, first at Berkley and then Harvard.[5] He took a break, though, to act as Assistant Secretary of the Treasury from 1961 to 1969 under presidents Kennedy and Johnson.[6]

Surrey wrote extensively on his concept of tax expenditures, and believed that a close analysis could lead to better expenditure control by Congress through a more complete accounting of spending.[7] Expenditure control rested on the belief that tax expenditures escaped the scrutiny applied to actual appropriations.[8] While Assistant Secretary of Treasury, Surrey implemented a "Tax Expenditure Budget" hoping that this would bring to light the form of government spending and induce Congress to abandon narrowly-tailored incentives.[9] Furthermore, Surrey anticipated that by re-phrasing "tax incentives" as "tax expenditures," policymakers would recognize what he considered the inconsistencies with the goal of a fair, efficient, and simple income tax.[10] Since 1974, federal law has required the Congressional Budget Office (CBO) and the Treasury to publish detailed lists of tax expenditures.[11] The CBO has always relied on the Joint Committee on Taxation (JCX) to produce this publication.[12] Since then, policymakers and many tax-oriented organizations have relied and still rely on tax expenditure analysis to judge implications of individual tax proposals, to gauge the overall

income tax system, and to measure aggregate government resources devoted to particular policies.[13]

B. The Overall Concept of Tax Expenditures

The general concept of a tax expenditure is that it is indirect government spending. By granting preferences which deviate from the established norm of income, Congress incentivizes certain taxpayer behavior. This is equivalent to Congress's collecting the exempted amount and then simply paying the taxpayer directly from government funds.

Not every deviation, however, is a tax expenditure. In order to qualify as a tax expenditure, a preference must not only be a deviation from the established norm, but also must be designed to encourage some particular taxpayer behavior; that is, it must be an incentive. Also, a deviation which is granted to every taxpayer across the board – such as the personal deduction – is not really a preference at all and, therefore, is inherently *not* a tax expenditure.

C. Adoption of the Tax Expenditure Concept

After Surrey's introduction of the concept, others picked up on and expanded his ideas. Many commentators wrote responses to Surrey's work, including Bitker, Andrews, and Kleinbard. Others have expanded on the idea of tax expenditures and done studies of their own.

Today, both the Department of the Treasury and the JCX produce tax expenditure budgets. However, the two entities define tax expenditures differently and therefore have different figures. Since 1975, JCX reports have always included a description of the features of the normal tax baseline used to identify and measure tax expenditures.[14] This baseline consists of certain norms inherent in the system which, while departures, are not considered tax expenditures.[15] These include one personal exemption for each taxpayer and dependent, the standard deduction, existing rate schedules, and deductions for business and investment

expenses.[16] Department of Treasury analysis, however, has changed significantly over time. Early reports used the same baseline as JCX reports, but as early as 1976, the Treasury acknowledged the arbitrariness of accepting certain features of the tax system as part of the "normal" tax structure.[17] Thus, the Treasury began analysis of these inherent qualities as well.[18]

This paper, like most others, addresses the tax expenditure analysis from the view of the JCX budgets. However, this paper asserts that perhaps tax expenditures are better viewed from the Treasury analysis. Tax expenditures are best viewed as an alternative means of government spending, and all such forms should be considered. There cannot be a meaningful debate if the term "tax expenditure" is so limited. For, the problem is not tax expenditures themselves, but rather their current design and use.

II. Tax Expenditures Defined

"The present federal income tax is replete with tax incentive provisions. Some were adopted to assist particular industries, business activities or financial transactions. Others were adopted to encourage non-business activities considered socially useful."[19] These preferences were viewed by Surrey as indirect government spending implemented via the IRC. He coined the term "tax expenditure" and used that term to describe his idea and make the concept public. Basically, a tax expenditure is any special provision in the IRC which represents a government expenditure through the tax system, and which is designed to achieve some desirable social or economic objective other than the measurement of net income under an income tax system. The social objective is the incentivized portion. Taxpayers are allowed deductions, credits or even preferential rates for participating in certain activities.

Surrey includes in his definition even relief provisions found in the IRC such as the recent GO ZONE Act to the extent that relief is granted for an activity that is voluntary.[20] The relief is in effect an incentive to engage in the voluntary activity; the whole purpose of the relief provision is to provide a monetary benefit through the IRC "so as to make the desired course of action financially more palatable to the taxpayer" and induce him into performing as such.[21]

Others have taken up Surrey's cause and given their own definitions of a tax expenditure. Professor Henry Aaron defines a tax expenditure as "any tax provision which is defined or advocated primarily because it so alters resource allocation as to improve economic efficiency."[22] Boris Bittker says that "'Special Tax Provisions' . . .means any and all provisions of tax law which are designed to afford significant preferential treatment within each of the normal basic taxpayer categories," in giving his meaning of a tax expenditure.[23] While these are all different in some respect, they are all based on Surrey's original definition.

Notwithstanding the above definitions of a tax expenditure, if a preference is granted on a basis over which the taxpayer has no control, then the preference is not a tax expenditure. In Bittker's argument for a Comprehensive Tax Base (CTB), he further defines his concept of a preference in reference to a norm.[24]

> The wholly nonpreferred taxpayer [ ] is the man who receives everything in fully taxable forms . . . and who does not otherwise qualify for special exemptions or credits. To the extent that the taxpayer fares better than this yardstick he is being preferred.
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> Reference to a tax provision as "preferential" or "special" [means that] the provision deviates from a norm. Implicit in the reference is the idea that the income tax has an essential integrity; that there is a fundamental standard for determining the tax base and the applicable rates; . . . that the proponent of a measure which deviates – which creates a preference – has a burden of proof which goes as much to the use of the tax system as the means of accomplishment as to the measure's specific social or economic objective.[25]

What Bittker is arguing is that a deviation is only a preference (meaning a tax expenditure) if it makes one taxpayer better off than another taxpayer. Thus, if a deviation is given across the board to all taxpayers, such as the standard deduction or personal exemption, then no one taxpayer is given a preference, and the provision should not be considered a tax expenditure.

Likewise, Surrey explained that "features of our income tax system are considered not as variations from the generally accepted measure of net income or as a tax preference but as part of the structure of an income tax system based on ability to pay."[26] This exception includes deviations such as: personal exemptions, the rate schedule under the individual income tax, the income splitting allowed for married couples filing joint returns or for heads of households, and tax benefits for the elderly and blind.

The distinction is made clearer with an example such as the preference given to taxpayers allowing for the deductibility of interest on a home mortgage. This deviation is a tax expenditure. Only taxpayers who choose to take out a loan in order to own a home are allowed the deduction. In contrast, the personal exemption – a deviation from the normal understanding

of income – afforded to all taxpayers is not a tax expenditure. Every taxpayer is allowed to take the exemption and as such, no taxpayer is allowed a preference over another. Interestingly, the additional deductions allowed for the blind and elderly are also not considered tax expenditures since a taxpayer has no control over how quickly she ages or if she goes blind (unless the taxpayer were to intentionally blind herself for some eccentric reason). These are extra deductions allowed to those likely under hardship, and are based on their ability to pay. Congress assumes that the elderly, for example, are typically on a low, fixed income and may have more difficulty in meeting the otherwise standard tax liability.

Thus, a deviation for which the taxpayer does not have a choice over whether to qualify is not a tax expenditure but is an inherent deviation in the form of the overall tax system. Only those deviations over which a taxpayer has control are considered as preferences and tax expenditures.

III. Establishing a Norm for Income

A. A Baseline

The idea that a tax expenditure is an exception to the norm implies there is a tax-norm or baseline from which to judge all deviations. The composition of this norm has been the center of much debate between tax experts. Surrey implied the use of a Haig-Simons approach, Bittker pondered and Andrews evaluated a CTB, Kleinbard proffers no norm at all, and others made their variations known as well.

It is likely that the debate centered on Surrey's adoption of the Haig-Simons approach since that definition has become the standard definition of income accepted by most scholars. Also, Surrey is considered the father of the tax expenditure debate, so it makes sense that most opinions use his works as a starting point. Therefore, a majority of writings in the tax

expenditure debate begin with the presumption of a Haig-Simons definition of income. This paper is no exception.

B. Section 61 of the Internal Revenue Code and the Haig-Simons Definition of Income

IRC §61(a) follows the Haig-Simons approach and defines income in a manner that makes it all encompassing, although it does so in a rather circular manner. IRC §61(a) defines gross income as "income from whatever source derived."[27] One interesting point is that the definition dos not actually define income, but gross income. The qualifier "gross" hints that there must be another calculation of income. Possibilities include net income and taxable income, which are sometimes but not always the same. According to Bittker, one difference between §61(a) gross income and taxable income is the result of deductions and credits rightfully allowable from a person's business expenses, which lower the all-inclusive gross income.[28] Bittker argues that a person is not to be taxed on his expenses incurred for the production of income related to a business. He does not see this as a tax expenditure for incentivizing business ownership, but rather as a proper exclusion in determining a person's income tax liability.[29] Various other provisions specifically excluding items from §61(a) are considered tax expenditures and are the focus of this paper.

The classic formulation of the well-known Haig-Simons definition of income is: income equals consumption plus net accretion in wealth. "Haig defined personal income as 'the money value of the net accretion to one's economic power between two points of time.'"[30] This included the taxpayer's consumption, which was thought to be interchangeable with Simons's definition that "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."[31]

The Haig-Simons definition and §61(a) seem aligned in that they consider any increase in wealth to be taxable income. Thus, they both seem to support the idea of a CTB. It is only the tax expenditure provisions which move the IRC away from this and give it its current form. Thus, there can be no debate over tax expenditures without at least a touching upon of the debate over income based taxes or consumption based taxes and a CTB

i. Tax Bases: Income versus Consumption

The Haig-Simons definition of income has been the source of one of the largest tax debates: should the government tax income or consumption? Currently, as everyone who has ever received a paycheck knows, the government taxes income. However, unbeknownst to most, this is merely a means to an end, for the true nature of our current tax system is a hybrid of both an income and a consumption tax. The government's goal is also to tax consumption; income is taxed merely as a proxy to consumption. Income is often viewed in tax policy as a measurement of the income earner's ability to consume. The more one earns, the more, in theory, he or she can consume.

"There are many instances of services compensated otherwise than with money or not compensated at all, and of goods and services consumed without the expenditure of money or the provisions of services or any other explicit exchange."[32] Thus, the argument is made that consumption, and not income, is what need be taxed, and is what *is* taxed. Under many provisions of the IRC, this non-monetary compensation must be included as taxable income at the fair market value of whatever is received. Thus, in reality, our system is a hybrid, but commonly referred to as an income tax.

ii. Comprehensive Tax Base

Tax expenditures make it urgent to consider whether they are departures or refinements of the ideal personal income tax.[33] Andrews realizes that the tax expenditure debate is centralized on the Haig-Simons definition of income: consumption and accumulation. Thus, he argues, we need to define what those two things are.[34]

Andrews defines consumption as the private and preclusive appropriation of goods.[35] Thus, consumption does not include: use of public things, things used by many people at once, or immaterial benefits not a part of the market economy (enjoyment).[36] Accumulation, he defines, is simply the difference between a taxpayer's wealth at the end of the period and his wealth at the beginning of the period. Thus, Andrews argues, if something falls outside of consumption and accumulation, it is not income and should not be taxed.

