NOTE

THE TAX EXPENDITURE BUDGET: WHAT THE U.S. CAN LEARN FROM GERMANY

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I. Introduction

During the late 1960's, budget officials came under pressure from President Johnson to impose a surcharge on corporate and individual income taxes, in part to fund the President's "Great Society" programs and the Vietnam War.[1] The House Ways and Means Committee, in an attempt to temper the proposed surcharge and make it more palatable to Congress, recommended reductions in direct spending to accompany the increased tax burden.[2] Professor Stanley Surrey assailed the members of the Ways and Means Committee for ignoring their knowledge of tax law in their pursuit of possible spending cuts.[3]

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[1] STANLEY S. SURREY, PATHWAYS TO TAX REFORM 1 (Harvard U. Press 1973).

[2] *Id.* As Surrey notes, the Ways and Means Committee is the first threshold for consideration of budget matters. *Id.* at 1-2.

[3] *Id.* at 2-7. Professor Surrey was rather abrasive as to the lack of attention given to these tax expenditure provisions: "The Treasury is apparently not evaluating them, but rather is adding new and indefensible items. This is no way to run a tax system and no way to run a budget policy." *Id.* at 7.

According to Surrey, the Internal Revenue Code included various tax incentives and subsidies that resembled direct expenditures, and thus offered a multitude of potential spending cuts.[4] These preferential tax provisions were, as he famously declared them, "tax expenditures."[5]

Tax expenditure theory posits that certain provisions of the Internal Revenue Code deliver financial assistance to taxpayers akin to direct expenditure programs, and that these code provisions deserve the same analysis and evaluation that is given to direct spending items.[6] Further, the theory suggests governments must focus on tax code provisions that provide tax preferences in order to control both tax and budgetary policy concerns.[7] In 1974, Congress embraced Surrey's tax expenditure concept and began identifying and calculating tax expenditures as part of its routine budgetary analysis.[8] Currently, both the Treasury Department and the Joint Committee on Taxation prepare tax expenditure budgets.[9] According to Congress, tax expenditures are, "those revenue losses attributable to provisions of the Federal tax laws, which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[10] Although the United States has been publishing a tax expenditure budget for over thirty years,[11] it still fails to

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4 *Id.* at 1-2.

5 Surrey, *supra* note 1, at 3-4.

6 Surrey, *supra* note 1, at 6.

7 STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 2 (1985).

8 Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344 (1974) [hereinafter "Congressional Budget and Impoundment Act"]. The applicable section of the Congressional Budget and Impoundment Act is codified at 2 U.S.C. § 622 (West 2003) (defining tax expenditures in subsection (3)).

9 *See* BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2004, ANALYTICAL PERSPECTIVES (2003), *available at* http://www.whitehouse.gov//omb/budget/fy2004/pdf/spec.pdf (last visited April 28, 2003) [hereinafter 2004 Analytical Perspectives]; ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2003-2007, Joint Committee on Taxation, December 19, 2002, *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2002_joint_committee_on_taxation&docid=f:83132.pdf (last visited April 28, 2003) [hereinafter 2004 JCT Budget]. The Treasury's tax expenditure budget accompanies the Federal Budget, while the JCT expenditure budget goes to each of the congressional tax committees – the House Committee on Ways and Means and the Senate Committee on Finance. CONGRESS OF THE UNITED STATES, CONGRESSIONAL BUDGET OFFICE, THE EFFECTS OF TAX REFORM ON TAX EXPENDITURES – A CBO STUDY 1, March 1988 (on file).

10 2 U.S.C. § 622(3).

11 Surrey and McDaniel, *supra* note 7, at 1. The U.S. Code bluntly defines the tax expenditure budget as "an enumeration of such tax expenditures." 2 U.S.C. § 622(3).

persuade some critics that the tax expenditure budget is a useful enterprise.[12]

Like the U.S., Germany has published tax expenditure budgets for a number of years and has developed its own implementation of the tax expenditure concept.[13] German tax expenditure analysis differs substantially from the U.S. system, both in its identification of tax expenditures and its classification of them.[14] Even though the German approach might elicit criticism similar to that made against the U.S. tax expenditure budget, it suggests new perspectives that would be beneficial to the U.S. in its budget analysis.[15] Thus, this paper argues that the German system offers worthwhile additions to the tax expenditure budget of the U.S.[16]

In Part A of the discussion that follows, this paper will trace the development of the tax expenditure concept, starting with its progenitor Prof. Stanley Surrey. In part B, the paper explores criticisms that have been leveled at tax expenditure theory, from the volleys between Prof. Surrey and Prof. Boris Bittker in the late 1960's to contemporary debates. In part C, the paper turns to the current incarnation of the U.S. tax expenditure budget, and explains the mechanics behind it. Part D will introduce the German tax expenditure concept and its unique mechanism for creating a tax expenditure budget. Part E proposes that the U.S. adopt certain facets of the German tax expenditure process, specifically: 1) calculating the tax expenditure budget every two years, or perhaps less frequently; 2) examining each tax relief provision to determine if it can be considered a subsidy, considering its scope, the consistency of its application over years, and its relation to the rest of the tax code, 3) explaining more fully the nature and purpose of each tax expenditure by a classification system similar to the one Germany uses, and 4) using "ability to pay" as a means for deciding if a provision is a tax expenditure or not. Finally, the paper concludes that providing more information is worth the extra effort necessary to add an "ability

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12 Although Professor Boris Bittker is the most recognized and celebrated opponent to tax expenditure theory, there are many others who will appear throughout this paper. *See, e.g.*, Bruce Bartlett, *The End of Tax Expenditures As We Know Them*, 92 TAX NOTES 413 (July 16, 2001).

13 *See* TAX EXPENDITURES: RECENT EXPERIENCES 65 (OECD 1996).

14 *See* Harry A. Shannon III, *The Tax Expenditure Concept in the United States and Germany: A Comparison*, 86 TNI 43-30 (Oct. 22, 1986).

15 *See* part D, *infra*.

16 *See* parts D and E, *infra*.

to pay" table to the U.S. tax expenditure budget.

II. Discussion

A. The Tax Expenditure Concept

Generally, a government can fund its social and economic programs through either direct funding – the "tax and spend" model – or indirect funding – expenditure-type code provisions or regulatory programs.[17] As Prof. Surrey and Paul McDaniel observed in their eponymous book, a government can choose from several methods in funding a particular activity or group, including direct subsidies, government loans, or a reduction in tax liability.[18] A reduction of tax liability can come in a variety of forms: exclusions, exemptions, deductions, credits, preferential rates, or deferrals.[19]

Before Stanley Surrey introduced his tax expenditure concept, economists theorized that deductions and exclusions from income had discernable effects on revenue collection and other aspects of tax policy.[20] Criticism of supposed loopholes in the U.S. tax code began as early as the 1940's.[21] Beginning in 1960, the U.S. Treasury asserted a hostile position to indirect spending to fund policy objectives, favoring direct programs instead.[22] While serving as Assistant Treasury Secretary during the Kennedy Administration, Prof. Surrey worked with other Treasury members to create the beginnings of the tax expenditure budget.[23] He had coined the term "tax expenditure" and put the finishing touches on the prototype tax expenditure budget as President Johnson exited the White House.[24] Importantly, Prof. Surrey and his

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[17] Mary L. Heen, *Reinventing Tax Expenditure Reform: Improving Program Oversight Under The Government Performance and Results Act*, 35 WAKE FOREST L. REV. 751, 757-58 (2001).

[18] Surrey and McDaniel, *supra* note 7, at 3.

[19] Surrey, *supra* note 1, at 6.

[20] Bartlett, *supra* note 12.

[21] Boris I. Bittker, *A "Comprehensive Tax Base" As A Goal Of Tax Reform*, 80 HARV. L. REV. 925 (1967). (noting that criticism of supposed tax expenditures began around the time of World War II). Bittker enumerates several sources of criticism, leading to the adoption of the "comprehensive tax base" as the primary organizing principle for tax reform. *Id.*

[22] Surrey and McDaniel, *supra* note 7, at 2.

[23] Jonathan Barry Forman, *Origins of the Tax Expenditure Budget*, 30 TAX NOTES 537 (Feb. 10, 1986).

[24] Bartlett, *supra* note 12.

