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**“Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base?:  
A Critique of the “New Paradigm” and Its Denouement”**

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## SCHEDULE FOR SP2010 NYU TAX POLICY COLLOQUIUM

(All sessions meet on Thursdays from 4-5:50 pm in Vanderbilt 208, NYU Law School)

1. January 14 – Lily Batchelder, NYU Law School, “\$750 Billion Misspent? Getting More from Tax Incentives” (with Austin Nichols and Eric Toder).
2. January 21 – Kimberley Brooks, McGill University Faculty of Law, “Tax Sparing: A Needed Incentive for Foreign Investment in Low Income Countries, or an Unnecessary Revenue Sacrifice?”
3. January 28 – Michael Knoll, University of Pennsylvania Law School, and Ruth Mason, University of Connecticut Law School, “What Is Tax Discrimination?”
4. February 4 – Michael Devereux, Said Business School, Oxford University, “Taxation of Outbound Direct Investment: Economic Principles and Tax Policy Considerations.”
5. February 11 – David Walker, Boston University Law School/NYU School of Law, “Suitable for Framing: Business Deductions in a Net Income Tax System.”
6. February 18 – Jeffrey Brown, University of Illinois Business School, “Automatic Lifetime Income as a Path to Retirement Income Security.”
7. February 25 – Andrew Walker, Milbank, Tweed, Hadley, and McCloy, “The Submerged Logic of ‘Doing Business’ and Attribution: Diving Below the Surface of the Offshore Lending ‘GLAM’”
8. March 4 – Rebecca Kysar, Brooklyn Law School, “Lasting Legislation.”
9. March 11 – David Weisbach, University of Chicago Law School, “Trade and Carbon Taxes.”
10. **March 25 – Robert Peroni, University of Texas School of Law, “Can Tax Expenditure Analysis Be Divorced From a Normative Tax Base?: A Critique of the ‘New Paradigm.’”**
11. April 1 – Douglas Shackelford, Kenan-Flagler Business School, University of North Carolina, “Capital Gains Taxes and the Return-Risk Tradeoff.”
12. April 8 – Joel Slemrod, University of Michigan Economics Department and Business School, “Car Notches.”
13. April 15 – Michael Schler, Cravath, Swayne, and Moore. [Title to be supplied.]
14. April 22 – James R. Hines, University of Michigan Business School and Law School, and Edward McCaffery, USC Law School, “The Last Best Hope for Progressivity in Tax.”

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Can Tax Expenditure Analysis Be Divorced  
From a Normative Tax Base?:  
A Critique of the “New Paradigm” and Its Denouement \*

J. Clifton Fleming, Jr. \*\* and Robert J. Peroni \*\*\*

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I. INTRODUCTION

In spite of the controversy that surrounds it, tax expenditure analysis (TEA), at its core, is a simple, intuitively obvious idea. For example, assume that recently independent hypothetical country Newlandia uses a currency symbolized by “N” and that it also imposes a 20-percent flat rate tax on annual net income in excess of an N5,000 exemption. Assume further that Newlandia’s economy is principally based on production of agricultural commodities with

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unstable prices. Consequently, the Newlandian Parliament has decided to stimulate manufacturing by providing a subsidy equal to five percent of the first N20,000 of each taxpayer's net manufacturing income above the N5,000 exemption. Thus, a taxpayer with N6,000 of net manufacturing income for a particular year will receive an N50 subsidy,<sup>1</sup> the subsidy for a taxpayer with N25,000 of net manufacturing income will be N1,000,<sup>2</sup> and no taxpayer's subsidy will exceed N1,000 per year.

The Newlandian Parliament has also considered the large number of residents who were tragically disabled by landmines during the country's recent war for independence. It has decided to provide an annual welfare benefit of N1,000 to each such victim.

Newlandia could implement the first of these decisions through annual tax-exempt cash payments equal to five percent of each taxpayer's net manufacturing income between the N5,000 floor and the N25,000 cap.<sup>3</sup> The second decision could be carried out in a similar manner by sending each landmine victim an annual tax-exempt payment for N1,000.

Alternatively, Newlandia could effectuate the first decision by reducing the 20-percent income tax rate to 15 percent with respect to each taxpayer's annual net manufacturing income between N5,000 and N25,000. The result would be tax savings of five percent of each taxpayer's net manufacturing income between the floor and the cap.<sup>4</sup> Similarly, Newlandia could implement the second decision by giving each landmine victim an additional N5,000 tax exemption. This would annually provide N1,000 to each victim, assuming that there were appropriate tax refunds to victims with incomes less than the sum of the N5,000 basic exemption and the N5,000 additional exemption.<sup>5</sup>

If Newlandia's taxpayers are rational and there are no significant non-monetary differences in the Newlandian legal system between tax-exempt cash payments and tax savings, taxpayers would be indifferent as between the preceding alternatives because they would receive the same amounts from the government either way.

This simple example illustrates TEA's fundamental insight, which is that when a taxpayer-favorable feature<sup>6</sup> of income tax law<sup>7</sup> is used to provide a subsidy or incentive for a

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<sup>1</sup>  $(N6,000 - N5,000) \times .05 = N50$ .

<sup>2</sup>  $(N25,000 - N5,000) \times .05 = N1,000$ .

<sup>3</sup> Thus, a taxpayer with N6,000 of net manufacturing income in a particular year would receive an N50 payment  $([N6,000 - N5,000] \times .05 = N50)$ , a taxpayer with N25,000 of net manufacturing income would receive an N1,000 payment  $([N25,000 - N5,000] \times .05 = N1,000)$ , and no taxpayer's cash payment would exceed N1,000.

<sup>4</sup> Thus, a taxpayer with N6,000 of net manufacturing income in a particular year would realize a tax savings of N50  $([N6,000 - N5,000] \times [.20 - .15] = N50)$ , a taxpayer with N25,000 of net manufacturing income would realize N1,000 of tax savings  $([N25,000 - N5,000] \times [.20 - .15] = N1,000)$ , and no taxpayer's tax savings would exceed N1,000. Compare §199 of the Internal Revenue Code (Code), which, generally speaking, applies a reduced tax rate for income from property manufactured in the United States through a special deduction mechanism.

<sup>5</sup> Each victim's tax savings from the additional exemption would be  $N5,000 \times .20$  tax rate = N1,000. Compare § 63(a)(3) of the Code, which confers an additional standard deduction on individuals who are age 65 or older or who are blind.

<sup>6</sup> The Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, § 3(a)(3), 88 Stat. 297, 299 (codified as amended at 2 U.S.C. § 622(3)), gives the following generally accepted list of such features:

discrete income source or taxpayer group,<sup>8</sup> the effect is the same as a direct cash payment from the government to the beneficiaries. Accordingly, Internal Revenue Code<sup>9</sup> provisions of this sort should be subjected to the same degree of quantification and cost/benefit analysis as actual disbursements from the U.S. Treasury.

The relevant cost/benefit analysis should explore each tax expenditure's desirability as a government program, its efficacy, its behavioral effects, its complexity costs for both taxpayers and the IRS, and whether its benefits could be better achieved through a direct expenditure program.<sup>10</sup> In addition, because other taxpayers must bear higher taxes in order to make up for the revenue shortfall resulting from tax expenditures, the cost/benefit analysis should also examine tax burden distribution effects.<sup>11</sup> Finally, because tax expenditures are de facto government programs that expand the impact of government, the cost/benefit analysis should examine the effect of tax expenditures on the size and role of government.<sup>12</sup> The purpose of TEA is to trigger these important inquiries.<sup>13</sup>

TEA has been a significant of U.S. tax policy debates since it was introduced by Stanley Surrey in 1967<sup>14</sup> and each year both the U.S. Treasury Department and the Staff of the Joint

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“provisions . . . 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.”

<sup>7</sup> Tax expenditure analysis (TEA) also can be applied to consumption taxes and wealth transfer taxes. *See, e.g.,* STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 233-39 (1985) [hereinafter SURREY & MCDANIEL, TAX EXPENDITURES]. Its most important role in the United States, however, has been with respect to the federal income tax and that will be the focus of this article.

<sup>8</sup> Provisions are not tax expenditures unless their availability is limited to a particular income source or subset of taxpayers. Thus, the tax reduction from 20 percent to 15 percent in the above example would not be a tax expenditure if it applied to all, or most, of the Newlandian taxpayers. For a discussion of the difference between generally applicable tax cuts and tax expenditures, see J. Clifton Fleming, Jr. & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 VA. TAX REV. 437, 495-500 (2008).

<sup>9</sup> Internal Revenue Code of 1986, as amended, 28 U.S.C. §§ 1-9834 (2010). Although this article will focus on the application of TEA in the United States, the initial example at *supra* text accompanying notes 1-5 demonstrates that TEA is applicable to the income tax system of any country. *See* Harry A. Shannon III, *The Tax Expenditure Concept in the United States and Germany: A Comparison*, 33 TAX NOTES 201 (1986) (discussing the development of TEA in Germany); Wolfgang Schön, *Taxation and State Aid Law in the European Union*, 36 COMMON MARKET L. REV. 911 (1999) (discussing TEA in European Union law).

<sup>10</sup> *See* PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR & PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 83 (2005) [hereinafter PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS], available at <http://permanent.access.gpo.gov/lps64969/TaxReformwhole.doc.pdf>; THE CENTURY FOUNDATION WORKING GROUP ON TAX EXPENDITURES, BAD BREAKS ALL AROUND 51-52 (2002); CITIZENS FOR TAX JUSTICE, JUDGING TAX EXPENDITURES 25-26 (2009), available at <http://www.ctj.org/pdf/judgingtep1109.pdf>.

<sup>11</sup> *See* PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 10, at 83; THE CENTURY FOUNDATION WORKING GROUP ON TAX EXPENDITURES, *supra* note 10, at 52.

<sup>12</sup> *See* CITIZENS FOR TAX JUSTICE, *supra* note 10, at 6; Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187, 197, 204 (2004) [hereinafter Shaviro, *Rethinking*]. One major concern is that tax expenditures “can mask government funding levels and allocations and obscure accountability for outcomes being funded.” Mary L. Heen, *Congress, Public Values, and the Financing of Private Choice*, 65 OHIO ST. L.J. 853, 912 (2004).

<sup>13</sup> *See* Fleming & Peroni, *supra* note 8, at 446-49, 487-89.

<sup>14</sup> Surrey introduced TEA into the tax policy consciousness of the United States by means of a speech to a financial industry professional group in 1967. *See* Stanley S. Surrey, *The United States Income Tax System—The Need for Full Accounting*, in TAX POLICY AND TAX REFORM: SELECTED SPEECHES AND TESTIMONY OF STANLEY S. SURREY 575, 575-85 (William F. Hellmuth & Oliver Oldman eds., 1973) [hereinafter Surrey, *Full Accounting*]; *see also*

Committee on Taxation of the U.S. Congress produce separate tax expenditure budgets listing all federal income tax provisions that fall under the tax expenditure rubric.<sup>15</sup> This exercise reveals that tax expenditures account for an enormous part of the fiscal impact of the federal government. For example, a recent study estimated that for 2010, federal tax expenditures would total \$1.16 trillion.<sup>16</sup> Thus, it is no surprise that the literature commenting on and analyzing TEA is now vast and reflects a wide range of views regarding the efficacy of TEA.<sup>17</sup>

Although some commentators have regarded the validity of TEA as obvious,<sup>18</sup> the general tone of the literature in the United States has been disparaging.<sup>19</sup> One of the most prominent criticisms came in 2005 when the Office of Management and Budget stated that “the [Bush] Administration believes that the concept of ‘tax expenditure’ is of questionable analytic value.”<sup>20</sup>

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STANLEY S. SURREY, *PATHWAYS TO TAX REFORM* 33 (1973); SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 7, at 88.

<sup>15</sup> The Congressional Budget and Impoundment Control Act of 1974, Pub L. No. 93-344, § 601, 88 Stat. 297, 323, requires the President’s annual budget submission to contain a list of tax expenditures and the Treasury Department prepares the actual list. The Staff of the Joint Committee on Taxation has produced its own tax expenditure list each year since 1972. See STAFF OF JOINT COMM. ON TAX’N, 111TH CONG., *ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2009-2013*, at 1 & n.2 (JCS-1-10; Jan. 11, 2010) [hereinafter STAFF OF JOINT COMM. ON TAX’N, 2010 ESTIMATES].

<sup>16</sup> See SENATE BUDGET COMMITTEE, *TAX EXPENDITURES: COMPENDIUM AND BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS*, 110TH CONG., 2D SESS. 12-13 (S. Pt. 110-667; 2008); see also LEONARD BURMAN, ERIC TODER & CHRISTOPHER GEISSLER, *HOW BIG ARE TOTAL INDIVIDUAL INCOME TAX EXPENDITURES AND WHO BENEFITS FROM THEM?* 13 (The Urban Institute 2008), available at [http://www.taxpolicycenter.org/UploadedPDF/1001234\\_tax\\_expenditures.pdf](http://www.taxpolicycenter.org/UploadedPDF/1001234_tax_expenditures.pdf).

<sup>17</sup> For a recent review and evaluation of this literature, see Fleming & Peroni, *supra* note 8.

