

Making Tax Expenditures Work

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INTRODUCTION.

TEs are revenue-reducing, IRS-administered “spending” programs run through the Internal Revenue Code. The forgone revenue from TEs exceeds the total amount of individual federal income tax collected annually. Tax Expenditure reform is needed now more than ever, to reduce federal revenue shortfalls. Repeated attempts to reform TEs have accomplished little, however, in the three decades since the Tax Reform Act of 1986. Enacting a federal partial-replacement Value Added Tax (VAT), such as the Graetz Competitive Tax Plan (the Graetz Plan), could provide a catalyst for TE reform. Mass filing of income tax returns is assumed in the TE literature, including the literature on the institutional design of TEs. The elimination of 120 million Form 1040s upends this background assumption and prompts reconsideration of the institutional design of TEs.

Based on Ed Kleinbard’s earlier work on framework legislation,² this Article proposes rules that would integrate Tax Expenditure information into federal budget processes and make Tax Expenditures “work” for their ongoing funding. Such framework legislation would incorporate long-ignored fiscal imperatives: (1) for Congressional committees – including but not limited to

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² Edward D. Kleinbard, Tax Expenditure Framework Legislation, available at <http://ssrn.com/abstract=1531945>.

the tax writing committees – to identify the performance goals and outcome measures for federal expenditure programs; (2) for Congressional committees with subject-matter expertise to evaluate new TE proposals prior to enactment; (3) for identification, collection, and analysis of data required to measure TE performance; (4) for Congress to create a management structure that facilitates oversight and periodic review of functionally related federal expenditure programs; and (5) for Congress to amend federal budget processes, to integrate Tax Expenditure information into the annual federal budget presentation.

Enactment of the Graetz Plan could provide an opportunity reform existing TEs. Broadening the base of the class income tax could reduce the rate for the new partial-replacement VAT. This Article argues that existing TEs should be grouped based on federal budget functions and evaluated alongside related direct expenditure programs. This approach must overcome the structural impediments of overlapping, yet Balkanized Congressional committee authority, as well as expenditure programs that straddle multiple budget functions. Congress would specify the oversight structure for the coordinated evaluation of functionally related expenditure programs. For example, GAO or OMB could oversee the evaluation, with input from each relevant agency' deputy director, Inspector General, and other leaders charged with achieving performance success. JCT's experts would supply revenue estimates. The IRS would adopt cost-accounting rules to enable the IRS to estimate its TE compliance costs. The likely result of this process is that many ineffective, inefficient, or inequitable TEs finally would be repealed. Congress also would provide for periodic functional review of related expenditure programs following adoption of the VAT.

In addition, effective Tax Expenditures might be consolidated or otherwise redesigned to reduce their taxpayer and administrative costs and improve their performance. For example, enactment of a partial-replacement VAT presents an opportunity to improve the EITC as a wage subsidy and as an antipoverty program—by simplifying eligibility requirements, testing for eligibility ex ante, encouraging savings, and increasing liquidity for EITC recipients. A redesigned EITC would be structured to create liquid savings (not solely an incremental wage supplement in the form of reduced payroll tax withholding) and better insulate low-income taxpayers from liquidity shocks that create pernicious poverty traps. In addition, a reformed EITC would be expanded, along the lines of Leonard Burman’s proposed Universal Work Credit. A more radical reform would replace the EITC with some form of Universal Basic Income subsidy. Whether a reformed EITC would continue to be administered by the IRS is an open question, particularly if the revenue-raising parts of the income tax apply only to high-income Americans.

I. TAX POLICY AND BUDGET POLICY AT A CROSSROADS

A. The Urgent Need for Federal TE Reform.

The Congressional Budget Office projects that U.S. demographic trends, including the retirement of aging Baby Boomers with too few workers to replace them, will significantly increase federal spending as a percentage of the U.S. Gross Domestic Product (GDP).³ The 2017

³ KLEINBARD, WE ARE BETTER THAN THIS, 176. Congressional Budget Office, The Long-Term Budget Outlook (2018) [add PIN cite].

tax legislation nonetheless reduced federal revenue as a percentage of GDP and significantly increased projected federal budget deficits. Increasing deficits is justified in some circumstances, but the current fiscal trajectory is unsustainable.⁴ Congress will need to increase federal revenue and cut federal expenditures to contain long-term fiscal imbalances.⁵ Democrats and Republicans disagree about how to move forward.

Prominent Democrats, including 2020 Presidential candidates, emphasize the need to increase revenue, in particular from wealthy and high-income Americans. Democrats argue that wage stagnation for middle-class workers and increasing wealth and income inequality justify higher income taxes and new wealth taxes on the rich. President Trump and Congressional GOP leaders, on the other hand, stress the need to cut federal expenditures, including spending on education, the social safety net, and infrastructure. President Trump and Congressional GOP leaders also favor significant cuts in the funding for federal agencies, whose missions include protection of health, safety, and the environment. GOP leaders argue the federal government should be much smaller, because private markets allocate goods and services better than the federal government, and redistribution of income or wealth based on financial need is ethically dubious.

TEs largely have been ignored in these policy debates. Repealing or reforming TEs must be part of the national policy discussion about our nation's fiscal future. TEs, which are omitted

⁴ GAO, Tax Expenditures 43 (2005) (stating "our nation's fiscal policy is on an unsustainable course").

⁵ Shaviro re use of "fiscal gap" in place of annual budget deficits.

from the main federal budget presentation, are less politically salient than other types of federal expenditures. The three main categories of expenditures shown on the federal budget are (1) interest on U.S. indebtedness incurred to finance budget deficits, (2) discretionary spending, and (3) “mandatory” spending. The interest on Treasury debt is the only type of expenditure that actually is mandatory.⁶ “Mandatory” spending—a misnomer—is spending that will occur unless Congress and the President enact legislation to reduce mandatory spending program benefits. This category of spending has been relatively stable until now, because it includes popular social insurance programs such as Social Security and Medicare. The amount of annual mandatory spending is dictated by eligibility criteria and benefit formulae. It is not subject to annual Congressional budget appropriations. Like mandatory spending, TEs generally are on “autopilot” and do not require annual appropriations

Discretionary spending, which comprises about one-sixth of the federal budget (excluding TEs), requires annual Congressional appropriations. Roughly half of discretionary spending is for Defense. The other half of discretionary spending is comprised of everything else the federal government funds directly (not through the tax system). Non-defense discretionary spending has been almost the exclusive focus for deficit-reduction spending cuts in the past decade. For example, the Budget Control Act of 2011 created 25 percent cuts in discretionary spending over a ten-year period.⁷ Also, only discretionary expenditures are subject to

⁶ KLEINBARD, WE ARE BETTER THAN THIS 160

⁷ KLEINBARD, WE ARE BETTER THAN THIS 180.

“sequestration”—across the board pro-rata federal expenditure program cuts that go into effect if members of Congress cannot reach agreement on the budget. Although Congress created the sequestration process as a “nuclear” option, to encourage members of Congress to reach agreement on budget matters, sequestration has been triggered multiple times. Obviously, a better approach would be to selectively reduce spending on ineffective or duplicative programs, while maintaining (or perhaps even increasing) funding for the most impactful government programs.

Although reforming TEs should be part of this process, it is not. Congress enacted the Government Performance and Results Act (GPRA) in 1993 and the GPRA Modernization Act (GPRAMA) in 2010 to assess and improve performance of federal programs. Improving government performance and results, based on specification of agency outputs and outcome, is a work in progress.⁸ GPRA, as amended by GPRAMA, applies to federal Executive Branch agencies. Although the law technically applies to administration of the federal tax system,

⁸ See, e.g., Seth D. Harris, *Managing for Social Change: Improving Labor Department Performance in a Partisan Era*, 117 W. Va. L. Rev. 100, 148-152 (2015) (describing problems with GPRA procedures and suggesting reforms for better Congressional oversight). See also Jerry Ellig, *Has GPRA Increased the Availability and Use of Performance Information?*, available at <https://papers.ssrn.com/abstract=1366039> (2009) (concluding that empirical data “are consistent with the theory that GPRA has indeed prompted improvements in the availability and use of performance information in the federal government”).

Presidents have not required Treasury and the IRS to comply with the 1993 law.⁹ The inapplicability of GPRA to TEs makes TEs even more attractive to interest groups that want targeted subsidies. Len Burman and Joel Slemrod note that TEs “have been proliferating since the mid-1990s.”¹⁰

B. A Partial-Replacement VAT as a Catalyst for TE Reform.

Where tax reform goes from here is unclear. One approach would be to significantly broaden the base of the income tax, through TE reform, as in the Tax Reform Act of 1986. Another—potentially complementary—approach would be to convert part of the U.S. income tax into a consumption tax. The Competitive Tax Plan, proposed by Michael Graetz, is the most prominent partial-replacement VAT proposal. Graetz argues that the U.S. should replace the mass income tax with a narrower class income tax on high-income Americans, and make up the lost revenue with a Value Added Tax. Under the Graetz Plan, taxpayers whose income does not exceed a new “family allowance” (\$50,000 for individuals or \$100,000 for couples or families) no longer would need to file a Form 1040.¹¹

Graetz notes that the income tax originally was a “class” tax that applied only to high-income Americans. The class tax became a “mass” tax in the middle of the twentieth century, when additional federal revenue was required. The U.S. is an outlier among developed

⁹ Heen.

