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WHAT'S WRONG WITH THE TAX EXPENDITURE LIST / HOW TO FIX IT

Every year, as directed by the Congressional Budget Act of 1974, government revenue estimators compile lists of "tax expenditures" — hundreds of billion of dollars of purported tax "loopholes" in the individual and corporate income taxes. Congress's Joint Committee on Taxation (JCT) has just released its list; the Treasury will issue its list with the Administration's new federal budget.

The Budget Act defines tax expenditures 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." In other words, a tax expenditure is anything that allows taxpayers to keep more of their own money than would be normal under the ordinary workings of a "pure" tax system.

But what "pure" tax system? The JCT states "the legislative history of the Act indicates that tax expenditures are to be defined with reference to a **normal income tax** structure. [Emphasis added.]" This may have been Congressional intent, and it is how the JCT and the Treasury do their calculations. But this brief explanation of the reports' income tax frame of reference is too cryptic to alert the average reader that a whopper of an assumption has been made.

Neither the JCT nor the Treasury makes it clear in its report that there is more than one view as to the proper basis for taxation. Neither points out that what they call a "normal" or "broad-based" income tax is a **biased** system that taxes income used for saving and investment much more heavily than income used for consumption. Neither points out that there is a strong case for an alternative, unbiased tax system that treats consumption and saving evenhandedly (any of the major consumption-based or saving-deferred tax reform plans); under **that** kind of tax system, most reported tax expenditures would not be considered loopholes. Furthermore, under a neutral tax system, much of the tax currently collected on capital income and some earnings of labor would be considered unwarranted **tax penalties**.

> ***[T]here is a strong case for an alternative, unbiased tax system that treats consumption and saving evenhandedly ... under that kind of tax system, most reported tax expenditures would not be considered loopholes.***

Under the broad-based income tax, income is taxed when earned. If it is used for consumption, there is generally no additional federal tax (except for a few selective excise taxes) on the enjoyment of the goods and services. If the income is saved, however, there is a subsequent tax on the earnings of the savings (the "service" being bought when the assets are acquired) — a tax on interest in the case of a bond, the corporate income tax in the case of equity. This is the **basic** income tax bias against saving. **Additional** biases are created by taxing after-tax corporate earnings a second time as dividends and capital gains, the estate and gift tax on accumulated savings, and the denial of immediate or full accounting for certain business costs.

These multiple layers of tax on saving and investment in current law derive from the "Haig-Simons" definition of taxable income, which was specifically designed to redistribute income from

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rich capitalists to poor workers. (Apparently, all savers are assumed to be rich, and anyone who doesn't save, no matter how high his salary income, is assumed to be poor.) However, the broad-based Haig-Simons income tax retards investment, which reduces wages and employment, and penalizes saving, keeping those who lack capital from getting any.

The basic tax bias against saving can be eliminated by extending tax deferral to all saving (as in a pension or deductible IRA), or by giving no deduction but exempting the returns (as in a Roth IRA or a tax-exempt bond). Additional biases can be eliminated by ending the double taxation of corporate income and scrapping the estate and gift tax. In fact, all the major tax reform plans move in one way or another to an unbiased consumption-based tax system.

If the starting point for the analysis were a tax system not biased against saving and investment, the reports' conclusions would often be completely reversed.

The current tax system is a hybrid — part way between the broad-based income tax and a neutral consumption-based system. Most provisions in the current tax system that are labeled as "tax expenditures" merely remove one or another bias against capital implicit in a broad-based income tax. Some of the offsets move fully to consump- tion-based treatment. Others go only part way.

Thus, something can be labelled a tax expenditure only **relative** to what one thinks of as the appropriate tax system. One can go item by item through the JCT and Treasury reports and find that most of the so-called tax expenditures are peculiar to the broad-based income tax with its Haig-Simons definition of taxable income. Most are not "loopholes" under a consumption-based tax.

Deferral of tax on pension or IRA contributions and earnings, deferral of tax on earnings in education saving accounts, reduced tax rates on long term capital gains, and the exclusion from taxable income of interest on tax-exempt bonds and earnings of Roth IRAs are branded "tax expenditures" vis-a-vis a broad-based income tax. However, **not** giving a similar deferral to unsheltered ordinary saving (or, imposing **any** tax on interest, dividends, and capital gains on saving that was not given a tax deferral) is regarded as a tax penalty relative to a neutral, consumption-based tax norm.

The tax revenue lost under the graduated corporate income tax by allowing some corporate income to be taxed at less than the top 35% rate is called a "tax expenditure" under the broad-based income tax. Measured against a neutral consumption tax, one would argue that the entire tax is double taxation.

The broad-based income tax regards "straight-line depreciation" or lengthy amortization as the norm for deducting the cost of plant, equipment, and rental housing, and most non-wage business costs relating to the exploitation of natural resources. It brands as a tax expenditure any "accelerated depreciation" or the "expensing" of various items that farmers, researchers, energy exploration and development operations, and small businesses are allowed to write off immediately. But depreciation (even accelerated depreciation) forces businesses to delay reporting legitimate expenses, understates costs, and overtaxes business income. A neutral tax system permits all capital investment to be expensed; anything less imposes a tax penalty.

Deductions and credits for education, for property taxes on owner-occupied housing, and for individuals' state and local income taxes are called tax expenditures vis-a-vis the broad-based income tax. Education outlays are, in part, costs of acquiring human capital and earning additional income. Property taxes and state and local income taxes are used primarily for education, investment in public infrastructure, and transfers to persons too poor to owe tax. All should be deductible by taxpayers under a consumption tax.

The only big items on the "tax expenditure" list that would still appear if measured relative to a consumption tax are the home mortgage deduction and the exclusion of employer provided health insurance and other miscellaneous fringe benefits. So far as various credits exceed the value of a deduction, they would spill over into "subsidy" as well.

As currently presented, the annual "tax expenditure" reports are highly biased and misleading. Any of three alternatives would be better.

(1) Scrap the reports.
(2) Redo the reports using a saving/consumption-neutral tax benchmark instead of the broad-based income tax.
(3) Present two sets of tax expenditure estimates, one measured against the "normal" income tax, and the other against a saving/consumption-neutral tax.

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As it stands, too many readers, including many Members of Congress and some presidential candidates, lack sufficient familiarity with basic tax concepts to understand how one-sided the current reports are, and how technically wrong, unjust to savers, and economically disastrous it would be to cut off these "tax expenditures" and give Washington hundreds of billions of additional dollars with which to play.

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