Treasury Department colleagues constructed the tax expenditure concept to cast deductions and exclusions in a negative light.[25] Specifically, the choice of the word "tax expenditure" implied a decidedly cynical connotation, and testimony before the Joint Economic Committee in the late 1960's attempted to cultivate similar feelings among Congressional members.[26]

In developing the tax expenditure concept, Prof. Surrey adopted the Schanz-Haig-Simons definition of income to establish the normative tax base for identifying tax expenditures.[27] According to this definition, the only items properly deductible from income would be those expenditures incurred in earning or producing income.[28] In Prof. Surrey's view, all tax code provisions fall into two categories – structural and subsidizing.[29] The latter are functionally equivalent to direct subsidy programs, where a taxpayer makes an imputed payment of her tax liability to the government and in turn receives a government subsidy through a tax benefit.[30] Prof. Surrey defined the tax expenditure concept in the following way:

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

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25 *Id.*

26 *Id.* At the outset of President Nixon's first term, Treasury Secretary Joseph Barr presented the prototype budget to the Joint Economic Committee. *Id.*, *citing* JOINT ECONOMIC COMMITTEE, THE 1969 ECONOMIC REPORT OF THE PRESIDENT, 91st Congress, 1st Session, pt. 1, at 4-94. During his testimony, Mr. Barr gave examples of 21 Americans who earned over $1 million in 1967 and paid no income tax due to tax preferences. Bartlett, *supra* note 12.

27 Surrey and McDaniel, *supra* note 7, at 4. Under the Schanz-Haig-Simons definition, "any increase in net economic wealth between two points of time plus consumption during that period" would be income to a taxpayer. *Id.*

28 *Id. See also* Surrey, *supra* note 1, at 20-21. Surrey explained the Haig-Simons concept by explaining that income focused, "on the accretion of funds . . . rather than on the uses of funds. The customary approach . . . is a comparison of two balance sheets, at the beginning and end of the taxable period, to determine the income for the period. But if funds are spent during the period, i.e., consumption occurs, the funds spent must be added algebraically to the balance sheet difference to determine the total income." *Id.* at 20. As is implied by the definition, any consumption for the purpose of earning or producing income should not be added back to the total funds. *Id.* at 21.

29 Surrey, *supra* note 1, at 6-7.

30 *Id.*

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.[31]

It is generally accepted that policy matters find their way into the tax code.[32] Long before tax expenditure theory arose, Congress had been infusing policy goals into code provisions, allowing indirect funding through tax expenditures since the establishment of the tax code.[33] Over the years, indirect spending through tax expenditures has expanded to account for a significant number of government programs.[34] For example, much of the legislation enacted during the Clinton administration, such as the Taxpayer Relief Act of 1997, contained numerous and extensive tax breaks for so-called special interest groups.[35] Similarly, President George W. Bush has sent a fair share of tax legislation to Congress, as commentators predicted he would based on his record as governor of Texas.[36] As such, observers of government

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[31] Surrey, *supra* note 1, at 6.

[32] *See* Tracy Kaye, *Sheltering Social Policy In The Tax Code: The Low-Income Housing Credit*, 38 VILL. LAW R. 871, 872 (1993) (noting that the home mortgage interest deduction has been available since 1913).

[33] *Id.* Consider that the first tax return, used in 1913, included deductions for interest, state and local taxes, and depreciation. Bartlett, *supra* note 12.

[34] Linda Sugin, *Tax Expenditure Analysis and Constitutional Decisions*, 50 HASTINGS L.J. 407, 408 (1999). Professor Sugin quotes former President Clinton's 1996 State of the Union Address, where he stated, "The era of big government is over," to suggest the administration had shifted its budgetary policy from direct to indirect spending. *Id.* (citing 1996-1 Pub. Papers 79 (Jan. 23, 1996)).

[35] *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997). Among the provisions introduced in the Taxpayer Relief Act of 1997 were the Child Tax Credit, the Hope and Lifetime Learning Credits for education, the deduction for interest on student loans, the 20% maximum capital gains rate for individuals, the exemption of gain from tax for sale of a principal residence, and numerous other changes to the tax code. *Id.* For more commentary on this legislation, *see, e.g.*, 1997 TAX LEGISLATION: LAW, EXPLANATION AND ANALYSIS (C.C.H. 1997).

[36] *See* Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-14, 115 Stat. 38 (2001) [hereinafter EGTRRA]. EGTRRA included reduction of individual tax rates, repeal of the phaseouts for personal exemptions and limits on itemized deductions effective in 2005, expansions of credits related to children, elimination of the marriage penalty in the standard deduction and the 15% bracket effective in 2005, provisions for more education assistance, reform of certain pension and IRA laws, as well as other enactments. *Id.* For a useful provision-by-provision description of EGTRRA, *see* RIA'S COMPLETE ANALYSIS OF THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001 (R.I.A. 2001). For example, the RIA analysis gives observations and illustrations of various amendments, such as the phase-in of lower marginal rates over years 2001-2006. *Id.* at 6-9 (explaining that taxpayers above the 15% bracket will realize savings on their returns, in addition to any refund they receive).

policy comment that spending through the tax code allows politicians to claim they are reducing the size of government by cutting taxes, while simultaneously increasing spending through expenditure programs.[37]

Prof. Surrey meant to undo this covert method of indirect spending by drawing attention to tax expenditure provisions and subsequently replacing them with direct spending programs.[38] By subjecting these spending programs to Congressional attention, Prof. Surrey hoped to deliver assistance more fairly and more efficiently than was possible through the use of tax expenditures.[39] Moreover, Congressional attention would help to eliminate unjustified, whimsical efforts of legislators, who amended the tax code rather than submitting to the normal budgetary process.[40] Indeed, enactments such as the Earned Income Tax Credit ("EIC") in 1975 demonstrate the potential for national opinion to shape tax policy.[41]

A tenet of the tax expenditure movement was the drive toward a

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One commentator predicted President George W. Bush would support tax reform typically proposed by Republican legislators, but with more practical expectations so as not to alienate Democrats. Martin Sullivan, *News Analysis - Taxes In Texas: Bush's Record*, 85 TAX NOTES 1622 (Dec. 27, 1999). While governor of Texas, Bush succeeded in making two major tax cuts by moderating his proposal, in turn bringing Democrats on board. *Id.* (noting that Texas Democrats praised Bush's efforts in cultivating tax reforms). During his presidential campaign, Bush proposed $1.3 billion in tax cuts; Democrats railed against it as too expensive, while Republicans said it did not go far enough. *Id.* Accordingly, Sullivan correctly predicted President Bush would advocate tax reforms but would steer clear of fundamental reform proposals suggested by Republicans, such as a change to a flat tax. *Id.*

[37] Herman P. Ayayo, *Tax Expenditures: Useful Economic Concept or Budgetary Dinosaur?*, 93 TAX NOTES 1152 (Nov. 19, 2001). The three billion dollar surplus projected for years 2002 through 2011 has all but vanished with President Bush's tax rebate program, the overall economic downturn, and an increase in government spending. *Id.*

[38] Surrey, *supra* note 1, at 30-31. Professor Surrey clearly intended the tax expenditure budget to serve as a vehicle for tax reform.

[39] *Id.* at 31.

[40] *Id.* at 31-32. *See also* Dennis J. Ventry, Jr., *The Collision of Tax and Welfare Politics: The Political History of the Earned Income Tax Credit, 1969-99*, 53 NAT'L TAX J. 983 (December 2000). Mr. Ventry observes that tax expenditures "are subject [] to the whims of politics and national mood," and can pass muster without review in the normal appropriations process. *Id.* at 983. Mr. Ventry acknowledges that the publication of the tax expenditure budget over the last thirty years has reduced the opportunity for such unseemly legislative action. *Id.* at 983, n.1.

[41] Ventry, *supra* note 40, at 983-84. Mr. Ventry observed that the EIC operated to combat poverty and welfare dependence, views which society had adopted during the mid-1970's. *Id.* (noting that national concerns included "welfare caseloads, unemployment rates, and the working poor"). Mr. Ventry notes that "the United States 'rediscovered' poverty in the early 1960s," and that President Johnson responded by simultaneously declaring war on poverty while taking a decidedly anti-welfare stance. *Id.* at 985.

