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SPECIAL REPORT

TAX ANALYSTS®

TAX EXPENDITURE BUDGETS: A CRITICAL VIEW

by Douglas A. Kahn
and Jeffrey S. Lehman

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In this article, Professors Kahn and Lehman argue that the concept of tax expenditures is flawed as a tool for measuring the propriety of tax provisions. It assumes the existence of one true and correct standard of federal income taxation that applies to all circumstances. To make that assumption, the proponents of the concept implictly make a particular moral claim about the relative importance of a wide range of values, including efficiency, consumption/savings neutrality, privacy, distributional equity, administrability, charity, and pragmatism. They then measure a tax provision's "normalcy" exclusively by how it conforms to their Platonic concept of income.

Professors Kahn and Lehman maintain that there is no single ideal concept of income. Instead, there are a number of plausible candidates, the choice among which constitutes a contestable, political decision. The tax expenditure budgets create an illusion of value-free scientific precision in a world where it is neither possible nor desirable to ignore the range of societal values that speak to how an income tax code is structured. The authors believe that the tax expenditure concept distorts public debate over tax provisions.

During the past few months, *Tax Notes* has featured an extended discussion about the "normalcy" (or lack thereof) of accelerated depreciation.[1] Two contributions to that discussion came from Professor Calvin Johnson of the University of Texas Law School, who disagreed with certain aspects of an article that Professor Kahn wrote in 1979.[2] And the debate shows no sign of slowing down.[3]

The interchange over the details of accelerated depreciation offers a useful backdrop against which to consider a more general issue: the intellectual coherence of the tax expenditure budgets.[4] The larger concept of tax expenditures was what motivated Kahn to examine the "normalcy" of accelerated depreciation 13 years ago. And, to our eyes at least, the issues raised by the concept are no less interesting today than they were in 1979.

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

An income tax stands inside, not outside, the society that enacts it.

Yet, the very statement of the task exposes its Achilles heel. It assumes the existence of one true, "correct," "normative" rule of federal income taxation that should be applied to any given transaction. The collection of all such rules stands as a kind of Platonic Internal Revenue Code, an implicit reprimand to the flawed efforts of our mortal Congress.[5]

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

The particular contours of our federal income tax serve to reaffirm public values that are "normative" in every sense of the word except the one used by advocates of tax expenditure budgets. The disallowance of a deduction for illegal bribes confirms that we think they are

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[1]The discussion began with an article last September. David Davenport, "The 'Proper' Taxation of Human Capital" (*Tax Notes*, Sept. 16, 1991, p. 1401). It continued with the following letters—Calvin Johnson (*Tax Notes*, Nov. 18, 1991, p. 858); Douglas Kahn (*Tax Notes*, Dec. 2, 1991, p. 1079); Michael McIntyre (*Tax Notes*, Dec. 16, 1991, p. 1319); Douglas Kahn (*Tax Notes*, Dec. 16, 1991, p. 1319); Michael Schler (*Tax Notes*, Dec. 23, 1991, p. 1430); Calvin Johnson (*Tax Notes*, Dec. 30, 1991, p. 1523); Deborah Geier, (*Tax Notes*, Jan. 27, 1992, p. 458).

[2]Douglas A. Kahn, "Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?" 78 *Mich. L. Rev.* 1 (1979).

[3]The most recemt contribution is from David Davenport, *Tax Notes*, Mar. 16, 1992, p. 1399.

[4]The prominence of tax expenditure budgets in tax policy debates is due largely to the efforts of the late Stanley Surrey. For a fair reflection of Surrey's views, *see* Stanley Surrey & Paul McDaniel, *Tax Expenditures* (1985).

