A Solution to The Problem of Defining a Tax Expenditure

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The popular definition of the term "tax expenditure" depends on the ability of tax specialists to identify departures from the normal structure of the income tax. That definition has many critics, since disputes over the normative features of the income tax are central to many tax policy debates. This article proposes a new methodology for distinguishing tax expenditures from other tax provisions. The author suggests that a series of practical definitions, each designed to accomplish one specified purpose for identifying tax expenditures, can cumulatively achieve all of those purposes.

Introduction

In 1968 the Treasury Department published a remarkable document containing a long list of purported tax subsidies and estimates of their costs in forgone federal revenues.[1] This "tax expenditure budget" has enjoyed enormous political success. It has induced Congress to alter its procedures for scrutinizing tax subsidies, now called tax expenditures,[2] and it has focused public attention on the indefensible consequences that often result when Congress uses special deductions, exemptions and other

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[1] Sec'y of the Treas. Ann. Rep. on the State of the Finances, Fiscal Year 1968, 326-40.

[2] For an excellent discussion of the current and projected uses of the tax expenditure budget, see Surrey & McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C. L. Rev. 235 (1979) [hereinafter cited as *Current Developments*]. *See also* Surrey & McDaniel, *The Tax Expenditure Concept and the Legislative Process*, in The Economics of Taxation (Aaron & Boskin, eds., 1980).

tax mechanisms to achieve its spending goals.[3] At the same time, it has generated a voluminous, often contentious literature, most of which addresses the subject matter of this article—the problem of defining a tax expenditure.[4]

The progenitors of the tax expenditure budget identify as a tax expenditure any provision of the Internal Revenue Code that departs from what they call the "normal" structure of the income tax.[5] They have developed a series of ad hoc tests for dis-

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[3] *See Lopsided Loopholes,* People & Taxes, No. 4, April 1980, at 2-5 for illustrations of the apparent unfairness of "spending programs" constructed from existing provisions of the Internal Revenue Code. The article states, for example, that the deduction for charitable gifts, often defended as a subsidy for private philanthropy, dispenses 47% of its benefits to the 3% of the taxpayers with incomes over $50,000. Whether or not the deduction for charitable gifts is "properly" classified as a tax expenditure is a subject of some debate among tax specialists. For the argument that the deduction is a tax expenditure, see McDaniel, *Study of Federal Matching Grants for Charitable Contributions,* in U.S. COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, DEP'T OF TREAS. 4 RESEARCH PAPERS TAXES 2417-532 (1977). For a contrary view, see Andrews, *Personal Deductions in an Ideal Income Tax,* 86 HARV. L. REV. 309 (1972). For a novel defense of the charitable deduction that apparently accepts the tax expenditure classification, see Brannon, *Tax Expenditures and Income Distribution: A Theoretical Analysis of the Upside-Down Subsidy Argument,* in THE ECONOMICS OF TAXATION, (Aaron & Boskin, eds., 1980).

[4] For the best of the early exchanges on the definition of a tax expenditure see Bittker, *Accounting for Federal Tax Subsidies in the National Budget,* 22 NAT'L TAX J. 244 (1971) [hereinafter cited as *Accounting for Federal Tax Subsidies*]; Surrey & Hellmuth, *The Tax Expenditure Budget—Response to Professor Bittker,* 22 NAT'L TAX J. 528 (1971); Bittker, *The Tax Expenditure Budget—Response to Professors Surrey and Hellmuth,* 22 NAT'L TAX J. 538 (1971). For an annotated bibliography, see U.S. ACCOUNTING OFFICE, TAX EXPENDITURES: A PRIMER 64-76 (1979).

A similar definitional controversy arose when the Canadian government announced its interest in developing a tax expenditure budget. *See* R. SMITH, TAX EXPENDITURES: AN EXAMINATION OF TAX INCENTIVES AND TAX PREFERENCES IN THE CANADIAN FEDERAL INCOME TAX SYSTEM (1979). For a lively debate on the utility of a tax expenditure budget in Canada, see *Tax Expenditure Analysis,* 1 CANADIAN TAXATION, No. 2 (Summer 1979); Surrey, *The Concept and Its Uses,* 3-14; Le Pan, *Some Conceptual Problems,* 15-18; Smith, *Definitional Problems,* 19-22; McGillivray, *The Canadian Context,* 23-25; *A Reply by Professor Surrey and Discussion,* 26-28.

[5] Commentators use "normal," "normative," "prescriptive" and "ideal" to describe that part of the tax system designed to raise revenue in a fair and efficient manner. The word "normal" is favored by protagonists of the tax expenditure concept, perhaps in the belief that it carries less of a requirement of theoretical purity. *See* OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSIS

tinguishing normal rules from special rules.[6] Critics forcefully argue that the list of tax expenditures yielded by this methodology has no serious claim of legitimacy. They insist that the proponents of any list of tax expenditures must set forth and defend the principles of taxation which define the norm.[7] Because of a well-founded fear of being drawn into an inconclusive debate over the proper organizing principles of an income tax, the tax expenditure champions have steadfastly refused to elaborate

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G: TAX EXPENDITURES, SPECIAL ANALYSES, BUDGET OF THE UNITED STATES GOVERNMENT 1980, at 184 (1979) [hereinafter cited as BUDGET OF THE UNITED STATES GOVERNMENT.] "Normative" is a favorite term of the economists, though Professors Surrey and McDaniel use normal and normative interchangeably. *See, e.g.*, Surrey & McDaniel, *The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 B. C. INDUS. & COMM. L. REV. 679, 683 (1976). The nuances in meaning of these words is unimportant in the context of this article.

[6] *See, Current Developments, supra* note 2, at 227-28. *See also* BUDGET OF THE UNITED STATES GOVERNMENT, *supra* note 5 317-19; S. SURREY, PATHWAYS TO TAX REFORM 15-24 (1973). These ad hoc tests generally include in the normal tax structure the rules that establish the tax rates, specify who is taxable on particular income items and define the persons and entities subject to tax. They also include the traditional exclusions for most nonmarket or imputed income, unrealized capital gains and some other "esoteric" economic benefits. These ad hoc tests treat as special rules most exclusions from income that depart from the Haig-Simons definition of income. They treat almost all deductions that are not justifiable on business grounds as special rules, even if the deduction arguably conforms to Haig-Simons. Problems in classifying particular code provisions have generally been resolved by reference to the real or assumed intent of Congress in adopting or continuing those provisions. *See* Surrey, *The Concept and Its Uses, supra* note 4, at 4.

