Income versus Consumption Tax Baselines for Tax Expenditures

Robert Carroll
The Tax Foundation
School of Public Affairs, American University

David Joulfaian
U.S. Department of the Treasury

James Mackie
U.S. Department of the Treasury

March 14, 2008

Abstract

This paper explores the implications of evaluating income tax expenditures under a consumptions tax. First it examines the conceptual differences between income and consumptions taxes. Next, an X-tax prototype of a consumption tax is employed to gauge the sensitivity of the estimates to the two baselines, current law income tax and the X-tax. The estimate capital income preferences are vastly different under the two regimes.

This paper is prepared for the NBER conference on Tax Expenditures. The authors are grateful to John Eiler, Robert Gillette, and Laura Power. The views expressed are those of the authors and do not necessarily represent those of the US department of the Treasury.

I. Introduction

Taxes are enacted in part to fund government. In addition, however, taxes sometimes are used to encourage certain economic activities or to redistribute the tax burden between groups of taxpayers. The features of the tax system that are intended to encourage certain activities or benefit certain groups are sometimes called tax preferences because they offer special, beneficial treatment to an activity or group. These preferences frequently are dubbed "tax expenditures," reflecting Stanley Surrey's idea that many tax preferences are similar to government spending programs cleared though (paid via) the tax system (Surrey, 1970; Surrey and McDaniel, 1985).

The process of identifying tax expenditures and quantifying their magnitude became formalized in 1974, when Congress enacted the Congressional Budget and Impoundment Control Act of 1974, which mandated the annual publication of tax expenditure estimates for all taxes in the Budget of the United States Government.[1] The Act defined tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[2]

Despite Surrey's proselytizing and Congressional action requiring an accounting of tax expenditures in the Budget, the tax expenditure concept remains murky. Most fundamentally, identifying special tax provisions that offer benefits to particular activities or groups requires an identification of the features baseline tax system. That is, a tax preference is a relative concept reflecting a lighter tax burden than would be obtained under some other set of tax rules. The identification and measurement of a tax expenditure is crucially dependent on how this set of tax rules is defined.

The 1974 Act provides little guidance on the baseline that should be employed in identifying preferences for all the taxes imposed by the Federal government. Following the lead of Surrey and others, tax expenditures generally have been measured relative to some notion of a comprehensive income tax and, at least in the U.S. Budget, tax expenditure analysis is limited to provisions of the U.S. income tax.[3] In formulating the baseline tax system, the framers of the tax expenditure chapter in the U.S. Budget (TEB) relied on a "practical" definition of comprehensive

---

[1] Congressional Budget and Impoundment Control Act (PL 93-344).
[2] Congressional Budget and Impoundment Control Act of 1974 (PL 93-344), sec. 3(3).
[3] Fiekowsky (1988) develops framework for evaluating excise tax expenditures. This is updated in Davie (1994)..

income, one that has evolved over the years, but that has never proven entirely satisfactory and deviates from comprehensive income in important ways.[4] The difficulty of defining the baseline tax system is evidenced by the use of somewhat different systems by the Congress and the Executive Branch, albeit both purport to reflect some notion of a comprehensive income tax. In addition, in the interests of "practicality or political realism," both of these baselines traditionally have omitted large or obscure items, such as (until recently) the implicit rental income from owner-occupied housing and that from financial services. Furthermore, neither Congress nor the Executive Branch include estimates of negative tax expenditures or tax penalties. This omission gives a rather one-sided perspective of the tax system, however consistent such an omission might be with Surrey's idea of focusing on tax provisions that are like government spending programs.

Additional ambiguities about the appropriate baseline tax system arise because what typically is called the U.S. income tax actually is a hybrid tax that combines features of a proper income tax with those of a proper consumption tax, as well as with provisions that would be found in neither tax. Moreover, while tax expenditures frequently are imbued with normative import, is not entirely clear what normative value can be obtained by comparing the U.S. tax system to a stylized version of an income tax or, for that matter, a consumption tax. Economists typically are concerned with issues of efficiency and equity and it in not at all clear that either a broad based income tax or a broad based consumption tax necessarily would represent the ideal tax system that in theory would be the most appropriate baseline. Caution seems especially warranted when considering the tax expenditures related to saving and investment incentives, features of the current tax system that many believe help promote economic growth. Undoubtedly many items on the official tax expenditures list represent poor tax policy, but certainly all of the items do not and the tax expenditure budget should not be taken uncritically as a hit list for tax reform.

Because it is so murky and because it is imbued with normative connotations, the ideas of a tax expenditure and of tax expenditure budgeting intended to supplement the traditional Budget, have proven to be fairly controversial. For example, when the Bush Administration first

[4] For example, until recently the tax expenditure analysis included in the U.S. Budget has applied a "classical" view of the income tax whereby the individual income tax is viewed separately from the corporate income tax. More recently, the U.S. Budget has considered income tax expenditures using a more holistic view of the income tax system that is consistent with the notion that income should generally be subject to tax once. This more recent presentation attempts to remove the double tax on corporate profits from the tax expenditures estimates.

came into office in 2001, it flirted with the idea of dropping the tax expenditure section of the Budget altogether, stating that tax expenditures are so ill defined as to be "of questionable analytical value."[5] Others have echoed this same theme over the years. Much of the recent criticism seems to have as its root the idea that the tax expenditures concept impeded progress towards the goal of reducing the tax on the return to saving and investment.[6] Indeed, the preexisting framework used for tax expenditures would have listed the lower tax rate on dividends enacted in 2003 as a tax expenditure even though corporate profits have already been taxed at the corporate level. Proposals to expand individual income tax free savings accounts may have been impeded by the preexisting framework that failed to take into account that the return to corporate equity is already taxed under the corporate tax.[7]

We do not attempt to settle the debate over whether tax expenditures are a useful concept. Rather, we attempt to put a little flesh on the bones of the notion that tax expenditures can look very different depending on the baseline tax system. We do this by classifying the major tax provisions that are considered tax expenditures in the Tax Expenditures chapter of the Analytical Perspectives volume of the FY 2009 U.S. Budget aginst a comprehensive income tax baseline and against a comprehensive consumption tax baseline and by providing new estimates of the size of selected tax expenditures relative to a consumption tax baseline.

The remainder of the paper is organized as follows. Section II provides a short background discussion explaining the importance of the baseline tax system. Section III considers in some detail net income tax baselines, including comprehensive income as well as the two income baselines used in the official tabulations of tax expenditures by the Executive Branch and by Congress. Section IV discusses the issues for classifying and measuring the major tax expenditures under a comprehensive income tax. With this as a background, Section V explores the implications of identifying tax expenditures using a consumption tax as a baseline, with particular attention on an X-tax (bifurcated VAT) regime as a convenient form of a consumption tax. We next provide in Section VI estimates of the size of selected tax expenditures under measured against an X-tax baseline. We conclude in Section VII.

II. The Importance of the Baseline Tax System

[5] FY 2002 Budget, Analytical Perspectives, p. 61.
[6] Bartlett, 11-12 and quite from Marty Sullivan therein.
[7] Toder (2005) addresses general aspects of tax reform.