<sup>18</sup> See, e.g., BURMAN, TODER & GEISSLER, *supra* note 16, at 2 (“[M]ost public finance economists believe that measuring tax expenditures is an important part of good budget management because tax expenditures can be designed to have the same effect on beneficiaries as direct spending programs and therefore impose the same opportunity costs in terms of higher taxes, reduced federal spending, and higher deficits.”); Michael J. Graetz, *Tax Policy Challenges*, 121 TAX NOTES 1439, 1447 (Dec. 22, 2008) (“And, when tax expenditures as failed policy is the topic, the healthcare story is not an isolated example . . . . The essential problem is this: presidents from both political parties and Congress today use tax exclusions, deductions and credits the way my mother used chicken soup, as a cure-all for every economic and social ill the country faces.”); Thomas L. Hungerford, *Tax Expenditures and Long-Term Federal Budget Pressures*, 121 TAX NOTES 1409, 1415 (Dec. 22, 2008) (“Tax expenditures account for a large proportion of the resources the federal government uses to achieve various national goals.”); Marjorie Kornhauser, *A Legislator Named Sue*, in CRITICAL TAX THEORY: AN INTRODUCTION 75, 79 (Anthony C. Infanti & Bridget J. Crawford eds., 2009) (“The current Code is riddled with tax expenditures aimed at both corporate and individual taxpayers alike.”); Martin A. Sullivan, *Economic Analysis—Tax Expenditures for Republicans*, 94 TAX NOTES 1571, 1572 (Mar. 21, 2002) (“Everyone knows that a tax expenditure is just a government spending program masquerading as a tax cut.”).

<sup>19</sup> See Bruce Bartlett, *The End of Tax Expenditures As We Know Them?*, 92 TAX NOTES 413 (July 16, 2001); Boris I. Bittker, *Accounting for Federal “Tax Subsidies” in the National Budget*, 22 NAT’L TAX J. 244 (1969) [hereinafter Bittker, *Accounting*]; Charlotte Crane, *The Income Tax and the Burden of Perfection*, 100 NW. U. L. REV. 171, 184 (2006) (characterizing TEA as an academic obsession); Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343, 345-66 (1989) (arguing, in part, that Surrey’s tax expenditure model is not grounded in any principle of distributive justice); Douglas A. Kahn & Jeffrey S. Lehman, *Tax Expenditure Budgets: A Critical View*, 54 TAX NOTES 1661 (Mar. 30, 1992); Bernard Wolfman, *Tax Expenditures: From Idea to Ideology*, 99 HARV. L. REV. 491 (1985) (reviewing SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 7).

<sup>20</sup> Letter of James D. Foster, Associate Director of Economic Policy, Office of Management and Budget 2 (quoting the Bush Administration’s 2002 budget presentation) (Sept. 2, 2005) [hereinafter Foster Letter], in U.S. GOV’T

Some of the many attacks on TEA are part of an effort to replace the federal income tax with a consumption tax regime by gradually adding consumption tax features to the Internal Revenue Code.<sup>21</sup> TEA is seen as an obstacle to this goal because it characterizes most of the Code's consumption tax elements as tax expenditures.<sup>22</sup> Other criticisms seem motivated by a desire to preserve particular tax benefits that TEA exposes as subsidies<sup>23</sup> and some attacks are based on asserted structural or theoretical flaws in TEA.<sup>24</sup> The attacks have ranged from speculation regarding TEA proponents' personal motives<sup>25</sup> to the argument that tax policy is irrelevant to the formation of public policy and, therefore, TEA should be ignored because it is a tax policy instrument.<sup>26</sup> The strongest attacks, however, have focused on the TEA baseline. For example, one prominent tax scholar has recently asserted that "[w]here tax expenditure analysis went off the rails . . . was not in its aim of identifying 'special' provisions . . . but in its means of doing so, through the identification of a supposedly canonical, yet in practice under-theorized . . . definition of the 'normative income tax base.'"<sup>27</sup>

The baseline issue arises because TEA deals with tax provisions that confer preferential treatment on particular income sources or taxpayer groups, as illustrated by the hypothetical at the beginning of this article. To identify such provisions, there must first be a baseline tax system from which the preferential provisions can be said to deviate in a taxpayer-favorable way.<sup>28</sup> Stated differently, an income tax provision cannot be properly considered a tax expenditure if its existence is required to implement the baseline income tax system. For example, the Section 162 deduction for business expenses is not a tax expenditure, even though

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ACCOUNTABILITY OFFICE, GAO-05-690, TAX EXPENDITURES REPRESENT A SUBSTANTIAL FEDERAL COMMITMENT AND NEED TO BE REEXAMINED 83 (Sept. 2005) [hereinafter GAO, FEDERAL COMMITMENT].

<sup>21</sup> See *infra* text accompanying notes 137-138.

<sup>22</sup> See STAFF OF JOINT ECON. COMMITTEE, 106TH CONG., TAX EXPENDITURES: A REVIEW AND ANALYSIS 5-6 (Comm. Print 1999) [hereinafter STAFF OF JOINT ECON. COMM., REVIEW]; Bartlett, *supra* note 19, at 420; see also Martin A. Sullivan, *Administration Reignites Old Battle Over Tax Expenditures*, 91 TAX NOTES 701 (Apr. 30, 2001) ("Republicans generally favor consumption taxes over income taxes . . . . If taxes on capital, on estates, and on foreign income were removed from the normal tax system used as a baseline for scoring tax expenditures, the tax expenditures budget would be transformed . . . to a positive force for the types of change Republicans seek."); Heen, *supra* note 12, at 896.

<sup>23</sup> At the Tax Foundation's November 16, 2000, national conference, then Treasury Secretary Lawrence H. Summers praised the Clinton's administration's education tax credits and the expanded earned income tax credit and criticized TEA because of its resistance to those and other tax expenditures that promote "very important values." Christopher Bergin, *Summers Says It's Important to Promote "Values" Through the Code*, 89 TAX NOTES 994, 994 (Nov. 20, 2000); see also Peter J. Wiedenbeck, *Paternalism and Income Tax Reform*, 33 U. KAN. L. REV. 675, 688-99 (1985).

<sup>24</sup> See generally Bartlett, *supra* note 19; Bittker, *Accounting*, *supra* note 19.

<sup>25</sup> See Bartlett, *supra* note 19, at 414 ("Surrey clearly intended the term 'tax expenditure' to be pejorative, undermining political support for tax preferences."); Daniel N. Shaviro, *Rethinking*, *supra* note 12, at 201-02, 204-05 ("[TEA] seems to be viewed in many circles as logically dubious special pleading in support of a particular policy agenda.").

<sup>26</sup> See David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 972-82 (2004). For our response to this argument, see *infra* text accompanying notes 146-155.

<sup>27</sup> Shaviro, *Rethinking*, *supra* note 12, at 199. We believe, however, that the literature summarized in Part III.A. of this article shows that the traditional TEA baseline is not under-theorized.

<sup>28</sup> See, e.g., Bittker, *Accounting*, *supra* note 19, at 247 ("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'").

it benefits taxpayers by reducing their taxable income, because the deduction is a normative element in the definition of the base of a net income tax.<sup>29</sup>

Surrey insisted that the baseline income tax system for purposes of identifying tax expenditures was a regime grounded in the Schanz-Haig-Simons (SHS) definition of income,<sup>30</sup> modified to incorporate widely accepted business accounting standards and the generally accepted structure of an income tax.<sup>31</sup> In prior work, we have explained that we agree with

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<sup>29</sup> Nor is the deduction in § 212(1) or (2) for the expenses of earning income from an income-producing activity that is not a trade or business a tax expenditure for much the same reason. Expenses of earning income are neither consumption nor additions to saving, and, therefore, should be deducted when computing the tax base of a net income tax. See William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 313 (1972) [hereinafter Andrews, *Personal Deductions*]; Boris I. Bittker, *Income Tax Deductions, Credits, and Subsidies for Personal Expenditures*, 16 J.L. & ECON. 193, 202-03 (1973) [hereinafter Bittker, *Personal Expenditures*]. It is true that the progressive rate structure gives the deduction for these costs an upside-down effect because the resulting tax savings of high-bracket taxpayers are a greater percentage of deducted costs than is the case for deductions by low-bracket taxpayers. The denial of deductions for income producing costs, however, would amount to imposing a tax penalty, see SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 7, at 80, thereby causing an economic distortion. See Bittker, *Personal Expenditures*, *supra*, at 199. On the other hand, replacing the deductions for income producing costs with credits would be problematic because setting the credit rate at the highest marginal tax rate would give lower-bracket taxpayers a windfall (indeed, they would be tax expenditure beneficiaries) and setting the credit rate at any level below the highest marginal rate would effectively penalize top-bracket taxpayers. See *generally id.* at 209. Moreover, the upside-down effect of allowing deductions for income producing costs “merely confirms [the fact] that the rate structure is progressive.” *Id.* at 208. On balance, the allowance of deductions for income producing costs is the best approach.

Nevertheless, in a few situations, even normative deductions can present sufficient complexity and administrability problems to warrant their being limited or disallowed in spite of the income mismeasurement that results from doing so. See, e.g., IRC §§ 62(a)(1), (a)(2), 63(b), 67 (which effectively disallow the deduction of most unreimbursed employee business expenses and income-producing expenses of an investment activity that does not involve rent or royalty income); § 274(n) (which generally disallows the deduction of 50 percent of business meals and entertainment expenses). Some commentators (including one of the authors of this article), however, have argued that § 67 is not an appropriate element of a properly designed income tax system. See, e.g., Jeffrey H. Kahn, *Beyond the Little Dutch Boy: An Argument for Structural Change in Tax Deduction Classification*, 80 WASH. L. REV. 1 (2005); Robert J. Peroni, *Reform in the Use of Phase-Outs and Floors in the Individual Income Tax System*, 91 TAX NOTES 1415 (May 28, 2001). Section 67 can be viewed as a negative tax expenditure or tax penalty provision. For a policy critique of tax penalty provisions, see Eric M. Zolt, *Deterrence Via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343 (1989).

<sup>30</sup> The most prominent statement of this SHS definition is:

Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to “wealth” at the end of the period and then subtracting “wealth” at the beginning. . .

HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938).

<sup>31</sup> See SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 7, at 3-4. The Treasury Department states that the principal modifications that it makes to the SHS definition for this purpose are:

1. There is a separate, unintegrated corporate income tax;
2. Generally, there are no inflation adjustments to values of assets and debts;
3. Individual income tax rates below the highest rate are not considered deviations from the baseline; and
4. Income is taxable only when realized.

Surrey on this point so long as it is understood that the SHS definition is simply a convenient device for implementing the deeper tax policy norm of ability-to-pay.<sup>32</sup>

Critics have continuously and strongly attacked TEA by characterizing the SHS baseline as unprincipled,<sup>33</sup> imprecise,<sup>34</sup> and insufficiently related to our hybrid income/consumption tax system as it actually exists.<sup>35</sup> Since the baseline is hopelessly defective, so the critics argue, TEA is fatally dysfunctional and the results of its application to the various subsidy and incentive provisions in the Internal Revenue Code can be disregarded.<sup>36</sup>

This line of attack can be countered by refuting the criticisms of the SHS baseline. We have undertaken to do so in an earlier piece<sup>37</sup> and our arguments will be summarized in Part IV of this article. Nevertheless, even some TEA supporters have suggested that TEA's effectiveness has been compromised by the intensity of the "baseline battle."<sup>38</sup>

In this vein, a 2008 report of major importance by the Staff of the Joint Committee on Taxation of the U.S. Congress argued that even if the attacks on the TEA baseline were unwarranted, they had so seriously compromised TEA's effectiveness that adoption of an alternative baseline was called for.<sup>39</sup> The report's pertinent language states:

. . . Driven off track by seemingly endless debates about what should and should not be included in the . . . [SHS baseline],<sup>40</sup> tax expenditure analysis today does not

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*See* OFFICE OF MGMT. & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2010, ANALYTICAL PERSPECTIVES 298, 307 (2009). The Staff of the Joint Committee on Taxation is in general agreement with the Treasury Department regarding these modifications. *See* STAFF OF JOINT COMM. ON TAX'N, 2010 ESTIMATES, *supra* note 15, at 5-10. Interestingly, Henry Simons, the principal American architect of the SHS definition, did not seem to regard the lower rates in the progressive rate tables for individuals as deviations from the baseline, *see* SIMONS, *supra* note 30, at 18-25, 218-20, and he was quite clear in stating that the realization principal was not a deviation, *see id.*, at 100, 207-08. Thus, Simons would regard Treasury's fourth modification above as unnecessary and would likely take the same view with respect to the third modification.

<sup>32</sup> *See* Fleming & Peroni, *supra* note 8, at 450-61

<sup>33</sup> *See, e.g.*, Kahn & Lehman, *supra* note 19, at 1663 (asserting that tax expenditure budgets "create only an illusion of value-free scientific precision in a heavily politicized domain").

<sup>34</sup> *See generally* Bartlett, *supra* note 19; Kahn & Lehman, *supra* note 19.

<sup>35</sup> *See, e.g.*, Daniel S. Goldberg, *The U.S. Consumption Tax: Evolution, Not Revolution*, 57 TAX LAW. 1, 28 (2003); Shaviro, *Rethinking*, *supra* note 12, at 215-16; Linda Sugin, *Tax Expenditure Analysis and Constitutional Decisions*, 50 HASTINGS L.J. 407, 427, 429 (1999).

<sup>36</sup> *See, e.g.*, STAFF OF JOINT ECON. COMM., REVIEW, *supra* note 22, at 8; *see also* Edward D. Kleinbard, Letter to the Editor, *The Need for a JCT: Kleinbard Responds to Yin*, 126 TAX NOTES 991 (2010) (characterizing the SHS baseline as "largely discredited").

<sup>37</sup> *See* Fleming & Peroni, *supra* note 8.

<sup>38</sup> *See* Michael J. McIntyre, *A Solution to the Problem of Defining a Tax Expenditure*, 14 U.C. DAVIS L. REV. 79, 81, 102-03 (1980); Shaviro, *Rethinking*, *supra* note 12, at 217-18.

<sup>39</sup> *See* STAFF OF JOINT COMM. ON TAX'N, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 7-8, 36-37 (2008) [hereinafter STAFF OF JOINT COMM. ON TAX'N, RECONSIDERATION].