[7] Professor Bittker asserts that "[w]hat is needed is not an ad hoc list of tax provisions, but a generally accepted model, or set of principles, enabling us to decide with reasonable assurance which income tax provisions are departures from the model. . .," *Accounting for Federal Tax Subsidies, supra* note 4, at 247. Professors Surrey and McDaniel accept the need for prescriptive rules but contend that these were provided by the drafters of the tax expenditure budget. Surrey & McDaniel, *supra* note 5, at 685 n.23. Professor Andrews, disagreeing with what he perceives to be the normative model of the proponents of the tax expenditure concept, states:

> I agree in the end it is useful to speak in terms of an ideal income tax and to evaluate departures from the ideal as tax expenditures whose purposes, not being reflected in the ideal, must be extraneous to the tax. But the ideal for this purpose must be carefully shaped and refined to reflect the intrinsic objectives of the tax.

Andrews, *supra* note 3, at 312.

their vision of the ideal tax structure.[8] Instead, they have defended their methodology on the practical ground that it has produced a list of tax expenditures acceptable to a majority of tax policy makers in Congress and the Treasury and to many other tax specialists.[9] Needless to say, tax specialists who object to that list have found this defense unpersuasive.

This article proposes a methodology for identifying tax expenditures which bypasses entirely the problem of obtaining consensus on the features of the normal tax structure. This methodology requires the identification of tax expenditures only for limited purposes and thus avoids the complex theoretical problem of developing a general, all-purpose definition of a tax expenditure. After introducing the methodology through a "horticultural metaphor," the article applies it to show how Congress could generate lists of tax rules that it should treat as the functional equivalent of spending programs for purposes of its legislative procedures. Finally, this article demonstrates the practical

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[8] Professors Surrey and Hellmuth stated:

> [The Treasury] was fully aware of the blood, sweat and tears developed in the debate over a comprehensive income tax base and did not see that as the appropriate approach. Thus, Professor Bittker puts up a straw man which he proceeds to beat without mercy—and a Bittker beating is indeed an awesome sight. This part of [Bittker's] article is in one sense a welcome vindication of the wisdom of not desiring to be pulled into the debate over a comprehensive tax base.

Surrey & Hellmuth, *supra* note 4, at 531 (footnotes omitted).

[9] Professor Surrey makes this point forcefully:

> The application of tax expenditure analysis to separate an income tax into its two elements clearly requires a definitional approach which determines the contours of the normative tax. *But the task of finding that definitional standard is not really a difficult one.* . . . [T]he tax expenditure budget developed by tax technicians in the United States, though representing various agencies—Treasury, the President's Budget Office (OMB), the Congressional Budget Office, the Congressional Budget Committees, and the Staff for the Congressional Joint Committee on Taxation—have been remarkably consistent in their enumeration of the items to be placed in that budget. This consistency has been maintained despite the many legislative changes occurring since 1968. *The technicians . . . have been able to agree on the appropriate classifications of items as either tax expenditures or alterations in the normative structure.*

Surrey, *The Concept and Its Uses, supra* note 4, at 4 (footnotes omitted and emphasis added).

and theoretical advantages of utilizing the methodology in what has come to be called a "tax expenditure analysis."

I. The New Methodology[10]

Tax specialists believe that a good definition of the term "tax expenditure" must capture the essential meaning of the term. Thus they agree that the definition should unambiguously divide the class of all past, present and potential provisions of the Internal Revenue Code into two mutually exclusive subclasses—tax expenditures and normal tax rules. While defenders of the Treasury Department's definition claim that it accomplishes this task, critics attack the definition by accumulating examples of hard-to-classify tax code provisions.

The following section employs a beguilingly simple horticultural metaphor to introduce an alternative to the generally accepted methodology for identifying tax expenditures. The lesson of this metaphor is used to expose a potential solution to the problem of defining a tax expenditure. The utility of this new methodology is then tested in several exemplary situations.

A. The Fable of the Garden

There was a rich man who bought an old estate that contained a once fine flower garden now engulfed in weeds. He hired a talented gardener to cultivate the garden and remove the weeds. Before undertaking his charge the gardener asked the owner to please define for him what constituted a weed, so that he would be sure to do what the owner wanted. "A weed," said the owner, "is a plant that has no proper place in a flower garden."

The gardener did not feel fully enlightened with this definition, but he nevertheless went to work and removed many, many plants without any problems of classification. After some days the owner visited the garden and saw that great improvements had been made. The gardener then asked what he should do about several types of plants that had foliage he found pleasing but which he suspected might be weeds. The owner suggested that the gardener take samples to experts at a nearby botanical

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[10] For an introduction to and bibliography of the philosophical literature on definition, see Encyclopedia of Philosophy 314. *See also* Dewey & Bentley, *Definition,* 44 J. Philosophy 281 (1947). For a law-related discussion, see Hart, *Definition and Theory in Jurisprudence,* 70 L. Q. Rev. 37-60 (1954).

garden for an opinion. The opinion was duly sought, and the gardener learned that the experts classified all of the flora in question as weeds. He began removing them at once.

Some days later, the owner again visited the garden. He saw the gardener about to dig out a row of dandelions that showed signs of having once been cultivated with care. "Stop!" the owner ordered. "Why would you destroy the dandelions when the blooms last so long and the greens are so delicious?" The gardener explained that all of the experts he had consulted had been in agreement that the dandelions had no proper place in a flower garden. "They have a place in my flower garden," the owner announced, and so they did.

B. The Lesson of the Fable

The problem of giving content to the definition of a weed—"a plant that has no proper place in a flower garden"—has some similarities to the problem of defining a tax expenditure. One obstacle to defining a weed is that part of what makes a weed a weed is its relationship to things external to it. Almost any plant may be considered a weed under particular circumstances. The water hyacinth, honored in Japan, is the curse of the Congo. Violets, mint, bonesets and morning glories are a pleasure to some and a pain to others. Even the rhododendron, whose blooms and foliage are universally acclaimed, is sometimes considered a weed in the Irish countryside. Similarly, whether a tax rule is "normal" or "special" often depends on its relationship to other rules. For example, a deduction for local property tax on a personal residence may be viewed as a tax expenditure or as part of the normal tax structure, depending on the treatment of imputed income from home ownership.[11] A definition that focused exclusively on the intrinsic qualities of tax code provisions would thus be incomplete. The definition either would miss many tax rules which are arguably within the tax expenditure subclass or would trivialize the classification process by including almost all code provisions within that subclass.

