ARTICLES

Tax Expenditures, Reform, and Distributive Justice

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Abstract

Tax reform is coming, and it will be an important part of any plan to avert national fiscal disaster. The President's Fiscal Commission recently presented a proposal for comprehensive tax reform that will form the basis for serious legislative discussion. At the center of that proposal is elimination of "tax expenditures," which are provisions in the tax law that operate like direct government spending. They include the charitable deduction, the home mortgage interest deduction, the exclusion for employer-provided health insurance, the child credit, the earned income credit, education credits and deductions, the tax preference for retirement savings accounts like IRAs and 401(k) plans, and dozens of others.

This article argues that elimination of tax expenditures is a flawed approach to tax reform. Tax expenditures are not an undifferentiated mass, but reflect a wide variety of federal policies, each of which requires independent evaluation. Before policymakers can decide whether to abolish tax expenditures, they need to know a lot more than the tax expenditure budgets currently reveal about what tax expenditures do, who benefits from them, and how much revenue could be raised by their repeal. They also need to decisively identify which provisions are tax expenditures, a perennial source of disagreement. This article argues that proposals to repeal tax expenditures reflect a normative preference for efficiency over equity, the traditional twin goals of tax policy, squandering the tax law's unique role in economic justice.

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I. INTRODUCTION

A ballooning federal deficit and growing populist hostility to taxation has lawmakers talking seriously about tax reform. Today's Internal Revenue Code[1] is dizzyingly complex, unfair, and impedes economic prosperity. It also fails to raise sufficient revenue to avert fiscal disaster.[2] Serious proposals for tax reform are on the table, and they share a simple, fundamental approach to reshaping the law: strip the Code of the myriad special deductions, credits and exclusions that allow individuals and corporations to reduce their tax liability. Without these preferences for particular types of income or expenditure, taxable income and tax payments would be higher for many taxpayers. These provisions, known as "tax expenditures,"[3] include many provisions that taxpayers have become accustomed to taking for granted. They include the charitable contribution deduction, the home mortgage interest deduction, the exclusion for employer-provided health insurance, the child credit, the earned income credit, education credits and deductions, and the tax preference for retirement savings accounts like IRAs and 401(k) plans.[4]

They are called "tax expenditures" because they achieve the same objectives as direct federal spending, but they are administered through the tax law. They are unlike "real" tax provisions that are necessary to accurately measure taxpayer income; without them, the tax law could still carry out its revenue collection function. Only the mechanism for administration distinguishes tax expenditures from direct expenditures — instead of the government allocating funds for particular programs, tax expenditures allow taxpayers to reduce their tax payments by participating in various activities.

Tax expenditure provisions were adopted to incentivize particular activities or to reduce the burden on certain individuals, families or businesses. For example, the home mortgage interest deduction was added to the Code in order to encourage homeownership. It operates as a federal subsidy for home mortgages because the deduction reduces the tax liability of mortgage holders. On account of the deduction, an individual's mortgage interest burden is reduced by an amount equal to the mortgage holder's interest payment multiplied by his marginal rate of tax.[5]

In total, the government estimates that tax expenditures are responsible for over one trillion dollars of revenue loss each year.[6] To help put that number in perspective, it

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[1] I.R.C. (West Supp. 2010).

[2] CONGRESSIONAL BUDGET OFFICE, PUB. NO. 4212, REDUCING THE DEFICIT: SPENDING AND REVENUE OPTIONS 1 (2011).

[3] *See* Congressional Budget Act of 1974, Pub. L. No. 93-344, § 3, 88 Stat. 297, 299. This act mandated the preparation of a tax expenditure budget and defined tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."

[4] The list of tax expenditures also includes numerous tax preferences for businesses, such as capital expensing, research credits, and deferral of certain types of income. This article is primarily concerned with the effects of tax expenditures on individuals.

[5] To illustrate, consider a taxpayer with an annual mortgage interest payment of $20,000. If his marginal rate of tax is 35%, the deduction saves him $7,000 in tax. If the government sent him a check for $7,000 and increased his tax liability by $7,000, he would be in the same economic position as he is with the deduction. A 20% marginal rate taxpayer would save only $4,000, but the analysis would remain the same.

[6] THOMAS HUNGERFORD, CONG. RESEARCH SERV., RL34622, TAX EXPENDITURES AND THE FEDERAL BUDGET 13 (May 26, 2010) ("In 2009, it was estimated that tax expenditures amounted to about $1

exceeds the total amount that the federal government spends through direct discretionary appropriations.[7] Tax expenditures not only operate to reduce tax liabilities of taxpayers, they sometimes entitle individuals to transfer payments through the tax administrative apparatus.[8] Because they are the equivalent of direct spending programs, reductions in tax due to tax expenditures increase the size of government.[9] They are essentially public programs that are managed by the Internal Revenue Service. This is in contrast with reductions in tax rates, which shrink the extent of government involvement in the private sector.

Tax reform has become virtually synonymous with simplification, understood as (1) broadening the tax base by repealing tax expenditures, and (2) lowering the statutory rates. Because they are better conceptualized as spending than taxing, reformers treat tax expenditures as extraneous to the fundamental purposes of the tax law: accurately measuring income and collecting revenue. Two important proposals reflecting this fundamental idea have been released in the last few months, and they will lay the framework for future discussions of tax reform in Congress.[10] The President's Fiscal Commission, led by Erskine Bowles and Alan Simpson,[11] embraced the approach most enthusiastically: it proposed drastic reductions in the statutory rates and repeal of all tax expenditures in the Code.[12] In fact, the Fiscal Commission's proposed simplification was so sweeping that it did not identify the numerous individual tax expenditure provisions to be repealed, but instead erased them all with a single stroke. It named the proposal the "zero plan,"[13] and its main tax reform objective was elimination of all tax expenditures. Similarly, the Bipartisan Policy Center's Debt Reduction Task Force, led by Pete Domenici and Alice Rivlin, followed the same basic approach of lowering rates and repealing tax expenditures.[14] Although it does not propose to lower rates as much as the Fiscal Commission's proposal, according to the Bipartisan Policy Center's plan, cutting tax expenditures will finance 38% of the plan's debt reduction by 2020.[15]

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trillion…."); *see* STAFF OF JOINT COMM. ON TAX'N, 111TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2009-2013 (Joint Comm. Print 2010).

[7] *See* OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, FISCAL YEAR 2012: HISTORICAL TABLES 167 tbl.8.7, 346 tbl.15.4 (2010).

[8] Approximately 40% of filers paid no income tax in 2009. The "refundable" credits authorize the government to send them checks through the tax system. *See* Roberton Williams, *Who Pays No Income Tax*, 123 TAX NOTES 1583, 1583 (2009).

[9] Donald Marron & Eric Toder, Measuring Leviathan: How Big is the Federal Government?, Presentation at Loyola Law School: Starving the Hidden Beast: New Approaches to Tax Expenditure Reform (Jan. 14, 2011), http://events.lls.edu/taxpolicy/documents/PANEL2MarronToderSizeofGovernment-presentationFinal01-06-11.pdf (analyzing the role of tax expenditures in measuring the size of government).

[10] *See infra* Part II.B for an analysis of these two plans in greater detail.

[11] It was bipartisan in that the members are associated with both Republicans and Democrats.

[12] NAT'L COMM'N ON FISCAL RESP. & REFORM, THE MOMENT OF TRUTH 29 (2010). The proposal does contemplate the possibility of retaining the earned income tax credit, a child credit, and some tax preferences for mortgage interest, health insurance, charitable giving and retirement savings. *See id.* at 30.

[13] *Id.* at 29.

[14] BIPARTISAN POL'Y CTR., RESTORING AMERICA'S FUTURE 31 (2010). The recommendation differed importantly in proposing a value-added tax to supplement the much simplified income tax in the proposal.

[15] *See id.* at 15. Nine percent of debt reduction is projected to come from new revenues, and 54% from spending cuts. Of course, if tax expenditures are treated as government spending, 92% of the total projected debt reduction comes from spending cuts.

The Tax Reform Act of 1986,[16] which followed the recommendations of the Treasury Department's comprehensive study,[17] exemplified this base-broadening conception of tax reform. Nevertheless, in the 1986 round of reform, the middle class's most beloved tax expenditures, such as the charitable deduction and the home mortgage interest deduction, were never seriously on the cutting block. Today's attack on tax expenditures is more radical than 1986's because tax reform must achieve more today than it did in 1986, when the sole goal of tax reform was improvement in the tax law. Tax reform was purposely separated from deficit reduction—the parameters for the 1986 legislation included a requirement that the new law raise the same amount of revenue as the prior law. To the contrary, tax reform today is inextricably linked to deficit reduction, so overhauling the tax system is only partially about improving the efficiency and fairness of the tax law, and more prominently about addressing the country's long-term fiscal challenges by increasing total revenue and reducing total expenditures.

There are only two ways to increase revenue within the constraints of the current tax system's design: broaden the base by including more in the determination of what is taxed, or increase rates.[18] The tax base and the tax rates are the only moving parts in the system that we have. The 1986 tax reform was devoted entirely to reducing rates, slashing them almost by half.[19] The current combination tax reform/deficit reduction proposals *reduce* rates, rather than increase them to raise revenue. Consequently, the reform proposals need to offer a drastic expansion of the tax base as a way to finance both increased revenue demands and a rate reduction. Compared to current law, repealing all tax expenditures enormously expands the universe of what gets taxed. Without tax expenditures, there are no tax-free fringe benefits,[20] no tax deferral for retirement savings,[21] no child credits,[22] no capital-investment expensing,[23] and no preferential rates for capital gains and dividends.[24] All of these provisions, and many dozens of others, are included in the list of tax expenditures compiled by the Joint Committee on Taxation.[25]

Other more radical proposals for tax reform discussed since 1986 have recommended a much broader tax base accompanied by historically low rates,[26] including

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[16] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

[17] OFFICE OF THE SECRETARY DEPARTMENT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH, at xi (1984). There have been other excellent tax reform reports over the years. *See, e.g.*, PRESIDENT GEORGE W. BUSH'S 2005 ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM (2005) (proposing significant simplification of the tax system, and consequently, reduction of tax expenditures, but not to the extent of the current proposals).

[18] Beyond the constraints of the current system's design is the introduction of new taxes, such as a national retail sales tax or value-added tax. This is what the Bipartisan Policy Center has suggested. *See* BIPARTISAN POL'Y CTR., *supra* note 14, at 30.

[19] The highest individual statutory rate immediately after that reform was 28%, although actual marginal rates were as high as 33% for some taxpayers. Prior to the reform, the highest statutory rate was 50%. The highest rate today is 35%.

[20] *See* I.R.C. § 132 (West Supp. 2010).

[21] *See* I.R.C. § 401 (West Supp. 2010).

[22] *See* I.R.C. § 24 (West Supp. 2010).

[23] *See* I.R.C. § 179 (West Supp. 2010).

[24] *See* I.R.C. § 1(h) (2006).

[25] *See* STAFF OF JOINT COMM. ON TAX'N, 111TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2009-2013, at 8-9 (Joint Comm. Print 2010).

[26] Compared to a generation ago, rates are historically low now. When Congress mandated a tax expenditure budget in 1974, the highest marginal rate was 70%. Marginal rates have been as high as 92%.

replacing the current system with some form of a consumption tax,[27] but they have never been enacted. Tax returns filed on a postcard have intrigued the public imagination, and would leave no physical space for special deductions or credits. Repealing tax expenditures is not the unique agenda of either the political left or right; rather, there is a call for a simpler tax system across the political spectrum. Thus, a consensus seems to be developing that tax expenditures are the stumbling block preventing sensible taxation and are responsible for uncontrollable government spending.[28]

A broad effort to rein in tax expenditures is undoubtedly a good idea. Nevertheless, this article advocates moderation, and argues that those who support a "zero plan" for tax reform have too simplistic an understanding of tax expenditures, and too naïve an approach to tax reform.[29] First, the conception of reform that eliminates tax expenditures erroneously treats them as an undifferentiated mass, and ignores the important role that some of them play in federal policy. Not all tax expenditures are giveaways to rent-seeking special interests and bad federal policy. Congress must pay as much attention to the purposes and effectiveness of individual tax expenditures, and evaluate them on a program-by-program basis, as they do in making decisions about whether to discontinue direct spending programs. Some tax expenditures may be worth their costs, if they achieve important policy goals. As part of that critique, this article argues that we know precious little about what tax expenditures do and how they affect individuals. The data that the government provides about tax expenditures sheds too little light on the issues that are important in deciding whether they are desirable elements of the law. Today's tax reform debate needs a new kind of tax expenditure budget[30] that would better inform policymakers about the nature of the benefits that individuals obtain from tax expenditures, who really enjoys benefits, and who would bear the economic loss that would follow their repeal.

Second, in this round of reform, revenue is central. To that end, this article challenges the assumption implicit in the tax expenditure budgets about how much revenue would be raised if all tax expenditures were eliminated. The revenue loss data that the government compiles do not sufficiently acknowledge that taxpayers would change their behavior to avoid paying tax, frustrating revenue-raising efforts after tax expenditure repeal.

Third, any legislative effort that relies on the distinction between tax expenditures and structural provisions in the law is bound to get lost in the morass over the definition of a tax expenditure. Ever since the term "tax expenditure" was coined,

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See Federal Individual Income Tax Rates History: Income Years 1913-2010, TAX FOUNDATION (Dec. 22, 2010), http://www.taxfoundation.org/files/fed_individual_rate_history-june2010.pdf.

[27] *See, e.g.*, ROBERT HALL & ALVIN RABUSHKA, THE FLAT TAX, at xiv (2nd ed. 1995); NEAL BOORTZ & JOHN LINDER, THE FAIRTAX BOOK 70-71 (2005). *See also* PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, *supra* note 17, at xiv.

[28] *See* NAT'L COMM'N ON FISCAL RESP. & REFORM, *supra* note 12, at 28.

[29] Entitlement spending, particularly health-care spending, is more important to the long-term fiscal challenge than are tax expenditures. The Fiscal Commission acknowledged this in its report: "Federal health care spending represents our single largest fiscal challenge over the long-run. As the baby boomers retire and overall health care costs continue to grow faster than the economy, federal health spending threatens to balloon. Under its extended-baseline scenario, CBO projects that federal health care spending for Medicare, Medicaid, the Children's Health Insurance Program (CHIP), and the health insurance exchange subsidies will grow from nearly 6 percent of GDP in 2010 to about 10 percent in 2035, and continue to grow thereafter." *See id.* at 36.

[30] The tax expenditure budgets compiled currently provide revenue loss information for a list of tax expenditures and very limited other data. *See infra* Section II.C.

there has been disagreement about which provisions count as tax expenditures.[31] The two government compilers of tax expenditure budgets, the Joint Committee on Taxation and the Treasury Department, disagree about the provisions to include in the list. Any version of tax reform that relies on this distinction places more pressure on the definition than it can bear. The tax expenditure budget was not designed to be the final arbiter of desirable law; it was meant to be an informational tool for Congress, the President, and other interested observers. It is a mistake to make it the critical source for tax reform because as an informational tool, it lacks a normative foundation.

Finally, this article questions the unstated normative position of the tax reform proposals. While the proposals acknowledge the need for revenue and the desirability of improving efficiency and economic growth, the tax law's role in promoting equity is largely ignored. This is an unfortunate oversight because taxation is uniquely suited to promote economic justice. Particularly where other aspects of the law aim for efficiency, the tax law's role in fostering a fair distribution of wealth and income is particularly important. Policymakers may need to balance efficiency losses against equity gains, and tax expenditures that promote equity may be worth retaining despite the costs in revenue and economic distortion.

The article proceeds as follows. The next section, Part II, provides background that explains the relevant history of tax expenditure analysis and the recent proposals for reform that rely so heavily on repealing tax expenditures. Part III critiques the tax reform proposals in particular, and the status quo concerning tax expenditures more generally. The serious problems that have long been present in the tax expenditure budget are illuminated by the tax reform debate, but the critiques developed here about the dearth of information concerning tax expenditures transcend that debate. If we are to continue compiling tax expenditure budgets, we need to start collecting a lot more data about who benefits from tax expenditures and whether they are effective in achieving their purposes. Part IV explains why the tax expenditure budget lacks the vigor to support tax reform, and Part V explores whether efficiency has overshadowed equity in the debate about tax expenditures and reform. The article concludes with a return to the basic principles of tax expenditure analysis, and considers how policymakers might use those principles in the tax reform process.