<sup>40</sup> The report actually uses the term "normal tax base" at this point. However, the report also clearly states that the normal tax base is the Haig-Simons definition of income. *See id.* at 19, 29. We refer to this construct as the "Schanz-Haig Simons" definition in order to reflect the contribution of the German scholar Georg Schanz. *See*

advance either of the two goals that inspired its original proponents: clarifying the aggregate size and application of government expenditures, and improving the Internal Revenue Code. . . .

. . .

*Whether these criticisms are correct is less important . . . than is the observation that they are prevalent.* Tax expenditure analysis is useful to policymakers only if its conclusions are widely agreed to be neutral, in both a political and an economic sense. The breadth and depth of the criticism of the present . . . [SHS]<sup>41</sup> tax base suggests that such agreement, if it ever existed, cannot be obtained in the current environment. In light of these realities, the JCT Staff believes that it is appropriate to revisit our tax expenditure methodology, in order to refashion it in a manner that will generally be viewed as more neutral and more principled than the current implementation.<sup>42</sup>

In response, the report stated that going forward, the Joint Committee Staff would neutralize the baseline critics by abandoning the SHS baseline and promoting a version of TEA that, to a large extent, had no normative baseline and that disregarded the SHS definition even in the limited area where a baseline was used.<sup>43</sup> Then, early in 2010, the Staff totally reversed itself by abandoning its non-normative approach and re-embracing the SHS baseline.<sup>44</sup> Because the Joint Committee Staff is arguably the most important non-partisan governmental voice in U.S. tax reform debates,<sup>45</sup> its rejection of the SHS baseline in favor of a supposedly neutral approach,<sup>46</sup> followed by its 2010 return to SHS orthodoxy, is not merely a short-lived curiosity. Instead, this event is a manifestation of the practical and theoretical difficulties involved in the critically important, longstanding TEA baseline controversy and it merits close analysis to see what light it sheds on the correct resolution of that controversy.

Although the Joint Committee Staff described its 2008-2010 baseline as a “new paradigm,”<sup>47</sup> its work was actually presaged by earlier efforts of tax scholars to develop a version of TEA that did not rely on the SHS baseline. In Part II of this article, we examine the precursors to the 2008 work of the Joint Committee Staff and explain their shortcomings. In Part III, we describe and evaluate the Staff’s 2008-2010 “new paradigm.” More importantly, we explain why that well-intentioned work was actually harmful to the defense of TEA and why the

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SIMONS, *supra* note 30, at 60-61. Therefore, we have substituted “SHS baseline” for “normal tax base” when quoting from the report.

<sup>41</sup> See *supra* note 40.

<sup>42</sup> See STAFF OF JOINT COMM. ON TAX’N, RECONSIDERATION, *supra* note 39, at 1, 37 (emphasis added) (footnote omitted).

<sup>43</sup> See *id.* at 39-47.

<sup>44</sup> See STAFF OF JOINT COMM. ON TAX’N, 2010 ESTIMATES, *supra* note 15, at 4-5.

<sup>45</sup> The Staff of the Joint Committee on Taxation is a non-partisan group of lawyers, economists and accountants. See <http://www.jct.gov/about-us/overview.html>; see also George K. Yin, *Should Congress Abolish the Joint Committee on Taxation?*, 126 TAX NOTES 861 (2010).

<sup>46</sup> The Joint Committee Staff characterized its 2008-2010 approach as “more principled and neutral” than the SHS baseline. See STAFF OF JOINT COMM. ON TAX’N, RECONSIDERATION, *supra* note 39, at 39.

<sup>47</sup> See *id.* at 1; STAFF OF JOINT COMM. ON TAX’N, 110TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2008-2012, at 1 (JCS-2-08; Oct. 31, 2008) [hereinafter STAFF OF JOINT COMM. ON TAX’N, 2008 ESTIMATES].

Staff’s 2010 re-embrace of the SHS baseline is a welcome development. Part IV explains that because the attacks on the traditional SHS baseline of TEA are misguided, it was never necessary to abandon that baseline in order to defend the TEA construct. Part V summarizes our analysis and conclusions.

## II. The Road to the “New Paradigm”

### A. Professor McIntyre’s Rhetorical Baseline

In the view of Professor Michael McIntyre, Surrey’s version of TEA contains a seriously problematic internal conflict. It is that TEA requires a baseline for distinguishing subsidies or incentives from legitimate components of a theoretically correct income tax system but that Surrey’s use of the SHS definition for this purpose has “subjected [TEA] to attack”<sup>48</sup> and provoked a “heated debate that . . . pulls into its vortex all who venture near.”<sup>49</sup> The implication is that this controversy has reduced TEA’s effectiveness. Professor McIntyre’s solution is to adopt what might be called a rhetorical baseline because he says that instead of using a normative standard to identify tax expenditures, we should listen to the language employed by the defenders/promoters of various tax provisions and apply TEA only to the extent that the tax provisions in question are advocated on the basis of spending-like benefits. Specifically, he says that “[t]ax specialists should apply the tax expenditure analysis to any tax provision defended on nontax grounds”<sup>50</sup> and that “the bare assertion that the tax rule under examination promotes a spending goal [should trigger] tax expenditure analysis.”<sup>51</sup> In his view, this linguistic methodology “would allow Congress to accomplish its legislative reform objectives without having to distinguish tax expenditures from normal tax rules”<sup>52</sup> and, therefore, the McIntyre approach “eliminates the feature that has subjected [TEA] to attack.”<sup>53</sup> The clear implication is that tax provisions that are not promoted as having subsidy or incentive effects cannot be classified as tax expenditures.<sup>54</sup>

We doubt that Professor McIntyre’s rhetorical method is a suitable solution to the attacks on TEA. The rhetorical baseline would likely cause advocates of tax subsidies and incentives to merely avoid expenditure-type language and, instead, defend their tax benefits on the grounds that they mitigate disincentives. For example, the various retirement savings incentives in the Internal Revenue Code are often defended as measures to overcome the Code’s bias against saving,<sup>55</sup> the preference for long-term capital gains is defended as necessary to counter a “lock-in” effect resulting from the realization doctrine,<sup>56</sup> and the temporary repatriation tax holiday provided by the now-expired Section 965 was promoted as necessary to mitigate a “lock-out” effect arising from the general rule of deferring tax on the income of U.S.-controlled foreign

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<sup>48</sup> McIntyre, *supra* note 38, at 103.

<sup>49</sup> *Id.*

<sup>50</sup> *Id.* at 101.

<sup>51</sup> *Id.* at 100.

<sup>52</sup> *Id.* at 87.

<sup>53</sup> *Id.* at 102.

<sup>54</sup> *See id.* at 100.

<sup>55</sup> *See* PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 10, at 89-93.

<sup>56</sup> *See* JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES 135, 282 (4th ed. 2008).

subsidiaries until the income is repatriated to the United States.<sup>57</sup> Additionally, advocates of certain incentives and subsidies would surely assert that their tax benefits should be adopted or preserved because they are actually part of a normative income tax and not because they produce spending-type benefits. For example, the general rule of deferral of U.S. tax on foreign-source business income earned by U.S.-controlled foreign corporations is often defended as being part of the normative income tax system because it is said to be an inevitable consequence of the separate juridical status of corporations and their shareholders.<sup>58</sup>

In other words, because Professor McIntyre's approach makes a tax provision's status as a tax expenditure wholly dependent on the rhetoric used by the provision's defenders, the promoters of tax subsidies and incentives would quickly make the necessary rhetorical shifts, thereby removing many, perhaps most, tax expenditures from the ambit of TEA and TEA would be effectively eviscerated even if it were also protected from critics of Surrey's SHS baseline. On the other hand, if Professor McIntyre intends for policy makers to look behind rhetorical shifts and make an independent determination as to whether particular tax provisions are subsidies or incentives, then a baseline tax system will be needed to sort subsidies and incentives from normative tax provisions and we will have returned to the very controversy that Professor McIntyre sought to avoid. Alternatively, if Professor McIntyre intends for policy makers to defeat rhetorical shifts by looking at the language that was used to promote particular subsidies and incentives before the adoption of his rhetorical approach to TEA, he may be successful in maintaining the tax expenditure label for some old subsidies and incentives but well-advised promoters of new provisions will likely avoid tax expenditure classification by using informed rhetoric in their advocacy. Moreover, the beneficiaries and defenders of old provisions will likely bring forth new iterations of those provisions which purport to replace them with a "different" scheme that relies on supporting rhetoric untainted by subsidy and incentive language. All of these considerations suggest that if Professor McIntyre's rhetorical baseline were adopted, the effectiveness of TEA would be rapidly undermined.

In spite of our doubts regarding Professor McIntyre's rhetorical baseline, we believe that it has a useful role as a supplement to traditional TEA. This role was suggested in the following observation by Surrey and his frequent co-author, Professor Paul McDaniel: "Most tax expenditures are *readily recognizable* since they are usually treated by their supporters as tax incentives or as hardship relief, and they are not urged as necessary to correct defects in the income tax structure itself."<sup>59</sup>

In other words, Professor McIntyre's rhetorical approach can serve as a useful analytical shortcut. Where an income tax provision is, in fact, promoted or defended on the basis of its subsidy or incentive effects, the provision could be automatically classified as a tax expenditure,

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<sup>57</sup> See Martin A. Sullivan, *High Tech Firms Bring Home \$58 Billion*, 112 TAX NOTES 556 (Aug. 14, 2006). Section 965 is inapplicable to dividends received in any taxable year starting on or after October 22, 2004. For a policy critique of § 965, see J. Clifton Fleming, Jr. & Robert J. Peroni, *Eviscerating the Foreign Tax Credit Limitations and Cutting the Repatriation Tax—What's ETI Repeal Got To Do With It?*, 104 TAX NOTES 1393 (Sept. 20, 2004).

<sup>58</sup> See, e.g., 1 NATIONAL FOREIGN TRADE COUNCIL, THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY 3 n.3 (2001) [hereinafter NFTC, FOREIGN INCOME PROJECT].

<sup>59</sup> Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C.L. REV. 225, 228 (1979) (emphasis added).

thus triggering cost/benefit analysis,<sup>60</sup> without the necessity of doing a deeper examination using the SHS baseline. Stated differently, Professor McIntyre's rhetorical baseline is useful as a sufficient, but not indispensable, indicium of tax expenditure status. Defenders of a provision that acquires a tax expenditure classification under the rhetorical approach could then attempt to escape that result by doing a full analysis under the SHS baseline but the onus would be on those defenders.

## B. The Fiekowsky-Treasury-Joint Committee Staff Approach

In 1980, Seymour Fiekowsky, the then Assistant Director of the U.S. Treasury Department's Office of Tax Analysis, argued that Surrey's version of TEA created problems for budget analysts in properly structuring the accounts of the federal fiscal budget.<sup>61</sup> He proposed to solve this budget organization problem by redefining the tax expenditure concept. His approach was to discard the SHS baseline and, instead, limit tax expenditures to those provisions of tax law that satisfied both of the following criteria:

(1) Absent the particular provision, does the existing tax law provide a general rule by which the results of the transaction would determine the transactor's tax liability? Put another way, is the specific tax provision inconsistent with the basic structure of the tax law, be it a user charge or a general revenue source like an excise or income tax?

(2) If the answer to question (1) is affirmative, is it possible to formulate an expenditure program administrable by a cognizant government agency that would achieve the same objective at equal, higher or lower budgetary cost?<sup>62</sup>

Fiekowsky was primarily concerned with the analysis and preparation of the federal budget presentation and his proposal was focused on those matters rather than on tax policy. However, others saw a tax policy application for Fiekowsky's work and, in 1983, the Treasury Department began using Fiekowsky's two-part test as the baseline for an alternative tax expenditure list that appears in the administration's annual budget presentation as a companion to the SHS baseline list.<sup>63</sup> The name given to the approach derived from Fiekowsky's test is the

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<sup>60</sup> The principal purpose of TEA is to trigger a rigorous cost/benefit analysis of tax provisions that are classified as tax expenditures. See Fleming & Peroni, *supra* note 8, at 487-89; see also Meg Shreve, *Conversations: Thomas Barthold*, 123 TAX NOTES 1532, 1533 (2009) (quoting Thomas Barthold, Chief of Staff of the Joint Committee on Taxation: "When our staff prepares background materials for committee hearings, it's often a discussion of how much does this cost, what are the distributional consequences, are there alternatives, what are the economic effects? That's really what a tax expenditure analysis is about.").

<sup>61</sup> See Seymour Fiekowsky, *The Relation of Tax Expenditures to the 'Fiscal Burden'*, 2 CAN. TAX'N 211, 215-19 (1980).

<sup>62</sup> *Id.* at 215.

<sup>63</sup> See *Full Text of Special Analysis G on Tax Expenditures*, TAX NOTES TODAY, 85 TNT 26-4 (Feb. 5, 1985); STAFF OF JOINT COMM. ON TAX'N, RECONSIDERATION, *supra* note 39, at 42. The Treasury Department prepares the tax expenditure lists that are included in the Administration's annual budget presentation. See STAFF OF JOINT COMM. ON TAX'N, 2010 ESTIMATES, *supra* note 15, at 1.

“reference law baseline” and Treasury has continued to use it for purposes of preparing its alternative tax expenditure list.<sup>64</sup>

Before 2008, however, the Joint Committee Staff steadily adhered to the SHS definition as the sole baseline when preparing its annual tax expenditure lists. Then in 2008, the Staff announced a “new paradigm for classifying tax provisions as tax expenditures,”<sup>65</sup> which it abandoned in 2010 in favor of a return to the SHS baseline. This new approach, even though short-lived, has considerable significance for tax policy and theory because it expressly renounced the SHS baseline on the ground that the attacks against it had mired TEA in controversy and undermined its effectiveness.<sup>66</sup> Instead, the Staff stated that it would henceforth identify tax expenditures by employing two separate categories. The first was “tax subsidies” and the second was “tax-induced structural distortions.”<sup>67</sup>

To give content to its first category—tax subsidies—the Staff defined a “tax subsidy” as “a specific tax provision that is deliberately inconsistent with an identifiable general rule of the present tax law . . . and that collects less revenue than does the general rule.”<sup>68</sup> This is, of course, largely indistinguishable from part one of the two-part test that was first developed by Fiekowsky and then adopted by Treasury as the reference law baseline.<sup>69</sup> The Joint Committee Staff gave content to its second category—tax-induced structural distortions—by relying on an economic efficiency analysis.<sup>70</sup>

In Part III, we examine the Joint Committee Staff’s 2008-2010 “new paradigm” and its two categories in detail.

