TAX POLICY

READINGS AND MATERIALS

THIRD EDITION

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CHAPTER ELEVEN

TAX EXPENDITURES

The federal income tax system consists really of two parts: one part comprises the structural provisions necessary to implement the income tax on individual and corporate net income; the second part comprises a system of tax expenditures under which Governmental financial assistance programs are carried out through special tax provisions rather than through direct Government expenditures. This second system is grafted on to the structure of the income tax proper; it has no basic relation to that structure and is not necessary to its operation. Instead, the system of tax expenditures provides a vast subsidy apparatus that uses the mechanics of the income tax as the method of paying the subsidies. The special provisions under which this subsidy apparatus functions take a variety of forms, covering exclusions from income, exemptions, deductions, credits against tax, preferential rates of tax, and deferrals of tax.[a]

A. INTRODUCTION

Tax expenditures are tax benefits used as incentives or rewards in lieu of outright payments by the government. As the opening quotation from Professor Stanley Surrey indicates, tax expenditures include credits; exclusions and exemptions; deductions not justified in computing net profit; lower tax rates on specified types of income; and, increasingly, timing benefits such as accelerated deductions and deferrals in accounting for income.

What we now regard as "tax expenditures" have perhaps always been with us. Tax expenditures have grown enormously in recent decades, however. Their growth reflects not only the increased size and complexity of the income tax, but also the increased willingness of Congress to influence economic and social choices by individuals and businesses.

Present terminology ("tax expenditure") and our awareness of the phenomenon are both of relatively recent vintage, and Professor Surrey is largely responsible for both. He served as the first Assistant Secretary of Treasury for Tax Policy under Presidents Kennedy and Johnson, and his work in that capacity led to the compilation of a Tax Expenditure Budget for the Fiscal Year 1968 published in the Treasury Secretary's annual report.

Six years after the Budget Act of 1974 implemented a requirement still in effect that both the Congressional Budget Committee and the President present annual estimates of the revenue costs of existing tax expenditures. These annual cost estimates help one appreciate the magnitude of the various tax expenditures.

Surrey's key contention was that direct expenditures and tax expenditures were substantively interchangeable. At the same time, the political approval process and the budgetary oversight of the two forms of expenditure were (and remain) completely different. Not being outlays from the Treasury, tax expenditures are not reflected in government expenditures and are not subject to the annual congressional appropriation process. They are not items listed in the budget and affect the budget only through tax receipts being lower than they otherwise would be.

Tax expenditures have obvious political appeal for members of Congress. In the case of new tax expenditures, or of liberalizing existing tax expenditures, some discipline has been introduced by a requirement Congress has imposed on itself that bills reducing revenues must contain offsetting revenue increases over a five- or ten-year span. As discussed in Chapter Seventeen, this budget process is subject to manipulation. Moreover, the process does not affect existing, ongoing tax expenditures. "Sunset" rules, which would terminate existing tax expenditures unless they were explicitly continued, have been proposed but not adopted.

Perhaps the clearest examples of tax expenditures are the incentive tax credits, which are usually calculated as a specified percentage of the taxpayer's expenditure on the rewarded behavior. The investment tax credit ("ITC") was the major tax credit between its initial enactment in 1962 and its sharp curtailment in 1986. Before 1986, the ITC allowed taxpayers making investments in tangible personal property (and some real property) for business use to offset their income tax liability by ten percent[b] of the cost of their qualifying investments. Investment tax credits were presented as explicit incentives to invest. As initially proposed by President Kennedy, the credit would have been available only for incremental investments over the taxpayer's normal replacements of business assets, but the incremental investment approach had been abandoned by the time the credit was enacted.

The ITC was the precursor of a flood of other tax credits. These included a credit for increasing outlays for research and development, a credit for providing low-income housing, a credit for wages paid to workers considered to be disadvantaged in various specified respects, education credits, a child care credit, an earned income tax credit ("EITC") for low-income taxpayers, a child tax credit, and a credit for elderly and disabled taxpayers. Unlike tax credits designed to be incentives, the last two tax credits—and arguably the

b. When first enacted in 1962, the ITC was only seven percent.

EITC as well—are designed merely to provide relief from tax.

Traditionally, the EITC has been unique in providing actual cash supplements, as opposed to a reduction in taxes owed. With the exception of the EITC, therefore, credits have benefitted only persons who otherwise would owe income tax, and thus have provided no incentive to individuals whose incomes are so low that they have no tax liability or to corporations that are operating at a loss. One response to this perceived problem has been to suggest making the credits "refundable"—*i.e.*, an amount equivalent to the tax credit would be given to persons who qualify for the credit whether or not they have tax liability against which to apply it. Thus, a "refund" would be made of a tax that had not been paid. While the EITC remains, by far, the most important refundable tax credit, there has been some recent expansion of the concept. For example, the credit of section 35 for certain health insurance costs is refundable, and section 24(d) makes the child tax credit partly refundable. (For these purposes, the wage withholding tax credit is not regarded as refundable, because the refund is out of tax previously withheld from the taxpayer's compensation.)

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

Unlike tax credits, exemptions and deductions vary in value among taxpayers—the higher the tax bracket, the greater the tax expenditure. For example, a $1,000 percentage depletion deduction is worth $350 to a corporation facing a 35 percent marginal tax rate, but only $150 to a corporation facing a 15 percent marginal tax rate. If the taxpayer has exhausted the tax basis of the mineral property giving rise to the percentage depletion deduction, the tax expenditure, whether $350 or $150, is an outright benefit—not merely a postponement of tax—because there is no compensating downward basis adjustment.

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

Although the basic idea of tax expenditures seems reasonable, putting the concept into use has proved difficult and controversial. Furthermore, even the basic concept has been challenged. As respects exemptions and deductions, the debate over tax expenditures merges into the debate over broadening the tax base.

Notes and Questions

(In)efficiency of tax expenditures

1. A significant question in using and structuring tax expenditures is whether they are efficient—does the Government get a sufficient bang for its buck? In many instances, such efficiency is difficult or impossible to measure, because of the nature of the benefit sought. (For example, measuring the benefit conferred on society, and on the individual workers, by an employer hiring disadvantaged workers would necessarily entail some level of subjectivity.) Nonetheless, Professor Calvin Johnson argues forcefully that, at least at present, tax incentives are extremely inefficient.

In large part, Professor Johnson bases his argument on the yields of tax-exempt bonds, because there, we can measure rather accurately the efficiency of the subsidy. Section 103 excludes from federal tax the interest on many state and local bonds. If a taxable bond yields 10 percent and an equivalent (considering such things as risk and liquidity) state bond yields 8 percent, this suggests that the investor is paying an "implicit tax" of 20 percent—the investor is voluntarily forfeiting 20 percent of yield in order to avoid taxation. This is a measure of efficiency because "[t]he implicit tax represents the only public return from the exemption system, in the form of cheaper costs for states and localities. The rest of the cost of the exemption is lost in terms of the purpose of the exemption, a cost without any delivered benefit."[c] Purchasing the state bond under the interest rates described would make sense only for a taxpayer whose marginal tax rate exceeded 20 percent. The governmental benefit (aiding the state) and the cost (foregone revenue) can both be measured accurately. If a taxpayer in the 35 percent bracket purchased a tax-exempt $1,000 bond under the interest rates assumed above, the federal Government would lose $35 in foregone revenue ($100 taxable interest x 35 percent) while the state would benefit to the extent of $20 in saved interest. (Note that the exclusion would be ideally efficient if the market drove the rate of the tax-exempt bond to 6.5 percent—this would mean that taxpayers in the top bracket (35 percent) would be indifferent between the taxable and tax-exempt investment, and that all foregone federal revenue

c. Calvin H. Johnson, *A Thermometer for the Tax System: The Overall Health of the Tax System as Measured by Implicit Tax*, 56 SMU L. REV. 13, 14 (2003).

would have been diverted to the intended beneficiary, the state, in the form of lower interest expense.)

Professor Johnson reports that the implicit tax on tax-exempt bonds "has been dropping in recent years, and is modest under current conditions, lower at times than the lowest statutory tax bracket of 10%."[d] Professor Johnson argues that the significance of this finding goes well beyond tax-exempt bonds. The low implicit rate on tax-exempt bonds indicates that investors find it easy to avoid taxes, and therefore are not willing to forego much income in order to achieve tax exemption. For this reason, Professor Johnson concludes that the use of tax incentives should be sharply curtailed and our generally porous tax system repaired:

> More generally, the modesty of the implicit tax means that there is a need for general repairs of the federal tax base. The demand for tax avoidance that would settle the implicit tax at the top statutory rate is swamped, not just by § 103 bonds, but by other investments that Congress has attempted to subsidize by giving or preserving a tax advantage. Congress, for instance, gives or expands the tax benefits of qualified pension funds or houses, and thousands of other things, by giving tax deductions that do not reflect economic cost or by giving exclusions for economic benefits.
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> With implicit tax so low, however, the use of the tax system for incentive or subsidy is no longer responsible. The loss to the system in cost is far higher than the benefit delivered. * * *
>
> The low implicit taxes indicate that the existing rates are fictive, or at least voluntary, for well-advised taxpayers. If they faced more than a paper tiger from the tax system, generally they would pay higher implicit tax. Reducing the rates and repairing the tax base would reduce the harm inflicted by the tax system.[e]

2. Much earlier, reports Dr. Gerard Brannon, the granddaddy of incentive tax provisions, the investment tax credit, had been condemned as inefficient: "That credit [ITC] operates like a uniform reduction in the price of equipment but in truth the price of equipment hasn't been reduced. Leading investors to think that equipment is cheaper than it is will distort investment. * * * When capital seems very cheap one tends to waste it."[f]

3. Do the preceding notes lead you to think that the best form for incentive tax expenditures to take is that they not be employed at all?

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d. *Id.* at 13.

e. *Id.* at [illegible]52.

f. Gerard M. Brannon [illegible]

Consider this question throughout the chapter, keeping in mind that no government program—whether tax expenditure or direct expenditure—works with perfect efficiency.

4. *Political attraction of tax expenditures.* When one considers the political dynamics involved, there is every reason to believe that Congress will continue to make extensive use of tax expenditures. Assume that, for whatever combination of political and policy reasons, members of Congress support the goal of delivering a given benefit to a given segment of society. Assume further that the benefit can be delivered, equally well, either in the form of a direct expenditure or a tax expenditure. Consider the political considerations in the choice. Voting for a direct expenditure requires a vote for more, spending, a vote for bigger government. By delivering the equivalent benefit in the form of a tax expenditure, members of Congress can tell voters that they have voted to cut taxes, and have refrained from voting in favor of additional spending.

B. TAX EXPENDITURES DESCRIBED AND DEFENDED

As noted above, since 1974 Congress has required the annual compilation and quantification of tax expenditures. The first excerpt below is the Office of Management and Budget's Fiscal Year 2011 explanation of the tax expenditures concept in operation. In terms of tax policy, this document is of considerable interest in several ways. First, a perusal of the pages of tax expenditures gives a sense of the breadth and magnitude of tax expenditures, each of which could be evaluated in terms of its policy justification. But more broadly, the accompanying document makes clear the complexity and uncertainty of the entire concept of tax expenditures and the tax expenditure budget. The concept of tax expenditures requires a "baseline" from which the "special" provision departs, but the baseline is not always clear.

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

The second excerpt is from an appendix of the final tax expenditure budget prepared by the George W. Bush Administration. A similar appendix was utilized through most of the Bush years, but was promptly discarded by the Obama Administration. The traditional tax expenditure budget was calculated similarly by the Bush and Obama teams, but the Bush appendix attempted additional calculations. First, the Bush appendix calculated tax expenditures assuming either of two alternative "baselines"—a "comprehensive" (or Haig-Simons) income tax baseline, and a consumption tax baseline. Additionally, the Bush appendix examined an aspect of an issue ignored in traditional tax *expenditure* analysis—a focus on "negative tax expenditures," those instances in which deviations from the norm increase, rather than decrease, the burden on taxpayers.

In the third excerpt, Professor Edward Zelinsky, who has written extensively about tax expenditures, takes on the presumption that tax expenditures are in some sense illegitimate. Professor Surrey (and many others following his lead), while acknowledging that tax provisions *could* be as carefully crafted as direct expenditure measures, clearly thought that the direct expenditure process was generally to be preferred. Obvious arguments support a preference for the use of direct expenditures. After all, direct expenditures are enacted through a legislative process centering on substantive congressional committees rather than the less-expert House Ways and Means Committee and Senate Finance Committee, and are administered by agencies with subject matter expertise rather than the Internal Revenue Service. Professor Zelinsky argues that appearances can be deceiving, and that the tax expenditure process may offer significant advantages.

ANALYTICAL PERSPECTIVES BUDGET OF THE UNITED STATES GOVERNMENT FISCAL YEAR 2011

Office of Management and Budget

Pages 207-13, 220-24 240-41 (2010)

Tax Expenditures

The Congressional Budget Act of 1974 (Public Law 93-344) requires that a list of "tax expenditures" be included in the budget. Tax expenditures are defined in the law as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability." These exceptions may be viewed as alternatives to other policy instruments, such as spending or regulatory programs.

Identification and measurement of tax expenditures depends importantly on the baseline tax system against which the actual tax system is compared. The tax expenditure estimates presented in this chapter are patterned on a comprehensive income tax, which defines income as the sum of consumption and the change in net wealth in a given period of time.

An important assumption underlying each tax expenditure estimate reported below is that other parts of the Tax Code remain unchanged. The estimates would be different if tax expenditures were changed simultaneously because of potential interactions among provisions. For that reason, this chapter does not present a grand total for the estimated tax expenditures.

Tax expenditures relating to the individual and corporate income taxes are estimated for fiscal years 2009–2015 using two methods of accounting: current revenue effects and present value effects. The present value approach provides estimates of the revenue effects for tax expenditures that generally involve deferrals of tax payments into the future.

* * *

Tax Expenditures in the Income Tax

Tax Expenditure Estimates

All tax expenditure estimates presented here are based upon current tax law enacted as of December 31, 2009. Expired or repealed provisions are not listed if their revenue effects result only from taxpayer activity occurring before fiscal year 2009. * * *

The total revenue effects for tax expenditures for fiscal years 2009–2015 are displayed according to the Budget's functional categories in Table 16–1.[g]

* * *

Two baseline concepts—the normal tax baseline and the reference tax law baseline—are used to identify and estimate tax expenditures. For the most part, the two concepts coincide. However, items treated as tax expenditures under the normal tax baseline, but not the reference tax law baseline, are indicated by the designation "normal tax method" in the tables. The revenue effects for these items are zero using the reference tax rules. The alternative baseline concepts are discussed in detail [below].

* * *

Table 16-3 ranks the major tax expenditures by the size of their 2011-2015 revenue effect. * * *

In the 2005 Analytical Perspectives, the treatment of capital gains was changed to exclude the portion of capital gains derived from corporate equity from the estimate of the tax expenditure for preferential tax rates on capital gains. In addition, the preferential rates on qualified dividend income that

g. For clarity of presentation, Table 16-1 as excerpted below provides data for the years 2011-15. (Ed.)

Table 16-1. ESTIMATES OF TOTAL INCOME TAX EXPENDITURES

(In millions of dollars)

	Total from corporations and Individuals					
	2011	2012	2013	2014	2015	2011-15
National Defense:						
Exclusion of benefits and allowances to armed forces personnel	11,530	11,570	11,920	12,370	12,860	60,250
International Affairs:						
Exclusion of income earned abroad by U.S. citizens	5,870	6,160	6,470	6,790	7,130	32,420
Exclusion of certain allowances for Federal employees abroad	1,020	1,070	1,120	1,180	1,240	5,630
Inventory property sales source rules exception	2,830	3,070	3,320	3,590	3,890	16,700
Deferral of income from controlled foreign corporations (normal tax method)	32,720	33,870	34,490	33,930	34,130	169,140
Deferred taxes for financial firms on certain income earned overseas	5,770	5,980	6,090	5,990	6,020	29,850
General Science, Space and Technology:						
Expensing of research and experimentation expenditures (normal tax method)	4,560	5,720	6,690	6,930	7,710	31,610
Credit for increasing research activities	3,850	3,080	2,460	1,964	1,568	12,922
Energy:						
Expensing of exploration and development costs, fuels	1,180	920	900	680	340	4,020
Excess of percentage over cost depletion, fuels	670	940	1,130	1,160	1,190	5,090
Alternative fuel production credit	20	10	0	0	0	30
Exception from passive loss limitation for working interests in oil and gas properties	20	20	20	20	20	100
Capital gains treatment of royalties on coal	60	60	70	80	100	370
Exclusion of interest on energy facility bonds	30	30	30	30	30	150
New technology credit	1,160	1,430	1,530	1,530	1,500	7,150
Energy investment credit	600	680	420	370	450	2,520
Alcohol fuel credit	8,870	10,940	6,690	3,610	2,030	32,140
Bio-Diesel and small agri-biodiesel producer tax credits	10	0	0	0	0	10
Tax credit and deduction for clean-fuel burning vehicles	260	130	170	230	390	1,180
Exclusion of utility conservation subsidies	130	120	120	120	120	610
Credit for holding clean renewable energy bonds	100	120	140	140	140	640
Deferral of gain from dispositions of transmission property to implement FERC restructuring policy	-400	-460	-490	-500	-470	-2320
Credit for investment in clean coal facilities	480	550	440	360	250	2,080
Temporary 50% expensing for equipment used in the refining of liquid fuels	930	760	630	-300	-790	1,230
Natural gas distribution pipelines treated as 15-year property	120	110	90	80	80	480
Amortize all geological and geophysical expenditures over 2 years	240	240	190	140	90	900
Allowance of deduction for certain energy efficient commercial building property	90	90	130	80	10	400
Credit for construction of new energy efficient homes	20	20	0	0	0	40
Credit for energy efficient improvements to existing homes	1,460	0	0	0	0	1,460
Credit for energy efficient appliances	50	0	0	0	0	50
Credit for residential purchases/installations of solar and fuel cells	180	180	190	190	190	930
Qualified energy conservation bonds	40	80	110	120	120	470
Natural Resources and Environment:						
Expensing of exploration and development costs, nonfuel minerals	90	100	100	100	100	490
Excess of percentage over cost depletion, nonfuel minerals	740	750	770	810	830	3,900
Exclusion of interest on bonds for water, sewage, and hazardous waste facilities	420	520	550	580	610	2,880