Another shared definitional obstacle is that rules which unambiguously separate weeds from flowers or tax expenditures from

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[11] *See* Pomp, *Mortgage Interest and Property Tax Deductions: A Tax Expenditure Analysis,* 1 CANADIAN TAXATION, No. 3, 23 (Fall 1979); Hellmuth, *Homeowner Preferences,* in COMPREHENSIVE INCOME TAXATION, 169, 179 (J. Pechman, ed., 1977).

normal tax rules unavoidably incorporate some subjective value judgments. To minimize the subjective element in the definition of a tax expenditure, the framers of the definition could obtain a consensus on the values they implicitly endorse. All of us are entitled, however, to our idiosyncratic preferences when we are the ones for whom the definition is being framed. In the fable, the owner of the garden was the ultimate arbiter of what constituted a weed. In the same way, the person or institution using the term "tax expenditure" has the final say on the contours of its definition. Consequently, the definitional problem would remain even if we could browbeat the world into agreeing on a standardized list of tax expenditures.

Finally, weeds and tax expenditures cannot be identified precisely without changing the core meaning of the terms. Some words have an intrinsic element of vagueness. The term "adult," for example, suggests a person who has fully developed physically and has acquired a measure of maturity. But distilling the vagueness from this term by specifying the age at which a person passes from childhood to adulthood would change the complex concept of "adult" into something simple and different.[12] Similarly, part of what makes a weed a weed is an aesthetic judgment that it is out of place where it is. The same is true of a tax expenditure. Since their meanings depend in part on value judgments, their definitions necessarily have soft, fuzzy edges—not the crisp lines of an itemized list.

In the face of real problems of definition, how was the gardener able to weed the garden to the satisfaction of the owner? More fundamentally, why would we anticipate that any competent gardener would be able to separate weeds from flowers without even addressing the definitional problems discussed above? The answer is that the gardener understood that his purpose for uprooting plants was to enhance the beauty of his employer's garden. This purpose became the touchstone for resolving all sorting issues. By sorting weed from flower by reference to the purpose of the sorting, an enormous theoretical problem was converted into a series of small, practical decisions. The gardener could make these decisions in most instances through the exercise of his aesthetic judgment.

Since the gardener's employer remained the ultimate arbiter

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[12] For discussion of this famous example, see ENCYCLOPEDIA OF PHILOSOPHY, *supra* note 10, at 315.

of what constituted a weed, he was not limited to the conventional purposes for distinguishing flowers from weeds, as illustrated by his unorthodox treatment of dandelions. But while the power of the owner to specify additional purposes for distinguishing weeds from other plants complicated the gardener's job, it did not create fundamental sorting problems. Once the employer informed the gardener of the special purpose for keeping dandelions, the gardener was able to continue the sorting of plants without further discussions with the owner.

Although the gardener and the owner did not crystallize their definition in a verbal formula, they implicitly defined the term "weed" by their actions. Describing those actions made the definition explicit. Thus a weed, for purposes of weeding the owner's garden, was "either a plant that does not enhance the beauty of the garden in the opinion of the gardener or one that the owner does not specifically identify as desirable in the garden." This definition was in no sense an all-purpose definition of a weed; by its own terms, it was useful only when the purpose of weeding was to enhance the beauty of the owner's garden. Nor was the rule it provided for sorting weeds from flowers self-executing; weeding remained a task that required a knowledge of plants and an artistic touch. For a skilled gardener, however, the definition gave instructions for sorting weeds from flowers that were fully adequate for the owner's purposes. Since the definition accomplished its sorting function, the problem of defining a weed for the limited purposes of the owner was solved.

For an analogous solution to the problem of defining a tax expenditure, we need to examine individually the myriad purposes for distinguishing tax expenditures from normal tax rules. For each such purpose, we must fashion a rule that will permit the persons responsible for identifying tax expenditures to accomplish that task. This methodology yields a definition of a tax expenditure that is not applicable at large, since a definition tied to use obviously must change if the use changes.

II. The Lesson Goes to Congress

Over the past half century, Congress has frequently used the tax system to reward favored economic activity and to relieve the personal hardships of individual taxpayers. These tax subsidies are similar in economic effect to the imposition of a tax otherwise due, followed by a corresponding government subsidy in

the amount of the tax collected. Until recently, however, Congress applied entirely different legislative procedures to its consideration of direct expenditures and tax expenditures—excluding tax expenditures, for example, from the budget-setting process. The proponents of the tax expenditure budget have apparently convinced a majority of Congress that radically dissimilar treatment of functionally equivalent policy measures is undesirable. In the Budget Reform Act of 1974,[13] Congress took the first steps toward a uniform system for considering direct and indirect spending programs.[14]

To treat tax expenditures like direct expenditures, Congress must decide which tax rules should be treated as the functional equivalents of spending programs. The tax expenditure budgets prepared by the Treasury Department and by several other government agencies provide a standardized list of purported tax expenditures. But critics contend that Congress should not use this list, since it contains many code provisions that arguably constitute part of the normal structure of the income tax. Both defenders and critics apparently agree that the legitimacy of the list depends on the success of the tax technicians in unambiguously bifurcating the tax code on some principled basis into "normal" and "special" parts.[15] Thus the problem of defining a tax expenditure is central to the movement to apply uniform procedures to the consideration of tax expenditures and direct expenditures.

The new methodology developed above would allow Congress to accomplish its legislative reform objectives without having to distinguish tax expenditures from normal tax rules. Three concrete examples illustrate the potential of that alternative methodology. While the examples do not attempt to take into account every political factor that might influence the definitional process, they are sufficiently realistic to provide a fair test of the methodology.

A. Example One: The Tax Expenditure Budget

For Congress to move toward unifying its procedures for eval-

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[13] 31 U.S.C. §§ 11(e), 1301-1353 (1976).

