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The Two Faces of Tax Neutrality: Do They Interact or Are They Mutually Exclusive?

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The term "tax neutrality" refers to at least two quite different concepts. In its most common usage, tax neutrality refers to tax provisions that conform to an ideal tax system. A tax provision that is consistent with such an ideal system is described as "neutral." A tax provision that cannot be reconciled with the ideal system is sometimes referred to as a "tax expenditure" item. I will discuss tax expenditures later in this paper.

As one might expect, various persons' visions of an ideal tax system will differ. However, those that refer to tax neutrality in this sense do share a fairly similar concept of what constitutes an ideal tax system.

Virtually all versions of an ideal tax are grounded on the so-called "Haig-Simons definition of income." That definition is described and explained most thoroughly in a book (Personal Income Taxation) authored by an economist, Henry Simons, a little over 50 years ago. Simons defined "personal income" as the increase in a taxpayer's wealth over a specified period of time (typically a period of a year) plus the market value of the taxpayer's consumption during that period. In his own words, Simons said that income was

the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question.

In other words, it is merely the result obtained by adding consumption during the period to 'wealth' at the end of the period and then subtracting 'wealth' at the beginning.

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2. Simons, supra note 1, at 50.
By way of illustration, Simons adopts the analogy of treating society as a giant partnership and an individual's income as the sum of his withdrawals (consumption) from the partnership and the change in value of his equity or interest in the partnership.

It is possible to view the Haig-Simons formula as an equation rather than as a definition of income. Income can thus be viewed merely as a surrogate for the accumulation of wealth and the consumption of goods and services, that is, the income tax is determined by a taxpayer's consumption of goods and services and on his accumulation of wealth. As we shall see, even the tax on the accumulation of wealth element is a tax on consumption.

How does the Haig-Simons definition relate to the income tax system currently in place? An expenditure that does not involve the consumption of goods or services results in a reduction of the taxpayer's wealth and so should reduce the taxpayer's tax base. Accordingly, expenditures that do not involve consumption should be allowable as deductions from a taxpayer's gross income. On the other hand, if an expenditure does involve a consumption, it should be taxed to the taxpayer; and so no deduction should be allowed against the taxpayer's gross income. The reduction of the taxpayer's wealth is balanced by the market value of the taxpayer's consumption. Income tax deductions, therefore, can be viewed as the system for taxing consumptions and for not taxing non-consumption expenditures.

Consumption denotes the value of rights exercised in the destruction of economic goods, which include services. It refers to a taxpayer's exhaustion of a portion of society's assets. To the extent that a person uses up society's goods, it is fair to allocate the burdens of the cost of running the government to that person. By denying a deduction for the cost of a consumption, the effect is to tax the consumption itself.

One thesis of this paper is that the Haig-Simons definition of income has been used for purposes which it cannot properly serve. The definition is a useful tool, but it does more harm than good when its evaluative attributes are exaggerated. In seeking to restrict the usefulness of Haig-Simons, I do not wish to minimize the true value that it has as an analytic tool by imposing a structure on the income tax system so that the role that broad

tax principles play in the system becomes comprehensible. In some of the illustrations that I discuss later in this paper, I will attempt to indicate the ways in which the definition is useful as well as some areas in which it provides no analytic assistance. At this point, I will digress briefly to demonstrate how the Haig-Simons approach can help explain why the taxation of earnings from savings is characterized by some commentators as double taxation, which therefore promotes consumption.

Under the Haig-Simons definition of income, the income tax can be seen to be more closely related to a consumption tax than would appear on its face. In essence, it is a tax on present consumption and on the present value of a taxpayer's future consumption. So, if I earn a dollar in Year One and use that dollar to purchase a dollar's worth of entertainment, I will be taxed on the dollar of income; but the income can be seen as merely representing the one dollar of consumption that I had. If I do not spend the dollar and, instead, save it, I am taxed on the present value of the consumption that I can enjoy at some future date when I (or someone else) spend the dollar for a consumption item.