II. HOW TAX EXPENDITURES BECAME THE PROBLEM

A. Tax Expenditures and Reform Were Always Linked, but Now We Really Need the Money

Tax expenditures, such as the charitable deduction and the exclusion for employee fringe benefits, have been part of the income tax since its earliest days, but they were not identified as such until 1967 when then-Assistant Secretary of the Treasury for Tax Policy, Stanley Surrey, introduced the term in a speech.[32] Over the course of the next few years, Surrey developed the idea in a series of articles and a book, which he

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[31] *See, e.g.*, Douglas A. Kahn, *Accelerated Depreciation – Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 MICH. L. REV. 1, 12 (1979) (accelerated depreciation); Renee Judith Sobel, *U.S. Taxation of Its Citizens Abroad*, 38 VAND. L. REV. 101, 102-103 (1985) (special treatment of foreign earned income); Edward A. Zelinsky, *Tax Policy v. Revenue Policy: Qualified Plans, Tax Expenditures and the Flat, Plan Level Tax*, 13 VA. TAX REV. 591, 592-593 (1994) (pension taxation); Douglas A. Kahn & Jeffrey S. Lehman, *Tax Expenditure Budgets: A Critical View*, 54 TAX NOTES 1661, 1663-4 (1992) (lower rates in a progressive system, and deductions for blind and elderly).

[32] *See* STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES, at vii (1973).

called *Pathways to Tax Reform*, linking tax expenditures and tax reform together in the minds of all observers from the beginning. Surrey's purpose was to reveal provisions of the tax law as expenditures rather than taxes, so that Congressional analysis of expenditure policy would also include these tax provisions. In order to enable lawmakers to consider tax expenditures along with direct expenditures, a list of provisions that qualified as tax expenditures needed to be compiled, and in 1968, Surrey's Treasury Department created the first tax expenditure budget. A few years later, Congress mandated that tax expenditure budgets be prepared along with the regular budget, and it has since been prepared annually by both the Treasury Department as part of the President's annual budget[33] and the Joint Committee on Taxation.[34] The analysis developed as part of the tax expenditure concept demanded that a tax provision that operates like a spending provision be analyzed as a spending provision, and subject to the same scrutiny as direct allocations.

It is no coincidence that the concept was developed in conjunction with a commitment to reforming the tax law, and the tax expenditure concept was an important part of the Tax Reform Act of 1976, the first major tax legislation following the mandated preparation of tax expenditure budgets. Surrey was skeptical of these provisions, and his Treasury was opposed to using the tax law to implement social policy, believing that direct programs were a better alternative.[35] Surrey was particularly concerned about the unfair effects of tax expenditures. In *Pathways for Tax Reform*, he wrote:

> It is clear, then, that most tax incentives have decidedly adverse effects on equity as between taxpayers at the same income level, and also, with respect to the individual income tax, between taxpayers at different income levels. As a consequence of these inequitable effects, many tax incentives look, and are, highly irrational when phrased as direct expenditure programs structured the same way. Indeed, it is doubtful that most of our existing tax incentives would ever have been introduced, let alone accepted, if so structured, and many would be laughed out of Congress.[36]

Surrey was thus concerned about both the horizontal inequity and vertical inequity caused by tax expenditures. The horizontal inequity involved unfairness between taxpayers in the same economic position where one taxpayer could reduce tax by using incentive provisions and the other could not. The vertical inequity arose from the treatment of taxpayers at different economic levels; higher-income taxpayers enjoyed greater benefits from deductions than did low-income taxpayers because the value of their deductions were higher on account of their higher tax rate. This produced an "upside-down effect" in which higher-income taxpayers received more subsidy than lower-income taxpayers engaged in the same level of the same activity.[37] Taxpayers too

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[33] *See* OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES, FISCAL YEAR 2012 (2011), *available at* http://www.whitehouse.gov/omb/budget/analytical_perspectives.

[34] The Joint Committee prepares its tax expenditure budget as a stand-alone document.

[35] *See* STANLEY SURREY & PAUL MCDANIEL, TAX EXPENDITURES 2 (1985).

[36] SURREY, *supra* note 32, at 136.

[37] For example, the mortgage interest deduction is generally available, but a taxpayer in the 35% bracket has an after-tax cost of only 65 cents on the dollar, while a taxpayer in the 15% bracket has an after-tax cost of 85 cents on the dollar. A deduction operates to reduce tax at the taxpayer's marginal rate. It is

poor to pay any tax were left out of the benefits provided through the tax system because they could not avail themselves of any tax incentives.[38] On account of these issues, Surrey was quite critical of tax expenditures overall.

Congress has, to some extent, taken Surrey's criticisms of the design of tax expenditures to heart. Under current law, there are some tax expenditures that are designed as credits rather than deductions. This design addresses the "upside-down" effect[39] of deductions—benefitting high-income taxpayers more than low-income taxpayers—that concerned Surrey. A credit reduces tax by a dollar amount so that the value of a credit is not dependent on one's marginal rate of tax. For example, the Child Tax Credit[40] is worth $1000 to every taxpayer with a child. Some credits under current law also ameliorate the non-taxpayer problem that troubled Surrey, allowing individuals who are too poor to have any tax liability to receive government subsidy through the tax system. For example, the American Opportunity Tax Credit[41] provides a credit for college expenses that is "refundable,"[42] which means that the government will send taxpayers checks, even if they have no tax liability. The term "refundable" is slightly misleading because, in these cases, there is nothing to refund; the government simply funds the expenditure. However, Congress has been quite stingy in authorizing refundable credits.[43]

At the same time, Congress has embraced tax expenditures and increased their number. The Treasury Department included 165 tax expenditure items in its 2010 list,[44] while the earliest budgets had less than a third that many.[45] As a percentage of GDP, tax expenditures were almost 6% of GDP when the government started measuring them, and are now over 7%.[46] As a percentage of GDP, they declined significantly for a few years following the Tax Reform of 1986, but have inched up since then.[47] In 2009, they constituted 22.5% of total federal expenditures.[48] That's a lot, considering that 46.9% of spending was mandatory.[49] Discretionary defense spending was 14.1% and discretionary non-defense spending was a mere 12.5% of total spending.[50]

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upside-down for tax expenditures intended to operate as subsidies because the low-rate taxpayer is presumably more needy, on account of lower income, than is the high-rate taxpayer.

[38] *See* SURREY, *supra* note 32, at 136.

[39] *See* SURREY & MCDANIEL, *supra* note 35, at 71.

[40] I.R.C. § 24 (West Supp. 2010).

[41] I.R.C. § 25A(i) (West Supp. 2009). This provision is effective through 2012. Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, Pub. L. No. 111-312, § 103, 124 Stat. 3296.

[42] I.R.C. § 25A(i)(6) (West Supp. 2009). The maximum credit is $3,000, but only 40% of it is refundable.

[43] *See infra* Section III.C for a fuller discussion of refundable credits.

[44] *See* OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES, FISCAL YEAR 2010, at 303-306 (2009), *available at* http://www.gpoaccess.gov/usbudget/fy10/pdf/spec.pdf.

[45] There were fifty-four in the 1972 budget prepared jointly by the Treasury Department and the Joint Committee on Taxation. *See* STAFF OF JOINT COMM. ON INTERNAL REVENUE TAX'N, 92D CONG., ESTIMATES OF FED. TAX EXPENDITURES 4-5 (Joint Comm. Print 1972).

[46] *See* HUNGERFORD, *supra* note 6, at 4 fig.2.

[47] *Id.*

[48] *Id*. at 5 fig.3.

[49] Mandatory spending includes entitlement programs like Social Security, Medicare and Medicaid, which accounted for 29.6% of total spending in 2009. *Id.* at 5.

[50] *Id.* at 5 fig.3.

These numbers illustrate why tax expenditures have become the focus of tax reform in a tax reform climate that is inseparable from the pressure of deficit reduction. Surrey's project was successful in convincing people that tax expenditures are really spending programs that are placed in the tax law, so tax expenditures are an irresistible source of funds. But some tax expenditures are effective and efficient spending programs, and alternative direct spending programs would be inferior institutional choices. For example, the Earned Income Tax Credit piggybacks on the core functions of the tax system, delivers its benefits with little cost, and reaches more intended recipients than an alternative program would. It is a program that may be more effectively administered through the tax system than through a direct spending program, so the Code may be the ideal place for that federal policy.[51] If tax reform is focused on improving the tax law for its own sake, tax expenditures that are well designed and effectively implemented in the tax system are desirable. But if tax reform is in service of revenue, tax expenditures become an easy target. It is not surprising that the deficit reduction/tax reform proposals are covetous of the 22.5% of total federal spending that has been loosely buried in the Code.

B. The Current Tax Reform Proposals

The Fiscal Commission's proposal for tax reform is part of its larger vision to invest where necessary to stay competitive, maintain a national safety net, and cut all excess spending.[52] Its overarching project was to determine how to get the national fiscal house in order, and deal with what it identified as the problem of a "crushing debt burden."[53] The Commission's formidable goals were (1) deficit reduction, (2) reducing the size of the public sector,[54] (3) stabilizing debt levels, (4) ensuring social security solvency, and (5) reducing tax rates. The plan it presented was most ambitious, including discretionary spending cuts, entitlement reform, and budget process reform, in addition to tax reform.

The Commission's plan was quite specific in some of its recommendations. For example, in its proposal to cut discretionary federal spending, it suggested reducing federal travel budgets and freezing the pay of members of Congress.[55] In its treatment of health-care savings, it proposed a specific reform of the Medicare cost-sharing rules and cuts in payments to hospitals for medical education.[56] It also included recommendations about payments to states for abandoned mines and FCC spectrum auctions—pretty detailed stuff for such a big report.[57] But in other ways, the recommendations were quite vague, such as suggesting honest budgeting for catastrophes, and requiring the President to propose annual limits on war spending.[58]

The recommendations for tax reform were somewhat inconsistent with the goals of the project overall. The first goal for tax reform was "sharply reduc[ing] tax rates,"[59] even though lower tax rates make it harder to raise the revenue required to address the

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[51] *See* David A. Weisbach and Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 961 (2004).

[52] NAT'L COMM. ON FISCAL RESP. & REFORM, *supra* note 12, at 12.

[53] *Id.* at 6.

[54] The report proposes to cap revenue at 21% of GDP and bring spending to that level. *Id.* at 14. In 2010, outlays were at 23.8% of GDP. *Id.* at 16. But revenues were only 15%. *Id.* at 10.

[55] *Id.* at 26.

[56] *Id.* at 37-38.

[57] *Id.* at 46.

[58] *Id.* at 22-23.

[59] *Id.* at 14.

current debt burden and reduce the deficit that we face. The report acknowledges that more revenue and less spending are both necessary parts of a responsible fiscal plan. However, reducing rates narrows the policy choices for increasing revenue–the only place to find increased revenue (without introducing other taxes) is in including more in the tax base. Consequently, the report recommends broadening the tax base.[60] Unfortunately, the pressure placed on the base is extraordinary when the objectives include both lowering rates and raising significant amounts of revenue. This explains why the Commission's recommendation starts by proposing the repeal of all tax expenditures in the Code;[61] the broader the base, the more revenue collected. Without any tax expenditures, the Fiscal Commission concluded that rates could be 8%, 14%, and 23%, and still raise $80 billion for deficit reduction.[62] That represents a very substantial rate cut compared to the current law rates of 10%, 15%, 25%, 28%, 33%, and 35%.[63]

The report failed to explain how it determined the amount of revenue that the broader tax base raises, and the Commission may be too optimistic about how much revenue the government can raise solely from base broadening. Tax expenditures are incentives. If they successfully encourage taxpayers to do things they would not otherwise do, then they are effective incentives. If they are, we might expect that removal of an incentive would discourage a taxpayer from continuing the behavior that was previously encouraged. Consider, for example, the charitable contribution deduction. It may encourage taxpayers to give to charity. A taxpayer in the 35% bracket who donates $100 to charity saves $35 in taxes. The tax expenditure budget includes that $35 as revenue loss to the federal treasury because the Congressional Budget Act of 1974 defined tax expenditures as "revenue losses."[64] However, the tax expenditure budget itself makes clear that the estimates of revenue loss included in the budget would "not necessarily equal the increase in Federal revenues (or the change in the budget balance) that would result from repealing these special provisions."[65] If that is the case, then it is important to know how the Fiscal Commission determined the amount of revenue that would be increased on account of tax expenditure repeal. The actual revenue raised could be much less than projected, depending on the effectiveness of the incentives and the post-reform rates. John Buckley recently suggested that "[individual] tax expenditure estimates grossly overstate the potential revenue" associated with their repeal, while corporate tax expenditure estimates may underestimate the revenue that could be raised by their repeal.[66]

In addition, the proposal to repeal all tax expenditures is inconsistent with the Commission's more nuanced approach to discretionary spending. Discretionary spending and tax expenditures are policy alternatives. As Surrey pointed out, tax expenditures are not part of the "structural provisions necessary to implement the income tax" but are "Governmental financial assistance programs carried out through special tax provisions rather than through direct Government expenditures."[67] While the Fiscal Commission explicitly supported investments in education, infrastructure, and research and

[60] *Id.* at 28.
[61] *Id.* at 29.
[62] *Id.* at 29-30.
[63] I.R.C. § 1 (West Supp. 2008).
[64] *See supra* note 3.
[65] OFFICE OF MGMT. & BUDGET, *supra* note 44, at 298.
[66] John L. Buckley, *Tax Expenditure Reform: Some Common Misconceptions*, 132 TAX NOTES 255, 259 (2011).
[67] SURREY, *supra* note 32, at 6.

development,[68] it failed to notice that this type of investment is subsidized through tax expenditures that the plan would repeal.[69]

The Fiscal Commission offered an "illustrative" tax reform plan that would retain a few tax expenditures and finance them with rates of 12%, 22% and 28%. The plan would retain the earned income tax credit and the child tax credit as they are under current law, and pared down tax expenditures for mortgage interest, charitable giving, employer-provided health insurance, and retirement savings. These retentions follow the Commission's stated principle to protect the truly disadvantaged;[70] the earned income tax credit operates to increase the take-home pay of low-income taxpayers who work. However, it is not clear how the other retained tax expenditures further the Commission's central goals. The exclusion for employer-provided health insurance is the single most costly tax expenditure, so its repeal would contribute significantly to revenue.[71] While this article demurs in endorsing specific tax expenditures, it offers a process for analyzing which to retain by emphasizing incidence and equity.

The Bipartisan Policy Center's report is quite similar to the Fiscal Commission's. Like the Fiscal Commission, the Bipartisan Policy Center considered restraining the federal debt as the major challenge to be addressed.[72] Its mission was equally ambitious, balancing the budget, fixing social security, addressing rising healthcare costs, and containing discretionary spending. Its tax reform proposal resembles the Fiscal Commission's in many ways. Most important for purposes of this article, the cornerstone of its tax reform is repeal of almost all tax expenditures. The report blames tax expenditures for excessive complexity, reducing productivity, making the tax system unfair, and encouraging fraud.[73] Its tax reform plan sets rates at 15% and 27%, somewhat higher than the zero option plan, but in the range of the Fiscal Commission's illustrative plan. Like the illustrative plan, it also retains income support for low-income taxpayers, pared down benefits for home mortgages, charitable contributions, and retirement savings, and taxes capital gains and dividends at ordinary rates.[74]

Some elements of the Bipartisan Policy Center's plan are innovative. For example, the subsidy for charitable contributions would be paid directly to charities, rather than to taxpayers, as under current law.[75] This approach would provide a federal subsidy for all charitable giving, unlike current law, which requires taxpayers to itemize deductions (instead of claiming the standard deduction) in order to claim charitable contribution deductions.[76] The Bipartisan Policy Center plan would repeal the standard deduction and the personal exemptions, but in their place, it would provide an earnings

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[68] NAT'L COMM. ON FISCAL RESP. & REFORM, *supra* note 12, at 12.

