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The Tax Expenditure Concept: Current Developments And Emerging Issues

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THE TAX EXPENDITURE CONCEPT: CURRENT DEVELOPMENTS AND EMERGING ISSUES*

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and

PAUL R. MCDANIEL***

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INTRODUCTION

In 1968, the Treasury Department published its first "tax expenditure" budget.¹ Only six years later, the Congressional Budget Act of 1974 made the concept of tax expenditures an integral part of a new congressional budget process. Pursuant to that Act, the 1975 Budget contained a "Special Analysis" entitled "Tax Expenditures,"² and all subsequent Budgets have included a similar tabulation. In 1976, both the House and the Senate Budget Committees established a targeted amount of reduction in tax expenditures as a goal of tax reform legislation and this step was a material factor in the

¹ ANNUAL REPORT OF THE SECRETARY OF THE TREASURY ON THE STATE OF THE FINANCES FOR FISCAL YEAR 1968, 326-40 (1969) [hereinafter cited as 1968 ANNUAL TREASURY REPORT].

² BUDGET OF THE UNITED STATES GOVERNMENT, 1976, Special Analysis F at 101 (1975). See also Special Analysis F in subsequent annual Budget Documents. For the Fiscal Year 1979 Budget this material is in Special Analysis G [the Special Analyses

passage of the Tax Reform Act of 1976.³ In 1977, the President, in assembling material for his consideration of changes in the tax system, asked the Treasury for a detailed report on the desirability of each item listed in the tabulation of tax expenditures. In 1977 and 1978, the Congress, in its continuing search for ways to make the ever-growing federal budget manageable, again recognized, as it had in 1974, that it must grapple with the role played by tax expenditures. The principal occasions for congressional analysis of tax expenditures were the consideration of "sunset" review for federal programs⁴ and the question of the jurisdiction of the Senate Appropriations Committee over "refundable" tax expenditure credits.⁵

These events, along with developments at the state and international levels,⁶ evidence a rapid and expanding recognition of the role that the tax expenditure concept plays both in tax policy issues and in budget policy issues. Indeed, once the presence of tax expenditures in a tax system is focused upon, there is a general awareness that unless attention is paid to those tax expenditures, a country has neither its tax policy nor its budget policy under full control. This awareness in turn opens up new facets of the concept of tax expenditures, and leads to new insights in the ways the concept affects the substance of fiscal policy and the political processes by which such policy is formulated. The purpose of this article is to describe current developments and emerging issues concerning the tax expenditure concept.⁷

I. CONCEPTUAL ISSUES

A. Definition of Tax Expenditure

1. Background

Essentially, the tax expenditure concept, as applied to an income tax, regards such a tax as composed of two distinct elements. The first element con-

are hereinafter cited as 1976, 1977, or 1978 Special Analysis F, respectively, and 1979 Special Analysis G).

³ See Surrey, *Reflections on the Tax Reform Act of 1976*, 25 CLEV. ST. L. REV. 303 (1976), reprinted in 6 TAX NOTES NO. 12 at 291 (March 12, 1978).

⁴ See Part V.D *infra*.

⁵ See Part V.B.1 *infra*.

⁶ In 1976, California by statute directed that a report on tax expenditures be included in the Governor's Budget. 1976 Cal. Stats. ch. 575. In 1971, the state by statute had directed the Department of Finance to prepare a biennial tax expenditure report. 1971 Cal. Stats. ch. 1762.

In 1976 and 1977, the two major international tax organizations chose the concept of tax expenditures as a principal subject for their annual meetings—the International Fiscal Association at its 1976 Jerusalem Congress, INTERNATIONAL FISCAL ASSOCIATION, GENERAL REPORT, TAX INCENTIVES AS AN INSTRUMENT FOR ACHIEVEMENT OF GOVERNMENT GOALS, LXIa CAHIERS DE DROIT FISCAL (Jerusalem Congress, 1976) [hereinafter cited as IFA 1976 Congress], and the International Institute of Public Finance at its 1977 Varna Congress, INTERNATIONAL INSTITUTE OF PUBLIC FINANCE, SUBSIDIES, TAX RELIEFS AND PRICES (Varna Congress, 1977) (to be published) [hereinafter cited as IIPF 1977 Congress].

⁷ This article covers primarily developments in the period 1976 to 1978 and is a companion piece to a previous article which had the same purpose for the period from 1974 to early 1976. See Surrey & McDaniel, *The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 B.C. IND. & COM. L. REV. 679 (1976).

tains the structural provisions necessary for implementation of a normal income tax. These structural provisions include the definition of net income; the specification of accounting periods; the determination of the entities subject to tax; and the specification of the rate schedule and exemption levels. These provisions compose the revenue raising aspects of the tax. The second element consists of the special preferences found in every income tax system. These special preferences, often called tax incentives or tax subsidies, are departures from the normal tax structure, designed to favor a particular industry, activity, or class of persons. Tax subsidies partake of many forms, such as permanent exclusions from income, deductions, deferrals of tax liabilities, credits against tax, or special rates. Whatever their form, these departures from the "normative" income tax structure essentially represent government spending for the favored activities or groups through the tax system rather than through direct grants, loans, or other forms of government assistance.

Put differently, whenever government decides to favor an activity or group through monetary assistance, it may elect from a wide range of methods in delivering that assistance. Direct assistance may take the form of a government grant or subsidy, a government loan, perhaps at a special interest rate, or a private loan guaranteed by the government. Instead of direct assistance, the government may work within the income tax system to reduce the tax otherwise owed by a favored activity or group. Examples of this indirect government assistance are investment credits, special depreciation deductions, deductions for special forms of consumption, or low rates of tax for certain activities. These tax reductions, in effect monetary assistance provided by the government, represent tax expenditures.⁸

Most tax expenditures are readily recognizable since they are usually treated by their supporters as tax incentives or as hardship relief, and they are not urged as necessary to correct defects in the income tax structure itself. The Treasury Department, in establishing the first tax expenditure tabulation in 1968, basically utilized the general economic definition of income—the increase in net economic wealth between two points in time plus consumption during that period. The Treasury modified this general definition by adding a reference to the "generally accepted structure of an income tax." The modification had the narrow, explicitly described function of excluding from the category of tax expenditures certain nontaxable items which economists would cover under the general economic definition of income but which historically have not been regarded as essential aspects of the structure of the Sixteenth Amendment income tax. These nontaxable items include such things as unrealized appreciation in the value of an asset and income imputed from an asset (for example, rental income imputed from ownership of a house). With the exception of its reference to the "generally accepted structure of an income tax," the Treasury closely followed the general economic definition of income. Thus, it included as tax expenditures those provisions allowing deductions for personal consumption items or other items not incurred in the

⁸ See generally Surrey & McDaniel, *supra* note 7, at 679-80.

earning or production of income. As to the "timing" criteria for defining income for the taxable period, the Treasury referred to widely accepted "standards of business accounting" used to determine income for financial reports.⁹

⁹ See Surrey & McDaniel, *supra* note 7, at 683. The definitional process was described for an international audience in Address by Stanley Surrey, *The Concept of Tax Reliefs—Its Relation to Tax Policy and Budget Policy*, IIPF 1977 Congress, *supra* note 6 (the 1977 Varna Congress used the term "tax relief" interchangeably with "tax expenditure" and in the excerpt below "tax expenditure" has been substituted for "tax relief" in several places).

Tax expenditure analysis is based on the concept of a normal or normative tax of the type under consideration. This paper focuses on the income tax and hence discusses the normal structure of such a tax. But the analysis is appropriate to any broad based tax intended to have a general application, as a consumption tax (such as a retail sales tax or a value added tax, or a progressive expenditure tax), a death tax, a general property tax, or a wealth tax. In terms of the income tax, the normative structure involves the determination of the base of the tax (net income); the accounting period; the taxable unit; and the rate schedule, including personal exemption levels. In the United States' analysis of tax expenditures, the normative concept of net income is the general economic definition of income under the "Haig-Simons" approach, i.e. increase in net economic wealth between two points of time plus consumption during that period. "Consumption" is broadly applied, and in essence covers all expenditures except those incurred as a cost in the earning or production of income and hence are proper offsets to gross income to arrive at taxable net income. Since the Haig-Simons approach does not identify appropriate accounting techniques, resort in establishing a normal structure is made to widely-accepted "standards of business accounting" used to determine income for financial reports. The application of these economic and accounting norms is then tempered by also referring to the "generally accepted structure of an income tax." This reference, it was pointed out, excluded as normative the inclusion of unrealized appreciation in asset values and of imputed income from homes or other assets, since in the United States, and largely elsewhere, these items are not commonly regarded as income for tax purposes though they fall within the economic definition of income.

The taxable unit is not defined by the Haig-Simons definition nor is there a normative concept of that unit. Rather, the choice of taxable unit—e.g., how to tax single persons versus married persons, working spouses as against non-working spouses, and the family in general—is regarded as a policy issue wider than tax policy per se and embracing a country's attitudes toward marriage, women in general, women in the work force, etc. Also the rate schedule itself is not a normative concept. Instead such matters as how progressive the rates should be or at what starting point in the income scale the rates should generally apply are matters for fiscal policy to determine. While factors such as the taxable unit or a rate schedule are necessary to the structure of an income tax, their particular determination—unlike the determination of the tax base and the accounting techniques to identify the net income of a given period—are not part of a normative concept of the income tax. However, once a general rate schedule is decided upon as a matter of fiscal policy, a special variation in that rate intended to confer a special tax benefit becomes a departure from a normal structure. But a general reduction of tax rates would not be a tax expenditure—though it would be relief from taxes.

The basic Treasury formulation of the tax expenditure concept and of the criteria utilized in classifying tax expenditures has stood up quite well as both the concept and the classification criteria have obtained wider application and consequently wider scrutiny. Using this formulation, technicians in the executive branch and in Congress charged with preparing the annual tabulation of tax expenditures have been able to maintain a high degree of consistency and uniformity in approach, even when faced with the need to classify a constant stream of legislative changes in the income tax. Although the Budget Act of 1974 required a legislative definition of the term "tax expenditure," since a number of operative provisions of that Act utilize the term,¹⁰ this def-

Essentially, then, the concept of a normal (or normative) income tax to be used in identifying tax expenditures is one of applying a general rate schedule (determined under fiscal policy) against a taxable unit's (determined under fiscal and social policy) net income base—with that base ascertained by including all items of gross income and deducting all expenditures associated with the earning or production of that income, with capital expenditures allocated over time in accordance with generally accepted accounting practices. This analysis extends to both the corporation income tax and the individual income tax. The norm, however, does not specify any particular general relationship between these two taxes, and thus does not specify a classical corporate tax structure, a completely integrated corporate tax, or a partially integrated corporate tax. However, once given a country's general choice of a corporate tax-individual income tax relationship, then special departures from that choice can be tax expenditures. (The United States tax expenditure analysis is made against the background of the present classical separation of the two taxes.) The analysis also does not specify whether the determination of the tax base is in terms of nominal accounts or in terms of inflation-adjusted accounts. However, here also, once a clear choice is made, any special departure can be a tax expenditure. Thus an approach that would adjust the cost of an asset for inflation in computing gain or depreciation but fail to make an adjustment in the real cost of funds borrowed to acquire the asset would be effecting only a partial or preferential change to reflect inflation and would thus involve a tax expenditure. (In the United States, tax expenditure analysis is made against the background of the present general nominal dollar determination of the base.) The "indexing" of the rate schedule for inflation is not a tax expenditure, since the shape of the rate schedule itself is not involved in the normative structure and hence a decision to change rate brackets because of inflation is equally outside the analysis.

It will be seen that the essential aspect of the definition of a normal income tax is the determination of the net income base allocated to the particular yearly accounting period utilized to compute tax liabilities. Generally speaking, in countries using a broadly-applied modern income tax, the determination of that base is not a matter on which informed fiscal experts would exhibit much disagreement if their function were solely to establish a normative structure.

¹⁰ For a description of the operative tax expenditure provisions in the Budget Act of 1974, Pub. L. No. 93-344, 88 Stat. 297 [hereinafter cited as Budget Act], see Surrey & McDaniel, *supra* note 7, at 683-84. Examples of these operative provisions include the requirement in section 601 that the President include tax expenditures in his annual Budget, and the requirement in section 708(a) that committees reporting bills which provide for new or increased tax expenditures include statements concerning the effect of the bill on current levels of tax expenditures and a five-year projection of the revenue effect of the change.

inition has not proved helpful. The language used by the drafters to define tax expenditure indicates their problem in capturing the concept in statutory words: "[tax expenditures are those] revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability . . ." ¹¹ The word "special" is not explicit enough to carry the definition, and the legislative history essentially resorted to references to existing tax expenditure tabulations to convey the congressional intent. The government technicians therefore have generally followed the original Treasury formulation, and, as stated above, have found that formulation sufficient to handle legislative tax changes and other matters. ¹² The fiscal 1977-1979 tax expenditure lists are set forth in Appendix A.

There remains in some discussions of tax expenditures the feeling that the concept somehow implies that the government is entitled to a taxpayer's entire income and that the enumerated tax expenditures, instead of being regarded as subsidies, should be seen as examples of governmental restraint in not taxing all of that income. ¹³ But clearly, the tax expenditure concept

¹¹ Budget Act, *supra* note 10, § 3(a)(3).

¹² Tabulations of tax expenditures are to be found in the following documents, so far published annually: BUDGET OF THE UNITED STATES GOVERNMENT, Special Analyses (see *supra* note 2); CONGRESSIONAL BUDGET OFFICE, FIVE-YEAR BUDGET PROJECTIONS, SUPPLEMENT ON TAX EXPENDITURES [hereinafter cited as CBO TAX EXPENDITURE TABULATION]; STAFF OF JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES (annual) [hereinafter cited as JOINT COMM. ESTIMATES]. See also SENATE BUDGET COMM., 94TH CONG., 2D SESS., TAX EXPENDITURES: A COMPENDIUM OF BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS (Comm. Print March 17, 1976) [hereinafter cited as S. BUDGET COMM. COMPENDIUM], and 95TH CONG., 2D SESS., TAX EXPENDITURES: RELATIONSHIPS TO SPENDING PROGRAMS AND BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS (Comm. Print September 1978). The 1977 CBO TAX EXPENDITURE TABULATION, *supra*, contains in Appendix a brief description of each item listed; the 1979 Special Analysis G also contains such descriptions.

While earlier Budget Special Analyses differed from congressional tax expenditure lists in not including deferral of tax on the income of controlled foreign corporations, the asset depreciation range, and capital gains at death, 1979 Special Analysis G includes these items. The functional categories are now identical with those used in the congressional lists.

¹³ The honey example used by Chairman Long in his testimony on S. 2, *The Sunset Act of 1977*, Hearings on S. 2 Before the Subcomm. on Intergovernmental Relations of the Senate Comm. on Governmental Affairs, 95th Cong., 1st Sess. 468-69 (1977) [hereinafter cited as *Hearings on the Sunset Act of 1977*], illustrates this point. Chairman Long states:

Some people would like to say, since we put a top tax bracket at 70 percent on individual income, that theoretically, the Government owns 70 percent of everything you make. That being the case, they would like to assume that an individual is getting some sort of tax advantage or escaping something if he fails to pay that 70 percent of his income. You could just as well take the same attitude about the personal exemptions, although they don't necessarily do that. So you can define "tax expenditure" however you want to do it. You may include one thing and I include another—it makes me think of this situation:

You could say that I saved 40 cents, because, instead of taking a bus downtown, I decided that I would walk. But you could just as

merely states that if *only* an "income tax" is desired and no other social or economic objectives are sought, such a tax should reach fully the normative scope of "net income." Whether that net income base is taxed at rates that are high or low is a decision apart from tax expenditure analysis. A deliberate decision to exclude certain items from that base because of particular social or economic goals becomes a tax subsidy since the conceded base of the tax has not been followed. As the Congressional Budget Office appropriately describes:

[A] tax expenditure is analogous to an entitlement program on the spending side of the budget; the amount expended is not subject to any legislated limit but is dependent solely upon taxpayer response to the particular provision. In this respect, tax expenditures closely resemble spending programs that have no ceiling.¹⁴

This view of tax expenditures is becoming clearer as discussion in the area proceeds, although some still attempt to make debating points based on the "all income belongs to the government" syndrome.¹⁵

2. Classification of Legislative Changes

As to fiscal 1979, all three tax expenditures lists—Special Analysis G in the President's Budget, the Congressional Budget Office Tax Expenditure

easily say that I saved \$1.50, because I could have hired a taxicab to go down there. Or you could say I saved \$50 because I seriously considered taking a limousine, and that would have cost me 50 bucks.

Now that type of logic is implicit all through this argument about tax expenditures.

Clearly the Chairman understands the concept and his example is but a debating point. Compare Chairman Long's statements, for example, in *Tax Reform Act of 1975: Hearings on H.R. 10612 Before the Senate Comm. on Finance, 94th Cong., 2d Sess.* 191, 503, 1637, 1664-65, 2404 (1976), that some provisions clearly are tax expenditures. In his above example, one could of course find a norm for a given individual and the "saving" would be readily measurable, though different if individuals had differing norms as presumably they would. But the income tax has but one normative base. The tax expenditure saving does vary with an individual's rate bracket, but that is simply an aspect that demonstrates a problem—and generally a defect—in utilizing a tax expenditure device to provide government assistance.

For examples of the mistaken view that the tax expenditure concept implies that all income belongs to the Government, see Friedman, *What Belongs to Whom?*, Newsweek, March 13, 1978, at 71; Stutsman, Brookes, Jewett and McCaskey, *Tax Reform*, reprinted in 123 CONG. REC. E3538-39 (daily ed. June 6, 1977) (statement of Rep. Goldwater); Smith, *Taxation of Capital in a Political Economy*, 38 TAX FOUNDATION'S TAX REV. NO. 7, 25 (July 1977); I. KRISTOL, TWO CHEERS FOR CAPITALISM 208 (1978).

¹⁴ 1977 CBO TAX EXPENDITURE TABULATION, *supra* note 12, at 1.

¹⁵ As discussed *infra* in text at notes 310-28, an amendment to the Revenue Act of 1978 was offered by Senator Glenn to subject tax expenditures to a "sunset process." During the course of the debate on that amendment, several members of the Senate Finance Committee opposed the amendment in part on the rhetorical assertion that the tax expenditure concept implies that all income belongs to the government. See, e.g., the remarks of Senators Bentsen and Hansen, at 124 CONG. REC. S17494, 17760 (daily eds. Oct. 7 and 9, 1978). Senator Long, ever resourceful in debate, produced a new image:

Tabulation in its Five-Year Budget Projections, and the Estimates of Tax Expenditures prepared by the Staff of the Joint Committee on Taxation—agree on which provisions of the tax code constitute tax expenditures.¹⁶ With each new piece of tax legislation, however, new classification issues emerge. For example, the Tax Reduction and Simplification Act of 1977 combined the minimum standard deduction (the low income allowance) and the regular standard deduction into a zero bracket amount in the rate scale, and defined itemized deductions in terms of the excess over the zero bracket amount. These changes eliminated the standard deduction from the list of tax expenditures. The zero bracket amount is now regarded as a part of the rate schedule; it is essentially a transformation of the minimum standard deduction into the rate schedule. The various itemized deductions remain, and their amounts are to be estimated by reference to the "floor" of the zero bracket amount.¹⁷

Looking ahead, welfare reform legislation may affect the list of tax expenditures. For example, the present tax expenditure lists include the exclu-

In my left hand I hold a big cigar, which I borrowed from a friend. It is an object of value.

I hold in my other hand a pencil. The Congress thought about the matter and decided to put a tax on the cigar, so we pay a tax on the cigar, and that results in some revenue for the Government. We once had a tax on pencils, but we took the tax off pencils, so the pencil bears no tax and the cigar does.

To apply [Senator Glenn's] argument to the cigar and the pencil, pencil users are being provided an unjust advantage because they are not paying the same tax we pay on cigars. Congress thought about what it wanted to tax and it said, "We want to tax the cigar." But to use the Senator's argument, the Government is losing a fantastic amount of money because the tax we have on the cigar does not apply to a pencil.

124 CONG. REC. S17491-92 (daily ed. Oct. 7, 1978).

Chairman Long confuses the issue by selecting metaphorically different tax bases. If the tax base is cigars (*i.e.*, income), no tax expenditures result *within that tax* from the failure to tax pencils (*i.e.*, net wealth). In contrast, if the tax is on cigars (income), but one-half the tax is deferred on cigars manufactured by small business to encourage their growth (small corporation income tax rates), a tax expenditure is present within the tax. See S. SURREY, *PATHWAYS TO TAX REFORM* 27 (1973), discussing the application of tax expenditure analysis to excise taxes.

¹⁴ The Congressional Budget Office stated that the 1976 Tax Reform Act involved forty-one tax expenditure changes. While most of the changes resulted in increases or decreases in existing tax expenditures, some tax expenditures were dropped and others were added. The items *dropped or phased out* were: exclusion of gross-up on dividends of LDC corporations; special rate for Western Hemisphere trade corporations; credit for purchases of new homes; five-year amortization of railroad rolling stock; five-year amortization for employer child care facilities.

The items *added* were: tax incentives for preservation of historic structures; contributions in aid of construction for certain utilities; credit (instead of deduction) for child and dependent care expenses; deduction for eliminating in buildings, etc., barriers for the handicapped; exclusion of contributions to prepaid legal services plans; employee stock ownership plans (ESOPs) funded through investment tax credits. See 1977 CBO TAX EXPENDITURE TABULATION, *supra* note 12, at Table 2 and the descriptive material in 1979 Special Analysis G.

¹⁷ See the discussion of estimates in the text at notes 28-29 *infra*.

sions from taxable income of government direct cash payments, such as social security payments and unemployment insurance payments. Yet, the tax expenditure lists do not include the government benefits in kind, such as food stamps, which are also excluded from taxable income. This difference in approach has been previously mentioned in the Special Analyses in the President's Budget as an aspect that may require reexamination. Where the benefits in kind closely resemble cash payments, as in the case of food stamps, so that problems of measurement are not really involved, it appears that their exclusion from taxable income should be considered a tax expenditure. The 1968 Treasury decision to exclude as a tax expenditure the non-inclusion in taxable income of the imputed income from homes and personal property did not really explore how that decision affected government services generally, or more particularly, government in-kind transfer programs.¹⁸ Furthermore, it is not clear that the "equivalent of cash" characterization which may fit food stamps would apply to any other in-kind program. Perhaps the discussion of welfare reform will clarify the area. Presumably in that discussion it will be necessary to determine whether conversion to monetary terms of existing government in-kind programs must itself be included in taxable income. The decision on that issue and the grounds advanced to support the decision may also clarify views regarding the treatment in the tax expenditure budget of remaining in-kind programs.

The 1978 changes in the corporate tax rate structure present an emerging classification issue. To date, all tax expenditure budgets have treated the corporate surtax exemption as a tax expenditure, while regarding the corporate tax as a flat rate tax. The lower rates, provided within the corporate surtax exemption range, traditionally were justified as aids to small business and, accordingly, were included in tax expenditure lists. In the Revenue Act of 1978, the existing "normal tax" and "surtax" structure was repealed and replaced by a five-step rate structure on corporate taxable income, with rates ranging from 17 to 46 percent. Concerning this change, the Ways and Means Committee Report stated: "With respect to business taxpayers, the basic corporate tax structure is changed and taxes are reduced, but the Committee does not consider a new tax structure to be a tax expenditure, even though the change reduces tax liabilities. The Congressional Budget Office does not agree."¹⁹ In some respects, the Ways and Means Committee justification of the changed rate structure is consistent with its view that the change simply implemented a new rate system for corporations. The Committee was concerned that the former "abrupt jump in tax rates" from 22 to 48 percent was undesirable. Moreover, it argued that the new system of graduated rates would reduce the impact of the tax provisions on a small business' selection of operating form.

These arguments appear to be structural rather than tax expenditure justifications. Nevertheless, the Committee also stated that it was making the

¹⁸ 1968 ANNUAL TREASURY REPORT, *supra* note 1.

¹⁹ H.R. REP. NO. 1445, 95th Cong., 2d Sess. 143 (1978). The Senate Finance Committee took the same position. S. REP. NO. 1263, 95th Cong., 2d Sess. 253 (1978).

change because tax relief was "especially needed for small companies."²⁰ The "small business" aspect was highlighted by the Committee decision to halt the progression of the rates at \$100,000 of taxable income, since 78 percent of corporate net income and 93 percent of corporate taxes are attributable to corporate income above \$100,000. And, despite the Committee's statement, the tables on changes in tax expenditures provided in the Committee Reports treat the revenue loss from the lower corporate rates on the first \$100,000 of taxable income as a tax expenditure.²¹

The 1978 changes in corporate rate structure do present an interesting conceptual issue. Certainly, tax expenditure analysis does not imply that a country can only adopt a flat rate corporate tax. Progressive rates traditionally have not been applied to corporations since a progressive rate schedule has largely been justified on "ability to pay" concepts, a concept that has little relevance to corporations. A country could choose, however, to have a truly graduated and progressive rate scale for corporations. But the 1978 legislation does not represent such a scheme. As noted above, the benefits of the new rate schedule are largely confined to "small business" because of the failure to extend the five-step rate schedule farther up the income scale. Moreover, the changes amount to only a \$7,750 reduction in tax impact on the first \$100,000 of income. This seems a relatively minor revenue change and not significant enough to take the five-step corporate tax rates out of the tax expenditure category in which the present two-step system is classified. On balance, we are therefore of the view that classification of the graduated rate system for corporations as a tax expenditure program for small business would be correct.

A renewed interest in the "integration" of the corporate and individual income taxes could present a classification problem if legislation integrating the two taxes were to develop. Budget Special Analysis G stated in 1978:

Treatment of individuals and corporations as separate tax-paying entities.—A theoretically pure income tax would integrate the taxation of individual and corporate income to avoid multiple taxation of any particular type of income. Only individuals would be taxed; corporate income would be taxed to shareholders, whether or not it was distributed in the form of dividends. However, for practical reasons, separate taxation is accepted as part of the normal tax structure for purposes of this analysis.²²

In contrast, the Treasury analysis in 1968 simply stated that "[t]he assumption inherent in current law, that corporations are separate entities and subject to income taxation independently from their shareholders, is adhered to in this analysis."²³ The Treasury analysis thus did not determine whether a "theoretically pure income tax" would integrate the two taxes. If the "practical

²⁰ H.R. REP. NO. 1445, *supra* note 19, at 79. The Senate Finance Committee Report emphasized the "small business" thrust of the new rate schedule even more heavily. S. REP. NO. 1263, *supra* note 19, at 110.

²¹ S. REP. NO. 1263, *supra* note 19, at 144.

²² 1979 Special Analysis G at 152 (emphasis added).

²³ 1968 ANNUAL TREASURY REPORT, *supra* note 1.

reasons" mentioned in Special Analysis G extend to the fact that economists and others are not agreed on the "pure" treatment of corporate and individual income taxes, and that a country therefore may choose among various relationships between these taxes—just as it may choose among various family unit decisions in constructing its "normative income tax"—then the expression "for practical reasons" may be acceptable.

The recent discussion of "integration" does exhibit a large degree of difference in viewpoint as to the appropriate relationship between corporate and individual income taxes, in terms of economic theory, financial attitudes, and structural aspects. Indeed, much of the discussion is in terms of incentives to capital formation and investment rather than in terms of theoretical concepts. Moreover, the more serious legislative approaches to integration that surfaced in 1977 and 1978 appeared to extend only to limited tax relief for dividends, though it was difficult to decide whether a reduction in tax at the shareholder level or a reduction in tax at the corporate level was being discussed.²⁴ If only a limited tax relief for dividends were to be enacted, then presumably the relief would be classified as a tax expenditure, especially if enactment rests on incentive grounds.²⁵ It may be that continued theoretical analysis of "integration" approaches will lead to more insight on appropriate classification, as well as to more guidance on the appropriate legislative response to the substantive questions. The experience in the United States certainly supports the view that the discussions thus far as to the economic, financial, accounting, and legal ramifications of the various suggested approaches to integration have not come close to the extensive exploration of these factors that sensibly should precede such a basic change in the income tax system.

In summary, the definition of tax expenditures has not as yet presented any basic problems.²⁶ There may be borderline situations in determining

²⁴ See generally C. McLURE, JR., MUST CORPORATE INCOME BE TAXED TWICE? (1979). See also McLure, Jr. & Surrey, *Integration of Income Taxes: Issues for Debate*, 55 HARV. BUS. REV. 169 (1977); *The President's 1978 Tax Program: Hearings on the President's Tax Proposals Before the House Comm. on Ways and Means*, 95th Cong., 2d Sess. (1978); M. BLUME, J. CROCKETT & I. FRIEND, FINANCIAL EFFECTS OF CAPITAL TAX REFORMS (1978).

²⁵ In this connection, theoretical analysis in Europe has not yet resolved the question whether the various European shareholder credits (and the German corporate rate reduction for dividends) should be considered as permissible responses within a set of possible normative relationships between the corporate and individual income taxes which a country can adopt or whether they constitute tax expenditures (in a system that views the classical system as normative) or tax penalties (in a system that views a fully integrated corporate tax as normative).

²⁶ Surrey & McDaniel, *supra* note 7, at 685-88, pointed out some definitional misconceptions. A few additions may be described here. Richard Goode states, "In my opinion . . . the present tax expenditure budget rests on a shaky conceptual foundation and for this reason is less convincing to skeptics than it would be if more rigorously derived." Goode, *The Economic Definition of Income*, in COMPREHENSIVE INCOME TAXATION 1, 27 (J. Pechman ed. 1977). He then suggests two alternatives, one being a broader tabulation using the Schanz-Haig-Simons definition, described *id.* at 7, and the other being a narrower tabulation including only those provisions where the legislative history indicates a dominant tax incentive or hardship relief motivation. *Id.* at 28. But as Charles Davenport in his Comments points out, Goode's second alternative using legislative history would result in the present tax expenditure list and not a narrower

whether a particular provision of the Code constitutes a tax expenditure, but

tabulation. *Comments by Charles Davenport*, in *COMPREHENSIVE INCOME TAXATION* 33, 34-35 (J. Pechman ed. 1977). Moreover, Goode's first alternative would not greatly differ from the present tabulation but would include net imputed rental income from owner-occupied homes, death benefits from life insurance policies, and accrued gains on capital assets. *Id.* at 34. These omissions have been explicitly discussed, however, in tax expenditure analysis. The Treasury 1968 guidance, which excluded these items—Goode calls that guidance “pragmatic,” Goode, *supra*, at 26—simply saw no point in pressing inclusion of these items especially when Congress and the public certainly do not come close to conceiving of their exclusion from the tax base as tax incentives. Indeed, much of the confusion over capital gains results from the inability of legislators to conceive of the use of the “realization concept” as a benefit to recipients of capital gains. Goode's criticism thus either disappears or is very narrowly confined and by no means supports his term “shaky conceptual foundation.”

A curious aberrational concern over the definitional aspect appeared in Treasury Secretary Blumenthal's testimony on the proposed Sunset Act of 1977:

I think it is important from the beginning to recognize that tax expenditures is not a clearly defined concept. . . .

It is not clear under this definition that the personal exemption or the standard deduction might not be categorized as a tax expenditure. [The definition referred to is the definition of tax expenditures in the bill, which was almost identical to that adopted in the Budget Act, quoted in text at note 11, *supra*].

Hearings on the Sunset Act of 1977, *supra* note 13, at 109.

Senator Kennedy in his testimony readily pointed out the Treasury's errors:

In his testimony last week, Secretary Blumenthal indicated that there might be problems in identifying tax expenditures. But the examples given do not suggest that the problems are significant. . . .

With respect to the specific examples cited by the Secretary, no tax expenditure budget for the past 10 years has included personal exemptions as a tax expenditure; every budget has included the standard deduction as a tax expenditure. To my knowledge, there is no disagreement as to either treatment.

Moreover, the Treasury seems to be concerned in its other examples by items that are not included in the tax expenditure budget. But the suggested definitional difficulties seem to be resolved in light of the thorough analysis that has characterized the efforts of the Congressional Budget Office and the Joint Committee on Taxation on this issue in recent years.

The Budget Reform Act of 1974 contains a workable definition of tax expenditures. So, too, do S. 2 and the legislation developed by Senator Glenn. Moreover, under the Budget Reform Act, the committee reports of the House Ways and Means Committee and the Senate Finance Committee must identify new or increased tax expenditures.

Therefore, the Joint Tax Committee and the Congressional Budget Office—as well as the Treasury—are given guidance by Congress as to the items that should be included in the tax expenditure budget.

Id. at 329-30.

Later, the Treasury, on further reflection, recognized that the definitional problem did not really exist and submitted a letter from Secretary Blumenthal which came back to the basic Treasury position:

In my testimony, I discussed the definitional difficulties in the tax expenditure concept. Section 401(a)(1) of Title IV contains a broad definition of tax expenditures which is subject to the difficulties cited by me in my testimony. On the other hand, tax expenditures are listed and *ipso facto*

any useful classification has borderline problems.²⁷ The important point, and one overlooked by some economists and others, is that the assertion of definitional impossibility is an assertion that a country has lost control of its tax and budget policies. The Congress at least understands that it must separate tax expenditures from the regular tax system if it is to have rational budget controls. Once those who seem to despair or agonize over definitional problems realize that an operative tax expenditure analysis is a legislative necessity—as well as an executive branch tool—then perhaps there will be more helpful discussion of the definitional boundary.

B. *Estimates of Tax Expenditures*

The technicians working on the tax expenditure tabulations have been able to handle the problems presented in estimating the various items.²⁸ This is not surprising since the analytical problems which arise in estimating tax expenditures are precisely the same as those presented in estimating revenues for any proposed legislative tax changes. These problems include: the handling of an estimate for one item when the item is affected by changes in other items—the so-called “stacking” of changes in interrelated items; the

defined in three places: the special analysis of the budget prepared by the Executive; the annual reports of the Congressional Budget Committees; and, the annual estimates of tax expenditures prepared for the Committee on Ways and Means and the Senate Finance Committee by the staff of the Joint Committee on Taxation. The definitional difficulties can be avoided if an abstract definition is replaced by reference to any of the currently used lists of specific tax expenditures. Furthermore, budget procedures already enacted require the specific identification of new tax expenditures as they are legislated.

Id. at 120.

Apparently the initial Treasury statement was prompted by its dislike at being caught between a directive by OMB at the last moment to support in principle the entire proposed Sunset legislation even as to termination of tax expenditures on lines parallel to termination of direct Budget programs—a Carter campaign position—and the Treasury's awareness that Chairman Long disagreed with the tax expenditure termination provisions (though not with the basic concept of reviewing tax expenditures, *see id.* at 470). The later Treasury letter reflected a more reasoned approach. *See also* text at notes 310-28.

Another definitional misconception surfaced in the 1977 Sunset Act Hearings. Senator Glenn indicated a preference for the term “tax incentive” instead of tax expenditure, *id.* at 87, not realizing that his terminology would leave out tax subsidies for the relief of hardships, *e.g.*, many of the income security items, which his basic position on Sunset legislation would want covered by the review and termination provisions.

²⁷ Professor Carl Shoup has pointed out:

The listing of tax expenditures will no doubt be “incomplete” (or overcomplete), but if publication were to be denied to any listing that was sure to be incomplete, on the grounds that incompleteness is “potentially misleading” . . . as indeed it is, national income accounts would never have appeared and no censuses would have been taken.

Shoup, *Surrey's Pathways to Tax Reform—A Review Article*, 30 J. FINANCE 1329, 1334 (1975).

²⁸ Much that has already been said about defining tax expenditures equally applies to estimating them. Surrey & McDaniel, *supra* note 7, at 688-90 discusses tax expenditure estimating techniques and some misconceptions about them.

assumption that economic behavior remains unchanged if an item is eliminated—the so-called “first-order” estimates; and the assumption that economic conditions remain unchanged by microeconomic measures. The technicians who supply these revenue estimates for tax reform proposals are the same individuals who furnish the tax expenditure estimates. Hence, any critical observations made of the tax expenditure estimates are essentially criticisms and observations concerning the basic revenue estimating procedures used by the Treasury and Congress. The criticisms may or may not be proper, but they must be seen as relating to basic revenue estimating procedures and not as criticisms of the tax expenditure concept itself.²⁹

²⁹ Hence the remark of Richard Goode in his paper at the Brookings Institution Conference on Comprehensive Income Taxation that “the tax expenditure estimates are less firmly based than would be desirable for official statistics,” Goode, *supra* note 26, at 28, seems strange indeed. Likewise strange, for a different reason, are Henry Aaron’s remarks in the same conference:

But it is futile to dream of a “grand budget” that sums direct expenditures—a set of affirmative actions actually taken—and tax expenditures—a set of actions *not* taken or revenues *not* collected. The list of things we have chosen not to do is infinite and unspecifiable. The futility of such an endeavor is revealed by the fact that if we try correctly to estimate the aggregate level of tax expenditures, the level of each particular tax expenditure depends on the number of tax provisions that are *defined* as tax expenditures. The level of social security outlays does not depend on whether we define, say, Federal Home Loan Bank Board advances to be in or out of the budget; but the revenue implications of, say, permitting the deduction of property taxes does depend on the fact that unemployment insurance is excluded. The impossibility of constructing an unambiguous grand tax expenditure budget should not divert attention from the immense value of program analysis that includes both direct and tax expenditures.

Comments by Henry Aaron, in COMPREHENSIVE INCOME TAXATION 30, 31 (J. Pechman ed. 1977) (emphasis in original). However, as Charles Davenport points out in his *Comments*, the same problem is presented in direct program estimates:

For example, if food stamps were eliminated, the outlays for aid to families with dependent children might increase, but no one suggests that estimates for the food stamp program are in error for this reason.

Comments by Charles Davenport, *supra* note 26, at 35.

The International Fiscal Association 1976 Congress, on the subject of incentives, said as to estimates:

Another difficulty was seen in determining the initial cost to be attributed to a tax incentive in cases where e.g. foreign capital or foreign technicians would not be attracted in the absence of such incentive.

Summary of Proceedings, [1976] I.F.A.Y.B. 46 (1976) [hereinafter cited as *IFA Summary*]. However, this comment indicates the problems that persist because of a failure to recognize that tax incentives are really spending programs. Thus, suppose a country, to attract foreign capital or foreign technicians, adopted a direct grant program of roughly the same cost magnitude as a tax incentive program for the same purpose. Surely the “cost” of the direct program would appear in the budget, even though without that program there might have been no foreign capital or foreign technicians. The revenue obtained from such attraction becomes an offsetting item. But the choice of a tax incentive spending program should show a similar “cost,” offset by the revenue brought in by the foreign capital and foreign technicians (including the “cost” itself). The two programs are thus comparable and the “cost” of each is in effect obtained in the same fashion, each cost being open-ended.

The President's 1978 tax reform proposals presented a descriptive prob-

Stiglitz and Boskin, in *Impact of Recent Developments in Public Finance Theory on Public Policy Decisions*, 67 *AM. ECON. REV.* 295 (1977), also misconceive the estimating process and fail to state that, to a great extent, their observations equally apply to all revenue estimates (the observations may be accepted as statements, but estimators and others familiar with the process have long been fully aware of the situation):

The other concept, the use of which is now written into law, is that of tax expenditures: the loss of revenue due to a particular provision. We have three major objections to this concept. First, as presently formulated, the measurement of foregone revenue implicitly assumes zero elasticities; the estimates of aggregate tax expenditures are correct only when one contemplates eliminating *all* deviations from taxing real economic income *simultaneously and* if the factors of production are in *perfectly inelastic supply* [which Boskin in 1977 and Heckman in 1974, among others, demonstrated is not the case]. Further, the estimates for particular so-called tax preferences are often extremely inaccurate. For example, if the tax law allows a deduction for charitable contributions, it is not correct to argue that abolishing the deduction will increase tax revenue by (the summing over all contributors who itemize deductions) the product of the marginal tax rate and the amount currently given to charity. The amount of resources flowing into each such "tax expenditure" category reflects the tax treatment of that category as well as others. Since the charitable deduction reduces the price for a dollar of charitable contributions from \$1 to $\$(1-t)$, where t is the marginal tax rate, any price elasticity at all in charitable giving would imply that abolishing the deduction would also reduce charitable contributions. Take the case of a family with a marginal tax rate of 20% which currently gives \$300 a year to charity. The tax expenditure budget counts .2 times \$300, or \$60, as a tax expenditure. Yet abolition of the deduction implies a 25 percent price increase; with the elasticity of -1.2 estimated by Feldstein (1976), contributions fall to \$210, and at the other extreme the "revenue foregone" is only \$42 if the extra \$90 does not flow into taxable income. The tax expenditure budget thus overestimates the revenue loss by more than 40 percent!

Id. at 296-97 (emphasis in original).

But the phrase "if the extra \$90 does not flow into taxable income" misses the issue. The \$90 is *already* in taxable income since the \$300 was a deduction from taxable income. The taxpayer would have to use the \$90 for some expense that would still qualify as deductible and would not be within the tax expenditure list. This is unlikely and hence the criticism of the estimate is unsound.

Another criticism in the same article is as follows:

[T]he tax expenditure concept suffers from a further defect: the legislation implicitly assumed that the "natural" tax base is income, broadly defined; as we shall argue below, there is little justification for this. That is, to know what is being "exempted" from taxation one needs to know what "ought" to be taxed.

Id. at 297.

The article then discusses, for example, whether "consumption" is a more appropriate tax base than "income." It may or may not be, but the present federal income tax is accepted as a tax that uses "income" as its base. It is therefore appropriate to structure a tax expenditure list for *that* tax accordingly. A different tax expenditure list would be—and could be—structured for a tax using "consumption" as the base, since the legislature, contrary to the assumptions of many economists who prefer the consumption base, would undoubtedly also work into such a tax a large number of "incentive" and "relief" exceptions.

Another aspect of the estimation process is the "feedback," or second order

lem for the technicians handling tax expenditures.³⁰ Those 1978 proposals involved major tax rate reductions which in turn reduced the value of all tax expenditures other than those utilizing a credit against tax technique. The proposals also recommended the elimination or direct scaling down of specific tax expenditures. To separate these varying effects, Budget Special Analysis G in 1978 first showed the existing tax expenditures under existing tax rates, and then showed the combined results of the recommended rate reductions and the revisions in particular tax expenditure items.³¹

effects, of proposed tax changes. Renewed interest has been expressed in efforts to estimate these effects. Attention has focused especially on proposals to reduce the tax on capital gains. See, e.g., M. Evans, *An Alternative to the Fiscal Stimulus Act of 1978: A Reduction in Capital Gains Tax Rates* (Chase Econometrics Assoc., Inc., May 1978). The hazards of such endeavors and the sometimes truly heroic assumptions required to be made are discussed and debated in Bristol, *Pitfalls in Using Econometric Models: The Chase and DRI Capital Gains Estimates*, 6 TAX NOTES No. 20 at 531 (May 15, 1978); Evans, *Capital Gains Taxes and Econometric Models*, 6 TAX NOTES No. 22 at 593 (May 29, 1978); Eckstein, *The Use of Econometric Models to Evaluate Capital Gains Changes*, 6 TAX NOTES No. 23 at 611 (June 5, 1978); Bristol, *Pitfalls in Equation Construction*, 6 TAX NOTES No. 23 at 635 (June 5, 1978). See also Gravelle, *Study by Chase Econometrics on Effects of Reducing the Capital Gains Tax Rate*, Library of Congress, Congressional Research Service (1978), reprinted in 124 CONG. REC. E2616 (daily ed. May 16, 1978). At this writing it appears that economists generally agree on the desirability of developing techniques that would provide accurate data on feedback effects in appropriate situations. However, there is no agreement that reliable techniques have yet been developed. Moreover, considerable care must be employed where tax expenditures are involved. Usually tax expenditures affect only the allocation of available resources and do not involve the creation of new resources. Hence, models showing net increases in jobs or capital from changes in tax expenditures are highly suspect. See the discussion of this subject in 124 CONG. REC. 14610-18 (daily ed. Sept. 6, 1978), which includes a Treasury Department technical analysis of the appropriate use of feedback estimates.

In proposing an increase in the capital gains deduction for individuals from 50 percent to 70 percent of the realized gain, the Senate Finance Committee reduced its estimated revenue loss of \$3.394 billion by an assumed \$1.092 billion "feedback," resulting from estimated increased realizations of gains. See S. REP. NO. 1263, 95th Cong., 2d Sess. 193 (1978). While there seemed to be general agreement among economists that the reduction might produce a short-term increase in realizations, Treasury economists concluded that there would be no long-term increase in the level of realizations by investors. See *Hearings Before the Senate Finance Committee on the Revenue Act of 1978*, 95th Cong., 2d Sess. 197-201 (1978) (statement of Secretary of the Treasury Blumenthal).

³⁰ Some estimating situations presented by the 1976 Tax Reform Act change—e.g., minimum tax changes, at-risk provisions, and the termination of some tax expenditures which had involved deferrals of tax liabilities—are discussed in the text at notes 156-62 *infra*.

³¹ See also CONGRESSIONAL BUDGET OFFICE, *THE PRESIDENT'S FISCAL YEAR TAX EXPENDITURE PROPOSALS* (April 1978).

The estimates for the tax expenditures involving itemized deductions—e.g., mortgage interest, charitable contributions—are made as follows: Since, in general, only the total of itemized deductions in excess of the zero bracket amount (\$2300 single, \$3400 married) is allowed, where there is an allowable excess considering itemized deductions as a group, then as to any particular itemized deduction the tax expenditure value of that item is computed by applying the marginal rate used by the estimators to the lesser of the amount of the excess or the amount of the specific item. As a consequence, the total of the separate estimates for the various itemized deduc-

Thus, as to the conceptual problems involved in estimating tax expenditures, we may conclude that a consensus among fiscal experts as to the estimates to be attached to those expenditures should be readily obtainable. The problems of estimating tax expenditures are similar, in this respect, to those involved in the identification of tax expenditures. Indeed, a moment's thought should indicate how serious are the consequences of asserting that tax expenditures cannot be identified or, if identified, that their costs cannot be ascertained. At bottom, this would be an assertion that the fiscal experts of a country do not know what is contained in their income tax or how much particular programs cost the government. In short, as stated earlier, the assertion would be an admission that the country has lost control of both its tax policy and its budget policy. Ten years ago the United States did not know what its tax spending programs were or how much they cost. The United States now realizes that in January, 1978 it had around 85 such programs involving over \$135 billion, a total equal to 27 percent of the estimated \$500 billion of direct budget outlays. Unquestionably, this figure represents too large an amount of revenue to allow its distribution to evade scrutiny or analysis. Yet, without the tax expenditure analysis commenced in 1968, that would be the situation today in the United States. The obvious point is that once experts are given the assignment of identifying and quantifying tax expenditures, the task can be accomplished, and a new dimension opened for fiscal policy.

C. Tax Penalties and Limits on Tax Expenditures

We have been discussing those departures in the present tax laws from a normative income tax whose effect is to provide government assistance through the income tax system. Along with these tax expenditure provisions, there are other provisions departing from a normative income tax whose effect is to penalize the taxpayer by requiring a greater tax payment than would occur under the normative net income base. One example is the disallowance of gambling losses in excess of gambling gains even where the gambling is entered into on a "for profit" basis.³² Other examples are found in the various "public policy" provisions denying deductions for certain business expenses involving lobbying, bribes, or fines.³³ A classification of these public

tions *overstates* the revenues that would be collected in the event that several of the *deductible* items were eliminated. In contrast, the total of the tax expenditure estimates of *exclusions* from gross income *understates* the revenue gain that the elimination of several of the exclusions would provide.

³² I.R.C. § 165(d). The provision was not adopted as a penalty. The legislative history, under the 1934 Act, indicates that the courts had limited the deduction of gambling losses to the amount of gains where gambling was illegal. But there was no such limitation for legal gambling, and apparently many taxpayers were deducting legal gambling losses but failing to report their gambling gains. The provision was designed to reach this evasion.

³³ I.R.C. § 162(c), (e), (f), (g), and regulations thereunder. Other tax penalty provisions include I.R.C. § 280B (denial of current deduction for losses sustained as a result of the demolition of a "certified historical structure"), and I.R.C. § 274(h) (disallowing the costs of attending more than two foreign conventions each year even

policy provisions as penalties does require, however, the assumption that "morality" has no place in a normative income tax, an assumption that may be hard to argue given the inevitable tendency of courts and legislatures in some instances to assert the overriding importance of public morality. Still, the result of these provisions is to tax more than net income.