When the dollar is spent at a future date, it will not incur a tax then because it was taxed in the prior year in which it was earned. However, the present value in Year One of a dollar that is to be spent in some future year (for example, Year Four) is less than one dollar. That is, the value in Year One of a person's consumption of a dollar's value in that year is greater than the value in Year One of a person's consumption of a dollar's value in Year Four. The value in Year One will be the amount consumed in Year Four discounted to present value, that is, the present value of a dollar to be used in a future year is the amount in the current year that is needed to produce the amount expended in the future year if invested at a specified rate of interest, typically compounded interest. The amount of discount depends upon the interest rate that is employed and the frequency of compounding, if a compounded rate is used.

Given the need to discount, one might question whether it is fair to tax a dollar saved at its current value when it will not

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be used for consumption until some future date. It is fair to do so since the dollar earned in Year One can be invested to produce income, and in Year Four, the taxpayer can expend on consumption not only the original dollar saved but also the income earned thereon between Years One and Four. For example, if the taxpayer expends in Year Four the saved dollar plus the amount earned thereon, the Year One discounted value of the amount expended will equal one dollar if the rate of income earned is equal to the discount rate.

One difficulty with the above analysis is that the income earned on the saved dollar will be subjected to taxation when earned. Since the justification for taxing in Year One the dollar saved in that year is that the present value of the amount that ultimately will be expended on consumption, the tax on that dollar incorporates a tax on the discounted value of one dollar spent in a future year plus a tax on the income earned on the investment of that dollar. Therefore, to tax separately each year's income from the investment of the dollar amounts to double taxation.

Returning to the question of tax neutrality, Simons contended that it is important to apply neutral standards in determining whether to adopt or retain tax provisions in order that the tax levies be fairly allocated. This concept of a fair allocation is often identified as "horizontal and vertical equity." Horizontal equity requires that any two persons having similar income positions should have a similar amount of tax liability. Vertical equity means that persons having disparate income positions should have comparably disparate tax liabilities. Apart from a desire for a just tax system in an absolute sense, the public's willingness to accept a tax system will be severely damaged if the public's perception of the system is that it is unfair, that is, that some persons are not bearing their fair share of the tax burden.

The late Professor Stanley Surrey embellished the tax neutrality concept and characterized tax provisions that violate the

5. Neither Simons nor his intellectual progeny discuss whether the more important consideration is the public's perception of fairness or actual fairness. The two do not necessarily go together. A completely proper and fair deduction that is permitted to one small group may be perceived by many others to be improper. Unless the justification for the deduction can be explained to the larger group's satisfaction, the deduction may have to be repealed, even if that causes the small group to be taxed on a disproportionately high income base. The perception of fairness by a substantial portion of taxpayers may be more important than the reality.
concept of neutrality and that benefit some taxpayers as "tax expenditures," that is, a failure to tax someone according to neutral principles was characterized by Surrey as a governmental expenditure which is essentially identical to a direct outlay of governmental funds. While Professor Surrey did not originate the "tax expenditure" concept, he is primarily responsible for its acceptance and popularity. The concept has been widely adopted; for example, the Congressional Budget Act of 1974 (Public Law 93-344) requires that a report on tax expenditures be submitted to the House and Senate Budget Committees and that a list of tax expenditures be included in the Budget of the United States Government.

According to the tax expenditure concept, a preferential treatment provided by the income tax laws to a group of taxpayers is identical to the Government's making a direct payment to that group. Preferential tax treatments, therefore, are listed as governmental expenditures. Preferential treatments include: the allowance of an unwarranted deduction, the failure to include a revenue item in gross income, the granting of a credit, a differential tax rate, or some other tax benefit.

As initially conceived, the principal standard that was employed to identify tax expenditures was the Haig-Simons definition of income, that is, a tax provision that fails to conform to the Haig-Simons ideal tax structure and that benefits a group of taxpayers is deemed to violate the principle of tax neutrality and so constitutes a tax expenditure in the amount of income tax that was not collected because of the preferential tax treatment. However, a Haig-Simons comparison is not the only standard against which a tax provision is measured. If Congress adopts a general principle as part of its tax system and if, for some policy purpose, Congress does not apply that principle uniformly, any departure from the normal principle that benefits certain taxpayers is treated as a tax expenditure. It is not always obvious, however, which tax provision is to be classified as the normal principle and which provision is the exception. In practice, it would seem that the notion of tax neutrality, as measured by an

ideal tax structure, will influence the determination of which tax provisions are the normal ones.

