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Tax Expenditures and Horizontal Equity: A Present-Day Reassessment

Nir Fishbien

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Tax Expenditures and Horizontal Equity: A Present-Day Reassessment

Nir Fishbien[*]

Tax expenditures are "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." The concept of tax expenditures was coined by the first Assistant Secretary for Tax Policy, Stanley S. Surrey, in the late 1960s, and was codified by the Congressional Budget Act of 1974, which requires that a list of tax expenditures be included in the U.S. budget. The concept relies on the Haig-Simons definition of income (with certain adjustments) as the baseline, a deviation from which is considered a tax expenditure.

There are two basic problems with attempts to define tax expenditures against a Haig-Simons baseline. First, it is not clear why the Haig-Simons, and not other definitions of income, should be used as a baseline. Second, it is not clear why such deviations are normatively problematic. Put bluntly, who cares whether a specific tax provision is a deviation from some theoretical definition of income?

This Article represents an attempt to recapture Surrey's original view of tax expenditures and assess its present-day implications: most importantly, that tax expenditures should be viewed as an attempt to identify departures that violate principles of horizontal equity, i.e., the idea that taxpayers with equal ability to pay should bear an equal burden of tax. As such, eliminating tax expenditures means eliminating many of the biases that are currently an integral part of the tax system. Doing so will make the tax system much more equitable for most Americans than any tax reform currently contemplated by Congress.

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I. INTRODUCTION

Tax expenditures are "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[1] In the late 1960s, the first Assistant Secretary for Tax Policy, Stanley S. Surrey, coined the concept.[2] The Congressional Budget Impoundment Act of 1974, which requires that a list of tax expenditures be included in the U.S. budget, first codified it. This list consists of almost 165 items that amount to roughly $1.6 trillion for fiscal year 2024 alone.[3] Surrey believed many of the tax expenditures could (and should) be provided in the form of spending programs.

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1 Congressional Budget and Impoundment Control Act of 1974, 2 U.S.C. § 622(3) (1988).

2 Surrey and Paul R. McDaniel developed the concept through the years. *See* STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES (1973) [hereinafter SURREY, PATHWAYS]; STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES (1985) [hereinafter SURREY & MCDANIEL, TAX EXPENDITURES]; *see also* Paul R. McDaniel & Stanley S. Surrey, *Tax Expenditures: How to Identify Them; How to Control Them*, 15 TAX NOTES 595 (1982); Stanley S. Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance*, 84 HARV. L. REV. 352 (1970); Stanley S. Surrey, *Government Assistance: The Choice Between Direct Programs and Tax Expenditures*, 8 TAX NOTES 507 (1979); Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970) [hereinafter Surrey, *Tax Incentives*]; Stanley S. Surrey, *Tax Subsidies as a Device for Implementing Government Policy*, 3 TAX ADVISER 196 (1972); Stanley S. Surrey & William F. Hellmuth, *The Tax Expenditure Budget – Response to Professor Bittker*, 22 NAT'L TAX J. 528, 537 (1969); Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 B.C. INDUS. & COM. L. REV. 679 (1976); Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept and the Legislative Process*, *in* THE ECONOMICS OF TAXATION 123 (Henry J. Aaron & Michael J. Boskin eds., 1980); Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C. L. REV. 225 (1979). For the subsequent supporting literature, see Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 DUKE L.J. 1155; Edward A. Zelinsky, *James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions*, 102 YALE L.J. 1165 (1993). In particular, see J. Clifton Fleming, Jr. & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 VA. TAX REV. 437 (2008) [hereinafter Fleming & Peroni, *Reinvigorating Tax Expenditure Analysis*]; J. Clifton Fleming, Jr. & Robert J. Peroni, *Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base?: A Critique of the "New Paradigm" and Its Denouement*, 30 VA. TAX REV. 135 (2010) [hereinafter Fleming & Peroni, *A Critique of the "New Paradigm"*].

3 *See* U.S. DEP'T OF THE TREASURY, OFF. OF TAX ANALYSIS, TAX EXPENDITURES (2024) [hereinafter TAX EXPENDITURES REPORT], https://home.treasury.gov/system/files/131/Tax-Expenditures-FY2025.pdf [https://perma.cc/N2VX-KY5A] (estimating total income tax expenditures for fiscal years 2023 to 2033).

The enormous amount of tax expenditures in the Internal Revenue Code (Code) by itself might indicate that Surrey failed in his primary aim, which was to persuade Congress to repeal or at least restrict tax expenditures. However, it is also clear that the concept has withstood the test of time despite constant criticism that started almost immediately after Surrey introduced it.[4]

Surrey developed the concept of tax expenditures in speeches between 1967 and 1968 and in many articles and books after returning to academia.[5] In 1967, Surrey coined the phrase "tax expenditure" to describe a provision in the Code that is a deliberate departure from accepted concepts of net income, which affects the economy in ways that are usually accomplished by explicit expenditures.[6] Surrey viewed tax expenditures as provisions in the Code not designed for the principal purpose of raising revenue. In his early career, he found that income tax is in fact composed of two distinct elements: (1) structural provisions necessary to implement a normal income tax, and (2) special preferences that mainly benefit a certain group of taxpayers and that were deviations from the normal structure of the system (recall Surrey's work was dominated by the idea that the tax system is compiled by an internally consistent framework).[7] Surrey called for a "full accounting"[8] for tax expenditures and their costs to encourage expenditure control and to facilitate tax reform. He argued that such accounting

4 *See, e.g.*, STAFF OF JOINT COMM. ON TAX'N, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 29–38 (Comm. Print 2008); Bruce Bartlett, *The End of Tax Expenditures as We Know Them?*, 92 TAX NOTES 413, 414 (2001); Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244, 258–59 (1969); Douglas A. Kahn & Jeffrey S. Lehman, *Tax Expenditure Budgets: A Critical View*, 54 TAX NOTES 1661, 1662–63 (1992); Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187, 201–02 (2004); David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 976 (2004). Nonetheless, many other countries have adopted the concept. *See* SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 2, 156; *see also* ORG. FOR ECON. COOP. & DEV., TAX EXPENDITURES: RECENT EXPERIENCES 107 (1996).

5 *See, e.g.*, SURREY, PATHWAYS, *supra* note 2, at 31–34.

6 *See* Stanley S. Surrey, Assistant Sec'y, U.S. Dep't of the Treasury, The U.S. Income Tax System – the Need for a Full Accounting, Remarks Before the Money Marketeers (Nov. 15, 1967), *in* U.S. Dep't of the Treasury, Annual Report of the Secretary of the Treasury on the State of the Finances for the Fiscal Year Ended June 30, 1968, at 322–23 (1969); SURREY, PATHWAYS, *supra* note 2, at 1, 3.

7 *See* STANLEY S. SURREY, A Half-Century with the Internal Revenue Code: The Memoirs of Stanley S. Surrey, at xviii (Lawrence Zelenak & Ajay Mehrota eds., 2022); *id.* at xvii.

8 SURREY, PATHWAYS, *supra* note 2, at 3.

would lead to a better tax system in terms of fairness and simplicity because tagging certain provisions as tax expenditures would result in the elimination of some (or most) of them.[9]

A couple of years later, the Treasury Department released its first tax expenditures budget, identifying "the major respects in which the current income tax bases deviate from widely accepted definitions of income and standards of business accounting and from the generally accepted structure of an income tax" and providing "estimates of the amount by which each of these deviations reduces revenues."[10] Such estimations were calculated based on the revenue forgone due to specific tax expenditures (without regard to how taxpayers would have reacted to the removal of the tax expenditure in question, or how their behavior would have changed due to such removal).[11]

Following that report, the Senate requested that its version of the Revenue Act of 1971 include estimates of losses in revenue from provisions of the Code and estimates of indirect expenditures through the operation of the Code. In response to that request, the Treasury Department indicated that it was willing to supply such information as requested and, consequently, in 1972, issued a joint report on tax expenditures with the Joint Committee on Taxation (JCT).[12] Two years later, the Congressional Budget and Impoundment Control Act of 1974 (Act) established the House and Senate Budget Committees to oversee the new congressional budget process.[13] Congress did not transfer any power to the Budget Committees from existing tax-writing committees.[14] Under the Act, tax expenditures, defined as "those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability," were to be enumerated into the "tax expenditures

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9 *Id.* at 4. Similar considerations led him to support the Subpart-F legislation earlier in 1962. *See* Nir Fishbien, *From Switzerland with Love: Surrey's Papers and the Original Intent(s) of Subpart-F*, 38 VA. TAX REV. 1 (2018).

10 U.S. Dep't of the Treasury, Annual Report of the Secretary of the Treasury on the State of the Finances for the Fiscal Year Ended June 30, 1968, at 326–40 (1969) [hereinafter U.S. Dep't of the Treasury, 1968 Fiscal Report].