	Total from corporations and individuals					
	2011	2012	2013	2014	2015	2011-15
Capital gains treatment of certain timber income	60	60	70	80	100	370
Expensing of multiperiod timber growing costs	290	290	320	310	310	1,520
Tax incentives for preservation of historic structures	470	490	520	540	570	2,590
Exclusion of gain or loss on sale or exchange of certain brownfield sites	60	40	30	10	0	140
Industrial CO2 capture and sequestration tax credit	0	0	0	60	130	190
Deduction for endangered species recovery expenditures	30	30	30	50	50	190
Agriculture:						
Expensing of certain capital outlays	70	80	90	90	90	420
Expensing of certain multiperiod production costs	110	110	120	120	120	580
Treatment of loans forgiven for solvent farmers	20	20	20	20	20	100
Capital gains treatment of certain income	590	550	680	830	970	3,620
Income averaging for farmers	90	90	90	90	100	460
Deferral of gain on sale of farm refiners	20	20	20	20	20	100
Commerce and Housing:						
Financial institutions and insurance:						
Exemption of credit union income	710	790	880	960	1,030	4,370
Exclusion of interest on life insurance savings	23,070	24,700	26,420	28,220	29,860	132,270
Special alternative tax on small property and casualty insurance companies	40	50	50	50	60	250
Tax exemption of certain insurance companies owned by tax-exempt organizations	200	210	210	220	220	1,060
Small life insurance company deduction	50	50	50	50	50	250
Exclusion of interest spread of financial institutions	960	1,070	1,160	1,250	1,330	6,170
Housing:						
Exclusion of interest on owner-occupied mortgage subsidy bonds	1,190	1,470	1,540	1,610	1,710	7,520
Exclusion of interest on rental housing bonds	1,010	1,240	1,300	1,370	1,450	6,370
Deductibility of mortgage interest on owner-occupied homes	104,540	116,620	127,840	139,000	149,560	637,560
Deductibility of State and local property tax on owner-occupied homes	23,710	29,730	31,340	32,700	33,690	151,170
Deferral of income from installment sales	810	880	1,020	1,150	1,260	5,120
Capital gains exclusion on home sales	31,300	39,510	43,640	48,200	53,230	215,880
Exclusion of net imputed rental income	37,630	40,810	41,020	48,330	56,100	223,890
Exception from passive loss rules for $25,000 of rental loss	7,330	8,510	9,670	11,120	13,010	49,640
Credit for low-income housing investments	6,170	6,660	7,540	7,910	8,030	36,310
Accelerated depreciation on rental housing (normal tax method)	5,870	7,100	8,380	9,360	9,970	40,680
Discharge of mortgage indebtedness	200	180	120	0	0	500
Credit for homebuyer	1,530	-1980	-1210	-800	-490	-2,950
Commerce:						
Cancellation of indebtedness	-10	-50	-30	0	40	-50
Exceptions from imputed interest rules	50	50	50	50	50	250
Treatment of qualified dividends	26,869	0	0	0	0	26,869

	Total from corporations and Individuals					
	2011	2012	2013	2014	2015	2011-15
Capital gains (except agriculture, timber, iron ore, and coal)	44,290	41,090	51,120	62,230	72,180	270,910
Capital gains exclusion of small corporation stock	170	290	300	470	690	1,920
Step-up basis of capital gains at death	44,520	53,270	57,260	61,560	66,180	282,790
Carryover basis of capital gains on gifts	4,790	2,050	2,740	2,940	3,160	15,680
Ordinary income treatment of loss from small business corporation stock sale	60	60	60	60	60	300
Accelerated depreciation of buildings other than rental housing (normal tax method)	-12,860	-13,960	-15,530	-16,360	-17,540	-76,250
Accelerated depreciation of machinery and equipment (normal tax method)	1,170	14,120	30,710	44,310	56,400	146,710
Expensing of certain small investments (normal tax method)	-3,200	-2,820	-710	210	760	-5,760
Graduated corporation income tax rate (normal tax method)	3,120	3,070	3,150	3,420	3,600	16,360
Exclusion of interest on small issue bonds	320	400	420	430	460	2,030
Deduction for US production activities	13,640	14,420	15,290	16,210	17,120	76,680
Special rules for certain film and TV production.	-60	-110	-90	-60	-50	-370
Transportation:						
Deferral of tax on shipping companies	20	20	20	20	20	100
Exclusion of reimbursed employee parking expenses	3,100	3,190	3,320	3,460	3,590	16,660
Exclusion for employer-provided transit passes	530	560	600	640	670	3,000
Tax credit for certain expenditures for maintaining railroad tracks	70	30	10	10	0	120
Exclusion of interest on bonds for Financing of Highway Projects and rail-truck transfer facilities	100	90	60	60	60	370
Community and regional development:						
Investment credit for rehabilitation of structures (other than historic)	30	30	30	30	30	150
Exclusion of interest for airport, dock and similar bonds	850	1,040	1,090	1,140	1,210	5,330
Exemption of certain mutuals' and cooperatives' income	110	110	120	120	120	580
Empowerment zones and renewal communities	430	580	680	740	730	3,160
New markets tax credit	800	810	780	740	660	3,790
Expensing of environmental remediation costs	-140	-140	-140	-130	-120	-670
Credit to holders of Gulf Tax Credit Bonds	80	70	50	50	50	300
Recovery Zone Bonds	30	40	40	40	40	190
Tribal Economic Development Bonds	390	470	490	520	550	2,420
Education, Training, Employment, and Social Services:						
Education:						
Exclusion of scholarship and fellowship income (normal tax method)	2,250	2,340	2,440	2,540	2,650	12,220
HOPE tax credit	840	4,250	4,460	4,680	4,900	19,130
Lifetime Learning tax credit	3,360	4,780	5,010	5,250	5,510	23,910
American Opportunity Tax Credit	11,380	0	0	0	0	11,380
Education Individual Retirement Accounts	70	80	80	90	100	420
Deductibility of student-loan interest	1,130	590	610	640	660	3,630
State prepaid tuition plans	1,580	1,750	1,860	1,950	2,050	9,190
Exclusion of interest on student loan bonds	550	670	710	740	780	3,450

	Total from corporations and Individuals					
	2011	2012	2013	2014	2015	2011-15
Exclusion of interest on bonds for private nonprofit educational facilities	2,220	2,720	2,850	3,000	3,170	13,960
Credit for holders of zone academy bonds	260	290	280	250	230	1,310
Exclusion of interest on savings bonds redeemed to finance educational expenses	20	20	20	20	20	100
Parental personal exemption for students age 19 or over	2,780	3,140	2,950	2,750	2,550	14,170
Deductibility of charitable contributions (education)	4,940	5,370	5,800	6,190	6,610	28,910
Exclusion of employer provided educational assistance	30	0	0	0	0	30
Discharge of student loan indebtedness	20	20	20	20	20	100
Qualified school construction bonds	310	630	940	1,060	1,060	4,000
Training, employment, and social services:						
Work opportunity tax credit	830	540	260	130	60	1,820
Welfare-to-work tax credit	10	10	0	0	0	20
Employer-provided child care exclusion	1,370	1,410	1,480	1,550	1,630	7,440
Employer-provided child care credit	10	0	0	0	0	10
Assistance for adopted foster children	490	520	550	580	610	2,750
Adoption credit and exclusion	460	90	90	90	90	820
Exclusion of employee meals and lodging (other than military)	1,110	1,170	1,230	1,300	1,370	6,180
Child credit	18,550	10,870	10,610	10,320	9,990	60,340
Credit for child and dependent care expenses	2,200	1,890	1,830	1,730	1,650	9,300
Credit for disabled access expenditures	20	30	30	30	30	140
Deductibility of charitable contributions, other than education and health	43,850	47,730	51,570	55,140	58,850	257,140
Exclusion of certain foster care payments	400	390	390	390	370	1,940
Exclusion of parsonage allowances	660	700	740	790	840	3,730
Exclusion for benefits provided to volunteer EMS and firefighters	60	0	0	0	0	60
Making work pay tax credit	14,160	0	0	0	0	14,160
Health:						
Exclusion of employer contributions for medical insurance premiums and medical care	176,964	191,540	208,650	228,040	248,600	1,053,794
Self-employed medical insurance premiums	5,740	6,150	6,580	7,120	7,780	33,370
Medical Savings Accounts / Health Savings Accounts	2,130	2,240	2,350	2,470	2,590	11,780
Deductibility of medical expenses	10,030	10,980	11,970	13,260	14,910	61,150
Exclusion of interest on hospital construction bonds	3,350	4,110	4,310	4,540	4,790	21,100
Deductibility of charitable contributions (health)	4,950	5,380	5,810	6,230	6,640	29,010
Tax credit for orphan drug research	320	350	380	410	450	1,910
Special Blue Cross/Blue Shield deduction	690	660	590	530	690	3,160
Tax credit for health insurance purchased by certain displaced and retired individuals	10	10	10	10	10	50
Distributions from retirement plans for premiums for health and long-term care insurance	330	360	400	440	490	2,020
Income security:						
Exclusion of railroad retirement system benefits	300	280	260	250	250	1,340
Exclusion of workmen's compensation benefits	5,940	6,070	6,170	6,270	6,370	30,820

	Total from corporations and Individuals					
	2011	2012	2013	2014	2015	2011-15
Exclusion of public assistance benefits (normal tax method)	670	710	740	760	790	3,670
Exclusion of special benefits for disabled coal miners	40	40	40	40	40	200
Exclusion of military disability pensions	110	110	110	110	120	560
Net exclusion of pension contributions and earnings:						
Employer plans	44,630	47,870	49,050	51,950	53,980	247,480
401(k) plans	67,061	70,168	72,716	74,712	76,183	360,840
Individual Retirement Accounts	14,080	15,770	16,190	16,400	16,500	78,940
Low and moderate income savers credit	1,170	1,130	1,060	1,000	960	5,320
Keogh plans	15,120	17,190	19,740	21,100	22,610	95,760
Exclusion of other employee benefits:						
Premiums on group term life insurance	2,160	2,280	2,320	2,350	2,390	11,500
Premiums on accident and disability insurance	340	350	360	360	360	1,770
Income of trusts to finance supplementary unemployment benefits	50	50	50	50	60	260
Special ESOP rules	1,800	1,900	2,000	2,100	2,200	10,000
Additional deduction for the blind	40	50	50	50	50	240
Additional deduction for the elderly	2,600	3,100	3,300	3,550	3,690	16,240
Tax credit for the elderly and disabled	10	10	10	10	10	50
Deductibility of casualty losses	640	680	720	750	780	3,570
Earned income tax credit[9]	6,200	8,380	8,540	8,790	9,090	41,000
Social Security:						
Exclusion of social security benefits:						
Social Security benefits for retired workers	20,240	21,380	22,560	24,160	26,810	115,150
Social Security benefits for disabled workers	7,160	7,450	7,750	8,080	8,580	39,020
Social Security benefits for spouses, dependents and survivors	3,140	3,150	3,170	3,200	3,330	15,990
Veterans benefits and services:						
Exclusion of veterans death benefits and disability compensation	4,370	4,630	4,910	5,200	5,510	24,620
Exclusion of veterans pensions	220	250	260	270	270	1,270
Exclusion of GI bill benefits	770	1,010	1,270	1,570	1,910	6,530
Exclusion of interest on veterans housing bonds	30	40	50	60	60	240
General purpose fiscal assistance:						
Exclusion of interest on public purpose State and local bonds	28,660	35,130	36,900	38,780	40,910	180,380
Build America Bonds	-2,120	-2,110	-2,030	-1,960	-1,880	-10,100
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	46,500	58,100	61,890	65,320	68,250	300,060
Interest:						
Deferral of interest on savings bonds	1,220	1,300	1,320	1,330	1,340	6,510
Addendum—Aid to State and local governments:						
Deductibility of:						
Property taxes on owner-occupied homes	23,710	29,730	31,340	32,700	33,690	151,170

9. The figures in the table indicate the effect of the earned income tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: * * * 2011 $51,450; 2012 $43,980; 2013 $43,860; 2014 $44,130; and 2015 $44,380.

	Total from corporations and Individuals					
	2011	2012	2013	2014	2015	2011-15
Nonbusiness State and local taxes other than on owner-occupied homes	46,500	58,100	61,890	65,320	68,250	300,060
Exclusion of interest on State and local bonds for:						
Public purposes	28,660	35,130	36,900	38,780	40,910	180,380
Energy facilities	30	30	30	30	30	150
Water, sewage, and hazardous waste disposal facilities	420	520	550	580	610	2,680
Small issues	320	400	420	430	460	2,030
Owner-occupied mortgage subsidies	1,190	1,470	1,540	1,610	1,710	7,520
Rental housing	1,010	1,240	1,300	1,370	1,450	6,370
Airports, docks, and similar facilities	850	1,040	1,090	1,140	1,210	5,330
Student loans	550	670	710	740	780	3,450
Private nonprofit educational facilities	2,220	2,720	2,850	3,000	3,170	13,960
Hospital construction	3,350	4,110	4,310	4,540	4,790	21,100
Veterans' housing	20	20	20	20	20	100
GO Zones and GO Zone mortgage	90	110	120	120	130	610
Credit for holders of zone academy bonds	260	290	280	250	230	1310

Note: Provisions with estimates denoted normal tax method have no revenue loss under the reference tax law method. All estimates have been rounded to the nearest $10 million. Provisions with estimates that rounded to zero in each year are not included in the table.

were enacted in the Jobs and Growth Tax Relief Reconciliation Act of 2003 were not identified as a tax expenditure. In this volume, the estimates reflect the pre-2005 methodology * * *. The preferential rate on qualified dividends is identified as a tax expenditure.

Interpreting Tax Expenditure Estimates

The estimates shown for individual tax expenditures * * * do not necessarily equal the increase in Federal revenues (or the change in the budget balance) that would result from repealing these special provisions, for the following reasons.

First, eliminating a tax expenditure may have incentive effects that alter economic behavior. * * * For example, if capital gains were taxed at ordinary rates, capital gain realizations would be expected to decline, resulting in lower tax receipts. Such behavioral effects are not reflected in the estimates.

Second, tax expenditures are interdependent even without incentive effects. Repeal of a tax expenditure provision can increase or decrease the tax revenues associated with other provisions. For example, even if behavior does not change, repeal of an itemized deduction could increase the revenue costs from other deductions because some taxpayers would be moved into higher tax brackets. Alternatively, repeal of an itemized deduction could lower the revenue cost from other deductions if taxpayers are led to claim the standard deduction instead of itemizing. Similarly, if two provisions were repealed

Table 16-3. INCOME TAX EXPENDITURES RANKED BY TOTAL 2011-2015 PROJECTED REVENUE EFFECT

(in millions of dollars)

Provision	2011	2011-15
Exclusion of employer contributions for medical insurance premiums and medical care	176,964	1,053,794
Deductibility of mortgage interest on owner-occupied homes	104,540	637,560
401(k) plans	67,061	360,840
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	46,500	300,060
Step-up basis of capital gains at death	44,520	282,790
Capital gains (except agriculture, timber, iron ore, and coal)	44,290	270,910
Deductibility of charitable contributions, other than education and health	43,850	257,140
Employer plans	44,630	247,480
Exclusion of net imputed rental income	37,630	223,890
Capital gains exclusion on home sales	31,300	215,880
Exclusion of interest on public purpose State an local bonds	28,660	180,380
Deductibility of State and local property tax on owner-occupied homes	23,710	151,170
Accelerated depreciation of machinery and equipment (normal tax method)	1,170	146,710
Exclusion of interest on life insurance savings	23,070	132,270
Social Security benefits for retired workers	20,240	115,150
Keogh Plans	15,120	95,760
Individual Retirement Accounts	14,080	78,940
Deduction for US production activities	13,640	76,680
Deductibility of medical expenses	10,030	61,150
Child Credit	18,550	60,340
Exclusion of benefits and allowances to armed forces personnel	11,530	60,250
Exception from passive loss rules for $25,000 of rental loss	7,330	49,640
Earned income tax credit	6,200	41,000
Accelerated depreciation on rental housing (normal tax method)	5,870	40,680
Social Security benefits for disabled workers	7,160	39,020
Credit for low-income housing investments	6,170	36,310
Deferral of income from controlled foreign corporations (normal tax method)	32,720	35,840
Self-employed medical insurance premiums	5,740	33,370
Exclusion of income earned abroad by U.S. citizens	5,870	32,420
Alcohol fuel credits	8,870	32,140
Expensing of research and experimentation expenditures (normal tax method)	4,560	31,610
Exclusion of workers' compensation benefits	5,940	30,820
Deductibility of charitable contributions (health)	4,950	29,010
Deductibility of charitable contributions (education)	4,940	28,910
Treatment of qualified dividends	26,869	26,869
Exclusion of veterans death benefits and disability compensation	4,370	24,620
Lifetime Learning tax credit	3,360	23,910
Exclusion of interest on hospital construction bonds	3,350	21,100
HOPE tax credit	840	19,130
Inventory property sales source rules exception	2,830	16,700
Exclusion of reimbursed employee parking expenses	3,100	16,660
Graduated corporation income tax rate (normal tax method)	3,120	16,360
Additional deduction for the elderly	2,600	16,240
Social Security benefits for spouses, dependents and survivors	3,140	15,990
Carryover basis of capital gains on gifts	4,790	15,680

Provision	2011	2011-15
Parental personal exemption for students age 19 or over	2,780	14,170
Making work pay tax credit	14,160	14,160
Exclusion of interest on bonds for private nonprofit educational facilities	2,220	13,960
Credit for increasing research activities	3,850	12,922
Exclusion of scholarship and fellowship income (normal tax method)	2,250	12,220
Medical Savings Accounts / Health Savings Accounts	2,130	11,780
Premiums on group term life insurance	2,160	11,500
Lifetime Learning tax credit	11,380	11,380
Special ESOP rules	1,800	10,000
Credit for child and dependent care expenses	2,200	9,300
State prepaid tuition plans	1,580	9,190
Exclusion of interest on owner-occupied mortgage subsidy bonds	1,190	7,520
Employer provided child care exclusion	1,370	7,440
New technology credit	1,160	7,150
Exclusion of GI bill benefits	770	6,530
Deferral of interest on U.S. savings bonds	1,220	6,510
Exclusion of interest on rental housing bonds	1,010	6,370
Deferred taxes for financial firms on certain income earned overseas	5,770	6,320
Exclusion of employee meals and lodging (other than military)	1,110	6,180
Exclusion of interest spread of financial institutes	960	6,170
Exclusion of certain allowances for Federal employees abroad	1,020	5,630
Exclusion of interest for airport, dock, and similar bonds	850	5,330
Low and moderate income savers credit	1,170	5,320
Deferral of income from installment sales	810	5,120
Excess of percentage over cost depletion, fuels	670	5,090
Exemption of credit union income	710	4,370
Expensing of exploration and development costs, fuels	1,180	4,020
Qualified school construction bonds	310	4,000
Excess of percentage over cost depletion, nonfuel minerals	740	3,900
New markets tax credit	800	3,790
Exclusion of parsonage allowances	660	3,730
exclusion of public assistance benefits (normal tax method)	670	3,670
Deductibility of student-loan interest	1,130	3,630
Capital gains treatment of certain income	590	3,620
Deductibility of casualty losses	640	3,570
Exclusion of interest on student-loan bonds	550	3,450
Empowerment zones, Enterprise communities, and Renewal communities	430	3,160
Special Blue Cross/Blue Shield deduction	690	3,160
Exclusion for employer-provided transit passes	530	3,000
Assistance for adopted foster children	490	2,750
Exclusion of interest on bonds for water, sewage, and hazardous waste facilities	420	2,680
Tax incentives for preservation of historic structures	470	2,590
Energy investment credit	600	2,520
Tribal Economic Development Bonds	390	2,420
Credit for investment in clean coal facilities	480	2,080
Exclusion of interest on small issue bonds	320	2,030
Distribution from retirement plans for premiums for health and long-term care insurance	330	2,020

