2

The tax expenditures concept

2.1 Introduction

Despite the general acceptance of the existence of tax expenditures, together with the increasing awareness of their importance and need for recognition amongst nations around the world, the concept itself, along with its various elements, is by no means settled. Debate on all aspects of tax expenditures, whether the pure concept, its purpose, its identification or the mere measure of tax expenditures, continues unfettered. This debate simply supports the importance of tax expenditures globally, along with the need for ongoing contributions.[1] Valuable insight into the dynamic and ongoing nature of the tax expenditures debate can be gleaned from the words of Surrey and McDaniel in 1985:

> The fact that there is debate about the classification and/or presentation of a particular item does not mean that the tax expenditure concept is fundamentally flawed. The tax expenditure concept requires a dynamic and continuing analysis of the provisions in a tax system. As the tax expenditure concept compels closer consideration of the role of a specific tax

[1] For example, we can contrast the statement contained in the 2002 United States Budget documents (with the 2010 bipartisan Report of the National Commission on Fiscal Responsibility and Reform). The 2002 Budget states:

> Underlying the 'tax expenditure' concept is the notion that the Federal Government would otherwise collect additional revenues but for these provisions. It assumes an arbitrary tax base is available to the Government in its entirety as a resource to be spent. Because of the breadth of this arbitrary tax base, the Administration believes that the concept of 'tax expenditure' is of questionable analytic value.
>
> United States of America, *Analytical Perspectives, Fiscal Year 2002, Budget of the United States Government* (2001), 61

In contrast, the 2010 report, which called for the abolition of all tax expenditures, states:

> America's tax code is broken and must be reformed. In the quarter century since the last comprehensive tax reform, Washington has riddled the system with countless tax expenditures, which are simply spending by another name. These tax earmarks – amounting to $1.1 trillion a year of spending in the tax code – not only increase the deficit, but cause tax rates to be too high. Instead of promoting economic growth

> provision (or non provision) in the overall tax system, new studies are undertaken, new data are developed, and continual rethinking of positions is required. Especially with respect to borderline issues, unanimity of opinion on classification issues is rare. But the debates and analyses are themselves important contributions to the continuing improvement of a country's tax and spending structures. Moreover, the number of classification or presentation issues that have inspired debate is insignificant in relation to the number of items on the tax expenditure list about which there is no disagreement.[2]

We aim, as Surrey suggests, to contribute to the necessary rethinking of the positions required for tax expenditure management. The difficulties surrounding the tax expenditure concept and tax expenditure analysis have been discussed in both academic literature and government reports since the genesis of the concept by Surrey in 1967 – over 40 years ago. These difficulties began with its theoretical constructs but have now extended to the practical implementation of the concept by governments around the world. It is not easy to unravel the difficulties associated with the tax expenditure concept as most, if not all, are inextricably tied to each other. Yet, ultimately, the difficulties stem from the basic requirement to identify a provision of the tax system as a tax expenditure so defined. This identification is generally determined according to a defined normative tax base or, more precisely, as a deviation from a defined tax benchmark. The essential nature of this question, along with the inevitable disagreement both domestically and internationally as to what is a *true* representation of the tax base, has at times distracted from the practical significance of the identification of tax expenditures and the benefits of tax expenditure analysis, reporting and management which we discuss in Chapter 4. This controversy in terms of tax expenditure analysis, which is at the end of the day an academic one, has ultimately led to calls by some to abandon the tax expenditure analysis and management process or to consider tax expenditures not as a tax policy tool or budgetary tool, but rather solely, and more broadly, as a matter of institutional design. The purpose of this chapter is to outline those controversies which we do not dispute are arguably significant. In Chapter 5 we argue that the way forward with respect to the controversial, but socially significant tax expenditure concept is to

> and competitiveness, our current code drives up health care costs and provides special treatment to special interests. The code presents individuals and businesses with perverse economic incentives instead of a level playing field.
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> United States of America, *The Moment of Truth* (2010)

[2] Surrey and McDaniel, *Tax Expenditures* (1985), 196–7.

explicitly acknowledge that the nature and purpose of tax expenditure analysis and management is governed by one's moral and political philosophy. In essence, if we accept that there will always be divergence in the academic debate surrounding tax expenditures and focus on this acceptance, a pragmatic perspective can prevail; one which requires a jurisdiction to identify its own purpose of tax expenditure reporting and analysis.

This chapter critically analyses, through an historical lens, the difficulties associated with the theoretical constructs of tax expenditure analysis. The object of this analysis, rather than being to resolve these controversies, is to demonstrate the moral pluralism that abounds, with the diverse approaches reflecting the subjective preferences of their respective author(s). By introducing the tax expenditure concept and critically reviewing the existing literature, we are able to identify the range of intractable controversies regarding the concept itself and, in Chapter 3, its application in specific jurisdictional contexts. A critical review of the controversies surrounding the tax expenditure concept, its application and the problematic measurement of tax expenditures is essential to the understanding of the concept of tax expenditures. In particular, the existing theoretical literature demonstrates the breadth and depth of the controversies surrounding the tax expenditure concept. Moreover, the controversies regarding the concept, whilst grounded in the definition of the tax benchmark, extend to the debate on rival measures of the quantum of tax expenditures, the specification of a tax expenditure reporting standard and the process by which tax expenditures ought to be managed.

This discussion on the controversies surrounding tax expenditures does not attempt to provide a contemporary, potentially elitist, prescription for the reporting, management and analysis of tax expenditures. Rather, it aims to highlight the choices one must make when designing a robust tax expenditure management regime which accepts the influences of a jurisdiction's political philosophy. To achieve this goal, this chapter specifically considers the concept of tax expenditures, the purposes of the categorisation of tax expenditures such as accountability and transparency, the different identification of tax expenditures, the measurement of tax expenditures and contemporary expansions of the concept.

2.2 The concept of tax expenditures

The concept of tax expenditures is elusive. Yet, the central tenet to the tax expenditure debate is the definition of the concept itself. As such, a discussion on tax expenditures of the type taken in this book warrants an initial analysis of how the term is defined because, despite the concept being around for half a century, tax expenditures are neither well known outside those directly involved with their use, analysis and reporting, easily defined even by those who are directly involved, nor easily understood. Ask the average citizen what a tax system is designed to do and they will tell you that it raises money from the general population to contribute to the public coffer. Any tax system is generally, and primarily, regarded as a mechanism by which governments raise revenue. Much of this revenue raised is used to support public spending programmes, particularly the provision of goods and services which may not be adequately provided by the market. There is, however, a secondary purpose for a tax system: it is a useful instrument though which a government can implement social and economic policy.[3] The use of the income tax regime for social and economic purposes allows a government an indirect (as contrasted with direct spending) means of potentially achieving its policy objectives. While outside the traditional revenue raising objective of any income tax regime this is a common phenomenon, with the relevant provisions known as 'tax expenditures'. When a tax system is used for this purpose, tax expenditures have the potential to steer taxpayers towards or away from certain behaviour by either imposing costs on, or providing benefits to them. However, both the use and the effect of tax expenditures within a country's tax regime is generally not well understood by citizens. Yet, the use is often significant both in terms of the sheer number of expenditure provisions within tax legislation and the effect of tax expenditures from a fiscal perspective, as they often result in a significant reduction in the amount of revenue raised compared with a benchmark tax system. The benchmark tax system, one of the most controversial aspects of tax expenditure reporting and analysis, is discussed later in this chapter.