11 *See* Edward D. Kleinbard, *Tax Expenditure Framework Legislation*, 63 NAT'L TAX J. 353 (2010).

12 *Id.* at 358.

13 Congressional Budget and Impoundment Control Act of 1974, 2 U.S.C. § 622(3) (1988).

14 ALLEN SCHICK, CONGRESS AND MONEY: BUDGETING, SPENDING AND TAXING 17, 78 (1980).

budget."[15] The Act provided that whenever a committee of either House proposes a bill or resolution that provides a new budget, alters spending authority, or increases or decreases revenues or tax expenditures, the report accompanying that bill or resolution should contain a tax expenditure analysis.[16]

The Budget Committees, with the help of the Congressional Budget Office (CBO), were officially in charge of producing an annual tax expenditure budget, and the executive branch was required to include a tax expenditure budget in the annual President's Budget transmittal to Congress. Nonetheless, the Senate Budget Committee eventually stopped using the analyses as part of the budgetary process, and the analysis became an informative rather than operational tool mainly used to highlight tax expenditures and provide bipartisan, objective information to Congress regarding their costs.[17]

Since 1975, the CBO traditionally relied on the JCT in preparing tax analysis mainly because the JCT had the requisite expertise with respect to revenue matters, and a statutory requirement obliging Congress to rely on estimates of the JCT when considering the revenue effects of proposed legislation.[18] The JCT reports included the tax expenditures analysis, with a description of the features of the "baseline" that is used to identify and measure tax expenditures.[19] The JCT defines this baseline as "a normal income tax structure," and the determination of whether a provision is a tax expenditure "is made on the basis of a broad concept of income that is larger in scope than 'income' as defined under general U.S. income tax principles," adding that it "uses its judgment in distinguishing between those income tax provisions (and regulations) that can be viewed as a part of normal income tax law and those special provisions that result in tax expenditures."[20]

In addition to the list published by the CBO (based on the JCT report), the Treasury also publishes its own list of tax expenditures, aimed at identifying provisions that are

15 *See* 2 U.S.C. § 622(3).

16 2 U.S.C. § 602(a).

17 Kleinbard, *supra* note 11, at 359.

18 *Id.* at 358.

19 STAFF OF THE JOINT COMM. ON INTERNAL REVENUE TAX'N, 94TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES (Comm. Print 1976).

20 STAFF OF THE JOINT COMM. ON TAX'N, 116TH CONG., ESTIMATE OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2018-2022, at 2 (Comm. Print 2018).

considered basic structural features of income tax that deviate from the existing structural rules.[21] It implements two baseline concepts: the normal tax baseline and the reference tax law baseline, both of which are used to identify and estimate tax expenditures.[22] For the most part, the two concepts coincide, but those items that are treated as tax expenditures under the "normal tax baseline," but not the "reference tax law baseline," are indicated in the report as "normal tax."[23] The normal tax baseline is based on a practical form of a comprehensive income tax, which is itself based on the Haig-Simons definition of income as the sum of consumption and the change in net wealth in a given period of time with certain adjustments: "The normal tax baseline allows personal exemptions, a standard deduction, and deduction of expenses incurred in earning income. It is not limited to a particular structure of tax rates, or by a specific definition of the taxpaying unit."[24] The reference tax law baseline is also based on a comprehensive income tax, but it is much closer to existing law, such that it is limited to special exceptions from a generally provided tax rule.[25]

Despite its informative function, the tax expenditures analysis has been an imperative part of tax policy considerations in the United States. Surrey's main argument was that tax expenditures suffered from inherent defects that made them inferior to analogous governmental spending programs. As such, he believed the analysis would show policymakers the real cost of tax expenditures and force their ongoing scrutiny.[26]

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21 *See Tax Expenditures*, U.S. DEP'T OF THE TREASURY, https://home.treasury.gov/policy-issues/tax-policy/tax-expenditures [https://perma.cc/HJQ9-LLW5] (last visited Oct. 31, 2024).

22 TAX EXPENDITURES REPORT, *supra* note 3, at 1.

23 *Id.*

24 *Id.* at 3.

25 *Id.* "Provisions under the reference tax law baseline are generally tax expenditures under the normal tax law baseline, but the reverse is not always true." *Id.* For example, "[u]nder the reference tax law, gross income does not include gifts defined as receipts of money or property that are not consideration in an exchange" or other transfer payments from the government. *Id.* Therefore, these provisions are not considered tax expenditures. On the other hand, while "the normal tax baseline also excludes gifts between individuals from gross income . . . all cash transfer payments from the Government to private individuals are counted [as] gross income, and exemptions of such transfers from tax are [therefore] identified as tax expenditures," unlike under the reference tax law baseline. *Id.*

26 SURREY, PATHWAYS, *supra* note 2, at 4.

Surrey was concerned with the "upside-down" subsidy that tax expenditures created.[27] Tax expenditures that came in the form of deductions most benefited those taxpayers subject to higher brackets. Nowadays, many of the tax expenditures are in the form of tax credits, rather than deductions—a testament to the effect of Surrey's criticism and the Tax Expenditure Analysis.[28] Yet tax expenditures in the form of credits could also be inequitable, as they benefit only those who file tax returns and, to the extent that the credits are not refundable, only those who, after all the exemptions and deductions allowed, still have taxable income.[29] Surrey was also concerned with the revenue cost of tax expenditures. He wanted to facilitate disclosure of the full cost of the federal government, including the extent to which direct spending programs or tax expenditures contributed to that cost. He believed such disclosure of tax expenditures and their costs would provide clear estimates of the revenue losses that could be added to the totals of direct congressional appropriations.[30] This could demonstrate that the income tax is already relatively broad, and that Congress can eliminate many

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27 *See* SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 79. As an example to the absurd, the following was provided:

> Another example of upside-down assistance is the medical expense deduction. Despite much debate about a national health insurance program, few people recognize that such a program already exists, run through the Internal Revenue Code. It has many of the features of a normal health insurance program. There is a *deductible*: only medical expenses in excess of 5 percent of adjusted gross income qualify for the tax deduction. There is a *coinsurance* element requiring the insured to pay a portion of the medical expenses above the deductible level; the coinsurance element is a function of the individual's marginal income tax rate. If an individual in the 11 percent bracket incurs $100 of medical expenses above the deductible level (5 percent of adjusted gross income), under the coinsurance element he or she must pay $89 of those medical expenses and the government will pay $11. In contrast, an individual who makes $50,000 a year and incurs the same $100 of medical expenses above the deductible level will pay $62, and the government will bear the remaining $38. Finally, for the wealthiest taxpayers, those with more than $200,000 per year adjusted gross income, the government will pick up $50 of each $100 of medical expenses above the deductible level. Again, poverty-level taxpayers and those claiming the standard deduction are automatically excluded. Indeed, since home ownership with its accompanying deductions for interest and property taxes is almost essential to the itemization of personal deductions, it is fair to say that the medical expense deduction constitutes a national health insurance program for well-to-do homeowners.

Id. (footnotes omitted).

28 *See, e.g.*, *The Distribution of Major Tax Expenditures in 2019*, CONG. BUDGET OFF. (Oct. 2021), https://www.cbo.gov/publication/57585 [https://perma.cc/QX55-6CKY].

29 *See* Donald C. Lubick, *A View from Washington*, 98 HARV. L. REV. 338, 340 (1984).

30 *See* SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 25, 226.

of the exceptions that impair its broad ability to collect taxes, rather than layer on fundamentally flawed new tax rules. The tax expenditures analysis was also aimed at exposing the real size of the government.[31] Altogether, the tax expenditures analysis provided a useful framework from which to evaluate the equity, efficiency, and administrability of certain tax provisions.[32]

Despite his desire to eliminate most preferential tax provisions, Surrey was aware of the tremendous power lobbyists held on Capitol Hill. He hoped that highlighting the shortcomings of tax expenditures would serve as a countermeasure to such influence.[33] Nonetheless, the current list of tax expenditures for the 2024 fiscal year alone totals approximately $1.6 trillion. This fact by itself might suggest that Surrey had failed in his primary goal. In any case, the efficacy of the analysis has been undercut substantially—a result of the constant criticism that started almost immediately after Surrey introduced the concept.[34] However, the concept has withstood the

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31 *See* Kleinbard, *supra* note 11, at 21. Shaviro criticizes this point:

> Tax expenditure analysis rests on an equivalence. *Tax Rule A*, it suggests, is really a spending rule, and thus should be restated as hypothetical *Tax Rule B* plus *Spending Rule C*, which in combination are equivalent. If the rule at issue is something . . . which one has determined ought not to be in the tax system to begin with, the process of re-description is relatively simple. *Tax Rule B* is simply the absence of any such tax rule, and the entire revenue consequences are attributed to *Spending Rule C*. If, however, the tax rule is "wrong," yet there ought to be some tax rule, as in the case of accelerated depreciation, (assuming it exceeds "correct" tax depreciation, such as economic depreciation), then the process is more cumbersome. One must do more work in specifying hypothetical *Tax Rule B* in order to attribute its net revenue loss, relative to actual *Tax Rule A*, to hypothetical *Spending Rule C*.
>
> So long as hypothetical *Rules B* and *C* are indeed equivalent to actual *Tax Rule A*, the exercise is tautologically correct. To have any significance, however, the restatement needs to be motivated. After all, one could just as easily decompose *Tax Rule A* into the even more favorable *Tax Rule D* . . . plus *Negative-Spending Rule E* . . . *Tax Rule A* then could be described as a tax penalty relative to *D*, as measured by *E*. One thus needs to explain why a particular counter-factual should be chosen from among the infinite possibilities as capturing the "true" character of the actual observed *Tax Rule A*.

Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187, 206 (2004).

32 Fleming & Peroni, *Reinvigorating Tax Expenditure Analysis*, *supra* note 2, at 485.

33 *See* Stanley S. Surrey, *The Congress and the Tax Lobbyist – How Special Tax Provisions Get Enacted*, 70 HARV. L. REV. 1145, 1154 (1957); *see also* Thuronyi, *supra* note 2, at 1158.

34 STAFF OF THE JOINT COMM. ON TAX'N, *supra* note 19, at 7–8 ("Driven off track by seemingly endless debates about what should and should not be included in the 'normal' tax base, tax expenditure analysis today does not advance either of the two goals that

test of time, despite such constant criticism. Part II accordingly reviews the two main lines of attack against the concept of tax expenditures and offers appropriate responses. Most of this criticism was, and still is, based on the idea that tax expenditures are measured against the Haig-Simons definition of income. Part III provides present-day examples of how tax expenditures should be analyzed and explores tax expenditures through the lens of horizontal equity. Finally, Part IV concludes that the modern tax system would greatly benefit from Surrey's insight.

II. TWO LINES OF ATTACK ON TAX EXPENDITURES

A. Incoherence of the Base

In its 1967 debut, the tax expenditures analysis scrutinized certain tax provisions and federal expenditures with equal rigor. Surrey called for a "full accounting" of the effects of these provisions with respect to the budget and the tax system. Since then, the concept has been highly controversial in U.S. tax policy. For practical reasons, Surrey believed a Haig-Simons definition of income should be used as a baseline for the tax expenditures analysis, reflecting the normative elements of the tax system.[35] He also thought that the Haig-Simons definition of income should be modified to incorporate certain other accepted business accounting standards and other modifications that reflect the "generally accepted structure of an income tax."[36]

The Haig-Simons definition of income is essentially based on "gain" or "accretion" and should generally include the sum of the market value of rights exercised in consumption and the change in the value of property rights (wealth) between the beginning and the end of the period in question.[37] Naturally, this definition created a relatively wide base—one that reaches further than the coverage of the existing U.S. income tax system (e.g., appreciation of capital assets that are currently not taxed due to

inspired its original proponents: clarifying the aggregate size and application of government expenditures, and improving the Internal Revenue Code.").

35 *See* Kleinbard, *supra* note 11; Stanley S. Surrey, *The United States Income Tax System — The Need for Full Accounting*, *in* TAX POLICY AND TAX REFORM: 1961-1969, at 575, 578 (William F. Hellmuth & Oliver Oldman eds., 1973); *see also* SURREY, PATHWAYS, *supra* note 2, at 33; SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 88, 186.

36 SURREY, PATHWAYS, *supra* note 2, at 12; SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 3–4.

37 SURREY, PATHWAYS, *supra* note 2, at 12.

the realization principle).[38] Additionally, other issues that arose since the adoption of the Haig-Simons definition of income required special attention (as to whether they have become part of the normative tax system).[39] As a result, Surrey suggested that the generally accepted structure of the income tax would be accounted for as well.[40] For Surrey, this generally accepted structure included, among others, the exclusion of imputed rental income on owner-occupied homes, personal exemptions, rate schedules, certain Section 162 deductions, and income-splitting for married couples as part of the base and not considered tax expenditures.[41]

Arguably, the main difficulty in the analysis is the determination of those normative elements that will comprise the base. Surrey admitted that such work "requires an intellectually consistent, thorough analysis of the normative structure of an income tax in today's world."[42] For Surrey, the Haig-Simons definition of income was just a convenient starting point, but in no way was it the end result.[43] Critics have strongly attacked the choice of the Haig-Simons baseline, characterizing it as "unprincipled, imprecise, and insufficiently related to our hybrid income/consumption tax system as it actually exists."[44] In the words of Douglas Kahn and Jeffrey Lehman, the process of identifying the baseline was like asking whether the National Zoo should house pandas, and answering by saying that other self-proclaimed experts have determined that "normative zoos" should only house bears and that pandas are not really bears.[45]

Daniel Shaviro argued that a more acceptable baseline would be one that draws a distinction between distributive tax rules based on equitable principles, such as ability-to-pay and tax rules that have no distributive purpose but instead serve mainly to provide benefits to certain taxpayers.[46] Even Shaviro agrees

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38 Interestingly, in a recent Supreme Court case, a majority of the Court soundly rejected an attempt to characterize realization as a constitutional norm embedded in the tax system. *See* Moore v. United States, 144 S. Ct. 1680, 1688–89 (2024).

39 *See* SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 5.

40 *See* SURREY, PATHWAYS, *supra* note 2, at 13.

41 *See* Fleming & Peroni, *Reinvigorating Tax Expenditure Analysis*, *supra* note 2, at 457.

42 SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 5; s*ee also* SURREY, PATHWAYS, *supra* note 2, at 15–19.

43 *See* SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 187–88.

44 Fleming & Peroni, *A Critique of the "New Paradigm," supra* note 2, at 145.

45 *See, e.g.*, Kahn & Lehman, *supra* note 4, at 1665.

46 *See* Shaviro, *supra* note 4, at 207–13.

that a baseline is needed to identify tax provisions that confer preferential treatment on particular income items or for particular taxpayer groups.[47]

Bittker was among the first to criticize the baseline problem and Surrey's call for "full accounting."[48] His primary concern was that evaluating the cost of tax expenditures may require "an agreed starting point" which might be hard to identify:

> What is needed is not an ad hoc list of tax provisions, but a generally acceptable model, or set of principles, enabling us to decide with reasonable assurance which income tax provisions are departures from the model, whose costs are to be reported as "tax expenditures." In this connection, it is important to note that the proposed "full accounting" is evidently intended to embrace every provision that serves as the substitute for an appropriation . . . .
>
> In listing the exclusion of social security benefits as a "tax expenditure" that ought to be reflected in the Federal Budget as aid to the elderly, the Treasury analysts very likely had in mind the fact that these receipts constitute income under the Haig-Simons definition. Conversely, their study accepts the deduction of business expenses under section 162 as necessary to the accurate determination of net income, with the result that the revenue "lost" by virtue of this provision is not reported as a "tax expenditure" to aid private enterprise. . . .
>
> To effect a "full accounting," then, we must first construct an ideal or correct income tax structure, departures from which will be reflected as "tax expenditures" in the National Budget.[49]

Bittker's main argument was that the full accounting for tax expenditures, as suggested by Surrey and implemented by the first Treasury report, was far from full and that the decisions regarding what to include and exclude in the list of tax

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[47] *Id.* at 208–13. Shaviro would like to see a baseline in accordance with what Richard Musgrave described as the distributional function of the public sector, which, under Shaviro, "should be thought of as limited to acting on the basis of broad equitable considerations, such as those involving inequality or ability to pay." *Id.* at 209. Shaviro continued:

> There need be no implication that Surrey was right in thinking that the income tax system should not be used to pursue "spending-like" (that is, allocative) goals that are distinct from its main distributional purpose, such as by containing special preferences for investment in particular industries. There is no ex ante reason to think that income tax, in some set of cases, might not be the optimal instrument for pursuing some set of goals that lie[s] outside its core distributional function. The point is simply one of clarifying that any such rules do something different than what one otherwise might primarily have in mind when thinking about [] "the income tax."

Id.

[48] Bittker, *supra* note 4, at 246.

[49] *Id.* at 247–48.

expenditures were arbitrary. For example, the list of tax expenditures did not include structural pillars of our tax system, such as the progressive tax rate, the separate taxation of corporate income, and certain provisions that determine the timing of income and deductions. All of the preceding could potentially be recast as tax expenditures. The Treasury's 1969 report indeed admitted that "[t]he design of the list seems best served by constructing what seemed a minimum list rather than including highly complicated or controversial items that would becloud the utility of this special analysis,"[50] and Bittker viewed that approach as causing the analysis to be arbitrary and far from the "full accounting" Surrey was calling for.