"comprehensive tax base," in order to eliminate preferential tax treatment and broaden the tax base to reduce rates generally.[42] The resulting comprehensive base would provide a neutral means for raising revenue, devoid of unseemly preferences.[43] Additionally, elimination of tax expenditures would bring policy-based programs under Congressional scrutiny, as they would be funded directly and more easily reviewed.[44] This point was of particular interest to Prof. Surrey, who repeatedly criticized Congress and the Executive branch for its failure to appreciate the magnitude of tax expenditures.[45] To that end, tax expenditure analysis compares the cost and effect of tax expenditure provisions with comparable direct spending programs, and seeks to determine whether those provisions can be justified as conventional direct expenditures.[46] Surprisingly, Prof. Surrey's eventual goal was *not* the wholesale replacement of tax expenditures with direct subsidy provisions.[47] Rather, he argued that a tax expenditure budget would target areas where Congress has delivered a financial benefit, and thereby decide whether a direct spending program or tax expenditure would be the most effective device.[48]

Tax expenditure analysis of certain tax provisions engenders substantial controversy.[49] Paramount among controversial issues is the so-called "upside down subsidy" problem.[50] In theory, a tax expenditure available to everyone offers inherently greater financial benefit to those

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[42] Surrey, *supra* note 1, at 18. Professor Surrey, in his famous speech of 1967 to the Money Marketeers, stated, "It can be suggested therefore that we need a full accounting for these [tax expenditures]." *See also* Bittker, *supra* note 21, at 926-27. Professor Bittker describes the goal of tax expenditure theory, and then condemns it as unworkable. *See id.*

[43] Bittker, *supra* note 21, at 26-27.

[44] *Id.*

[45] Surrey, *supra* note 1, at 7. Professor Surrey stated, "The items in this Tax Expenditure Budget total between $60 and $65 billion . . . Yet most of these items seem almost to live a life of their own, undisturbed and unexamined. No agency really studies or controls them. The Office of Management and Budget largely neglects them . . . The executive departments likewise are usually unconcerned . . . ." *Id.*

[46] Shannon, *supra* note 14.

[47] Surrey, *supra* note 1, at 129.

[48] *Id.*

[49] Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 DUKE L. J. 1155, 1159-60 (1988).

[50] Surrey, *supra* note 1, at 37. "The translation and consequent restatement of a tax expenditure program in direct expenditure terms generally show an upside-down result utterly at variance with usual expenditure policies." *Id. See also* Thuronyi, *supra* note 49, at 1160.

in higher income brackets.[51] For example, tax deductions for mortgage interest and state property taxes present an unconscionable scenario when analyzed as upside-down subsidies.[52] Further, the deduction for home mortgage interest is particularly troublesome, as low income taxpayers rarely itemize their deductions and consequently cannot take advantage of the deduction.[53]

Surrey lampooned the charitable contributions deduction, demonstrating its unpersuasive logic when applied to taxpayers in substantially different situations.[54] For example, a taxpayer with no tax liability cannot deduct any amount for a charitable contribution, and derives no tax benefit as a result.[55] Alternatively, a wealthy person receives increasingly greater benefits as she moves up the tax bracket, and as her donation increases.[56] Prof. Surrey portrayed this seemingly backward affair as a direct subsidy program, whereby the government matches the charitable grants of wealthy taxpayers and at the same time completely denies any such assistance to the poor.[57] As Prof. Surrey asserts, the government could never suggest such a program, yet the

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[51] MARVIN CHIRELSTEIN, FEDERAL INCOME TAXATION 1, 413 (9th ed., Foundation Press 2002). Professor Chirelstein explains that the dollar value of a deduction from income is the amount excluded times the taxpayer's marginal rate. *Id.* "[D]eductions of any kind generate larger tax benefits for high than low-bracket taxpayers, and in that respect detract from the progressivity of the income tax." *Id.* at 178. *See also* Thuronyi, *supra* note 49, at 1160.

[52] Surrey, *supra* note 1, at 37. Professor Surrey demonstrates that poor taxpayers with no tax liability receive no benefit from the mortgage interest deductions, while married couples earning over $200,000 (who were in the then-effective 70% bracket) would end up paying their bank only $30 on every $100 of interest owed as a result of the deduction. *Id.*

[53] Thuronyi, *supra* note 49, at 1159, n.26 (observing that the standard deduction will generally eclipse any benefit a low income person would receive by itemizing deductions).

[54] Surrey, *supra* note 1, at 7.

[55] *Id.*

[56] *Id.* Surrey also offers the following example:

A 70%-bracket taxpayer selling stock for a gain of $2 million would pay tax on income of $1 million (since the $2 million gain would be reduced by a deduction for 50% for long-term capital gains). The tax liability from the sale would therefore be $700,000, with after-tax proceeds of $1,300,000. If the taxpayer donated the stock to charity instead, the charitable contribution deduction would save him $1,400,000 in tax (70% of $2 million). Thus, the taxpayer would be $100,000 better off if he donated the stock to charity instead of selling it. *Id.* The 70% bracket was the highest bracket available in 1973, when Surrey wrote his "Pathways" book. *Id.*

[57] Surrey, *supra* note 1, at 7. Surrey explained the issue by using a taxpayer in the 70% bracket, who donates $10,000 to charity. *Id.* The $10,000 deduction would result in a $7,000 reduction in tax liability for the taxpayer. *Id.* Surrey portrays the transaction as effecting a $3,000 contribution by the taxpayer, and a matching $7,000 contribution by the government. *Id.*

charitable contribution provision of the tax code effectuates the very same program.[58] Therefore, tax expenditure analysis purports to allow policymakers to target and eliminate these injudicious tax concessions.[59]

In addition, tax expenditures complicate the tax code, increase administrative difficulty, and make estimation of actual revenue losses very difficult to determine.[60] Moreover, the I.R.S. proves a poor administrator of these indirect subsidy programs.[61] As an illustration, the tax code affords preferential treatment for dairy farmers in the form of accelerated depreciation, as well as the potential use of the cash accounting method, to encourage production of cattle.[62] On the other hand, the Department of Agriculture gives money to farmers for reducing herd size and slaughtering their cattle.[63] Lastly, certain provisions actually end up costing the government more money than it would require under a direct spending regime.[64]

Prof. Surrey hoped that formulation of a tax expenditure budget would accomplish several different goals: a reworking of the tax code to increase efficiency and effectiveness, a restoration of public confidence in the appropriations process, simplification of the tax code, improved evaluation of current and proposed tax expenditure provisions, and consideration of possible civil rights or other constitutional concerns.[65] Nonetheless, his tax expenditure theory has endured much criticism, as discussed in the next section.

B. *Criticism of the Tax Expenditure Concept*

Professor Boris Bittker emerged an early foil in Prof. Surrey's campaign for an expenditure budget.[66] Even before expenditures became part of the Federal budget, Bittker leveled the most sound and

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58 *Id.*

59 *Id.*

60 Thuryoni, *supra* note 49, at 1161.

61 *See* Surrey, *supra* note 1, at 102-125. Professor Surrey shows how provisions for accelerated deductions for various industries have created abusive deferral opportunities and tax shelters. *Id.*

62 Thuronyi, *supra* note 49, at 1161.

63 *Id.* As Professor Thuronyi suggests, the apparent disconnect should resolve in favor of the Dept. of Agriculture, as it is the better-equipped entity to determine the proper incentive for farmers. *Id.*

64 Surrey, *supra* note 1 at 210-11. *See also* Thuronyi, *supra* note 49, at 1162

65 *See* Surrey, *supra* note 1, at 30-49.