[14] For a detailed discussion of the Budget Reform Act of 1974 and an analysis of issues that have arisen in implementing it, see Surrey & McDaniel, *supra* note 5, at 709-20.

[15] *See* notes 5-7 and accompanying text *supra*.

uating tax expenditures and direct expenditures, it must have the kinds of cost data on tax subsidies that are regularly available on direct spending programs. The vehicle for providing Congress with such data is the tax expenditure budget. To construct that budget, tax analysts must develop a list of the tax expenditures contained in the Internal Revenue Code. The task of listing tax expenditures differs markedly from the task of listing direct spending programs. For direct expenditures, federal money raised through taxes or loans is physically spent; someone "taking inventory" of direct spending programs would observe the programs in action. But for tax expenditures, "spending" is a logical construct. No money physically enters the federal till and no money goes out, even though the economic impact of a tax subsidy may be equivalent to the impact of a direct spending program. A physical inventory of tax expenditure programs is therefore impossible.

To overcome this special difficulty of identifying tax expenditures, the framers of the tax expenditure budget have attempted to unambiguously bifurcate the Code into normal and special parts.[16] They are needlessly ambitious. The clear purpose of the tax expenditure budget is to give Congress reliable estimates of the costs in forgone revenue of tax provisions that are functionally equivalent to spending programs.[17] Since its purpose is strictly informational, differences of opinion among tax specialists over the proper treatment of particular tax rules become footnotes, figuratively and literally, to the tax expenditure budget.[18] For example, those persons assigned the job of producing a tax expenditure budget could achieve its purpose by including in the budget every tax rule that is arguably a tax expenditure, with an annotation for the controversial items. Since those persons would have conveyed all the information they possessed, their budget surely fulfills its informational function.

An all inclusive list, however, is but one of many solutions to the problem of producing a useful tax expenditure budget. As a

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[16] *See* note 6 and accompanying text *supra*.

[17] According to Professors Surrey and McDaniel, "Certainly a government should know how much it is spending and for what purposes. A tax expenditure budget provides this essential and elementary knowledge with respect to the spending channelled through the tax system." Surrey & McDaniel, *supra* note 4, at 692.

[18] This suggestion is made in Shoup, *Surrey's Pathways to Tax Reform—A Review Article*, 20 J. FIN. 1329, 1334 (1975).

perfectly acceptable alternative, those drawing up the list could develop ad hoc rules for limiting the list to items that have been supported in Congress for tax expenditure reasons—that is, because of some nontax goal that the tax rule allegedly advances—since these are the items for which the cost data are most likely to be relevant to congressional budget decisions. Other approaches are also possible—a minimum list with annotations or a consensus list with annotations might be better choices. In choosing among alternative approaches, those drawing up the list of tax expeditures only have to decide which approach best conveys the information at their disposal, taking into account, for example, the costs of acquiring data and the time, convenience and intelligence of those who requested the tax expenditure budget. This decision is a practical one and is obviously independent of the theoretical issue of which tax rules are normal and which ones are special.

B. Example Two: Assigning Tax Expenditures to the Appropriate Congressional Committee

Both the House of Representatives and the Senate manage their legislative business through a complex network of committees. In the House, all tax bills, including bills containing tax expenditure proposals, are routed to the Ways and Means Committee; in the Senate, the Finance Committee has this jurisdiction.[19] Direct spending bills, in contrast, are controlled by the standing committee with jurisdiction over their subject matter. Until recently, no mechanism operated to coordinate congressional consideration of tax expenditure proposals with direct expenditure proposals encompassing the same subject matter.[20]

Logic suggests that tax expenditures should be subjected to the same kinds of cost/benefit scrutiny and political tradeoffs applicable to functionally equivalent direct spending programs. To implement a coordinated approach, Congress must decide which tax rules to treat as tax expenditures. Using the new methodology, Congress could achieve its goal of coordinating re-

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[19] The tax legislative process is fully described in Surrey, *The Federal Tax Legislative Process*, 31 RECORD OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK 515 (1976).

[20] For a discussion of the tentative steps Congress has taken to subject tax expenditures to the discipline of the budget process, see *Current Developments, supra* note 2, at 328-30.

view of tax expenditures and direct expenditure proposals without bifurcating the tax code into normal and special parts. Any tax bill containing a provision whose classification was the subject of legitimate dispute could be referred to both the tax and the relevant nontax congressional committee. Congress could instruct the nontax committee to assume that the disputed provision was in fact a tax expenditure and to scrutinize it accordingly. The tax committee would be given the opposite instruction. The result would be that all tax expenditures, plus some tax rules that may or may not be tax expenditures, would be evaluated by the appropriate nontax legislative committee according to traditional budget criteria. At the same time, the tax committee would examine all tax rules which are part of, or are arguably part of, the normal tax structure according to traditional tax policy criteria.

The possibility of concurrent jurisdiction by both the tax and nontax congressional committees eliminates the need for deciding unambiguously which committee has the predominant jurisdictional claim. Concurrent jurisdiction may be desirable even for tax rules that clearly fall into the special classification, since the tax committees have the expertise to disguise the spending program in the appropriate tax language. Congress has already experimented with this technique in considering the energy tax credits contained in the 1978 Tax Act.[21] Concurrent jurisdiction, of course, is the common solution for spending programs that arguably fall within the subject matter of more than one committee.

C. Example Three: Sunset Legislation

Over the past several years, Congress has held hearings on legislation that would subject all federal spending programs, including tax expenditures, to periodic review and the threat of automatic termination.[22] This review procedure, popularly called "sunset," would terminate tax expenditure programs after five

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[21] I.R.C. §§ 44C, 44D & 44E. For a fascinating account of the politics that led to concurrent jurisdiction over the refundable portion of the energy tax credits and some sophisticated suggestions for extending the technique of concurrent jurisdiction, see Surrey & McDaniel, *supra* note 2, at 130-44.

[22] For discussion of the 1976 sunset proposal, see McIntyre, *The Sunset Bill: A Periodic Review for Tax Expenditures,* Tax Notes, Aug. 9, 1976, at 3. *See also Current Developments, supra* note 2, at 330-35.

years unless they were reenacted following an analysis of their effectiveness by the executive branch and the appropriate congressional committees. The mechanics of sunset obviously require a crisp dividing line between tax expenditures and other tax rules, since only tax expenditure programs would be assigned a cut-off date.