A proper method of removing items from income, according to Andrews, is a deduction, and he sees at least some personal deductions as fulfilling this role. Thus, some personal deductions and other deviations are not actually tax expenditures. For example, the standard deduction for taxpayers, as opposed to itemized deductions, recognizes that the tax system, to some extent, is based on ability to pay. Although this is a deviation from the general concept of taxation on receipts under a Haig-Simons approach, the standard deduction is not considered a tax expenditure. Rather, as Andrews sees it, it is a method of properly reserving a portion of income to the taxpayer by removing it from the realm of taxation. Similarly, the IRC allows deductions for dependants. These are not considered incentives for people to have more children, but rather are a method of reserving to the taxpayer a set amount of income for the *expense* of supporting dependents. Andrews argues that the deduction is the proper mechanism for excluding this reservation.

Others critique Andrews and argue that it is not consumption, but rather the power or ability to consume, which is important. "[A]n ideal personal income tax is one in which tax burdens are accurately apportioned to a taxpayer's consumption and accumulation – the uses to which income is typically put rather than the sources from which it is derived."[37] These arguments seem to be based on the well established theory that the source of income should be disregarded; if it is income, then it should be subject to tax. However, these two lines of argument seem to be advocating the same thing – accretion of wealth, from whatever source should be subject to an ideal income tax.

Andrews considers the CTB an attempt to reflect an ideal income tax: "one under which all personal income is taxed, uniformly and comprehensively."[38] This includes regular, recurring cash receipts; compensation for services, use of capital, or a combination thereof; net accretion in wealth; and aggregate consumption plus accumulation of real goods and services or claims thereto.[39] Simons did not assert that all these should be included; neither did he suggest any way to easily determine what should be included and excluded.[40] This is a complicated problem in which competing considerations of fairness and practicality must be continuously weighed against each other.[41] (The concepts of equity and practicality and how one must often cede to the other are discussed below). However, the common conclusion is that an item's source is generally not relevant. Rather, income of any form should be taxed.

One advantage to the "power to consume" interpretation of Simons's view is that the complexities of determining minute consumption do not enter into his definition of income.[42] Simons's definition also is able to draw a line of what is and is not income. On the other hand, a CTB makes it difficult to determine what, if anything should be excluded.

iii. Shaviro and Psychic Income

Like Andrews, Shaviro evaluates a CTB but takes it one step further. In his view, to understand income, we must first understand consumption. The Haig-Simons approach, according to Shaviro, suggests that consumption, and thus income, is broad and can exist even in the absence of any material income. Under this theory, the mental state of satisfaction or enjoyment is sufficient. This type of income is often referred to as "psychic income." Note that this is in direct contrast to Andrews, who specifically excludes enjoyment from his definition of consumption and thus a CTB.

The main problem with psychic income is that it is totally impractical and immeasurable. Perhaps these are the exact reasons Andrews excludes it. The government would have to determine how much a person enjoyed something, or at least ask the taxpayer to do it. This would be a very subjective income tax, fraught with enforceability and compliance issues. Thus, many arguments are made as a solution that the perceived enjoyment should be measured by a more objective standard such as the fair market value of the thing being enjoyed.

Likewise, Shaviro argues that current law already takes into account a taxpayer's utility. Taxable consumption is commonly viewed as limited to satisfactions from the use of economic resources. If a taxpayer pays market value for consumption, then it is assumed that his subjective utility is equal to that price. Furthermore, the current tax system allows for casualty losses, prizes, and entertainment; all of which Shaviro argues is based on the taxpayer's utility. Fair market value, he argues, is used as a proxy to measure the subjective value of income.

However, if psychic income is included as Shaviro proffers, then the opposite argument could be made that a person with dissatisfaction would have reduced income. This would exclude from tax items a person consumed but in no way enjoyed and actually regretted or

suffered. Thus a person with consumption, and a great deal of it, could pay no tax if his regrettable consumption was equal to and offset his enjoyed consumption. Likewise, a person with unenjoyed consumption would have no income. Moreover, the question arises as to what to do when a person's regrettable consumption exceeds his enjoyed consumption. Would he be due a tax refund? What about an offset to be carried forward and/or carried back, such as net operating losses to be applied against previous or future enjoyable consumption? These examples show the problems of psychic income and why most exclude it. Taxing it is simply not practical.

C. Alternatives to Tax Expenditures

The most commonly proffered alternative to tax expenditures is a system utilizing direct subsidies in their place. Under such a system, taxpayers would generally be taxed on their gross receipts under a Haig-Simons approach. The government would then redistribute its revenue to taxpayers in the form of direct subsidies. Taxpayers would receive a check from the government in the determined amount according to eligibility. This is typically thought to be the equivalent to a tax expenditure while having the added bonus of lowering marginal rates.

Another alternative to tax expenditures is simply to tax all income under a Haig-Simons approach but with lower rates. This is commonly thought to be the best means of taxation as it is thought to produce the most benefits. The broadened base allows for increased revenues and possibly even lower rates. The lower rates in turn induce taxpayers to increase taxable behavior thereby generating even more revenues for the government.

IV. Previous Conclusions and Arguments: Direct Expenditure Analysis

A. Surrey: A Preference for Direct Expenditures

Tax expenditures include: exemptions, deferrals, exclusions, deductions, special rates, and credits. According to Surrey, these incentives could provide the same benefits via direct government spending in the form of grants or subsidies. He begins his comparison by listing falsely asserted virtues of tax expenditures.

First on his list is the assertion that tax expenditures 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. The need for Government to participate can be fulfilled by a tax incentive, and this is asserted as a virtue of tax incentives – they provide government assistance.[43]

The argument is often made, as evidenced by an example he gives, that the best way to subsidize a businessman is through his income tax liability.[44]

Nevertheless, Surrey makes the counterargument that all this points to is the need for government assistance, not to the virtue of any particular method of so providing.[45] "The existence of that need has no relevance to the question whether the need should be met by an incentive or by a direct subsidy."[46]

Surrey has a point. The fact that government assistance is needed and thus we should have incentive-based spending is conclusory. There is no analysis in this argument. Therefore, the need for government assistance itself is not enough to support a tax expenditure program. However, he does not seem to offer here any decisive reason why a tax expenditure is an inherently poor method.

Second on his list of alleged virtues is that tax expenditures are simple and involve less government supervision.[47] The idea is that tax expenditures require no new bureaucracy, and

new proposals can go into effect immediately upon enactment.[48] The IRS is already in place and is able to calculate the required amount of return afforded to each taxpayer. However, Surrey seems to crush this advantage by asserting that other already existing bureaucracies could do the same.[49] He argues: "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."[50]

It is true that already existing bureaucracies could handle the subsidies in the same simple manner as the IRS – filling out a form and divvying out funds. However, the government is rarely rational, as Surrey naively believes. Moreover, the other bureaucracies are teeming with additional "red tape" which the IRS is accustomed to circumventing, at least when it comes to the refunding of tax amounts. Mainly, the IRS is used to doing this already, and while no new bureaucracies would need to be formed for an already existing agency to do the same, new divisions of those existing bureaucracies would be required. Just because something is possible does not make it easy or feasible, much less preferable.

Surrey does concede that in many cases, direct expenditure programs are likely over-structured.[51] He sees the want of incentive-based spending as reactions to and valid criticisms of badly designed expenditure programs.[52] However, he argues that the alleged simplicity of tax expenditures is illusory.[53] He gives examples of certification requirements for meeting the criteria of certain incentives. He further notes that these are not critiques of the noted programs, but are observations meant to show that even incentive-based spending may require complex requirements.[54]

While Surrey's assertions may be true in some circumstances, people generally know whether they qualify for most incentives. The incentive is designed to induce certain behavior.

Thus, in order for it to work, a person must know about it. The taxpayer will either have acquiesced in the behavior or have resisted. There is often, for the common man at least, little confusion as to whether he qualifies for a home mortgage interest deduction or a credit for environmental upgrades to his home windows. Consequently, meeting the requirements is not difficult to overcome.

Surrey notes the alleged advantage that tax expenditures promote private decision making.[55] "It is said that better progress will be made towards the solution of many social problems if individual decisionmaking [sic] is promoted, and that since tax incentives promote this they should be preferred to approaches that underscore government-centered decisionmaking [sic]."[56]

Surrey counters that this contention "is really a variant of the previous 'red tape' argument."[57] He argues: "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 decisionmaking [sic] and less scope for government control."[58]

Surrey further points out that, after careful thought, if a simple structure is desired and considered wise, "it would assume considerable irrationality to say that the simple structure will necessarily be kept if a tax incentive is used but scrapped in favor of a more complicated structure if a direct expenditure is used."[59]

Surrey is again arguing that there is no need for a direct expenditure program to be a complicated bureaucracy teeming with red tape. However, while something need not be so, when history shows us that it *will* be so, we begin to notice the pattern, and Surrey once again naively relies on the rationality of big government. There is no doubt that a direct expenditure program could be designed to be as streamlined as the tax system. However, it is rarely the case

that something will be streamlined when more and more politicians are allowed to get their hands on it. The more complicated political process of direct government spending cannot be fully circumvented; discretionary spending must be reviewed.

Surrey finally addresses what he calls the illusion that Congress will be willing to vote dollars through tax incentives that it would otherwise refuse through a direct subsidy program.[60] Many members of tax committees have noted that expenditures are in fact involved and therefore Congress is aware that it is spending the money.[61] However, Surrey fails to take the analysis further and apply it to the taxpayers who vote for the congressmen. While Congress may be aware that it is "holding the front door shut [while letting] hidden expenditures in through the back door,"[62] voters are not. Thus, through "back-door expenditures,"[63] legislators are able to seemingly reject government spending while actually promoting it. Such tactics were shown by the Democratic Party in 2010 when they boasted "tax cuts" to constituencies nationwide.[64] However, upon a close examination of the so called tax cuts, it was revealed that all items listed were in fact tax expenditures.[65]

Moreover, it is not certain that this preference is an illusion as Surrey suggests. Taxpayers generally perceive a tax expenditure as a personal break. Although it is incentivized spending, that particular taxpayer has to give up less of his income than he otherwise would be required to pay. Thus, taxpayers see this as preferable to a system where they are required to pay more even if they receive it back. Decreases in collection – what most might (wrongfully) perceive as "tax cuts" – are popular with taxpayers, while increased government spending – even if illusory – is not. This plays heavily into the political aspects, which are discussed below, regarding general considerations of tax policy.

Surrey then lists asserted defects of tax expenditures. First, they permit windfalls.[66] First, incentives pay taxpayers for doing what they would already do anyway, thus generating no additional activity.[67] Surrey concedes, though, that this is not a problem unique to tax expenditures, and it is difficult to structure a credit system avoiding this problem without introducing complexity and arbitrariness, including a direct expenditure program.[68] He further notes that it may even be desirable to tolerate the windfall in certain programs, while in others it would be desirable to eliminate it.[69]

Surrey seems to forget his own concept behind tax expenditures – incentive. If taxpayers were already inclined to act accordingly, then there would be no need to incentivize the behavior. Granted, some taxpayers may experience a windfall, but the opposition's argument poses a scenario where the majority of taxpayers will be privy to this undeserved gain. Conversely, the majority of taxpayers must be acting in opposition to the desired behavior, or Congress would not see fit to reward them for their beneficial changes. While the argument may be made that Congress simply may be doling out benefits to please constituents, this rewards system would be more noticeable and therefore more likely to be implemented through direct subsidies. If Congressmen are attempting to reward constituents, they want them to know, and are not likely to do so in such a hidden manner.

Second, Surrey argues that tax expenditures promote inequity.[70] This is an amalgamation of other arguments including that tax expenditures are worth more to high-income taxpayers than to low-income taxpayers, and that they only benefit those inside the tax system.[71] The first part, that the expenditures are worth more to high-income taxpayers, is the "upside-down subsidy argument" addressed below. At times, some find this upside-down mechanism to be "worrisome," and a credit rather than a deduction is used. Surrey argues that this unfairness

persists in (then) recently proposed legislation.[72] However, to counter using one of his own arguments, this goes not to the nature of the program, but to its design. There is no reason a tax expenditure need be an upside-down subsidy. They could be designed, as this paper suggests, to phase out and apply only to those in need.