There are only a few of these "tax penalty provisions," and the list has been kept narrow by the Congress.³⁴ These tax penalties can be seen as substitutes for direct regulatory measures, limiting or proscribing specific activities. When so viewed, tax penalties are regulatory provisions embodied in an income tax system. We will later consider other tax measures, framed as excise taxes, that also have a regulatory purpose. The discussion of regulatory tax measures would seem equally applicable to tax penalties.³⁵

In addition to the tax penalty provisions, and not to be confused with the tax penalties, is a group of provisions adverse to taxpayers consisting of limits placed on the use of the tax expenditures themselves. Thus, the restriction on the deductibility of capital losses is a concomitant limit on the tax expenditure treatment of capital gains.³⁶ Similarly, the 1978 Energy Tax Act denied the investment credit and accelerated depreciation for boilers fueled by oil and gas.³⁷ The minimum tax is another limitation on the use of tax expenditures since the "preferences" included in the base for determining that tax are tax expenditure items.³⁸ The decision under the 1976 Tax Reform Act to en-

though the excess conventions are business-related). The denial for tax deduction purposes of certain accounting reserves is not a tax penalty, but rather an effort to have administratively feasible accounting rules. The 1954 experience indicates that a full tax acceptance of accounting reserves would set off a wave of pessimism on the part of company controllers and accounting firms.

³⁴ S. SURREY, *PATHWAYS TO TAX REFORM* 336-37 (1973) [hereinafter cited as *PATHWAYS*].

³⁵ The appropriate Budget presentation of these tax penalties is discussed in the text at note 163 *infra*.

³⁶ The 1977 JOINT COMM. ESTIMATES, *supra* note 12, at 4, states, "The limitation on the deduction of a net long-term capital loss is a limit on the incentive made available through the special treatment for capital gains." If capital gains were treated as ordinary income, then the deduction of capital losses would presumably be liberalized. But some limitations might remain, since the "realization" concept permits the taxpayer to realize his losses and postpone his gains. Any such remaining limitations would thus be a concomitant of retention of the realization concept. As the incentive effect of that concept—as opposed to the accrual concept—becomes more understandable, retention of the realization concept could well be listed as a tax expenditure. See *PATHWAYS*, *supra* note 34, at 18-19.

A 1976 addition to the tax penalty list is the disallowance of certain deductions associated with the demolition of historic buildings, I.R.C. § 280B. This penalty was enacted at the same time as a tax expenditure (five year amortization) for the rehabilitation of historic structures, I.R.C. § 191, and superficially could be seen as a limit on that tax expenditure. But while the tax system is in each case being used for a social purpose, the tax penalty is essentially separate in structure and effect from the tax expenditure and therefore different from the capital gain-capital loss relationship.

³⁷ See I.R.C. §§ 48(a)(10), 167(p).

³⁸ The only exception under the minimum tax is the inclusion, as a preference under the minimum tax, of accelerated depreciation in excess of straight-line depreciation for leased property. Of course, the accelerated depreciation methods of I.R.C.

force the congressional opposition to the boycott against Israel essentially utilized limitations on the availability of certain tax expenditures as the sanctions for this anti-boycott policy. These tax expenditures were the deferral of income on domestic international sales corporations (DISC) and the deferral of tax on the income of controlled foreign subsidiaries.³⁹ Superficially, some may see these boycott limitations as tax penalties and deplore the use of the tax system for that purpose—a view that has force when tax penalties are really involved. In fact, provisions such as these, limiting existing tax expenditures, perform a function quite different from the tax penalties.

It must be recognized that once tax expenditures are injected into the tax system to serve, for example, certain international economic goals, it is acceptable in a policy sense to place limits on their use where the limits serve other international goals. What may be deplored is that, in particular instances, an analysis of the limitations may often indicate that the limitations are not the most sensible set of sanctions. Thus, in the boycott area, since Congress has now legislated direct sanctions,⁴⁰ the overlap would seem hard to justify. It would be useful to determine whether the direct sanctions do eliminate the need for a separate set of limits written into the tax expenditure provisions.

Another form of limitation on tax expenditures occurs when Congress, in its "reform" efforts, eliminates or reduces the scope of the tax expenditure either by applying the proper normative rule or by attaching non-normative limitations on the use of tax expenditures. In 1976, illustrations of the first approach were the adoption of certain capitalization requirements for farm tax shelters and accrual accounting for certain farm corporations.⁴¹ An

§ 167(b) are themselves on the classification borderline, in view of their generosity in many situations. Note that ADR is included in the tax expenditure list. See 1979 Special Analysis G at 152.

³⁹ I.R.C. §§ 999, 995(b)(1)(F)(ii), and 952(a)(3). The sanctions also extend to denial of the foreign tax credit, I.R.C. § 908. Since that credit is not a tax expenditure, the denial becomes a tax penalty—though perhaps the denial and the grouping of the credit with DISC and deferral says something about the congressional attitude toward the tax credit or the lack of analysis in the hasty technical implementation of the congressional anti-boycott policy.

In a related matter, the 1976 Tax Reform Act amended I.R.C. § 964(a) to provide that illegal bribes paid by a foreign subsidiary shall not reduce the earnings and profits of the subsidiary, for example, to determine the inclusion of such earnings and profits in the income of the United States parent under Subpart F. Since without this legislation the bribe would be subtracted in determining earnings and profits—a cold technical concept having no room for morality, *see* Rev. Rul. 77-442, 1977-2 C.B. 264—this legislation is a tax penalty. Congress in the Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 94 Stat. 1494, adopted direct sanctions against bribery overseas by United States enterprises, raising the question whether the 1976 tax penalty is now needed.

⁴⁰ Export Administration Amendments Act of 1977, Pub. L. No. 95-52, 91 Stat. 235.

⁴¹ The amortization requirement for real estate construction period interest and taxes, I.R.C. § 189, does not fully apply a normative approach since it contains a 10-year limit even though the building may have a longer life. See the 1977 CBO TAX EXPENDITURE TABULATION, *supra* note 12, at Table 2, for tax reform provisions that will decrease tax expenditures.

example of the second approach—that of using limitations that are not a part of the normative tax system but are simply designed to reduce the benefits of tax expenditures—is the minimum tax.⁴²

These varied approaches to tax expenditures can indeed become confusing and it is doubtful that the tax technicians themselves have always kept the separate categories in mind.⁴³ But it is desirable to clarify the analysis of these different approaches to ensure that resort to them remains manageable and appropriate.⁴⁴

⁴² The "at risk" provisions in I.R.C. § 465 are perhaps viewed by Congress as in the same category as the minimum tax, that is, an ad hoc limitation on the tax expenditures involved. Yet, unlike the minimum tax, whose preferences are with one exception limited to tax expenditures, see note 38 *supra*, the "at risk" disallowance extends to business expenses which are deductible as part of the normative net income concept. It is not clear whether thought was given to this application. This application, however, does raise the question whether the "at risk" concept is itself a normative tax concept or a tax expenditure limitation. The basic issue is when a "loss" or "expense" is really a "loss" or "expense." The *Crane* (331 U.S. 1 (1947)) approach allows a deduction when funds, even non-recourse borrowed funds, are spent with a reconciliation to be made later if the taxpayer need not repay the borrowed funds. The "at risk" approach suspends the deduction until the taxpayer has spent "his own" funds, including as "his own" funds borrowed amounts for which he is liable and leaving aside the boundary lines involved in the definition of "at risk." The issue thus becomes one of the proper timing of otherwise proper tax deductions. It is thus a tax accounting question for which appropriate standards have not yet evolved. In a world where tax shelters are not abused, it might be possible to live with the *Crane* rule, which has the justification of emphasizing the time at which funds were spent. In addition, "at risk" does control the "sales price" or "market value" of assets where the only parties involved, besides the I.R.S., are the buyer and seller, and their interests are not adverse, e.g., certain motion picture and book arrangements. The "at risk" rule is further justified by emphasizing the time at which the taxpayer had to utilize his own funds. One gets the impression that the current Treasury technicians tend in the direction of considering the "at risk" approach to be a proper tax rule and not just an anti-tax expenditure abuse weapon. Impetus was given to this view by the extension of the "at risk" rules in the 1978 Act, although real estate activities and widely held corporations remain exempt from the rules.

⁴³ Thus, 1979 Special Analysis G, at 149, groups as "negative tax expenditures or tax penalties" the treatment of gambling losses, the limitation on the deductibility of capital losses, the non-deductibility of costs associated with the demolition of historic buildings, see note 36 *supra*, and the denial of "certain normal tax treatment" under the anti-boycott provisions. The term "negative tax expenditures" is not a helpful one for provisions that are tax penalties—in essence regulatory devices—and the term "tax penalties" is more useful. Moreover, the grouping itself is improper as the text indicates.

⁴⁴ The issues surrounding the classification of a foreign revenue measure as an "income tax," qualifying for the foreign tax credit under I.R.C. § 901, would seem to illustrate the text. In Revenue Rulings 78-61, 78-62, and 78-63, 1978-8 I.R.B. 11, 16, and 18, the standard applied for qualification is whether the foreign tax "constitutes an 'income tax' as determined from an examination of the Federal income tax laws of the United States." Rev. Rul. 78-62, *supra*. Presumably this standard does not require that the foreign tax contain all or any of the tax expenditures present in the United States income tax. Yet, it would seem that the standard does require a rather close approximation of our normative concept of an income tax—the concept which permits our classification of non-normative provisions as tax expenditures. Thus, the foreign tax must have a "purpose . . . to reach net gain and . . . is so structured as to

D. Excise Taxes and Regulatory Use of the Tax System

Tax expenditures represent a use of the tax system to provide governmental financial assistance. The tax expenditures are essentially spending programs and thus become a part of the budgetary process. In recent years, Congress has suddenly turned to using the tax system for regulatory purposes as well. This injection of regulatory provisions into the tax system, like the initial use of tax expenditures, has come into being without any analysis of the regulatory provisions themselves, or of the resulting complications for the tax system, the regulatory process, the legislative process, and executive branch administration. Congress has long utilized tax expenditures without developing criteria for determining when to resort to a tax expenditure and when to resort to a direct program in situations where government assistance is the

be almost certain of doing so." Rev. Rul. 78-62, *supra*. But the standard should also recognize that there can be differing responses to particular questions and each of those responses can constitute part of a "normative tax." The recent rulings stress that "the gain on which the foreign tax is levied must be realized in the United States sense." Rev. Rul. 78-62, *supra*. See also the phrase "gain actually realized," Rev. Rul. 78-61, *supra*. If this statement is understood as applying to situations involving artificial or fictitious gains, e.g., the use of "posted prices" as the base of the tax, Rev. Rul. 78-63, *supra*, or other estimated gains, Rev. Rul. 78-62, *supra*, the statement is acceptable. But if it were used to deny credit for a general income tax which includes in the base imputed income from owner occupied homes, as the reference in Rev. Rul. 78-63 to the *Woolworth* case, 54 T.C. 1233 (1970), implies, or appreciation in value reached annually under an accrual concept (compare the Canadian Carter Commission recommendation for including accrued asset appreciation on a five-year basis—would such a Canadian income tax really not be creditable?), then the statement is inappropriate. Such a general income tax would, certainly as far as economists view the matter, be a "better" income tax than the United States income tax.

Thus a country with an income tax that comes closer to the economists' normative model should be a qualifying "income tax" under I.R.C. § 901. A country with an income tax that contains many tax expenditure provisions also should still have an "income tax" within § 901. That country is like the United States, whose income tax embodies both a normative tax and tax expenditures. A country with an income tax that contains tax penalty provisions also should still have an "income tax" within § 901. Thus, if a country desiring to *encourage* oil drilling has a tax expenditure provision allowing the deduction of intangible drilling expenses, it still has a qualifying income tax. If another country desiring to *discourage* oil drilling has a tax penalty provision denying all deduction for drilling expenses, it also should still have a qualifying income tax. But a country which has only a gross income tax, and thus clearly has a different normative model to begin with, does not have a qualifying income tax.

Tax expenditure analysis can thus help to answer some of the questions regarding qualification as an "income tax" under § 901. That analysis, however, cannot answer other questions under § 901, such as whether an income tax applied only to a single industry is an "income tax"; whether an income tax applied only to foreigners is an "income tax"; whether an income tax applied at one rate to foreigners from "exemption countries" and at a higher rate to foreigners from "foreign tax credit countries" is an "income tax"; or, whether a government which owns resources and foregoes royalty revenues, thus relying only on its income tax, still has a qualifying income tax. See Revenue Rulings 78-233, 78-234, and 78-235, 1978-23 I.R.B. 13, 15, and 16, which involve some of these issues and do not resolve them in a wholly satisfactory manner. The Internal Revenue Service has initiated a Regulations project to examine the problem in a comprehensive fashion.

policy goal. In similar fashion, Congress is now using the tax system for regulatory purposes, again without examining the criteria necessary to govern the choice between tax regulatory devices and direct regulatory measures.

Historically, Congress has resorted to excise taxes—such as taxes on white phosphorous matches, narcotic drugs, or adulterated butter⁴⁵—when it thought that direct regulation would be unconstitutional. Occasionally, Congress has used these taxes when the tax committees either became impatient with the failure of other committees to respond to public pressure, or when the tax committees simply desired to undertake certain actions themselves. The anti-gambling excise taxes of 1958 are an example of this use of excise taxes.⁴⁶ This historical regulatory use of excise taxes, however, has gradually diminished.⁴⁷ Originally, of course, excise taxes were primarily used for revenue purposes. In 1965, Congress severely reduced the number of these revenue-raising excise taxes in a deliberate move to bring some order to the excise tax field. Essentially, the scope of excise taxation was then limited to a few significant revenue raising excise taxes, such as alcohol and tobacco, and to excise taxes that were essentially user charges often connected with trust funds, such as the various highway taxes.⁴⁸

In 1969, congressional tax technicians began to utilize excise taxes as sanctions to enforce what were essentially restrictions on tax expenditures or tax provisions that could be classified as tax expenditures. For example, in 1969 various excise taxes were adopted to restrain tax-exempt private foundations from resorting to activities substantively prohibited under regulatory tax provisions.⁴⁹ In 1974, Congress also used such excise taxes to enforce the substantive tax restrictions regulating pension plan activities.⁵⁰ The basic congressional decision in each situation was to use the tax structure itself to impose the substantive regulatory rules. Since the tax-exempt foundation was a creature of the tax laws, using the tax system to restrict its abuses was a natural reaction. Even so, direct penalties rather than excise taxes could have been used as sanctions. Nevertheless, the tax technicians, having molded the substantive regulatory tax provisions, kept the entire regulatory structure within the tax system by using excise tax sanctions.⁵¹ Most of the 1974 pen-

⁴⁵ PATHWAYS, *supra* note 34, at 155. For a historical description, see R.A. LEE, A HISTORY OF REGULATORY TAXATION (1973).

⁴⁶ I.R.C. §§ 4401-4424.

⁴⁷ An exception was the interest equalization tax enacted in 1964 to control the outflow of investment dollars to purchase foreign securities. *See* former I.R.C. §§ 4911 et seq. (repealed 1976). The tax approach was here adopted after a thorough canvass of alternative direct regulatory measures, such as an overall dollar limit on purchases and a government auction of transferable rights to purchase within that limit.

⁴⁸ Excise Tax Reduction Act of 1965, Pub. L. No. 89-44, 79 Stat. 136.

⁴⁹ I.R.C. §§ 4940-4948.

⁵⁰ I.R.C. §§ 4971-4975.

⁵¹ Apparently, the Treasury Department desired sanctions involving fines and enforcement in the federal district courts, while the Joint Committee Staff desired the excise tax sanctions.

sion plan regulatory structure could have been placed entirely outside the Code and implemented as a direct labor regulatory system—the Treasury approach in 1967 and 1968.⁵²

Other recent examples of the use of the excise tax sanction are the excise tax on lobbying expenditures by tax-exempt organizations in excess of permitted amounts,⁵³ the excise tax on real estate investment trusts to police required distributions of income,⁵⁴ and the excise tax on self-dealing and other activities relating to trusts established by coal mine operators to finance black lung benefit payments.⁵⁵ These recent excise tax sanctions are related to existing tax expenditures or tax assistance provisions, and hence the use of the tax sanction is understandable.⁵⁶ Even here, however, no criteria seem to have been sufficiently developed to determine when the sanction should be an excise tax and when the sanction should be a direct civil, or even criminal, penalty.

The recent developments in the energy field have introduced essentially new regulatory uses of excise taxes. Unlike the foundation or pension plan excise taxes, where there was a previous link to the tax system, the energy taxes represent an innovation. They involve a deliberate choice between using the tax system, through excise taxes, as the way to impose regulatory policy goals, and using direct regulatory laws to reach these same goals.⁵⁷

The energy regulatory taxes fall into two classes. The first class involves the imposition of regulatory standards within the contours of excise taxes.⁵⁸ This regulatory use of the tax system has been favored by many economists, especially in the pollution field,⁵⁹ although generally these economists have not directed their research to developing criteria governing the choice between tax regulation and direct regulation, nor have they considered the ef-

⁵² Perhaps the House Ways and Means Committee in 1973 desired to "get into the act" along with the Labor committees. But in 1968, at least Chairman Mills was willing to follow the Treasury decision to exclude use of the tax system and instead to consider the area as one involving only a direct regulation of labor. The Congressional Joint Committee Staff, while acquiescing in the 1968 decision, in the 1973 legislation desired to use the tax system.

⁵³ I.R.C. § 4911.

⁵⁴ I.R.C. § 4981.

⁵⁵ I.R.C. §§ 4951-4953.

⁵⁶ I.R.C. § 4981, relating to real estate investment trusts, is an exception, since the treatment of real estate investment trusts, mutual funds, and Subchapter S corporations, all of which are enabled, in effect, to move out of the scope of the corporation income tax, have not been treated as tax expenditures but as appropriate accommodations to the relationship between the corporation income tax and the individual income tax.

⁵⁷ Most of the historical regulatory excise taxes did not involve a choice since direct regulation was not thought to have constitutional infirmities. The 1964 interest equalization tax did involve a choice of approaches since direct regulation was a constitutional route.

⁵⁸ The proposed Hospital Cost Containment Act, H.R. 8337, 95th Cong., 1st Sess. (1977), while a regulatory measure, would use an excise tax sanction applicable to hospitals to enforce its standards.

⁵⁹ See, e.g., A. KNEESE & C. SCHULTZE, *POLLUTION, PRICES AND PUBLIC POLICY* (1975).

fects of the choice on the legislative and administrative processes.⁶⁰ An example is the "gas guzzler" excise tax on fuel-inefficient cars, adopted in 1978.⁶¹ A clear alternative here was a direct regulatory approach with civil fines as the sanction. Indeed, under the Energy Production and Conservation Act, a set of direct mileage standards simultaneously is employed to reach the same result.

In the administrative or legislative consideration of the alternatives, no well researched position on the criteria governing the choice between a tax sanction and a regulatory sanction, or governing the choice to impose both a tax sanction and a regulatory sanction, was developed. At best, in enacting the excise tax, there seems to have been a feeling that if direct regulation proved too onerous for manufacturers, Congress would bail out the automobile companies through new legislation rather than see prohibitive fines imposed for failure to comply. In contrast, since the customer ultimately pays the manufacturer's excise tax sanction under the tax approach, perhaps the selection of the tax approach was based on the belief that Congress would be less ready to bail out the customer. But if the customers rebelled against the extra cost of the excise tax and the companies could not sell automobiles, it is not clear why Congress would not here also be willing to bail out the automobile companies.⁶² In short, we have no clear answer why the tax approach is preferable to the direct approach, assuming the regulatory standards are the same under each approach. The Internal Revenue Service has had experience in administering an excise tax in the automotive field; indeed, there is a truck excise tax now. Presumably, the Service did not regard the excise tax approach as a significant departure from its prior responsibilities.

A second class of energy regulatory taxes is even newer in concept and was adopted in the House version of the 1978 Energy Tax Bill. It involves the use of the tax system as a substitute for what economists call "service ratemaking." The House bill contained an excise tax on the production of crude oil. With prices fixed on "old oil" at a lower level than "new oil," the energy officials faced the question how to allocate the low priced oil—a typical problem in regulation when producers are prevented from obtaining windfall prices. A tax on crude "old oil," which would in effect allow its market price to rise to the level of "new oil" as the tax was passed on to consumers, would eliminate this problem of allocation by eliminating any low priced oil. Such a

⁶⁰ For an earlier discussion, see *PATHWAYS*, *supra* note 34, at 155.

⁶¹ I.R.C. § 4064.

⁶² If a regulatory standard becomes difficult for a company to meet and the standard is enforced by a fine, the standard may in effect become prohibitive or at least involve very high compliance costs. This is because non-compliance, leading to payment of the fine, may be regarded by the public as a lawless act and the company would not want to subject itself to that stigma and consequent damage to its image. Hence, Congress might be willing to step in and relax the standard. In contrast, payment of a regulatory excise tax because of non-compliance, though a cost to the company, might not carry the same stigma and image damage. Thus, a fine, though intended to be non-prohibitive, may in operation become prohibitive, while the excise might remain non-prohibitive.

tax also would prevent the windfall profits from going to the producers. Instead, the windfall profits would go to the Treasury via the revenues collected through the excise tax.

The receipt of the excise tax revenues led to new analytical difficulties—what should the Treasury do with these windfall revenues? Since billions of dollars were involved, the stakes were high. Should taxpayers in general receive the funds through tax rebates, and if so, which taxpayers? Should special consideration be given to low-income users of gasoline adversely affected by the price rise, or should the funds be given to producers as a quid pro quo for seeking new supplies of oil or new sources of energy? In the alternative, should the revenues be used as “sweeteners” to soften any recommendations for serious tax reform proposals through reduced income tax rates, or should the revenues be used to help finance the social security system? Should the revenues be used to finance new spending programs unrelated to energy? In addition to these analytical difficulties, the large amounts involved had a macroeconomic effect which had to be taken into account in determining fiscal policies.

One senses that the proponents of using the tax system for this second kind of regulatory purpose did not foresee the political and economic problems involved in distributing the revenues raised by the “regulatory” excise tax. Essentially, the tax approach substituted the problem of “who gets the revenues” for the problem under the direct regulatory approach of “who gets the cheap product.” It is by no means clear that the new problem is any easier to solve than the old problem. The political difficulties involved in the acceptability of decisions on the revenue allocation seem equally as severe as those involved in the acceptability of decisions on the product allocation.⁶³

⁶³ The House oil and gas equalization taxes and per capita rebates thereof were not included in the final Energy Tax Act of 1978 as passed by Congress. See REP. NO. 1324, 95th Cong., 2d Sess. 55-57 (1978).

This article is not the place for a comprehensive analysis of the 1977-1978 energy legislation. Obviously, a retrospective analysis describing the choices between the tax approach and the direct regulatory approach in the various areas involved and the reasons for the final decisions is very much in order on the part of energy and tax experts with a taste for tax detail as well as regulatory expertise.

For a brief general description, as of July 1977, of the Administration's energy proposals, see S. Breyer, *The Regulatory Implications of the President's Energy Proposals* (The First Boston Corporation, July 1977). Professor Breyer, in the 1978 manuscript of a forthcoming book, “The Reform of Economic Regulation,” discusses briefly the considerations relevant to the choice between tax regulation and direct regulation in the two classes of regulatory situations described in this article, and his discussion is not limited to the energy field. The discussion leans to the use of the tax system, but has yet to be extended to the impact on the legislative or administrative process and the political and economic problems involved in allocating the revenues in the second class of situations. A later paper by Breyer, “Taxes as a Substitute for Regulation,” in *Papers on Energy Policy Meeting on Growth and Change* (Univ. of Kentucky, 1978), touches on these latter aspects and also on the technical problems involved in determining the amount of the appropriate tax. See also Brannon, *Tax Policy and Producer Incentives in the Energy Crisis*, in *Papers on Energy Policy Meeting on Growth and Change* (Univ. of Kentucky, 1978); Davenport, *The Role of Taxation in the Regulation of Energy Production and Consumption*, 31 NAT'L TAX J. 221 (1978); Mead, *The*

Clearly, much more analysis is required before we can decide whether or when a tax approach in either of these two classes of regulation is preferable to a direct regulatory approach. The economists who feel they know the difficulties of the regulatory approach seem far too eager to seize on the tax system, though it is apparent they have not yet foreseen the difficulties that may exist in the latter choice. Not the least of these difficulties is how Congress should handle the consideration of regulatory taxes, a matter discussed further in Part V.

As stated earlier, the "tax penalty" provisions in the income tax can also be analyzed as regulatory measures, though the regulatory purpose in their adoption is not as evident as in the use of the various regulatory excise taxes. Since there are few tax penalty provisions, little thought seems to have been given to developing the criteria necessary to determine whether an income tax penalty or a direct regulatory approach is preferable in a particular situation. We would suppose these criteria would not differ from those that should govern when a regulatory excise tax is involved.

Since we do not yet have full understanding of the criteria appropriate to a choice between providing financial assistance through the tax system—tax expenditures—rather than through direct spending, and equally do not have the criteria for determining when to regulate through the tax system—income tax penalties and regulatory excise taxes—rather than through direct regulation, we are not in a position fully to compare the criteria for similarities and differences. Certainly the major questions are the same—whether the governmental goal is an appropriate one; to what extent will the tax approach or the direct approach achieve the desired objective; and, if both approaches are possible candidates, which approach is the more effective. We can also sense that the problems caused, for example, in the legislative process and in tax administration would be present under each approach. The definitional questions involved in analyzing these major questions would also seem the same in that the regulatory excise taxes resemble tax credits and are easy to identify and in that the tax penalties present the same kind of classification issue as do tax expenditure exclusions or deductions. Moreover, the aspect of estimation would also appear identical. Further, while the upside-down aspect of tax expenditures is not present in the regulatory excise taxes, it is present in the tax penalty provisions, where it operates adversely to the taxpayer as contrasted with tax expenditure assistance.⁶⁴ We are thus left with the general view that the criteria and issues are essentially identical,

Uses of Taxes, Regulation and Price Controls in the Energy Sector, 31 NAT'L TAX J. 229 (1978).

Of course, traditional direct regulation, such as rent control or fixing a low price on old oil, can be analyzed as an implicit tax on the owners of real property or the producers of oil, with implicit direct spending to tenants or the consumers of oil products. But Congress has not taken this approach, and the tax committees presumably would not claim jurisdiction over such direct controls.

⁶⁴ Those advocating regulatory taxes must keep in mind that the taxes are deductible, whereas direct fines or penalties are not deductible. See *PATHWAYS*, *supra* note 34, at 172-73. In the case of the gas guzzler tax, the purchaser would be denied inclusion of the tax in basis, so that in effect the tax, like a fine, becomes non-deductible. I.R.C. § 1016(e).

whether it be tax expenditure assistance or regulatory excise taxes and income tax penalties that are under consideration.⁶⁵ Perhaps further thought will disclose differences that may exist, and this question is thus an aspect of the exploration necessary in both areas.

E. Other Taxes

The first list of federal tax expenditures for taxes other than the income tax was prepared in the 1976-1977 period. Senator Kennedy, in testimony before the Senate Finance Committee in 1976, submitted a list of tax expenditures prepared by the authors for the estate and gift taxes as in effect prior to the Tax Reform Act of 1976.⁶⁶ Subsequently, we prepared a revised list of tax expenditures under the estate, gift, and generation-skipping taxes, reflecting the changes made by the 1976 Act.⁶⁷ That list is set forth in Appendix C.

It is understood that technicians in the Office of Management and Budget (OMB) and in the Congressional Budget Office (CBO) have com-

⁶⁵ The question whether a monetary levy is a "tax" or a regulatory assessment presents a different question from whether an admitted tax is being used for regulatory purposes. As to the former question, there can be borderline cases in which a monetary levy may either be a "tax" or a "non-tax" measure involving fines, assessments, or the like. *See, e.g.*, the legislative history involving the financing of payments to miners afflicted by "black lung" disease. While originally structured as a non-tax measure involving a fund financed by "premiums" and "assessments" on coal mined, as a result of a jurisdictional claim by the Senate Finance Committee over the measure because it involved a "tax," the legislation finally emerged in the technical language of a tax. *See* Black Lung Benefits Revenue Act of 1977, Pub. L. No. 95-227, 92 Stat. 11 (1978), adding I.R.C. § 4121 to the Code. This per ton tax on coal finances the Black Lung Compensation Insurance Fund, established to pay benefits under the Black Lung Benefits Reform Act of 1977, Pub. L. No. 95-239, § 13, 92 Stat. 95 (1978).

The question whether a financial payment is a "tax" can, of course, arise apart from congressional committee jurisdiction (including the constitutional provision that bills "raising revenue" must originate in the House), *e.g.*, under § 164 allowing a deduction for "taxes," (*see, e.g.*, *Trujillo v. Commissioner*, 68 T.C. 670 (1977) and *McGowan v. Commissioner*, 67 T.C. 599 (1976) (deciding mandatory "contributions" of a percentage of wages to a state disability fund are deductible "income taxes" under I.R.C. § 164(a)); I.R.C. § 901 allowing a credit for "income taxes"; the constitutional requirement that "all Duties, Imports and Excises shall be uniform throughout the United States," U.S. CONST. art. I, § 8, cl. 1.

Under present attitudes, an excise tax would be administered by the Internal Revenue Service, but a fine (or fee or assessment) would be administered by the regulatory agency involved, with resort to the federal courts where necessary. Presumably, an excise tax could be administered by a regulatory agency even though a "tax" is involved, but it would seem that this approach would be unlikely.

It may be observed that some "complexity" issues are different for tax expenditures than for regulatory taxes. Thus, a tax expenditure complicates the income tax form while a regulatory excise is likely to be compartmentalized with its own separate form. Moreover, the audit and administrative problems may differ in other respects.

⁶⁶ *Revision of Federal Estate Tax Law, Hearings Before the Senate Comm. on Finance*, 94th Cong., 2d Sess. 22, 45 (1976) (statement of Sen. Kennedy).

⁶⁷ S. SURREY, W. WARREN, P. MCDANIEL, & H. GUTMAN, *FEDERAL WEALTH TRANSFER TAXATION* 884 (1977) [hereinafter cited as *FEDERAL WEALTH TAXATION*]. *See id.* at 880-87, for a discussion of particular items included in or excluded from the list, and the revenue estimating procedures employed.

menced studies looking toward the inclusion of tax expenditures under the wealth transfer taxes in the annual tax expenditure list prepared by those offices. It is important that this work proceed since present tax expenditure lists, while encompassing the bulk of tax expenditures, do not as yet give a complete picture of the extent of spending effected through the federal tax system.⁶⁸

II. TAX POLICY ISSUES

The tax expenditure concept, as it is gradually internalized by those responsible for and involved in the formulation of tax policy, has produced some discernible shifts in several areas normally denominated as "tax policy" issues. It has become increasingly clear that a number of matters traditionally treated as concerns of "tax policy" would more accurately be classified as "spending policy" issues. It remains true, however, that decisions to utilize the tax system to expend federal funds do have important implications for normative tax policy issues. In this part, we consider the impact of the tax expenditure concept on both tax and spending policy issues.

A. Tax Reform Aspects

Recent legislative efforts for tax reform centered almost exclusively on items in the tax expenditure list. Data showing that very high income individuals pay little or no income tax⁶⁹ have continued to fuel the quest for tax

⁶⁸ OMB does not require any specific statutory authority to expand its tax expenditure budget to include the wealth transfer taxes. See 120 CONG. REC. S7935 (1974) (statement of Sen. Muskie).

The House Ways and Means Committee Report on the Estate and Gift Tax Reform Act of 1976 recognized that tax expenditures are contained in the estate and gift tax provisions. However, the Report then proceeded to list as tax expenditures some items that constitute part of the normal structure of a transfer tax (e.g., the marital deduction) as well as true tax expenditures. H.R. REP. NO. 1380, 94th Cong., 2d Sess. 73 (1976). This kind of confusion illustrates the need for the careful separation in the wealth transfer taxes of the normal tax provisions from the tax expenditure provisions.

⁶⁹ See U.S. TREAS. DEPT., HIGH INCOME TAX RETURNS: 1974 AND 1975 (Mar. 3, 1977); U.S. TREAS. DEPT., HIGH INCOME TAX RETURNS: 1975 AND 1976 (Aug. 1978), for reports on high income taxpayers emphasizing those tax returns that incurred little or no tax liability. The 1977 Report revealed that in 1975, 215 returns with adjusted gross income (AGI) of \$200,000 or more paid no federal income tax; 2,858 returns with AGI of \$50,000 or more paid no tax. The Treasury report complacently reassured us, however, that "most" high income taxpayers pay "very substantial amounts of tax," although the data supplied by the Treasury indicated that these "substantial" amounts were in fact considerably below the taxes that would have been paid had these same taxpayers not been the beneficiaries of tax preferences. The 1978 Report disclosed that, as a result of the Tax Reform Act of 1976, the number of no-tax individuals with adjusted gross incomes in excess of \$200,000 had declined to 22 in 1976. The 1978 Report emphasized that the problem of low effective rate-high income individuals was even a greater problem than the no-tax individuals. Finally, the report noted, the average effective tax rate for the over-\$200,000 income group was only 35%, which the Treasury described as "substantial." 1978 Report at 5-7.

reform.⁷⁰ The reasons why wealthy individuals do not pay the effective rates of tax at the levels indicated by the tax rate schedules are almost without exception to be found in the tax expenditure budget.⁷¹

Appendix B sets forth the distribution by income class of tax expenditures provided through the individual income tax for fiscal 1977. These statistics clearly reveal both the reasons why the progressivity of the federal income tax system is so much less than a 14-70 percent rate schedule would imply, and why taxpayers with the same economic incomes can pay substantially different amounts of federal income taxes. Specifically, Appendix B indicates the quantitative extent of the upside-down character of the tax expenditures employed in the United States. In fiscal 1977, the top 1.4 percent of taxpayers, with "expanded gross income"⁷² of \$50,000 or more, received 31.3

Some have seized on the Treasury studies to conclude that the income tax bears disproportionately on the upper income groups in the country. They reach this rather startling conclusion by referring to such facts as the upper one-half income group pays 94% of all personal income taxes, the top 25% pay over 70% of personal income taxes, and the top 1.4% (over \$50,000 adjusted gross income) pay 23% of the taxes. See 124 CONG. REC. H1975-76 (daily ed. Mar. 13, 1978) (statement of Rep. Kemp). The conclusion that upper income groups pay a disproportionate amount of tax, on the basis of these facts, is a non sequitur. The data merely reflect the use of a progressive income tax in the United States. Similar results would be expected if the marginal rates ranged from 2% to 20%. The only relevant data to determine the appropriateness of the tax burden on upper income individuals are data pertaining to effective rates of tax. Here, studies have repeatedly shown that, on the average, the effective rate never exceeds about 32% to 36%, even for taxpayers with incomes in excess of \$1 million annually. Such data hardly seems to justify a picture of an "overburdened" upper income class. For recognition of this point, see 124 CONG. REC. H7924 (daily ed. Aug. 4, 1978) (statement of Rep. Wright); 124 CONG. REC. E1819 (daily ed. Apr. 12, 1978) (statement of Rep. Vento).

⁷⁰ Nevertheless, the reduction in the tax rate on capital gains, in the Revenue Act of 1978, demonstrated little concern for this situation.

⁷¹ The period from 1976 to 1978 did not produce significant developments in, or require modification of, our earlier analysis of the use of effective rates in formulating tax policy. Surrey & McDaniel, *supra* note 7, at 698-706. Those studies on effective rates that have appeared confirm our prior conclusion that traditional effective rate analysis—comparing actual taxes paid to actual economic income—remains a valid and useful tool in determining the effects of tax expenditures. See, e.g., the following studies by the Library of Congress, Congressional Research Service: Gravelle, Tax Provisions and Effective Tax Rates in the Oil and Gas Industry (Oct. 6, 1977), reprinted in 123 CONG. REC. S16946 (daily ed. Oct. 11, 1977) (statement of Sen. Kennedy); Gravelle, Provisions Reducing the Effective Tax Rate of Commercial Banking Organizations (Jan. 19, 1977). See also U.S. TREAS. DEPT., EFFECTIVE INCOME TAX RATES PAID BY UNITED STATES CORPORATIONS IN 1972 (May, 1978). See note 69 *supra*.

⁷² "Expanded gross income" is adjusted gross income plus tax preferences subject to the minimum tax. The term does not include items of income that do not appear on tax returns, notably interest from tax-exempt bonds.

A curious aspect of the "expanded gross income" definition is that it treats the deduction for investment interest up to the amount of investment income as not a tax preference. Apparently, in the view of the Treasury economists, high income taxpayers routinely borrow funds and make investments with no objective of making a profit. But the Treasury assumption seems clearly wrong and results in an overstatement of the effective rates of tax paid by high income taxpayers. More analysis is required to allocate properly investment interest. One suspects, for example, that a

percent of the Treasury "tax checks" delivered through the tax expenditure mechanism—over \$26 billion out of a total of almost \$84 billion spent. On the average, taxpaying units in this select group received, in effect, federal subsidies of \$71,429. The 49,000 taxpayers with incomes above \$200,000, representing 5/100 of 1 percent of total returns, on the average received federal tax subsidies of \$535,653. Tax sheltered individuals live in stately mansions!

The upside-down character of tax expenditures is also strikingly apparent when individual items in the tax expenditure budget are considered. The top 1.4 percent of taxpayers, with expanded gross incomes of \$50,000 or more, received from 66.7 percent to 80 percent of tax expenditures for natural resources; 85.4 percent of the tax expenditures resulting from exemption of the interest on state and local bonds; 87 percent of the revenues from tax-exempt industrial development bonds issued for pollution control purposes; 86.3 percent of the tax expenditures involved in industrial development bonds generally; 75.6 percent of the tax expenditures for rental housing; 60 percent of the benefits from the Asset Depreciation Range (ADR) system; 73.3 percent of the revenues involved in the charitable contributions deduction for education; 58.8 percent of the revenues from the charitable contributions deduction for health; 43.2 percent of the revenues for all other charitable contributions deductions; 67.7 percent of the tax expenditures resulting from preferential treatment of capital gains; and 100 percent of the benefits of the maximum tax on earned income.

While some tax expenditures provide relatively greater benefits to those with incomes below \$50,000, only 14 of the 69 tax expenditures set forth in Appendix B reflect a progressive distribution pattern, that is, the greatest percentage of benefits going to the low income groups, with the percentage declining as income increases. Moreover, these 14 tax expenditures involve only \$10.9 billion. In short, less than 13 percent of the total tax expenditures are distributed on a progressive basis.⁷³

It thus remains true, after a decade of tax reform efforts sharpened by tax expenditure analysis, that the overwhelming majority of tax expenditure programs, and of the funds distributed thereunder, benefit the upper income groups. Not only are the tax expenditure provisions the primary cause of tax inequity, but it seems safe to say that the provisions do not even achieve what most Americans would perceive to be a fair distribution of funds, measured by criteria applied to direct spending programs. Major strides toward tax equity—horizontal and vertical—could be achieved by eliminating all the tax expenditures from the Internal Revenue Code. But, short of total repeal, ac-

large part of the investment interest should be allocated to untaxed, unrealized appreciation. The 1978 Treasury Report, *supra* note 69, at 12-14, reflects a greater sensitivity to the problem, recognizing that the decision to treat only investment expenses in excess of investment income as the tax preference element is an "arbitrary" one. Existing data do not, however, permit a more precise method of matching interest deductions and income.

⁷³ See Manvel, *Tax Expenditures by Income Classes*, 7 TAX NOTES NO. 3 at 55 (July 17, 1978) (describing the allocation of tax expenditures to income classes in terms of transfer payments, capital gain items, and all other tax expenditures).

tion can be taken to improve the fairness of both the tax system and of the tax expenditure programs. The 1976-1978 legislative experience revealed some significant trends in this "second best" approach to tax reform.⁷⁴

B. *The Trend to Tax Credits*

1. Tax Credits Versus Special Tax Deductions: Efficiency, Equity, and Program Funding Issues

A trend continued during the period from 1976 to 1978 was the increased reliance on tax credits, instead of special deductions or exemptions, as the mechanism for providing federal financial aid or incentives through the tax system. The reasons for the shift to tax credits vary depending on the type of preferential provision which they replace. In determining whether tax credits should be utilized in lieu of special business deductions, for example, the tax expenditure concept indicates that the same cost-benefit analysis must be made of tax spending programs as is made of direct spending programs. The results of such analysis tend to favor using tax credits rather than special deductions, assuming, of course, that the studies demonstrate a need for some federal financial assistance.

Cost-benefit studies have been particularly effective in exposing the inefficiencies in the program areas supported by the "tax shelter" deductions. For example, studies have demonstrated an unacceptably high level of inefficiency in the tax expenditures used to construct oil and gas, and real estate tax shelters.⁷⁵ This inefficiency results from passive tax shelter investors retaining a substantial portion of tax expenditure funds which should be expended in actual drilling or construction operations. The waste, in large part, results from the interaction of progressive rates with the special deduction technique. In effect, the tax shelter syndicator is selling the tax benefits that the driller or developer is unable to use. While the special deductions for oil or real estate are valuable for the 70 percent tax bracket investors, there are not enough 70 percent investors to provide the driller or developer with needed funds. Accordingly, the tax shelter deal is modified to make it attractive to the 50 percent investor, with a resulting windfall to the investors in brackets above 50 percent, and a waste of federal funds. A tax credit to the driller or developer, even if available to passive investors, would largely eliminate this type of inefficiency.⁷⁶

⁷⁴ For a general discussion of tax reform issues, vintage early 1978, see Surrey, *Current Tax Developments in Perspective*, 11 CREIGHTON L. REV. 807 (1978).

⁷⁵ Regarding real estate tax shelters, see H. AARON, *SHELTER AND SUBSIDIES: WHO BENEFITS FROM FEDERAL HOUSING POLICIES?* (1972); KURTZ, *Tax Incentives for Real Estate Have Failed*, 3 REAL ESTATE REV. NO. 2 (Summer 1973); McDaniel, *Tax Reform and the Revenue Act of 1971: Lesions, Lagniappes and Lessons*, 14 B.C. IND. & COM. L. REV. 813 (1973). Regarding oil and gas tax shelters, see G. BRANNON, *ENERGY TAXES AND SUBSIDIES* (1974); McDaniel, *Tax Shelters and Tax Policy*, 26 NAT'L TAX J. 353 (1973).

⁷⁶ Additionally, the studies have shown that even where the funds are employed by drillers and developers, investments with low national priorities result, e.g., development wells instead of exploratory drilling, or shopping centers instead of low-income housing. This aspect of the efficiency problem, however, is one of proper program design, rather than one of credits versus deductions.

A 1977 Congressional Budget Office study of real estate tax shelter subsidies reached a similar conclusion, and recommended that consideration be given to replacing the accelerated depreciation deduction for real estate with a tax credit for builders of low income housing. Similarly, it has been proposed that the deduction for intangible drilling and development costs be replaced with a tax credit.⁷⁷ In recent years, the enactment of new tax subsidies to business via the tax credit technique, such as the WIN tax credit⁷⁸ and the target jobs tax credit,⁷⁹ further illustrate this response to the inefficiency of certain special deductions.

More recently, the 1977 National Energy Plan, as proposed by the President, contained new or expanded tax expenditure programs, almost all of which were structured as tax credits. The President recommended that taxpayers' costs of undertaking certain energy conservation and conversion actions be reduced. The cost reduction was provided in some instances by tax credits and in others by direct spending programs. The President's National Energy Plan unfortunately did not articulate why tax spending was to be preferred over direct spending in any given program area. Where the tax route was proposed, however, the tax credit mechanism was almost exclusively employed. Thus, in the business area, the President's plan included a 10 percent tax credit for investment in approved conservation measures and a 10 percent tax credit for investment in energy saving equipment. The lone exception to the credit approach was a proposal to extend the special deduction for intangible drilling costs to geothermal drilling.⁸⁰

In Congress, the House generally followed the President's approach to national energy policy, although it did add a percentage depletion allowance for geothermal resources.⁸¹ The Senate nevertheless rejected the Presidential and House bill reliance on taxes as regulatory or penalty measures. The Senate Finance Committee version shifted entirely to the tax incentive route, providing for some \$40 billion in new and expanded tax expenditures between 1978 and 1985.⁸² Additional tax expenditures were added on the Senate floor. With only a few exceptions, both the Finance Committee and the floor amendments relied on tax expenditures in the form of tax credits, rather than special deductions or exemptions.⁸³ The Energy Tax Act of 1978, as it fi-

⁷⁷ As to housing, see CONGRESSIONAL BUDGET OFFICE, REAL ESTATE TAX SHELTER SUBSIDIES AND DIRECT SUBSIDY ALTERNATIVES (May 1977) [hereinafter cited as CBO HOUSING STUDY]. As to oil, see McDaniel, *Tax Shelters and Tax Policy*, 26 NAT'L TAX J. 353, 375 (1973); *Tax Reform Act of 1975: Hearings on H.R. 10612 Before the Senate Comm. on Finance*, 94th Cong., 2d Sess. 193 (1976) [hereinafter cited as *SFC 1976 Hearings*].

⁷⁸ I.R.C. §§ 40, 50A-50B.

⁷⁹ I.R.C. §§ 44B, 51-53. The targeted jobs tax credit was adopted in the Revenue Act of 1978 to replace the expiring new jobs tax credit.

⁸⁰ EXECUTIVE OFFICE OF THE PRESIDENT, ENERGY POLICY AND PLANNING, NATIONAL ENERGY PLAN 78 (1977) [hereinafter cited as NATIONAL ENERGY PLAN].

⁸¹ H.R. 8444, 95th Cong., 1st Sess. (1977). See also H.R. REP. NO. 543, 95th Cong., 1st Sess. 129-30 (1976).

⁸² S. REP. NO. 529, 95th Cong., 1st Sess. 19-26 (1977).

⁸³ See e.g., the Senate version of the energy tax bill, H.R. 5263, 95th Cong., 1st Sess. (1977) § 1012 (energy cost credit for the elderly); § 1013 (credit for increased

nally emerged from Congress, more closely followed the Senate than the House approach, although a modified regulatory "gas guzzler" tax was included.⁸⁴

The tax expenditure concept inevitably does drive advocates of tax preferences toward the use of credits as opposed to special deductions or exemptions. As the 1977-1978 energy tax legislation demonstrated, tax credits and direct grants result, or can result, in identical economic consequences to the government and to beneficiaries of the programs.⁸⁵ This result does not mean, however, that tax policy makers therefore should be indifferent to the use of tax credits as opposed to direct grants. There are important differences in, and consequences of employing, the two approaches which to date have not been sufficiently appreciated or analyzed by proponents of tax expenditures. Some of the more crucial of these differences and consequences will be identified below.

The trend to tax credits in lieu of special deductions in the business area continues to demonstrate that neither Congress nor a number of departments in the executive branch have yet mastered the technique of evaluating tax credits as alternatives to direct grants. The Senate Finance Committee Report and the Senate floor debates on the proposed energy tax credits demonstrated that the Senate had very little concrete evidence before it (1) as to the need for a given credit; (2) if there was a need, why the level of funding provided by the credit was appropriate; or, (3) whether the program design implicit in the credit reflected the program design which would have been adopted had a direct spending program been under consideration.

This last point requires a caveat. The tax expenditure analysis should not lead policy makers unthinkingly into substituting tax credits for special business deductions. Assuming that a need for federal financial aid for a particular activity has been established, the next question is the most effective form

cost due to imported oil); § 1028 (credit for electric motor vehicles); § 1044 (tax credit for production of oil and gas from nonconventional sources); § 1055(e) (credit for home heating oil). Exceptions to the tax credit approach included § 1027(b) (exclusion from employer income of value of employer-furnished van pooling services); § 1042 (percentage depletion for peat and geopressured methane gas); § 1043 (intangibles deduction for geopressurized methane gas).

⁸⁴ The final bill included tax credits for residential insulation and other energy conserving components; for residential solar, wind, and geothermal equipment; for vehicles used in van pooling; for personal use electric or hydrogen motor vehicles; for business investment in "alternative energy property" and "specially defined" energy property; for business insulation costs; and, for business investment in congeneration and recycling equipment. Tax expenditures that did not employ the credit technique included the exclusion from income of employer-provided van pooling service; percentage depletion for geothermal deposits and geopressured natural gas; and, immediate deduction of intangible drilling costs for geothermal wells. S. REP. No. 1324, 95th Cong., 2d Sess. (1978).