### III. Critique of the Joint Committee Staff’s New Paradigm

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<sup>64</sup> Another commentator, Victor Thuronyi, also saw tax policy implications in Fiekowsky’s work. In Thuronyi’s view, TEA’s chief purposes are “[1] to facilitate the replacement of tax expenditures with non-tax-based programs and [2] to guide budgetary choices between tax-based and non-tax-based assistance.” Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 DUKE L.J. 1155, 1186 (1988). To carry out the first function, Thuronyi proposed that TEA be applied in two steps: “(1) indentifying a provision’s significant purposes, and (2) determining whether a nontax program can serve those purposes at least as well.” *Id.* at 1187. This is effectively the adoption of the second part of Fiekowsky’s two-part test. *See supra* text accompanying notes 61-62. However, Thuronyi argued that TEA should also be used to identify “tax provisions that, even if not reasonably replaceable with direct spending programs, provide support similar to that provided through non-tax-based subsidies.” Thuronyi, *supra*, at 1196. Moreover, he specified that for this latter purpose, the traditional definition of tax expenditures should be used. *See id.* Thus, Thuronyi’s proposal turned out to be an acceptance of the SHS baseline with a refinement to identify a subset of tax expenditures that are replaceable with direct spending programs. Arguably, Surrey’s version of TEA accomplished this refinement by applying cost/benefit analysis to provisions that are identified as tax expenditures.

<sup>65</sup> STAFF OF JOINT COMM. ON TAX’N, RECONSIDERATION, *supra* note 39, at 1.

<sup>66</sup> *See id.* at 39.

<sup>67</sup> *See id.* at 39-42.

<sup>68</sup> *Id.* at 39.

<sup>69</sup> *See supra* text accompanying notes 61-64. The Joint Committee Staff explicitly pointed out the congruence of its definition and Fiekowsky’s work. *See* STAFF OF JOINT COMM. ON TAX’N, RECONSIDERATION, *supra* note 39, at 39-40.

<sup>70</sup> *See* STAFF OF JOINT COMM. ON TAX’N, RECONSIDERATION, *supra* note 39, at 41.

As previously noted, the Joint Committee Staff's 2008 TEA report and its 2010 return to the SHS baseline are of major significance because the Staff is arguably the most important body of non-partisan experts involved in the federal tax policy process. Moreover, the 2008 report provides one of the strongest endorsements of TEA by a government agency in many years.<sup>71</sup>

While we applaud the Joint Committee Staff's efforts in producing this report and trying to develop a new approach to TEA, we will argue in this Part III that the 2008 report ultimately failed in its primary goal of avoiding controversy and that the version of TEA advanced in the report had characteristics that gave cause for serious concern. Specifically, we will explain that the Joint Committee Staff's "new" approach would not have avoided controversy over the baseline to be used in TEA analysis. Moreover, we will present the case that the Joint Committee Staff's new approach had important defects that could be overcome only by forthrightly grounding TEA in a normative baseline that is linked to the ability-to-pay and neutrality principles and that requires tax expenditures to be scrutinized under a form of cost/benefit analysis that includes considerations of administrability, complexity, and fairness.

#### A. Choice of a Baseline: The Joint Committee Staff's Approach Versus SHS and Ability-to-Pay<sup>72</sup>

As noted in Part I of this article, TEA has been a lightning rod for intense criticism. In response, the Joint Committee Staff attempted to circumvent the critics by presenting an approach to TEA that would hopefully make some of the important condemnations irrelevant. In particular, the 2008 report attempted to respond to what the Joint Committee Staff labeled "the most important consensus objections."<sup>73</sup> According to the Staff, these objections are: first, that "it is not possible to identify in a neutral manner the terms of the 'normal' tax [i.e., SHS] to which present law should be compared,"<sup>74</sup> and, second, that many critics of TEA "believe that the 'normal' tax has been fashioned, not simply to serve as the baseline from which to identify tax expenditures, but also to advocate the adoption of that 'normal' tax into law, by presenting it as an aspirational but achievable tax system that is superior to the current Internal Revenue Code."<sup>75</sup> In our judgment, the Staff's approach in the 2008 report does not succeed in sidestepping these criticisms and, in addition, introduces problems of its own. More importantly, when the criticisms noted by the Staff are addressed head on, they do not withstand scrutiny and, therefore, do not require a replacement for the SHS baseline.

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<sup>71</sup> See *id.* at 6-7. For a prior governmental report that supports greater use of TEA, see GAO, FEDERAL COMMITMENT, *supra* note 20. For prior documents by governmental officials or governmental bodies that criticize TEA, see Foster Letter, *supra* note 20, at 83 (criticizing GAO report that calls for reexamination of TEA so that it may be more effectively used); STAFF OF JOINT ECON. COMM., REVIEW, *supra* note 22 (strongly criticizing TEA as inconsistent with the view that income belongs to taxpayers and that tax liability is determined through the democratic process).

<sup>72</sup> A significant portion of this Part III.A. of the article (*infra* text accompanying notes 82-111) is drawn in large part from our earlier article, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, which first appeared in 27 VA. TAX REV. 437, 450-61 (2008).

<sup>73</sup> STAFF OF JOINT COMM. ON TAX'N, RECONSIDERATION, *supra* note 39, at 9.

<sup>74</sup> *Id.* at 9.

<sup>75</sup> *Id.*

As noted in Part II, the Joint Committee Staff’s 2008-2010 approach attempted to uncouple TEA from SHS by dividing tax expenditures into “tax subsidies” and “tax-induced structural distortions.” Nevertheless, the first of the Staff’s categories, tax subsidies, did require a baseline, just not the SHS baseline. The substitute baseline for identifying items in the tax subsidies category was described by the Staff as those tax provisions that are “deliberately inconsistent with an identifiable general rule of the present tax law . . . and that [collect] less revenue than does the general rule.”<sup>76</sup> This baseline is comparable to the “current law reference tax baseline” that is used as an alternative approach in the tax expenditure budgets produced by the Treasury.<sup>77</sup> In our judgment, however, this baseline is problematic because it has the unfortunate effect of creating traction for the preservation of dubious Code provisions by giving them normative status where they have managed to become “an identifiably general rule of the present tax law.”<sup>78</sup> Additionally, this baseline creates the possibility of a one-way ratchet in which the success of interest groups in getting large tax expenditures into the Code can result in those tax expenditures gaining normative status.<sup>79</sup>

By contrast to the Joint Committee Staff’s baseline for identifying tax subsidies, Surrey peremptorily declared that the proper baseline is the Schanz-Haig-Simons definition of income,<sup>80</sup> modified to incorporate widely accepted business accounting standards and the generally accepted structure of an income tax.<sup>81</sup> We basically agree with Surrey that this is the appropriate baseline to use in TEA and we believe that this baseline is superior to the baseline adopted by the Joint Committee Staff in its 2008 report. In our view, however, an understanding of this normative SHS baseline for TEA requires a brief explanation of a more fundamental concept—the principle of ability-to-pay.

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<sup>76</sup> See *id.* at 39.

<sup>77</sup> See OFFICE OF MGMT. & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2009, ANALYTICAL PERSPECTIVES 288, 296-97, 315-17 (2008) [hereinafter OFFICE OF MGMT. & BUDGET, 2009 ANALYTICAL PERSPECTIVES].

<sup>78</sup> See STAFF OF JOINT COMM. ON TAX’N, RECONSIDERATION, *supra* note 39, at 9. Examples are expensing for small businesses, accelerated depreciation, corporate tax rates below the top rate in the § 11 rate table, deferral of foreign-source income earned by U.S. residents through foreign corporations, and exclusion of public assistance benefits. See OFFICE OF MGMT. & BUDGET, 2009 ANALYTICAL PERSPECTIVES, *supra* note 77, at 288-91.

<sup>79</sup> A possible example is the § 199 deduction with respect to domestic production activities. In that regard, see the following by the Office of Management and Budget:

To the extent [the deduction for domestic production activities] is viewed as a tax break for certain qualifying businesses (“manufacturers”), it would be a tax expenditure. In contrast, the deduction may prove to be so broad that it is available to most U.S. businesses, in which case it might not be seen as a tax expenditure. Rather, it would then represent a feature of the baseline tax rate system because the deduction is equivalent to a lower tax rate. In addition, it might not be a tax expenditure to the extent it is viewed as providing relief from the double tax on corporate profits.

OFFICE OF MGMT. & BUDGET, 2009 ANALYTICAL PERSPECTIVES, *supra* note 77, at 317. For our criticism of this analysis, see Fleming & Peroni, *supra* note 8, at 499-500; *infra* text accompanying note 122.

<sup>80</sup> See SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 7, at 3-4.

<sup>81</sup> See *id.* at 4; Thuronyi, *supra* note 64.

The parameters of a normatively correct income tax base are usually determined by applying an array of widely accepted tax policy criteria.<sup>82</sup> One of the most important of these criteria is the proposition that the income tax burden should be allocated among resident taxpayers in relation to their taxpaying capacities, often referred to as the principle of ability-to-pay.<sup>83</sup> Indeed, it is appropriate to regard this longstanding concept with its lengthy intellectual history<sup>84</sup> as the major fairness norm in the U.S. federal income tax system.<sup>85</sup>

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<sup>82</sup> See JOSEPH M. DODGE, J. CLIFTON FLEMING, JR. & DEBORAH A. GEIER, *FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY* 117-50 (3d ed. 2004).

<sup>83</sup> See *Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp*, League of Nations Doc. E.F.S. 73.F.19., at 18 (1923), reprinted in 4 STAFF OF JOINT COMM. ON TAXATION, *LEGISLATIVE HISTORY OF UNITED STATES TAX CONVENTIONS* 4003, 4022 (1962); U.S. TREAS. DEP'T, *BLUEPRINTS FOR BASIC TAX REFORM* 1, 24 (Jan. 17, 1977) [hereinafter U.S. TREAS. DEP'T, *BLUEPRINTS*]; MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION* 28, 38-39 (6th ed. 2009); WILLIAM A. KLEIN, JOSEPH BANKMAN DANIEL N. SHAVIRO & KIRK J. STARK, *FEDERAL INCOME TAXATION* 11-12 (15th ed. 2009); RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 232-40 (4th ed. 1984); RICHARD SCHMALBECK & LAWRENCE ZELENAK, *FEDERAL INCOME TAXATION* 21-22 (2d ed. 2007); STEPHEN G. UTZ, *TAX POLICY* 31-32, 41 (1993); Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 29 (1993); Martin J. McMahon, Jr. & Alice G. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, 4 FLA. TAX REV. 1, 72-80 (1998); Robert L. Palmer, *Toward Unilateral Coherence in Determining Jurisdiction to Tax Income*, 30 HARV. INT'L L.J. 1, 9-10 (1989); Donald Phares, *Tax Equity Analysis*, in THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 399 (Joseph J. Cordes, Robert D. Ebel & Jane G. Gravelle eds., 2d ed. 2005) [hereinafter ENCYCLOPEDIA]; Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 574-80 (1965); see also U.S. TREAS. DEP'T, *DISTRIBUTIONAL ANALYSIS METHODOLOGY*, OTA PAPER NO. 85, at 6 (1999), available at <http://www.ustreas.gov/offices/tax-policy/library/ota85.pdf> [hereinafter U.S. TREAS. DEP'T, *DISTRIBUTIONAL ANALYSIS*]. For a discussion of the use of fairness considerations in defining income, see Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45 (1990).

<sup>84</sup> Adam Smith endorsed the ability-to-pay principle as a foundational tax norm although, failing to understand that it differed from the benefit principle, he conflated the two. See Richard A. Musgrave, *Fairness in Taxation*, in ENCYCLOPEDIA, *supra* note 83, at 135. Smith's statement was: "The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state." ADAM SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* 371 (4th ed. 1850). Kant also recognized the ability-to-pay principle as a norm of taxation. Like Smith, he conflated it with the benefit principle but he also clearly acknowledged the redistributive implications of the ability-to-pay principle. IMMANUEL KANT, *THE METAPHYSICS OF MORALS* 101 (Mary Gregor ed., 1996). More recent commentators on taxation have recognized that the ability-to-pay and benefit principles are separate norms. See, e.g., LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP* 16-30 (2002); Deborah A. Geier, *Time to Bring Back the Benefit Norm?*, 102 TAX NOTES 1155 (Mar. 1, 2004); Sagit Leviner, *From Deontology to Practical Application: The Vision of a Good Society and the Tax System*, 26 VA. TAX REV. 405, 423-30 (2006).

<sup>85</sup> See U.S. TREAS. DEP'T, *BLUEPRINTS*, *supra* note 83, at 1; C. EUGENE STEUERLE, *CONTEMPORARY U.S. TAX POLICY* 10 (2004) [hereinafter STEUERLE, *CONTEMPORARY TAX POLICY*]. For discussion of the history of the rise of the ability-to-pay concept as a foundational principle in U.S. tax policy, see RICHARD J. JOSEPH, *THE ORIGINS OF THE AMERICAN INCOME TAX: THE REVENUE ACT OF 1894 AND ITS AFTERMATH* 89-90, 95-96 (2004); Ajay K. Mehrota, *Envisioning the Modern American Fiscal State: Progressive Era Economists and the Intellectual Foundations of the U.S. Income Tax*, 52 UCLA L. REV. 1793 (2005); Dennis J. Ventry, Jr., *Equity versus Efficiency and the U.S. Tax System in Historical Perspective*, in *TAX JUSTICE: THE ONGOING DEBATE* 25 (Joseph J. Thorndike & Dennis J. Ventry, Jr. eds., 2002).