The second part has to do with the fact that a person whose income is so low as not to be included in the tax system will receive no benefit from an incentive-based spending program. The inequity stems from the fact that the "focus was, as in any positive tax system, on writing the rules for *taxpayers*."[73] Surrey argues that this criticism "is properly levied against most of the existing tax incentives, and probably most of the [(then)] proposed incentives" since they arose "without any serious thought ever having been given to the question whether they were fair."[74]

He proffers a system where a tax expenditure is fashioned to avoid this criticism and designed more along the lines of a direct expenditure.[75] He suggests something of a uniform tax credit "with positive taxpayers receiving a diminishing final share depending on their tax bracket."[76]

As to those outside of the tax system, if these credits are made refundable, then they could be included in the system. There is nothing keeping low-income earners from filing income tax returns, even though they are not required to do so. In the same fashion, if a direct expenditure program were used, it is doubtful that everyone would be required to file for the subsidy and have the government determine eligibility; doing so is simply not feasible. Either way, to gain the benefits of the system, taxpayers must participate.

Thirdly, Surrey suggests that tax expenditures distort market choices. He notes that this is always true with a tax expenditure, as this is their purpose.[77] Tax expenditures are designed to change a taxpayer's desires and align his interests with those of the government. This inherently

distorts the free market and produces bias in allocation.[78] Surrey proffers though, that when this argument is made as a downside of incentives, it is meant only as it applies to undesirable distortions.[79] Surrey's largest problem with these distortions is that they often go unnoticed.[80] Nevertheless, he concedes that the criticism is equally applicable to direct expenditures, and thus this disapproval does not by itself tell which method is better.[81]

There is no counterargument for this disadvantage of tax expenditures. They inherently distort free marketability; that is their purpose. The only solace is that it is generally considered beneficial.

Finally, there is the asserted drawback that tax expenditures keep rates high. This is the typical argument proffered by most opponents. The concept is simple: by constricting the tax base, tax revenues are decreased and the difference must be made up by higher rates. The solution for many is the use of direct government spending with a broader tax base as a result of not having tax expenditures. Surrey saw this criticism as one which many overlook in their advocacy of incentive-based spending; he also saw this as a reminder that government funds are being spent.[82]

Conversely, it can be argued that direct subsidies would cause a further increase in rates, rather than a decrease. A direct subsidy system would undoubtedly broaden the base as fewer exceptions to taxable income would exist. Therefore, more revenue would be collected. However, this would not automatically cause a decrease in the rates. As a result of the subsidies, there would also be increased government spending. At the very least, it is easy to see how the rates would remain the same.

That is still only a portion of the picture, however. The IRS is accustomed to issuing checks via the Treasury and has the means of doing so. A change in the system of paying

citizens via different departments of government would have substantial administrative costs, leading back to the argument that some new bureaucracy, no matter how minimal, would have to be created (or at least expanded) to comply. These increases in costs would have to be offset by increased revenues – higher rates. The costs cannot simply be absorbed by utilizing existing personnel since this would be a whole new function in addition to already existing functions. Thus, the particular bureaucracy making the payments would have to utilize new personnel.

Surrey also lists losses resulting from utilization of tax expenditures rather than a direct spending program. First, he argues that confusion and complications result from the source of different committees. Basically, the IRS is not specialized in particular areas other than taxes. Surrey believes that the IRS should not be considering methods of social change, but rather keep its scope limited to its area of expertise – tax.

> By definition, such programs are designed to induce action to meet a particular social goal . . . and would not be a part of the tax structure were they not deliberately cast as tax incentives. Such government programs would normally be considered by the appropriate congressional committee charged with the legislative area involved . . . . These committees are responsible for overseeing and developing legislation in their jurisdictional fields, and so are able to coordinate the Government's programs and policies . . . . Tax incentives suddenly charge [the tax committees] with acting on substantive matters outside their fields of responsibility simply because the program uses the tax system.[83]

Similarly, Surrey argues that the result of the tax committees considering non-tax matters is to have incentive programs isolated from the regular flow of legislation, making coordination and priorities difficult to ascertain.[84] This isolation continues today, despite previous attempts by Congress to coordinate the systems (discussed below). Surrey's concerns also reach the area of political bargaining over the tax incentives.[85] He does suggest the possibility of having the tax committees refer proposals to the respective substantive committees, but feels that such a system is too awkward and has complications, such as which committee would be controlling.[86]

One solution, proffered elsewhere in this paper, despite Surrey's concerns, is to have the respective substantive committees review the proposals and make a recommendation to the tax committees. While Surrey finds this method awkward, it could be highly beneficial. The substantive committees can better foresee both the intended and unintended consequences of the proposals. Furthermore, if the proposals were in a direct subsidy system, they would have to review them anyway, so the workload is no different than that suggestion by other solutions. This proposed method would simply allow the admitted experts to review the proposal and the tax committees to impose them on the constituency with ease. As to which committee would be controlling, the answer is obviously neither. The substantive committees would be in charge of reviewing and drafting while the tax committees would be in charge of ensuring the new provisions do not conflict with existing provisions. Also, the tax committees should review the proposals from the substantive committees to ensure the wording is consistent with other tax laws to avoid differences in terminology and definitions.

Also, Surrey argues that incentives do not improve the tax system, but rather are likely to cause significant damage thereto.[87] He brings up, once more, the inequities of the incentive-based programs, but also mentions complexity. Surrey argues that the tax system is complex enough as is, and the addition of incentivized exceptions will only add further confusion and complication.[88] Moreover, the additions (exceptions) make it harder to distinguish between the subsidies and the system's proper structure.[89]

While Surrey is right that the IRC is overcomplicated as is, and that further complications should be avoided, tax expenditures are not necessarily the culprits. A major part of the IRC's complexity is its complex wording and organization, or lack thereof. Furthermore, if a direct subsidy method were adopted, taxpayers would go from compliance with one code and the use of

one expert, to compliance with many different organizations and the use of perhaps several "experts" in attempts to qualify for the subsidies in addition to filing tax returns. Therefore, the compilation of all incentives into one area actually affords taxpayers some simplicity. Taxpayers have the convenience of using only one expert (i.e. a CPA or tax attorney) instead of several. This goes to both simplicity and efficiency, since taxpayers can save both time and money.

B. Bitker: A Response to Surrey

Bitker begins, like all, with the debate over the tax base and the Haig-Simons definition. He recognizes that a true CTB would be all income under §61(a) with no exclusions, deductions, credits, or any other preference. The only exception would be business deductions, which everyone agrees fall outside of the Haig-Simons definition of income.

However, Bitker also recognizes that a CTB does not solve all the problems of the personal income tax. He gives many examples of items which would still be troublesome: how to tax families, the distinction between personal and business expenses, and the double taxation of corporate shareholders.

Moreover, Bitker makes an interesting point regarding deviations from the norm. He asks that if it makes sense to allow different filing statuses, then why do we assume that other deviations are illicit preferences? It could be another way to treat taxpayers more equitably. This is an interesting point since Surrey argues that preferences lead to *inequity*.

Bitker also proffers the theory of the "second best." He says, "To the extent that a departure from the Haig-Simons definition of income is compelled by administrative difficulties . . . [and not] by its contribution to a social or economic goal, the advocates of a CTB have given too little attention to the paradox of the 'second best.'"[90] This approach does win approval. CTB promoters embrace the Haig-Simons concept of income because it describes an ideal tax base

from which tax expenditures can be measured. Bittker, though, proposes using this ideal to see which reform programs come the closest to the ideal, all the while insisting that the best program would not necessarily be the one which eliminates the most preferences.[91] Rather, the one with a tax burden distribution that closely resembles the ideal would be the preferred provision.[92] This method of judging a tax system would recognize that "unavoidable preferences . . . might be offset by deliberately preserving (or even creating) other preferences."[93] The idea is that providing certain tax expenditures may bring the current system closer to an ideal tax than eliminating all tax expenditures.

In order to implement the Haig-Simons definition of income, all appreciation of wealth must be taxed. However, defining "appreciation to wealth" is complicated, and taxing all forms of it is difficult to accomplish. Nevertheless, there are other methods to value accretion of wealth, and these methods are second bests. Some of these second bests may be in the form of tax expenditures. Tax expenditures may be implemented in the form of preferential tax rates on an item that otherwise would go untaxed while also incentivizing the behavior which produces such income. Also, Bitker notes that there are some preferences which cannot eliminated, so the tax system compensates in other areas. Therefore, it is important not to have a "knee-jerk" reaction to every tax expenditure.

In conclusion, Bitker argues the following. First, a true CTB would be all income under §61(a) and would be much more comprehensive and require a more sweeping change of the tax system than has ever been argued or realized. Also, many of the required changes for a true CTB would be opposed, even by most proponents of a CTB. Moreover, valuation of many of the newly included items would be problematic at best and often impossible. Finally, there are other concerns such as equity which should play a role and may actually favor tax expenditures.

C. Upside-down Subsidies as a Result of the Progressive Rate Structure

Surrey makes the argument that tax expenditures are inequitable since they are worth more to the rich than the poor.[94] One defect he points out is that the tax expenditure is only beneficial to those inside the taxing system; that is, those who have not earned enough income or have losses available to offset such income are not benefitted.[95]

Surrey has a point. An incentivized deduction, or any deduction, is worth more to a taxpayer in higher bracket than it is to a taxpayer in a lower bracket. This is due not to some special tax expenditure calculation, but to the progressive nature of the income tax structure. Deductions are taken at the taxpayer's highest applicable rate. Thus, a deduction for a taxpayer in a higher bracket receives a higher percentage.

However, Surrey forgets to apply his own argument: the fault "points not to the virtue of tax incentives."[96] The fault lies not in the system of tax expenditures, but in using deductions. As Surrey points out, Congress has recognized this problem with deductions, and has in some cases used credits. By using a tax credit, the taxpayer receives a dollar for dollar reduction in tax liability, as opposed to a ratable deduction applied using the taxpayer's highest marginal rate. Congress has even made some credits refundable (such as the Earned Income Tax Credit) and restricted certain credits so that they are inapplicable to high income earners.

This system would undoubtedly please Surrey and ease his concerns regarding equity. In fact Surrey even touches on this in his article when he discusses fashioning an incentive program more along the lines of a direct expenditure program with taxpayers receiving a diminishing final share depending on their tax bracket.[97]

D. An Historical Look at Marginal and Effective Tax Rates and their Roles as Tax Expenditures

Our tax system is progressive, that is, "higher-income groups pay a disproportionate share of federal taxes because they earn a disproportionate share of pretax income."[98] There is a way in which the effective rates can be viewed as a departure from the marginal rates and are therefore preferences and tax expenditures. Likely this would be what Kleinbard calls Tax-Induced Structural Distortions (see below).

In 2009 the CBO published an article entitled *Historical Effective Federal Tax Rates: 1979 to 2006*.[99] The article addresses the disparity between marginal and effective tax rates. When this information is put alongside data collected by the Tax Foundation of historical marginal rates, the differences are noticeably stark.