⁸⁵ For example, the President proposed a tax credit for certain business energy conservation costs. He proposed, however, direct grants to tax-exempt organizations that incurred the same costs. No explanation was offered why the direct grant approach was adopted for tax-exempt entities rather than refundable tax credits, and tax credits for business rather than direct grants. See NATIONAL ENERGY PLAN, *supra* note 80, at 42.

of providing that aid. Generally, the alternatives to tax credits are outright grants and loans. Assume that the loan approach is adopted. If it is then decided to provide the loan through the tax system, three techniques are available: (1) accelerated deductions in which the amount of the loan is the tax saving in the early years of the life of the asset; (2) an income exclusion with a corresponding basis adjustment, in which the amount of the loan is the amount of tax that would have been due had the excluded amount constituted currently taxable income; or, (3) a tax credit repayable in full over time with no basis reduction, in which the amount of the loan is the creditable amount itself. The amount of the "tax loan" under the first two techniques is a function of the tax rates—the higher the tax bracket the larger the amount of the federal loan.

The repayable tax credit approach in (3) makes the same federal loan available regardless of the bracket of the taxpayer. In this sense, therefore, the results in approach (3) seem fairer than those in approaches (1) and (2). But, if one compares the results to commercial lending practices, that conclusion is less certain. Private lending institutions do, after all, lend larger amounts to those with higher incomes than to those with lower incomes. The rationale for this practice is obvious and it would seem not patently unreasonable for the government to adopt the same view in the loan programs that it administers. Thus, the shift from an accelerated deduction to a tax credit is not necessarily called for if (a) a loan rather than a direct grant is the desired form of federal assistance, and (b) the variation in the size of loans under the accelerated deduction is roughly equivalent to that observed in commercial lending practices. On the other hand, because it is the government making the loan, attention must be focused on the question whether individuals and corporations with large net incomes merit larger loans than do their lower income counterparts.

There is, moreover, one marked difference between private and most direct government loans and the loans made available through techniques (1) and (2) above. This difference lies in the failure to charge interest on the "tax loan" programs.⁸⁶ Possibly, an interest charge would be imposed if Congress adopted technique (3). This situation could be remedied by imposing a direct annual interest charge on taxes deferred as the result of accelerated deductions, or deferred income inclusion. The interest incurred could be paid to the Treasury each year with the taxpayer's tax return. Such a procedure would complicate tax administration. Moreover, Congress to date has not displayed much concern over the interest free use of government funds through accelerated deductions. If that concern develops, then it is possible that a shift to repayable tax credits in technique (3) would take place since the amount of the loan in the case of tax credits would appear simpler to determine than would the amount of the loan generated by the tax savings from accelerated deductions. Again, to emphasize a familiar point, the foregoing analysis does

⁸⁶ The minimum tax may be viewed as an annual interest charge on the tax loans effected through the accelerated deductions to which it applies. The interest charge is quite erratic, however, varying (1) from taxpayer to taxpayer as a result of the basic exemption and offset for one-half of the regular taxes paid, and (2) from asset to asset depending on its useful life.

not suggest that the government should use the tax system to provide loans. It simply points out that *if* the tax system is to be used (a very big *if*!), proper construction of the loan program does not necessarily involve the use of tax credits rather than accelerated deductions.

In the area of business tax subsidies, therefore, the waste resulting from the interaction of deductions and progressive rates that has been identified and quantified by the tax expenditure concept appears to have been an important factor in the congressional and executive branch decisions to employ tax credits rather than special deductions as the mechanism for providing the subsidies. But, in terms of clearly demonstrating the need for federal financial support, identifying effective program design, establishing proper levels of federal funding, and articulating the criteria for choosing the tax as opposed to the direct spending route to aid business, Congress and the executive branch still fall considerably short of full implementation of the tax expenditure analysis.⁸⁷

In the area of federal tax subsidies for personal expenditures, a similar trend to tax credits is emerging. New tax expenditure proposals more frequently take the form of tax credits rather than itemized personal deductions, and a number of proposals have been advanced to convert existing deductions to tax credits. Three major aspects of tax expenditure analysis appear to have contributed to this trend.

First, tax expenditure analysis has been particularly effective in exposing the upside-down results produced by special deductions for personal costs.⁸⁸ The tax credit technique is perceived to avoid an increase in benefits as a

⁸⁷ For example, the targeted jobs tax credit enacted as part of the Revenue Act of 1978 provides tax credits to employers who hire qualified employees from seven specific "target groups." I.R.C. § 51(d). Qualified employees are those certified as such by the Secretary of Labor and the Secretary of the Treasury. Since the Labor Department appears to be the appropriate agency to handle employment programs, its presence in the certification procedure is logical. What was never made clear, however, was why the Department of Labor was not also authorized to issue the subsidy checks directly, since its certification constituted the critical program eligibility requirement. In short, the program was structured to require both Labor and Treasury involvement, when it appeared Labor alone would have been sufficient. Perhaps the real answer lies not in program design issues, but in the issue of which congressional committees would exercise control over the program. See *infra*, Part V.

Two 1978 changes in tax expenditures did not employ the tax credit approach. One was the increase in the exclusion for long-term capital gains from 50% to 60% of the gain. This change was viewed as an expansion of an existing tax expenditure in a form that it had traditionally taken. No thought was given to converting the exclusion to a tax credit. The other change was the introduction of a series of special deductions for United States citizens living overseas. Here again, tax credits could have been employed. However, the use of deductions in I.R.C. § 913 appears to have been grounded in part on the mistaken view that the excess expenditures incurred by a United States citizen living abroad for higher costs of living, education, housing, home travel and living in "hardship" areas represent extraordinary costs of producing income. Although the items appear to be personal under normal United States tax principles, use of the deduction technique would be appropriate if one were persuaded that in fact they represented costs of producing income.

⁸⁸ Some commentators have asserted that the "upside-down" argument is not applicable to the deduction for charitable contributions. This conclusion is reached,

function of higher tax brackets, a result that is produced automatically when the deduction technique is employed. It is not clear whether tax credit proponents philosophically believe that benefits should not rise with income or whether they simply wish to eliminate an argument against their proposed tax expenditure. In any event, it is evident that an expenditure program effected through a tax credit usually more closely resembles a corresponding direct program than does one implemented through a special deduction or exemption (we, at least, are unaware of any direct spending programs that are structured to provide progressively increased financial benefits as income or wealth rises). The impact of the equity issues so dramatically posed by tax expenditure analysis of personal deductions is reflected in the evolution in the proposed tax expenditure for the costs of higher education. Initially, such proposals were almost always advanced in the form of special deductions for such costs or for contributions to a "qualified higher education fund."⁸⁹ Subsequently, however, proponents of tax expenditures for higher education costs converted their proposals to the tax credit approach approved by the Senate in 1976 and 1977,⁹⁰ and by both the House and Senate in 1978.⁹¹

however, by using an "after tax and after charitable deductions disposable income" test and then observing that, under this test, changing the deduction for charitable contributions to a credit would be more beneficial to the rich, since the consequent decline in their charitable contributions caused by the decline in tax benefit would give the rich more disposable income. Since the price elasticity effect of the tax deduction is greater than one, the rich would save more in lower charitable contributions than their increased tax, and the poor would give up in higher contributions more than their lowered tax. But one can ask whence comes the "disposable income" test. The fact that the rich are moved to change the consumption patterns previously induced by the tax system to patterns that involve less in charitable contributions and more in, say, travel or entertainment is not an argument against the upside-down characterization. The increase in disposable income produced by the tax change, as compared to the prior pattern, is just the reflection of the earlier shift in how disposable income was utilized. An increase in disposable income could equally result if a previously allowed deduction for, say, travel expenses, were eliminated, but that is hardly an argument that the elimination would favor the rich or that the initial allowance of the deduction hurt the rich.

Essentially the above argument must rest on the view that contributions to charity are not "consumption" under the Haig-Simons definition. This view hardly seems supportable when, for example, one reads literature urging the wealthy and corporations to contribute only to those colleges that would employ more conservatively-inclined professors. The view that the charitable contribution is not "consumption" really comes from changing "consumption" in the Haig-Simons definition to refer to a "standard of living" and then concluding that since charitable contributions do not increase a "[material] standard of living" they are not "consumption." There is some of this same shift in definition in U.S. TREASURY DEPT., BLUEPRINTS FOR BASIC TAX REFORM (Jan. 17, 1977), 31 *et seq.* But the shift in definition does not seem an acceptable modification of the Haig-Simons definition. One doubts that Simons would approve this reworking of his definition.

⁸⁹ See, e.g., H.R. 9678, 92d Cong., 1st Sess. (1971).

⁹⁰ See The Tax Reform Bill of 1976, H.R. 10612, § 2601, 94th Cong., 2d Sess. (as passed by the Senate); The Social Security Financing Amendments of 1977, Senate Amendment No. 1057 to H.R. 9346, 95th Cong., 1st Sess. (as passed by the Senate), 123 CONG. REC. S18792-93 (daily ed. Nov. 4, 1977).

⁹¹ See H.R. REP. NO. 1790, 95th Cong., 2d Sess. (1978) (the Conference Committee report on the Tuition Tax Credit Act of 1978).

A second aspect of special itemized personal deductions thrown into sharp relief by tax expenditure analysis is the exclusion of standard deduction (zero bracket amount) taxpayers from the tax expenditure program. With the higher standard deduction figures approved in 1975, 1977, and 1978,⁹² every tax expenditure program implemented as an itemized personal deduction automatically excludes some 77 percent of all taxpayers—almost all of whom are low and middle income individuals—from the program. Although the result could be avoided by allowing the itemized deduction outside the standard deduction, that is, removing the implicit floor imposed on all itemized deductions by the zero bracket amount, such an action would not eliminate the upside-down effect of the subsidy. The tax credit approach may therefore be the more acceptable way to include in the tax spending program those whose itemized deductions are below the zero bracket amount. Such considerations appear to account in part for the decisions in the 1978 Energy Tax Act to provide individual tax credits instead of itemized personal deductions for solar energy equipment, energy saving devices such as windmills, energy saving efforts such as installing storm windows or more energy-efficient heating equipment, and for the purchase of electric powered automobiles.⁹³ Similarly, suggestions to convert the present itemized deductions for charitable contributions and home mortgage interest and property taxes to credits appear motivated in part by the equity issues raised by the tax expenditure analysis.⁹⁴

Third, tax expenditure analysis has accelerated the trend towards tax credits by demonstrating that when an itemized personal deduction is viewed as a spending program, the level of funding for the program fluctuates up and down as the result of decisions totally unrelated to the program itself. An increase in tax rates automatically increases the federal spending inherent in a special deduction or exemption. Conversely, a tax reduction automatically reduces the size of the tax expenditure program. Once this fluctuation is perceived, it becomes evident that beneficiaries of a special deduction have a direct financial stake in every tax change considered by the Treasury or Congress.⁹⁵ Some specific examples of this phenomenon are discussed in Part IV.

Recognition that general tax trends are in the direction of reducing the value of the itemized personal deductions, and that support of the deduction

⁹² The Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26, increased the standard deduction to 16% of adjusted gross income with an overall maximum of \$2,600 for joint returns and \$2,300 for single individuals. The Tax Reduction and Simplification Act of 1977, Pub. L. No. 95-30, 91 Stat. 126, converted the standard deduction (and the prior low-income allowances) to a \$3,200 "zero bracket amount" for joint returns (\$2,200 for single individuals). The Revenue Act of 1978 increased the zero bracket amounts to \$3,400 and \$2,300 respectively.

⁹³ See note 84 *supra*.

⁹⁴ 123 CONG. REC. S11408 (daily ed. July 1, 1977) (statement of Sen. Kennedy).

⁹⁵ See 124 CONG. REC. H2395 (daily ed. Apr. 3, 1978) (statement of Rep. Conable), for a discussion of the estimated decline in charitable receipts resulting from increases in the standard deduction since 1969.

mechanism involves beneficiaries of special deductions in tax issues in which they should have little interest, may lead to the conclusion that each itemized deduction should be replaced with a tax credit. For example, some charitable organizations⁹⁶ and some congressional supporters⁹⁷ of incentives for private philanthropic giving have recommended that a tax credit be substituted for the charitable contribution deduction. A tax credit equal to, for example, 30 percent of the donor's contribution would insure that aggregate amounts received by charity would be increased somewhat over present levels. Moreover, the credit would be much more insulated from extraneous shifts in tax policy than is a deduction. Consequently, it seems likely that we shall see a greater interest in the use of tax credits instead of itemized personal deductions as the beneficiaries and supporters of programs financed via the itemized personal deduction mechanism become more cognizant of the arbitrary variations in federal funding levels for their programs, produced by actions completely unrelated to the tax expenditure program itself.

2. Tax Credits Versus Basic and Dependents' Exemptions: Interaction of Spending and Structural Issues

Tax expenditure analysis does not, of course, imply that all deductions or exemptions should be converted to tax credits. If a deduction or exemption is a part of the normal structure of a tax on net income, it is inappropriate to convert such a provision to a tax credit. For example, replacing a deduction for wages with a tax credit would impose a tax penalty on those in tax brackets above the one corresponding to the break-even point for the tax credit. Such a penalty provision is as much a deviation from a normal tax system based on net income as is a tax preference.

Certain recent and proposed actions indicate that policymakers are not sufficiently discriminating in their enthusiasm to convert deductions and exemptions to tax credits. For example, in the Tax Reform Act of 1976, Congress substituted a tax credit for the basic exemption in the wealth transfer taxes.⁹⁸ This action was justified in part on the ground that the exemption was "worth more" to high bracket estates than to lower bracket estates.⁹⁹ But the basic exemption can be viewed as part of the normal structure of the progressive transfer tax, in effect constituting an amount of wealth transferred that is subject to a zero rate. The "worth more" argument is irrelevant to an analysis of an exemption or deduction that is part of the normative structure of a tax. Accordingly, the result of the 1976 legislation was to give a hidden tax reduction to those estates otherwise below the 32 percent bracket and impose a hidden tax increase on estates above that rate bracket. If a

⁹⁶ The National Committee for Responsive Philanthropy, a group of social action exempt organizations, is conducting a study of the desirability and effects of such a change.

⁹⁷ See note 94 *supra*.

⁹⁸ I.R.C. § 2010.

⁹⁹ H.R. REP. NO. 1380, 94th Cong., 2d Sess. 15-16 (1976).

different distribution of the relative tax contributions by estates was the desired end result, it would have been politically more open to have increased the exemption for all estates and raised the top rates.¹⁰⁰

Similarly, the President proposed in 1978 that the personal exemptions in the income tax system be converted to tax credits.¹⁰¹ In analyzing the President's proposal, it is useful to differentiate between the basic personal exemption and the dependents' exemption. One can make a strong case for the proposition that the dependents' exemption does constitute a tax expenditure—in effect a form of children's allowances. Regarded as a tax expenditure, the dependents' exemption provides relatively larger children's allowances for higher income than for lower income families, and no allowances at all for families whose income is less than the zero bracket amount. So viewed, changing the exemption to a tax credit—especially if the credit were made refundable—would improve the equity of the tax expenditure. At the very least, it seems unlikely that the United States would adopt a direct children's allowances program that would exclude poverty level families completely and would provide high income families with larger payments per child than low income families.¹⁰²

A different analysis would have to be applied to the basic personal exemption. This is part of the normative rate structure of the income tax—in effect a part of the zero rate bracket. Consequently, the upside-down analysis applied to the dependents' exemptions above is irrelevant. The President's proposed shift to a tax credit for the basic exemption therefore must be justified as a disguised change in the rate structure, in effect reducing taxes for those below the 32 percent bracket and increasing taxes for those above that bracket. The same distributional and revenue results could be achieved by increasing the basic exemption for all taxpayers and correspondingly increasing the tax rates for upper income taxpayers. The choice between the two techniques is thus essentially a matter of political judgment and does not involve tax expenditure analysis.

In short, viewing the basic personal and the dependents' exemptions as performing different functions, conversion of the personal exemption to a tax credit must be defended on political grounds, while conversion of the dependents' exemption to a tax credit rests on tax expenditure analysis and forces us to examine further whether the dependents' tax credit also should be made refundable and taxable. There are some who insist, however, that the basic personal and dependents' exemptions do not perform two different functions.

¹⁰⁰ For a more extensive discussion of the issues raised in the text, see FEDERAL WEALTH TRANSFER TAXATION, *supra* note 67, at 829-31.

¹⁰¹ Under President Carter's 1978 tax recommendations, the \$750 personal exemptions would have been converted to \$240 tax credits. See HOUSE COMM. ON WAYS AND MEANS, 95TH CONG., 2d Sess., THE PRESIDENT'S 1978 TAX PROGRAM 75 (Comm. Print 1978).

¹⁰² In the Netherlands, the Labor Government in 1976 proposed repeal of the existing dependents' exemptions in the income tax and correspondingly increasing the amount of the direct children's allowances. The children's allowances constitute taxable income and predictably there was strong opposition to the proposal from high income taxpayers with children.

Instead, they see both exemptions as establishing a level of *family* income below which it is inappropriate to impose positive rates. Thus, both exemptions are seen as part of the normative tax structure. For advocates of this view, the decision between tax credits and exemptions is basically one of comparative distributional effects of the two approaches and of the political openness of the approach adopted to achieve the desired distribution of the tax burden. In any event, regarding the basic and dependents' exemptions in this manner means that tax expenditure analysis should not be applied to either type of exemption. Thus, under this view, the question of refundable and/or taxable credits for dependents would never arise.¹⁰³

A judgment as to the correctness of proposals to substitute tax credits for the personal exemptions thus can be made only if proponents of such an action plainly articulate their views on the underlying structural questions. Clearly, tax expenditure analysis should not drive policy makers to use tax credits as a reflex response to the rhetorical assertion that deductions or exemptions are inferior to credits because deductions and exemptions are "worth more" to high than to low income individuals. Tax credits are appropriate substitutes where special tax deductions or exemptions are involved. Tax credits generally are inappropriate substitutes where the deductions or exemptions involved form part of the normative structure of an income tax.

3. Factors Inhibiting the Trend to Tax Credits

Despite the inevitable push toward the use of tax credits in lieu of special deductions or exemptions that is provided by the tax expenditure concept, several factors resist such a movement. Two of the more important factors that have surfaced in both recent studies and legislative experience serve to illustrate this resistance.

The first factor is that the change of an existing deduction to a tax credit may alter the relative amounts received by beneficiaries of the program. Opposition can therefore be expected from those who would be relative financial

¹⁰³ The text discussion reveals that the treatment of the personal exemptions in the tax expenditure budget raises issues that must be resolved by preparers of the budget. Tax expenditure budgets to date have not treated the dependents' exemptions as tax expenditures, in effect adopting the second view discussed in the text. Fundamentally, that view regards the basic and dependents' exemptions as a taxable unit notion, *i.e.*, the family is the taxable unit and the exemption level should therefore vary according to family size. One difficulty with that justification, however, is that the taxable unit for income tax purposes does not include dependents, *i.e.*, income of dependents is not included in family income. *See, e.g.*, I.R.C. § 73. Consistent application of the taxable unit rationale would require inclusion in the tax expenditure budget of the revenue loss resulting from the failure to include dependents' income in the taxable income of the family (or from the failure to restrict sufficiently the definition of a "dependent"). But, tax expenditure budgets have not reflected any such item. It seems clear that a tax expenditure budget cannot as a matter of consistency exclude both the dependents' exemption and the failure to include income of dependents in family taxable income (or alternatively the failure to define "dependent" with sufficient precision so as to reach the same net result). One or the other set of rules constitutes a form of children's allowances and should be so reflected.

losers under the change. For example, studies conducted for the Commission on Private Philanthropy and Public Needs indicate that, while a 30 percent tax credit for charitable contributions would increase the aggregate amount received by all charities, organizations such as colleges and universities, museums, and symphonies might suffer some reduction in total funds.¹⁰⁴ This result, of course, reflects the fact that low and middle income donors favor different charities than do high income donors. A tax credit would allow the low and middle income donors—who in total out-of-pocket dollars contribute more to charity than do high income donors—to exercise an increased amount of control over the disposition of the federal tax expenditure funds. Correspondingly, the federal funds controlled by the upper income donors would be reduced. The reallocation of the federal funds from charities favored by high income donors to those supported by low and middle income donors will obviously be resisted by the presently favored group.¹⁰⁵

The second factor inhibiting a shift from deductions to tax credits is the tax simplification theme. It is asserted that the computation of a tax credit involves more steps—at least two—and more complex arithmetic—usually multiplication and division rather than simple subtraction—than is required in calculating deductions. When these computational difficulties are added, taxpayers make more errors in the preparation of their tax returns.¹⁰⁶ In addition, tax credits allowed outside the standard deduction (zero bracket amount) significantly increase the audit burden of the Internal Revenue Service. Thus, no matter how IRS officials may view the equity or rationality of itemized deductions, they may be expected to oppose a shift of such deductions to credits outside the standard deduction on the grounds that such an action requires virtually every taxpayer to compute the credit. Such computations would significantly increase the problem of tax return error, and impose an impossible audit burden on the IRS, at least under present financial resources available for audit activity.

C. Refundable Tax Credits

One of the striking results of tax expenditure analysis has been the confluence around the concept of refundable tax credits of those in the "tax

¹⁰⁴ See Feldstein and Taylor, *The Income Tax and Charitable Contributions: Estimates and Simulations With the Treasury Tax Files*, 3 RESEARCH PAPERS SPONSORED BY THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS 1419, 1433 (U.S. Treas. Dept. 1977).

¹⁰⁵ Actually, a more complex calculation is required of universities and the like. A change of the charitable contribution deduction to a tax credit may prevent such institutions from suffering even greater losses as the result of the impact of other tax trends such as lower tax rates and a higher zero bracket amount.

¹⁰⁶ See JOINT COMM. ON TAXATION, ISSUES IN SIMPLIFICATION OF THE INCOME TAX LAWS 38-39 (Comm. Print 1977). When a floor and/or limit is placed on a deduction, however, the greater simplicity alleged for tax deductions seems to disappear. In addition, with the proliferation of tax credits, it becomes necessary to establish an order in which the credits are to be taken. A proposal for ordering existing tax credits was set forth in U.S. TREAS. DEPT., THE PRESIDENT'S 1978 TAX PROGRAM 39 (1978). See also I.R.C. § 53.

reform" camp, who generally oppose the use of tax expenditures, and those in the "tax preference" camp, who generally advocate tax expenditures.¹⁰⁷ This agreement on the refundability issue is interesting because it indicates that proponents of these seemingly polar views have in fact accepted the validity of the tax expenditure analysis—although the motives for advocating refundability may be quite different. For example, considerable discussion has focused on whether the investment tax credit should be refundable. The earliest congressional proponent of a refundable investment credit was Senator Kennedy, the acknowledged leader of the tax reformers in the Senate. His proposal was quickly endorsed by Senator Long, Chairman of the Finance Committee.¹⁰⁸

A combination of practical politics and conceptual perceptions surrounding the refundable investment credit issue appeared to coalesce the positions of these two Senators, who generally hold opposing views on tax policy. Senator Kennedy's espousal of a refundable investment tax credit arose not so much from a commitment to the efficacy of the credit as such, but rather from applying tax expenditure analysis to the credit given his realistic political appraisal that the credit was not going to be repealed. Assuming that a federal subsidy for investment in machinery and equipment was to be provided through the tax system, the issue then became whether the credit was structured in a rational and equitable manner as compared to a direct spending program.

This comparison revealed a number of defects in the credit. First, the former limitation on the credit to 50 percent of current tax liability would be difficult to justify as a rational limit if a direct program were administered by the Commerce Department. Indeed, in the Tax Reduction Act of 1975, the then 50 percent limit had been temporarily increased for selected industries to 100 percent of tax liability.¹⁰⁹ In addition, this line of inquiry inevitably leads to questioning the rationality of limiting the allowable credit to the purchaser's tax liability. It is unlikely, if the Secretary of Commerce were administering the program, that she would condition a grant for the purchase of new machinery and equipment on a demonstration by the purchaser that it had incurred a tax liability to the Treasury. Clearly, conditions on direct grants might well be imposed, but it appears highly unlikely that tax liability would be among them.¹¹⁰ Moreover, Senator Kennedy questioned the equity aspects of making tax liability a prerequisite for claiming the credit. Such a condition excludes newly created businesses that frequently experience losses

¹⁰⁷ The first refundable tax credit employed in the United States income tax system was the earned income credit enacted as part of the Tax Reduction Act of 1975. I.R.C. § 43. This refundable credit was justified as (1) an offset to higher social security taxes, and/or (2) as a means of encouraging those on welfare rolls to obtain employment. S. REP. NO. 36, 94th Cong., 1st Sess. 32-35 (1975).

¹⁰⁸ See *SFC 1976 Hearings*, *supra* note 77, at 211, 1923-24, 2061; 123 CONG. REC. S5770 (daily ed. Apr. 7, 1977) (statement of Sen. Long) (introducing S. 1270).

¹⁰⁹ I.R.C. § 46(a)(7)-(9).

¹¹⁰ Apparently no direct federal subsidy program is conditioned on a potential recipient's demonstrating that a tax liability would be incurred for the year in question.

in start-up years; businesses that experienced losses during the 1973-1975 recession period and, due to net operating loss carryovers, would not have tax liability for some years;¹¹¹ and tax-exempt institutions.

Practical politics also affected the Kennedy backing of a refundable credit. His initial proposal for a refundable credit had been advanced before the Finance Committee in testimony on the pending Tax Reform Act of 1976. It was renewed in 1977 when the Administration proposed an increase in the investment credit from 10 percent to 12 percent.¹¹² In Kennedy's view, an increase in the credit rate primarily would assist the very large and profitable corporations while providing no help to those unable to take full advantage of the existing 10 percent rate. Accordingly, he advocated using the funds targeted for business stimulation to make the 10 percent credit refundable—again accepting the political reality, if not the need, for such an expenditure of federal funds.

Senator Long's championing of the refundable investment credit appears to rest in part on an agreement with the view that a limitation is neither rational nor equitable under spending program criteria.¹¹³ This view was also advocated forcefully by lobbyists for the leasing industry, banks, airlines, railroads, and shipping companies, all of whom are prevented by the limitation from obtaining full current benefit of the credit even though they made the purchases, or leased from other purchasers, intended to be stimulated by the credit.¹¹⁴ Moreover, as we shall discuss in greater detail in Part V, refundability represents a potential method to expand the influence of the already powerful Finance Committee chaired by Senator Long.

Since the Administration opposed the refundable investment credit, the Tax Reduction and Simplification Act of 1977 did not include the proposal.¹¹⁵ Senators Kennedy and Long urged that the concept be included in the President's 1978 tax reform proposals,¹¹⁶ but Treasury opposition to the

¹¹¹ Of course, unused investment credits then can be carried forward. I.R.C. § 46(b). But to a business, the value of a carry forward is obviously discounted substantially as compared to immediately available funds.

¹¹² See *Tax Reduction and Simplification Act of 1977: Hearings on H.R. 3477 Before the Senate Comm. on Finance*, 95th Cong., 1st Sess. 167-80 (1977). See also note 108 *supra*.

¹¹³ See 123 CONG. REC. S5770 (daily ed. April 7, 1977) (statement of Sen. Long).

¹¹⁴ In general, the investment credit is available only to corporate lessors. *But see* I.R.C. § 46(e)(3). The support of those in the leasing business for a refundable investment credit is something of a mystery. One would think that a refundable credit might cause some businesses that are presently lessees because of the lack of sufficient tax liability to use the credit in full to become purchasers, a result that would reduce the volume of leasing business.

On the issue whether the investment credit should be made available only to users of the property and thus not to lessors. *see* McDaniel, *Tax Reform and The Revenue Act of 1971: Lesions, Lagniappes and Lessons*, 14 B.C. IND. & COM. L. REV. 813 (1973).

¹¹⁵ 123 CONG. REC. S6577-83 (daily ed. Apr. 27, 1977).

¹¹⁶ Letter from Senators Long and Kennedy to Secretary of the Treasury Blumenthal, August 12, 1977. The President's 1978 tax proposals did recommend increasing the present 50% of tax liability limit to 90%.

concept kept it out of the package. The grounds for the Treasury position have not been publicly articulated, but the failure to require a basis adjustment for the refundable credit, discussed below, appears to account in part for the Treasury resistance. The Revenue Act of 1978, however, moved closer to a refundable credit by increasing the 50 percent limitation to 90 percent over a period of four years.¹¹⁷

Not only does the tax expenditure analysis almost inevitably push legislators toward the use of tax credits rather than deductions or exemptions, it also pressures them to adopt refundable tax credits as a matter of logic and equity. The persuasiveness of the tax expenditure analysis in this regard was especially evident in the handling by the Senate of the energy tax legislation in the period from 1975 to 1977. In its initial consideration of the 1975 Energy Conservation and Conversion Act, the Finance Committee tentatively approved converting House-passed tax credits to refundable credits.¹¹⁸ Neither the 1977 energy tax legislation proposed by the President nor the legislation passed by the House incorporated the refundability concept for the approved tax credits.¹¹⁹ The Finance Committee's version of the energy tax bill, however, included five refundable tax credits.¹²⁰ On the Senate floor, one of these credits was deleted, but five other refundable credits were added.¹²¹ Thus, the Senate version of the energy tax bill went to conference with nine refundable tax credits.

The revenue implications of refundability are significant. The following table sets forth, in millions of dollars, the total revenue costs for the refundable tax credits approved by the Senate in its energy tax bill and isolates the costs of the refundable feature for each of the credits.

Refundable Credits	FY 1978 Refundable Portion	FY 1978 Total Cost	FY 1978-1985 Refundable Portion	FY 1978-1985 Total Cost
1. \$400 Residential insulation	\$26	\$529	\$464	\$9,274
2. \$2,200 Residential solar	1	27	39	784
3. 15% Alternative energy property (business conversion)	104	424	1,253	8,633
4. 10% Specifically defined energy property (business heat conservation).....	174	486	747	4,604
5. \$75 Elderly.....	0	0	7,284	8,411
6. \$150 Residential heating oil.....	0	183	471	5,897
7. \$150 Residential electricity derived from imported residual oil.....	0	6	16	332
8. \$150 Residential propane gas.....	0	69	239	2,382
9. Contingent refined imported petroleum product adjustment				(Becomes effective only if Administration subsequently raises import fees on refined products)
TOTAL	\$305	\$1,724	\$10,513	\$40,317

As the table shows, for fiscal 1978 the refundable feature of the approved credits constituted 17 percent of the total revenue cost of the credits, a percentage that would rise to 25 percent for the total tax expenditures from fiscal 1978 through fiscal 1985.

Because of the above revenue implications and Treasury opposition, only one of the tax credits approved in the Energy Tax Act of 1978 was refundable—the credit for business installation of solar and wind energy equipment. But the House agreement to the refundability of this particular credit—apparently selected for no special reason itself—may presage a future House willingness to move in the direction the Senate has taken on several occasions. For example, in its consideration of the Social Security Financing Act of 1977,¹²² the Senate Finance Committee initially approved a refundable tax credit for state and local governments and certain nonprofit organizations equal to one-half the increased social security taxes imposed on employers by the bill.¹²³ Later, however, at the request of the Senate Budget Committee, the Finance Committee withdrew the refundable credit and substituted a lower tax rate for these employers. On the floor, the Senate added a college tuition tax credit as an amendment to the Social Security Financing bill.¹²⁴ It also approved an amendment by Senator Bumpers—in general a member of the tax reform group—to make the credit refundable. Senator Bumpers' principal argument for refundability was equity: "It would be patently unfair for us to approve the [college tuition tax credit] and say to a lot of people in this country who need help much worse than those who are going to get it under the [proposed] amendment, 'There is nothing in this bill for you.'"¹²⁵ Similar equity considerations had caused the Senate in its version of the Tax Reform Act of 1976 to make the child care credit in section 44A refundable,¹²⁶ although the refundability aspect was dropped in conference.¹²⁷

Thus, the trend to tax credits as the favored vehicle for implementing tax expenditure programs almost surely will carry with it a corresponding im-

¹¹⁷ I.R.C. § 46(a)(3).

¹¹⁸ Goodnough, *Senate Finance Reports Out Windfall Tax Measure*, 3 TAX NOTES No. 31 at 23-26 (Aug. 4, 1975).

¹¹⁹ See NATIONAL ENERGY PLAN, *supra* note 80, at xv-xxiii; H. REP. NO. 543, 95th Cong., 1st Sess. (1977).

¹²⁰ S. REP. NO. 529, 95th Cong., 1st Sess. 3-5 (1977). The credits made refundable were those for home insulation costs, renewable energy source equipment, business energy investment, specially defined energy property, and intercity bus service.

¹²¹ The intercity bus credit was deleted and the credits listed as items 5-9 in the table in text following were added.

¹²² H.R. 9346, 95th Cong., 1st Sess. (1977).

¹²³ S. REP. NO. 572, 95th Cong., 1st Sess. (1977).

¹²⁴ 123 CONG. REC. S18792-803 (daily ed. Nov. 4, 1977). The Senate amendment was rejected by the Conference Committee. S. REP. NO. 612, 95th Cong., 1st Sess. 78-79 (1977). The tuition tax credit bill passed by the House in 1978 was not refundable. H.R. 12050, 95th Cong., 2d Sess. (1978). The Senate Finance Committee bill provided refundable tuition tax credits.

¹²⁵ 123 CONG. REC. S18802 (daily ed. Nov. 4, 1977).

¹²⁶ 122 CONG. REC. S1215-54 (daily ed. July 21, 1976).

¹²⁷ S. REP. NO. 1236, 94th Cong., 2d Sess. 48-51 (1976).

petus to expand the utilization of the refundability mechanism. Refundability is seen as a necessary element to ensure that the tax expenditure program mirrors a corresponding direct program in terms of rationality, efficiency, and equity.¹²⁸ As in the case of the trend to tax credits, however, certain forces resist the implementation of the refundability concept. In the area of business tax credits, some economists oppose refundability on the ground that federal subsidies should not be given to businesses operating at a loss lest the government grants provide inefficiently operated businesses with means to continue operation after market forces have prophesied their demise. These economists, who are often strong tax reform advocates, will frequently be joined—in the kind of curious political alignments that the refundability concept seems to produce—by many of the largest corporations. For example, those corporations that are not restricted by the 50 (increasing to 90) percent of tax liability limit in the investment credit may oppose refundability and urge instead that the available subsidy funds be allocated to increasing the investment tax credit rate from 10 percent to some higher level. Similarly, where new business credits are proposed, profitable companies may oppose diversion of substantial revenue to low-or-no tax liability entities. Thus, as we saw in the case of the shift from deductions to credits, the issue of allocation of the available subsidy revenues among potential beneficiaries affects the manner in which refundability is viewed.

In the area of tax credits for personal costs, refundability likely will be opposed by those responsible for tax administration. As discussed above,¹²⁹ the shift of an itemized deduction to a tax credit outside the standard deduction brings some 77 percent of taxpayers into the subsidy system. As a result, the particular item must be computed and disclosed on millions more returns. Refundable personal credits magnify the problem since such credits require that some 15 million non-filers, generally those with incomes below poverty levels, must become tax return filers to benefit from the tax subsidy. Thus, refundability runs counter to the considerable efforts over the past decade to relieve poverty level individuals from the burdens of tax payment and tax return filing and preparation. Moreover, as the experience with the refundable earned income credit has demonstrated, it is not a simple matter for the income tax administration system to reach poverty level persons and convince them that they should now file tax returns.¹³⁰ This last point, however, focuses more on why the tax system is being used to effect the federal subsidy program in the first place—an issue to which we return below—than to the issue whether, if the tax system is used, poverty level individuals should be included in the program. Finally, as discussed later in Parts III and V, refundability raises substantial issues concerning budget policy and the legislative process.

¹²⁸ See CBO HOUSING STUDY, *supra* note 77.

¹²⁹ See text at note 92 *supra*.

¹³⁰ See Schenk, Simplification for the Average Taxpayer, II ALI-ABA Conference on Tax Simplification 3, 7 (Jan. 4-7, 1978) (to be published). In response to this problem, the Revenue Act of 1978 included provisions to simplify the credit so that it could be incorporated in the withholding system and refunds could be provided to employees on a current basis. I.R.C. §§ 43(f) and (h), 3507.

D. Taxable Tax Credits

An issue that has not yet surfaced in legislative consideration of tax credits is the proper income tax treatment of tax credits themselves. We have pointed out in prior discussions the need to consider whether the amount of the tax credit itself should constitute taxable income to the recipient.¹³¹ The Treasury has approached the issue somewhat obliquely in its recommendation for basis adjustments when business tax credits are involved.¹³² But a basis adjustment for the business assets is an alternative to taxability, and the propriety of such an adjustment must be based on an assumption that the amount of the credit under normal income tax principles constitutes taxable income. Indeed, tax expenditure analysis indicates that many tax credits should constitute taxable income.

If the amount of the tax credit is not included in income, the upside-down effect of tax expenditures effected through special deductions or exclusions remains in the tax expenditure effected through the tax credit. This point can best be understood by comparing the treatment of direct government subsidy programs. Most direct commercial subsidy payments constitute taxable income. In contrast, if the payment constitutes a contribution to capital, the payment is excluded from income but the taxpayer reduces the basis of its assets. This basis reduction, in effect, defers the tax on the subsidy, but as stated above, assumes that the subsidy represents taxable income. If a business tax credit is used in lieu of a direct subsidy, the same tax result should occur. That is, the amount of the credit either must be included in income or there must be a basis adjustment to ensure collection of the tax on the subsidy over time.

The following table illustrates this analysis by comparing a taxable direct subsidy of \$10 for each \$100 investment in machinery and equipment, assuming a 10-year life, with a 10 percent investment credit.

	Taxable Direct Subsidy	Taxable Investment Credit	Nontaxable Investment Credit	Nontaxable Investment Credit- Basis Adjustment
Operating income	\$100	\$100	\$100	\$100
Subsidy	10	10	—	—
Depreciation	- 10	- 10	- 10	- 9
Taxable income	100	100	90	91
Tax (50% rate)	50	50	45	45.50
Credit	0	- 10	- 10	- 10
Tax liability	50	40	35	35.50
After-tax cash	60	60	65	64.50

The after-tax cash position of the taxpayer with a nontaxable investment credit is increased by the amount of the tax imposed on the direct subsidy. The

basis adjustment technique reaches the same net result as a taxable subsidy, but only after 10 years. And, if the tax rates are varied, the higher bracket taxpayer will always realize a greater after-tax benefit than a lower bracket recipient of the same nontaxable credit.

The tax expenditure principle suggesting that a tax credit, or any tax expenditure, should be first reconstructed as a direct spending program, applies equally in determining whether a tax credit should be taxable. After reconstructing a tax credit as a direct spending program, normal income definition principles are then applied to the tax subsidy program. If the corresponding direct subsidy would be included in income, so should the amount of the tax credit. Conversely, if the corresponding direct program would not result in taxable income, neither should the tax credit. Moreover, if the direct program would be treated as a nonshareholder contribution to capital and taken into account by means of a basis adjustment, the same result should follow to the tax credit recipient.

Applying the foregoing analysis to the investment credit, the critical issue is whether the credit restructured as a direct subsidy would always constitute taxable income to the recipient or whether it would qualify for the section 118-section 362(c) basis adjustment rule as a nonshareholder contribution to capital. Under the tests laid down by the Supreme Court in *United States v. Chicago, Burlington and Quincy R.R. Co.*,¹³³ a direct subsidy program structured like the investment credit would appear to constitute a contribution to capital rather than, for example, income for services rendered. Accordingly, under present rules, one proper income tax treatment of the investment credit would be a basis adjustment. Alternatively, Congress could simply mandate that the amount of the credit constitutes currently taxable income, with no basis adjustment.

As noted above, Congress has not yet evidenced any overt awareness of the need to determine the proper income tax treatment of tax expenditures. Yet, perhaps unknowingly, it has already legislated the equivalent of a taxable tax credit. That action was taken in connection with the enactment of the "new jobs tax credit" in the Tax Reduction and Simplification Act of 1977, and continued with respect to the "targeted jobs tax credit," enacted in the Revenue Act of 1978 as section 44B to replace the new jobs tax credit. Section 280C requires that the deduction for wages paid during the year be reduced by the amount of the jobs tax credit allowed under section 44B. The purpose of the reduction is to prevent the combination of the wage deduction and credit from producing tax write-offs in excess of 100 percent of wages actually paid. Such a result could have been avoided by making the jobs tax credit taxable. The net effect of section 280C is thus precisely the same as if Con-

¹³¹ See Surrey & McDaniel, *supra* note 7, at 693 n.43; McDaniel, *supra* note 114, at 839, 844.

¹³² See President Ford's Economic Message of October 8, 1974, 120 CONG. REC. 34421 (1974).

¹³³ 412 U.S. 401 (1973).

gress had provided that the amount of the jobs tax credit constituted taxable income to the taxpayer claiming the credit. Assuming the taxpayer qualified for a \$10 jobs tax credit and paid wages of \$50, the following table demonstrates this fact.

	Targeted Jobs Tax Credit With Wage Deduction Reduced	Taxable Targeted Jobs Tax Credit With No Reduction of Wage Deduction
Income	\$100	\$100
Taxable credit	- 0	10
Deduction for wages	- 40	- 50
<u>Taxable income</u>	<u>60</u>	<u>60</u>
Tax (50% rate)	30	30
<u>Tax credit</u>	<u>- 10</u>	<u>- 10</u>
Tax	20	20

A provision similar to the *de facto* taxable jobs credit was contained in the tuition tax credit measure adopted by the House and Senate in 1978. That measure required that a taxpayer claiming the proposed education tax credit reduce any deductions for educational expenses by the amount of such expenses which qualified for the credit.¹³⁴

The section 280C technique for achieving the equivalent of a taxable tax credit evidences clever work by tax technicians. But, it does not represent a sufficient response to the broader issue of the proper income tax treatment of the subsidies made available through tax expenditures. Normative structure deductions, such as for wages or costs of producing income, should not be complicated and distorted to achieve what can be done directly and simply. While the taxability issue is most easily perceived in the context of tax credits, the problem is inherent in all tax expenditures. What is needed is a systematic analysis by the Treasury and the Staff of the Joint Committee on Taxation that would (1) hypothetically recast all existing tax expenditures as direct expenditures; (2) determine, under normative income tax rules, the proper income tax treatment of the subsidies as recast; and (3) request Congress to provide the requisite general statutory authority to apply through regulations the proper tax treatment to each tax expenditure. The Treasury and Joint Committee Staff, of course, should make a similar advance determination for all proposed new tax expenditures considered by Congress. The taxability of tax expenditures raises important equity issues that must be addressed. In the

¹³⁴ See H.R. REP. NO. 1790, 95th Cong., 2d Sess. (1978). The bill was not passed by Congress because the Senate refused to agree to the Conference Committee Report which the House had altered to include elementary and secondary schools. 124 CONG. REC. S19141-44 (daily ed. Oct. 14, 1978).

final analysis, nontaxability of the tax expenditures ensures that a person will be wealthier if he receives a government tax subsidy than if he had by his own efforts earned an identical amount.

One who has followed the implications of the preceding discussion on tax credits will be aware that with a refundable, taxable tax credit we have now come full cycle to a direct spending program. Such a credit is the exact replication of a direct subsidy in the tax system. It can satisfy the criteria applied to direct spending programs—need, efficiency, and equitable distribution of benefits. Moreover, since it impairs neither horizontal nor vertical equity, a taxable tax credit has no adverse effect on tax equity. The question then is why use tax expenditures instead of direct expenditures? What is gained and, perhaps more importantly, who gains from the use of the tax rather than the direct spending mechanism? Conversely, what is lost and who are the losers if the tax expenditure route is followed?

We have addressed these questions in detail elsewhere;¹³⁵ however, the 1976-1977 experience throws some of the previously proffered answers into sharper focus. First, the use of refundable and taxable tax credits may hamper tax simplification efforts and the effective administration of the tax system. We discuss these issues in the following section. The winners are, of course, those who can secure approval of a tax expenditure, but who could never obtain a direct subsidy. The principal reasons why they can win congressional approval of tax expenditures now appear to lie (1) in the power politics of the committee system in Congress and (2) in the willingness of non-tax executive branch departments to accede to or even support requests for new, continued, or expanded tax expenditures. The politics of the committee system are discussed in Part V and the executive department's support of tax expenditures is discussed in Part IV.

E. Tax Simplification

The theme of tax simplification continues to make periodic appearances at center stage in United States tax policy discussions. The causes of tax complexity have been well known for a long time, and have not only gone unremedied, but indeed have intensified. One therefore approaches with some diffidence the question whether tax expenditure analysis can aid in achieving a simpler income tax system. For decades, authorities addressing the tax simplification issue have recognized that tax preferences constitute a major source of complexity in the tax system.¹³⁶ The tax expenditure budget now lists and quantifies those tax preferences. This very process, we believe, provides guidelines as to the scope of the simplification issue, a more realistic perception of the obstacles to simplification, and a more refined strategy for achieving simplification.

¹³⁵ See PATHWAYS, *supra* note 34, at 126-54; Surrey & McDaniel, *supra* note 7, at 693-98.

¹³⁶ For a compilation of authorities see McDaniel, *Federal Income Tax Simplification: The Political Process*, 34 TAX L. REV. 27 (1978).

As set forth in Appendix A, there are approximately 85 tax expenditure programs in the income tax system. For fiscal 1979, the combined revenue cost of these tax expenditures has been estimated to exceed \$135 billion. In turn, this figure represents 20 percent of total anticipated federal spending for fiscal 1979.¹³⁷ Both the number of programs and the revenues involved were significantly increased by the tax legislation in 1978. From a statutory drafting standpoint, each tax expenditure may require numerous sections of the Code to implement the program.

It is clear that enormous tax simplification could be achieved by repeal of all tax expenditures in the income tax. But the tax expenditure budget itself reveals how futile it is to expect any such action in the near future. No one can seriously believe that 20 percent of the federal budget could be repealed in the name of "tax simplification."¹³⁸ Indeed, one suspects that if such an all-or-nothing approach were ever taken in a tax reform bill, few of even the most ardent congressional tax reformers would support it. A moment's reflection indicates why this is so. In a number of instances, the purposes for which funds are provided through tax expenditure programs are purposes virtually everyone would agree should be supported by federal financial aid. In some cases, the tax expenditure program is the only or the largest federal program presently in force. Consequently, serious difficulties would be encountered in attacking a tax expenditure for a widely-approved objective when the primary justification is merely "tax simplification." Even the promise of using the revenues from repealed tax expenditures for general rate reductions seems unlikely to assuage tax expenditure program beneficiaries—who suspect that increased funds in taxpayers' pockets will not find their way back into the particular activity supported by the tax subsidy.

As the foregoing analysis suggests, tax expenditure principles can assist in devising effective strategies for achieving tax simplification. First, the issue of "complexity" is different for normative tax structure provisions than for tax expenditure provisions. A normative tax on net income—computed annually by varying taxable units, with progressive rates applied to an infinite variety of economic activities—inherently contains a significant and unavoidable degree of complexity. In dealing with normative provisions, the task of "tax simplification" is to ensure that such rules are clear, consistent, and logically coherent. The objective is to ensure that the normative income tax responds to

¹³⁷ The total anticipated federal spending for fiscal 1979, \$635 billion, is made up of \$500 billion in direct expenditures plus \$135 billion in tax expenditures. See THE BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1979 at 11; 1978 JOINT COMM. ESTIMATES, *supra* note 12, at 8.

¹³⁸ Apparently, there are those who believe the need for simplification could support this result. The compilers of U.S. TREAS. DEPT., BLUEPRINTS FOR BASIC TAX REFORM (Jan. 17, 1977) [hereinafter cited as BLUEPRINTS] would be numbered in this group. See also Senator Hatfield's proposed Simpliform Tax Act of 1977, S. 1969, 95th Cong., 1st Sess. (1977), and his statement thereon at 123 CONG. REC. S13196 (daily ed. Aug. 1, 1977). An editorial call for elimination of all tax expenditures was sounded by the Chatanooga Times, Dec. 29, 1977, reprinted in 124 CONG. REC. S141 (daily ed. Jan. 20, 1978) (statement of Sen. Sasser).

simple or complex transactions with appropriately simple or complex tax rules.