The Tax Expenditure Budgets that are prepared by the Staff of the Joint Committee on Taxation and by the Congressional Budget Office rely on both Haig-Simons neutrality principles and on departures from normal Congressional policies to compile their lists of tax expenditures. Since 1983, the U.S. Office of Management and Budget, in formulating its tax expenditure budget, has purported to rely exclusively on departures from normal Congressional policies. It appears, however, that the tax neutrality concept, as determined by reference to an ideal tax system, has greatly influenced the determination of which provisions depart from normal Congressional policies.

Since the Haig-Simons definition plays such an important part in the formulation of the several tax expenditure budgets, it is worth examining how useful that definition is in determining the appropriateness of a given tax provision. By the way, it is noteworthy that tax expenditure budgets list only expenditures; they make no mention of tax receipts from the taxation of items that would be excluded if a neutral view of income, as determined by Haig-Simons concepts or by reference to "normal" tax policies, were adopted.

Simons himself admitted that "it is not possible, in practice, to define, establish or adhere closely to an ideal tax base." There often are reasons to repudiate or disregard the direction established by an objective definition of income, and "such concessions are often the part of wisdom and sound policy." Also, the proper tax treatment of some items cannot be determined merely by referring to income definitions, that is, the deductibility of expenses that have a business purpose but also provide a personal benefit to the taxpayer. Simons claimed no more than that his definition provides a tool of analysis which, though crude, is useful. To see the limitations of that tool, let us consider the application of the definition to a few selected tax items.

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10. Id. at 30-31.
Under the tax law, a donee does not have income from receiving a gift as that term is defined by case law.\textsuperscript{11} Simons states that there is no justification for excluding gifts from a donee’s income since it increases his wealth. Simons does recognize that in certain circumstances it would be administratively difficult to apply an income tax to gifts and in certain other circumstances it would be harsh to tax a gift fully to the donee; but, in general, he believed that gifts should be taxed.\textsuperscript{12} One example of a gift that it would be difficult to tax is the partaking of a meal at a friend’s home. Similarly, it would be difficult to administer a tax on the loan of a car to a friend or a family member for an errand. Another problem would arise in connection with support provided to family members. If the support is a legal obligation of the transferor, would it be proper to treat it as a gift? Even if the transferor is not legally obligated for support (for example, where a parent or grandparent pays the expenses of a college education of a child who is over the age of 18 years and where there is no legal obligation to pay those expenses), it does not appear to be good tax policy to tax the child. In any event, there are reasons for excluding gifts from income even where the gift does not create some special problem such as those noted above.

The funds donated by a donor were previously taxed to the donor when he earned them. Drawing upon the Haig-Simons approach, the taxation of the donor’s prior retention of his earnings can be viewed as a tax on the consumption that will be obtained from those funds at some future date. Putting it differently, when a taxpayer is taxed on a dollar of income, he is entitled to a dollar of consumption (without allowing for depletion due to the payment of a tax liability thereon). In what respect do the funds transferred by a donor represent a consumption of goods or services? If it is not a consumption, then the taxation of the donor for a dollar earned by him and the taxation of that dollar as income to the donee when the dollar is transferred to the donee constitutes double taxation. The gift transaction should be contrasted to a taxpayer’s purchase of another’s services in which event the payment to the employee represents a consumption by the payer; the taxation of the payee on the receipt of the payment does not constitute double taxation since the payer

\textsuperscript{11} I.R.C. § 102 (1986).

\textsuperscript{12} SIMONS, supra note 1, at 125-147.
has obtained his consumption for the dollar that was previously taxed to him.

