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# **Tax Expenditure Framework Legislation**

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Preliminary draft. Comments are welcomed.

## Tax Expenditure Framework Legislation

### I. INTRODUCTION.

#### A. From Sideshow to Center Ring.

Tax expenditures have been closely analyzed in the United States for over 30 years, but to date the U.S. Congress has failed to incorporate tax expenditure analysis in any meaningful way into its budget decisions.<sup>1</sup> Explicit federal outlays are developed through an elaborate budget-setting process, but the preparation of the annual federal Budget largely ignores tax subsidies, and thereby privileges them, even though those subsidies function like outlays in most substantive senses.<sup>2</sup> Precisely because tax expenditures fall outside established Congressional budget constraints, Congress has come to rely on them expansively. The result is a system in which tax subsidies have become the preferred vehicle for delivering new spending programs – even fixed-dollar appropriation-equivalent programs – in cases where the tax system offers no particular advantage as the delivery mechanism.

Today, our tax system is riven with special exceptions to an extent unmatched since the Tax Reform Act of 1986. The result is that federal interventions in the American economy are far more ubiquitous than is generally understood, and the tax system is saddled with higher marginal rates than otherwise would be necessary, in each

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<sup>1</sup> The tax expenditure literature is voluminous. One recent paper that reviews the literature is the report of the Staff of the Joint Committee on Taxation, *A Reconsideration of Tax Expenditure Analysis*, JCX-37-08 (May 12, 2008) (available at <http://www.jct.gov>). As a matter of disclosure, the author was Chief of Staff of the Joint Committee on Taxation at the time the cited paper was prepared. For a slightly different recent perspective, see Fleming and Peroni, “Reinvigorating Tax Expenditure Analysis and Its International Dimensions,” 27 *Virginia Tax Review* 437 (2008).

<sup>2</sup> Howard E. Shuman, *Politics and the Budget: The Struggle Between the President and the Congress* (3d. ed. 1992) at 126.

case with attendant efficiency consequences. At the same time, the annual federal budget is systematically understated by amounts exceeding \$1 trillion per year,<sup>3</sup> and classic government spending programs often overlap or compete with tax subsidy counterparts.

This paper therefore considers how tax expenditures might be brought more directly into the federal budget process. That process, reflected in several statutes since the landmark Congressional Budget and Impoundment Control Act of 1974, is the best-known example of what Elizabeth Garrett has termed “framework legislation.”<sup>4</sup> Very simply, the term describes a statute that embodies internal rules of procedure by which a legislature goes about developing substantive legislation in a specific area. Framework legislation helps legislatures to develop substantive outcomes – for example, how much money the government should spend and raise in taxes in a year – but framework legislation does not directly dictate those substantive outcomes.

In short, then, this paper inquires into how tax expenditure analysis fits into existing budget framework legislation, and how that process can be improved. The paper argues that existing budget framework legislation does not simply underweight the importance of tax expenditures, but actually privileges this form of government spending over explicit spending programs. The paper further argues that the recent work of the Staff of the Joint Committee on Taxation (the “JCT Staff”) to redefine tax expenditures in a more objective fashion, in particular with respect to the subset that the JCT Staff terms “tax subsidies,” has satisfied a critical precondition to bringing tax expenditures more effectively within budget framework legislation.

Finally, the paper suggests that every tax subsidy (the subset of tax expenditures most susceptible of being included within budget framework legislation) can be placed into one of three categories for purposes of developing tax framework rules of

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<sup>3</sup> Kleinbard, “How Tax Expenditures Distort Our Budget and Our Political Processes,” 123 Tax Notes 925 (May 18, 2009).

<sup>4</sup> See, for example, Garrett, “Framework Legislation and Federalism,” 83 *Notre Dame L. Rev.* 1495 (2008); Garrett, “Conditions for Framework Legislation,” in Richard W. Bauman and Tsvi Kahana (eds.), *The Least Examined Branch: The Role of Legislatures in the Constitutional State*, ch. 14 (2006); Garrett, “The Purposes of Framework Legislation,” 14 *J. Contemp. Legal Issues* 717 (2005); Garrett, “Rethinking the Structures of Decisionmaking in the Federal Budget Process,” 35 *Harv. J. on Legis.* 387 (1998); Garrett, “Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process,” 65 *U. Chi. L. Rev.* 501, 549 (1998).

application. Some tax subsidies (e.g., the low-income housing tax credit, or many energy incentives) constitute fixed-dollar allocations: they operate as direct competitors to classic discretionary spending appropriations. Others are open-ended in dollar terms, but offered for a fixed term (e.g., the dozens of “extenders” that periodically gallop through the legislative process like a herd, led by the research and development tax credit). Tax expenditures in the third category are both open-ended in dollar terms and indefinite in term. The paper concludes by sketching some possible procedural rules for each category, in light of each one’s substitutability with spending programs subject to existing framework processes.

### B. Framework Legislation.

Framework legislation is sometimes called a “precommitment” mechanism:<sup>5</sup> the legislation’s procedural rules and timetables are specified in advance of knowing the specific legislation or substantive issues to which the framework will be applied. Because framework legislation ordinarily is developed in an environment removed from the drama of any particular contentious substantive debate, legislatures can adopt processes that improve their ability to come to a substantive resolution, without prejudging how the processes will affect any particular outcome. The result, it is hoped, is a higher-quality final legislative product.<sup>6</sup>

Framework legislation may itself not resolve substantive controversies, but of course framework legislation directly affects those substantive outcomes, albeit in ways

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<sup>5</sup> See, e.g., Rebecca Kysar, *Sunsets and the Tax Code*, 40 *Ga. L. Rev.* 341, 342-43 (2005).

<sup>6</sup> As developed by Garrett, framework legislation can serve any of five purposes: (i) enacting a symbolic response to a problem, (ii) providing neutral rules for considering future substantive decisions, (iii) addressing collective action problems (for example, through the adoption of procedures to develop costly information that serves the collective legislative good), (iv) entrenching certain substantive policies, and (v) changing the balance of power within different constituencies in Congress. Garrett, “The Purposes of Framework Legislation,” 14 *J. Contemp. Legal Issues* 717 (2005).

Of these purposes, the second and third resonate most strongly as serving important and objective long-term policy goals. Symbolic acts, for example, can in some cases affect substantive outcomes, but as Garrett emphasizes, only framework legislation can overcome the collective action problems that otherwise hobble the ability of a legislature to develop and evaluate reliable information on new legislative initiatives. In general, while acknowledging that all framework legislation is intensely political, this paper concentrates on the more objective attributes and uses of framework legislation.

that ordinarily are opaque to legislators at the time the framework rules are adopted. One need only look to the 2009 debates on healthcare for a vivid example of how framework rules (in particular, the rules of the Senate, which determine how that chamber will conduct debate) have driven substantive outcomes. One can easily imagine a very different bill if the Senate's rules did not require the Majority Leader to proceed by Unanimous Request quite so often, or if the right to filibuster were more narrowly constructed.<sup>7</sup>

Federal framework legislation also has the odd property of being nonbinding: although passed by both chambers of Congress and signed into law by the President, federal framework laws generally have no different status than the internal rules by which each chamber regulates its processes. As a result, each chamber of Congress can waive, modify or abandon the rules adopted in framework legislation, just as it can do in respect of any other of its internal rules of procedure.<sup>8</sup>

Garrett further has identified several conditions that appear to be necessary before Congress will enact a framework law. The most salient of these is the ability to specify precisely the abstract class of problems for which a procedural framework is desirable, so that the framework law (which by definition is a precommitment device designed to apply in the future to conditions and legislation not yet apparent) will have its intended effect. It follows that tax expenditure framework legislation is a feasible topic to entertain only if one can define the concept of tax expenditures in a manner that is generally agreed

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<sup>7</sup> Cf. Barbara Sinclair, "The New World of U.S. Senators," in *Congress Reconsidered*, Lawrence Dodd and Bruce Oppenheimer, eds., at 1-2 ("The U.S. Senate has the most permissive rules of any legislature in the world. Extended debate allows senators to hold the floor as long as they wish unless cloture is invoked . . ."); Norman Ornstein, "Our Broken Senate," 2 *The American – Journal of the American Enterprise Institute*, March/April 2008, at xx.

<sup>8</sup> Framework legislation has at least three important practical advantages over the internal rules of each chamber of Congress. First, Congress appears more reluctant to waive the application of its own legislative frameworks than to do so for its internal rules of procedure; as a result, framework legislation can be more efficacious in channeling a substantive debate towards a resolution. Second, framework legislation can impose identical rules on each chamber; by contrast, the House of Representatives and the Senate adopt their own internal rules. Third, some remedies for breach of framework legislation protocols (e.g. the sequester mechanism formerly in place to enforce budget agreements) can be implemented only through legislation. Nonetheless, given that the strictures imposed by framework legislation ultimately can be waived by either chamber, the difference between adopting a set of processes as law or as internal rules is one of degree, not kind.

to be neutral (that is, not implicitly to advance any particular political party's preferred policies) and acceptably precise. A major argument of this paper is that the recent work of the Staff of the Joint Committee on Taxation (the JCT Staff) in developing a new taxonomy of tax expenditures satisfies these conditions. Section II of this paper amplifies this point.

### C. The Urgency of the Situation.

By any measure, tax expenditures represent an enormous part of the U.S. government's operations.<sup>9</sup> The Congressional Research Service calculated that the JCT Staff list of tax expenditures published in October 2008<sup>10</sup> comprised 247 tax expenditures, the simple sum of which for fiscal year 2008 totaled some \$1.2 *trillion*.<sup>11</sup> Ninety percent of this \$1.2 trillion represented tax expenditures for individuals, and ten percent (\$118 billion) a reduction of corporate income tax.

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<sup>9</sup> The discussion in this subsection is developed in more detail in Kleinbard, "How Tax Expenditures Distort Our Budget and Our Political Processes," 123 Tax Notes 925 (May 18, 2009).

<sup>10</sup> JCT Staff, *Estimates of Federal Tax Expenditures for Fiscal Years 2008-2012*, JCS-2-08 (October 31, 2008).

<sup>11</sup> Congressional Research Service, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, at 13 (aggregate estimates) and 6 (number of tax expenditures), S. Prt. 110-667, 110<sup>th</sup> Cong., 2d Sess. (hereinafter, "CRS Compendium"). The JCT Staff itself does not sum up tax expenditures, on the grounds that there are important interactive effects across the different items (so that the revenue consequences of repealing all or a group of tax expenditures differ from the simple sum of the consequences of repealing each).

The CRS Compendium's figures for 2008 include, in addition to those items described as tax subsidies under the new framework adopted by the *JCT Reconsideration*, the items listed in Table 4 of the Staff of the Joint Committee on Taxation's *Estimates of Federal Tax Expenditures for Fiscal Years 2008-2012*, JCS-2-08 (October 31, 2008). These items (primarily the "deferral" of the income of controlled foreign corporations and accelerated depreciation) are now treated by the JCT Staff as tax-induced structural distortions, not tax subsidies, but are carried in the annual tax expenditure lists for the sake of historical continuity. The simple sum of these items for 2008 was about \$46 billion. This is a very small fraction of the \$1.2 trillion in total tax expenditures reflected in the 2008 summation. Moreover, in years prior to 2008 the JCT Staff's workproduct treated these items as tax expenditures indistinguishable from tax subsidies (as employed in 2008). To preserve continuity in the historical data summarized in this section, the text therefore uses the sum of tax subsidies and identified tax-induced structural distortions as the relevant figure for 2008.

The \$1.2 trillion spent in 2008 on tax expenditures is greater than the entire amount raised by the individual income tax in 2008, or for that matter all federal discretionary spending in that year (in each case, about \$1.1 trillion).<sup>12</sup> Indeed, it is more than twice as much as all nondefense discretionary spending in 2008 (\$528 billion).<sup>13</sup> What is more, tax expenditures have grown rapidly in number over the years, from 60 items in the JCT Staff's first tax expenditure list in 1972 to 247 in 2008.<sup>14</sup>

In 1974, when federal accounting for tax expenditures was first officially adopted, the simple sum of all tax expenditures amounted to 5.7 percent of GDP.<sup>15</sup> At the same time, explicit discretionary spending actually has declined substantially as a percentage of GDP, from levels around 10 percent of GDP in the early 1980's to less than 8 percent today.<sup>16</sup>

By fiscal year 2008, the simple sum of all tax expenditures had reached an extraordinary 8.6 percent of GDP.<sup>17</sup> To put this number in context, if tax expenditures

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<sup>12</sup> Congressional Budget Office, *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook* at 3 (March 2009) (hereinafter, CBO Preliminary Analysis).

<sup>13</sup> Office of Management and Budget, *A New Era of Responsibility: Renewing America's Promise*, H. Doc. 111-19, 111<sup>th</sup> Cong., 1<sup>st</sup> Sess. at Table S-3.

<sup>14</sup> *JCT Reconsideration* at 4.

<sup>15</sup> Tax expenditures climbed from that level to an all time high in the mid-1980's of 9.7 percent of GDP, and then fell by virtue of the base broadening and rate reductions of the Tax Reform Act of 1986, reaching a modern low of 5.3 percent of GDP in 1991. The rate stayed in the neighborhood of 6 percent of GDP during most of the 1990's, but then began a steep climb.

These figures come from the data underlying Hungerford, "Tax Expenditures and the Federal Budget," Congressional Research Service Pub. No. RL34622 (February 27, 2009) at Figure 2, p. 5, which the author of that article was kind enough to share with me. Dr. Hungerford has confirmed to the author that the 2008 entry in Figure 2 was based on preliminary data, and that the correct entry should be 8.6 percent.

<sup>16</sup> Hungerford, "Tax Expenditures and the Federal Budget," Congressional Research Service Pub. No. RL34622 (February 27, 2009) at Figure 2, p. 5. An earlier version of the same material was published in Hungerford, "Tax Expenditures: Good, Bad, or Ugly?," *Tax Notes*, Oct. 23, 2006, at 325.

<sup>17</sup> Author's calculation (\$1.223 FY 2008 tax expenditures/\$14.224 FY 2008 GDP). The GDP figure comes from the Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2009 to 2019*, at 16 (January 2009).

today were the same percentage of GDP as was the case in 1974, the simple sum of 2008 tax expenditures would have been some \$412 billion lower than the actual estimates. The 2008 figure is very close to the situation in 1985 (i.e. just before the Tax Reform Act of 1986), when tax expenditures amounted to 8.7 percent of GDP.

Aggregate tax expenditures as a percentage of all income taxes also were very close in 1985 compared to 2008 (87 percent in 1985, and 84 percent in 2008).<sup>18</sup> This is particularly telling, because most tax expenditures are expressed as deductions or exclusions, and their value fluctuates with tax rates: in lower rate environments, non-credit tax expenditures have lower value.<sup>19</sup> In general, 2008 was a much lower tax rate environment than was the case in 1985: for tax expenditures today to be running at roughly the same percentage of GDP and income tax revenues as in 1985 confirms that tax expenditures have multiplied in degree as well as in number.