66 Bartlett, *supra* note 12.

enduring critique of the concept: the lack of agreement over the "normative" or ideal tax structure.[67] In sum, Bittker argued the tax expenditure concept has no value if there is no "agreed starting point, departures from which can be identified."[68] Without agreement on a normative model, tax expenditure analysis proceeds from an arbitrary list of tax code provisions that provides no insight into costs or revenue losses.[69] Prof. Bittker argued in his exchange with Prof. Surrey that a consensus on the definition of a normative tax base was simply impossible.[70]

Measuring tax expenditures has proven extraordinarily difficult. As Prof. Bittker argued, calculation of lost revenue without accounting for possible changes in taxpayer behavior may render an unrealistic representation of actual expenditure costs.[71] Importantly, a tax expenditure budget that assumes no change in taxpayer behavior is antithetical to the evaluation of expenditures as monetary outlays.[72] In

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67 *See* Bittker, *supra* note 21, at 985. "There are many problem areas in which the search for 'preferences' is doomed to fail because we cannot confidently say which provisions are 'rules' and which are 'exceptions.'" *Id. See also* Boris I. Bittker, *Accounting for Federal Tax Subsidies in the National Budget*, 22 NAT'L TAX J. 244 (1969) [hereinafter Bittker, Accounting]; Julie Roin, *Truth in Government: Beyond the Tax Expenditure Budget*, 54 Hastings L. J. 603, 610-11 (2003).

68 Accounting, *supra* note 67, at 247.

69 *Id.* "What is needed is not an ad hoc list of tax provisions, but a generally acceptable model, whose costs are to be reported as 'tax expenditures.'" *Id.*

70 Boris I. Bittker, *The Tax Expenditure Budget – A Reply to Professors Surrey and Helmuth*, 22 NAT'L TAX J. 538, 539 (1970). Professor Bittker essentially renewed the arguments he raised earlier, and also illustrated that not even Professor Surrey and the Treasury agreed on a normative tax base definition. *Id.*

71 *Id.* "To be fully informative, of course, the [tax expenditure] 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 what the taxpayer would have done in its absence, its 'cost' cannot be accurately measured by merely recomputing the tax liability on the return as filed." *Id.*

72 Seymour Fiekowsky, *The Relation of Tax Expenditures to the Distribution of the "Fiscal Burden,"* 2 CANADIAN TAXATION 213 (Winter 1980), *cited in* Bartlett, *supra* note 12 (alleging "the estimated magnitudes of tax expenditures are generally neither dimensionally comparable to amounts conventionally entered on the uses side of the budget, nor are they computed in a manner which makes them additive with each other"). Since 1982, the expenditure budget has presented both lost-revenue and outlay-equivalent amounts, and in doing so has helped present a more complete picture of expenditures. Bartlett, *supra* note 12. It is possible that the separate calculations are instead more confusing and perhaps provide more fodder for lawmakers to promote special interest groups. For instance, the outlay-equivalent amounts are generally greater than the lost-revenue amounts, because outlays would be taxable to recipients and must be "grossed up" to account for the taxable amount. *Id.*

the absence of a certain tax provision, a taxpayer might alter her behavior and derive a tax benefit from another provision.[73] Alternatively, a taxpayer might behave in a certain manner in order to derive a particular benefit, and elimination of the benefit might cause her to behave differently.[74] In similar fashion, a taxpayer who benefits from a certain tax expenditure program could end up qualifying for another program, if certain expenditure provisions were invalidated.[75] Recent studies demonstrate that the deduction for charitable contribution substantially affects charitable donation, and thus the elimination of the deduction would influence taxpayer decisions.[76]

Additionally, the tax expenditure budget quantifies each item completely independent of other items, and thus presents a non-additive picture of the cost of expenditure programs.[77] While this approach is logical, due to the progressive rate structure and its effect on the value of deductions and exemptions, it also limits the usefulness of the budget.[78] Another problem with expenditure analysis is it proceeds as if in a vacuum; the cost of the program is calculated with and without the provision in question, ignoring obvious inaccuracy in some cases.[79] Last, there is some question as to deferral of certain gains.[80] On the one

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[73] Roin, *supra* note 67, at 618-19. "[I]ndividuals profiting from one governmental program may migrate to another if their original program is shut down. As a result, the use of a zero expenditure baseline to score the costs of such programs is misleading." *Id.*

[74] *Id.* "[T]axpayers who lose 'their' tax expenditures may gravitate towards investment in other tax-favored activities . . . ." *Id. See also* Bittker, Accounting, *supra* note 67, at 247.

[75] Roin, *supra* note 67, at 17. "Just as taxpayers who lose 'their' tax expenditures may gravitate towards investment in other tax-favored activities, individuals profiting from one governmental program may migrate to another if their original program is shut down." *Id.*

[76] *See* Laura Tiehen, *Tax Policy and Charitable Contributions of Money*, 54 NAT'L TAX J. 707 (2001). The author notes that tax-savvy charitable donors generally have higher incomes than those who donate without any tax purpose. *Id.* at 716.

[77] Bartlett, *supra* note 12.

[78] *See, e.g.*, Thomas S. Neubig & David Joulfaian, *The Tax Expenditure Budget Before and After the Tax Reform Act of 1986*, Office of Tax Analysis, U.S. Treasury Department (1988), *available at* http://www.ustreas.gov/offices/tax-policy/library/ota60.pdf (last visited April 28, 2003). The change in marginal rates in 1986 reduced the total amount of expenditures by $115 billion. *Id.*

[79] Consider the calculation for tax-exempt interest on municipal bonds: the expenditure budget calculates the amount of revenue lost as if the interest were taxable. Thruonyi, *supra* note 49, at 1160. Interest rates on municipal bonds are usually lower than those on securities, and therefore receive an implicitly lower return on their investment amounts. *Id.* Consequently, the amount of revenue actually lost through exclusion of interest on municipal bonds is lower than is included in the expenditure budget. *Id.*

[80] Bartlett, *supra* note 12.

hand, capital gains are deferred until they are realized rather than accrued.[81] However, some deferrals have been treated more like perpetual exemptions, such as payments made to IRAs.[82] Therefore, it is extremely difficult to make any reliable calculation of revenue lost through expenditure provisions.[83]

Many criticize the implementation of expenditure theory and the individual expenditures chosen (and not chosen) by the Treasury. The use of the Haig-Simons definition draws significant criticism from Bittker:

The trouble is that, aside from the many ambiguities that become apparent as soon as one attempts to apply the Haig-Simons definition to the protean stream of economic life, any system of income taxation is an aggregation of decisions about a host of structural issues that the Haig-Simons definition does not even purport to settle.[84]

Under a strict interpretation of the Haig-Simons base, numerous items not traditionally taxed would be made includable in income, such as imputed income on an owner-occupied home, imputed income from household work by a nonworking spouse, personal exemptions, and even the graduated tax rate schedule.[85] Taxpayers would also derive

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81 *Id.*

82 It is noteworthy that the OMB now calculates revenues lost on IRA's in present value terms, to more accurately reflect the actual amounts at play. 2004 Analytical Perspectives, *supra* note 9, at 73. While the 2000 budget listed an IRA expenditure upwards of $15 million dollars, the 2002 budget reduces that amount to around $6 billion because of taxes that will be paid upon withdrawal of IRA funds. *Id.*

83 Michael Graetz, *Paint-by-Numbers Tax Lawmaking*, 95 COLUMBIA L. REV. 609, 666 (1995). Professor Graetz recognizes the pitfalls of attempting to calculate costs of proposed tax legislation: "The problems of distributional tables [] make clear that they are often misleading. The relevant staffs disagree over the incidence of certain taxes, the taxpaying unit to be evaluated, the appropriate measurement of income, and even the meaning of distributing a change in taxes." *Id.*

84 Bittker, Accounting, *supra* note 67, at 260.

85 For both imputed income on an owner-occupied home and on income from household work by a non-working spouse, the inclusion in income would not be allowed as a deduction. *See* Bartlett, *supra* note 12. Imputed income from living in one's home reflects the notion that, if two people lived in different homes, and each occupant owned the other home, they would pay rent to each other. *Id.* Thus, each technically derives income when living in her own home. *Id.* Interestingly enough, the Department of Commerce calculates imputed rent from owner-occupied homes in the GDP. *Id.* In 1999, imputed rent totaled nearly $577 billion. *See* Survey of Current Business, Table 8.21 Imputations in the National Income and Product Accounts, at 83 (August 2000), *available at* http://www.bea.doc.gov/bea/ARTICLES/NATIONAL/NIPA/2000/0800nipt.pdf (last visited April 28, 2003). Marginal rates below the top rate could also be includable as expenditures, especially in light of the inclusion of lower corporate rates as expenditures. Douglas A.