Year	Top Marginal Rate	Top Effective Rate	Year	Top Marginal Rate	Top Effective Rate	Year	Top Marginal Rate	Top Effective Rate
1979	55%	21.80%	1988	33%*	20.70%	1997	39.60%	23.80%
1980	70%	22.30%	1989	33%*	19.90%	1998	39.60%	23.40%
1981	70%	21.50%	1990	33%*	19.90%	1999	39.60%	24%
1982	50%	20.40%	1991	31%	20.60%	2000	39.60%	24.20%
1983	50%	19.40%	1992	31%	21.20%	2001	39.10%	24.10%
1984	50%	19.30%	1993	39.60%	23.20%	2002	38.60%	23.70%
1985	50%	18.90%	1994	39.60%	23%	2003	35%	20.40%
1986	50%	18.30%	1995	39.60%	23.70%	2004	35%	19.70%
1987	38.50%	21.50%	1996	39.60%	24.20%	2005	35%	19.30%
						2006	35%	18.90%

[100]

While at first this may seem as an inherent difference since effective rates are not incentives, when we look further to see what is causing the disparity, in may cases the answers are tax expenditures. The differences can be explained by preferential rates for capital gains and dividends, which are meant to induce taxpayers to invest.[101] Also, the higher income earners are more likely to engage in tax planning, which allows them to take advantage of every possible deduction and credit for which they can possibly qualify. Thus the differences are often greatest at the top marginal rate. Conversely, the difference in the lowest marginal rates and the effective rates are typically much smaller since such taxpayers are often not as sophisticated. This also plays into the upside-down subsidy problem.

E. The Effect of Tax Expenditures on the Federal Budget Deficit

i. A Breakdown of the Budget: Where the Money is Spent

In an article from early 2010, it was predicted that the federal government would spend $3,600,000,000,000 ($3.6 Trillion).[102] Approximately 20% of that would go to defense, 20% to Social Security, 20% to other healthcare programs, 14% to "safety net programs", 6% on national debt, and a final 20% on miscellaneous spending including transportation and education.[103]

This amount of spending was reported to be 24% of GDP.[104] However, preliminary data showed that revenues would amount only to less than 15% of GDP.[105] With such a little amount being spent on repaying the ever-growing debt, some measure must be taken to remedy the position in which we have put ourselves.

ii. Possible Methods of Reducing the Deficit

The Tax Policy Center (hereinafter, "the Center) "is made up of nationally recognized experts in tax, budget, and social policy who have served at the highest levels of government."[106]

The Center "provides timely, accessible analysis and facts about tax policy to policymakers, journalists, citizens, and researchers."[107] The Center "concentrate[s] on four overarching areas of tax policy that are critical to future debate: [Fair, simple, and efficient taxation; Social policy in the tax code; Long-term implications of tax and budget choices; and State tax issues]."[108] The Center is considered a forerunner and expert in its field. Three staff members at the Center, Rosanne Altshuler, Ketherine Lim, and Roberton Williams, published a paper entitled "Desperately Seeking Revenue" which exposéed the critical state of the federal budget.[109]

This piece begins by stating how the CBO predicted a federal budget deficit of nearly $1.6 trillion for 2009.[110] The authors examine several possibilities of narrowing that gap, while conceding that their intentions are not to balance the budget but simply reduce the deficit to 2% of gross domestic product (GDP).[111] At the time of publication, the deficit was 3.2% of GDP.[112] These possibilities are examined both with and without the extension of the "Bush tax cuts." The first possibility examined is raising all individual income tax rates proportionately.[113] The Center concludes to reach the 2% GDP goal, all tax rates including preferential rates would have to be raised 15% if the current law had been allowed to sunset as scheduled, or an increase of nearly 50% with the current extension.[114] The 15% increase is not so impossible. As the article points out, the 15% marginal rate would increase to 17.2% and the 28% rate would increase to 32.2%.[115] While these increases are likely to be unpopular, they are not politically unfeasible.

Next the authors look to raising only the top three rates proportionately.[116] The rationale behind this objective is one of equity. By raising only the top rates, the lower income earners are protected, and a tax hike is imposed on only the top 6% of taxpayers.[117] To meet the 2% GDP goal, the top rates would have to increase by 30%, twice as much of an increase as under the

previous proposal if the laws had sunset as proscribed.[118] However, with the extension, the top rates would have to more than double.[119]

Another idea is to raise rates only on those single taxpayers with income over $200,000 and married couples filing jointly with income over $250,000.[120] This policy was derived from what President Obama targeted in his 2008 campaign.[121] If the laws had been allowed to sunset, the targeted tax rates would have to have been increased by more than 40%, and with the extended rates now require a 160% increase, raising the top rate to about 91%.[122]

The authors then consider eliminating all itemized deductions.[123] This would limit all taxpayers to the standard deduction. According to the Center, at that time, 32% of taxpayers itemized; thus, there would be a tax increase on 32% of all taxpayers.[124] This would broaden the base of the tax significantly, especially when considering that the top three rates included only 6% of taxpayers. Under this proposal, if the tax cuts had been allowed to expire, the 2% GDP mark could be met with a surplus.[125] However, with the extension of the tax cuts, this proposal still falls short.[126]

Finally, the authors examine the effect of limiting the value of itemized deductions to 15%.[127] This is a more stringent version of what President Obama included in his 2010 budget, but still does not produce the needed effect.[128] This proposal would supply about 80% of the needed revenues to meet the goal if the provisions expired, but only about 20% of the needed revenues with the extension of the cuts.[129]

iii. The Ineffectiveness of Increased Taxes

What this study shows is that the only methods capable of decreasing the deficit to a manageable size via increased rates are politically unfeasible. Thus, sadly, politically feasible tax increases within the current tax structure cannot generate sufficient revenues to bring federal

budget deficits under control.[130] Moreover, no method was capable of reducing the deficit completely, much less creating any sort of surplus.

Most importantly, these conclusions ignore any sort of behavioral consequences.[131] The article, though, acknowledges a long line of studies showing that when tax rates are increased, individuals – "particularly those at the top of the income distribution" who pay the majority of taxes – decrease the effect by reducing their taxable behaviors.[132] This is done by reducing the number of hours worked and possibly spending more time in leisure, shifting income to tax-exempt items, or spending more on tax-deductible items.[133] Thus increased rates would have even less benefit than predicted and cannot bring government spending within a desirable range.

iv. Direct Expenditures Require Increased Rates

Under the traditional view, if tax incentives are eliminated, the base of the tax is broadened; as a result, the same amount of revenue can be collected with lower rates. This, of course, assumes no changes in taxpayer behavior.

Under a new analysis, though, if tax incentives are eliminated, marginal rates will actually have to increase, despite the broadened base. If the government adopts a direct expenditure program, there will be increased direct spending caused by the payments to the taxpayers. Thus, there must be increased revenue collection. Granted this will be provided in part by the broadened base. However, this will not lead to lower rates. The broadened base is generally assumed to compensate for the increased collection needs. A simultaneous decrease in rates would cause a net decrease in collections. This is because under a tax expenditure program the amount theoretically dispensed is equal to the amount exempted. Thus, assuming no changes in behavior, static rates are the best we can hope for with a change to direct expenditures.

Nonetheless, this is not a realistic assumption. The Center itself recognized that taxpayer behavior plays a role and tends to shift with changes in the revenue laws. Even the Treasury realizes this result. The Tax Expenditure Budget calculates tax expenditures by the amount of revenue foregone – that is, the amount of the deduction or credit taken or difference in preferential rate – not the revenues that would be raised by repealing the rule because repeal would have behavioral consequences. These consequences can be easily predicted with the shift to a direct expenditure method.

The base would be broadened, but not by the addition of extra taxpayers. Instead, each taxpayer would lose deductions and credits and the use of preferential rates which kept his tax liability low, even if artificially so. Thus, a taxpayer will view this loss as an increase in the amount of tax he now has to pay – analogous to an increase in rates – and will change his income-earning behavior accordingly to avoid paying the extra tax. The final result is that a change to direct expenditures is the same as increased rates, and may in fact even *require* increased rates.

The argument can be made that under the same conditions, the political process could result in elimination of some of the spending. As a result, effective rates could be lowered, possibly increasing economic activity which in turn could generate more tax revenue. However, this paper assumes that the political process would actually preclude eliminating any spending. Discretionary spending by Congress is often entrenched since constituents see the benefits not as legislative grace, but as receipts they deserve and often have come to depend on. Thus, it is more likely that the political process will maintain the current level of spending and the argument proffered above would prevail.

Moreover, with a direct subsidy program, taxpayers are taxed under a Haig-Simons definition of income. Under such a definition, receipt of a government subsidy would be taxable. Thus, a higher amount of a direct subsidy would be required to place the taxpayer in the same position as he would be in under a tax expenditure system due to the tax he would be required to pay. Since the government had to pay more to reach the same result, it must generate more revenue to compensate. The main way for the government to accomplish this is to increase marginal rates. Thus, it is clear that a direct subsidy can lead to increased rates while tax expenditures can be utilized to avoid this problem.

V. A Reformation of Tax Expenditures

A. A Reformed Analysis by the Congressional Joint Committee on Taxation

Most arguments over tax expenditures stem from Surrey's definition as departures from the norm. There is no consensus among scholars, however, regarding the norm for taxable income. As illustrated above, arguments are made in the areas of: income vs. consumption tax base; psychic income or enjoyment; and progressivity, whether inherent in the tax system or utilized as an incentive.

Kleinbard came to the rescue by offering a new definition to shift focus from the debate over whether something is a tax expenditure and to whether a tax expenditure is useful under the given circumstances. This approach responds to the objection that it is not possible to reach a consensus regarding the normal tax, and that the normal tax serves both as a measurement and aspiration.

Under Kleinbard's theory, the broad term "tax expenditure" is broken into two key components: Tax Subsidies and Tax-Induced Structural Distortions. Tax Subsidies are defined as specific tax provisions deliberately inconsistent with an identifiable general rule of the present

tax law (not a hypothetical "norm") that collects less revenue than the general rule. There are three sub-categories: Tax Transfers; Social Spending, and Business Synthetic Spending. Tax Transfers are a payment without regard to income tax liability. Social Spending is a subsidy unrelated to the production of business income but related to the supply of labor. Business Synthetic Spending is a subsidy to induce behavior directly related to the production of business or investment income, but unrelated to the supply of labor. These are not fixed categories, but general guidelines which were offered with some reservation in fear that they may lead to further debate over definitions drawing focus from the real use of tax expenditure analysis.

Tax Induced Structural Distortions are provisions of the IRC currently classified as tax expenditures which do not fit easily as a tax subsidy since there is no consensus regarding a general rule – ie: deferral, or the decision whether to structure a corporation with debt or equity. They are defined as structural elements of the IRC that materially affect economic decisions in a manner imposing substantial economic efficiency costs. These look only to efficiency, but without reference to any normative tax system.

Kleinbard introduced this new analysis with the same aspirations Surrey had when he coined the term tax expenditure – bringing focus on the tremendous amount of unsupervised government spending via the tax system.[134] Recent debate, though, had turned tax expenditure analysis into a battleground over what the normative tax system was or should be.