Simons apparently would treat the gift of funds to a donee as a consumption by the donor, and so he did not deem a tax on the donee to constitute double taxation. The transfer of funds from a donor to a donee does not, however, exhaust any of society's goods; the exhaustion of a good would seem to be a *sine qua non* for a consumption. An alternative approach, suggested by Professor Wayne Barnett in several unpublished papers, is to treat the transfer to the donee as a commitment by the donor to have the donee expend the funds on the donor's behalf. Thus, the donor is permitted either to use the taxed funds for his own consumption or to obtain a vicarious consumption by having another use the funds. My point is that the choice between these two alternative approaches (Simons' approach which taxes the gift and Barnett's approach which excludes it) is not aided by referring to the Haig-Simons definition. But, Haig-Simons is helpful in focusing the resolution of this issue on questions concerning consumption.

The determination as to the propriety of excluding gifts from income will turn ultimately on one's view as to what taxpayers should be allowed to do with their taxed income. If one believes that it is proper to permit a taxpayer to have someone else use the taxed funds for consumption, then gifts should be excluded. If gifts are not excluded, the donor's capacity to transfer his taxed income to others for their consumption will be impaired since the taxation of the gift as income to the donee will reduce the amount available to the donee. This issue turns on attitudes and values in which Haig-Simons plays no part.

To take another example (and one to which Simons himself refers), consider the deductibility of expenses that assist in the production of income and also satisfy personal needs or benefits. Child care expenses and commuting expenses are two illustrations of this type of expenditure. I will discuss child care expenses later in this paper. Another example is the question of how the tax law should treat expenses incurred in obtaining a professional or trade education. An education can qualify the taxpayer to earn income in a profession or trade, and so the expenses incurred in obtaining that education can be viewed as a business expense or as a capital expenditure that can be depreciated over a period no longer than the taxpayer's life expectancy. On the other hand,
an education also has personal, noneconomic benefits to a taxpayer, that is, it benefits the taxpayer in ways that have no bearing on the production of income. Should a deduction or amortization be permitted for such expenditures or should the personal aspect of the education control so that no deduction will be allowed? The current tax law denies any deduction or amortization for educational expenses incurred in qualifying to enter a new trade or profession. The rationale for that treatment is that the personal aspect of the education is so inextricably entwined with the business aspect that it is not possible to allocate the expense between them. On the other hand, once the taxpayer has entered a trade or profession, his expenses in obtaining an education that maintains or improves his skills are deductible. Yet, the education of a person already engaged in his trade or profession provides no less personal benefit than does an education obtained prior to entering the trade or profession. Haig-Simons provides no insight that would help determine whether the current law's treatment is proper or whether some other approach would be preferable.

One possible rationale for the current treatment of educational expenses is that it is analogous to the replacement depreciation method (sometimes referred to as the "retirement-replacement-betterment accounting method"). Replacement depreciation is a method under which the initial investment in certain assets is capitalized and neither deducted nor amortized. As each item is replaced, a deduction is taken for the cost of the replacement. Restaurants may use that method for the treatment of their chinaware. Similarly, the expenditure for obtaining the education needed to enter a trade or profession is capitalized, and the expenditures incurred after entering the trade or profession, even some that are capital in nature, are currently deducted.

Horizontal and vertical equity concepts, which underlie tax neutrality, are not helpful in determining whether the comparison

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15. Treas. Reg. §1.162-5(a), (c) (as amended in 1967).

of income should be made on an individual basis or on the basis of a family unit or whether it should be made on an individual basis for some purposes and on a family unit basis for other purposes. They also are not helpful in defining a family unit. One reason that Haig-Simons does not help resolve the question of the proper treatment of gifts is because it does not address the question of the extent to which several persons should be treated as a single taxable unit for some purposes. Of course, gifts are only one example of tax problems that raise questions involving the choice of a taxable unit.

The current treatment of gifts by the tax law has made the measurement of a taxable unit turn, for certain limited purposes, on the donor's intent in making the transfer. If the transfer proceeds from detached and disinterested generosity of the donor, then the donor and the donee are treated as a single taxable unit for the purpose of permitting the unit one consumption. Also, the donee's gain on the sale or exchange of donated property is determined by using the basis that the donor had in that property with certain adjustments. Thus, for the limited purpose of measuring the donee's gain, the donor and the donee are treated as a single taxable unit.