The idea of a baseline tax system is absolutely critical to understanding what tax expenditures are and why they are controversial. Tax expenditures can only be understood as deviations from a hypothetical baseline tax system that serves as a point of comparison.[8] This is because tax expenditures are a *negative* concept defined by reference to what is *not* done, i.e., taxes that are not collected.[9] This negative, hypothetical, aspect is the ultimate source of most of the controversy regarding tax expenditures. It requires specification of an appropriate baseline tax system, and there is widespread disagreement over which baseline tax system to use and how to measure it.

The importance of the chosen baseline, and the controversy created by lack of agreement has been widely recognized since Surrey first began promoting the tax expenditure concept. In a 1969 article critical of the tax expenditure concept, Boris Bittker writes

> A systematic compilation of revenue losses requires an agreed starting point, departures from which can be identified. What is needed is not an ad hoc list of tax provisions, but a generally acceptable model, or set of principles, enabling us to decide with reasonable assurance which income tax provisions are departures from the model, whose costs are to be reportable as "tax expenditures"… The lack of an agreed conceptual model makes it impossible to say whether a large number of structural features of the existing federal income tax laws are, or are not, "tax expenditures"…[10]

Similar quotes can be found through the years in many articles written about tax expenditures,[11] and the same point has consistently been made in the discussion of tax expenditures in the annual chapter on tax expenditures in the U.S. Budget. Contrary to Surrey's suggestion, there simply is not a commonly held notion of the appropriate baseline tax system.

Arguments about the proper tax baseline commonly concern either: (a) the most appropriate concept of net income, or (b) the choice between an income tax or consumption tax baseline. The focus on net income often involves defining comprehensive income and what deviations from this ideal are unavoidable for some practical or political reason. The focus on income versus consumption taxation is fundamentally about whether provisions that reduce the as a tax preference (and hence as bad tax policy) or as part of the baseline tax system.

---

[8] Bradford (1986), p. 242.
[9] Both Ladd (1995), p. 2 and Aaron (1977), p 31 emphasize this characteristic of tax expenditures. Bradford (1986), p. 242 makes essentially the same pint when he says that tax expenditures can only be understood in light of the basis structure of taxation, to which they represent exceptions.
[10] Bittker (1969), cited in Bartlett (2001), p. 2
[11] See Goode (1977), pp. 27-28, Bradford (1986), p. 242, Bradford (1989), pp. 7-8, Bartlett (2001), p. 7.

Ultimately, of course, whether a policy deviates from accepted income or consumption tax norms is not the crucial question. Rather, the issue is whether particular tax rules act to maximizes economic welfare. A provision labeled as a tax expenditure nonetheless may represent sound economic policy,[12] and this can be true whether the baseline tax system is income or consumption. Nonetheless, we do not attempt to define the optimal tax system. Instead, we stay within the traditional parameters of the debate and proceed by viewing tax expenditures from two different perspectives: an income tax and a consumption tax. We also focus on the importance of how broad or narrow the tax base is to measuring tax expenditures under an income and consumption tax baseline. We note, however, that the difference between an income and consumption tax – the tax burden on capital income – is at the root of many of the complaints about the inefficiency of an income tax**.**

III. Net Income Baselines

A. Introduction

Because there are differences in what income can mean, there is substantial disagreement over the appropriate baseline even among those who accept the idea that an income tax is the (or perhaps *an*) appropriate baseline against which to identify and measure tax expenditures. The choices typically discussed include comprehensive income as well as income concepts that lie somewhere between current law's tax base and comprehensive income. The two most prominent of these are "reference law" and "normal law."

B. Comprehensive Income

Many economists support a comprehensive income baseline.[13] Comprehensive income (sometimes called Haig-Simons income or economic income) is defined as accretion to an individual's real purchasing power occurring within a year, i.e., as consumption plus the change in inflation adjusted net worth or saving.[14] It is generally considered the "ideal" or "pure" base for an income tax.[15] It includes all accretions to wealth, regardless of whether realized, related to a market transaction, or representing a return to capital or labor. Capital gains and losses,

[12] Bradford (1986), p. 240, Bradford (1989), p. 7, and Bartlett (2001) pp 7-8.
[13] Goode (1979) suggests such a base, p. 28. Someone also says this – find the quote.
[14] This also is referred to as Haig-Simons income or economic income. See Goode (1977) and Bradford (1986).
[15] This conclusion, however, is tautological, rather than based on an analysis of the economic effects of alternative tax bases.

adjusted for inflation, would be included in comprehensive income as they accrue. Business investment and casualty losses, including losses caused by depreciation, would be deducted. Implicit returns, such as those accruing to homeowners, also would be included in comprehensive income. A comprehensive income tax generally would not have a separate tax on certain types of income, such as corporate profits, nor would it include an alternative minimum tax (AMT) designed to take back the value of certain tax preferences or benefits for certain taxpayers but not for others.

It is common to suggest (see, e.g., the FY 2003? Budget of the United States) that a comprehensive income baseline is an option that would be preferable to what is seen as the potentially more arbitrary standards provided by reference law and normal law. There are, however, serious difficulties with adopting a comprehensive income base.[16]

One difficulty with using comprehensive income as a baseline tax system is that it is not a fully specified, objective concept.[17] While this point is repeatedly made in the tax literature, it nonetheless may not be sufficiently appreciated. A great deal of judgment is required in determining which items are or are not considered to be income. Substantial ambiguity surrounds the appropriate treatment of leisure, human capital, consumer interest expense, childcare expenses, work related expenses, gifts and bequests, charitable contributions, medical expenses, non-money benefits derived from working, certain taxes, certain types of government services, and inflation adjustments, among others.

Another difficulty is posed by the serious measurement problems that confront attempts to accurately gauge the size of many items in a comprehensive income tax base such as the implicit rent on owner-occupied housing and other consumer durables, deductible work related expenses, economic depreciation, accruing capital gains, benefits received from public goods, and benefits received from charities. Adjusting for inflation also raises potentially complicated measurement issues.[18]

Finally, the highly abstract, theoretical nature of many items in comprehensive income may make it an unacceptable concept for some, whether or not it can be unambiguously specified

---

[16] See, for example, the discussions in Bittker (1967) (Hav. Law Rev.), Bradford (1986), chapters 2 and 3, Goode (1977), and Bartlett (2001), pp.4-5.
[17] See Bradford (1986), pp. and Goode (1977), pp.
[18] See, for example, Aaron (1976) – the introduction, and Denison (1976).

and measured.[19] Surrey had such concerns and excluded from his idea of a tax expenditure items of income that are of too "technical or abstract" a nature.[20] The standard example of such a technical or abstract item of income is the homeowner's implicit rental income, which Surrey would not include in his baseline tax system.

So severe are its conceptual and measurement problems that tax proposals purporting to be rooted in "comprehensive income" end up quite far from the theoretically pure concept. For example, Bradford (1986) proposes a "genuine income tax" whose base differs from a comprehensive income tax by excluding the implicit rent from owner-occupied housing and other consumer durables (but allowing a deduction for all consumer interest), taxing realized rather than accruing capital gains, excluding the consumption value of leisure and of household production of goods and services, and excluding the consumption value of government services received in kind, among other things.[21] The comprehensive income measure discussed by Goode (1977) also deviates importantly from a rigorous application of comprehensive income.