2.2.1 *The phrase 'tax expenditures'*

The phrase 'tax expenditures', as first coined by Stanley Surrey in 1967, has been defined in various ways and, to date, despite decades of

[3] For an analysis of specific examples see Stead, 'Implementing Disaster Relief Through Tax Expenditures: An Assessment of the Katrina Emergency Tax Relief Measures' (2006) who argues that aid for Hurricane Katrina victims in the form of tax relief was distorted in a manner typical of similar tax relief. See also Cavanaugh, 'On the Road to Incoherence: Congress, Economics, and Taxes' (2002).

controversy and an increasing number of governments adopting comprehensive tax expenditure reporting, there is no universally agreed definition. Definitions adopted by various nations and international bodies are discussed in Chapter 3. However, a few of those definitions which have developed include:

- 'those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability; and the term "tax expenditure budget" means an enumeration of such tax expenditures';[4]
- 'the estimated costs to the tax revenue of preferential treatment for specific activities';[5]
- a provision that is a 'substitutable tax provision'. That is, a tax provision 'that can be replaced with a non-tax-based federal program that fulfils the current tax provision's purposes at least as effectively as does the current provision itself';[6]
- a provision that performs a mainly allocative task and therefore can be identified as exceptional within the primarily distributive income tax framework;[7]
- a provision comprising a 'tax subsidy'[8] and/or a 'structural income distortion'. A tax subsidy is a specific legislative rule that departs from a general taxing rule that might be discerned from the legislation overall. A structural income distortion is, it seems, a specific legislative rule that 'materially affect[s] economic decisions in a manner that imposes substantial efficiency costs';[9] and
- a tax expenditure as a provision in the tax code that is expressly identified as promoting a 'spending' purpose.[10]

The various different ways that the same concept is described means that the phrase 'tax expenditures' is simply an idea, an expression, or the

[4] 2 United States Code § 622(3).
[5] OECD, *Best Practices for Budget Transparency* (2002), 7 (para 2.2).
[6] Thuronyi, 'Tax Expenditures: A Reassessment' (1988), 1186. Similarly, see Steuerle, *Contemporary US Tax Policy* (2004) (defining 'tax expenditures' as 'spending programs channelled through the tax system … These tax provisions generally grant special tax relief to encourage certain kinds of behaviour by taxpayers or to aid taxpayers in special circumstances.').
[7] Shaviro, 'Rethinking Tax Expenditures and Fiscal Language' (2004).
[8] Witte, *The Politics and Development of the Federal Income Tax* (1985).
[9] United States of America, *A Reconsideration of Tax Expenditure Analysis* (2008).
[10] McIntyre, 'A Solution to the Problem of Defining a Tax Expenditure' (1980–81).

language used to describe a group of laws within a tax regime. Within the context of a government's fiscal policy, it is no different to terms such as fines, fees, levies, deficits, surpluses and pensions, to name a few.[11] Each is an integral part of the language used by governments around the world. Each is grounded in theoretical or normative underpinnings. Each is attached to a jurisdiction's moral and political philosophy. Yet no other term has attracted the international debate that has attached to tax expenditures and tax expenditure analysis. We propose that the reason for this is the very reason why tax expenditure management cannot be abandoned. Tax expenditures are simply too significant in terms of their impacts on the international economy, the fiscal position of the states, the constitutional framework of countries, public administration in general and tax administration in particular, and the legitimacy of governments. We justify this claim later. For now, we use the more pragmatic justification that tax expenditures are part of the tax systems of every developed country around the world.[12]

2.2.2 The original intent of the 'tax expenditure' concept

The 'tax expenditure' concept, as it was first identified, was designed to demonstrate the similarity between direct government spending, on the one hand, and spending through the tax system on the other. In essence, the identification of benefits provided through the tax system as 'tax expenditures' allows analysts to consider the fiscal significance of those parts of the tax system which do not contribute to the primary purpose of revenue raising. Where a taxpayer is entitled to a tax expenditure that taxpayer has paid the tax due under the normal tax structure and then received a reduction in tax liability due to the tax expenditure entitlement. It is essentially a short cut to a direct payment by a government. The reason for this is that government programmes can generally be implemented in one of two ways. This can be demonstrated by considering two alternate scenarios:

[11] Shaviro, 'Rethinking Tax Expenditures and Fiscal Language' (2004), 190.

[12] OECD, *Tax Expenditures in OECD Countries* (2010), 14. See also Polackova Brixi et al. (eds), *Tax Expenditures – Shedding Light on Government Spending Through the Tax System: Lessons from Developed and Transition Economies* (2004); Nordic Working Group, *Tax Expenditures in the Nordic Countries* (2010); Villela et al., *Tax Expenditure Budgets: Concepts and Challenges for Implementation* (2010); and Burton and Stewart, *Promoting Budget Transparency Through Tax Expenditure Management: A Report on Country Experience for Civil Society Advocates* (2011).

Scenario 1:

A government wants to contribute to half the costs associated with a child's education up to a maximum amount of $500. The government can collect $500 in tax from a taxpayer (a parent of the child) and pay a direct subsidy of $500 to that taxpayer (parent) on proof that $1,000 has been spent on a child's education. This would be considered a direct government expenditure.

Scenario 2:

A government decides not to tax the taxpayer (parent) to the extent of $500 in circumstances where tax policy indicates the government ought to collect that tax (a tax expenditure). This is achieved by the taxpayer (parent) being given a $500 credit off their tax liability upon proof that the taxpayer has spent $1,000 on a child's education. That is, a 50 per cent credit is given up to a maximum of $500.

In both of the scenarios outlined above, the taxpayer is in the same position economically, with the process of collecting the tax and then making a payment avoided in Scenario 2, arguably resulting in administrative efficiency. However, in almost all respects the delivery of these government benefits is treated differently. At the broadest level, for budget purposes in most, if not all jurisdictions, the direct subsidy of $500 outlined in Scenario 1 will be exposed to greater political and/or critical scrutiny than the tax expenditure outlined in Scenario 2.