Provision	2011	2011-15
Exclusion of certain foster care payments	400	1,940
Capital gains exclusion of small corporation stock	170	1,920
Tax credit for orphan drug research	320	1,910
Work opportunity tax credit	830	1,820
Premiums on accident and disability insurance	340	1,770
Expensing of multiperiod timber growing costs	290	1,520
Credit for energy efficiency improvements to existing homes	1,460	1,460
Exclusion of railroad retirement system benefits	300	1,340
Credit for holders of zone academy bonds	260	1,310
Exclusion of veterans pensions	220	1,270
Temporary 50% expensing for equipment used in the refining of liquid fuels	930	1,230
Tax credit and deduction for clean-fuel burning vehicles	260	1,180
Tax exemption of certain insurance companies owned by tax-exempt organizations	200	1,060
30% credit for residential purchases/installations of solar and fuel cells	180	930
Amortize all geological and geophysical expenditures over 2 years	240	900
Adoption credit and exclusion	460	820
Credit for holding clean renewable energy bonds	100	640
Exclusion of utility conservation subsidies	130	610
Expensing of certain multiperiod production costs	110	580
Exemption of certain mutuals' and cooperatives' income	110	580
Exclusion of military disability pensions	110	560
Discharge of mortgage indebtedness	200	500
Expensing of exploration and development costs, nonfuel minerals	90	490
Natural gas distribution pipelines treated as 15-year property	120	480
Qualified energy conservation bonds	40	470
Income averaging for farmers	90	460
Expensing of certain capital outlays	70	420
Education Individual Retirement Accounts	70	420
Allowance of deduction for certain energy efficient commercial building property	90	400
Capital gains treatment of royalties on coal	60	370
Capital gains treatment of certain timber income	60	370
Exclusion of interest on bonds for Financing of Highway Projects and rail-truck transfer facilities	100	370
Ordinary income treatment of loss from small business corporation stock sale	60	300
Credit to holders of Gulf Tax Credit Bonds	80	300
Income of trusts to finance supplementary unemployment benefits	50	260
Special alternative tax on small property and casualty insurance companies	40	250
Small life insurance company deduction	50	250
Exceptions from imputed interest rules	50	250
Additional deduction for the blind	40	240
Exclusion of interest on veterans housing bonds	30	240
Exclusion of special benefits for disabled coal miners	40	200
Industrial CO2 capture and sequestration tax credit	0	190
Deduction for endangered species recovery expenditures	30	190
Recovery Zone Bonds	30	190
Exclusion of interest on energy facility bonds	30	150
Investment credit for rehabilitation of structures (other than historic)	30	150
Exclusion of gain or loss on sale or exchange of certain brownfield sites	60	140

Provision	2011	2011-15
Credit for disabled access expenditures	20	140
Tax credit for certain expenditures for maintaining railroad tracks	70	120
Exception from passive loss limitation for working interests in oil and gas properties	20	100
Treatment of loans forgiven for solvent farmers	20	100
Deferral of gain on sale of farm refiners	20	100
Deferral of tax on shipping companies	20	100
Exclusion of interest on savings bonds redeemed to finance educational expenses	20	100
Discharge of student loan indebtedness	20	100
Exclusion for benefits provided to volunteer EMS and firefighters	60	60
Credit for energy efficient appliances	50	50
Tax credit for health insurance purchased by certain displaced and retired individuals	10	50
Tax credit for the elderly and disabled	10	50
Credit for construction of new energy efficient homes	20	40
Alternative fuel production credit	20	30
Exclusion of employer-provided educational assistance	30	30
Welfare-to-work tax credit	10	20
Bio-Diesel and small agr-biodiesel producer tax credits	10	10
Employer-provided child care credit	10	10
Cancellation of indebtedness	-10	-50
Special rules for certain firm and TV production	-60	-370
Expensing of environmental remediation costs	-140	-670
Deferral of gain from dispositions of transmission property to implement FERC restructuring policy	-400	-2,320
Credit for homebuyers	1,530	-2,950
Expensing of certain small investments (normal tax method)	-3,200	-5,760
Build America Bonds	-2,120	-10,100
Accelerated depreciation of buildings other than rental housing (normal tax method)	-12,860	-76,250

simultaneously, the increase in tax liability could be greater or less than the sum of the two separate tax expenditures, because each is estimated assuming that the other remains in force. * * *

Present-Value Estimates

The annual value of tax expenditures for tax deferrals is reported on a cash basis in all tables except Table 16–4. Cash-based estimates reflect the difference between taxes deferred in the current year and incoming revenues that are received due to deferrals of taxes from prior years. Although such estimates are useful as a measure of cash flows into the Government, they do not accurately reflect the true economic cost of these provisions. For example, for a provision where activity levels have changed, so that incoming tax receipts from past deferrals are greater than deferred receipts from new activity, the cash-basis tax expenditure estimate can be negative, despite the fact that in present-value terms current deferrals have a real cost to the Government. Alternatively, in the case of a newly enacted deferral provision, a cash-based estimate can overstate the real effect on receipts to the Government because the newly deferred taxes will ultimately be received.

Discounted present-value estimates of revenue effects are presented in

Table 16–4 for certain provisions that involve tax deferrals or other long-term revenue effects. These estimates complement the cash-based tax expenditure estimates presented in the other tables.

The present-value estimates represent the revenue effects, net of future tax payments that follow from activities undertaken during calendar year 2009 which cause the deferrals or other long-term revenue effects. For instance, a pension contribution in 2009 would cause a deferral of tax payments on wages in 2009 and on pension fund earnings on this contribution (e.g., interest) in later years. In some future year, however, the 2009 pension contribution and accrued earnings will be paid out and taxes will be due; these receipts are included in the present-value estimate. * * *

Tax Expenditure Baselines

A tax expenditure is an exception to baseline provisions of the tax structure that usually results in a reduction in the amount of tax owed. The 1974 Congressional Budget Act, which mandated the tax expenditure budget, did not specify the baseline provisions of the tax law. As noted previously, deciding whether provisions are exceptions, therefore, is a matter of judgment. As in prior years, most of this year's tax expenditure estimates are presented using two baselines: the normal tax baseline and the reference tax law baseline. Tax expenditures may take the form of credits, deductions, special exceptions and allowances, and reduce tax liability below the level implied by the baseline tax system.

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

The reference tax law baseline is also patterned on a comprehensive income tax, but it is closer to existing law. Reference law tax expenditures are limited to special exceptions from a generally provided tax rule that serve programmatic functions in a way that is analogous to spending programs. Provisions under the reference law baseline are generally tax expenditures under the normal tax baseline, but the reverse is not always true.

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

- Income is taxable only when it is realized in exchange. Thus, the deferral of tax on unrealized capital gains is not regarded as a tax expenditure. Accrued income would be taxed under a comprehensive income tax.
- There is a separate corporate income tax. Under a comprehensive income tax, corporate income would be taxed only once—at the shareholder level, whether or not distributed in the form of dividends.
- Noncorporate tax rates vary by level of income.
- Individual tax rates, including brackets, standard deduction, and

personal exemptions, are allowed to vary with marital status.

- Values of assets and debt are not generally adjusted for inflation. A comprehensive income tax would adjust the cost basis of capital assets and debt for changes in the general price level. Thus, under a comprehensive income tax baseline, the failure to take account of inflation in measuring depreciation, capital gains, and interest income would be regarded as a negative tax expenditure (i.e., a tax penalty), and failure to take account of inflation in measuring interest costs would be regarded as a positive tax expenditure (i.e., a tax subsidy).

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

Tax rates. The separate schedules applying to the various taxpaying units are included in the reference law baseline. Thus, corporate tax rates below the maximum statutory rate do not give rise to a tax expenditure. The normal tax baseline is similar, except that, by convention, it specifies the current maximum rate as the baseline for the corporate income tax. The lower tax rates applied to the first $10 million of corporate income are thus regarded as a tax expenditure under the normal tax. By convention, the Alternative Minimum Tax is treated as part of the baseline rate structure under both the reference and normal tax methods.

Income subject to the tax. Income subject to tax is defined as gross income less the costs of earning that income. Under the reference tax rules, gross income does not include gifts defined as receipts of money or property that are not consideration in an exchange nor does gross income include most transfer payments from the Government.[2] The normal tax baseline also excludes gifts between individuals from gross income. Under the normal tax baseline, however, all cash transfer payments from the Government to private individuals are counted in gross income, and exemptions of such transfers from tax are identified as tax expenditures. The costs of earning income are generally deductible in determining taxable income under both the reference and normal tax baselines.

Capital recovery. Under the reference tax law baseline no tax expenditures arise from accelerated depreciation. Under the normal tax baseline, the depreciation allowance for property is computed using estimates of economic depreciation.

Treatment of foreign income. Both the normal and reference tax baselines allow a tax credit for foreign income taxes paid (up to the amount of U.S. income taxes that would otherwise be due), which prevents double taxation of income earned abroad.

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

Table 16-4. PRESENT VALUE OF SELECTED TAX EXPENDITURES FOR ACTIVITY IN CALENDAR YEAR 2009
(In millions of dollars)

Provision	Present Value of Revenue Loss
Deferral of income from controlled foreign corporations (normal tax method)	20,060
Deferred taxes for financial forms on income earned overseas	3,540
Expensing of research and experimentation expenditures (normal tax method)	2,750
Credit for holding clean renewable energy bonds	350
Expensing of exploration and development costs—fuels	275
Expensing of exploration and development costs–nonfuels	130
Expensing of multiperiod timber growing costs	90
Expensing of certain multiperiod production costs—agriculture	180
Expensing of certain capital outlays—agriculture	120
Deferral of income on life insurance and annuity contracts	19,400
Accelerated depreciation on rental housing	6,980
Accelerated depreciation of buildings other than rental	-15,850
Accelerated depreciation of machinery and equipment	3,150
Expensing of certain small investments (normal tax method)	-40
Deferral of tax on shipping companies	20
Credit for holders of zone academy bonds	610
Credit for low-income housing investments	5,420
Deferral for state prepaid tuition plans	7,100
Exclusion of pension contributions—employer plans	74,280
Exclusion of 401(k) contributions	113,000
Exclusion of IRA contributions and earnings	4,000
Exclusion of Roth earnings and distributions	11,200
Exclusion of non-deductible IRA earnings	510
Exclusion of contributions and earnings for Keogh plans	6,270
Exclusion of interest on public-purpose bonds	26,470
Exclusion of interest on non-public purpose bonds	11,460
Deferral of interest on U.S. savings bonds	270

* * *

Appendix: Performance Measures and the Economic Effects of Tax Expenditures

The Government Performance and Results Act of 1993 (GPRA) directs Federal agencies to develop annual and strategic plans for their programs and activities. These plans set out performance objectives to be achieved over a specific time period. Most of these objectives are achieved through direct expenditure programs. Tax expenditures, however, may also contribute to achieving these goals. * * *

Comparison of tax expenditure, spending, and regulatory policies. Tax expenditures by definition work through the tax system and, particularly, the income tax. Thus, they may be relatively advantageous policy approaches when the benefit or incentive is related to income and is intended to be widely available. Because there is an existing public administrative and private compliance structure for the tax system, the incremental administrative and compliance costs for a tax expenditure may be low in many cases. In addition, some tax expenditures actually simplify the operation of the tax system, (for example, the exclusion for up to $500,000 of capital gains on home sales). * * *

[A] variety of tax expenditure tools can be used, e.g., deductions; credits; exemptions; deferrals, floors, ceilings; phase-ins; phase-outs; and these can be dependent on income, expenses, or demographic characteristics (age, number of family members, etc.). This wide range of policy instruments means that tax expenditures can be flexible and can have very different economic effects.

Tax expenditures also have limitations. In many cases they add to the complexity of the tax system, which raises both administrative and compliance costs. For example, personal exemptions, deductions, credits, and phase-outs can complicate filing and decision-making. The income tax system may have little or no contact with persons who have no or very low incomes, and does not require information on certain characteristics of individuals used in some spending programs, such as wealth. These features may reduce the effectiveness of tax expenditures for addressing socioeconomic disparity. Tax expenditures also generally do not enable the same degree of agency discretion as an outlay program. * * *

Outlay programs have advantages where direct Government service provision is particularly warranted such as equipping and providing the armed forces or administering the system of justice. Outlay programs may also be specifically designed to meet the needs of low-income families who would not otherwise be subject to income taxes or need to file a tax return. Outlay programs may also receive more year-to-year oversight and fine tuning through the legislative and executive budget process. In addition, many different types of spending programs including direct Government provision; credit programs; and payments to State and local governments, the private sector, or individuals in the form of grants or contracts provide flexibility for policy design. On the other hand, certain outlay programs, such as direct Government service provision, may rely less directly on economic incentives and private-market provision than tax incentives, which may reduce the relative efficiency of spending programs for some goals. Finally, spending programs, particularly on the discretionary side, may respond less readily to changing activity levels and economic conditions than tax expenditures.

Regulations have more direct and immediate effects than outlay and tax-expenditure programs because regulations apply directly and immediately to the regulated party (i.e., the intended actor) generally in the private sector. Regulations can also be fine-tuned more quickly than tax expenditures because they can often be changed as needed by the Executive Branch without legislation. * * * [R]egulations generally do not directly affect Federal outlays or receipts. Thus, like tax expenditures, they may escape the degree of scrutiny that outlay programs receive. However, major regulations are subjected to a formal regulatory analysis that goes well beyond the analysis required for outlays and tax-expenditures. * * *

Some policy objectives are achieved using multiple approaches. For example, minimum wage legislation, the earned income tax credit, and the food stamp program are regulatory, tax expenditure, and direct outlay programs, respectively, all having the objective of improving the economic welfare of low-wage workers.

Tax expenditures, like spending and regulatory programs, have a variety of objectives and effects. When measured against a comprehensive income tax, for example, these include: encouraging certain types of activities (e.g., saving for retirement or investing in certain sectors); increasing certain types of after-tax income (e.g., favorable tax treatment of Social Security income); reducing private compliance costs and Government administrative costs (e.g., the exclusion for up to $500,000 of capital gains on home sales); and promoting tax neutrality (e.g., accelerated depreciation in the presence of inflation). Some of these objectives are well suited to quantitative measurement, while others are less well suited. Also, many tax expenditures, including those cited above, may have more than one objective. * * *

ANALYTICAL PERSPECTIVES BUDGET OF THE UNITED STATES GOVERNMENT FISCAL YEAR 2009 (APPENDIX)

Office of Management and Budget

Pages 315-18, 320, 322-25 (2008)

Treasury Review of the Tax Expenditure Presentation

This appendix provides a presentation of the Treasury Department's continuing review of the tax expenditure budget. The review focuses on three issues: (1) using comprehensive income as a baseline tax system; (2) using a consumption tax as a baseline tax system; and (3) defining negative tax expenditures (provisions that cause taxpayers to pay too much tax).

* * *

Differences Between Official Tax Expenditures and Those Based on Comprehensive Income

As discussed in the main body of the chapter, tax expenditures are measured relative to normal law or reference law baselines that deviate from a comprehensive concept of income. Consequently, tax expenditures identified in the Budget can differ from those that would be identified under a comprehensive income tax baseline. This appendix compares major tax expenditures listed in the tax expenditure budget with those implied by a comprehensive income baseline.

* * *

Major Tax Expenditures from the Traditional Budget under a Comprehensive Income Tax Baseline

Comprehensive income, also called Haig-Simons income, is the real, inflation-adjusted accretion to one's economic power arising between two points in time, e.g., the beginning and ending of the year. It includes all accretions to wealth, whether or not realized, whether or not related to a market transaction, and whether a return to capital or labor. Inflation-adjusted capital gains (and losses) would be included in comprehensive income as they accrue. Business investment and casualty losses, including losses caused by depreciation, would be deducted. Implicit returns, such as those accruing to homeowners, also would be included in comprehensive income. A comprehensive income tax baseline would tax all sources of income once and only once. Thus, it would not levy a separate tax on corporate income leading to the double taxation of corporate profits.

Comprehensive income is widely held to be the idealized base for an income tax even though it is not a perfectly defined concept. * * *

Furthermore, comprehensive income does not necessarily represent an ideal tax base * * * . [S]ome elements of comprehensive income would be difficult or impossible to include in a tax system that is administrable.

Classifying individual tax provisions relative to a comprehensive income baseline is difficult in part because of the ambiguity of the baseline. * * * Nonetheless, Appendix Table 1 attempts such a classification for each of thirty illustrative large tax expenditures from the Budget.

Table 1 classifies fifteen of the thirty items as tax expenditures under a comprehensive tax base (those in panel A). Most of these give preferential tax treatment to the return on certain types of savings or investment. They reflect the hybrid nature of the existing tax system * * * .

Panel B displays items that probably are tax expenditures, but that raise additional issues. Current law, for instance, allows deductions for home mortgage interest and for property taxes on owner-occupied housing. The tax expenditure budget includes both of these provisions. A comprehensive tax base would allow both deductions, but it would also include imputed gross rental income. * * *

The next category (panel C) includes items whose treatment is less certain. * * *

Medical expenditures may or may not be an element of income. These expenditures may be viewed as a reduction of net worth (e.g. cost of earning income) rather than as discretionary spending, and so are not really consumption and should be excluded from the tax base. However, expenditures for medical care may be considered as indistinguishable from other consumption items which are not excluded from a comprehensive income base. * * *

The final category (panel D) includes items that would not be tax expenditures under a comprehensive income tax base. A tax based on comprehensive income would allow all losses to be deducted. Hence, the exception from the passive loss rules would not be a tax expenditure.

Major Tax Expenditures under a Comprehensive Income Tax That Are Excluded from the Current Budget

While most of the major tax expenditures in the current budget also would be tax expenditures under a comprehensive income base, there also are tax expenditures relative to a comprehensive income base that are not found on the existing tax expenditure list. These additional tax expenditures include the imputed return from certain consumer durables (e.g., automobiles), the difference between capital gains (and losses) as they accrue and capital gains as they are realized, private gifts and inheritances received, in-kind benefits from such Government programs as food-stamps, Medicaid, and public housing, the value of payouts from insurance policies, and benefits received from private charities. * * *

Differences Between Official Tax Expenditures and Tax Expenditures Relative to a Consumption Tax Base

* * *

Treatment of Major Tax Expenditure under a Comprehensive Consumption Baseline

* * * [T]he major difference between a comprehensive consumption tax and a comprehensive income tax is in the treatment of saving, or in the taxation of capital income. Consequently, many current tax expenditures related to preferential taxation of capital income would not be tax expenditures under a consumption tax. * * *

Revised Estimates of Selected Tax Expenditures

* * *

Double Tax on Corporate Profits

A comprehensive income tax would tax all sources of income once. Taxes would not vary by type or source of income.

* * *

Appendix Table 3 provides an estimate of the negative tax expenditure caused by the multiple levels of tax on corporate profits. This negative tax expenditure is measured as the shareholder level tax on dividends paid and capital gains realized out of earnings that have been fully taxed at the corporate level. * * *

The negative tax expenditure is large in magnitude; it exceeds $41 billion in the years 2007 through 2013. It is comparable in size (but opposite in sign) to all but the largest official tax expenditures. JGTRRA reduced but did not eliminate the double tax on corporate profits.[h]

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h. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) reduced the "double tax" on corporate earnings by taxing most dividends at capital gains rates (which rates were themselves reduced). These tax reductions, along with the rest of the 2003 Act, sunset after 2010. The "double tax" on corporate earnings is the primary issue considered in Chapter Fourteen. (Ed.)