Ability-to-pay is a foundational principle in the income tax systems of many other countries as well. See Henry Ordower, *Horizontal and Vertical Equity in Taxation as Constitutional Principles: Germany and the United States Contrasted*, 7 FLA. TAX REV. 259, 304 (2006); Frans Vanistendael, *Legal Framework for Taxation*, in 1 *TAX LAW DESIGN AND DRAFTING* 15, 22-23 (Victor Thuronyi ed., 1996). The ability-to-pay principle has even been made a constitutional limitation on the power to tax in Italy, Spain, and Germany. See Vanistendael, *supra*; cf. Basic Facts About the United Nations, *The United Nations: Organization*, available at

Nevertheless, the ability-to-pay concept has drawn sharp criticism because its meaning can be controversial at the margins. For example, commentators often refine the ability-to-pay fairness concept by subdividing it into a horizontal equity component (taxpayers with equal incomes should pay equal amounts of tax) and a vertical equity component (taxpayers with unequal incomes should pay amounts of tax which are sufficiently unequal to fairly reflect the differences in their incomes).<sup>86</sup> Other commentators, however, have criticized these refinements by asserting that horizontal equity has no significance as a tax policy norm separate from vertical equity or that neither horizontal nor vertical equity has any content that is independent of more general notions regarding fundamental fairness.<sup>87</sup> There has also been understandable disagreement regarding certain nuances of the ability-to-pay concept, such as the proper handling of psychic income, leisure, underachievement, and various personal characteristics of taxpayers.<sup>88</sup> Finally, ability-to-pay analysis has been criticized for focusing on taxation without considering the distributional effects of government expenditures<sup>89</sup> and for using the prevailing distribution of income as the measure of taxpaying capacity without inquiring into whether that income distribution is itself fair.<sup>90</sup> As noted, these points have caused some commentators to dismiss the ability-to-pay concept as unhelpful.<sup>91</sup>

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<http://www.un.org/aboutun/basicfacts/unorg.htm> (“The fundamental criterion on which the scale of assessments is based is the capacity of countries to pay.”).

<sup>86</sup> See DAVID F. BRADFORD, *UNTANGLING THE INCOME TAX* 150–53 (1986); JOSEPH M. DODGE, *THE LOGIC OF TAX* 88 (1989); GRAETZ & SCHENK, *supra* note 83, at 28–29; WILLIAM A. KLEIN, *POLICY ANALYSIS OF THE FEDERAL INCOME TAX* 7 (1976); Eric M. Zolt, *The Uneasy Case for Uniform Taxation*, 16 VA. TAX REV. 39, 86–98 (1996).

<sup>87</sup> See generally Paul R. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607 (1993); Louis Kaplow, *A Note on Horizontal Equity*, 1 FLA. TAX REV. 191 (1992); Richard A. Musgrave, *Horizontal Equity: A Further Note*, 1 FLA. TAX REV. 354 (1993); Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT’L TAX J. 139 (1989); Richard A. Musgrave, *Horizontal Equity, Once More*, 43 NAT’L TAX J. 113 (1990). But see Joseph M. Dodge, *Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles*, 58 TAX L. REV. 399, 458–59 (2005) [hereinafter Dodge, *Theories*].

<sup>88</sup> See STAFF OF JOINT COMM. ON TAXATION, 105TH CONG., *REPORT RELATING TO THE IMPACT ON INDIVIDUALS AND FAMILIES OF REPLACING THE FEDERAL INCOME TAX* 107–17 (Joint Comm. Print 1997); Anthony C. Infanti, *Tax Equity*, 55 BUFF. L. REV. 1191 (2008); Zolt, *supra* note 86, at 89–101; see also Barbara H. Fried, *The Puzzling Case for Proportionate Taxation*, 2 CHAPMAN L. REV. 157, 182–83 (1999). These strike us as peripheral matters that do not undercut the basic utility of the ability-to-pay principle.

<sup>89</sup> See MURPHY & NAGEL, *supra* note 84, at 24–25, 30, 184; Fried, *supra* note 88, at 182. In our view, an unfairly distributed tax burden is problematic, even in the unlikely case in which tax inequity is completely corrected by redistributive spending. This is because even perfectly redistributive spending is unlikely to overcome the taxpayer resentment, and consequent negative effect on tax compliance and respect for law generally, that results from a facially unfair tax burden distribution. See also Dodge, *Theories*, *supra* note 87, at 451–52, 456–57.

<sup>90</sup> See MURPHY & NAGEL, *supra* note 84, at 28–30; Fried, *supra* note 88, at 182. This criticism overlooks the fact that the ability-to-pay concept is a tax burden distribution norm, not an income distribution norm. To demand that the ability-to-pay concept provide a normative basis for both tax burden distribution and income distribution is to demand too much. A separate income distribution norm is required. See also Dodge, *Theories*, *supra* note 87, at 454 (“[T]he point of the ability-to-pay principle is precisely that a tax base keyed to market outcomes is the only rational foundation for a system of redistribution that would alter such outcomes. Existing distributions . . . have no normative status whatsoever under the objective ability-to-pay tax justice norm.”).

<sup>91</sup> See, e.g., LOUIS EISENSTEIN, *THE IDEOLOGIES OF TAXATION* 56 (1961) (“To speak forcefully of ability to pay is merely to indulge in evasive rhetoric.”); MURPHY & NAGEL, *supra* note 84, at 30 (“[T]he vague idea of ‘ability to pay’ will not help us when we move to the different question of what distributive [aims] a just government should have.”); SLEMROD & BAKIJA, *supra* note 56, at 264 (“On the compelling questions of the day, however — such as whether millionaires ought to pay 70 percent, 50 percent, or 30 percent of their income in tax or whether poor families should pay anything at all — the ability-to-pay principle has nothing concrete to offer.”); Alvin Warren, *Would a Consumption Tax Be Fairer*

In our view, these criticisms greatly undervalue the importance of the ability-to-pay principle in establishing the general structure and content of the federal tax base. This utility plus the intuitive appeal<sup>92</sup> of the ability-to-pay principle has caused it to persist as a major parameter of tax policy.<sup>93</sup> Thus, a prominent tax economist has recently referred to the horizontal equity component of ability-to-pay as “perhaps the queen of all principles affecting government policy.”<sup>94</sup> Ultimately, the decision to use the ability-to-pay concept as a foundational principle of the tax system is based on a societal decision that other approaches are inferior.<sup>95</sup>

More importantly, the preceding controversies and criticisms have been made effectively irrelevant by the development of a U.S. tax policy consensus under which the ability-to-pay concept means that taxpayers with larger net incomes in a given year should generally pay more tax (calculated with progressive rates) than those who have smaller net incomes in the same year,<sup>96</sup> and that when comparing net incomes for this purpose, the realization principle is

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*Than an Income Tax?* 89 YALE L.J. 1081, 1092–93 (1980) (“Such definitions reduce to statements that society should appropriately tax what it should appropriately tax.”).

<sup>92</sup> Regarding the intuitive appeal of the ability-to-pay principle, Professor Dodge has observed:

[T]he ability-to-pay principle can be constructed from a [preference-neutral] Rawls-type contractarian method: A person in ignorance of his or her material station in life (and moderately risk-averse) would opt to be forced to contribute to government according to the ability-to-pay principle (so long, of course, as everybody else is subject to the same taxing principle).

Dodge, *Theories*, *supra* note 87, at 460. Consistent with this view, William Safire, the conservative New York Times political editor, said: “Most of us accept as ‘fair’ this principle: the poor should pay nothing, the middlers something, the rich the highest percentage.” William Safire, *The 25% Solution*, N.Y. TIMES, Apr. 20, 1995, at A23, *quoted in* MICHAEL J. GRAETZ, THE U.S. INCOME TAX: WHAT IT IS, HOW IT GOT THAT WAY, AND WHERE WE GO FROM HERE 11 (1999) [hereinafter GRAETZ, THE U.S. INCOME TAX]. Professor Schmalbeck reached the same conclusion as Safire. Richard L. Schmalbeck, *Race and the Federal Income Tax: Has a Disparate Impact Case Been Made?*, 76 N.C. L. REV. 1817, 1820 (1998).

<sup>93</sup> See U.S. TREAS. DEP’T, BLUEPRINTS, *supra* note 83, at 1; STEUERLE, CONTEMPORARY TAX POLICY, *supra* note 85, at 10.

<sup>94</sup> See STEUERLE, CONTEMPORARY TAX POLICY, *supra* note 85, at 10 (“[H]orizontal equity . . . asserts that those with equal ability to pay should pay equal taxes. . . . Horizontal equity is perhaps the queen of all principles affecting government policy . . . .”); see also Gene Steuerle, *A Consensus Base for Tax Reform*, 113 TAX NOTES 371 (Oct. 23, 2006) [hereinafter Steuerle, *Consensus*].

<sup>95</sup> See generally Reuven S. Avi-Yonah, *The Three Goals of Taxation*, 60 TAX L. REV. 1, 14–15 (2006).

<sup>96</sup> See, e.g., TESTIMONY BEFORE THE UNITED STATES SENATE FINANCE COMM. OF ROBERT J. CARROLL, DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS), U.S. TREAS. DEP’T, at 3 (Sept. 20, 2006), *available at* <http://www.ustreas.gov/press/releases/reports/carrolltestimony%209.20.06.pdf> [hereinafter CARROLL TESTIMONY] (“the tax system should be appropriately progressive.”); PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 10, at 49 (“All members of the Panel endorsed the goal of a progressive tax structure.”); Thomas L. Hungerford, *Tax Expenditures: Good, Bad or Ugly?*, 113 TAX NOTES 325, 329 (Oct. 23, 2006) (“About two-thirds of Americans ‘believe that people with high incomes should pay a larger share of their income in taxes than those with lower income.’”); Theodore P. Seto & Sandi L. Buhai, *Tax and Disability: Ability-to-Pay and the Taxation of Difference*, 154 U. PA. L. REV. 1053, 1057 (2006) (“Standard tax theory largely ignores differences — other than differences in ‘income’—in the ability of taxpayers to pay taxes.”). On a related matter, the Pew Research Center for the People and the Press conducted a series of national polls of adult Americans showing that from 1994 to 2007, agreement with the statement that it is the government’s responsibility “to take care of people who can’t take care of themselves” increased from 57% to 69% and agreement that the government should assist the needy even if doing so causes an increase in government debt rose from 41% to 54%. See PEW RES. CENTER FOR THE PEOPLE & THE PRESS, TRENDS IN POLITICAL

applied,<sup>97</sup> an objective, market-based standard is used,<sup>98</sup> and items that cannot be feasibly measured (e.g., leisure, psychic income, and forgone opportunities) generally are omitted from the tax base.<sup>99</sup> The emergence of this consensus has made the ability-to-pay principle a workable concept despite the various uncertainties and controversies at the margins.<sup>100</sup>

Integrally related to the ability-to-pay principle is the widely accepted Schanz-Haig-Simons (SHS) definition of income, which provides that an individual's income is the sum of his or her consumption and change in wealth during the taxable period (usually a year).<sup>101</sup> Under this definition, both amounts that are consumed and amounts that are saved are included in the tax base.<sup>102</sup> Obviously, this is a way of describing an individual's taxpaying ability.<sup>103</sup> Thus, SHS is generally understood to be based on the ability-to-pay principle and as a formula for implementing that principle.<sup>104</sup>

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VALUES AND CORE ATTITUDES: 1987-2007 (Mar. 22, 2007), available at <http://people-press.org/reports/pdf/312.pdf>. For an article that analyzes the moral, economic, and administrative effects of a progressive rate structure, see Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905 (1987).

<sup>97</sup> See U.S. TREAS. DEP'T, BLUEPRINTS, *supra* note 83, at 46–47; William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1141–48 (1974); Christopher H. Hanna, *Tax Theories and Tax Reform*, 59 SMU L. REV. 435, 437–38 (2006); Ronald A. Pearlman, *A Tax Reform Caveat: In the Real World, There Is No Perfect Tax System*, in TOWARD FUNDAMENTAL TAX REFORM 106, 108–09 (Alan J. Auerbach & Kevin A. Hassett eds., 2005); Deborah H. Schenk, *A Positive Account of the Realization Principle*, 57 TAX L. REV. 355, 396 (2004).

<sup>98</sup> See SIMONS, *supra* note 30, at 51; Dodge, *Theories*, *supra* note 87, at 449; see also KLEIN, *supra* note 86, at 7 (“On balance, the case for objectivity . . . has carried the day with respect to the tax system. But, again, . . . it is useful to keep in mind that by opting for objectivity, we have simultaneously decided to settle for a less-than-perfect measure of ability.”).

<sup>99</sup> See U.S. TREAS. DEP'T, BLUEPRINTS, *supra* note 83, at 3, 159–62; 1 U.S. TREAS. DEP'T, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH 14–15, 37–42 (Nov. 1984) [hereinafter U.S. TREAS. DEP'T, TAX REFORM]; WALTER J. BLUM & HARRY KALVEN, JR., THE UNEASY CASE FOR PROGRESSIVE TAXATION 64 (1953); BRADFORD, *supra* note 86, at 16–19, 155–56; KLEIN, BANKMAN, SHAVIRO & STARK, *supra* note 83, at 81–82; Dodge, *Theories*, *supra* note 87, at 449–50; Vada Waters Lindsey, *The Widening Gap Under the Internal Revenue Code: The Need for Renewed Progressivity*, 5 FLA. TAX REV. 1, 3, 7–8, 39–40 (2001); Herbert A. Stein, *What's Wrong with the Federal Tax System*, in COMMITTEE ON WAYS AND MEANS, TAX REVISION COMPENDIUM 107, 110–14 (Comm. Print 1959); see also PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 10, at 30 (The Treasury Department calculates ability-to-pay in terms of “wages and salaries, business or farm net income, taxable and tax-exempt interest, dividends, rental income, realized capital gains, cash transfers from the government, and retirement benefits.”).