These data suggest a consistent pattern of increasing reliance on tax expenditures, interrupted principally by the single base-broadening convulsion of the Tax Reform Act of 1986. Tax expenditures of course can be the most efficient means of delivering certain government subsidies, but it is greatly improbable that optimal policy design explains why the aggregate growth in tax expenditures has outstripped the growth in explicit government spending. The more straightforward explanation is that the ever-increasing reliance on tax expenditures to deliver government programs is a symptom of institutional weakness in the design of current budget framework legislation. There is a

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<sup>18</sup> Interestingly, total taxes as a percentage of GDP were 17.7 percent in both 1985 and 2008.

Historical data are available for all figures other than tax expenditures in the Office of Management and Budget's annual Budget of the U.S. Government's Historical Data volume.

Tax expenditures generally are measured only for income taxes: the JCT Staff, for example, does not calculate excise tax expenditures. For this reason, the text looks to tax expenditures as a percentage of income taxes only.

<sup>19</sup> See generally Litsokin, "Tax Expenditures and Business Cycle Fluctuations," available at <http://ssrn.com/abstract=1372782>. One can see the effect of tax rate cuts, for example, by looking at *nonbusiness* tax expenditures on either side of the 2001-2003 tax cuts. Nonbusiness tax expenditures amounted to 6.5 percent of GDP in 2001, but only 5.6 percent in 2006, reflecting the sharp tax rate cuts introduced in 2001 and 2003. Tax Policy Center, *The Tax Policy Briefing Book*, chapter on tax expenditures, available at: <http://www.taxpolicycenter.org/briefingbook/background/expenditures/change.cfm>.

natural incentive for politicians to deliver “targeted tax cuts” rather than be labeled “tax and spend” legislators, even when the economic consequences are the same.<sup>20</sup> Tax expenditure framework legislation can counterbalance that tendency, so that decisions as to how much government should spend, and how that spending should be delivered, are made in a neutral fashion.

#### D. Tax Expenditure Framework Legislation and Tax Reform.

Enthusiasts for traditional income tax reform (that is, broadening the current income tax base and lowering rates) sometimes see tax expenditure analysis as a sword that, if wielded expertly, can lead to major tax reform. These enthusiasts might argue that the purpose of bringing tax expenditures more firmly into the budget process should be to eliminate *current* tax expenditures that fail some objective set of standards. It is improbable, however, that tax expenditure framework legislation by itself will prove an effective stalking horse for tax reform.

As a precommitment device, framework legislation generally is created in an environment where its consequences for future substantive legislation cannot be predicted. Framework legislation thereby establishes procedures that might modulate certain legislative biases going forward (for example, the instinct to spend in excess of our collective means), but it is not necessarily helpful in revisiting past substantive decisions with a view to reaching a different outcome. To take one example, in 1995 Congress adopted the Unfunded Mandates Reform Act of 1995.<sup>21</sup> The 1995 statute adopted new framework rules aimed at discouraging the natural inclination of Congress (if unimpeded) to “enact more unfunded mandates than is socially optimal because of a fiscal illusion.”<sup>22</sup> The new unfunded mandates framework legislation has affected the outcomes of subsequent legislation,<sup>23</sup> but no one has ever suggested that it be employed

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<sup>20</sup> These themes are developed in Kleinbard, “How Tax Expenditures Distort Our Budget and Our Political Processes,” 123 Tax Notes 925 (May 18, 2009).

<sup>21</sup> P.L. 104-4. An “unfunded mandate” is a federal law that direct the States to incur real implementation costs to accomplish the legislation’s purpose (for example, new worker safety standards), but where Congress can capture any political credit.

<sup>22</sup> Garrett, “Framework Legislation and Federalism,” 83 *Notre Dame L. Rev.* 1495, 1525 (2008).

<sup>23</sup> *Id.* at 1519-1524.

to tabulate the costs of pre-existing unfunded mandates, with a view to revisiting their wisdom or fairness.

When it comes to modulating the spiraling cost of existing tax expenditures, the ultimate problem is essentially the same as curbing the growth in social security or other entitlements spending. In each case, the real issue is not just one of process, but of substance – more particularly, a lack of Congressional consensus on the uses and goals of the tax system.<sup>24</sup>

## II. TAX EXPENDITURE AND BUDGET CONCEPTS.

### A. Defining Tax Expenditures.

The phrases “tax expenditure” and “tax expenditure budget” first appeared in a 1967 speech delivered by Assistant Secretary for Tax Policy Stanley Surrey.<sup>25</sup> The speech defined “tax expenditures” in passing as “deliberate departures from accepted concepts of net income” that operated “to affect the private economy in ways that are usually accomplished by [explicit] expenditures.”<sup>26</sup> Surrey called for a “full accounting” of tax expenditures, in order both to encourage “expenditure control” and to facilitate

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<sup>24</sup> The best example to the contrary might be the framework legislation developed to enable Congress to make decisions as to which armed forces facilities to close following the winding down of the Cold War. Even there, however, the substantive decision (to close bases and reduce the military budget by a specified amount) preceded the framework legislation. The analogy in the tax arena would be a decision by Congress to reduce the deficit by \$500 billion/year through scale backs in tax expenditures (the substantive decision), followed by an agreed framework for considering which expenditures were most appropriate to be eliminated or scaled back.

<sup>25</sup> Surrey, “Excerpts from Remarks Before The Money Marketeters on *The U.S. Income Tax System -- the Need for a Full Accounting*, November 15, 1967, in United States Department of the Treasury, *Annual Report of the Secretary of the Treasury on the State of the Finances for the Fiscal Year Ended June 30, 1968* (Government Printing Office, 1969) at 322 (hereinafter, the “1968 Treasury Report”). The speech is reprinted in W.F. Hellmuth and O. Oldman (eds.), *Tax Policy and Tax Reform: Selected Speeches and Testimony of Stanley S. Surrey* (1973).

For comprehensive histories of the first years of the tax expenditure budget, see Forman, “Origins of the Tax Expenditure Budget,” 30 *Tax Notes* 537 (1986); Surrey and McDaniel, “The Tax Expenditure Concept and the Budget Reform Act of 1974,” 17 *B. C. Indus. & Com. L. Rev.* 679 (1976).

<sup>26</sup> 1968 Treasury Report at 323.

“tax reform.”<sup>27</sup> Thus, from the outset Surrey saw tax expenditure analysis as a budget tool as well as a device for advancing his tax policy desiderata.

Surrey’s proposals precipitated an enormous literature on the topic of tax expenditures. Ironically, only a small portion of this work has been devoted to Surrey’s agenda of incorporating tax expenditure analysis into the budget process.<sup>28</sup> Instead, most of these subsequent papers addressed whether tax expenditure analysis was a neutral tax policy tool, and in particular whether the “normal” tax (the baseline against which tax expenditures were identified and quantified) met academic standards of rigor in its specification.

Many tax academics and policy experts criticized Surrey’s original construct, and with it most implementations of tax expenditure analysis, as resting on insufficiently rigorous foundations. These critics argued that the ideal “normal” tax system previously used as the baseline from which to identify tax expenditures did not correspond to any generally accepted formal definition of net income. Some observers further viewed the promulgation of the “normal” tax baseline as a thinly veiled agenda for a specific form of tax reform. Under this view, the normative tax system at the heart of tax expenditure analysis was not simply an analytical tool, but was also an aspirational goal of the process.

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<sup>27</sup> 1968 Treasury Report, *supra* at 322-323, 326; *see also* Stanley S. Surrey, *Pathways to Tax Reform* at 39-40 (Cambridge, Mass., Harvard University Press, 1973) (describing uses of a tax expenditure budget).

<sup>28</sup> Surrey himself of course developed this theme in later work. *See, e.g.,* Stanley S. Surrey and Paul R. McDaniel, *Tax Expenditures* (1985), ch. 2; Surrey and McDaniel, “The Tax Expenditure Concept and the Budget Reform Act of 1974,” *17 B.C. Ind. And Com. L. Rev.* 679 (1976); Surrey and McDaniel, “The Tax Expenditure Concept and the Legislative Process,” in Henry J. Aaron and Michael J. Boskin, *The Economics of Taxation*, at 123 (1980); Surrey and McDaniel, “The Tax Expenditure Concept: Current Developments and Emerging Issues,” *20 B.C. Ind. And Com. L. Rev.* 225 (1979). Other papers that have considered how tax expenditures might actually be applied to the budget process include Eismeier, “The Power Not to Tax: A Search for Effective Controls,” *1 J. of Policy Analysis and Mngmt.* 333 (1982); Garrett, “Rethinking the Structures of Decisionmaking in the Federal Budget Process,” *35 Harv. J. on Legis.* 387, 433-437 (1998); Davie, “Addressing Tax Expenditures in the Budgetary Process,” in Roy T. Meyers, ed., *Handbook of Government Budgeting*, ch. 11 (1998); [Neubig; others].

The JCT Staff's 2008 theoretical contribution to tax expenditure literature, *A Reconsideration of Tax Expenditure Analysis*,<sup>29</sup> reviews this literature, and considers the principal academic criticisms of tax expenditure analysis as previously implemented by the JCT Staff and by the Treasury Department. In keeping with its role as a nonpartisan tax, rather than budget, staff, the JCT Staff's work concentrated on the use of tax expenditure analysis in tax policy, rather than in helping to establish budget priorities.

To address the concerns of critics, *A Reconsideration of Tax Expenditure Analysis* introduced a new taxonomy of tax expenditures. The new paradigm divides the universe of such provisions into two main categories: tax expenditures in a narrow sense, which were labeled "tax subsidies," and a new category that termed "tax-induced structural distortions." The two categories together cover much the same ground as did the previous methodology for defining tax expenditures, and in some cases extends the application of the concept further. The revised approach does so, however, without relying on a hypothetical "normal" tax to determine what constitutes a tax expenditure, and without holding up that "normal" tax as an implicit criticism of present law. The result should be a more principled and neutral approach to the issues.

The JCT Staff now defines a "tax subsidy" as a specific tax provision that is deliberately inconsistent with an identifiable general rule of the present tax law (not a hypothetical "normal" tax), and that collects less revenue than does the general rule.<sup>30</sup> The tax subsidy tax base thus is constructed by asking what constitutes the general rule, and what the exception, under actual present law. As a result, the JCT Staff's determination of an item as a tax subsidy in most

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<sup>29</sup> *A Reconsideration of Tax Expenditure Analysis*, JCX-37-08 (May 12, 2008) (hereinafter, *JCT Reconsideration*).

<sup>30</sup> The JCT Staff's new approach further divides tax subsidies into three subcategories: "tax transfers" (e.g., the refundable portion of the earned income tax credit), "social spending" (e.g., charitable contribution deductions) and "business synthetic spending" (incentives intended to subsidize or induce behavior directly related to the production of business or investment income). These subdivisions are intended simply to help policymakers compare tax subsidies to others with a similar purpose. All tax subsidies raise questions of equity, efficiency and ease of administration. The three subcategories can be useful, however, to suggest that these factors may have different weights across the different subcategories.

cases is made, not by reference to an alternative and hypothetical “normal” tax chosen by the JCT Staff, but rather by reference to the face of the Internal Revenue Code itself (along with its legislative history and similar straightforward tools for identifying legislative intent).

Despite the narrower definition of “tax subsidies” when compared to earlier JCT Staff definitions of “tax expenditures,” in fact the great majority of individual items that the JCT Staff previously defined as tax expenditures by reference to its construction of a hypothetical “normal” tax remain tax subsidies today. For example, the first JCT Staff set of estimates prepared under the new methodology lists only five major items that previously had been classified as tax expenditures, but that fell outside the new, and narrower, definition of tax subsidies.<sup>31</sup>

Nonetheless, some important provisions previously identified as tax expenditures cannot easily be described as exceptions to a general rule of present law, because the general rule is not clear from the face of the Internal Revenue Code. Accelerated depreciation is an example; so, too, is the treatment of the foreign earnings of U.S. multinational corporations. In light of this ambiguity, such a provision cannot properly be classified as a tax subsidy in the sense now used by the JCT Staff.

In response, the JCT Staff created a second major category of tax expenditures alongside tax subsidies, labeled “tax-induced structural distortions.” These are defined as structural elements of the Internal Revenue Code (not deviations from any clearly identifiable general tax rule and thus not tax subsidies) that materially affect economic decisions in a manner that imposes substantial economic efficiency costs. Tax-induced structural distortions are analyzed solely under economic efficiency principles, and not from any normative perspective.

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<sup>31</sup> JCT Staff, *Estimates of Federal Tax Expenditures for Fiscal Years 2008–2012*, JCS-2-08, at Table 4, p. 69 (Oct. 31, 2008). These in turn amount to less than four percent of the simple sum of all tax expenditures. See n. 10, *supra*.

One slightly oversimplified way of looking at matters is that any intellectually honest legislator should agree with the classification of her legislative proposal as a tax subsidy; indeed, in many cases the legislator could be expected to take pride in that characterization. By contrast, the category of tax-induced structural distortions identifies areas where legislators disagree on the provision's policy premises.

The analysis of tax-induced structural distortions is extremely important, and one of the real successes of *A Reconsideration of Tax Expenditure Analysis* was to develop an environment for analyzing their economic impact that could withstand allegations of a political or policy prejudice of the issues. Another, less appreciated, benefit of separating tax-induced structural distortions from tax subsidies is that the division neatly dovetails with a critical condition for developing successful framework legislation. As noted previously, because framework legislation is developed in prior to, and without direct knowledge of, the application to which it will be put, framework legislation must be reasonably specific in its scope, and its application must satisfy the preponderance of legislators as reasonably objective. The prior JCT Staff definition of tax expenditures failed the first leg of this test, and the category of tax-induced structural distortions probably fails the second.

By removing tax-induced structural distortions from any tax expenditure framework legislation that is developed for *budget* purposes, one is left with rules governing the process for considering tax subsidies. This category can be defined with reasonable clarity. Moreover, tax subsidies fall more squarely within the ambit of the classic budgetary tradeoffs among competing allocative agendas than do tax-induced structural distortions. For purposes of this paper, therefore, the term “tax expenditures” is restricted to positive *tax subsidies* — that is, specific tax provisions that are deliberately inconsistent with an identifiable general rule of the present tax law (not a hypothetical “normal” tax), and that collect less revenue than does the general rule.<sup>32</sup>

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<sup>32</sup> The converse case, an exception that deliberately overtaxes compared to the general rule, is a “negative tax subsidy.”