Appendix Table 1. COMPARISON OF CURRENT TAX EXPENDITURES WITH THOSE IMPLIED BY A COMPREHENSIVE INCOME TAX[1]

Description	Revenue Effect 2009
A. Tax Expenditure Under a Comprehensive Income Tax	
Capital gains (except agriculture, timber iron ore, and coal)	55,940
Net exclusion of pension contributions and earnings: 401(k) plans	51,000
Net exclusion of pension contributions and earnings: Employer plans	45,670
Accelerated depreciation of machinery and equipment (normal tax method)	44,120
Capital gains exclusion on home sales	34,710
Exclusion of interest on public purpose State and local bonds	25,900
Exclusion of interest on life insurance savings	23,500
Deferral of income from controlled foreign corporations (normal tax method)	13,780
Net exclusion of pension contributions and earnings: Keogh plans	13,000
Accelerated depreciation on rental housing (normal tax method)	11,760
Net exclusion of pension contributions and earnings: Individual Retirement Accounts	11,700
Exclusion of net imputed rental income on owner-occupied housing	7,550
Exclusion of workers' compensation benefits	5,920
Credit for low-income housing investments	5,780
Expensing of research and experimentation expenditures (normal tax method)	4,990
B. Possibly a Tax Expenditure Under a Comprehensive Income Tax, But With Some Qualifications	
Deductibility of mortgage interest on owner-occupied homes	100,810
Step-up basis of capital gains at death	36,750
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	33,200
Child credit	29,950
Exclusion of Social Security benefits for retired workers	18,640
Deductibility of State and local property tax on owner-occupied homes	16,640
Deduction for U.S. production activities	15,330
Earned income tax credit	5,440
C. Uncertain	
Exclusion of employer contributions for medical insurance premiums and medical care	168,460
Deductibility of charitable contributions, other than education and health	46,980
Deductibility of medical expenses	5,920
Social Security benefits for the disabled	5,810
Deductibility of charitable contributions, health	5,300
Deductibility of charitable contributions, education	5,270
D. Probably Not a Tax Expenditure Under a Comprehensive Income Tax	
Exception from passive loss rules for $25,000 of rental loss	8,840

1. The measurement of certain tax expenditures under a comprehensive income tax baseline may differ from the official budget estimate even when the provision would be a tax expenditure under both baselines. * * *

Appendix Table 3. REVISED TAX EXPENDITURE ESTIMATES[1]

Provision	Revenue Loss						
	2007	2008	2009	2010	2011	2012	2013
Imputed Rent On Owner-Occupied Housing	3,890	5,440	7,550	10,480	14,540	20,180	28,010
Double Tax on corporate profit[2]	-41,230	-44,340	-46,860	-49,520	-52,340	-55,310	-58,460

* * *

JAMES MADISON AND PUBLIC CHOICE AT GUCCI GULCH: A PROCEDURAL DEFENSE OF TAX EXPENDITURES AND TAX INSTITUTIONS

Edward A. Zelinsky[*]

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Introduction

Few academic doctrines can claim the intellectual and political success of tax expenditure analysis. In roughly a generation's time,[1] Professor Surrey's procedural and substantive critique of tax subsidies has become entrenched in the law school curriculum and in legal scholarship. More impressively, the tax expenditure concept has been enshrined in federal law[4] and become part of the daily discourse of the national budget process.

In earlier articles, I have revisited the substantive tax expenditure indictment of tax subsidies to suggest that the Surrey school's invariable preference for direct government outlays is misplaced. While the classification of particular features of the Internal Revenue Code as either normative or subsidizing is critical to tax expenditure analysis, that classification cannot always be made with confidence.[6] Moreover, the substantive case against tax

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1. Calculations described in the appendix text.

2. This is a negative tax expenditure, a tax provision that overtaxes income relative to the treatment specified by the baseline tax system.

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1. Professor Surrey developed the fundamental premises of tax expenditure analysis—the classification of tax provisions as normative or subsidizing and the equivalence of the latter to direct spending—during the later years of the Johnson Administration when serving as the Assistant Secretary of the Treasury for Tax Policy.

4. *See* 2 U.S.C. § 640(c)(3) (1988) (adopted as part of Congressional Budget and Impoundment Control Act of 1974, requiring promulgation of annual tax expenditure budget).

6. In particular, I have argued that the Code's present treatment of qualified plans is consistent with the terms of a normative income tax and is therefore undeserving of characterization as a tax expenditure. *See* Edward A. Zelinsky, *The Tax Treatment of Qualified Plans: A Classic Defense of the Status Quo*, 66 N.C. L. REV. 315 (1988). I have also criticized the reflexive classification as a tax subsidy of the deduction for certain state and local taxes. *See* Edward A. Zelinsky, *The Deductibility of State and Local Taxes: Income Measurement, Tax Expenditures and Partial, Functional Deductibility*, 6 AM. J. TAX POL'Y 9 (1987). Professor Kahn has similarly suggested that accelerated

subsidies depends upon a comparison of such subsidies with an idealized vision of direct spending. In theory, tax expenditures can be designed as efficiently and progressively as programs using direct governmental outlays. On the other hand, if we compare the messy realities of tax preferences with the equally unattractive realities of direct expenditure programs, tax preferences emerge better than most of the Surrey school would acknowledge. Indeed, in particular cases, a tax subsidy may be more efficient than an equivalent direct spending program because such a subsidy uses the pre-existing tax system to communicate federal policy at relatively low marginal cost. Thus, as a matter of substantive policy, a certain agnosticism is in order: in some instances, direct government outlays will be preferable to comparable tax expenditures; in other cases, a subsidy through the Internal Revenue Code will be the preferred means of implementing federal policy.

In this Article, I revisit the procedural aspects of the tax expenditure critique to argue against that critique insofar as it is premised on the asserted expertise of direct expenditure institutions. The core of my argument is that the institutions formulating and administering tax policy are more competitive and visible than their direct outlay counterparts because tax institutions are subject to more numerous and diverse constituencies than the specialized, limited-clientele organizations that design and implement direct government spending. Tax institutions, because of their greater visibility and more competitive nature, are less susceptible to interest group capture and possess greater legitimacy under pluralist criteria than their direct expenditure equivalents. This perspective leads to a form of agnosticism as well: the congressional committees that design and the administrative agencies that implement tax subsidies may, in particular cases, be preferable to their direct expenditure counterparts.

To develop my argument, I will initially review the procedural case against tax preferences and will then contrast the expertise-based premise of this perspective with the Madisonian/public choice/pluralist tradition in American political thought, a tradition that focuses, not upon the asserted proficiencies of policymakers, but upon the interplay of competing interest groups in the political process. * * * I will then elaborate my argument about the differences between the administrative agencies and congressional

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depreciation may be consistent with the provisions of a normative income tax. *See* Douglas A. Kahn, *Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 MICH. L. REV. 1 (1979). Professor Stein, on the other hand, has vigorously contested my views, defending the classification as a tax subsidy of the Code's qualified plan provisions. *See* Norman P. Stein, *Qualified Plans and Tax Expenditures: A Reply to Professor Zelinsky*, 9 AM. J. TAX POL'Y 225 (1991); Edward A. Zelinsky, *Qualified Plans and Identifying Tax Expenditures: A Rejoinder to Professor Stein*, 9 AM. J. TAX POL'Y 257 (1991); *see also* Douglas A. Kahn & Jeffery S. Lehman, *Tax Expenditure Budgets: A Critical View*, 54 TAX NOTES 1661, 1664 (1992) ("[V]ery few items fit neatly into" categories of normative and subsidizing); Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 DUKE L.J. 1155, 1156 (1988) (introducing "substitutable tax provisions" concept).

committees that formulate and implement direct expenditure programs and the equivalent tax organizations.

Let me emphasize at the outset, what I am not saying: I am not suggesting that the institutions that design and implement the tax law are immune from capture by interest groups or perfectly implement the pluralist model of democracy. I am not declaring that, in all cases, a tax subsidy is better designed and administered than its direct expenditure counterpart or that the interplay of interest groups mechanically dictates legislative and administrative outcomes: ideology, accident, history, inertia, partisanship, public opinion, cultural norms, bureaucratic aggrandizement, the idiosyncrasies of legislators and the legislative process, and the personalities and proclivities of individual decisionmakers, as well as their concern for the public interest, all affect the outcomes of political and administrative processes. The procedures by which taxes are designed and administered are not ideal or pretty or inhabited exclusively by the pure of heart.

I am suggesting that, in the long term, institutional differences of the sort I explore below do systematically affect legislative and bureaucratic outcomes for better and for worse. A defense of the tax system along these lines constitutes an important counterweight to the widespread, contemporary disillusionment with that system.

The Procedural Case Against Tax Expenditures: the Expertise of Direct Expenditure Institutions

In its original incarnation, the procedural critique of tax subsidies embodied two basic concerns: that such subsidies, undisclosed in the federal budget, were not subject to the same scrutiny as direct monetary expenditures, and that such subsidies, designed and implemented by congressional tax-writers and the Department of the Treasury, were not formed or administered using the specialized subject matter expertise of the other committees of Congress and the nontax executive departments.

The first part of this critique gave rise to the proposal for the tax expenditure budget, the annual identification, as part of the federal government's regular budgetary process, of the subsidies contained in the Internal Revenue Code and of their projected costs. Today, the preparation of such a budget is required by statute. Not surprisingly, much political and academic attention has been devoted to determining the items properly included in the yearly tax expenditure budget and the revenues foregone as a result of such items.

While the tax expenditure school had quick (and, I think, useful) success in persuading Congress of the need for an annual tax expenditure budget, it has had less impact *vis-à-vis* the second element of its procedural critique, i.e., the failure, in the design and implementation of tax preferences, to utilize the subject matter expertise of the nontax congressional committees and executive departments. Professor Yorio expressed the concern in these terms:

> The process by which tax subsidies are enacted and administered also increases the risk that they would fail a cost-benefit test. To

begin with, a tax subsidy enters the Code after review primarily by the House Ways and Means Committee and the Senate Finance Committee. Charged principally with matters of tax and finance, both committees are usually less informed about the specifics of the problems justifying government intervention than those Congressional committees that grapple regularly with the problems. Moreover, the duty of administering tax subsidies is left to the Internal Revenue Service (IRS), which generally has no particular expertise with respect to the problem that the preference was enacted to remedy. Although it may be theoretically possible for the relevant tax committees and the IRS to obtain and digest the information required to make a rational cost-benefit decision about a specific tax expenditure, the process of education and learning is likely to be haphazard and incomplete. As a practical matter, it is virtually impossible for two congressional committees and one administrative agency to master the plethora and diversity of proposals for using the Code to accomplish societal goals.[15]

From one vantage point, this critique is easily remedied by making the enactment and implementation of tax preferences a joint undertaking of the relevant tax and nontax institutions. Subsidies implemented through the Code can, before or after passage by the Ways and Means and Finance Committees, be submitted to additional expert review by the proper subject matter committees of Congress. Congress can—and, on occasion, does—provide for the joint administration of particular tax subsidies by the IRS and the appropriate nontax administrative agency.[17] * * *

On the most fundamental level, the expertise critique of tax expenditures invokes the important notion in American political culture that disinterested, "trained, nonpartisan experts [can] best manage the subtle and difficult social questions of the modern world."[20] From this vantage point, Professor Surrey's procedural case for the subject matter proficiency of nontax institutions is an appeal to the managerial and technocratic values underpinning such expert-oriented institutions as civil service systems, independent regulatory agencies, and municipal governments run by city managers. Professor Surrey's perspective is thus firmly rooted in the tradition of Progressive, New Deal, and good government reformers who placed great confidence in the processes and outcomes of professional decisionmaking—a tradition which, in Professor Banfield's apt, but wary, description, seeks "to replace politicians with

15. Edward Yorio, *Equity, Efficiency, and the Tax Reform Act of 1986*, 55 FORDHAM L. REV. 395, 425 (1987).

17. For example, under the low-income housing credit established in Section 42, important administrative functions are assigned to the U.S. Department of Housing and Urban Development and the U.S. Department of Agriculture.

20. LEWIS L. GOULD, REFORM AND REGULATION, AMERICAN POLITICS FROM ROOSEVELT TO WILSON 210 (2d ed. 1986).

experts."[21]

Interest Group Theory: Madison, Pluralism, Public Choice, and Monitoring Political Agents

James Madison, in contrast, was skeptical of institutional arrangements that presume "[e]nlightened statesmen will . . . always be at the helm" of government.[22] For Madison, self-government is not a matter of entrusting public authority to experts but, rather, of coping with the inevitable "spirit of party and faction in the necessary and ordinary operations of government."[23] * * *

In much contemporary discussion, Madison's concerns are echoed in the vocabulary of public choice. * * * An important variant of this perspective "conceives regulation as a service supplied to effective political interest groups."[29]

Public choice analysis—emphasizing the rent-seeking nature of interest group activity, the incentives of political entrepreneurs to supply such groups, collective action problems which prevent the effective organization of the public at large, and the capture of legislatures and administrative agencies by organized, concentrated constituencies—reinforces Madison's preference for competitive political processes that pit diverse and conflicting groups against one another. While it is possible in a Madisonian process for interests to respond to their situation collusively rather than competitively, attempting to satisfy their respective needs by combining into broad, mutually useful coalitions, nevertheless, insofar as the legislative or administrative environment approaches Madison's ideal, the presence of more diverse and numerous interest groups discourages such logrolling: more heterogeneous groups will find it more difficult to negotiate mutually acceptable positions for a common front; more numerous groups will find it more costly to bargain with one another and more difficult to detect and prevent defection from and freeloading on the coalition.

* * * [R]elatively closed processes, less visible to some groups or to the general public than to other groups, are more easily captured by the interests that can readily monitor those processes and therefore intelligently punish and reward such processes' decisionmakers. Conversely, more visible institutions, subject to effective oversight by numerous and diverse interests and by the public as a whole, are less prone to capture by any particular clientele since competing interests and the general public are all watching.

Madison's view of organized constituencies, some would assert, is overly pessimistic, ignoring the possibility (and the reality) that "factions" can (and do) play a constructive role in the body politic.

21. EDWARD C. BANFIELD, HERE THE PEOPLE RULE 170 (2d ed. 1991).
22. *See* THE FEDERALIST NO. 10, at 80 (James Madison) (Clinton Rossiter ed., 1961).
23. *Id.* at 79.
29. Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. MGMT. SCI. 335, 356 (1974).

* * * [F]rom the perspective I advance, it is not necessary that any (or all) of the interest group theories explain exhaustively all political behavior; it is merely necessary to start with their common teaching that political institutions influenced by more numerous and more diverse groups are preferable to governmental organizations influenced by more limited and more homogeneous constituencies.

* * *

It is thus important to reiterate the asymmetry between the invariable preference of the Surrey school for direct monetary expenditures and my more agnostic perspective. I am not advancing a countermyth that the processes that formulate and administer tax subsidies are invariably superior to their direct expenditure counterparts. In particular cases, the benefits flowing from the expertise of a nontax committee or of a direct expenditure department may reasonably be perceived as outweighing the correlative dangers of capture. There are also cases where susceptibility to capture is a desired quality, ensuring an intended responsiveness of governmental arrangements to a favored clientele: a grateful nation might rationally prefer veterans institutions beholden and therefore responsive to those who served in the armed services rather than veterans programs administered with less partiality by the IRS or evaluated with less solicitude by the tax committees. The larger points of this Article are that the trade-off between expertise and capture exists, that the choices this trade-off presents should not be ignored simply by asserting the superior expertise of direct expenditure institutions and that, in some instances, the greater independence and visibility of tax-writers and administrators will be preferable to the alleged subject matter proficiency of their more specialized, capturable counterparts in the direct expenditure system.

The Madisonian Nature of Tax Institutions

For purposes of the Surrey critique, we can view tax and direct expenditure policy as formulated and administered in four stages. Initially, the congressional committees design and authorize programs within their respective jurisdictions. Next, the full houses of Congress act on the committees' product. Third, the President approves or disapproves the decision of the House and Senate. Finally, the appropriate executive department executes the program agreed upon by Congress and the President.

The tax expenditure procedural critique is aimed at the first and fourth stages of this process. At the first stage, the critique asserts that the nontax committees of Congress possess expertise due to their specialization in particular subject matters. This expertise is utilized in the formulation of direct spending programs but is not used in the formulation of tax subsidies since such subsidies are designed by the Ways and Means and Finance panels, generalist bodies with less opportunity and less inclination to acquire subject matter proficiency than the narrowly focused nontax committees of Congress.

A similar analysis applies at the fourth stage of the policy process. Direct outlay programs are administered by specialized executive departments which, it is argued, develop great understanding of the programs they implement and the problems those programs address. In contrast, the Treasury and the IRS, distracted by the need to run the tax system, do not develop comparable expertise as to the subsidies confided to their administration.

The Madisonian/public choice/pluralist perspective suggests that this critique romanticizes the congressional committees that design, and the executive departments that administer, direct spending programs while ignoring the benefits of the more competitive processes through which taxes are formulated and implemented. The specialized orientation of the nontax committees and departments makes each of these institutions highly susceptible to capture by the limited constituencies affected by its comparatively narrow jurisdiction. In pluralist terms, the outcomes emanating from direct expenditure committees and departments possess less legitimacy than if more numerous and more diverse groups were to participate in the deliberations of these institutions.

Consider, for example, the case of agriculture. Many provisions of the Internal Revenue Code can quite comfortably be classified as subsidies for the farm industry.[45] The tax expenditure procedural critique suggests that, as a matter of process, such subsidies should not be designed in Congress' tax-writing committees because these bodies lack the expertise to formulate farm policy. Instead, the agriculture committees should develop farm programs using direct outlays of government funds.

However, within the farm committees there are generally not significant countervailing pressures from nonagricultural constituencies, while in the Ways and Means and Finance panels agricultural interests are forced to contend with the competing pressures of other groups also seeking largesse from the public fisc. * * *

Similarly, the procedural indictment of tax preferences contends that, in the implementation of agricultural subsidies through the Code, the IRS lacks the expertise of the Department of Agriculture. However, in the administration of farm subsidies, the Secretary of the Treasury possesses greater independence from farm interests than the Secretary of Agriculture. The Secretary of Agriculture relies on farm lobbies to support his policy agenda and his department's budget. He and his subordinates may have worked with agricultural interests before appointment and may return to agriculture after government service. When a Secretary of Agriculture proposes to abolish farm subsidies, he strikes at the very rationale for his agency's existence. * * *

In the vocabulary of the economic theory of regulation, the Department of Agriculture and Congress' farm committees supply industry-specific

45. For example, a number of farm assets are singled out statutorily for particularly rapid cost recovery: certain horses, I.R.C. §§ 168(e)(3)(A) (1992), certain agricultural and horticultural structures, I.R.C. §§ 168(e)(3)(D)(I) (1992), and fruit- and nut-bearing trees and vines, I.R.C. §§ 168(e)(3)(D)(ii) (1992). Similarly, qualifying family farms enjoy estate tax benefits. I.R.C. §§ 2032A (1992).

services—agricultural subsidies—to a limited number of buyers—farm interests. In contrast, the Treasury and Congress' tax-writers supply more fungible services—tax subsidies—in a more competitive environment, distinguished by many more possible purchasers and consequent collective action problems.

* * *

Indeed, contra to the Surrey critique, tax institutions, because of their greater political freedom, are better positioned than direct expenditure organizations to design and implement policies informed by expertise. The theoretical skill of direct spending organizations is of little practical significance when the clienteles of such organizations effectively dominate them and their decisions. In contrast, the counterbalancing pressures on tax writers and tax administrators leave them comparatively freer to make decisions informed by expertise if they are so inclined.