[69] For example, education subsidies are in various provisions of the Code. *See* I.R.C. § 25A (West Supp. 2010); I.R.C. § 117 (2006); I.R.C. § 221 (2006); I.R.C. § 222 (West Supp. 2010); I.R.C. § 529 (West Supp. 2009); I.R.C. § 530 (West Supp. 2008). There is a tax credit for research and development. *See* I.R.C. § 41 (West Supp. 2010).

[70] NAT'L COMM'N ON FISCAL RESP. & REFORM, *supra* note 12, at 12.

[71] *See* OFFICE OF MGMT. & BUDGET, *supra* note 33, at 252. That tax expenditure alone is projected to cost over a trillion dollars over the five-year budget window in the most recent estimate, 2012-16.

[72] *See* BIPARTISAN POL'Y CTR., *supra* note 14, at 2.

[73] *See id.* at 31.

[74] *Id*. at 128. The report includes a complete list of all tax expenditures that would be retained. *Id.* at 130.

[75] *Id.* at 34.

[76] It would not, however, solve the problem of capture of the benefit by donors. *See infra* Part III.A.3.

credit for all wage earners[77] that would prevent a low-income taxpayer from owing tax on his first dollar of earnings. Most importantly, the plan proposes that a new "Debt Reduction Sales Tax" be adopted to raise revenue.[78] Its design closely resembles the value added taxes currently in use in all OECD countries, and would be imposed at a rate of 6.5% starting in 2013. While the report is highly critical of tax expenditures, the DRST alleviates some of the pressure on tax expenditures to do all the work.

The Bipartisan Policy Center presented its plan as a combination of spending cuts, tax expenditure cuts, and new revenues. A chart included in the report appears to show that approximately half the money comes from the spending side and half the money comes from the tax side. In 2020, 9% of the debt reduction is from new revenues (offset by rate cuts), 38% is from tax expenditure cuts, and 54% is from spending cuts.[79] However, clear understanding of tax expenditures makes it apparent that only 9% is really from new sources of revenue and the rest is from cuts in spending, whether from the discretionary side of the direct budget or the tax expenditure side of the tax system. It is important to know whether the revenue comes from cutting programs or from raising taxes because the individuals affected are likely to be different. The recent Congressional insistence on reducing spending, but not raising taxes, as a condition to raising the debt ceiling, severely limited the government's choice for sources of funds, and will require significant cuts to government programs.[80] But there seems to be an insurmountable political opposition to tax increases.[81]

The Fiscal Commission's tax reform plan included the goal of maintaining or increasing progressivity.[82] In order to achieve that goal, while also reducing rates, capital gains and dividends would have to be taxed at ordinary rates, which the illustrative plan does.[83] Retention of the earned income tax credit is also imperative in the proposed tax reform to conform with the Commission's distributional goals. The Bipartisan Policy Center did not include progressivity as one of its prime objectives, but it did state, in its summary of recommendations, that its proposed reforms would make the tax system more progressive,[84] and its plan also taxes capital gains and dividends at the same rate as ordinary income. The Tax Policy Center has done a distributional analysis of both plans, under various baselines and with a variety of statutory reforms.[85] Compared to current policy, the Fiscal Commission's plan reduces after-tax income at every income level,[86] but the share of federal taxes goes down slightly for higher income taxpayers and goes up

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[77] BIPARTISAN POL'Y CTR., *supra* note 14, at 35.

[78] *Id*. at 38-39.

[79] *Id.* at 15.

[80] Congressional Budget Control Act of 2011, Pub. L. No. 112-25, § 251(b)(2)(A), 125 Stat. 239, 241 (2011). This act committed to reducing the federal deficit by $2.1 trillion over 10 years, but much of the detail is left to be determined by a joint congressional committee.

[81] *See, e.g.*, Editorial, *Ideology Trumps Economics*, N.Y. TIMES, July 12, 2011, at A22.

[82] NAT'L COMM. ON FISCAL RESP. & REFORM, *supra* note 12, at 28.

[83] *Id.* at 31. The Joint Committee and the Treasury disagree about whether the preferential rate for capital gains and dividends is a tax expenditure. The Joint Committee includes it in its list, but the Treasury does not on the grounds that the preferential rates are offset by the double taxation of corporate income.

[84] BIPARTISAN POL'Y CTR., *supra* note 14, at 17.

[85] *See* TAX POL'Y CTR., DEFICIT REDUCTION PROPOSALS (2010), *available at* http://www.taxpolicycenter.org/taxtopics/Deficit-Reduction-Proposals.cfm.

[86] *See* TAX POL'Y CTR., "CHAIRMEN'S MARK" OPTION 1: THE ZERO PLAN VARIANT RETAINING THE CHILD TAX CREDIT AND EARNED INCOME TAX CREDIT TABLE T10-0252 (2010), *available at* http://taxpolicycenter.org/numbers/Content/PDF/T10-0252.pdf.

for lower income taxpayers.[87] This is a reduction in progressivity as measured by one of the standard definitions under which progressivity increases only if tax shares for higher income taxpayers increase.[88] An alternative approach to measuring changes in progressivity looks at relative changes in after-tax income, rather than tax shares.[89] According to the distributional tables prepared by the Tax Policy Center, after-tax income goes down for everyone, but in a somewhat inconsistent way, with the fourth (second highest) quintile seeing the smallest percentage reduction.[90] The Bipartisan Policy Center's proposal appears to be more progressive than the Fiscal Commission's. Only the top quintile would see an increase in its percentage share of federal taxes paid under their proposal.[91] Additionally, after tax-income would not be reduced at all for the bottom quintile, but would be reduced by an increasing proportion in each quintile as income goes up, increasing progressivity compared to the baseline.[92]

C. Tax Expenditures and Budget Policy

The approach to tax reform that repeals all (or almost all) tax expenditures in the name of deficit reduction is consistent with the traditional approach to the tax expenditure budget—as a tool of budget policy. Repealing all tax expenditures helps achieve the goals of those concerned that tax expenditures are an invisible, illegitimate, and unchecked hemorrhaging of federal funds. It treats tax expenditures as a source of funds to be garnered for proper federal goals.

This was the way that Surrey imagined the tax expenditure budget would function when he first advocated it,[93] and the budget itself reflects that approach. The design of the tax expenditure budget mimics that of the larger federal budget, organized by administrative function, and detailing revenue loss on account of each item.[94] It allows tax benefits to be readily compared to direct spending. Congress can study the budgets, evaluate the efficacy of the spending, and decide when to replace a tax provision with a direct spending provision or repeal it altogether. Tax expenditure analysis—the

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[87] *See id.* The tables do not explain their results, but the overall effect of the changes is complex, with reduced rates offsetting greater income inclusion. The Tax Policy Center did not run distributional analyses for the most extreme version of reform presented in the report, the pure zero option. However, the Tax Policy Center's analysis shows variations depending on the treatment of payroll taxes, in addition to income taxes. *See* TAX POL'Y CTR., FINAL REPORT'S "ILLUSTRATIVE TAX REFORM PLAN" (2010), *available at* http://www.taxpolicycenter.org/taxtopics/Fiscal_Commission_Table_Guide.cfm.

[88] *See* Martin Sullivan, *How to Read Tax Distribution Tables*, 90 TAX NOTES 1747, 1749 (2001) (describing distributionally neutral tax cuts as proportionate to tax burden).

[89] William Gale & Peter Orszag, *Bush Administration Tax Policy: Distributional Effects,* 104 TAX NOTES 1559, 1560 (2004) (describing a distributionally neutral change as one that gives everyone the same percentage change in take-home income).

[90] *See* TAX POL'Y CTR., *supra* note 86.

[91] Tax Pol'y Ctr., BIPARTISAN POLICY CENTER TAX REFORM PLAN AGAINST CURRENT POLICY BASELINE, TABLE T10-0249 (2010), *available at* http://taxpolicycenter.org/numbers/Content/PDF/T10-0249.pdf.

[92] *See id.*

[93] *See* Stanley Surrey & Paul McDaniel, *The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 B.C. INDUS. & COM. L. REV 679, 679 (1976) ("[T]ax subsidies constitute a form of government spending and thus are essentially linked to the methods of government spending traditionally covered in budget documents.").

[94] Both the Joint Committee on Taxation and the Treasury Department follow this design. Thus, the budget includes a heading, for example, of "national defense" and lists therein the tax expenditures for national defense and the estimated revenue cost of each specific provision. The Treasury also includes a list of the largest tax expenditures, in descending order, which is a more useful organization for those interested in tax reform.

exercise of evaluating a tax program by reference to spending goals—was intended to be the mechanism by which policymakers could decide whether a tax-based spending program was desirable.[95] Inclusion in the list of tax expenditures provided the signal that a provision required scrutiny as spending. Surrey clearly expected that application of tax expenditure analysis to many provisions included in the list would lead policymakers to decide that the provision was not an appropriate way to spend federal funds.[96] As a matter of budget policy, the challenge presented by tax expenditure analysis was to justify individual provisions of the Code as legitimate spending of federal funds.

The initial roadblock to the budget-policy approach was convincing people that these provisions should be analyzed the same way as direct spending, rather than as simple tax reductions.[97] Eventually, the equivalence between tax expenditures and direct spending became widely accepted, and the debate shifted to how tax expenditures should be integrated into budget policy—who should decide about tax-based spending, and the level of review to which tax expenditures should be regularly subjected.[98] Unfortunately, the vision for integrating tax expenditure review into the budget process never came to pass in any substantial way, and the proliferation of tax expenditures is a by-product of that failure. Instead of fostering cooperation between the substantive Congressional committees and the tax-writing committees, the tax-writing committees have become "a Congress within the Congress,"[99] legislating on all matters of federal policy and spending federal funds without coordinating with appropriating committees.

From the perspective of budget policy, tax expenditure analysis has been a complete failure, and wiping the slate clean seems like an appropriate response. Wholesale repeal is a quick and effective way to remove the power of the tax-writing committees over federal spending—it effectively returns power to the substantive committees over their areas of expertise. But it is not a permanent solution standing alone. While repeal slows down the work of the tax committees, without significant legislative change governing the procedures for adopting and reviewing tax expenditures, the tax committees can be expected to return to their old ways.[100] From a budget policy perspective, the new provisions adopted might better reflect current priorities, and the overall gains might be worthwhile, but repeal might simply create new opportunities for lobbyists and the legislators who love them.[101]

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[95] *See* SURREY & MCDANIEL, *supra* note 35, at 99-117.

[96] *See* SURREY, *supra* note 32, at 234-35 (discussing the upside-down subsidy of the home-mortgage interest deduction).

[97] Even the Treasury Department was skeptical a decade after Surrey's introduction of it. *See* OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, SPECIAL ANALYSIS G, BUDGET OF THE UNITED STATES GOVERNMENT 3 (1983) (embracing the notion that the tax expenditure idea implies that the government has a claim to 100% of a taxpayer's resources).

[98] *See, e.g.*, Linda Sugin, *Tax Expenditure Analysis and Constitutional Decisions*, 50 HASTINGS L.J. 407 (1999) (arguing against constitutionalizing the tax expenditure concept).

[99] Edward Kleinbard, *The Congress Within the Congress: How Tax Expenditures Distort Our Budget and Our Political Processes*, 36 OHIO N.U. L. REV. 1, 3 (2010).

[100] This is why Professor Kleinbard has proposed framework legislation for tax expenditures. *See* Edward Kleinbard, *Tax Expenditure Framework Legislation*, 63 NAT'L TAX J. 353, 378-379 (2010).

[101] *See, e.g.*, Richard Doernberg & Fred McChesney, *Doing Good or Doing Well?: Congress and the Tax Reform Act of 1986*, 62 N.Y.U. L. REV. 891 (1987); Edward McCaffery & Linda Cohen, *Shakedown at Gucci Gulch: The New Logic of Collective Action*, 84 N.C. L. REV. 1159 (2006); Edward Zelinsky, *James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions*, 102 YALE L.J. 1165 (1993).

Contrary to the views of those concerned that tax expenditures undermine budget policy, this article takes the position that tax expenditures are more important in tax policy than in budget policy. Specifically, tax expenditures can and must play a key role in affecting the distribution of the benefits and burdens of government.[102] Achieving distributional fairness was long thought to be a central normative function of tax policy,[103] and tax expenditures play an important part in the fairness of the tax system overall. Even if there were complete consensus on the exact amount of revenue to be raised from the tax system, there would still be a lively tax policy discussion about where that revenue should come from. Tax policy is important because it contains the discussion about who pays; it reflects our judgments about who is entitled to the rewards of society and how much individuals owe one another. Consequently, it is troubling that the current discussion of tax reform pays virtually no attention to how the tax expenditures that are primed for repeal affect the distribution of the tax burden or the benefits from government. The call for repeal of tax expenditures is driven primarily by efficiency and increasing simplicity.[104]

From the perspective of distributive justice, tax expenditures are an important component in the institutional structure of government levies and outlays. Tax expenditures provide an important bridge between the distributional analysis of taxes and the distributional analysis of spending. From this perspective, any proposal to summarily repeal all tax expenditures is unintelligible because it fails to acknowledge that the distributional effects of tax expenditures are not simply a by-product of budget policy, but part of their purpose.[105] Shifting the tax reform debate to questions of equity will be difficult because equity in taxation is often treated as an underappreciated value. Because of that, we currently lack the basic tools to measure the distributional effects of the tax system.

If tax expenditures are to be the major focus of tax reform—as they seem to be—it is imperative that policymakers better understand what tax expenditures do and for whom. The distributional effects of tax expenditures are not part of the tax reform debate because the issues that we treat as relevant to tax reform have ignored the question of who really benefits from tax expenditures. But before Congress simply repeals all tax expenditures, it must identify the winners and losers from each and every one. It must also evaluate the effects of each provision relative to its purpose to determine whether a provision is effective in carrying out a desirable federal policy. Evaluation on these grounds is necessary for deliberative decision making about tax expenditures. Revenue effects are important, but they are only one piece of the tax reform analysis. With the information available today, it is impossible to make any intelligent decision about repealing tax expenditures.

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[102] This is the issue for distributive justice as understood by liberal political theory. *See generally* Linda Sugin, *A Philosophical Objection to the Optimal Tax Model*, 64 TAX L. REV. 229 (2011).

[103] JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY 917-24 (Batoche Books 2001) (1848).

[104] *See* David Kocieniewski, *I.R.S. Watchdog Calls for Tax Code Overhaul*, N.Y. TIMES, Jan. 6, 2011, at B3 (noting that the I.R.S.'s taxpayer advocate recommends simplification but acknowledges that tax expenditures benefit everyone).

[105] The Fiscal Commission's "zero plan" eliminates all tax expenditures, including the earned income tax credit and the child tax credit and proposes rates of 8%, 14% and 23%. NAT'L COMM'N ON FISCAL RESP. & REFORM, *supra* note 12, at 29.

III. WHO REALLY BENEFITS FROM TAX EXPENDITURES?

We need to know a lot more about tax expenditures before deciding whether it's a good idea to eliminate them. The distributional effects of tax expenditures have not been part of the tax reform debate because the issues that we treat as relevant to tax reform—revenue, economic growth, and efficiency—ignore the question of who benefits from tax expenditures. It is time to change that and take the role of tax expenditures in the distribution of government benefits and burdens more seriously. Tax expenditures have become indispensible to understanding federal policy, but their distributional analysis has not improved, despite their increasing importance to public spending.

Public fairness depends on both taxing and spending because it is the sum total of these government activities that define the relationship of individual contributions and public entitlements. Similarly, the level of effective progressivity depends on income shares, tax shares, and public benefit shares.[106] Tax expenditures are equivalent to both government spending programs and reductions in taxes that individuals owe, so they are relevant to both parts of the necessary inquiry into overall public fairness. To measure the real total level of progressivity, both government benefits and tax burdens must be taken into account, and changes to current law must be evaluated by measuring the consequences to individuals of tax cuts or increases as well as changes in public benefits of every type.