C. Normal Tax vs. Reference Law

Prior to 1983 both Congress and the Executive Branch used the same baseline for tax expenditure estimates, one that is now referred to as "normal tax." Since 1983, however, the Executive Branch has used a slightly different baseline, called "reference tax."[22] Neither baseline conforms fully to a comprehensive income tax. Both are consistent with the rather vague mandate provided by the 1974 Congressional Budget Act.[23]

The Congressional "normal tax" concept accepts deviations from comprehensive income that it believes to be rooted in practical or administrative necessity. These include exclusions for items of income that are a component of comprehensive income only because of "relatively technical or theoretical arguments." The "normal tax" deviates from a comprehensive income

---

[19] This point has been emphasized by many, but finds early expression in Bittker (1967) cited in Aaron (1969), p. 543.
[20] Surrey and Hellmuth (1969), National Tax Journal, cited in Goode (1979), p. 27. There is a similiar quote in the 1968 Treasury report as cited by Surrey in "Federal Income Tax Reform…", Harvard Law Review (1970), pp. 354-355.
[21] This is essentially the same tax proposed as the "model comprehensive income tax' in *Blueprints for Basic Tax Reform* (1977).
[22] These tax bases are discussed in several places, including the annual Budget (e.g., Analytical Perspecitives, pp. 112-113 of the 2003 Budget), Bradford (1986), pp. 240-242 and Neubig (1989), pp. 244-245.
[23] Apparently Stanley Surrey disagreed with this and strenuously opposed Treasury's adoption of the "reference law" standard. An internal Treasury legal analysis, however, confirmed that "reference law" is consistent with the 1974 mandate (David Keyser memo of 1982). Furthermore, no legal challenges have been mounted against Treasury's adoption of the reference law standard.

tax in several important ways by: (1) including a separate tax on corporations (double tax on corporate profits), (2) not indexing for inflation, (3) not imputing a return for owner-occupied housing and other consumer durables, (4) not taxing accrued capital gains, and (5) allowing the personal exemption and the standard deduction, among other differences. The "normal tax" concept also accepts the alternative minimum tax (AMT) as a feature of the baseline tax system although it is unlikely that a comprehensive income tax would include a separate parallel tax system.

As originally conceived, to qualify as a tax expenditure under the Executive Branch's "reference law" standard, a tax provision must have passed a two part test. First, it must represent a deviation from a generally provided tax rule. Second, it must be susceptible to design and oversight by a (non-tax) government agency as a spending program. Over time, however, the conceptual basis of the "reference law" standard has become blurred and is not discussed in the Tax Expenditures chapter of the U.S. Budget.

The Congressional "normal tax" baseline is the closer of the two to Surrey's original idea of an "accepted concept of net income." It also may be the closer of the two to the idea of comprehensive income. The Executive Branch's "reference law" baseline focuses instead on deviations from generally available actual tax rules. Reference law's emphasis on the ability to mimic a tax expenditure with a spending program strongly emphasizes the idea that tax expenditures should be similar to direct spending programs.

Reference law appears to some as a more practical standard because it identifies deviations from "generally available" tax rules rather than deviations from a hypothetical, nonexistent, but ideal tax system. But determining the "generally available" rule requires a great deal of judgment, and in the end one is still forced to specify as a baseline a hypothetical nonexistent tax system.

Reference law's emphasis on the ability to design an analogous spending program[24] also has superficial appeal for the practical minded, but upon reflection offers little real insight. A literal interpretation would not discriminate among tax provisions since any tax program could be administered as a spending program, at least in a trivial sense; the same rules could be applied and enforced, and the check written, by a non-tax federal agency. One is then forced to fall back

[24] According to Neubig (1989), p. 245, the emphasis on the ability to define a analogous spending program is the primary difference between the normal tax and the reference tax baselines.

on judgments about what spending programs typically do and how they typically are run; in short, one is left nowhere since there are no obvious standards to apply to such questions. Furthermore, the requirement that the tax subsidy be sufficiently like a spending program (to the extent that it has intellectual content at all) could be applied to deviations from any tax base, not just from deviations from someone's idea of generally available rules.

As it turns out, there is very substantial overlap between the normal tax and the reference law baselines.[25] Nonetheless, they differ with respect to several key tax provisions. These differences historically have included accelerated depreciation (a tax expenditure under the normal tax but not under the reference law standard), low rates of tax on capital gains (a tax expenditure under the normal tax but not under the reference law standard), the graduated corporate tax rate structure (a tax expenditure under the normal tax but not under the reference law standard), and deferral of income from controlled foreign corporations (a tax expenditure under the normal tax but not under the reference law standard).

More recently, the Executive Branch has added several tax expenditures, dramatically changed the calculation of several tax expenditures, and omitted what some would consider to be major tax expenditures. These decisions were intended to improve the tax expenditure concept used in the U.S. Budget and, in some respects, align reference law more closely with the notion of comprehensive income (see e.g., the FY 2006 Budget).

One such item that recently has been added is the exclusion of net rental income from owner-occupied housing. A second addition is the exclusion from tax of the implicit income received from certain in-kind financial services, such as those provided on checking accounts. The calculation of several tax expenditures was also changed to adopt a more holistic view of the income tax system rather than the "classical" approach of accepting the legitimacy of both an individual income tax and a separate corporate income tax. These changes involved accounting for the fact that the return to equity-financed investment in the corporate sector that benefits from deferral of tax when held within tax-free savings vehicles has already been taxed under the corporate income tax; that is, accounting for the fact that some corporate profts are taxed twice, a feature of the current tax system that is inconsistent with both income and consumption tax principles. Similarly, the Executive Branch presentation in the U.S. Budget does not include the

[25] Neubig (1989), p. 245 says that "only a dozen or so items out of the 120-130 tax expenditure provisions are different between the treasury/OMB and the JCT/CBO tax expenditure budgets.

preferentially low tax rates on dividends and capital gains which were enacted or reduced in 2003. According to the Congresses' Joint Committee on Taxation (2007), which continues to view the individual income tax and the corporate income tax as separate components of the baseline tax system, this is the largest single tax expenditure under the "normal tax" baseline.

IV. Cataloging Tax Expenditures Against a Comprehensive Income Tax Baseline.

Before identifying and measuring tax expenditures relative to a consumption tax base, it is useful in providing context and insight to first to discuss the issues that arise under a comprehensive income tax base. As emphasized above, classifying individual tax provisions relative to any baseline, such as an income tax or consumption tax baseline, is difficult because of the ambiguities involved in defining any baseline. It can also be difficult because of the interactions between tax provisions (or their absence), which, in some cases, can have a dramatic affect on their measurement.

Table 1 groups the major tax expenditures reported in the U.S. Budget into three categories depending upon their classification under comprehensive income tax baseline: (1) a tax expenditure under a comprehensive income tax, (2) possibly (or likely) a tax expenditure under a comprehensive income tax, and (3) unclear whether a tax expenditure under a comprehensive income tax.[26] Most of the items listed in the first group – a tax expenditure under a comprehensive income tax – provide special tax treatment to the return on certain types of savings or investment. They reflect the hybrid nature of the existing tax system that attempts to reduce the high rate of tax on capital income in various ways (e.g., tax-free savings vehicles/accounts, lower tax rates on investor level income, accelerated deprecation/expensing). Even these relatively clear-cut items, however, can raise ambiguities in light of the absence of integration of the corporate and individual tax systems. For example, in the case of corporations, accelerated depreciation and expensing of R&D can be thought of as offsetting the corporate income tax, and so might not be tax expenditures relative to a comprehensive income baseline that does not include a separate corporate tax..