¹⁰ LEONARD E. BURMAN & JOEL SLEMROD, TAXES IN AMERICA 155 (2013).

¹¹ GRAETZ, 100 MILLION UNNECESSARY RETURNS (2010 update).

countries in its heavy reliance on an income tax to raise revenue. Every other developed country relies heavily on a goods and services tax, e.g., a Value-Added Tax (VAT), which is similar in effect to the retail sales taxes with which Americans are familiar.¹² The Graetz Plan would bring the U.S. federal tax system into closer conformity with the tax systems of other developed countries. Even if the high-profile Graetz Plan is not enacted, respected economists have expressed the view that “all roads lead to a VAT,”¹³ meaning that some form of federal Value Added Tax probably will be adopted in the U.S. to address federal revenue needs.

If the United States adopted the Graetz Plan, 120 million fewer U.S. households would need to file a Form 1040.¹⁴ The filing of Form 1040 functions as an application for the tax subsidies that are incorporated into the IRC and administered by the IRS—TEs. Graetz notes that adoption of his Competitive Tax Plan could facilitate Tax Expenditure reform.¹⁵ In his view, Tax Expenditures that continue to benefit the rich Americans who still have to file income tax returns would be revealed as subsidies that disproportionately benefit high-income taxpayers. This “sunshine” would make repeal of such subsidies more likely. In addition, future Tax

¹² Unlike sales tax, a VAT is collected at each stage of the production and sale of a good or service, instead of only at the point of retail sale.

¹³ Martin Sullivan.

¹⁴ GRAETZ, 100 MILLION UNNECESSARY RETURNS (2010 ed.)

¹⁵ GRAETZ, 100 MILLION UNNECESSARY RETURNS.

Expenditures no longer could be framed as “middle-class” tax cuts, thus eliminating the political “cover” for Tax Expenditures that disproportionately benefit high-income Americans.

There is more to be said about the possible effects of Graetz Plan on Tax Expenditure reform however. If the Graetz Plan were enacted, what methods should we adopt to reform Tax Expenditures in the new environment, with 120 million fewer Form 1040s being filed by Americans? This Article explores suggests an approach to evaluate functionally related TEs and direct expenditures and develops approaches to reform of Tax Expenditures.

II. THE STATE OF TE ANALYSIS AND REFORM.

TE reform could raise significant revenue, reduce inequality, and improve the efficiency of the federal tax system. Although TE reform is a perennial issue in tax policy, not much progress has been made on TE reform since the Tax Reform Act of 1986. [add transition to summarize reasons.]

A. Conceptual Disagreements about TEs.

Disagreements about the conceptual foundation for TEs have hindered TE reform efforts. American TE reformers in the 1960s through 1980s linked TE reform with adoption of a comprehensive income tax base. This linkage was consistent with a specific progressive tax policy agenda. Stanley Surrey developed the concept of Tax Expenditures during the 1960s.¹⁶ The idea was that tax subsidies delivered through the IRC are a form of government “spending”

¹⁶ Shaviro, *Fiscal Language*, and Kleinbard, *We Are Better than This*, note earlier German precursors.

in the form of forgone tax revenue.¹⁷ Surrey criticized Tax Expenditures on various grounds. For example, he argued that subsidies delivered in the form of tax exclusions and deductions constitute inequitable “upside-down” subsidies, because a taxpayer’s savings from a reduction in the tax base depend on the taxpayer’s marginal tax rate; the higher the taxpayer’s tax rate the larger the taxpayer’s subsidy. In Surrey’s view, such subsidies should be eliminated or replaced by direct expenditure programs with distributional effects that fit the goals of the subsidy.

Surrey defined the term “Tax Expenditure” as tax rules that depart from the Haig-Simons comprehensive income tax base. This continues to be the traditional conceptual approach to defining Tax Expenditures.¹⁸ Tax scholars who follow in Surrey’s footsteps frame Tax

¹⁷ Consistent with the approach used in Weisbach and Nussim, using common vernacular, this Article sometimes equates “spending” and direct outlays. [add PIN cite] As Daniel Shaviro correctly notes, the common distinction between taxing and spending makes no sense; he argues for the more accurate distinction between the distributive function and allocative function of government. Daniel Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 Tax L. Rev. 187 (2004) (concluding that “treatment of certain tax rules as really spending mistakenly presupposes that the distinction between taxes and spending is economically meaningful” and advocating for policy makers to use economist Richard Musgrave’s distinction between the distributive and allocative functions of government), available at SSRN: <https://ssrn.com/abstract=571223>.

¹⁸ Joint Committee on Taxation, *Estimates Of Federal Tax Expenditures For Fiscal Years 2016-2020* (2017):

Expenditure analysis in terms of the traditional benchmark of the “normal” income tax base, which incorporates the norms of equity and fairness, with a particular focus on “ability to pay” tax.¹⁹ Under this approach, tax rules that are based on ability to pay, determined on an ex post

Tax Expenditures are defined under the Congressional Budget and Impoundment Control Act of 1974 (the “Budget Act”) as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.” Thus, Tax Expenditures include any reductions in income tax liabilities that result from special tax provisions or regulations that provide tax benefits to particular taxpayers....

The legislative history of the Budget Act indicates that Tax Expenditures are to be defined with reference to a normal income tax structure (referred to here as “normal income tax law”). 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.

Id. (citation omitted).

¹⁹ See, e.g., J. Clifton Fleming & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and its International Dimension*, 27 VIRGINIA TAX REV. 437 (2008), available at

basis, are less suspect than tax rules that are targeted tax reductions (for a specific group of taxpayers) and not based on ability to pay. Under this traditional approach, the latter type of tax rules should be evaluated using cost-benefit analysis (CBA) and repealed if CBA does not justify the TE.²⁰ Even if a Tax Expenditure passes muster initially under CBA, legislators should consider whether CBA would support converting the Tax Expenditure into a direct outlay program.²¹ This Tax Expenditure reform camp typically favors repeal of Tax Expenditures other than Tax Expenditures that relate to “ability to pay.”

<https://ssrn.com/abstract=1119326>; James R. Repetti, *Democracy and Opportunity: A New Paradigm in Tax Equity*, 61 VAND. L. REV. 1129 (2008); available at <https://ssrn.com/abstract=1010987>.

Repetti (arguing that equity is the bottom “turtle” on which all other turtles lie and preferring, on equity grounds, “a progressive income tax that burdens investment income” instead of a consumption tax).

[Repetti also discusses the importance of a mass income tax for democratic participation; add Repetti to Zelenak’s “fiscal citizenship” argument]

²⁰ Fleming and Peroni.

²¹ What is the result of doing this however, if equity analysis of a tax rule in isolation fails to take into account the “spending” side of the budget or underlying legal rules (e.g. property and contract law rules), which have also allocative and distributional consequences? Does CBA of a Tax Expenditure, in isolation, tell us anything about whether a Tax Expenditure is justifiable? And is it not a little incoherent to ignore consequences other than equity at the stage of defining Tax Expenditures, only to invoke CBA as the decision-procedure for deciding whether to repeal a Tax Expenditure or convert it into a direct spending program?

The Tax Reform Act of 1986 was the high-water mark of the comprehensive income tax base approach to TE reform.²² The 86 Act significantly broadened the base of the federal income tax, reducing or eliminating many TEs in the process. This base-broadening facilitated large income tax rate reductions. The 1986 “triumph of tax reform” was short-lived however.²³ Now, three decades later, the IRC is replete with hundreds of TEs, significantly narrowing the income tax base.

Since 1974,²⁴ Treasury and the Joint Committee on Taxation (JCT) have prepared an annual Tax Expenditure Budget, which sorts TEs into 20 separate budget functions (e.g., health, housing, and education) and estimates the cost of each TE during the next five years.²⁵ JCT publishes the annual Tax Expenditure Budget as a standalone document. The Treasury’s TE Budget is attached in the Analytical Perspectives portion of the President’s budget proposal, but the TE estimates are not incorporated into the President’s main budget presentation of federal expenditures (aka outlays). Surrey believed that highlighting large revenue losses from Tax Expenditures would motivate Congress to reform Tax Expenditures, but he was overly

²² Shaviro, ‘86 Act, PENN.

²³ Farber & Frickey.

²⁴ Congressional Budget and Impoundment Control Act of 1974 (Pub. L. No. 93-344), sec. 3(3).

²⁵ JCT and Treasury use different estimation methods; forgone revenue versus outlay equivalent.

optimistic about TE reform.²⁶ In recent decades, Tax Expenditures have proliferated, especially since the mid-1990s.²⁷ Efforts to reform TEs have stagnated.

One impediment to TE reform is a longstanding controversy about the conceptual foundations for TEs. Policy debates about TEs have been mired in definitional controversies since Surrey's time, because his definition of Tax Expenditures was tied inextricably to an "ideal" comprehensive income tax base.²⁸ Boris Bittker famously critiqued the comprehensive

²⁶ Mary L. Heen, Reinventing Tax Expenditure Reform: Improving Program Oversight Under the Government Performance and Results Act, 35 WAKE FOREST L. REV. 751 (2000). Surrey envisioned the TE Budget as a "hit list" that Congress would target for repeal. Shaviro, *Fiscal Language* at 25.