As I already mentioned, a workable income tax system cannot comply fully with Haig-Simons or with any other version of an ideal income measurement. Practical, administrative considerations will prevent the adoption of such systems. The doctrine of realization and the availability of reporting on the cash receipts and disbursements method do violence to the Haig-Simons definition; and yet (with only a few exceptions such as the treatment of original issue discount) the tax law requires realization and permits cash method reporting. Simons himself concedes that the requirement of realization is a practical necessity.

Another major distortion to Haig-Simons occurs because the tax laws do not tax imputed income, especially imputed income from the use of consumer properties such as a residence, a yacht, an art collection, and similar items. For example, if a taxpayer purchases valuable paintings, he not only escapes taxation on the unrealized appreciation of a painting over the years that he holds

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18. SIMONS, supra note 1, at 153.
it, he also escapes taxation on the income he obtains from the paintings by having them available on his wall for his viewing. Once the inclusion of these treatments in the tax system are accepted as necessary (or at least as highly desirable) for policy reasons, then the tax system has so departed from the Haig-Simons ideal that other provisions that fail to conform to Haig-Simons cannot be attacked on neutrality grounds. Indeed, since the tax system does not adhere to Haig-Simons in many substantial respects, the conformance of a single provision to the Haig-Simons model may cause greater inequity than would another approach that disregards Haig-Simons. Before considering some illustrations, we should turn to the second meaning or "face" of tax neutrality to see how that concept relates to the Haig-Simons standard.

Tax neutrality is sometimes used to describe a tax system that does not create a bias that could influence a taxpayer to choose one investment or course of action over another. For example, if the tax on the income from rental realty is less than the tax on the same amount of income from bonds, the tax law will distort the market choice between investing in realty or in bonds. As used in this context, a tax neutral provision is one that permits the choice of investment or action to be made on the basis of market or personal considerations without influence from the tax laws. The question arises whether there is a conflict between seeking this type of neutrality and the Haig-Simons neutrality of a tax system that conforms to an ideal definition of income.

First, note that the imposition of a tax system will influence some market decisions no matter how the system is designed. The system can be designed to be neutral as to certain choices, but there will always be others over which the tax laws exert an influence. Take this example. Fred is engaged in a self-employed business, and his income is taxed at a 50 percent rate (an unrealistic figure under current tax schedules but one that simplifies computations). In effect, the government has become a partner with Fred so that it takes 50 percent of his income and bears 50 percent of his business expenses. In considering whether to incur a business expense, such as an advertising expense, Fred will take into account that he will bear only 50 percent of the cost. His silent partner will bear the other 50 percent. This type of consideration becomes especially weighty if the business expense is one that contains an element of personal benefit to Fred.
Travel and entertainment expenses are examples of such expenses, especially when the trip is to an attractive location. It is true that only 80 percent of the cost of Fred's meals can be deducted, but that limitation only reduces the government's share of Fred's costs. The government nevertheless will bear a portion of the expense of Fred's meals while on travel status, and that will influence Fred's decision whether to undertake the business trip.

As I previously noted, a number of doctrines that contravene Haig-Simons are embraced in the tax system because they are necessary to its orderly administration. The operation of these doctrines often creates a tax bias that skews personal and financial choices. The question can then arise as to whether tax adjustments should be adopted to eliminate that bias. Let us consider several illustrations.

H and W have been engaged in separate businesses for several years before they had a child. W took time off from work to have their child and to care for the infant for the first two months of his life. W now has to decide whether to terminate her job and to stay home and care for her child or to pay for child care and return to her work.