## B. The Functional Relationship Between Tax Expenditures and Outlays.

Beginning with Stanley Surrey's first speech on the subject,<sup>33</sup> analysts frequently have maintained that tax expenditures, particularly tax expenditures in the narrow sense described in this paper – that is, government subsidies that can be identified as deliberate exceptions to general rules of the actual income tax system – are functionally indistinguishable from explicit government spending.<sup>34</sup> This observation is true, but sometimes is presented in an incomplete manner.<sup>35</sup>

Federal government interventions in the form of explicit outlays generally come in two flavors: discretionary spending, which is subject to an annual budget and appropriations process, and “direct” spending, in which Congress authorizes a program and obligates the federal government to provide specified benefits to any person that satisfies the stated criteria for the life of the program (which may be indefinite).<sup>36</sup> In some cases those direct spending criteria include means-testing; in others, they do not. The current “Cash for Clunkers” program is an example of discretionary spending (which

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<sup>33</sup> See note 10, *supra*.

<sup>34</sup> See, e.g., Stanley S. Surrey, *Pathways to Tax Reform*, 1973; Stanley S. Surrey and Paul R. McDaniel, *Tax Expenditures* (1985).

<sup>35</sup> Stanley S. Surrey and Paul R. McDaniel, *Tax Expenditures* (1985) at ch. 2, for example, do not distinguish between tax expenditures that are analogous in their budgetary effects to entitlements programs, on the one hand, and appropriations programs, on the other.

<sup>36</sup> For particularly useful brief overviews of the budget process, see Keith, *Introduction to the Federal Budget Process*, Cong. Res. Service, Nov. 20, 2008; Dauster, “The Congressional Budget Process,” in *Fiscal Challenges: An Interdisciplinary Approach to Budget Policy* (Garrett, Graddy and Jackson, eds.), ch. 1 (2008).

Despite the fact that the public spends over \$100 million per year to pay for the operating budget of the Congressional Research Service, its general reports, like the Keith paper cited above, are not made directly available to the public at no charge. A vigorous commercial samizdat market exists for Congressional Research Service papers. In that connection, the Keith paper, together with a number of other helpful Congressional Research Service reports on Budget topics, has recently been published by a commercial publisher, TheCapitol.Net, in *The Federal Budget Process* (2009).

Standard texts include Konigsberg, *America's Priorities: How the Government Raises and Spends \$3 Trillion Per Year*, (2007); Schick, *The Federal Budget: Politics, Policy, Progress* (3d ed. 2007) [Rubin; Wildavsky].

explains the August 2009 crisis in the program when the appropriated sums proved insufficient for the demand from qualifying persons). Social Security and Medicare are the paradigmatic examples of “direct” spending.

Most “direct spending” arises from the subcategory of “entitlements” programs, but some (e.g., payment of interest on government debt) does not. Because the term “direct spending” is confusing (as ordinary appropriations can appear to the nonspecialist to involve the government directly spending money on a project), and because entitlements programs are the appropriate analogy to many tax expenditures, this paper sometimes uses the term “entitlements programs” to describe legislation that technically applies to all direct spending.

The federal budget framework legislation adopted in 1990 (which remains the template for budget framework rules today, notwithstanding the expiration of some of its critical enforcement mechanisms) contemplates different rules for Congressional consideration of annual discretionary spending, on the one hand, and new direct (entitlement) spending or new taxes, on the other.<sup>37</sup> The result can be visualized as two separate pipelines, with different schedules and different enforcement mechanisms for each.

In brief, Congress makes most discretionary spending decisions on an annual basis. Direct spending (entitlement) programs, by contrast, generally are not appropriated annually, and (in the absence of a program modification) therefore are not subject to the annual budget or appropriations processes.<sup>38</sup> The same is true of amendments to the tax system. In other words, once launched, new direct spending or new provisions of the Internal Revenue Code sail on, unimpeded by any automatic Congressional review or approval, unless by their terms those programs or provisions have a limited life. In budget

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<sup>37</sup> Testimony of Peter R. Orszag, Director of the Congressional Budget Office, before the Committee on Budget of the House of Representatives, “Issues in Reinstating a Statutory Pay-As-You-Go Requirement,” July 25, 2007, available at <http://www.cbo.gov>; Joyce and Reischauer, “Deficit Budgeting: The Federal Budget Process and Budget Reform,” 29 *Harv. J. on Legis.* 429, 437 (1992).

<sup>38</sup> Garrett, “Rethinking the Structures of Decisionmaking in the Federal Budget Process,” 35 *Harv. J. on Legis.* 387, 397-401 (1998); [Schick; CRS docs].

terminology, once enacted, their financial consequences are subsumed into the “baseline.”

In the case of discretionary spending, the annual Concurrent Budget Resolution itself effectively establishes the level of anticipated revenues that will pay for the spending contemplated by the Budget Resolution. The Resolution sets out specific revenue-raising targets, which the taxwriting committees are charged with satisfying, and spending ceilings (loosely divided into broad categories).<sup>39</sup> The Appropriations Committees in turn allocate (through 13 subcommittees) the funds available for appropriations to 13 functional categories. The relevant budget framework legislation sets out a timetable by which the Budget Resolution should be adopted by both Chambers, and Appropriations Bills passed by Congress. In practice, this timetable is almost never met. A specific Appropriation Bill that sought to spend more money than allocated to it through the Budget Resolution and the Appropriations Committee’s division of funds available for appropriation to each of the 13 Appropriations Bills would be subject to a point of order. In practice, Congressional appropriations follow the instructions of the Budget Resolution for the relevant year. Ignoring any timing differences between the appropriation of funds and the actual outlay of those funds,<sup>40</sup> the Budget Resolution thus establishes the projected net deficit (or surplus) to be expected from the government’s next fiscal year of operation, comprising (i) proposed levels of discretionary spending for that year (set annually through the Budget process), (ii) the projected costs of continuing

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<sup>39</sup> As discussed in Section IV, those revenue targets are simply net numbers – for example, an instruction to raise federal revenues by \$50 billion over the next ten years, when compared with the revenues projected to be received in that period in the absence of any change in law. The Budget Resolution does not, for example, direct the taxwriting committees to eliminate the preferential tax treatment of intangible drilling costs.

<sup>40</sup> See Aaron Wildavsky and Naomi Caiden, *The New Politics of the Budget Process* (5<sup>th</sup> ed. 2004), at 8-10. Technically, Appropriations permit an agent of the federal government to commit the government to spend money; the actual transfer of cash to the private sector is an “outlay,” which may occur years later. The annual deficit is constructed by comparing revenues for a period with outlays; as such, it does not measure simply what the current Congress has enacted, but also the consequences of prior Appropriations that are spent in the relevant period.

(or modifying) existing entitlement spending programs, and on the other side (iii) anticipated revenues.<sup>41</sup>

Entitlement programs follow a different path. In the absence of any statutory modification, *existing* entitlements and tax provisions continue from year to year without regard to the budget process.<sup>42</sup> Their financial consequences are tracked, in aggregate terms, to establish “baseline” projected expenses and revenues, but the budget process begins with that baseline, rather than revisiting it on some scheduled basis. By contrast, even long-standing discretionary spending programs must be re-appropriated every year.

The budgetary analysis of a *new* revenue or entitlements program can be understood as a single snapshot taken at the time the legislation is considered. In the case of a tax expenditure, for example, that snapshot is the inverse of that of a new revenue-raising provision: it comprises a picture of estimated net reductions in federal revenues over the relevant “budget window” (currently, 10 years) as a result of the new tax rule. This picture in turn is formed by comparing two projected revenue streams: the federal revenues that are projected to be collected if the proposal in question is adopted, and the federal revenues that are projected to be collected under the tax code in its current form (the “revenue baseline”).<sup>43</sup> In the case of a tax measure, these projections of the “as amended” and baseline revenues are prepared by the nonpartisan JCT Staff.

Current framework internal rules of the House of Representatives and the Senate generally require that any projected net costs from revenue or entitlements bills be “paid for” through offsetting revenue increases or entitlements cuts (the so-called “Pay As You

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<sup>41</sup> The presentation of the Budget is further confused by the fact that Social Security trust funds and Postal Service operations are excluded from the official Budget, but included in the “unified budget.” (For a description of the mechanism and the politics behind this decision, see Konigsberg, *supra* n. XX, at 83-85.) Nonetheless, most government presentations use unified budget numbers, because that effectively nets current Social Security trust fund surpluses against federal general fund deficits.

<sup>42</sup> As a very technical matter, funds for some entitlement programs (such as Medicaid, but not Social Security, for example) must be regularly appropriated, but those appropriations occur virtually automatically, so as to avoid a government breach of a contractual obligation. Cf. Hungerford, “Tax Expenditures and the Federal Budget,” Congressional Research Service Publication RL34622 (Feb. 27, 2009) at 2.

<sup>43</sup> Kleinbard and Driessen, “A Revenue Estimate Case Study: The Repatriation Holiday Revisited,” 120 Tax Notes 1191 (Sept. 22, 2008).

Go” – PAYGO – rules), but these offsets are themselves also one-time projections of future revenues or outlays. PAYGO thus is the mechanism for enforcing financial discipline on new entitlements programs or amendments to the Internal Revenue Code; PAYGO is irrelevant for discretionary spending, where the ‘hard caps’ of the annual Budget Resolution define the available pot of money.

It is important to emphasize that the budget process approaches *all* new revenue provisions and entitlement (direct) spending provisions as a one-time exercise in projecting the future revenue or outlay consequences of the proposal. For example, the budget process today contains no Procrustean rules for automatically adjusting entitlement/direct spending to reflect weaker than projected revenues – or conversely, to automatically increase tax rates to reflect greater than projected entitlement claims.<sup>44</sup>

This approach reflects not only the indefinite life of most tax or entitlements provisions, but also, and more critically, the open-ended nature of the Congressional commitment, in which the program in question is made available to all persons that satisfy its criteria. One obvious consequence of the current process, however, is that a new “permanent” tax expenditure, having been paid for through some countervailing tax measure over the relevant budget window (generally, 10 years) is simply subsumed into the budget baseline. Neither the cost of the new provision nor the revenues raised by the “pay for” are tracked in any fashion (except by the tax expenditure budget described in Section IV, below, which in turn is purely hortatory in effect), and no aspect of the budget process requires that the provision ever be revisited again. Congress of course retains the power to modify entitlement spending or uncapped tax expenditure programs, or to raise taxes to fund gaps between costs and revenues that develop over time, but Congress just as obviously finds revising often-settled expectations to be extraordinarily difficult.

Many tax expenditures can best be analogized to entitlement programs (direct spending), because they apply indefinitely, and are available to any person that self-

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<sup>44</sup> Earlier Budget framework legislation (the Gramm-Rudman-Hollings sequestration mechanism) predating the PAYGO concept effectively did require Congress to correct for estimation errors, but that reflected the fundamentally different thrust of pre- and post-1990 budget framework legislation. See note xx, *infra*; Joyce and Reischauer, “Deficit Budgeting: The Federal Budget Process and Budget Reform,” 29 *Harv. J. on Legis.* 429, 437 (1992).

certifies that the person meets the specified criteria.<sup>45</sup> This paper uses the term “uncapped” tax subsidies to describe these benefits delivered through the tax system that are made available through a self-certification process to any qualifying person, regardless of the ultimate cost, and which as a result are best analogized to entitlement programs.

The Internal Revenue Code now also contains numerous examples of what this paper terms “fixed-dollar” tax subsidies. These are programs contained in the Internal Revenue Code that offer benefits collected by taxpayers through the tax system, but where the benefits are limited in amount, and awarded through processes exogenous to the ordinary administration of the tax laws. The low-income housing credit is an important example of a fixed-dollar tax subsidy; the credit is a fixed amount apportioned to each State, and a taxpayer can claim the credit only after being certified by a State agency through a rigorous application process. Fixed-dollar tax subsidies are functionally indistinguishable from appropriations, not entitlements. One of the major themes of this paper is that, just as the Budget today follows different pipelines for discretionary spending (appropriations) and entitlements, so too it probably is necessary to talk about different framework rules for fixed-dollar and uncapped tax expenditures.

The paper further divides uncapped subsidies into “temporary” and “permanent” categories. This reflects the fact that a great many tax subsidy programs today are unlimited in their total cost, but have a limited life.

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<sup>45</sup> Hungerford, “Tax Expenditures: Good, Bad, or Ugly?,” 113 Tax Notes 325, 328 (Oct. 23, 2006); Toder, “Tax Cuts or Spending – Does it Make a Difference?,” 53 National Tax J. 361 (2000).

### III. CURRENT TAX EXPENDITURE FRAMEWORK RULES.

This Section III briefly describes the principal framework statutes (or analogous internal Congressional rules) that relate to tax expenditures, and demonstrates their impotence. In light of the data summarized in Section I, it should not be surprising to learn that tax expenditures essentially are immunized from running the gauntlet of the elaborate federal budget framework legislation developed over the last 35 years. Notwithstanding the regular publication of a “tax expenditure budget,” tax expenditures hide from scrutiny in plain sight, both in the annual federal budget and in our presentation of new revenue legislation.<sup>46</sup> The internal Congressional rules restricting limited tax benefit legislation are routinely ignored, and the PAYGO rules have been arbitrated to provide no effective limits to the quantum of government subsidies delivered through the tax system.

#### A. The Tax Expenditure Budget.

Concurrently with Stanley Surrey’s 1967 speech introducing the term “tax expenditures” to public discourse, the Treasury Department under his leadership released its first tax expenditure budget.<sup>47</sup> This document sought to identify “the major respects in which the current income tax bases deviate from widely accepted definitions of income and standards of business accounting and from the generally accepted structure of an income tax” and to provide “estimates of the amount by which each of these deviations reduces revenues.”<sup>48</sup> In each case, the amount of a tax expenditure was calculated as the revenues forgone by the provision in question, presumptively calculated on a “static” basis (that is, without regard to anticipated taxpayer behavioral responses to the

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<sup>46</sup> Accord, Westmoreland, “Standard Errors: How Budget Rules Distort Lawmaking,” 95 *Georgetown L.J.* 1555, 1585-87 (2007) (describing opacity of tax expenditures); Thuronyi, “Tax Expenditures: A Reassessment,” 1988 *Duke L. J.* 1155, 1171 (1988) (taxwriting committees “can trade tax expenditures off against tax rates”).

<sup>47</sup> 1968 Treasury Report at 326.

<sup>48</sup> 1968 Treasury Report at 327. Consistent with Surrey’s goal of expenditure control, the 1968 and later Treasury Reports presented tax expenditures in the same functional categories under which direct expenditures are classified in the Federal budget.

hypothetical removal of the tax benefit, other than changes in tax return filing elections).<sup>49</sup> The 1968 effort was reprised in 1970.