A. We Are Ignorant About Who Really Benefits from Tax Expenditures

1. Where Are the Distributional Tables?

Distributional tables present data about households in different income groups. They may show the effective rate of tax applicable to households at different income levels or the percentage share of total tax payments made by households in different categories. More narrowly, they may show how many households at different income levels claim the standard deduction or the dollars claimed as deductions for mortgage interest or charitable contributions. Distributional tables are often organized by quintile, so that 20% of all households are aggregated, and data about their tax liability displayed. The Tax Policy Center's analysis of the tax reform proposals[107] breaks out the highest quintile into smaller categories because the top 1% is a very different population from the top 20%; data about the top 20% might not present an accurate picture of the situation for the very top earners. Distribution tables are important because they show how the law affects taxpayers at different points along the income spectrum, and consequently how progressive aspects of the system are.

Distributional tables for tax expenditures could show various things. The purpose of distributional tables for tax expenditures would be to indicate how much taxpayers in different income classes claim in tax expenditure benefits. Most simply, distributional tables could show the dollar value of deductions, exclusions, and other preferences claimed by taxpayers in different income classes. Alternatively, they could indicate the relative shares of total deductions, exclusions or other preferences, the relationship of total income to tax expenditures claimed, or any other data that might be relevant when comparing how the tax system affects taxpayers at different income levels.

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[106] Eugene Steuerle, *Can the Progressivity of Tax Changes Be Measured in Isolation?*, 100 TAX NOTES 1187, 1187-88 (2003).

[107] *See supra* notes 85-91.

The Treasury version of the tax expenditure budget provides no distributional data, and the Joint Committee's report includes data on only a handful of provisions. The most comprehensive recent analysis of individual income tax expenditures concluded that all income groups benefit from tax expenditures.[108] High-income taxpayers benefit more than low-income taxpayers in both dollar amounts and as a percentage of their income.[109] However, low-income taxpayers benefit more in relation to the taxes they pay.[110] The study, conducted by the Tax Policy Center, provided significantly more information than any government source, but still did not include business tax expenditures, which would have increased the distribution of benefits to high-income taxpayers.[111]

The government was more forthcoming with distributional data in the early tax expenditure budgets than it is today. In the first budget, prepared jointly by the Joint Committee and the Treasury, there were forty-three distributional estimates included in the presentation. The next budget included forty-five items in the distributional tables. In 1975, the Joint Committee/Treasury included no distribution numbers, apparently because the drafters of the report had insufficient time to compile them.[112] But a few months later, the 1976 compendium prepared for the Senate Budget Committee included fifty distribution tables.[113] Distributional data was provided for virtually all of the individual provisions included in the tax expenditure budget; corporate provisions were excluded to avoid making assumptions about which individuals to assign the benefits in the corporate tax.[114] Although these early budgets included distribution data for so many items, the informational value of that data was somewhat limited because the reports did not include income distribution data that would help to evaluate the data provided on the tax expenditures. The data included the total revenue loss to taxpayers in different income classes as well as the percentage of taxable returns in each income class, but it did not include the total income in each class or nontaxable returns.[115] Total revenue loss is not an accurate measure of benefit.[116] Nevertheless, it is clear from the early budgets that high-income taxpayers disproportionally benefited from tax expenditures, and tax expenditures connected to investment income were more skewed to high-income taxpayers than other tax expenditure provisions.[117] According to the Tax Policy Center study, it is still true that investment preferences are most beneficial to high-income taxpayers.[118] For 2007, the preferential rates on capital gains and dividends were enjoyed by the "top 1 percent of taxpayers and provide[d] little income gain for anyone else."[119]

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[108] Leonard Burman, Christopher Geissler & Eric Toder, *How Big Are Total Individual Income Tax Expenditures and Who Benefits from Them?*, 98 AM. ECON. REV. 79, 82 (2008) (analyzing 2007 data).

[109] *Id.*

[110] *Id.*

[111] *Id.* at 79, 80 n.2.

[112] STAFF OF JOINT COMM. ON TAX'N, 94TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES 5-6 (Joint Comm. Print 1975).

[113] STAFF OF S. BUDGET COMM., 94TH CONG., TAX EXPENDITURES COMPENDIUM OF BACKGROUND MATERIAL AND INDIVIDUAL PROVISIONS 4 (Comm. Print 1976).

[114] *Id.*

[115] Unlike today, in those years, the Tax Policy Center did not supplement the government's data with additional distribution tables.

[116] *See* STAFF OF JOINT COMM. ON TAX'N, 103D CONG., METHODOLOGY AND ISSUES IN MEASURING CHANGES IN THE DISTRIBUTION OF TAX BURDENS 3 (Joint Comm. Print 1993).

[117] *See id.*

[118] Burman et al., *supra* note 108, at 79-80.

[119] *Id.* at 82.

The Joint Committee has long included about a dozen distribution tables in its analysis.[120] But the items that are included in the recent tables and appear most favorable to the rich, such as the mortgage interest deduction, are not the ones that appeared most favorable to the rich in the early budgets. In 1981, consistent with the Tax Policy Center's analysis for 2007, the Joint Committee's analysis showed that the preference for capital gains provided an enormous benefit for high-income taxpayers.[121] The most recent budget included no distribution table for any investment-related tax expenditure,[122] and the Treasury no longer treats the preference for capital gains as a tax expenditure.[123] The Joint Committee's choice to include distribution tables for more social-policy flavored tax expenditures, but not for investment preferences, clearly skews the distribution tables so that current tax expenditures appear more favorable to lower-income taxpayers than is warranted. A more extensive distributional analysis of investment provisions would provide a more balanced impression of the distribution of tax expenditures overall. A more detailed set of information would be helpful to policymakers in evaluating who benefits from tax expenditures. In addition, an integrated distributional analysis of taxes and spending would give a more complete picture of the benefits and burdens of government.[124]

2. *The Real Incidence of Tax Benefits Matters*

While distributional tables are helpful, they can also be misleading because they measure dollars claimed on tax returns. The person who reduces her tax on account of a tax expenditure provision may not actually be any better off than she would have been without the tax expenditure. We need to know the real incidence of the benefits — who is actually made better off on account of the tax provision. There are no distributional tables prepared by anyone that provides this information, but it is crucial to understanding the true effect of tax expenditures on individuals.

Consider this example. The tax law might allow a deduction for installing energy-saving windows. Such a provision would constitute a tax expenditure. Assume that prior to such a deduction being adopted into law, energy saving windows cost $1,000

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[120] In 1981, there were 12 provisions in the tables, and in 2010, there were still 12. *See infra* notes 121-122.

[121] STAFF OF JOINT COMM. ON TAX'N, 97TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1981-1986, at 19 (Joint Comm. Print 1981).

[122] STAFF OF JOINT COMM. ON TAX'N, 111TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2009-2013, at 49-54 (Joint Comm. Print 2010). The items included in the 2010 distribution tables are: medical deduction, real estate tax deduction, SALT deduction, charitable deduction, child care credit, EITC, Social Security exclusion, child credit, education credits, student loan interest deduction, mortgage interest deduction, and the negative tax expenditure for phase out of the personal exemption.

[123] In 2004, the Treasury stopped treating the preferential rates for capital gains and dividend as tax expenditures, even though they had been designated that way since the first budget was prepared in 1972 (in fact, in the first budget, the capital gains preference was the largest single item). In changing the treatment, the administration explained that the double taxation of corporate income under a system with a separate corporate tax was being offset by the reduced taxation of capital gains and dividends, making the preference an integral part of that structure, rather than a tax expenditure that provided a special rate for income from particular sources. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES, FISCAL YEAR 2004, at 138-39 (2003), *available at* http://www.gpoaccess.gov/usbudget/fy04/browse.html.

[124] The Joint Committee never models the effects of spending programs. *See* STAFF OF JOINT COMM. ON TAX'N, 103D CONG., METHODOLOGY AND ISSUES IN MEASURING CHANGES IN THE DISTRIBUTION OF TAX BURDENS 40 (Joint Comm. Print 1993). *See also* Gale & Orzsag, *supra* note 89 (arguing that progressivity can only be measured with both taxes and spending).

each. Enactment of the deduction should encourage people to buy energy-saving windows. An individual in the 35% bracket bears an after-tax cost of only $650 for a $1,000 window because she can reduce her tax liability by $350 by buying it. In this example, the taxpayer enjoys both the nominal (statutory) incidence and real (economic) incidence because she claims the deduction on her return and is really $350 better off on account of it. But the price of windows might rise on account of the deduction. If the price rises to $1,100, then the taxpayer saves $385 on account of the deduction. But she is not $385 better off because she had to pay $100 more for the window. The producer of the window enjoys that $100 benefit and the purchaser's benefit is only $285. The nominal incidence is all on the purchaser, but the real incidence in this example is split between the producer and the consumer.

In its recent comprehensive review of tax expenditures, the Joint Committee claimed that the principal utility of tax expenditure analysis "appears to have been as a tool of tax policy and tax distributional analysis."[125] The tax expenditure budget is an informational tool, but it fails to provide the relevant information necessary to decide whether a provision should be repealed because real incidence is essential information. The tax expenditure budget is unlikely to become an effective tool of tax distributional analysis without incidence data about all tax expenditures. In the early reports, when the distributional tables were most extensive, the provisions that were excluded from the tables were those with indeterminate incidence; the staff did not want to make assumptions about the individuals who would have paid the tax if a business incentive was repealed.[126] Similarly in the recent distributional analysis by the Tax Policy Center, business and investment-related tax expenditures, whose beneficiaries may be hard to identify because the nominal taxpayer may not be the beneficiary, were excluded from the analysis.[127]

In 1993, the Joint Committee undertook a project to better present accurate distributional data and produced a report, but the tax expenditure budgets have not followed through on the ideas presented there and the empirical work does not seem to have been attempted.[128] The distributional data in the Joint Committee's budget follows the revenue cost model of the tax expenditure budget. But loss of economic well-being is not the same as revenue collected from tax.[129] Better distributional data that measures real costs and benefits to people will make the tax expenditure budget more relevant to the core concerns of tax policy. Information about who benefits from a tax expenditure should be considered at least as important as information about how much revenue might be raised on a provision's repeal. Unfortunately, only the latter information is available in the government data.

From a distributional perspective, we have to understand both *what* we are spending on, and *who* benefits from that spending.[130] These are two separate pieces of information, and the tax expenditure budget would ideally provide both, even where the

[125] STAFF OF JOINT COMM. ON TAX'N, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 6 (Joint Comm. Print 2008).

[126] *See* S. BUDGET COMM., 94TH CONG., TAX EXPENDITURES: COMPENDIUM OF BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS 4 (Comm. Print 1976).

[127] *See* Burman, et al., *supra* note 108.

[128] STAFF OF JOINT COMM. ON TAX'N, 103D CONG., METHODOLOGY AND ISSUES IN MEASURING CHANGES IN THE DISTRIBUTION OF TAX BURDENS (Joint Comm. Print 1993).

[129] *Id.* at 26.

[130] This is what Daniel Shaviro's proposed methodology tries to do. *See* Daniel Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187 (2004).

analysis is more complex than the hypothetical windows in the simple example above. Take the classic tax expenditure example of the exclusion for interest on municipal bonds. The tax expenditure budget treats this exclusion as a tax expenditure because interest income is generally included in taxable income; § 103 is an exception to that rule.[131] But it would be a mistake to assume that the benefit in the budget goes to the holders of the bonds who are not required to include the interest. The exclusion was adopted to provide a subsidy for state and local governments. The reduced interest rate paid by municipalities is an implicit tax on holders. If the entire exclusion were a transfer from the federal government to the states, then holders would get no real benefit from owning municipal bonds, and policymakers might want to maximize that benefit. However, for tax-exempt bonds, it is well known that the benefit does not flow entirely to issuers because issuers need to pay a premium rate of interest in order to attract sufficient purchasers.[132] It also flows to high-bracket taxpayers who receive a windfall interest rate from municipal bonds compared to the after-tax rate of taxable bonds of equal risk.[133] The real policy issue in the § 103 exemption is not the exclusion for the interest earned by all the taxpayers receiving it, but the benefit to states and windfalls to high-rate holders. The tax expenditure budget could provide more useful information if it quantified these benefits, which policymakers could consider in designing the provision and deciding whether it should be retained in the tax law.

We make the mistake of believing that the individuals who benefit from a tax expenditure are the ones who would pay tax if the provision did not exist. It follows from the way that the tax expenditure budget measures revenue loss: by considering how much the nominal taxpayer would owe if not for the provision. But this is a mistake. Revenue losses attributable to particular taxpayers do not imply that those taxpayers actually receive windfall benefits. Consider the exclusion for employer-provided health insurance. Because of its enormous revenue cost, it must be on the table in discussions of tax reform, and it is already scheduled to be pared down—though not eliminated—under the health care reform legislation adopted last year.[134] Workers do not pay tax on the value of health benefits their employers give them. The revenue-cost approach treats this tax expenditure as a benefit to workers. But it might not really make workers better off because tax-free fringe benefits allow employers to pay their workers less money, and workers may not value the benefits as much as they cost.[135] The exclusion's repeal might

[131] The Reconsideration report treats it as an exception to the Code's general rules and the traditional tax expenditure budget treats it as an exception from the normal tax, but the result is the same. *See* STAFF OF JOINT COMM. ON TAX'N, 110TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2008-2012, at 16 (Joint Comm. Print 2008). This was the only budget prepared applying the methodology introduced in the Reconsideration report. *See* STAFF OF JOINT COMM. ON TAX'N, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 6 (Joint Comm. Print 2008).

[132] For example, if corporate bonds pay 10%, then municipal bonds of equal risk should pay 6.5% if they are marketed to 35% rate holders. In fact, municipalities generally have to pay somewhat more than 6.5% in order to attract sufficient buyers, making 35% rate holders prefer municipal bonds to equivalent corporate bonds solely for tax reasons.

[133] *See* Boris Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?* 16 SAN DIEGO L. REV. 735, 744 (1979).

[134] Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 9001(a), 124 Stat. 119, 848-54 (2010).

[135] For example, $100 of health insurance is worth more than $100 cash wages on account of the exclusion. A worker in the 15% bracket only has $85 cash after paying tax on the cash, but still has $100 of insurance. But employers know this and may reduce the fringe benefit by the tax savings so that workers only get $85 in health insurance. The benefit of the exclusion goes to the employers, who are able to save

only impose transition losses on workers, depending on how wages would adjust to the repeal. The exclusion might actually benefit employers more than employees, so employers might be the losers if the tax benefit is removed. With the tax expenditure provision, employees receive the benefits tax-free, but employers can pay less in wages on account of the exclusion. If the exclusion allows employers to pay less in total compensation, then the repeal of the exclusion could make employees demand more cash wages, increasing employer costs, which might be borne by owners or customers of firms, and not employees, as the revenue-loss approach suggests.

There are two levels at which we need to understand incidence in approaching tax reform. First, the standard incidence question looks at real, economic incidence and not just nominal incidence. Second, and most important for reformers contemplating legislative change, is who would be harmed by repeal. The answer to these questions might be the same, but not necessarily. And for some provisions, the answer to the first inquiry might be nobody if the market has completely competed away the benefit, making the second inquiry the only relevant one in deciding whether the repeal is good policy. The second question is crucial in any reform that repeals tax expenditures because repeal may cause asset values to decline, producing losses for individuals.

For example, the home mortgage interest deduction may have been completely competed away in the market long ago and capitalized into the price of housing. In that case, the real beneficiaries of the deduction would be limited to those who owned homes at the time the provision was adopted because their home rose in value on the adoption and they paid a price that did not account for any anticipated tax deduction. Even if the tax benefit has not been completely competed away, it is unlikely that the revenue loss, and the taxpayers to whom that revenue loss is attributed in the tax expenditure budget, accurately measures the benefits enjoyed by the provision now. Repeal may create losers out of people who never enjoyed an unwarranted windfall.

Before we reduce the tax benefits for mortgage interest, we should know who will suffer the greatest loss in home value on account of the change. Loss in asset value is unlikely to be uniform across all taxpayers or all homes, and it may not be concentrated at the top of the income spectrum, even if the highest earners garner the greatest dollars of revenue loss from the deduction (as the Joint Committee's distributional tables show). The mortgage interest deduction may be more fully capitalized into the price of moderate housing than expensive housing because rich people have houses that cannot be fully financed within the million dollar limit of § 163(h)(3). If owners of more modest houses will see the largest percentage drop in the value of their homes from repeal of the deduction, policymakers should be aware of that. Currently, there is no attempt to determine who would lose the most asset value on account of a change in the law, and therefore there is no consideration of such losses in the design of legislation. This is an unfortunate lacuna in the tax reform discussion.