The example provided is one which uses a tax credit as the form of delivery of the tax expenditure. However, there are many other ways to achieve a reduction in tax payable to specific classes of taxpayers either because of certain taxpayer characteristics or because of certain behaviour. This may be achieved via a deduction for expenses not normally allowed, an accelerated or increased deduction for normal expenses, the deferral of the recognition of certain income or an outright exemption from taxation for income that would otherwise be assessable. What is common to the delivery of a tax expenditure to taxpayers, however, is the necessity of the taxpayer or the activity to meet the qualifying factor/s. For example, a tax deduction is often available for philanthropic activities. The qualifying behaviour may be a donation to specified charities. Research and development undertaken by certain entities may attract a concession in the form of accelerated deduction or credit. The qualifying behaviour is the need to undertake eligible research and development. The very need to meet criteria of itself raises issues such as gaming by taxpayers, which we address later.

2.2.3 Negative tax expenditures

The tax expenditures discussed so far are known as positive tax expenditures and are the main focus of any tax expenditure reporting and analysis undertaken by jurisdictions around the world. However, there is a second category of tax expenditures: negative tax expenditures. Jurisdictions often also report on negative tax expenditures, or what are regarded as provisions of the tax regime which treat certain taxpayers or activities disadvantageously. Where a negative tax expenditure applies, those taxpayers or activities are taxed at a higher rate compared to the benchmark tax system so defined. For example, taxes imposed on cigarettes and alcohol may be regarded as negative tax expenditures. These types of tax expenditures, despite being revenue raising in nature, have the same purpose as positive tax expenditures, that is, the achievement of a social or economic policy goal.

2.2.4 A useful starting point

Defining tax expenditures in terms as we have just done is a useful starting point in any discussion on tax expenditures. Understanding what constitutes a tax expenditure in simple terms means that it is possible to consider the purpose of classifying parts of a tax regime as belonging to that category of provisions which are not about revenue raising but rather are part of the broader social and economic policy of a government. It allows the type of analysis undertaken in a book like this, and it allows an understanding of the importance of the reporting and management of tax expenditures as part of any democratic process. However, we do not purport to claim that this discussion on the definition of tax expenditures is comprehensive and complete – in fact, far from it. To this end, we also argue that the definition of tax expenditures should go beyond those traditional definitions discussed above to remove the prerequisite of being expressly legislated. We argue that this prerequisite provides an unnecessarily narrow view of what constitutes a tax expenditure and is a restriction on the types of activities captured within the definition. Later, we outline our reasoning for expanding the definition to include implicit and operational tax expenditures. For now, we turn to the purpose of categorising a provision of the tax regime as a tax expenditure.

2.3 The purpose of categorisation

By now it will be obvious to the reader that inherent in tax expenditure analysis is the need to categorise the various provisions of an income tax regime as tax expenditures. Before undertaking that categorisation, however, a consideration of 'why' this categorisation is undertaken is required as it clearly influences and ultimately shapes the identification process. This is also a problematical question, as the purpose of categorisation is no less decisive than the concept itself. Some see tax expenditure analysis as an important tool in tax reform.[13] Others see it as a tool in spending reform.[14] Yet, these different purposes will shape a nation's fundamental choice as to how it identifies and treats its tax expenditures. A nation which adopts the view that the purpose of tax expenditure analysis is designed to promote efficiency and/or equity within its tax regime is likely to undertake a different approach to tax expenditure analysis than a nation which adopts the view that tax expenditure identification and reporting is designed to promote political engagement. The purpose of tax expenditure analysis and reporting adopted by a nation will also have

[13] For further explanation of the two purposes see: Shannon, 'The Tax Expenditure Concept in the United States and Germany: A Comparison' (1986). Shannon, at p. 202, states:

> The tax expenditure concept and analysis have important implications for tax reform. The concept divides tax law into those provisions that constitute tax expenditures and those provisions that do not. According to tax expenditure analysis, tax expenditures should be evaluated as spending, rather than as taxing provisions. Thus tax expenditure analysis helps focus tax reform. With respect to tax expenditures, tax reform becomes the process of purging from existing law and proposed legislation those tax provisions identified as tax expenditures that would not be justifiable if cast as direct expenditures.

He then goes on to state:

> In addition to providing a focus for tax reform the tax expenditure concept also has important implications for the budgetary process. If tax expenditures are essentially equivalent to direct expenditures channelled through the tax system, it would be irresponsible not to take them into consideration in the budgetary process. If tax expenditures represent money the government spends, any government budget that does not account for tax expenditures will be incomplete. The problem of calculating accurately the amount of a tax expenditure, therefore, is much more important within the context of the budgetary process, than within the context of tax reform.

[14] McDaniel, 'Identification of the "Tax" in "Effective Tax Rates", "Tax Reform" and "Tax Equity" ' (1985), 277.

a fundamental effect on the benchmark it adopts to identify tax expenditures within its tax regime.

This difference in 'purpose' has stemmed from Surrey's initial adoption of a tax expenditures list where the purpose was narrowly defined. His aim was to make a limited list of provisions which did not fit the usual purpose of taxation law and for this reason he adopted a narrowly defined tax expenditure concept framed upon the criteria of the provision being (1) an expressly legislated taxation rule, (2) within the income tax, (3) that departs from the specified income tax benchmark and (4) that is directly substitutable for direct spending.[15] Surrey's purpose was to identify spending rules which were 'hidden' in the United States' federal income tax code with a view to applying spending criteria to assessing the merits of these rules. Surrey therefore envisaged tax expenditure reporting as a key step in fulfilling his relatively narrow purpose of treating all government spending uniformly.[16]

An alternate purpose of tax expenditure reporting can be critical assessment of the operation of a taxation system assessed against defined moral norms. For example, if a community seeks to maximise economic efficiency and/or social justice, it might express such aspirations by defining how its taxation system might promote such goals. To assess the impact of the tax system against such goals a broader approach to tax expenditure reporting would relax Surrey's restrictive specification of the tax expenditure concept. In particular, the first, second and fourth criteria might be excised so that a tax expenditure would arise whenever a tax rule departed from the specified benchmark.

2.3.1 Framing the question of what is a tax expenditure

Tax expenditure analysis, or the identification of certain provisions of a tax regime for the purposes of comparison between provisions of the tax law which are special deductions, credits and other allowances, with government subsidies, was first recognised in Germany as early as 1954.[17] However, it wasn't until 1967 that the phrase 'tax expenditures' entered the sphere of mainstream tax policy and tax expenditure analysis became

15 For a discussion by Surrey on what he considers the definitional aspects see Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (1973), 15.

16 For a recent consideration of tax expenditures in the context of the United States' tax regime, see United States of America, *The Moment of Truth* (2010).

17 Shannon, 'The Tax Expenditure Concept in the United States and Germany: A Comparison' (1986), 203.

increasingly popular amongst developed jurisdictions. The phrase 'tax expenditures' was initially coined for the purpose of highlighting provisions of the tax regime which were, in effect, direct spending provisions. This purpose remains a central tenet to the reporting of tax expenditures by an increasing number of jurisdictions. However, as previously stated, despite almost universal acceptance of the concept of tax expenditures, there is no one universally accepted definition of the term. We argue that the lack of consensus stems from the divergence of opinion on the underlying and central concept that tax expenditures are attempting to identify.