²⁷ Mary L. Heen, Reinventing Tax Expenditure Reform: Improving Program Oversight Under the Government Performance and Results Act, 35 WAKE FOREST L. REV. 751 (2000); EDWARD D. KLEINBARD, WE ARE BETTER THAN THIS XX (20XX). See also Burman & Slemrod 155 (noting increases in the number and cost of TEs since mid-1990s).

²⁸ See, e.g., Edward D. Kleinbard, Chief of the Joint Committee on Taxation, RETHINKING TAX EXPENDITURES, address delivered at Chicago-Kent College of Law Federal Tax Institute, May 1, 2008:

Tax expenditure analysis no longer provides policymakers with credible insights into the equity, efficiency, and simplicity issues raised by a new proposal or by present law, because the premise of the analysis (the validity of the "normal" tax base) is not universally accepted. 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 inspired its original proponents: clarifying

income tax base foundations for Surrey's definition of Tax Expenditures, arguing that it was incoherent.²⁹ A related critique of Surrey's TE concept is that a consumption tax base (instead of an ideal comprehensive income tax) could provide the definitional baseline, which would alter the classification of various IRC rules as Tax Expenditures. For example, the Treasury Department under President George W. Bush objected to the preparation of the annual Tax Expenditure Budget on these grounds.³⁰ Conceptual and definitional debates about TEs have continued for decades.³¹

Commentators periodically have tried to escape this definitional morass. Daniel Shaviro challenged the notion that TEs are "spending" provisions, not "tax" provisions, on the grounds

the aggregate size and application of government expenditures, and improving the Internal Revenue Code.

Id. at 7.

²⁹ Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967) (noting conceptual problems with defining the "normal income tax structure"); Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244 (1969).

³⁰ U.S. Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2002*, Ch. 15 at 61 (2001) (questioning the analytic value of the Tax Expenditure concept because the comprehensive income tax base is "arbitrary").

³¹ See, e.g., Douglas A. Kahn and Jeffrey S. Lehman, *Tax Expenditure Budgets: A Critical View*, TAX NOTES Mar. 30, 1992 1661, 1665 (critiquing normative baseline tax structures).

that “‘taxes’ and ‘spending’ are not coherent categories.”³² Shaviro posited that the more relevant distinction is between “allocative” rules and “distributional” rules that are part of the fiscal system.³³ The purpose of “allocative” rules is to affect the allocation of assets, meaning “the amount, use, and character of ... assets.”³⁴ In colloquial terms, allocative rules affect the size of the aggregate economic pie. The purpose of “distributive” rules is to “[affect] who has what.”³⁵ Distributive rules thus affect the way in which the pie is sliced and distributed. The IRC fundamentally is a set of distributional rules. Shaviro argues that allocative rules in the IRC, which subsidize specific activities or assets, thus are the tax rules that should be treated as TEs.³⁶ “When an allocative program uses tax benefits, such as special deductions or credits, in lieu of direct appropriations, ‘taxes’ and ‘spending’ for the fiscal system may appear to be lower, even if the choice of mechanism has no effect on the substance of government

³² Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language 2* (2003), available at <http://papers.ssrn.com/abstract=444281>.

³³ *Id.* at 2-3 (drawing on economist Richard Musgrave’s distinction between “allocative” and “distributional” fiscal functions).

³⁴ *Id.* at 3.

³⁵ *Id.*

³⁶ *Id.* Shaviro concludes that Surrey’s approach to TEs, which incorporated a specific normative stance on progressivity and a comprehensive income tax base, was doomed to failure because it was “fighting so many battles at once.” *Id.* at 3-4.

programs.”³⁷ The appearance of “smaller government” thus is a fiscal illusion.³⁸ Shaviro notes that meaningless fiscal language is used as a “weapon of political combat,” with conservatives favoring less “spending” and lower “taxes.”³⁹

Edward Kleinbard, as head of the JCT, also attempted to rethink TE analysis. The Kleinbard JCT sought to reinvigorate Tax Expenditure analysis by giving up on the quest for a consensus normative benchmark for the income tax, instead adopting a more pragmatic approach to classifying and analyzing Tax Expenditures, with a view to reforming them. The Kleinbard JCT distinguished between “tax subsidies” and “tax induced structural distortions.” It defined tax subsidies without regard to an ideal “normal” tax baseline, instead focusing on whether a tax reduction rule is consistent or inconsistent with a general rule adopted in the IRC.⁴⁰

Tax Subsidies include: “Tax Transfers;” (2) “Social Spending;” and (3) “Business Synthetic Spending.”⁴¹ “Tax Transfers” are defined as “payments to persons made without regard to their income tax liability, usually because there was no income tax liability to begin with, or because the person’s income tax liability was eliminated by another tax subsidy.”⁴² For example, the refundable portion of the EITC is within this category. Second, “Social Spending”

³⁷ Id. at 3-4.

³⁸ Id. at 12.

³⁹ Id. at 6.

⁴⁰ Kleinbard Address.

⁴¹ Kleinbard Address.

⁴² Kleinbard Tax Expenditure Address at 14.

is defined to include “Tax Subsidies that are unrelated to the production of business income and Tax Subsidies related to the supply of labor.”⁴³ For example, the nonrefundable portion of the EITC is within this category. Third, “Synthetic Business Spending” is defined to include “Tax Subsidies intended to subsidize or induce behavior directly related to the production of business or investment income (but excludes any Tax Subsidies related to the supply of labor).”⁴⁴ With respect to structurally induced distortions, such as the debt-equity distinction in the corporate tax, the Kleinbard JCT argued that the primary policy focus should be on reducing economic misallocations.⁴⁵ JCT later abandoned the Kleinbard JCT approach to defining TEs.

B. Additional Concerns Regarding TEs.

Notwithstanding the incessant conceptual debates about specifying what constitutes a Tax Expenditure, the consensus view among experts is that reform of Tax Expenditures continues to be a high priority issue in tax policy.⁴⁶ TE reform should respond to earlier critiques of TEs, such as the upside-down subsidy argument, but also address other concerns about TEs. An

⁴³ Id.

⁴⁴ Id. at 15.

⁴⁵ Id. at XX.

⁴⁶ See David Schizer, *Limiting Tax Expenditures*, Columbia Public Law Research Paper No. 14-432;

Columbia Law and Economics Working Paper No. 502 (2014), available at

<https://ssrn.com/abstract=2538771> [already published in Tax L Rev?] (“scaling back ... ‘ Tax

Expenditures’ should be a high priority, as many commentators and presidential commissions have urged”).

additional concern is that Congress cannot control the annual growth in the cost of TEs. Discretionary spending programs are subject to annual budget appropriations (and in extreme cases to sequestration), but most TEs are on auto-pilot and do not require annual authorization. Discretionary spending can be capped, but most TEs are similar to mandatory spending programs, which generally are not capped. Also, in recent decades Presidents and the Congress have focused almost exclusively on discretionary outlays (just one-sixth of the federal budget) to reduce budget deficits. TEs largely have been ignored in this process.

Another concern is lack of accountability for TEs. The assumption is that many, if not most, TEs are ineffective and a waste of limited government resources. Many federal spending programs are subject to mandatory performance review, under federal budget law. Although TEs are a form of “spending,” Presidents and the Congress have not subjected TEs to mandatory federal performance review. Nor do the President and the Congress perform functional review of TEs and related programs that are authorized by Congressional Committees with subject-matter expertise. The lack of coordination between TEs and non-tax subsidy programs can create program duplication and even outright inconsistencies between tax and non-tax subsidy programs. Also, lack of coordination increases complexity. As Edward Kleinbard observes, the Congressional tax writing committees have extraordinary power because they are not constrained by subject-matter expertise, as are Congressional committees with authority in specific substantive areas, such as housing, education, or energy. In addition to formulating rules to raise revenue, the tax writing committees can create tax subsidies for anything. It is not surprising that members of the tax writing committees receive larger political contributions than members of committees with narrower authority.

Commentators agree that TE reform is a high priority. Goals of TE reform could include ensuring that (1) the distributional consequences of TEs are fair; (2) Congress can control the growth of program costs; (3) TEs are subject to performance review to assess efficacy; (4) federal agencies coordinate to perform functional analysis of related programs, to address overlap, inconsistencies and potential inefficiencies. Commentators disagree about how best to accomplish Tax Expenditure reform.

C. Extant Approaches to Reforming Tax Expenditures.

Policy approaches to TE reform can be broad, narrow, or somewhere in between. A “global” approach to TE reform could be as broad as advocating for repeal of all TEs that do not reflect ability to pay (consistent with the Surrey tax expenditure reform camp). Global approaches to TE reform could be more refined however. For example, some commentators advocate for grouping TEs into relevant categories (“baskets”) and either (1) reforming Tax Expenditures in a unitary fashion within each Tax Expenditure basket, or (2) consolidating multiple Tax Expenditures into a new aggregate Tax Expenditure for each type of basket. Other commentators reject global approaches to Tax Expenditure reform and argue for evaluation and reform of each individual Tax Expenditure.