<sup>100</sup> For recent vigorous defenses of the ability-to-pay principle, see Dodge, *Theories*, *supra* note 87, at 449–61; Seto & Buhai, *supra* note 96.

<sup>101</sup> See JOSHUA D. ROSENBERG & DOMINIC L. DAHER, THE LAW OF FEDERAL INCOME TAXATION 19 (2008) (“The most widely accepted definitions of income are those of Professors Haig and Simons.”); Hanna, *supra* note 97, at 436 (“The Haig-Simons definition of income is generally considered by most tax scholars to be the ideal definition of income.”); see also 1 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS 3-2 (3d 3d. 1999) (“Among contemporary American economists, the so-called Haig-Simons definition of ‘income’ is the most widely accepted . . .”); SLEMROD & BAKIJA, *supra* note 56, at 28.

<sup>102</sup> See SIMONS, *supra* note 30, at 50.

<sup>103</sup> Indeed, Simons characterized the SHS definition as a “measure of the individual's prosperity.” *Id.* at 206; see also Warren, *supra* note 91, at 1085–86 (“The arithmetical process of the Haig-Simons definition should not, however, obscure the nature of the aggregate tax base, which is the product of the society's private capital and labor for the accounting period. The Haig-Simons calculation simply identifies how much of that product has ended up in each taxable unit.”).

<sup>104</sup> SHS is principally based on the ability-to-pay concept. See U.S. TREAS. DEP'T, BLUEPRINTS, *supra* note 83, at 31; U.S. TREAS. DEP'T, DISTRIBUTIONAL ANALYSIS, *supra* note 83, at 7; Andrews, *Personal Deductions*, *supra* note 29, at 326-329; Dodge, *Theories*, *supra* note 87, at 450; see also Joseph M. Dodge, *What's Wrong with Carryover Basis Under*

Not surprisingly, the theoretical criticisms leveled at the ability-to-pay principle with regard to the lack of clarity at the margins or the failure to include certain items<sup>105</sup> have also been directed at SHS. Because the U.S. tax policy consensus accepts ability-to-pay as a workable concept despite these objections, that same consensus has also embraced SHS as a practical policy guide.<sup>106</sup>

To be sure, the SHS concept has not prevented the income tax from acquiring a mass of incoherent and inefficient special interest provisions.<sup>107</sup> Moreover, SHS is not the exclusive criterion of good tax policy. It must be weighed against other important criteria such as enforceability, administrability, economic efficiency, simplification, revenue yield, and governmental effectiveness. Nevertheless, the SHS definition does provide a principled structure that is useful for testing the efficacy of tax provisions and opposing ill-advised tax policy moves in the context of an income tax base, which is the predominant underlying base of the federal income tax system.

A second major tax policy principle is that, to the greatest extent possible, tax provisions should achieve neutrality—i.e., taxpayer behavior should be altered as little as possible from what it would be in the absence of a particular tax provision.<sup>108</sup> Incentives and subsidies, including tax expenditures, enhance the after-tax economic returns from affected activities and cause taxpayers to engage in those activities to a greater extent than would otherwise be the case, distorting taxpayer behavior and interfering with the free market's allocation of resources.<sup>109</sup> Professor Walter Blum stated this point as follows:

A more classical line of attack on special dispensations under the income tax is that they cause a misallocation of economic resources. By taxing (and thus penalizing) certain activities less than others the preferential provisions—so the argument goes—cause more resources to flow into these endeavors than would be attracted if the tax system were

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*H.R. 8*, 91 TAX NOTES 961, 971 (May 7, 2001) (suggesting that the assignment-of-income doctrine, a core principle of the U.S. federal income tax, may be based on the ability-to-pay concept). Consistent with the principle of ability-to-pay, the consumption element of SHS is measured in objective, market-based terms. See Daniel Shaviro, *The Man Who Lost Too Much: Zarin v. Commissioner and the Measurement of Taxable Consumption*, 45 TAX L. REV. 215, 223–24 (1990).

<sup>105</sup> See Fleming & Peroni, *supra* note 8, at 42–55; see also Infanti, *supra* note 88.

<sup>106</sup> See SLEMROD & BAKIJA, *supra* note 56, at 30 (“As long as we are operating an income tax, it is important to understand how the tax system’s definition of income compares to the ‘true’ measure of income.”); Hanna, *supra* note 97, at 448–49; Stanley A. Koppelman, *Personal Deductions Under an Ideal Income Tax*, 43 TAX L. REV. 679, 683 (1988) (the SHS “definition has become the generally accepted foundation for modern day, normative analysis of the meaning of income as a base for personal taxation”). But see Boris I. Bittker, *A “Comprehensive Tax Base” as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967); Douglas A. Kahn, *Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 MICH. L. REV. 1, 3–10 (1979).

<sup>107</sup> See Steuerle, *Consensus*, *supra* note 94, at 372 (“What has essentially happened to the tax policy process in recent decades is that it has increasingly adopted many of the bad habits of the expenditure policy process.”); SLEMROD & BAKIJA, *supra* note 56, at 31–53.

<sup>108</sup> See 1 U.S. TREAS. DEP’T, TAX REFORM, *supra* note 99, at 13; SLEMROD & BAKIJA, *supra* note 56, at 131–35.

<sup>109</sup> See CARROLL TESTIMONY, *supra* note 96, at 3; GAO, FEDERAL COMMITMENT, *supra* note 20, at 49–50; PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 10, at 70–72; SLEMROD & BAKIJA, *supra* note 56, at 218; Eric J. Toder, *Tax Cuts or Spending — Does It Make a Difference?*, 53 NAT’L TAX J. 361, 362 (2000).

perfectly neutral, and as a result scarce resources are utilized in less productive combinations. I concur in the soundness of this reasoning.<sup>110</sup>

Before aspects of the tax system that are not neutral can be evaluated and addressed, however, they must first be identified; a focused analytical tool is highly useful for that purpose. TEA serves this end with respect to incentives and subsidies delivered through income tax provisions. Stated differently, TEA is a device for identifying features of the tax system which cause taxpayers to pursue certain activities more extensively than they otherwise would.<sup>111</sup> Thus, a legitimate concern for neutrality in the tax system drives the use of TEA as a tool of sound tax policy.

Accordingly, in our view, the proper baseline for TEA is an income tax generally based on the ability-to-pay, SHS, and neutrality concepts. In its 2008 report, the Joint Committee Staff adopted a different baseline, a reference tax baseline, which we believe to be less coherent than an SHS baseline grounded in ability-to-pay and neutrality principles. Moreover, as we explain in Part III.B., the reference tax baseline used by the Joint Committee Staff in 2008-2010, although well-meaning to be sure, gave too much deference to bad tax policy that had already made its way into Code. The differences between us and the Joint Committee Staff on this point are not vast, however, at least with respect to those tax expenditure provisions falling within the tax subsidies category (as opposed to those falling within the tax-induced structural distortions category).

#### B. The Joint Committee Staff's New Approach to Examining "Tax Subsidies" Would Not Have Avoided Controversy or Criticism of TEA

Most importantly, we believe that the Joint Committee Staff's reference tax baseline would not have avoided controversy and would have attracted vigorous attacks by TEA opponents. In an important sense, the "new" baseline was not new at all because it was expressly grounded in income tax principles. The pertinent portion of the 2008 report states: "[W]e recognize that our specific implementation of tax expenditure analysis is firmly wedded to the view that the current Internal Revenue Code is at heart an income tax, because we employ that perspective when we attempt to identify what are the Code's general rules . . . ." <sup>112</sup> This means that notwithstanding its stated goal of a value-neutral analysis and notwithstanding that it seemed to reject the SHS baseline used by Surrey, the Joint Committee Staff's 2008-2010 approach explicitly accepted income taxation rather than consumption taxation as the baseline. This further means that the Joint Committee Staff's distortion analysis inevitably accepted the consumption/savings distortion produced by an income tax, but not by a consumption tax, and only focused on other distortions. Thus, the Staff's distortion analysis would surely have been attacked by those who advocate tax expenditure provisions that are based on consumption tax principles.

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<sup>110</sup> Walter J. Blum, *Tax Policy and Preferential Provisions in the Income Tax Base*, in 1 COMMITTEE ON WAYS AND MEANS, TAX REVISION COMPENDIUM 77, 82 (Comm. Print 1959); see also COMMISSION OF THE EUROPEAN COMMUNITIES, DIVIDEND TAXATION OF INDIVIDUALS IN THE INTERNAL MARKET 18 (COM (2003) 810 final Brussels 19.12.2003); Martin A. Sullivan, *Economic Analysis: Tax Incentives and Economists*, 111 TAX NOTES 20, 23 (Apr. 3, 2006) [hereinafter Sullivan, *Tax Incentives*].

<sup>111</sup> See Shaviro, *Rethinking*, *supra* note 12, at 204.

<sup>112</sup> STAFF OF JOINT COMM. ON TAX'N, RECONSIDERATION, *supra* note 39, at 16.

Moreover, to prevent their favorite subsidies from being scrutinized under rigorous cost/benefit analysis, all tax subsidy advocates would certainly have attacked the Joint Committee Staff's baseline as vigorously as they have attacked Surrey's baseline. Stated differently, beneficiaries of subsidies and distortions abhor any form of cost/benefit analysis and would have fought against the Joint Committee Staff's 2008-2010 version of TEA as vigorously as they have fought against Surrey's original version. The TEA beneficiaries would have pressed the familiar objections to TEA that the Joint Committee Staff attempted to outflank with its 2008-2010 taxonomy of tax subsidies and tax-induced structural distortions. For example, TEA beneficiaries would surely have made baseline-oriented objections in the form of arguments that their preferences are not properly classified as tax subsidies or tax-induced structural distortions and should be viewed as consistent with a general rule of the current Internal Revenue Code.

In addition, there would have been heated debates in which the beneficiaries of tax-induced structural distortions would have argued that the distortions are facially justified by claims of countervailing factors and that rigorous cost/benefit analysis should not be applied to them. For example, the Joint Committee Staff's 2008-2010 approach treated deferral of U.S. tax on the income of foreign subsidiaries as a tax-induced structural distortion rather than a tax subsidy but would presumably have subjected it to a cost/benefit analysis (limited apparently to efficiency concerns) to examine whether deferral should be repealed (i.e., a full inclusion system adopted) or replaced with a territorial system. However, many U.S. corporations and their tax advisers are opposed to either repeal of deferral or adoption of a territorial system because the present deferral system is more generous to taxpayers than either of those alternatives.<sup>113</sup> Thus, U.S. multinational corporations can be expected to resist any tax expenditure-based analysis of deferral, even the Joint Committee Staff's distortion-based approach. Defenders of deferral undoubtedly would have argued that deferral is not a tax expenditure at all<sup>114</sup> and, in any event, that deferral is conclusively justified by competitiveness claims even though those claims are unsupported by rigorously tested empirical evidence.<sup>115</sup>

A related set of points can be made with respect to Section 199. When fully phased in, the Section 199 deduction for nine percent of "qualified production activities income,"<sup>116</sup> will reduce the top rate on that income from 35 percent to approximately 32 percent in the best-case scenario.<sup>117</sup> This provision was enacted in 2004, not for the purpose of more accurately defining income, but expressly to "make investments in domestic manufacturing facilities more attractive"<sup>118</sup> and to "assist in the creation and preservation of U.S. manufacturing jobs."<sup>119</sup> This

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<sup>113</sup> See J. Clifton Fleming, Jr. & Robert J. Peroni, *Worse Than Exemption*, 59 EMORY L.J. 79 (2009).

<sup>114</sup> See Bartlett, *supra* note 19, at 416-17 (arguing that deferral is not a tax expenditure); see also NORMAN TURE, TAXING FOREIGN SOURCE INCOME: THE ECONOMIC AND EQUITY ISSUES 8-12 (Tax Foundation 1976) (arguing that deferral is not a tax subsidy).

<sup>115</sup> See, e.g., NFTC, FOREIGN INCOME PROJECT, *supra* note 58.

<sup>116</sup> IRC §199(a)(1)(A).

<sup>117</sup>  $.35 - (.35 \times .09) = .3185$ .

<sup>118</sup> STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS, at 170 (Comm. Print 2005).

<sup>119</sup> *Id.*

purpose would seem to indisputably label Section 199 as a tax expenditure<sup>120</sup> and require it to be subjected to cost/benefit scrutiny, including an examination of its distortive effects, its revenue cost, its complexity costs, whether its broad definition of production makes it poorly targeted, the extent to which it actually creates or preserves jobs, and the benefit to the economy from creating or preserving those otherwise non-competitive jobs.

Nevertheless, in its 2008 budget document, the Bush Administration made the following argument:

[T]he deduction may prove to be so broad that it is available to most U.S. businesses, in which case it might not be seen as a tax expenditure. Rather it would then represent a feature of the baseline tax rate system because the deduction is equivalent to a lower tax rate.<sup>121</sup>

In other words, the Bush Administration argued that this provision, enacted for a clear tax expenditure purpose, was likely to morph into a general rule of the baseline system which would cause it to shed its tax expenditure status and thereby escape appropriate cost/benefit scrutiny.