Further, even if the Haig-Simons definition of income could be applied consistently and serve as a baseline, Bittker was concerned with how the baseline would be used with respect to elements of other areas in the tax world, such as the exclusion from taxable income of gifts, bequests, life insurance proceeds, and recoveries for personal injuries and wrongful death, accelerated depreciation deductions, special accounting privileges (such as installment sale reporting), the foreign tax credit, and many other similar items.[51] Other scholars criticized the choice of the Haig-Simons baseline because they believed the baseline should stem from elements of consumption tax. They argued that, although the federal income tax is not based on consumption tax, it has important consumption tax features, making it a hybrid system.[52] The practical implication of this argument is either that there is no feasible baseline or that the proper baseline should be based on consumption tax.[53]

As a response to the "baseline" problem, Seymour Fiekowsky, who was the Assistant Director of the U.S. Treasury Department's Office of Tax Analysis, proposed to redefine the tax expenditure analysis by abandoning the Haig-Simons baseline and instead limiting tax expenditures to those tax provisions that

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50 U.S. Dep't of the Treasury, 1968 Fiscal Report, at 330 (1969).

51 Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L. TAX J. 244, 252 (1969).

52 Chris Edwards, *Tax Expenditures and Tax Reform*, CATO INST. (July 25, 2023), https://www.cato.org/policy-analysis/tax-expenditures-tax-reform [https://perma.cc/Q5DL-EUH9] ("A consumption base is a better starting point to identify unjustified tax preferences, and a better model to guide tax reforms. The current federal 'income' tax is actually a hybrid, part Haig-Simons and part consumption, and this study argues that Congress should move toward the latter.").

53 Bartlett, *supra* note 4, at 420–21.

meet two questions: (1) whether the provision is inconsistent with the current structure of the tax law, and (2) whether any other government agency could administer an equivalent spending program at any comparable cost.[54] Following Fiekowsky's steps,[55] the JCT conducted a thorough study on the tax expenditure analysis in general, and the baseline problem in particular, and released a major report in 2008, in which it argued that the "baseline" approach has significantly demolished the effectiveness of the tax expenditures analysis as a whole.[56]

The JCT report called for abandoning the Haig-Simons baseline and adopting an alternative one.[57] In its new approach, and following Fiekowsky's suggestion, the JCT suggested dividing the tax expenditure analysis into two main distinct categories: tax expenditures in the narrow sense, or "Tax Subsidies," and a new category that would include a list of structural elements of the Code (that do not necessarily deviate from an identifiable baseline), materially affecting economic decisions and imposing substantial economic efficiency costs, or "Tax-Induced Structural Distortions."[58]

The Tax Subsidies category sought to catch specific tax provisions that are deliberately inconsistent with *identifiable* general rules of the *existing* tax code, such that there is no need to define (and compare) to a hypothetical normative tax baseline.[59] An additional condition was that the specified provision "collects less revenue than does the general rule."[60] On the other hand, the Tax-Induced Structural Distortions category was residual, created with the main purpose of listing important provisions that were previously flagged as tax expenditures but would escape such characterization under the new Tax Subsidies category.[61] This could occur when the provision in question could not easily be described as an exception to a current tax law because the general rule was not clear on its face.[62] An additional condition was that the specified provision has a significant effect

54 Seymour Fiekowsky, *The Relation of Tax Expenditures to the Distribution of the 'Fiscal Burden*,' 2 CAN. TAX'N 211, 215–16 (1980).

55 *See* STAFF OF THE JOINT COMM. ON TAX'N, *supra* note 4, at 39.

56 *Id.* at 7–9.

57 *See generally id.*

58 *Id.* at 9–10.

59 *Id.* at 9, 39.

60 *Id.*

61 *See id.* at 9–10.

62 *Id.* at 40–41.

on the economy.[63] The two categories together were aimed to cover much of the same ground as did the "classical" tax expenditures analysis, and "in some cases extend the application of the concept further."[64]

For tax subsidies to overcome the baseline issue—primarily how to define the normative baseline, a deviation from which will result in a tax expenditure classification—the report suggested using an "identifiable general rule of the present tax law" as the base.[65] This modification would ensure that any provision which deviates from present tax law and collects less revenue than does the general rule would be labeled as a tax expenditure. The report suggested that such an "identifiable general rule of the present tax law" should closely correspond to the current reference tax baseline used by the Treasury report. The JCT anticipated that the Tax Subsidies category would comprise the most significant tax expenditures.[66]

Nonetheless, by removing the hypothetical normative base (originating from the Haig-Simons definition of income) and using the reference law baseline—such as the current tax rules—the JCT's suggested approach would not flag some of the most significant tax provisions (that under the "older" approach were tax expenditures) because they cannot easily be described as exceptions to a general rule of present law, since such a general rule is not clear from the face of the Code. The JCT provides deferral as an example.[67] In the years prior to the Global Intangible Low-Taxed Income mechanism, "deferral" allowed active foreign earnings of U.S. Multinational Enterprises (MNEs) to escape any U.S. tax until such earnings were repatriated to the United States (for example, in the form of a dividend). Under the "classic" tax expenditure analysis, deferral was flagged as a tax expenditure because the normative tax base originally was defined to treat all foreign earnings of U.S. MNEs as subject to current tax, while the deferral of active earnings was considered the exception.[68] Under the proposed JCT approach, such deferral would not have been classified as a tax expenditure (under the tax subsidy category), since present law (at the time of writing)

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63 *Id.* at 10.
64 *Id.* at 39.
65 *Id.*
66 *Id.*
67 *Id.* at 10.
68 *Id.* at 41–42.

seemed ambiguous as to what exactly was the general rule for taxing foreign earnings.[69]

The JCT's answer to that ambiguity was the new category of Tax-Induced Structural Distortions. As noted, this category would include the structural elements of tax law (and not just mere deviations from an identifiable general tax rule, and thus not tax subsidies) that "materially affect economic decisions in a manner that imposes substantial economic efficiency costs."[70] The JCT suggested that this new category would be analyzed solely under economic efficiency principles and not from any normative perspective, such that no normative base would be necessary.[71]

The report explains that tax "deferral" of active foreign earnings should be classified as a tax expenditure (under the Tax-Induced Structural Distortion category) because it materially affects economic decisions mainly with respect to foreign versus domestic investment.[72] In this way, the JCT ensured that deferral and the like would stay under constant examination. Another example discussed was the different taxation of debt and equity, which generally encourages businesses to leverage their capital structures and, as such, materially affects economic decisions.[73]

Surprisingly, while abandoning the Haig-Simons baseline to avoid criticism and controversy, the JCT's new Tax-Induced Structural Distortions adopt, even if implicitly, a normative baseline that is grounded in income tax principles, rather than, for example, a consumption tax. Notwithstanding its stated goal of a value-neutral analysis, the JCT's new approach must face normative questions to determine whether a certain provision qualifies as a Tax-Induced Structural Distortion, such that it must be isolated and analyzed as a tax expenditure. Proponents of tax expenditures have normally argued that their preferences are facially justified and should not be subject to a cost-benefit analysis.[74] They would surely use the same arguments to claim that their preferences do not deviate from the existing rules nor materially affect the economy, dodging both the first and the

[69] *Id.* at 41.
[70] *Id.*
[71] *Id.*
[72] *Id.* at 41–42.
[73] *Id.* at 10.
[74] *See, e.g.*, Fleming & Peroni, *A Critique of the "New Paradigm," supra* note 2, at 165–67.

second categories, respectively. This would merely replace one line of attack (the normative baseline) with another (what is the existing law or what materially affects the economy).[75] Due to the problems discussed above and other related issues, the JCT reversed its position in 2010 and abandoned its new approach, re-embracing the Haig-Simons baseline once again.[76]

Another attack on the use of the normative base is that it presumably suggests that "provisions that fall *outside* the implicit baseline of the tax expenditure budget (tax expenditures) are somehow corrupt, dangerous, and evil," and that "[t]hey should be changed as soon as possible to conform with the 'neutral' position."[77] This is not, however, what the tax expenditures analysis advocates for. The classification of an item as a tax expenditure does not in itself make that item either a desirable or an undesirable provision.[78] The classification is aimed to help Congress and the public identify items that are not part of the normative tax structure.[79]

B. Recasting Tax Expenditures as Direct Expenditures

Another major line of attack against the tax expenditures analysis is mainly associated with David Weisbach and Jacob Nussim. In a 2004 article,[80] Weisbach and Nussim argued whether a tax expenditure deviates from a certain baseline is in

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75 *See* Paul A. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607, 616 (1993).

76 *See* U.S. DEP'T OF THE TREASURY, OFF. OF TAX ANALYSIS, TAX EXPENDITURES 297 (2010), https://home.treasury.gov/system/files/131/Tax-Expenditures-FY2010.pdf [https://perma.cc/5YZL-TEMA] ("Identification and measurement of tax expenditures depends importantly on the baseline tax system against which the actual tax system is compared. The tax expenditure estimates presented in this chapter are patterned on a comprehensive income tax, which defines income as the sum of consumption and the change in net wealth in a given period of time.").