[26] Note that the classification used here was modified somewhat from that appearing in the tax expenditure chapter in the U.S. Budget to facilitate the discussion and measurement of tax expenditures under a consumption tax/X-tax regime discussed below. Also, due to various data limitation we were not able to include all of the major tax expenditures listed in the U.S. Budget in Table 2 (or Table 3 below).

Even though the items in the second grouping are possibly or even likely a tax expenditure under an X-tax, thsese items raise additional issues. Current law, for instance, allows deductions for home mortgage interest and for property taxes on owner-occupied housing. The presentation of tax expenditures in the U.S. Budget includes both of these provisions. A comprehensive income tax base would allow both deductions (essentially as a business expense), but it would also include in the tax base imputed gross rental income. Current law does not include gross rental income, however, and so on this basis the home mortgage interest deduction and the deduction for property taxes on owner-occupied housing are properly tax expenditures under a comprehensive income tax base.[9] Indeed, the sum of the tax expenditure for these two deductions, plus the tax expenditure for the failure to include net rental income, sums to the total tax expenditure for owner-occupied housing relative to a comprehensive income tax base.

Considered in isolation, State and local (income and property) taxes other than on owner-occupied housing would not be a tax expenditure under a comprehensive income baseline. Such taxes represent a reduction in net worth. However, when considering property taxes on such durables as automobiles, it must be remembered that current federal tax law fails to impute to income the services from these assets making the deduction for property taxes inappropriate, as discussed above for housing.

It also is important to remember that an idealized comprehensive income tax would include in income the value of (many) services received from State and local governments. Without such an imputation, one could argue that State and local taxes should not be deductible because they represent a proxy for the value of the services received; in essence, they represent spending on consumption. The existing US tax system does not impute to income the value of these services, so on this basis there is a fairly strong argument to be made that the deduction of these taxes does represent a tax expenditure relative to a comprehensive income baseline. A similar point could be made about the property tax paid on owner-occupied housing, and the argument in support of its deductibility under a comprehensive income baseline assumes that any associated services are included in the tax base. A difficulty with the view that State and local taxes represent user fees for consumption services is that, even if correct in aggregate, it could

[9] If there were no deduction for interest and property taxes, the tax expenditure base (i.e., the proper tax base minus the actual tax base) for owner-occupied housing would equal the homeowner's net rental income: gross rents minus(depreciation+interest+property taxes+other expenses). With the deduction for interest and property taxes, the tax expenditure base rises to gross rents minus (depreciation+other expenses).

well be incorrect in each individual case. It presumes that each taxpayer's consumption of State and local services relates directly to the amount of State and local taxes paid. Such a presumption is difficult to sustain when taxes are levied across taxpayers on a basis of other than benefits received.

The table also includes the child credit and the earned income tax credit. These seem likely to be tax expenditures under a comprehensive income baseline, although the case is not air tight. Credits would not be allowed under a strict comprehensive income tax baseline, because they reduce tax liability below that implied by the income level. But, it might be argued that taxpaying capacity should be adjusted for the basic expenses of living and of raising a child and on such a view these credits might not be considered tax expenditures. Furthermore, the credit could be though of as similar to allowing a lower tax rate schedule to certain families, and broadly available tax rate differences, e.g., schedules that vary for singles, joints, and heads of households, with a progressive rate structure under each, are not generally thought of as tax expenditures. On the other hand, the existing income tax has personal and dependent exemptions, and a zero bracket amount that presumably already adjust for some differences between income most broadly conceived and that which represents sufficiently discretionary spending power as to be considered appropriate for taxation. If these adjustments are deemed sufficient, then the child credit and earned income tax credit would be seen as tax expenditures.

The partial exclusion of Social Security benefits from tax is also listed. To the extent that Social Security is viewed as a pension, comprehensive income would include all contributions to Social Security retirement funds (payroll taxes) and tax accretions to value as they arise.[14] Benefits, however, would not be included because the fall in the value of the individual's Social Security account would be offset by an increase in cash. In contrast, to the extent that Social Security is viewed as a transfer program, all contributions should be deductible from income and all benefits received should be included.

In contrast to any of these treatments, current law excludes one-half of Social Security contributions (employer-paid payroll taxes) from the base of the income tax, makes no attempt to tax accretions, and subjects some, but not all, benefits to taxation. The difference between current law's treatment of Social Security benefits and their treatment under a comprehensive

---

[14] As a practical matter, this may be impossible to do. Valuing claims subject to future contingencies is very difficult, as discussed in Bradford, *Untangling the Income Tax*, pp. 23–24.

income tax would qualify as a tax expenditure, but such a tax expenditure differs in concept from that included in the U.S. Budget.

The tax expenditures in the U.S. Budget[15] reflect exemptions for lower-income beneficiaries from the tax on 85 percent of Social Security benefits. Historically, payroll taxes paid by the employee represented no more than 15 percent of the expected value of the retirement benefits received by a lower-earning Social Security beneficiary. The 85 percent inclusion rate is intended to tax upon distribution the remaining amount of the retirement benefit payment—the portion arising from the payroll tax contributions made by employers and the implicit return (i.e., inside build-up) on the employee and employer contributions. Thus, the tax expenditure conceived and measured in the current budget is not intended to capture the deviation from a comprehensive income baseline, which would additionally account for the deferral of tax on the employer's contributions and on the rate of return. Rather, it is intended to approximate the taxation of private pensions with employee contributions made from after-tax income[17]. Hence, the tax expenditure budget understates the tax advantage accorded Social Security retirement benefits relative to a comprehensive income baseline.

Medical expenditures, and, in particular, the premiums paid on employer-based health insurance, would seem to be an element of comprehensive income,[28] but there is some ambiguity. Some argue that medical expenditures do not represent discretionary spending, and so are not really consumption. Instead, these expenditures are a reduction of net worth and should be excluded from the tax base. Certainly a strong case can be made that some medical expenditures are a cost of earning income (a reduction in net worth) that might properly be deductible, although the same argument would apply to food, clothing, and shelter. In contrast, others argue that there is no way to distinguish medical care from other consumption items.

[15] This includes the tax expenditure for benefits paid to workers, that for benefits paid to survivors and dependents, and that for benefits paid to dependents.

[17] Private pensions allow the employee to defer tax on all inside build-up. They also allow the employee to defer tax on contributions made by the employer, but not on contributions made directly by the employee. Applying these tax rules to Social Security build-up and out of the employer's contributions, but would allow the employee to exclude from his taxable income benefits paid out of his own contributions.

[27] In addition, it might be appropriate to allow a deduction for premiums and tax benefits paid, rather than taxing premiums and exempting benefits paid, as discussed below in the consumption tax section. would require the employee to include in his taxable income benefits paid out of inside build-up and out of the employer's contributions, but would allow the employee to exclude from his taxable income benefits paid out of his own contributions.