First, let us consider whether the cost of child care should be a deductible expense. The child care expense bears elements of a personal consumption (an expense of having and caring for a child) but also bears elements of a business expense of producing income. W might contend that the child care expense is a necessary expense of freeing her to earn income since she could not work if the child's needs were not met. On the other hand, before the child was born, W was able to earn the same income without incurring child care expenses. The expense can be viewed as a cost of having and caring for a child, which is a personal expenditure. Indeed, even after birth, W does not have to care for the child; she could place the child up for adoption. The child care cost is incurred primarily because W chose to have and to retain the child. Let us assume for purposes of this illustration that my analysis is correct. The expense of having the child cared for is a personal expenditure that cannot be deducted under normal definitions of a business expense and would not be deductible

under the Haig-Simons approach. Even so, that does not definitively resolve the question of whether the expense should be deductible.

H and W file a joint tax return, and their marginal tax bracket is 50 percent (again, an unrealistic figure). The annual cost of providing child care for the infant will be $5,000. If W stays home and takes care of the child herself, she will provide services valued at $5,000 to the family. Because the tax laws do not tax imputed income, the family will retain $5,000 of income after taxes from W’s services.

Instead, W can return to work, earn income of $8,000 before taxes are deducted, and pay $5,000 to provide child care for her infant. Since W’s $8,000 will be taxed at a 50 percent rate, she will retain only $4,000 after taxes as compared to the $5,000 that she would retain from providing child care services herself. The failure to tax W’s imputed services creates a tax bias in favor of staying home and not retaining her job. In these facts, the tax bias is especially strong since W will net $1,000 less, after taxes, than she must pay for the child care expenses. So, it will cost W $1,000 a year in cash outlay to continue her job instead of staying home. W may nevertheless decide to continue her employment, but the tax bias will make that a more difficult decision.

Even if W could earn $15,000 annually from her job so that she would show a net profit of $2,500 after paying her taxes and child care costs, there would still be a tax bias against her returning to work. The failure to tax the imputed income that W would produce by staying home reduces the financial benefits that W would otherwise have obtained by choosing work over staying home.

Congress could eliminate the tax bias described above. One method of elimination would be to tax W on imputed income from caring for her child, but that course is subject to administrative and practical objections. An alternative approach is to grant W a deduction for the expenses she incurs for child care. If that cost is deductible, there is no tax benefit to either choice that W might make; the choice can be made on the basis of personal and financial consideration unhindered by tax influence.

20. Current tax law provides a credit for a portion of child care expenses rather than
Note, however, that granting W a deduction for child care expenses will increase another tax bias that exists. The decision whether to have a child will take many factors into account including the cost of caring for the child. Since a parent can provide the service of child care and since the resulting income to the family from receiving the benefit of that service is not taxed, the cost of child care is lower than it would be if the imputed income were taxed. That will influence the decision whether to have a baby. If child care expenses are nondeductible, the tax bias will operate only when one of the spouses intends to stay home and care for the baby. If child care expenses are made deductible, that will expand the circumstances in which there is a tax bias favoring a decision to have a child.

From this scenario, we can see that the existence of a tax bias is not a sufficient justification for granting a tax benefit that removes the bias. The removal of one tax bias will almost certainly create a new bias or expand an existing one as to some other choice. In determining whether to grant a deduction for child care expenses, Congress should determine whether there are social, economic or political reasons to prevent the tax laws from influencing the choice on which the existing bias operates, and Congress should determine whether the resulting creation of a new bias is of less importance than the removal of the bias in question.

Congress also should consider whether there is available some other arrangement that would resolve the problem and whether that other arrangement is preferable. For example, the child care problem might be addressed by having the federal government provide (or encourage others to provide) free child care facilities. That choice raises the question as to the importance of decentralizing the decision for the selection of the type of child care to be employed. Note, however, that the provision of free child care services raises another tax issue, namely, should the recip-
The Haig-Simons principles are of no help whatsoever in deciding whether to adopt an adjustment that neutralizes one tax bias and opens another. The bias against W's working was created by a necessary departure from the Haig-Simons model (the failure to tax imputed income); there is no reason why there should be a presumption against correcting that bias because the correcting provision would also contravene Haig-Simons principles. Just because the decision to neutralize a tax bias by granting a deduction will rest on economic and social policy considerations, that does not turn the tax benefit obtained from such a deduction into a governmental subsidy.