In advancing this analysis, I seek neither to demonize direct expenditure institutions nor to create a countermyth about the organizations that formulate and administer tax subsidies. * * *

On the other hand, my analysis is an antidote to the benign, expertise-oriented argument of the Surrey school for the superiority of direct expenditure institutions, and suggests that tax institutions are better than is popularly thought or academically portrayed. Agricultural interests seem to do well in the tax-writing committees; they probably do better in direct spending contexts. Farm interests can view the Secretary of Agriculture as their natural ally; the same cannot be said of the Commissioner of Internal Revenue.[46]

* * *

Doernberg and McChesney take direct aim at the "political fairy tale"[53] of Gucci Gulch, the hallways outside the tax-writing committees densely packed with high paid, well-dressed lobbyists. The conventional story is that the denizens of Gucci Gulch lost in 1986, the general welfare prevailing over special interests in the rewriting of the tax code. In the spirit of public choice theory, Professors Doernberg and McChesney tell us the truth is otherwise: "tax politics as usual, with considerable sums of money changing hands"[55]—tax benefits supplied and purchased.

* * *

[I]n the Doernberg-McChesney analysis, * * * a key piece of evidence is the vast quantum of campaign contributions received from diverse sources by the members of the Finance and Ways and Means panels. Yet, the aggregate size of those donations and the variety of sources suggest that Congress' tax-

46. While I have illustrated my case with the example of agriculture, I could have used the transportation industry, the natural resources lobbies, the real estate business, veterans groups or any of the interests that seek and obtain largesse from the federal fisc.

53. Richard L. Doernberg & Fred S. McChesney, *Doing Good or Doing Well?: Congress and The Tax Reform Act of 1986*, 62 N.Y.U. L. REV. 891 (1987), at 893.

55. *Id.*

writers are not dependent upon any particular set of contributors. For those concerned about interest group capture, such a state of affairs is preferable to the alternative: legislators heavily indebted for campaign funds to limited constituencies. The economic theory of regulation suggests that the senators and representatives who serve on nontax committees will find themselves in this unfortunate situation, highly reliant for campaign funds upon the relatively homogeneous interest groups serviced by the committees on which such legislators sit.

* * *

Objections, Qualifications and Refinements

I now want to anticipate some objections to my analysis and, where appropriate, qualify and refine my argument. First, it can be argued that, if the generalists who write and administer the tax laws are not knowledgeable about particular substantive areas of government, their lack of expertise engenders a form of capture stemming from their consequent dependence on the information provided by interest groups. Bureaucrats in direct expenditure agencies and members of Congress on nontax committees can, the reasoning goes, independently evaluate the data and proposals advanced by constituencies within their respective jurisdictions because such legislators and bureaucrats possess independent, countervailing expertise; tax personnel, in contrast, are more dependent upon importuning constituencies because tax personnel cannot assess the validity of what they are told. When, for example, the farm lobby furnishes data and advice to the Secretary of Agriculture or to members of Congress' agriculture committees, those individuals can evaluate that material for themselves or can turn to professional staff which can evaluate it for them. On the other hand, the argument runs, tax writers and administrators, generalists lacking specialized expertise in agriculture, are effectively captured by the farm lobby on whose information they depend.

By way of rejoinder, I should first make explicit my skepticism towards the claim of expertise for direct expenditure institutions[.] * * *

Finally, even if direct expenditure institutions possess superior expertise in the abstract, such institutions, because of their greater proclivity towards political capture, are less likely than tax organizations to make decisions actually informed by such expertise. Paradoxically, tax decisionmakers, even if theoretically less knowledgeable in particular substantive areas, are better able to make decisions informed by the expertise they do possess because their more competitive, visible environment frees them to use what expertise they have.

These observations, in turn, suggest further qualification of my thesis: as individuals and institutions in the tax process specialize to acquire proficiency in particular areas of substantive policy, the tension between capture and expertise reemerges. A Treasury lawyer who specializes in the tax problems of agriculture acquires industry-specific skills and knowledge likely to affect his views and future employment; a senator with a narrowly-focused concern about the tax problems of agriculture will develop a relationship with the farm lobby similar to that of a member of the Senate's agriculture panel. If too much substantive policy is channeled through the tax committees and the Treasury, these institutions will be forced to organize themselves internally by subject matter and thus start to resemble their more capturable direct expenditure counterparts. * * * [T]he tax system does not have infinite capacity in the generalist, multi-constituency form in which it exists today; if overutilized, the tax system will be forced to specialize in a fashion which replicates the expertise and capturability characteristics of direct expenditure institutions.

Another possible rejoinder to my analysis would suggest that the competitive nature of the second and third stages of the process for adopting direct government outlays compensates for capture in the first and fourth stages, thereby redeeming the process as a whole from the effects of special interests. The Surrey school could concede that, while the specialized committees of Congress and the nontax departments of the executive branch are highly vulnerable to capture by their respective constituencies, the problem is corrected in the deliberations of the full houses of Congress and in the President's participation in the process. * * *

While there is an element of truth to this line of thought, there is much overstatement in it as well. Left to their own devices, the Department of Agriculture and Congress' agriculture committees would probably devote most of the federal budget to farm subsidies. The full Congress and the President obviously will not let this happen. However, it overstates the corrective influence of the President and Congress as a whole to conclude that they can completely eradicate the consequences of capture in the direct expenditure committees and executive departments. The consensus among scholars studying Congress is that a particular clientele's domination of a committee leads to a final outcome more favorable to that clientele. It is similarly a commonplace among students of American government that an interest group's control of an administrative agency affects the final outcome of the political process in ways favorable to that group.

In terms of the stylized, four stage process, the decisions of legislative committees set agendas and furnish resources for the debates of the full bodies in the second stage, thereby affecting the results of those second stage deliberations. If we view the floors of both houses as arenas dedicated to logrolling, the interest that loses in committee has no log to roll. Conversely, the interest doing well in committee has more logs to roll and, hence, is likely to emerge at the end with a larger portion of the overall largesse being dispensed. By the same token, the President's options are heavily circumscribed by the actions of the federal bureaucracy, actions which frequently constitute services supplied to clientele interests.

* * *

Implications

What, then, are the implications of my analysis? First, and perhaps most important, are its rhetorical ramifications. Embedded in the tax expenditure literature is an invariable preference, procedural as well as substantive, for direct government outlays. Similarly embedded in popular and academic discourse is a pronounced disillusion with the federal tax system. My analysis suggests a more balanced view of the processes for enacting and administering tax subsidies.

* * *

The organizations that design and implement federal taxes are not ideal or populated by the pure of heart. However, Madison, like his near contemporary Adam Smith, reminds us that perfection is not the criterion against which human institutions ought to be measured and that the utility of such institutions does not depend upon the motives or moral worthiness of those who populate them.

My argument further suggests that tax subsidies ought to be preferred to direct expenditures when there is a need for detached administration and oversight by decisionmakers less susceptible to capture. Because of his competing constituencies and functions, the Secretary of the Treasury is more likely to implement an agricultural program independently of farm lobbyists than the Secretary of Agriculture; the Treasury is also more apt than the Department of Agriculture to disapprove a farm subsidy it administers and propose the subsidy's abolition. An important instance of such detached evaluation is the Treasury's 1984 tax reform study which recommended abolishing a variety of federal tax subsidies for, inter alia, transportation, military and mineral interests.[78] It is hard to conceive of the direct expenditure departments proposing such sweeping repeal of the programs they administer. Similarly, the Ways and Means and Finance panels, because of their greater visibility and offsetting clientele pressures, are better positioned than the direct expenditure committees to oversee subsidy programs objectively.

* * *

Notes and Questions

5. The Office of Management and Budget (OMB) presents a compilation of tax expenditures, valuing each separately, but expressly notes that it cannot provide a total of all the listed tax expenditures. Why does the whole not equal the sum of the parts?

6. In most cases, tax expenditures are designed to bring about changes in the behavior of taxpayers. Thus, to the degree the tax expenditure is successful, we might expect less of the subsidized activity if the subsidy were removed. Nonetheless, the OMB does not reflect such "behavioral effects" in its estimates. Why not?

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78. U.S. DEP'T OF THE TREASURY, 2 TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 47, 223, 324 (1984) (proposing abolition of military-related exclusions from gross income, repeal of variety of tax preferences relative to energy and natural resources, and abolition of tax benefits for merchant marine capital construction fund).

7. What is the difference between computing tax expenditures on a cash-flow basis and on a present-value basis? Why is the distinction likely to be particularly important with respect to tax expenditures that take the form of deferrals?

8. The 1974 Congressional Budget Act, which mandated the tax expenditure budget, did not specify the "baseline" to which tax expenditures are to be compared. This omission is significant, because the baseline is probably the most important and most controversial aspect of the process. The officials charged with preparing the tax expenditure budgets thus have some leeway to change their approach over time, which may lead to charges of manipulating the process to serve political goals of the party controlling the Presidency (in the case of the OMB) or Congress (in the case of the Congressional Budget Committee).

9. The problem in selecting the baseline is dramatically demonstrated by the realization rule. As we have seen throughout this book, myriad problems, both conceptual and practical, arise from the failure to tax unrealized appreciation. Should failure to adhere to the Haig-Simons definition of income with regard to unrealized gain be regarded as a massive tax expenditure, or is the realization rule so basic that it is the "norm"? If so, should instances in which the law requires mark-to-market tax treatment be regarded as negative tax expenditures?

10. OMB compiles the tax expenditure budget using "reference law" and "normal tax" baselines. While the reference law baseline is an attempt to derive a supposed norm from present law, the normal tax baseline deviates from present law toward the Haig-Simons "ideal," at least in some respects. Because the concept of income is broader under Haig-Simons than under present law, OMB observes that "[tax expenditures] under the reference law baseline are generally tax expenditures under the normal tax baseline, but the reverse is not always true."

Some of the items classified as tax expenditures under the normal tax baseline, but not under the reference law baseline, are of significance. For example, accelerated depreciation (more rapid than economic depreciation) and corporate tax rates below the top rate (35 percent) are regarded as tax expenditures under the normal tax baseline, but not under the reference law baseline.

11. Note, however, that even the normal tax baseline embodies "several major departures from a pure comprehensive income tax." These include the failure to regard unrealized appreciation as income, failure to take account of inflation, and accepting a two-level tax on corporate income as part of the baseline.

12. The Appendix to the OMB tax expenditure budget for FY 2009, like most Bush-era tax expenditure budgets, undertakes an alternative computation of tax expenditures using a comprehensive, or Haig-Simons, baseline. Is such a baseline to be preferred to those traditionally used in the tax expenditure budget?

13. While tax expenditures, almost by definition, make the Internal Revenue Code longer and more complex, particular tax expenditures can actually simplify compliance with, and administration of, the law. Simplifying tax expenditures include provisions such as section 121 (effectively exempting from income most capital gains on sales of principal residences) and section 179 (allowing many taxpayers to immediately deduct purchases of equipment, rather than deducting the cost over time through capitalization and depreciation).

On the other hand, many tax expenditures clearly result in significant complication on all levels. An important example is the earned income tax credit, which brings millions of individuals who otherwise would not need to file returns into contact with the Internal Revenue Service. Whatever benefits the EITC may bring, simplifying life for either low-income taxpayers or the Service is not among them. (But, on the third hand, any program designed to deliver tens of billions of government dollars to low-income individuals would have to entail considerable complexity for the recipients and for *some* government agency.)

14. The Appendix of the FY 2009 (Bush) tax expenditure budget attempts to analyze tax expenditures under a comprehensive, Haig-Simons, definition of income. Difficulties, results some perhaps unexpected, immediately appear. Given the broader sweep of income under the Haig-Simons definition than under the norms of current law, one counterintuitive result is that some items presently classified as tax expenditures might not be regarded as tax expenditures under the comprehensive tax baseline. For example, deductions for home mortgage interest and property taxes on owner-occupied housing are regarded as tax expenditures under the traditional tax expenditure budget. But if the imputed value of living in the owner-occupied house should be regarded as Haig-Simons income, then associated expenses, such as interest and property taxes, would be appropriate deductions, and thus those deductions should not be regarded as tax expenditures.

15. Traditionally, little or no official attention has been given to deviations from the norm that increase taxes (such as various limitations on the deduction of losses). Do you find useful the concept of negative tax expenditures explored in the FY 2009 Appendix?

16. The double tax on corporate earnings can be viewed as a negative tax expenditure. The FY 2009 Appendix notes that Congress granted partial relief

21. How does a reduction in income tax rates affect tax expenditures?

22. Is the concept of tax expenditures merely a way of framing the issue as to what should be included in the income tax base?

23. If a credit against tax is allowed for purchase of a depreciable asset, should the tax basis of the asset thereafter be the full price paid for it or its cost reduced by the tax credit?

24. Professor Surrey argued that almost any tax expenditure could be duplicated, in substantive effect, by a direct expenditure program. Is this correct? What difference would it make? Would direct expenditures be more closely scrutinized? Would direct expenditures exclude as potential beneficiaries those with so little income that they paid no income tax, as tax expenditures routinely do?

25. Would charities be indifferent if Congress ended the tax deduction for charitable contributions and substituted, as Professor Surrey suggested, "a direct expenditure program under which the Government matched with its grants, on a no-questions-asked and no-second-thoughts basis, the gifts of private individuals to the charities they selected"?[j] Would such a direct expenditure be constitutional if the charity were a church?

26. Of course, even a tax expenditure in the form of a charitable contribution deduction could be constitutionally suspect. In a detailed review of this topic, Professor Linda Sugin concludes that, though the issue is not entirely free from doubt: "Indirect benefits do not imply government support and approval to the same extent as benefits that emanate straight from the government,"[k] and "it is clear that the economic equivalence of tax benefits and direct spending is not the most important factor to consider in establishment clause analysis."[l]

27. The structure of a tax expenditure can be important. Prior to the Tax Reform Act of 1986, taxpayers over the age of 65 and blind taxpayers were allowed an additional personal exemption, which had the effect of a deduction for all such taxpayers. The 1986 Act, in addition to reducing the amount of the benefit, changed its structure—rather than a personal exemption available to all aged and blind taxpayers, it was restructured as an increased standard deduction, which is of no value to those who itemize deductions.[m] What policy choices, or what views of the effects of age or blindness, justify one structure

j. Surrey, *supra* note a, at 133.

k. Linda Sugin, *Tax Expenditure Analysis and Constitutional Decisions*, 50 HASTINGS L.J. 407, 471 (1999).

l. *Id.* at 472.

m. Section 63(f).

as compared to the other? What different set of decisions would be reflected by converting the tax advantage to a "refundable" credit?

28. Why does Congress give a tax advantage to taxpayers who are elderly or blind, and not to taxpayers with other afflictions, such as quadriplegia? Can such distinctions be defended?

29. Tax expenditures arising from deferral of tax liability have attracted relatively little political opposition, perhaps because the advantages of deferral are better understood by the beneficiaries than by the general public. Moreover, such tax expenditures can be defended politically on the grounds that the tax is "merely" being postponed.

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

30. Professor Zelinsky asserts that Surrey and his adherents have unfairly painted tax expenditures, in part due to a failure to "compare the messy realities of tax preferences with the equally unattractive realities of direct expenditure programs."

31. Zelinsky asserts that the choice between tax expenditures and direct expenditures may entail a tradeoff between expertise and "capture." Which way does a desire for knowledgeable decisionmakers point? What does Zelinsky mean by "capture," and why does he view capture as a serious concern?

32. Zelinsky uses agriculture to illustrate his argument. Given that all three officials are appointed by the President and serve at his pleasure, why is it more likely that the Secretary of Agriculture will be more responsive to a particular constituency (agricultural interests) than will the Secretary of the Treasury and the Commissioner of Internal Revenue?

33. Professor Zelinsky makes a telling point, in noting the broad Treasury proposals in 1984 ("Treasury I," which ultimately led to the Tax Reform Act of 1986), and observing that "[i]t is hard to conceive of the direct expenditure departments proposing such sweeping repeal of the programs they administer."

34. For reasons perhaps more obvious, members of the House and Senate agriculture committees are far more likely to be allied with agriculture

interests than are members of the Ways and Means and Finance Committees—or than the membership of the House and Senate as a whole. Who is likely to seek a seat on an agriculture committee—a representative of a rural or urban state or district? From what industry can a member of an agricultural committee look to receive a disproportionate share of her campaign contributions?

Professor Zelinsky's point is not that the tax committees are "inhabited exclusively by the pure of heart," but that they are more likely to serve disparate, competing constituencies.

35. After reading Professor Zelinsky's argument, are you, like he, "agnostic" concerning the choice between tax expenditures and direct expenditure programs, or do you generally prefer one approach or the other?

36. A relatively new statute, the Government Performance and Results Act of 1993 ("Results Act"), offers the possibility of more effective oversight of government programs, including those administered through tax expenditures. In response to that Act, each year's Tax Expenditure Budget includes an appendix that evaluates tax expenditures and compares them to direct expenditures and regulations, which are alternative means of pursuing governmental goals. (See Appendix of the 2011 Tax Expenditure Budget; similar appendices have been in each budget since 1993.)

Professor Mary Heen concludes that "[t]he Results Act framework, if comprehensively applied, provides a new opportunity to address the management and oversight problems posed by the use of tax expenditures as alternatives to direct expenditure programs."[n] While promising in theory, however, Professor Heen expresses concern, based on early experience with two employment tax credits (Welfare-to-Work Tax Credit and Work Opportunity Tax Credit), that the information generated by the executive review may not lead to effective legislative oversight:

> The lack of integrated review in these particular cases does not derive from a lack of transparency or a dearth of data; instead, it represents, depending upon your view of the legislative process, either "business as usual" or a structural failure to consider tax system and direct spending alternatives as part of a coordinated program review process.[o]

C. THE TAX EXPENDITURES CONCEPT CHALLENGED

Unless carefully confined, the premise of the tax expenditures concept might be ridiculed by *reductio ad absurdum*: any portion of a taxpayer's

n. Mary L. Heen, *Reinventing Tax Expenditure Reform: Improving Program Oversight Under the Government Performance and Results Act*, 35 WAKE FOREST L. REV. 751, 825 (2000).

o. *Id.* at 826.

income that the Government allows the taxpayer to keep would be a tax expenditure. In a slightly less extreme form, under a progressive income tax rate structure, any revenue lost by failure to tax everyone at the top bracket rate might be considered a tax expenditure.

The more limited view of tax expenditures requires the application of normative standards, but, as the excerpts in this subchapter demonstrate, these standards are open to challenge. Professors Kahn and Lehman argue that the definition of the "norm" in tax law cannot be divorced from broader societal judgments—that the tax laws "serve to reaffirm public values that are 'normative' in every sense of the word except the one used by advocates of tax expenditure budgets." Professor Bittker, perhaps the leading tax scholar of his generation, criticized the tax expenditure concept in 1969, when Stanley Surrey's idea was new and prior to the 1974 congressional mandate for an annual tax expenditure budget. Finally, the brief excerpt from Philip Oliver may cast doubt on the concept by suggesting that one deduction generally regarded as a classic tax expenditure—the deduction for home mortgage interest—may be helpful in equitably measuring income, rather than merely furthering the nontax goal of assisting taxpayers in purchasing homes.