1. Global approaches to TE reform.

The recent trend in commentary is that Tax Expenditures should be reformed globally, using a basket approach.⁴⁷ Repealing individual Tax Expenditures is quite difficult politically, in part because beneficiaries of existing Tax Expenditures organize effectively to lobby and fight repeal,⁴⁸ while the taxpayers who would benefit from Tax Expenditure reform are diffuse and do not organize to fight for Tax Expenditure reform.⁴⁹ For Tax Expenditures that are “sticky” but ineffective,⁵⁰ global or basket Tax Expenditure reforms may overcome the political obstacles to reform or repeal of individual Tax Expenditures.

⁴⁷ See, e.g., David Schizer, *Limiting Tax Expenditures*, Columbia Public Law Research Paper No. 14-432; Columbia Law and Economics Working Paper No. 502 (2014) (opposing the consensus global approach to Tax Expenditure reform) , available at <https://ssrn.com/abstract=2538771> .

⁴⁸ Schizer at 6 (noting that “political hurdles” to reforming a Tax Expenditure “are quite daunting” because “each tax expenditure draws support from a range of interest groups”).

⁴⁹ Richard L. Doernberg and Fred S. McChesney, *Gucci Gulch: Doing Good or Doing Well?*, 62 NYU L. REV. 891, 898 (1987) (invoking Mancur Olsen’s theory of collective action to explain lack of organization among those who stand to benefit from tax expenditure reform that would broaden the income tax base).

⁵⁰ Fleming & Peroni, *supra* note XX, at XX.

Commentators have proposed various types of global and basket approaches to limit deductions and exclusions in the IRC.⁵¹ These approaches include: (1) fixed-dollar caps;⁵² (2) percentage-of-income caps;⁵³ (3) fixed-dollar floors;⁵⁴ (4) percentage-of-income floors;⁵⁵ (5) phaseouts and cliffs;⁵⁶ (6) fixed-percentage of Tax Expenditure as cap on tax savings;⁵⁷ (7) “haircuts” (disallowance of a fixed-percentage of Tax Expenditures);⁵⁸ (8) replacing deductions

⁵¹ Eric J. Toder, Joseph Rosenberg, & Amanda Eng, EVALUATING BROAD-BASED APPROACHES FOR LIMITING Tax Expenditures (2013) (describing and comparing six broad approaches for limiting Tax Expenditures) [hereinafter “Toder, Rosenberg, & Eng”], available at <http://www.taxpolicycenter.org/publications/evaluating-broad-based-approaches-limiting-tax-expenditures>.

⁵² See generally Toder, Rosenberg, & Eng, *supra* note XX at XX; Schizer, *supra* note XX at 42-45.

⁵³ See generally Toder, Rosenberg, & Eng, *supra* note XX at 7; Schizer, *supra* note XX at 45-47.

⁵⁴ See generally Schizer, *supra* note XX at 37-39.

⁵⁵ See generally Schizer, *supra* note XX at 39-42.

⁵⁶ See generally Schizer, *supra* note XX at 47-49.

⁵⁷ See generally Toder, Rosenberg, & Eng, *supra* note XX at 7; Schizer, *supra* note XX at 49-51. Schizer calls this approach the “Maximum Fraction” approach.

⁵⁸ See generally Toder, Rosenberg, & Eng, *supra* note XX at 7; Schizer, *supra* note XX at 51-55.

and exclusions with fixed-rate refundable credits;⁵⁹ and (9) including Tax Expenditures in the base of the Alternative Minimum Tax (AMT).⁶⁰

Consolidation of existing Tax Expenditures is another type of basket approach to Tax Expenditure reform.⁶¹ For example, the 2005 Bush Tax Reform Panel recommended the consolidation, into just two new credits—the Family Credit and the Work Credit—of all of the following: “family, child, and work-related tax benefits, such as the standard deduction, personal exemption, [nonrefundable] child tax credit, head of household filing status, EITC, and refundable child tax credit.”⁶²

A vocal minority of commentators reject global or basket approaches to Tax Expenditure reform.⁶³ For example, tax scholars in the Welfarist camp reject the traditional tax policy

⁵⁹ See generally Lily L. Batchelder, Fred T. Goldberg, Jr., Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23 (2006).

⁶⁰ See generally Toder, Rosenberg, & Eng, *supra* note XX at 7.

⁶¹ THE PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, & PRO-GROWTH: PROPOSALS TO FIX AMERICA’S TAX SYSTEM (2005), available at <http://govinfo.library.unt.edu/taxreformpanel/final-report/index.html>.

⁶² Bush Tax Reform Panel Report at 60. [Add similar expert panel and think tank consolidation proposals.]

⁶³ See, e.g., David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L. J. 955 (2004); Schizer.

norms, including equity and “ability to pay,”⁶⁴ and suggest that each Tax Expenditure be evaluated individually, with an ex ante focus on the incentives and consequences created by tax rules.⁶⁵ David Weisbach and Jacob Nussim argue that a Tax Expenditure may be defensible on Utilitarian Welfarist grounds, either because of benefits of overlapping outlay and tax programs or because the IRS can administer some programs at a lower administrative cost than other

⁶⁴ See, e.g., Thomas D. Griffith, *Should ‘Tax Norms’ Be Abandoned? Rethinking Tax Policy Analysis and the Taxation of Personal Injury Recoveries*, 199 WIS. L. REV. 1115 (1993).

⁶⁵ David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L. J. 955 (2004). In theory, Welfarist approaches can take into account a “taste for fairness.” Kaplow & Shavell. In practice, however, certain consequences (e.g., fear or the taste for fairness) are ignored in decision procedures. MATTHEW D. ADLER & ERIC A. POSNER, *NEW FOUNDATIONS OF COST-BENEFIT ANALYSIS* (2006). Although Welfarists argue that their normative approach is best because it takes into account anything people care about, in practice decision procedures cannot take into account everything people care about. *Id.* Every normative approach—including Welfarist approaches—is implemented via decision procedures with real world limitations, which means that decision procedures always push some considerations “off-screen” and leave other considerations “on-screen.” *Id.* See also, CASS SUNSTEIN, *LAWS OF FEAR: BEYOND THE PRECAUTIONARY PRINCIPLE XX* (2005) (advocating for CBA, instead of the Precautionary Principle, while acknowledging that even CBA may not take into account all relevant policy considerations).

agencies.⁶⁶ Under this approach, a targeted tax rule that benefits a specific group is not suspect solely because the benefit is located in the IRC.

The Welfarist approach does not distinguish between Tax Expenditures on the basis of size, type, or budget category. As a result, this individualized approach would require that each Tax Expenditure be analyzed using complex Welfarist criteria. Determining whether the consequences of every Tax Expenditure do or do not promote social welfare, applying various social welfare functions, would demand inordinate institutional resources.⁶⁷ In the current budget-constrained environment, such costly, indiscriminate TE analysis is not feasible. This is part of the reason that the statutory requirement to conduct performance review of Tax Expenditures has been ignored for two decades by Presidents of both political parties.⁶⁸ What is needed is a defensible system of Tax Expenditure classification that allows policy makers (1) to focus on certain Tax Expenditures (e.g., based on Tax Expenditure size or Tax Expenditure budget category) or (2) to group and reform Tax Expenditures that share policy-relevant features. Ideally such a classification system also would guide reformers towards the appropriate balance of normative criteria for evaluating and reforming each category of Tax Expenditures.

⁶⁶ David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L. J. 955 (2004).

⁶⁷ ADLER & POSNER, *NEW FOUNDATIONS OF COST-BENEFIT ANALYSIS*, *supra* note XX, at XX.

⁶⁸ Heen, *supra* note XX, at XX; Kleinbard, *We Are Better than This*, *supra* note XX, at XX.

Consistent with Weisbach and Nussim's Welfarist agenda for Tax Expenditure reform, David Schizer advocates for individual evaluation of each Tax Expenditure and suggests a three-step approach for performing such evaluations:⁶⁹

First, what programmatic benefits would we lose? What positive externalities are created, and how much would we have without the subsidy? Can we tighten up the tax expenditure to get all (or most) of the benefits at a lower cost? Second, do we incur an offsetting welfare cost by increasing excess burden? What are the effects on labor and savings decisions, administrative costs, and planning? Third, do we incur an offsetting cost in distribution? Who is claiming the tax benefit? What is the economic incidence of this benefit?

Schizer's approach to analyzing each individual Tax Expenditure thus requires empirical information about (1) the programmatic benefits of the TE, (2) the excess burden of the TE, and (3) the distributional effects of the Tax Expenditure (taking into account incidence).⁷⁰ Although he explicitly opposes grouping Tax Expenditures into "baskets," for the purpose of Tax

⁶⁹ David Schizer, *Limiting Tax Expenditures*, Columbia Public Law Research Paper No. 14-432; Columbia Law and Economics Working Paper No. 502 (2014), available at <https://ssrn.com/abstract=2538771> [already published in Tax L Rev?].

⁷⁰ David Schizer, *Limiting Tax Expenditures*, Columbia Public Law Research Paper No. 14-432; Columbia Law and Economics Working Paper No. 502 (2014), available at <https://ssrn.com/abstract=2538771> [already published in Tax L Rev?].