[5]"Tax expenditure analysis, as applied to a particular tax, requires an understanding of the normative structure of that tax in order to determine whether a provision is a part of the structural or the tax expenditure component." *Id.* 3-4.

naughty. Similarly, the limitation on losses from wagering transactions shows that we do not consider them to be an appropriate foundation for a career. Conversely, the exclusion from income of tort recoveries is an expression of public compassion. And our refusal to tax people when their neighbors help them move furniture, or (as some have suggested) when they enjoy a few moments of leisure, suggests a shared sense of a private domain in which even the tax collector will respect people's right to be left alone.

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

The Choice Among Utopias

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

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

(2) Other, more practically minded observers, worry that the taxes that would satisfy perspective (1) would not generate enough revenues for the government to finance its current level of operations. They believe that Nicholas Kaldor had it right almost 40 years ago, when he argued that the proper income tax system is what we now call a consumption tax. Such observers are willing to accept the fact that a consumption tax biases taxpayers' choice between labor and leisure. They console themselves with the observation that at least a consumption tax avoids biasing the choice between savings and current consumption.

At least a consumption tax avoids biasing the choice between savings and current consumption.

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

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

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

The tax expenditure budget's conception of an appropriate tax base has no legitimate claim to establishing the terms of political debate.

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

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

What is disturbing about the language of tax expenditures is its tone of moral absolutism. The tax expenditure budget is said to distinguish "normal" tax practice from that which is deviant. Sometimes it is said to distinguish provisions that are "normative" (?) from those that are (presumably) nonnormative (?!). This language is doubly confusing. First, it suggests that provisions that fit *within* the implicit baseline of the tax expenditure budget are somehow pure, safe, and good. They should not be changed because "neutral" principles have blessed them.

[6]A marginally less depressive type might derive a trace of hope from the so-called "theory of the second-best." Perhaps the move from perspective (4) to perspective (5) undoes some of the "damage" that was done by the prior "declines." For a sophisticated discussion of the relevance of the theory of the second best to tax policy analysis, see Daniel Shaviro, "Selective Limitations on Tax Benefits," 56 *U. Chi. L. Rev.* 1189, 1218-20 (1989).

Conversely, the language suggests that provisions that fall *outside* the implicit baseline of the tax expenditure budget (tax expenditures) are somehow corrupt, dangerous, and evil. They should be changed as soon as possible to conform with the "neutral" position. To flirt with them is to call one's probity into question.

This is, of course, a bit of an overstatement. But, it captures the rhetorical direction of the tax expenditure budget. And that rhetorical direction is grossly misleading. The tax expenditure budget's conception of an appropriate tax base has no legitimate claim to establishing the terms of political debate. It should not immunize provisions of the code from political discussion, nor should it change the burden of justification for others.

The Illusion of Value-Free Precision—An Example

The reference point for construction of the tax expenditure budget is a measure of taxable income that is close to position (4) above, with some variations.[7] That may be some people's Platonic Internal Revenue Code, but it is obviously not everyone's. The choice among perspectives is a contestable, contingent, political decision. Thus, while the several existing tax expenditure budgets give an appearance of being the products of a highly sophisticated, expert, neutral examination of the tax system, they could just as accurately be characterized as exercises in mystification. They create only an illusion of value-free scientific precision in a heavily politicized domain.[8]

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

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

One can advance plausible arguments in favor of taxing unrealized gains. One can advance plausible arguments against granting accelerated depreciation deductions. One could also argue for the status quo with regard to each of these features. But, there is no *a priori* reason to classify one feature differently from the other, or to allocate a heavier burden of persuasion to those who attack realization or defend accelerated depreciation than one allocates to those who defend realization or attack accelerated depreciation.[9]

Obfuscating the Debate—Another Example

In addition to this central conceptual flaw, tax expenditure budgets have the unfortunate tendency to confuse by inviting an easy equation of "tax expenditures" with direct expenditures of federal dollars. Tax expenditures automatically become "subsidies." And central questions about the appropriate goals for our American income tax get lost in the transition.

Tax expenditure budgets have the unfortunate tendency to confuse by inviting an easy equation of 'tax expenditures' with direct expenditures of federal dollars.