> Tax expenditure analysis *should* serve as an important pragmatic tool for policymakers to use in sorting out their priorities, and in understanding in a straightforward way both the economic consequences of their decisions and the policy alternatives that might be relevant to the implementation of their ideas. Instead, a significant strand of legal academic work has deprecated the normative basis of tax expenditure analysis.[135]

The debates regarding tax expenditures have been misguided in that they focus on whether or not an incentive *is* a tax expenditure instead of debating whether a tax expenditure is a useful mechanism for implementing the provision under analysis. While the issue of whether a

provision is a tax expenditure is important, it should be a preliminary discussion and not the focus of debate. As a result of the misguided debates, tax expenditures have gone largely unnoticed by both the public and Congress.[136]

Kleinbard gives astonishing figures on the growth of tax expenditures. In 1974, Tax expenditures amounted to 5.7% of GDP.[137] An all-time high was reached right before the Tax Reform Act of 1986 where tax expenditures totaled 9.7% of GDP.[138] Tax expenditures thereafter began to fall reaching a new modern low of 5.3% in 1991.[139] Tax expenditures remained steady around 6% for about a decade, but then began a steep climb.[140] Kleinbard calculated that the 2008 tax expenditures totaled 8.6%, nearing once more the all-time high.[141]

> Moreover, because most tax expenditures are expressed as deductions or exclusions and their value is determined by the taxpayer's marginal tax rate – tying into the upside-down subsidy argument – in low-rate environments, these have lower value.[142] 2008, when compared to 1985, was a low-rate year. Thus, to reach such a high monetary value of Tax Expenditures, the quantity of such must be even higher. "That tax expenditures today are running at roughly the same percentage of GDP and income tax revenues as in 1985 confirms that tax expenditures have multiplied in degree as well as in number."[143]

Kleinbard gives one reason, among others, for this growth which is identical to one proffered by this article – politics.

> Tax subsidies . . . permit a marvelous muddling of budget terminology: they increase government spending in economic terms but can be presented as "targeted tax cuts" . . . . Congress can pander to important constituencies that for the last three decades have agitated for lower taxes and smaller government, while giving US what we actually want – more discretionary spending and, implicitly, a larger government.
>
> What makes tax expenditures irresistible to a member of Congress from either political party is this ability to describe oneself as a tax cutter while actually spending money.[144]

Kleinbard explores a possible solution in another article, *Tax Expenditure Framework Legislation*.[145] Framework legislation is the equivalent to internal congressional rules of procedure which guides the legislature in developing substantive legislation.[146] This legislation

has the oddity of being passed by both houses of Congress and being signed into law by the President without actually being binding.[147] In accordance with the framework legislation adopted to limit future congressional ability to utilize tax expenditures, the Budget Act included a provision to allow Congress to address other appropriate matters to carry out the purpose of the act – to bring into the light the use and true nature of tax expenditures.[148] Proponents of tax expenditures had hoped this authority would be used to subject them to the same as explicit outlays.[149] The idea was that budget committees would review the tax expenditures before referral to the tax committees for implementation into the IRC. This is very similar to the idea proffered in this paper that the affected substantive congressional committees review the expenditures. This system ultimately failed. However, its failure was not due to any inherent reason, but rather politics. Then Chairman of the Senate Finance Committee Russell Long fervently fought this process and adamantly refused to cede any authority to the new Budget Committees.[150]

A second attempt was made in 1977 to revise the Senate rules to implement the suggestion of this paper.[151] Once again, though, Senator Long objected to the substantive committees reviewing tax expenditures.[152] The Senate Budget Committee soon conceded defeat to Senator Long and the Finance Committee by abandoning all efforts to use the budget process to direct and possibly constrain tax expenditures.[153] As a result, there is still virtually no coordination between tax expenditures and actions by the substantive authorization-appropriations committees in the same budget area.[154] This paper aims to correct this.

Kleinbard also suggests that the simplicity involved is a key factor for tax expenditure growth. He seems to be referencing tax expenditures' aspects of feasibility and practicality, discussed below. He even asserts that there are good reasons in particular applications to use tax

expenditures as a mechanism for delivering federal subsidies.[155] These include: taking advantage of the pre-existing reach of the IRC and the IRS, allowance for fine-tuning benefits to families, self-certification for qualification, broad participation, and relatively low administrative costs.[156]

Nevertheless, Kleinbard is not all pro-expenditure. One major problem Kleinbard sees with the current state of tax expenditures is the elevation of the tax committees to what he calls "a congress within a congress."[157]

> The discovery by the tax-writing committees that any spending program . . . can be recast as a tax subsidy means that the tax-writing committees now fill *both* fundamental functions of a legislature: they raise revenues . . . and they spend those revenues themselves, through the tax subsidies that they marry to the payfors in shaping "revenue neutral" legislation.[158]

The tax committees have found a way to increase spending on policies of their choosing through decreasing the transparency of those benefits to most observers, and decreasing the obviousness of the tax costs incurred as a result, consequently leading to fiscal illusion.[159] This is akin to Surrey's arguments regarding substantive committees.

Kleinbard argues that this results in unhealthy policy for three reasons: it leads to less coherent tax policies, it obfuscates the size and activities of the Government while reducing tax salience, and it distorts decision-making at every level of Congress.[160]

One solution to these problems that Kleinbard mentions is proffered by Professor George Yin.[161] Yin suggests the use of temporary legislation so as to force Congress to review and renew the legislation every-so-often.[162] However, Kleinbard counters, and rightfully so, that, given the method of renewing legislation, this is the equivalent of just making it permanent.[163] Rather, Kleinbard – along with this paper – argues that the answer is to fix the budget measurement process while simultaneously restructuring the route tax expenditures take.[164]

First, tax expenditures should be required to be placed on the fiscal budget along with direct discretionary spending to make it clear to all that this is money being spent by the

government.[165] This is aligned with Surrey's hope that the tax expenditure budgets would cause alarm and slow the growth of tax expenditures in his day. However, the separate stating of tax expenditures has not helped and hopefully the integrated statements will do more good. Moreover, with Kleinbard's proposed method of analysis, there would be no sting of defining a norm since there is no need to reference what the income tax is or should be.[166] While his concept still makes reference to an identifiable general rule of tax law, this benchmark is definable while a "norm" is not. Kleinbard simply looks to what the law is, with no aspirations of what it should be.

Second, as previously argued, tax expenditures should be made to travel through the respective substantive subcommittees in Congress.[167] This would remove the "congress within a congress" effect and allow the experts to determine what spending should be made in their areas.

B. Reversion to Original Analysis

Unfortunately Kleinbard's proposals did not take hold, and tax expenditure analysis has reverted to the same old debates. Tax expenditure analysis for a particular provision remains unutilized, sadly, and the debate over whether an item is a tax expenditure based on copious definitions rages on. Instead of debating whether a tax expenditure is a useful method if implementing a particular item, debates continue to focus on whether an item *is* a tax expenditure, or tend to spell out the evils of tax expenditure without addressing potential benefits.

C. Limited and Targeted Tax Benefits

There is a special subset of tax expenditures which are targeted to a limited group of beneficiaries, typically ten or fewer.[168] These limited benefit tax expenditures are commonly referred to as "limited tax benefits" or, more colloquially, "tax earmarks."[169] Typically these

limited beneficiaries are known by the proponents of the legislation, and the expenditures are perceived as political deals.[170]

Kleinbard analyzes these in light of framework legislation attempting to limit congressional use of limited benefits.[171] This paper concedes that tax expenditures should not be so used and applauds the attempts of Line Item Vetoes to remove them from proposed legislation. Unfortunately, this process was deemed unconstitutional by the Supreme Court.[172] Subsequently, the House and Senate each adopted framework legislation to limit the use of tax earmarks.[173] However, this legislation replaced the JCX as the nonpartisan agent for identifying and removing earmarks with the respective Chairmen of the Senate Finance and House Ways and Means Committees.[174] This did nothing more than subvert the individual wills of earmark proposing Senators to the individual wills of the Chairmen. As Kleinbard put it, "the result is the appointment of the foxes to guard henhouses."[175]

Congress should take the steps necessary to ensure that tax earmarks are not being used by congressman to assign benefits as reciprocal deal makers. This should be by once again having a non-partisan entity such as the JCX review the proposals for such before enactment. Since the line item vetoes by the executive branch were deemed unconstitutional, the JCX should be given the authority to veto line items. Perhaps this would stand the test of the Supreme Court.

VI. Tax Expenditures in Light of Overall Tax Policy Considerations: A Look at Surrey's Analysis through Sneed's Criteria

Professor Joseph Sneed addressed several common considerations in tax policy in his 1965 article *The Criteria of Federal Income Tax Policy*.[176] Sneed makes the point that tax policies should be evaluated around certain principles.[177] Mainly, Sneed proffers some guidelines in designing a tax system, including that the burden placed on taxpayers should be

sufficiently light and compatible to avoid distortion; however, the burden should not be eliminated.[178] Moreover, the use of taxes to encourage certain behavior requires both intelligence and restraint.[179] Finally, Sneed argues that the allocation of tax burdens should reflect social, political, ethical, and economic aspirations.[180]

In so arguing, Sneed offers seven macro-criteria which he suggests have shaped the rates and structure of our current tax system.[181] These criteria include: Adequacy, Practicality, Equity, Stability, Economic Equality, Free Market Compatibility, and Political Order.[182]
This paper uses these criteria in analyzing current tax policies by comparing the use of direct government spending in the form of subsidies to indirect government spending in the form of tax expenditures.[183] Although the criteria are examined independently, it is important to remember that a final conclusion cannot be reached until all criteria are coalesced. Nevertheless, these criteria are often competing, and one often dominates the other.[184]

A. Equity

i. Sneed's Concept of Equity

Sneed addresses equity by first mentioning its underpinnings: Equity involves the manner in which the burden of the tax is to be apportioned. It is a matter heavily colored by self-interest. While all agree that those who are equal in relevant aspects should bear equal burden . . . there is a difference of opinion about what aspects are relevant and whether equality does exist with respect to those aspects.[185]

Sneed settles on a definition of equity as the criterion asserting that "those are equal whose consumption and net accretion [under the Haig-Simons approach] are equal . . . . When equals, so defined, are not taxed equally, there is a departure from the standard."[186]

Sneed expounds on equity by explaining two different types: vertical and horizontal.[187] Both are judged by the standard of income.[188] Vertical equity is regarded as the appropriate manner in which unequals should be treated, that is the extent by which two taxpayers' incomes are different, while horizontal equity addresses the equal treatment of equals.[189]

Sneed then uses vertical equity to address the tax policy goal of reducing economic inequality. In addressing this, Sneed concludes that the criterion dictates not only progressive rates and exemptions which 'vanish' as adjusted gross income increases, but also elimination of structural advantages that principally benefit upper income classes and creation and preservation of those the impact of which is confined to the lower classes.[190]

Basically, Professor Sneed argues that the benefits for the poorest should be preserved and the benefits for the richest eliminated. Sneed finishes this discussion by emphasizing the reduction of inequality by saying that he is willing to "sacrifice some degree of Equity if advancement of some degree of Reduced Economic Inequality is desired."[191]

ii. Application to Tax Expenditures

By definition a tax expenditure is a preference; therefore, there is bound to be some inherent inequality since one taxpayer is receiving a benefit over another. However, the presence of this inequality would seem to depend on whether we are looking at horizontal or vertical equity. First, as to horizontal equity, any difference in the treatment of taxpayers who are similarly situated is a distortion of equity and is undesirable.

However, this is dependent on how "similarly situated" is defined. Under the typical definition, similarly situated taxpayers are those who have the same gross income on a strict numerical basis, regardless of its source. Thus, there may be two taxpayers both with gross incomes of $200,000. However, if one taxpayer receives his income from sources all of which

are ordinary and receives no deductions, he is treated differently than his counterpart who receives a preferential rate for dividends or capital gains. Similarly, both taxpayers would be taxed differently than one who would receive accelerated depreciation expenses under ACRS. Here, horizontal equity is incompatible with tax expenditures.

On the other hand, if "similarly situated" is defined as those taxpayers with not merely the same income, but rather income from similar sources, then taxpayers who are so similarly situated would receive similar tax treatment. As defined, horizontal equity is fully compatible with horizontal equity.