Until this point in the book, we have couched tax expenditures in simple terms as being the equivalent of direct spending programmes; however, the issue of identifying tax expenditures is arguably much more complex. Is a tax expenditure a provision contained in the tax legislation that is directly substitutable for a spending programme? Is a tax expenditure a provision which provides preferential tax treatment to one group of taxpayers over another group of taxpayers? Or, is a tax expenditure a much wider concept that captures all departures from a normative or benchmark tax system regardless of whether they can be substitutes for a direct spending programme or provide benefits to a specific class of taxpayer? Put simply, the answer will vary depending on who is asked this question and, as such, despite the longevity of the concept its definition is by no means settled. We do not purport to provide a definitive answer to the question of what a tax expenditure is, but rather argue that there is no one answer. It is precisely a jurisdiction's underlying purpose for categorising provisions of a tax regime as tax expenditures which frames the answer as to how that jurisdiction defines a tax expenditure for its own purposes. However, identification of tax expenditures is at the core of any analysis as before tax expenditure analysis and management can occur, in whatever form deemed appropriate by a jurisdiction, it is necessary to determine which provisions of a tax regime are considered tax expenditures. Throughout the literature, various criteria have been recognised as possible approaches to identifying tax expenditures, each of which have an inherent purpose attached. These include the following: the pursuit of a non-fiscal policy goal, convertibility of the provision into a direct expenditure, the benefit of a limited group of taxpayers, the reduction of revenue and the deviation from a benchmark tax structure.[18]

[18] OECD, *Tax Expenditures in OECD Countries* (2010), 15–16, citing the criteria identified by Ende et al., 'Tax Expenditures in the Netherlands' (2004).

2.3.2 The elusive underlying concept

It has been stated that there is no universally accepted theoretical or practical definition of a tax expenditure. Further, those who have attempted to define the term invariably link it to another, just as elusive, concept. These secondary concepts are generally associated with some form of preferential tax treatment, being a substitutable (for direct spending) tax provision, or promoting a purpose other than direct fiscal revenue raising. Each of the different definitions gleans insight into, in the case of academic work, the author's or, in the case of country reporting, the reporting body's particular views on the purpose of identifying tax expenditures. Consequently, the concept is first and foremost dependent on the purpose for which the term is being used. The literature on tax expenditures reveals the purposes of identifying tax expenditures as falling into two broad categories: first, promoting efficiency within the tax regime specifically and budgetary process generally; and second, promoting equity along with political engagement via a discussion and debate on the relative merits of specific tax expenditures and their associated fiscal costs.[19] Jurisdictions do not have to explicitly state one purpose but rather may adopt one or both of these broad purposes for identifying tax expenditures. Ideally, the purpose adopted is explicit; however, often it is merely implicit in the use for which a jurisdiction analyses tax expenditures and must be extrapolated from various documents. Whether explicit or implicit, once the purpose of identifying tax expenditures is determined, it is then possible to ascertain the means by which they are identified or, more specifically, the criteria which provide the benchmark which underpins tax expenditure identification, which is the most controversial of all discussions in the tax expenditures debate. It is also possible to consider other issues such as measurement which arise as a consequence of the differences in the explicitly defined or inherently adopted purpose of tax expenditure reporting and analysis by a jurisdiction and subsequent variances in the recognised benchmark.

We argue that lack of agreement in relation to the tax expenditure concept can be explained if we accept that the controversial nature of the subject of tax expenditures is inevitable for both deontological and empirical

[19] Within the context of the United States, see, for example, Woellner, 'Spending on an Empty Wallet: A Critique of Tax Expenditures and the Current Fiscal Policy' (2006), who analyses several tax expenditures which he claims are counterintuitive to accepted tax policy norms.

reasons. History has proven that an elitist model is not possible. As such, it is the criteria underlying the benchmark which we argue flow from the different moral assessments of what a community values which shapes a nation's tax expenditure analysis and management. A community must make choices about how its tax system is to operate and must weigh the competing imperatives against each other, with these choices becoming embedded in the particular view of the tax expenditure concept adopted. The reason why the identification of tax expenditures which requires the identification of a benchmark is by no means settled is arguably because there are two broad schools of thought as to the imperative which tax expenditure analysis is attempting to achieve. Fleming and Peroni make the point that for tax expenditure analysis to be more than rhetoric, it must possess a principled basis for it to have any normative force,[20] a point with which we agree. However, that basis will be influenced by a nation's views on fundamental tax policy principles or, more specifically, efficiency and equity.[21]

2.3.3 'Good' tax criteria

Traditionally, tax expenditure analysis has been grounded in equity principles on the basis of the normative benchmark being the Schanz–Haig–Simons definition of income, which we discuss later. As Fleming and Peroni point out, however, the Schanz–Haig–Simons definition of income derives from the 'ability to pay' principle.[22] As such, where it is accepted that a nation models its tax system on ability to pay, the benchmark will reflect this. Equity, or fairness, nevertheless will not be the only criteria upon which a tax system will be based, and often a competing concept is one of efficiency or neutrality. As such, there is the argument that the tax expenditure benchmark should be designed on the basis of efficiency, where tax expenditure analysis will reveal those provisions of the tax regime which distort the effect of tax. We do not purport to argue that equity is more important than efficiency, or vice versa. Rather, we argue that this is for a nation to decide. Many jurisdictions will ultimately

[20] Fleming and Peroni, 'Reinvigorating Tax Expenditure Analysis and its International Dimension' (2008), 450.

[21] See Fleming and Peroni, 'Reinvigorating Tax Expenditure Analysis and its International Dimension' (2008), for a comprehensive discussion on the fundamental tax policy principles relating to tax expenditure analysis.

[22] The 'ability to pay' principle is the proposition that taxes should be levied according to a taxpayer's ability to pay tax. Therefore, the more income, the higher the tax.

adopt a hybrid approach to the benchmark used for defining tax expenditures, starting with the Schanz–Haig–Simons definition of income and then adapting it for other criterion of good tax policy, such as economic efficiency, but also factors such as enforceability, administrability, simplification and effectiveness.[23]

An analysis of the approaches by different countries, which is more comprehensively discussed in Chapter 3, reveals that jurisdictions have historically considered that tax expenditure analysis and reporting serves different purposes, with their own assessment of the conflicting imperatives of good tax policy. Inextricably tied to this assessment is the function for which tax expenditures are then identified by these nations. The impetus for tax expenditures reporting in the United States, by exposing tax expenditures as the equivalent in outlays of direct spending, was tax reform. Whilst in Germany, the emphasis on the tax expenditure concept has centred around budgetary policy rather than reform[24] with the budgetary process in Germany taking into account the cost of tax expenditures.[25] We argue that no matter the fundamental purpose adopted by a nation and no matter the tax policy imperatives adopted, a robust tax expenditures management framework is arguably an essential element to both of these purposes. This leads us to a discussion on the function of identifying tax expenditures.