[28] In addition, it might be appropriate to allow a deduction for premiums and tax benefits paid, rather than taxing premiums and exempting benefits paid, as discussed below in the consumption tax section.

Those who view medical spending as consumption point out that there is choice in many health care decisions, e.g., whether to go to the best doctor, whether to have voluntary surgical procedures, and whether to exercise and eat nutritiously to improve and maintain one's health and minimize medical expenditures. This element of choice makes it more difficult to argue that medical spending is more "necessary" than, or otherwise different from, other consumption spending.

The deduction for U.S. production activities also raises problems. To the extent that it is viewed as a tax break for certain qualifying businesses ("manufacturers"), it would be a tax expenditure. In contrast, the deduction may prove to be so broad that it is available to most U.S. businesses, in which case it might not be seen as a tax expenditure. Rather, it would then represent a feature of the baseline tax rate system because the deduction is equivalent to a lower tax rate. In addition, it might not be a tax expenditure to the extent it is viewed as providing relief from the double tax on corporate profits (an argument that is not entirely consistent with a deduction that is available for all forms of business organization, not just corporations).

The next grouping – unclear whether a tax expenditure under a comprehensive income tax –includes charitable donations whose treatment is less certain. [18] Under existing law, charitable contributions are deductible, and this deduction is considered on its face a tax expenditure in the current budget.[19] The treatment of charitable donations, however, is ambiguous under a comprehensive income tax. If charitable contributions are a consumption item for the giver, then they are properly included in his taxable income and a deduction for contributions would be a tax expenditure under a comprehensive income tax base. In contrast, charitable contributions could represent a transfer of purchasing power from the giver to the receiver. As such, they would represent a reduction in the giver's net worth, not an item of consumption, and so properly would be deductible, implying that the charitable deduction is not a tax expenditure. At the same time, however, the value of the charitable benefits received probably is income to the recipient. Under current law, such income is not taxed, qualifying it for a tax expenditure, although this exclusion is not included on the official list of tax expenditures. So, the donor's deduction might proxy for the failure to tax the recipient, even if the donor's

[18] See, for example, Goode, The Economic Definition of Income, pp. 16–17, and Bradford, Untangling the Income Tax, pp. 19–21, and pp.30–31.
[19] The item also includes gifts of appreciated property, at least part of which represents a tax expenditure relative to an ideal income tax, even if one assumes that charitable donations are not consumption.

deduction were not seen as a tax expenditure if considered in isolation. If the donation was seen as consumption for the donor and as income for the recipient, then allowing the donor a deduction and failing to impute income to the recipient both would be tax expenditures.

V. Tax Expenditures under a Consumption Tax Baseline

A broad-based consumption tax can be viewed as an income tax plus a deduction for net saving. This follows from the definition of comprehensive income as consumption plus the change in net worth. Thus, it seems straightforward to conclude that current law's deviations from a consumption base include: (a) tax expenditures on a comprehensive income tax base associated with exemptions and deductions for certain types of income, plus (b) overpayments of tax, or negative tax expenditures, to the extent net saving is not deductible from the tax base. In reality, however, the situation is more complicated. A specific form of consumption tax needs to be choosen as a baseline tax system. Below we describe the general issues related to a consumption tax baseline, our choice of an X-tax regime for our consumption tax baseline, and various measurement issues relate to an X-tax regime.

A. General Issues Related to a Consumption Tax Baseline

It is not always clear how to treat certain items under a consumption tax. One problem is determining whether a particular expenditure is an item of consumption. Spending on medical care and charitable donations are two examples discussed above.

There may be more than one way to treat various items under a consumption tax. For example, a consumption tax might ignore borrowing and lending by excluding from the borrower's tax base the proceeds from loans, denying the borrower a deduction for payments of interest and principal, and excluding interest and principal payments received from the lender's tax base. On the other hand, a consumption tax might include borrowing and lending in the tax base by requiring the borrower to add the proceeds from loans in his tax base, allowing the lender to deduct loans from his tax base, allowing the borrower to deduct payments of principal and interest, and requiring the lender to include receipt of principal and interest payments. In present value terms, the two approaches are equivalent for both the borrower and the lender; in particular both allow the tax base to measure consumption and both impose a zero effective tax rate on interest income. But which approach is taken obviously has different implications (at least on an annual flow basis) for the treatment of many important items of income and expense, such as the home mortgage interest deduction.

Some exclusions of income are equivalent in many respects to consumption tax treatment that immediately deducts the cost of an investment while taxing the future cash flow. For example, exempting the yield (income) on an investment is equivalent to consumption tax treatment as far as the normal rate of return on new investment is concerned. This is because expensing generates a tax reduction that offsets in present value terms the tax paid on the investment's future normal returns. Expensing gives the normal income from a marginal investment a zero effective tax rate. However, a yield exemption approach differs from a consumption tax as far as the distribution of income and government revenue is concerned. Pure profits in excess of the normal rate of return would be taxed under a consumption tax, because they are an element of cash flow, but would not be taxed under a yield exemption tax system. Should exemption of certain kinds of investment income and certain investment tax credits, which also reduce the effective tax rate on capital income, be regarded as the equivalent of consumption tax treatment?

Looking at provisions one at a time can be misleading. The hybrid character of the existing tax system leads to many provisions that might make good sense in the context of a consumption tax, but that generate inefficiencies because of the problem of the "uneven playing field" when evaluated within the context of the existing tax rules. It is not clear how these should be classified. For example, many saving incentives are targeted to specific tax favored sources of capital income. The inability to save on a similar tax-favored basis irrespective of the ultimate purpose to which the saving is applied potentially distorts economic choices in ways that would not occur under a broad-based consumption tax.

In addition, provisions can interact even once an appropriate treatment is determined. For example, suppose that it is determined that financial flows are out of the tax base under a consumption tax. Then the deduction for home mortgage interest would seem to be a tax expenditure. However, this conclusion is cast into doubt because current law generally taxes interest income. When combined with the homeowners' deduction, this results in a zero tax rate on the interest flow, consistent with consumption tax treatment.

Capital gains would not be a part of a comprehensive consumption tax base because there would be no attempt to tax income. Given this, how should existing tax expenditures related to capital gains be classified?

Such considerations suggest that, as with an income tax, trying to compute the current tax's deviations from "the" base of a consumption tax is difficult if not impossible because deviations cannot be uniquely determined, making it very difficult to do a consistent accounting of the differences between the current tax base and a consumption tax base.

B. The X Tax as a Baseline Consumption Tax System

This paper attempts to determine and measure the major items in the Executive Branch's framework for tax expenditures that would be tax expenditures under a specific type of consumption tax: an X-tax that raises the same revenue as the existing income tax. An X-tax facilitates comparison to the current methodology used for tax expenditures because its structure is similar to the current income tax. An X-tax is also similar to a VAT-type consumption tax under which businesses are taxed on their receipts less purchases,[29] but an X-tax consists of both a business level tax and a household level tax.