Consider the additional standard deductions available to the blind and to the elderly, listed as tax expenditures by the Congressional Budget Office. How might it be meaningful to speak of these deductions as "subsidies"? Surely they do not subsidize *behavior* that Congress desires. We may be able to make ourselves look older or younger, but dates of birth seem immutable. And sadistic though our elected representatives might be, no one believes they want taxpayers to blind themselves.

No, in this context, the only conceivable way to think of the deductions as subsidies is to emphasize that they show solicitude for a particular category of *people*—a form of welfare expenditure through the Internal Revenue Code. To be sure, the solicitude takes the form of a deduction against taxable income rather than that of, for example, a refundable credit against taxes along the lines of the Earned Income Tax Credit. Thus, it is more symbolic than financial solicitude in the case of blind and elderly people who would have no taxable income even without the extra deductions. But, some would say, that is precisely the point. The deductions are not only subsidies,

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[7]Surrey and McDaniel describe the "normative" ideal as being "based on the Schanz-Haig-Simons (S-H-S) economic definition of income," coupled with "widely accepted standards of business accounting," but "tempered by reference to 'the generally accepted structure of an income tax.'" *Id.* at 4. For a slightly different approach, *see* Michael McIntyre, "A Solution to the Problem of Defining a Tax Expenditure," 14 *U.C. Davis L. Rev.* 79 (1980).

[8]Note that the problems we sketch in the text do not exhaust the ways in which value-free scientific precision in this domain is illusory. Suppose that the choice of normative framework were not politically contestable, and that everyone agreed that the Haig-Simons definition was the appropriate Platonic ideal. As Professor Bittker pointed out long ago, ambiguities within that concept leave substantial discretion to the drafter of the tax expenditure budget. *See* Boris Bittker, "Accounting for Federal 'Tax Subsidies' in the National Budget," 22 *Nat'l Tax J.* 244 (1969); Boris Bittker, "The Expenditure Budget—a Reply to Professors Surrey and Hellmuth," 22 *Nat'l Tax J.* 538 (1969).

[9]Surrey and McDaniel justify the decision not to include the doctrine of realization in tax expenditure budgets by invoking the "generally accepted structure of an income tax"; the doctrine is one of "those items [that] have not been commonly regarded as income for tax purposes." *Ibid.* The notion of a "generally accepted structure" is (to put it mildly) not self-defining ("commonly regarded" for how long and by whom?). It has much more the air of a conclusion than of a principle for analysis. Moreover, if "generally accepted" and "commonly regarded" are intended to evoke the importance of tradition and continuity in the development of the tax laws (values we share), why are those values different in kind from the kinds of justifications commonly offered for items included in the tax expenditure budgets?

but also nasty, upside-down subsidies that benefit the elderly and blind rich but not the elderly and blind poor.[10]

The problem with this line of argument is that it tempts us to sneak around through the back door to reach a conclusion without confronting the contestable premises underlying that conclusion. In this context, the conclusion that the deductions are tax expenditures might presume that under a "normative" income tax, all taxpayers should receive the same "standard deduction." It might be understood as an initial "zero bracket" in the progressive rate structure. But if that is so, why are not differences in standard deduction (or in the rate structure itself) based on marital status just as objectionable? Such differences exist in current law, but are not listed in the tax expenditure budget.

More directly, why isn't *any* standard deduction for nonitemized expenditures a tax expenditure? Why isn't the existence of marginal rates below the highest marginal rate a tax expenditure? What is the logic that protects a progressive rate structure from being branded nonnormative?

What is the logic that protects a progressive rate structure from being branded nonnormative?