2.4 The function of identifying tax expenditures

Tax expenditures are now a major feature of not only the tax system, but also government policy and the overall economy and, consequently, the tax expenditure concept is central to a government's fiscal function.[26] In essence, the identification of benefits provided through the tax system as tax expenditures allows analysts the obvious function of considering the fiscal significance of those parts of the tax system which do not contribute to the primary purpose of revenue raising.[27] However, we argue that

23 Fleming and Peroni, 'Reinvigorating Tax Expenditure Analysis and its International Dimension' (2008), 458.
24 Shannon, 'The Tax Expenditure Concept in the United States and Germany: A Comparison' (1986), 204.
25 Shannon, 'The Tax Expenditure Concept in the United States and Germany: A Comparison' (1986), 204.
26 See the material cited in Chapter 1, note 22.
27 For a discussion of the Bush Administration's criticisms of the concept of tax expenditure and its questioning of the analytic value, see Roin, 'Truth in Government: Beyond Tax Expenditure Budget' (2003).

there is more to tax expenditures than simply determining the fiscal value of each identified expenditure and evaluating that identified expenditure within a direct expenditure framework. If a nation so chooses, it also creates the opportunity for enhancing the legitimacy of tax systems specifically and government more generally, that is, the promotion of political engagement. As such, tax expenditure analysis has two distinct but equally important functions: it has important implications for a nation's budgetary process, and it is a tool used in the tax reform process. A third function that is also becoming increasingly relevant, and which may be described as a by-product of the two primary functions, relates to the international significance of tax expenditures, particularly in a comparative context.

2.4.1 Reporting on tax expenditures

The genesis of modern tax expenditure analysis was the simple process of the reporting of those provisions regarded as tax expenditures for the purposes of revealing them as the equivalent of direct spending outlays. Put simply, traditionally, the central tenet of tax expenditure analysis is the notion that tax expenditures are directly comparable to direct government expenditures. The argument proffered is that if equivalent direct government expenditure is not justifiable because it is either inefficient or inequitable, the tax expenditure is also inefficient or inequitable and should not be part of any tax regime. The comparison of tax expenditures with direct expenditures adopts the view that tax expenditures are a transfer of public resources, achieved by reducing tax obligations with respect to a benchmark tax.[28] Determining which tax expenditures are equivalent to direct spending programmes, along with the fiscal costs associated with the tax expenditure, has traditionally been the primary purpose for reporting on tax expenditures. In turn, this has led to a significant number of governments producing tax expenditures statements. Consequently, this makes tax expenditures an integral part of a country's budgetary process. Once it is accepted that tax expenditures are part of the budgetary process, the substantive elements of the reporting are revealed. That is, there is a need for the reporting of tax expenditures to include not only the measurement of those expenditures as is traditionally done, but also contain a rigorous review and oversight process. We refer to this as the management of tax expenditures.

[28] OECD, *Tax Expenditures in OECD Countries* (2010), 14.

There is no doubt that the most significant advances in tax expenditure analysis by revenue authorities around the world has been in the reporting of tax expenditures, with a traditional emphasis on fiscal costs. This increased level and sophistication of reporting is evident in the discussion in Chapter 3 when we consider the various approaches adopted by different jurisdictions. From an economic perspective, the most significant impact of a government's tax expenditures programme is the scale of the programme. The scale of the programme relates not only to gross revenue foregone as measured in the reporting process but also as a measure relative to the scale of direct spending.[29] If it is accepted that tax expenditures are directly comparable to direct expenditures as is suggested here, it necessarily follows that the cost should also be included in any government's budget. As such, the reporting of tax expenditures from a fiscal cost perspective has traditionally been and continues to be the dominant purpose for the categorisation. A consequence of the reporting of tax expenditures is the ability of a nation to expose many of the perceived advantages as well as failings of these expenditures as contrasted with direct expenditures. We discuss the importance of revealing these failings in Chapter 4.

The decision by a nation to report tax expenditures is a significant part of the reason for categorising provisions of a tax regime as tax expenditures as contrasted with other provisions of the tax regime. That is, reporting is a means in itself through the public disclosure of tax expenditures. However, arguably, this traditionally adopted reason for reporting tax expenditures has its limitations, and jurisdictions which limit the purpose of identifying tax expenditures to mere reporting (disclosure) are not fully embracing the broader purpose of the tax expenditure concept. Generally, the reporting of tax expenditures is simply designed to facilitate a comparison between direct spending decisions and revenue foregone through tax expenditures. Consequently, a limiting factor is the fact that tax expenditure statements generally only consider existing tax expenditures, and then, as previously emphasised, only consider those existing tax expenditures in terms of reporting rather than any substantive management. As such, the traditional approach to tax expenditures is arguably deficient in that it is both limited to an *ex post* analysis and it is a mere analysis rather than a genuine management framework. If the

[29] Many countries do not report aggregate tax expenditure data. However, in Australia aggregate *measured* tax expenditures for the 2007/2008 financial year amounted to 7.1 per cent of GDP: Australia, *2007/2008 Tax Expenditures Statement* (2008), 14.

reporting of tax expenditures serves the purpose of being an important tool in spending reform it is imperative that the type of analysis undertaken is extended to an *ex ante* review of all proposed tax expenditures. This is simply because budget control is difficult where new tax expenditures are introduced without being subject to rigorous review and future oversight.

2.4.2 Accountability and transparency

Whilst the traditional rationale for categorising a provision of the tax regime as a tax expenditure is the reporting of that provision as a deviation from the benchmark so defined and an ascertaining of the fiscal significance of both the individual and aggregated tax expenditures, jurisdictions have also recognised the significance of the identification of tax expenditures from a public policy and administrative perspective. A democratic government should aspire to openness, accountability and transparency in relation to all of its policy measures and this will include tax expenditures. Tax expenditures are a significant social and economic policy instrument applied across the full policy spectrum.[30] By their very nature, tax expenditures are designed to compensate or reward particular taxpayer behaviour, or, in the case of negative tax expenditures, designed to punish particular behaviour and impose a cost on negative externalities. Given that tax expenditures are a significant policy instrument, questions will always arise as to accountability and transparency within the tax regime when tax expenditures are used. The tax expenditure concept and analysis, by dividing provisions of tax law into those that are part of the normative base and those which are not, plays an important role in both the reform and integrity of any tax regime for jurisdictions which adopt the view that the tax expenditure concept is designed to aid reform.

The usefulness of tax expenditure analysis as a policy tool leads us back to the earlier discussion on the purpose of categorisation by individual nations and the competing tax policy imperatives. Previously, authors have argued that the usefulness of tax expenditure analysis depends on one's view as to the objective or subjective nature of the identification of tax expenditures. Many view tax expenditure analysis as highly subjective but used under the guise of being an objective standard, while there are others who do not perceive any subjectivity in the process and argue that

[30] Howe and Landau, 'Do Investment Attraction Incentives Create Decent Jobs? A Study of Labour Conditions in Industry Assistance Contracts' (2008).