We disagree with this characterization of the Section 199 deduction. The type of income that qualifies for the deduction is, indeed, defined very broadly to include counter-intuitive items.<sup>122</sup> Nevertheless, the service, retail, and financial sectors of the economy are largely excluded from Section 199. In our judgment, this means that the scope of Section 199 is too narrow to allow it to qualify as a general rule; it should be regarded as a tax expenditure and subjected to appropriately rigorous cost/benefit analysis. But this example shows how a decision to make current general law the baseline for TEA purposes creates an opening for characterizing dubious provisions as part of the baseline and, therefore, exempt from cost/benefit analysis.

These observations segue into a closely-related related point. If current general law is the baseline, the legislative process then contains a perverse incentive for making tax expenditures as broad as possible, instead of carefully targeted, because the broader the tax expenditures is, the better the chance that it can be passed off as a general rule and therefore, not a tax expenditure at all. This will have the presumably unintended effect of actually increasing the fiscal harm caused by tax expenditures and decreasing the effectiveness of tax expenditures as a substitute for direct expenditure programs.

A final observation about the use of current general law as the baseline is that this approach gives support to those who would advocate new tax expenditures by arguing that they are not materially different from old tax expenditures that have arguably grown into general rules and, therefore, that cost/benefit analysis need not be applied to the new tax expenditures. This, in turn, would lead to a proliferation of tax expenditures in various areas, thus undercutting the effectiveness of a TEA as a device for helping control the growth of tax expenditure provisions.

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<sup>120</sup> See *supra* text accompanying notes 59-60; *supra* note 79.

<sup>121</sup> OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES, FISCAL YEAR 2008, ANALYTICAL PERSPECTIVES 315 (2007).

<sup>122</sup> See IRC § 199(c)(1), (4).

Note that the Joint Committee Staff's reference tax baseline was still a baseline that would have been used to identify many tax provisions as "tax subsidies" that should be forced to undergo a presumably rigorous cost/benefit analysis.<sup>123</sup> This means that the Joint Committee Staff's 2008-2010 approach to TEA would have been used by tax reformers as a policy tool for ridding the Code of tax provisions that violated the reference tax baseline and were unable to survive the TEA evaluation process. Thus, one can imagine that many TEA critics would have continued to view the Joint Committee Staff's revised TEA approach as defective because it would have been used to advocate the adoption of Code changes that brought the current Code closer to the aspirational but achievable reference tax baseline. So it is possible to argue that the Joint Committee Staff's new approach did not even effectively address one of the most important objections to TEA identified in its 2008 report.

### C. Problems with Joint Committee Staff's New Category of Tax-Induced Structural Distortions

As noted previously, the Joint Committee Staff's 2008-2010 approach to TEA divided tax expenditures into two categories: tax subsidies that are identified through application of a reference law baseline and tax induced structural distortions. We have explained our views regarding the inferiority of the reference law baseline in comparison to the SHS benchmark. We now turn to the Staff's second category of tax expenditure—tax-induced structural distortions—that were to be identified "by considering their economic efficiency costs, not by invoking any normative tax system."<sup>124</sup> In our view, this analytical approach had the unfortunate effect of ignoring the negative impact on the health of the tax system that these "structural distortion" tax expenditures may cause by making the law more difficult for the Internal Revenue Service (IRS) to administer and by eroding taxpayer voluntary compliance because of increased complexity and unfairness.<sup>125</sup> It also had the effect of ignoring tax fairness concerns in evaluating these types of tax provisions in the Code. Stated differently, the Joint Committee Staff's approach might have weakened the effectiveness of TEA, because, with respect to the tax-induced structural distortions portion of its new approach, it seemed to use a version of cost/benefit analysis that focuses only on economic efficiency and eliminates equity concerns and concerns about other negative effects (e.g., administrability) on the tax system.<sup>126</sup> By contrast, tax subsidies apparently were to be scrutinized under a form of cost/benefit analysis that includes equity, administrability, and other relevant factors in addition to economic efficiency.<sup>127</sup> We see no sound reason for effectively applying a less rigorous form of cost/benefit analysis by ignoring these other important tax policy concerns when evaluating tax-induced structural distortions.

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<sup>123</sup> See STAFF OF JOINT COMM. ON TAX'N, RECONSIDERATION, *supra* note 39, at 9 (stating that the Joint Committee Staff anticipated that the tax subsidies category of its new TEA approach would "comprise the preponderance of items that today are classified as tax expenditures").

<sup>124</sup> *Id.* at 41.

<sup>125</sup> The Joint Committee Staff's report explicitly stated that "[w]hile tax expenditure analysis can be helpful in identifying efficiency, equity and ease of administration issues . . . our definition of Tax-Induced Structural Distortions looks only to the substantive criterion of efficiency." *Id.* at 42. For this purpose, the Joint Committee Staff adopted the conventional definition of efficiency from economics: "A tax system is perfectly efficient if individuals and firms make the same decisions in the presence of the tax as they would if the tax did not exist, subject only to the fact that they are less wealthy by virtue of paying the tax." *Id.* at 53.

<sup>126</sup> See *id.* at 10 n.19, 41-42.

<sup>127</sup> See *id.* at 48-77.

Many tax-induced structural distortions mentioned in the Joint Committee Staff report (including the deferral privilege) raise serious equity and administrability concerns that are seemingly ignored under the Joint Committee Staff's 2008-2010 approach.

Moreover, despite the Joint Committee Staff's attempt to find consensus on these issues, its approach to treating some tax expenditures as "tax-induced structural distortions," subject to less rigorous scrutiny than "tax subsidies," would not have avoided controversy. Indeed, it would have spawned a new set of characterization controversies. For example, as noted above, the Joint Committee Staff in its 2008 report treated the deferral of tax on income earned by a U.S. corporation through a foreign subsidiary as a "tax-induced structural distortion" but not a "tax subsidy" because deferral imposes substantial efficiency costs but is not a deviation from any clearly identifiable tax rule.<sup>128</sup> This meant that deferral would be subjected to a less-demanding form of cost/benefit analysis than if it were a tax subsidy. We and other commentators, however, would dispute this characterization of deferral and argue instead that deferral is an exception to the general rule regarding the Code's treatment of business income earned by a U.S. person.<sup>129</sup> In our view, the general approach of the U.S. income tax system is to impose current tax on business income earned by a U.S. person, whether that income is earned through an unincorporated branch, a sole proprietorship, a pass-through entity (i.e., a partnership, a limited liability company taxed as a partnership for federal income tax purposes, or an S corporation), or an entity taxed as a C corporation for federal income tax purposes.<sup>130</sup> Deferral with respect to foreign-source income earned by U.S. persons through a foreign corporation is a deviation from this general approach. Thus, the deferral privilege is a significant departure from the current taxation of business income that generally prevails within the present income tax system.<sup>131</sup> Accordingly, we would argue that deferral should have been treated as a "tax subsidy" under the Joint Committee Staff's 2008-2010 TEA approach and subjected to the stronger version of cost/benefit analysis that applied to tax subsidies. This illustrates that the Staff's tax-induced structural distortions category actually would have created new controversies rather than avoided disputes.

Presumably, the major purpose of the Joint Committee Staff's "new" approach to TEA was to identify subsidies and tax distortions that should be forced to undergo a rigorous cost/benefit analysis, i.e., the Staff's purpose was to force advocates of particular expenditures to defend their tax benefits on the merits with a degree of particularity that goes beyond generalized claims that the tax benefits "will do great things for the U.S. economy" or "the provisions are no worse than the ones you have enacted for other special interest groups." In other words, we are sure that the Joint Committee Staff had a larger purpose than a labeling exercise. If that is the case, it is difficult to understand why the Joint Committee Staff's new approach allowed tax-induced structural distortions to undergo a less rigorous cost/benefit analysis than its narrowed definition of tax subsidies. Both types of provisions often raise serious equity and

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<sup>128</sup> See *id.* at 41.

<sup>129</sup> See Fleming & Peroni, *supra* note 8, at 532-33.

<sup>130</sup> See I.R.C. §§ 1, 11, 61(a)(1), (a)(2), 63, 702, 1366; ELISABETH A. OWENS, THE FOREIGN TAX CREDIT 3 (1961) ("[T]he source or nature of income, whether it is from one type of business or another, earned or unearned, from a foreign or domestic source, is largely immaterial in the basic tax structure.").

<sup>131</sup> See, e.g., AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION—PROPOSALS ON UNITED STATES TAXATION OF FOREIGN PERSONS AND OF THE FOREIGN INCOME OF UNITED STATES PERSONS 171-72 (1987).

administrability concerns as well as efficiency concerns and the proponents of both types of provisions should be required to show that the benefits of the provisions exceed all of their costs (including the tax policy costs).

#### IV. RESPONDING TO THE CRITICISMS OF TEA

Not only did the Staff's 2008-2010 approach result in a less robust iteration of TEA than the traditional version based on the SHS baseline, but it was also based on a false premise—that the criticisms of the SHS baseline could not be successfully countered and, therefore, that they had to be avoided by substantially disconnecting TEA from its long-established normative moorings. To the contrary, it appears to us that the criticisms of SHS-grounded TEA are unpersuasive and should be rejected. We have cataloged these denunciations and replied to them at length in an earlier article<sup>132</sup> and we refer interested readers to that prior work. We have also responded to some of those criticisms in Part III.A., above.<sup>133</sup> In this Part IV we will focus principally on four criticisms of the SHS baseline that were identified by the Joint Committee Staff as requiring a move to its 2008-2010 construct because, in the Staff's view, these complaints had not been convincingly answered. We will disagree with the Joint Committee Staff's conclusion that there are no convincing arguments in defense of TEA's conventional normative baseline and we will, therefore, conclude that no new TEA approach was required.

##### A. The Staff's "Unanswerable" Criticisms

First, in its 2008 report, the Joint Committee Staff argued that proponents of traditional TEA had failed to adequately respond to criticisms that the SHS "normal tax" baseline is underspecified and that TEA is in reality a tool for promoting a tax reform agenda.<sup>134</sup> We have dealt with the criticisms of the "normal tax" baseline above.<sup>135</sup> In sum, we believe that the SHS baseline does indeed have a core set of coherent principles that are widely accepted in the context of an income tax system. Thus, contrary to the Joint Committee Staff's 2008 report, the claim that the normal tax (SHS) baseline is merely a "series of ultimately idiosyncratic or pragmatic choices"<sup>136</sup> simply cannot withstand scrutiny. In our view, the discussion in Part III.A., above, demonstrates that the SHS baseline is both principled and workable in applying TEA to specific tax provisions or proposals in an income tax system.

In response to the Joint Committee Staff's assertion that proponents of the SHS baseline have not satisfactorily answered the criticism that the TEA is a tool for promoting tax reform proposals aimed at promoting an income tax base, we would say that, of course, TEA can and has been used as an instrument of tax reform. By bringing to the light of day tax subsidy provisions that cannot survive a rigorous cost/benefit analysis, TEA is, of course, helping provide support for tax reform proposals aimed at eliminating those provisions. This sensible effect of TEA surely cannot be a basis for criticism of it. And, in an income tax system, the

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<sup>132</sup> See Fleming & Peroni, *supra* note 8.

<sup>133</sup> See *supra* text accompanying notes 80-111.

<sup>134</sup> STAFF OF JOINT COMM. ON TAX'N, RECONSIDERATION, *supra* note 39, at 35.

<sup>135</sup> See *supra* text accompanying notes 80-111.

<sup>136</sup> STAFF OF JOINT COMM. ON TAX'N, RECONSIDERATION, *supra* note 39, at 36.

baseline will necessarily be grounded in income tax principles (we believe that SHS is the proper baseline for this purpose) and that means TEA will definitely be used to support income tax reform rather than a move to a consumption tax regime. If Congress decided to replace the income tax base with a consumption tax base, then the baseline would be different but TEA would still be an important tool.<sup>137</sup> With that different baseline, for example, the savings incentive provisions in current tax law that are treated as tax expenditures would be part of the normal consumption tax baseline.<sup>138</sup> We readily acknowledge that to be the case but fail to see how that point is an appropriate critique of TEA as applied in an income tax system. Instead, that point really is a demand that the income tax be replaced with a consumption tax regime, an issue that is outside the scope of this article.<sup>139</sup> TEA does not, in fact, require the enactment of an income tax;<sup>140</sup> it merely requires that if net income has been chosen as the tax base, tax provisions that depart from the function of properly defining net income should be identified and evaluated as government programs effected through the tax system. As we stated in our earlier article, “if TEA is a clandestine device for promoting base broadening, then it is a salutary tool for pursuing a widely shared tax policy goal.”<sup>141</sup>

The Joint Committee Staff also discussed the argument that TEA represents inappropriate “tax exceptionalism”—the supposedly unrealistic idea that the tax system should be treated specially and be free of the political compromises that are present in direct spending programs and other actions of the federal government.<sup>142</sup> The Joint Committee Staff itself rebuts this criticism in its 2008 report. The tax system is special in that it affects virtually every person and special interest tax provisions undermine the self-assessment tax system itself by creating the perception in taxpayers that the system is unfair and unworthy of support. These special interest tax provisions thereby undercut the voluntary taxpayer compliance that is essential to making the tax system function effectively. Thus, the tax system merits having a special analytical tool like TEA to analyze the efficacy of tax subsidy provisions.<sup>143</sup> We would further argue that TEA does not really represent tax exceptionalism. It is merely a tool for making sure that government programs operated through the tax system are carefully analyzed and do not avoid accountability. In other words, rather than treating tax subsidy provisions as having an “exceptional” status that exempts them from normal governmental program scrutiny, TEA attempts to bring analytical parity between direct government programs and tax expenditure programs by requiring that tax expenditure programs undergo an appropriately rigorous cost/benefit review.

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<sup>137</sup> Fleming & Peroni, *supra* note 8, at 508-09.

<sup>138</sup> On the other hand, there are numerous other tax expenditure provisions under an SHS baseline that would also be tax expenditures if a consumption tax baseline were used. *Id.* at 509-10.