Expenditure reform, Schizer draws a fundamental distinction between (1) “aggregate” subsidies and (2) “individually-based” subsidies. For Tax Expenditures that are “aggregate subsidies,” “marginal benefits vary only with the activity level of *all* claimants *in the aggregate*.”⁷¹ For Tax Expenditures that are “individually-based” subsidies, “marginal benefits also vary with the activity level of each claimant.” This distinction might be used to group categories of Tax Expenditures and deliver the Tax Expenditure benefits in a more cost-effective fashion if a partial replacement VAT is adopted.

Only the “class” of high-income taxpayers would continue to file Form 1040s under the Graetz Plan. If a Tax Expenditure is an aggregate subsidy, the goal is to incentivize an activity, such as conversion to solar power or contributions to charities that provide public benefits. Such a Tax Expenditure should not be limited based on the taxpayer’s income. All Americans should be able to receive the benefit, regardless of income. It would not make sense to provide the subsidy only to high-income taxpayers, so the subsidy should not be in the IRC. This conclusion is consistent with Graetz’s assumption that almost all Tax Expenditures should be repealed if his Plan is adopted.

For individually-based subsidies, we would need to ask which group of taxpayers is supposed to receive the benefits of the existing subsidy. If the subsidy is a wage subsidy and/or an anti-poverty subsistence subsidy, such as the EITC, the high-income taxpayers who still file Form 1040 would be ineligible to receive the subsidy. The remaining questions then are: (1) should the subsidy be continued for its intended beneficiaries? (2) if so, how should the subsidy

⁷¹ Schizer at 5.

be designed? and (3) by whom (which government agency) should the subsidy be administered and delivered? If, on the other hand, high-income taxpayers are the targets for the subsidy, the subsidy rule could be in the IRC. There would be few subsidies of this sort, but one example might be the tax subsidy for charitable contributions.

III. INSTITUTIONAL DESIGN IMPLICATIONS FOR TAX EXPENDITURES.

A. Repealing, Replacing or Reforming Tax Expenditures That Are Ineffective, Inefficient, or Inequitable.

TEs that are ineffective, inefficient, or inequitable should be repealed, replaced, or reformed.⁷² For example, Anne Alstott describes such a subsidy, the Targeted Jobs Tax Credit.⁷³ The credit (now repealed) provided a subsidy to employers for hiring new workers from within nine categories of disadvantaged job applicants, but permitted employers to certify the eligibility of workers *after* the employer hired them.⁷⁴ Empirical evidence suggested that a large percentage of the TJTC payments made to employers were for hiring employees that the

⁷² David Schizer suggests evaluating Tax Expenditures in steps. The first step is to ask what programmatic benefits the Tax Expenditure delivers. Schizer, *supra* note XX.

⁷³ Anne L. Alstott, *Work vs. Freedom: A Liberal Challenge to Employment Subsidies*, 108 YALE L. J. 967, 1033-38 (1999), available at http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=4002&context=fss_papers.

⁷⁴ Alstott, *Work vs. Freedom* at 1034 (describing the retrospective certification procedure).

employer would have hired without the credit.⁷⁵ Alstott notes, more generally, that employment subsidies are problematic for a number of reasons:

Not least, they would require ongoing government manipulation of labor market processes that economists do not fully understand. By distorting market allocations, they could—ironically—lure even more people into a lifetime of dead-end jobs. Employment subsidies are also extremely difficult to design and administer. Past programs have been notable failures, largely because of administrative dilemmas that are virtually insoluble in programs of this kind.⁷⁶

Of course, determining whether a subsidy is ineffective, inefficient, or inequitable often is challenging. Complicating matters, Jacob Goldin and Yair Listokin correctly note that taxpayer *perceptions* of a tax incentive—not simply the existence of the tax incentive—determine taxpayers’ behavioral responses to the incentive.⁷⁷

[Add Schizer’s “Grand Slam” example]

One tipoff that a tax incentive warrants a closer look is an inconsistency between the tax subsidy and nontax subsidies or regulation. Victor Thuronyi provides an illustration of an

⁷⁵ Alstott, *Work vs. Freedom* at 1035-36 (summarizing research findings).

⁷⁶ Alstott, *Work vs. Freedom* at 971.

⁷⁷ Jacob Goldin & Yair Listokin, *Tax Expenditure Salience*, 16 AM. L. & ECON. REV. 144, 145 (2014), available at <https://academic.oup.com/aler/article/16/1/144/135066> (estimating salience to taxpayers of the deductions for charitable contributions and home mortgage interest).

inconsistency between tax and nontax rules: the tax system provides subsidies to encourage dairy farmers to expand production and herd size, but the Department of Agriculture simultaneously provides subsidies to encourage farmers to reduce production and herd size.⁷⁸ The example illustrates the potential lack of coordination between tax policy and nontax policies.

⁷⁸ Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 DUKE L.J. 1155, 1161 (1988).

[TEs] are administered by the Internal Revenue Service (IRS), an agency unfamiliar with the substantive problems addressed by subsidies and unable to coordinate tax expenditures with subsidy programs administered by other agencies. The various subsidies that the tax code provides to dairy farmers illustrate this last objection. The dairy farmer subsidies include accelerated depreciation deductions on livestock and equipment and the acceptance of "cash accounting," both of which defer tax liability with no interest. While these tax provisions subsidize production and encourage herd expansion, the Department of Agriculture, on the other hand, pays dairy farmers to curtail production and slaughter their herds. Such inconsistency in policy would be much less likely if the Department of Agriculture, rather than the IRS, provided all subsidies to farmers. If the same congressional committee reviewed and the same agency administered all subsidies in a particular substantive area, at least the subsidies would not simultaneously encourage and discourage the same activity. The result would be consistent and more efficient subsidies.

Id. (citations omitted).

Weisbach and Nussim argue that even such a facial inconsistency might make sense from the perspective of allocating subsidies and regulation based on institutional design and organizational expertise. For example, the IRS may be better than the Department of Agriculture at administering business subsidy programs generally (e.g., accelerated depreciation and use of the cash method of accounting), and the Department of Agriculture may be better than the IRS at regulating dairy farming to optimize herd size.⁷⁹ Allocating organizational responsibility in this way could produce the very inconsistency that Thuronyi uses to illustrate a fundamental problem with Tax Expenditures. Weisbach and Nussim conclude that “a decision to have separate tax and spending programs is a decision to have specialization in each program.” Such specialization increases accuracy at the cost of increased complexity. A decision to integrate a tax and spending program, conversely, is “a decision for simplicity.”⁸⁰

Tax subsidies that duplicate nontax subsidies also should be examined. [Add material and examples.]

The difficulty in culling hundreds of TEs is figuring out where to start. The Welfarist approach seems intractable. An alternative would be to group TEs based on the budget function under which they are listed in the TE budget. TEs within a budget function could be evaluated alongside direct expenditure programs within the same budget function. This approach must overcome the structural impediments of overlapping Congressional committee authority. An example of a successful coordination between multiple agencies, including the

⁷⁹ W&N at 994-95.

⁸⁰ W&N at 995.

IRS, involved the regulatory implementation of the Affordable Care Act. Also, expenditure programs might straddle multiple budget functions, but that problem is not unique to tax expenditures. Congress would specify the oversight structure for the coordinated evaluation of functionally related expenditure programs. For example, GAO or OMB could oversee the evaluation, with input from each relevant agency' deputy director, Inspector General, and other leaders charged with achieving performance success. JCT's experts would supply revenue estimates. The IRS would need to adopt cost-accounting rules, to enable the IRS to estimate its TE compliance costs. The likely result of this process is that many ineffective, inefficient, or inequitable TEs would be repealed. Congress also would provide for periodic functional review of related expenditure programs following adoption of the VAT.

B. Improving Tax Expenditures That Are Not Repealed.

The possibility that fewer Form 1040s might be filed presents an opportunity to reconsider the design, administration, and delivery of effective Tax Expenditures, including federal anti-poverty tax subsidies. In addition, the adoption of a partial replacement VAT raises the ancillary question of whether new subsidies should be adopted to offset the regressivity of the new VAT.

The EITC is widely regarded as “a uniquely effective and viable anti-poverty program.”⁸¹

The existing literature on institutional design provides a helpful foundation for thinking about

⁸¹ See, e.g., DJV at 1011:

The overwhelming majority of economic evidence suggests that the EITC constitutes a uniquely effective and viable anti-poverty program. It responds directly to the economic changes of the past few decades, “explicitly

reforming the EITC in the context of adoption of a partial-replacement VAT. Commentators argue that integration of a government transfer program into the tax system “combines administrative, humanitarian, and political goals.”⁸² Administrative cost and complexity of transfer programs with an income-eligibility requirement might be reduced by integrating the tax and transfer system.⁸³ The IRS has expertise in income measurement and the capacity to issue refund checks. Also, allowing transfer program beneficiaries to apply for benefits by filing

supplementing the wages received by low-wage workers”. It offsets the tax burden, which has fallen increasingly on the working poor, accounting especially for rising excise and payroll taxes. It shrinks the income gap between rich and poor. And as reported by the CEA, the EITC lifted 4.3 million persons out of poverty in 1997, including 2.2 million children under the age of 18, more than any other government program. The EITC has proven such an effective anti-poverty program at the federal level, that 11 states have enacted their own EITCs. According to recent studies, state-level EITCs produce the same kind of positive benefits as their federal counterpart.