income in the form of public capital, through their use of roads and other public benefits.[86] Inclusion of deductions of charitable contributions in the tax expenditure budget cannot be reconciled with the exclusion of certain tax-exempt entities.[87] Indeed, even Surrey conceded that a rigid application of Haig-Simons could not provide a workable foundation for his expenditure theory, and utilized numerous amendments to accommodate logical exceptions.[88] Modern critics seize on this point, calling expenditure theory "an illusion of value-free scientific precision in a heavily politicized domain."[89] Others cite the preferential treatment of capital gains in the tax expenditure budget as an error, arguing capital gains should be wholly excludable from income under Haig-Simons.[90] Perhaps the most obvious indicator of disagreement over tax expenditures is the discrepancy between the Treasury Department budget and the Joint Committee on Taxation budget, as the latter includes a section of its appendix dedicated to JCT and Treasury disagreements over individual provisions.[91] Notwithstanding any current conflict between the Treasury and Joint Committee expenditure budgets, the mere fact that the list of expenditures changes on occasion shows the somewhat fleeting nature of the expenditure definition.[92]

Although the reference law method was supposed to provide a less subjective budget than the normal tax method,[93] it has fallen short in that regard.[94] For instance, the reduced rates on the first ten million dollars

Kahn & Jeffrey S. Lehman, *Tax Expenditure Budgets: A Critical View*, 54 TAX NOTES 1661, 1664 (Mar. 30, 1992). However, Simons himself argued there should be NO corporate income tax in his view, and it can be reasoned that a Haig-Simons definition does not allow for inclusion of corporate rates in an expenditure budget. Bartlett, *supra* note 12.

86 *See* Charles Hulten & Robert M. Schwab, *A Haig-Simons-Tiebout Comprehensive Income Tax*, 44 NAT'L TAX J. 67 (1991).

87 Roin, *supra* note 57, at 612.

88 Surrey, *supra* note 1, at 8.

89 Kahn and Lehman, *supra* note 85, at 1661.

90 *See* Bruce Bartlett, *Why the Correct Capital Gains Tax Rate Is Zero*, 84 TAX NOTES 1411 (Sept. 6, 1999). *See also* Jim Saxton, TAX EXPENDITURES: A REVIEW AND ANALYSIS, Joint Economic Committee, U.S. Congress (Aug. 1999), p. 5 (on file).

91 Bartlett, *supra* note 12.

92 In 1983 the Office of Management and Budget decided that certain items, which up to that point had been considered tax expenditures, would henceforth be part of the normative tax base. *Id.* (referring to Office of Management and Budget, Budget of the United States Government, 1983: Special Analysis G, Tax Expenditures (1982), p. 37).

93 The difference between normal tax method and reference law method is discussed in the next section. *See infra* part IIC.

94 Boris I. Bittker & Lawrence Lokken, *Tax Expenditure Budget*, *in* FEDERAL TAXATION

of corporate income and the preferential treatment of capital gains are both considered part of existing law and therefore are not expenditures in the reference law budget.[95] Nonetheless, the determination that these items are structural provisions is arguably just as subjective as the choices made in creating the normative tax base.[96] On the other hand, certain items, such as the preferential treatment of capital gains and stepped-up basis at death, are usually included in the expenditure budget when they might properly be deemed mitigation of double taxation.[97]

It is possible that tax expenditure programs, for whatever controversy and debate they incite, may in fact be *more effective* than direct programs, jeopardizing Prof. Surrey's basic theory.[98] In a recent article, David Neumark and William Wascher demonstrated through empirical evidence that, as between welfare, minimum wage, and the EITC, the tax credit may provide the most effective measure of relief to poor families.[99] Specifically, the authors show that welfare can impose long-term dependency problems.[100] A comparison of the EITC and minimum wage shows the EITC provides a more effective incentive to work, and thus may be the more beneficial of the two.[101]

In the midst of the battle between tax expenditure proponents and opponents, the Treasury Department and the Joint Committee on Taxation ("JCT") have successfully published tax expenditure budgets for a number of years, as is discussed below.

C. *The Current Tax Expenditure Budget of the U.S.*

Recognizing the sizeable portion of revenue supposedly lost through tax expenditure programs, Congress mandated incorporation of a tax expenditure budget into the Federal budget beginning in 1974.[102]

OF INCOME, ESTATES, AND GIFTS 1 (R.I.A., 2003) (criticizing the tax expenditure budget for its subjectivity, and using many of the same criticisms that Professor Bittker has articulated over the past 30 years).

95 *Id.*

96 *Id.*

97 Saxton, *supra* note 90, at 5.

98 *See* David Neumark & William Wascher, *Using the EITC to Help Poor Families: New Evidence and a Comparison with the Minimum Wage*, 56 NAT'L TAX J. 281 (2001).

99 *Id.* at 281-83.

100 *Id.* at 281.

101 *Id.* at 283.

102 *See* Congressional Budget and Impoundment Act, *supra* note 8. The Congressional

The Treasury compiles its tax expenditure budget in the "Analytical Perspectives" section of the annual budget documents.[103] The JCT also prepares a tax expenditure budget, to provide guidance to the tax committees in Congress.[104]

The Treasury budget utilizes two foundational criteria in creating its tax expenditure budget.[105] The first is the "normal tax method."[106] Notably, the JCT uses the normal tax method in computing its tax expenditure budget as well.[107] This method essentially reflects a modified version of the Haig-Simons definition of income by using a more narrowly construed "comprehensive" tax base.[108] Specifically, certain credits, exemptions, and deductions – which would otherwise be considered tax expenditures under Haig-Simons theory – are conceded as non-expenditures.[109] It is interesting that, although the JCT budget and the Treasury budget use the same baseline definition in identifying tax expenditures, the JCT budget uses a more narrow definition and consequently enumerates more tax expenditures than the Treasury budget does.[110]

The Treasury budget also utilizes a "reference law method," which establishes tax expenditures based on deviations from existing tax

Budget and Impoundment Act mandated calculation of tax expenditures as a part of the normal Treasury budget:

> [O]n or before April 1 of each year, the director shall submit to the committees on the budget of the house of representatives and the senate a report [on] . . . the levels of tax expenditures under existing law, taking into account projected economic factors and any changes in such levels based on proposals in the budget submitted by the President for such fiscal year. Such report shall also include a discussion of national budget priorities, including alternative ways of allocating budget authority and budget outlays for such fiscal year among major programs or functional categories, taking into account how such alternative allocations will meet major national needs and affect balanced growth and development of the United States.

Id.

103 *See* 2004 Analytical Perspectives, *supra* note 9.

104 *See* 2004 JCT Budget, *supra* note 9, at 1.

105 2004 Analytical Perspectives, *supra* note 9, at 101.

106 *Id.*

107 Bittker and Lokken, *supra* note 94, at 3.

108 *Id.*

109 *Id.* Particular items include: personal exemptions, the standard deduction, joint filing benefits for spouses and heads of household, and nonrecognition of unrealized gains. *Id.*

110 *See* 2004 JCT Budget, *supra* note 9, at 12-14. The JCT Budget lists the items considered tax expenditures under its normative tax base, but not under the Treasury's definition. *Id.*

law.[111] Essentially, the reference law method deems code provisions to be tax expenditures when they amount to an exception to generally accepted rules in the Internal Revenue Code.[112] Accelerated depreciation provides the best example of the distinction between normal and reference law methods.[113] The normal tax method adheres to a Haig-Simons baseline and identifies accelerated depreciation as a deviation from the normative definition; reference law method looks to the Internal Revenue Code and finds a general acceptance of accelerated depreciation.[114] Thus it does not identify certain depreciation rules as tax expenditures.[115]

The Treasury budget measures tax expenditures according to three bases: lost revenues, outlay equivalents, and present value estimates for certain provisions that provide deferral of payment.[116] Lost revenue amounts assume the additional tax that would be collected in lieu of the tax expenditure provision, provided everything else remains the same.[117] Notably, items such as credits receive different treatment under the lost revenue and outlay equivalent approaches than other purported tax expenditures, owing to their "dollar for dollar" nature.[118] Unlike the Treasury budget, the JCT tax expenditure budget calculates lost revenues only.[119]

If the tax expenditure movement was in fact a means to generate opposition to certain tax provisions, that enterprise has been only marginally successful: since 1913, only thirteen tax expenditure

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[111] *See* 2004 Analytical Perspectives, *supra* note 9, at 101. The normal tax method is narrower than the reference law method, and thus it separates out more provisions as tax expenditures. *Id.* Items that qualify as tax expenditures under the normal tax method but not under the reference law method are indicated by placing "(normal tax method)" next to the item. *See id.* at 103 (noting the expensing of research and experimentation expenditures is included under the normal tax method only). Provisions are considered tax expenditures if they are exceptions "from some general rule stated in the law." *Id.*

[112] Bittker and Lokken, *supra* note 94, at 4.