Indeed, the key difference between an X-tax and a VAT is the point at which the tax on labor compensation is collected. A VAT does not allow firms to deduct labor compensation, so the tax on compensation is collected from the business. In contrast, an X-tax allows businesses to deduct compensation paid to workers and then subjects compensation to an individual level tax, which can, and typically does, include progressive tax rates. Compared to a VAT, this bifurcation of the tax base into separate business and individual level taxes allows for a more progressive distribution of the tax burden across income levels. For our purposes, this feature of an X-tax facilitates the comparison of a consumption tax baseline to the current tax system.

The X-tax used here was designed to replace federal individual and corporate income taxes in 2010. Ultimately, we compare a broad-based consumption tax to the current income tax, but there are important difference between a broad-based tax, whether consumption or income-based and the current income tax. It has been estimated that tax preferences generally reduce the size of the tax base relative to either a consumption or income tax by 40 percent to 50 percent.[30] To distinguish between differences in the tax base related to the income-consumption tax baseline and more general base broadening, we separately estimate tax expenditures under a broad-based X-tax and a narrow-based X-tax, with all the current law preferences in place.

The business tax base under a X-tax approximates a subtraction method VAT, except that compensation paid to employees is deductible and instead taxed under a separate individual tax. The top individual and business tax rates were set to 35 percent. Rather than an exemption or standard deduction, individuals would be subject to a progressive tax rate schedule that includes an effective zero bracket amount. The X-tax base also excludes financial flows from the tax base including interested payments and expenses. A more detailed description of the X-tax base is provided below.

Individuals

[29] Of course, it is the deduction of the cost of investment goods, i.e., expensing, that makes the VAT a tax on consumption.

[30] *2003 Economic Report of the President*, p. 191.

- Base – Wages, pension distributions, employer-based health insurance premiums, and unemployment compensation.
- Rates – A progressive tax rate schedule with four tax rate brackets – a zero tax bracket that mimics a large generous exemption, a 15 percent rate bracket, a 25 percent rate bracket, and a 35 percent rate bracket – as described in Table 1. There would be no alternative minimum tax (AMT).

Businesses

- Base – Gross receipts less purchases from other businesses (including purchases of all tangible property), wages, contributions to pension accounts, and employer-based health insurance.

- Rates – A single business tax rate of 35 percent. All businesses – C corporations, as well as flow-through businesses, such as S corporations, partnerships and sole/farm proprietorships, would be subject to the business level tax.

Treatment of Particular Sectors

- Housing – Housing is treated using a tax pre-payment approach. Sales of new housing, renovations and rentals by landlords would be taxed. Because the homeowner is allowed no deduction for the price of the house, the full value of the house would be taxed when purchased, which in present value terms is equivalent to taxing the annual flow of housing services that the house is expected to produce. The consumption tax on the service flow over the life of the asset is pre-paid at the time the house is purchased, whence the term tax pre-payment approach. There would be no deduction for mortgage interest.

- Financial Services – The value of financial intermediation services would be taxed in some way.

- International Trade – While the baseline X-tax envisions border adjustments (i.e., exports deductible, imports taxed), the revenue from such border adjustments is not incorporated into the broader structure of the proposal to attain revenue neutrality.

- Government and other non-profit organizations – The wages and fringe benefits of all employees would be subject to the individual tax. Business activities of government entities and other tax-exempt organizations are not subject to tax.

- No transition relief would be provided.

C. <u>Classifying Major Tax Expenditures Relative to An X-Tax Baseline</u>

Table 3 shows the largest tax expenditures reported in the Budget classified according to whether they would be considered tax expenditures under the X-tax baseline. The classification is not particularly precise because we are not certain how much weight to attach to exact mechanical rules of the X-tax, as opposed to the intent of a consumption tax, nor how much weight to attach to interactions among tax provisions.

<u>Provisions probably considered tax expenditures under the X-tax baseline</u>

The deductibility of property taxes on owner-occupied housing probably would be a tax expenditure relative to the X-Tax baseline, but there are some ambiguities. Setting aside the issue of how benefits received from State and local governments are taxed, properly measuring the net service flow from housing would require some kind of deduction for property taxes.[31] Property taxes represent a reduction in net worth, not an item of consumption. But current law does not tax the service flow from housing, making the deduction of property taxes unwarranted.

There also is the issue of the taxation of government services receive by the homeowner and paid for by the property tax on housing. These should be taxed under a comprehensive consumption tax, and although the X-tax makes no explicit imputation for them, it turns out that the pre-payment approach would seem to tax such services automatically. This is because, like property taxes, services, such as education, provided to homeowners would seem to be reflected in housing prices (see the *Bluebook*). In contrast, current law fails to impute the value of such services but does allow a deduction for the tax that pays for the services, giving an additional argument to support the view that the deduction of property taxes is a tax expenditure.

The deduction for property taxes other than those imposed on housing also probably is a tax expenditure relative to an X-tax and the analysis parallels that for taxes on owner-occupied housing.

The deduction for State and local income taxes also probably represents a tax expenditure under an X-Tax baseline. These taxes can be thought of as payments for services received, and the services are not imputed to income. As mentioned above in the income tax

---

[31] As discussed in the *Bluebook*, under a pre-payment approach to taxing housing, the property tax already implicitly is deducted to the extent that it reduces the price of the house. No additional deduction would be needed to measure and tax the net service flow from housing that is received by the homeowner.

discussion, however, there might not be a very close connection between taxes and benefits, casting some doubt on this rationale.

The tax expenditures for Social Security measure a tax benefit relative to a baseline that is somewhere between a comprehensive income tax and a consumption tax. The properly measured tax expenditure relative to a consumption tax baseline would include only those Social Security benefits that are accorded treatment more favorable than that implied by a consumption tax, which would correspond to including 50 percent of Social Security benefits in the recipient's tax base, because consumption tax treatment would allow the exclusion of about ½ of the benefits. Thus, the existing tax expenditure is correct conceptually, but is not measured properly relative to a comprehensive consumption tax baseline. Indeed, part of what is measured should be counted as a negative tax expenditure relative to a consumption tax baseline because it represents an over-taxation of benefits received.

There is a strong case for viewing the child credit and the earned income tax credit as social. welfare programs (transfers). As such, they would be tax expenditures relative to a consumption baseline. Nonetheless, these credits could alternatively be viewed as relieving tax on “nondiscretionary” consumption, and so not properly considered a tax expenditure.

As discussed in the previous section, there is disagreement within the tax policy community over the extent to which medical care and charitable giving represent consumption items. There also is the issue of how to tax medical insurance premiums. Under current law, employees may exclude from their income insurance premiums paid for by their employers. The self-employed also may exclude (via a deduction) medical insurance premiums from their taxable income. From some perspectives, these premiums should be included in the X-tax base because they represent consumption. Yet an alternative perspective would support excluding the premium from the tax base as long as the value of any medical services paid for by the insurance policy were included, as would be the case under an X-tax. But even from this alternative perspective, the official tax expenditure might continue to be a tax expenditure under an X-tax baseline because current law excludes the value of medical services paid with insurance benefits from the employee's taxable income.

The taxation of Social Security benefits for the disabled also is difficult to classify. As discussed above, these benefits generally ought to be taxed because they represent purchasing power. However, the associated Social Security taxes ought to be fully deductible, but they are not. Hence the proper treatment is unclear. Moreover, if the insurance model is applied, the taxation of Social Security benefits might be a negative tax expenditure.