Eliminating tax expenditures today, without incidence data, would be a cynical gesture. But Congress might find it politically irresistible for that reason. It made a similar gesture in 1986 when it increased the corporate tax. In 1986, the individual income tax—which is salient for individual taxpayers—was reduced. Simultaneously, the corporate tax—which is hidden from view of the individuals who bear the burden of it—paid for that reduction. Corporations are not human, so they cannot bear the burden of

$15 in costs. Workers who have insurance on their spouse's plan, for example, don't receive even the $85 value from the fringe benefit and would be better off with an even lesser amount of cash.

taxation. Instead, individuals with relationships to corporations bear the real incidence of the corporate tax. Unfortunately, there is no definitive determination of who that is, whether shareholders, employees, or consumers. Reducing individual taxes and raising corporate taxes was a sleight of hand that made individuals believe that their taxes were reduced, even if their burden was not, because they paid for that reduction by bearing the burden of the increased corporate tax.

It is possible that incidence data cannot be collected for some (many?) tax expenditures. Economists, not lawyers, will need to carry out the formidable task this analysis demands.[136] Nevertheless, the inability to compile real distributional incidence analyses would be relevant in deciding what to do about particular provisions. If it is impossible to know the incidence for a particular tax or provision, then policymakers might want to reconsider implementing that provision. The cynical approach to tax reform is to impose the tax whose incidence is unknown, in the hope that people will fail to notice it or believe it does not fall on them. But the tax provision with unknown incidence is the one we should be wary of, and tax reform should make burdens and benefits from the tax system more, rather than less, transparent.

3. Subsidies Should Be Distinguished From Incentives

Connected to the question of incidence is the distinction between subsidies and incentives, a distinction that has never been clearly drawn in the discussion of tax expenditures. A subsidy provides an economic benefit to a person or makes something cheaper for him, while an incentive induces a person to behave in a particular way. It matters *who* gets the subsidy, but not who is incentivized. In its comprehensive study of tax expenditures, the Joint Committee called its biggest category "tax subsidies," but it described "social spending" in that category as either subsidizing or inducing behavior,[137] as though the distinction was not important. This is a mistake. For policymakers, it should matter whether a provision is a subsidy or an incentive because the measurement of a program's success depends on the purpose it has. If a provision is designed to provide a subsidy for particular people (like families with children) because Congress wanted to ensure they had sufficient resources, it is important that the market not shift the tax benefit to other people (who do not have children). If Congress's goal was instead to increase certain types of activity in the economy, market shifting of benefits would be less of a concern. Thus, it is important to know whether a provision actually operates as a subsidy or as an incentive, and who is subsidized or incentivized, and the tax expenditure budget would be a more useful informational tool if it provided this information.

An incentive for one taxpayer could operate as a subsidy for another. Recall the example of the energy-saving windows in the last section and how the real incidence shifted, in part, from the consumer to the producer. The tax expenditure in that example was an incentive for the consumer, but a subsidy for both the producer and the consumer. To continue with that example, consider the effects on incentives and subsidies if the

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[136] The Joint Committee on Taxation undertook a comprehensive analysis of how distribution tables should be compiled, analyzing all the relevant issues, including the definition of economic burden of tax, the framework for measuring burden, the time horizon for measuring, shifting of burdens in the market, and the distinction between burden and revenue collected. Assumptions need to be made, even in the most rigorous approach. *See* STAFF OF JOINT COMM. ON TAX'N, 103D CONG., METHODOLOGY AND ISSUES IN MEASURING CHANGES IN THE DISTRIBUTION OF TAX BURDENS (Joint Comm. Print 1993).

[137] STAFF OF JOINT COMM. ON TAX'N, 110TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2008-2012, at 6 (Joint Comm. Print 2008).

price of the windows rose to $1,538. In that case, there would be no subsidy for the consumer at all. The consumer would claim a deduction of $1,538 for the cost of the windows, saving $538 in tax, and bear the same $1000 after-tax cost that she had prior to the adoption of the provision. While the tax deduction might continue to operate to incentivize the behavior by making it appear advantageous, it really provides no benefit to the taxpayer. For lower bracket taxpayers, the energy-saving windows tax expenditure could actually operate as a negative subsidy (i.e., a tax). If a market adjustment fully captures the benefits at the 35% bracket level so that price rises to $1,538, a 25% bracket taxpayer has an after-tax cost of $1,154, $154 more than he would have paid if the tax law had never included the provision. Of course, in this case, the lower-bracket taxpayer should not feel encouraged by the tax law to purchase these windows, but that assumes that he understands that the market has shifted the entire benefit away from him.

Policymakers should be more concerned with understanding incidence for subsidies than for incentives because subsidies constitute value transfers to particular individuals or institutions. If Congress wants to subsidize individuals, it should know whether the intended individuals receive the benefit, or whether they lose it to third parties in the market. At the same time, policymakers must be concerned with the effects of incentives because that will indicate whether the law is successful in producing its intended goals for society. Consider how these analyses are related by thinking about the education subsides in the Code. Congress may want to provide a subsidy for education because students and their parents have a difficult time affording it and may suffer from devoting too many of their resources to it. The subsidy would alleviate a financial burden on a needy group, reflecting a distributional policy judgment about students and their families. If the price of education rises in response to the tax benefits,[138] the subsidy objective is frustrated. On the other hand, Congress may want to provide an incentive for education because the American population is too ignorant to produce the goods and services necessary for economic growth and prosperity. If that is the goal, it may not matter which individuals get educated as long as a sufficient number do. That policy does not have a distributional objective since it is not designed to provide benefits to identifiable people. In that case, the incentive is enacted to produce a particular market effect that corrects for a market failure in which too few individuals are educated. If more people become educated, the policy is a success, regardless of who enjoys the benefit of the foregone tax revenue. If taxpayers perceive education to be cheaper on account of the tax credits (even if it was not), so enroll when they otherwise would not have, then the incentive is effective even though they are not subsidized. Alternatively, if educational institutions provide better education because they have more resources per student, the policy goal of increasing the knowledge of the workforce may be accomplished. So, the education provisions in the Code may be good policy, but it depends on what the policy is. The distributional story reflects an equity concern, while the market failure story reflects an efficiency concern. When government designs and

[138] There is some concern that educational institutions may have captured the tax benefits by raising tuition, but there is little evidence of it. *See* ELAINE MAAG, DAVID MUNDEL, LOIS RICE & KIM RUEBEN, TAX POL'Y CTR., SUBSIDIZING HIGHER EDUCATION THROUGH TAX AND SPENDING PROGRAMS (2007), *available at* http://www.taxpolicycenter.org/UploadedPDF/311453_education.pdf. While prices can change for many reasons, economists can sometimes identify correlations between prices and taxes when changes occur in the law. For example, changes in rates of subsidy under the charitable contribution deduction have been correlated with changes in levels of giving. *See, e.g.*, JANE GRAVELLE & DONALD MARPLES, CONG. RESEARCH SERV., R40518, CHARITABLE CONTRIBUTIONS: THE ITEMIZED DEDUCTION CAP AND OTHER FY2011 BUDGET OPTIONS 4-8 (2010).

implements policies like the education credits, it should know whether the policy is a failure if the benefits do not reduce the cost for the nominal taxpayers, or if the same number of people engage in the activity regardless of the provision.

The Joint Committee used the charitable contribution deduction as an example of a subsidy or incentive, without concern for which it is.[139] It might be either, or both, and it matters which it is. If the deduction is an incentive that causes donors to increase their gifts by at least as much as the tax benefit,[140] it is an incentive to the donor and a subsidy to charity. Policymakers might then want to tweak the provision to adjust the overall level of support for the work of charities. The Bipartisan Policy Center's design for the charitable credit reflects the assumption that the tax savings is an extra amount for the charity because it proposes that the government send matching grants to the charities.[141] But donors might not allow the charities to have the tax savings. In the Bipartisan Policy Center's scheme, taxpayers might reduce their contributions on account of the matching grant.

Under current law, in which charitable gifts entitle donors to a deduction,[142] taxpayers might not increase their gifts on account of the tax benefits that they will receive. They may have decided how much to give without regard to the tax consequences. Many non-itemizers make gifts to charity, so it is clear that an incentive is not necessary to induce them to give. If donors give exactly what they would have given without the deduction, then the deduction provides no incentive. However, there is still a subsidy for itemizers who claim the charitable deduction because there is a reduction in tax on account of the gift. But the incidence of the subsidy is on the donors themselves—i.e., it rewards them for giving to charity.[143] That might be desirable if public policy is to reward virtue, but it is more likely that policymakers would be dubious about the provision if the tax benefits subsidize donors rather than charitable organizations.

Surrey's upside-down subsidy critique of tax expenditure analysis assumes that the nominal claimant of the deduction is the beneficiary of the subsidy. A subsidy for charitable donors, at their marginal rate of tax, means that the rich receive greater subsidy per dollar of donation than do the poor. But if the organizations receive the subsidy (whether directly, as in the Bipartisan Policy Center's proposal, or indirectly through the donor grossing up the gift), the tax rate of the donors is not relevant to the distributional analysis. Rather, the beneficiaries of the charity are the relevant group in the distributional analysis. If the organization receives the benefit of the subsidy, the extent to which the taxpayer increases his contribution is what matters.[144]

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[139] STAFF OF JOINT COMM. ON TAX'N, 110TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2008-2012, at 6 (Joint Comm. Print 2008).

[140] *See* Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1404 (1988).

[141] *See* BIPARTISAN POL'Y CTR., *supra* note 14, at 33-34.

[142] I.R.C. § 170 (West Supp. 2010).

[143] For example, if a taxpayer in the 30% bracket would give $100 to charity in the absence of a deduction, consider what he would do with the deduction. If he increases his contribution to $143, then the deduction incentivizes him and subsidizes the charity because the after-tax cost to him is the same as before and the charity gets the tax benefits. If he still gives $100, then the deduction is no incentive but subsidizes him because it reduces his after-tax cost of the gift to $70.

[144] The Code's longstanding deduction for the fair market value for appreciated property has, during times of high tax rates, clearly operated as a subsidy to high-bracket donors, even if it also provided an incentive. Consider high tax rates: If T paid tax at 70% and donated property worth $10,000 with a basis of $1,000, T is entitled to a $10,000 deduction worth $7,000 in tax savings and has no income to include.

The Fiscal Commission included a somewhat novel proposal for charitable contributions in the illustrative plan (the zero plan would abolish tax benefits for charitable giving). It proposed a 12% nonrefundable credit, subject to a 2% adjusted gross income floor.[145] This design limits two things about the charitable credit. First, the value is uniform for all taxpayers, regardless of marginal rate.[146] Second, a taxpayer's first gifts are non-creditable because only amounts in excess of 2% of income would be eligible for the credit. This is a high floor, and it reveals the Fiscal Commission's assumption that the provision would operate as either an incentive or a subsidy for large gifts, but not for small gifts. It suggests that taxpayers who give less than 2% of their adjusted gross income are either inelastic givers or do not give until it hurts, but that taxpayers either need a push (incentive) or deserve a reward (subsidy) if they give above that floor.[147] If they are treating the provision as an incentive, then below the floor, the design of the provision presumes that the deduction is a subsidy for the taxpayer, so it is not desirable policy.

B. Distributional Neutrality Is Not Distributive Justice

The terms commonly used to describe the distributional effects of tax changes are misleading, and policymakers need a more precise understanding of the effects of trading tax expenditures for rate cuts. A "distributionally neutral" change in the tax law is one in which tax shares do not change. In other words, if the third quintile pays 10% of total tax prior to a change in the law, a distributionally neutral change would continue to collect 10% of total tax from the third quintile.[148] Total taxes may go up or down as part of the change, but if the share of taxes remains the same, the change is distributionally neutral.

Distributional neutrality does not imply normative equality. First, a distributionally neutral change that significantly raises revenue might impose a disproportionate burden on low-income taxpayers, even if their tax shares remain the same. This is standard welfare analysis: a dollar of tax is more burdensome to a low-income taxpayer than a high-income taxpayer. Consider X and Y. X has $10 in income and Y has $100 in income. Before the change, assume that X pays $1 and Y pays $15 in tax. A distributionally neutral change that raises everyone's taxes might take $4 from X and $56 from Y.[149] This leaves X $6 and Y $44. If subsistence requires $8, then X is much worse off after this change than is Y, even though the change is distributionally neutral. As a result, distributional neutrality is not necessarily normatively neutral because such changes have effects on individuals at different income levels that must be

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Selling the property would have produced a $9,000 taxable gain, which would have incurred a $6,300 tax liability, netting T only $3,700 on the sale. T gets a substantial windfall—almost double the value—by giving the property to charity rather than realizing the gain. Even with a preferential capital gains rate cutting the tax in half, the gift nets T more than the sale. Gift: $7,000 tax savings. Sale: $10,000 proceeds – $3,150 tax = $6,850 cash. Since tax savings is as good as cash to taxpayers with sufficient income, T has a $150 windfall, even where the gain is taxed at half the rate of ordinary income.

[145] NAT'L COMM'N ON FISCAL RESP. & REFORM, *supra* note 12, at 31.

[146] It would not be available to non-taxpayers because it is not refundable. This distinguishes the Bipartisan Policy Center's provisions, which provide a matching grant to charities regardless of the donor's tax situation.

[147] The Congressional Budget Office estimates that total donations would generally decline with a floor, but that the tax subsidy would decline by much more. A floor retains the incentive to give above the floor. *See* CONG. BUDGET OFFICE, PUB. NO. 4030, OPTIONS FOR CHANGING THE TAX TREATMENT OF CHARITABLE GIVING 10 (2011).

[148] *See* Sullivan, *supra* note 88.

[149] This change holds X constant at 6.25% and Y at 93.75% of total tax paid, with $16 total before the change and $60 after (with tax liabilities rounded to nearest dollar). This is what tax shares are about.

defended on fairness grounds. Second, a distributionally neutral change redistributes within income categories, rather than across them. For example, if X and Y each earn $100, a distributionally neutral change could increase X's tax liability by $20 and reduce Y's by the same $20. There are individual winners and losers from distributional changes, but they occur within income cohorts. For these reasons, distributional neutrality is not necessarily normatively neutral because such changes have effects on individuals within income levels that also must be defended on fairness grounds.

Policymakers must look beyond distributional neutrality to establish equitable treatment of individuals. From this perspective, it is important to know the characteristics of the individuals who bear the burdens of distributionally neutral changes to decide if the government is favoring particular choices that individuals make. Do people with children receive benefits that are not available to those without? Do two-worker families receive benefits compared to one-worker households? Are older people taxed less on their income? More educated people? People who live on the coasts or in cities? These are all dimensions of difference among individuals and it is not "neutral" to move the tax burden among them as long as tax paid by individuals who happen to inhabit the same income quintile remains a constant share of taxes paid. Instead, the tax reform debate must be more explicit about what characteristics are relevant to determining tax burdens. A just government might reduce the tax burden on families with children as a way to alleviate the costs of children, but it should be explicit and purposeful in taxing them less than families without children. Income is clearly part of the relevant measure, but not sufficient to determine a just tax. Some tax expenditures are adjustments that Congress has used to distinguish taxpayers, and we must be careful that tax reform does not sacrifice any precision that has been honed in determining abilities to pay.

Grouping by income in distributional analyses is also problematic when wealth might be a more relevant measure for fairness. All the distributional analyses performed by the Joint Committee measure with reference to income, even when the tax at issue is levied on another base.[150] For example, a sales tax is imposed on consumption, but the distributional analysis of a sales tax in the methodology used by the Joint Committee allocates the burden by income group as an implicit tax on earning. It does the same thing for wealth taxes.[151] This is helpful in comparing different types of taxes to one another because it gives a standard measure common to all of them. But determining a just division of the benefits and burdens of government requires more than comparisons according to income. Income is not an ultimate arbiter of difference along which all differences can be measured. Particularly where we are looking at tax payments, consideration of wealth is as relevant as income.