'tax expenditure analysis is attractive as a tool for tax reform because it is objective'.[31] We argue that it is neither objective in the traditional sense of the word, nor is it without merit. Surrey originally proposed an elitist tax expenditure model, in which he attempted to build in objectivity, with the purpose of designing tax expenditure reporting and analysis to reveal tax expenditures as the equivalent of direct spending programmes with the aim of tax reform, or essentially a reduction in the number of spending programmes implemented through the tax regime. To this end, tax expenditure reporting has been a dismal failure as we are at a point in time where the use of tax expenditures is pervasive and growing.[32] This growth is not only in the fiscal value of tax expenditures but the number of tax expenditures in existence. However, this does not automatically lead to the conclusion that a lack of objectivity results in a call for the abandonment of tax expenditure reporting and analysis. Rather, it leads to the conclusion that tax expenditure reporting and analysis is grounded in a nation's own moral and political philosophy. There will in this case still be a principled basis for using tax expenditure analysis as a policy tool.

While we argue that the tax expenditure concept is not objective, the view that tax expenditure analysis is an objective analytical tool is not without merit, particularly when we consider the number of items which are considered tax expenditures, and to which no one would doubt this categorisation. To this end, the underlying purpose for tax expenditure analysis may not be objective, meaning that the benchmark across nations will vary, but the flow on processes, that is, the actual analysis and management, may be objective. The advantage of realising the benefits of accepting tax expenditure analysis and management as objective 'at a time when many government budgets are threatened by population ageing and adverse cyclical developments'[33] is that tax expenditure analysis aids governments in avoiding inefficient spending programmes, some of which may utilise tax expenditures.[34] Further, if we accept that tax expenditure reporting and analysis is unlikely to reduce the number of tax expenditures within a regime and the fiscal cost of those tax expenditures, there is even greater importance in the recognition of tax expenditures for accountability and transparency purposes. The OECD seems to adopt this stance when it states that 'there is a perceived need

[31] Shannon, 'The Tax Expenditure Concept in the United States and Germany: A Comparison' (1986), 202.

[32] OECD, *Tax Expenditures in OECD Countries* (2010), 3.

[33] OECD, *Tax Expenditures in OECD Countries* (2010), 14.

[34] OECD, *Tax Expenditures in OECD Countries* (2010), 3.

for greater understanding of the issue, of the trend in tax expenditures, and of successful practices with respect to their enactment, budgetary reporting, and review'.[35] The OECD is not focusing on a comparison of tax expenditures with direct expenditures but rather the accountability and transparency which results from the reporting of tax expenditures per se. As such, it becomes increasingly important to distinguish between the separate parts of any income tax regime to ensure that all government programmes, whether via direct spending or tax expenditures, are subject to the same degree of scrutiny and accountability.

Opponents to the tax expenditure concept would disagree with us as they are likely to continue to argue that the notion that tax expenditure analysis is an objective policy tool can be dismissed on the basis of the controversies surrounding the identification of tax expenditures. However, where it is agreed within a nation as to the fundamental underpinnings of the tax expenditure concept, reporting on tax expenditures promotes analysis of tax policy principles and potential improvements to the tax system for that particular community. Put simply, the discussion that surrounds tax expenditure reporting, such as the definition of tax expenditures and the requisite tax benchmark, allows a consideration both by a country's citizens as a whole as well as its government as to what that society wants for its tax system. Citizens are then able to make a more informed choice about what it considers to be a fair, efficient and simple tax system. By reporting on tax expenditures, not just in terms of fiscal value, but also for the purpose of accountability and transparency, many more of their negative characteristics may be revealed leading to the conclusion that tax expenditures are often a 'second best' policy after direct spending.[36] Surrey and McDaniel, in 1985, provided a list of the characteristics they believed were exposed by tax expenditure analysis, cataloguing the different negative features of tax expenditures.[37] These negative features have been highlighted subsequently in voluminous literature. We return to these in Chapter 4.

2.4.3 *International aspects of tax expenditures*

Within domestic jurisdictions, the identification of tax expenditures has been for the purpose of budgetary considerations and/or for the purpose

[35] OECD, *Tax Expenditures in OECD Countries* (2010), 15.
[36] Lienert, *Manual on the Role of the Legislature in the Budget Process* (2010), 13.
[37] Surrey and McDaniel, *Tax Expenditures* (1985), 102–3.

of driving tax reform. However, over the decades the reporting of tax expenditures has resulted in a third use: as a tool to be used for comparative analysis purposes at an international level. This use is not a new phenomena; however, the number of bodies and parties undertaking the studies, along with its level of sophistication, has increased over the decades. The practical work of international organisations is considered in Chapter 3, but there are also academic reports which have undertaken a comparative study. Historically, McDaniel and Surrey, in 1985, undertook the first analytic and data collection process needed to facilitate a study of the international aspects of tax expenditures. In doing so, they considered six industrialised countries and developed lists for these countries using uniform criteria. The purpose for undertaking such a study was to allow for international comparative analyses as well as for the purposes of international economic relationships.[38] The lack of international consensus on the benchmark tax system makes international comparability difficult; however, commonalities do exist between jurisdictions.[39] For example, OECD countries consistently use what is known as the comprehensive income tax benchmark as contrasted with the expenditure tax benchmark,[40] resulting in agreement as to a key element of any tax regime. Further, over time the work undertaken by the OECD, which we discuss in Chapter 3, is becoming more sophisticated in its ability to adjust for differences. Limitations, however, should not be dismissed, as it is currently not possible to ensure that the data is fully comparable,[41] nor would we suggest that this is ever likely to be the case in the future.[42]

McDaniel and Surrey in 1985 recognised that the most important applications of tax expenditures reporting and analysis are and will remain in the context of the budget and tax policies of the individual jurisdictions,[43] a point with which, over a quarter of a century later, we agree. However, it

[38] McDaniel and Surrey, *International Aspects of Tax Expenditures: A Comparative Study* (1985), 5.

[39] For example, all OECD countries regard a progressive income tax rate structure as part of the tax base.

[40] The difference being that under a comprehensive tax benchmark savings are included whereas with an expenditure tax benchmark savings are excluded.

[41] Heady, 'Tax Expenditures: Definitional and Policy Issues' (2011).

[42] The OECD explicitly recognises that there are differences between various countries' tax expenditure methodologies in general and their benchmark tax systems in particular but argues that where the goal of international studies is better policy, comparative studies are useful: OECD, *Tax Expenditures in OECD Countries* (2010), 18.