The "principle" of neutralizing tax influences on choices is not a true principle. Tax influences cannot be eliminated, and therefore they are a necessary cost of having an income tax system. The so-called principle of neutrality is merely a recognition that the cost of such a tax influence is sometimes too great because considerations of economic or social policy dictate that some specific choice should be made on market or personal grounds. The neutralizing of the tax influence on such a choice often will require adopting a provision that does not conform to the Haig-Simons definition of income. In that respect, this type of neutrality can be said to conflict with Haig-Simons neutrality.

Haig-Simons is useful to explain the skeletal framework of an income tax system as pictured in a kind of blueprint. It provides a conceptual structure. Once construction began on the system, however, it became clear that the blueprint was inadequate in many important respects. The final product bears only a slight resemblance to the original plan. The departure from that plan is so extensive that there is no sense in attempting to conform current additions to and modifications of the structure to the original or "ideal" concept.

That is not to say that there are no overarching concepts to the income tax system. Rather, it is to say that the income tax system is much more complex than the structure delineated by
the relatively simple formula that Simons pronounced. The popularity of Haig-Simons may be attributable partly to its simplicity but primarily, as shown below, it is because it serves a useful political purpose in underpinning the tax expenditure concept. The beauty of the tax expenditure concept is that it purports to embody a highly sophisticated view of the tax system when, in fact, it rests on a rather simplistic premise.

Returning to the tax expenditure budget, it rests partly on the notion that there is a normal or neutral tax system and that a provision that departs from that ideal system lacks neutrality and violates equity requirements. The proponents of this budget do not claim that any departure from tax neutrality is wrong, but they maintain that anyone seeking the enactment of such a departure has the burden of proving that there are strong policy considerations to justify the distortion of an ideal system, the same type of policy considerations that should accompany a decision to make a direct expenditure of Government funds. By imposing a heavy burden of persuasion on those seeking to retain or adopt provisions that benefit some taxpayers, the proponents of the tax expenditure concept have gained a political advantage. They have loaded the political dice in their favor since they tend to disapprove of such provisions.

The profit-oriented activities of an individual typically are not isolated from his personal needs and desires. People are not purely income-making machines. It is common, therefore, to find that an individual will have mixed profit and personal motives for making an expenditure. One objection to the tax expenditure budget concept is that it draws a kind of Maginot Line in which the tax provisions that fall on one side of the line are classified as expenditures and the provisions on the other side are considered to be proper. Rather than viewing tax provisions as falling on one side of the line or the other (a sort of “one is either pregnant or not pregnant approach”), it would be more useful to view tax provisions as lying on a spectrum, their place on which depends upon how closely associated the provision is to income measurement. The further removed that a provision lies from income measurement, the greater the policy justification for that provision should be. However, the comparison of different provisions and the policy justifications for them cannot be reduced to some precise or mathematical formula. The fact alone that the
adoption of a tax provision rests on policy considerations should not make that provision suspect. Virtually all tax provisions rest on policy considerations since there are very few items that relate exclusively to income measurement.

Take one last illustration. Jeff pays $100,000 cash to purchase a residence. Thereafter, he lives in the house which continually appreciates in value. Jeff is not taxed on the income he obtains by using the house, and he is not taxed on the house's appreciation so long as he continues to hold the property. While Jeff gets no depreciation deduction for the use of the house (quite properly since he recognizes no income therefrom), he is allowed a deduction for the property taxes imposed on the property.