The debate over progressive taxation continues to follow its uneasy course.[11] Among the defenses that seem to retain substantial support, however, are variants of the "equal-sacrifice" position—the idea that the burdens of government should exact a roughly equal sacrifice from each taxpayer. Such defenses turn out to be theoretically difficult. It is easy to assume that any individual will experience a declining marginal utility of income, as he or she moves from "necessities" to "luxuries." But, there is no reason to think that different individuals will see marginal utility decline at the same rate, or in the same pattern. And at some level, the interpersonal utility comparisons implicit in the purest conception of "equal sacrifice" become meaningless.

But this defense of progressive taxation is willing to live with a somewhat less pure conception of "equal sacrifice." It makes the social judgment that rich people can afford to spare more of their next dollar of income than poor people can. Rather than measuring citizens' personal utility curves, the rate structure can be said to describe a social judgment about what standardized hypothetical utility curve we are willing to attribute to citizens for the purpose of allocating the tax burden.

Note something about this logic: it could equally well support arguments in favor of certain forms of public direct expenditures on behalf of all poor people. Yet that fact alone is *not* enough to lead tax expenditure budgets to include the low marginal rates found in a progressive rate structure. We presume that is because one might plausibly think it *especially* relevant in the tax context—a reason to lower an individual's tax burden that might not be powerful enough to warrant the creation of a program of direct public expenditures.

This same logic, however, can also support the special deductions for the blind and the elderly. Such deductions can be seen as rough adjustments to the standardized hypothetical utility curve—a crude recognition that those who are blind or aged must spend more to meet their basic needs than young, sighted taxpayers must spend. Moreover, one might plausibly think such a recognition to be *especially* relevant in the tax context. A supporter of equal-sacrifice progressivity could plausibly support an adjustment to the rate schedules of the blind and the elderly without necessarily feeling compelled to support a direct expenditure program on their behalf.

Conclusion

Tax expenditure budgets divide all tax provisions into categories. One category comprises "pure tax" provisions that appear to serve no "nontax" goals. The deduction allowed a business for paying a commission to a salesman may be a representative example. The other category comprises "pure subsidy" provisions that seem to serve *only* nontax goals. The Earned Income Tax Credit, which subsidizes the wages of low-income workers with children, may be a representative example. To the extent tax provisions might arguably serve both tax and nontax goals, the function of the tax expenditure budget is to decide which set of goals predominates.

Our tax laws respond to fundamental questions about what values matter to us as a society. The tax expenditure budget presumes that some of us should be deemed to know the answers better than others.

Our point is that very few items fit neatly into one category or the other. Virtually all provisions of the tax laws have elements that some individuals might consider independent of the "core" task of measuring a particular concept of "income." On the other hand, since any income tax, no matter how defined, will influence citizen behavior, it would be a strange tax system that pretended to ignore those effects. Those effects are properly important considerations in determining which conception of income we would like to use.

We think democratic debate would be promoted if we knew how much additional revenue could be gained by repealing each of the code provisions shown in the various tax expenditure budgets, as well as who would bear the incidence of that additional revenue. We think democratic debate would also be promoted in precisely the same way, however, if we knew how much additional revenue could be gained through a host of changes to provisions that are *not* shown on the tax expenditure

[10] It bears mention that the distributional effects of this particular deduction are not so thoroughly "upside down" as they were before the provision was changed from a personal exemption allowance to an additional standard deduction. The standard deduction is of use only to taxpayers who do not itemize their deductions (taxpayers who tend to have lower incomes than itemizers), and its benefits are phased out for very-high-income taxpayers.

[11] *See*, e.g., Joseph Bankman & Thomas Griffith, "Social Welfare and the Rate Structure: A New Look at Progressive Taxation," 75 *Calif. L. Rev.* 1905 (1987); Walter Blum and Harry Kalven, "The Uneasy Case for Progressive Taxation," 19 *U. Chi. L. Rev.* 417 (1952).

budgets. Most tax provisions, like most policy judgments, are good only as long as their price tags are not exorbitant. Here again, the tax expenditure budget hides that fact by suggesting that certain features of the tax system are different *in kind* from others.