EXPENDITURE BUDGETS: A CRITICAL VIEW

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

54 Tax Notes 1661, 1661-63 (1992)

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

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

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

The particular contours of our federal income tax serve to reaffirm public values that are "normative" in every sense of the word except the one used by advocates of tax expenditure budgets. The disallowance of a deduction for illegal bribes confirms that we think they are naughty. Similarly, the limitation on losses from wagering transactions shows that we do not consider

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them to be an appropriate foundation for a career. Conversely, the exclusion from income of tort recoveries is an expression of public compassion. And our refusal to tax people when their neighbors help them move furniture, or (as some have suggested) when they enjoy a few moments of leisure, suggests a shared sense of a private domain in which even the tax collector will respect people's right to be left alone.

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

The Choice Among Utopias

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

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

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

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

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

extent it is realized through market interactions.

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

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

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

What is disturbing about the language of tax expenditures is its tone of moral absolutism. The tax expenditure budget is said to distinguish "normal" tax practice from that which is deviant. Sometimes it is said to distinguish provisions that are "normative" (?) from those that are (presumably) nonnormative (?!). This language is doubly confusing. First, it suggests that provisions that fit *within* the implicit baseline of the tax expenditure budget are somehow pure, safe, and good. They should not be changed because "neutral" principles have blessed them. Conversely, the language suggests that provisions that fall *outside* the implicit baseline of the tax expenditure budget (tax expenditures) are somehow corrupt, dangerous, and evil. They should be changed as soon as possible to conform with the "neutral" position. To flirt with them is to call one's probity into question.

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

The Illusion of Value-Free Precision—An Example

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

Consider two features of our tax system. First, it grants a form of accelerated depreciation. Second, it does not tax unrealized gains. The first feature appears in tax expenditure budgets. * * * 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. * * *

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

* * *

ACCOUNTING FOR FEDERAL "TAX SUBSIDIES" IN THE NATIONAL BUDGET

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

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

* * *

Fleshing out Mr. Surrey's proposal, the Treasury has estimated the revenue lost by virtue of "the major respects in which the current income tax bases deviate from widely accepted definitions of income and standards of business accounting and from the generally accepted structure of an income tax." These estimates were published, along with a discussion of the conceptual framework governing the items selected for inclusion, in an exhibit to Secretary Fowler's final report as Secretary of the Treasury, under the title "The Tax Expenditure Budget: A Conceptual Analysis." This study should be

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5. Surrey, Taxes and the Federal Budget (speech to Financial Executives Institute, Dallas Chapter, Feb. 13, 1968), p. 13.

regarded as only a first step in achieving the "full accounting" envisioned by Mr. Surrey. * * *

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

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

In listing the exclusion of social security benefits as a "tax expenditure" that ought to be reflected in the Federal Budget as aid to the elderly, the Treasury analysts very likely had in mind the fact that these receipts constitute income under the Haig-Simons definition. Conversely, their study accepts the deduction of business expenses under §162 as necessary to the accurate determination of net income, with the result that the revenue "lost" by virtue of this provision is not reported as a "tax expenditure" to aid private enterprise. In making this distinction, no value judgment is intended: the deduction of business expenses and the exclusion of social security benefits are not treated differently because one provision is "good" and the other "bad," but because one is helpful or necessary in defining net income, while the other distorts the computation of income. Thus, in asking that the revenue losses resulting from "deliberate departures from accepted concepts of net income and through special exemptions, deductions and credits" be reported as

p. Present law no longer provides an additional personal exemption for aged and blind taxpayers; they are entitled, however, to an increased standard deduction. Section 63(f). (Ed.)

"expenditures," Mr. Surrey noted that these "tax benefit provisions" will have to be separated from provisions that serve to define income accurately: "We should not, of course, overlook the difficulties of interpretation or measurement involved here."[9] * * * In the same vein, the Treasury study seeks to identify the provisions of existing law that deviate "from widely accepted definitions of income and standards of business accounting and from the generally accepted structure of an income tax."

To effect a "full accounting," then, we must first construct an ideal or correct income tax structure, departures from which will be reflected as "tax expenditures" in the National Budget. Although Mr. Surrey is not explicit on the point, his proposal has much in common with the call for a comprehensive income tax base, which similarly presupposes an ideal tax structure—based on the Haig-Simons definition of income—any departure from which is to be regarded as a maverick that must shoulder a heavy burden of justification.

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

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

A whole-hearted enemy of "backstairs" spending might, I suppose, argue

9. Surrey, The United Income Tax System—the Need for a Full Accounting (speech to Money Marketeers, Nov. 15, 1967), p. 5.

that a disclosure of the cost of the cash receipts and disbursements method of accounting or of the realization concept would be a first step to their elimination. * * *

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

Assuming a consistent application of the Haig-Simons definition, however, there are many other areas that would generate "tax expenditures" for inclusion in the Budget, including the exclusion from taxable income of gifts, bequests, life insurance proceeds, and recoveries for personal injuries and wrongful death; * * * personal and dependency exemptions; imputed income from assets and housewives' services; the non-recognition provisions (e.g., exchanges of like-kind property, corporate reorganizations, etc.); depreciation deductions that exceed declines in market value * * *; current deductions for expenditures that have value beyond the current year (e.g., research and experimental expenses, institutional advertising, and outlays for industrial know-how); special accounting privileges (e.g., installment sale reporting); the foreign tax credit[15] and other items. The Treasury study—perhaps because it is offered as a "minimum" rather than comprehensive list—makes a number of compromises in applying the Haig-Simons definition in these areas. Thus, it estimates the cost of excluding employers' contributions to pension plans and the interest component of life insurance savings, but not the revenue cost of excluding increases in the taxpayer's net worth resulting from other transactions. Similarly debatable lines are drawn at other points, in that the study estimates the revenue cost of excluding or deducting: public assistance, but not gifts from charitable agencies, friends, and relatives; sick pay and workmen's compensation, but not recoveries and settlements in personal injury suits; child care expenses of employees, but not their moving expenses; accelerated depreciation on buildings, but not straight-line depreciation (even though it too may exceed the property's decline in market value); the

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

expensing of research and experimental expenditures, but not the rapid amortization of such outlays (even if their long-term value is substantial), nor the expensing of comparable outlays for good will, industrial know-how, etc.; nonbusiness state and local taxes, but not foreign taxes. * * *

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

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

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

* * *

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

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

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

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

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

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

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

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

* * *

SECTION 265(2): A COUNTERPRODUCTIVE SOLUTION TO A NONEXISTENT PROBLEM

Philip D. Oliver*

40 Tax Law Review 351, 394-96 (1985)

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

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

Unlike *A, B* chooses to invest his $50,000 cash at 10% interest. He borrows $50,000, also at 10%, to purchase his house. *B* receives taxable income of $5,000 from his investment, but the deduction for the $5,000 interest paid by *B* will offset the interest income. *B*'s taxable income therefore is equal to *A*'s.[184] Because these taxpayers have engaged in transactions that are

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

Of more importance is the assumption that all three taxpayers would itemize deductions even substantially equivalent in economic terms, their taxable income should be affected in the same way.

C, having no choice, also borrows to purchase his residence. Like *B*, he receives a $5,000 interest deduction. Since *C* has no offsetting income item, *C* has $5,000 less taxable income then either *A* or *B*. This result, however, is precisely what we should expect. *A* and *B* each has $50,000 of assets that, given a 10% interest rate of return, will produce $5,000 annually.

* * *

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

* * *

Notes and Questions

37. In criticizing the tax expenditures concept, Professors Kahn and Lehman did not mean that every provision in the Internal Revenue Code is normal because it exists, thus depriving us of any standard for judgment. They are saying, in effect, that "normal" is not a useful standard. Virtually every tax provision has political or social implications. In their view, all provisions should be reviewed on their merits, without trying for an automatic rule that will distinguish tax expenditures from normal provisions.

38. Should failure to adopt the Haig-Simons definition of income be regarded as a tax expenditure?

39. Many items generally regarded as tax expenditures are also identified as items of tax preference under the alternative minimum tax provisions (sections 55-59). The AMT provisions demonstrate congressional ambivalence about these items. Does the existence of the AMT provisions support either the proponents or the detractors of the tax expenditures concept?

40. Professor Bittker argues persuasively that a "full accounting" of tax expenditures is likely to be unattainable. Yet not all the distinctions are as nebulous as he suggests. For example, consider his comparison of the exclusion from gross income of Social Security benefits (classified in the official tax expenditure budgets as a tax expenditure favoring the elderly) with the

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without the interest deduction. If this were not the case, *A* would be in a favored position since a portion of the interest deduction of *B* and *C* would be absorbed by the zero bracket amount, and only the excess would be deductible. *See* I.R.C. § 63.

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

section 162 deduction of business expenses (*not* classified as a tax expenditure favoring business). Do you agree with the classifications of the official tax expenditure budgets, or agree with Bittker' suggestion that either of these provisions might logically be included as part of a "full accounting"?

41. In evaluating critiques such as those put forward by Kahn and Lehman, and by Bittker, remember that the fair question is not whether the tax expenditure technique is perfect. No analytic tool will ever meet that test. The question should be whether, even with its considerable imperfections, the tax expenditure concept, on balance, is helpful to Congress and the public in understanding what is going on in the large and complex federal budget.

42. Does Oliver's argument suggest that the home mortgage interest deduction is justified? That it does not constitute a tax expenditure?

43. Note that defense of the present-law home mortgage interest deduction is necessary only because present law fails to reach the imputed income generated by owner-occupied homes. A more ideal system might tax all owners on the imputed income from housing, in which case the interest deduction, as an expense associated with the generation of taxable income, clearly would be appropriate. In that case, the three taxpayers in Oliver's example would have appropriate differences in taxable income as a matter of course.

44. Are we left with a hopeless standoff between the proponents of the tax expenditures approach and its opponents?

D. WHAT FORM SHOULD TAX EXPENDITURES TAKE?

This subchapter opens with a brief excerpt from an article written by William Bradley and Philip Oliver in 1983, not long before the investment tax credit ("ITC") was virtually repealed in the Tax Reform Act of 1986. While the authors focused on the ambiguity in the ITC statute and the Service's administration of it, the broader point made by the excerpt is the importance of clarity in any tax expenditure.

The primary excerpt in this subchapter is from Professor Goldberg's article on "periodic" tax expenditures. Tax expenditures can take many forms. Some, like the former ITC, are one-time exemptions. Under the ITC immediately prior to the Tax Reform Act of 1986, taxpayers who made qualifying expenditures could reduce their taxes by ten percent of the amount expended. No further subsidy from the ITC was to be expected from that year's expenditures (though taxpayers might expect that the program would continue to be available for the next year's expenditures).

Many tax expenditures, however, give rise to ongoing tax preferences. Professor Goldberg terms these preferences "periodic." Examples include the exclusion of interest on most bonds issued by states and their subdivisions (section 103) and the deduction of interest on home mortgages (section 163(h)(3)). Purchasers of state-issued bonds and homes expect to derive a tax advantage not just in the year of purchase, but in the future as well. And they expect to be able to sell these assets to others, who can themselves benefit from the same favorable tax treatment.

Professor Goldberg discusses the problems that arise when Congress changes its mind and removes a periodic tax expenditure.

INVESTMENT TAX CREDIT: THE ILLUSORY INCENTIVE

William H. Bradley* & Philip D. Oliver**

2 Virginia Tax Review 267, 269-70 (1983)

If ITC is to provide its intended salutary effect, it is apparent that clarity in application of the provisions is important. In fact, while always desirable, clarity is of significantly greater importance here than in most areas of tax law, because a "tax expenditure" such as ITC can be justified only as a stimulus, as a means of encouraging taxpayers to do things which otherwise have nothing to do with taxation or tax policy (in the case of ITC, making investments in certain capital assets).[11]

* * *

The major thesis of this article is that the failure by Congress and the Internal Revenue Service to provide clear guidance to taxpayers with respect to the question of whether particular items of property qualify for the credit has frustrated, to a significant extent, the incentive to invest intended by Congress when it enacted the ITC provisions. In prescribing property which qualifies for the credit, inconsistent and vacillating interpretations by the Internal Revenue Service have compounded the ambiguity of the statute and the regulations. To the extent that the availability of ITC, where the primary governmental goal is unrelated to the raising of revenue, is governed by an unclear legal framework, the likely result is that taxpayers will tend to make the same investment they otherwise would have made, then seek the maximum ITC available. This phenomenon entirely frustrates the governmental policy of encouraging investment and converts a stimulus into a windfall.[16]

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11. Most tax provisions are directed only at the raising of revenue, and while complexity and ambiguity are never desirable, at least in these instances the complexity and ambiguity are likely to be associated with traditional tax goals, such as the accurate determination of the amount, timing, and character of the income.

16. Even where the law is unclear, the possible availability of ITC will still provide taxpayers some motivation to make a given investment, despite possible challenge from the Service. This would appear to be an inefficient "tax expenditure," however, since it can reasonably be assumed that a taxpayer will not substantially alter its investment policy when it knows that it may be "buying a lawsuit."

TAX SUBSIDIES: ONE-TIME VS. PERIODIC— AN ECONOMIC ANALYSIS OF THE TAX POLICY ALTERNATIVES

Daniel S. Goldberg*

49 Tax Law Review 305, 305-27, 329, 331-47 (1994)

Introduction

The current tax system integrates structural revenue raising provisions with policy-driven tax incentive, or subsidy, provisions designed to induce taxpayers to engage in activities favored by Congress for extrinsic political or social reasons. The wisdom of this dual mission has been the subject of extensive analysis and criticism. Indeed, the Tax Reform Act of 1986 marked a distinct shift away from the use of tax incentives.

It now has become apparent that this country is likely to reverse much of the 1986 tax reform and to resume using the tax system to provide incentives for business and other socially desirable activities. * * *

At this stage in tax evolution, one either could warn again of the dangers of using the tax system to advance social and economic goals, or accept the inevitable and attempt to insure that tax incentives are structured in the best possible way. Adopting the latter course, this Article offers a new and useful framework for structuring tax policy in the 1990's in order to minimize harmful economic and social side effects of tax incentives. The Article identifies the most pernicious type of tax incentives as periodic subsidies, that is, subsidies that are available to taxpayers over a period of years, rather than on a one-time basis. Periodic subsidies are inefficient and are likely to decrease the horizontal equity of the tax system. Drawing on the jurisprudence of just compensation law and on economic theory, the Article concludes that Congress should refuse to succumb to the temptation to use periodic tax incentives as an instrument of tax and economic policy but, instead, should employ only one-time subsidies. In reaching this conclusion, the Article takes issue with the recent scholarship of Professors Michael Graetz[7] and Louis Kaplow[8] whose advice to eschew transition relief for tax changes apparently has gained substantial currency among tax policymakers.

* * *

A New Tax Policy Framework for Tax Incentives

The Traditional Approach: Tax Expenditures

All tax incentive provisions have one thing in common, regardless of their form. They are designed to generate a movement of capital or labor into a particular activity by reducing the effective tax on income from that activity. A tax incentive provision works only when it has the effect of reducing a participant's tax. The resultant reduction in the federal government's revenue collection attributable to the tax incentive provision can be viewed as a subsidy

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7. Michael J. Graetz, Legal Transitions: The Case of Retroactivity in Income Tax Revision, 126 U. Pa. L. Rev. 47 (1977-1978) [hereinafter Tax Revision].

8. Louis Kaplow, An Economic Analysis of Legal Transitions, 99 Harv. L. Rev. 509 (1986).

to the tax-favored activity. Stanley Surrey referred to the lost revenue attributable to a tax incentive provision as a "tax expenditure."

Commentators sometimes disagree about which tax provisions represent subsidies and which represent integral parts of the income tax structure because they involve measurement of income. Structural components are the so-called normative elements of a revenue raising system. They include the definition of income, the specification of accounting periods, the determination of entities subject to tax, and the specification of tax rate schedules and exemption levels. Thus, a change in tax rates, for example, does not constitute a subsidy. Rather, tax rates represent a cooperative agreement on burden sharing once the tax base has been established.

In contrast, a tax subsidy is a special preference that represents a departure from the normal tax structure, designed to favor a particular industry, activity or class of people. In that sense, tax subsidies represent an alternative to direct government financing of the recipients of those preferences and should be analyzed as such. Examples of tax subsidies include cost recovery deductions exceeding economic depreciation and various targeted tax benefits ranging from the deduction for research and development expenses to the exclusion for scholarships.

Although tax rates are not tax subsidies, the economic benefit of any tax subsidy through deduction or exemption is influenced significantly by the tax rates. The greater the tax rate, the greater will be the subsidy impact of a special deduction or exclusion.

Long before the 1980's, Stanley Surrey and his adherents argued that activities should be encouraged, if at all, through direct government subsidies instead of tax incentives. They contended that using the tax system to subsidize activities was undesirable, and that if the social policy objectives were desired, direct government grants would be preferable to tax incentive provisions.

Under what now has become accepted as traditional tax policy analysis, based upon Surrey's insight, tax incentive provisions are categorized according to the manner in which they operate: by exclusion, deduction or credit. Traditional analysis focuses on the upside down nature of tax subsidies that operate through exclusions or deductions by comparing them to direct expenditures. Thus, tax policy analysis under the traditional approach would ask whether the tax system is a more efficient means for providing the subsidy than a direct grant and, if so, whether the subsidy should take the form of an exclusion, deduction or credit, bearing in mind the equity of each mechanism.

A New Framework: One-Time vs. Periodic Subsidies

A comparison of tax incentive provisions with direct grants and the trichotomy of alternative forms of subsidy, while important, is typically where analysis of tax incentive provisions ends. Tax policy analysis should take the further, and I believe essential, step of dividing tax incentive provisions into two categories: (1) those that provide one-time subsidies in the year of acquisition of the property or commencement of the activity and (2) those that operate each year the property is owned or the activity is conducted by artificially increasing the after-tax yield from the property or activity. This additional step is even more important than the steps under the traditional approach. Such a distinction becomes particularly important whenever a decision is made to discontinue a tax subsidy.

The investment tax credit and the deduction for research and development expenses represent examples of the first category of incentives. Once received by the taxpayer, the subsidy cannot be removed or altered. The decision to purchase the property or engage in the activity is affected by the one-time payment, which would be considered together with the current and long-term financial projections for the activity. This type of tax incentive can be turned on and off by the government without concern for ignoring the taxpayer's reliance because the taxpayer's subsidy cannot be affected by later government policy. To be sure, the following year Congress could increase the subsidy so that taxpayers who waited a year could obtain a greater benefit than those taxpayers who acted earlier. A taxpayer's reliance argument, however, would be no greater than the consumer who purchased an item of clothing at full price when he could have waited for the item to go on sale. The taxpayer may feel unhappy, but has not suffered a direct subsidy reduction; he has received exactly what he bargained for notwithstanding the post-acquisition price reduction.

The second type of tax incentive operates through subsidies made in periodic (generally annual) installments. Examples include accelerated depreciation and tax-exempt interest on municipal bonds. In enacting the tax incentive provision, the government has promised the taxpayer that if she acquires the property, the federal government each year will subsidize the economic yield. For example, accelerated depreciation promises the owner an annual subsidy in the amount of the reduced tax liability resulting from the accelerated portion of the depreciation (reduced by the present value of the anticipated tax on the extra gain at time of sale).[24] Similarly, municipal bonds promise the owner an annual subsidy in the amount of the forgone federal tax on the interest received from the issuer. Thus, in deciding whether to acquire property or engage in the desired activity, the taxpayer makes a present value calculation of an annuity of tax subsidies beginning in the year of acquisition and ending with the year of expected disposition (or full depreciation of the property or maturity of the tax-exempt bond). Thus, the taxpayer has a legitimate reliance interest in expecting the subsidy to continue for the life of the activity, unless the duration of the subsidy otherwise was limited initially.