77 *See, e.g.*, Kahn & Lehman, *supra* note 4, at 1663.

78 *See* SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 5.

79 *See id.*

80 *See generally* Weisbach & Nussim, *supra* note 4. In contrast, Zelinsky raised a similar but different argument:

> The core of my argument is that the institutions formulating and administering tax policy are more competitive and visible than their direct outlay counterparts because tax institutions are subject to more numerous and diverse constituencies than the specialized, limited-clientele organizations that design and implement direct government spending. Tax institutions, because of their greater visibility and more competitive nature, are less susceptible to interest group capture and possess greater legitimacy under pluralist criteria than their direct expenditure equivalents.

Zelinsky, *supra* note 2, at 1166.

fact an unnecessary inquiry and whether the particular tax expenditure is best operated through the tax system rather than through an alternative governmental spending program:

> [T]he decision to implement a "nontax" program through the "tax system" has little or nothing to do with tax policy. Instead, the tax expenditure decision, which we will also call the integration decision or the decision to combine tax and spending programs, is solely a matter of institutional design. It is about assigning projects such as tax collection, education, defense, or housing to specific units of government. Different groupings of activities will perform differently, and we should use those groupings that yield the best possible performance.
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> . . . [O]ur theory focuses on institutional design–the question of how the government chooses to compartmentalize its functions. It is entirely irrelevant whether some piece of government policy complies with independent tax norms. If the underlying policy is held constant, there are no effects of putting a program into or taking a program out of the tax system even if doing so hurts or enhances traditional notions of tax policy. Welfare is the same regardless of whether the program is formally part of the tax system or is located somewhere else in the government. If we mistakenly look only at the tax system instead of overall government policy, we will draw the wrong conclusions. Putting a program into the tax system makes the tax system look more complicated, but there is unseen simplification elsewhere. The tax system will seem less efficient, but the efficiency of government policy is unchanged.[81]

Weisbach and Nussim's theory focuses on "institutional design" considerations, namely how the government chooses to divide its functions into units and which way will provide the best possible set of public policies and government services.[82] As such, it is irrelevant, as the argument goes, to examine whether a specific government policy complies with independent tax norms. Rather, one should consider whether the total welfare would have changed had the program been implemented somewhere else in the government and not in the Code. Weisbach and Nussim believed that the contention that the tax collection function should necessarily be separated from other functions of the government is not true in and of itself, and that there are good reasons for not separating it from other functions of the government.[83] Weisbach and Nussim's concern was that focusing

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81 Weisbach & Nussim, *supra* note 4, at 957–58.
82 *Id.* at 958.
83 *See id.* at 957–59.

on the tax system would blind policymakers from *overall* government considerations.[84]

While it might not make sense to charge the IRS with the responsibility of military defense, for example, it might be wise, as Weisbach and Nussim argued, to implement all federal welfare-type programs through the IRS.[85] The reason is that there are benefits to putting welfare and tax into the same organizational unit. Both programs rely on income, both require large-scale information and financial processing, and both are based on redistribution grounds.[86] As a result, implementing welfare programs with tax collection might actually result in an overall benefit in the form of efficacy and coordination. To Weisbach and Nussim, this emphasizes the main point that tax expenditures should not be judged through a tax policy lens but rather through a larger governmental perspective, taking into account the potential benefits of coordination between various types of government activities. To the extent that the administration of welfare programs does not require highly specialized operatives, such as those associated with military defense, for example, integrating them into the tax system might result in lower costs and other benefits of coordination.[87] Put differently, the only important question is which approach—administrating the program through the tax system or through a separate governmental unit—provides the best delivery mechanism.[88]

One significant problem with Weisbach and Nussim's argument is that their cost-benefit analysis requires an evaluation of the tax system and its functions, so that we can measure the effectiveness and cost of the tax expenditure in question when it is implemented in the tax system, and compare it against the effectiveness and cost of the same tax expenditure in the form of governmental spending. This, in turn, raises another question, as to who exactly would be responsible for evaluating the costs in both alternatives and how such evaluation would be conducted. In this context, a key question is whether the evaluation should consider other tax expenditures

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84 *Id.* at 958.
85 *Id.*
86 *Id.* at 959.
87 *Id.*
88 *Id.* at 963–64.

that are currently implemented in the tax system. Clifton Fleming and Robert Peroni explain:

> [T]o determine whether a particular government subsidy, such as a deduction for medical expenses, is best delivered as a direct expenditure or as a subsidy through the tax system, we need to know the tax system's content and structure so that we can evaluate the effectiveness of the tax expenditure alternative and the costs it imposes on the tax system. The results of this evaluation must then be taken into account along with the costs and benefits of the direct expenditure alternative. One way to do this analysis is to assume that the contemplated tax expenditure would occur in an income tax regime identical to the present system with its irrational and inefficient load of tax expenditures. This would distort the analysis, however, because the systemic costs (in terms of complexity, enforceability, and possible unfairness) of a proposed tax expenditure would likely appear much smaller if the tax expenditure were evaluated as just one item among many others that were also dubious but that were assumed to be constant.[89]

As noted, if we want to evaluate the real costs of tax expenditures and their effects on the tax system, we should not just add the marginal costs of an additional tax expenditure. Rather, we should measure the cost of tax expenditures as a whole. This could only be done by comparing the current tax system with all the tax expenditures that are already an integral part of it, to a tax system with *none* of those provisions. By doing so, we would find the real cost of tax expenditures, rather than the marginal additional cost of one expenditure, added to a tax system already full of existing tax expenditures. This also means that in order to evaluate the cost of a single tax expenditure, we must compare the cost that it would impose on the tax system as if it were the first and only one in the system. This contradicts what Weisbach and Nussim had in mind. They wanted us to examine the cost of adding an additional tax expenditure into a system already full of them. The reason for using a tax expenditures-free system as the subject of comparison, rather than one that already has other tax expenditures implemented in it, is that such system would be the most efficient form of a tax system. Unfortunately, the problem in this exercise—structuring a theoretical tax system free of tax expenditures for comparison—is that it would take us back to the discussion of what a normative baseline should be or, more specifically, what

89 Fleming & Peroni, *Reinvigorating Tax Expenditure Analysis*, *supra* note 2, at 469–70.

constitutes the normative and most efficient tax system. This is exactly the discussion Weisbach and Nussim wanted to avoid.[90]

One important conclusion from the above is that tax expenditures have an *overhead* cost, which the tax system *accrues* just by having them in it. That cost is in the form of a reduction in the system's efficacy and is the result of the several unique characteristics of tax expenditures. First, tax expenditures are by nature inequitable, especially if in the form of deductions, where tax expenditures are more valuable to high-income earners than to low-income earners. In many cases, these inequitable provisions escaped real scrutiny when first enacted and remain part of the Code only because repealing them might be too complicated (although they would not have been enacted were they properly considered in the first place).[91] In that sense, tax expenditures are characterized as "being there to stay there," hiding in plain sight with other structural tax features of the Code. To that extent, it is also difficult to keep tax expenditures within their "proper" bounds, and they are often being used by taxpayers to shelter income. Take as an example the recently enacted twenty percent pass-through deduction under Section 199A. Although the deduction's declared goal was mainly to benefit small and medium-sized businesses (by limiting it to taxpayers with taxable income lower than the threshold and explicitly excluding certain lines of business, such as the performance of services in the fields of health, law, athletics, and art), nevertheless some excluded taxpayers planned to claim the deduction by "cracking apart" otherwise ineligible excluded activities' or services' revenue streams from eligible revenue streams, such that as much income as possible would qualify for the deduction.[92] As a result, the Treasury had to issue proposed regulations directly aimed at restricting that "cracking" strategy (as well as other tax-planning strategies). Obviously, such an effort has a significant cost beyond the general costs of running

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90 *Id.*

91 *See* SURREY, PATHWAYS, *supra* note 2, at 133–34.