More generally, our critical view of tax expenditure budgets is pragmatic, not nihilistic. We do not believe that all arguments are equally good, or equally persuasive. Indeed, the two of us often disagree between ourselves about whether a particular argument is persuasive or not. But we both believe strongly that the need to evaluate such arguments on their ("normative") merits cannot be obviated by talismanic reference to an "expert" understanding of one particularized vision of the "normal" or "ideal" tax base.

We find it valuable to point out those provisions of the code that depart from what one would expect to find if one's sole concern were measuring accumulations of wealth during a taxable year. We also find it valuable to point out the different conceptions of "consumption" that might underlie arguments for or against the allowance of a particular deduction. But in precisely the same way, we find it valuable to point out the different conceptions of "privacy" or "family" or "charity" that might underlie arguments for or against other provisions of the code. Our tax laws respond to fundamental questions about what values matter to us as a society. The tax expenditure budget presumes that some of us should be deemed to know the answers better than others.[12]

[12]After completing this article, we came across two intriguing articles. In "Qualified Plans and Identifying Tax Expenditures: A Rejoinder to Professor Stein," 9 *Am. J. of Tax Policy* 257 (1991), Professor Edward Zelinsky presses some of the same points we make above in the context of debates over the appropriate income tax treatment of pension savings. Similarly, in "Tax Expenditures: A Reassessment," 1988 *Duke L.J.* 1155, Professor Victor Thuronyi appreciates some of the problems created by the inescapably subjective nature of the tax expenditure concept. He suggests that it would be more productive for analysts to identify lists of "substitutable tax provisions"—provisions of the code whose "significant purposes" might be achieved at least as well through a direct expenditure program.

Professor Thuronyi's approach offers advantages over Professor Surrey's. As we understand Professor Thuronyi, he sees less normative significance to the existence of a potential nontax substitute for a tax provision than Professor Surrey saw to tax expenditures. He appreciates that whether the nontax provision or the tax provision is more desirable depends upon the particular package of "purposes" one is interested in fulfilling, and it appears that he would require preparers of such lists to specify and expose to debate the "purposes" that they believe the tax provision is intended to serve.

On the other hand, as Professor Thuronyi himself recognizes, the preparation of a list of "substitutable" provisions within the code carries the same problems of subjectivity and indeterminacy as the preparation of a tax expenditure budget. That means his proposal raises the same problems of expertise, burden-shifting, and mystification we have set forth in the text above. The substantive arguments that would lead one to include a provision on the "list" are, of course, arguments that could be presented directly for the provision's repeal and (perhaps) replacement with a direct expenditure program. So why do we need experts to identify a separate "list"? We are concerned that whatever benefits might attend the preparation of a single, all-inclusive "list" of "substitutable tax provisions" would be overwhelmed by the cost to the political process of delegating a special power to the experts charged with preparing the lists.

Consider the question, "Should the National Zoo house panda bears?" If one were to hold a public hearing on the matter, one could expect to hear a range of interesting arguments presented by citizens interested in issues ranging from urban planning to animal rights, from budgetary policy to biological diversity. Yet, consider how you would react to a person who offered the following testimony:

> I am from the American Society of Zookeeping Experts. In my expert opinion, and in the opinion of my fellow experts, 'normative zoos' are, by definition, zoos that house no animals other than bears(!) Following the traditions of my discipline, I have accordingly engaged in substantial research into the question whether panda bears are truly bears or merely raccoons. I report to you today that they are raccoons. Accordingly, I have placed panda bears on the Roster of Prohibited Animals.

Tax experts, like zookeeping experts, are important members of American society. Their ideas should figure prominently in debates over national tax policy. The question for us is whether tax expenditure budgets grounded in a contestable vision of tax policy are ultimately any more valuable to such debate than a Roster of Prohibited Animals grounded in an idiosyncratic vision of zookeeping.

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