The first tax expenditure budgets had no formal role in the budget process, and the Bureau of the Budget had no great interest in the concept.<sup>50</sup> The first tax expenditure budgets thus were purely hortatory in effect. The Senate, however, was an early subscriber to the concept. The Senate version of the Revenue Act of 1971 would have required the inclusion in the budget of estimates of “losses in revenue” from provisions of the Federal income tax laws and also estimate of indirect expenditures through the operation of the Federal tax laws.<sup>51</sup> The Senate receded from its amendment in conference after the Treasury Department indicated its willingness to supply the desired information to the Congressional tax-writing committees as requested.<sup>52</sup> In response to this Congressional interest, the JCT Staff and the Treasury Department issued a joint report on tax expenditures in 1972; it followed in form and concept the earlier work of the Treasury Department.<sup>53</sup>

Congress more formally embraced Surrey’s concept of tax expenditure analysis in the Congressional Budget and Impoundment Control Act of 1974 (the “Budget Act”).<sup>54</sup> The Budget Act defined tax expenditures as “those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax,

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<sup>49</sup> *Id.* at 329. For a more detailed description of the methodology employed, see the joint Treasury-JCT Staff tax expenditure analysis described in the next footnote.

<sup>50</sup> Forman, *supra* n. XX, at 540.

<sup>51</sup> Conf. Rep. to Accompany H.R. 10947, H. Rep. 92-708, 92<sup>nd</sup> Cong., 1<sup>st</sup> Sess., at 49 (Dec. 4, 1971). The history is described in *Estimates of Federal Income Tax Expenditures*, prepared by the Staffs of the Treasury Department and Joint Committee on Internal Revenue Taxation, Joint Committee print no. JCS-28-72 (October 4, 1972) at 1.

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

<sup>53</sup> *Id.* The document may have been intended as a confidential document for the use of the taxwriting committees, as the report stated that “It is planned later to prepare a revised and more extensive report which will be made available to the public.”<sup>53</sup> In any event, Tax Notes published tables from it (or the subsequent version) on June 11, 1973.

<sup>54</sup> P.L. 93-344.

or a deferral of tax liability, and the term ‘tax expenditure budget’ means an enumeration of such tax expenditures.”<sup>55</sup>

Consistent with Surrey’s vision of expenditure control, the newly-constituted House and Senate Budget Committees were charged with the duty “to request and evaluate continuing studies of tax expenditures, to devise methods of coordinating tax expenditures, policies, and programs with direct budget outlays, and to report the results of such studies” to the respective chamber of Congress on a recurring basis.<sup>56</sup> To assist in that effort, Congress directed the Congressional Budget Office (the “CBO”), which also was created by the Budget Act, to produce an annual tax expenditure budget.<sup>57</sup> Moreover, the Executive Branch was required to include a tax expenditure budget in the annual President’s Budget transmittal to Congress.<sup>58</sup>

In light of the traditional expertise of the JCT Staff in respect of revenue matters, and a separate statutory requirement that Congress rely on JCT Staff estimates when considering the revenue effects of proposed legislation,<sup>59</sup> the CBO essentially delegated to the JCT Staff the production of the mandated annual tax expenditure publication. These arrangements continue to the present day.

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<sup>55</sup> Codified as 2 U.S.C. §622(3).

<sup>56</sup> P.L. 93-344 §101(c) and §102(a). These sections amended House and Senate rules, respectively. The current rules relating to the duties of the budget committees are clause 4(b)(6) of Rule X of the Rules of the House of Representatives, September 14, 2007 (<http://www.rules.house.gov/ruleprec/110th.pdf>) and clause 1(e)(2)(C) of Rule XXV of the Standing Rules of the Senate, September 14, 2007 (<http://rules.senate.gov/senaterules/Rules091407.pdf>).

<sup>57</sup> The CBO is required to provide an annual report to Congress on “the levels of tax expenditures under existing law, taking into account projected economic factors and any changes in such levels based on proposals in the budget submitted by the President for such fiscal year.” P.L. 93-344 §202(f)(1)(B). The Budget Act required that the report accompanying the first concurrent budget resolution allocate tax expenditures among major functional categories. P.L. 93-344 §301(d)(6). The report to accompany any bill or resolution reported from committee providing new or increased tax expenditures must contain a statement detailing how these will affect the levels of tax expenditures under existing law and for the following five fiscal years. P.L. 93-344 §308(a)(2) and §308(c)(3).

<sup>58</sup> The Budget Act amended the Budget and Accounting Act of 1921(P.L. 67-13) to require this. P.L. 93-344 §601.

<sup>59</sup> P.L. 93-344 §201(g), now codified at 2 USC §601(f).

Section 301(a)(6) of the Budget Act<sup>60</sup> contemplated that the Concurrent Resolution could address “such other matters . . . as may be appropriate to carry out the purposes of this Act.” Immediately following the passage of the Budget Act, proponents of tax expenditure analysis had reason to be optimistic that this authority would be used to subject tax expenditures to the same vetting to which explicit outlays were subject. These hopes went largely unmet, however, in large part because of the intransigence of the Chairman of the Senate Finance Committee, Russell Long, who was unwilling to cede any authority to the new Budget Committees.<sup>61</sup>

For example, Senate reformers had hoped to use the new budget process, and in particular tax expenditure concepts, to prod the “recalcitrant” Senate Finance Committee to take up tax reform.<sup>62</sup> The Concurrent Resolution for Fiscal Year 1977 accordingly directed the Finance Committee to reduce tax expenditures by a specified sum. In response, Senator Long made an extraordinary appearance as a witness before the Senate Budget Committee, where he told his colleagues “I am simply here to urge that the Budget Committee stay within its jurisdiction.”<sup>63</sup> The bill reported out by the Finance Committee (which ultimately became the Tax Reform Act of 1976) came close to meeting the assigned net revenue target, but ignored the instruction to reduce tax expenditures, and relied on budget accounting gimmicks for its purported savings.<sup>64</sup> And

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<sup>60</sup> Codified as 2 U.S.C. §632(b)(4).

<sup>61</sup> Allen Schick, *Congress and Money: Budgeting, Spending and Taxing* (1980), at 509 (Long’s actions with respect to 1975 energy legislation “put the Budget Committee on notice that its resolutions should deal only with revenue totals . . . [and] wanted to deter [the Budget Committee] from expressing any assumptions with regard to future revenue actions by his committee.”); Surrey and McDaniel, “The Tax Expenditure Concept and the Budget Reform Act of 1974,” 17 *B.C. Ind. And Com. L. Rev.* 679 (1976); Surrey and McDaniel, “The Tax Expenditure Concept and the Legislative Process,” in Henry J. Aaron and Michael J. Boskin, *The Economics of Taxation*, at 123 (1980); Surrey and McDaniel, “The Tax Expenditure Concept: Current Developments and Emerging Issues,” 20 *B.C. Ind. And Com. L. Rev.* 225 (1979).

<sup>62</sup> Allen Schick, *Congress and Money: Budgeting, Spending and Taxing* (1980), at 529-31.

<sup>63</sup> *Id.* at 531.

<sup>64</sup> The extraordinary history of this conflict between the Senate Finance Committee and the then-new Senate Budget Committee is summarized in Allen Schick, *Congress and Money: Budgeting, Spending and Taxing* (1980) at 526-539; Surrey and McDaniel, “The Tax Expenditure Concept and the Legislative Process,” in Henry J. Aaron and Michael J. Boskin, *The Economics of Taxation*, at 123 (1980), at 125-128.

in 1977 an attempt to revise the Senate Rules to permit each authorizing (substantive subject-matter) committee to “study and review tax expenditures related to subject matters within its jurisdiction” was defeated, following objection by Senator Long.<sup>65</sup>

Within a few years of the enactment of the Budget Act, the Senate Budget Committee apparently conceded defeat, by abandoning any effort to use the budget process to direct particular levels of tax expenditures.<sup>66</sup> In a sense this was the defining moment for tax expenditure analysis as a budget tool, because the Budget Committee’s retreat meant that going forward tax expenditure analysis would be employed solely as an informational tool, rather than a vehicle by which the Budget Committee could impose on the taxwriting committees any mandatory revisiting of existing tax subsidies in light of changed economic circumstances. It is ironic that the Senate, having been the first chamber to embrace tax expenditure analysis, would be unable to resolve the sharp differences between the Chairmen of its Budget and Finance Committees.

Today, the Budget Concurrent Resolutions simply establish an overall revenue target for the taxwriting committees to meet. In very general terms, the annual Budget Resolution sets revenue and spending targets for the year.<sup>67</sup> As to revenue targets, Surrey and McDaniel long ago conceded that “within this figure the tax-writing committees are free to raise or lower tax expenditures, constrained only by the [aggregate] revenue level figures established by the budget resolutions.”<sup>68</sup> And on the other side, the Budget Resolution’s spending targets apply only to explicit government disbursements. Tax expenditures effectively fall between the budget cracks, as Paul McDaniel argued some years ago:

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<sup>65</sup> Id. at 140.

<sup>66</sup> Allen Schick, *Congress and Money: Budgeting, Spending and Taxing* (1980) at 512 (Senate Budget Committee in 1977 had been scarred by earlier disputes with the Senate Finance Committee, and “were not in the mood for another fight.”), 526-539 (describing the earlier disputes surrounding the Tax Reform Act of 1976), and 543 (1978 marked a jurisdictional cease fire between the Budget and Finance Committees, based on the Budget Committees restricting their work to revenue aggregates).

<sup>67</sup> See, e.g., see Keith, *Introduction to the Federal Budget Process*, Cong. Res. Service, Nov. 20, 2008, at 6-8; Dauster, “The Congressional Budget Process,” in *Fiscal Challenges: An Interdisciplinary Approach to Budget Policy* (Garrett, Graddy and Jackson, eds.) (2008) at 12.

<sup>68</sup> Stanley S. Surrey and Paul R. McDaniel, *Tax Expenditures* (1985), at 47.

“Nonetheless, the budget process [i.e., the tax expenditure budget] has not proved an effective device by which to review, control, and coordinate tax expenditures with direct spending. The review of tax expenditures has been left to ad hoc actions by tax writing committees. Tax expenditures are largely uncontrolled by the budget process because no effective limits are imposed on them. The tax writing committees are not given directions by the budget resolution as to the level of tax expenditures for a given fiscal year. Instead, the committees are given an overall revenue figure that they are to meet. But they can meet this revenue target by increasing or reducing rates, personal exemptions, or the standard deduction for non-itemizers. Finally, there is virtually no coordination between tax expenditures and actions by the authorization-appropriations committees in the same budget area.”<sup>69</sup>

The tax expenditure budget remains an official part of the Budget process, but its role continues to be limited to that of information, rather than constraint, and the disputes between the taxwriting and Budget committees of the mid-1970’s do not appear to have been revisited.<sup>70</sup> The information gleaned from the tax expenditure budget presentation arguably informs Congressional thinking on particular issues, and in this sense satisfies one goal of framework legislation, as presented by Garrett: the process solves the collective action problem, by providing nonpartisan expert resources (the CBO and the JCT Staff) to furnish objective information to the entire Congress and other interested stakeholders. But the result is not a “budget” in any normal sense of the word. The tax expenditure budget thus serves as simply a sort of memorandum account in relation to the “real” budget shaped through the annual Budget Resolution.

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<sup>69</sup> McDaniel, “Tax Expenditures as Tools of Government Action,” in Lester M. Salamon, ed., *Beyond Privatization: The Tools of Government Action* (1989), 167, 178.

<sup>70</sup> Writing a few years after the Budget Act’s enactment, Allen Schick concluded that “The Budget Act requires only the publication of information on tax expenditures . . . . The cumulative effect has been an outpouring of data on tax expenditures. But here, too, the division of power between the Budget and Tax Committees is uncertain, and the Act increases the prospects for strife within Congress.” Allen Schick, *Congress and Money: Budgeting, Spending and Taxing* (1980) at 502-503. See also, Garrett, “Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process,” 65 *U. Chi. L. Rev.* 501, 555-556 (1998) (“Whether this new access to information has brought about the anticipated periodic review is unclear. As promised, the budget process did result in a deluge of information. The wide availability of the information, however, has not resulted in any regularized review process for tax expenditures.”)

During some years in the Clinton presidency, the administration’s budget proposals did include tax expenditures alongside explicit spending in each functional category. Garrett, “Rethinking the Structures of Decisionmaking in the Federal Budget Process,” 35 *Harv. J. on Legis.* 387, 434 n. 124 (1998).

In sum, the tax expenditure budget mandated by the Budget Act today is largely separate from the explicit expenditure presentation (that is, the federal “Budget” as generally understood and presented) and largely hortatory in effect. Tax expenditures are simply not constrained by either the revenue or spending targets of the Budget Resolution. The tax expenditure budget by itself does not constrain Congress from allocating resources to a particular social or business objective without limit, so long as the allocation takes the form of a tax subsidy.<sup>71</sup> Moreover, tax expenditures, like tax provisions generally, continue indefinitely, unless enacted as temporary provisions – and even in that case, are highly likely to be extended indefinitely. Again, this stands in sharp contrast to the annual nature of most discretionary explicit appropriations.

As a practical matter, the tax expenditure budget in recent years has served only as a fishing ground, in which Congressional staffers troll for “payfors” (existing tax expenditures that can be sacrificed) to provide a revenue offset for a member’s preferred new tax expenditure.<sup>72</sup> As the previous section of this paper demonstrated, the data suggest that the fishing ground in fact has grown steadily, so that in fact we do not see a new tax expenditure adopted in exchange for the abandonment of an existing subsidy that has lost its political champions. This may reflect estimation errors, but more likely is another instance of the consequences that follow from the fact that, once “paid for” for through the budget window, a permanent tax expenditure continues indefinitely, even if its “payfor” does not.<sup>73</sup>

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<sup>71</sup> As one small example, Dauster, *supra* n. xx, explains how a reconciliation bill can direct a taxwriting committee to recommend new legislation that raises a specific dollar amount in new tax revenues. At the same time, the instructions may impose limits on how much in new spending within its jurisdiction the committee can recommend. While the “fungibility rule” permits limited tradeoffs between tax and explicit outlay programs within the jurisdiction of the taxwriting committee, *id.* at 27-28, tax expenditures actually permit unlimited tradeoffs, by allowing the taxwriting committee to create (in effect) new spending programs, so long as the overall tax objectives of the reconciliation bill are met.

<sup>72</sup> Davie, “Addressing Tax Expenditures in the Budgetary Process,” in Roy T. Meyers, ed., *Handbook of Government Budgeting*, 277, 295 (1998). See also, in this regard, the extensive discussion of the political dynamics of temporary effect legislation in a PAYGO environment in Garrett, “Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process,” 65 *U. Chi. L. Rev.* 501, 549 (1998).

<sup>73</sup> In certain scenarios the Byrd Rule operates to prohibit the conscious matching of a short-term revenue raiser with a long-term tax subsidy.

## B. Limited Tax Benefits.

Congress also has adopted framework rules (as both statutes and internal rules) to deal with “limited tax benefits,” more colloquially referred to as “tax earmarks.”<sup>74</sup> Limited tax benefits can be understood as special transition rules or other highly targeted tax expenditures where the principal intended recipients of the federal subsidy are few in number (typically, ten or fewer) and known to the legislation’s sponsors.