<sup>139</sup> Stated differently, in our view, much of the dispute about the traditional TEA baseline is really a dispute about the appropriate base (income versus consumption) for the federal tax system and not a dispute about whether SHS is a sufficiently neutral and principled TEA baseline in the context of an income tax system. See WILLIAM D. ANDREWS & PETER J. WIEDENBECK, BASIC FEDERAL INCOME TAXATION 532 (6th ed. 2009) (“Much of the recent criticism of tax expenditure analysis seems to come from proponents of consumption taxes.”).

<sup>140</sup> Fleming & Peroni, *supra* note 8, at 492.

<sup>141</sup> *Id.* at 490.

<sup>142</sup> See Kyle Logue, *If Taxpayers Can't Be Fooled, Maybe Congress Can: A Public Choice Perspective on the Tax Transition Debate*, 67 U. CHI. L. REV. 1507, 1525 (2000); Weisbach & Nussim, *supra* note 26, at 957, 968.

<sup>143</sup> See STAFF OF JOINT COMM. ON TAX'N, RECONSIDERATION, *supra* note 39, at 37 (stating that the Joint Committee Staff “believes that there is merit in a presumption in favor of a tax system that is as simple and as easy to administer as possible”).

Finally, in its 2008 report, the Joint Committee Staff raised and dismissed what it called the “last penny” argument—namely, the claim that TEA “is based on the ‘sinister premise . . . [that one should] think of all income tax as virtual state property, and forbearance to tax away every last penny as itself a tax expenditure.’”<sup>144</sup> The Joint Committee Staff rejected this argument by citing and quoting from our earlier article on tax expenditure theory.<sup>145</sup> In that prior work, we dismissed the “last penny” argument against TEA, as follows:

. . . TEA, however, cannot be interpreted as implying that . . . [Congress’] taxing power makes the federal government the owner of all income earned by U.S. residents unless TEA can be fairly understood as asserting that Congress has a normative obligation to adopt a generally applicable income tax and that 100% is the normatively correct rate for such a tax. TEA does not, however, require the enactment of an income tax and it does not, in fact, prescribe any particular level of generally applicable income taxation as normatively correct. Moreover, TEA does not dictate that revenue gained by eliminating tax expenditures must be spent by the federal government. Indeed, TEA has nothing to say about whether such revenue should be used for direct expenditure purposes or to pay for tax rate reductions.<sup>146</sup>

#### B. The Weisbach and Nussim Critique: Is Tax Policy Relevant to TEA?

Apparently included by the Joint Committee Staff in its list of unanswerable criticisms of the SHS baseline was a then recent challenge by Professors David Weisbach and Jacob Nussim.<sup>147</sup> We have made a detailed response to the Weisbach and Nussim challenge in our earlier article and interested readers are directed to that work<sup>148</sup> but we wish to make one additional point. Weisbach’s and Nussim’s principal argument is that the controlling question regarding tax expenditures is whether particular subsidies and incentives are best operated through the tax system or through some other means such as a direct expenditure program administered by a nontax agency.<sup>149</sup>

They contend that when answering this question, “[i]t is entirely irrelevant whether some piece of government policy complies with independent tax norms”<sup>150</sup> such as the ability-to-pay and neutrality principles. Tax norms, however, deal with (1) the fairness of the tax burden distribution, (2) whether taxpayers can sufficiently understand the law (3) whether taxpayers can comply with the law and whether the government can administer it at a reasonable cost, (4) whether the tax system distorts taxpayer choices, (5) whether the system raises adequate revenue, and (6) whether the system is conducive to economic growth. If Weisbach’s and Nussim’s foregoing statement is to be accepted on its face, and there seems to be no reason not to do so,

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<sup>144</sup> STAFF OF JOINT COMM. ON TAX’N, RECONSIDERATION, *supra* note 39, at 35 (quoting from Charles Fried, *Whose Money Is It?*, WASH. POST, Jan. 1, 1995, at C-7).

<sup>145</sup> See STAFF OF JOINT COMM. ON TAX’N, RECONSIDERATION, *supra* note 39, at 38.

<sup>146</sup> Fleming & Peroni, *supra* note 8, at 492-93 (footnotes omitted); see also Shaviro, *Rethinking*, *supra* note 12, at 204.

<sup>147</sup> See Weisbach & Nussim, *supra* note 26.

<sup>148</sup> See Fleming & Peroni, *supra* note 8.

<sup>149</sup> Weisbach & Nussim, *supra* note 26, at 973-76. Weisbach and Nussim frankly admit that this is a difficult and complex question to answer. See *id.* at 992-1023.

<sup>150</sup> *Id.* at 958.

then they are arguing that we should disregard all of these concerns when deciding whether to operate government programs through the tax system. This argument overlooks the facts that the primary purpose of the federal income tax is to raise revenue for federal government purposes,<sup>151</sup> that a high degree of voluntary compliance is required for the income tax to perform this function,<sup>152</sup> and that the application of cost/benefit analysis to any tax expenditure must seriously consider the effects of its complexities and inequities (if any) on IRS treatment of taxpayers, on voluntary taxpayer compliance, and on the ability of the IRS to effectively perform its enforcement function.<sup>153</sup> Stated differently, Weisbach's and Nussim's insistence on ignoring tax policy norms apparently would require policymakers to disregard the negative effects to the tax system caused by the adverse impact on compliance and enforcement arising from complexities and inequities engendered by tax expenditures.<sup>154</sup> By contrast, TEA provides a cost/benefit framework within which to answer the question on which Professors Weisbach and Nussim are focused (simplification and coordination versus specialization)<sup>155</sup> but that also requires a broader inquiry that includes critical issues affecting compliance and administration, such as distributional fairness, distortive effects, and general effectiveness,<sup>156</sup> in addition to coordination, governmental simplification, and specialization.

The immediately preceding discussion allows us to segue into a closely related point—TEA is an important tool for defending the health of the tax system. Revenue, the principal product of the tax system, is the ultimate determinant of the scope and effectiveness of many important government programs. In a country as large and complex as the United States, the needed revenue can be produced only by a healthy tax system—i.e., a tax system that is adequate in terms of its revenue raising capacity, that is administrable by the revenue authority, and that attracts a high degree of voluntary compliance by taxpayers. Voluntary compliance, in turn, is importantly related to the perceived fairness of the tax system and to its level of complexity. Tax

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<sup>151</sup> See STEUERLE, CONTEMPORARY TAX POLICY, *supra* note 85, at 15; Douglas Holtz-Eakin, *The Case for a Consumption Tax*, 113 TAX NOTES 373, 375 (Oct. 23, 2006); Sullivan, *Tax Incentives*, *supra* note 110, at 22. For a different statement of the same principle, see Andrews, *Personal Deductions*, *supra* note 29, at 313 (“[T]he primary . . . effect of the [income] tax . . . is to reduce private consumption and accumulation in order to free resources for public use.”).

<sup>152</sup> The overall Internal Revenue Service (IRS) audit coverage rate for returns of individuals has been below 1% for the fiscal years 1997–2006 inclusive. See INTERNAL REVENUE SERVICE, FISCAL YEAR 2006 ENFORCEMENT AND SERVICE RESULTS 3, [http://www.irs.gov/pub/newsroom/11-06\\_enforcement\\_stats.pdf](http://www.irs.gov/pub/newsroom/11-06_enforcement_stats.pdf).

<sup>153</sup> See 1 U.S. TREAS. DEP'T, TAX REFORM, *supra* note 99, at 9; GRAETZ, THE U.S. INCOME TAX, *supra* note 92, at 105-07; SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 7, at 26–27; Charles E. McLure, Jr., *Economics and Tax Reform: 1986 and Now*, 113 TAX NOTES 362, 363 (Apr. 4, 2006); Sullivan, *Tax Incentives*, *supra* note 110, at 22; see also Edward Yorio, *Equity, Efficiency, and the Tax Reform Act of 1986*, 55 FORDHAM L. REV. 395, 425–26 (1987); Edward Yorio, *The Future of Tax Reform: A Rejoinder to Professor Zelinsky*, 55 FORDHAM L. REV. 899, 904–05 (1987).

<sup>154</sup> Regarding such complexities and inequities, see PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 10, at 5; STAFF OF JOINT ECON. COMM., 109TH CONG., INDIVIDUALS AND THE COMPLIANCE COSTS OF TAXATION 6 (Joint Comm. Print 2005); SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 7, at 107; Blum, *supra* note 110, at 83; Toder, *supra* note 109, at 370.

<sup>155</sup> Professors Weisbach and Nussim provide a thoughtful demonstration of how cost/benefit analysis applies to their focus issue by discussing the possibility of integrating the food stamp program into the income tax system. See Weisbach & Nussim, *supra* note 26, at 997–1023; see also Toder, *supra* note 109, at 368–69.

<sup>156</sup> See PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 10, at 83 (“[T]he Panel believes that . . . tax preferences should be treated like any direct spending program, and should be evaluated by policymakers based on objective criteria, such as their cost, the distribution of their benefits, overall effectiveness, and the appropriateness of administering them through the tax system.”).

provisions that undermine taxpayer compliance because of their inequity or complexity and tax provisions that erode the capacity of the IRS to administer the tax law degrade the health of the tax system and undermine the government's principal revenue source.

TEA is highly relevant to this concern because it forces tax expenditures to undergo a cost/benefit analysis that identifies and highlights tax provisions whose costs to the health of the tax system outweigh any net gains that are otherwise achieved from using a tax expenditure in place of a direct expenditure program. Thus, TEA is much more than a labeling exercise; it is a guardian of the revenue raising capacity of the tax system, and therefore, a guardian of many other governmental functions. This is an additional point that is overlooked by the Weisbach and Nussim approach.

Another important justification for TEA that seems undervalued by Weisbach and Nussim relates to the federal budget. Surrey's primary motivation for initially advancing TEA seems to have been to more completely illuminate the full cost of the federal government through the production of a tax expenditure budget that identifies the revenue lost by individual tax expenditures.<sup>157</sup> In theory, these individual losses could then be combined into a total tax expenditure cost.

Ironically, this quantitative aspect is the weakest component of TEA. This so because the revenue loss estimates for the individual tax expenditure items are computed on a mostly static basis.<sup>158</sup> Thus, the revenue loss estimate for each tax expenditure is far from precise. It is not an accurate measure of what would be gained by repealing a particular tax expenditure, and, therefore, not an accurate measure of the cost of that tax expenditure.<sup>159</sup>

In spite of this inaccuracy, however, the quantitative aspect of TEA is useful from a budget standpoint for several reasons. First, tax expenditure estimates are usually more accurate than totally ignoring all revenue loss, thereby effectively assigning a zero cost to tax expenditures. Stated differently, these estimates help dispel the political illusion that tax expenditures are somehow "free," unlike direct governmental expenditures. Second, closely related to this point is that tax expenditure estimates help make the resulting revenue loss a part of budget consciousness. Third, these estimates, inaccurate though they may be, provide some sense of the magnitude of the related tax expenditures and allow them to be compared at least roughly to direct expenditure alternatives. It would certainly be worthwhile, however, to investigate the possibility of improving the accuracy of tax expenditure estimates by including in their preparation the dynamic elements that are used when calculating the revenue increases or decreases that are projected to result from tax rate changes.<sup>160</sup>

## V. CONCLUSIONS

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<sup>157</sup> See Surrey, *Full Accounting*, *supra* note 14, at 576-78.

<sup>158</sup> See STAFF OF JOINT COMM. ON TAX'N, 2008 ESTIMATES, *supra* note 47, at 40-41.

<sup>159</sup> See OFFICE OF MGMT. & BUDGET, 2009 ANALYTICAL PERSPECTIVES, *supra* note 77, at 288.

<sup>160</sup> See STAFF OF JOINT COMM. ON TAX'N, RECONSIDERATION, *supra* note 39, at 81-82; STAFF OF JOINT COMM. ON TAX'N, OVERVIEW OF REVENUE ESTIMATING PROCEDURES AND METHODOLOGIES USED BY THE STAFF OF THE JOINT COMMITTEE ON TAXATION 18-19 (JCX-1-05; Feb. 2, 2005); Edward D. Kleinbard & Patrick Driessen, *A Revenue Estimate Case Study: The Repatriation Holiday Revisited*, 120 TAX NOTES 1191, 1193 (Sept. 22, 2008).

The analysis in this article has contended that traditional TEA, which uses the SHS baseline in identifying tax expenditure provisions, is properly grounded in the ability-to-pay and neutrality principles. It has an established core that makes it an important and effective analytical tool of tax policy, notwithstanding the many criticisms that it has endured over the years. In our view, the central purpose of TEA is to serve as a triggering mechanism for a rigorous cost/benefit analysis of governmental programs implemented through the federal income tax system and that the SHS baseline is the appropriate measuring rod for this purpose. Stated differently, TEA's main focus is on transparency and accountability concerning governmental programs delivered through the tax system. It is meant to have a much needed restraining effect on the strong impulse by many members of Congress to support the enactment of governmental programs in the form of tax incentives and subsidies that would not pass muster under a cost/benefit analysis as direct spending programs and that would have a detrimental effect on income tax compliance and enforcement. Thus, while we welcome the Joint Committee Staff's 2008-2010 effort to reinvigorate TEA as a tool of tax policy analysis, we believe that if its rejection of the SHS baseline had endured, it would have undermined, rather than strengthened, TEA. We also believe that the Joint Committee Staff's 2008 report gave far too much credence to the critics of the SHS baseline, which is a widely accepted criterion for evaluating income tax provisions. In addition, we believe the Joint Committee Staff's 2008-2010 TEA approach would not have satisfied most critics of TEA and would have opened up new avenues of attack on the TEA process. For these reasons, we applaud the denouement of the "new paradigm" and welcome the Joint Committee Staff's return to the SHS baseline.