In contrast, the simplification issues presented by tax expenditures are quite different. Here, the complexities of "spending" programs become complexities of the tax system. Because the spending program is to be implemented through the Internal Revenue Code, tax language must be employed to describe the program, and the tax return must be complicated with a seemingly endless series of lines and instructions. The result is that the tax system is inevitably complicated by the decision to use tax expenditures. Thus, although we can conclude that tax simplification is a feasible and desirable goal where normative tax provisions are involved, the decision to use tax expenditures inevitably produces a more complex tax system.

Accordingly, we must ask whether matters would be simplified *if* most of the tax expenditures were eliminated. The answer is clearly yes, *if* the tax expenditures so eliminated were not replaced by direct programs. *If*, however, the tax expenditures were replaced with direct programs, the answer depends in part on whether the direct programs in themselves would be more complex, for example, as to qualification requirements and other details. This is a likely result since direct programs generally are constructed, wisely or unwisely, with much more detail than the counterpart tax expenditure programs.¹³⁹ But if we disregard this initial difference, the following results of the change from a tax to a direct program become apparent: The tax laws would be simpler, and hence clearly the complexity of tax administration would be lessened; the administration of the tax expenditure programs would be dispersed among a number of agencies; tax lawyers would lead a more relaxed life, while the work of their non-tax colleagues would increase; taxpayers would face a far simpler tax return, since they would no longer have to read numerous items having no application to them;¹⁴⁰ and those taxpayers benefited by the direct programs would have to fill out more forms and then send them to other agencies, the number of forms depending on the particular program. Overall, one would expect a net gain in cost-benefit ratios. While the dispersal of programs and resulting forms for administration may in one sense foster complexity, the net gain in reduced complexity for an inherently complex normative income tax system would place matters on the plus side. And, after all, it is *tax* simplification that we are discussing.

¹³⁹ The text statement, of course, depends on the nature of the direct program. If, for example, the itemized deduction for state property taxes were instead reflected in a HUD program to assist homeowners, the detail for aid recipients could presumably increase. But if it were reflected in increased federal revenue-sharing aid to state and local governments, the converse would be the case.

¹⁴⁰ While a particular tax expenditure may in itself appear simpler than would its counterpart direct program, that expenditure becomes an added item on a tax return making the entire return more difficult to handle. Thus, while a tuition tax credit in itself may look simpler than direct educational assistance—"just a line in the tax return"—when we consider that the tuition credit becomes credit number 10 or so on the tax return, the added complexity of that "simple line" becomes far more serious.

A second issue in devising methods of tax simplification is the effect of repealing individual tax expenditures. As previously stated, we think it unlikely that total repeal of all tax expenditures, even if all revenue were applied to rate reductions, will be realized in the near future. Nevertheless, achieving tax simplification by step-by-step repeal of tax expenditures may be possible if realistic strategies are pursued. Objective and comprehensive studies of existing and proposed tax expenditures suggest three different strategies:

(1) For those tax expenditures for which no direct federal program is needed, outright repeal, perhaps coupled with use of the revenue involved for general rate reduction, is the appropriate strategy. The preferential treatment of capital gains would be a candidate for such treatment.

(2) For those tax expenditures for which a federal program is needed, but which overlap or closely resemble existing direct programs, the appropriate strategy is to couple repeal of the tax expenditure with a corresponding transfer of all or part of the revenues to the direct program, as amended to encompass the scope of the tax expenditure program. The special tax preferences for farm operations, pollution control, and state and local taxes would be among the possible candidates for such treatment.

(3) For those tax expenditures for which a federal program is needed, but for which no adequate direct program presently exists to which the tax expenditure revenues can be transferred, a new direct program must be developed if the effort to repeal the tax expenditure is to be successful. Examples of such tax expenditures would likely include the medical expense deduction and the charitable contributions deduction.

Implementation of the suggested approach to tax simplification obviously is a lengthy process—over 85 tax expenditure programs cannot be dealt with properly in a short period of time. Moreover, the approach requires the development of more sophisticated and coordinated techniques for considering tax expenditures both within Congress and the executive branch. These techniques and the necessary studies must in turn take into account the political process through which the proposals must be approved. The discussion in Parts IV and V below illustrates the methods and political obstacles to implementing tax simplification.

F. Tax Administration

The existence of tax expenditures complicates enormously the task of tax administration. Indeed, as Commissioner of Internal Revenue Jerome Kurtz graphically demonstrates, much of the available IRS time, effort, and personnel must be devoted to "spending program administration" rather than "tax administration":

Each of [the tax expenditure] provisions is, in effect, a non-revenue related expenditure program written into the tax law. Each entails its own special set of issues, definitions and limitations Because of these provisions I find myself, a Commissioner of Internal Revenue, administering programs of many other agencies. If

these programs were parceled out to those agencies, the concentration of programs would be diffused and the tax law and administration would be vastly simpler [T]he administrative problems which result from [the complexities created by tax expenditures] are formidable. To help taxpayers and officials alike, we must provide an inventory of 368 different forms for public use, along with instructions for each When a provision is placed into the tax law which applies only to a relatively small segment of the taxpaying population, it nevertheless requires additional instructions and lines on the tax return which is distributed to all taxpayers. Thus, each narrowly applicable provision increases the filing burden for everyone, both for those to whom the provision does not apply as well as for those to whom it does.¹⁴¹

Clearly, even if ideally structured refundable, taxable tax expenditures are employed, the administration of the normative income tax system becomes hopelessly burdened. As long as the Internal Revenue Service must implement, regulate, audit, and litigate over 85 programs that have nothing to do with the collection of taxes, it is obvious that the performance of its primary task of administering the normative rules necessary to implement an income tax system will suffer. In addition, it is questionable whether IRS tax lawyers, accountants, agents, engineers, and administrators represent the most competent group to implement and oversee particular spending programs. Obviously, some agency of the federal bureaucracy must administer a financial aid program. But it is less than obvious why the Internal Revenue Service is better equipped to handle a national program to encourage and support the arts, for example, than is the National Endowment for the Arts.¹⁴² What is clear is that every Revenue Agent cannot possibly be an expert in the intricacies of the normative income tax and in the details of over 85 spending programs encompassing every area in which government operates.

A related concern is the considerable impact and costs of the paperwork generated by federal programs. The tax forms have borne a good deal of the blame for the perception that the government requires excessive paperwork from the private sector.¹⁴³ Without assessing the validity of the conclusion that the paperwork burden is excessive,¹⁴⁴ it seems apparent that the task of

¹⁴¹ Kurtz, *Tax Simplification: Some Observations from a Retrospective View of the United States' Experience*, Address Before the Eleventh General Assembly of the Inter-American Center of Tax Administrators, *reprinted in* 123 CONG. REC. S8349, 8351 (daily ed. May 23, 1977) (statement of Sen. Kennedy).

¹⁴² See H.R. 1739, H.R. 7896, H.R. 9325, 95th Cong., 1st Sess. (1977), proposing tax expenditures to provide financial aid to the arts and to artists.

¹⁴³ See COMMISSION ON FEDERAL PAPERWORK, FINAL REPORT ON FEDERAL TAXATION: FINDINGS AND RECOMMENDATIONS (June 1977). Rule XXIX of the Standing Rules of the Senate requires a paperwork impact statement to be prepared with respect to proposed legislation. See S. REP. NO. 66, 95th Cong., 1st Sess. 105 (1977), for an example of such a statement in connection with the Tax Reduction and Simplification Act of 1977.

¹⁴⁴ See KAUFMAN, RED TAPE: ITS ORIGINS, USES AND ABUSES 56-58 (1977).

completing tax forms cannot be made less onerous so long as Congress and the executive branch continue to channel one-fifth of total federal spending through the tax system.

It is thus clear that tax expenditures have substantially complicated and overburdened the tax administrators. What is now needed is more detailed information separating the costs and time devoted by the Internal Revenue Service to administration of the normal income tax system. The costs of implementing spending programs through the tax system in terms of planning, forms, regulations development, rulings issuance, collection, audit, and litigation must be ascertained. The gains or losses to be incurred by converting tax expenditures to direct programs—dealing with potential program beneficiaries only instead of over 80 million tax return filers annually—must be calculated. Detailed information of this nature should assist Congress and the executive branch as they decide whether to implement or expand a program directly or through the tax system.

G. Inflation Adjustments

In the face of persistent inflation in the United States, it is not surprising that during the 1976-1978 period increasing attention was focused on proposals to index the tax system, in whole or in part, for inflation.¹⁴⁵ Tax expenditure analysis does not indicate whether a country should or should not automatically adjust its tax system to take inflation into account. That decision must be based on the broad economic conditions facing a government, and on the policies which that government chooses to pursue.¹⁴⁶

Indexation measures can be applied to rates, brackets, or to elements in the tax base, such as the basis for assets. In the case of the tax base, tax expenditure analysis does indicate that once a government has decided to index elements in the tax base for inflation, indexing must be consistently applied or tax expenditures can result. In the United States, the decision has been made not to adjust the tax base for inflation on an automatic basis. That decision is, of course, subject to review and change. But so long as the present policy decision is maintained, any action to index a particular aspect of the tax base for inflation will create a tax expenditure. For example, the House-passed version of the Revenue Act of 1978 included a provision to adjust gain realized on the sale or exchange of certain capital assets for the inflationary element, if any, inherent in the gain.¹⁴⁷ This proposal, given the present policy not to index the tax system on an across-the-board basis, constituted a clear tax expenditure benefiting holders of particular types of investments.

¹⁴⁵ For an explanation of indexing, see Brinner & Munnell, *Taxation of Capital Gains: Inflation and Other Problems*, [1974] NEW ENG. ECON. REV. 3 (Sept./Oct.).

¹⁴⁶ For a comparison of the extent to which various countries have indexed their tax system for inflation, and the varying reasons for taking, or not taking, such action, see INTERNATIONAL FISCAL ASSOCIATION, *INFLATION AND TAXATION*, LXIIA CAHIERS DE DROIT FISCAL INTERNATIONAL (Vienna Congress 1977).

¹⁴⁷ See H.R. REP. NO. 1445, 95th Cong., 2d Sess. 125 (1978).

Excluded from the proposal were debt instruments, savings accounts, the cash value of life insurance and annuity contracts; and inventories and other assets, all of which are also adversely affected by inflation.¹⁴⁸

Tax expenditure analysis therefore requires that proponents of inflation adjustments for capital gains justify their proposal as a *federal spending program*. Critical issues in analyzing such proposals include the question whether inflation in the United States is high enough to indicate a need for any subsidy to offset its effect; whether data indicate that sellers of capital assets are in greater need of a federal subsidy than those whose investments are in the form of savings accounts or bonds; whether this federal subsidy would possibly accelerate inflationary trends; and, how benefits of the subsidy would be distributed among income classes.¹⁴⁹

A different, but still tax, response to inflation, is Arthur Okun's proposal to provide selective tax relief for employers and workers if a company agrees to hold wage and price increases below prescribed rates.¹⁵⁰ Such a measure would constitute a tax expenditure program. Whatever the merits of the proposal in terms of the "stagflation" problem, it is clear that tax expenditure analysis must be applied if its operation and effects are to be clearly perceived by policymakers.¹⁵¹

In short, tax expenditure analysis does not indicate whether a tax system should or should not be adjusted automatically for inflation. But it does demonstrate that if the United States is to change its present policy and avoid creating new tax expenditures, it must identify and correct *all* the elements in the tax system that are affected by inflation—adjustments that would necessarily produce taxable income for some as well as deductions for others. Selective adjustment for inflation in fact would constitute federal subsidy programs for the favored investment or activities. Using tax expenditure analysis, it is apparent that these proposed tax subsidies must therefore be justifiable as spending programs before such changes can be implemented.

¹⁴⁸ Advocates of inflation adjustments usually focus their concern on the taxability of gains attributable to inflation (or the lesser depreciation resulting from not indexing the basis of assets) and fail to mention that inflation produces untaxed gains for the same persons, e.g., borrowers repaying debt with inflated dollars.

¹⁴⁹ See generally INFLATION AND THE INCOME TAX (H. Aaron ed. 1976).

¹⁵⁰ Okun, *The Great Stagflation Swamp*, 14 THE BROOKINGS BULL. No. 3 at J/6 (Fall 1977).

¹⁵¹ The so-called "tax based insurance policy" (TIP) was analyzed in various studies included in CURING CHRONIC INFLATION (Okun and Perry eds. 1978), but none focused the issue in tax expenditure terms. President Carter made a broad proposal for a kind of TIP (applicable to wages only) in his anti-inflation proposals announced in October, 1978. The President's proposal is essentially a wage insurance program, insuring employees whose wage increases are held within a prescribed limit against a price rise in excess of that limit. The program is to be administered, however, by the Internal Revenue Service rather than the Labor Department. Nevertheless, the structuring of the program, not yet developed at the time of its announcement, should be based on the recognition that it is an *insurance* program and not a tax matter. Essentially, the payments should be treated as wage payments and tax policy decisions should be formulated on the basis of that concept.

III. BUDGET PRESENTATION ISSUES

One major use of the tax expenditure concept is in the formulation of the United States Budget. The years 1976 to 1978 saw continued development of some previously identified budget implications,¹⁵² and the emergence of additional ramifications of the concept.

A. *Current Issues in Budget Presentation*

The Office of Management and Budget and the Congressional Budget Office, in preparing the direct and tax expenditure budgets, are required to decide the proper budget presentation of legislative actions associated with tax expenditure and tax penalty provisions. The budget presentation of five identified categories of these provisions, as follows, must be resolved.

1. Refundable tax credits: The budget presentation issue to be resolved is whether the revenue associated with the refunded portion of refundable tax credits should be included in direct budget outlays, or whether the entire credit should be placed in the tax expenditure budget, with separate estimates for the portion that offsets tax liabilities and for the portion that is refunded. The present example of this category is the refundable earned income credit.

2. Provisions that phase-out tax expenditures by adopting the correct normative rule: The issue for resolution is whether the increased revenues from these provisions should be reflected only in direct budget receipts, with a corresponding reduction in and ultimate elimination of the item from the tax expenditure budget, or whether a negative figure should be included in the tax expenditure budget during the phase-out of the tax expenditure. The provisions in this category are illustrated by the repeal of accelerated deduction items such as the five-year amortization previously provided for railroad rolling stock.

3. Provisions that reduce or limit the scope of a specific tax expenditure: The issue for resolution is whether the increased revenues from these provisions should be reflected only in direct budget receipts, with a corresponding reduction in the tax expenditure, or whether the tax expenditure budget should reflect a figure for the total tax expenditure with a separate figure reducing the tax expenditure revenue loss. An example in this category is the denial of domestic international sales corporation (DISC) benefits for participation in an international boycott.

4. Provisions that reduce or limit the scope of more than one tax expenditure: The budget presentation issue is whether the revenue increase from these provisions should be reflected solely in direct budget receipts, or whether the revenue figure for each affected tax expenditure should be appropriately reduced. Examples of provisions in this category include the minimum tax, the "at risk" rules, and the limitation on the deduction for investment interest.

5. Tax penalties: The budget presentation issue to be resolved is whether the revenue from tax penalties should be reflected in increased direct budget

¹⁵² See Surrey & McDaniel, *supra* note 7, at 691-98.

receipts, or as a negative figure in the tax expenditure budget. The examples in this category include the disallowance of gambling losses in excess of gambling gains, as discussed in Part I.¹⁵³

In the following discussion, we examine first the present budget treatment of the above items by OMB and CBO. We then propose more comprehensive budget approaches for consideration.

B. Existing Budget Practices

1. Treatment of Refundable Credits

The earned income credit is so structured that if an individual's tax liability is not sufficient to absorb the full credit, any excess credit is refunded to the individual. Differences of opinion have existed over the budget presentation of the refunded portion. The OMB originally included the refundable portion of the credit in direct budget outlays, while placing the portion that offset tax liabilities in the tax expenditure budget.¹⁵⁴ In contrast, the CBO included the entire credit in the tax expenditure budget, with separate estimates for the two portions.¹⁵⁵

From a budgetary standpoint, the choice between the two treatments turns on whether the crucial budgetary distinction is the issuance of checks by the Treasury, as in the original OMB approach, or the inclusion of the total funds expended for a particular program in a single place in the budget, as in the CBO approach. The original OMB approach divided a tax expenditure program into two parts—that which produces a tax reduction, and that which produces an outright grant of Treasury funds. The principal function of the direct budget, under this view, is to show all Treasury outlays. Hence, proper budgetary practice would require inclusion of the refundable portion of a tax expenditure in that budget. Since tax expenditures are not fully integrated into the regular budget, it is a necessary corollary that the tax expenditure program be split into two parts and shown in different parts of the budget presentation. This approach thus differs significantly from the CBO approach. The justification for the CBO approach is that a clear budget presentation should reflect the total costs of each program, both those incurred through tax reductions and those incurred through refundability. The crucial budgetary emphasis is on the program, rather than on whether a Treasury check is issued for all or part of the tax credit.

In 1977, OMB accepted the CBO approach for the earned income credit and placed the entire earned income credit in the tax expenditure budget, with separate estimates for the two parts.¹⁵⁶ From the standpoint of proper

¹⁵³ See text at notes 32-34 *supra*.

¹⁵⁴ See 1976-1978 Special Analyses F.

¹⁵⁵ See 1977 and 1978 CBO TAX EXPENDITURE TABULATION, *supra* note 12, for fiscal years 1978-1982. The annual JOINT COMM. ESTIMATES, *supra* note 12, have similarly treated the earned income credit.

¹⁵⁶ 1979 Special Analysis G at 160. In the First Concurrent Resolution on the Budget for Fiscal Year 1979, Congress decided to treat the refundable portion of the earned income credit as a direct budget outlay. Presumably, CBO and OMB will follow this practice in future budget presentations.

budget presentation by the executive branch, there seems little basis on which to choose one or the other of these approaches to refundable credits.¹⁵⁷ Nevertheless, there are important practical differences between the two approaches in the congressional tax, budget, and appropriations processes. These differences are analyzed in Part V.A below.

2. Provisions That Phase-Out Tax Expenditures by Adopting the Correct Normative Rule

The issue of the proper presentation of the budget effect resulting from the phase-out of a tax expenditure has specifically arisen in the context of legislative actions to repeal accelerated deductions—tax deferral—items. The revenue estimate for an existing tax deferral item in Special Analysis G of the 1979 Budget is the difference between (1) the tax payments that would have been made for the year in question had the deferral provision never been enacted, and (2) the tax payments actually made. For example, under one of the five-year amortization provisions, the tax loan on any given investment with a 15-year useful life is paid off in years 6 through 15. In the meantime, however, new assets qualifying for the tax deferral are being acquired in years 6 through 15. Hence, the revenue loss shown in Special Analysis G for deferral items in any given year represents the net of the tax loan repayments *and* the new tax loans being made for the year in question.¹⁵⁸

Suppose, however, that Congress repeals a tax deferral granting accelerated deductions, as it did in 1976 in the case of the five-year rapid amortization for railroad rolling stock. After the effective date of the repeal, no new tax loans are made, and hence the only tax loan repayments are by taxpayers who had invested previously in the qualifying property. In resolving the budget presentation of the phenomenon, OMB, in the 1978 Special Analysis F and the 1979 Special Analysis G, showed negative figures for certain terminating 5-year amortization provisions.¹⁵⁹ The negative figures reflected the increased taxes from the repayment of the tax loans that will be due as the ability of taxpayers to take out new tax loans ceases, since, as a consequence of the repeal, no new government loans will be made under the tax expenditure program. The increased federal receipts from the termination of the tax ex-

¹⁵⁷ In Hartman & Pechman, *Issues in Budget Accounting*, in SETTING NATIONAL PRIORITIES: THE 1978 BUDGET 425, 434 (J. Pechman ed. 1977), it is argued that treating the refundable portion of the tax credit as a tax expenditure may have a practical political effect. Presidents tend to talk about limiting federal spending, by which they mean direct outlays in the Budget. Thus, including the refundable portion as direct outlays may reduce the amounts available for other federal programs. If a fully developed negative income tax were implemented, this aspect obviously becomes quite important, although, as discussed in the text at Part III.C *infra*, again full budgetary integration of tax and direct spending programs appears to be the real answer to the problem.

¹⁵⁸ 1979 Special Analysis G at 154-55.

¹⁵⁹ See 1979 Special Analysis G at 158-59; 1978 Special Analysis F at 128. 1977 and 1978 CBO TAX EXPENDITURE TABULATION, *supra* note 12, did not show negative figures for terminating tax expenditures.

penditures should be reflected, however, in the direct budget estimates. If that is the case, it is then improper to show a negative figure in the tax expenditure budget (just as it is improper to show the refundable portion of a tax credit as a direct budget outlay *and* as an item in the tax expenditure budget). Eliminating the increased receipts that result from repeal of a tax expenditure item from the direct budget, and showing the revenue effect solely in the tax expenditure budget would be consistent with the treatment of refundable credits as discussed above, that is, all revenue effects associated with tax expenditures appear in the tax expenditure budget and are shown nowhere in the direct budget.

3. Provisions That Reduce or Limit the Scope of a Specific Tax Expenditure

As discussed in Part I,¹⁶⁰ Congress may impose limits on specific tax expenditure items. The 1976 action to deny DISC benefits to taxpayers who cooperate in international boycotts illustrates this congressional power. Although the issue is not discussed in Special Analysis G or the CBO budget presentation, presumably the revenue loss associated with these tax expenditure items is simply reduced, and direct budget receipts reflect a corresponding increase in revenue. Alternatively, as in the case of the 1976 congressional action with respect to DISC (viewing DISC as a tax deferral provision), the budget effects could have been reflected entirely in the tax expenditure budget, that is, the revenue loss from DISC apart from the 1976 changes could have been shown and a separate negative figure employed to reflect the reduction in funds expended through DISC following the 1976 changes.

The approach adopted in the OMB budget is not unexpected, but one can question whether it is consistent with the practice described in subsection 2 above with respect to the elimination of tax expenditures.

4. Provisions That Reduce or Limit the Scope of More Than One Tax Expenditure

Provisions such as the minimum tax, the "at risk" rules, and the limitation on the deduction for investment interest cut across and affect indirectly several tax expenditures. The result of each provision is to increase direct budget receipts and, consequently, to reduce the revenue expended through the affected tax expenditures. In the case of the minimum tax, the tax expenditure budgets of both OMB and CBO reduce the revenue loss for each tax expenditure affected by the minimum tax by the minimum tax revenue associated with the particular tax expenditure.¹⁶¹

In contrast, in the case of the limitation on investment interest and the "at risk" rules, the difficulty of matching a portion of the revenue gain with a particular tax expenditure and the fact that the rules apply to non-tax expen-

¹⁶⁰ See text at notes 36-44 *supra*.

¹⁶¹ 1979 Special Analysis G at 154; 1977 CBO TAX EXPENDITURE TABULATION, *supra* note 12, at 5.

diture items have required that the revenue effects of such provisions be reflected only in increased direct budget receipts. Accordingly, the tax expenditure figures have not correspondingly been reduced.¹⁶²

5. Tax Penalties

The revenue derived from the tax penalty provisions discussed in Part I presently shows up in direct budget revenue receipts.¹⁶³ In these penalty situations, the persons involved are paying additional amounts, not properly designated "income taxes," to the government. In lieu of stating these amounts as direct budget revenue receipts, these amounts could be excluded from the income tax total shown in direct budget receipts and then classified separately in the tax expenditure budget as receipts from tax penalty provisions. Such an approach would appear consistent with that adopted for direct outlays associated with tax expenditures like the refundable tax credits, as discussed above.

C. Toward a More Comprehensive Budget Presentation of Tax Expenditures and Tax Penalties

1. A Unified Direct and Tax Expenditure—Tax Penalty Budget

The preceding discussion indicates that present budget practices are not wholly consistent in presenting revenues and outlays associated with tax expenditures and tax penalties. The problems of budget presentation encountered to date could be avoided by a budget that fully integrated tax expenditures and tax penalties with direct budget receipts and outlays in a single unified budget. A unified budget, for example, would reflect the following items insofar as the income tax is concerned:

I. Receipts

- A. Cash Receipts Derived from the Normal Income Tax System
- B. Receipts Associated with Tax Expenditures and Tax Penalties
 - 1. Imputed revenue receipts associated with tax expenditures
 - 2. Cash receipts from special provisions that limit tax expenditures
 - 3. Cash receipts from tax penalties

II. Outlays

- A. Direct Cash Outlays
- B. Outlays Associated with Tax Expenditures
 - 1. Imputed outlays from tax expenditures
 - 2. Cash outlays associated with tax expenditures (*i.e.*, refundable tax credits)

The above unified budget presentation would achieve the dual objectives of reflecting all direct budget receipts and outlays in a single place, and re-

¹⁶² 1979 Special Analysis G at 154; 1977 CBO TAX EXPENDITURE TABULATION, *supra* note 12, at 5.

¹⁶³ See text at notes 32-34 *supra*.

flecting all program receipts and outlays, actual or imputed, in a single place. A more rational and informative total budget would then be available for policy makers.

2. Expansion of Special Analysis G

Short of adopting a fully unified budget, Special Analysis G could be expanded and refined to mitigate some of the current presentational problems. A more comprehensive Special Analysis G might be retitled "Tax Expenditures and Tax Penalties." The Special Analysis would then include two parts:

Part I: Special Analysis of Receipts and Outlays

- A. Imputed Revenue Receipts Associated with Tax Expenditures
- B. Imputed Outlays Associated with Tax Expenditures¹⁶⁴

Part II: Direct Receipts and Outlays Associated with Tax Expenditures and Tax Penalties

- A. Receipts
 - 1. Minimum tax, "at risk" rules, etc.
 - 2. Tax penalties
- B. Outlays
 - 1. Refundable portion of tax credits

If desired, the effects of Parts I and II could then be netted to demonstrate the net revenue result of employing the tax system to expend funds in excess of that reflected in direct outlays, and of collecting funds in excess of the amounts normal income tax rules would produce.

The expansion of Special Analysis G in the manner described does not achieve all the benefits of a fully unified budget. But, refinement of the Special Analysis along the lines outlined above would result in a more complete budget presentation than we now have of the extent to which the tax system is employed to achieve non-tax objectives.

IV. INTERACTION OF TAX AND BUDGET POLICY ISSUES

A. *Need for a Coordinated Approach*

Parts II and III of this article discussed the relationship of the tax expenditure concept to tax policy and to budget policy as separate issues. Yet, the essence of the tax expenditure concept is that tax policy considerations involving tax expenditures are essentially related to the budget process. Hence, in any assessment of tax expenditures a coordinated approach to tax policy and budget policy is necessary.

Whether an existing tax expenditure or a new expenditure is being examined, one basic question is why the tax system is being utilized to carry out the particular policy objective. Direct spending programs are continually

¹⁶⁴ The 1978 CBO TAX EXPENDITURE TABULATION, *supra* note 12, at 27 (Table 5), sets forth the items suggested in Part I.A and I.B in the text at notes 1-31 *supra*.

being assessed as to their effectiveness (in terms of achieving objectives), efficiency (in terms of cost-benefit relationships), equity (in terms of social welfare achieved), and overall priority (in terms of a proper allocation of resources). A tax expenditure program with the same objective as a direct spending program likewise must be assessed in these terms. Suppose, for example, that the HEW Secretary is asked to design a program with the specific objective of providing assistance for educational expenses, and, further, that the Treasury Secretary is asked to design a program with the same objective but using the tax system. Initially it must be determined whether the two programs differ, even though the same objective is sought. If the programs are different, the next issue is ascertaining the material points of difference and the reasons for the differences. It would seem in the end that if the two programs do differ, what is really involved is a choice between different programs and not between a direct spending program and a tax expenditure program designed to meet the same objective. If one of the programs reaches different individuals, spends more or less money, or has different conditions, then policy choices are required in evaluating those program differences. Once the choices are made, then the results selected can be built into either a spending or a tax program. All this lies in the area of program design, and knowledgeable decisions should be forthcoming in this area.¹⁶⁵

There is a consequence of using the tax route, however, that does not exist under the direct spending route.¹⁶⁶ Most tax expenditures—since they are structured as exclusions, deductions, or deferrals—are dependent on the

¹⁶⁵ Feldstein, *The Theory of Tax Expenditures* (Harvard Institute of Economic Research, Sept. 1975), appears to examine the question of tax expenditure versus direct government spending. But the paper initially makes the assumption that the tax expenditure concept assumes direct spending is always better than a tax expenditure, and that tax reform must therefore aim for the elimination of all tax expenditures. Contrary to this conclusion, the tax expenditure concept indicates that a *choice* is always involved, and it is that *choice* which must be considered. Of course the concept, by focusing on a tax expenditure as a spending program, does indicate that, on government priority and political grounds, funds would not be voted for direct programs in many of the tax expenditure areas even if a direct program were efficiently devised. For example, Congress would not spend direct program funds to encourage shopping centers or commercial office buildings even though an existing tax expenditure program using accelerated depreciation does spend government funds for those activities.

Feldstein goes on to state that a tax subsidy for publicly favored forms of consumption may achieve a desired increase in the amount of such consumption, and do so more effectively than public provision of such goods. But apparently his comparison is between a tax subsidy and direct government provision of the goods in question. That comparison still does not tell us what are the terms of trade between a Treasury tax subsidy check, and a direct spending check afforded through a grant from an agency of government representing an alternative to the tax expenditure route. Since this type of comparison is not considered, Feldstein does not consider the upside-down effect of tax subsidies or the inability of non-taxable individuals or entities to participate in the subsidy—the equity effects. He is really comparing giving government funds to people, although the method he examines to provide the funds is limited to tax subsidies and does not consider direct monetary payments, and provision by government itself of the goods or services. But that comparison, as stated above, is only one step in the series of questions to be asked.

¹⁶⁶ See text at Part II *supra*.

basic rate structure for their value as benefits. The rate structure now runs from 14 percent to 70 percent, or 50 percent on earned income. At one point in 1977, President Carter considered a possible change in the tax rates to a structure running from 12 percent to 50 percent. That change, especially at the top brackets, would have materially reduced the amounts expended through a number of tax expenditures. In 1978, the President recommended a rate structure running from 12 percent to 68 percent, which had the same tendency to reduce the amounts expended through tax expenditures, though not as significant. The Revenue Act of 1978 did produce a somewhat similar effect, however, by reducing taxes through a widening of the tax brackets. In addition, in 1977 and 1978 Congress, largely in the interest of tax simplification, increased the standard deduction (zero bracket amount), thereby reducing the number of "itemizers."¹⁶⁷ As a consequence, the personal deductions requiring itemization—such as the incentive deductions for homeownership and charitable contributions—or the hardship relief deductions—such as for medical expenses—became useless for itemizers who switched to the standard deduction (zero bracket amount). Further, the Revenue Act of 1978 increased the personal exemptions to \$1,000, thus raising the income floor below which no tax is due, a step which will eliminate a number of individuals from the tax expenditure programs. The overall effect of the individual rate reductions and increased floor will be to reduce tax expenditures for individual taxpayers.

All this seems strange indeed. If the tax expenditures have valid objectives, it is peculiar that the accomplishment of those objectives suddenly is altered because fiscal goals or other overall tax objectives, such as simplification, require changes which automatically reduce the value of the tax expenditures without any consideration given to that consequence.¹⁶⁸ The result throws considerable doubt both on the wisdom behind the objectives of the tax expenditure programs so affected, and on the use of the tax route to accomplish those objectives.¹⁶⁹

Returning to the matter of program design, suppose the various aspects described above are considered and, as a consequence, the end results of the tax program and the direct spending program are designed to be the same.

¹⁶⁷ The technical arrangement involved a substitution of a zero rate bracket for both the standard deduction and the minimum standard deduction (low income allowance) at a figure higher than the standard deduction, and then an allowance for itemized deductions only for the amount in excess of the zero bracket.

¹⁶⁸ In 1969, 46% of the individuals filing tax returns itemized their deductions. For 1977, the estimate is around 23%, and the changes approved in the Revenue Act of 1978 should bring that figure down still further. As a consequence, the tax incentives for homeownership, for example, were in less than 10 years taken away from over 50% of the individuals who were then receiving the benefits of those incentives presumably because of the social objectives said to be obtained by the incentives. Yet, throughout this period neither HUD nor any other group offered serious objections to what was happening to the incentives or indeed even raised the question.

¹⁶⁹ See 123 CONG. REC. S11408 (daily ed. July 1, 1977) (statement of Sen. Kennedy), calling attention to the effect of the developments, discussed in the text, in diminishing the force of the charitable deduction as an incentive to charitable giving.

The choice between a tax program and a direct spending program will then involve institutional legislative factors, institutional administrative factors, and political and psychological factors, among others. As to legislative factors, important considerations are the congressional committees and the particular legislators who will have jurisdiction over, and thus control of, the programs if the tax route is chosen as opposed to a direct program. The expertise, reputation, and power of the legislative actors, including both the Congressmen and their staffs, are involved here.¹⁷⁰ As to administrative factors, the choice of administrative agency will depend upon which agency, the Treasury—Internal Revenue Service unit or another governmental department, is better equipped to supervise the particular program. These legislative and administrative factors do not always present clearly defined alternatives and in some situations overlaps may lessen the importance of the decision. Thus, legislative jurisdiction may be shared by several committees. Or the Internal Revenue Service may be mandated to require a certification of qualification for the tax expenditure from the government department normally responsible for the activity involved.¹⁷¹ But very often, the choice presented by the legislative and administrative factors will be a clear one along the lines first indicated.

As to political and psychological factors, for many people the use of the tax expenditure route effectively hides the fact that government funds are involved and gives the appearance that only private funds are being utilized. Perhaps those who so view the situation do not understand the tax expenditure concept or, perhaps, do not want to understand the concept given the results of tax expenditure analysis. The focus on private funds quickly leads to the belief that private decision making is involved. For some, this private decision making is a laudable goal. The next step along this line of thought is

¹⁷⁰ For an enumeration of the Senate committees that would have jurisdiction over the types of direct programs that could be substituted for the tax expenditures in the tax expenditure budget, thereby shifting the present jurisdiction over the programs and the funds involved from the Senate Finance Committee to those other committees, see 1978 CBO TAX EXPENDITURE TABULATION, *supra* note 12, at Tables 1 and 2. See also 124 CONG. REC. S5703 (daily ed. Apr. 17, 1978) (statement of Sen. Kennedy). For example, legislative jurisdiction over 33 programs and \$48 billion would shift to the Senate Human Resources Committee; 14 programs and \$42 billion would shift to the Senate Commerce, Science, and Transportation Committee; and 14 programs and \$23 billion would shift to the Senate Banking, Housing, and Urban Affairs Committee.

In his statement Senator Kennedy said: "It is humanly impossible for the 18 members of the Finance Committee and the 37 members of the Ways and Means Committee to be Renaissance men and women in employment, commerce, energy, health, education, housing, banking, state and local finance, transportation, investment, the cities, shipping, agriculture, foreign trade, life insurance, the environment, military personnel, veterans, the elderly, the handicapped, and all the other areas in which tax spending programs are now being used and in which expertise in the areas is obviously required." *Id.* at S5704.

¹⁷¹ For example, see I.R.C. § 169, five-year amortization for a "certified pollution control facility" and I.R.C. § 191, five-year amortization for "any certified historic structure," each requiring certification by the appropriate federal regulatory agency.

that *only* through the tax expenditure approach can the goal of private decision making be achieved.¹⁷² What is not perceived is that the same private decision making can accompany a direct government grant.

¹⁷² See Havemann, *Tax Expenditures—Spending Money Without Expenditures*, 9 NAT'L J. 1908 (Dec. 10, 1977). The subtitle is "Republicans are latching onto tax expenditures as a way to spend federal money while preserving individual choice and minimizing bureaucratic red tape." Consider this excerpt from the article:

If Republicans appreciate the way tax expenditures don't show up on the spending side of the budget, they also have found many other advantages to the use of the tax code to provide federal benefits. Tax expenditures have proved consistent with the ideology of free enterprise and individual initiative.

Take, for example, Domenici's proposal to give a tax credit of \$75 to elderly and poor heads of households. The Senate voted by a split of 88-2 to attach the proposal to its energy tax bill (HR 5263).

Domenici explained in an interview that his proposal, unlike a federal grant program, would give the elderly the responsibility to take care of themselves. "My natural inclination," he said, "is to let people do the problem-solving rather than the government."

If the money to finance a program does not flow through Washington, Domenici said, the federal government does not have to spend a lot of money to administer it. Nor does it have an opportunity to smother the program in red tape, he added. The absence of red tape is one of the reasons why Sen. Bob Packwood, R-Ore., is one of the Finance Committee's leading advocates of tax expenditures.

"With any federal grant program," Packwood said in an interview, "there's a tendency for us in Washington to be convinced that we know best what the recipients should do with their money." Packwood said he is a firm believer in the opposite principle: that individuals know best what they need.

When the federal government assigns to itself the job of administering a program or writing the regulations that govern what recipients can do, Packwood said, almost invariably it makes a mess of things. "We can set goals pretty well," he said, "but we can't manage very well."

Packwood added a related point: that federal management or regulation often forces uniformity on the recipients of federal aid. If the federal government established a grant program for the families of college students, he said, it might load the program down with so many regulations that students attending only certain kinds of colleges would qualify. On the other hand, he said, a tax expenditure would promote a diverse system of higher education.

Tax expenditures also permit regional diversity, Packwood added. "What we need in New York City may not be what we need in Newport, Ore."

Rep. Barber B. Conable, Jr. of New York, the ranking Republican member of the Ways and Means Committee, said it was appropriate for Congress to tie fewer strings to money that it leaves in private hands through tax expenditures than to money that it collects in taxes and redistributes in spending programs. "And we Republicans tend to resist the devices for financing social purposes that carry with them tighter controls," Conable said in an interview.

Roth sounded a similar theme last May 12 [1977] when he testified to the House Budget Committee on tuition tax credits. "I believe there is something fundamentally wrong in the growing concept that working American taxpayers should come to Washington to apply for government

The tax expenditure approach involves private decision making by generally allowing a taxpayer to declare himself eligible for the "tax grant," that is, to determine, in the first instance, whether he is eligible for the exclusion or deduction that constitutes the tax expenditure. The Internal Revenue Service may later examine that conclusion if it audits the tax return. In contrast, under most direct spending programs, the person seeking the monetary benefit must first establish eligibility with the agency handling the program before a grant is received. But, this difference in mechanics is not an inherent or necessary attribute of either type of program. A particular tax expenditure program may require a certification from a government agency to enable the taxpayer to claim the benefit on the return,¹⁷³ and a direct spending program could be run on a payment first, audit later basis.¹⁷⁴

Additional interrelated psychological and political factors are present in the choice of routes. Thus, under the present budget system, both revenues and budget outlays are kept lower when tax expenditures are used instead of direct programs. Hence, legislators or Presidents desirous of not appearing to be "big spenders" can quite comfortably approve tax expenditures without hurting their image of fiscal conservatism.¹⁷⁵ Similarly, the focus on tax rules permits the debating points to shift away from the real issues. Thus, consider President Carter's 1978 proposals to reduce or eliminate certain "entertainment deductions" and the attacks made on the grounds that the President's proposals would curtail spending in luxury restaurants, thereby creating unemployment for the workers in those restaurants, and that the proposals would seriously affect the theatre, baseball, and other sports activities because of their dependence on "entertainment" ticket purchases.¹⁷⁶ Essentially, those voicing these attacks were not debating the merits of the proposals as

aid programs financed by their own taxes," Roth said. He urged that Congress enable "our working people to keep more of what they earn to pay their own bills and not the government's."

Id. at 1909.

The statements obviously exhibit only a surface description, and none of the Congressmen quoted bother to explain why, if they strongly desire simplicity and initial private decision, they do not so structure direct programs. To say, as Senator Packwood does, "that individuals know best what they need," is an absolute non sequitur as to why a tax program should be chosen. The real question is whether these Senators and Representatives are acting under an unexplored and honestly mistaken illusion or whether they are using the illusion to justify the enactment of a tax program where they would be politically unwilling affirmatively to vote for a direct spending program with the same objective, either with a lack of controls and hence similar to the tax route, or with some controls.

¹⁷³ See note 171 *supra*.

¹⁷⁴ The payment of Medicare and Social Security benefits have some elements of a payment first—audit later approach.

¹⁷⁵ See Havemann, *supra* note 172.

¹⁷⁶ See *The President's 1978 Tax Reduction and Reform Proposals, Hearings on the President's 1978 Tax Program Before the House Comm. on Ways and Means, 95th Cong., 2d Sess. 5377-417 (1978); 124 CONG. REC. S17564-69 (daily ed. Oct. 7, 1978) (Senate floor debate rejecting a proposal to disallow 50% of "business" meal deductions); 124 CONG. REC. S17967-69 (daily ed. Oct. 10, 1978) (Senate floor debate rejecting a proposal to reduce deductions for entertainment costs).*

aspects of a proper tax structure, but were instead seeking to maintain existing tax rules for their claimed incentive effect in enabling luxury restaurants, the theatre, and sports activities to survive.¹⁷⁷ But, it is unlikely that any of the legislators making these arguments would lend his name to a bill giving a direct government grant to a "luxury restaurant," with the grant increasing in proportion to the luxury of the restaurant, or to a bill giving a direct grant to high level advertising or other executives if they promise to continue to eat in luxury restaurants. The number of direct programs which a resourceful mind could produce to protect luxury restaurants is obviously large—and it is just as obvious that no legislator would choose to defend those programs. The very use of these arguments to attack a tax proposal illustrates how the political rules change when a tax program is the focal point of a debate. We lack a full analysis of the psychological and political factors that may be involved in the choice of routes. Presently, the effects of tax versus direct programs represent an area that the political scientists largely have left untouched.¹⁷⁸

Both a study of the criteria that should govern the choice between the tax expenditure route and the direct budgetary route, and an assessment of the various tax expenditures, existing and proposed, in the light of those criteria, clearly are necessary. While progress in accomplishing such studies has been slow in contrast to the need, the Congressional Budget Office has at least indicated that it fully understands this need, and has produced several such studies. One study involves the existing tax expenditures for low income housing.¹⁷⁹ Another concerns the proposed tax credit for higher education.¹⁸⁰ The CBO also has assisted the House Budget Committee Task Force on Tax Expenditures in holding hearings on certain new tax expenditures.¹⁸¹ The

¹⁷⁷ The present line dividing non-deductible "entertainment" expenses from deductible business expenses is not considered as a tax expenditure because it is assumed Congress has been making an effort properly to locate the line under appropriate normative tax structure criteria. But if the line is drawn on the basis of the subsidy arguments advanced to attack the proposals, then the result should be classified as a tax expenditure.

¹⁷⁸ See Good & Wildavsky, *A Tax By Any Other Name: The Donor Directed Automatic Percentage Contribution Bonus, A Budget Alternative for Financing Government Support of Charity*, 4 RESEARCH PAPERS SPONSORED BY THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS 2389 (U.S. Treas. Dept. 1977), for a discussion of some of the questions raised in the text in the context of the charitable contributions deduction.

¹⁷⁹ CBO HOUSING STUDY, *supra* note 77.

¹⁸⁰ CONGRESSIONAL BUDGET OFFICE, FEDERAL AID TO POST-SECONDARY STUDENTS: TAX ALLOWANCES AND ALTERNATIVE SUBSIDIES (Jan. 1978) [hereinafter cited as CBO EDUCATION STUDY]. The Administration recognized that to defeat the congressional impetus for a tax expenditure for college tuition (a tax credit) it was necessary to counter with a direct program and then explain the difference between the two. Also, the congressional committees charged with jurisdiction over expenditure programs for education have realized that one basic issue involved is whether those committees or the tax committees will control the formulation of federal aid to education. Ultimately, in 1978, Congress passed the Administration's direct program. The tuition tax credit proposed died in Conference because of the Senate refusal to accept the House provision extending the tax credit to elementary and secondary school costs, and also perhaps because of the promised Presidential veto of any tuition tax credit bill.

¹⁸¹ See, e.g., *Hearings on College Tuition Tax Credits Before the Task Force on Tax Expenditures, Government Organization and Regulation of the House Comm. on the Budget*,

substantive material produced and issues raised in these various activities underscore the need for a coordinated study of tax expenditures that, on the executive side, involves OMB, the Treasury, and those government agencies that would have control over a program if structured as a non-tax program.

Unfortunately, the executive branch has been slow to respond to these needs. In the Republican period, apparently little thought was given to the entire issue. Thus, a Department of Agriculture letter criticizing, from the standpoint of agricultural objectives, certain tax relief provisions of the Tax Reform Act of 1976 seems to have been buried in OMB.¹⁸² Even the present Democratic Administration sponsored insulation tax credits and other energy credits in its energy program without any real thought as to why the tax route should be chosen, how the credits would affect IRS administration, or how this choice of tax credits would weaken Presidential and Treasury opposition to the use of tax credits by others for *their* programs. The Treasury, in its intense preoccupation in 1977 and 1978 with devising and then defending a tax reform program, and with defending energy taxes and credits for which it had no institutional enthusiasm, has yet to plan an orderly study of tax expenditures.

In its efforts to pursue other budgetary goals, OMB likewise appears to have failed to plan studies. In addition, political goals pushed the Administration in the direction of tax credits in the 1978 urban program, again undercutting the Treasury Department's and the Internal Revenue Service's opposition to the use of tax credits. Moreover, the proposed urban tax credits were structured so that the IRS merely would be paying for items certified by other agencies. Except for the political view that the tax system must "contribute something" to the urban program, the payments just as readily could have been made by those other agencies.¹⁸³

95th Cong., 1st Sess. (1977) [hereinafter cited as *Task Force Hearings*], and the Report thereon (Comm. Print 1977).

¹⁸² See Surrey, *supra* note 3, at §22 n.34, 6 TAX NOTES No. 12 at 301 n.34.

¹⁸³ The proposed urban program would provide, on a two-year trial basis, an additional five points on the investment credit for equipment and industrial buildings in distressed areas and certified by the Economic Development Administration, up to a total amount of \$200 million each year. Obviously, this is a spending program and belongs entirely in the Economic Development Administration. The urban program also called for an employment credit, to replace the existing jobs credit, for employment of minority persons certified by the local agency administering the CETA programs. Here also that agency could fully handle the incentive payments.

The added investment credit for distressed areas under the urban program and the President's recommendation to limit "small issue" industrial development bonds to "economically distressed areas" have the clearly unfortunate aspect of introducing for the first time geographical limitations into the income tax. These limitations probably could survive attack under the "uniformity" clause of the Constitution, which has been construed to require only "geographical uniformity," since taxpayers wherever situated can obtain the tax benefits. Moreover, since a direct spending program so structured would be constitutional, why should a tax expenditure program have to be tested under the constitutional uniformity clause? It would seem difficult for the Supreme Court not to consider these urban program tax credits as spending programs when the executive branch and Congress, by including them as tax expenditures, thereby state they are spending programs.

While the executive branch has responded slowly, there are signs that the basic need for coordinated study in the tax expenditure field is recognized in the Treasury and OMB. The 1977 OMB-Treasury testimony on the proposed Sunset legislation¹⁸⁴ essentially stressed the desirability of coordinated review of tax expenditure and direct programs by the executive agencies involved. In particular, Treasury Secretary Blumenthal, in his testimony on the 1978 tax proposals, stated that

[T]he Administration intends to analyze tax and non-tax subsidies for housing. Our objective is to determine the need for subsidizing particular segments of the housing market and the most efficient means of providing needed subsidies.¹⁸⁵

Indeed, the HEW reaction to the tax credit for education in presenting an alternative direct program is an indication that the Administration recognized there are two levels to a tax expenditure debate: First, does Congress believe a serious government assistance goal is involved and, second, if so, how should the assistance be provided. Hence, if the Congress does desire to provide the assistance, merely deploring the use of the tax expenditure route will not be an effective political response. Instead, the response at least must involve an alternative direct method of providing the assistance. While the alternative may not win the battle, at least there is a chance that the issue will be fought out on more rational grounds.¹⁸⁶ As the experience in 1978 illustrates, when the tuition tax credit and increased direct educational assistance were competing approaches, the final choice of the direct assistance may be an indication that if the Department whose jurisdiction and expertise are involved—here HEW—strongly supports the direct approach and is backed by the President, the direct approach will be accepted.