92 *See* David Kamin et al., *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation*, 103 MINN. L. REV. 1439, 1465–66 (2019). Law firms could presumably use the "cracking" strategy to claim the deduction. Partners in a law firm would set up a separate real estate investment trust (REIT). *Id.* at 1466. The REIT, which is eligible for the deduction, "would hold all of the law firm's real estate assets. Then the REIT could charge the law firm the maximum rent that could plausibly be justified for use of [real estate] assets . . . in order to transform some of the law firm's legal service income into rental income earned by the REIT [and a deduction to the law firm]. This rental income would then qualify for the pass-through deduction." *Id.*

the IRS, such as promulgating a dedicated set of regulations and ensuring taxpayers' compliance (i.e., through audits). As a result of greater incentives for taxpayers to "cheat" the system (which could be the result of certain tax expenditures), such cost is increased. Notably, even the regulation seems to leave the door open for a number of tax-planning maneuvers that will provide the benefits of the pass-through deduction to unintended taxpayers.[93]

Second, due to their upside-down nature (when in the form of deductions) and their application to a limited group of taxpayers, tax expenditures are, in fact, incentives that are provided in a form that directly contradicts Congress' initial intention when it established a *progressive* tax system. As such, tax expenditures are harmful to the equity and structure of the tax system, as explicitly set by Congress (since no tax expenditures are enacted with the principal purpose of further benefiting the rich).[94]

Third, tax expenditures, by dividing the consideration and the administration of government spending programs, confuse and complicate the tax legislative process. Generally, the House Ways and Means Committee and the Senate Finance Committee govern tax legislation.[95] These committees would normally not consider the substantive areas involved in most tax expenditures; such provisions charge them with handling matters that are outside of their scope of responsibilities, impeding the decentralization of the legislative process.[96] Similarly, additional costs are imposed on the already underfunded IRS,[97] the expertise of which does not extend to these other areas.[98]

Fourth, tax expenditures have a negative influence on the notion of fiscal citizenship to the extent the latter is linked to taxpaying rather than tax return filing. Larry Zelenak suggests that perception matters in this case and that simply not labeling transfer programs as part of the tax system (and thus increasing the number of *taxpaying* citizens, although they receive net transfers from the federal government), could have a great

93 *Id.* at 1463.

94 *See* SURREY, PATHWAYS, *supra* note 2, at 137.

95 *See* Tax Analysts, *Reforming Tax Expenditures*, YOUTUBE, at 09:35–10:14 (Apr. 14, 2021), https://www.youtube.com/watch?v=-pRW-sxCa2I [https://perma.cc/TT4G-UQ42].

96 *See* SURREY, PATHWAYS, *supra* note 2, at 142.

97 Emily Horton, *Underfunded IRS Continues to Audit Less*, CTR. ON BUDGET & POL'Y PRIORITIES (Apr. 18, 2018, 10:30 AM), https://www.cbpp.org/blog/underfunded-irs-continues-to-audit-less [https://perma.cc/R24Q-HH7F].

98 SURREY, PATHWAYS, *supra* note 2, at 143. As discussed, this in turn also creates the problem of a lack coordination between tax expenditures and other substantive programs.

positive influence on the social contract between the people, the state, and the tax system as a whole.[99]

Fifth, tax expenditures do not improve the tax system. To the contrary, they are likely to damage it significantly by making the tax system, which is already complicated as is, even more complex. Tax expenditures, mixed with the tax code's structural provisions, lead to confusion and the "blurring of concepts and objectives."[100]

In economic terms, one might try to describe this as the rule of "*diminishing* costs," where the marginal cost of each tax expenditure is *reducing*, rather than *increasing*.[101] This is, in essence, the most dangerous element of tax expenditures: the more we have in our tax code, the cheaper (and more tempting) it would be to implement an additional one (rather than trying to remove them entirely). As Surrey put it:

> It is no answer to say, as do some cynics, that since the tax system today has so many special provisions there should be no objection, when worthwhile programs are involved, to adding still more to the heap. Rather, the effort should persist to contract those existing special provisions that are improper and wasteful. We know from long experience that provisions can be enshrined in tax laws far past their usefulness and long after their defects become clear. We should not, when alternatives are present, freeze in more special provisions, especially since programs in the complex areas of social policy to which many tax incentive proposals relate are essentially experimental in nature.[102]

To better understand the "overhead" cost on the tax system that is associated with tax expenditures, it might be wise to look at the earned income tax credit (EITC) as an example (in addition to the aforementioned 199A deduction). In essence, the EITC is a welfare system that is integrated into the tax system. Weisbach and Nussim would like us to simply "compare the benefits of having two programs and two administrative agencies . . . to the benefits of having a single agency administering both programs," but they failed to consider the

99 Lawrence Zelenak, *The American Families Plan and the Future of the Mass Income Tax*, 172 TAX NOTES 1277, 1279–80, 1283–85 (2021).

100 SURREY, PATHWAYS, *supra* note 2, at 146.

101 *See* Chuck Marr & Brian Highsmith, *Reforming Tax Expenditures Can Reduce Deficits While Making the Tax Code More Efficient and Equitable*, CTR. ON BUDGET & POL'Y PRIORITIES (Apr. 15, 2011), https://www.cbpp.org/research/reforming-tax-expenditures-can-reduce-deficits-while-making-the-tax-code-more-efficient [https://perma.cc/2746-X955].

102 *Id.*

overall effect on the tax system resulting from the use of the system for purposes other than distribution.[103] Arguably, the more the tax system is used to administer other programs, the more lucrative it is to deceive it. In the EITC context, taxpayers are now incentivized to cheat the system so that they are eligible for the credit. This could be done by differing deductions so that a taxpayer's taxable income would be just above the threshold to make them eligible for the refundable credit.[104] Weisbach and Nussim would argue that the same incentives to cheat exist even if a separate governmental agency administers the program, and that similar audit and enforcement costs would be imposed. I do not believe this to be true or that the costs are comparable. Deceiving the tax system might have unpredictable costs, especially if and when the system is used to implement more spending programs. Deceiving a certain welfare program would have a more limited effect. Furthermore, the integrity of the tax system is a key element of a functioning government and is relevant to a much larger part of the population—all taxpayers, rather than only those who use the welfare program—and, as such, any impairment of the system's integrity might have an unpredictable and unmeasurable result.

Weisbach and Nussim's approach seems to be based entirely on weighing the benefits of governmental simplification and coordination from administering a certain program through the tax system, against the benefits of specialization that are the result of administering the same program through a dedicated, separated unit.[105] By doing so, Weisbach and Nussim ignore the "overhead" cost with respect to the other tax expenditures in the tax system, which would otherwise be ultimately focused on revenue collection.[106]

Separately, Weisbach and Nussim argue that their approach would save time since, under their cost-benefit approach, one can simply skip over the question of whether a certain tax provision is or is not an element of a normative tax system and move directly to deciding whether the tax system is the best delivery

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103 *See* Weisbach & Nussim, *supra* note 4, at 957.

104 *See* James Edward Maule, *No Thanks, Uncle Sam, You Can Keep Your Tax Break*, 31 SETON HALL LEGIS. J. 81, 88–89 (2006).

105 *See* Weisbach & Nussim, *supra* note 4, at 983–88.

106 *See generally* Fleming & Peroni, *Reinvigorating Tax Expenditure Analysis*, *supra* note 2, at 471.

mechanism.[107] Nonetheless, the determination of whether the tax system is indeed the best delivery system in and of itself requires a distinct, time-consuming examination, as noted above. It might be difficult to determine whether a delivery through the tax system is more cost-efficient than delivery through a separate government unit. Advocates of tax incentives and subsidies would likely still engage in a heated debate regarding whether the provision at issue is most fitted to be administered through the tax system, rather than through any other government unit.[108] Currently, those advocates focus on the first question of the tax expenditures analysis, specifically whether the provision in question is part of the normative baseline. They would now shift their attention to argue that it is more efficient to administer the program through the tax system, but there is no reason to believe that such a debate would be any shorter or conserve time.[109]

In addition, one of the key elements of the current tax expenditures analysis is that in considering whether to administer a certain spending program through the tax system or through a separate government agency, one must first determine (1) whether it is even possible to recast the tax expenditure as an analogous direct spending program and (2) whether such a direct spending program is *desirable*.[110]

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107 *Id.* at 468–69, 475–76.

108 *See id.* at 480.

109 *See id.* at 475–76.

110 *Id.* at 473–74. Fleming and Peroni provide the Section 103 exemption from interest on state and local government bonds as an example:

> [T]he direct expenditure analogue of the section 103 exemption for interest . . . would be a program of cash payments divided between governmental borrowers and wealthy individual investors with the portion received by the investors being windfalls that cause no reduction in the interest costs of the governmental borrowers. Not only would this be wasteful, it would also be objectionable from a distributional standpoint because the windfall payments would go overwhelmingly to high-income taxpayers. A direct expenditure program displaying these characteristics of waste and inequity would have little (hopefully no) chance of being enacted. With these flaws exposed by TEA's mandatory recasting of the section 103 exemption into a direct expenditure program, the next question would be whether the simplification and coordination gains that might result from putting the program into the tax system—and this is the focus of Weisbach's and Nussim's analysis—would be large enough to transform an appalling direct expenditure program into an acceptable tax provision. The answer is likely no but Weisbach and Nussim seem to regard the inquiry as unimportant. Instead, they apparently view the issue of simplification and coordination gains as determinative when we believe that it should be only one factor in a broader analysis.

Id. at 474 (footnotes omitted).