Second, in the realm of vertical equity, differently situated taxpayers are supposed to be treated differently. A tax expenditure may make little difference, so long as it is allowed on a broad base and not confined to the benefit of upper income earners. Thus, if a tax expenditure is designed to phase out at certain high levels of adjusted gross income, it would not be inconsistent with vertical equity.

iii. Application to Direct Expenditures

If there are no preferences and every taxpayer who is similarly situated is taxed exactly the same then there is no horizontal inequity whatsoever in the taxing system. However, it is uncertain whether direct spending would make a difference as to similarly situated taxpayers. The direct subsidies from the government would still be implemented to persuade certain behaviors as the tax expenditures do, the result of which is outside the scope of this paper. Nevertheless, in brief, if the receipts were taxed as income then it is foreseeable that the otherwise similarly situated taxpayers would have the same inequitable taxing as if tax expenditures were used. This results from the fact that to receive the subsidy, the taxpayer would have to show that he qualifies for it, just as he must with a tax expenditure. Thus, not

every taxpayer with the same amount of income as defined under the Haig-Simons approach would receive the subsidy, causing disparity.

As to vertical equity, direct subsidies would perhaps remove the inequity of upper income earners receiving more of a benefit since the subsidies would not be received on a basis in accordance with the taxpayers' marginal tax rate, as is the case with tax expenditures in the form of a deduction or exclusion. This would be the result regardless of taxability of the subsidy's receipt.[192]

iv. Which is Better

Horizontal equity may favor direct subsidies under the standard definition; however, this is not certain given the aforementioned arguments. Moreover, there seems to be little difference in the taxpayers' treatment regarding vertical equity. The similar results of both horizontal and vertical equity under either tax expenditures or direct subsidies perhaps erode some of the "self interest" and allow for a more objective view – that it does not really matter since the result is likely the same. Thus, overall, equity favors neither method. On the other hand, perhaps Professor Sneed realized this, and since neither method is preferred it is a purely subjective decision. Either way, the conclusion is that the results are likely the same regardless of the path taken.

B. Practicality

i. Sneed's Concept of Practicality

Practicality is one of the most important criteria, if not the most important overall. As Sneed suggests, practicality plays the role of keeping the other criteria in the realm of realistic possibilities. That is, practicality helps one evaluate whether a certain goal is feasible. As Sneed says, one outstanding feature of practicality is the restraint it imposes on zealous aspirations to

achieve near perfect conformity with other criteria.[193] Practicality checks us and suggests that IRC provisions, though not perfect, are at least workable solutions to a difficult problem.[194] This criterion therefore has many facets, including primarily politics and enforceability.

On the political side, practicality is viewed as political feasibility – the ability of a provision to take effect given the political atmosphere and political beliefs held by individuals and groups. Political movements often shift and tax policies move with them. In short, there are many political obstacles to implementation of certain tax policies. This is distinguishable from the political use of the tax system to implement certain policies, which goes more to the criterion of political order (see below) than practicality.

Regarding enforceability, Sneed comments that practicality encompasses three well-known maxims proffered by Adam Smith regarding taxation: (1) certainty, meaning that the time, manner, and amount of payment should be clear and known; (2) convenience, dealing with the time and manner of payment; and (3) economy in collection, pertaining to the ease of administrability.[195] Sneed further notes that "structural unity and simplicity of the tax, convenience and ease in assessment and collection . . . certainty of obligations imposed . . . [and] adequate powers in government to deal effectively with the recalcitrant and fraudulent" are important aspects of practicality."[196]

ii. Application to Tax Expenditures

In terms of political feasibility, tax expenditures are typically easy to incorporate into the tax system. Generally, people do not have a problem with paying fewer taxes. The issue arises, however, when those supporting a redistribution scheme feel that only lower income earners should reap the benefits of paying fewer taxes, that certain industries should or should not be favored, or that taxpayers in certain geographic locations are not worthy. While some may scoff

at the mere notion of a wealth redistribution scheme, it is widely accepted that such a scheme is often proffered as a legitimate goal of government as implemented via the personal income tax. Nevertheless, this is not a death sentence for tax expenditures. Instead, a tax expenditure can be designed to apply only to income earners under a certain income level. Alternatively, a tax expenditure could be designed to "phase out" at a prescribed level of income. Yet another alternative recently proffered by McMahon is to quantify the benefit and tax it as a receipt.[197] Any of these methods would allow the ease of implementing a tax expenditure without subjecting it to the criticisms that it only benefits those who need no benefit.

Regarding enforceability, tax expenditures are already enforced via the income tax return filed by the taxpayer and reviewed by the IRS. Thus, there is already a method in place and a body with the required expertise. One cannot legitimately argue that the IRS is not well suited to determine whether a taxpayer qualifies for certain deductions, credits or exemptions; rather such is the primary function of certain aspects of the IRS. Granted, many tax expenditures have very complex calculations and require the taxpayers to make these calculations currently. Similarly, there is a need for increased confidence and competence in the IRS which has very limited auditing functions. Therefore, taxpayers can play the "audit lottery" and render the current system ineffective, to at least some extent. However, there are bound to be such pervasive problems in any enforceability regime under a direct subsidy approach as well, and while the current system which is already utilized for tax expenditures is not perfect, it is at least arguably a good one.

iii. Application to Direct Expenditures

Direct expenditures are harder to justify politically. Given that the whole concept of a tax expenditure is that it is hidden government spending, and that the public prefers transparency in

government spending, it would seem that people would in fact prefer a direct expenditure. However, people are always willing to pay a lower tax liability, while people are not always willing to pay taxes only to have the government spend them in a certain way. Granted the entire concept of a tax expenditure is that it really makes no difference, and the government is spending money either way. Nevertheless, taxpayers are either not cognizant of this fact or simply do not understand the concept. Either way, the appearance of more tax and minimal increase in benefits, if any, to the particular taxpayer serve as difficult barriers for a direct subsidy program to overcome.

Moreover, direct expenditures have a much lengthier implementation process. In order for the government to actually collect and spend money, there must be a budgetary process. This process is excruciating and often leads to spending proposals having to compete for money. Thus, if a direct expenditure went through the budgetary process, it may not make it through to the other side, and no benefit would be bestowed, not even upon those who actually need it. While all tax bills require an accompanying revenue impact analysis, this is still simpler than the budgetary process of a direct expenditure. Tax laws, under PAYGO are simply required to be tax neutral. Tax Neutrality occurs when a proposal will not cause a greater deficit than exists. Thus, under a tax expenditure program where the amount of theoretical government spending is equal to the amount of theoretical collection, there is no change under PAYGO. However, under direct subsidies, it is harder to calculate the change because the money taken in is pooled together and then disbursed for many different uses.

As to enforceability, direct expenditures require a payout from the government which in turn creates oversight issues. Whenever government is doling out money, people see the opportunity for fraud. There are countless examples from disasters where the government was

paying people more than once for the same thing, or paying people who were not deserving. While the same can be said for tax expenditures, those are already enforced by the IRS through the income tax return. In contrast, there is neither a system nor a body in place with the expertise to enforce a direct subsidy.

iv. Which is Better

Tax expenditures better meet the criterion of practicality. First, tax expenditures are easier to put into place than a direct expenditure since they do not have to go through the budgetary process. One of the benefits of a tax expenditure is that people are only considered to have paid the government what they got out of it. That is, the government is considered to spend only what the taxpayers in fact did not give – the amount of the credit, deduction, exclusion or difference in rate structure.

On the other hand, with a direct expenditure, taxpayers are required to pay taxes, without credits or deductions or preferential rates, and the government uses the revenues therefrom as it sees fit. Thus, while in each case the government is paying the same people the same amount of money, with a direct expenditure there is a stigma of the government taking one taxpayer's money and using it to subsidize another taxpayer. With tax expenditures, the view can be taken that each taxpayer subsidizes himself only, since he knows the government spending is going directly to him (or in fact never leaving his wallet).

Tax expenditures are also easier to enforce. As mentioned, the IRS already checks a taxpayer's qualification for any claimed tax expenditures via the audit process. Since enforcement of direct subsidies would require something new, whether a new division or branch or whatever form of bureaucracy, it is less desirable than a system which utilizes what is already in place. Conceding that the audit process is not perfect, as evidenced by the "tax gap," there is

no assurance that the new system would be any better. Furthermore, I believe it makes more sense to spend the additional money and effort required of an additional system by bettering an existing one. One properly functioning system is better than any two mediocre systems.

C. Adequacy

i. Sneed's Concept of Adequacy

According to Sneed, the revenue from a tax system is adequate when it is sufficient to accomplish the purposes for which the revenue is raised.[198] However, when a government passing the tax has the power to print money, it could accomplish its revenue goals by printing more money.[199] This, though, would inevitably lead to inflation and is not a sustainable method of raising revenue.[200] Taxation, therefore, is used ultimately as a tool to curb inflation.[201] Thus, Sneed further argues that taxation is adequate when it maintains a stable price level.[202]
In analyzing a particular feature, adequacy refers to the aggregate revenue effect of that feature.[203] That is, if a provision results in significant loss of potential revenue, then adequacy is not well served and the provision is disfavored.[204] Conversely, adequacy supports a provision when significant additional revenue is expected to result.[205] When no significant alteration of revenue is expected, the provision is neutral as to adequacy.[206]

ii. Application to Tax Expenditures

It is undeniable that the current personal income tax system is inadequate in so much as it fails to raise enough revenue to compensate for the level of government spending. This is evident from the current federal budget deficit. Some might argue that granting preferences to people and allowing them to pay even less in taxes only further exacerbates the problem. However, this is looking at tax expenditures from the wrong view. A tax expenditure allows the government to subsidize a particular taxpayer indirectly by simply not collecting the amount

from him that would be paid to him. Therefore, while a tax expenditure does not result in increase revenue for the government, it also does not result in a loss of revenue.

iii. Application to Direct Expenditures

Direct expenditures should be viewed in the same manner. It is conceded that without preferences, the tax system would inevitably raise more revenue. However, this is only half the story, as there would also be a sharp increase in discretionary budgetary spending. Moreover, this is a more difficult result to ascertain since there is an actual collection and then a real distribution of funds. This means that the amount of the distribution is comingled with all other tax revenue making the determination more complex. First, the extra amount would have to be segregated, and then determined whether that amount was sufficient. However, this is really unnecessary since we can assume (ignoring behavioral consequences) that if the preferences were eliminated, then the government would simply be collecting the amount that it is presumed to collect and redistribute in a tax expenditure. Thus a direct subsidy program seems adequate, assuming no changes in taxpayer behavior.

iv. Which is Better

Tax Expenditures offer a simpler method of accomplishing adequacy. There is no need to determine gross receipts of tax revenue and then determine whether that is sufficient to cover the desired subsidy, as would be required with a direct expenditure. Nevertheless, as to which one raises sufficient revenue for the desired government subsidy, this criterion remains indeterminable.

D. Stability

i. Sneed's Concept of Stability

According to Sneed, Stability requires that the tax base is broad and the rate structure is flexible.[207] Breadth is necessary to assure a high degree of responsiveness of the base to economic changes, and flexibility to provide similar responsiveness of the rates. A broad base which varies in the same direction as income, together with a rather high average marginal rate, provide "built-in flexibility," while flexible rates make possible "formula for discretionary flexibility." This gives a means to quickly change the magnitude of disposable income, which in turn either increases the use of existing facilities or curbs inflation.[208]

ii. Application to Tax Expenditures

Tax expenditures narrow the base, and breadth assures responsiveness to economic changes; however, responses to economic changes can also be met with tax expenditures. Tax expenditures can even be made to sunset and/or allow for extensions to better cope with the possibility of change. However, Tax Expenditures tend to become entrenched. Thus, there needs to be a way to force a meaningful review of the tax expenditures. One method consistent with the theme of this paper would be to force the tax expenditures through either the budget committees or the relevant substantive committees periodically. Moreover, tax expenditures allow flexibility; a system allowing for deviations inherently allows for change and is therefore flexible.

iii. Application to Direct Expenditures

Direct spending broadens the base. The generally accepted concept of a direct subsidy system is one without deviations from an established norm of income and under such a system, the tax base would be broader than one where the system allowed for exceptions. However,

direct spending denies flexibility to some degree. The general disallowance of deviations from an established norm of income by its own terms precludes changes which would otherwise be available to meet new demands.

iv. Which is Better

This criterion seems relatively neutral. The allowance of change inherent on tax expenditures allow for flexibility in the rate structure, as does the breadth of a direct subsidy system accompanied by a high marginal rate.