Specifying the purpose of subjecting certain tax rules to sunset poses some difficulties. The basic motive for sunset legislation is clear enough—some federal programs, once enacted, are said to take root and survive as organisms independent of Congress and the voters. By imposing an automatic termination date, sunset would force supporters of these "hidden" federal programs to make a public defense. This motive justifies subjecting obscure federal programs—tax expenditures or direct expenditures—to sunset, but it arguably does not justify imposing the risks of sunset on *all* spending programs. Under sunset, legislation that has already been debated publicly and has majority support in both houses of Congress can be repealed automatically if a reenactment bill is bottled up in committee, filibustered to death on the floor of the Senate or vetoed by the President. Applying sunset to the Medicare program, revenue sharing or the Federal Trade Commission budget, for example, would be unnecessary, even mischievous, like a bank calling the mortgage loans of its reliable and solvent customers just to put them to the test.

Applying sunset to some but not all spending programs would present enormous political problems, however, since the political support for sunset rests on the perception that it is merely a procedural reform, not an attack on specific programs. Selective sunset would require Congress to decide what programs to subject to the threat of termination. An immediate debate on the merits of specific programs would then be unavoidable, contrary to the plan of sunset for orderly review over a period of years.

To apply sunset to tax expenditures, therefore, Congress ideally would want a list of tax expenditures with some claim to legitimacy that could be adopted without precipitating a debate on the classification of particular tax rules. The source of that legitimacy is unimportant. Congress could employ a variety of techniques to produce a consensus list of tax expenditures. One technique would be to adopt without change a list developed for

some other purpose, such as for the tax expenditure budget.[23] An alternative would be to modify an existing list by eliminating tax rules that were difficult to classify or that otherwise provoked controversy.[24] A third approach might be for those seeking passage of sunset legislation to negotiate the list, item by item, with those members of Congress whose support was considered necessary. What goes on the list, then, is a question of practical politics—not tax theory. A list that unambiguously bifurcated the tax code into normal and special parts would have no special appeal.[25]

D. The Examples in Perspective

By following the procedures outlined in the above examples, Congress would produce for itself three definitions of the term "tax expenditure."[26] Each of the definitions would be exactly tailored to achieve a narrowly specified congressional purpose. None of the definitions requires an ability to unambiguously divide the tax code into normal and special parts.

Despite the economic equivalence of tax expenditures and direct expenditures, the two forms of "spending" have some inher-

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[23] *See* text accompanying notes 16-18 *supra*.

[24] Supporters of sunset now realize that many purported tax expenditures can be subjected to automatic termination only by substantially redrafting sections of the tax code. Tax shelter abuses, for example, are the product of the perverse interaction of several "normal" tax rules; to repeal tax shelters, the offending tax rules must be rewritten, not simply repealed. *See* McIntyre, *supra* note 22, at 6.

[25] The House Rules Committee's Task Force on Federal Spending Limitations has held hearings on a variety of proposals for controlling the growth of federal spending. See McDaniel, *Tax Expenditures and Federal Spending Limitations*, Tax Notes, April 7, 1980, at 475. To be effective, spending limitations should impose controls on disguised spending through the tax system. Implementing a limitation on tax expenditures poses definitonal problems similar to those encountered in identifying tax expenditures for sunset legislation. In both cases an unambiguous list of tax rules is required. Spending limitations enforced through a balanced budget requirement arguably could ignore tax expenditures, since a failure to include a tax expenditure on the spending side of the budget would offset the failure to include a deemed tax receipt on the revenue side of the budget. For a collection of articles on tax and spending limitations, see *Proceedings of a Conference on Tax and Expenditure Limitations*, 32 NAT'L TAX J., No. 2, (Supp. 1979).

[26] As illustrated above in Example 3, see notes 22-25 and accompanying text *supra*, Congress might find reason to use the same list of tax expenditures for more than one purpose.

ent differences, the most obvious being that the budget cost of a tax expenditure cannot be measured by recording outlays from the federal fisc. No one can seriously argue that the identical procedures applicable to direct spending programs should apply to purported tax expenditures. The goal of Congress should be to fashion institutional arrangements for managing tax expenditures that would be comparable in their effects to the necessarily different arrangements applicable to direct spending programs. But the examples above illustrate that a debate over the features of the normal tax structure has little or no relevancy to the achievement of that goal.

III. A Further Application of the Lesson: The Use of a Tax Expenditure Analysis

Only an Alice in Wonderland character would judge the merits of a direct spending program by applying traditional tax policy criteria. Everyone understands, for example, that the case for funding the Navy has nothing to do with its ability to fairly and efficiently raise revenue for the government. Tax expenditure champions have vigorously asserted that tax policy criteria are equally inappropriate in judging the merits of indirect spending through the tax code. They insist that tax expenditures should be recast as functionally equivalent spending programs and then evaluated according to traditional budget criteria. They call this two-step procedure a "tax expenditure analysis."[27] The logic of their position is unassailable.

Tax expenditure critics accept the logic of applying a tax expenditure analysis to tax rules which unquestionably constitute indirect spending programs. They see that procedure as a valuable analytical tool, for example, in judging the merits of the exclusion for interest on state and local bonds—a tax code rule which they concede acts solely as a federal interest subsidy.[28] They balk, however, in applying it to tax rules which are at least arguably defensible on tax policy grounds. Tax expenditure champions accept in principle this limitation on the tax expenditure analysis. But in practice they would apply a tax expenditure analysis to any tax rule that appears in the Treasury De-

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[27] *See, e.g.*, S. Surrey, *supra* note 6, at 36.

[28] *See, e.g.*, Andrews, *supra* note 3, at 311.

partment's tax expenditure budget.[29]

The tax expenditure analysis should be liberated from its historical ties to the consensus list of tax expenditures prepared by the Treasury Department. As long as the tax expenditure analysis is linked to such a list, the results of its application are discredited in the eyes of anyone who is not part of the consensus.[30] Even more significantly, that linkage places unnecessary restraints on the use of a tax expenditure analysis. Tax specialists have mistakenly assumed that a tax expenditure analysis ought to measure the intrinsic worth of a tax code provision.[31] This error has made the definition of the term "tax expenditure" central to the invocation of that procedure. This section argues that tax specialists should use a tax expenditure analysis to evaluate *arguments* made on behalf of a tax rule—not to directly judge the worth of the rule itself. After illustrating the operation and advantages of the proposed new methodology for invoking a tax expenditure analysis, this section provides the theoretical underpinning for that approach.