Surrey explained that, given a congressional decision to provide assistance, the relevant question would be "when should it be furnished through a direct expenditure program and when through a special tax program?"[111] Presumably, such an analysis would also have to be conducted under Weisbach and Nussim's suggestion, just at different stages of the legislative process.

Finally, the tax expenditures analysis is important in identifying taxpayers' real "economic" income. Stated otherwise, when the analysis characterizes a tax expenditure as such, it treats the expenditure as an additional tax liability paid by the taxpayers and then returned to them in the form of a check from the government. One can think of this as a two-step process. First, taxpayers are deemed to have computed their tax liability by applying the statutory rates to their *economic income*. Each taxpayer's "economic tax check" then forwards the resulting tax liability to the government. Then the government remits to the taxpayer a check for the relevant subsidies for which the taxpayer qualifies. This "tax subsidy check" is the result of provisions in the Code that are tax expenditures.[112] The "economic" income is solely the result of the taxpayer's wealth, and in order to isolate it from the taxable income, we need to be able to identify the various applicable tax expenditures.[113]

Determining the taxpayer's economic income is important so that economists can examine the inequalities that are grounded in the structure of the tax system rather than in its expenditure features.[114] McDaniel further explained that a failure to differentiate the tax component from the spending component of the tax system has led to practical difficulties, such as classifying *economic* inequities that are the result of tax spending as economic inequities that are in the structural elements of the tax system.[115] That is not true. Only if, after restoring tax expenditures to the tax base, taxpayers with the same amounts of economic income do not pay the same amounts of economic tax, then this signals possible defects in the structural elements of the tax system. Surrey himself had a similar notion in mind:

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111 SURREY, PATHWAYS, *supra* note 2, at 129, 180–81; *see also* SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 26.

112 Paul R. McDaniel, *Identification of the "Tax" in "Effective Tax Rates," "Tax Reform" and "Tax Equity,"* 38 NAT'L TAX J. 273, 273 (1985).

113 *See id.* at 273–74.

114 *See id.* at 277–78.

115 *See id.* at 277. Of course, the spending program by itself (in the form of credit, deduction, etc.) "may be an unwise, ineffective, or inefficient subsidy." *Id.*

> The tax expenditure concept in essence considers these special provisions as composed of two elements: the imputed tax payment that would have been made in the absence of the special provision (all else remaining the same) and the simultaneous expenditure of that payment as a direct grant to the person benefited by the special provision. The exemption, deduction, or other type of tax benefit is thus seen as a combined process of assumed payment of the proper tax by the taxpayer involved and an appropriation by the Government of an expenditure made to that taxpayer in the amount of the reduction in his actual tax payment from the assumed payment — that is, the tax reduction provided by the special provision.[116]

Obviously, in real life, the process of sending a check (the "economic tax check") and receiving a check (the "tax subsidy check") to and from the government is collapsed into a single step by which the taxpayer nets the two checks in the process of completing an income tax return and paying her remaining tax liability or claiming a refund. The tax expenditures analysis is crucial for determining economic income in order to discover real defects in the normative tax structure.[117] As such, the current tax expenditures analysis is an important tool to identify economic income and a tool that could be lost if Weisbach and Nussim's approach were to be adopted.

III. TAX EXPENDITURES ANALYSIS AND HORIZONTAL EQUITY

Tax expenditures are not geographically limited to the United States. The concept of the tax expenditure analysis attracted international attention shortly after its presentation in the United States. In 1976 and 1977, the International Fiscal Association and the International Institute of Public Finance raised the importance of the concept in their annual meetings, and shortly thereafter, a number of countries, including Canada and the United Kingdom, adopted it.[118] Some regard the recent "state aid" cases as an attempt by the European Commission to apply normative tax rules on member states, which, in a sense, is similar to the tax expenditures analysis.[119]

A survey in Germany, Italy, and Israel showed that in those countries, tax expenditures are evaluated against a constitutional

116 SURREY, PATHWAYS, *supra* note 2, at 6–7.

117 *See* McDaniel, *supra* note 112, at 276.

118 SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 2.

119 For a thorough discussion on such an attempt and the related problems associated with it, see Ruth Mason, *Identifying Illegal Subsidies*, 69 AM. U. L. REV. 479 (2019).

norm of equality.[120] There, tax expenditures are conceptualized as unequal tax treatments of equal taxpayers that are disproportionate to their aims and have no rational basis.[121] This experience of evaluating tax expenditures against a norm of equality is helpful because it is unnecessary to measure tax expenditures against a theoretical baseline. Instead, each tax expenditure is a line drawn to distinguish between taxpayers and can be assessed on its own terms by comparing the treatment of different groups of taxpayers against a background norm of equal protection. In fact, and as will be discussed below, I believe this was Surrey's original intention with respect to the tax expenditure analysis. With respect to any new and existing tax expenditure that deviates from the principle of horizontal equity, Congress should consider whether its purpose justifies such deviation. More importantly, Congress should determine whether such deviation is proportional, namely whether it causes the least damage to horizontal equity. This type of analysis could be a new process for JCT staff, in addition to the determination of the costs of tax expenditures in foregone revenue.[122]

Similarly, tax expenditures in the United States should be analyzed as to whether they achieve *fairness* in the tax system. The analysis should identify departures from horizontal equity, such as the idea that taxpayers with equal abilities to pay should bear equal tax burdens.[123] Since the United States does not have "constitutionalized" horizontal tax equity principles as some other countries do, a theoretical comprehensive income based on the Haig-Simons definition of income serves as a second-best solution to guarantee fairness.[124] Such a tax expenditure analysis

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120 *See generally* Reuven Avi-Yonah, *Should U.S. Tax Law Be Constitutionalized? Centennial Reflections on Eisner v. Macomber (1920)*, 16 DUKE J. CONST. L. & PUB. POL'Y 65, 70–81 (2021) (discussing the history and the evolution of how tax expenditures are viewed in these countries).

121 *See generally id.* at 69.

122 *Id.* at 88 ("A report along these lines may persuade members of Congress to stop listening to lobbyists and cut back on some of the more egregious tax expenditures.").

123 *See* Fleming & Peroni, *Reinvigorating Tax Expenditure Analysis*, *supra* note 2, at 456–58. The ability-to-pay concept in and by itself is regarded as a longstanding concept in the U.S. federal tax system. *See id.* at 456.

124 SURREY, PATHWAYS, *supra* note 2, at 31 ("The prime objective of income tax reform is to achieve greater fairness in the federal tax system and thereby restore the confidence of the public in that system. This confidence has been seriously diminished. What we know and read about public attitudes indicates a lack of trust in the tax system, a belief that there are privileged groups escaping taxes while the average person must pay his tax bills. This view of the tax system, and in particular the income tax, is — unfortunately — justified by the actual facts.").

could resemble the Treasury's general explanations of the administration's fiscal year revenue proposals report, which is published yearly to discuss the administration's newly proposed revenue provisions.[125]

Surrey was specifically concerned with tax expenditures because he believed that they took advantage of the tax system's vulnerability:

> The tax expenditures tumble into the law without supporting studies, being propelled instead by cliches, debating points, and scraps of data and tables that are passed off as serious evidence. A tax system that is so vulnerable to this injection of extraneous, costly, and ill-considered expenditure programs is in a precarious state from the standpoint of the basic tax goals of providing adequate revenues and maintaining tax equity. It is therefore imperative that the process and substance of these tax expenditures be reexamined.[126]

Surrey's end goal was grounded in principles of fairness and horizontal equity. As the economist Alvin Rabushka (of the flat tax) said, the federal tax system had become "the most discriminatory body of law in a country that has tried to exterminate discrimination everywhere else in society."[127] For Surrey, the fairness of a tax system hinges on how well it achieves horizontal and vertical equity.[128]

Horizontal equity means that the tax burden on similarly situated taxpayers should be equal, while vertical equity means that taxpayers with different incomes should pay different amounts of tax proportional to the differences in their incomes.[129] Accordingly, the dominant goal of a tax reform should be that the tax system adhere to principles of fairness and horizontal equity.[130] Surrey noted that the principle of horizontal equity is the backbone of the income tax and is an "aspect inherent" in the Haig-Simons definition:

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125 *Revenue Proposals*, TREASURY.GOV, https://home.treasury.gov/policy-issues/tax-policy/revenue-proposals [https://perma.cc/YZ7K-A9GT] (last visited Sep. 28, 2024).

126 SURREY, PATHWAYS, *supra* note 2, at 6.

127 Ryan J. Donmoyer, *Flat Tax Strategy: The IRS as Poster Boy for Tax Reform*, 77 TAX NOTES 1305, 1305 (1997); *see, e.g.*, Jesse Drucker & Eric Lipton, *How a Trump Tax Break to Help Poor Communities Became a Windfall for the Rich*, N.Y. TIMES (Sep. 27, 2020), https://www.nytimes.com/2019/08/31/business/tax-opportunity-zones.html [https://perma.cc/3336-JL4T].