[113] *See* 2004 Analytical Perspectives, *supra* note 9, at 103.

[114] *Id.*

[115] *Id.* (identifying "normal tax method" tax expenditures on lines 47, 55,56, and 57 that demonstrate this issue).

[116] *See* 2004 Analytical Perspectives, *supra* note 9, at 101.

[117] Bittker and Lokken, *supra* note 94, at 4.

[118] *Id.* A direct outlay for a credit is larger than the same for revenue lost, because a direct outlay would be taxable to its recipient. *Id.* Thus, a $100 credit would require a $154 outlay for a 35% bracket taxpayer. *Id.*

[119] *See* 2004 JCT Budget, *supra* note 9, at 17.

programs have been removed from the tax code.[120] Nonetheless, a number of commentators have called for adding to, rather than eliminating, the tax expenditure budget.[121] Professor Julie Roin emphasizes the democratic nature of our society and its need to remain informed.[122] She argues persuasively that elimination of the tax expenditure budget would impair current leaders' ability to learn from prior legislation, deter the introduction of redundant programs, and deprive the citizenry of their ability to remain informed.[123] Likewise, Professors Heen and Garrett argue that other legislative mechanisms provide worthy devices for tracking the accountability of government officials.[124] Most importantly, condemnation of the tax expenditure budget due to the inaccuracy of its cost approximations is untenable.[125] Quite simply, the *entire* Federal budget relies on cost estimations that may or not be accurate, and therefore this argument rings hollow.[126]

D. *The German Tax Expenditure Budget*

It is interesting that Germany began its own tax expenditure analysis around the same time that the U.S. did.[127] Much like the U.S., the German government is obligated to calculate a tax expenditure budget and report it to the "Bundestag and Bundesrat" as part of the regular budget.[128] The tax expenditure budget evaluates individual

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120 Chris Edwards, *D.C. Needs Taxpayers to Move Back to City, Says Tax Foundation*, TAX NOTES, 94 TNT 164-54 (Aug. 22, 1994).

121 *See* Roin, *supra* note 67, at 622-32 (advocating more information in the budget, and a regulatory expenditure section of the budget); Elizabeth Garrett, *Harnessing Politics: The Dynamics of Offset Requirements In The Tax Legislative Process*, 65 U. CHI. L. REV. 501 (1998) (recommending that PAYGO rules be enforced against legislators who pursue legislation for special interest reasons rather than for sound public policy reasons); Mary Heen, *supra* note 17 (advocating more oversight by government entities via the Government Performance and Results Act).

122 Roin, *supra* note 67, at 605-8.

123 *Id.*

124 *See generally* Garrett, *supra* note 121; Heen, *supra* note 17.

125 *See* Roin, *supra* note 67, at 615-19.

126 *Id.*

127 Recent Experiences, *supra* note 13, at 9.

128 *Id.* at 65. The expenditure budget is mandated by the Law to Promote Economic Stability and Growth, at section 12. *Id.* *See also* Shannon, *supra* note 14. For information on the Bundestag and Bundesrat, *see* Basic Law for the Federal Republic of Germany, *available at* http://eng.bundesregierung.de/top/dokument/The_Federal_Government/Function_and_constitutional_basis/Basic_Law/Xa._State_of_Defense/ix6107_36085.htm?naviKnotenID=6107&ixepf=6107_36085&script=0 (last visited Apr. 28, 2003).

income tax and corporate income tax expenditures, as well as some taxes the U.S. budget does not consider.[129] However, the German tax expenditure concept deserves close examination, as it illuminates important truths about the U.S. concept that warrant reexamination and possible reform.[130] A significant difference from U.S. tax expenditure analysis is the division of tax expenditures according to the purpose for each.[131] Specifically, the German budget classifies each tax expenditure as support, adjustment aid, productivity or growth aid, or "other tax concession."[132] Moreover, there are specific items – such as preferential treatment for pension income – that are considered part of the baseline tax system and are not considered tax expenditures.[133]

The most significant difference between Germany and the U.S. in their respective tax expenditure analyses is in the identification of tax expenditures.[134] Like U.S. officials, German lawmakers realize the importance of defining the normative tax base.[135] Germans, however, acknowledge some degree of subjectivity and even ambiguity in determining a normative tax base, unlike tax expenditure proponents who defend their expenditure budgets by pointing to various definitions of income.[136] A more persuasive methodology is to focus on areas of agreement in tax expenditure analysis, and ask *why* different people tend to categorize certain provisions in similar ways.[137] This question leads to a more visceral but no less valuable analysis of equity in the tax base for the purpose of evaluating different provisions as tax expenditures.[138]

In defining tax expenditures, Germany does not compare its tax provisions with a normative tax base, but looks more stringently at the

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129 *Id.* The German expenditure report also includes expenditures in: regulations that affect income tax, net worth tax, business tax, turnover tax, company tax, insurance tax, motor vehicle tax, excise taxes on beer and tobacco, mineral oil and salt taxes, betting and lottery taxes, property tax, and inheritance taxes. *Id.*

130 Shannon, *supra* note 14.

131 Recent Experiences, *supra* note 13, at 66.

132 *Id.* The budget uses letters next to each expenditure to indicate its objective: E = support; A = adjustment aid; P = productivity aid; and S = other concessions. *Id.*

133 *Id.* at 167.

134 Shannon, *supra* note 14.

135 *Id.*

136 *Id.*

137 *Id.*

138 *Id.* It is interesting that Simons, who dispensed with equitable concerns in formulating his definition of income, acknowledged that equity concerns would require some concessions in his theory. *Id.*

income being taxed for guidance in defining the underlying tax structure.[139] German tax expenditure theorists thus consider the allocation of the overall tax burden in society as crucial in identifying provisions for examination in their expenditure budget.[140] As a result, Germany considers a taxpayer's ability to pay as essential in defining tax expenditures.[141] In other words, tax burdens should be borne according to each person's ability to pay, and similarly the use of income as a normative basis for a tax structure must account for a taxpayer's ability to pay.[142] Although "ability to pay" as a criteria in expenditure analysis might be criticized as too subjective or unyielding, it is no more subjective than the various tax bases used by the U.S. budget.[143]

Germany identifies structural and tax expenditure provisions according to three criteria.[144] First, structural provisions include those based on concerns for income and the ability to pay, and thus attempt to equitably allocate the tax burden to the appropriate members of society.[145] Second, provisions that account for facilitating administration and simplification of the code are considered structural as well.[146] Third and most instructive are provisions that neither distribute burdens nor ease administration, but rather account for other purposes such as attempting to influence spending or economic behavior.[147] For Germans, provisions that fall into this third category are the equivalent of tax expenditures – any tax law that is based on some social or economic concern beyond those stated in the first two scenarios.[148]

Under German theory, therefore, code provisions that reflect a desire to equitably distribute the tax burden would be considered normative, rather than tax expenditures.[149] So long as such provisions

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139 Recent Experiences, *supra* note 13, at 66.

140 *Id.*

141 Shannon, *supra* note 14.

142 *Id.*

143 *Id.* Mr. Shannon argues that equitable concerns are built into many areas of the law outside of taxation without question, and the inclusion of equitable principles in tax expenditure analysis should not be so troubling. *Id.*

144 Recent Experiences, *supra* note 13, at 66-67.

145 *Id.*; Shannon, *supra* note 14.

146 Recent Experiences, *supra* note 13, at 66.

147 Shannon, *supra* note 14.

148 *Id.*

149 *Id.*

invoke sound social or economic goals, they may be considered non-expenditures.[150] This structure provides the foundation for this article's proposal.