Following what was perceived in retrospect to have been an excessive use of limited tax benefit provisions in the political dealmaking attendant on fashioning Congressional support for the Tax Reform Act of 1986, the Congressional taxwriting committees announced a policy of self-restraint in this area.<sup>75</sup> In 1996, Congress formalized its practices by enacting the Line Item Veto Act, a framework statute aimed in part at imposing new procedural constraints on limited tax benefits.<sup>76</sup> That statute required the JCT Staff to identify any “limited tax benefits” in a new revenue statute; these were defined as revenue-losing provisions providing a tax benefit to 100 or fewer beneficiaries, or transition relief to 10 or fewer beneficiaries (unless the provisions fell into certain specified exceptions). The President then could use his new line-item veto authority conferred by the Line Item Veto Act to cancel any limited tax benefit, in which case the benefit would become effective only if both chambers of Congress overrode the veto.

President Clinton exercised his new line item veto authority to cancel several limited tax benefit provisions of the Taxpayer Relief Act of 1997. Litigation ensued, and

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<sup>74</sup> For a useful summary of the history of Congressional efforts to curb its own appetite to grant limited tax benefits, see Evans, “The New Rules for Limited Tax Benefits in Tax Legislation,” 119 Tax Notes 597 (May 12, 2008). Evans and I disagree on how best to read current Senate Rule XLIV (5) that governs its consideration of limited tax benefits, but that disagreement is not relevant to the points developed in this paper.

<sup>75</sup> *Id.* at 600.

<sup>76</sup> P.L. 104-130 (1996). In addition to Evans, *supra* n. xx, see McClure and Lanning, “The Line Item Veto Act As It Relates to Limited Tax Benefits,” 74 Tax Notes 787 (Feb. 10, 1997).

the Supreme Court eventually ruled that the Line Item Veto Act was unconstitutional.<sup>77</sup> As a result, the Act's procedures for reviewing limited tax benefits were abandoned.

In 2007, the House and the Senate each adopted internal rules designed to operate as frameworks to identify limited tax benefit provisions, and their intended beneficiaries. Unlike framework legislation, however, the two rules differ somewhat in their definitions, as well as in their quasi-legislative history.<sup>78</sup>

From the perspective of this paper, the most remarkable difference between the 1996 framework legislation addressing limited tax benefit provisions and the 2007 internal rules is that the rules adopted by each chamber in 2007 replaced a nonpartisan and expert resource (the JCT Staff) as the agent responsible for identifying limited tax benefits with self certification by the Chairman of the House Ways and Means Committee and the Senate Finance Committee, respectively. Since legislation favorably reported by the two committees invariably reflects the desires of their chairmen, the result is the appointment of foxes to guard henhouses.

In 2007, for example, the Chairman of the Senate Finance Committee concluded that certain legislation designed to funnel several billion dollars to New York City through an ersatz tax credit mechanism was a limited tax benefit under the relevant Senate rules, but the Chairman of the House Ways and Means Committee, in a heated exchange with a member of the minority, refused to do so when the question was raised on the floor of the House. Instead, the Chairman maintained that, under the House rule, the identification of limited tax benefits was a matter solely within his discretion, so that his decision not to identify a tax provision as a limited tax benefit necessarily foreclosed any debate as to whether his ruling correctly applied the House rule.<sup>79</sup>

Virtue in the Congress is not concentrated in any one member, however, and the following year the Chairman of the Senate Finance Committee declined to identify as a limited tax benefit another ersatz tax credit provision designed to funnel \$250 million in federal funds to a real estate investment trust that had agreed to sell certain Montana

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<sup>77</sup> *Clinton v. New York*, 524 U.S. 417 (1998).

<sup>78</sup> Evans, *supra* n. xx, analyzes the two rules in detail.

<sup>79</sup> *Id.* at 606.

timberlands to the Nature Conservancy and other conservation-oriented buyers.<sup>80</sup> Among other conditions of the statute, lands eligible for the tax credit were required to be subject to a “native fish habitat conservation plan approved by the United States Fish and Wildlife Service,” of which only one such agreement was known to be extant.

### C. Pay-As-You-Go Legislation.

So-called statutory PAYGO budget laws also can be viewed as a form of tax expenditure framework legislation. Indeed, PAYGO rules (which today do not exist in statutory form) serve as the only precommitment procedural constraint on adding new tax expenditures to the Internal Revenue Code.

PAYGO has undergone many mutations over the years, sometimes finding expression as framework legislation, and sometimes as an internal rule of one or both chambers of Congress. So, too, the remedies for a PAYGO violation have varied, from a point of order at the time legislation is considered to sequestration of funds otherwise available for outlay. One critical difference between statutory and internal rules-based PAYGO is that only the former can invoke a sequestration (a hold-back) of otherwise-available outlays for direct (entitlement) spending programs as the mechanism for encouraging compliance with the PAYGO rules; during the 12 years (1990- 2002) that PAYGO sequestration could have been triggered, however, a sequestration of funds was never ordered.<sup>81</sup>

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<sup>80</sup> Freddoso, “Constituency of One: The Farm Bill Includes a Plum Deal for Plum Creek Timber,” National Review Online, May 12, 2008.

<sup>81</sup> Rebecca Kysar, “Lasting Legislation,” [ssrn cite?] at [15]; Testimony of Peter R. Orszag, Director of the Congressional Budget Office, before the Committee on Budget of the House of Representatives, “Issues in Reinstating a Statutory Pay-As-You-Go Requirement,” July 25, 2007, available at <http://www.cbo.gov>, at 2.

Sequestration as a Budget framework enforcement mechanism predated PAYGO. Sequestration first was introduced in the Balanced Budget and Emergency Deficit Control Act of 1985 (Gramm-Rudman-Hollings). That legislation adopted fixed deficit reduction targets, and held Congress to them, even if the reason for an increase in the deficit (or a failure to reduce the deficit to the target level) was attributable to factors outside Congress’s control, such as an economic recession. PAYGO was introduced by the Budget Enforcement Act of 1990; that law reoriented Budget enforcement mechanisms away from fixed deficit reduction targets to the split system (different rules for discretionary spending and entitlements programs) that still holds sway. In doing so, the 1990 Budget framework legislation repurposed sequestration as the device to discourage Congress from passing *new* mandatory spending or tax legislation that would increase

The PAYGO framework statute effectively expired in 2002,<sup>82</sup> but as of the 110<sup>th</sup> Congress both chambers of Congress have adopted internal PAYGO rules. The House version of PAYGO works on a bill-by-bill basis, while the Senate version is closer to prior statutory PAYGO rules, in looking to aggregate effects within a year.<sup>83</sup>

Very generally, PAYGO budget rules (whether statutory or rules-based) require that proposed reductions in baseline tax revenues be offset by other tax increases or cuts in entitlement programs; in practice, of course, PAYGO as applied to tax legislation contemplates that a proposed tax decrease be offset by a tax increase elsewhere.<sup>84</sup> The different iterations of PAYGO rules do not apply to continuations of existing entitlement programs, but rather govern only statutory changes to revenue legislation or open-ended (i.e., entitlement, or “direct”) spending *not* directed by the Budget Resolution. The idea of PAYGO is to require a matching of *projected* new entitlement program costs or tax reductions, on the one hand, with *projected* new revenue streams or entitlement program reductions, on the other.<sup>85</sup> In practice, the PAYGO rules most frequently apply to balancing proposed tax reductions against proposed tax increases (“payfors”).

Under current House and Senate PAYGO rules, projected incremental revenues and projected incremental entitlement spending of PAYGO-compliant legislation must be in balance for the first five years after enactment, and for the ten-year period after

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the deficit. See Joyce and Reischauer, “Deficit Budgeting: The Federal Budget Process and Budget Reform,” 29 *Harv. J. on Legis.* 429 (1992); [others].

<sup>82</sup> P.L. 107-312 (Dec. 2, 2002).

<sup>83</sup> Testimony of Peter R. Orszag, Director of the Congressional Budget Office, before the Committee on Budget of the House of Representatives, “Issues in Reinstating a Statutory Pay-As-You-Go Requirement,” July 25, 2007, available at <http://www.cbo.gov>, at 12; [CRS Reports].

<sup>84</sup> For brief summaries of the PAYGO rules that have applied over the last two decades, see Konigsberg, *supra* n. XX, at 40-41; Schick, *supra* n. XX, at 58-60. See also [CRS Reports].

<sup>85</sup> By contrast, discretionary spending programs do not require projections, and therefore it is not difficult for the CBO to estimate their costs. The Anti-Deficiency Act makes it a crime for a government official to commit the government to spend amounts not appropriated by Congress. As a result, Congress is not presented with the *fait accompli* of the Defense Department ordering one aircraft carrier too many. The amount appropriated simply is the estimate (subject only to the timing of outlays of the appropriated amounts, which may fall in subsequent fiscal years).

enactment;<sup>86</sup> in practice, budget accounting legerdemain has rendered the five-year test largely meaningless.<sup>87</sup> Moreover, projected revenues and costs are calculated on an undiscounted basis, so that \$1 billion in incremental tax reduction today can be offset by \$1 billion in projected incremental tax revenues in ten years. Similarly, except in special circumstances, such as a reconciliation bill, which triggers the “Byrd rule” in the Senate, projected expenditures or revenues beyond the ten-year window are ignored; this means that legislation can be designed to be revenue neutral over the first ten years, when it is not expected to be revenue-neutral in a present value sense.<sup>88</sup>

When budget accounting gimmickry has proved insufficient to cause an inconvenient PAYGO constraint to vanish, Congress has often resolved the problem by simply waiving the bothersome rule. In the previous era of “PAYGO scorecards,” and the threat of sequestration of otherwise disbursable funds if a negative scorecard was not remedied, Congress simply reset the scorecard to zero on multiple occasions, thereby

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<sup>86</sup> When the reconciliation process is invoked, the Senate’s Byrd Rule further imposes the requirement that a point of order lies against any legislation that would increase deficits in years past the ten-year budget window. See n. [87], *infra*.

<sup>87</sup> Kleinbard, “How Tax Expenditures Distort Our Budget and Our Political Processes,” 123 Tax Notes 925, 934, n. 41 (May 18, 2009).

For additional examples of the pervasive use of accounting gimmickry to satisfy PAYGO requirements, see Block, “Budget Gimmicks,” in *Fiscal Challenges: An Interdisciplinary Approach to Budget Policy* (Garrett, Graddy and Jackson, eds.), ch. 2 (2008); Block, “Pathologies at the Intersection of the Budget and Tax Legislative Processes,” 43 *B.C. L. Rev.* 863, 888-897 (2002) (outlining how combination of repealing installment sales reporting and then ‘repealing the repeal’ effectively was scored for PAYGO purposes as if it were a net revenue raiser, through the mechanism of arbitrarily resetting the sequester meter). For a comparison of Congressional budget practices to private-sector accounting scandals, see Block, “Congress and Accounting Scandals: Is the Pot Calling the Kettle Black?” 82 *Neb. L. Rev.* 365 (2003).

<sup>88</sup> The Byrd rule has several triggers, but in this context the rule is violated by legislation considered under a reconciliation process that would create or increase a deficit in the “out” years (those beyond the ten-year window). Robert Keith, “The Budget Reconciliation Process: the Senate’s Byrd Rule,” Congressional Research Service Report RL30862 (April 7, 2005).

The Byrd rule is an interesting example of framework legislation in action. It applies only to the Senate, and its only enforcement mechanism is that a point of order on the Senate floor lies against legislation under consideration that violates the rule. Nonetheless it is incorporated in a statute (as section 313 of the Congressional Budget Act of 1974, as adopted in the Budget Enforcement Act of 1990, and codified as 2 U.S.C. section 644). Note that the Byrd rule not only does not apply to the House of Representatives, but also has no application to legislation that is not considered as a reconciliation bill.

effectively waiving the application of the entire sequestration process.<sup>89</sup> And in the 110<sup>th</sup> Congress, when PAYGO was a matter of internal rules rather than framework legislation, each chamber of Congress waived those rules in 2007 (before any of the fiscal crisis legislation enacted in 2008) in order to extend relief from the alternative minimum tax for millions of individual taxpayers (and hence voters) for another year –despite having counted those future revenues in its PAYGO calculations in respect of prior legislation.<sup>90</sup>

As of this writing, the House of Representatives has passed new PAYGO framework legislation, the “Statutory Pay-As-You-Go Act of 2009.”<sup>91</sup> If enacted, this legislation would reintroduce sequestration of outlays for mandatory spending programs (subject to numerous exceptions for some of the largest and most visible entitlements programs), but would exempt certain revenue and spending policies (such as continued alternative minimum tax relief and the Administration’s proposed extension of certain expiring lower tax rates on individuals) said to total several trillion dollars over the next 10 years from the revived PAYGO protocols.<sup>92</sup>

#### D. Consequences of Current State of Affairs.

PAYGO framework legislation or rules (or their close cousin, the Senate’s Byrd rule, which provides that a point of order lies against certain revenue-decreasing provisions in reconciliation legislation where the reporting committee has failed to meet its reconciliation instructions) effectively are the only framework provisions that today limit tax expenditures at all. PAYGO rules have, however, have not always been effective

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<sup>89</sup> Rebecca Kysar, “Lasting Legislation,” [ssrn cite?] at [15].

<sup>90</sup> P.L. 110-166 (the Tax Increase Prevention Act of 2007). For the revenue estimate, see Staff of Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 110<sup>th</sup> Congress, Joint Committee print JCS-1-09 (March, 2009), available at <http://www.jct.gov>. Congress again waived PAYGO for the 2008 extension of AMT relief as well.

<sup>91</sup> H.R. 2920. For a brief description, see BNA Daily Tax Report, “House Passes Statutory Pay-Go Bill; Measure Faces Tough Senate Prospects,” 139 DTR G-7 (Jul. 23, 2009). For helpful background on recent statutory PAYGO measures generally, see Testimony of Peter R. Orszag, Director of the Congressional Budget Office, before the Committee on Budget of the House of Representatives, “Issues in Reinstating a Statutory Pay-As-You-Go Requirement,” July 25, 2007, available at <http://www.cbo.gov>.

<sup>92</sup> See Committee for A Responsible Federal Budget, “The Statutory Pay-as-You-Go Act of 2009,” available at <http://www.crfb.org/documents/StatutoryPAYGOAnalysis.pdf>.

in limiting the number or value of tax subsidies, and the effects of those rules often are perverse.

1. Limited effectiveness. As described briefly in Section I, tax expenditures have steadily increased in number and magnitude since 1989, which year for this purpose can be taken as representing the fully phased-in implementation of the Tax Reform Act of 1986. Most of this growth has occurred since 2000, and can be explained by the repeal of PAYGO strictures prior to the change in control of the Congress in 2006 – an objection that admittedly can hardly be laid at the feet of the PAYGO concept. Even within the budget-conscious 1990’s, however, tax expenditures trended steadily upwards, growing from roughly 5.4 percent of GDP (1989) to 6.6 percent (1999).<sup>93</sup> There are at least four factors at work that explain this.