Distributionally neutral tax changes highlight the importance of the definition of income cohorts. Given the increased income inequality that has developed over the last generation, we should be more discerning at the top. There is a world of difference between the top 5% and the top 1%,[152] and even the top tenth of 1%, so that any change

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[150] *See* STAFF OF JOINT COMM. ON TAX'N, 103D CONG., METHODOLOGY AND ISSUES IN MEASURING CHANGES IN THE DISTRIBUTION OF TAX BURDENS 9 (Joint Comm. Print 1993).

[151] *Id.* at 10.

[152] In the Tax Policy Center's analysis, the top 5% has an average income of $443,618, the top 1% has an average income of $2,262,666 and the top 0.1% has an average income of $9,870,712. The breaks are as follows: top 5%, $270,410; top 1%, $701,245; and top 0.1%, $3,209,498. *See* TAX POL'Y CTR.,

that increases the taxes of the top 1% while reducing the rest of the top 5% is not a distributionally neutral change; it is an important change in the level of progressivity given the background of income shares. Distributional analyses must be sensitive to the levels at which income significantly changes a person's options in life. Quintiles are likely too wide at both the bottom and the top, but in the middle, they may be adequate. The Tax Policy Center's analyses of the tax reform proposals currently on the table are significantly more sensitive to this problem than the government's numbers,[153] but nobody has tried to understand where income breaks really matter for well-being or ability to pay tax.

Tax reformers must grapple with the fact that any reform will make certain individuals losers. Taking the Tax Reform Act of 1986 and our history since its adoption as a model, we can expect a reintroduction of tax expenditures after wiping the slate clean in a major reform.[154] If the return of tax expenditures is inevitable,[155] then the costs to individuals of their repeal must be measured against the temporary efficiency gains their repeal will foster. Reform must tolerate losses for some individuals as the price for greater overall gains. But we cannot know whether increased efficiency is worth the cost if we are in the dark about precisely what the costs are, which individuals will bear them, and what the costs are buying. The current discussion is incomplete in ignoring that these costs exist.

C. The Distributional Effects of Tax Expenditures Have Changed

While we are ignorant about so many aspects of tax expenditures, there are some things that we can be confident about. One is that tax expenditures are different today than they were forty years ago, and they are widely available to people at all income levels. Nina Olson, the National Taxpayer Advocate, recently wrote in her annual report to Congress:

> There is a widespread belief that the influence of "special interests" is the biggest roadblock to comprehensive tax reform. There is no doubt that many provisions in the tax code benefit narrow groups of taxpayers . . . . But the dirty little secret is that the largest special interests are us—the vast majority of U.S. taxpayers. Virtually all of us benefit from certain exclusions from income, deductions from income, or tax credits (collectively known as "tax expenditures").[156]

Despite the broad enjoyment of tax expenditures, they continue to be burdened by the reputation that Surrey gave them. He believed that tax expenditures were undeserved giveaways to high-income taxpayers.[157] His project of identifying and measuring tax expenditures was inseparable from his idea that they should be repealed.

DISTRIBUTION OF FEDERAL TAX CHANGE BY CASH INCOME PERCENTILE, PROPOSAL IN 2022 EVALUATED AT 2018 INCOME LEVELS, *available at* http://taxpolicycenter.org/numbers/Content/PDF/T10-0249.pdf.

[153] *See* TAX POL'Y CTR., *supra* note 87. The Joint Committee's 2010 distributional tables define the top category as $200,000 and up. STAFF OF JOINT COMM. ON TAX'N, 111TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2009-2013, at 48-54 (Joint Comm. Print 2010).

[154] *See* HUNGERFORD, *supra* note 6.

[155] Given the dynamic between lobbyists and Congress, they probably are. *See* Richard L. Doernberg & Fred S. McChesney, *Doing Good or Doing Well? Congress and the Tax Reform Act of 1986*, 62 N.Y.U. L. REV. 891, 925 (1987) (offering a model of tax legislation that produces constant statutory change). *See also* McCaffery & Cohen, *supra* note 101, at 1233-35.

[156] TAXPAYER ADVOCATE SERV., 2010 ANNUAL REPORT TO CONGRESS 9 (2010).

[157] *See* SURREY, *supra* note 32, at 134-38.

Surrey's tax expenditure budget was intended to increase their transparency by naming and quantifying them. Consistent with Surrey's preference for a more progressive, purer income tax, the earliest budgets included distributional information that showed tax expenditures primarily benefiting the rich by favoring income from capital as well as various personal expenditures.[158] Tax expenditure reform was properly understood as part of the comprehensive income tax agenda of left-leaning reformers.[159]

That story is more complex today. The advent of refundability—disbursing federal money to individuals who owe no income tax—has dramatically expanded the potential reach of federal policy administered through the tax law, and tax expenditures now include crucial programs for the poor. For decades, families with the lowest incomes were mostly left out of tax benefit largesse, but the recent growth of refundable provisions has changed that.[160]

When the tax expenditure budget was first designed, there were no refundable provisions in the income tax.[161] In 2010, there were five that provided transfers to individuals too poor to owe tax: the earned income tax credit,[162] child credit,[163] American Opportunity Tax credit,[164] first-time homebuyer credit,[165] and make work pay credit.[166] The 2008 distribution tables included in the Joint Committee's budget[167] show a subtle, but distributionally important, shift from the early versions. While the mortgage interest deduction and the charitable contribution deduction still provide disproportionate benefits to high-income taxpayers, the distributional tables also include other tax expenditures that are more beneficial to low- and middle-income taxpayers. The EITC is the starkest example: including the refundable portion of the credit, taxpayers with incomes below $20,000 enjoyed half the total dollar value of the credit, while taxpayers earning over $200,000 received none.[168] The education credits and the student loan interest deduction similarly produced no benefit to taxpayers in the highest income category. While very low-income individuals received scant benefit from those provisions, taxpayers with incomes below $75,000 enjoyed more than half the total dollar benefit of both those education subsidies.

The effect of refundability (i.e., the amount of transfers in excess of tax liability) of the five provisions for 2010 was estimated to be $102.7 billion.[169] While this number

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[158] *See supra* Part III.A.1.

[159] *See* Shaviro, *supra* note 130, at 201.

[160] The Joint Committee's 2008 budget separated the refundable portion of tax expenditures from the nonrefundable portion and included a total of about $300 billion in transfers to the poor over the five-year window. While significant, that total transfer to poor people is dwarfed by a single tax expenditure, the $680 billion subsidy of employer-provided health insurance to tax-owing taxpayers. Tax expenditures total over a trillion dollars annually. *See* STAFF OF JOINT COMM. ON TAX'N, 110TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2008-2012, at 50, 56 (Joint Comm. Print 2008).

[161] The EITC was first adopted in 1975 as a temporary measure, and the maximum credit was $1,452. *See* John Karl Scholz, *Taxation and Poverty: 1960-2006*, 25 FOCUS 52, 54 (2007).

[162] I.R.C. § 32 (West Supp. 2010).

[163].I.R.C. § 24 (West Supp. 2010).

[164] I.R.C. § 25A (West Supp. 2010).

[165] I.R.C. § 36 (West Supp. 2010) (expired April 30, 2010). *See* STAFF OF JOINT COMM. ON TAX'N, 112TH CONG., LIST OF EXPIRING FEDERAL TAX PROVISIONS, 2010-2020, at 2 (Joint Comm. Print 2011).

[166] *Id.;* I.R.C. § 36A (West Supp. 2009) (expired 2010).

[167] STAFF OF JOINT COMM. ON TAX'N, 111TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2009-2013, at 48-54 (Joint Comm. Print 2010).

[168] This is not a surprise, though it should be noted that the distribution tables use an expanded definition of income. *See id.* at 49-54.

[169] *See id.* at 46, n.4.

is relatively small compared to the total tax expenditures for the year, it is substantial enough to have weight in the debate over tax expenditures, particularly from the perspective of total federal benefits for low-income Americans. The latest numbers available are from 2008, but it is reasonable to expect that the distribution of tax expenditure benefits to low-income taxpayers will increase in the 2009 and 2010 statistics. In those years, the education credit was larger and refundable, the earned income credit was increased for taxpayers with three or more children, and the threshold for refundability of the child credit was lower.[170]

At the same time that Congress has been adding more tax-based spending programs targeted to low-income taxpayers, it has limited various tax expenditures for high-income taxpayers by instituting income phaseouts and caps.[171] The Code also includes provisions that claw back tax benefits from high income taxpayers,[172] such as the alternative minimum tax[173], the phaseout for personal exemptions[174] and itemized deductions.[175] The most recent budget includes a distribution table that shows a negative tax expenditure (i.e., a penalty) on account of the phaseout of personal exemptions for high-income taxpayers and those subject to the alternative minimum tax. The table indicates that taxpayers earning over $200,000 incur about 90% of this tax penalty.[176] Other changes in the underlying tax base that increase tax expenditure benefits to lower income individuals include growth in above the line tax expenditures that can be enjoyed regardless of whether a taxpayer itemizes deductions.[177] Low-income taxpayers rarely itemize deductions because those deductions must exceed the standard deduction for itemizing to be worthwhile.[178]

In all, the latest tables show a substantially different distribution of tax expenditures than did the early tax expenditure budgets. Today, some of the most progressive features of the tax law are tax expenditures. Repealing all tax expenditures would mean ending the largest anti-poverty cash entitlement program.[179] According to the Congressional Research Service, virtually all the federal support for housing, a majority of support for education, training, and employment, and a substantial amount for income security were provided through tax expenditures.[180] These developments show that a subtle shift has taken place, and an attack on tax expenditures is no longer a rebuke solely to hidden largesse for the rich, as it may once have been. This shift also indicates that tax reform that eliminates tax expenditures may have to be paired with new direct

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[170] These provisions have been extended through 2012. Tax Relief, Unemployment Insurance Reauthorization, Job Creation Act of 2010, Pub. L. No. 111-312, § 103, 124 Stat. 3296, 3299 (2010).

[171] *E.g.,* I.R.C. § 25A (West Supp. 2010) (phaseout for education credits); I.R.C. § 24 (West Supp. 2010) (phaseout for child credit); I.R.C. § 32 (West Supp. 2010) (phaseout for EITC).

[172] These may be understood as rate adjustments. *See infra* Part V.C.

[173] I.R.C. § 54 (West Supp. 2009, I.R.C. § 56 (West Supp. 2010).

[174] I.R.C. § 151 (2006).

[175] I.R.C. § 68 (2006). This phaseout is currently repealed through 2012. Tax Relief Act of 2010, § 101.

[176] STAFF OF JOINT COMM. ON TAX'N, 111TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2009-2013, at 54 (Joint Comm. Print 2010).

[177] *See, e.g.*, I.R.C. §§ 62(a)(2), (17), (18), (19) (West Supp. 2010).

[178] For 2011, the standard deduction is $5,800 for single taxpayers and $11,600 for married taxpayers. I.R.S. News Release IR-2010-127 (Dec. 23, 2010).

[179] CHRISTINE SCOTT, CONG. RESEARCH SERV., RL31768, THE EARNED INCOME TAX CREDIT: AN OVERVIEW 1 (2010).

[180] THOMAS HUNGERFORD, CONG. RESEARCH SERV., RL33641, TAX EXPENDITURES: TRENDS AND CRITIQUES 14-16 (2008).

spending programs to replace the safety net that these tax provisions currently offer. It might be good policy design to replace some of these programs with direct spending alternatives, but the total revenue savings from tax reform will be significantly less if tax expenditures are replaced with direct spending, than if they are simply repealed.[181]

The extension of tax expenditures to provide greater benefits to lower income individuals has apparently made them more objectionable to more people, rather than more acceptable to Surrey's successors. The contemporary attack on tax expenditures comes from across the political spectrum,[182] and tax expenditures currently reflect policies that run the gamut from increasing the international competitiveness of U.S. companies and encouraging business investment to alleviating the costs of children and making work pay for low-income wage-earners. In short, there are tax expenditures for everyone to hate. Nevertheless, it is bizarre to imagine that such a diverse set of provisions could be uniformly repugnant to so many people. These diverse federal policies would never be lumped together and repealed if they did not share the administrative mechanism of the tax system. The Fiscal Commission and Bipartisan Policy Center were significantly more reflective in considering cuts in direct spending than they were in considering cuts in tax-based spending. Congress must approach tax reform with the same attention to detail.

IV. THE TAX EXPENDITURE BUDGET CANNOT BEAR THE RESPONSIBILITY FOR REFORM

Any proposal to eliminate all tax expenditures puts more pressure on the definition of what constitutes a tax expenditure than it can bear. Until now, the tax expenditure budget has primarily been an informational tool.[183] But the repeal of all tax expenditures makes that budget the litmus test for acceptable tax rules, a burden too heavy for an informational project. Even prior to the current plans to remove all tax expenditures, the tax expenditure budget has been a hit list for lawmakers searching for revenue,[184] and categorization as integral to the revenue-raising function has protected a provision from that search.[185] To hang tax reform on an informational document elevates the purpose that the document serves, and as the stakes rise, there is likely to be even less consensus on the provisions to be included as tax expenditures.

If provisions of the tax law are to be divided into tax expenditures, which are bad, and provisions that make up the necessary structure of the tax, which are good, then a sharp line between those categories must be drawn. For example, a tax based on net

[181] The total tax expenditure for the earned income tax credit for 2008-2012, including both the refundable and nonrefundable portions, was estimated to be $250 billion. *See* STAFF OF JOINT COMM. ON TAX'N, 110TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2008-2012, at 50, 58 (Joint Comm. Print 2008).

[182] On the right, see Martin Feldstein, *The 'Tax Expenditure' Solution for Our National Debt*, WALL ST. J., July 20, 2010; Bruce Bartlett, *Spending Through The Tax Code*, FORBES, May 28, 2010; N. Gregory Mankiw, *The Blur Between Spending and Taxes*, N.Y. TIMES, Nov. 20, 2010, at Bu5; on the left see *Limiting Tax Expenditures Must Be Part of Congress's Efforts to Balance the Budget*, CITIZENS FOR TAX JUSTICE (Apr. 22, 2010), http://www.ctj.org/pdf/taxexpenditures.pdf; JASON LEVITIS, NICHOLAS JOHNSON, & JEREMY KOULISH, CTR. ON BUDGET & POL'Y PRIORITIES, PROMOTING STATE BUDGET ACCOUNTABILITY THROUGH TAX EXPENDITURE REPORTING (2009). The government agrees. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-318SP, OPPORTUNITIES TO REDUCE POTENTIAL DUPLICATION IN GOVERNMENT PROGRAMS, SAVE TAX DOLLARS, AND ENHANCE REVENUE (2011).

[183] *See* Sugin, *supra* note 98, at 413.

[184] Tax expenditures are often regarded as "payfors" in the budget process. *See* Kleinbard, *supra* note 99, at 3.

[185] *See* Sugin, *supra* note 98, at 413-17.

income must include structural provisions that are necessary to measure net income accurately, such as a deduction for business expenses. Without that deduction, the tax would be imposed on gross receipts, not net income. But there are many provisions that are not as easily categorized as business expenses, like the treatment of the family and the separate corporate and individual income taxes. Even within business expenses, some costs, such as business meals, are only partially connected to the production of income and partially connected to personal consumption, so their categorization as structural is not completely accurate. The Treasury and Joint Committee have alternative approaches to accelerated depreciation, a business expense, and whether it should be treated as normal. Despite decades of trying, nobody has been able to decisively draw the line between structural provisions and tax expenditures, and the topic continues to be contested today. The Joint Committee on Taxation and the Treasury Department each prepare a tax expenditure budget, and the items included in the two versions do not entirely overlap.[186] As long as the government has been compiling the tax expenditure budget, critics have challenged the "normal" baseline against which it measures spending for a range of reasons.[187] Boris Bittker immediately found nothing normatively attractive about the normal tax.[188] Others quibbled about which provisions should be treated as normal, even though they accepted the income-centric definition of normal that the early budgets adopted.[189] Some suggested that all provisions in the Code should be evaluated like tax expenditures.[190] There have always been provisions excluded from the list because they are administratively necessary, even where they provide benefits or incentives that might otherwise count as departures from the normal baseline, such as the realization rule.[191]

In 1983, the Treasury staff challenged the baseline used in the earlier budgets with publication of its Special Analysis G.[192] In that report, Surrey's key insight about tax expenditures—that some tax provisions are equivalent to direct outlays—was tested.[193] The report reduced the definition of tax expenditures to "tax subsidies," which it defined as provisions that apply to a narrow class of taxpayers or transactions and are exceptions from general provisions.[194] The result was a redefined baseline that stopped treating items as tax expenditures if they constituted elements "necessary to make the tax operational."[195] The most significant changes made to the Treasury baseline at that time

[186] The Joint Committee analyzes the ways in which its estimates differ from Treasury's, including some differences in the base and differences in calculations of the estimates. *See* STAFF OF JOINT COMM. ON TAX'N, 111TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2009-2013, at 19 (Joint Comm. Print 2010).