E. Free-Market Compatibility

i. Sneed's Concept of Free Market Compatibility

It is generally conceded that the optimal allocation of resources occurs when the market is perfectly competitive, and that when this is so, the social cost of goods produced is equal to what society considers it worth by evidence of the market price.[209] Sneed argues that the intrusion of tax and government spending into this economic equilibrium destroys it.[210] Hence, no matter the form, a tax is always intrusive and erodes free marketability at least to some degree. From this standpoint, Sneed proffers that the goal of fiscal policy should be to make the presence of government as least intrusive as possible.[211] This policy, according to the article, is well known to economists as "avoidance of excess burden."[212] Under this concept, it is recognized that a tax is necessary, but that tax should be made as unobtrusive as possible.

A counterintuitive part of this principle is that a tax which reaches all items within the class subjected to the tax is less intrusive in the market than a tax which reaches only a portion of those items.[213] In accordance with this, items should be chosen for taxation which do not have a high rate of substitution.[214] The income tax is generally accepted as being in conformity with this idea, especially when income is given a broad definition.[215]

ii. Application to Tax Expenditures

Since the income tax is considered least intrusive when income includes all accretion of wealth, a system of incentivized deviations is inevitably more intrusive. However, tax expenditures could be used to restrict taxpayers to items with a low substitution rate, or they can be used to artificially create a low substitution rate. According to Sneed, this would actually lower the effect of the intrusion of the tax into the market. One aim of fiscal policy is "to make the presence o government as unobtrusive as possible so that the optimum allocation of resources may be approached as closely as possible."[216] The tax will be considered less intrusive to the overall system when imposed on an item with a low substitution rate because there is no untaxed alternative and the taxpayer is not induced to change his behavior.[217] Since taxpayer behavior is unaffected, the market is not really changed.[218]

Tax expenditures create distortions by influencing the allocation of resources. Nevertheless, some tax expenditures can improve economic efficiency if they correct a market externality. Market externalities cause a decline in society's overall welfare. Without mandate or regulation, the externality would not be reflected in the economic calculus of the parties causing the degradation. Thus, while not all tax expenditures perform this function (and direct subsidies could also do this), the point is that tax expenditures are not wholly inapposite of free market compatibility, and in some cases can be designed to actually help.

iii. Application to Direct Expenditures

If a comprehensive consumption approach is adopted, there would be far less distortion of a free market. The broader the base is, the less distortion of the market that results. Even an agreeable consumption tax making some concessions would inevitably cause some distortion. If

the income tax is maintained without tax expenditures, this would bring the tax closer to full compatibility with a free market, but would still be intrusive nonetheless.

iv. Which is Better

This criterion favors direct expenditures since they exhibit a tax system with little to no deviation and therefore a purer market. Nevertheless, tax expenditures are not wholly inapposite of a free market and may actually help reduce the effects of an otherwise intrusive tax.

F. Political Order

i. Sneed's Concept of Political Order

Sneed argues that political order best conveys "the idea that a tax should be measured against not only other criteria, but also against those standards, guidelines, and practices reflected in the political process."[219]

First, tax law is based in the constitutional power to tax, and such power should be employed consistently with the protection afforded an individual by the Constitution.[220] Furthermore, enactment and administration of the tax laws are confined to the corresponding branches of government by the Constitution.[221]

Furthermore, political order deals with the aspect of political policy or the political process. Sneed notes, "The dominant political forces frequently employ the tax structure . . . to satisfy their more immediate wants and aspirations."[222] As mentioned, this should be distinguished from political feasibility (discussed above) which deals with the practical ability to implement a tax provision in light of political opposition.

Both aspects of political order are important – the overall constitutional restraints and the political ideals of the moment. However, the political policies play a more crucial role in analysis. Sneed argues that "[c]onformity with political order exists when that portion of the tax

being examined promotes the order deemed best by the viewer."[223] This is inherently a personal judgment which is influenced by history and personal experience; neither truth nor error can be established.[224]

ii. Application to Tax Expenditures

Tax expenditures are constitutional; at least no one has ever seriously argued that they are not, and even if they were to so argue, the argument is likely to fail. Tax expenditures are revenue provisions which are passed in Congress under its constitutional ability to tax. Further, political policies shift often, and tax expenditures are easily manipulated to follow those changes. This ability makes tax expenditures favorable as opposed to true discretionary spending which must be reviewed in a grueling process, by the end of which political desires of the public may have changed.

iii. Application to Direct Expenditures

Direct spending is constitutional. This is a simple exercise of Congress's ability to tax and spend for both enumerated in the Constitution and implied therein under Article I, §8, Clauses 1 and 3. There can be no question here.

However, direct subsidies are less suited for the ever-changing political atmosphere. Political ideals often get in the way of government subsidies as some groups feel that other groups do not deserve the payment and vice versa. Republicans or conservatives in general have a general tendency to shy away from any direct government spending, while Democrats and other liberals are more likely to support a direct subsidy program; and with political ideals changing as rapidly as they do, the slow budgetary process is a poor method for achieving ever-changing goals.

iv. Which is Better

As to constitutionality, the criterion favors neither method. Moreover, Sneed says that political order is served when the tax examined promotes the ideals deemed best by the viewer. If the viewer is considered any one taxpayer, then this criterion is so subjective as to make it indeterminate. However, if the viewer is regarded as all taxpayers generally, then it becomes much more objective. Under the latter, the criterion remains neutral. Tax expenditures are better suited for political parties to meet their more immediate wants and aspirations. Still, when taxpayers as one whole group propose an ideal, it is typically reflected in a more direct form of spending since there is little opposition.

G. No Overall Preference for Either Method

Tax expenditures are favored by: Practicality. In contrast, direct expenditures are favored only by Free Market Compatibility. The remaining criteria of Equity, Adequacy, Stability, and Political Order are neutral. Thus, while tax expenditures are not clearly preferable as a method of tax policy, when viewed under the guidelines of Professor Sneed's tax policy criteria they do not cast the evil shadow that is typically perceived. The conclusion to draw from this is that tax expenditures may have their downfalls. However, so do direct expenditures. As such, tax expenditures are not inherently bad and should still be considered as a means to the end.

VII. The Value of a Dollar and Tax Cuts

A. Keynes and Surrey: The Argument for Direct Expenditures

In his article comparing tax expenditures to direct expenditures, Surrey states, "[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."[225] However, this is not really true.

Conventional economic models rely on the Keynesian view that government spending is better for jump-starting the economy than tax incentives. Reports traditionally stated that an extra dollar of government spending raises GDP by $1.57 while a dollar of tax cuts raises GDP by only 99¢.

B. Romer: The Argument for Tax Policy Stimuli

In a joint study, Christine Romer, Chairwoman of the President's Council of Economic Advisors, and her husband David Romer, professor at University of California, Berkley, compared the ability of direct subsidies to stimulate the economy to that of tax cuts.[226] While tax cuts are not tax expenditures, the study shows that tax policy can be designed to be beneficial.

The Romers discovered that tax policy has a powerful influence on economic activity. Historically, each dollar of tax cuts has raised GDP about $3 – three times as much as the Keynesian view suggests. Other recent work supports their view. Mountford and Uhlig report that deficit financed tax cuts work best among three scenarios to improve GDP. Alesina and Ardagna identified 91 episodes since 1970 where policy stimulated the economy. Furthermore, studies show that successful stimuli rely almost entirely on cuts in business and income taxes. Failed stimuli result mostly from increases in government spending. Lump sum rebates provide little impetus for spending or production. Moreover, a combination of increases in both taxes and spending has an even stronger tendency to fail. These studies are hard, if not impossible, to reconcile with both Keynesian theory and Surrey's statement, and point to tax policy as the best fiscal tool to combat recession – particularly tax changes that influence incentives to invest.

Tax cuts are traditionally thought of as decreases in the marginal (and/or effective) tax rates. These are distinguishable from tax expenditures which are incentivized deviations from the taxes imposed. Although tax expenditures are commonly referred to by many taxpayers and

policymakers, this is inherently wrong. Nonetheless, tax cuts are a powerful tool and must be considered. Moreover, the studies show that direct subsidies are not necessarily the best approach, and policymakers should keep an open mind to all possibilities. Similarly, policymakers should consider all methods of tax policy reform.

VIII. Conclusion: Tax Expenditures should be Considered for their Usefulness

Kleinbard and Surrey recognized the ease with which tax subsidies move through Congress. Although they both saw problems with the structure, Kleinbard conceded that there were times when a tax expenditure was more beneficial. Moreover, there is no inherent reason why tax expenditures could not weave their way through the respective substantive committees of Congress. The substantive committees could review the proposals and make recommendations to the tax committees who could then implement the provisions into the IRC. This would be the best of both worlds and is a process envisioned by both Kleinbard and Surrey. Generally, tax expenditures are viewed as part of the problem, since they result in less revenue being collected. However, I propose that this is the wrong light in which to view tax expenditures. While tax expenditures are by definition government spending, it is within this definition I believe lays the answer. Tax expenditures are defined as indirect government spending in as much as the government can be considered as having collected a specific amount from a taxpayer and then paid it back. Thus, the amount of hypothetical government spending in a tax expenditure is exactly equal to the amount of hypothetical government collection. There is inherently no gap – no deficit.

If tax expenditures can be formulated to exclude the inherent inequalities which make them so disfavored as a form of government spending then there is no reason they cannot be used

more prevalently as such. The idea of "vanishing deductions," as Sneed called them, could solve the problems of inequity in the "upside down subsidies."

Moreover, as previously argued, tax expenditures are more politically feasible, further alleviating the problems suggested by the authors of the Tax Policy Center's article. Finally, there is no substitution problem since tax expenditures can be implemented in the same manner as direct expenditures. This is not to say that the current tax expenditure policy and method is a cure-all. As Sneed recognized, the use of a taxing system to incentivize taxpayer behavior is a useful tool, but one which should be used with restraint. Nevertheless, Andrews recognized that if something is not income, then a deduction is the proper way to remove it from taxation. Still, Surrey was correct that tax expenditures should be removed from the shadows of the congressional halls. The fact is that tax expenditures, however analyzed, are forms of congressional spending, and as such, they should be subject to review as any other form of discretionary spending. Taxpayer education is the key.

Although tax expenditures are by definition a form of spending, the public does not view them as such. The general belief is that tax expenditures can be made analogous to a tax cut, despite how inaccurate this is. In fact, a publication recently promulgated by the Democratic Party hails many "tax cuts" implemented by its policies[227]. Most people, regardless of political views, would look at these "tax cuts" as beneficial and an overall "good thing." However, these "cuts" are nothing more than spending and fall squarely within the definition of a tax expenditure. Yet, the general public is not likely to fight the politicians in their implementation as they would as if these "incentives" were made via direct subsidies. While it may simply be a matter of verbiage, it is primarily this political feasibility aspect of practicality that makes tax

expenditures more preferable to politicians as a means of spending. This goes to show why the public must be educated as to the fact that tax expenditures are actually a form of spending.