Although these tax expenditures probably are constitutionally valid, the injection of these geographical limitations is deplorable. It could well set off a lengthening list of "geographical" tax expenditures. Since the Congress rarely approaches tax benefits with careful analysis, acceptance of geographical variations in these tax expenditure urban programs could lead to acceptance of geographical variations in cases where the result would be unconstitutional, *e.g.*, personal exemption levels that would vary geographically.

Indeed, the Revenue Act of 1978 included some elements of the President's proposed urban program, though with much less emphasis on economically distressed areas. Thus, I.R.C. §§ 48(a)(1)(E) and 48(g) were added to provide an investment credit for costs of rehabilitating buildings more than 20 years old that are used in the taxpayer's trade or business. The targeted jobs tax credit was substituted for the expiring new jobs tax credit, along the lines the President had recommended. The "small issue" exemption for industrial development bonds was increased generally, with a specific provision included for facilities constructed under a HUD urban development action grant. I.R.C. §§ 103(b)(6)(D), 103(c)(6)(I).

¹⁸⁴ See text at notes 310-28 *infra*.

¹⁸⁵ *The President's 1978 Tax Program, Prepared Statements of Administration Witnesses Before the House Comm. on Ways and Means*, 95th Cong., 2d Sess. 15 (1978) (statement of the Honorable W. Michael Blumenthal).

¹⁸⁶ The HEW approach in 1978, suggesting an alternative direct assistance route, contrasts with its approach in 1977 which was limited to attacking the tax expenditure program. Compare 124 CONG. REC. H2199 (daily ed. Mar. 20, 1978) with 123 CONG. REC. S5303 (daily ed. Mar. 31, 1977).

Finally, OMB apparently is beginning to take a stronger position on the need to analyze tax expenditures, and the Treasury is now willing to work with CBO and OMB on a program of studies. It should be noted, however, that in a coordinated study of tax expenditures, it is important that budget managers recognize that elimination of some tax expenditures may require direct programs which will necessitate an increase in the direct outlays of a particular agency. In other words, the revenue gained from closing down a tax expenditure may have to be added to the direct budget of the agency taking over the underlying program. If the government budget managers do not allow for this flexibility, the agencies involved will simply dig in and defend continuance of the tax expenditure, even where the tax expenditure program is inferior to a direct program.

The need for a coordinated approach is particularly evident in the exposure of most tax expenditures to "tax reform" efforts. The essence of tax expenditures is to provide governmental assistance through the income tax. This use of the tax system clearly runs counter to the concept of horizontal equity under that tax. This concept of horizontal equity holds that families with the same income should pay the same individual income tax, and, similarly, that corporations with the same profits should pay the same corporate tax. The concept is essentially a description of the "fairness" that the public perceives is the essence of the income tax, and the justification for its prominence in the federal fiscal system. Tax expenditures thus are perceived by many as "tax preferences" or as "tax loopholes." Hence, tax expenditures naturally become the focus of tax reform attention and attacks. As a result, tax expenditures will continue to create a tension that renders government assistance inherently unstable. *If* that assistance is an important national priority, it is therefore necessary to consider whether a direct program that would not involve such tax reform tension is a better way of providing the assistance. Thus, while in the eyes of some, political and psychological factors make the tax expenditure approach desirable, other political and psychological factors point in precisely the opposite direction.¹⁸⁷

¹⁸⁷ Chairman Long's testimony in the Sunset Hearings, *supra* note 13, touched on an aspect of this tension:

I want to talk about the issue of tax expenditures. Incidentally, this is one area where I think politicians may find it to their temporary advantage to deceive and mislead the public. They won't find it to their long-range advantage.

People find you out, gentlemen, for what you are, whether you like it or not. If you are doing business straightforward and honestly with them when they find you out, that is to your advantage; if you are doing business deceitfully when they find you out, you are going to get the worst of it.

There are a lot of people who like to use this phrase, "I voted to reduce tax expenditures" rather than saying, "I voted to raise your taxes." But let's look at what some of these "tax expenditures" are. They involve situations in which some persons are not taxed the same as others. For example, that involves veterans where we give them a tax advantage with regard to their veterans' benefits. That involves a credit for child care expenses or for the hiring of welfare recipients. "Tax expenditures" involve incentives for the working poor to take a job rather than remain on wel-

B. Some Possible Courses of Action

In comparing a direct approach and a tax approach, the essential questions are whether a particular government assistance program is an important priority and, if so, is a direct approach available and, if so, how do the two approaches compare. These questions clearly lend themselves to sensible, coordinated studies. The studies may be conducted within the executive branch or the legislative branch, or both. A preliminary step, that would advance such studies, would be a more detailed explanation, in the Budget, of the presence and effects of the related tax expenditures.

The Budget Special Analyses now describe in considerable detail the amounts, goals, and effects of the government's direct spending programs in the areas selected for the Analyses. While in recent years tax expenditure programs have begun to be mentioned, as yet there is neither the same detailed descriptive material nor any substantial analysis relating the tax expenditures to the direct programs or to the priorities in particular areas. These Special Analyses could provide such detail, and presumably would indicate several appropriate studies. For example, Part 5 of the Budget, "Meeting Federal Needs: The Federal Program By Function," provides descriptive material for the outlays under the budget classifications. Tax expenditures are

fare; they involve a credit for the purchase of a new house or the deduction on a home mortgage. All those matters are regarded as "tax expenditures," and a repeal of those provisions would involve a major tax increase on poor, disabled, aged. Anyone who wants to go out and tell those old people he voted for a reduction in "tax expenditures" hoping to lead them to think he either voted to reduce Government spending or to cut their taxes is deceiving them.

People find us out for doing that kind of thing. I would urge that we not try to mislead the people into thinking that, when we put more taxes on, we have cut their taxes or cut Government spending when we really did just the opposite.

How many people here want to go out and tell people, "I support the sunset bill. Let me tell you what that does to you, Grandma. That guarantees you an automatic tax increase. Let me tell you what it means, Mr. Homeowner. It guarantees you a tax increase on your home. I support the sunset bill. Let me tell you what that does to you, little widow woman. It means you are going to pay taxes on that social security check that you have been receiving since your husband died. I support the sunset bill. Let me explain what that means to you, Mr. Veteran. It means hereafter you will pay a tax on your veteran's disability pension check."

Hearings on the Sunset Act of 1977, supra note 13, at 465-66.

This testimony does underscore the assistance that lies behind tax expenditures and the political force of that assistance. What the testimony leaves out is that the assistance could be provided through direct programs and presumably should be provided if the issue cuts as deep as the testimony indicates. The testimony also indicates the political and informational barriers that can make it difficult to substitute direct programs for tax expenditure programs.

For comments by some Senators on the effects of using tax expenditures and the lack of coordination in decisions whether to use tax expenditures or direct programs, see *Can Congress Control the Power of the Purse? Hearings Before the Senate Comm. on the Budget, 95th Cong., 1st Sess. 24-25, 35-36, 44-46, 84-94 (1977)*. See also S. BUDGET COMM. COMPENDIUM, *supra* note 12.

mentioned in the introductory material, and particular tax expenditures are described in the material under some of the functional categories, such as Income Security. But, for most of the budget functional categories, the material covers only direct outlays. Even where tax expenditures are referred to, their amounts are not included in the outlay tables, so that a complete picture of amounts being spent is not presented. Thus, there remains considerably more opportunity in the budget documents to integrate the discussion of direct programs and tax expenditure programs.

There are certainly enough subjects for study, and sensible planning would produce a feasible schedule and allocation of tasks. For example, one set of studies is suggested by the failure of tax reform in certain areas, such as the tax expenditures for low income rental housing. Obviously, the continued exception of such housing from reform provisions restricting the real estate tax shelter is a clear indication that government assistance is thought to be necessary. A new program must be substituted for the tax shelter assistance before the latter assistance, inefficient and inequitable though it is, is disapproved by Congress. The CBO study in this area is a useful starting point for analysis.¹⁸⁸ Other tax shelters that prove resistant to reform also are candidates for study. Along the same line, the termination dates placed on various tax expenditure provisions—the five-year amortization provisions, such as for rehabilitated housing and historic buildings, the legal services provisions, or provisions such as the targeted jobs credit adopted in 1978 and set to end after 1981—are an open invitation for study. The need is underscored by the tendency often to extend the life of these provisions in the absence of adequate studies.¹⁸⁹

Tax expenditure provisions for which Congress requires a special Treasury report are a high priority for coordinated study. One example of these provisions is the assistance provided Puerto Rico through the tax expenditure tax credit—previously an exemption—for United States companies engaged in activities in Puerto Rico. Preliminary Treasury Department studies have indicated that in 1976 almost 80 percent of the \$533 million revenue cost of these provisions went not to Puerto Rico, but to large United States corporations, principally drug and electronic companies. Whether Puerto Rico itself receives a corresponding benefit is not yet clear, though it would appear that those companies provide few jobs as compared to the tax benefits they receive. Further, the 1976 change in the terms of the tax provisions has created a very serious instability in Puerto Rico's fiscal position, since the change leaves billions of dollars, presently located in Puerto Rican banks and other financial institutions, in a highly volatile state.¹⁹⁰

¹⁸⁸ CBO HOUSING STUDY, *supra* note 77.

¹⁸⁹ A recognition of the need for the studies is contained in section 554 of the Revenue Act of 1978, which requires a joint Treasury-Labor Department study on the targeted jobs tax credit to be submitted to Congress by June 30, 1981.

The congressional decision not to extend the one-year credit for the purchase of new homes was in large part the result of a HUD study that demonstrated the uselessness, and consequent wastage involved in the credit. Surrey & McDaniel, *supra* note 7, at 721.

¹⁹⁰ See U.S. TREAS. DEPT., THE OPERATION AND EFFECT OF THE POSSESSIONS CORPORATION SYSTEM OF TAXATION, FIRST ANNUAL REPORT (June 1978).

Presently, section 555 of the Revenue Act of 1978 requires the Treasury to submit a study of the 1978 changes in capital gains taxation to Congress by September 30, 1981. The study is to include an analysis of the effectiveness—or, we assume, the lack thereof—of the changes in “stimulating investment and increasing the rate of economic growth.” The study also is to explore the effects of the change in capital gains taxation on employment growth and the level of tax revenues. This study thus should provide an opportunity for the Treasury to examine in detail the merits of the rather extravagant claims made by the proponents of capital gains tax reductions in the 1978 legislative debates.

In addition, follow-up studies on the effectiveness of the energy tax credits produced by the 1978 legislation will be required to see if the credits are as promising and rational as their proponents ardently proclaim. Similarly, the pollution control tax expenditures require study to ascertain their effectiveness and to explain why government assistance for business in meeting pollution control requirements has taken the tax route and not the direct assistance route. Such a study also could extend to the use of regulatory taxes rather than, or along with, direct regulation in the environmental area and the energy area.

Tax expenditures in several other diverse areas indicate the need for coordinated study. In the medical-health area, tax expenditures merit study so as to provide information on their efficiency and equity, and thereby to make available material helpful in considering a national health program.¹⁹¹ The tax expenditures made available through the exemption for certain types of industrial development bonds, notably hospital bonds, residential housing bonds, pollution control bonds, and bonds issued under the “small issues” exemption, require study to determine their efficiency and role in meeting national needs in these areas. Coordinated study is also necessary for those tax expenditures that exist side-by-side with direct programs in the same field. The rental housing tax shelter expenditures mentioned above are one example. Homeownership tax expenditures and the child care tax expenditure are additional examples. Likewise, the tax expenditures in the estate and gift tax area are kept well hidden, and need the study they have never received. This study should cover the 1976 Act changes and also extend to non-tax expenditure structural defects in those taxes.¹⁹²

Finally, the developments in congressional consideration of welfare revision may provide additional topics for study. This revision raises questions as to the appropriateness of the present income tax exemptions for many trans-

¹⁹¹ For some earlier studies, see SETTING NATIONAL PRIORITIES: THE 1974 BUDGET 109-29 (Fried et al. eds. 1973); B. MITCHELL & J. VOGEL, HEALTH AND TAXES: AN ASSESSMENT OF THE MEDICAL DEDUCTION (Rand R-1222-OEO, 1973); K. DAVIS, NATIONAL HEALTH INSURANCE 14-17 (1975).

¹⁹² For a list of the tax expenditures, see Appendix C, *infra*; FEDERAL WEALTH TRANSFER TAXATION, *supra* note 67, at 884. For a description and criticism of the 1976 Act changes, see Surrey, *supra* note 3; McDaniel, *Foreward: The Interaction of Tax Planning and Tax Policy*, 19 B.C. L. REV. 387 (1978). For a description of structural defects, see Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161 (1977).

fer payments. If the proposed basic welfare payment is made taxable—an issue in itself—it is difficult to see why other transfer payments, such as unemployment insurance, social security, and so on, should remain untaxed.

These suggestions for study could, of course, be amplified. There are many tax expenditures, and most of them have never been carefully studied, either as tax items or in the coordinated approach here suggested. What is needed is not, therefore, a prolonged search for subjects of study or long debate on priorities and scheduling, but rather, a concerted effort by the necessary participants to begin the studies. The main responsibility for the executive branch falls on OMB, strongly backed by the Treasury, and responsibility for the legislative branch falls on CBO, strongly backed by the Budget Committees. If President Carter is ever to reach his goal of ending the “disgrace” he sees in the tax system, these studies are a necessary step in the process.

V. LEGISLATIVE PROCESS ISSUES

The processes by which Congress considers tax and budget policy legislation are continually evolving and continually subject to stress. Two distinct but related effects of the tax expenditure concept were brought into sharper focus by the legislative actions in the period between 1976 and 1978. The first concerned the impact of the Congressional Budget Act of 1974¹⁹³ on the procedures for dealing with tax legislation. The second concerned the question of committee jurisdiction over tax expenditures and procedures for considering areas where tax and direct measures overlap. This part explores both of these effects, particularly in light of the congressional budget process, and the authorization-appropriations process.¹⁹⁴

A. Tax Expenditures and the Budget Process

1. The Tax Reform Act of 1976

The Tax Reform Act of 1976 provided the occasion for the first major test of the efficacy of the procedures established by the 1974 Budget Act to subject tax expenditures to the new congressional budget process.¹⁹⁵ In the First Concurrent Budget Resolutions for Fiscal 1976, the House and Senate Budget Committees had attempted to exert some control over the level of tax expenditures by providing for a \$1 billion increase in revenues through “tax reform legislation.”¹⁹⁶ In early 1976, as the Budget Committees began consideration of the First Concurrent Resolution on the Budget for Fiscal Year

¹⁹³ Pub. L. No. 93-344, 88 Stat. 297 (1974).

¹⁹⁴ For our prior discussion of legislative process issues, see Surrey & McDaniel, *supra* note 7, at 709-20. For a discussion of recent developments in the tax legislative process, see Surrey, *The Federal Tax Legislative Process*, 31 RECORD ASSOC. OF BAR OF CITY OF NEW YORK 515 (1976); McDaniel, *supra* note 136.

¹⁹⁵ For an overview of the 1976 Act, see Surrey, *supra* note 3.

¹⁹⁶ See H. REP. NO. 698, 94th Cong., 1st Sess. (1975). The assumption was deleted from the binding Second Concurrent Resolution for Fiscal 1976 because there was no tax bill then pending which could have been enacted in time to generate \$1 billion in revenues in fiscal 1976.

1977, attention was shifted from "tax reform" and focused on the more precise term used in the Budget Act—"tax expenditures."¹⁹⁷ The difficult question presented for the Budget Committees at this juncture was how to effect a positive reduction in the level of tax expenditures.

One possible technique would simply have placed a limit on the total dollar amount of tax expenditures permissible for the following year. For example, if the tax expenditure list for fiscal year 1976 totaled \$102 billion, the Budget Resolution for Fiscal 1977 could have provided for a maximum \$100 billion in tax expenditures. There are a number of problems with such an approach, however, not the least of which is that a \$2 billion reduction in tax expenditures could be accomplished with no change in the tax expenditure provisions. This result could be achieved by a simple rate reduction or an increase in the standard deduction, which, in turn, would automatically reduce the dollar cost of many tax expenditures. Furthermore, it is possible that a Budget Resolution phrased in terms of a reduction of the aggregate revenues involved in tax expenditures would not achieve the objective sought in the Budget Resolution—review, evaluation, and, where appropriate, reduction or elimination of tax expenditures.

An obstacle in achieving the Budget Resolution objectives was the sensitivity of the Senate Finance Committee, and especially its Chairman Senator Long, to what they considered a potential intrusion on the Finance Committee's jurisdiction. Pursuant to section 301(c) of the Budget Act, the Finance Committee on March 15, 1976 submitted its views on the level of federal revenues for fiscal 1977 to the Senate Budget Committee. In its submission, the Finance Committee simply called for a net reduction in revenues for fiscal 1977 totaling \$19.6 billion.¹⁹⁸ The method of reaching that figure, whether through extension of the existing temporary tax cuts or by increasing tax expenditures, was not detailed, and the figure itself was to result from the Finance Committee deliberations on H.R. 10612, the House-passed Tax Reform Bill of 1975.

The Finance Committee commenced hearings on the Tax Reform Bill on March 17, 1976. Almost immediately, Senator Long began to state his displeasure with the interest in tax expenditures being evidenced by the Senate Budget Committee and the Congressional Budget Office.¹⁹⁹ On April 1, 1976, with the Resolution due to be reported out by the Committee by April 15, 1976, he appeared before the Budget Committee during its markup of the First Concurrent Budget Resolution for Fiscal 1977. Senator Long argued that it was unrealistic to anticipate any significant revenue gains from tax re-

¹⁹⁷ See S. REP. NO. 731, 94th Cong., 2d Sess. 8 (1976); Surrey & McDaniel, *supra* note 7, at 706-07 n.85.

¹⁹⁸ See *Fiscal Year 1977 Finance Committee Report Under the Congressional Budget Act*, 94th Cong., 2d Sess. (Mar. 4, 1976). For background material, see STAFF OF SENATE FINANCE COMM., 94th CONG., 2D SESS., DATA AND MATERIALS FOR THE FISCAL YEAR 1977, FINANCE COMMITTEE REPORT UNDER THE CONGRESSIONAL BUDGET ACT (Comm. Print 1976).

¹⁹⁹ SFC 1976 Hearings, *supra* note 77, at 406.

form in fiscal 1977. One basis for this conclusion was his assertion that revenue raising measures traditionally were prospective, while revenue losers were usually retroactive.²⁰⁰

It was thus obvious that, if the budget process was to exert any control over spending through the tax system in fiscal 1977, a specific reference to tax expenditures was required in connection with the First Concurrent Resolution for that year. The Senate Budget Committee Report on the First Concurrent Resolution therefore provided for a \$2 billion net revenue increase resulting from changes in existing tax expenditures.²⁰¹ The Budget Resolution itself, however, merely set a revenue target of \$362.5 billion, to be achieved by subtracting a total of \$15.3 billion in revenue reductions from an estimated \$377.8 billion in revenues, if the 1975 tax cuts were not extended.²⁰² The Budget Committee Report made clear that the \$15.3 billion figure was to be reached by netting the \$17.3 billion revenue loss resulting from extension of the temporary tax cuts for a full year and the \$2 billion revenue gain to be realized by cutting back on existing tax expenditures.²⁰³

The Senate approved the Budget Resolution on April 8, 1977. Prior to this approval, however, members of the Finance Committee exerted considerable effort in floor debate to establish the Committee's freedom to reach the \$15.3 billion in the Budget Resolution by any combination of tax cuts, tax increases, and changes in tax expenditures that the Committee might decide upon.²⁰⁴ The Conference Committee then met on the Budget Resolution. The House Budget Committee, in its Report, had likewise assumed a \$2 billion revenue gain from modification of existing tax expenditures.²⁰⁵ The Conference Committee Report stated that the Budget Resolution was based on an assumed \$2 billion revenue gain from "tax reform."²⁰⁶ The First Concurrent Resolution was adopted by the House and the Senate on May 12 and 13, 1976, respectively.

In the meantime, as the Senate Finance Committee concluded its hearings on the tax reform bill and commenced its markup sessions, the pressure created by the Budget Resolution became apparent. For example, Senator Long discouraged some who sought new or expanded tax expenditures on the ground that the Committee had to raise the revenue to meet the budget target. In addition, however, his remarks indicated that he recognized the possibility of satisfying the Budget Resolution by manipulating effective dates

²⁰⁰ 4 TAX NOTES No. 15 at 5-10 (Apr. 12, 1976). Senator Kennedy pointed out prior legislative examples that conflicted with Senator Long's position. 122 CONG. REC. S4711 (daily ed. Mar. 31, 1976). See also *SFC 1976 Hearings*, *supra* note 77, at 1699-705.

²⁰¹ S. REP. NO. 731, *supra* note 197, at 6, 8.

²⁰² S. CON. RES. 109, 94th Cong., 2d Sess. (1976). The "temporary" tax cuts had originally been implemented in the Tax Reduction Act of 1975.

²⁰³ S. REP. NO. 731, *supra* note 197, at 6.

²⁰⁴ See, e.g., 122 CONG. REC. S5295, 5326 (daily eds. Apr. 8 and 9, 1976).

²⁰⁵ H. REP. NO. 1030, 94th Cong., 2d Sess. 23-24 (1976).

²⁰⁶ H. REP. NO. 1008, 94th Cong., 2d Sess. (1976). The use of the term "tax reform" rather than "tax expenditures" was not intended, and was never treated, as a change in meaning. The \$2 billion figure was selected because it represented approximately a 2% reduction in tax expenditures, which corresponded to the 2% reduction in direct programs being recommended.

to shift the revenue effects of the tax expenditures into fiscal years after 1977.²⁰⁷ Thus, H.R. 10612, as reported to the Senate floor in June, 1976, reflected the influence exerted on the Finance Committee by the overall revenue target set by the Budget Resolution. Nevertheless, the bill did not comply with the Budget Committee method of reaching the target and, in the Budget Committee's view, the objective of the budget process was evaded despite the Finance Committee's technical compliance with the Budget Act.

The Finance Committee bill technically came close to the overall target figures for fiscal 1977 established in the First Concurrent Budget Resolution. The Finance Committee bill produced "reductions" of nearly \$15 billion for fiscal 1977, as compared to the \$15.3 billion targeted by the Resolution. The \$15 billion figure was reached, however, by obtaining only \$980 million in revenue from "tax reforms" and by then cutting off the tax cut extensions as of June 30, 1977, rather than extending them throughout fiscal 1977 as contemplated by the Budget Resolution. The latter action "saved" \$1.8 billion. Hence, the budget target of \$15.3 billion in net tax reduction was met by a \$15.5 billion tax cut extension and a \$980 million increase from tax reforms.²⁰⁸

Thus, the Finance Committee bill rejected the premises on which the Budget Resolution target figures were based. It provided neither a \$17.3 billion tax cut nor a \$2 billion reduction in tax expenditures. Indeed, even the \$980 million figure for reductions in tax expenditures in 1977 reached by the Committee was suspect. This figure was reached only by reversing the process that Senator Long previously had described to the Budget Committee as "normal."²⁰⁹ Contrary to Senator Long's earlier assumption, the Finance Committee made the revenue gainers in the bill retroactive and deferred the effective dates of the prospective revenue losers, in some instances skipping fiscal 1977 completely. As a result, revenue gains were artificially bunched in fiscal 1977 and net losses in fact resulted from the Finance Committee actions on tax expenditures for all fiscal years after 1977.²¹⁰

In its treatment of effective dates, of course, the Finance Committee was manipulating its bill to effect technical compliance with the Budget Act. But it was also undermining a rational budget process of bringing tax expenditures under effective control of Congress. There is little point in a budget process that produces technical compliance in one year but allows the approval of expenditures which prove uncontrollable in subsequent years. Thus, while on balance the Finance Committee in 1976 obviously felt pressured to comply with the Budget Resolution, it demonstrated a remarkable ability to avoid and actually subvert the goals which the Resolution sought to achieve.

Recognizing these circumstances, the Budget Committee determined at the outset of the Senate floor consideration of H.R. 10612 to challenge the

²⁰⁷ See, e.g., *SFC 1976 Hearings*, *supra* note 77, at 2059.

²⁰⁸ 122 CONG. REC. S9571 (daily ed. June 16, 1976) (statement of Sen. Long). It was widely assumed that the Senate Finance Committee left itself a margin of some \$800 million to "play with" on the Senate floor, *i.e.*, further tax reducing amendments would be accepted to increase the \$14.5 billion net revenue reduction in the bill to the targeted \$15.3 billion.

²⁰⁹ See text and note at 200 *supra*.

²¹⁰ S. REP. NO. 938, 94th Cong., 2d Sess. 34 (1976).

Finance Committee bill as violating the First Concurrent Budget Resolution. Senator Muskie, Chairman of the Budget Committee, and Senator Bellmon, the ranking Republican member of the Committee, argued that in adopting the First Concurrent Resolution, Congress had also adopted the method to be employed in reaching the target figures. That method, as reflected in the Budget Committee Report, was designed to produce specified economic results—a certain form of fiscal stimulus through a full year extension of the tax cuts and a degree of fiscal restraint from cuts in government direct and tax expenditures. By changing the mix of tax cuts and tax increases, the Senate Finance Committee's bill would produce different economic results from those approved by Congress.²¹¹ In opposition, Senator Long, along with members of the Finance Committee, argued that passage of the First Concurrent Resolution required only that the Budget Resolution figures be met. The \$2 billion figure for tax expenditures appeared only in the Budget Committee Report, not in the Resolution itself. According to the Finance Committee, the Report simply expressed the Budget Committee's views of the most desirable way to achieve the \$15.3 billion figure. As such, the Finance Committee was free to disagree, and the full Senate could then work its will. Under this view, the Finance Committee bill was not subject to a point of order on the ground that it was in violation of the Budget Resolution. In the debate, Senator Long also invoked fears of a Budget Committee invasion of the jurisdiction of other committee chairmen if the Muskie-Bellmon views were upheld.²¹²

The debate on whether the Finance Committee bill as reported was or was not in compliance with the Budget Resolution ended inconclusively. To force the issue, Senator Muskie offered an amendment to extend the temporary cuts for all of fiscal 1977. This amendment would bring the tax reduction figure up to the \$17.3 billion figure posited by the Budget Committee. If the Muskie amendment passed, then it was hoped that the tax reform amendments offered by a coalition of fifteen Senators would bring the tax expenditure reduction figure up to the targeted \$2 billion. Since preliminary votes indicated that the Muskie amendment would be defeated, he withdrew it.²¹³ Predictably, the Senate then proceeded to reject virtually all the tax reform amendments to the bill and added a host of new tax expenditures. When H.R. 10612 left the Senate floor, instead of a \$2 billion reduction in tax expenditures for fiscal 1977, tax expenditures were increased by \$260 million, a figure that quickly accelerated to almost \$850 million by fiscal 1981.²¹⁴

²¹¹ 122 CONG. REC. S9568-84, 9711-26 (daily eds. June 16 and 17, 1976).

²¹² *Id.*

²¹³ The debate on the Muskie amendment appears at 122 CONG. REC. S9737-46, 9827-55, 9880-84, 9988-10010 (daily eds. June 17, 18 and 21, 1976). The proposals of the tax reform coalition appear at 122 CONG. REC. S9583-89 (daily ed. June 16, 1976) (statement of Sen. Kennedy). At the conclusion of Senate floor consideration of H.R. 10612, Senator Muskie moved to recommit the bill to the Finance Committee with instructions to report out a bill containing only the tax cut extensions. The motion was tabled. 122 CONG. REC. S13582-88 (daily ed. Aug. 5, 1976).

²¹⁴ See generally 122 CONG. REC. S14383 (daily ed. Aug. 24, 1976) (statement of Sen. Kennedy).

While no clear cut votes had been taken, it was obvious that the budget process had failed to constitute a significant force in achieving *particular* tax reforms on the Senate floor. A number of factors may have accounted for this failure. While some Senators opposed the necessary revenue raising reforms on the merits, others may have feared a "power grab" by the Budget Committee. Still others, as the defeats for tax reform and the victories for new tax preferences mounted, simply concluded that the bill would be cleaned up in Conference. Others still apparently had not grasped that preferential tax provisions constitute federal spending and had difficulty seeing how the policies of the Budget Act really applied to tax provisions. Whatever the reasons, the 1976 experience demonstrated that the Budget Act had little impact on Senate floor votes on particular issues. Yet, at the conclusion of the Senate floor debate, Senator Long himself added an amendment that it was the sense of the Senate that the Senate Members of the Conference Committee seek to reduce the net revenue reductions in the bill to the \$15.3 billion figure targeted in the Budget Resolution.²¹⁵

Obviously, a formidable task faced the Conference Committee on the Tax Reform Act of 1976. In contrast to the Senate bill, the House version of H.R. 10612 provided a \$1.7 billion revenue gain from cuts in tax expenditures for fiscal 1977, with revenue gains for each year thereafter up to a projected \$2.5 billion in fiscal 1981.²¹⁶ In the Conference Committee, the discipline sought to be achieved by the budget process reasserted itself. Although the individual provisions of the Conference bill in some respects differed sharply from the House bill, the revenue gain from tax reform was almost \$1.6 billion for fiscal 1977, with the revenue gains increased to \$2.47 billion by fiscal 1981.²¹⁷ A number of factors combined to produce this result. Conferees were quite sensitive to revenue and budget considerations, detailed revenue estimates were made available by the staffs for each issue under consideration, and the Conference Committee sessions for the first time on a major tax bill were open to the public and the press.

In the meantime, work on the Second Concurrent Resolution on the Budget for Fiscal 1977 had begun. The Senate version assumed a fiscal 1977 revenue gain of \$1.1 billion from tax reform; the House version assumed a \$1.6 billion gain.²¹⁸ The Conference Committee report assumed a \$1.6 billion gain, the same as provided in the Conference Committee version of the Tax Reform Act of 1976.²¹⁹ On September 16, 1976, Congress adopted the Second Concurrent Budget Resolution for Fiscal 1977 as recommended by

²¹⁵ 122 CONG. REC. S13784 (daily ed. Aug. 6, 1976) (statement of Sen. Long).

²¹⁶ See HOUSE COMM. ON WAYS AND MEANS, TAX REFORM ACT OF 1975, H.R. REP. NO. 658, 94th Cong., 1st Sess. 19 (1975). The figures in the text vary somewhat from those shown in the Committee Report, reflecting subsequent revisions in the revenue estimates by the Staff of the Joint Committee on Taxation.

²¹⁷ STAFF OF JOINT COMM. ON TAXATION, SUMMARY OF THE TAX REFORM ACT OF 1976, at 108 (Oct. 4, 1976).

²¹⁸ S. REP. NO. 1204, 94th Cong., 2d Sess. 7 (1976); H.R. REP. NO. 1457, 94th Cong., 2d Sess. (1976).

²¹⁹ H.R. REP. NO. 1502, 94th Cong., 2d Sess. 5 (1976).

the Conference Committee. The same day both the House and the Senate approved the Conference Report on H.R. 10612, the Tax Reform Act of 1976.

Evaluation of the adequacy of the budget process to control tax expenditures—on the basis of the 1976 experience—must be a mixed one. On the one hand, the \$2 billion target figure appears to have exerted a significant influence on the deliberations of the tax writing Committees and on the Conference Committee.²²⁰ Even so, the approaches of the Senate Finance Committee and the House Ways and Means Committee, as well as the experience on the floor of each house, were quite different. In part, this difference may be accounted for by the fact that Representative Ullman, Chairman of the House Ways and Means Committee, was instrumental in securing enactment of the 1974 Budget Act and, indeed, served for a time as Chairman of the House Budget Committee. Thus, cooperation rather than confrontation marked the relationship between the House Budget Committee and the Ways and Means Committee. The Senate Finance Committee, in contrast, adopted quite a different tactic. While it felt constrained by the Budget Resolution, much of its effort was devoted to circumventing it. This approach undoubtedly reflected the philosophical and personal differences between Senator Muskie and Senator Long. In any event, the result in the Senate was confrontation rather than cooperation between the two committees. In addition, once the bill reached the Senate floor, the discipline envisioned by the budget process could not restrain the erratic treatment of the tax system that traditionally results from the Senate floor open rule.

Recognizing these problems, however, the budget process did produce two important results on the Senate floor. First, the budget process apparently motivated the Long amendment, noted above, that committed the Senate conferees to try to report a bill that complied with the Budget Resolution. Second, the budget process provided Senator Muskie a vehicle with which to emphasize, for the Congress and the press, that the absence of significant reform was directly contrary to assumptions underlying the Budget Resolution and significantly undercut a rational budget process.

²²⁰ Another effect of the budget process was realized subsequently. The Senate version of H.R. 10612 contained a number of tax expenditures for energy conservation and production. The Conferees agreed to drop all these provisions from the bill, with the understanding that the Finance Committee would add them to H.R. 6860, 94th Cong., 1st Sess. (1975), the Energy Tax Bill enacted by the House in 1975, and then still pending before the Finance Committee. The Finance Committee took this action, but added to H.R. 6860 a one-half cent per gallon increase in the federal gasoline tax. The tax increase was necessary because H.R. 6860 was scheduled for floor action after passage of the Second Concurrent Resolution on the Budget. If only the tax expenditures had been included in H.R. 6860, the bill would have been subject to a point of order under section 311 of the Budget Act since it would have reduced revenue levels below the mandatory figure established by the Budget Resolution. Since they had to be financed by higher taxes, the Senate then lost its enthusiasm for energy-related tax expenditures, and H.R. 6860 was allowed to die.

2. The 1977-1978 Experience

The passage of the Tax Reduction and Simplification Act of 1977, the Energy Tax Act of 1978, and the Revenue Act of 1978 continued the interaction between the budget process and the tax legislative process that had been experienced in 1976.

a. Budget Resolutions and the Tax Credit for Higher Education Costs

The revised budgetary and tax proposals, submitted by President Carter in January of 1977, necessitated a Third Concurrent Resolution on the Budget for Fiscal 1977. Like the First Concurrent Resolution for Fiscal 1978, adopted in May, 1977,²²¹ the Third Resolution did not seek to impose any limitations on tax expenditures.²²² In the Second Concurrent Resolution for Fiscal 1978, however, proponents of tax expenditures, drawing on the experience of earlier efforts of tax reformers to employ the budget process in the cause of tax reform, succeeded in adding the revenue necessary to fund a proposed tax credit for the costs of higher education to the Resolution. During the House floor consideration of the Budget Resolution, Congressman Giaimo, Chairman of the House Budget Committee, opposed the amendment to the Budget Resolution to decrease federal revenues (and increase the deficit) by the estimated \$175 million cost of a tax credit for higher education. Congressman Giaimo's primary objection was procedural. He maintained that "[the college tuition tax credit] should be taken to the proper legislating committees of the Congress. If it passed there, then it can be included in the budget. But we should not start in the reverse manner of getting it passed through the budget with the hope that putting it in this budget will act as some sort of priority incentive toward getting those committees to act on it." Despite this argument, the House adopted the amendment.²²³

In the Senate, a similar amendment was offered by Senator Roth, a Republican member of the Senate Finance Committee. It was opposed by the Budget Committee. In particular, Senator Muskie stated that the Budget Resolution procedure was not the appropriate vehicle for approving individual tax provisions. Senator Long announced that he would vote for the Roth amendment. A majority of the Finance Committee followed Senator Long's lead.²²⁴ By adopting the Roth amendment to the Budget Resolution in Sep-

²²¹ See S. REP. NO. 134, 95th Cong., 1st Sess. (1977).

²²² See S. REP. NO. 9, 95th Cong., 1st Sess. 13 (1977). The Resolution did provide for postponement of the effective date for the changes in the sick pay exclusion made in the Tax Reform Act of 1976. In addition, the proper treatment of the refundable portion of the earned income credit was considered, as discussed in text at Part V.B.1 *infra*.

²²³ See 123 CONG. REC. H9028-31 (daily ed. Sept. 8, 1977).

²²⁴ See 123 CONG. REC. S14515-16 (daily ed. Sept. 9, 1977). The position taken by Senator Long and the Finance Committee on the tuition tax credit may seem inconsistent with their prior position opposing the specific tax assumptions built into the Budget Committee Report. However, the distinction is that a floor vote on a particular item expresses the will of the Senate; the Senate never votes on a Budget Committee Report as such.

tember, 1977, Congress ensured that the college tuition tax credit proposal could be added to subsequent revenue legislation by creating more "room" in the budget for revenue reducing measures. Subsequently, Senator Roth succeeded in having the credit appended to the Social Security bill passed by the Senate in November.²²⁵ Acceptance by Senator Long and the Finance Committee of the Roth amendment to the fiscal 1978 Budget Resolution can hardly be taken as general acquiescence in such a procedure. One could expect substantial opposition from the Finance Committee to an amendment to a Budget Resolution that proposed, for example, an increase in revenues to make room in the budget for an effort to repeal a tax expenditure such as the deduction for intangible drilling and development costs.

The tuition tax credit proposal represented only half of the 1978 debate over how to provide assistance for higher education costs. An alternative proposal was to provide direct financial assistance for higher education costs incurred by low- and middle-income families. This debate graphically illustrated the interchangeability of tax and direct expenditure programs. In an effort to divert the congressional drive for tuition tax credits that had gained momentum in 1977, the President, in early 1978, proposed expansion of the programs that provide direct financial assistance to defray the educational costs of students from low- and middle-income families. The President's proposal was approved by the House Committee on Education and Labor in somewhat modified form in the Middle-Income Tuition Assistance Act. In its March 15, 1978 letter of recommendation to the House Budget Committee, the Ways and Means Committee neither recommended enactment of tuition tax credits nor did the Committee urge provision in the Budget Resolution for such tax credits. Subsequently, however, the House Ways and Means Committee reported out H.R. 10250, the Tuition Tax Credit Act of 1978, providing tuition tax credits not only for the costs of higher education, but also for the costs of elementary and secondary education.

The House Budget Committee's Report on the First Concurrent Budget Resolution for Fiscal 1979 provided \$1.4 billion to finance the proposed direct financial assistance program,²²⁶ but specifically recommended against enactment of tuition tax credits.²²⁷ The Budget Committee preferred the direct financial assistance approach because, unlike the tax credits, financial assistance was not provided to high income families and the direct program was less expensive than the tuition tax credit approach in the long run.²²⁸ Recognizing the political force behind the tax credit approach, however, the Report stated: "In line with the views expressed by the Appropriations Committee, the committee recommends that if Congress agrees to a revenue reduc-

²²⁵ The debate on the Roth amendment to the Social Security bill can be found at 123 CONG. REC. S18792-803 (daily ed. Nov. 4, 1977). The Conference Committee deleted the Senate-passed college tuition tax credit from the final version of The Social Security Financing Amendments of 1977, H.R. 9346, 95th Cong., 1st Sess. (1977). See H.R. REP. NO. 837, 95th Cong., 1st Sess. 79 (1977).

²²⁶ H.R. REP. NO. 1055, 95th Cong., 2d Sess. 7 (1978).

²²⁷ *Id.* at 13.

²²⁸ *Id.* at 18.

tion to accommodate tuition tax credits, then the additional budget authority and outlays provided in this function [education] for the proposed Middle-Income Student Assistance Act should be eliminated."²²⁹

During the House floor consideration of the First Concurrent Budget Resolution for Fiscal 1979, an amendment was offered to provide \$635 million additional revenue reduction to accommodate the tuition tax credits. House Budget Committee Chairman Giaimo argued unsuccessfully that there was sufficient room in the revenue reductions provided in the Budget Resolution to provide for the tuition tax credits if adopted. (Presumably, however, the requisite "room" could have been provided only by reducing general tax cuts or by revenues resulting from tax reforms adopted by the Ways and Means Committee.) Accordingly, in Giaimo's view, it was unnecessary to adopt the further revenue reduction proposed by the floor amendment. Moreover, the effect of adopting the floor amendment, which dealt only with revenue reductions, would leave in the Budget Resolution both the \$1.4 billion in direct outlays recommended by the Budget Committee and the \$635 million in revenue reductions for the tax credits proposed by the floor amendment. Even so, the House adopted the floor amendment.²³⁰ In the Senate, the Senate Budget Committee Report on the First Concurrent Resolution for Fiscal 1979 neither recommended nor opposed adoption of tuition tax credits. Instead, the Senate Report recommended a revenue floor which "would allow for a number of legislative proposals including a college tuition tax credit" ²³¹

The Conference Committee Report on the First Concurrent Budget Resolution for Fiscal 1979 adopted a middle ground by providing a revenue floor that would accommodate a tuition tax credit. In addition, the Resolution also

²²⁹ *Id.* at 73-74. As to other tax expenditure matters, the House Budget Committee Report stated: "The Committee strongly supports tax reform to reduce unnecessary tax expenditures. It assumes that any reduction in individual or corporate taxes beyond the level recommended by the committee will be offset, dollar for dollar, by revenue gains achieved through tax reform." *Id.* at 13. The Report also showed the aggregate revenues in tax expenditures associated with each budget function. *Id.* at 5.

²³⁰ 124 CONG. REC. H3595-607 (daily ed. May 4, 1978).

²³¹ S. REP. NO. 739, 95th Cong., 2d Sess. 33 (1978). The Senate adopted the First Concurrent Budget Resolution without discussion of the tuition tax credit issue. 124 CONG. REC. S7446-58 (daily ed. May 15, 1978). At the time of the floor consideration of the Budget Resolution, the Senate Finance Committee had approved a tuition tax credit approach and the Senate Education Committee had approved a direct assistance approach.

As to other tax expenditure matters, the Senate Budget Committee Report made no assumptions with regard to elimination or reduction of existing tax expenditures, reiterating, however, the Committee's view that "it is as important to control the growth of tax expenditures as it is to control the growth of direct spending programs." S. REP. NO. 739, 95th Cong., 2d Sess. 36 (1978). In addition, the Senate Budget Committee for the first time set forth in its Report the tax expenditures related to each budget function. Indeed, the tax expenditure data provided by the Senate Budget Committee was more detailed than that in the corresponding House Budget Committee Report, note 226 *supra*.

provided funds for a direct student assistance program, although not in amounts as great as originally provided in the House Budget Committee Report:

The conference substitute includes \$0.3 billion in revenue reductions and \$0.7 billion in budget authority for additional middle income student tuition assistance. This represents a 50 percent reduction in total resources included in the House resolution for both the tax expenditure and grant proposal forms of this assistance, since it is not expected that both proposals will be implemented as introduced.²³²

Subsequently, the House of Representatives adopted the Tuition Tax Credit Act of 1978.²³³ The House floor debates revealed that both proponents and opponents of the tax credits clearly understood that the proposed tax expenditure was to be considered and evaluated as an alternative to direct assistance under the President's proposal. Direct spending criteria, such as distribution of benefits by income classes, costs as compared to benefits, constitutionality (under the House bill tax credits would benefit religious elementary and secondary schools), ease of administration, and the like, were by and large applied to the tax credit proposal.²³⁴

The Senate likewise passed its version of the tuition tax credit measure. The major difference from the House bill was that the Senate bill covered only the costs of higher education, whereas the House-passed measure covered elementary and secondary education costs in addition to higher education costs.²³⁵ Having acted favorably on the tuition tax credit, the Senate then proceeded to approve the College Opportunity Act of 1978, providing direct financial aid for education costs along the lines recommended by the President.²³⁶

The inability of the conferees to resolve the differences between the two tuition tax credit bills, the Senate Conferees' involvement in considering the Revenue Act of 1978, and the threat of a Presidential veto meant that the binding Second Concurrent Resolution on the Budget had to be adopted before either the tax or the direct approach to providing financial support for education costs could be passed. Accordingly, the Conference Report stated: "The conferees believe enactment of both a tuition tax credit and a college tuition assistance spending program would be inefficient and duplicative. The Congress should choose between these two proposals."²³⁷ Ultimately, the tu-

²³² 124 CONG. REC. H3943 (daily ed. May 15, 1978).

²³³ H.R. 12050, 95th Cong., 2d Sess. (1978).

²³⁴ 124 CONG. REC. H4727-99 (daily ed. June 1, 1978).

²³⁵ As in the House floor debate, Senators discussed the bill in spending terms although some sought to establish that the tax credits involved only a "tax cut," not a government spending program. For the Senate floor debate, see 124 CONG. REC. S13070-72, 13106-36, 13146-58, 13191-256, 13310-87 (daily eds. Aug. 10, 11, 14 and 15, 1978).

²³⁶ 124 CONG. REC. S13464 (daily ed. Aug. 16, 1978).

²³⁷ H.R. REP. NO. 1594, 95th Cong., 2d Sess. (1978).

tion tax credit bill died in the Ninety-Fifth Congress because of the refusal of the Senate to accept tuition tax credits for elementary and secondary education costs.²³⁸ The direct spending program was enacted.

The tuition tax credit-direct spending alternative presented Congress, and especially the Budget Committees, with unique opportunities to formulate criteria for choosing between tax and direct spending approaches to a given problem and to coordinate proposed tax expenditures with overall national policies in a particular area. Both opportunities were missed. Congress, rather than affirmatively choosing between the two approaches, attempted to approve both, even though the educational policies, benefits distribution, and administration of the two programs differed widely and were even contradictory in some respects.²³⁹ Nor did the Budget Committees seize their opportunity to analyze and compare the programs, either with each other or with existing education policies, and to present the results to their respective houses with a positive recommendation as to which was preferable. The failure of the Committees to make an affirmative recommendation may be explained by the caution with which they have approached taking substantive positions on particular budget items. Less understandable was the Committees' failure to conduct the necessary comparative studies to articulate the criteria for Congress to employ in choosing between the tax and direct spending approaches, and the failure to exercise responsibility to ensure that a tax spending program, if adopted, was properly structured and coordinated with direct spending programs in the area.

b. Budget Resolutions and the Energy Tax Bill

The effect of the budget process on the effective dates of tax expenditures was illustrated during Senate consideration of the Energy Tax Bill in late 1977.²⁴⁰ The energy tax legislation was reported to the Senate floor after adoption of the Second Concurrent Resolution for Fiscal 1978, which established binding figures for that year.²⁴¹ At the outset of the Senate floor consideration of the Energy Tax Bill, the Budget Committee asserted that the Finance Committee bill provided \$800 million more in tax reductions, via new and expanded tax expenditures, than permitted by the Budget Resolution. Senator Long argued that the bill was not subject to a point of order because section 1056 of the Finance Committee bill empowered the Secretary of the Treasury to defer until October 1, 1978 the effective dates of the various tax expenditure provisions if necessary to ensure compliance with the Resolution.

²³⁸ 124 CONG. REC. S19141-44 (daily ed. Oct. 14, 1978).

²³⁹ The effort to approve both approaches—the tuition credit approach being sidetracked on the last day—was in part a response to the Presidential threat of a veto of any tuition credit. The Congress did want to adopt increased educational assistance. Its clinging to both approaches would assure that end result. Also, the efforts to pass the tuition credit were in large part a reflection of the desire of many in Congress to give assistance at the elementary and secondary school level, and the tuition credit was viewed as the only possible constitutional route to that end (though others saw that approach as grasping at constitutional straws that were not realistic).

²⁴⁰ Energy Tax Act, H.R. 5263, 95th Cong., 1st Sess. (1977).

²⁴¹ H.R. REP. NO. 582, 95th Cong., 1st Sess. (1977).