First, as applied to the 1990’s in particular, tax rates also trended up in this period. Higher tax rates generally make tax expenditures more valuable, because so many are designed as deductions or exemptions. This arguably points not to issues with PAYGO as a concept as much as it does to issues with how various tax subsidies are designed.<sup>94</sup>

Second, even when PAYGO framework legislation or rules nominally are operative, Congress can waive them, and has regularly done so. The 2007 and 2008 legislation to extend alternative minimum tax relief for individuals are recent examples.<sup>95</sup> Importantly, outside of reconciliation bills, waiver requires only a majority vote of the chamber in question.

Even had Congress never waived PAYGO rules and tax rates had remained constant, tax expenditures probably would have crept up over time, as a result of the limitations of the current revenue estimating methodologies. As noted, the rules of engagement for revenue estimating look to a ten-year window, and do not take any sort of

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<sup>93</sup> Hungerford, “Tax Expenditures and the Federal Budget,” Congressional Research Service Pub. No. RL34622 (February 27, 2009) at Figure 2, p. 5. For an explanation of the data source for the specific numbers, see n. 14, *supra*.

<sup>94</sup> Lily L. Batchelder, Fred T. Goldberg, Jr., and Peter R. Orszag, Efficiency and Tax Incentives: The Case for Refundable Tax Credits, 59 STAN. L. REV. 23 (2006)

<sup>95</sup> See n. xx. *supra*.

time value of money concepts into account. Thus, PAYGO-compliant legislation that creates a new healthcare tax subsidy must be paid for in its first ten years, but legislators are free to ignore longer-term trends in healthcare costs, on the one hand, or demographic trends, on the other. More generally, the simplistic accounting rules governing revenue estimates invite wholesale accounting gimmickry, which means simply that actual tax expenditure costs can be expected to rise while the legislation enabling those new subsidies can be described as PAYGO-compliant.<sup>96</sup>

Most important, PAYGO by design looks to budget neutrality, not to how that neutrality is achieved. Even if budget accounting methods were robust, tax rates constant, tax subsidies well designed, and PAYGO waivers nonexistent, tax expenditure utilization could be expected to trend upwards over time. The reasons are that tax subsidies (as an exercise in “not-taxing”) would remain privileged over explicit government spending in the budget process, and that PAYGO reduces the salience of spending through tax subsidies. The net result might not be larger deficits (if PAYGO worked perfectly according to its aims), but nonetheless would lead to a larger government, with higher real tax rates (and efficiency costs) imposed on those private sector activities that remained in the tax system, than might be appreciated by legislators and citizens alike.<sup>97</sup> The next subsection takes up these points.

2. Perversity. The perversity introduced by PAYGO comes in part from the arbitrary distortion of the details of a tax legislative proposal (or package) to achieve an arbitrary revenue target, and in part from the implicit tradeoffs that PAYGO rules encourage between specific “targeted tax cuts,” on the one hand, and higher marginal rates, on the other. The first point is very important for tax policy generally, but the second is more relevant to this paper.

PAYGO framework rules have taught the taxwriting committees how to increase spending on policies of their choosing through tax subsidies, but at the same time to couch the resulting legislation as “revenue neutral,” with the attendant implication that nothing much has changed. The result is a decrease in the salience of those government

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<sup>96</sup> See n. xx. *supra*.

<sup>97</sup> Kleinbard, “How Tax Expenditures Distort Our Budget and Our Political Processes,” 123 Tax Notes 925, 927-29 (May 18, 2009).

interventions to most observers (but not, of course, to the beneficiaries), and in turn a decrease in the salience of the tax costs incurred to finance those spending policies.<sup>98</sup> Lower tax salience is associated with bigger government (that is, a larger tax base).<sup>99</sup> The end result is a classic example of fiscal illusion, in which arguably not just taxpayers but also many members of Congress underestimate the tax increases implicit even in “revenue neutral” legislation, by virtue of the way the legislation is framed.<sup>100</sup> Members promote new spending programs as “targeted tax cuts,” and defend existing tax expenditures by framing their repeal as “tax hikes.”

One consequence of this predilection for tax expenditures is the obfuscation of the size and activities of our government. We cannot determine by inspection of our budget how much support the federal government provides to the energy sector, nor do we know the nature of those programs. In practice, we cannot even assure ourselves that tax subsidies and expenditure programs do not embody conflicting objectives. Tax

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<sup>98</sup> See Kleinbard, “How Tax Expenditures Distort Our Budget and Our Political Processes,” 123 *Tax Notes* 925, 932-36 (May 18, 2009). On tax salience generally, see Finkelstein, “E-Z Tax: Tax Salience and Tax Rates,” NBER Working Paper 12924 (February 2007).

<sup>99</sup> *Id.* The efficiency consequences of raising taxes through low salience mechanisms are more ambiguous, and depend on taxpayer starting expectations about government revenue policies. *Id.* See also, Becker and Mulligan, “Deadweight Costs and The Size of Government,” 46 *J. of Law and Economics* 293 (2003).

<sup>100</sup> Edward Zelinsky, “Do Tax Expenditures Create Framing Effects? Volunteer Firefighters, Property Tax Exemptions, And the Paradox of Tax Expenditure Analysis,” 24 *Va. Tax. Rev.* 797 (2005). Zelinsky offers empirical evidence that many voters (and presumptively, many policymakers) are vulnerable to “framing effects,” in which the outcome to a policy question — here, a question of choosing between a tax expenditure and an explicit government outlay — depends on how the question is presented (i.e., “framed”). In this particular case, survey participants did not view a local property tax exemption offered to volunteer firefighters as imperiling their “volunteer” status to the same extent as participants did when the same dollar value was expressed as an explicit payment. For an earlier application of framing analysis to tax policy questions, see McCaffery, “Cognitive Theory and Tax,” 41 *UCLA L. Rev.* 1861 (1994).

The fundamental difference between much framing literature, including Zelinsky’s article, and my argument is that, in the framing literature, participants are asked to choose between two policies. My point is that tax expenditures today are framed in a way that both policymakers and the public are unaware that they are making any choice at all. But framing unquestionably is directly relevant to tax expenditures, particularly when it comes to repealing one: at that point, a curtailment of a government spending program (in an economic sense) is instead deliberately framed by opponents as a “tax increase.”

expenditures augment fiscal illusion, and fiscal illusion in turn drives poor policy.<sup>101</sup> Because the straightforward facts are not presented in a straightforward manner, we cannot debate fairly the efficiency costs of a system whose spending and revenues are disguised, not only from citizens, but also from most legislators.

In theory, there is no difference between new explicit spending coupled with a revenue “payfor,” on the one hand, and a new tax expenditure of equal magnitude paired with the same “payfor,” on the other. In practice, however, the two are not comparable, because the first is presented as a Budget line item and as a political matter as a tax increase (more accurately, a “tax and spend” proposal), while the second is presented in the Budget as a nothing—the government is presented as constant in size, when in fact its handprint on the private economy has grown.

Imagine, for example, that the current “Cash for Clunkers” federal subsidy (a lump sum made available to individuals who trade in old and inefficient automobiles for new more efficient vehicles) was instead developed by the taxwriting committees as a “Refundable Tax Credit for Clunkers” program. The allocative effect would have been essentially identical, but the program would not necessarily have competed on a level playing field with other stimulus proposals for funding, and the program itself would not even have appeared as a component of the Budget’s expenditures for the year.

Even the repeal of an existing tax expenditure and its replacement with a new one is not a “nothing”: if underlying policies favor the repeal of the first expenditure, then the fair question is, how should the incremental revenues from that repeal be allocated? But the change in spending policies from the old tax expenditure to the new one is invisible in the budget, and is explicitly considered (if at all) only in the taxwriting committees.

Ironically, the PAYGO rules increase the persuasiveness of the fiscal illusion that “revenue neutral” legislation necessarily means that no one’s taxes have gone up. At the same time, the annual accretions of revenue “payfors,” particularly permanent revenue-raising items used to fund temporary tax expenditures like the research tax credit (which expenditures in turn are regularly extended, and require still more “payfors” to do so)

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<sup>101</sup> Daniel Shaviro has developed these themes at length. See, e.g., Shaviro, *Taxes, Spending, and the U.S. Government's March Towards Bankruptcy* (2006).

have economic efficiency consequences. Moreover, the fundamental issues of the size and functions of government will remain invisible in revenue neutral tax legislation. And PAYGO rules do not effectively restrict the use of tax subsidies only to those cases where the tax system really is the superior delivery mechanism for the subsidy in question.

The budgetary imperative to spend through the tax system interferes with the internal workings of Congress. Petitioners for federal largesse can and do file claims with both substance-matter (authorizing) committees and taxwriting committees. The resulting programs in turn can duplicate, overlap, or conflict with one another: there is no express Congressional mechanism designed to ensure that policies are coordinated, or even communicated among different committees.

This phenomenon has been widely studied with respect to social services,<sup>102</sup> but it also applies to energy or agricultural policies, or many other instances of discretionary spending. Moreover, as outlined above, the Congressional budget process is not designed to present to the public and to Congress as a whole an annual comprehensive picture of the total costs of all the discretionary outlay budget functions, including tax subsidies as well as direct outlays (although admittedly the component data are published by various agencies in different formats, and studies of individual areas are prepared from time to time, as in the case of the Energy Information Agency analysis described earlier).

Paying for tax expenditures, as a PAYGO environment requires, adds another unappreciated consequence, which in some ways is even more corrosive to the political process: it elevates the taxwriting committees into a special status—in fact, into what I previously have termed a *Congress within the Congress*. The discovery by the taxwriting committees that any spending program, even a fixed dollar grant program (like the gasification project program briefly described above, or the low-income housing tax credit), can be recast as a tax subsidy means that the taxwriting committees now fill *both* fundamental functions of a legislature: they raise revenues (through the traditional tax function, including the periodic search for payfors), and they spend those revenues

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<sup>102</sup> Staudt, “Redundant Tax and Spending Programs,” 100 *Northwestern L. Rev.* 1197 (2006).

themselves, through the tax subsidies that they marry to the payfors in shaping “revenue neutral” legislation.<sup>103</sup>

The resulting bill is presented to the House or the Senate floor as revenue neutral tax legislation, but in fact the committees of Congress with substance-matter expertise have been deprived of the opportunity to fight for the ability to spend that money themselves. The substantive committees do not supervise how tax subsidies are designed or spent, they do not track the efficacy of the tax programs, they do not necessarily coordinate that spending with their own spending, and they even have lost the ability to argue that their priorities should be preferred over those reflected in the tax legislation.

In the same vein, “permanent” tax subsidies are not subject to any sort of review or oversight by authorizing committees (the Congressional committees charged with substance-matter expertise), and there does not exist any comprehensive Congressional efficacy review program for tax subsidies. So tax expenditures, once implemented, are essentially unmonitored by any arm of Congress, and simply disappear below the surface into the mainstream of baseline revenues.

#### IV. DESIGNING TAX EXPENDITURE FRAMEWORK LEGISLATION.

##### A. The Purposes of Tax Expenditure Framework Legislation.

Well-designed framework legislation can offer both the processes and the information necessary for Congress to forge a practical consensus on the size and contents of the federal budget – which is to say, the terms under which the federal government will intervene in the private sector. Current budget frameworks, however, are incomplete, because they largely ignore tax expenditures. As a result, Congress operates through the prism of fiscal illusion. Congress ignores both the social costs attendant on using government subsidies to distort private sector allocations of goods and services, and the deadweight loss of higher taxes used to pay for these subsidies. What is needed,

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<sup>103</sup> Cf. Stanley S. Surrey and Paul R. McDaniel, *Tax Expenditures* (1985), at 65 (“[A]lthough [under the post-1974 Budget process] the tax-writing committees are subject to the overall revenue figure, they are free to increase or decrease tax spending at will within that amount.”) and 66 (“Put another way, the tax committees have the jurisdictional ability to take over much of the legislative field by providing a ‘tax answer’ to the issue.”).

then, is a structural overhaul of budget framework legislation that can overcome current skewed incentives and bring tax expenditures into the budget process.

Garrett has proposed five principal goals that framework legislation might serve.<sup>104</sup> Existing tax expenditure framework legislation arguably has at least partially accomplished the one of these objectives (providing neutral rules for considering future substantive decisions), although of course there is room for improvement, particularly with respect to studies of the performance of tax expenditures in meeting their stated objectives (as opposed to the revenues forgone by them).<sup>105</sup> What the current process lacks in particular are neutral rules to address the externalities induced by the current fiscal illusion that tax expenditures (particularly “paid for” tax expenditures) are costless. That is, the purpose of tax expenditure framework legislation should be to internalize those costs, by re-engineering the budget process to ensure that the costs associated with tax expenditures are subject to the same vetting process as are outright expenditures. In turn, developing such rules will require changing the balance of power within Congress, by addressing the “Congress within the Congress” phenomenon that (along with wholly-deficient accounting principles) is the core weakness of PAYGO legislation.

#### B. The Conditions for Adoption.

Garrett has analyzed the conditions for the adoption of framework legislation; she concludes that the most important objective condition required before Congress can be expected to take up framework legislation is that “Congress must be able to identify a concrete problem and describe it with specificity so that the framework can be triggered in appropriate circumstances.”<sup>106</sup>

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<sup>104</sup> See n. 5, *supra*.

<sup>105</sup> Carl Davis, *Judging Tax Expenditures*, 125 *Tax Notes* 677 (Nov. 9, 2009). Current processes provide abundant data on the revenue cost of a new proposal and the revenues forgone by existing tax expenditures, including (in the latter case) an extensive annual review by the JCT Staff. The current edition of the biennial *CRS Compendium* summarizing what is known about existing tax expenditures totals over 1300 pages.

<sup>106</sup> Garrett, “Conditions for Framework Legislation,” in Richard W. Bauman and Tsvi Kahana (eds.), *The Least Examined Branch: The Role of Legislatures in the Constitutional State*, ch. 14 (2006) at 296. Garrett goes on to consider some political conditions under which efforts to develop framework legislation might be particularly fertile. In light, however, of the

Garrett's proposition can be expanded slightly to describe the necessary criteria for the adoption of tax expenditure framework legislation. First, there must be a palpable sense of urgency with respect to a concrete problem. Second, that problem must be susceptible of being specified in advance of the consideration of any substantive legislation in sufficient detail that Congress can have confidence that the legislation will operate on the intended cases, but not be triggered by unintended ones. This second condition is a predictive exercise, because framework legislation by definition is adopted in advance of the substantive legislation to which the framework legislation might apply. Third, the mechanism invoked by the framework legislation to address the problem must itself be perceived as neutral – that is, as not reflecting explicit political agendas. Of course the process in practice influences the outcome, but successful framework legislation typically cannot be described as overtly advancing the political agenda of one party or the other.