E. *Proposal – Germany Provides An Alternative*

Which income tax rules are special provisions representing Government expenditures made through the income tax system to achieve various objectives apart from that tax, and which income tax rules constitute the basic structure of the income tax itself and hence are integral to having such a tax at all? What is required to answer this central question of definition is a normative model for an income tax structure. That normative model in turn will depend on a definition of income for income tax purposes.[151]

Prof. Surrey answered his query by utilizing the Schanz-Haig-Simons definition of income, reflecting a consumption-based approach.[152] However, courts and commentators have long held that individuals should be taxed based on their "ability to pay."[153] Prof. Surrey himself acknowledged certain provisions, such as the deduction for medical expenses, attempted to equalize taxpayers based on their ability to pay, and thus the deduction might not qualify for tax expenditure treatment.[154] However, Prof. Surrey contended that a direct health care expenditure program would be more appropriate than this tax expenditure approach, so that attention would be properly focused on the cost of medical care rather than taxpayers' ability to pay income

[150] *Id.* Shannon notes that the rate structure will be considered a structural provision, so long as it does not adopt some premise contrary to the "ability to pay" convention (ie: a regressive rate structure). *Id.* at n.82.

[151] Surrey, *supra* note 1, at 7.

[152] *Id.* at 20-21.

[153] *See* Stephen Utz, *Ability to Pay*, 23 WHITTIER L. REV. 867 (2002) (discussing the evolution of the ability to pay rationale). *See also* 149 CONG. REC. H3004-01, *H3008 (April 9, 2003). "We passed a tax bill last spring; and I do not remember the exact figure, but something like 75 percent of the benefit went to people who make more than $100,000 in this country. Now, if that is a fair tax structure, I will be darned. I mean, I have to relearn the meaning of fairness. The whole idea of a tax structure is to pay on [sic] one's ability to pay." *Id.* (statement of Rep. McDermott). *See* Graetz, *supra* note 83, at 610. "Fairness is often said to require that people with equal ability to pay taxes pay equal amounts of tax, and those with greater ability to pay, pay more." *Id.*

[154] Surrey, *supra* note 1, at 21-22. Professor Surrey elaborated that the deduction for medical expenses could be "appropriate under an income tax since a deduction is needed to equalize the 'ability to pay' an income tax between a family with an illness and a family without an illness." *Id.* at 21.

tax.[155]

Herein lies the possibility for a more relevant and helpful tax expenditure budget: certain code provisions reflect the basic concept that taxpayers should be taxed on their ability to pay.[156] It is somewhat inherent to the Haig-Simons approach that the ability to pay is a necessary component of consumption.[157] In other words, consumption is arguably a measure of one's ability to pay and is thus implicitly incorporated into Prof. Surrey's comprehensive tax base.[158] Therefore, a portion of the tax expenditure budget should focus on and acknowledge certain provisions that reflect the ability to pay rationale, following the example set by Germany.

Consider two items listed as tax expenditures in both the Treasury and JCT tax expenditure budgets: the Child Credit and the Earned Income Credit ("EIC").[159] Both the Treasury and JCT tax expenditure budgets identify these credits as sizable revenue losses for the year 2003, each totaling several billion dollars.[160] The inclusion of both credits in the same sections of the tax expenditure budgets obscures an important difference between them - specifically, the EIC provides relief on an "ability to pay" basis, while the Child Credit does not.[161]

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155 *Id.* at 22.

156 Utz, *supra* note 153, at 927. "A 'normal' tax structure, against which tax expenditures are to be judged, must simply be an 'ideal' tax structure based on ability to pay or some other concept. By and large, even the sophisticated participant in tax expenditure debates has assumed ability to pay as a fundamental principle." *Id.*

157 *Id.* at 932. "[T]he ability to pay approach may now be said to serve as a mainstay of consumption tax advocacy." *Id.*

158 *Id.* at 947. Those who advocate using consumption should recognize that ability to pay is a valid benchmark for distributing tax burdens. *Id.* Although Professor Utz determines that ability to pay is a poor device for measuring tax burdens, the point is no less valuable – ability to pay can help in fashioning the normative tax base. Utz, *supra* note 153, at 947.

159 Table 6-1 of the Analytical Perspectives section lists estimates of all income tax expenditures, and lists the Child Credit on line 91 and the Earned Income Tax Credit on line 126. *See* Analytical Perspectives, *supra* note 9, at 103-5. Each credit qualifies as a tax expenditure under both the normal and reference law methods. *See id.* Likewise, Table 1 of the JCT tax expenditure budget lists the Child Tax Credit and Earned Income Credit. JCT Expenditure Budget, *supra* note 9, at 24-6.

160 The Treasury estimates over $21 billion will be lost at the hands of the Child Credit in 2003, and nearly $5 billion as a result of the Earned Income Tax Credit in the same year. *See* 2004 Analytical Perspecitives, *supra* note 9, at 104-5. The JCT budget estimates $27.1 billion will be lost to the Child Credit and $34.1 billion lost to the Earned Income Credit. *See* JCT Expenditure Budget, *supra* note 9, at 24-6.

161 *See In re Thomas and Lynnette Dever*, 250 B.R. 701 (2000). *See also* Terry L. Meyers, *Refund Due to Child Tax Credit Not Exempt in Bankruptcy*, 90 TAX NOTES 1498

Congress amended the Internal Revenue Code of 1954 with the Tax Reduction Act of 1975 that included establishment of the EIC.[162] The EIC, as legislators explained, was designed to provide assistance to "those who are most in need of the relief."[163] Senators commented that the EIC targeted those with little or no income, who struggled with rising food and energy prices.[164] Importantly, Congress enacted the EIC to provide poverty-level taxpayers with some disposable income that they would presumably spend and thereby stimulate the economy.[165] Moreover, heads of households qualifying for the EIC are encouraged to work and receive the refundable credit, rather than receive government benefits.[166]

Unlike the EIC, the Child Credit applies to a much broader class of taxpayers, and its legislative history does not utilize any "ability to pay" language.[167] Primarily, the Child Credit reflects sound social policy and returns some income to taxpayers to invest in their families, in recognition of the diminished value of the exemption for dependents.[168] Further, proponents of the Child Credit anticipated that parents would use the extra income to save for their children's education expenses.[169] Congressional testimony abundantly demonstrates that the Child Credit was supposed to help middle-class families with child-related expenses, rather than helping low-income families exclusively.[170]

(March 7, 2001). The case and its rationale are discussed below. Each credit finds its way into the tax expenditure budget for the same reason – neither the Treasury nor the JCT considers them "structural," but rather fits the definition set forth in 2 U.S.C. § 622(3), by providing a special credit.

[162] *See* Pub. L. No. 94-12, § 204, 89 Stat. 26 (1975).

[163] S. REP. NO. 94-36, at 11 (1975), *reprinted in* 1975 U.S.C.C.A.N. 54, 64.

[164] *Id.*

[165] *Id.*

[166] *Id.* The EIC increases low-income taxpayers' after-tax earnings, providing incentive to earn a living rather than remain on the welfare rolls. *Id.*

[167] *See, e.g.*, H.R. REP. NO. 105-148, at 309-10 (1997). The House and Senate reports show that Congress wanted to reduce the tax liability of families, recognizing that costs increase along with family size. *Id.*, S. REP. NO. 105-33, at 42 (1997).