Typically, the X-tax is conceived of as a tax on real, not financial, flows. That is, the X-tax would exclude from its base any financial transactions, including interest paid. Consequently, from this perspective, the deduction for home mortgage interest would be a candidate for a tax expenditure under the X-tax. In addition, there is nothing about the tax prepayment approach to dealing with the implicit rental value of owner-occupied housing that would justify a deduction for home mortgage interest.

Nonetheless, the case for making the deduction of home mortgage interest a tax expenditure relative to the X-tax baseline is far from air tight. It might be wrong to view the deduction for home mortgage interest in isolation from the other provisions of the present tax code. Under current law, interest income, including that earned through mortgage lending, generally is taxed, while it should not be under our X-tax. A homeowner's mortgage interest deduction could be viewed as counterbalancing the lender's inclusion, eliminating from the tax base debt's share of the rental income earned on an investment in owner-occupied housing, as would be appropriate under a consumption tax.

<u>Items that are not tax expenditures under the X-tax Baseline</u>

Most of the items in the grouping that are not tax expenditures under the X-tax baseline relate to tax provisions that eliminate or reduce the tax on various types of capital income. In many cases, provisions that reduce taxes on capital income would not be considered tax expenditures under our X-tax baseline because the X-tax is intended to eliminate the tax on capital income. This classification reflects the elimination or reduction of tax on capital income rather than the mechanics by which the tax is eliminated or reduced.

Thus, for example, excluding retirement savings earnings would not be a tax expenditure because the X-tax would not include those earnings in its base – it does not seek to tax capital income.

In our classification we do not distinguish between types of retirement saving vehicles, although one might do so if greater emphasis were placed on the mechanics of the policy. Thus, for example, if one paid a great deal of attention to mechanics, contributions out of labor earnings to a Roth (backloaded) IRA would not be a tax expenditure under the X tax baseline because such contributions would be made on an after-tax basis. In contrast, contributions to a tradition (front loaded) IRA that allowed a deduction against wages would be a tax expenditure. By the same token, the tax on distributions from a tradition IRA would be a negative tax expenditure, to the extent that the distribution came out of contributions rather than earnings.

In contrast to a classification system that places a great emphasis on mechanincs, we place emphasis on the net effect. Thus, since the net effect of all the retirement savings provisions is to reduce or eliminate the tax on capital income, we classify all of them as not being tax expenditures.

Under our X-tax there would be no attempt to tax capital gains on home sales, so current law's exclusion of such gains would not be a tax expenditure. Expensing of business investment is the norm under the X-tax, so current law's provisions that allow R&E spending to be expensed would not be considered a tax expenditure when judged against the X-tax baseline. The production deduction also moves towards a zero rate of tax on capital income, and so would not be a tax expenditure under the X-tax.

In addition, current law's failure to tax the annual net rent from owner-occupied housing would not be a tax expenditure measured against the X-tax baseline. One way to think of this is that a consumption tax would impose no tax on capital income, including the implicit return to owner-occupied housing. Current law clearly conforms to this treatment. Furthermore, current law applies the pre-payment approach to owner-occupied housing, just as does the X-tax. That is, under current law, a homeowner pays tax on the funds used to buy the house but is excused from tax on the houses service flow. This treatment is wrong under an income tax but right under a pre-payment consumption tax.

The items in the last grouping could be viewed as negative tax expenditures under the X-tax baseline. For example, when judged against expensing, accelerated depreciation is a tax penalty, not a tax subsidy. The exception from the passive loss rules probably would not be a tax expenditure because proper measurement of income, and hence of consumption, requires full deduction of losses.

VI. Tax Expenditure Estimates under the Income Tax and the X-Tax Baseline

As discussed above, estimating the gap between tax expenditures under the current reference law baseline and a comprehensive consumption tax, as represented by a revenue neutral X-tax regime, involves several conceptual changes to the tax system: (1) changing the tax base to reflect the differences between an X-tax and an income tax, (2) broadening the tax base by removing the various special tax provisions, and (3) adjusting the tax rate schedule to bring the new hypothetical broad-based X-tax into budget balance. Table 3 presents estimates of the major tax expenditures under several alternative baselines to facilitate comparison as the current income tax system is moved from its current narrow base to an X-tax with a broad base, while raising the same revenue. [32]

The tax expenditures estimates under the current reference law methodology are presented in column 1. In column 2, the baseline tax system is transformed to an X-tax by removing the return to saving and investment, as well as interest flows, from the tax base. In column 3, the baseline tax system is broadened by eliminating all the various special tax preferences. In column 4, the rate schedule in the baseline tax system is adjusted to raise the same revenue as the current income tax for 2010.

This step-by-step process allows us to show how the tax expenditures are affected under each baseline tax system. As can be seen by comparing current reference law (column 1) and a narrow-based X-tax (column 2), those tax provisions relieve the tax on the return to savings and investment, such as individual retirement accounts (IRAs) and 401(k)-type accounts, are no longer tax expenditures. To the extent the current tax treatment taxes return to savings and investment more heavily than an X-tax, the provisions become surtaxes. For example, the lower tax rate on capital gains is estimated as a $60 billion tax expenditure under reference law, but a surtax of -$121 billion under the narrow-based X-tax because capital gains would no longer be taxed under an X-tax. Similarly, accelerated depreciation, while an investment incentive relative to current law, does not go as far as expensing of investment under an X-tax and also becomes a surtax under the X-tax baseline.

The special tax provisions that are unrelated to saving and investment generally remain tax expenditures, but change in value somewhat due to the change in the definition of the tax base under the X-tax. The change in taxpayer's taxable income as capital income is removed

[32] Estimates are prepared using US Treasury micro-simulation models which employ a baselines consistent with the Administration's economic forecast for the year 2010.

from the tax base lowers taxpayer's tax liabilities as their income moves down the tax rate schedule. This has the effect of reducing the value of most of these tax expenditures somewhat.

The effect of broadening the tax base by eliminating the various special tax provisions unrelated to an X-tax is shown in column 3. The effect on the tax base from elimination of the special tax provisions is dramatic. For example, the tax expenditure for the charitable giving deduction rises from $55 billion to $57 billion. Note that we included repeal of the AMT as part of base broadening under the rationale that the broader tax base under the AMT, in effect, gets subsumed as part of base broadening.[33] This likely explains the very large changes in those special tax provisions that are also AMT preferences, such as the state and local income tax deduction and property tax deduction. The tax expenditure for the state and local income tax deduction, for example, rises from $36 billion under the narrow-based X-tax to $80 billion under the broad-based X-tax.

In the final step, we adjust the tax rate schedule (and brackets) so that the narrow-based X-tax raises the same revenue as the current income tax (column 4). Tax rates need to be increased in order to make up the shortfall in revenue. These somewhat higher tax rates increase the value of most of the tax expenditures somewhat. This last step illustrates yet another aspect of how arbitrary tax expenditure estimates can be – they also depend on the tax rate schedule and the level of overall taxes. As tax revenues rise or fall, taxpayers move through the tax rate schedule, which has effects the value of tax expenditures.