Id. (citations omitted).

⁸² AA at 565 (summarizing arguments made by proponents of tax-transfer integration). DJV at 999 (summarizing Carter Administration views regarding various advantages of EITC over traditional transfer programs).

⁸³ AA at 564-65.

income tax returns can reduce the stigma of applying for transfer benefits.⁸⁴ In addition, situating transfer programs in the tax system makes the transfer program more acceptable politically than if the transfer program existed outside the tax system as a standalone welfare program.⁸⁵ Public support for sending “workers” “tax refund” checks may be greater than public support for sending “welfare” beneficiaries “welfare” checks.⁸⁶

Considering the tax-transfer integration issue in the context of EITC design, Anne Alstott observes that the standard arguments for tax-transfer integration oversimplify the institutional design issue.⁸⁷ She argues that “the tax system’s limitations render the EITC inherently inaccurate, unresponsive, and vulnerable to fraud and error in ways that traditional welfare programs are not.”⁸⁸ Integration proponents are correct that means-tested transfer programs

⁸⁴ AA at 565. DJV at 999 (noting that an expanded EITC “provided aid ‘in a form less stigmatizing’ than traditional public assistance programs”).

⁸⁵ AA at 565. Dennis J. Ventry, *The Collision of Tax and Welfare Politics: The Political History of the Earned Income Tax Credit, 1969–99*, 53 *Nat’l Tax J.* Vol. 983, 999 (2000), available at <https://ssrn.com/abstract=966351>. [DJV]

⁸⁶ DJV at 999. Ventry observes that in the late 1970s, Carter “Administration officials were confident in the [EITC expansion] proposal’s political attractiveness, believing that providing subsidies via the tax system would “improve the legislative feasibility of the plan by using a tax rather than a welfare mechanism.” In their view, the EITC “was not welfare,” because it “rewarded work, not dependency,” and “would assist the working poor ‘without labeling them as welfare recipients.’” *Id.*

⁸⁷ AA at 535 (critiquing “the simple case” for tax-transfer integration).

⁸⁸ AA at 535.

typically have an income eligibility requirement and the IRS is expert at measuring income. Alstott notes, however, that “income” is defined and measured differently in the transfer and tax systems because the two systems have divergent goals and characteristics.⁸⁹ These differences impact the way in which each system “balance[s] the desirability of a comprehensive definition of income against the cost of administering such a definition.”

Consequently, any transfer program that adopts the tax system’s rules and procedures necessarily strike a different balance than traditional transfer programs do. Further, these different institutional choices make tax-based programs less accurate in tailoring benefits to needs, less responsive to changing needs, and less capable of enforcing compliance than their traditional counterparts.⁹⁰

The EITC has two separate goals; it is partly a wage subsidy, to encourage work, and partly an income-redistribution program, to provide subsistence benefits to low-income families.⁹¹ If the wage subsidy aspect dominates, as it did in earlier years,⁹² the EITC’s inaccuracy, lack of

⁸⁹ AA at 567.

⁹⁰ AA at 567-68.

⁹¹ AA at 568-69.

⁹² See, e.g., DJV at 1008-09 (noting that in 1995 Treasury Assistant Secretary of Tax Policy Leslie Samuels testified that 78 percent of the EITC functioned as an offset for payroll taxes, including Social Security taxes, with the remaining 22 percent constituting a transfer to low-wage workers, to incentivize “work over welfare”).

responsiveness, and compliance shortcomings may not be an important concern. Over, time, however, the redistributive aspect of the EITC has grown, increasing the significance of the integration issue.⁹³

Transfer and tax systems define both “income” and “family” differently. Transfer systems define both broadly, in an attempt to determine a household’s total economic resources, out of which a family can pay for essential goods and services.⁹⁴ The tax system defines both income and family (the taxpaying unit) more narrowly.⁹⁵ Unlike the income tax, transfer program rules typically take into account wealth and cash flows, in addition to income.⁹⁶ Limiting the EITC financial eligibility test to the narrow tax definition of income allows wealthy taxpayers with little income to receive the EITC.⁹⁷

Alstott also compares the “responsiveness” of tax and transfer programs “to changing circumstances” over time.⁹⁸ She distinguishes between (1) the interval used to measure eligibility of benefits and (2) the interval for the payment of benefits to beneficiaries. The eligibility interval usually is shorter for transfer benefit programs (e.g., monthly) than for

⁹³ AA at 570-72.

⁹⁴ AA 572.

⁹⁵ AA at 571-72.

⁹⁶ AA at 571.

⁹⁷ AA at 575 (citing EITC study, which concluded that “up to 10 percent” of 1988 EITC benefits were paid to taxpayers with significant assets).

⁹⁸ AA at 579.

programs in the income tax system, which uses an annual accounting period.⁹⁹ Even if the payment interval for a program in the income tax is more frequent than annual, beneficiaries understandably do not want to run the risk that they will have to repay benefits in a lump sum later, if they subsequently fail the annual eligibility requirements. This may be part of the reason that taxpayers did not use the “advance payment” option for the EITC, which allowed EITC beneficiaries to receive larger paychecks throughout the year, instead of a lump sum refund check after they file an income tax return.¹⁰⁰

The potentially conflicting goals of compliance and participation also have to be balanced in tax and transfer programs.¹⁰¹ The integration of the EITC into the “mass” income tax system promotes participation. EITC participation rates are significantly higher than participation rates for non-integrated transfer programs.¹⁰² The other side of the coin is that EITC noncompliance and overpayments are a significant concern.¹⁰³ EITC noncompliance and overpayments have multiple causes, including: preparation of income tax returns by unregulated tax return preparers who have an economic incentive to increase their clients’ tax refunds; and taxpayer

⁹⁹ AA at 579-

¹⁰⁰ AA at 581-582. “Advance payment creates the illusion of responsiveness, but it cannot deliver true responsiveness as long as the EITC remains linked to the annual accounting interval of the federal income tax.” Id. at 582. The advance payment option was repealed in 2010. P.L. 111-225 [add pin cite].

¹⁰¹ AA at 584.

¹⁰² AA at 586.

¹⁰³ AA at 586-89.

confusion about the complex EITC eligibility rules.¹⁰⁴ Taxpayers who claim the EITC but later fail the eligibility rules nonetheless often are low-income families.¹⁰⁵

Alstott counsels policymakers to weigh the well-known advantages of tax-transfer integration against the less obvious disadvantages she highlights. Ideally, she notes, “a more sophisticated approach to tax-transfer integration ... would attempt to create alternative institutions that incorporate the best features of tax and welfare administration and are stronger than either standing alone.”¹⁰⁶

Continuing Alstott’s institutional design analysis of the EITC, David Weisbach and Jacob Nussim compare the design of the SNAP program and the design of the EITC.¹⁰⁷ They view the integration question as a question of institutional design and organization of government bureaucracy. Advocating for a Welfarist analysis of each individual program, to address the

¹⁰⁴ Leslie Book, *Meeting Taxpayers Where They Live: Improving US Refundable Credits While Reflecting the Lives of the Working Poor* (2018) (two most common sources of EITC overstatement are eligibility errors regarding definition of qualifying “child” and income overstatement by unregulated tax return preparers to qualify the taxpayer for the EITC), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3056474.

¹⁰⁵

¹⁰⁶ AA at 590-91.

¹⁰⁷ David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L. J. 955, 981 (2004) (discussing Alstott’s integration approach and noting “[t]he tradeoff is between the simplicity benefits of integration and the accuracy benefits of separation”).

organizational issue, they characterize the accuracy and cost tradeoff decisions as a “problem of marginal benefits and marginal costs.” The added wrinkle in the integration context is that the costs of accuracy will vary between tax and nontax government bureaucracies.¹⁰⁸ They conclude that the SNAP program should not be integrated into the tax system because the SNAP program must respond quickly to drops in income.¹⁰⁹ Conversely, they conclude that the EITC “works reasonably well within the tax system” because responsiveness is less important for the EITC program than it is for the SNAP program.

If the Graetz Plan were adopted, the historic conceptual link between the income tax system and the EITC would be severed. Graetz concedes that “protecting low-and moderate-income workers from a tax increase or loss of the EITC without requiring them to file tax returns is probably the most challenging task for the new tax system [he proposes].”¹¹⁰ He opposes VAT exemptions for essential goods and services.¹¹¹ He argues that the VAT-reduction benefits of exemptions should not be provided to higher-income taxpayers, and that exemptions would

¹⁰⁸ W&N at 993 (observing “the independent variable is the institutional structure itself, which then determines the tradeoff between accuracy and complexity”).

¹⁰⁹ W&N at 961, 1023 (“if alleviating short-term hunger is an important enough goal of the [SNAP program]” the SNAP program should not be integrated into the tax system, which is unresponsive to short term scarcity of resources).

¹¹⁰ Graetz (2008) at 171.