Section I.C. of this paper and the work cited therein demonstrated that Congress today regularly delivers allocative interventions in the private sector through tax expenditures to a degree not seen since just before the Tax Reform Act of 1986, and that many of these interventions cannot be defended as cases where the tax system is the optimal delivery mechanism. Section III in turn argued that existing framework mechanisms are inadequate to address the problem. The result corrodes tax policy and administration, and introduces economic inefficiencies probably not fully appreciated by members of Congress in their decisionmaking, by virtue of the fiscal illusions that tax expenditures promote. Moreover, Congressional resource allocation policies are diffused, and sometimes contradicted, by the completely different paths followed by new spending programs and tax expenditures. Congress could therefore reasonably conclude that a relatively discrete problem exists, and that addressing the problem should be viewed as a matter of urgency.

The more interesting question is whether the problem can be defined with the kind of specificity and objectivity necessary to impel Congress to surrender some of its own autonomy to adopt a binding framework that would govern future consideration of

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unpredictability of the political process, this paper concentrates on the more objective criteria identified in the literature.

new tax expenditures. Until recently, this would have been an impossible condition to satisfy, because even the tax expenditure work of the JCT Staff (a nonpartisan organization) was viewed by some as premised on unacceptable ideological conclusions as to the contours of the ideal income tax.<sup>107</sup> While this interpretation might be characterized as overstated, it was deeply felt.<sup>108</sup>

The recent work of the JCT Staff in this area, however, was designed expressly to overcome this objection, by breaking the traditional definition of “tax expenditures” into two categories (tax subsidies and tax-induced structural distortions), and by defining the former by reference to the Internal Revenue Code itself and straightforward interpretations thereof. In other words, Congress itself defines tax subsidies through the visible structure of the Internal Revenue Code. By contrast, tax-induced structural distortions can candidly be described as tax policy issues that give rise to significant efficiency consequences and that are of interest to the JCT Staff at any particular point in time. These tax policy issues almost never have a clear resolution, and in many cases are difficult to conceptualize as quasi-spending decisions. For example, it is not terribly meaningful to describe international “deferral” as the equivalent of a government cash infusion into the international business of U.S. firms, because doing so effectively assumes a controversial tax policy conclusion.<sup>109</sup> For this reason, it would appear that framework legislation might most appropriately be limited to the new category of tax subsidies.

If it chose to do so, Congress thus could develop framework legislation that would apply to proposed tax subsidies. The definition of “tax subsidies” could be based on the 2008 work of the JCT Staff, and the legislative history could signal Congress’ assent to the Staff’s current categorization of tax subsidies – or conversely identify places where Congress expected that categorization to be revised. The new JCT Staff definition,

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<sup>107</sup> *JCT Reconsideration* at XX.

<sup>108</sup> [Bartlett, etc.]

<sup>109</sup> The implicit conclusion would be that the norm is that the income of foreign subsidiaries of U.S. firms should be taxed currently by the United States, when the same rule would not apply to impute income to shareholders in domestic firms, or to shareholders of foreign firms that are not controlled foreign corporations. But see J. Clifton Fleming and Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and its International Operation*, 27 *Va. Tax Rev.* 437 (2008).

combined with the adoption through legislative history of its application at a particular moment in time (subject to such exceptions as Congress might describe) would provide both a reasonably precise definition and a rich set of precedent that could usefully inform the subsequent identification of new tax subsidies.

The next question is, how would the proposed framework legislation identify tax subsidies in future revenue bills? Here the answer can follow the format developed in earlier budget framework legislation, when Congress created the Congressional Budget Office (CBO) to serve as an independent nonpartisan analyst of budget policies and author of economic and budget projections. Very recent history has demonstrated the independence and integrity of the CBO.<sup>110</sup> Just as the CBO estimates the budget consequences of all legislation, and CBO identifies and estimates the cost of unfunded mandates (as required by the Unfunded Mandate Reform Act), so too it would identify new tax subsidies in revenue legislation.<sup>111</sup>

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<sup>110</sup> In July 2009, CBO Director Douglas Elmendorf, who had been appointed to his position by a Democratic-controlled Congress, testified that major healthcare reform legislation under consideration by Congress would not achieve its objective of controlling long-term healthcare costs, but rather would increase the government's cost in this area in the future. Subsequent news reports revealed that Director Elmendorf had been lobbied directly by the President, and the CBO's analysis was the subject of withering criticism by its former director, and the current Director of the Office of Management and Budget, Peter Orszag. See, e.g., Tiron, "Dems strategize to counter CBO health estimate," *The Hill*, July 26, 2009. The *Washington Post* described Elmendorf's testimony as "a startling assertion." Murray and Montgomery, "Bipartisan Talks on Reform Move Toward Center," *Washington Post*, Aug. 6, 2009. It is a testament to Congress's high regard for the CBO, the personal integrity of its current Director, and the ultimate forbearance of senior members of Congress that Dr. Elmendorf's testimony was taken seriously by Congressional negotiators, and that no political recriminations have (to date) been visited on the CBO.

<sup>111</sup> It is the author's view that the CBO is better suited to this task than is the JCT Staff, from the perspective of both the relative stature and the independence of the two organizations. In particular, the JCT Staff is very much staff to the two taxwriting committees, and therefore almost by definition to their Chairmen. The CBO by contrast is organized as an independent agency controlled by the Congress, not Congressional staff, and has a clear statutory mission. Similarly, the Chief of Staff of the JCT serves at the pleasure of the two Chairmen of the taxwriting committees, while the CBO Director is appointed for a fixed term and can be removed only by a majority vote of one chamber of Congress. These differences have real meaning within Congress.

A larger question, not strictly germane to the present paper, is whether the tax legislative process could be improved by relocating the function of the JCT Staff within the CBO.

One of the great advantages of framework legislation generally is that it enables the Congress to invoke the assistance of nonpartisan and expert resources; that is, the framework also acts as a hook from which to hang an infrastructure of independent experts.<sup>112</sup> Those independent experts are critical to giving Congress the information necessary to hold informed debates. Moreover, there are good arguments that reliance on trustworthy experts to assist in framing, and offering solutions to, difficult questions can improve social welfare, even in the context of democratic decisionmaking.<sup>113</sup> The presence of qualified and trustworthy experts to act as resources to the legislature therefore can be expected to enhance the quality of legislation.

The identification of tax subsidies in new framework legislation plugs nicely into the existing expert budget infrastructure on which Congress already relies. As a result, relying on the CBO to identify and score new tax subsidies in revenue bills will be unsurprising to members of Congress, and the CBO's findings, while often the subject of grumbling, should not trigger political defections from the larger framework process.

Current revenue estimating framework rules for proposed tax expenditures are flawed and easily manipulated by the designers of new proposals (for example, through phase-in and phase out rules, or through floors or ceilings on benefits designed only to satisfy a revenue estimating target), but this observation more generally encompasses all revenue estimates.<sup>114</sup> Certainly these rules should be revised, in particular to reflect time value of money principles and to forestall gaming the budget window period, but because this issue applies broadly to all revenue estimates, and because its exposition deserves a paper of its own, this paper does not develop this theme further.

In summary, it appears feasible both to define the scope of those tax expenditure provisions subject to framework legislation (i.e., tax subsidies, as defined by the recent

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<sup>112</sup> Garrett, "The Purposes of Framework Legislation," 14 *J. of Contemporary Legal Issues* 717, 741-42 (2005).

<sup>113</sup> McCubbins and Rodriguez, "When Does Deliberating Improve Decisionmaking?," 15 *J. Contemp. Legal Issues* 9, 35-39 (2005).

<sup>114</sup> See n. xx supra; Michael J. Graetz, Paint-By-Numbers Lawmaking, 95 *Colum. L. Rev.* 609 (1995); Elizabeth Garrett, Accounting for the Federal Budget and its Reform, 41 *Harv. J. on Legis.* 59 (2004).

JCT Staff work) and to specify a politically acceptable mechanism for identifying those tax subsidies in the course of the legislative process (i.e., the CBO). It remains, of course, to propose the actual framework rules that would be invoked once a tax subsidy is identified.

### C. Rules of Application.

Tax subsidies can usefully be placed into three categories for purposes of developing tax framework rules of application. Some tax subsidies (e.g., the low-income housing tax credit, or energy incentives like the qualifying gasification credit described earlier in the text) are fixed-dollar allocations. Others are open-ended in dollar terms, but offered for a fixed term (e.g., the dozens of “extenders” that periodically gallop through the legislative process like a herd, led by the research and development tax credit). Tax expenditures in the third category are both open-ended in dollar terms and indefinite in term.

1. Fixed-Dollar Allocation Tax Subsidies. Fixed-dollar tax subsidies are those tax subsidies where a ceiling is imposed on the total dollar value of federal benefits made available to qualifying taxpayers. Fixed-dollar tax subsidies are direct competitors of classic appropriations, and should be treated as discretionary expenditures for all purposes of the federal Budget. The relevant framework legislation should require that the program be created by the relevant authorizing (i.e., substance-matter specialist) committee of each chamber. That committee, not the taxwriting committees, should shape the program’s purpose and size. The program should be referred to the taxwriting committees only for purposes of amending the Internal Revenue Code to adopt the program. Finally and most important, any authorized allocations should be appropriated through the regular Budget process of the Appropriations and Budget Committees.

Because a fixed-dollar tax subsidy is indistinguishable in every sense from discretionary spending, the Budget consequences of the subsidy should be measured on an “expenditure-equivalent” basis.<sup>115</sup> In practice what this means is that the value of the subsidy is “grossed up” to reflect not only the nominal dollar value of the subsidy, but also the implicit treatment of the subsidy as tax-exempt, when a corresponding actual government expenditure paid to a taxpayer would be treated as taxable income. (On the

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<sup>115</sup> [Cite Bush OMB discussions].

other side of the ledger, government tax revenues also would be grossed up to reflect the hypothetical taxes collected.) Failing to do so would retain a systematic bias in favor of establishing fixed-dollar government interventions as tax subsidies, because their Budget consequences would imply lower government spending.

The approach recommended here would be salutary in several dimensions. First, it would end the race between the taxwriting committees and the authorizing committees to capture new programs. Second, it would centralize subject-matter control over allocative policies, so that (for example) tax subsidy energy programs in fact are coordinated with overt expenditure energy subsidy programs. Third, it should restrict the use of the Internal Revenue Code to those cases where the authorizing committees conclude that the tax system in fact is the most efficient delivery system for the subsidy in question, because in other instances the authorizing committees would have little reason to surrender control of the process through referral to a second committee. Fourth, it would undo the current phenomenon of the “Congress within a Congress,” in which the taxwriting committees treat new revenue streams from whatever source as their proprietary assets to dispose of (through “revenue neutral” new allocative policies); instead, each proposed new policy would compete with all others for scarce Budget resources, and as a correlative matter new revenue streams would finance those policies developed by the larger Congressional authorization and appropriation processes. Finally, this approach would mean that the presentation of the Budget would be more accurate and transparent to all users, both within and outside of Congress.

Underlying the central recommendation to bring tax expenditures within the ambit of authorizing committees is a tentative judgment that the pendulum has swung too far in the long-term dismantlement of the Congressional “fiefdoms” formerly presided over by chairs of authorizing committees.<sup>116</sup> Certainly it is fair to expect, for example, that the Speaker of the House should be able to articulate a strategic goal of the majority party, and then rely on the Chair of the relevant authorizing committee to develop legislation

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<sup>116</sup> For a summary history of the ebb and flow of power within Congressional committees, see John H. Aldrich and David W. Rohde, *Congressional Committees in a Continuing Partisan Era*, in Lawrence C. Dodd and Bruce I. Oppenheimer, eds, *Congress Reconsidered*, 9<sup>th</sup> ed., ch. 10 (2009).

along those lines.<sup>117</sup> But by the same token, it also is fair to expect that members of an authorizing committee develop substantive expertise in the areas within their committee’s jurisdiction, and of course employ and rely on expert staff, all in aid of fashioning effective legislation. The recommendation that tax subsidies (in this case, fixed-dollar allocation tax subsidies) be approved by the relevant authorizing committee is intended to bolster the second point without quarreling with the first.

Recent experience with the Obama Administration’s healthcare legislation has demonstrated that the taxwriting committees can coordinate their work with authorizing committees when the requisite political will exists. For example, the House Energy and Commerce Committee took the lead in negotiating revisions to accommodate the demands of small businesses with respect to proposed payroll taxes on businesses that fail to provide health insurance for employees, and the House Ways and Means Committee’s bill in turn was closely coordinated with the work of the Education and Labor Committee.<sup>118</sup>

In the same vein, the coordination between taxwriting and authorizing committees required by the proposal outlined here would be costly, in the sense that it would require time, commitment and compromise by Members, but this is a feature, not a bug: it means that framework legislation recommended here would effectively impose a modest procedural presumption against new tax subsidies. This presumption in fact is desirable, for the reasons articulated above.

Professors Weisbach and Nussim have argued that tax expenditure analysis inappropriately implies that the tax system should be “privileged,” by virtue of an implicit presumption in tax expenditure work that the tax system should be kept pristine from all the messy compromises and mixed motives that explain government interventions in the private sector.<sup>119</sup> In fact, as noted earlier, there is a persuasive

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<sup>117</sup> See *id.* at 234 – 36 (conflicts between Speaker Pelosi and then-chair of the House Committee on Energy and Commerce, John Dingell).

<sup>118</sup> See, e.g., BNA Daily Tax Report, “Energy and Commerce Modifies Small Business Tax Penalties, Approves Bill,” August 3, 2009.

<sup>119</sup> Weisbach and Nusim, “The Integration of Tax and Spending Programs,” 113 *Yale L.J.* 955 (2004).

argument that just such a presumption should exist, for the simple reason that nearly all of us participate directly in the tax system (but not in particular agricultural crop subsidies, for example). The resulting complexity and the bewildering exceptions that provide benefits to only a small fraction of taxpayers erode confidence in, and therefore compliance with, the system.<sup>120</sup> Ironically, this is an area where lower salience might have positive externalities: by moving many subsidies out of the tax system, their salience might be reduced, but at the same time taxpayer confidence in the simpler and more neutral tax system should increase. The overall allocative intervention by the government might remain the same, but in a broad-based tax system that relies heavily on self-assessment to collect its revenues, there are important reasons to focus on attitudes towards the apparent fairness of the tax system in isolation.

More fundamentally, the presumption of privilege today runs in exactly the opposite direction from that suggested by Weisbach and Nussim. Tax expenditures today are privileged, both in their funding (through the ability of the taxwriting committees to siphon off available revenues to fund their preferred allocative interventions in “revenue neutral” legislation not fully tested by the rest of Congress), and in their opacity (because they are invisible in the Budget as formally presented). Consider, in this respect, the “Refundable Tax Credits for Clunkers” hypothetical posed earlier in this paper. The purpose of the recommendations made above is not so much to privilege the tax system as it is to eliminate the current privileging of tax subsidies.