[43] McDaniel and Surrey, *International Aspects of Tax Expenditures: A Comparative Study* (1985), 4.

is remiss not to note the production and use of international comparative studies by organisations such as the OECD with the aim of its most recent publication, *Tax Expenditures in OECD Countries*, designed to shed light on the use of tax expenditures through a study of ten OECD countries. The stated purpose of the study was to help government officials and the public better understand some of the technical and policy issues behind the use of tax expenditures by highlighting 'key trends and successful practices' and addressing a 'broad range of government finance issues, including tax policy making, tax and budget efficiency, fiscal responsibility and rule making'.[44] When used for these purposes, international comparative studies have significant benefits.

We have argued that the identification of the purpose and function of tax expenditure analysis and management is what allows a nation to determine what elements of its tax regime it considers to be tax expenditures. This is because these decisions form the basis for determining the benchmark against which tax expenditures are identified. As such, we argue that the purpose and function drives the identification, and at the heart of tax expenditure analysis lies the identification of specific elements of a tax regime as tax expenditures. Herein lies the greatest of tax expenditure analysis controversy.

2.5 The identification of tax expenditures

A tax expenditure can only be identified as such when it is contrasted with or compared to another theoretical or practical base. To this extent, while tax expenditure reporting and analysis has become increasingly popular, consensus as to what constitutes a tax expenditure, whether debated by academics or pragmatically required by domestic jurisdictions to enable reporting, has not been reached. Debate as to what constitutes a tax expenditure has ensued for more than four decades, with that debate, whilst undertaking an international focus, being the most fierce in the United States. As such, in this part we critically analyse what constitutes a tax expenditure by considering the historical developments of the definition, most notably observing that by and large the debate has been fuelled not by reporting bodies but by academics generally arguing about the definition.[45] What is also revealed in this discussion is the need for an

[44] OECD, *Tax Expenditures in OECD Countries* (2010), 3.

[45] See McDaniel and Surrey, *International Aspects of Tax Expenditures: A Comparative Study* (1985) who argue that there is a great deal of consensus and that it is only at the periphery that there is debate.

ongoing consideration of what constitutes a tax expenditure. As Surrey and McDaniel prophetically stated in 1985, tax expenditure analysis needs to undertake a dynamic and continuing analysis of the provisions in a tax system.[46] Further, any consideration of what constitutes an identified tax expenditure from a definitional perspective needs to be placed in the context of the fact that some of the concepts relating to tax expenditures are in fact afforded a common consensus and this often occurs no matter what the purpose and function individual nations adopt. In essence, what must not be lost in any discussion on the definitional issues surrounding tax expenditures is that there is a deal of consensus on what constitutes a tax expenditure for reporting purposes regardless of how the benchmark is defined by both academics and reporting bodies alike and, as such, some of the arguments are quite correctly classified as being at the margin. This, however, does not detract from the significance of the debate.

The ensuing debate as to what constitutes a tax expenditure should also lead the reader to the logical conclusion that it is not possible to suggest that a universal definition of tax expenditures is or can be ascertained with certainty. We certainly do not intend to suggest this is the case. Quite the contrary: we remind the reader that the overarching thesis of this book is that a unanimous international, or even domestic, definition cannot be reached because neither international or domestic moral objectivity is possible. It is the absence of moral objectivity that makes the need to define tax expenditures so as to afford identification, one of the most contentious questions surrounding any analysis of tax expenditures. The underlying purpose makes it no less contentious, whether theoretical and undertaken by academics or the purpose is much more pragmatic with the definition used by jurisdictions in their reporting of tax expenditures.

Whatever the label applied to tax expenditures, definitional issues arise out of the fundamental need to define a benchmark or basic tax structure from which tax expenditures are considered deviations or exceptions. This identification of a country's normative taxation system is intrinsically contentious and can only be resolved, albeit contingently, by a community's adoption of a unique combination of normative tax principles that reflects the community's priorities. Moreover, the process by which this normative tax framework is adopted ought to reflect the community's normative tax policy process.

[46] Surrey and McDaniel, *International Aspects of Tax Expenditures: A Comparative Study* (1985), 196.

The choice of benchmark is significant not only in providing the definition to determine what constitutes a tax expenditure but, where tax expenditure analysis is used as a budgetary tool, it can have significant bearing on the aggregate estimate of revenue foregone. For example, where negative tax expenditures are included in the aggregate estimate, the value of the revenue foregone from negative expenditures may be significantly underestimated.

Below, we focus on non-legislative (academic) definitions of tax expenditures as defined by reference to the alternative normative, or benchmark, taxation systems adopted. Inherent in this discussion is an acceptance that there are many different views of the normative or benchmark tax base but, by and large, there is significant consensus as to what is and is not a tax expenditure no matter how defined. In Chapter 3, we consider legislative definitions of tax expenditures which are generally adopted by jurisdictions for the purposes of tax expenditure reporting.

2.5.1 The history of the generally adopted 'normative tax base'

We have already discussed the fact that the concept of tax expenditures had its genesis in the works of Stanley Surrey. He first used the expression on 15 November 1967 in a speech calling for 'full accounting' whilst he was Assistant Secretary for Tax Policy in the United States Treasury Department. In that speech, as reproduced in the *Annual Report of the Secretary of the Treasury on the State of the Finances for the Fiscal Year Ended June 30, 1968*, Surrey's desire to have tax expenditures recognised as the equivalent to direct spending outlays is obvious. Surrey was concerned with the 'hidden' aspect of tax expenditures and the use of the tax system for purposes other than raising revenue. He described this hidden aspect of tax expenditures in the following terms:

> A tax system presumably concerns itself with raising revenues rather than spending funds. But a closer analysis of our present tax system would reveal real substance to the phrase. Through deliberate departures from accepted concepts of net income and through various special exemptions, deductions, and credits, our tax system does operate to affect the private economy in ways that are usually accomplished by expenditures – in effect to produce an expenditure system described in tax language.[47]

[47] Surrey, *Excerpts from Remarks Before the Money Marketeers on the US Income Tax System – The Need for a Full Accounting in the Annual Report of the Secretary of the Treasury on the State of the Finances for the Fiscal Year Ended June 30, 1968* (1968), 322.