VII. A Concluding Comment

While this paper focused on the how tax expenditures under the income tax would be viewed from the prism of a consumption tax, there are a number of differences between the two that are left off the official tax expenditure list. Additional possible tax expenditures may include current laws exclusion from individual income tax of benefits paid by insurance policies, in-kind benefits from Government programs such as Medicaid and public housing, and benefits received from charities.[34] Under some theories of a comprehensive consumption tax, the value of leisure and of household production of goods and services would be included as a tax expenditure. The

[33] Of course, this also has the effect of mixing to some degree the effects of base broadening and the adjustment to the tax rate schedule (column 4) because the AMT rates schedule is also eliminated under base broadening. In simulations not reported here, we found that the AMT has little effect (i.e., raises little revenue) once most special tax provisions have been eliminated in column 3.

personal exemption and standard deduction (or the X-tax analogue) also might be considered tax expenditures, although they can be viewed differently, e.g., as elements of the basic tax rate schedule.

Importantly, current law also deviates from a consumption tax norm in ways that increase, rather than decrease, tax liability – it has a number of large negative tax expenditures relative to a consumption tax baseline. One large item on this list would be the inclusion of capital income in the current individual income tax base. The corporate income tax, or more generally a measure of the double tax on corporate profits, also would be a negative tax expenditure. The passive loss rules and NOL carry-forward provisions also might generate negative tax expenditures, because the change in net worth requires a deduction for losses (consumption = income—the change in net worth). Because human capital is a productive asset, its cost (e.g., certain education and training expenses, including perhaps costs of college and professional school) should be expensed, but it is not under current law.

References

Bartlett, Bruce (2001). The End of Tax Expenditures as We Know Them?. IRET Policy Bulletin No. 84, June 13.

Bradford, David F., Untangling the Income Tax (Cambridge, MA: Harvard University Press, 1986), pp. 15–31.

Davie, Bruce F. (1994). “Tax Expenditures in the Federal Excise Tax System.” National Tax Journal. 47 (March), pp. 39-62.

Bittker, Borris, “Accounting for Federal Tax Subsidies in the National Budget” (1969) 22 National Tax Journal 244

Economic Report of the President, 2003. “Tax Policy in a Growing Economy.” Chapter 5 (Washington, D.C.: U.S Government Printing Office, 2003): 175-211.

Fiekowsky (1988), “Tax Expenditures Cleared Through Excise, employment, and Estate and Gift Taxes”, unpublished mimeo.

Fiekowsky, Seymour. The Relation of Tax Expenditures to the Distribution of the Fiscal Burden. Canadian Taxation 2 (Winter 1980): 211-219.

Goode, Richard, ``The Economic Definition of Income" in Joseph Pechman, ed., Comprehensive Income Taxation (Washington, D.C.: The Brookings Institution, 1977), pp. 1-29.

Ladd, Helen. "The Tax Expenditure Concept after 25 Years." Presidential address to the National Tax Association 86th Annual Conference on Taxation, Charleston, Nov. 1994.

Neubig, Thomas. The Current Role of the Tax Expenditure Budget in U.S. Policymaking. in Neil Bruce, ed. Tax Expenditures and Government Policy. Kingston, Ontario: John Deutsch Institute for the Study of Economic Policy, 1988.

Neubig, Thomas S. and David Joulfaian. The Tax Expenditure Budget Before and After the Tax Reform Act of 1986, OTA paper 60, 1988.

Surrey, Stanley S. and Paul R. McDaniel. Tax Expenditures. (Harvard University Press: Cambridge, MA, April 1985.

Surrey, Stanley S. and Hellmuth. Tax Expenditures. (Harvard University Press: Cambridge, MA, April 1985.

U.S. Department of the Treasury, Blueprints for Basic Tax Reform (Washington, D.C.: U.S. Government Printing Office, 1977).

Toder, Eric. Tax Expenditures and Tax Reform: Issues and Analysis, The Urban Institute, 2005, mimeo.

Table 1

Tax Expenditures Under Current Law Baseline Used by the Executive Branch

	Current Law Baseline
	2010
Tax Expenditure Under a Comprehensive Income Tax Base	
Net Exclusion of contributions and earnings: 401(k) plans	68
Net Exclusion of contributions and earnings: Employer plans	42
Net Exclusion of contributions and earnings: Keogh plans	16
Net Exclusion of contributions and earnings: IRAs	13
Exclusion of interest for state and local bonds	27
Exclusion of on life insurance savings	28
Deferral of income from controlled foreign corporations	15
Lower tax rate for capital gains	60[1]
Accelerated depreciation of machinery and equipment	6
Accelerated depreciation of rental housing	9
Possibly (or Likely) Tax Expenditure Under a Comprehensive Income Tax Base	
Home mortgage interest deduction	115
State and local income tax deduction	38
Property tax deduction	17
Exclusion of social security benefits	NA
Exclusion of employer-based health insurance premiums	169
Child tax credit	46
Earned income tax credit	49
Manufacturing deduction	26
Unclear Whether a Tax Expenditure Under a Comprehensive Income Tax Base	
Charitable contributions deduction	63

[1] Estimates reported here may not be consistent with those reported in the official budget estimates due to minor methodological differences

[2] Excludes benefit of lower rates for corporate equity.

Table 2

Exemption and Tax Rate Schedule under a Revenue Neutral X-tax

Tax Rate	Unmarried Individuals	Married Couples
0%	0 to $20,000	0 to $40,000
15%	$20,000 to $45,000	$40,000 to $90,000
25%	$45,000 to $150,000	$90,000 to $300,000
35%	$150,000 and over	$300,000 and over

Table 3

Tax Expenditure Estimates Under Various Baselines[1]

	Current Law Baseline	X-tax with C.L. Base	X-tax with Broad Base	Revenue Neutral X-tax with Broad Base
	(1)	(2)	(3)	(4)
Possibly Tax Expenditure Under X-Tax Base				
Home mortgage interest deduction	115	112	97	112
State and local income tax deduction	38	36	80	91
Property tax deduction	17	15	51	51
Charitable contributions deduction	63	55	57	61
Exclusion of social security benefits	NA	NA	NA	NA
Exclusion of employer-based health insurance premiums	169	169	181	149
Child tax credit	46	45	49	50
Earned income tax credit	49	49	49	50
Not Tax Expenditure Under X-Tax Base				
Capital gains exclusion on home sales	38	0	0	0
Net Exclusion of contributions and earnings: 401(k) plans	68	0	0	0
Net Exclusion of contributions and earnings: Employer plans	42	0	0	0
Net Exclusion of contributions and earnings: Keogh plans	16	0	0	0
Net Exclusion of contributions and earnings: IRAs	13	0	0	0
Exclusion of interest for state and local bonds	27	0	0	0
Exclusion of on life insurance savings	28	0	0	0
Manufacturing deduction	26	0	0	0
Deferral of income from controlled foreign corporations	15	0	0	0
Surtax Under X-Tax Base				
Lower tax rate for capital gains	60[2]	-121	-113	-107
Accelerated depreciation of machinery and equipment	6		-29	
Accelerated depreciation of rental housing	9		-19	

[1] Estimates reported here may not be consistent with those reported in the official budget estimates due to minor methodological differences
[2] Excludes benefit of lower rates for corporate equity