128 Martin J. McMahon Jr., *2018 Erwin N. Griswold Lecture Before the American College of Tax Counsel: Tax Policy Elegy*, 71 TAX LAW. 421, 424 (2018).

129 Fleming & Peroni, *A Critique of the "New Paradigm," supra* note 2, at 158.

130 *See* SURREY, PATHWAYS, *supra* note 2, at 31.

> To a very large degree the analysis under the income tax flowed from the concept of horizontal equity under the tenets of that tax, an aspect inherent in the Haig-Simons definition of income. Such a concept is clearly relevant to taxes that are applied in terms of an individual's total position, as is the normative model of an individual income tax.[131]

The difficulty is the determination of who is "similarly situated." Ideally, "two taxpayers with equal incomes, *however derived*, should pay equal income taxes."[132] However, tax expenditures make things much more complicated. For example, is a working taxpayer who earns $100 of wage compensation "similarly situated" to a taxpayer who receives $100 of welfare benefits? Would a taxpayer who consumes $100 of food be considered "similarly situated" to a taxpayer who consumes $100 of iPhone games? Answering these questions requires a discussion of social policies, and the tax expenditure analysis should not avoid such a discussion but rather provide the basis for discussing it. Take, for example, the biggest item in the current tax expenditure analysis: the exclusion of employer contributions for medical insurance premiums. Under current law, employer-paid health insurance premiums and other medical expenses (including long-term care) are not included in an employee's gross income even though the employer can deduct these as a business expense.[133] This exclusion is the largest tax expenditure in the federal budget, costing over $3.44 trillion from 2024 to 2033.[134]

This exclusion also means that employees who work for an employer that provides such benefits receive a tax subsidy by not having to include the employer's contribution in their income. On the other hand, self-employed individuals and employees who do not receive health benefits from their employer generally must pay for health insurance and medical care—with limited tax benefits offered to them.[135] Since this tax expenditure is in the form of an exclusion, it is, in effect, regressive since tax rates rise with income. Thus, high-income taxpayers benefit most from the

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131 *Id.* at 26–27.

132 McMahon, *supra* note 128, at 424 (emphasis added).

133 *See* I.R.C. § 106(a).

134 TAX EXPENDITURES REPORT, *supra* note 3, at 33 tbl.3.

135 *See* GARY GUENTHER, CONG. RSCH. SERV., RL33311, FEDERAL TAX TREATMENT OF HEALTH INSURANCE EXPENDITURES BY SELF-EMPLOYED: CURRENT LAW AND ISSUES FOR CONGRESS 1–2, 5–7 (2009).

exclusion.[136] These are the types of inequalities that a horizontal equity-focused tax expenditure analysis would address.

Another example is the deductibility of home mortgage interest and local property.[137] Notwithstanding the general rule that expenses incurred in relation to untaxed investment, such as the investment of purchasing an owner-occupied home, are not deductible, current law generally allows an owner or occupant to deduct mortgage interest paid on their primary residence.[138] Additionally, an owner or occupant may take a deduction for local property taxes paid on real property (the 2017 tax reform capped the deductibility of any taxes paid in any taxable year, including for local property taxes, to $10,000).[139] The combined cost of these tax expenditures is roughly $1.28 trillion from 2024 to 2033.[140]

These deductions create an unjustified distinction between homeowners who can claim them and renters who cannot. Homeowners also benefit from the exclusion of the imputed income from home ownership (worth $1.95 trillion from 2024 to 2033).[141] The alleged purpose of these deductions is to promote home ownership; however, empirical research shows that these deductions may have a larger effect on the *size* of homes purchased rather than on the decision to become a homeowner.[142] In other words, these deductions are inefficient and ineffective at achieving their stated purpose, as they disproportionately benefit wealthier individuals in purchasing more expensive property. Renters do not enjoy similar tax benefits. Permitting deductions only for mortgaged homeowners is unfair to renters and is not predicated on a rational distinction between the two consumer groups. Whether one is paying a mortgage or paying rent, they are paying for housing all the same. Congress should allow similar deductions for renters or repeal such deductions to comply with horizontal equity.[143]

Some argue that this tax expenditure is justified based on some non-tax bases, such as supporting the existing system of employer-provided insurance. Empirical literature, however,

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136 *See id.* at 5.

137 *See* I.R.C. § 163(h)(3).

138 *Id.*

139 *See* I.R.C. § 164(a).

140 *See* TAX EXPENDITURES REPORT, *supra* note 3, at 24 tbl.1.

141 *Id.*

142 *See* MARK P. KEIGHTLEY, CONG. RSCH. SERV., R41596, THE MORTGAGE INTEREST AND PROPERTY TAX DEDUCTIONS: ANALYSIS AND OPTIONS 14–15 (2014).

143 Avi-Yonah, *supra* note 121, at 121–22.

questions whether this tax expenditure is necessary to maintain a functional health system in the United States.[144] Congress should "repeal the expenditure and include premiums as income or let people who do not receive such employer-sponsored benefits create equivalent tax-free health savings accounts" to achieve horizontal equity.[145] A tax expenditure analysis could raise the relevant competing social policies and values related to this tax expenditure that will allow Congress, and the public, to make that decision.[146]

Basing the tax expenditures analysis on fairness and horizontal equity considerations would shift the discussion from secondary questions of what the normative base is or what existing law says on a certain issue, to the primary question of what is fair and right. Such discussion should be much more accessible to the general public and would not necessarily require prior tax knowledge. This, in turn, will make the analysis more

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144 *See id.* at 118 ("[I]t is unlikely that medium and large firms will wholesale exit the employer-provided insurance [even if this tax expenditure were to be eliminated] because of other non-tax benefits, such as the negotiating power obtained with group size, benefits of group purchase, and ease of plan choice and administration. Second, when the scale of the non-group market is dramatically increased by individuals leaving employer-provided insurance, the non-group market might function better and provide lower prices. Besides, the promotion of the employer-sponsored insurance system is not necessarily a benefit to society because it distorts the labor market by limiting job-to-job mobility and warping retirement decisions."); *see also* Jonathan Gruber & Brigitte C. Madrian, *Health Insurance, Labor Supply, and Job Mobility: A Critical Review of the Literature* 7 (Nat'l Bureau of Econ. Rsch., Working Paper No. 8817, 2002) (arguing that the economic effects of this tax expenditure are detrimental to the job market because many employees do not leave their jobs due to the availability of health insurance, even though they would prefer otherwise).

145 Avi-Yonah, *supra* note 121, at 119.

146 Scholars have suggested that any proposed change in the tax system in general, whether or not such change pertains to a tax expenditure provision, should be viewed in the prism of fairness and equity considerations. In their paper, Alice Abreu and Richard Greenstein claim that the tax system in its entirety, not just tax expenditures, should be examined based on social values and policies:

> It should be replaced with a view that acknowledges that social values are necessarily intrinsic to the tax system. The reason is not that tax expenditures *qua* tax expenditures are a proper part of the tax system and may offer the best or most efficient delivery of the intended benefit, as Dr. Joseph Pechman and some noted scholars have argued. We take no position on the ongoing debate between scholars who embrace the concept of tax expenditures and those who urge its abandonment on pragmatic or efficiency grounds. We argue instead that the bifurcated view of the tax system should be replaced with a unified view that acknowledges the influence of social values and the promotion of social policies throughout the tax system, and not only through tax expenditures.

Alice G. Abreu & Richard K. Greenstein, *Rebranding Tax / Increasing Diversity*, 96 DENV. L. REV. 1, 18 (2018).

effective as Congress would be concerned with enacting tax benefits that are equitable since the public is informed—and efficient—as the time spent on deliberation would be dedicated to on-point, important questions of fairness.

IV. CONCLUSION

Tax expenditures are "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[147] The first Assistant Secretary for Tax Policy, Stanley S. Surrey, coined the concept in the late 1960s, and it was codified by the Congressional Budget and Impoundment Control Act of 1974, which requires that a list of tax expenditures be included in the U.S. budget.[148] For practical reasons, the concept relies on the Haig-Simons definition of income as the baseline (while acknowledging that not all deviations from Haig-Simons are treated as tax expenditures), but that does not seem to be Surrey's original intent.

This paper is an attempt to bring the debate on tax expenditures back to where it started. Surrey was not mainly focused on which definition of the income tax should be used as the baseline against which tax expenditures are measured. Rather, he cared about the way tax expenditures distinguish between taxpayers based on criteria other than ability-to-pay, resulting in unfairness and the impairment of horizontal equity. We should share those same concerns.

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147 I.R.C. § 106(a).

148 William McBride, *A Brief History of Tax Expenditures*, TAX FOUND. (Aug. 22, 2013), https://taxfoundation.org/research/all/federal/brief-history-tax-expenditures/ [https://perma.cc/8PTK-98AZ].