[187] *See generally* Clifton J. Fleming & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 VA. TAX REV. 437 (2008) (noting that despite numerous criticisms of tax expenditure analysis, the government continues to use this tool).

[188] *See* Boris Bittker, *A Comprehensive Tax Base As a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 931-934 (1967).

[189] *See* Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343, 352 (1989); William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972).

[190] *See* Douglas A. Kahn & Jeffrey S. Lehman, *Tax Expenditure Budget: A Critical View,* 54 TAX NOTES 1661, 1664-65 (1992).

[191] *See* SURREY & MCDANIEL, *supra* note 35.

[192] OFFICE OF MGMT. & BUDGET, *supra* note 97.

[193] *Id.* at 3.

[194] *Id*. at 5.

[195] *Id*. at 3.

was treating accelerated depreciation and graduated rates for corporations as basic structural features of the tax law.

The Treasury made additional changes to the definition of the baseline tax in 2004.[196] At that time, it stopped treating the preferential rates for capital gains and dividend as tax expenditures, even though they had been designated that way since the first budget was prepared in 1972 (in fact, in the first budget, the capital gains preference was the largest single item). In changing the treatment, the administration explained that the double taxation of corporate income under a system with a separate corporate tax was being offset by the reduced taxation of capital gains and dividends, making the preference an integral part of that structure, rather than a tax expenditure that provided a special rate for income from particular sources.[197] This was a major challenge to the reference law baseline from Special Analysis G, in which the Treasury had explicitly chosen to continue treating the capital gains preference as a tax expenditure. The 2004 report included a table of negative tax expenditures (i.e., tax penalties) that treats the tax on corporate profits as a negative tax expenditure.[198] The $25 billion negative number for that item dwarfed most other items in the budget.[199]

Also in 2004, the Treasury budget included a small but important change in measuring the tax expenditure from accelerated depreciation under the normal tax. In 1983, the reference law baseline was adopted without any tax expenditure for accelerated depreciation, but the 2004 change replaced the prior benchmark of straight-line depreciation in the normal tax method with an inflation-adjusted economic depreciation.[200] The revised estimates were much smaller than under the prior approach, and were negative in some years. Although the Treasury's explanation makes clear that the negative tax expenditures do not mean that the law provides slower depreciation than economic depreciation would prescribe, the obvious conclusion to draw from the tables is that depreciation is too slow and the tax law is penalizing those subject to it. The explanation that the numbers are a product of cash-flow accounting[201] is unlikely to be understood by most people interested in the tax expenditure budget. That budget discontinued measuring the tax expenditure for depreciation under the old system, depriving readers of comparative data[202] and minimizing the appearance of benefits to taxpayers investing in capital projects.

During the last decade, Treasury has tweaked other aspects of the tax expenditure budget and its analysis as well. For example, in 2006, it started including imputed income from home ownership as a tax expenditure.[203] In 2005, Treasury included a discussion of tax expenditures compared to regulation, as well as direct spending,[204]

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[196] OFFICE OF MGMT. & BUDGET, *supra* note 123. I critiqued these changes more fully in Linda Sugin, *Sustaining Progressivity in the Budget Process*, 45 B.C. L. REV. 1259, 1274-1282 (2004).

[197] OFFICE OF MGMT. & BUDGET, *supra* note 123, at 138-139.

[198] *Id.* at 139-140.

[199] It included shareholder level tax on dividends paid and capital gains realized out of earnings taxed at the corporation, and corporate tax on inter-corporate dividends and corporate capital gains on stock sales. *Id.* at 110, 140.

[200] *Id.* at 137-138.

[201] *Id.* at 138.

[202] *Id.* at 138 n.31.

[203] OFFICE OF MGMT. AND BUDGET, ANALYTICAL PERSPECTIVES, FISCAL YEAR 2006, at 356 (2005).

[204] OFFICE OF MGMT. AND BUDGET, ANALYTICAL PERSPECTIVES, FISCAL YEAR 2005, at 300-302 (2004).

enlarging the discourse from the Joint Committee's more rigid approach that considered direct spending as the paradigm against which tax expenditures should be determined.[205]

In recent years, critics favoring a move to consumption taxation have challenged the income-centric approach that continues to inform the tax expenditure budgets today.[206] In that vein, a more fundamental challenge to tax expenditure analysis was presented in the Treasury's appendices, starting in 2004.[207] In that report, Treasury included an analysis of tax expenditures in a consumption tax, reviewing its traditional list under a consumption tax model.[208] It deemed some provisions to be tax expenditures under both approaches, others not to be tax expenditures under a consumption tax and a remaining few to be debatable. The analysis called into question the propriety of including many provisions in the budget, but did not offer a comprehensive alternative pursuant to the alternative baselines.[209]

The most recent development in the debate over the tax expenditure baseline was the Joint Committee's Reconsideration report.[210] Concerned that disagreement over the underlying conception that supported the tax expenditure budget undermined the integrity of the budget produced, the Joint Committee presented a new approach to tax expenditures that treated the tax law as moderately coherent to determine which provisions are included in the budget. Its first (and only) budget using the new methodology was released a few months later. The Reconsideration report was a comprehensive project, and it offered a new taxonomy and a new baseline that was designed to be devoid of any normative content. In fact, it dispensed with the notion of a single, coherent baseline altogether. Rather than compile the budget by asking which provisions in the Code are exceptions from an extrinsic and idealized normal tax as Surrey and the Joint Committee had traditionally done, the new methodology generated the budget by extrapolating from the tax law itself. A new category of "Tax Subsidies" was generated by reference to discernible general rules of current law; the general rules thereby became a new baseline.[211] The Joint Committee did not explain how it decided which provisions constitute the general rules, and there is no clear principle that the report adopted that would provide predictability and consistency.[212] Inferring from the first budget implementing the report, general rules are those that have been around a long time, have broad sweep, and do not create structural distortions.[213] The general rules are

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[205] The Joint Committee's long-held position was that tax provisions providing less favorable treatment than a normal income tax are not within the statutory definition of a tax expenditure. *See* STAFF OF JOINT COMM. ON TAX'N, 108TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2004-2008, at 3 (Joint Comm. Print 2003).

[206] *See* Bruce Bartlett, *The End of Tax Expenditures as We Know Them?*, 92 TAX NOTES 413, 414-415 (2001); *see also* Shaviro, *supra* note 130, at 189.

[207] Later Treasury reports continued the presentation. *See* OFFICE OF MGMT. AND BUDGET, *supra* note 123, at 314-322.

[208] *Id.* at 130-140.

[209] These appendices are critiqued in Sugin, *supra* note 196, at 1276-1282.

[210] STAFF OF JOINT COMM. ON TAX'N, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS (Joint Comm. Print 2008).

[211] Tax Subsidies are provisions that are "deliberately inconsistent with an identifiable general rule of the present tax law . . . and collect[] less revenue than does the general rule." STAFF OF JOINT COMM. ON TAX'N, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 9 (Joint Comm. Print 2008).

[212] The Joint Committee modeled the baseline on the work of Seymour Fiekowsky. *See id.*

[213] The report introduced the concept of "tax-induced structural distortions." That category consists of general rules of the Code that "materially affect economic decisions in a manner that imposes substantial economic efficiency costs" such as the distinction between debt and equity. *See* STAFF OF JOINT COMM. ON

not unlike the normal baseline used in the old analysis, so the tax expenditure budget under the reconsidered approach resembled prior versions.

Regardless of the merits of these numerous critiques of—and changes to—the normal baseline that forms the basis of the tax expenditure budget, they do indicate that there has not been consistent support for a single baseline among important constituencies in Congress, the Treasury Department, and the larger tax community. The changes that have been made to both the official tax expenditure budgets reveal the malleability of the baseline and its unavoidable politicization. Consequently, any project to use that baseline as the model for tax reform stands on shaky ground. More importantly, these developments show that there is little normative power in the baseline today. Enacting tax reform that carries out such a baseline would lack a coherent conception of distributive justice, an important foundation for any tax system.

V. REFORMERS PRIVILEGE EFFICIENCY OVER EQUITY

Tax reform that eliminates tax expenditures from the Code favors efficiency over equity. Efficiency improves both because tax expenditures distort taxpayer choice among activities and investments, and because removing tax expenditures broadens the base and allows rates to be reduced. Replacing tax expenditures with rate cuts reduces the tax law's interference in market transactions. It is a deceptively attractive solution to our fiscal problems because we can see the cut in rates that we enjoy, but the benefits and burdens of tax expenditure repeal are less transparent.[214]

The sacrifice of equity for efficiency is not new with these recent deficit reduction proposals. There has long been a trend toward treating efficiency as the prime normative goal of tax policy.[215] Efficiency seems more precise, has a clear direction and presents itself as a mathematically pure objective.[216] Though lip service is often paid to equity, the heart of tax reform has been increasingly about efficiency. The Tax Reform Act of 1986 is a good example. In that paradigm of tax reform, statutory rates were cut, and incentives to engage in investments solely for tax savings were removed from the law.[217] It had been wasteful for the tax law to encourage investors to build empty shopping centers and office buildings all over America. Nevertheless, there were winners and losers in the Tax Reform Act of 1986, and policymakers need to be concerned with fairness to the individuals who are affected by reform.

Both the Fiscal Commission proposal and the Bipartisan Policy Center proposal follow this model, trading tax expenditures for rate cuts. In fact, the insistence on rate cuts reveals a greater interest in increasing efficiency than in deficit reduction, the ostensible goal of the project. The Fiscal Commission's recommendation to cap revenue at 21% of GDP[218] was also extraneous to the task of deficit reduction, but revealing as to the real objective of the reform. Although the Bipartisan Policy Center included a "national debt reduction sales tax"[219] as a way to address the revenue concern, like the

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TAX'N, 110TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2008-2012, at 1, 13 (Joint Comm. Print 2008).

[214] *See supra* Part III.2.

[215] Boris Bittker considered himself an "Old Turk" equity sympathizer in 1979, when a new generation of efficiency theorists was on the rise. *See* Bittker, *supra* note 133, at 737.

[216] *See* James Repetti, *Democracy and Opportunity*, 61 VAND. L. REV. 1129, 1130-1131 (2008).

[217] § 469 suspended the deductions from business activities in which taxpayers did not actively participate. *See* Tax Reform Act of 1986 § 501. *See also* I.R.C. § 469 (2006).

[218] NAT'L COMM'N ON FISCAL RESP. & REFORM, *supra* note 12, at 14.

[219] BIPARTISAN POL'Y CTR., *supra* note 14, at 31.

Fiscal Commission, it largely seized this moment of opportunity for tax reform to primarily make the system more efficient. It described its proposed tax as "simple, pro-growth."[220]

A. Taxes Are Bad For Growth

Efficiency as a goal is a normative choice that has never been fully justified for tax policy. It embodies an unreflective belief that economic growth is good and that market results are just. Only on the fringes of tax policy does anyone question this belief.[221] While market defenders argue to banish distributional concerns from economic regulation, leading welfarists believe that the tax system is the proper place for such concerns.[222] Economic regulation has generally eschewed distributional concerns in favor of growth,[223] which is a sensible approach only as long as the distributional issues are better handled by an institution designed to handle them well—like the tax system. If economic regulation is designed to maximize growth and the tax system is designed to maximize growth, there is precious little opportunity to focus on distribution. Nevertheless, there is a growing interest in the real world in designing taxation for growth. In the editorial pages of the *Wall Street Journal*, Daniel Henninger recently argued that the primary purpose of taxation should be promoting economic growth.[224]

Unfortunately, growth is an incoherent standard for a tax system. By definition, taxation produces "excess burden" or "deadweight loss," which is an efficiency cost that arises as a by-product of moving resources from private hands to public coffers.[225] Any attempt to avoid a tax creates an efficiency loss. Taxation always reduces the net individual rewards from economic activity and thereby burdens that activity. The only way to avoid excess burden is through lump-sum taxation, such as a head tax that is fixed regardless of economic activity.[226] Every tax system actually in use impedes growth in some way, so a growth norm favors repeal of every existing tax. Income taxes reduce the gains from earning income, so repealing an income tax would promote more work and investment, and consequently growth. Consumption taxes deter consumption, so repealing a consumption tax would promote demand, and consequently growth. Wealth taxes reduce the accumulation of wealth, so repealing a wealth tax would better promote savings, and consequently growth. Tax policy for growth is best achieved without taxes at all, so growth is an inapt norm for tax reform.

Tax expenditures are purposely inefficient. They are adopted precisely because they encourage individuals and businesses to engage in activities they would not

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[220] *Id.* at 29.

[221] *See* LIAM MURPHY & THOMAS NAGEL, THE MYTH OF OWNERSHIP: TAXES AND JUSTICE 103-109 (2002). Neither author is a tax lawyer or economist. The most prominent recent tax debates, such as the income vs. consumption tax debate, have focused largely on efficiency. *See, e.g.*, Joseph Bankman & David Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax*, 58 STAN. L. REV. 1413, 1414 (2005-2006); Chris William Sanchirico, *A Critical Look at the Economic Argument for Taxing Only Labor Income*, 63 Tax L. Rev. 867, 870-871 (2010).

[222] *See* Louis Kaplow & Steven Shavell, *Why the Legal System is Less Efficient than the Income Tax in Distributing Income*, 23 J. LEGAL STUD. 667, 667-68 (1994).

[223] *See, e.g.*, A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 124-127 (2d ed. 1989).

[224] Daniel Henninger, *What Are Taxes For?*, WALL ST. J. (Dec 16, 2010), http://online.wsj.com/article/SB10001424052748704828104576021672925440698.html.

[225] *See* DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 174-207 (1986).

[226] *See* RICHARD MUSGRAVE AND PEGGY MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE (5th ed. 1989).

undertake in the absence of tax inducement, the very definition of an inefficient tax provision. It is not surprising that economists are predisposed against them,[227] but it is curious that they are criticized on account of that inefficiency. The normative goal of an efficient tax is at odds with the normative goals of a tax containing special incentives and preferences, and an inefficient tax is only bad public policy if the appropriate norm is efficiency. If Congress has national security reasons for discouraging dependence on fossil fuels, for example, it is reasonable for it to incentivize the development of alternative power sources, even though such incentives distort the market. If Congress believes that two families with the same income have different taxpaying abilities if one family has children in college, it might reduce tax in connection with the costs of college, even though that distorts the market for education.

Government creates costs in the course of achieving public policies unrelated to revenue collection, and we generally know to consider the benefits to be gained through those policies and balance them against the costs. Discussions of tax reform seem to have forgotten that the inefficiencies produced by tax expenditures might be outweighed by their beneficial effects on other values, such as the distribution of the benefits and burdens of government. The problem is broadly endemic in all discussions of tax reform, but particularly prominent in the debate about tax expenditures. The tax law is as complex as it is because, at its best, Congress has attempted to make distinctions among taxpayers. These distinctions may be inefficient, but they are not necessarily bad.

B. Efficiency is the New Normal in the Tax Expenditure Baseline

The most important recent analysis of tax expenditures adopted the efficiency-first perspective. In 2008, the Joint Committee on Taxation did a comprehensive investigation of the analysis used to consider tax expenditures[228] and designed a new approach for identifying tax expenditures that chose efficiency as its unstated normative framework. The Joint Committee's discussion adopted the economist's perspective that tax expenditures are presumptively illegitimate because inefficient,[229] and accepted welfare economics as the criteria for analysis.[230] By adopting a welfarist paradigm in discussing tax expenditures, which are inherently inefficient, the report demanded that equity benefits overcome efficiency detriments to maximize welfare overall.[231] In addition, in applying the new approach, the Joint Committee stated that "efficiency is an

[227] Congressional Research Service Economist Jane Gravelle said: "I have to admit the first thing that flowed to my mind when I was going to address the question of 'do tax incentives work,' is I hope not, because the vast majority of them are really not consistent with what, you know, an economist would suggest." Tax Analysts, Transcript of Proceedings at the 2006 Tax Analysts Conference Series: Tax Incentives–Do They Work, and Are They Worth the Cost? (April 6, 2006), http://www.taxanalysts.com/www/conferences.nsf/KeyLookup/KBUN-7FAURD?OpenDocument&link=transcript.