A. An Example: The Dependency Exemption[32]

Some commentators argue that in a tax structure which ideally defines income in terms of personal consumption plus the net change in savings, the proper taxpayer on an income item is

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[29] Professor Surrey states:

> We thus can put the basic question of whether we desire to provide that financial assistance at all, and if so in what amount—a stock question any budget expert would normally ask of any item in the regular budget. We can inquire whether the program is working well, how its benefits compare with its costs; whether it is accomplishing its objectives—indeed, what are its objectives? Who is actually being assisted by the program, and is that assistance too much or too little? Again, these are stock questions directed by any budget expert at existing programs. *They all equally must be asked of the items and programs in the Tax Expenditure Budget.*

S. SURREY, *supra* note 6, at 35-36 (emphasis added).

[30] *See* text accompanying notes 8-9 *supra*.

[31] The case for or against a tax rule obviously depends on the strength of all arguments that might support it. Since a tax expenditure analysis is useless in evaluating tax policy arguments, it alone cannot determine the worth of any tax rule that conceivably forms part of the normal structure of the tax.

[32] This subsection uses as an example I.R.C. § 151, which provides a personal exemption of $1,000 for each of the taxpayer's dependent children.

the person who saves or consumes that income.[33] Applying that principle in the family context, the proper taxpayer on income earned by a parent and spent on a child would be the child. Since the tax authorities cannot measure the actual consumption and savings of children in a family, they need some indirect method of calculating the correct theoretical result. The $1,000 dependency exemption crudely approximates the distribution of burdens that would prevail if dependent children were taxed on that share of the family income which they presumptively enjoy.

In evaluating this argument, the tax expenditure analysis should remain on the shelf. The argument asserts that the goal of the dependency exemption is the fair distribution of tax burdens—obviously a traditional tax policy goal. A proper inquiry, therefore, would pose some or all of the following questions: Is the theoretical norm of taxing income to the beneficiary a sound one in terms of notions of fairness in the distribution of tax burdens? Is the ad hoc technique for implementing that norm too crude? Is a better technique available? Does the rule produce undesirable nonneutralities in economic choices? Are these possible nonneutralities significant in light of the alleged fairness gains?[34]

Other commentators argue for the exemption on the ground that support of children is in part a community responsibility and should be subsidized by the government through the tax system.[35] Since the asserted goal of the exemption under this argument is a spending goal—the wise expenditure of public funds—the argument should be evaluated according to budget criteria using a tax expenditure analysis. Analysts should convert the tax rule into a functionally equivalent spending program and subject it to the scrutiny appropriate for related spending programs. They should determine, for example, whether the assumed spending goal of the tax rule is important

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[33] For a presentation and defense of the proposition that the beneficiary of an income item is the person properly taxable on that income, see McIntyre & Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax*, 90 HARV. L. REV. 1573 (1977).

[34] Tax specialists generally agree that a tax rule should not cause an inefficient allocation of resources if that result can be avoided without sacrificing administrative resources or fairness. A tax rule justified for efficiency reasons, however, may be difficult in theory to distinguish from a tax rule adopted to advance an economic goal not germane to a revenue-raising goal.

[35] *See, e.g.*, McIntyre & Oldman, *supra* note 31, at 1602.

or trivial, whether or not the costs of achieving the goal are commensurate with the benefits and whether the benefits are properly targeted or produce windfalls. In all probability, most analysts would judge the $1,000 deduction deficient according to budget criteria.

What could we fairly conclude about the desirability of the dependency exemption if this project were carried out? First of all, if we found, as expected, that the $1,000 allowance could not be justified according to budget criteria, we would know that the spending argument was a false one. If we also found that the tax policy argument was defective, we would know that the allowance was indefensible, unless, of course, commentators could develop additional arguments not previously considered. We might also learn which of its features made it a bad spending rule or a bad revenue-raising rule and whether or not those features were correctable. Alternatively, we might discover that the tax policy argument for the allowance was fundamentally sound. In any event, we would know as much about the merits of the dependency exemption provision as our analytical tools are capable of uncovering.

In contrast, what would we learn about the dependency exemption from the traditional tax expenditure analysis? In my view, virtually nothing. The traditional approach requires us to determine initially whether the dependency exemption is "normal" or "special." Even those tax specialists who are most optimistic about our ability to bifurcate the tax code into normal and special parts concede that the classification of the dependency exemption is problematic.[36] This analysis is thus stuck at square one. An analyst who simply ignored the classification problem and treated the exemption as a tax expenditure would probably conclude that it is unjustified, but only persons oblivious to the constraints of sound reasoning would give any weight to that finding. Similarly, if an analyst arbitrarily treated the exemption as a normal part of the tax code, his defense of the exemption would be tainted beyond redemption. In summary, arbitrary premises about the nature of a tax rule yield arbitrary conclusions about its merits.[37]

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[36] *See Current Developments, supra* note 2, at 263-65.

[37] This problem arises in many other situations. The deductions for medical expenses and for charitable contributions should be analyzed as tax expenditures when they are defended on the ground that they advance desirable social

B. Another Example: The Business Lunch Deduction[38]

Commentators almost uniformly consider the business meal deduction to be a feature of the normal structure of the income tax, though many oppose it as unsound tax policy.[39] As a normal provision, it would traditionally enjoy immunity from a tax expenditure analysis. But the methodology advocated in this article would employ a tax expenditure analysis to evaluate nontax arguments made in defense of the business expense deduction.