Moreover, Senator Long offered his assurances that, whatever the results of the legislation passed by the Senate, he would not return with a bill from conference that was in violation of the Budget Resolution.²⁴²

Senator Abourezk raised a point of order contending that the Finance Committee bill was in violation of section 303 of the Budget Act because it exceeded the budget authority for fiscal 1978. The Chair ruled that a point of order did not lie on that ground, presumably because of the authority granted to the Secretary of the Treasury to defer the revenue losses until fiscal 1979.²⁴³ Senator Abourezk then refined his point of order, asserting that the bill was in violation of section 303(a)(2) of the Budget Act, which provides that it is out of order to consider a measure providing an increase or decrease in revenues to become effective in a fiscal year until the First Concurrent Resolution for that year has been adopted. Section 1056 of the Finance Committee bill allowed the Secretary of the Treasury to defer the effective dates of the tax expenditures to a date not later than October 1, 1978, in other words, until fiscal 1979. Hence, the Senator maintained that the bill was in violation of the Budget Act since the First Concurrent Resolution for Fiscal 1979 would not be adopted until about May 15, 1978. Senator Long then moved to change the date to which the Secretary could defer the tax expenditure effective date to September 30, 1978. As so amended, the bill was not subject to the point of order since the provisions would all have to become effective in fiscal 1978, a year for which the First Concurrent Resolution had already been adopted.²⁴⁴

The Budget Committee did not press its original point concerning the extent to which the Finance Committee bill exceeded the revenue losses allowed by the binding Second Budget Resolution for Fiscal 1978. Rather, the Committee stated that it would wait to assess the impact of Senate floor amendments. As amended by Senator Long, however, the bill seemed susceptible to a point of order under section 311(a) of the Budget Act. Section 311(a) provides that after Congress has completed action on the Second Concurrent Budget Resolution, it is out of order to "consider" any bill reducing revenues for the fiscal year covered by the Resolution if "enactment of such bill . . . as reported"²⁴⁵ would cause revenues to be less than specified in the Resolution. Yet, section 1057 of the Finance Committee bill did provide that it was the sense of the Senate that the Senate conferees should bring back a bill from the Conference Committee within the budget limits. As in 1976, the Senate Finance Committee was attempting to provide itself with maximum

²⁴² 123 CONG. REC. S17681 (daily ed. Oct. 25, 1977) (statement of Sen. Long). Section 1057 of H.R. 5263, The Energy Production and Conservation Tax Incentive Act, as reported by the Finance Committee, provided that it was the sense of the Senate that the Senate Conferees "to the extent practicable" reduce the revenue loss from the bill to that provided in the Budget Resolution.

²⁴³ 123 CONG. REC. S17683 (daily ed. Oct. 25, 1977). In addition, technically it would appear that the point of order should have been raised under section 311 of the Budget Act. See text at note 244 *infra*.

²⁴⁴ 123 CONG. REC. S17683 (daily ed. Oct. 25, 1977).

²⁴⁵ Budget Act, *supra* note 10, § 311(a) (emphasis added).

flexibility by technical compliance with the letter of the Budget Act. The Budget Committee did not subsequently raise a point of order under section 311(a).

c. Budget Resolutions and the Revenue Act of 1978

The budget process played a major role in the Senate floor debate on the Revenue Act of 1978, materially influencing both the procedures by which the bill was considered and the substantive provisions that emerged, or failed to emerge, in the Senate-passed measure.

(i) *The Budget Situation.* By the time the Senate Finance Committee reported the 1978 Revenue Act on October 1, 1978, the binding Second Concurrent Resolution on the Budget for Fiscal 1979—October 1, 1978 to September 30, 1979—had been adopted. That Budget Resolution provided for \$21.9 billion in tax reductions for fiscal 1979.²⁴⁶ The Finance Committee bill produced net tax reductions of \$20.5 billion.²⁴⁷ Accordingly, the fiscal 1979 Budget had room for additional tax reductions of \$1.4 billion in that year. The tuition tax credit bill and the energy tax legislation were still pending in conference committee; it was assumed that the tax reductions in those measures would absorb the remaining \$1.4 billion in the Budget. Technically, however, since neither bill had been reported out of conference and approved by both Houses at the time the Senate began consideration of the Revenue Act of 1978, the full \$1.4 billion was still available to be absorbed by Senate floor amendments to the 1978 Revenue Act. Accordingly, no amendment was subject to a point of order on the ground that it exceeded the Budget Resolution until amendments providing \$1.4 billion in tax reductions for fiscal 1979 had been approved by the Senate.

(ii) *The Issue of Out-Year Budget Effects.* The first point of interaction between the budget and tax legislative processes in the Senate debate on the 1978 tax bill arose in connection with the impact of Budget Act requirements on years beyond the fiscal year for which a Budget Resolution has been adopted. As discussed above, section 303(a) of the Budget Act provides that it is out of order to consider any measure providing an increase or decrease in revenues which is to become effective in a fiscal year for which the First Concurrent Resolution has not yet been adopted. An exception to this rule is provided in section 303(b), however, permitting such measures to be considered if they become effective in the second succeeding fiscal year—the so-called “leapfrog” provision. Thus, as the Senate began consideration of the 1978 Act, amendments providing revenue reductions for fiscal 1979 within the \$1.4 billion remaining under the budget limit, or for fiscal years 1981 and thereafter, were not subject to a point of order under section 303(a). In contrast, amendments providing for revenue reductions commencing in fiscal 1980 were subject to a point of order.

²⁴⁶ H.R. CON. RES. 683, 95th Cong., 2d Sess. (1978); H.R. REP. NO. 1594, 95th Cong., 2d Sess. (1978).

²⁴⁷ S. REP. NO. 1263, 95th Cong., 2d Sess. 16 (1978).

The unsatisfactory situation produced by the section 303 Budget Act rules was made clear by an amendment offered by Senator Roth to reduce federal income taxes by one-third over a three-year period. This amendment represented the highly publicized "Kemp-Roth" Republican tax cut plan.²⁴⁸ To comply with the fiscal 1979 Budget Resolution, only a 7 percent tax cut was provided for 1979, with larger cuts then scheduled for 1980 and 1981.²⁴⁹ Senator Muskie, Chairman of the Senate Budget Committee, raised a point of order under section 303(a) of the Budget Act on the ground that the Roth amendment provided a revenue reduction in fiscal 1980. Since the First Concurrent Resolution for Fiscal 1980 had not been adopted, the "leap-frog" exception in section 303(b) did not apply to protect the Roth amendment. The Chair sustained the point of order. Senator Long appealed the ruling of the Chair.²⁵⁰

In terms of the technical interpretive question presented by Senator Muskie's point of order, the Budget Act language is less than completely clear. Furthermore, the issue in the Senate debate was not decided on a precise legal interpretation of the statutory language. Senator Muskie's basic argument was that the budget process would provide no restraint on out-year spending if section 303(a) were not applied as he asserted it should be. Accordingly, Congress could avoid the discipline of the budget process by scheduling tax cuts into future years and thereby make the setting of budget targets in those years a largely preordained formalism. Moreover, Senator Muskie pointed out that the Budget Act does contain a mechanism to accommodate particular amendments that reduce revenues in the succeeding fiscal year, since a Budget Act waiver can be obtained upon a passage of a resolution approved by the Budget Committee and adopted by the Senate. Senator Roth had obtained no such waiver.²⁵¹ Senators Long and Roth, on the other hand, argued that Senator Muskie's interpretation of the Budget Act was contrary to common sense. The Senators maintained that interpreting the Act to permit an amendment reducing revenues in fiscal 1979, 1981, and 1982, but subjecting an amendment that included revenue reductions in fiscal 1980 to a point of order, was absurd.

By a vote of 48-38, the Senate overruled the decision of the Chair sustaining Senator Muskie's point of order. The Roth amendment was then voted down on its merits. Whether the budget vote represents a permanent repudiation of Senator Muskie's interpretation of the Budget Act is not yet clear. A number of Senators appear to have voted to overrule the ruling of the Chair because they wanted an opportunity to vote up or down on the highly publicized Roth amendment itself without being precluded from doing so by a

²⁴⁸ For the floor debates on the Roth amendment, see 124 CONG. REC. S17200-09, 17216-37, 17245-50, and 17319-25 (daily eds. Oct. 5 and 6, 1978).

²⁴⁹ *Id.* at S17206.

²⁵⁰ *Id.* at S17238-45.

²⁵¹ Interestingly, Senator Bellmon, ranking Republican on the Senate Budget Committee, had filed a budget waiver resolution for the Roth amendment but the Budget Committee had not acted on it at the time Senator Roth called up his amendment. *Id.* at S17241.

point of order based on the Budget Act. The episode clearly points up a weakness in the budget process. From one viewpoint, a budget process does seem absurd that permits unlimited out-year tax reductions, for example, for fiscal 1981 and following, but bars reductions for fiscal 1980. More persuasively, however, the leapfrog exception itself is the aberration in a rational budget process. What is wrong in the present Budget Act is not the bar to revenue reductions in the first succeeding fiscal year, but the failure similarly to bar tax reductions that go into effect in succeeding fiscal years. Thus, the response to the "absurdity" argument is that the failure of the Act to control the Budget in the second fiscal out-year is no reason for failure to control the Budget in the first out-year.

While the Roth amendment did not itself involve tax expenditures, the Senate action taken on that amendment applied equally to amendments providing for tax expenditures beginning in fiscal 1979 but scheduling increases in revenue reductions in later years. Under the present interpretation of section 303(a), the nonrefundable portion of a tax expenditure is treated as a reduction in revenues. Accordingly, following the Senate vote on the Roth amendment, Senator Muskie felt he was barred from raising a point of order as to amendments that scheduled increases in tax expenditures in fiscal 1980.²⁵²

The out-year effect of scheduled tax reductions, or increases in tax expenditures, represents a serious problem for the budget process. It seems clear that if the United States is to continue a single year budgeting process, the exception in section 303(b) should be repealed. Failure to do so, especially if the precedent set by the vote on the Roth amendment is followed, forebodes potentially disastrous results for a disciplined congressional budget procedure. Partly in recognition of this fact, Senator Long himself offered a sense of the Senate amendment to the 1978 Revenue Act stating that the Senate Conferees on the bill should limit the revenue loss for fiscal years after 1979 "to an extent that is practicable and feasible."²⁵³ To a substantial extent, the Conference agreement achieved this objective. Nonetheless, the larger problem of the proper functioning of the budget process remains. It is not satisfactory to continue to resolve that problem on an ad hoc basis in the context of a particular item of proposed tax legislation. Inevitably, as in the case of the Roth amendment, other issues and concerns will be involved that will prevent undivided attention to the budget issue itself.

A step short of outright repeal of section 303(b) of the Budget Act would treat nonrefundable tax expenditures as "spending authority" for purposes of section 303. The leapfrog exception in section 303(b) applies *only* to revenue reductions. Consequently, a measure that provides new "spending authority" in a succeeding fiscal year is subject to a point of order under section 303(a)

²⁵² See, e.g., the tuition tax credit amendment offered by Senator Packwood and adopted by the Senate which scheduled increases in the allowable credit in 1979 and 1980, *id.* at S17193-200; the special carryback provision for net operating losses attributable to product liability losses that was made effective commencing in fiscal 1980, *id.* at S17771-72 (daily ed. Oct. 9, 1978).

²⁵³ *Id.* at S17766, 18037.

even if it leapfrogs the immediately succeeding fiscal year. Under the suggested approach, revenue reductions not involving tax expenditures, such as rate reductions, changes in brackets, personal exemptions, or zero bracket amounts, would be eligible for the leapfrog exception, while scheduled increases in tax expenditures would not. To date, however, the nonrefundable portion of tax expenditures is treated as a revenue reduction for Budget Act purposes. Only the refundable portion of tax expenditures is treated as "spending authority."²⁵⁴

(iii) *The Impact of the 1979 Budget Limits.* The limits of the fiscal 1979 Budget had a marked impact on the provisions that were included in the Senate-passed version of the Revenue Act of 1978. The effects were in part foreseen and in part accidental. As the Revenue Act came to the Senate floor, some \$1.4 billion in unused revenue reductions were available under the pending Budget Resolution for Fiscal 1979. The first amendment adopted by the Senate—Senator Haskell's amendment providing an extension of the general jobs tax credit and a deferral of the corporate rate cuts—actually reduced the revenue loss in the Finance Committee bill by \$203 million, thus placing amendments in order that produced revenue losses of over \$1.5 billion for fiscal 1979. However, Senator Packwood, fearing a veto of a separate tuition tax credit bill, offered the tax credit proposal as an amendment to the Revenue Act. The Senate passed this amendment, thereby absorbing \$334 billion of the remaining budgeted tax reductions. An amendment offered by Senators Bumpers and Kennedy to provide \$537 million in further tax reductions for middle-income individuals was also adopted.²⁵⁵ Senators Packwood and Kennedy then offered an amendment to repeal DISC and to use the revenues from that repeal to reduce the top corporate tax rate to 45 percent as opposed to the 46 percent rate provided in the Finance Committee bill. The Senate rejected the portion of the amendment repealing DISC, but adopted the corporate rate reduction.²⁵⁶ This action produced an additional \$563 million revenue reduction in fiscal 1979. Obviously this result was totally unanticipated by the amendment sponsors.

As a result of the foregoing actions in the Senate, however, only \$135 million in fiscal 1979 tax reductions remained available under the Budget Resolution. A series of amendments, some with effective dates carefully tai-

²⁵⁴ See text at notes 278-79 *infra*.

²⁵⁵ 124 CONG. REC. S17209-16 (jobs credit), S17332-34 (tuition tax credit), S17325-32 (rate reductions) (daily eds. Oct. 5 and 6, 1978). Procedurally, the Packwood tuition tax credit was initially offered as an amendment to the House bill rather than the Senate Finance Committee amendment to the House bill. The Bumpers-Kennedy proposal was an amendment to the Packwood amendment. The usual procedure in Senate floor consideration of a tax bill is, at the conclusion of floor debate, to strike the House bill and substitute the Finance Committee amendment (as amended on the floor) in lieu thereof. To prevent their measure from being lost in that process, Senators Packwood and Kennedy subsequently moved to have their amendments considered as amendments to the Committee bill rather than the House bill. Once this action was taken, the fiscal 1979 revenue reduction involved absorbed part of the available \$1.4 billion as described in the text. See 124 CONG. REC. S17550-51, 17670-71 (daily ed. Oct. 7, 1978).

²⁵⁶ 124 CONG. REC. S17374-84 (daily ed. Oct. 6, 1978).

lored to produce a minimal fiscal 1979 effect, soon absorbed this amount.²⁵⁷ Thus, after three days consideration of the bill, and with a large number of amendments still remaining to be offered, any amendment producing a fiscal 1979 revenue loss was subject to a point of order and could not be considered by the Senate.²⁵⁸ Only by deferring the effective date into out-years could further revenue reducing measures be considered. Such amendments could have been in order because of the Senate interpretation of the Budget Act discussed above.²⁵⁹ At this juncture, however, another procedural bar was raised.

(iv) *The Impact of Cloture.* The Revenue Act of 1978 came to the Senate floor only two weeks before the scheduled termination date of the Ninety-Fifth Congress. Accordingly, considerable pressure was exerted for quick action on the bill. Nonetheless, a number of Senators were prepared to offer major non-tax legislation which, for a variety of reasons, had not been previously scheduled for Senate floor consideration as amendments to the tax bill. These amendments included, for example, the Humphrey-Hawkins full

²⁵⁷ On October 9, 1978, Senator Muskie circulated the following "scorecard" to demonstrate how the budget resolution figure of \$21.9 billion in tax reductions had been reached:

	Budget Effect of H.R. 13511 as amended by Senate (\$ millions)	Remainder Under Budget Ceiling (\$ millions)
Finance Committee Report	-20,534	1,366
Haskell Jobs Credit and Corporate Rate Change	+203	1,569
Bumpers Individual Rate Reduction	-537	1,032
Packwood Tuition Credit	-334	698
Packwood Corporate Rate Change	-563	135
Bumpers Charitable Lead Trusts	-15	120
Percy Railroad Rolling Stock (Sec. 861)	*	120
Javits National Research Services Awards	-52	68
Danforth Taxable Bond Option	*	68
Hathaway Technical Corrections Act Excluding Carryover Basis	-8	60
Metzenbaum Rehabilitation Credit	-9	51
Morgan S&L's	-5	46
McGovern Trucks	-12	34
Wallop Capital Gains	+2	36
Dole Child Care Credit	-5	31
Miscellaneous Bills	-31	0
	<u>-21,900</u>	

* Less than \$1 million.

²⁵⁸ Senator Long stated he would support Senator Muskie if he raised a point of order regarding the fiscal 1979 limit, 124 CONG. REC. S17551-52 (daily ed. Oct. 7, 1978). Later, when a point of order was raised by Senator Muskie, to an amendment that would not be within the limit, the Senate sustained the point of order, 124 CONG. REC. S17813 (daily ed. Oct. 9, 1978).

²⁵⁹ See text at notes 246-54 *supra*.

employment bill, hospital cost containment legislation, and the sunset measure. Proponents of these bills saw the tax bill as the last opportunity to obtain a Senate vote on their particular legislation in 1978. Opponents, of course, wanted to debate each proposal at length in an effort to defeat it.

The Senate normally imposes no limits on the number of amendments that may be offered to a tax bill, nor does it impose any significant germaneness requirement. Accordingly, facing the prospect that the tax bill might fail to pass the Senate before the scheduled adjournment date, Majority Leader Byrd filed a cloture motion with respect to the tax bill.²⁶⁰ The motion was passed and cloture was invoked,²⁶¹ with the following impacts on the tax bill under the rules accompanying cloture.

First, only amendments filed prior to the cloture vote could be considered after cloture was invoked. Moreover, once cloture was invoked, a filed amendment could not be revised or amended by its sponsor. As a result, after the cloture vote, any amendment reducing revenues in fiscal 1979 was subject to a point of order under the Budget Act, at least in the absence of other amendments being adopted that increased fiscal 1979 revenues. The sponsor of the amendment could not avoid the point of order by revising the effective date since such an action would have constituted a prohibited revision of the amendment. The combination of cloture and the budget process therefore protected the few tax reforms included in the Finance Committee bill and prevented the addition of the large number of floor-approved tax expenditures that usually accompany a tax bill leaving the Senate floor. A primary example of the first category was the inability of Senators Helms and Reigel to secure a vote on their amendment to delete the Finance Committee provision repealing the state and local gasoline tax deduction.²⁶² In the second category, for example, an amendment proposing an energy tax credit for the elderly was ruled out of order.²⁶³ It seems likely that, absent the combination of the cloture rules and the budget process, both amendments would have been adopted by the Senate.

Second, once cloture was invoked, a very strict germaneness rule became operative. Unless an amendment dealt quite specifically with a subject contained in the Finance Committee bill, the amendment was subject to a point of order. On this basis, for example, amendments were ruled out of order that would have prohibited the Internal Revenue Service from issuing fringe benefit regulations, that would have reversed an IRS ruling on investment annuities, and that would have sanctioned the award of attorney's fees to taxpayers in certain types of cases.²⁶⁴

Third, even if an amendment was submitted prior to cloture, did not reduce fiscal 1979 revenues, and was germane, it nonetheless was subject to a point of order if it amended the Finance Committee bill in more than one place. Again, this cloture rule is applied in the Senate with extreme technical-

²⁶⁰ 124 CONG. REC. S17357 (daily ed. Oct. 6, 1978).

²⁶¹ 124 CONG. REC. S17818 (daily ed. Oct. 9, 1978).

²⁶² 124 CONG. REC. S17826-32, 17989-93 (daily eds. Oct. 9 and 10, 1978).

²⁶³ 124 CONG. REC. S17813 (daily ed. Oct. 9, 1978).

²⁶⁴ *Id.* at S17822, 17832.

ity. For example, an amendment by Senator Nelson to modify the Finance Committee capital gains provision by reducing the exclusion factor from 70 percent to 60 percent was out of order because it changed 70 percent to 60 percent in two different lines of the Committee bill without incorporating the unchanged intervening language into the amendment so as to satisfy the one place rule.²⁶⁵ In addition, a number of amendments proposing new or expanded tax expenditures were not brought up because they violated this rule.

Finally, once cloture was invoked, each Senator was allowed only one hour of floor time. Thus, a Senator who used up his or her allotted hour could no longer offer amendments to the bill.

The interaction of cloture and the budget process produced a tax bill that left the Senate floor with far fewer "Christmas tree" amendments, usually in the form of tax expenditures, than any Senate-passed measure in recent years. The out-year revenue problems were substantially due to the number of amendments adopted prior to cloture that had small fiscal 1979 impacts, but were scheduled to lose larger amounts of revenues in subsequent fiscal years.²⁶⁶ The Senate conferees were armed with the sense of the Senate's resolution, however, and this resolution, coupled with Administration opposition to out-year revenue losses, helped produce a bill in the Conference Committee that kept such revenue losses within acceptable limits.²⁶⁷

Thus, the Senate floor action on the Revenue Act of 1978 again demonstrated that the budget process, standing alone, is not an adequate instrument to prevent the proliferation of floor amendments increasing tax expenditures. On the other hand, it is quite evident that the budget process can be effective when it is backstopped with strict germaneness and closed rule principles, as in the House floor action on tax bills. However, the cloture adopted for the 1978 Senate tax bill was highly unusual and is unlikely to be repeated, especially since more Senators now realize the effect of cloture on the amendment process.

3. Other Aspects of the Budget Process

The budget resolution process and floor actions to sustain that process were the most visible aspects of the interaction of tax expenditure and budget issues in the 1976-1978 legislative experience. But there are other means by which the Budget Act provisions are employed to subject tax expenditures to the scrutiny and control imposed on direct expenditure programs. For example, the House Budget Committee's Task Force on Tax Expenditures has held hearings on such proposed tax expenditures as the college tuition tax credit,²⁶⁸ although the Senate Budget Committee abandoned use of its tax

²⁶⁵ 124 CONG. REC. S17966 (daily ed. Oct. 10, 1978).

²⁶⁶ See, e.g., the amendment by Senator Metzenbaum to provide an investment credit for rehabilitation of certain buildings used in a trade or business which had an effective date of September 1, 1979, so that only one month's revenue loss would be reflected in fiscal 1979. 124 CONG. REC. S17552-58 (daily ed. Oct. 7, 1978).

²⁶⁷ See H. REP. NO. 1800, 95th Cong., 2d Sess. 310 (1978).

²⁶⁸ *Task Force Hearings*, *supra* note 181. See also the Tax Force hearings on the impact on cities of President Carter's proposed change in the investment tax credit (Feb. 15, 1978).

expenditure task force during 1976-1978. Additionally, the Congressional Budget Office has cautiously accelerated its activities with respect to tax expenditures. The Budget Act, sections 202(a) and (c), imposes the duty on CBO to provide information to the Budget Committees concerning tax expenditures. Such studies also are to be provided to any other committee upon request and "to the extent practicable."

The first comprehensive study produced by CBO under the foregoing authority was its background paper, "Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives" (May, 1977). The study was requested jointly by the Chairmen of the House Budget Committee and of the House and Senate committees with legislative jurisdiction over direct housing programs. In addition, CBO released a study in January, 1978, of the proposed college tuition tax credits analyzing the effects of various tax and non-tax programs to provide financial assistance to middle-income families incurring costs of higher education.²⁶⁹ A more limited report was prepared by CBO on the refundable tax credit for intercity bus companies contained in the energy tax bill in 1977.²⁷⁰

B. Tax Expenditures and the Authorization-Appropriations Process

The impact of the tax expenditure concept on issues of committee jurisdiction and the need to coordinate tax and direct programs were brought into clearer focus during the 1976-1978 legislative period.

I. Treatment of Refundable Tax Credits in the Budget Resolutions

The proper treatment of refundable tax credits must be resolved under the congressional budget process, just as it must be resolved under the Budget submitted by the President. Proper treatment is essential since characterizing the refundable portion of a tax credit either as an outlay or as a revenue reduction has a number of practical ramifications for the tax legislative process. These ramifications will be explored following a discussion of how the Budget Resolutions treated the earned income credit.

Prior to the Third Budget Resolution for Fiscal 1977, the House and Senate Budget Committees reached a series of temporary compromises on the proper treatment of the refundable portion of the earned income credit in the Budget Resolutions. The House Budget Committee had taken the position that the refundable portion of the credit was an outlay, thus corresponding to the OMB treatment in the President's Budget. The Senate Budget Committee, largely at the urging of Senator Long and the Finance Committee, had taken the position that the entire revenue associated with the credit should be shown as a reduction in revenues.

²⁶⁹ CBO EDUCATION STUDY, *supra* note 180.

²⁷⁰ 123 CONG. REC. S17826 (daily ed. Oct. 26, 1977) (statement of Sen. Heinz). See also CONGRESSIONAL BUDGET OFFICE, PRESIDENT CARTER'S ENERGY PROPOSALS: A PERSPECTIVE 81-99, 127-29 (June 1977), for a Staff Working Paper analysis of proposed energy tax credits.

No open confrontation on this issue emerged until the House Budget Committee Report on the Third Concurrent Budget Resolution for Fiscal 1977 specifically took the position that the refundable portion of the credit was an outlay.²⁷¹ In contrast, the Senate Budget Committee Report treated the entire credit as a tax reduction, an action strongly supported by Senator Long.²⁷² The Conference Report temporarily accepted the Senate position, stating that "the [Budget] Committees intend to reconsider this question *de novo* during consideration of the First Budget Resolution for FY 1978 with the intent of developing a common position at that time between the two Houses and the Administration."²⁷³ That intention was not realized, however. The Conference Committee Report on the First Concurrent Resolution for Fiscal 1978 merely repeated the quoted language, now looking toward a solution of the issue in the Second Budget Resolution.²⁷⁴ But in the Conference Report on the Second Budget Resolution for Fiscal 1978, the Senate position was adopted: "The conferees, however, agreed that this decision should not dictate future decisions on the treatment of payment in excess of tax liability. This decision by the conferees, therefore, does not create a precedent."²⁷⁵

In its Report on the First Concurrent Resolution for the Budget for Fiscal 1979, the Senate Budget Committee reversed its prior position and treated the refundable portions of the earned income credit and the proposed credit for education costs as outlays. The House Budget Committee, in line with the fiscal 1978 agreement, treated the entire earned income credit, including the refundable portion, as a reduction in revenues. The Conference Committee then adopted the Senate position, which had been the House position for the previous two years, and treated the refundable portions of the tax credits as outlays.²⁷⁶

The treatment of the refundable portion of tax credits under the Budget Resolution has some practical ramifications. Although the amount of the federal deficit or surplus remains the same regardless of the treatment, some differences are produced depending on the approach adopted. First, the "scorekeeping" function established by the Budget Act requires the Budget Committees to report on a recurring basis the effect on revenues and budget "outlays" of existing and proposed legislation.²⁷⁷ Treating the refundable portion of a tax credit as an "outlay" will make the item more visible in the

²⁷¹ H.R. REP. NO. 12, 95th Cong., 1st Sess. 6 (1977).

²⁷² 123 CONG. REC. S2907-08 (daily ed. Feb. 22, 1977).

²⁷³ H.R. REP. NO. 30, 95th Cong., 1st Sess. 5 (1977).

²⁷⁴ See H.R. REP. NO. 134, 95th Cong., 1st Sess. 5 (1977).

²⁷⁵ H.R. REP. NO. 601, 95th Cong., 1st Sess. 5 (1977). The Administration apparently supported the Senate position for purposes of the Budget Resolution, although it had not necessarily changed its views on the merits. The 1979 Special Analysis G reflected this changed position.

²⁷⁶ S. REP. NO. 739, 95th Cong., 2d Sess. 36 (1978); H.R. REP. NO. 1055, 95th Cong., 2d Sess. 150 (1978); H.R. REP. NO. 1173, 95th Cong., 2d Sess. (1978). Presumably future CBO and OMB Special Analysis G budgets will follow the congressional treatment.

²⁷⁷ 31 U.S.C. § 1322(d) (1976).

scorekeeping reports than if it simply is reflected in the overall revenue figures as a reduction in revenue.

Second, when the refundable portion of a tax credit is classified as an outlay, the "crosswalk" provisions of section 302 of the Budget Act become operative. Under section 302, "outlays" and "new budget authority" must be allocated in the Conference Report on a Concurrent Budget Resolution among each committee that "has jurisdiction over bills and resolutions providing such new budget authority." Accordingly, the Finance Committee, for example, is limited by the outlays allocated to it. If the Finance Committee reported out a bill with refundable credits in excess of such outlays, the bill would have to be referred to the Appropriations Committee under section 401 of the Budget Act.

Third, if a refundable credit is an "outlay," it would seem to follow that it also represents a "spending authority" under the Act.²⁷⁸ This characterization is important in part because section 303(a) of the Budget Act subjects to a point of order any legislation that provides new "spending authority" for a fiscal year before the First Concurrent Resolution on the Budget is adopted for that fiscal year. An exception to section 303(a) contained in section 303(b), however, allows prospective revenue reducing legislation to be considered without being subject to a point of order if it "leapfrogs" into the next fiscal year.²⁷⁹ This exception does not apply, however, if the proposed legislation constitutes "spending authority" under section 401. Thus, while a refundable tax credit, with an effective date in the subsequent second fiscal year, is not subject to a point of order under section 303(a) if it constitutes a "reduction in revenues," such a credit would be subject to a point of order if the credit constitutes "spending authority." As we have seen, the Senate Finance Committee has shown considerable adeptness in manipulating effective dates of tax expenditures to effect technical compliance with the applicable Budget Resolution. Treatment of the refundable portion of a tax credit as "spending authority" under section 401 would inhibit such actions. Furthermore, under section 402(f) of the Budget Act, the Appropriations Committees would obtain jurisdiction to study the refundable tax expenditure "spending authority" provisions and report from time to time their "recommendations for terminating or modifying such provisions."

Finally, treating refundable credits as revenue outlays would subject that portion of the resulting tax expenditure program to the overall spending ceilings established by the Budget Resolution. This in turn means that such tax expenditures would be required to compete with direct outlay programs for priority in the annual congressional appropriations process. Tax expenditures are now exempt from that priority selection process, since they receive an automatic first priority for federal funds. As a corollary, the flexibility of the

²⁷⁸ The term "outlays" is defined in 31 U.S.C. § 1302(a)(1) (1976); the term "spending authority" in 31 U.S.C. § 1351(c)(2) (1976).

²⁷⁹ For example, revenue legislation proposed in January, 1978 with a January 1, 1979 effective date is subject to a point of order under section 303(a). However, under the exception in section 303(b), the same legislation could be considered in January, 1978 if the effective date were changed to October 1, 1979.

Finance Committee in providing a given tax reduction by a mix of tax cuts and tax expenditures would be impaired if refundable credits were subjected to the priority selection process.

2. The 1977 Energy Tax Legislation

In the view of many observers, the Finance Committee's real concern with the treatment of refundable tax credits is the possibility that the exclusivity of its jurisdiction over tax expenditure aspects of tax legislation might be abrogated. The 1977 energy tax legislation provided a dramatic illustration of this issue. The stage for the jurisdictional problems in the Senate can be usefully set by considering the development of the 1977 energy legislation in the House. The procedure employed in the House for dealing with the energy legislation represented a significant advance toward implementing rational procedures for coordinating tax and direct programs in the same substantive area.

When the President submitted his National Energy Plan to the House,²⁸⁰ Speaker O'Neill established an Ad Hoc Committee on Energy to receive and to coordinate the reports of five standing committees, including Ways and Means, on H.R. 8444, The National Energy Act.²⁸¹ For the first time, a non-tax committee was empowered to coordinate tax expenditures and tax regulatory measures with proposals approved by other House committees. The Ad Hoc Committee had the power to choose direct instead of tax approaches to energy problems, even though Ways and Means might have favorably reported tax measures. In fact, a marked degree of cooperation existed among the various committee chairmen with responsibility for the energy legislation. The procedure followed was impressive. Over 113 separate legislative initiatives were considered by some 200 members of the House sitting in committees before arriving at the bill reported to the floor by the Ad Hoc Committee.²⁸²

As observed by Ways and Means Chairman Ullman, the procedure followed by the House on the energy legislation will have to be employed in the future as complex national issues are addressed.²⁸³ Indeed, the House action on the 1977 energy bill represents the most rational procedure yet adopted to evaluate and coordinate tax expenditure (or tax regulatory) proposals with direct spending (or direct regulatory) approaches to a given problem. The success of the technique, however, appeared to rest on two essential ingredients: strong leadership from the Speaker and a willingness by committee chairmen to work cooperatively. Neither of these factors was present as the Senate took up the energy tax legislation.

²⁸⁰ THE NATIONAL ENERGY PLAN, *supra* note 80.

²⁸¹ See H.R. Res. 508, 95th Cong., 1st Sess. (1977), and the House floor consideration thereof at 123 CONG. REC. H3349-55 (daily ed. Apr. 21, 1977).

²⁸² See REPORT OF THE HOUSE AD HOC COMMITTEE ON ENERGY, H.R. REP. NO. 543, 95th Cong., 1st Sess. (1977), and 123 CONG. REC. H8173 (daily ed. Aug. 1, 1977).

²⁸³ 123 CONG. REC. H8183 (daily ed. Aug. 1, 1977).

In the Senate, the unified approach of the House to the energy legislation was abandoned, with the tax portions of H.R. 8444 being referred to the Finance Committee and the non-tax portions to the Energy Committee. The Senate Finance Committee rejected completely the President's proposed reliance on excise taxes as regulatory measures to increase oil and gas conservation efforts.²⁸⁴ Instead, the Finance Committee recommended a set of new tax expenditures, totaling some \$40 billion by fiscal 1985, to encourage conservation. Included in the list were five refundable tax credits.²⁸⁵

When the energy tax bill reached the Senate floor, Senator Hollings, a member of the Appropriations Committee, moved to refer the bill to that Committee with instructions to report the bill back to the Senate with an amendment deleting the refundable portions of those tax credits not previously approved by a full Senate vote. The motion was based on section 401(b)(2) of the Budget Act, which provides that in certain circumstances a bill reported by a committee and containing new "spending authority" must be referred to the Appropriations Committee for up to fifteen days. The Appropriations Committee position was that the refundable portion of each of the credits constituted "spending authority" as defined in section 401(c)(2) of the Budget Act.²⁸⁶

Somewhat surprisingly, Senator Long was agreeable to the referral to the Appropriations Committee. He rejected, however, the view that such a referral was required by the Budget Act. He argued that "spending authority" as defined in section 401(c)(2) includes only payments "the budget authority for which is not provided for *in advance* by appropriations Acts."²⁸⁷ Refundability of the tax credit was achieved in the bill by treating creditable amounts in excess of tax liability as overpayments of tax, thus triggering a refund. Refunds of taxes are made pursuant to a permanent appropriation measure.²⁸⁸ Under the Long view, budget authority for refundable credits had been provided "in advance" and, accordingly, the refundable portions of the tax credits did not fall within the purview of section 401(c)(2) of the Budget Act.²⁸⁹

Upon Senator Hollings' agreement to delete the reference to section 401 from his motion to refer the energy bill to the Appropriations Committee,

²⁸⁴ The House bill did contain some new tax expenditures. For a critical analysis of those provisions, see 123 CONG. REC. S14272 (daily ed. Sept. 7, 1977) (statement of Sen. Kennedy).

²⁸⁵ See S. REP. NO. 529, 95th Cong., 1st Sess. 120-22 (1977). The refundable credits were those for (1) residential insulation costs, (2) residential solar, wind, and geothermal costs, (3) business investment in "alternative energy property," (4) business investment in "specially defined energy property," and (5) intercity bus transportation.

²⁸⁶ Section 401(b)(2) of the Budget Act, note 10 *supra*, additionally requires that the legislation, if enacted, not exceed the budget authority allocated to the Finance Committee under the crosswalk provisions of section 302(b) of the Budget Act, discussed in text at notes 277-78 *supra*. This provision was not violated by the Finance Committee bill if the refundable portions of the credits listed in note 57 *supra* constituted "spending authority." The floor debate on the Appropriations Committee motion appears at 123 CONG. REC. S18037-52 (daily ed. Oct. 28, 1977).

²⁸⁷ Budget Act, *supra* note 10, § 401(c)(2) (emphasis added).

²⁸⁸ 31 U.S.C. § 711(3) (1976).

²⁸⁹ *Id.* at S18039-40 (statement of Sen. Long).

Senator Long agreed to the motion.²⁹⁰ The bill was referred to the Committee, which immediately reported it back to the floor with an amendment deleting the refundable portions of the specified credits. On the merits, the Appropriations Committee amendment was defeated and the refundable credits remained in the bill.²⁹¹ Technically, of course, Senator Long can argue that the referral of the bill to the Appropriations Committee did not constitute a determination that the refundable portion of a tax credit constitutes "spending authority" under the Budget Act. Nevertheless, implicit acceptance of the principle that spending authority was involved is present, since otherwise there was no reason to refer the energy bill to the Appropriations Committee. Even accepting this view, however, a number of technical issues are yet to be resolved concerning the treatment of refundable credits.

In the first place, Senator Long's reliance on the legislation making permanent appropriations for tax refunds seems misplaced. That legislation applies only to refunds of "moneys erroneously received."²⁹² Refundable credits do not readily fit within this phrasing. Thus, the language in section 401(c)(2) of the Budget Act, requiring bills containing new spending authority to be referred to the Appropriations Committee, should not be read to exclude refundable credits from the definition of "spending authority." It should be noted, however, that section 401(c)(2) is of limited scope. The section applies only to bills reported out by a committee. Thus, if the Senate Finance Committee reported a nonrefundable credit, a floor amendment to make the credit refundable, even if offered by the Finance Committee, would not be referable to the Appropriations Committee under the Budget Act.²⁹³ Moreover, a refundable credit reported by the Finance Committee would not be subject to referral to the Appropriations Committee if the refundable amount did not exceed the Finance Committee's "crosswalk" outlay allocation under section 302 of the Budget Act. Thus, if the refundable portion is treated as "spending authority," the separate referral can be avoided if the Budget Resolution has provided for outlays sufficient to fund the refundable portions of the credits and if such outlays have been allocated to the Finance Committee under the crosswalk procedure.

The 1977 Senate floor experience on the refundable energy tax credits revealed the need for more carefully delineated procedures if the appropriations process is to be protected from circumvention by refundable tax expenditures. More broadly, of course, while the refundability feature of a tax credit makes the avoidance of the appropriations process more obvious,²⁹⁴ the same avoidance is presented by the nonrefundable portion of tax expenditures.

²⁹⁰ *Id.* at S18043.

²⁹¹ *Id.* at S18044-52.

²⁹² 31 U.S.C. § 711(3) (1976).

²⁹³ For example, in the Senate consideration of the Social Security Financing Amendments of 1977, a floor amendment to make the college tuition tax credit refundable was therefore not subject to a point of order. 123 CONG. REC. S18802-03 (daily ed. Nov. 4, 1977).

²⁹⁴ Senator Chiles apparently realized for the first time that the Finance Committee could assume jurisdiction over the entire Federal Budget by means of tax expenditures during the debate over the Energy Tax Act of 1977:

Recognition of this fact led Senator Kennedy to introduce Senate Resolution 326 requiring that whenever the Finance Committee reports a bill containing or extending a tax expenditure, or whenever a tax expenditure floor amendment is offered by, on behalf of, or with the approval of the Finance

... I think you could kind of use the device in a lot of ways.

I just started looking at a few appropriations bills. I find school assistance in the federally impacted areas, and it would seem to me if you wanted to you could say that we are going to give a refundable tax credit to those areas that have an Army base there.

After all, that is something that is important in the fact that they do not pay any taxes, so we will give them a refundable tax credit. Therefore, regardless of whether the Appropriations Committee decided to cut the impacted funds, if we decided to just give them a refundable tax credit we could do so.

I look at another appropriation bill, and I see security supporting assistance. Under that appropriation act Israel is down from \$750 million, Egypt for \$93 million, Jordan for \$9 million. Let us give Israel a refundable tax credit. They do not pay any taxes to the Federal Government now, but we can give them a refundable tax credit. If we can do it for the bus companies, why can we not do it for Israel. So we give them a refundable tax credit, and we do it that way.

I look at another one, and I see the Panama Canal Zone, which is a subject of great interest now. For the Panama Canal Commission we are putting up some funds. Well, they do not pay any taxes now, but there is no reason why you cannot give them a refundable tax credit. It is said the Nation needs this device. It is something we need, so if we decide to, or the Committee on Finance decides to, we just make a refundable tax credit.

You would take every item, I think, that is in any of the appropriations bills or any other item we want to think about and call it a refundable tax credit, and I think that is the concern that the Appropriations Committee has after that comes out and after that is in that bill.

.....
The whole reason for the Budget Act was because we felt we had to have some control over spending. We were having all kinds of good items coming out, and I have never voted for a bad appropriation since I have been in government. They are all good, and they all benefit someone. But no one was tending the store and saying we have only got so many dollars to spend, and so we have got to set priorities.

So we said in the Budget Act we are going to try to set some priorities, and we are going to say that is the Budget Committee's prerogative to try to set those. But that comes up for debate, and everybody on this floor has an opportunity to put his 2 cents worth in to determine what those priorities should be. But within those broad priority numbers we allow the authorizing committee and the appropriating committee to say where the money should be spent, for what kind of items it should be spent and, at the same time, in that act we try to cut out the backdoor spending, the trust fund device that had been used, and all of the other kinds of backdoor devices.

Now, I can tell you if we can have this kind of device as a refundable tax credit it would be the biggest backdoor spending of any that there is. There would just be no way of controlling that because nothing would go through. It would not go through the Budget Committee, it would not go through the Appropriations Committee, and it would not go through the authorizing committees.

Committee,²⁹⁵ the measure must be referred both to the Appropriations Committee and to each other committee having legislative jurisdiction over the subject matter encompassed by the tax expenditure provision. Each committee to which a referral is made would have 14 days in which to consider the tax expenditure and to report its recommendations to the Senate. The Kennedy resolution would apply whether the tax expenditure provision were refundable or not.

3. The Tuition Tax Credit Legislation

The House-passed version of the 1978 tuition tax credit bill provided a nonrefundable tax credit for tuition costs. In the Senate Finance Committee, however, the tuition tax credit was made refundable.²⁹⁶ This action brought into play two provisions of the Budget Act. First, the refundable feature was scheduled to become effective for a fiscal year (1980) for which the First Concurrent Budget Resolution had not been adopted. This action violated section 303(a) of the Budget Act. Accordingly, the Finance Committee also reported out a resolution to waive section 303(a). This resolution was referred to the Budget Committee for action. Second, the jurisdiction of the Appropriations Committee was invoked under section 401 of the Budget Act, since new spending authority had been approved by the Finance Committee in excess of the outlay authority allocated to the Committee under the First Concurrent Resolution.²⁹⁷

Both the Budget Committee²⁹⁸ and the Appropriations Committee²⁹⁹ issued reports adverse to the Finance Committee Bill. Rather than face a direct vote on the committees' actions, the Finance Committee reported out its tuition tax credit bill without the refundable feature.³⁰⁰ On the Senate floor, however, Senator Long offered an amendment to make the credit refundable. To test the Budget Act application, he raised a point of order against his own amendment under sections 303 and 401 of the Budget Act. The point of order was sustained by the Chair and appealed by Senator Long. The full Senate, however, sustained the Chair's ruling. Senator Long then submitted a revised refundability amendment, and moved formally to waive section 303(a)

²⁹⁵ It is unclear why S. Res. 326 would not apply to tax expenditure amendments offered on the Senate floor by Senators "independent" of the Finance Committee. If floor amendments are to be covered, it would seem that all must be governed if the procedure is to be workable. Indeed, the broader rule might have the salutary effect of limiting such floor amendments.

For a description of the extent of the overlap of Senate Finance Committee jurisdiction (as a result of tax expenditures) with the jurisdictions of committees with legislative and appropriations responsibilities for direct programs in the areas covered by the tax expenditures, see 124 CONG. REC. S5703 (daily ed. Apr. 17, 1978) (statement of Sen. Kennedy).

²⁹⁶ S. REP. NO. 1066, 95th Cong., 2d Sess. (1978).

²⁹⁷ See the discussion of Budget Act sections 303(a) and 401 in text at notes 278-79 *supra*.

²⁹⁸ S. REP. NO. 1067, 95th Cong., 2d Sess. (1978).

²⁹⁹ S. REP. NO. 1065, 95th Cong., 2d Sess. (1978).

³⁰⁰ See 124 CONG. REC. S13070-71 (daily ed. Aug. 10, 1978).

of the Budget Act. This motion also was defeated by the full Senate and the revised amendment was likewise ruled out of order.³⁰¹

The impact of the budget process on the tuition tax credit bill made several important points clear. From a *budgetary standpoint*, the budget process itself was applied in analyzing the provision. That is, the refundable portion of the credit was treated as a "spending authority" and the budget process then operated just as it would have in the case of a direct spending program. From a *program standpoint*, a tuition tax credit excluding taxpayers with no tax liability is impossible to defend on equity grounds. Thus, the budget process operated well as a process, but the result of that operation, viewed from a spending perspective, was an inequitable program. Obviously, much closer coordination of tax and direct spending programs is required to ensure that, if the tax spending route is followed, both proper program design and compliance with the budget process can be achieved.³⁰²

In addition, the tuition tax credit bill experience pointed up two aspects of the increasing Senate sensitivity to the impact of tax expenditures. First, the Appropriations Committee is obviously inhospitable to refundable tax credits, viewing such devices as infringements on its jurisdiction. This attitude must be tempered since absolute rejection of refundability means that the neediest members of society cannot benefit from those tax expenditures that are adopted. Second, the Budget Committee was keenly sensitive to the "out-year" budget effects produced by pre-scheduled increases in the amount of the allowable tax credit.

C. Non-Tax Committees and Tax Expenditures

The growing understanding and acceptance of tax expenditure analysis inevitably impels non-tax committees and their staffs into the tax legislative process. Increasingly these committees have come to realize that tax expenditures have a significant impact on policies they are pursuing through direct programs. The preceding discussion has highlighted some examples of this phenomenon where the Budget and Appropriations Committees have become involved in the tax legislative process because of their recognition of the real nature of tax expenditure provisions. The following discussion indicates briefly the actual and potential involvement of other non-tax committees in the consideration of tax legislation.

³⁰¹ 124 CONG. REC. S13370-76 (daily ed. Aug. 15, 1978).

³⁰² It should be noted that the budget process as such did not technically preclude the Finance Committee from reporting out a refundable tuition tax credit. Upon failure to secure a waiver of section 303(a) from the Budget Committee, the Finance Committee could have provided for a smaller refundable tuition tax credit which stayed within the budget spending limits for fiscal 1979 and did not increase in the following years. This action would have eliminated any objection from the Budget Committee. However the measure still would have been subject to the Appropriations Committee jurisdiction because room for the refundable portion of the credit had not been provided in the outlay allocation to the Finance Committee. Apparently, the Finance Committee felt it was more important to have a larger nonrefundable credit than a smaller refundable one.

Paragraph 3(b) of Rule XXVI of the Standing Rules of the Senate provides for joint referral of a bill to two or more committees upon motion of the Majority and Minority Leaders. This joint referral procedure technically affords the opportunity to refer bills that include tax expenditures both to the Finance Committee and to the legislative committee with jurisdiction over the subject matter covered by the tax expenditure. Senator Long, however, has demonstrated that he is alert to the dangers posed by this procedure to the exclusive Finance Committee jurisdiction over tax expenditures by objecting, in at least one instance, to a proposed joint referral of a tax expenditure bill.³⁰³

A second potential for the involvement of non-tax committees in the review of tax legislation was Senate Resolution 4, "The Committee System Reorganization Amendment of 1977,"³⁰⁴ which reflected a major effort by the Senate to reorganize the structure and jurisdiction of its committees. The question of jurisdiction over tax expenditures was considered in the development of Senate Resolution 4 by the Temporary Select Committee to Study the Senate Committee System. In the original version of the resolution, each standing committee of the Senate would have been empowered to "study and review tax expenditures related to subject matters within its jurisdiction, and submit reports and its recommendations with respect thereto."³⁰⁵ Senator Long appeared before the Select Committee to object to the provision. He argued that the non-tax committees already had the power to conduct such studies. Formalization in the Senate Rules, he contended, would lead to unnecessary duplication of committee work and staff personnel.³⁰⁶ As a result, Senate Resolution 4, as reported by the Select Committee and adopted by the Senate, did not contain the language quoted above.³⁰⁷

In addition to the tax expenditure activities by the Budget Committees and CBO, other non-tax committees have involved themselves in tax legislation by holding hearings and issuing reports on tax expenditures that cover subjects within their legislative jurisdiction.³⁰⁸ As a result, the staffs of these committees have become more aggressive participants in the tax legislative

³⁰³ 123 CONG. REC. S2373-74 (daily ed. Feb. 7, 1977).

³⁰⁴ S. Res. 4, 95th Cong., 1st Sess., 123 CONG. REC. S1827 (daily ed. Feb. 1, 1977).

³⁰⁵ S. Res. 4, § 101(a)(2), 95th Cong., 1st Sess., 123 CONG. REC. S10 (daily ed. Jan. 4, 1977).

³⁰⁶ See 123 CONG. REC. S1640 (daily ed. Jan. 28, 1977).

³⁰⁷ See S. Res. 4, 95th Cong., 1st Sess., 123 CONG. REC. S1827 (daily ed. Feb. 1, 1977). The vote adopting the resolution as amended is at 123 CONG. REC. S2307 (daily ed. Feb. 4, 1977).