¹¹¹ Graetz (2008) at ____.

drive up the VAT rate.¹¹² In his view, it would be better to make the base of the VAT very broad, to minimize the VAT rate and direct VAT offsets to the TPs most in need of such offsets.¹¹³

Graetz proposes payroll tax adjustments as new regressivity offsets, to replace the existing EITC.¹¹⁴ Such payroll adjustments would increase workers' take-home pay throughout the year, instead of providing a lump sum annual amount as under the current EITC.¹¹⁵ The payroll adjustment proposal might not enhance the welfare of low-income workers in the long run, however. Incrementally higher worker paychecks will not solve the pressing problem of liquidity traps for low-income taxpayers with no savings and volatile income. The demise of the EITC "advance payment" option indicates that EITC beneficiaries overwhelmingly prefer to receive lump sum amounts instead of incremental increases in their paychecks. In addition, it may be ill-advised, politically, to tap payroll taxes for current anti-poverty subsidies. Payroll taxes

¹¹² Graetz (2008) at ____.

¹¹³ Graetz (2008) at ____.

¹¹⁴ Graetz (2008) at 174. The offset would not be exact, in part because Graetz proposes to improve the existing EITC subsidy as it is converted from an income tax subsidy into a payroll tax subsidy: "For several reasons, it is not appropriate that this tax relief and low-wage subsidy correspond precisely to that provided by the current [EITC]. For example, the EITC now contains serious penalties on marriage, which should not be replicated in the new system." *Id.* Depending on the VAT rate, Graetz also notes that the aggregate payroll adjustment might need to exceed the current aggregate EITC amount. *Id.*

¹¹⁵ Graetz (2008) at 174.

historically have low political salience and Social Security benefits have high political salience.¹¹⁶

In terms of overall satisfaction with our tax system, it would make no sense to deliver anti-poverty subsidies through the payroll tax system and put a public spotlight on the enormous amount of payroll taxes that everyone other than the payroll adjustment beneficiaries will continue to pay.

Adoption of the Graetz Plan also necessitates new regressivity offsets for *unemployed* persons. A new regressivity offset that continues the EITC work/wage/earned-income requirement does not provide assistance to unemployed persons, including disabled people, retirees, and many students. Graetz responds this concern by noting that retirees' monthly Social Security old age benefit would be increased, under automatic cost-of-living-adjustment rules, to reflect the economic effects of a new VAT on prices of goods and services.¹¹⁷ Not all benefit programs (and funding for benefit programs) incorporate such COLA provisions, however. For example, block grants to states, which fund Temporary Assistance to Needy Families ("TANF") do not automatically adjust for cost of living increases. Graetz suggests that COLA provisions could be added to federal programs and funding mechanisms that currently lack COLA provisions, to address such concerns.¹¹⁸

The original Graetz proposal include a "smart card" delivery mechanism as an alternative to payroll adjustments. These smart cards would function in a manner similar to existing EBT cards

¹¹⁶ Gamage & Shansky (distinguishing between market salience and political salience).

¹¹⁷ Graetz (2008) at 177.

¹¹⁸ Graetz (2008) at 177.

that are used to deliver monthly benefits to SNAP recipients. Graetz notes that such smart cards could be used to deliver regressivity offsets to unemployed low-income Americans, as well as low-income workers.¹¹⁹

The updated Graetz Plan proposes that both types of regressivity offsets be adopted, in effect (1) using payroll adjustments for workers to take the place of the existing EITC¹²⁰ and (2) using distribution of smart cards to take the place of the existing Child Tax Credit.¹²¹ [Add additional details about regressivity offsets for updated Graetz Plan. See Eric Toder, Jim Nunns, and Joseph Rosenberg article on 2013 Graetz Plan update.¹²²]

The proposal does not specify which government entity or agency would administer and deliver the smart cards. The likely candidates would be the IRS or the Social Security Administration (“SSA”). If eligibility for the monthly smart card were targeted to low-income and middle-income households, the default administrator would seem to be the IRS, which is

¹¹⁹ Graetz (2008) at 179.

¹²⁰ Graetz 2013 Update at 9 (“protect low-and-moderate-income workers from a tax increase through payroll tax cuts”)

¹²¹ Graetz 2013 Update at 9 (“protect low-and-moderate income families from a tax increase by substantially expanded refundable tax credits for children, delivered through debit cards to be used at the cash register”).

¹²² Eric Toder, Jim Nunns, and Joseph Rosenberg, *Using a VAT to Reform the Income Tax* (2012), <http://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/412489-Using-a-VAT-to-Reform-the-Income-Tax.PDF>

“expert” in tracking and measuring income and has existing systems for payment of benefit checks.

Historically, costs for IRS administration of the EITC have been lower than the costs for non-tax agency administration of non-tax transfer programs.¹²³ On the other hand, error rates for the EITC program have been higher than error rates for non-tax transfer programs. In response, the IRS has diverted audit resources to greater oversight of EITC compliance.¹²⁴ IRS audits have reduced the EITC overpayment rate. As Gabriel Zucman notes, however, tax evasion is much more of a problem among self-employed taxpayers and high net-worth taxpayers.¹²⁵ Going forward, it makes little sense for the IRS to spend its scarce (increasingly scarce in recent years) enforcement resources auditing low-income taxpayers who claim a few hundred dollars or few

¹²³ See, e.g., DJV at 1010-11 (during the mid-1990s, EITC administrative costs were 1 percent of payments, but administrative costs of AFDC were 16 percent of total claims and administrative costs of the Food Stamp program were 15.4 percent of total claims).

¹²⁴ See, e.g., DJV at 1010 (recounting history of IRS auditing of EITC program, including \$100 million IRS spent in 1998, which reduced EITC overpayments by \$977 million). Subsequent IRS outreach and simplification of the EITC rules have reduced the EITC overpayment rate. DJV at XX.

¹²⁵ Gabriel Zucman, *Tax Evasion and Inequality* (2-15-18 draft for UCLA Colloquium) at 25-26, 37 (noting that “audits show high evasion rates among the self-employed, but little evasion among salaried workers and retirees,” and “the top 0.01% of the wealth distribution,” with net wealth of \$45 million or more, “evades 25%-30% of its taxes,” which is “an order of magnitude greater than the average evasion rate of 3%).

thousand dollars of EITC (or EITC replacement benefits), instead of auditing taxpayers whose tax underpayments are likely to be orders of magnitude higher.

Mass auditing of EITC recipients probably does not maximize returns on scarce tax enforcement dollars. The IRS nonetheless recently announced plans to increase IRS oversight of EITC recipients, in effect requiring them to endure an IRS audit before receiving EITC benefits.¹²⁶ If eligibility for the benefit depends only on the number of children in the household, recipients could provide their children's age and Social Security numbers, and family structure to the SSA. Payment of benefit checks by the SSA would be within the SSA's areas of competence.

The 2005 Bush Tax Reform Panel expressed serious concerns about creating a new monthly government cash grant ("prebate"), in connection with the "Fair Tax" proposal to adopt a federal retail sales tax.¹²⁷ The proposed monthly prebate benefit would be pegged to the amount of retail sales tax that a low-income or middle-income household likely would pay.¹²⁸ Even if the prebates were made available regardless of the recipient's income, eliminating the

¹²⁶ [add cite]. Prominent economist Len Burman captured the response of many commentators when he tweeted that the proposal was "batshit crazy".

¹²⁷ THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, & PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM (2005), available at <http://govinfo.library.unt.edu/taxreformpanel/final-report/index.html>.

¹²⁸ BUSH PANEL REPORT at 211-212. For example, if the federal retail sales tax rate were 34 percent and the pre-tax poverty level were \$10,000, the annual benefit would be \$3,400, which is about \$283 per month. Id. at 212.

need to track income, a federal agency still would have to monitor other characteristics of recipients (e.g., marital status and family size and structure) to prevent benefit duplication and fraud. A prebate program would cost less, although still a significant amount, if the prebate were phased out as income increased. Tying the prebate to income would substantially increase the complexity of the program and the cost to the federal government to administer it.¹²⁹ The cost of such a prebate program would be funded by the new consumption tax, which would require an increase in the rate of that new tax.

¹²⁹ BUSH PANEL REPORT at 214.

The proposed cash grant programs would require all eligible American families to file paperwork with the IRS or another federal government agency in order to claim their benefits under this new entitlement program. A federal agency would need to manage the program, verify individuals' marital status and number of eligible children, and write checks to every family in the United States. Eligibility rules would be necessary, for example, to ensure that a child claimed as a dependent could not also file for his or her own separate cash grant.

Substantial additional complexity would be imposed by a targeted cash grant program because determining eligibility would require additional information. For example, a program based on annual income would require the IRS or

The Panel also considered a “Targeted Cash Grant Program” developed by the Treasury Department at the Panel’s request.¹³⁰ The program designed by Treasury would provide cash grants of up to \$7,068 for married couples, with an extra \$2,570 for each dependent.¹³¹ The grant program would include complex income phase-ins and phaseouts to target the intended beneficiaries.¹³² The Panel concluded that the Targeted Cash Grant Program would comprise 30 percent of all federal spending, which is more than the sum of Social Security, Medicare, and Medicaid spending, and would result in redistribution of 6 percent of GDP.¹³³ Funding the program would require an estimated revenue increase of 34 percent.¹³⁴ The Panel did not recommend adoption of the Targeted Cash Grant Program, based on concerns about the scope of its redistribution and cost, as well as the growth in the size of the federal government it would require.¹³⁵

Eliminating mass filing of Form 1040 creates an opportunity to:

another federal government agency to make many of the same determinations now made under the current income tax.