Jeff has a friend, Mary, who purchases a house for $100,000 at the same time that Jeff acquired his. Mary had $100,000 capital available to put into the house, but she chose instead to borrow $100,000 from a bank at 10 percent interest. Mary chose to borrow the needed funds because she can invest her $100,000 of capital in a partnership and earn a 15 percent return. So each year, Mary will earn $15,000 on the partnership investment of her $100,000 capital, and she will make an interest payment of $10,000 on the loan. However, the income that she earns on her partnership investment is taxable to her. Assuming a 50 percent marginal rate, Mary would retain only $7,500 of the income from her partnership investment after taxes. If the interest payment that Mary must make were not deductible, Mary's earnings from her partnership investment would yield $2,500 less than that interest payment. Mary would probably be better off not to borrow the money and to invest her $100,000 in the purchase of the house. On the other hand, if the interest payment is deductible, Mary can make the interest payment out of her partnership investment income and still have $2,500 left over after taxes. To allow an interest deduction encourages Mary to invest her funds more efficiently in that she can produce a larger rate of return from the partnership investment than she can obtain by using the funds to purchase the house. By granting an interest deduction, the tax law has neutralized the tax consequences of choosing between investing in a residence and borrowing the funds so that capital can be invested elsewhere. The deduction also neutralizes the tax treatment of home purchasers who do not have the capital available to put into their homes and so must borrow
the needed funds. The merits of providing that neutrality depend upon policy considerations that have nought to do with so-called normal definitions of income.

The failure to tax homeowners on the imputed rental value of their homes creates a tax bias in favor of purchasing a home rather than to rent one. That bias is expanded by permitting an interest deduction for those who borrow the purchase price of the home (or some part thereof). Congress perceives the bias for home ownership to be an acceptable cost of obtaining its policy objectives. Indeed, it is likely that the interest deduction was granted in order to create a tax bias against renting and in favor of home ownership. Congress may believe that home ownership fosters social stability and promotes good citizenship. Note that even without an interest deduction, the failure to tax imputed income creates a tax bias against renting, but the adoption of the interest deduction enhances that bias.

Should the interest deduction be classified as a tax expenditure or government subsidy? To the extent that the deduction neutralizes the tax treatment of those who have sufficient capital to invest in a residence and of those who borrow the purchase price, it can be seen as merely negating a market distortion that the tax law introduced. But, to the extent that the deduction induces persons to purchase homes rather than to rent, it can be viewed as a subsidy to home ownership. How should the determination be made as to whether the allowance of the deduction is a subsidy or merely a neutralizer? Should it turn on the subjective purpose of Congress, assuming one can determine some institutional purpose for that body, or should it be determined by the consequences of the provision regardless of the Congressional motive? The difficulty of resolving that issue and the questionable utility of any characterization that might be reached are part of the reasons that a tax expenditure budget is so misleading.

There are numerous types of tax provisions which I have not discussed in this paper. For example, I have not discussed the appropriateness of the personal deductions, such as medical expenses, casualty and theft losses. Those deductions raise the question of whether profit measurement should be the exclusive

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21. The deduction for interest on a home mortgage is included in the list of tax expenditure items by all three tax expenditure budgets.
goal of a definition of "income" for tax purposes. Stating it differently, are those items to be treated as consumptions for income tax purposes? For example, if after earning $1,000 for his services, A were to collect that amount in cash from the paymaster, and if immediately after receiving his pay in cash, A were mugged and relieved of the $1,000, should A be treated as having consumed the $1,000 for tax purposes so that A will be taxed on that amount? As to charitable contributions, one question is whether the allowance of a deduction is a subsidy for charitable activities or whether it is a proper recognition that a charitable contribution is not a consumption by the donor and is not a deferred and vicarious consumption by the donor when the charitable donee expends the donated funds. I will leave such issues for a later paper or for others to explore. As to charitable and medical expenses, there already exists an excellent article by Professor William Andrews and a thoughtful reply by Professor Mark Kelman.\textsuperscript{2} Haig-Simons is not very useful in determining how to characterize such items.

The inclusion of such personal items in a tax expenditure budget indicates that they are not proper tax allowances because they do not come within the definition of income. That may be so, but that determination rests on a complex analysis of the goals and function of an income tax system, the need for which analysis is obscured by placing the item on a list of non-qualifying provisions. Perhaps the major fault of the tax expenditure budget is that it permits a relatively few people to make these judgments without revealing the basis of their determinations much less exposing to the legislators the nature of their analysis and the values on which their ultimate conclusion rests. It suggests an application of a more mechanical and precise standard than exists.