2. Temporary Uncapped Tax Subsidies. Temporary tax subsidies are not comparable to outlays in one fundamental respect, which is that government’s financial commitment is open-ended. Thus, in contrast to the \$1 billion “Cash for Clunkers” program, or a hypothetical \$1 billion “Refundable Tax Credits for Clunkers” program (or the low-income housing tax credit), the 2008 first-time homebuyer’s tax credit is available to any individual who satisfies its criteria within the specified time frame.<sup>121</sup> It

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<sup>120</sup> McClure, “The Budget Process And Tax Simplification/Complication,” 45 Tax L. Rev. 25, 57 (1989). As a recent example, the 2008 general instructions for the basic personal income tax return, the Form 1040, are 161 pages long. How many readers of that document found helpful the special rules for recipients of awards from the Exxon Valdez litigation (p. 37)?

<sup>121</sup> This fundamental distinction of course is presented more forcefully in the case of “permanent” tax subsidies, discussed below.

is for this reason that tax subsidies traditionally have been linked to “entitlement” spending programs, rather than to discretionary appropriations.

The immediate consequence of the open-ended nature of these tax subsidies is that the Congressional appropriations mechanism cannot be invoked, because appropriations are always fixed dollar amounts. Instead, tax expenditure framework legislation presumably must treat open-ended tax subsidies like a new entitlements program, which is to say the legislation would be scored as “direct” spending that bypasses the appropriations process.

George Yin has forcefully developed the argument that temporary tax subsidies have one great virtue when compared with ‘permanent’ ones: they must be continuously paid for, in the form of new tax measures each time the subsidies are renewed.<sup>122</sup> This means that the risks of estimation errors are greatly reduced, because instead of taking one snapshot of the future, comprising a comparison of projected ‘baseline’ revenues with the projected ‘as amended’ consequences of the proposal, the regular renewal of temporary effect legislation requires periodic ones, and those later snapshots will be informed by experience gleaned from earlier years of the rule’s operation.<sup>123</sup>

Yin’s solution of recasting more tax expenditures as temporary measures has the merit of addressing the measurement problems associated with predicting future revenue (or mandatory spending) streams, and the deliberate budget accounting gimmickry, that

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<sup>122</sup> Yin, “Temporary-Effect Legislation, Political Accountability, and Fiscal Restraint,” 84 *N.Y.U. Law Rev.* 174 (2009).

<sup>123</sup> Whether temporary tax subsidy legislation invariably leads to a more perfect match of aggregate revenue offsets to those tax subsidies is a more complex question, because it depends on the pattern over time of the offset in question. For example, if Congress enacts a one-year tax subsidy of \$1 billion and pays for it with a one-year tax increase of \$1 billion, the matching of increments and decrements to future revenues is achieved. If, on the other hand, a permanent tax subsidy is paired with a 10-year revenue “payfor,” then after 10 years (that is, outside the budget window) the tax subsidy will add to the deficit. (For that reason, the Byrd Rule would essentially prohibit this result in the context of a Reconciliation measure.) But on the other hand, imagine that a one-year \$1 billion tax subsidy is offset by a permanent increase in revenues of \$100 million/year (equating to \$1 billion in revenues in the 10-year budget window). The subsidy is not renewed. After 10 years, the revenue “payfor” by hypothesis will continue, with the result that on a net basis the temporary effect legislation will have led to an increase in tax burdens. The phenomenon would be compounded if the tax subsidy were extended each year, and in each case is paid for by another permanent \$100 million/year revenue raiser.

today bedevil efforts to apply PAYGO concepts to new direct spending or tax problems. As such, it is a useful complement to more robust PAYGO procedures. Those more robust procedures in turn might include a long list of PAYGO accounting reforms, beginning with the introduction of time value of money concepts.

Even a perfect matching in present value terms of future revenue costs and ‘payfors’ does not, however, resolve all of the problems with tax expenditures today.<sup>124</sup> More robust estimating processes will not resolve the deadweight losses associated with perfectly revenue-neutral tax legislation riddled with new temporary tax expenditures, nor will they dissolve the miasma of fiscal illusion that tax expenditures permit. More generally, they will not address the “Congress within the Congress” role of the taxwriting committees, which is the other key framework issue in tax expenditures today.

The “Congress within the Congress” problem can be addressed by breaking the stranglehold of the taxwriting committees on the unilateral disposition of new revenue sources. The fact that the appropriations process is irrelevant to uncapped entitlements programs does not mean that the process should remain wholly within the baliwick of the taxwriting committees. Again, to do so would be to permit the taxwriting committees to capture for themselves and their clients assets (in the form of new revenue streams, whether from “loophole closers” or rate increases), rather than to put those assets into the larger Congressional decisionmaking apparatus.

One approach would be to revisit the resolution of the war between the Senate Budget and Finance Committees in the mid-1970’s described in Section III. Experience suggests, however, that such efforts to revisit old wars rarely succeed. Moreover, it is not obvious why the members of Congress would find it collectively advantageous to transfer the power to dispose of new revenue sources from the taxwriting to the Budget committees, particularly if doing so were understood as giving the latter an effective veto over existing as well as new tax subsidies (as the Budget committees effectively asserted in the mid-1970’s).

A more constructive avenue to explore would be to take seriously the analogy of uncapped tax expenditures to entitlements programs. While it is true that the taxwriting

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<sup>124</sup> For a longer discussion of these points, see Kleinbard, “How Tax Expenditures Distort Our Budget and Our Political Processes,” 123 Tax Notes 925, 934-936 (May 18, 2009)

committees have jurisdiction over many entitlements programs, that is not the invariant case, and where there are substantive authorization committees with more subject-matter expertise (for example, in energy), then the construction of an entitlement program, whether couched as a spending program or an uncapped tax subsidy, ought to be assigned to that committee. Given that a great many more members collectively serve on the authorization committees (in the aggregate) than do on the taxwriting or Budget committees, this approach appears to have the virtue of playing to the larger self interest of the members of Congress.

As in the case of fixed-dollar tax subsidies, therefore, and for all the same reasons, the framework legislation should require that the relevant authorizing committee (the committee with subject-matter expertise) develop the tax subsidy legislation, and refer it to the taxwriting committees. The Concurrent Budget Resolution in turn would direct the taxwriting committees to raise revenues projected to offset the projected costs of the tax subsidy (assuming for the moment that the goal of the Resolution in respect of this temporary subsidy was revenue neutrality). And in turn the projected costs would be reflected on the face of the Budget as an on-budget item.

3. “Permanent” Uncapped Tax Subsidies. A new uncapped tax subsidy of indefinite term raises all the same budgetary control issues as do current uncapped entitlements programs, such as Medicare or Social Security. Many proposals have been made to rethink how the federal budget should address uncapped costs in these entitlement programs, but of course no framework legislation today exists to address this phenomenon. Much of the discussion in the immediately preceding subsection is directly relevant here, and I begin with the premise that the authorizing committees again would be required to develop any proposed new permanent uncapped tax subsidy program.

In developing its new taxonomy of tax expenditures, the JCT Staff divided tax subsidies into three subcategories: Tax Transfers (i.e., refundable credits that are paid regardless of tax liability), Social Spending (tax subsidies that are unrelated to the production of business income and tax subsidies related to the supply of labor), and Business Synthetic Spending (tax subsidies intended to subsidize or induce behavior directly related to the production of business or investment income, but excluding any tax subsidies related to the supply of labor). The analogy of Tax Transfers to existing

uncapped entitlement programs seems to be particularly persuasive, and it therefore is difficult to imagine imposing budgetary framework processes on this subcategory of tax subsidies that do not apply to other means-based entitlement programs. Similarly, while the analogy may not be quite so perfect, it appears exceedingly implausible to imagine imposing the constraints of a hypothetical new framework on a proposed expansion of the charitable contribution deduction.

The last category however – Business Synthetic Spending – arguably is different. Here the moral imperative of “entitlement,” as commonly understood, falls away completely, and one is left with a simple government intervention in the private economy, perhaps to overcome an externality, but even more plausibly to respond to a persuasive political clientele.<sup>125</sup> These programs today run at the rate of well over \$100 billion/year, and are likely to have particularly noxious economic efficiency consequences.<sup>126</sup> It therefore would seem desirable to consider novel framework mechanisms to ensure that Business Synthetic Spending programs are fully vetted by Congress. But how would such a framework rule operate?

Within the context of current framework rules, the basic design challenges for a better approach to newly-proposed tax expenditure are two. First, there are the problems associated with measuring PAYGO compliance – that is, the projected costs of the new subsidy, and the projected incremental revenues from the selected “payfor.” These problems require revisiting PAYGO accounting, most importantly by introducing time value of money principles and rules to prevent the artificial gaming of the budget window horizon, but it would be a relatively straightforward exercise for the Congressional Budget Office and the JCT Staff to offer a joint proposal designed to improve these accounting rules, were there Congressional interest in doing so. The other problem relates to the “Congress within a Congress” role of the taxwriting committees, as described above. The same remedy proposed there would work in this instance as well.

#### D. Tax Framework Legislation and Tax Reform.

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<sup>125</sup> On the history of the term “entitlement,” as used in the budget process, see Konigsberg, *supra* n. XX, at 79.

<sup>126</sup> Calculated on a tax expenditure, not a revenue estimate, basis. See *JCT Reconsideration* at XX; [latest JCT TE numbers].

None of the suggestions made to this point is responsive to what many observers have in mind when they propose framework legislation for tax expenditures, which is to apply some sort of cap or trigger to the cost of *existing* tax subsidies, so as to curb their growth, or even to shrink their overall cost. While the sentiment is understandable, it appears to misconstrue the design of most successful framework legislation, by trying to use a procedural device designed to internalize in the consideration of future legislation the social costs of certain externalities instead to force a substantive renegotiation of the present tax system.

More generally, tax expenditure analysis has always been the victim of being asked to do too much. Almost from the start, critics saw the “normal” tax system that was constructed as the tax expenditure baseline as an aspirational tax reform proposal, and deprecated tax expenditure analysis for serving this essentially political goal.<sup>127</sup> The same risk applies to tax expenditure framework legislation. If construed as a device to force reconsideration of the \$1 trillion per year in current tax expenditures, proposed tax expenditure framework legislation would repeat the Senate Budget Committee’s tactical error in its wars with the Finance Committee in the mid-1970’s. There does not appear to be a satisfying *procedural* solution to the problem of particular embedded tax entitlements: Congress instead will revisit them as a substantive matter when Congress decides it is hungry enough for the revenue, or for a more efficient tax system.

Tax expenditure framework legislation thus should not be misconstrued as the vehicle for reexamining existing tax subsidy programs. Nonetheless, it might be possible as a technical matter to design framework legislation that applied to curb *future* Business Synthetic Spending (for example) as a whole, including future spending on existing tax subsidies. For example, imagine that a framework law permits the Budget committees to include in the Budget Resolution a directive that Business Synthetic Spending in general be cut five percent for the next three years, when compared with the baseline. Would that be implementable?

The answer seems to be yes, but with some difficulty. Tax returns are filed after the fact, and relate to all the activities of a taxpayer for the taxable year in question. A “first come first served” sort of cap, analogous to the Cash-for-Clunkers stampede, where

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<sup>127</sup> *JCT Reconsideration* at 34-38.

some taxpayers get 100 percent of the standard subsidy, and latecomers are foreclosed, therefore cannot work when applied to tax returns. For the same reason, it is extremely difficult to determine what a taxpayer's tax liability would be in the absence (or scaleback) of a particular subsidy, because of (i) behavioral responses and (ii) interaction effects within the tax return. Scaling back a multinational corporation's interest deductions, to take an easy example (although technically not one of a tax subsidy in current law) might cost the corporation a good deal of money, or not, depending on such factors as whether it is profitable for the year in question, has net operating losses from other years that can be carried into the current year, and whether it has excess foreign tax credits (the utilization of some of which might become viable by virtue of fewer expenses allocated against foreign-source income). So one cannot use a scaleback mechanism to target precisely how much of a subsidy a particular firm or industry would receive.

A directive to reduce all Business Synthetic Spending by five percent for the next year, however, arguably could be implemented by a pro rata scaleback of all business subsidies, in an amount projected to yield on a revenue estimate basis the same present value (in this example) as five percent of the simple sum of all such subsidies. The actual effect of this scaleback on the deficit would be susceptible to estimation error, but it would be closer to the intended outcome than doing nothing. It also in general would be a superior approach to raising business tax rates, as the latter would introduce more deadweight loss, while the former would tend to reduce the distortions attendant on the non-uniform distribution of Business Synthetic Spending across industries.

All of this, however, has the flavor of a clumsy and unrealistic device to accomplish a more straightforward objective, which in this case is substantive business tax reform, in the old-fashioned sense of broadening the tax base and lowering rates. If Congress is not genuinely interested in the latter, it is unlikely to embrace this awkward second best solution.

In short, it probably is asking too much of tax expenditure framework legislation to expect that it operate as the stalking horse for classic tax reform. It is more useful to imagine using framework legislation to protect *post-reform* tax systems: that is, not as a device to compel the devaluation of existing tax subsidies, but to protect going forward the presumptively broader base of a post-reform tax. Exactly this phenomenon famously

happened in 1986 and the years thereafter: a major tax reform effort broadened the tax base, and then years of new tax expenditures whittled it back down again.

In such a post-reform world, one could usefully consider adopting framework legislation that set target ceilings on tax subsidies, as a percentage of projected GDP, for example. Again the value of tax subsidies for the relevant future budget year would be calculated on a tax expenditure (projected revenue forgone) basis, which for the reasons described above is imperfect but good enough. The enforcement mechanism would be straightforward: if projected tax subsidies for the relevant budget year breached the statutory ceiling percentage of GDP, then a surcharge would automatically be imposed on all tax rates sufficient to fund the shortfall.<sup>128</sup> Such a mechanism would be more feasible than a spending sequester (with all its attendant disruptions, knock-on costs and injustices). The tax rate surcharge would be triggered, not by uncontrollable events (because the entire mechanism would look to future projections of both GDP and tax expenditure costs, rather than actual deficits), but by Congress's own excessive enthusiasm for tax subsidies, and therefore would not repeat the mistake of Gramm-Rudman-Hollings, which sought to impose sequestration as the remedy for economic developments outside the control of Congress. Like an impending execution, the prospect of scheduled tax surcharges that Congress could have avoided, but did not, would wonderfully concentrate the minds of its Members.

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<sup>128</sup> Charles McClure proposed an automatic tax surcharge as a budget enforcement tool many years ago. McClure, "The Budget Process And Tax Simplification/Complication," 45 Tax L. Rev. 25, 88 (1989). I am indebted to David Gamage for drawing this work to my attention.