³⁰⁸ See, e.g., *Federal Tax Policy and Urban Development: Hearings Before the Subcomm. on the City of the House Comm. on Banking, Finance and Urban Affairs*, 95th Cong., 1st Sess. (1977), and the Report thereon (Comm. Print 1977); SENATE COMM. ON THE INTERIOR, AN ANALYSIS OF THE FEDERAL TAX TREATMENT OF OIL AND GAS AND SOME POLICY ALTERNATIVES, 93d Cong., 2d Sess. (1974). Some committees have involved themselves in tax provisions that are not non-tax expenditures. See, e.g., SUBCOMM. ON COMMERCE, CONSUMER AND MONETARY AFFAIRS OF THE HOUSE COMM. ON GOVERNMENT OPERATIONS, FOREIGN TAX CREDITS CLAIMED BY UNITED STATES PETROLEUM COMPANIES, H.R. REP. NO. 1240, 95th Cong., 2d Sess. (1978).

process. In addition, the Congressional Research Service of the Library of Congress has developed the staff capacity to deal with tax expenditure issues and has prepared reports on various provisions that have proved influential in congressional deliberations.³⁰⁹

Increasing involvement by non-tax committees and staffs appears inevitable as the tax expenditure concept becomes integrated into congressional thinking and procedures. While this involvement complicates the tax legislative process, in the long run it is probably a development to be welcomed. At a minimum, the substantive expertise of these committees and staffs should improve the equity and efficiency of those tax expenditure programs that are employed. More broadly, better coordination of tax and direct spending programs could result, with questions being raised more frequently as to the wisdom and propriety of using the tax route.

D. *The Sunset Legislation*

In 1976, momentum gathered in the United States Senate to enact "sunset" legislation. The basic purpose of the legislation was to ensure regular, periodic review of the need, effectiveness, and efficiency of each authorization; termination of the program was the sanction if the requisite review was not undertaken.³¹⁰ Under the 1976 proposal, authorization of federal programs would terminate every five years on a staggered basis unless reenacted. Moreover, all programs would be required to undergo a zero base review by the executive branch and by the appropriate congressional committees, if necessary, before reenactment.

The 1976 legislative proposal was reintroduced as S. 2 in January, 1977. As did the 1976 bill, S. 2 included tax expenditures in the sunset process. Title IV of the 1977 bill established a procedure whereby five-year termination dates would be set for each tax expenditure with the definition of tax expenditures encompassing not only the income tax but "any tax."³¹¹ Prior to the termination date, the tax writing committees would be required to conduct a "sunset" review of the tax expenditure scheduled to terminate that year.³¹²

³⁰⁹ See, e.g., Gravelle, Hughes & Farb, *The Domestic International Sales Corporation (DISC) Provision and its Effect on Exports and Unemployment: A Background Report* (Apr. 30, 1976), reprinted in 122 CONG. REC. S6324-27 (daily ed. May 3, 1976); Tannenwald and Farb, *Comparative Cost-Effectiveness of Alternative Investment Tax Incentives* (June 7, 1976), reprinted in 122 CONG. REC. S8684-89 (daily ed. June 8, 1976); Gravelle, *Provisions Reducing the Effective Tax Rate of Commercial Banking Organizations* (Jan. 19, 1977); Gravelle and Kiefer, *Deferral and DISC: Two Targets of Tax Reform* (Feb. 3, 1978), reprinted in 124 CONG. REC. S1286-91, S1409-13 (daily eds. Feb. 6 and 7, 1978); Gravelle and Kiefer, *U.S. Taxation of Citizens Working in Other Countries: An Economic Analysis* (Apr. 20, 1978), reprinted in 124 CONG. REC. S6193-202 (daily ed. Apr. 24, 1978).

³¹⁰ S. 2925, 94th Cong., 2d Sess. (1976). See McIntyre, *The Sunset Bill: A Periodic Review for Tax Expenditures*, 4 TAX NOTES NO. 32 at 3 (Aug. 9, 1976).

³¹¹ S. 2, § 401(b), 95th Cong., 1st Sess., 123 CONG. REC. S148 (daily ed. Jan. 10, 1977).

³¹² *Id.* § 411.

Predictably, the inclusion of tax expenditures in the sunset process aroused controversy. The Subcommittee on Intergovernmental Relations of the Senate Committee on Government Operations held hearings on S. 2 in March, 1977.³¹³ OMB supported Title IV of the bill. Budget Director Lance specifically noted that a review of outlay programs in a given area "without also reviewing [tax expenditures in the same area] would surely be inappropriate."³¹⁴

The Treasury stated that it was "not opposing" the use of termination dates for tax expenditures. Secretary Blumenthal proceeded, however, to dwell at some length on technical problems the Treasury saw in implementing such a procedure. Terminating a tax expenditure, in the Treasury view, was more complicated than terminating a direct program. Because of the technical interrelationships between Code provisions, the Treasury pointed out that termination of one Code provision frequently requires changes in others, and therefore that extensive study would be required to determine the full economic effects of a given change. Furthermore, as to tax expenditures created by regulations and rulings—such as the exclusion for Social Security benefits and tax deferral for income earned by foreign subsidiaries of United States corporations—the Treasury contended that substantive legislation to terminate, not mere termination dates, would be required. Finally, the Treasury noted that because business and economic decisions are based on tax considerations, total termination without transition rules might prove unfair.³¹⁵

While the Treasury statement devoted itself to identification of the problems, it did not address itself to how the problems could be solved. Actually, however, none of the problems raised by the Treasury was incapable of resolution. Senator Kennedy, in a statement before the Intergovernmental Relations Subcommittee, pointed out that the "problems" identified by the Treasury were also "problems" in terminating direct programs. Senator Kennedy also suggested that the requisite budgetary and legislative expertise existed to solve the problems in each case.³¹⁶

The "problems" raised by the Treasury, not surprisingly, provided part of the ground for Senator Long to recommend that Title IV in its entirety be deleted from S. 2.³¹⁷ When the full Government Operations Committee considered the bill in June, 1977, Title IV was modified on the motion of Senate Finance Committee members Roth and Danforth. Under their motion, tax expenditures would be "reviewed" periodically, but no automatic termination date would be established. Feeling that "review" was no improvement on existing procedures, Senator Glenn, the sponsor of Title IV, moved to drop Title IV from the bill entirely in order to seek its passage in its original form on

³¹³ *Hearing on the Sunset Act of 1977, supra* note 13.

³¹⁴ *Id.* at 93.

³¹⁵ *Id.* at 109-11.

³¹⁶ *Id.* at 329.

³¹⁷ *Id.* at 484.

the Senate floor.³¹⁸ Accordingly, as reported by the Committee³¹⁹ and as subsequently approved by the Senate Rules Committee,³²⁰ S. 2 contained no provisions governing tax expenditures.

Frustrated by his inability to get the sunset bill scheduled for floor debate during 1978, Senator Muskie offered the bill as a floor amendment to the Revenue Act of 1978. Senator Glenn then offered his proposal to apply the sunset process to tax expenditures as an amendment to the Muskie amendment. Opponents of the Glenn amendment were prepared to follow the strategy of debating the amendment until cloture was invoked, after which both the Glenn and Muskie amendments would fall because they were non-germane to the Revenue Act. To force a vote prior to cloture, Senator Glenn moved to table his own amendment. That motion was defeated with a curious mixture of proponents and opponents of the Glenn amendment combining to defeat the tabling motion. Perhaps the opponents so voting did not want to see a showdown vote occur on the motion, and hence clouded the vote by joining the proponents of the amendment. Once cloture was invoked, both of the sunset amendments were out of order.³²¹

Several arguments were advanced by opponents of the Glenn amendment. First, Senator Long argued that termination of a tax expenditure, if it was not reauthorized under the sunset process, constituted a "backdoor" tax increase for taxpayers. This result, he asserted, was different from that which obtained by application of the sunset procedure to direct spending programs.³²² Senator Long's argument is disingenuous at best. Termination of a tax expenditure may result in a tax increase in the end *if Congress so decides*. But, Congress also might decide to use the increased tax revenues made available by the termination to provide a general tax reduction, or to fund new or increased tax expenditures. Consistent with Senator Long's argument, one could equally assert that the termination of a direct spending program will produce a tax reduction since revenue targets can be lowered. But, of course, the termination may or may not produce that result depending on the use Congress decides to make of the newly available funds. Thus, though the mechanics are somewhat different, the results of terminating both tax and direct expenditures basically are the same. In either case, there is an increase

³¹⁸ See Common Cause, *Sunset Process for Tax Loopholes*, 8 IN COMMON No. 3 at 14 (Summer 1977); *Tax Expenditures Dropped from Sunset Bill*, 5 TAX NOTES No. 27 at 7 (July 4, 1977). Compare Senator Hart's bill, S. 921, to provide periodic review but not termination of tax expenditures. 123 CONG. REC. S3490 (daily ed. Mar. 4, 1977).

³¹⁹ S. REP. NO. 326, 95th Cong., 1st Sess. (1977).

³²⁰ S. REP. NO. 981, 95th Cong., 2d Sess. (1978).

³²¹ See 124 CONG. REC. S17357-73, 17475-500, 17536-43, 17729-36, 17819 (daily eds. Oct. 6, 7 and 9, 1978). Senator Glenn subsequently offered an amendment that it was germane to subject to the sunset process the tax expenditures adopted in the Revenue Act of 1978. That amendment was tabled. *Id.* at S17969-72.

Following a change in the basic Muskie sunset bill, the Glenn amendment provided for a 10-year cycle in which all tax expenditures would be reviewed.

³²² 124 CONG. REC. S17475 (daily ed. Oct. 7, 1978). See also 124 CONG. REC. S16776 (daily ed. Sept. 30, 1978). Senator Long's phrase probably was an intentionally ironic reference to the "backdoor spending" phrase that was used to characterize tax expenditures in the early years of the discussion of the concept.

in the amount of revenue available to the government, and Congress must make a decision as to the uses to which those amounts will be put.³²³

Members of the Finance Committee also argued that sunset for tax expenditures was unnecessary because the Committee already periodically reviewed the provisions.³²⁴ This argument, of course, is really an objection to the whole sunset process. Direct spending programs, after all, are likewise periodically reviewed, typically annually, by the appropriate authorizing and appropriations committees or subcommittees. If it is desirable to establish a regular schedule to review direct programs, it is equally desirable to apply the same procedure to tax expenditures. Moreover, nothing in the sunset process would prevent the Finance Committee from reviewing particular tax expenditures before the scheduled time.

The most fundamental objection advanced by Senator Long and other members of the Finance Committee against the sunset process, however, was that they did not want to have to assume the burden of proof to reauthorize a tax expenditure. Under present procedures, the burden of challenging tax expenditures is on opponents of a tax expenditure seeking the expenditure's repeal. Under sunset, the burden would shift to proponents of a tax expenditure to persuade Congress and the President that a tax expenditure should be reenacted. Procedurally, this process would mean that a particular tax expenditure would terminate, for example, if thirty-four Senators filibustered the proposed reauthorization and prevented cloture. Similarly, a tax expenditure would lapse if the President vetoed a congressionally approved reauthorization and there were not enough votes to override the veto.³²⁵ Again, the answer to this objection is that precisely the same procedure applies to direct spending programs. The Finance Committee members put forward no reasons to justify a different procedure for tax expenditures.

In sum, the arguments advanced against the Glenn amendment³²⁶ do not justify exempting tax expenditures from any sunset process that ultimately is

³²³ A number of tax expenditures are now enacted with automatic termination dates. Senator Long did not explain why the "automatic tax increase" argument was not equally applicable to such provisions.

³²⁴ 124 CONG. REC. S17494 (daily ed. Oct. 7, 1978). For a study, by an organization supporting the Glenn amendment, of the "review" given in the past by the tax committees to tax expenditures, see COMMON CAUSE, GIMME SHELTERS (May 1978).

³²⁵ 124 CONG. REC. S17492, 17496, 17735 (daily eds. Oct. 7 and 9, 1978).

³²⁶ Some particular aspects of the Glenn amendment should be noted. First, the refundable portion of the earned income credit (and any future refundable credit) is treated as an "outlay." Accordingly, that element of the earned income credit would be subject to sunset procedures for direct spending programs even in the absence of a tax expenditure component of sunset legislation. See 124 CONG. REC. S17485 (daily ed. Oct. 7, 1978).

Second, the Glenn amendment itself proposed to give the tax-writing committees considerably more discretion over the extent to which tax expenditures are subjected to sunset review than would be given to the authorizing and appropriations committees with respect to direct expenditures. The amendment provided a two-step procedure: (1) The Congressional Budget Office, working with the tax-writing committees, would prepare an "inventory" of tax expenditure items; (2) the tax-writing committees would then submit for congressional approval a resolution establishing a review timetable for those items in the inventory that the tax-writing committees de-

adopted by Congress. These arguments were simply debating points designed to allow the Finance Committee to continue its jurisdiction over tax expenditures unimpeded by procedures presently applicable to direct spending programs.³²⁷ We need not concern ourselves here with the merits of the sunset technique. Many observers doubt its efficacy in dealing with direct spending

terminated should be subjected to the sunset process. See 124 CONG. REC. S17363-64 (daily ed. Oct. 6, 1978). Step (2) is an undesirable provision when compared to the sunset process applicable to direct spending programs. It would enable the tax-writing committees to exempt any tax expenditure item from the sunset process. Of course, Congress could override the committees' recommendations. But it seems undesirable to place the initial decision for exemption within the tax-writing committees. It is true that some direct spending programs would be exempt from sunset, e.g., social security, but this was a decision of the Government Operations Committee, not the authorization-appropriations committees. Those committees would not be given the "exemption privilege" for the direct spending programs that would be granted to the tax-writing committees under the Glenn amendment.

³²⁷ This debating point approach to the Glenn amendment typifies arguments made elsewhere. Thus, those who support the sunset principle when applied to direct spending programs but who attack the Glenn amendment always overlook the point that their arguments addressed to the tax side of "sunset" equally apply to the spending side, which they do not attack. See, for example, the statement of Reginald Jones, Co-Chairman of the Business Roundtable, made at a Tax Foundation lunch, Oct. 25, 1978:

Let's begin with some legislative history on "sunset" legislation. This is a concept that enjoys wide, bipartisan support as a way of bringing federal spending programs under control. It is a direct response to the dramatic increase in the percentage of federal spending for so-called uncontrollable programs, which comprise more than three-quarters of all federal spending.

These are programs where spending mandated by earlier congressional action could not be appreciably altered. Under sunset legislation, almost all federal spending programs would be systematically reviewed by the Congress and would automatically be terminated—brought to sunset—unless they were specifically reauthorized by the Congress. . . .

Sunset legislation is sure to be revived in the next Congress, and the question is going to be: Should sunset legislation include or exempt review of the so-called tax expenditures? . . .

Both business and individuals would be thrown into a constant state of uncertainty with respect to major investment and consumption decisions, if the application of important tax provisions were subject to possible cancellation. And since some tax expenditures would be up for review every year (to spread the Congressional workload), the state of uncertainty would be permanent.

That's all we need in these times of uncertainty over so many other aspects of government—regulations, monetary and fiscal policy, energy policy, antitrust policy, foreign trade policy—every one of them already a strong inhibitor of business investment. Uncertainty as to the continued application of major tax provisions would damage business, investor, and consumer confidence. Instead of contributing to economic stability, the sunset concept applied to tax expenditures would cause even worse fluctuations in investment and consumption decisions—fluctuations that would aggravate existing economic problems.

Apart from their exaggerated tone, such statements, which obviously apply as well to direct spending programs, must really characterize the speakers as believers in tax sunrises but no tax sunsets.

programs. What is clear, however, is that if sunset legislation ultimately is enacted, it must apply to tax and direct expenditure programs alike. The technical problems envisioned by the Treasury seem capable of satisfactory resolution. A sunset process that excludes programs expending almost 25 percent of total federal funds would undoubtedly prove as unsatisfactory and ineffectual as a budget control process that fails to cover tax expenditures.³²⁸

*E. Development of Mechanisms to Coordinate Tax
and Direct Expenditures*

We have previously outlined the procedure by which more rational and effective congressional consideration and coordination of tax and direct expenditures could be effected within the framework of the present budget process.³²⁹ Obviously, at the end of 1977, implementation of that ideal procedure remained far from realization in actual practice. Nonetheless, in particular instances, effective coordination has taken place. In addition, there were signs of movement toward a better system, although as we earlier predicted, the path to reform has not proved an easy one.

The 1976-1978 legislative experience did suggest some lessons to be learned and some possibilities for additional gradual steps that can be taken to move the legislative process toward more complete integration of tax expenditures with direct spending programs. First, it is clear that the goal of integration probably cannot be realized without a combination of forceful exercise of authority by the leadership in each House and of cooperation between the tax and non-tax committees. That combination existed in the House of Representatives in its consideration of the 1977 energy legislation. It does not yet exist in the Senate. Nevertheless, the Budget Committees can move to bring tax expenditures under control by utilizing their Task Forces on tax expenditures to develop and carry out hearings and to issue reports on an agreed upon set of tax expenditures, and by requesting comprehensive reports to be prepared by CBO on the tax expenditures selected for Task Force hearings. In addition, the Budget Committees, under section 801 of the Budget Act, may request that any program evaluations of tax expenditures conducted by OMB, the Treasury or the "various executive agencies" be made available to the Committees. The Committees themselves should encourage the development of such evaluations.³³⁰

³²⁸ Subsequent to passing the Revenue Act of 1978, the Senate passed the basic sunset bill, S. 2, 95th Cong., 2d Sess. (1978). The bill as approved by the Senate did not, however, include the Glenn tax expenditure title and Senator Glenn did not offer his amendment. See 124 CONG. REC. S18145-97, 18211-21 (daily ed. Oct. 11, 1978). With the conclusion of the Ninety-Fifth Congress, S. 2 died, which was the result expected when it was passed by the Senate. Thus the sunset measure must be considered anew by the Ninety-Sixth Congress. The House has not to date acted on sunset legislation.

³²⁹ Surrey & McDaniel, *supra* note 7, at 717-20.

³³⁰ Attention has been given by the Senate Budget Committee to such matters. See *Can Congress Control the Power of the Purse?*, Hearings Before the Senate Comm. on the Budget, 95th Cong., 1st Sess. (1977).

Furthermore, the legislative experience demonstrated that the Budget Committees should include, in the body of the Budget Resolution, and not just in the accompanying Committee Report, directions to reduce existing tax expenditures by a specified amount. The requisite authority for such an action would appear to be granted by section 301(a)(6) of the Budget Act. This section directs that the First Concurrent Resolution shall include not only the recommended levels of revenues and the aggregate level of revenue increases or decreases, but also "such other matters relating to the Budget as may be appropriate to carry out the purposes of [the Budget] Act."

Several amendments to the Budget Act are suggested by the 1976-1978 legislative experience. The Budget Act should be amended to require closer coordination of tax and direct spending programs between the tax committees and the authorizing and appropriations committees, perhaps along the lines of the resolution introduced by Senator Kennedy.³³¹ The support of the chairmen of the non-tax committees is, of course, an essential prerequisite to the success of such an effort. The Budget Act also should be amended to prevent out-year increases in tax expenditures that "leapfrog" the succeeding fiscal year. It may be desirable as a budgetary matter to move to multi-year budgeting for all programs. But until that step is taken—both for tax and direct spending programs—the present procedure whereby it is possible to schedule increases in tax expenditures for the current fiscal year and the second, third, and succeeding fiscal years, but not for the first succeeding fiscal year,³³² is irrational and harmful to the existing single-year budget process.

Finally, even in the absence of formal coordination, each House and Senate authorizing committee is empowered to hold hearings and obtain CBO reports on particular tax expenditures. To date, neither tax writing committee has evidenced any great interest in obtaining the objective studies that are required if tax expenditures are to be intelligently evaluated. This information vacuum could be filled by non-tax committees to ensure that their expertise is brought to bear on the necessity and proper structure of a proposed tax expenditure.

VI. INTERNATIONAL ASPECTS OF TAX EXPENDITURES

A. *Consideration by International Organizations*

The concept of tax expenditures as developed in the United States is rapidly becoming a subject of interest in the rest of the world. In considerable part, this interest results from the discussion of tax expenditures as a princi-

³³¹ See text at notes 294-95 *supra*.

³³² The text assumes the Muskie interpretation of section 303 of the Budget Act, and not the result produced by the Senate vote overruling the Chair's acceptance of that interpretation as applied to the Revenue Act of 1978, which overruling permitted scheduled increases for the first succeeding fiscal year as well. See text at notes 246-54 *supra*. Note that even under the overruling vote, while "leapfrogging" is not involved, the problem of increasing tax expenditures for all succeeding fiscal years remains.

pal topic at recent annual meetings of the two major international fiscal organizations.³³³

At its Jerusalem 1976 Congress, the International Fiscal Association (IFA) selected "Tax Incentives as an Instrument for Achievement of Governmental Goals—Their Role in Income Taxation and a Comparison with Alternative Instruments Regarding Both Economic and Social Goals" as one of its topics.³³⁴ The IFA Directive guiding the preparation of National Reports for about twenty countries described the tax expenditure concept, asked whether thinking about the tax system in the various countries had encompassed that concept, and requested the preparation of a tax expenditure budget for each country. The IFA General Report described the response:

On the basis of the National Reports, only the United States and Germany have a systematic treatment of tax expenditures in their legislation, and of the two countries the treatment in the United States is more detailed. Consequently, in the National Reports only those for the United States and Germany could present a formally recognized list of tax expenditures and accompanying estimates. Japanese legislation has a listing of special provisions under the heading "Special Taxation Measures," and the Japan Report uses this legislation as the basis for its statement of tax expenditures. However, it would seem the legislative classification does not cover all items here considered as tax expenditures, so that the enumeration in the Japan Report is not as inclusive as in the United States or Germany.

Viewed as a whole, therefore, only the Reports from the United States, Germany, and Japan include what may be regarded as reasonably comprehensive tax expenditure budgets with reliable estimates. In several other countries, while the legislation does not embody the concept, there appears to be considerable thinking about tax expenditures—though not in such terminology—as represented by discussions regarding special tax provisions usually of the tax incentive type. This has enabled the National Reports from these countries to present what the Reporters regard as a reasonably com-

³³³ In addition, *PATHWAYS*, *supra* note 34, the first U.S. full-length exposition of the subject, was reviewed in periodicals in several other countries including France, Germany, Japan, and the United Kingdom. Discussions of the tax expenditure concept by U.S. writers that have appeared in European journals include Ault, *Steuervergünstigungen in der Bundesrepublik Deutschland und den USA*, 4 *STEUR UND WIRTSCHAFT* 335 (1974), and McDaniel, *The Tax Expenditure Concept: Theory and Practical Operation*, 45e *MAANDBLAD BELASTINGBESCHOUWINGEN* 245 (1976).

³³⁴ The International Fiscal Association has a large international membership composed of practicing tax specialists (tax executives, lawyers, accountants), government officials, and academics. On each of the two subjects chosen for an annual Congress it publishes a Cahier containing Reports prepared by National Reporters selected for the various countries having local branches (there are usually around twenty or so Reports) and a General Report summarizing and analyzing the contents of the National Reports. The National Reports follow the guidelines set forth in a Directive prepared by the General Reporter, so that the Reports provide organized comparative material. The particular subject is then discussed at the Annual Congress and the conclusion of the Congress is summarized in a Resolution.

prehensive list, though it required considerable research and judgment on their part and the estimates often are incomplete or more in the nature of guesses. Countries in this group include Australia, Israel, and Finland. In other countries, though not much previous thinking on the subject existed, the research by the National Reporters did enable them also to accomplish this result. See, for example, Netherlands, United Kingdom, and Austria.

As to the remainder of the countries, for the most part the systematic study of tax incentives seems largely unexplored ground and the National Reporters valiantly worked to present whatever material they could gather on their own. In many cases they appear to have achieved useful and reasonably comprehensive lists. But necessarily the extent of the enumeration of tax expenditures for most of the countries varies considerably in the detail presented.³³⁵

Against this background, the General Report reached the following conclusions:

The great difficulty which the National Reporters experienced in drawing up tax expenditure budgets and the absence of studies of the equity and efficiency aspects of tax incentives are strong indications that tax incentives are little understood or studied.

.....

The great majority of the National Reports indicated that there is almost no recognition in the fiscal process that tax incentives and direct expenditures are alternative courses to accomplish government goals. Consequently, there is almost no consideration of the criteria that should govern the choice between these courses once it is decided to provide government financial assistance to achieve a particular goal. The result is a significant and unfortunate gap in knowledge regarding important aspects of tax and expenditure policy. There is obviously much work to be done by governments and private research in these fields.

.....

The material in the National Reports clearly demonstrates that the preparation of a tax expenditure table for a country is a feasible goal. The United States and Germany are ready illustrations. If this subject had been studied by IFA, say around ten years ago, those countries could not have responded any differently from other countries. Yet because of work done within government, their National Reporters are now in a position to provide extensive official data, both qualitative and quantitative.

The matter can be approached from the opposite side. It would seem that knowledge of the tax expenditure aspects of a tax system is essential to the orderly management of that system and fiscal policy in general. A government that is not in a position to identify and quantify the tax expenditures imbedded in its tax system has really lost control over an important aspect of fiscal policy. Hence, it is essential that governments make an effort to prepare tax expenditure tables. Academic research can be helpful here as the National

³³⁵ IFA 1976 Congress, *supra* note 6, at 19.

Reports show, most likely as to classification questions. But the preparation of estimates would seem primarily a government task unless existing data and academic research are such that the task can be performed outside government. The point is, however, that this should not be required, and governments themselves should be in a position to possess and make available the necessary data.

An overall view of the National Reports indicates that while classification questions will arise at the borderline, and a few may require further analysis, by far the major part of the task does not involve seriously debatable points. Nor are there theoretical issues that stand in the way of obtaining estimates, given the decision to use "first order" estimates. The problem as to quantification is present absence of the desired data, not confusion as to what is needed.³³⁶

Undoubtedly, the IFA consideration of tax expenditures will stimulate work in this area in other countries.³³⁷ Indeed, the Netherlands National Reporter, Professor Victor Halberstadt of the Economic Institute of Leyden University, is now working on a study by a Commission organized by the Netherlands Finance Ministry to consider tax expenditures in the Netherlands tax system. This study has the potential to develop the tax expenditure concept against the background of European fiscal systems and thus should contribute importantly both to further understanding of the concept and to comparative approaches under the concept. Similarly, Canada has instituted a study to identify tax expenditures in its tax system.

³³⁶ *Id.* at 38-39.

³³⁷ On tax expenditures, the *IFA Summary*, *supra* note 29, at 46, concluded:

The Congress also considered the factors involved in the choice between tax incentives and direct expenditures. The need was felt for further research to explore the factors and ascertain the criteria governing decisions in this respect.

On two points the Congress was in general agreement, one that tax incentive programs should be scrutinized as carefully as other matters of budgetary and economic policy, the other, that further research into the effect of tax incentive measures would be useful, in particular, in order to measure their cost/benefit ratio.

The Summary also said:

There was general agreement as to the usefulness of defining and evaluating tax incentives. Such evaluation should include the effects achieved, the revenue losses involved, and any equity consequences. Some difficulty was seen, however, in formulating unambiguously and uncontroversially a revenue concept against which all incentives could be identified and the connected revenue costs measured.

The third sentence obviously asks too much—"unambiguously and uncontroversially" identify "all incentives"—and is really a backhanded way of indicating that borderlines may remain indefinite. See Shoup, *supra* note 27.

For discussion of the tax expenditure concept in the Dutch system, see Halberstadt and de Kam, *About the Choice Between Direct Versus Tax Expenditures*, paper presented before the IIPF 1977 Congress, *supra* note 6; Christiaanse, *Tax Expenditures*, 106e WEEKBLAD VOOR FISCAL RECHT 69 (1977). For a listing and analysis of tax expenditures in the United Kingdom, see WILLIS & HARDWICK, *TAX EXPENDITURES IN THE UNITED KINGDOM* (1978) (reviewed in Bird, *Current Reading*, 26 CANADIAN TAX J. 621 (1978), in reference to the Canadian material).

In its Varna 1977 Congress, the International Institute of Public Finance (IIPF)³³⁸ also considered the subject of tax expenditures. The theme of that Congress was "Subsidies, Tax Reliefs and Prices." The term "tax reliefs" was used to cover the "tax expenditure" concept. From the discussion, it appeared that most of the members attending the Varna Congress felt comfortable with the technical aspects of the concept and saw no essential difficulties with the definitional or estimation aspects. In addition, the majority of members clearly recognized both the absence in official thinking and academic research of this technique for examining a tax system and the essential need for developing a tax expenditure approach to a tax system.³³⁹ As perhaps might be expected, these public finance economists readily saw the utility of the concept in advancing understanding of the various tax systems and the need for careful analysis of the use of tax expenditures. By contrast, and as expected, some of the IFA members at the Jerusalem Congress, being practicing tax experts and recognizing the warning signals posed under tax expenditure analysis for an uncritical use of tax expenditures, were often prone to be protective of the present use of tax incentives.

Like the IFA and the IIPF, the Committee on Fiscal Affairs of the Organization for Economic Cooperation and Development (OECD) has found itself almost inevitably drawn into an exploration of the tax expenditure concept. Its Working Party No. 2 for a number of years has been developing and publishing comparative statistical and descriptive material on the fiscal systems of member countries. The material covers such broad subjects as, on the one hand, tax revenue statistics and, on the other hand, the social aspects of taxation. Under the social aspects of taxation are studies on homeownership, the average production worker, and the family unit. It is increasingly becoming evident to those working on these matters that comparative data on overall budgets and on government assistance to particular groups or activities must take account of the assistance being provided through the tax structure as well as the customary direct budgetary assistance. As a consequence, this Working Party is gradually, though slowly, widening its exploration of the tax expenditure concept and studying how it may be applied usefully in the context of

³³⁸ This organization, considerably smaller than IFA, is composed almost entirely of public finance specialists, usually academics or government officials. Its membership extends to East European countries. A program committee organizes the preparation of individual papers in accordance with the program agenda and these papers are discussed at the annual Congress. The papers are published in a single volume, generally about one year after the Congress at which they were presented. No resolutions are adopted. The 1977 proceedings will be published in *SUBSIDIES, TAX RELIEFS AND PRICES* (Hauser ed., forthcoming).

³³⁹ The opening address on this phase of the Congress, Surrey, *supra* note 9, obviously had no problems in accepting the concept! But even the discussion of that paper essentially posed no issues that had not been explored in writings in the United States. The various papers presented contributed useful observations on the criteria for choosing between tax assistance and direct assistance, on the political and psychological factors that underlay the use of tax assistance, on the almost universal tendency of legislatures to approve tax expenditures more readily than direct assistance, and on the adverse effect on the basic tax structure of injecting tax expenditures into an income tax system.

the varying tax systems of the member countries. It would seem impossible to develop comprehensive comparative material on the subjects being studied in the OECD without applying tax expenditure analysis.³⁴⁰ It is possible therefore that the OECD studies may be important in advancing the use of the tax expenditure concept, both within its member countries in their own budgetary and tax policies and in the presentation of comparative tax and other fiscal statistical and descriptive material.

The OECD work would be substantially advanced if it, or some European government or research organization, would commence the initial preparation

³⁴⁰ See, e.g., IFA 1976 Congress, *supra* note 6, at 40-41, which contains these observations:

The OECD has published comprehensive material on Revenue Statistics of OECD Member Countries; the latest published in 1975 covers 1965-1972. These statistics, following a standard classification established by OECD, indicate tax revenues as a ratio of GNP. The study, however, excludes tax expenditures. Yet tax expenditures can affect such ratios, since one country may finance certain activities through the tax system while another country finances the same activities through the direct budget. The two countries looked at in terms of collected revenues alone may show the same ratio whereas in fact the first country could actually have more relative participation of the public sector in the economy once tax expenditures are included. While the OECD is aware of this, it presumably feels at this time that the available national data do not permit tax expenditures to be included in these comparisons. As indicated above, it would appear that further activity by the OECD in developing a coordinated approach to the identification and quantification of tax expenditures by the various governments would be useful in prompting those governments to obtain the needed data. Certainly it would seem to be within the reach of the OECD, given sustained cooperation by the fiscal authorities of the countries, to develop the necessary framework for the data and to supply reasonable guidelines on any borderline questions that arise.

Other comparative studies under consideration by the OECD also require tax expenditure data to make the international comparisons meaningful, and would thus complement a basic tax expenditure study. For example, one set of studies relates to government financing in selected functional areas, such as health, housing, etc. Certainly the extent of financing through tax expenditures is a necessary ingredient. Thus in housing one should look at tax expenditures to individuals for home ownership, to business to construct homes, and to financial institutions to lend funds for the construction or purchase of homes. These tax expenditures would be joined with other government budget aids such as grants, loans, guarantees and the like to form the complete picture. Another OECD comparative study relates to the distribution of income among households by percentile classes. Such a study, however, requires a definition of "income" and in turn that definition will involve tax expenditure concepts. Thus "income" could be defined as taxable income plus income excluded from the tax base because of tax expenditures plus personal exemptions (to extent not included in tax expenditures). Presumably, most governments would, however, proceed the other way and have data on money incomes. But once those data are obtained and taxable income is known, the difference defines the magnitude of tax expenditures (plus personal exemptions). Hence such a distribution of income study would necessarily complement a basic tax expenditure study. (Transfers in kind may also have to be considered.)

of tax expenditure budgets for the member countries. This work could proceed first through a listing of the tax expenditure items and then progress to obtaining the data necessary for the revenue estimates. In this regard, one gets the impression that in some European countries it is believed that work on the preparation of a tax expenditure budget cannot proceed without an ironclad agreement on the concept of a normative income tax. Instead, however, if countries actually proceeded to develop such a budget against the background of the generally accepted views regarding the structure of an income tax, the classification issues requiring discussion and analysis would quickly emerge and quickly yield to rational resolution. The consideration of the tax expenditure concept by the International Fiscal Association and the International Institute of Public Finance would support this view. The approach here suggested could initially apply to the income tax but should later be extended to other global-type taxes, such as the value added tax, the wealth tax, and the estate or inheritance tax.³⁴¹

If the OECD, or a European government or research organization, would thus develop an organized comparative approach to the use of tax expenditure data and analysis, it is to be hoped that other regional organizations such as The Organization of American States, ASEAN, and OAO, would in turn apply that approach to their studies. The United Nations and the International Monetary Fund in their analyses of fiscal systems similarly could assist countries in the use of the tax expenditure concept and also advance its application to comparative fiscal studies.

B. Impact of Tax Expenditure Concept in Particular International Tax Matters

The tax expenditure concept lies underneath the surface of a number of important international tax matters. The development of these particular matters has not expressly utilized that concept and its application as such has not been explored. Yet the problems involved and the range of solutions so far adopted or available nevertheless are susceptible to consideration in terms of tax expenditure analysis. The application of tax expenditure analysis to these international matters is, however, still in a tentative stage and much more exploration is in order.

1. GATT: DISC and the Exemption Approach to International Double Taxation

The European Communities and Canada have challenged the United States income tax provisions for exports, called DISC, as being contrary to the General Agreements on Tariffs and Trade (GATT) prohibition on export

³⁴¹ See also McDaniel, *The Tax Expenditure Concept in the International Context*, 47e MAANDBLAD BELASTINGBESCHOUWINGEN 115 (1978). The Rotterdam Institute for Fiscal Studies, Erasmus University, Rotterdam, which Institute is composed of lawyers and economists conducting research on tax policy issues of international concern, has announced that as a part of its research program for 1978-1979 it will undertake a project, "International Aspects of Tax Expenditures," scheduled for implementation in 1979.

subsidies. The DISC provisions technically provide a deferral of United States income tax on a portion of the profits earned by taxpayers exporting United States products.³⁴² A DISC is a separate domestic corporation, usually a paper company, to which a portion of the export profits may be allocated under a favorable artificial statutory formula that departs from section 482 arm's length pricing. Under the original DISC provisions, the corporate income tax was not applied to one-half of the export profits as long as that one-half was invested in export related assets. The amount of profit on which tax may be deferred, under 1976 legislation, is now governed by an incremental requirement which somewhat reduces that amount below one-half. The typical use of a DISC, under the statutory formula, is to allocate an artificial commission to the "paper" corporation on goods exported by the parent. Since the DISC has no employees, it obviously does nothing to earn the commission. Upon receiving the artificial commission, the DISC in turn invests its funds in the export accounts receivable of the parent exporter. In actual operation, the "deferral" of tax can become the practical equivalent of exemption.

The GATT asked a Panel of Experts to consider the European challenge to DISC. This Panel found DISC to be a proscribed export subsidy within the GATT rules. The Panel first examined the economic effect of the DISC legislation, and concluded that it "conferred a tax benefit . . . essentially related to exports."³⁴³ It then stated that "if the corporation income tax was reduced with respect to export related activities and was unchanged with respect to domestic activities for the internal market this would tend to lead to an expansion of export activity."³⁴⁴ Noting that, according to the United States Treasury, exports had increased as a result of the DISC legislation, and considering "the fact that so many DISCs had been created was evidence that DISC status conferred a substantial benefit,"³⁴⁵ the Panel concluded that the legislation should be regarded as an export subsidy. In determining whether the deferral of tax under the DISC provisions constituted a remission of tax or an exemption from tax, the Panel "was not convinced that a deferral, *simply* because it is given for an indeterminate period, was equal to a remission or an exemption."³⁴⁶ Nevertheless, the Panel noted that no provision was made for the interest component normally associated with a later or deferred payment of tax. As a result, the Panel ruled that the DISC legislation constituted a partial exemption from tax and hence a subsidy, leading presumptively to any or a combination of the following consequences in the export sector:

- (a) lowering of prices, (b) increase of sales effort and (c) increase of profits per unit. Because the subsidy was both significant and broadly based it was to be expected that all of these effects would

³⁴² I.R.C. §§ 991-997.

³⁴³ GENERAL AGREEMENT ON TARIFFS AND TRADE, UNITED STATES TAX LEGISLATION (DISC), REPORT OF THE PANEL L/4422, at 15-16, para. 67 (November 2, 1976).

³⁴⁴ *Id.*

³⁴⁵ *Id.* at para. 68.

³⁴⁶ *Id.* at para. 71 (emphasis in original).

occur and that, if one occurred, the other two would not necessarily be excluded. A concentration of the subsidy benefits on prices could lead to substantial reduction in prices. The Panel did not accept that a reduction in prices in export markets need automatically to be accompanied by similar reduction in domestic markets. These conclusions were supported by statements by American individuals and companies and the Panel felt that it should pay some regard to this evidence.³⁴⁷

The Panel therefore concluded that "the DISC legislation in some cases had effects which were not in accordance with the United States' obligations under Article XVI:4 [of the GATT],"³⁴⁸ and that "the various options under the DISC legislation for the allocation of profits from export sales, . . . could influence the size of the exemption."³⁴⁹

It is difficult to see how the Panel could reach any other conclusion. DISC is included in the United States tax expenditure budget and is thus recognized as the functional equivalent of an interest free government loan, potentially unlimited in duration, to United States exporters. It is defended by its supporters as an incentive to exports. Those supporters described in glowing terms its effect in increasing exports, which description, of course, turned into arguments utilized by the Europeans. Present Treasury thinking considers DISC as a waste of money in that, at a revenue cost of over \$1 billion, it produced at best only a \$2.9 billion increase in exports for the year 1976, less than 3 percent of total exports. Considering the interaction with flexible exchange rates and the possible displacement of non-DISC exports, the increase in exports engendered by DISC was probably even smaller.³⁵⁰ The Treasury approach thus regards DISC as a cost ineffective subsidy. The United States defense of DISC before the Panel was necessarily a weak one, given the circumstances surrounding DISC, and essentially rested on the assertion that a *deferral* of tax under DISC was not a subsidy. This was clearly an unacceptable argument to the economists on the Panel. The Panel decision on DISC thus broke no new ground but instead represented a rational acceptance of the strong arguments provided to the Europeans by the origins of DISC and the contentions of its supporters.

At the same time, however, the United States had, in effect, counter-claimed against the Europeans by claiming that their tax treatment of exports was also contrary to GATT. Thus, the United States pointed out that France under the "territoriality principle" in its income tax does not tax the income of foreign branches owned by French companies.³⁵¹ Consequently, where a French-owned foreign branch sold goods manufactured by a French com-

³⁴⁷ *Id.* at para. 73.

³⁴⁸ *Id.* at para. 74.

³⁴⁹ *Id.* at para. 75. See Rodriquez, III, *Note on Recent Development Under General Agreement on Tariffs and Trade (GATT)*, 18 HARV. INT'L L.J. 706 (1977).

³⁵⁰ See U.S. TREAS. DEPT., *THE OPERATION AND EFFECT OF THE DOMESTIC INTERNATIONAL SALES CORPORATION LEGISLATION*, 1976 ANNUAL REPORT (April 1978).

³⁵¹ The foreign branch must qualify, under French law, as a "permanent establishment" in the other country. This would make its profits taxable by that country if the country imposed an income tax.

pany, the profits on the sale by the branch were not taxed by France. In contrast, the United States would tax the company in this situation absent any use of DISC. France, under the "territoriality principle," also exempts from the French income tax 95 percent of the dividends received from a French-owned foreign subsidiary, the remaining 5 percent being considered as includable in income to offset the deductions by the parent of expenses attributable to the dividends. France does tax a French company on its profits on goods transferred to its foreign subsidiary, and thus taxes profits which DISC in effect partially exempts in the United States. In addition, France taxes exports to third parties, which are not fully taxed in the United States as a result of the DISC provision. But France does not, under its income tax, tax the foreign source income of its business taxpayers where that income is derived from a foreign branch or subsidiary.

In effect France, in tax terminology, uses the "territoriality principle" of only source taxation rather than worldwide taxation of income. This principle, in effect, results in the "exemption of foreign income" method of avoiding double taxation of international income by allowing exclusive tax jurisdiction to the country in which the income arises. With some variations, the Dutch and Belgian tax systems similarly use the territoriality principle, and hence the exemption approach.

The United States, in contrast, uses the "foreign tax credit" method. The United States imposes its tax on foreign branch profits of a United States company as the profits are earned, and on dividends from a subsidiary of a United States parent company when distributed to the parent, or constructively distributed under the "Subpart F" tax haven rules. The United States then grants a credit against its tax for the tax of the foreign country up to a limit which approximates the United States tax on the foreign source income. The tax jurisdiction of the foreign country—the country of income source—is thus a primary jurisdiction but not an exclusive jurisdiction.

The tax expenditure budget in the United States does not consider the foreign tax credit to be a tax expenditure, but instead regards that credit as an appropriate accommodation of the United States tax system to the tax systems of other countries. Nevertheless, since the basic premise of the United States income tax is that it is a worldwide tax, any treatment of foreign income or income related to foreign activities that reduces the initial United States tax on such income before application of the credit is a tax expenditure. Hence, the DISC deferral of export profits and "deferral" of tax on the income of United States controlled subsidiaries (apart from Subpart F), postponing imposition of United States tax until repatriation of the profits through distribution as a dividend, are regarded as tax expenditures, since these preferences undercut the worldwide jurisdictional basis of our normative income tax. The foreign tax credit does not undercut that jurisdictional basis, but instead accommodates the jurisdictional basis to the tax systems of source countries, thereby preventing "international double taxation."

One would suppose that if the French were to establish a tax expenditure budget they would not treat their exemption of foreign source income as a tax expenditure. Instead, presumably, they would regard their territoriality principle as a counterpart to our foreign tax credit approach, that is, as the

accommodation under the French normative concept of an income tax to other tax systems to avoid double taxation. While it may be argued that a foreign tax credit approach all in all is a better approach in today's tax world, the exemption system has its supporters. It is, for example, an alternative along with the foreign tax credit approach presented in the "Methods for Elimination of Double Taxation" of Article 23A of the OECD Model for bilateral tax conventions.³⁵²

Despite this analysis, in considering the United States claim that European tax treatment of exports violated GATT, the GATT Panel, consisting of the same individuals who made the DISC decision, ruled that the French treatment of foreign income from export sales abroad was a subsidy under GATT. The Panel again

started by examining the effects of the income tax practices before it in economic terms . . . [noting that] the particular application of the territoriality principle by France allowed some part of export activities, belonging to an economic process originating in the country, to be outside the scope of French taxes. In this way, France has foregone revenue from this source and created a possibility of a pecuniary benefit to exports in those cases where income and corporation tax provisions were significantly more liberal in foreign countries.³⁵³

The Panel further found that while these "practices may have been an incidental consequence of French taxation principles rather than a specific policy intention, they nonetheless constituted a subsidy on exports because the . . . benefits to exports did not apply to domestic activities for the internal market."³⁵⁴ The Panel also noted that the French tax treatment of dividends from abroad ensured that the benefits were fully preserved.³⁵⁵ The Panel concluded that "[i]n circumstances where different tax treatment in different countries resulted in a smaller total tax bill in aggregate being paid on exports than on sales in the home market, . . . there was a partial exemption from direct taxes."³⁵⁶ The same decision was reached by the GATT Panel for the Netherlands³⁵⁷ and for Belgium.³⁵⁸

The decision is certainly an interesting one. In tax expenditure terms, it appears to conclude that the territoriality principle and the "exemption"

³⁵² The "exemption" system is also presented as an alternative in the Draft Treaty being prepared by the U.N. Group of Experts on Treaties Between Developed and Developing Countries. See Surrey, *United Nations Group of Experts and the Guidelines for Tax Treaties Between Developed and Developing Countries*, 19 HARV. INT'L L.J. 1, 43 (1978).

³⁵³ GENERAL AGREEMENT ON TARIFFS AND TRADE, INCOME TAX PRACTICES MAINTAINED BY FRANCE, REPORT OF THE PANEL L/4423, at 11, para. 47 (November 2, 1976).

³⁵⁴ *Id.* at para. 48.

³⁵⁵ *Id.* at para. 49.

³⁵⁶ *Id.* at para. 50.

³⁵⁷ GENERAL AGREEMENT ON TARIFFS AND TRADE, INCOME TAX PRACTICES MAINTAINED BY THE NETHERLANDS, REPORT OF THE PANEL L/4425 (November 2, 1976).

³⁵⁸ GENERAL AGREEMENT ON TARIFFS AND TRADE, INCOME TAX PRACTICES MAINTAINED BY BELGIUM, REPORT OF THE PANEL L/4424 (November 2, 1976).

method of relief against double taxation as to exports are not an acceptable part of a normative tax system. This would leave the "foreign tax credit" method as the only acceptable approach. If this is so, it would equally appear that the "exemption" method is also a tax subsidy—though not a GATT export subsidy (unless goods exported from the residence country are involved in the foreign activities)—when applied to exempt from residence country tax the income of a foreign branch engaged in activities other than export sales, or the dividends of a foreign subsidiary earning profits from such activities. The GATT Panel decision would also support the United States classification of the deferral of tax on such foreign subsidiary profits as a tax expenditure, since it really implies that anything short of current taxation of those profits is a tax subsidy—though, again, not necessarily a GATT export subsidy since exports are not directly involved.

It is thus understandable that France and other countries using the territoriality principle and the "exemption" method cannot accept the decision of the GATT Panel. Their principal contention is that, whatever other countries may see as defects of that principle and the exemption method, they have a long historical base in European tax systems. Their defense of the method in the modern world is rested on this history and on tax jurisdiction concepts, rather than on the importance of continuing the "exemption" method to provide, in effect, a subsidy for exports and other foreign activities. If, of course, the defense were placed only on any subsidy effect of the "exemption" method, with a recognition that current realities made the history irrelevant and the jurisdictional basis outmoded, then the "exemption" method would not be acceptable as part of a normative income tax and would pass into the tax expenditure category.³⁵⁹ The GATT Panel decision may at least stimulate further reflection on the appropriate international accommodation of a country's income tax to the income taxes of the other countries of the world.³⁶⁰

³⁵⁹ In a world in which tax havens abound, the exemption method is a greater encouragement to their use than the foreign tax credit method. Hence, if exemption countries are willing to tolerate the unrestricted use by their business enterprises of tax havens, the suspicion would arise that there is more of subsidy present and less of historical or jurisdictional principle involved in the justification of the continued use of the exemption method. Of course, use of the foreign tax credit method is not per se a defense against tax havens if a deferral approach is allowed, but the foreign tax credit method may involve a day of some reckoning whereas the exemption method does not. French tax officials have said that France "watches out" for tax haven problems and hence its exemption approach in practice does not promote tax haven activities.