The economic consequences of periodic subsidies are more variable and unpredictable than those of one-time subsidies. The financial impact of a one-

24. Periodic deductions, such as nonaccelerated depreciation, do not necessarily represent subsidies. For example, depreciation represents a mechanical means of allocating the cost of property over the property's life; in that sense, it attempts to mirror, as much as practicable, the property's decline in value. As such, this deduction and other periodic deductions do not represent subsidies, but rather are structural as an inherent part of the measurement of income.

time tax subsidy can be computed in a fairly straightforward manner. A taxpayer can value the subsidy because tax rates will be known for the year of the subsidy. Therefore, policymakers can set the subsidy at the appropriate level to elicit the desired activity.

Periodic subsidies, on the other hand, involve economic benefits extending beyond the year of the taxpayer's expenditure. Accordingly, a subsequent event such as a change in the tax rates affects the subsidy. For example, a reduction in tax rates in subsequent years effectively reduces the amount of a periodic deduction or exemption subsidy. If the after-tax yield to a taxpayer in a tax-subsidized activity declines, property customized for or dedicated on a long-term basis to that activity suffers a reduction in value as well. Thus, although changes in tax rates are not themselves subsidies, changes in tax rates from a long-standing norm will affect the level of a subsidy. Periodic subsidies, therefore, represent something of an unguided missile in tax policy.

Whether a subsidy takes the form of an exclusion, deduction or credit, however, often is not the most relevant feature in analyzing the effect of the subsidy. The most significant feature of a subsidy from an economic viewpoint in many cases is whether it is periodic and, therefore, whether taxpayers act currently with the expectation of obtaining benefits in future years.

This feature may have practical political ramifications as well. A one-time subsidy requires an immediate outlay by the government to fund the subsidy. Accordingly, it would have to be accounted for entirely in the year it is availed of by the taxpayer, through purchase or expenditure, in the form of lower tax collections, thereby creating a greater budget deficit in that year. In contrast, a periodic subsidy of equivalent value could be accounted for over its entire life. Therefore, although a one-time subsidy may be a theoretical substitute for a periodic subsidy, it may not be a politically viable one.

A government's choice of a periodic subsidy instead of a one-time subsidy masks its real cost. In effect, it allows the government easy tax subsidy payment terms because it is accounted for through reduced tax collections in years subsequent to the year in which the subsidized taxpayer engaged in the desired activity or made the desired expenditure. It therefore creates the illusion that subsidy payments are to be made in the future, whereas the government has committed itself in the initial year to make those payments. In essence, the government has borrowed money in the initial year to make a subsidy payment in the amount of the present value of the series of periodic tax benefits, and will repay that borrowing, plus interest, in installments. The ability to obfuscate the real cost of the tax subsidy through the use of a periodic subsidy, however, should not dictate its use.

The Fundamental Problems in Removing Periodic Subsidies

Equity

Periodic Subsidies Contrasted with One-Time Subsidies

Repeal of a periodic tax subsidy on which the taxpayer has acted in reliance is inequitable and can have a serious destabilizing effect on the economy. As a result, Congress should not remove a periodic subsidy without either transition relief for or compensation of the recipient.

The inequity created by repeal of a periodic tax subsidy can be understood best by observing the dynamics of a periodic subsidy. Introduction of a subsidy may result in some degree of extraordinary profits for recipients. If a lengthy adjustment period is needed for taxpayers to respond to the subsidy, the subsidy could result in windfalls to those recipients who already engage in, or otherwise would have engaged in, the desired activity, or to those who respond to the subsidy quickly. Those windfall benefits would continue until a sufficient amount of the encouraged activity develops to allow market forces to bid down profits from those activities. Excess profits are created during the adjustment period to encourage the desired behavior. The government cannot attempt to recoup the windfalls because to do so would blunt the incentive effect of the subsidy.

'Moreover, during the adjustment period, property particularly suitable for the subsidized activity, if in limited supply, would increase in value because the return that it generates, including the subsidy, would increase. The property's increase in value largely would reflect the present value of the excess profits during the adjustment period.

The removal of the subsidy is precisely the reverse side of the coin. When a periodic tax subsidy is reduced or eliminated before the activity is terminated (or prior to an announced termination date), an owner who already has made the expenditure cannot undo that decision. The owner's profit from the activity reflects and is dependent on the subsidy. The owner's reduced profit (or losses) resulting from elimination of the subsidy will continue until aggregate market output in the activity adjusts and is reduced sufficiently to raise prices. During the adjustment period, the owner will suffer reduced income or operating losses. The longer the adjustment period, the greater the overall economic impact of the subsidy's repeal on the owner. Likewise, the value of the activity or property dedicated to the activity will be reduced, reflecting its reduced return, which then would not include the subsidy that has been removed. That economic loss would not merely offset the previous windfall because those who suffer the loss may or may not have been recipients of the previous windfall.[27]

A periodic subsidy represents a government promise of future benefits or subsidy payments that are intended to cause taxpayers to make current expenditures and changes in their investments. A taxpayer's decision to make that expenditure is based upon the estimated present value of the stream of subsidy payments.[28] Removing the subsidy for those who already have

27. For example, a taxpayer who purchased property for its then fair market value, which already reflected the value of the subsidy, will have paid a premium for the subsidy benefits. Removal of the subsidy will cause a loss to that taxpayer equal to that premium, that is, the portion of that taxpayer's purchase price attributable to the subsidy.

28. Professor Graetz, however, would argue, in effect, that such a present value calculation would have been irrational because the taxpayer would have been unreasonable to expect the subsidy payments to continue for the duration of the defined term—for example, years to maturity of a tax-

responded represents a breach of promise.

The injury resulting from this breach of promise should be analyzed by reference to two distinct interests that the recipient has in the subsidy and for which the recipient may be entitled to protection: first, the interest in continuing to receive the subsidy itself for the agreed-upon term, and second, the right to retain a capitalized value of the subsidy for disposition. From the perspective of both equity and long-term economic efficiency, the recipient of a subsidy should be entitled to continue receiving the periodic subsidy promised, even if the subsidy results in large gains to the recipient. Moreover, in some cases a transferee of the subsidized property or activity also should be entitled to the continuing benefits of the subsidy. If a periodic subsidy is to be removed, however, the recipient should be compensated by the government for the value of the removed subsidy that has been capitalized into the price of the subsidized property or activity.

One-time subsidies, in contrast, generally can be removed without inequity to its recipients. When a tax incentive elicits oversupply and therefore production of an unneeded item, the government should be able to eliminate it prospectively. Otherwise, the economy would be saddled forever with any artificially induced market inefficiency.

Repeal of a one-time subsidy is always prospective. To be sure, even one-time subsidies can elicit changes in behavior that reverberate throughout the economy and can have far-reaching effects. That is true regardless of whether the subsidies are made through the tax system or directly. For example, a one-year investment tax credit, if effective, will cause manufacturers to increase their purchases of productive equipment and machinery because of the reduced cost of the machinery. Those purchases should allow expanded production and reduce end product production costs, as well as end product prices, because of the increased supply of the end product. Thus, purchasers of the end product share the reduction in the cost of machinery resulting from the one-time subsidy. * * *

Users of that product may come to depend upon lower prices of the product and adjust their behavior and choices accordingly. For example, they may come to depend upon an adequate supply of the product at its prevailing price, even though that price prevails only because of a government subsidy. If the one-time subsidy is eliminated, the cost structure of new producers increases, thereby reducing the supply of that product and pushing up the price. The product user again shares the cost increase. Does that user now have any argument that he reasonably relied upon the subsidy for the product and is entitled to continue buying that product at the subsidized price?

This example illustrates the destabilizing effect on the economy of all subsidies, whether made through the tax system or otherwise, and whether one-time or periodic. Turning the spigot on and off can significantly impact

exempt bond, or the entire recovery period of a depreciable asset. Rather, "[i]n the market context, only behavior that takes into account probabilities of change is treated as reasonable." Graetz, Tax Revision, note 7, at 66. Treasury, at least in 1977, took a contrary view. See Treasury Dep't. Blueprints for Basic Tax Reform 187, 200-01 (1977) (favoring grandfathering and phase-ins).

the economics of the subsidized property or activity. Subsidies, therefore, should be used sparingly and then only when overriding policy justifications dictate.

One-time subsidies, however, do not create an interest to recipients on which they can rely for similar subsidies in the future. The immediate recipient of the one-time subsidy (in the illustration, the producer) makes its economic decisions based upon that knowledge, but should be precluded from claiming reliance on any implied promise or expectation that the subsidy will be repeated in future years.

For the user of the product manufactured by the subsidy recipient and others further down the chain, the introduction and later removal of the subsidy are similar to all other changes in cost or demand structure affecting their products. Although the subsidies can be destabilizing, they do not create reliance interests. The user should not be able to rely on the government's continuation of the subsidy.

* * * [T]he harm resulting from destabilizing effects of one-time subsidies is very different in degree from the harm resulting from the removal of periodic subsidies, on which recipients have relied directly in making long-term business decisions. The first elicits objections from businesses that it is difficult to plan purchases and production and that government subsidization policy has made it more difficult. The second, however, elicits objections rising to the level of breach of promise against the government. That objection in the private law context is the type that gives a remedy of damages to the injured party. Although these differences may seem a matter of degree, they are so large that they become differences in kind.

The Right to Continuation of the Periodic Subsidy for the Duration of the Activity

The clearest example of a periodic subsidy for which recipients should be protected by continuation of the subsidy is the exclusion from gross income of interest from state and local bonds. Because a tax-exempt bondholder is not taxable on the interest from the bond, market forces cause the yield or interest rate on a tax-exempt bond to be significantly lower than an equivalent taxable bond. The relevant financial comparison of the two bonds should be their respective after-tax yields rather than pretax yields. The issue price of these bonds, by virtue of market forces, reflects the value of the tax exemption so that the after-tax yield from such bonds approximately equals the after-tax yield of taxable bonds of equivalent credit quality and term. Viewed another way, a prospective purchaser of a tax-exempt bond pays a premium for the bond compared to the price that would be paid for a taxable bond of equivalent pretax yield. The premium reflects the value of the exemption from income tax of the stream of interest payments to be earned on the bond.

The exclusion from income of the interest appears to be a subsidy to bondholders. In reality, however, a large part of the subsidy is transferred to the issuing state or municipality because the exemption permits the state or municipality to borrow money by issuing the bonds at a lower-than-market interest rate. The allocation of the subsidy between the issuer and the private investor depends on the supply and demand of tax-exempt obligations which, in turn, depends on the investors' marginal income tax rates.

If the tax exemption for existing state and municipal debt obligations were eliminated, the owners of those bonds would have a justifiable complaint that they relied on the government's promise of interest income exclusion in making their investment decisions for the term of the bond. These bonds should be entitled to continued exclusion, regardless of whether new bonds issued by states or municipalities are eligible for similar tax-exempt status. Indeed, those investors paid for the promise of tax exemption by paying a premium for the bond relative to an equivalent taxable bond.

Arguably, the risk of reduction or loss of the subsidy, for example, the removal of the tax exclusion for the interest, is discounted by the market and, therefore, also is capitalized in the bonds' value. If that is the case, the government's subsidy is more of an expectation of likely government action or inaction, for which there is no commitment, than it is a promise. Therefore, the tax exclusion would not be fully capitalized, causing the interest rate on the bonds to include a risk premium reflecting the possibility of the change in the law. But it appears certain, given the longstanding existence of the exclusion, that the tax exemption is regarded by investors as a promise. Accordingly, virtually all of the exclusion is reflected in the bond's value.

Thus, it is no more justifiable for the government to terminate unilaterally a periodic subsidy that has already elicited the desired behavior by recipients, without transition relief (that is, grandfathering or compensation) than it is for the government to coerce repayment of a one-time subsidy. This equivalence leads one to conclude that a periodic subsidy should not be removed for current recipients unless transition relief is provided. To restate the proposition, a periodic subsidy should be continued for the current recipient who reasonably anticipated that the subsidy would continue and acted in reliance on it.

* * *

The Right to Receive or Be Compensated for the Capitalized Value of the Periodic Subsidy Upon its Removal

A second problem with periodic subsidies involves the protection of the recipient's interest in a somewhat more debatable manner: the protection of the capitalization of the subsidy in the value of the subsidized property or activity. * * *

Returning to the illustration involving tax-exempt bonds, it is clear that the periodic subsidy now accorded tax-exempt bonds by means of the exclusion of interest from gross income is capitalized in the value of the bonds. The issue price of the bonds at original issue and the subsequent market price of those bonds reflect the value of the subsidy. If that subsidy were eliminated for future holders of the bonds that already have been issued, the bonds would suffer a significant reduction in value, even if the interest income exclusion remained available to the original holders. Such a policy change would render the bonds illiquid, at least at their pre-policy change value, thereby destroying an important attribute of the financial asset, its ready marketability. In that event, only financially distressed holders or those whose tax rates somehow were reduced to zero would seek to dispose of those bonds at the resale price, which would be substantially below the original issue price (regardless of what happened to market interest rates). Holders with continuing financial stability or taxable income also would experience detriment. Interestingly, loss of liquidity experienced by those holders would not be offset against any government savings because the continued exclusion would permit the interest to escape taxation. The described inequity results because the market value of the bonds at any time, and therefore any holder's purchase price, incorporates the tax exemption. In substance, the periodic subsidy in the form of an income exclusion has attached to the bonds themselves rather than being personal to the holders of those bonds. The bonds should continue to be viewed in that light to reflect the reasonable expectations of the bond purchasers who, in reliance upon the promise of present and future tax exemption of the interest from those bonds, purchased those bonds at the original issue price (or, in the after-market, at a price reflecting the tax exemption for the term of the bond).

To the extent that the subsidized property (such as the equipment in the first illustration) is a depreciating asset with a relatively short limited life or liquidity of the property is not an important attribute because, for example, it has a dedicated use that is not easily changed, the problem, as a practical, although not as a theoretical matter, becomes less significant. As long as the owner can and likely will continue to realize the value of the subsidy through continued use of the property, wealth reduction due to loss in resale value may be sufficiently small relative to the cost of determining and administering compensation to the owner that, arguably, it may be ignored. Where, however, the owner is unable to continue to realize the value of the subsidy through continued use of the property or liquidity of the property is an important component of its value, which will be the case, generally, if the subsidized property is of a long or unlimited economic life (such as the tax-exempt bond), the problem becomes much more significant. The market value of the property and, therefore, its purchase price is tied inextricably to its expected future market value upon resale. Accordingly, even retroactive relief by continuation of the benefits of the periodic subsidy to the original owner will not correct the problem, because the resale value of the property is dependent upon the availability of the subsidy to future owners. A prospective purchaser, to whom the subsidy will not be available, would be unwilling to pay a price equivalent to the fair market value of the property when the subsidy existed. * * * [39]

Even if desirable, it may be impossible to compensate the owner for her loss. Determining the magnitude of the owner's loss would be very difficult if

39. For example, suppose Congress proposed elimination of the home mortgage interest deduction available to owners of owner occupied residential real estate. See IRC § 163(h). Elimination of the deduction would increase the after-tax cost of the mortgage payment and therefore the after-tax cost of owning the residence, a property generally purchased with mortgage financing. One would expect a reduction in home prices to follow.

compensation were in the form of an outright payment because the amount of loss is dependent upon secondary and tertiary market consequences. Indeed, Professor Graetz has noted that elimination of the tax benefit could cause a reduction in the supply of formerly subsidized property, resulting in an increase in the economic return from the existing property by virtue of its relative scarcity. Professor Graetz concludes that full compensation would have to take these market adjustments into account.

The size and speed of the adjustment resulting from the elimination of a tax benefit and the impact of the elimination on the owner of property receiving the benefit depend upon many factors. * * * These market adjustments and fluctuations, which are inherent when subsidies are introduced as a fiscal policy tool, likely make it impossible to quantify the loss accurately. That impossibility, however, should not suggest that no compensation is warranted when a periodic subsidy is removed. Rather, it suggests that determining the compensation amount would require simplifying assumptions and likely would result in some degree of over- or undercompensation.

If transition relief took the form of the continued periodic subsidy attaching to the property, great complexity could result. Not all competing properties on the market would offer the same tax attributes. Administering such a system could be very difficult.

* * *

In sum, these inequities that would arise on repeal of a periodic subsidy and the complexity of any possible relief raise serious questions regarding the wisdom of their use.

The Need for Transition Relief

The government should have the option to remove uneconomic subsidies, even if they are the periodic type with long-term responses, and even if the subsidy has been capitalized into the value of the property. Forcing the government to continue all subsidies for future purchases would doom the economy to permanent inefficiency by resulting in subsidizing activities that already produce adequate supply of product or oversupply. If the subsidy is removed, however, transition rules should be enacted to prevent inequities, and in some cases, current owners should be entitled to compensation for their resultant wealth reduction. To state the proposition advanced in this Section, (1) a periodic subsidy should not be removed, even prospectively for transferees, if the current recipient of the subsidy reasonably anticipated that the property would be transferable, or, alternatively, (2) if the subsidy is removed, the current recipients should be compensated for the present value of the lost subsidy over an appropriate adjustment period. In many cases, only the second of these alternatives is feasible.

Initially, this proposition may seem objectionable or, at the very least, politically impossible to implement. Indeed, the right of a tax subsidy recipient to enjoy continued benefits from a tax provision, either through grandfathering or compensation, has been the subject of significant scholarship. Professor Graetz contends that policymakers should be free to make at least "nominally prospective" changes in the tax law without grandfathering or compensating those adversely affected by the change. "Nominally prospective" changes are changes that alter the rules only for post-enactment periods, but affect the tax treatment and value of assets acquired before enactment and, therefore, have retroactive impact.[46]

Professor Graetz's view essentially is premised on the proposition that a taxpayer whose tax liability is reduced by a tax subsidy is getting away with something, or, in his parlance, is the beneficiary of horizontal inequity. As the goal of tax change is to reduce that horizontal inequity, a change in the law with that objective should not necessitate either compensating the adversely affected taxpayer or grandfathering the tax subsidy as it affects the taxpayer.

This Article takes a different view. The legislative choices regarding burden sharing are found in the structural components of the tax law (for example, tax rates). Burdens are and should be shared as provided by those structural components. Tax incentive provisions, in contrast, are equivalent to direct subsidy payments outside the tax system. As tax savings to a recipient are only the medium for such payment, they should be ignored when evaluating burden sharing. Just as one does not take into account direct subsidies in determining whether the tax system is equitable, one should similarly ignore subsidies made indirectly through the tax system.

Removing a periodic subsidy after a taxpayer has acted upon it imposes an additional burden on that taxpayer unrelated to her income level or ability to pay. Accordingly, it results in a deviation from the burden sharing norm inherent in the structural components and lacks appeal to the distributional fairness on which the tax system as a whole relies.