The business lunch deduction is permitted by judicial interpretation of the "ordinary and necessary" language of Internal Revenue Code Section 162.[40] Congress has reinforced this interpretation by specifically excluding "quiet business lunches" from the statutory restrictions on entertainment expenses, which it enacted in 1962.[41] No one, least of all the Congress, has viewed this deduction as the product of an explicit or implicit congressional spending decision, though commentators occasionally speak of the deduction as a subsidy for the well-heeled businessman.[42] This subsidy language probably reflects well-founded

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goals. They should be analyzed according to traditional tax criteria, however, in other circumstances. *See* Andrews, *supra* note 3, at 331-43. The deduction for interest payments on personal debts is often treated as a tax expenditure but has been defended on tax policy grounds. *See* Gunn, *Is the Interest Deduction for Personal Debts a Tax Expenditure?* 1 CANADIAN TAXATION, No. 4, at 46 (1979). The child-care credit can be treated as either a tax expenditure or a part of the normal tax structure, depending on the rationale offered in its defense. *See* McIntyre, *Evaluating the New Credit for Child Care and Maid Service,* Tax Notes, May 23, 1977, at 7. The same has been said of the casualty loss deduction. See Blum, Book Review (SURREY, PATHWAYS TO TAX REFORM), 1 J. CORP. TAX, 486, 489 (1975). Other ambiguous areas include the exclusion of imputed income from home ownership, the deferral of tax on contributions to pension funds, the gift and scholarship exclusions, the concession rate on earned income and the exemption (or deferral) for controlled foreign corporations.

[38] This subsection analyzes the arguments for and against the Carter Administration's 1978 proposal to deny a business expense deduction for one-half of the cost of a business lunch. U.S. DEP'T OF TREAS., THE PRESIDENT'S 1978 TAX PROGRAM 195-204 (1978) [hereinafter cited as TAX PROGRAM].

[39] See Halperin, *That's Entertainment,* Tax Notes, September 11, 1978.

[40] I.R.C. § 162 states, in pertinent part:

> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . .

[41] *See* I.R.C. § 274(e)(1).

[42] *See* Bittker, *Income Tax Deductions, Credits, and Subsidies for Personal*

cynicism about the business necessity of some claimed deductions, rather than an implied assertion that the judicial gloss on section 162 has produced a disguised spending program.

Commentators have defended the proposal to deny a portion of the business meal deduction on two independent grounds. According to one line of reasoning, an expenditure genuinely motivated by business considerations should be deductible, but the tax authorities cannot distinguish genuine and bogus business meals without provoking protracted litigation. A 50% deductibility rule would limit the well-documented abuses that full deductibility has spawned without adding to the complexity of the tax code.[43]

Under the other line of reasoning, business meals should be deductible in computing the net income of the payor but should be taxable income to the beneficiary of the business meal, in much the same way that in-kind wages are deductible to the payor and taxable to the recipient. This argument applies the principle advanced in the preceding example that the beneficiary of consumption goods is the proper taxpayer under a tax system such as ours.[44] Under this argument, the denial of the deduction to the payor is proper as an administratively feasible method of making the payor a "withholding agent" on amounts paid to the beneficiary. Analysts would justify allowing a deduction for 50% of the cost of a meal as a transitional device, a concession to political exigencies or a rough attempt to minimize possible hardships.[45]

Analysts should evaluate both of the above arguments according to tax policy criteria—not budget criteria—under the methodology recommended in this article. Both arguments claim that the 50% deductibility rule raises tax revenue according to consistently applied fairness principles. Both marshall evidence tending to demonstrate that the recommended tax rule is a proper means of achieving an asserted tax policy goal. Since the asserted goal has nothing to do with the expenditure of public funds, a tax expenditure analysis of these arguments would be a useless frivolity.

Expenditures, 16 J. OF L. & ECON. 193 (1973).

[43] *See* Tax Program, *supra* note 38, at 200.

[44] *See* note 34 and accompanying text *supra*.

[45] *See Business and Pleasure*, People & Taxes (December 1977), at 3; Halperin, *supra* note 39.

The main argument advanced by opponents of the Carter Administration's proposal was the possible reduction in jobs within the restaurant industry that enactment of the proposal would produce.[46] Since the maintenance of jobs in a particular industry is typically a spending goal and not a revenue-raising goal, analysts should subject this argument to a tax expenditure analysis. To carry out this analysis, they should recast the business lunch deduction as a spending program and evaluate it according to budget criteria. They should try to determine, for example, the number of jobs, if any, that the constructed spending program is responsible for, its costs per job, the job impact of alternative uses of the forgone tax revenue and the appropriateness of spending government money to achieve the asserted goal. By carrying out the above analysis, they would probably conclude that the business lunch deduction, viewed as a jobs program, is ludicrously wasteful.[47] Whatever they concluded, however, they would have given this argument full consideration without having to determine whether the business lunch deduction was a normal or special part of the tax code.[48]

C. The Theoretical Underpinning of the New Approach

As tax specialists long ago discovered, a tax expenditure analysis can be performed on virtually any tax rule, even on rules which unquestionably are integral to the operation of the income tax.[49] But conducting a tax expenditure analysis indiscrimi-

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[46] *See, e.g.*, STATEMENT OF V. ROSELLINI, ET AL., BEFORE HOUSE WAYS AND MEANS COMMITTEE, March 20, 1978, in BNA, Daily Report for Executives, Special Supplement, DEP No. 54, 03-5 (estimating 63,000 jobs lost from reform of business lunch deduction).

[47] *See* LIBRARY OF CONGRESS STUDY, cited in Halperin, *supra* note 39, at 301.

[48] The problem in the text could arise in many other contexts. The special treatment of the oil industry is generally defended on tax expenditure grounds, though it was originally adopted for tax policy reasons. The same may be said of accelerated depreciation, cash accounting for farmers, the deduction for interest on personal loans, the exclusion of part of the income of overseas employees and even the capital gains exclusion.

[49] For example, the deduction for amounts paid as rent of a business premises—everyone's idea of a normal tax rule—can be cast as a spending program, with the amount "spent" measured by the amount of tax forgone by allowing the deduction. This constructed spending program then could be evaluated according to budget criteria. The goal of the constructed spending program would not be easy to detect—perhaps it would be an "incentive" to businessmen to engage in profit-seeking activity. *See* text accompanying note 52 *infra*

nately yields no usable information. Proper interpretation of the conclusions of a tax expenditure analysis requires a principled basis for invoking it. Recognizing this, the early proponents of a tax expenditure analysis applied it only to those tax rules which they had first identified as tax expenditures. Their definition of a tax expenditure was the familiar one, requiring tax rules to be characterized unambiguously as normal or special.[50] The overwhelming drawback of this system is that it substantially limits the potential benefits of a tax expenditure analysis. Rigorously applied, it restricts the tax expenditure analysis to an examination of tax provisions that demonstrably are not part of the normal structure of the income tax, thereby barring it from a constructive role in the analysis of many controversial tax issues.