The use by developed countries of the exemption approach appeals to developing countries, for that approach meshes well, in the eyes of the developing countries and the enterprises affected, with the prevalent tendency of those countries to utilize tax incentive devices, e.g., tax holidays, accelerated depreciation, etc., to attract foreign investment. However, this inevitable effect of the exemption approach gives an aura of subsidy rather than of tax jurisprudence. This is not to say that the foreign tax credit approach represents a problem-free solution. The credit approach requires a consideration of the "tax sparing" issue, discussed in the text at note 362 *infra*.

³⁶⁰ The exemption system is justified by some on the ground that it pushes in the direction of source tax neutrality for foreign investment through its focus on the tax system of the source country. It thereby places all enterprises with activities in that

2. The Treaty of Rome

It appears that other international organizations may need to utilize tax expenditure analysis to decide substantive issues of interpretation in the international agreements they enforce. Thus, Articles 92-94 of the Treaty of Rome impose limits on "aid" (*Beihilfen*) granted by a Member State "in any form whatsoever" that distorts competition. The Commission of the European Communities has taken the position that State "aid" includes financial benefits provided through preferential tax provisions. This view appears to have been upheld, at least implicitly, by the Court of Justice of the European Communities.³⁶¹ Under this view, the application of the Treaty provision would be facilitated by development of internationally accepted criteria for differentiating provisions that constitute part of the normative structure of the various tax systems employed by Common Market Countries, which should not constitute "aids" under Article 92-94, and deviations from the normative structure, which should constitute "aids" or tax expenditures within the Treaty terms. Of course, denominating a particular provision as a tax "aid" does not imply that it constitutes per se a violation of the Treaty. It simply means that the same standard Treaty test of distortion of competition should be applied equally to tax aids as to direct aids.

3. Double Taxation Treaty Principles and Negotiations

Tax expenditure analysis may be helpful in approaching some present issues in formulating and negotiating bilateral tax treaties regarding double taxation. Two illustrations are tentatively presented here, since the application of the tax expenditure analysis to this area is still in a formative stage.

a. *Tax Sparing*. While some developed countries are willing, in a limited way, to extend by treaty "tax sparing" foreign tax credits to taxes foregone by developing countries under the latter's tax incentive provisions, the United States has thus far resolutely refused to allow these tax sparing credits.³⁶² Suppose, however, a developing country makes the following argument to the United States: "We are both countries that use tax expenditure analysis. If we

country, whether domestic or foreign owned, on the same income tax footing as to those activities. But such neutrality can only be achieved if all residence countries utilize the exemption approach. The foreign tax credit approach focuses on residence country neutrality—and thus appeals to many economists—in that enterprises resident therein, whether investing at home or abroad, are subject to the same income tax (as long as the source country tax does not exceed the residence country tax). This latter neutrality can be achieved by a particular country using the tax credit method regardless of the method used by other countries. Thus, given the desire of many countries to use the foreign tax credit method, the exemption method is inherently incapable of achieving the objective posited by those using the source tax neutrality justification.

³⁶¹ See Ault, *supra* note 333.

³⁶² For a historical reference on this official United States position, see S. SURREY, *The United States Tax System and International Tax Relationships*, in *TAX POLICY AND TAX REFORM: 1961-1969, SELECTED SPEECHES AND TESTIMONY OF STANLEY S. SURREY* 317 (W. Hellmuth & O. Oldman eds. 1973). See also Liebman, *A Formula For Tax-Sparing Credits in U.S. Tax Treaties With Developing Countries*, 72 *AMER. J. OF INT'L L.* 296 (1978).

utilized a system with no tax expenditures and, say, a 40 percent corporate rate, and then used a direct spending program to increase investment, such as having our Commerce Ministry issue checks for 10 percent of the costs of investment in equipment, the United States would credit the regular tax paid by a branch or subsidiary of a United States enterprise. The direct subsidy would, of course, be includable in income or treated as a contribution to capital and subtracted from cost in determining the depreciation basis for United States tax purposes. Suppose, instead, we utilize a 10 percent investment credit. Under present United States policy, only our tax as reduced by the investment credit would be allowed as a foreign tax credit. Yet, since we classify the investment credit as a tax expenditure, and thus the equivalent to a direct program—and so does the United States—you should view the result as if our full regular tax were paid and therefore grant a tax sparing credit by treaty. The United States, of course, may require the amount of the credit to be included in income or may reduce basis for purposes of computing the recipients' United States tax liability. The investment credit would thereby be regarded as the equivalent of a direct spending program."³⁶³ If we assume that United States tax technicians are wary of tax sparing, and keep in mind the historical United States position and the conventional arguments, do tax technicians have rational answers to offer the developing country?

The answer to this question lies in an examination of the techniques used by developing countries to attract investment. There would seem to be at least five categories of these techniques:

- (1) a lower overall regular tax rate—here the United States would only credit the reduced tax;
- (2) a tax expenditure incentive, such as the investment credit, accelerated depreciation, or the special tax holiday—here the United States under present practice would only credit the reduced tax;
- (3) collection of the regular tax, but a direct grant program directly or closely linked to the tax paid, such as a percentage of that tax, so as to rebate in effect part of that tax—here the United States under present practice would only credit the net amount, regular tax less rebate, even where there was proper United States income tax treatment of the grant;³⁶⁴

³⁶³ The consequence of proper income tax treatment by the United States of the investment credit and of the recognition of a tax sparing credit would be to split the benefit of the investment credit between the taxpayer and the United States Treasury, assuming a United States tax rate of 50%.

³⁶⁴ See Rev. Rul. 69-433, 1969-2 Cum. Bull. 153, ruling that a Virgin Islands subsidy of 75% of the Virgin Islands income tax, which subsidy was paid under the Virgin Islands Industrial Incentive Program, reduces the amount of creditable tax. This view was followed in *HMW Industries, Inc. v. Wheatley*, 504 F.2d 146 (3d Cir. 1974), in holding the subsidy to be a tax reduction and not a non-shareholder contribution to capital, so that a reduction in the basis of the recipient corporation's assets was not required. Note also the IRS position that a Brazilian Central Bank subsidy of 85% of the withholding tax of 25% on interest levied by Brazil on interest paid by Brazilian borrowers to foreign lenders, which lenders usually require the Brazilian borrower to absorb the 25% withholding tax, reduces the amount of the withholding tax that can be credited by the lender. Rev. Rul. 78-258, 1978-26 I.R.B. 17. This

- (4) collection of the regular tax and a direct grant program not linked to the tax paid but instead paralleling in content the tax expenditure, such as direct cash assistance for investment—here the United States would under the present practice credit the full tax paid, but would properly treat the cash assistance as a contribution to the capital of the recipient and reduce the tax basis of its investment assets;
- (5) collection of the regular tax and a direct program not paralleling the tax expenditure, such as a highway program or a port facility for a number of enterprises—here the United States would credit the full tax paid.

Case (1) clearly seems to present a proper result. Case (5) also seems clear at the opposite pole from case (1). Cases (2), (3), and (4), however, raise the issue posed earlier. If it is said that a credit should not be allowed for the tax paid in case (3)—the direct program linked to the tax, but an initial “payment” of the full tax—then a fortiori no credit should be allowed for the tax reduction in case (2), where there is in fact only a lower tax payment since the tax expenditure is an item that directly determines the final tax. Conversely, if a credit is allowed in case (2) for the full tax, including the reduction effected by the tax expenditure, it would seem that a credit for the full tax should be allowed in case (3), in view of the “payment” of the full amount of the tax. While under present practice it would seem strange to allow a credit in case (3), since the direct subsidy linked to the tax would seem to make it indistinguishable from the overall rate reduction in case (1), still the argument for the “tax sparing” credit earlier presented does, as indicated above, extend to both cases (2) and (3). That argument, of course, rests on the allowance, under present practice, of a credit for the full tax in case (4), assuming that the appropriate United States income tax treatment is applied to the direct assistance.

The answer that the United States Treasury tax treaty policy officials might make to the argument earlier advanced supporting recognition of a tax credit in cases (2) and (3) would be the following: “The present foreign tax credit is aimed at preventing duplicative income tax payments. That is the fundamental policy underlying the tax credit mechanism. Hence, the result in case (1). Case (3) follows then a fortiori since the tax payment is by hypothesis always linked with an offsetting ‘grant’ and no tax sparing credit should be allowed as a matter of *foreign tax credit* policy. In other words, if there is in fact no double tax payment either because of an overall rate reduction (as in case (1)) or because the ‘payment’ is simultaneously offset by a related direct

position reversed letter rulings previously granted to U.S. banks stating that the full 25% tax was creditable. For discussions of this Brazilian situation, see McIntyre, *The Foreign Tax Credit and the Brazilian Rebate*, 6 TAX NOTES NO. 4 at 67 (Jan. 23, 1978); Guttentag and Nauheim, *The Foreign Tax Credit and the Brazilian Rebate: A Reply*, 6 TAX NOTES NO. 14 at 351 (April 3, 1978); *Response of Michael J. McIntyre*, 6 TAX NOTES NO. 14 at 354 (April 3, 1978); Surrey, *Foreign Tax Credit Issues in Relation to Developing Countries: Withholding Taxes on Interest Payments and Discriminatory Taxes* (in forthcoming publication by Columbia University Center for Law and Economics of its Conference on “United States Taxation and Developing Countries,” at 27-28 (1978)).

payment (as in case (3)), then no credit should be allowed. As to case (2) and the argument based on tax expenditure analysis, case (2) involves a 'duplication' of income tax payment if a tax expenditure is regarded as a constructive payment of tax and then a constructive direct expenditure. But it must be recognized that granting a tax sparing credit in case (2), in the real world, is an invitation to the widespread use of tax incentives since, like the exemption method, it focuses the attention of multinational enterprises on securing tax incentives from developing countries. In the real world, tax incentives are far easier to push past policy officials and legislatures than are direct expenditures. Hence, it is not enough for a developing country to say 'We use tax expenditure analysis.' Rather, the questions are, 'Do you really mean that? Do you test your tax expenditures rigorously and use them only when you really would vote funds for a direct program and hence are *only* using the tax spending route for really valid reasons?' Since presumably no country, including the United States, can answer those questions 'yes' under oath, the argument of the developing country presented earlier would seem to be lacking reality. Given the essential inability of adequately testing the rigidity of the adherence to the full implications of tax expenditure analysis, the wisest approach for the United States is to remain with its refusal to allow tax sparing credits. Under this view, with a tax sparing credit thus denied in case (2), a full credit, as stated earlier, must be denied in case (3), since otherwise case (2) is easily sidestepped. A full foreign tax credit would continue to be allowed in case (4) since such direct monetary grants, not linked to the tax payment as in case (3), are accepted fiscal techniques."

The advocates of the tax sparing credit might reply as follows: "We were earlier urging a proper conceptual approach under tax expenditure analysis to support the allowance of the 'tax sparing' credit. It is not proper under the conceptual approach for the United States to look behind our tax provisions or direct grants and consider what factors led to the choice. After all, the United States has many tax expenditures involving large amounts, so that it is inappropriate for the United States to question why our country has tax expenditures in its system. Further, if our argument is valid as to case (2), then there should also be a credit in case (3) since there would be no point in differentiating these situations."

Here the matter rests. One suspects that pragmatists would stand by the present United States approach and not accept the conceptual analysis offered to support the tax sparing credit in case (2) or the credit in case (3). Also, one senses in the real world that such a course of action is the wiser one, for both the United States and especially the developing countries. While those countries may perhaps resent the United States' effort to "protect them" from the use of tax incentives and tax expenditures, still the United States' experience with these devices, objectively utilized, certainly provides the United States with full credentials to offer advice. Finally, the argument based on *duplicative tax payments* to deny a credit in case (3)—tax payment and grant linked to tax—is a strong one and if accepted it would also deny a credit in case (2)—tax expenditure built into the tax system.

b. *Treaty Negotiations.* The use of tax expenditure analysis may help in assessing the appropriateness of proposals, other than tax sparing, advanced

by countries in negotiations over a particular double taxation income treaty. As general propositions, the following can presumably be stated: First, assuming that withholding taxes on gross amounts are part of a normative tax structure, Country A is entitled to obtain application of the normative income tax structure of Country B for the residents of Country A receiving income from passive investment or activities in Country B which do not involve a trade or business there. The denial of the benefit of a normative tax provision would be a tax penalty imposed on Country A residents but not on Country B residents. Second, Country A is not entitled to insist on obtaining for its residents receiving income from Country B a tax expenditure not granted by Country B to its own residents. These results would seem to be aspects of the proper application of the non-discrimination clause contained in the usual tax treaty. Third, Country A is not entitled to obtain for its residents the application of the tax expenditure provisions of the income tax of Country B just because they are receiving such income from Country B. Since Country B presumably could limit its direct spending provisions to residents of Country B, it can, if it so wishes, likewise limit its tax expenditures. Fourth, if, however, a resident of Country A is engaged in trade or business through a permanent establishment in Country B or is the sole shareholder of a Country B corporation, with such permanent establishment or corporation subject to the Country B basic income tax, then Country A is entitled to obtain both the normative tax provisions and the tax expenditure provisions of the Country B income tax for the permanent establishment or corporation. This result also would seem to be involved in the proper application of the non-discrimination clause. This last statement assumes that Country B could not deny to the permanent establishment or corporation the assistance available under a direct spending program of Country B. Finally, Country A is not entitled to obtain for the permanent establishment or corporation a tax expenditure not otherwise granted by Country B (similar to the second proposition above). Thus, tax expenditure analysis becomes a helpful device to shape the contours of the non-discrimination clause and otherwise guide tax treaty negotiations.

The foregoing line of reasoning can be applied to the troublesome issues arising in negotiations over the international application of a particular country's corporation income tax when that tax involves a form of "integration" with the individual income tax. This problem is especially difficult in negotiations between a country with a "classical" corporation tax and a country with an "imputation" system or other form of integration.³⁶⁵ If Country A has a classical corporate tax and Country B an imputation system, such as a shareholder credit, then for Country B to insist on obtaining a shareholder credit from Country A for shareholder-residents of Country B receiving dividends from Country A corporations would be equivalent to asking Country A to provide a tax expenditure for Country B shareholders. The same would be true if Country B asked for a "split rate" or dividend deduction as to dividends paid by Country A corporations to such shareholder-residents in Country B.

³⁶⁵ For a discussion of this subject, see Ault, *International Issues in Corporate Tax Integration*, 10 *LAW & POLY IN INT'L BUS.* 461 (1978).

On the other hand, if Country B has an imputation system under which it grants a shareholder credit to Country B residents who are shareholders in Country B corporations, and *if* that imputation system is regarded as a normative part of the Country B domestic income tax structure, the problem is more difficult. Essentially the question then becomes one of how Country B regards the international application of its domestic imputation system in the absence of treaty, that is, would its normative system differentiate or not differentiate between resident and foreign shareholders. If it is the latter—no differentiation—then Country A in asking for application of the imputation credit to Country A residents who are shareholders in Country B corporations is simply asking for non-discriminatory application of the Country B normative structure. Presumably, Country A would not even have to ask for such application since, by hypothesis, that application should be in existence under the assumption as to the Country B normative structure. If it is the former—differentiation—then Country A is asking Country B to create a new tax expenditure. The treaty non-discrimination clause would not seem to require that the shareholder credit be extended to foreign shareholders. However, if Country B has a split-rate system or a dividend deduction system, then while a country could unilaterally not extend that treatment to dividends paid to foreigners if the country so regarded its normative tax structure, under the treaty non-discrimination clause the split-rate or deduction might have to be applied to those dividends.

The difficulty with the above discussion is the lack of a clear answer to the question of what is the normative income tax structure of domestic "integration" systems as applied unilaterally in an international context. If a split-rate or deduction method of integration is used, the present general tendency is unilaterally to apply the consequences to all dividends, even those going to foreign shareholders, presumably because of the influence of the non-discrimination clause as applied at the corporate level. If, however, a shareholder credit approach is used, the general tendency is unilaterally to deny the credit to foreign shareholders.³⁶⁶

Somewhat the same analytical issues arise with the question whether a country with an imputation system, including deduction at the corporate level, must apply that system to the foreign source income of its domestic corporations. Behind all these questions is also the question whether the answer turns

³⁶⁶ Some countries by treaty, *e.g.*, France and the United Kingdom, extend the imputation credit to foreign individual shareholders. The United Kingdom in the U.K.-U.S. pending treaty and in the U.K.-Netherlands treaty also extends the credit to foreign parent corporations, but it is uncertain whether other imputation countries will take that course.

Some countries may argue that an imputation system applied to domestic shareholders but denied to foreign shareholders constitutes, in effect, an increase in the dividend withholding tax applied to foreign shareholders. A country under international rules is free to set that tax at the rate level it chooses. A treaty negotiation, however, involves a consideration of the rate level of withholding taxes. In this view, the treaty country not having an imputation system would contend it is entitled to a lower treaty withholding rate on dividends than the treaty withholding rate specified for the imputation country.

on the unilateral approach to prevention of double taxation utilized by a country, such as the exemption method or the foreign tax credit method.³⁶⁷ The lack, as yet, of clear answers to these questions involving the determination of a normative tax structure in this context indicates the need for more study. In the meantime, however, treaty negotiations must proceed. Even though definitive guidelines are lacking, the negotiations should attempt to distinguish between the issues involving a normative application of a tax provision and the issues involving a request for the creation of a new tax expenditure.

The corporate integration area would seem to be only one example of how tax expenditure analysis may help to sharpen the thinking on troublesome issues in treaty negotiations. The appropriate resolution of the treatment of "non-permanent residents" may be another example—what should their tax treatment be in comparison, on the one hand, with transients in a country and, on the other hand, with the indigenous permanent residents or citizens of the country. This discussion obviously does not attempt to catalogue all such possible applications of tax expenditure analysis nor to determine the answers produced by that analysis.³⁶⁸ The intent instead is to indicate the apparent relevance of tax expenditure analysis as a guide to the solution of troublesome international issues of the character here described.

VII. STATE AND LOCAL TAX EXPENDITURES

Those concerned with state and local taxes are gradually coming to apply tax expenditure analysis to such taxes. For example, the budget submitted annually by the Governor of the State of California has, since the 1975-1976 Budget, contained a list of major tax expenditures effected through the principal taxes employed by the State. For 1977-1978, the total of such tax expenditures was over \$3.5 billion. The discussion in the Governor's Budget Summary also reveals a clear perception of the relationship between traditional tax reform efforts and the tax expenditure analysis.³⁶⁹

Apart from special tax provisions written in by the states themselves, many states automatically adopt all or parts of federal tax expenditures. This result occurs whenever a state bases its income tax on the federal income tax. Automatic adoption of federal tax expenditures by a state may, of course, have marked effects on its own fiscal policy and may result in expenditures of state funds for purposes or in amounts that would never be approved for direct support by its legislature. A list of these "passive" tax expenditures has

³⁶⁷ *Ault, supra* note 333.

³⁶⁸ See note 44 *supra*, indicating how tax expenditure analysis is useful in shaping guidelines to determine the qualification of a tax as an "income tax" under the foreign tax credit provisions.

³⁶⁹ See 1977-1978 GOVERNOR'S BUDGET SUMMARY, STATE OF CALIFORNIA A-51 to A-57 (1977). The need for a similar tax expenditure list for Massachusetts has been recognized and called for by a non-governmental group. See MASS. COUNCIL OF CHURCHES & MASS. FOUNDATION FOR HUMANITIES AND PUB. POL'Y, TAXES: FAIR OR FOUL? AN ETHICAL OVERVIEW OF TAXATION IN MASSACHUSETTS 33 (1977).

been prepared for the State of Colorado.³⁷⁰ Other states that have based their tax system in whole or in part on the federal income tax would be assisted by similar lists in the implementation of their tax and spending policies.

CONCLUSION

During the period from 1976 to 1978, the practical application of the tax expenditure concept and the theoretical analysis of its implications continued to expand, both nationally and internationally. Yet, progressive implementation of the concept requires increased study by tax and budget experts in and out of government. The task of educating the taxpaying public, and their elected representatives, to understand both the concept and the effects of tax expenditures on tax equity and budget efficiency is also an ongoing one.

³⁷⁰ Hildred, *Passive Tax Expenditures in State Income Taxes*, reprinted in 123 CONG. REC. S12905 (daily ed. July 27, 1977).

APPENDIX A*
TAX EXPENDITURE ESTIMATES BY FUNCTION¹
(In millions of dollars)

Description	Corporations			Individuals		
	1977	1978	1979	1977	1978	1979
National defense:						
Exclusion of benefits and allowances to Armed Forces personnel				1,095	1,260	1,370
Exclusion of military disability pensions				105	115	120
International affairs:						
Exclusion of income earned abroad by U.S. citizens				545	360	385
Deferral of income of domestic international sales corporations (DISC)	945	1,135	1,335			
Deferral of income of controlled foreign corporations	570	615	665			
Special rate for Western Hemisphere trade corporations	35	25	15			
General science, space, and technology:						
Expensing of research and development expenditures	1,395	1,450	1,520	30	30	30
Energy:						
Expensing of exploration and development costs	820	885	965	210	300	300
Excess of percentage over cost depletion	1,090	1,120	1,210	305	340	370
Capital gains treatment of royalties on coal ..	10	15	15	45	50	60
Natural resources and environment:						
Exclusion of interest on State and local government pollution control bonds	170	220	265	85	110	130
Exclusion of payments in aid of construction of water and sewage utilities	15	10	10			
5-yr. amortization on pollution control facilities	-80	-130	-45			
Tax incentives for preservation of historic structures			5			5
Capital gains treatment of certain timber income	185	205	230	55	60	65
Capital gains treatment of iron ore	5	5	10	5	5	10
Agriculture:						
Expensing of certain capital outlays	80	70	75	375	445	460
Capital gains treatment of certain ordinary income	10	10	10	330	350	365
Deductibility of noncash patronage dividends and certain other items of cooperatives ..	455	490	525	-165	-175	-185
Commerce and housing credit:						
Dividend exclusion				450	475	505
Exclusion of interest on State and local industrial development bonds	195	235	270	95	115	135
Exemption of credit union income	70	80	90			
Excess bad debt reserves of financial institutions	535	705	790			
Deductibility of mortgage interest on owner-occupied homes				4,490	4,985	5,530
Deductibility of property tax on owner-occupied homes				4,205	4,665	5,180
Deductibility of interest on consumer credit ..				1,785	2,120	2,350
Expensing of construction period interest and taxes	475	500	525	150	140	90
Excess first-year depreciation	45	45	50	140	145	155
Depreciation on rental housing in excess of straightline	80	70	70	320	300	290

TAX EXPENDITURE ESTIMATES BY FUNCTION¹—Continued
(In millions of dollars)

Description	Corporations			Individuals		
	1977	1978	1979	1977	1978	1979
Commerce and housing credit—Continued						
Depreciation on buildings (other than rental housing) in excess of straight line		140	130	140	125	115
Asset depreciation range	1,955	2,245	2,640	100	115	135
Capital gains (other than farming, timber, iron ore, and coal)	520	540	575	6,910	7,430	7,990
Deferral of capital gains on home sales				890	935	980
Capital gains at death				7,280	8,120	8,975
Corporate surtax exemption	3,875	3,885	3,540			
Investment credit	8,880	10,735	12,320	2,075	2,390	2,725
Credit for purchase of new homes				100		
Transportation:						
Deductibility of nonbusiness State gasoline taxes				685	760	840
5-yr. amortization on railroad rolling stock ..	-35	-40	-40			
Deferral of tax on shipping companies	130	105	85			
Community and regional development: 5-yr. amortization for housing rehabilitation ...	10	5	5	15	10	5
Education, training, employment, and social services:						
Exclusion of scholarship and fellowship income				245	295	330
Parental personal exemption for students age 19 or over				750	770	790
Exclusion of employee meals and lodging (other than military)				280	300	325
Exclusion of contributions to prepaid legal services plans				5	10	15
Investment credit for employee stock ownership plans (ESOPs)	245	255	305			
Deductibility of charitable contributions (education)	235	255	285	525	585	645
Deductibility of charitable contributions to other than education and health	290	315	350	3,935	4,370	4,855
Maximum tax on personal service income ...				555	665	800
Credit for child and dependent care expenses				475	525	575
Credit for employment of AFDC recipients and public assistance recipients under work-incentive programs	15	15	20			
Jobs credit	565	1,475	1,035	125	985	860
Health:						
Exclusion of employer contributions for medical insurance premiums and medical care				5,560	6,340	7,225
Deductibility of medical expenses				2,230	2,435	2,655
Expensing of removal of architectural and transportation barriers to the handicapped ..	5	10	10			
Deductibility of charitable contributions (health)	145	160	175	790	875	970
Income security:						
Exclusion of social security benefits: Disability insurance benefits				470	550	605
OASI benefits for retired workers				3,790	4,210	4,700
Benefits for dependents and survivors				860	950	1,040
Exclusion of railroad retirement system benefits				250	265	280

TAX EXPENDITURE ESTIMATES BY FUNCTION¹—Continued
(In millions of dollars)

Description	Corporations			Individuals		
	1977	1978	1979	1977	1978	1979
Income security—Continued						
Exclusion of workmen's compensation benefits				720	835	970
Exclusion of special benefits for disabled coal miners				50	50	50
Exclusion of unemployment insurance benefits				1,500	1,200	1,135
Exclusion of public assistance benefits				330	345	360
Exclusion of sick pay				110	75	60
Net exclusion of pension contributions and earnings:						
Employer plans				8,715	9,940	11,335
Plans for self-employed and others				1,390	1,650	1,920
Exclusion of other employee benefits:						
Premiums on group term life insurance				860	905	955
Premiums on accident and disability insurance				70	75	80
Income of trusts to finance supplementary unemployment benefits				10	10	10
Exclusion of interest on life insurance savings				1,850	2,025	2,225
Exclusion of capital gains on home sales for persons age 65 and over				40	70	70
Additional exemption for elderly				1,140	1,155	1,215
Additional exemption for the blind				20	20	20
Excess of percentage standard deduction over minimum standard deduction				530		
Deductibility of casualty losses				320	360	395
Tax credit for the elderly				230	250	255
Earned income credit:						
Nonrefundable portion				365	285	265
Refundable portion				900	945	900
Veterans benefits and services:						
Exclusion of veterans disability compensation				745	840	830
Exclusion of veterans pensions				35	40	40
Exclusion of GI bill benefits				260	200	170
General government:						
Credits and deductions for political contributions				85	60	75
General purpose fiscal assistance:						
Exclusion of interest on general purpose State and local debt	3,105	3,470	3,865	1,725	1,925	2,150
Deductibility of nonbusiness State and local taxes (other than on owneroccupied homes and gasoline)				7,660	8,505	9,440
Tax credit for corporations doing business in U.S. possessions	450	485	520			
Interest:						
Deferral of interest on savings bonds				585	625	670
MEMORANDUM						
Combined effect of provisions disaggregated above:						
Capital gains	730	775	840	15,555	17,020	18,515
Exclusion of interest on State and local debt	3,470	3,925	4,400	1,905	2,150	2,415
Deductibility of State and local nonbusiness taxes				11,105	12,325	13,680
Deductibility of charitable contributions	670	730	810	5,250	5,830	6,470

¹All estimates are based on the tax code as of Dec. 31, 1977.

*The Table is from Office of Management and Budget of The United States Government, Fiscal Year 1979, Special Analyses 158-160 (1978) (Special Analyses G, Table G-1).

APPENDIX B*
DISTRIBUTION OF TAX EXPENDITURES AFFECTING INDIVIDUALS
BY INCOME GROUP: FISCAL YEAR 1977

(Dollars in millions)

Expanded Income Class (\$000)	Thousands of returns filed (estimated) ¹	Percentage of returns in Income Group	Tax Expenditures received by Income Group	Percentage of Tax Expenditures received by Income Group
0- 5 }	25,474 }			
5-10 }	20,109 }	51.8%	10,027	11.9%
10-15 }	16,106 }			
15-20 }	11,824 }	31.7%	17,410	20.7%
20-30 }	9,907 }			
30-50 }	3,347 }	15.1%	30,361	36.1%
50-100 }	985 }			
100-200 }	198 }			
200 and over }	49 }	1.4%	26,247	31.3%
Total	87,998	100.0%	84,045	100.0%

*Source: U.S. Treasury Department.

¹Calendar 1977.

Expanded Income Class (\$000)	(1)		(2)		(3)		(4)		
	Percentage of returns in Income Group	Benefits and allowances to Armed Forces Personnel	Percentage distribution by Group	Exclusion of Military Disability Pensions	Percentage distribution by Group	Exclusion of Income Earned Abroad	Percentage distribution by Group	Capital Gains Treatment of Timber	Percentage distribution by Group
0-5	51.8%	125	52.5%	10	47.6%	10	7.3%	*	1.8%
5-10		450		40		30		1	
10-15	31.7%	270	36.9%	25	38.1%	27	12.5%	1	5.4%
15-20		135		15		41		2	
20-30	15.1%	55	8.2%	10	13.3%	102	50.8%	5	25.5%
30-50		45		4		175		9	
50-100	1.4%	10	1.4%	1	1.0%	104	29.4%	11	67.3%
100-200		4		*		40		17	
200 and over		1		*		16		55	
Total	100.0%	1,095	100.0%	105	100.0%	545	100.0%	55	100.0%

Expanded Income Class (\$000)	(5)		(6)		(7)		(8)		
	Percentage of returns in Income Group	Capital Gains Treatment of Iron Ore	Percentage distribution by Group	Expensing Exploration and Development	Percentage distribution by Group	Interest on State and Local Pollution Control Bonds	Percentage distribution by Group	Excess of Percentage Over Cost Depletion	Percentage distribution by Group
0-5	51.8%	*	0.0%	2	2.4%	*	0%	3	2.3%
5-10		*		3		*		4	
10-15	31.7%	*	0.0%	3	3.8%	*	1.2%	4	3.6%
15-20		*		5		1		7	
20-30	15.1%	*	20.0%	8	19.0%	3	11.8%	11	18.7%
30-50		1		32		7		46	
50-100	1.4%	1	80.0%	47	74.8%	26	87.0%	70	75.4%
100-200		1		45		19		65	
200 and over		2		65		29		95	
Total	100.0%	5	100.0%	210	100.0%	85	100.0%	305	100.0%

Expanded Income Class (\$000)	(9)		(10)		(11)		(12)		
	Percentage of returns in Income Group	Capital Gains on Coal Royalties	Percentage distribution by Group	Capital Gains Treatment of Farm Income	Percentage distribution by Group	Expensing of Farm Capital Outlays	Percentage distribution by Group	Deduction for Mortgage Interest	Percentage distribution by Group
0-5	51.8%	*	2.2%	1	1.5%	2	5.3%	3	2.0%
5-10		1		4		18		89	
10-15	31.7%	1	6.7%	9	7.0%	31	18.1%	354	24.6%
15-20		2		14		37		748	
20-30	15.1%	4	24.4%	27	23.6%	64	41.9%	1,613	61.1%
30-50		7		51		93		1,131	
50-100	1.4%	9	66.7%	68	67.9%	78	34.7%	470	12.3%
100-200		7		56		27		68	
200 and over		14		100		25		14	
Total	100.0%	45	100.0%	330	100.0%	375	100.0%	4,490	100.0%

Expanded Income Class (\$000)	(13)		(14)		(15)		(16)		
	Percentage of returns in Income Group	Deduction for Real Estate Taxes	Percentage distribution by Group	Deduction of Interest on Consumer Credit	Percentage distribution by Group	Credit For New Home Purchase	Percentage distribution by Group	Deferral of Capital Gain on Home Sales	Percentage distribution by Group
0-5	51.8%	6	1.9%	1	2.0%	1	4.0%	9	4.0%
5-10		75		35		3		27	
10-15	31.7%	280	19.4%	141	24.5%	17	43.0%	151	42.8%
15-20		535		297		26		230	
20-30	15.1%	1,194	53.0%	641	61.2%	34	49.0%	300	48.3%
30-50		1,033		450		15		130	
50-100	1.4%	679	25.7%	187	12.3%	3	4.0%	30	4.9%
100-200		253		27		1		10	
200 and over		150		6		*		3	
Total	100.0%	4,205	100.0%	1,785	100.0%	100	100.0%	890	100.0%

Expanded Income Class (\$000)	(17)			(18)			(19)			(20)		
	Percentage of returns in Income Group	Dividend Exclusion	Percentage distribution by Group	Capital Gains General	Percentage distribution by Group	Capital Gains at Death	Percentage distribution by Group	Excess of Straight Line	Percentage distribution by Group	Depreciation in Rental Housing	Excess of Straight Line	Percentage distribution by Group
0-5		7		27		29		3		3		
5-10	51.8%	34	9.1%	94	1.7%	99	1.8%	4		4		2.2%
10-15		50		184		194		4		4		
15-20	31.7%	58	24.0%	290	6.9%	305	6.9%	7		7		3.4%
20-30		111		558		588		12		12		
30-50	15.1%	105	48.0%	1,077	23.7%	1,134	23.6%	48		48		18.8%
50-100		63		1,429		1,506		73		73		
100-200	1.4%	17	18.9%	1,166	67.7%	1,228	67.7%	68		68		75.6%
200 and over		5		2,085		2,197		101		101		
Total	100.0%	450	100.0%	6,910	100.0%	7,280	100.0%	320		320		100.0%

Expanded Income Class (\$000)	(21)			(22)			(23)			(24)		
	Percentage of returns in Income Group	Other Depreciation in excess of straight line	Percentage distribution by Group	Expensing of Research and Development	Percentage distribution by Group	Exclusion of interest on industrial development bonds	Percentage distribution by Group	Excess First Year Depreciation	Percentage distribution by Group	Excess First Year Depreciation	Percentage distribution by Group	
0-5		1		*		*		1		1		
5-10	51.8%	2	2.1%	*	0.0%	*	0.0%	2		2		2.1%
10-15		2		*		*		2		2		
15-20	31.7%	3	3.6%	1	3.3%	2	32.1%	3		3		3.6%
20-30		5		1		3		5		5		
30-50	15.1%	21	18.6%	4	16.7%	8	11.6%	21		21		18.6%
50-100		32		8		29		32		32		
100-200	1.4%	30	75.7%	6	80.0%	21	86.3%	30		30		75.7%
200 and over		44		10		32		44		44		
Total	100.0%	140	100.0%	30	100.0%	95	100.0%	140		140		100.0%

Expanded Income Class (\$000)	(25)		(26)		(27)		(28)		
	Percentage of returns in Income Group	Expensing of Construction Period interest and Taxes	Percentage distribution by Group	Investment Credit	Percentage distribution by Group	Asset Depreciation Range	Percentage distribution by Group	State Gasoline Taxes	Percentage distribution by Group
0- 5 } 5- 10 } 10- 15 } 15- 20 } 20- 30 } 30- 50 } 50-100 } 100-200 } 200 and over	51.8% 31.7% 15.1% 1.4%	1 } 2 } 2 } 3 } 6 } 22 } 34 } 32 } 48 }	2.0% 3.3% 18.7% 76.0%	16 } 144 } 264 } 237 } 388 } 412 } 336 } 160 } 118 }	7.7% 24.1% 38.6% 29.6%	1 } 2 } 4 } 5 } 8 } 20 } 17 } 18 } 25 }	3.0% 9.0% 28.0% 60.0%	1 } 21 } 76 } 136 } 249 } 138 } 50 } 11 } 3 }	3.2% 30.9% 56.5% 9.4% 100.0%
Total	100.0%	150	100.0%	2,075	100.0%	100	100.0%	685	100.0%

Expanded Income Class (\$000)	(29)		(30)		(31)		(32)		
	Percentage of returns in Income Group	5-year Amortization Housing Rehabilitation	Percentage distribution by Group	Exclusion of Scholarships and Fellowships	Percentage distribution by Group	Parental personal exemption for students 19 and over	Percentage distribution by Group	Charitable contributions for education	Percentage distribution by Group
0- 5 } 5- 10 } 10- 15 } 15- 20 } 20- 30 } 30- 50 } 50-100 } 100-200 } 200 and over	51.8% 31.7% 15.1% 1.4%	* } * } * } 1 } 2 } 3 } 4 } 5 }	0.0% 0.0% 20.0% 80.0%	40 } 80 } 60 } 35 } 15 } 10 } 5 } * }	49.0% 38.8% 10.2% 2.0%	5 } 110 } 240 } 193 } 44 } 45 } 88 } 20 }	15.3% 57.7% 11.9% 15.1%	* } 2 } 5 } 12 } 25 } 96 } 87 } 98 } 200 }	0.4% 3.2% 23.1% 73.3% 100.0%
Total	100.0%	15	100.0%	245	100.0%	750	100.0%	525	100.0%

Expanded Income Class (\$000)	(33)			(34)			(35)			(36)		
	Percentage of returns in Income Group	Credit for child and dependent care	Percentage distribution by Group	Jobs Credit	Percentage distribution by Group	Exclusion of Employees meals and lodging	Percentage distribution by Group	Maximum tax on personal service income	Percentage distribution by Group			
0- 5 } 5- 10 }	51.8%	3 } 65 }	13.6%	1 } 9 }	8.0%	5 } 30 }	12.5%	— } — }	0.0%			
10- 15 } 15- 20 }	31.7%	97 } 121 }	43.6%	16 } 14 }	24.0%	70 } 70 }	50.0%	— } — }	0.0%			
20- 30 } 30- 50 }	15.1%	165 } 41 }	41.2%	23 } 25 }	38.4%	40 } 35 }	26.8%	— } *	0.0%			
50-100 } 100-200 }	1.4%	7 } 1 }	1.6%	20 } 10 }	29.6%	20 } 8 }	10.7%	60 } 237 }	100.0%			
200 and over		* } 1 }		7 } 1 }		2 } 2 }		258 } 555 }				
Total	100.0%	500	100.0%	125	100.0%	280	100.0%	555	100.0%			

Expanded Income Class (\$000)	(37)			(38)			(39)			(40)		
	Percentage of returns in Income Group	Exclusion of prepaid legal services	Percentage distribution by Group	Charitable contributions other than health and education	Percentage distribution by Group	Employer contributions for medical insurance	Percentage distribution by Group	Medical expense deduction	Percentage distribution by Group			
0- 5 } 5- 10 }	51.8%	* } 1 }	20.0%	2 } 54 }	1.4%	91 } 494 }	10.5%	9 } 125 }	6.0%			
10- 15 } 15- 20 }	31.7%	1 } 1 }	40.0%	204 } 397 }	15.3%	814 } 1,028 }	33.1%	312 } 394 }	31.7%			
20- 30 } 30- 50 }	15.1%	1 } 1 }	40.0%	866 } 712 }	40.1%	1,547 } 882 }	43.7%	633 } 408 }	46.7%			
50-100 } 100-200 }	1.4%	* } * }	0.0%	652 } 423 }	43.2%	456 } 178 }	12.7%	221 } 79 }	15.6%			
200 and over		* } 5 }		625 } 3,935 }		70 } 5,560 }		49 } 2,230 }				
Total	100.0%	5	100.0%	3,935	100.0%	5,560	100.0%	2,230	100.0%			

Expanded Income Class (\$000)	(41) Percentage of returns in Income Group	(42) Charitable contributions health	Percentage distribution by Group	OASDI: Disability benefits	Percentage distribution by Group	(43) OASDI: Retired workers	Percentage distribution by Group	(44) OASDI: Dependents and Survivors	Percentage distribution by Group
0- 5 } 5- 10 } 10- 15 } 15- 20 } 20- 30 } 30- 50 } 50-100 } 100-200 } 200 and over }	51.8% - 31.7% 15.1% 1.4%	* } 10 } 20 } 40 } 100 } 155 } 130 } 135 } 200 }	1.3% 7.6% 32.3% 58.8%	135 } 132 } 67 } 43 } 45 } 32 } 14 } 2 } *	56.8% 23.4% 16.4% 3.4%	1,085 } 1,061 } 541 } 345 } 360 } 255 } 118 } 21 } 4 }	56.6% 23.4% 16.2% 3.8%	246 } 241 } 123 } 78 } 82 } 58 } 27 } 5 } *	56.6% 23.4% 16.3% 3.7%
Total	100.0%	790	100.0%	470	100.0%	3,790	100.0%	860	100.0%

Expanded Income Class (\$000)	(45) Percentage of returns in Income Group	(46) Railroad retirement benefits	Percentage distribution by Group	Workmens compensation benefits	Percentage distribution by Group	(47) Disabled coal miners benefits	Percentage distribution by Group	(48) Employer pension plans	Percentage distribution by Group
0- 5 } 5- 10 } 10- 15 } 15- 20 } 20- 30 } 30- 50 } 50-100 } 100-200 } 200 and over }	51.8% 31.7% 15.1% 1.4%	72 } 70 } 35 } 23 } 24 } 17 } 8 } 1 } *	56.8% 23.2% 16.4% 3.6%	206 } 202 } 103 } 66 } 68 } 48 } 22 } 4 } 1 }	56.7% 23.5% 16.1% 3.7%	15 } 14 } 7 } 5 } 5 } 3 } 1 } * } * }	58.0% 24.0% 16.0% 2.0%	38 } 416 } 1,030 } 1,515 } 2,608 } 1,672 } 912 } 375 } 149 }	5.2% 29.2% 49.1% 16.5%
Total	100.0%	250	100.0%	720	100.0%	50	100.0%	8,715	100.0%

Expanded Income Class (\$000)	(49)		(50)		(51)		(52)	
	Percentage of returns in Income Group	Individual pension plans	Percentage distribution by Group	Premiums on group term life insurance	Percentage distribution by Group	Premiums on accident & disability insurance	Percentage distribution by Group	Capital gains on homes of persons over 65
0-5		2		14		1		*
5-10	51.8%	32	2.4%	76	10.5%	6	10.0%	1
10-15		76		126		11		2
15-20	31.7%	115	13.7%	159	33.1%	13	34.3%	4
20-30		266		239		19		7
30-50	15.1%	349	44.3%	137	43.7%	11	42.9%	6
50-100		420		70		6		9
100-200	1.4%	112	39.6%	28	12.7%	2	12.8%	6
200 and over		18		11		1		5
Total	100.0%	1,390	100.0%	860	100.0%	70	100.0%	40

Expanded Income Class (\$000)	(53)		(54)		(55)		(56)	
	Percentage of returns in Income Group	Additional personal exemption for aged	Percentage distribution by Group	Tax Credit for the elderly (retirement credit)	Percentage distribution by Group	Exclusion of interest on life insurance savings	Percentage distribution by Group	Exclusion of Sick Pay
0-5		70		30		43		5
5-10	51.8%	304	32.8%	120	65.2%	209	13.6%	12
10-15		218		50		209		30
15-20	31.7%	134	30.9%	19	30.0%	207	22.5%	35
20-30		151		10		340		14
30-50	15.1%	127	24.4%	1	4.8%	324	35.9%	8
50-100		92		*		301		5
100-200	1.4%	33	11.9%	*	0.0%	132	28.0%	1
200 and over		11		*		85		*
Total	100.0%	1,140	100.0%	230	100.0%	1,850	100.0%	110

Expanded Income Class (\$000)	Percentage of returns in Income Group	Unemployment benefits	(58)		Exclusion of Public Assistance	Percentage distribution by Group	Excess of percentage over minimum deduction	Percentage distribution by Group
			Exclusion of Trust Earnings— Supplemental Unemployment benefits	Percentage distribution by Group				
0- 5 } 5- 10 } 10- 15 } 15- 20 } 20- 30 } 30- 50 } 50-100 } 100-200 } 200 and over	51.8% 31.7% 15.1% 1.4%	168 } 382 } 320 } 276 } 223 } 80 } 45 } 6 } *	1 } 2 } 2 } 2 } 1 } * } * } * }	30.0% 40.0% 30.0% 0.0%	148 } 111 } 33 } 18 } 17 } 3 } * } * } *	78.5% 15.4% 6.1% 0.0%	— } — } 50 } 193 } 250 } 30 } 6 } 1 } *	0.0% 45.9% 52.8% 1.3%
Total	100.0%	1,500	10	100.0%	330	100.0%	530	100.0%

Expanded Income Class (\$000)	Percentage of returns in Income Group	Additional personal exemption blind	(62)		Casualty loss deduction	Percentage distribution by Group	Veterans disability compensation	Percentage distribution by Group
			Earned income credit (refundable and nonrefundable)	Percentage distribution by Group				
0- 5 } 5- 10 } 10- 15 } 15- 20 } 20- 30 } 30- 50 } 50-100 } 100-200 } 200 and over	51.8% 31.7% 15.1% 1.4%	1 } 5 } 4 } 2 } 3 } 2 } 2 } 1 } *	710 } 555 } — } — } — } — } — } — }	30.0% 30.0% 25.0% 15.0%	* } 14 } 33 } 59 } 61 } 76 } 42 } 16 } 19 }	100.0% 0.0% 0.0% 0.0%	38 } 91 } 159 } 163 } 196 } 73 } 21 } 4 } *	17.3% 43.2% 36.1% 3.4%
Total	100.0%	20	1,265	100.0%	320	100.0%	745	100.0%

Expanded Income Class (\$000)	(65)		(66)		(67)		(68)		
	Percentage of returns in Income Group	Veterans Pensions	Percentage distribution by Group	G.I. Bill Benefits	Percentage distribution by Group	Interest on General State and Local Debt	Percentage distribution by Group	Deductibility of other State and Local Taxes	Percentage distribution by Group
0- 5	51.8%	18	85.7%	75	63.5%	*	0.0%	4	1.1%
5- 10		22		90		1		80	
10- 15	31.7%	4	14.3%	52	28.5%	7	2.5%	352	13.9%
15- 20		1		22		36		717	
20- 30	15.1%	*	0.0%	15	7.3%	59	12.1%	1,710	45.8%
30- 50		*		4		150		1,796	
50-100	1.4%	*	0.0%	2	0.7%	533	85.4%	1,595	39.2%
100-200		*		*		359		766	
200 and over		*		*		580		640	
Total	100.0%	35	100.0%	260	100.0%	1,725	100.0%	7,660	100.0%

Expanded Income Class (\$000)	(69)	
	Percentage of returns in Income Group	Deferral of Interest on Savings Bonds
0- 5	51.8%	17
5- 10		66
10- 15	31.7%	66
15- 20		65
20- 30	15.1%	107
30- 50		101
50-100	1.4%	94
100-200		42
200 and over		27
Total	100.0%	585

*Less than \$500,000.
 —No benefit from provision.

APPENDIX C
LIST AND ESTIMATES OF TAX EXPENDITURES
TAX EXPENDITURE BUDGET ESTIMATES BY FUNCTION
TRANSFER TAXES*

(Millions of dollars, fiscal years)

FUNCTION	1977	1978	1979	1980	1981
Agriculture:					
Deferral of estate tax payments (farms)	\$ 2	\$ 8	\$ 10	\$ 12	\$ 15
Preferential valuation for real property (farms)	—	8	9	9	10
Commerce and transportation:					
Deferral of estate-tax payments (closely held business)	2	12	14	16	18
Preferential valuation for real property (closely held business)	—	6	6	7	8
Education, training, employment, and social services:					
Deductibility of charitable contributions (education)	350	375	400	430	465
Deductibility of charitable contributions (social services)	260	280	300	320	345
Health:					
Deductibility of charitable contributions (health)	275	295	315	340	365
Income security:					
Exclusion for annuities from qualified retirement plans	75	80	85	90	95
Failure to tax all generation-skipping transfers	580	625	670	705	740
Exclusion for life insurance proceeds on which decedent paid premiums	10	11	12	12	13
Preferential treatment for lifetime gifts (failure to gross-up gifts made more than 3 years before death)	225	240	260	280	300
Orphan's deduction	—	5	6	7	7
General government:					
Exclusion for gifts to political organizations	2	2	2	3	3
Revenue sharing and general purpose fiscal assistance:					
Credit for state death taxes	600	635	670	710	745
Interest:					
Bonds redeemable at face value ("flower bonds")	125	135	145	155	165

* Estimates prepared by Gerald R. Jantscher, The Brookings Institution, Washington, D.C. This table is from Surrey, Warren, McDaniel and Gutman, Federal Wealth Transfer Taxation 884 (1977).