¹³⁰ BUSH PANEL REPORT at 214.

¹³¹ BUSH PANEL REPORT at 214.

¹³² BUSH PANEL REPORT at 214.

¹³³ BUSH PANEL REPORT at 214.

¹³⁴ BUSH PANEL REPORT at 214.

¹³⁵ BUSH PANEL REPORT at 214.

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- Redesign the EITC to allow more frequent payment intervals;¹³⁶
- Redesign eligibility requirements to reduce compliance complexity, administrative cost, and both error and fraud;¹³⁷
- Make eligibility determination prospective and more frequent (and “responsive”);¹³⁸
- Increase savings and liquidity, to better insulate low-income taxpayers from liquidity shocks that create poverty traps and capture willpower bandwidth.¹³⁹
- [Address lack of coordination among means-tested benefit program and effective tax rates in excess of 100% in phaseout ranges.¹⁴⁰]

Consider alternatives to a redesigned EITC:

¹³⁶ Chicago experiment by Holt.

¹³⁷

¹³⁸ [“responsiveness” is partly about liquidity traps and cash flows: it’s not just about “income;” respond to W&N 1016, 1017]

¹³⁹

¹⁴⁰ See Daniel N. Shaviro, *Effective Marginal Tax Rates on Low-Income Households*, 84 TAX NOTES 1191, 1196 (1999) (concluding that overlap of benefit program phaseouts creates effective marginal rates in excess of 100 percent); Daniel Shaviro, *The Minimum Wage, the EITC, and Optimal Subsidy Policy*, 64 U. CHI. L. REV. 405, 409 (1997); [add McCaffery UCLA article?]. [W&N 995: “welfare programs typically contain phaseouts, which act as a marginal tax on income. Failing to coordinate these phaseouts can lead to very high marginal rates and a marginal rate structure that seems random.”]

- i. Burman’s Universal Wage Credit.¹⁴¹
- ii. UBI proposals.¹⁴² [Social Dividend; demogrant etc.]

[Add discussion of Data Collection.¹⁴³]

C. Framework Legislation to Constrain New Ineffective Tax Expenditures.

Even if the Graetz Plan became the law and Tax Expenditures were massively reformed, the tax writing committees in Congress could propose new Tax Expenditures in the future.¹⁴⁴ A

¹⁴¹ Leonard E. Burman, *A Universal Wage Credit: Filling the Gap in the 21st Century Labor Market*, Oct. 9, 2017 draft copy on file with the Author.

¹⁴² Fleischer & Hemel.

¹⁴³ [add Data Collection function: The annual filing of Form 1040s also serves the function of allowing the federal government to collect and compile data. Research data collection, including SOI, NIPA accounts, Green Book, inequality measures such as Gini. Also note that lack of necessary data stymied performance review of Tax Expenditures. See Mary Heen’s article on history of failed Tax Expenditure performance review].

¹⁴⁴ An oft-repeated saying, attributed to Otto von Bismark, asserts: “The less people know about how sausages and laws are made, the better they’ll sleep at night.” *As Certain as Death — Quotations about Taxes* (2006 ed.) (compiled & arranged by Jeffery L. Yablon), TAX NOTES, Jan. 9, 2006, at 103, available at http://taxprof.typepad.com/taxprof_blog/files/2005-24966-1.pdf. Another take on this old saying, attributed to J. Mark Iwry, captures the concern that Tax Expenditures might resurface even if the Graetz Plan became the law: “No one who has witnessed tax lobbyists’ perennial infestation of Capitol Hill can ever again confuse the making of tax laws with the making of sausages: at least when you make

cynical articulation of this concern is the public choice view that tax legislation is sold to the highest bidder.¹⁴⁵ Less cynically, Daniel Shaviro observes that tax legislation swings back and forth, like a pendulum, between tax reform and tax instrumentalism.¹⁴⁶ If adoption of the Graetz Competitive Tax Plan facilitates comprehensive Tax Expenditure reform, special interest groups still would have strong incentives to seek new targeted tax rules that favor them.

Tax Expenditure reform, as part of adoption of the Graetz Plan, could be strengthened by the adoption of new “Framework Legislation” that could constrain the adoption of new Tax Expenditures going forward. “Framework Legislation” is a set of statutorily prescribed procedural rules for developing substantive legislation.¹⁴⁷ Edward Kleinbard builds on his JCT Tax Expenditure classification system to consider whether Framework Legislation could constrain the proliferation of Tax Expenditures going forward.¹⁴⁸ His proposal focuses on Tax

sausages, you know the pigs won’t be coming back.” Id. at 115 (Tax Notes 2006 ed. posted on TaxProf Blog).

¹⁴⁵ Richard L. Doernberg and Fred S. McChesney, Gucci Gulch: Doing Good or Doing Well?, 62 NYU L. Rev. 891 (1987).

¹⁴⁶ Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1 (1990).

¹⁴⁷ Garrett, Elizabeth, The Purposes of Framework Legislation, 14 Journal of Contemporary Legal Issues 717 (2005) (developing and elaborating on the term “framework legislation”).

¹⁴⁸ Edward D. Kleinbard, *Tax Expenditure Framework Legislation*, USC Center in Law, Economics and Organization Research Paper No. C10-1, USC Legal Studies Research Paper No. 10-1 (2013) [hereinafter

Expenditures that are subsidies (not tax-induced structural distortions).¹⁴⁹ He observes that tax subsidies with a fixed-dollar cap, such as the low-income housing credit, are so similar to direct outlay programs that they should be subject to the same budget processes as direct outlay programs. In addition, he argues that such a subsidy should have to be created by the relevant specialist committee in Congress, not by the tax writing committees.¹⁵⁰

Temporary uncapped tax subsidies, such as the temporary homebuyer's credit, do not mesh well with the nontax Congressional budget appropriations process, because such tax subsidies have no fixed dollar cost.¹⁵¹ George Yin has argued that the temporary nature of these subsidies highlights their costs, because they must be "paid for" (subject to the limitations of the PAYGO rules) each time they are extended.¹⁵² Kleinbard nonetheless argues that these subsidies still are problematic because they mask deadweight losses, foster fiscal illusion, and give the tax

"Kleinbard, Framework Legislation"], available at <http://ssrn.com/abstract=1531945>. Kleinbard observes that Framework Legislation is not powerful enough to reform existing "embedded" Tax Expenditures, but may suffice to prevent new Tax Expenditure abuse, following Tax Expenditure reform. Kleinbard, Framework Legislation at 53.

¹⁴⁹ Kleinbard, Framework Legislation, supra note XX at 14.

¹⁵⁰ Kleinbard, Framework Legislation, supra note XX at 45.

¹⁵¹ Kleinbard, Framework Legislation, supra note XX at 49.

¹⁵² Kleinbard, Framework Legislation, supra note XX at 49 (citation omitted).

writing committees inordinate power relative to other Congressional committees.¹⁵³ For these reasons, Kleinbard argues that these types of tax subsidies also should be developed by the Congressional committee with relevant subject-matter expertise, not by the tax writing committees, with the costs of the subsidy reflected “on-budget.”¹⁵⁴ Similarly, Kleinbard argues that new “permanent” uncapped tax subsidies should be developed by the Congressional committee with relevant subject-matter expertise.

He opines that Framework Legislation could not be imposed on permanent uncapped “Tax Transfers” and “Social Spending” tax subsidies, to bring them on-budget, because the direct outlay analogues of these tax subsidies would be treated as “entitlement” spending that is not subject to the annual budget appropriations process.¹⁵⁵ Conversely, the JCT Tax Expenditure category of “Business Synthetic Spending” is different enough from direct outlay “entitlement” programs that it could be brought on-budget with Framework Legislation.¹⁵⁶

¹⁵³ Kleinbard, Framework Legislation, supra note XX at 50 (describing tax writing committees as a “Congress within the Congress” because the tax writing committees can raise revenue and can “spend” in any substantive area by creating a tax subsidy that favors activity in that area). See also Kleinbard, Edward D., *The Congress within the Congress: How Tax Expenditures Distort our Budget and our Political Processes*, 36 Ohio Northern Univ. L. Rev. 1 (2010).

¹⁵⁴ Kleinbard, Framework Legislation, supra note XX at 51.

¹⁵⁵ Kleinbard, Framework Legislation, supra note XX at 51-52.

¹⁵⁶ Kleinbard, Framework Legislation, supra note XX at 52.

Kleinbard's proposals focus on (1) better integrating Tax Expenditure information into the federal budget process and (2) reallocating the power to propose new subsidies from the Congressional tax writing committees to the Congressional committees with relevant subject matter expertise. Additional procedural rules could inhibit impulsive adoption of new Tax Expenditures and facilitate performance review of Tax Expenditures.

[Add to ideas from Century Foundation Report, Mass. Report, and Schizer; note what is being measured/optimized.] For new Tax Expenditures, require Congressional statement of purpose, measurable outcomes, data collection required for performance review, and periodic performance review. Require periodic functional analysis for 5 big Tax Expenditure budget functions. Coordination between Executive Branch and Congressional Committees is challenging but essential.]