These "back-door" subsidies can be a better method of spending than the direct political process mainly because of their shorter and simpler process. However, this paper argues that the hidden aspect should be removed and that tax expenditures should be utilized only in the open and not to slip in hidden expenditures. The expediency and convenience of tax expenditures, however, should not be wasted. This method of spending has its uses. The overall argument is that taxpayers should be made aware of the spending aspects, but that tax expenditures should not be shunned just because they are spending.

A good blending of the experts' points of view is, first, to have the tax expenditures as defined by Kleinbard published in a budget as Surrey advocated and implemented. This is done already, to some extent, so we are partially there. But the budget should be reviewed in the same manner as discretionary spending, or perhaps even be combined with the discretionary budget. This should be furthered by highly publicizing the budget and educating the public on how tax expenditures work and the overall concept that they are in fact a form of government spending. Secondly, as Kleinbard explores, the expenditures should be subject to review by substantive congressional committees in the public eye. Newly proposed tax expenditures should be reviewed before referral to the tax committees for implementation, and existing tax expenditures should be subject to periodic review. Any recommended changes should be made by these committees before referral. The tax committees' job would be limited to implementing the expenditures into the IRC and ensuring they coalesce with ease.

This would help ensure that poorly designed tax expenditures were either eliminated or re-thought. This would also avoid the problem of "herding" in renewals of temporary

legislation. By using this blended method, tax expenditures can serve their valid and beneficial purpose while not being a form of *runaway* spending. While this procedure has been attempted before, it is hoped that the ugly side of politics will not inhibit this useful, analytical process.

Additionally, the Romer study indicates that tax policies better stimulate the economy than government subsidies threefold. This is by no doubt a desirable result, especially given the current and projected future size of the federal budget deficit. While this study focuses on tax cuts and not tax expenditures, it does show the benefits of utilizing tax policy as opposed to direct subsidies. Further research regarding tax expenditures specifically as a means of economic stimulus is needed and welcomed.

Finally, other studies have concluded that increased rates will be ineffective in narrowing the federal deficit. The overall point is that tax expenditures, at this point, should not be dismissed summarily as they often seem to be. Tax expenditure analysis should be an important tool for policymakers to use in sorting out priorities and in understanding both the economic consequences and the tax policy alternatives relevant to their ideas.[228]

IX. Endnotes

i Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*. 83 Harv. L. Rev 705 (1970)
[1] Staff of Joint Committee on Taxation, *A Reconsideration of Tax Expenditure Analysis*, JCX-37-08, 2 (2008) [hereinafter *JCX*] (Kleinbard).
[2] Id.
[3] Andrews, *A Source of Inspiration* 98 Harv. L. Rev. 332, 332 (1984-1985) [hereinafter *Inspiration*] (gives a good history of Surrey. located on Hein Online.)
[4] Id.
[5] Id.
[6] Id.
[7] JCX, *supra* note 1, at 2.
[8] Id.
[9] Id.
[10] Id at 3.
[11] Id; Congressional Budget Act of 1974, Pub. L. 93-344.
[12] JCX *supra* note i, at 3.
[13] Id.
[14] Id at 22.
[15] Id.
[16] Id.
[17] Id at 25.
[18] Id.
[19] Surrey, *supra* note i, at 705.
[20] Id at 712.
[21] Id at 712,713.
[22] Id at 709 (citing Henry Aaron , *Inventory of Existing Tax Incentives: Federal*, Tax Institute of America, Symposium on Tax Incentives (1969)).
[23] Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 Harv. L. Rev. 925, 926 (1967).
[24] Id.
[25] Id.
[26] Surrey, *supra* note i, at 707 (quoting the fiscal 1968 report to Secretary of the Treasury).
[27] IRC 61(a).
[28] Bittker, *supra* note 24, at 932.
[29] Id.
[30] Id.
[31] Id.
[32] William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 Harv. L. Rev. 309, 318 (1972) [hereinafter *Deductions*].
[33] Id at 312.
[34] Id.
[35] Id.
[36] Id.
[37] Id at 313.
[38] Id at 317.
[39] Id at 318.
[40] Id at 323.
[41] Id.
[42] Id at 324.
[43] Surrey, *supra* note i, at 716.
[44] Id.
[45] Id.

[46] Id..
[47] Id.
[48] Id.
[49] Id.
[50] Id at 717.
[51] Id.
[52] Id.
[53] Id.
[54] Id at 718.
[55] Id.
[56] Id.
[57] Id.
[58] Id.
[59] Id at 719.
[60] Id at 732.
[6161] Id.
[62] Id.
[63] Id.
[64]Democratic Policy Committee *available at* **http://dpc.senate.gov/dpcpress.cfm?doc_name=fs-111-2-166** (posted on taxprof.typepad.com). This comment is not meant to express any political views (positive, negative, or otherwise) of the author regarding the Democratic Party. This paper is intended to be party-neutral. The example is meant to reflect the political process as a whole and is not meant to be illustrative of any particular group.
[65] Id.
[66] Surrey, *supra* note i, at 719.
[67] Id.
[68] Id.
[69]Id at 720.
[70] Id.
[71] Id.
[72] Id at 721.
[73] Id at 720 (emphasis in original).
[74] Id.
[75]Id at 723.
[76] Id. Interestingly, Surrey goes on to note that this technique may be difficult and rarely feasible given its novelty. He also notes his perceived difficulty in convincing the business community of this approach. Nevertheless, this method has been implemented areas such as the Earned Income Tax Credit, and the Child Tax Credit and recently the American Opportunity Credit.
[77] Surrey, *supra* note i, at 725.
[78] Id.
[79] Id.
[80] Id.
[81] Id.
[82] Id at 725-726.
[83] Id at 728.
[84] Id.
[85] Id at 729.
[86] Id.
[87] Id at 731.
[88] Id.
[89] Id at 732.
[90] Bittker, *supra* note 23, at 983.
[91] Id at 984.
[92] Id.
[93] Id.
[94] Surrey, *supra* note i, at 720.

[95] Id.
[96] Id at 716.
[97] Id at 723.
[98] Id.
[99] Congressional Budget Office, *Historical Effective Tax Rates: 1979 to 2006*, (2009). Earlier publications on the same topic were published by the CBO and are available at http://www.cbo.gov/publications/collections/taxdistribution.cfm.
[100] Please See Exhibits 1 and 2, attached. Data comprised from http://www.**tax**foundation.org/publications/show/151.html and http://www.cbo.gov/publications/collections/collections.cfm?collect=13
[101] There may be other causes to explain the differences, but these are ignored to show the role that the preferential rates for capital gains play as tax expenditures.
[102] Center on Budget and Policy Priorities, *Policy Basics: Where Do Our Tax Dollars Go?* (2010).
[103] Id.
[104] Id; Gross Domestic Product (GDP) is the amount of final goods and services produced in a year, in a country measure by the market value of those goods and services.
[105] Id.
[106] TPC website, about US tab *available at* http://www.taxpolicycenter.org/aboutus/index.cfm.
[107] Id.
[108] Id, Mission Stmt *available at* http://www.taxpolicycenter.org/aboutus/mission.cfm.
[109] Altshuler, et al, Tax Policy Center, *Desperately Seeking Revenue*, Abstract (2010) [hereinafter *TPC*].
[110] Id at 2.
[111] Id at 4.
[112] Id at 3.
[113] Id.
[114] Id.
[115] Id at 4.
[116] Id at 5.
[117] Id.
[118] Id.
[119] Id.
[120] Id.
[121] Id.
[122] Id.
[123] Id.
[124] Id.
[125] Id. Note that there would not be a budgetary surplus, but rather more than enough revenue would be raised for the 2% GDP goal.
[126] Id.
[127] Id at 6.
[128] Id.
[129] Id.
[130] Id at Abstract.
[131] Id at 4.
[132] Id at 6.
[133] Id.
[134] Edward D. Kleinbard, *The Congress within the Congress: How Tax Expenditures Distort our Budget and Our Political Processes*, 36 Ohio N. U. L. Rev. 1, 4 (2010) [hereinafter *The Congress within a Congress*].
[135] Id at 3 (emphasis in original).
[136] Id at 19.
[137] Id at 14.
[138] Id at 15.
[139] Id.
[140] Id.
[141] Id.

[142] Id.
[143] Id.
[144] Id at 18.
[145] Edward D. Kleinbard, *Tax Expenditure Framework Legislation* (2010) [hereinafter *Framework Legislation*] (*available at* http://ssrn.com/abstract=1531945).
[146] Id at 5.
[147] Id at 6.
[148] Id at 10.
[149] Id.
[150] Id.
[151] Id.
[152] Id.
[153] Id.
[154] Id at 11(citing McDaniel, 1989, 178.)
[155] The Congress within the Congress, *supra* note 135, at 15.
[156] Id at 16-17.
[157] Id at 18.
[158] Id at 18-19 (emphasis in original).
[159] Id at 19.
[160] Id at 20.
[161] Id at 22 (citing George K. Yin, *Temporary-Effect Legislation, Political Accountability, and Fiscal Restraint*, 84 N.Y.U. L. Rev. 174 (2009)).
[162] Id.
[163] Id at 24.
[164] Id at 27.
[165] Id at 28.
[166] Id.
[167] Id.
[168] Framework Legislation, *supra* note 146, at 12.
[169] Id.
[170] Id.
[171] Id.
[172] Id.
[173] Id at 13.
[174] Id.
[175] Id.
[176] Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 Stan. L. Rev. 567 (1965).
[177] Id.
[178]Id.
[179] Id.
[180] Id.
[181] Id. Professor Sneed's article also addresses the impact of innumerable micro-criteria. However, these are not addressed in this paper as they vary widely and are based on the ends sought to be accomplished.
[182] Id.
[183] While all of Professor Sneed's criteria are addressed, not all are done separately. Some criteria have been combined. Also, in some instances, different names are given to the criterion, which I felt better conveyed their meaning.
[184] Id at 572.
[185] Id at 574.
[186] Id at 579.
[187] Id at 577.
[188] Id.
[189] Id at 577, 581.
[190] Id at 584-585.
[191] Id at 586.

[192] If the subsidy is taxed upon receipt, the higher income earner's higher bracket would cause a lower net receipt. Conversely, the lower income earner's bracket would cause a respectively higher net receipt. On the other hand, if the receipts are not taxed, then there is no difference in the taxpayers' treatments of the subsidies.
[193] Id at 573
[194] Id at 574
[195] Id at 572.
[196] Id, at 573.
[197] Martin J. McMahon, *Taxing Tax Expenditures?* (2011) (University of Florida Levin College of Law Research Paper No. 2011-03) (*available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1710267).
[198] Sneed, *supra* note 177, at 570.
[199] Id.
[200] Id.
[201] Id.
[202] Id.
[203] Id at 571.
[204] Id.
[205] Id.
[206] Id.
[207] Id at 592.
[208] Id.
[209] Id at 586-587.
[210] Id at 587.
[211] Id.
[212] Id.
[213] Id at 587-588.
[214] Id at 588.
[215] Id.
[216] Id at 587.
[217] Id at 588.
[218] Id.
[219] Id at 594.
[220] Id.
[221] Id.
[222] Id at 596.
[223] Id at 597.
[224] Id.
[225] Surrey, *supra* note i, at 717.
[226] Gregory Mankiw, The New York Times, *Tax Cuts Might Accomplish What Spending Hasn't* (12/13/2009).
[227] Democratic Policy Center, *supra* note 65.
[228] The Congress within the Congress, *supra* note 135, at 3.