[168] H.R. REP. NO. 105-148, at 309-10. The Report states: "[O]ver the last 50 years the value of the dependent personal exemption has declined in real terms by over one-third. The Committee believes that a tax credit for families with dependent children will reduce the individual income tax burden of those families." *Id.*

[169] *Id.*

[170] *See* 143 CONG. REC. H4922-01 (July 9, 1997). "The question is, who will get those tax cuts? We believe that middle-income Americans ought to get those tax cuts; that they ought to receive deductions for education for their children, that they ought to receive child tax credits . . . Democrats and the President believe those tax cuts ought to go to middle-

In *In re Thomas and Lynnette Dever*, a couple with three minor children filed for Chapter 7 bankruptcy in 1999, while claiming $1500 in child tax credits that year.[171] The Devers claimed that the $1500 was comparable to public assistance or a welfare subsidy, and therefore it belonged outside the scope of the bankruptcy proceeding under Idaho law.[172] The claim invited the Idaho Bankruptcy Court to compare the Child Credit with the EIC, which courts had previously determined was a form of public assistance and properly beyond the reach of bankruptcy creditors.[173] In a different Idaho Bankruptcy Court proceeding earlier

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income people for deductions for their children's education and for child tax credits." *Id.* (statement of Rep. Kilpatrick). *See also* 143 CONG. REC. H4922-05 (July 9, 1997). "[T]he President's proposal would give a child credit only to those who work and pay Federal taxes, income or withholding, Social Security, period." *Id.* (statement of Rep. Levin). *See* 143 CONG. REC. E1281-01 (July 20, 1997). "[M]iddle-income families will benefit from a $500 per child tax credit. A family that has a child today will receive an estimated $10,309 in tax relief under the Republican plan by the time that child is 18. The tax relief will also create education investment accounts that will allow parents to save tax-free for their children's higher education." *Id.* (statement of Rep. Packard). *See* 143 CONG. REC. S6440-02, *S6461. "We want to let families decide how to invest their own money in their own children and for their own futures. The whole purpose of a $500 tax credit was to allow families to invest their own money-which after all they earned-in the education, housing, nutrition, nurturing, and health care of their children . . . Nobody ever disputed the fact that the purpose here was a clear-cut tax cut to let families decide how to spend their own money on their own children. Remember, this is not all of their money; only $500 per child." *Id.* (statement of Sen. Gramm). *See* 143 CONG. REC. S6332-01, *S6333:

> It costs the average American couple today twice- twice-the proportion of their yearly household income to pay the mortgage than it cost their parents; average Federal income payroll taxes rose from 2 percent of family earnings in 1950 to 24 percent in 1990; health costs have skyrocketed in the past 20 years, sending 4 to 5 million women to work for medical insurance alone . . . And because of our efforts to ensure bipartisan cooperation, the Finance Committee bill we consider today . . . is structured to provide major tax relief-relief to America's hard working and overburdened families. There were three criteria that guided our work. We wanted tax relief for middle-income families, tax relief to promote education, and tax relief to stimulate economic growth, opportunity, and jobs. With these objectives in mind, we crafted a bill that includes a $500 per child tax credit.

Id. (statement of Sen. Roth).

[171] *In re Dever*, 250 B.R. at 703. I.R.C. § 24 allows taxpayers a $500 credit against their tax liability for each qualifying child. *Id.*

[172] *Id.* at 704. Idaho bankruptcy law allows debtors to exclude "benefits the individual is entitled to receive under federal, state, or local public assistance legislation . . . ." *Id.* (citing IDAHO CODE § 11-603(4)).

[173] *Id.* at 705; Sorensen v. Sec. Of the Treasury of the United States, 475 U.S. 851, 864 (1986). "The earned income credit was enacted . . . to provide relief to low-income families hurt by rising food and energy prices." *Id.* *In re Searles*, 445 F. Supp. 749, 755 (D. Conn. 1978) (stating, "[The EIC] is a payment made to low-income taxpayers to help them meet

that year, the Court had found that the Hope education credit was distinctly different from the EIC, in that Congress was not attempting to assist the poor alone but all families generally.[174] In similar fashion, the Court in *Dever* held the Child Credit provided aid to taxpayers without regard for their financial status, and that the phase-out at income of $110,000 hardly reflects a public assistance motive.[175] Additionally, the Hope Credit and the Child Credit are nonrefundable and cannot assist a taxpayer beyond reducing her tax liability, while the EIC provides benefits beyond liability for taxes.[176] The Court's analysis demonstrated the EIC is fundamentally different from both the Hope and Child credits, in its endeavor to assist those less able to meet their tax liability.[177]

In consideration of the above discussion, this article urges Treasury officials and JCT members to include in their tax expenditure budgets some mechanism to separate "ability to pay" provisions from others in their list of tax expenditures. These provisions would include the EIC, the deduction for qualified medical expenses,[178] tax preferences for the blind, elderly, and disabled,[179] the exclusion of social security benefits,[180] and the welfare to work credit.[181] While the mechanism

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basic costs of life").

[174] *See* In re Crampton, 249 B.R. 215, Bankr. Rep. (CCH) ¶ 78,208 (Bankr. D. Idaho Jun. 1, 2000). The Hope education credit delivers assistance to many families, including wealthy families, while the EIC limits assistance to poor taxpayers who work. *Id.* at 218.

[175] *Id.* at 706. The court noted that the EIC phased out completely for taxpayers earning over $30,850. *Id.*

[176] *Id.* The Court stated that taxpayers have some claim to the EIC beyond their liability, and thus it appears more in the nature of a public subsidy than the Hope and Child credits. *Id.*

[177] *Id.*

[178] *See* Surrey, *supra* note 1, at 21-22. As Professor Surrey correctly noted, the purpose of the medical expense deduction is to bring a family with qualifying expenses in line with a family without them, in accordance with their ability to pay.

[179] Surrey, *supra* note 1, at 127-28. Professor Surrey observes that provisions that mitigate personal hardships are technically not a preference, as they cannot encourage or discourage any sort of behavior. *Id.* In reality, provisions that assist taxpayers in these situations help them overcome misfortune. *Id.*

[180] *See* 149 CONG. REC. H3004-01, *H3008. "Explain it to my mother who is watching this, will you? Because she really wants to understand how this fair tax structure, when she is living on Social Security, why she has to pay a 6 percent sales tax, because I have no idea." *Id.* (statement of Rep. McDermott). Similarly, Professor Bittker reviewed the contention that social security payments increase a taxpayer's wealth and are not related to financial need, summarily dismissing the argument. *See* Bittker, *supra* note 42, at 935.

[181] *FY 98 Budget Education Issues: Hearin Before the House Ways and Means Comm., 104th Cong.* (1997)(statement of Donald C. Lubick, Acting Asst. Sec. (Tax Policy) Dept. of

could be as simple as making a notation next to individual items (as the Treasury does with regard to the normal tax method), a more effective method would be to create a new table for applicable provisions. Additionally, German tax expenditure practice uses a two-year window that attempts an analysis over a longer period of time. By adopting a "tax expenditure window" larger than the Treasury and JCT budgets utilize, Congress will have a better estimate of long term effects of tax expenditure provisions.[182]

III. Conclusion

Tax expenditure analysis is a concededly ambiguous enterprise, but its value is as a provider of information rather than an infallible predictor of revenue losses. Indeed, President George W. Bush seeks to end tax expenditure analysis, presumably to keep his own tax code wrangling quiet. Tax expenditure analysis would seem even more important, simply to keep legislators apprised of administration efforts

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the Treasury). Although the welfare-to-work credit provides a benefit to employers, it is essentially a benefit that provides assistance to needy families via the employer.

> "The goal of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 is to move individuals from welfare to work. However, it is anticipated that the process of moving some welfare recipients to work will be a difficult challenge for a variety of reasons, including a recipient's lack of prior work experience and skills relevant to the demands of a changing labor market. To encourage the hiring of these welfare recipients, the President proposes a new welfare-to-work credit that would enable employers to claim a 50-percent credit on the first $10,000 of annual wages paid to certain long-term family assistance recipients [] for up to two years."

Id. (statement of Donald C. Lubick, Acting Assistant Secretary, Dep't of the Treasury). Other provisions (such as investment credits for low-income housing) are similar to the welfare-to-work credit, but the benefit they deliver is not as tangible to the taxpayer as this credit. *Id.*

[182] Graetz, *supra* note 83, at 612-13:

> "Rather than looking to the long-term or even overall effects of tax legislation on federal revenues, Congress looks only to annual revenue effects over a five- or ten-year period. Indeed, Congress has bound itself legislatively to focus on this question through statutory budgetary requirements. In contrast, there are no specific constraints regarding the distribution of tax changes, and the basic distributional question being addressed is unquestionably a proper one. In changing a tax system whose history - indeed its constitutional status - is grounded in notions of ability to pay, it is obviously important for policymakers to attempt to know the distributional consequences of proposed changes. However, as with the revenue estimates, the basis for congressional evaluation and decision making regarding distributional issues is seriously flawed."

Id.

in this respect. To that end, creation of a new table in the tax expenditure budgets would present another aspect of budgetary policy with minimal effort. Still, the *impact* of the new table speaks volumes about the foundational principles of our tax code. Further, by identifying provisions that reflect our concern with taxpayers' ability to pay, legislators might be encouraged to consider and suggest enactments in support of the ability-to-pay convention.