[228] STAFF OF JOINT COMM. ON TAX'N, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS (Joint Comm. Print 2008).

[229] The report acknowledged that economists are generally opposed to tax expenditures because they interfere with the market, making tax expenditures presumptively problematic going into the analysis. *Id.* at 49.

[230] *Id.*

[231] Even if tax expenditures were not presumptively inefficient, welfare economics still might not be the best tool for judging them. Welfare economics presents one, narrow view of equity that should have to compete with other conceptions of a fair society before it is incorporated as the standard for evaluating tax expenditures. Welfare economics reflects a particular conception of good government policy grounded in utilitarian principles. Equity-promoting tax policy might not be welfarist at all, so tax expenditure analysis might better reflect a different standard.

inherently more neutral construct than is equity"[232] in a project in which neutrality was the stated goal.[233]

In the report, the Joint Committee created a new category of tax provisions, which it called "tax-induced structural distortions," that had not existed in prior tax expenditure budgets. It described tax-induced structural distortions as general rules of the Code that "materially affect economic decisions in a manner that imposes substantial economic efficiency costs."[234] By using efficiency costs as the standard, the definition for tax-induced structural distortions makes an efficient tax the hypothetical alternative baseline, replacing the traditional normal (income) tax base that Surrey had designed in compiling the early tax expenditure budgets. In this revised approach, only efficiency matters. Equity concerns for tax-induced structural distortions were completely absent from the Joint Committee's analysis. The Joint Committee defended its choice of efficiency as the sole criterion for analyzing tax-induced structural distortions because it concluded that only its category of "tax subsidies" raises equity issues. It defined tax subsidies as provisions that are "deliberately inconsistent with an identifiable general rule of the present tax law . . . and that collect[] less revenue than does the general rule."[235] The report distinguished the normative framework for tax subsidies from that applicable to tax-induced structural distortions by concluding that the latter are mostly about taxation of capital income where "efficiency goals loom largest."[236]

Applying efficiency as the normative standard is inadequate for tax-induced structural distortions and any other tax provision. Contrary to the Joint Committee's conclusion, the taxation of capital income presents one of the most important equity issues in the tax system; full taxation of capital income would significantly increase the share of taxes paid by the rich. Both tax reform proposals include capital gains and dividends as ordinary income because that treatment is crucial to the overall progressivity of the plans. The Joint Committee offers the distinction between debt and equity as an example of a tax-induced structural distortion.[237] From an efficiency perspective, the law should be consistent in their tax treatment, whether we tax them both in full (or double) or exempt them both from tax. However, from an equity standpoint, it may make a big difference whether we tax them both in full (or double) or exempt them both from tax because the rich and poor are likely to be affected differently, and individuals have different consequences depending on their holdings.

At the other end of the spectrum, if efficiency is neutral and neutrality is the goal in designing taxation, we should expect that norm to spill over into all categories of tax provisions, even those that are designed to address distributional issues. And in fact, the Joint Committee's report was concerned with efficiency in the tax subsidy category. For example, the report noted that there is a connection between the refundable provisions

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[232] *Id.* at 42.

[233] *Id.*

[234] *Id.* at 10. For the only tax expenditure budget to implement this approach, *see* STAFF OF JOINT COMM. ON TAX'N, 110TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2008-2012, at 7 (Joint Comm. Print 2008).

[235] STAFF OF JOINT COMM. ON TAX'N, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 9 (Joint Comm. Print 2008).

[236] *Id.* at 42.

[237] *Id.* at 41.

(like the EITC and child credit) and income distribution, but it was primarily concerned with targeting and incentives,[238] both of which are efficiency concerns.[239]

C. Tax Expenditures Affect the Fairness of the Tax Rates

The privileging of efficiency over equity constricts the analysis of tax expenditures to focus too narrowly on the definition of the tax base. Tax expenditures, along with rates and exemptions, must be part of a discussion of overall tax progressivity. In a debate about tax fairness, the effects of tax expenditures on relative burdens must be made apparent. Redistributive tax expenditures reflect other concepts of justice that might not be wealth-maximizing, but deserve serious consideration as public policy goals. For example, the earned income tax credit may be best understood as a basic guaranteed minimum for productive members of society,[240] the education credits may be best understood as providing equal opportunity for economic success,[241] and the exclusion for health insurance may be best understood as an elevated public value in bodily integrity that is more important than protecting individual property interests. These provisions may also produce positive economic effects, but even if they do not, they might be good public policy.

In addition, some tax expenditures may be best understood as a legitimate part of the rate structure, rather than as a problem in the tax base. Rates are uniformly treated as part of the general rules of the Code, so that the existing rate schedule at any time is part of those rules and never a tax expenditure.[242] Therefore, rate changes over time would never appear in the tax expenditure budget. Rates are about individuals and their burdens, so they need to be evaluated on those terms. The efficiency norm is inapt as applied to decisions about the effective rates of tax that individuals bear. Efficiency may be relevant to setting marginal rates,[243] but policymakers must set effective rates as well as marginal rates.

This may be the best way to conceptualize the role of the earned income tax credit in the system overall, since it allows the lowest-income workers to enjoy a negative rate of tax. Similarly, the child tax credit may be about adjusting burdens on families with children. The negative tax expenditures that have recently appeared in the tax expenditure budgets may also be best understood as part of the structure of distributing burdens to individuals. These negative tax expenditures include the phaseout of the personal exemption and the double taxation of corporate income. Designating the phaseout of the personal exemption as a negative tax expenditure in the budget, as the Joint Committee did in its report,[244] suggests that high-income taxpayers subject to that phaseout are being overtaxed. But that phaseout could be understood instead as part of the rate structure, as the Joint Committee treated the personal exemption and standard deduction as zero-bracket amounts.[245] If rates are outside tax expenditure analysis, as this

[238] *See id.* at 6.

[239] Efficiency and equity are related in that inefficiencies can sometimes change the distribution of tax benefits. *See* Bittker, *supra* note 133, at 744.

[240] It is an alternative to the minimum wage. *See* Daniel Shaviro, *Minimum Wage, the Earned Income Tax Credit, and Optimal Subsidy Policy*, 64 U. CHI. L. REV. 405, 408 (1997).

[241] This is what Professor Repetti considers the core normative value in our system. *See* Repetti, *supra* note 216, at 1131.

[242] *See* SURREY & MCDANIEL, *supra* note 35, at 3.

[243] This is what the optimal tax model determines.

[244] STAFF OF JOINT COMM. ON TAX'N, 110TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2008-2012, at 37 (Joint Comm. Print 2008).

[245] *Id.*

approach suggests, and the personal exemption is a matter of rates, then its reduction is not a negative tax subsidy, but an increase in rates. While that rate increase may be hidden from public scrutiny by its design as an exemption phaseout, it is still essentially a rate adjustment. Because tax expenditure analysis treats rates as distinguished from the base, it is important to properly identify rate elements and base elements. Reduced rates on particular investments are subsidies to those investments, but increased rates to particular individuals are simply rates. The phaseout of exemptions is about burdens on individuals on account of their total income, so it should be treated as part of the rate structure, where fairness controls.

VI. REFORM MUST HEED THE LESSON OF TAX EXPENDITURE ANALYSIS

Repealing all tax expenditures misunderstands the demands of tax expenditure analysis—that policymakers consider each tax expenditure to decide whether the policy is desirable and whether the mechanism is the best one for carrying out that policy.[246] Surrey's key insight—that spending through the tax code is the same as direct spending—has gained widespread acceptance, even among those who might prefer to see these provisions as simple tax cuts.[247] Lawmakers who frame their favorite policies as tax provisions clearly understand the equivalence, and the academic literature generally treats it as a fact.[248] Tax expenditure analysis has been singularly powerful in providing reasoning to critics of tax incentives across the political spectrum; such critics regularly argue that tax expenditures should be subject to the same scrutiny as direct expenditures, if not repealed.[249]

The Fiscal Commission Report is inconsistent in its adoption of tax expenditure analysis. While it identifies tax expenditures as spending, it fails to subject them to the standards for spending reductions that it applies to direct spending in the rest of the report, contrary to the central lesson of tax expenditure analysis. Undifferentiated repeal of tax expenditures fails to do the rigorous work that Surrey's key insight demands. The Commission engages in a much more thoughtful and measured approach to cutting discretionary spending and entitlement spending than it does for tax-based spending. Instead, the report seeks to eliminate spending through the tax law simply because it is administered through the tax law. This is not a consistent or principled approach to cutting spending and it misunderstands what tax expenditure analysis demands.

If we are to take the lessons of tax expenditure analysis to heart and analyze tax expenditures on the same terms as direct spending, we need to understand that repealing

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[246] *See* SURREY & MCDANIEL, *supra* note 35 (arguing that cutting tax expenditures are the best way to reduce government spending); Fleming & Peroni, *supra* note 187, at 444-45.

[247] *See, e.g.*, Feldstein, *supra* note 182; *See also* Mankiw, *supra* note 182.

[248] David Weisbach and Jacob Nussim offer a framework for considering federal programs that dispenses with the tax expenditure methodology, but adopt this key component as part of the starting point because they consider how to determine when the tax law is the appropriate vehicle for a spending policy. Weisbach & Nussim, *supra* note 51, at 958. Edward Kleinbard considers how the budget process can be improved through this insight. *See* Kleinbard, *supra* note 100. I considered the constitutional implications of this insight. *See* Sugin, *supra* note 98. The Treasury's 2007 Budget moved beyond the taxing/spending analysis to compare tax expenditures to regulation. *See* OFFICE OF MGMT. & BUDGET, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES, FISCAL YEAR 2007, at 300-302 (2006).

[249] *See, e.g.*, Bruce Bartlett, *Spending Through the Tax Code*, FORBES.COM (May 28, 2010), http://www.forbes.com/2010/05/27/finance-economy-tax-code-opinions-columnists-bruce-bartlett_print.html; CITIZENS FOR TAX JUSTICE, JUDGING TAX EXPENDITURES 4 (2009), *available at* http://www.ctj.org/pdf/judgingtep1109.pdf; GEN. ACCOUNTING OFFICE, GAO/GGD/AIMD-94-122, TAX EXPENDITURES DESERVE MORE SCRUTINY 2 (1994), *available at* http://archive.gao.gov/t2pbat3/151813.pdf.

tax expenditures will not produce the $1 trillion in revenue that tax expenditures currently cost. This is true for a variety of reasons. First, a tax expenditure may carry out a policy that Congress will want to replace with a direct spending program. Second, the revenue cost of tax expenditures cannot be added up to produce a total revenue loss (or recoupment) because tax expenditures may interact in a way that misstates total revenue loss when aggregated.[250] Third, scoring of tax expenditures may be mistaken because of projected behavioral effects. Fourth, tax expenditures in the form of exclusions and deductions are dependent on tax rates, which would be lower in a Code without any tax expenditures.

Tax expenditures differ from each other because they reflect different spending policies, and consequently cannot be treated as monolithic. Rather than repealing all tax expenditures, it might be helpful to categorize tax expenditures along the lines of the following four categories: (1) modifications to the base that reflect reasonable differences about the ideal baseline, such as provisions that make the system more consumption-tax like and less income-tax like; (2) provisions that correct market failures or cognitive biases of taxpayers; (3) giveaways to powerful interests and special constituents; and (4) provisions that adjust levels of disposable real income of individuals. Each statutory provision demands categorization and then analysis on its own terms. Only the provisions in Category 3 are clear candidates for quick repeal.

Category 1 may be the least appropriate to place on the reform chopping block because these provisions most closely resemble the ones that we treat as integral to the tax system.[251] These are provisions that make the tax system a hybrid income-consumption tax, and they are in the Code because there is no consensus on an ideal tax base. The baseline in the tax expenditure budget does not represent an ideal to achieve, but rather a reference for information. The provisions in the Code that provide tax benefits to retirement savings, such as 401(k) plans and Roth IRAs, as well as the deductions for capital investment,[252] fit into this category. While they may be characterized as tax expenditures, their function in the law is to modulate the income base. There is no shortage of debate on what the best tax base is, and calling these provisions tax expenditures and repealing them on that ground ignores the much more substantive discussion of this issue taking place in the academic literature.[253]

Elimination of the provisions that fall in Category 2 could undermine the growth goals that are so prevalent in the debate about tax reform today.[254] These provisions are designed to improve efficiency, so they should be welcomed by the tax reformers who care most about growth and efficiency. For example, tax benefits for development of alternative energies fall in this category. Individuals fail to account for the environmental and political costs of fossil fuels, but alternative energy is too expensive to compete with the artificially low price of fossil fuels. Tax benefits for alternative energies alter the market price to make such energies more competitive. Correcting market failures improves efficiency, so provisions that fall into this category should not be repealed in the quest for efficiency.

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[250] *See* OFFICE OF MGMT. & BUDGET, *supra* note 44, at 2.

[251] To borrow from Special Analysis G, these may be elements "necessary to make the tax operational." *See* OFFICE OF MGMT. & BUDGET, *supra* note 97, at 3.

[252] I.R.C. §§ 168(k), 179 (West Supp. 2010).

[253] The income tax/consumption tax debate is the most enduring in all tax policy. *See, e.g.*, Bankman & Weisbach, *supra* note 221; Sanchirico, *supra* note 221.

[254] *See supra* Part V.A.

Category 4 includes all the provisions that adjust for taxpaying ability along any dimension. It includes credits for earners,[255] child-related breaks of all kinds,[256] special provisions for the elderly and blind,[257] state and local taxes,[258] medical expenses,[259] and perhaps charitable contributions.[260] Evaluating these provisions requires a political-philosophical discussion about what each provision does and how it fits into the social fabric. Some of this discussion has been taking place in the academic literature, but not in the current discussion of tax expenditure repeal and reform. Child tax benefits, for example, reveal ideas about family and community.[261] Payments per child, like the child tax credit,[262] reflect the notion that families with children have less ability to pay tax and that children are entitled to support from other members of society beside their parents. These are the provisions that affect the core concerns of tax policy—what individuals and society owe to each other. These are the provisions that give meaning to who is rich and who is poor in our society, and they are crucial to have as part of the tax system.

VII. CONCLUSION

This article is a challenge to those who would take the quick route to tax reform by repealing all tax expenditures. It argues that tax expenditures do not share enough characteristics to warrant common treatment, and those who would repeal them all have failed to understand the role they play in federal policy. The movement towards tax reform primarily for growth and efficiency is inconsistent with the demands of tax policy. The most distinctive role for tax policy is in distributive justice, and tax expenditures are a crucial mechanism for achieving fairness in the allocation of government benefits and burdens among individuals. This article calls for recognizing tax expenditures as the important distributive tool that they are, and demands greater understanding of the role of tax expenditures in achieving fairness. The debate on tax reform needs to be informed by a richer understanding and much more data than we have today about what tax expenditures do, who benefits from them, and who would bear the inevitable losses that would result from their repeal.

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[255] I.R.C. § 32 (West Supp. 2010).

[256] I.R.C. §§ 21, 24, 36C, 129, 151(c) (West Supp. 2010).

[257] I.R.C. § 63(f) (2006).

[258] I.R.C. § 164 (West Supp. 2010).

[259] I.R.C. §§ 106, 213 (West Supp. 2010).

[260] I.R.C. § 170 (West Supp. 2010). *See* Andrews, *supra* note 189.

[261] *See generally* ANNE L. ALSTOTT, NO EXIT: WHAT PARENTS OWE THEIR CHILDREN AND WHAT SOCIETY OWES PARENTS (2005) (discussing the fairness of a tax system where the childless subsidize the costs of those who freely decide to have children).

[262] I.R.C. § 24 (West Supp. 2010).