Viewing tax incentive provisions as part of the burden sharing scheme, as Professor Graetz does, incorrectly leads one to view the elimination of periodic tax subsidies as a means of improving horizontal equity. On the contrary, periodic tax benefits which, in static terms, appear to create horizontal inequity, in dynamic terms, represent simply a collection of an amount promised and due from the government. When the subsidy terminated is a periodic subsidy enacted to encourage taxpayer behavior, it should be viewed analytically as a one-time subsidy, payment of which is made on the installment basis. The recipient of a periodic tax subsidy in the form of reduced tax liability, in reality, enjoys merely a deferred payment of a previous period's subsidy. The recipient already has paid for the subsidy by making what Congress determined to be a socially desirable expenditure in a previous year. The wisdom of the legislative policy choice should be addressed with respect to the year in which taxpayers respond to it, not in subsequent years.

This view does not depend upon whether the periodic tax subsidy represents a wise or even a sensible policy choice from an economic viewpoint, or whether it adds to overall equity in the economic system. Indeed, I would suggest that over the years, most periodic tax subsidies have proven to be mistakes. * * *

Professor Graetz's analysis and justifications for nominally prospective

46. Graetz, Tax Revision, note 7, at 49.

tax changes with retroactive effect underscore the uncertainty and danger of periodic subsidies because, once in place, they can be so easily reinterpreted as causing unjustified horizontal inequity. His analysis, therefore, represents another persuasive argument that periodic subsidies should be avoided.

* * *

One-Time Subsidies, in Contrast

Problems of unfairness, compensation and transition relief that arise upon removal of periodic tax subsidies do not afflict one-time subsidies. After a one-time subsidy has been received, a taxpayer's return on investment is determined solely by market forces, unaugmented by further subsidy. * * * Accordingly, one-time subsidies could be removed equitably, without compensable harm to one who previously has been the recipient of the subsidy. Moreover, one-time subsidies would seem to avoid the perceived problem that some taxpayers are looting the treasury and continue to do so after the incentive is no longer necessary or desirable.

* * *

Economic Efficiency and the Predictability of Tax Laws

One-time subsidies also are superior to periodic subsidies in terms of economic efficiency. First, economic efficiency is served by predictable tax subsidies (assuming there are to be subsidies at all) so that those affected by subsidies can rely on that predictability. Making periodic subsidies uncertain in duration and subject to removal by legislative whim, is economically inefficient because it requires the government to include a risk premium in the subsidy. A risk premium overpays for desired activities unless the subsidy is removed before its expected term has expired.

In contrast, a one-time subsidy is completely predictable because there is 100% certainty that it will be obtained. A periodic subsidy can never attain that level of predictability so long as there is a risk of an uncompensated termination. Moreover, even if the duration of the periodic subsidy were assured, its value could not be assured because of potential changes in the structural components of the income tax (such as tax rates), income levels and market conditions. As a result, the need for risk premiums for periodic subsidies cannot be avoided.

* * *

In sum, periodic subsidies, even if not subject to removal, are less efficient than one-time subsidies. When risk of repeal is factored in, however, they become substantially less efficient.

Illustration: Commercial Real Estate

Periodic subsidies have represented a major component of the government's fiscal policy, and the Code is replete with them. The economic impact of the creation and removal of a periodic tax subsidy is illustrated most graphically by the accelerated depreciation deductions accorded to owners of real estate in the early 1980's and their effective removal through enactment of the passive activity loss rules in 1986. This Section illustrates shortcomings in the periodic tax subsidies accorded real estate during this period and the devastating consequences of their removal without adequate transition relief.

Periodic Subsidy for Real Estate During the Early 1980's

In 1981 Congress created significant tax incentives for real estate by means of accelerated depreciation. In substance, owners of real estate were able to recover the cost of their depreciable real estate (buildings and other improvements, but not land) over a 15-year period. Thus, for income tax purposes, a building would be regarded as having been used up and valueless after only 15 years even though, in virtually all likely situations, the building would have retained substantial value and in many cases increased in value during that same period. The recovery period was lengthened by subsequent legislation to 18 years and later to 19 years. But, even after these changes, the tax depreciation in most cases greatly exceeded the actual reduction, if any, in value of those buildings.

The legislative judgment to grant special deductions and, therefore, impose a lighter tax burden on real estate and real estate activities was motivated by a desire to increase the production of depreciable real estate for the good of the entire economy. The supply of commercial buildings increased from 1981 to 1986 as a result of new construction, although it is impossible to prove that the 1981 legislation caused the building boom because of the inherent limitations on statistical analysis in a dynamic economy.

Congress did not limit the special tax relief for real estate to new construction. It extended the provision to any depreciable real estate acquired by a taxpayer after the effective date of the legislation, so long as the new owner did not own a significant interest in it beforehand. The accelerated depreciation allowed new owners to purchase old buildings and write off the cost of the buildings over the generously short recovery period of 15 years. The extension of the tax subsidy to existing property appears to have been pure governmental largesse, significantly increasing the purchases and sales of existing depreciable real estate. * * *

Taxpayers fortunate enough to own income producing real property received windfalls. The tax legislation actually increased the demand for and value of their property by allowing a prospective purchaser to obtain a tax benefit from acquiring the existing property. * * *

After 1981, substantial capital flowed into real estate production and resulted in a building boom. Prospective owners no longer needed to be assured of the same tenant demand, low interest financing and relatively low vacancy rate to project a profit from operating a newly constructed building or purchasing an existing building. Production soared and rental space, particularly office space, increased in supply. Net income from operating property tended to decline as a result. Some economists predicted that this phenomenon would continue until real estate activities earned no more on a net after-tax basis than had been the case prior to 1981. However, during the 1980's, it appears that real estate operating yields may have declined even below the level predictable by the subsidy alone, because an expectation of appreciation may have influenced people to accept less in current yield in anticipation of large gains upon sale.

After 1981, capital flowed into real estate activities from sources other than real estate professionals. One might characterize a real estate investor as participating in or acquiring a "tax shelter." * * *

Congress' Response: The Passive Activity Loss Rules

Public antipathy toward tax shelters may explain why Congress enacted a new set of anti-tax shelter provisions, the passive activity loss rules. * * *

The effect of the passive loss rules has been to preclude taxpayers from offsetting earned income and portfolio income (such as investment income from stocks, bonds and bank and money market accounts) with real estate and other tax shelter losses. By precluding the use of those losses, Congress effectively removed the tax subsidy from those activities. Indeed, because even cash operating losses from real estate and other tax shelter investments and actual reductions in value in the investments through deterioration or obsolescence cannot be used to offset nonpassive income until the investment is sold or discontinued, the antishelter rules not only removed the subsidy but, in many cases, also imposed a penalty on the activity.

Yet, Congress made no attempt to compensate property owners for either the loss of the subsidy or the loss in value of the property, which would not enjoy tax-preferred treatment in the hands of a prospective purchaser. In passing the 1986 Act, Congress appeared to recognize the importance of transition rules in preventing inequity, but failed to provide adequate protection. The passive loss provision contained special effective dates and phase-in provisions. On their face, those rules appeared to exclude current owners of real estate and other passive activities from much of the impact of the new rules.[82] These phase-in rules, however, interacted with two other important changes contained in the 1986 Act: (1) the alternative minimum tax (AMT) and (2) the investment interest expense limitation. Most importantly, passive losses allowable under the phase-in rules constituted tax preference items for AMT purposes. Under appropriate circumstances, the passive losses were rendered without tax benefit and, therefore, unusable to an investor. Moreover, by eliminating the subsidy entirely for prospective purchasers of the property, the 1986 Act did nothing to protect the value of the property that had become dependent on the subsidy.

* * *

The Decline of Real Estate Prices and The Savings and Loan Crisis

The crisis in the savings and loan (S&L) industry had many causes, ranging from unpredictable economic changes to bad business judgment to

82. Generally, the passive activity loss rules were effective for years beginning after 1986. Reg. § 1.469-11. However, the rules were phased in for certain post-effective date losses. Passive losses from a "pre-enactment interest" (an interest held on October 22, 1986, the date of enactment, or acquired thereafter pursuant to a written "binding contract" in effect on such date and at all times thereafter) were disallowed in the transition years to the extent of 35% in 1987, 60% in 1988, 80% in 1989 and 90% in 1990. IRC § 469(m).

thievery. One of its most significant causes was the decline in real estate prices that resulted from Congress' shift in tax policy toward real estate.

Many S&Ls invested in mortgages on new real estate projects that promised high yields during the 1980's due to generous depreciation recovery rates. * * * As long as real estate values increased during the early 1980's, those loans that had been made prudently were well-secured and safe. Many S&Ls lent money on outrageous projects with little economic feasibility to obtain front-end fees and what appeared to be high, but risky yields. However, even more conservatively managed institutions lent money on real estate projects at prudent loan-to-value ratios (ratios of the amount of the loan to the fair market value of the project securing the loan). Those loans were well-secured as long as real estate values were maintained or increased, which occurred during the transition period of the early 1980's.

The values of those properties depended on the generous tax benefits accorded real estate. The availability of those tax benefits to prospective owners supported the market prices of the property even though the rental income may not have been sufficient to make them economic.

When the government withdrew the subsidies in 1986 by enacting the passive activity loss rules and lengthening depreciation recovery periods for property acquired after 1986, real estate had to be operated or sold without benefit of the tax subsidies. Investors, who could no longer use losses from real estate to offset other income, were less likely to provide the equity funds for new projects or to purchase existing projects. As a result, a major source of equity for real estate acquisitions evaporated. Moreover, by the time Congress passed the 1986 Act, vacancy rates in many buildings had increased with the added supply of rentable space brought about by the tax subsidies.

An insufficient number of buyers existed for real estate projects that were put on the market for sale. Prices for real estate stopped increasing and in many cases began to fall. Consequently, the S&Ls as well as other banking institutions that had been well-secured when real estate values were high became undersecured. That situation was particularly dangerous for institutions that had made nonrecourse loans. Defaults became more common, prices declined further and the market became flooded with available real estate.

Even falling prices failed to attract new buyers. First, without tax subsidies, the projects were not worth as much as they had been previously. Second, the banking industry's reaction to the falling prices was precisely the opposite of what would be necessary to stop those declines. * * *

Prudent policy for any individual S&L on the brink of insolvency dictated that it collect as much as possible of its outstanding real estate loans and refuse to loan additional amounts in a falling real estate market. What represented prudent policy for any individual institution, however, became an unfortunate overall banking policy for sellers of real estate when all financial institutions adopted it. Thus, the surplus of owners needing to sell and the dearth of buyers with ready funding sources transformed predictable price declines into free falls.

* * * [I]t should be recognized that the real estate boom was spurred by

the federal government's creation of significant periodic tax subsidies for the industry in 1981. Congress removed them in 1986, and replaced them with what amounted to tax penalties. * * *

[M]any S&Ls and other banking institutions were locked in. Their loan portfolios were created when the real estate securing the loans had value supported by the government subsidies. Only after the loans were made was the collateral devalued. The existence of federal deposit insurance will, of course, leave the federal taxpayers bearing the ultimate economic cost of many of these losses.

* * *

Illustration of Future Tax Policy Choice: Owner-Occupied Real Estate

The experience of real estate owners during the 1980's could be repeated if the periodic tax subsidies accorded other subsidized activities such as tax-exempt bonds and retirement savings were eliminated, even prospectively. Owner-occupied residential property appears to be a potential candidate in Congress' search for base broadening tactics. Economic destabilization could result if these periodic subsidies were eliminated, even if the elimination were prospective only and limited to future owners, because the value of the subsidies has been capitalized in the price of the properties.

Subsidies for owner-occupied housing include the deduction for home mortgage interest and the deduction for real property taxes. * * *

These deductions, if viewed as an encouragement to purchase a home, could be viewed as periodic subsidies. Elimination of these deductions would increase the after-tax cost of home ownership. * * *

Transition problems created by the elimination of the subsidies would not be solved merely by making the changes prospective and grandfathering current homeowners because the subsidies no longer would be reflected in the market prices that prospective purchasers of homes would be willing to pay. Even the prospective elimination of the subsidies would be likely to produce a reduction in single-family home prices and, in some cases, the elimination of the homeowner's built-up equity (the value of the home less the mortgage on it). Thus, regardless of how desirable in theoretical policy terms, the elimination of the "middle class" subsidies to home ownership may be, even the prospective elimination would cause considerable economic dislocation and financial hardship to current homeowners, absent compensation for the loss by the government. Such compensation, as a practical matter, would be unlikely because the elimination of the subsidies would have derived from the desire to eliminate the governmental expenditure through the tax system rather than out of some sense of theoretical tidiness, however laudable that latter goal may be.

* * *

Conclusion

* * * [E]nactment of periodic tax subsidies should be rejected unless Congress is willing to define, specifically limit and guarantee their duration. In the absence of such assurances, Congress should be prepared to live with

periodic subsidies permanently or to compensate recipients if the subsidies are later removed. Use of certain periodic subsidies that involve the creation of transferable long-term benefits could require that the subsidy become a permanent part of the tax law if compensation is not politically viable.

As a practical matter, however, it is unlikely that Congress will be willing to retain every periodic subsidy enacted. Therefore, Congress should overcome the temptation to enact periodic tax subsidies.

Notes and Questions

45. Obviously, clarity is to be desired in any provision of law, including any provision of tax law. Do you agree with Bradley and Oliver that clarity is particularly important for incentive tax expenditures?

46. Professor Goldberg asserts a sharp dichotomy between one-time incentives and periodic incentives. Can a taxpayer never legitimately rely on the continuation of one-time incentives? Should a taxpayer always be entitled to rely on the continuation of periodic incentives?

47. As Goldberg recognizes, even if the incentive statute remains unaltered, changes in tax rates can materially affect the value of incentives. For example, it is likely that some presently-outstanding state bonds were issued before 1981, when the maximum rate on unearned income was 70 percent; clearly, the value of the tax exemption is worth much less today, with a maximum rate under 40 percent.

48. Would the logic of Professor Goldberg's argument lead one to conclude that Congress could not materially alter its basic form of taxation—for example, by instituting a consumption tax as a replacement for, or significant addition to, the income tax—without compensating all who entered the tax-preferred investment on the assumption that the income tax would continue as the dominant federal tax? (Here, many of the transition problems resemble those discussed in Chapter Seven, particularly in Notes #77-85.)

49. As one example of a periodic tax preference, which perhaps never should have been enacted but cannot be ended without working an injustice, Goldberg highlights the home mortgage interest deduction. Importantly, present owners may have profited little from the deduction, because their purchase price was inflated by the existence of the tax preference. As Kay and King argued (see Chapter Three, Note #2), this problem "demonstrates why tax capitalization is such a dangerous trap; although we believe it would be better if the system had never incorporated these concessions, it does not seem that it would now be either equitable or desirable to withdraw them."

50. Most observers would give high marks to the Tax Reform Act of 1986 as an example of true tax reform. The 1986 Act, however, not only removed

periodic preferences, but substituted tax penalties (or "negative tax preferences") in the form of passive loss limitation rules. Professor Goldberg argues that this combination of actions, undertaken for the perhaps laudable purpose of curtailing tax shelters, thereby contributed to the savings and loan crisis of the late 1980s. That crisis ultimately cost taxpayers and investors hundreds of billions of dollars.

51. Professor Goldberg puts forward full compensation to present beneficiaries of preferences as an acceptable alternative to keeping the tax preferences on the books, but he acknowledges that such compensation would be difficult to compute, and highly unlikely as a political matter. His primary message is that Congress should not start down the periodic preference route.

52. But what are we to do once Congress places an unwise periodic preference in the law? Given that full compensation of present beneficiaries is not realistically in the cards, does Professor Goldberg's logic doom us to keep an inefficient and unwise preference forever?

53. While Professor Goldberg argues that generous transition rules (at a minimum) are required for fairness, Professor Sheldon Pollack sees a somewhat different value in grandfathering and similar transition relief. While such relief may look like (and, indeed, may be) politically-inspired relief for special interests, it may make possible better law over the long term:

> Tax reformists sneer at the "corrupt" use of transition rules to benefit special interests located in the districts of committee members. However, the granting of favors by transition rules was one of [House Ways and Means Chairman] Rostenkowski's most skillful tactics in gaining passage of a purer reform package [in the Tax Reform Act of 1986] than what would otherwise have been possible. On the whole, aggregating support for a tax bill by offering generous transition rules (to permit certain industries or even individuals to retain more favorable treatment under prior law) should be viewed as preferable to offering special tax provisions or expenditures that become a permanent fixture in the Code. The old maxim that politics is the art of the possible is lost upon those who seek the radical implementation of their ideal tax policies.[q]

54. Observe that while periodic incentives may be worse policy than one-time subsidies, as Professor Goldberg argues, they may be attractive to Congress. They allow Congress to reward preferred constituencies today, while pushing most of the revenue cost of doing so into the future.

55. Professor Michael Graetz, whose work is frequently referred to (and disputed by) Professor Goldberg, argues that the risk of legal change is simply

q. Sheldon D. Pollack, *A New Dynamics of Tax Policy*, 12 AM. J. TAX POL. 61, 80 (1995).

one more risk for investors to take into account, and should not deter Congress from changing the law: "The tax law must remain a flexible instrument of public policy. When a provision has outlived its usefulness, it should be eliminated without the delay and windfall gains inherent in grandfathering prior transactions. People should make investments with the expectation that political policies may change."[r]

56. Goldberg differs with Graetz concerning whether principles of tax equity support removal of tax incentives. Graetz would favor ending an incentive that should never have been enacted; the recipient was the beneficiary of "horizontal inequity," and the tax system should attempt to reduce such inequity. Goldberg, by contrast, views tax incentives as the equivalent of direct subsidy payments from government. Therefore, he argues, tax incentives should be ignored in an analysis of the tax system's equity, just as direct subsidies effected through appropriations would be ignored. (Here, it might be noted, Goldberg effectively adopts Surrey's insistence that tax expenditures are the functional equivalent of direct government spending.) Again, Goldberg emphasizes that the primary lesson to be drawn is that Congress should not employ periodic tax incentives in the first place.

57. Is there anything special about tax provisions? Governments frequently change the law, upsetting expectations. What if a state where gambling was legal changed its law after investors had spent billions of dollars building casinos in the reasonable expectation that the state would continue to allow gambling? What of producers and sellers of alcoholic beverages, many in business for decades, when Prohibition was instituted in 1919? What of the holders of billions of dollars worth of slaves when the Thirteenth Amendment[s] freed all slaves without compensation of their owners?

It is easy to understand a moral imperative to end slavery, and less weighty moral and practical arguments can be advanced against gambling and alcoholic beverages. It is less obvious that society should advance its moral and other policy judgments without any compensation to those who lawfully relied on the earlier societal view. Yet, the lesson of history, which Professor Goldberg does not dispute in the tax context, is that compensation will rarely be forthcoming from the political system. Barring compensation, should society implement its current views of policy, or refrain from doing so on the basis that such a change would be unfair to those who relied on earlier law?

r. Michael J. Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47, 87 (1977).

s. President Lincoln's Emancipation Proclamation of 1862 (effective January 1, 1863) clearly did not free all slaves. Leaving aside questions of Presidential authority and the practical problem of enforcement at a time when the United States Government was not in control of the states where most slaves lived, the proclamation was wholly inapplicable to the northern tier of slave states, from Delaware to Missouri, which had not seceded. Only with the post-war Thirteenth Amendment were all slaves freed.