The two preceding examples illustrate a more expansive approach to invoking a tax expenditure analysis. Under this approach, the bare assertion that the tax rule under examination promotes a spending goal triggers a tax expenditure analysis.[51] Once invoked, analysts would conduct the tax expenditure analysis in the same way as is contemplated under the traditional system. The interpretation of the conclusions of the tax expenditure analysis must change, however, to reflect the change in the triggering mechanism. The traditional system employs a tax expenditure analysis after proof that the tax rule is in fact a spending program embedded in the tax code. Evaluation of the constructed spending program, therefore, fairly tests the tax rule itself. Under the new system, we have only an assertion that the tax rule promotes a spending goal. Consequently, the tax expenditure analysis simply determines the merits of the tax rule as a spending program. As illustrated in the two examples above, it says nothing at all about the suitability of the tax rule for promoting tax policy goals.

This approach may appear to differ significantly from the way

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for a discussion of the problem of evaluating a spending program with unspecified goals.

[50] *See* S. Surrey, *supra* note 6, at 35-39.

[51] Tax analysts cannot always distinguish goals associated with raising revenue from goals associated with spending, since tax policy is a tool of fundamental social and economic policy. Exempting the poor from tax, for example, is typically both a tax policy and a spending policy goal. But this problem poses no difficulty here, since the approach recommended in this article can accommodate an analysis of an argument according to both tax policy and spending policy criteria.

direct expenditure programs are typically evaluated. In fact, however, this approach parallels the mode of analysis that budget specialists employ (or ought to employ) when they attempt to determine the merits of spending programs enacted for mixed or unclear motives.[52] Assume, for example, that Congress has voted to build a dam in the state of an influential senator. Assume further that Congress has completed inconclusive studies of the possible benefits of the dam, and the dam's proponents have alleged multiple and inconsistent goals for it. How should a budget analyst go about evaluating that spending program? I venture that he would postulate possible goals for the dam—flood control, hydroelectric power, flat-water recreation—and test to see if the expenditures for the dam were an appropriate means of achieving those goals, individually and in combination. He would eliminate from his analysis the possible political benefits of the dam, since an evaluation of those benefits would go beyond his professional competence. He would do what I recommend the tax specialists do when faced with legislation with unclear goals: he would evaluate the possible arguments for the legislation—not the legislation itself.

D. Notes from the Flower Garden

In the modified tax expenditure analysis illustrated above, the problem of identifying tax expenditures vanished like dew in the noon sun. The vanishing act was not a linguistic trick, a definitional sleight of hand. The problem was solved by applying the methodology developed in Section 2, above. Once the purpose of the modified tax expenditure analysis—testing nontax arguments—was clearly specified, the solution became obvious. Tax specialists should apply the tax expenditure analysis to any tax provision defended on nontax grounds.[53]

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[52] Professor Bittker notes the irony of tax specialists' wanting to duplicate for tax rules the review procedures applied to spending programs without understanding how defective those procedures typically are. Bittker, *supra* note 4, at 244 n.1. Also ironic is the complaint that analyzing tax rules as spending rules is inappropriate because of the difficulty of knowing the true purpose of the tax rule, when a similar situation for spending programs commonly arises and presents no great difficulties.

[53] Professors Surrey and McDaniel suggest that "[m]ost 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." *Current Developments,*

EPILOGUE

Our tax code has been forged in the cauldron of politics. The goals it has pursued, or allegedly pursued, are multiple and inconsistent. Many code provisions unquestionably function as spending programs, while others arguably serve both spending and revenue-raising goals. This state of affairs poses problems for Congress in managing the tax system and for tax specialists in analyzing it. The progenitors of the tax expenditure budget have articulated a promising system for coping with these problems—a system that has enjoyed remarkable success in Congress. The controversial part of that system is its recommended methodology for identifying disguised spending programs. The alternative methodology presented in this article extends their system and eliminates the feature that has subjected it to attack.[54]

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supra note 2, at 228. In recognizing tax expenditures by the arguments used to support them, Surrey and McDaniel are following the approach recommended in the text. They depart from this approach, however, when they fail to interpret the conclusion of their tax expenditure analysis in light of the method used for invoking it.

[54] This point is illustrated by examining Professor Kahn's recent attack on the tax expenditure concept. *See* Kahn, *Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 MICH L. REV. 1 (1979). Kahn argues that the debate over the merits of tax policy arguments in favor of accelerated depreciation should not be "stifled" by the Treasury Department's designation of accelerated depreciation as a tax expenditure. Under the methodology of this article, the fact that the tax expenditure budget includes revenue forgone as a result of certain accelerated depreciation deductions merely signifies that Congress views those deductions as an alternative to a direct investment subsidy. Analysts may try to persuade Congress to view them differently, but they can hardly complain that Congress has stifled debate by measuring the revenue forgone through accelerated depreciation.

Kahn offers a novel argument in favor of some form of accelerated depreciation. Under conventional accounting theory, depreciation should allocate the tax cost of an asset to the income earned by that asset. Straight-line depreciation rests on the simplifying assumption that an asset generates income in equal annual amounts over its useful life. Kahn accepts this simplifying assumption but argues that depreciation should allocate the tax cost of an asset to the present worth of the income earned by the asset. Assuming a positive real interest rate, Kahn's allocation method would result in accelerated depreciation for at least some assets.

Under the methodology of this article, tax analysts would evaluate Professor Kahn's argument without first attempting to determine whether accelerated depreciation is a normal or special rule. Since Kahn's argument is obviously a tax policy argument, analysts should test it according to tax policy criteria.

No one should propose a solution to the problem of defining a tax expenditure and expect to bypass completely the heated debate that the tax expenditure idea has engendered. This debate pulls into its vortex all who venture near. Mentioning the "problem" of identifying tax expenditures, for example, implicitly attacks those who proclaim that no problem exists. Similarly, speaking of a "solution" affronts those who contend that no solution is possible. The positions taken in this article are nevertheless genuinely compatible with the core position of both the progenitors of the tax expenditure budget and their critics and furnish no fuel to either side for continuing their apparently unendable debate.

They would learn nothing about the merit of Kahn's argument by casting accelerated depreciation as a spending program and testing it according to budget criteria.