Surrey, a supporter of comprehensive income taxation, undertook his initial work on tax expenditures driven by his desire to have identified tax expenditures recognised as equivalent to direct expenditures, with the aim of consequently converting them into direct spending programmes or having them repealed. The context in which the tax expenditure concept was introduced by Surrey was one that involved tax reform in light of the subsequent *Tax Reform Act* 1969. His theory of tax expenditures was founded upon a model of government that called for rational and informed members of government to procure institutional reform in conjunction with taxation reform. In 1973, Surrey published his treatise *Pathways to Tax Reform: The Concept of Tax Expenditures*[48] providing further details of his research into tax expenditures and defending his classification and analysis of tax expenditure provisions. The impetus for Surrey's coining of the phrase, or what he describes as an 'illumination',[49] was a pragmatic one; to improve the tax system by exposing tax expenditures as special tax provisions which are similar to direct government expenditures such as, for example, grants, loans and interest subsidies. Surrey, in that seminal work, laid the foundation for what is generally understood to be the two-part categorisation of a tax regime and the foundation for the definition of the term tax expenditure:

> The federal income tax system consists really of two parts: one part comprises the structural provisions necessary to implement the income tax on individual and corporate net income; the second part comprises the system of tax expenditures under which Government financial assistance programs are carried out through special tax provisions rather than through direct government expenditures. This second system is grafted on to the structure of the income tax proper; it has no basic relation to that structure and is not necessary to its operation. Instead, the system of tax expenditures provides a vast subsidy apparatus that uses the mechanics of the income tax as the method of paying the subsidy. The special provisions under which this subsidy apparatus functions take a variety of forms, covering exclusions from income, exemptions, deductions, credits against tax, preferential rates of tax and deferrals of tax.[50]

The work by Surrey laid the foundation for the assumption that provisions of a tax system are neatly and easily divided into two distinct categories: structural provisions, those provisions which serve the traditional tax purpose of revenue raising; and tax expenditures, those provisions which

[48] Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (1973).
[49] Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (1973), 3.
[50] Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (1973), 6.

are essentially financial assistance programmes. The former, it is generally argued, should be evaluated on the basis of traditional tax criteria, such as equity, efficiency and simplicity, whilst the latter should be assessed using budgetary criteria. The notion of dividing the tax regime into two parts is not difficult to grasp. However, the issue then becomes one of how to distinguish between the two separate parts of the tax system in order to apply the different evaluative criteria, and this *is* difficult. At the root of tax expenditure analysis is the basic definitional question as to which income rules are special provisions designed to achieve social and economic objectives of a government and which income tax rules constitute the basic structure of an income tax system and are thus integral to the revenue raising function of income tax.[51] As stated, the argument proffered is then one of the criteria upon which the two separate parts of the tax system are evaluated.

The process of determining the structural provisions, according to Surrey, is not a process which can be applied to domestic jurisdictions uniformly. This is because, as he states, an income tax requires not only those provisions which shape a normative income tax, but also those provisions which are structural parts of an income tax. Those parts which shape the normative income tax, Surrey argued, were those parts which receive a general consensus and 'would essentially be treated in the same way by any group of tax experts building the structure of an income tax and being governed in that task by all the requirements implicit in such a tax because it is an *income tax*'.[52] Those provisions which contain the structural parts of the income tax system, Surrey argued, 'could, in the view of such group of tax experts, conceivably be treated differently from country to country depending on the views and the policies shaped by other goals in the particular society, rather than by factors special to an income tax'.[53] According to Surrey, these provisions are not part of the normative income tax but do become part of the structural elements of an income tax and are therefore not considered tax expenditures.[54] Surrey, along with his future co-author McDaniel, maintained that the normative tax base was that of the Schanz–Haig–Simons definition of income and this should be used for the purposes of determining whether a tax provision is a structural provision or a tax expenditure. The Schanz–Haig–Simons

51 Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (1973), 15.
52 Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (1973), 17 (original emphasis).
53 Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (1973), 17.
54 Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (1973), 17.

definition of income is well known and understood as 'the algebraic sum of (1) the market value of the 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'.[55] In other words, a person's income to be taxed is their annual consumption plus their annual savings. Although arguably the normative tax base can be better described as the comprehensive tax base with amendments to take into account structural provisions.

Surrey regarded the determination of a normative model as requiring a consideration of a variety of questions going to the fundamental income tax structure. The questions that he highlighted were:

- What receipts should be included and what expenses allowed to obtain the proper measure of net income for an income tax – 'proper' in the sense that it is an *income tax* for which the measure is being sought;
- In what time periods should includable receipts be included and allowable expenditures be taken (e.g., cash and accrual accounting, expensing of capitalisation of expenditures, and if the latter, how written off – the method of depreciation, for example);
- Over what period of time should the measurement itself be made (e.g., averaging and net operating loss questions);
- What is the unit whose income is being measured (e.g., is the family to be taxed as a unit or the members separately taxed);
- How should the income of organisations of individuals be treated (e.g., the relationship of corporate income and the corporate tax to the tax treatment of the shareholders.[56]

Twelve years after his initial work on tax expenditures was published, Surrey, with his co-author Paul McDaniel, published a second book on the subject simply entitled *Tax Expenditures*.[57] Despite the ongoing criticism, Surrey and McDaniel's definition of tax expenditures in 1985 remained the same as the initial formulation and, as such, they maintained their reliance on the same normative tax structure, with little variation to Surrey's initial formulation of a tax expenditure. Ignoring the substantive criticisms made of the concept and the politics of tax expenditure management, they restated Surrey's initial broad definition of tax expenditures:

[55] Simons, *Personal Income Taxation* (1938), 50.
[56] Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (1973), 16–17.
[57] Surrey and McDaniel, *Tax Expenditures* (1985).

> The tax expenditure concept posits that an income tax is composed of two distinct elements. The first element consists of structural provisions necessary to implement a normal income tax, such as the definition of net income, the specification of accounting rules, the determination of the entities subject to tax, the determination of the rate schedule and exemption levels, and the application of the tax to international transactions. These provisions compose the revenue-raising aspects of the tax. The second element consists of the special preferences found in every income tax. These provisions, often called tax incentives or tax subsidies, are departures from the normal tax structure and are designed to favour a particular industry, activity or class of persons. They take many forms, such as permanent exclusions from income, deductions, deferrals of tax liabilities, credits against tax, or special rates. Whatever their form, these departures from the normative tax structure represent government spending for favoured activities or groups, effected through the tax system rather than through direct grants, loans, or other forms of government assistance.[58]

Surrey and McDaniel continued by stating that 'tax expenditure analysis is based on the concept of a normative tax of the type under consideration',[59] expanding taxes for consideration beyond income tax for which they continued to rely on the Schanz–Haig–Simons normative concept of net income to distinguish between the two parts of an income tax system. Any concession to the criticisms they faced was minimal; however, whilst continuing to advocate for the Schanz–Haig–Simons base, Surrey and McDaniel acknowledged that it was the mere starting point. They stated:

> Although the S–H–S definition is a useful starting point for identifying the normative provisions in an income tax, it cannot be sued alone to distinguish normative provisions from tax expenditure provisions. One reason for this is that Simons applied his definition of income to only a few items. He did not discuss the appropriate technical treatment of many receipts (such as government transfer payments, personal damages and scholarships) or of many expenditures or losses (such as medical expenses, casualty losses, and charitable contributions). A second reason is that the S-H-S definition does not address all the issues involved in framing a normal income tax, such as the taxable period to be sued in applying the definition. A third reason, more narrowly applicable to the definition of income, is that the S–H–S definition, though theoretically correct, is too rigid and demanding to be applied comprehensively in a national income tax. It remains an 'ideal', a 'theoretically pure treatment'.[60]

[58] Surrey and McDaniel, *Tax Expenditures* (1985), 3.
[59] Surrey and McDaniel, *Tax Expenditures* (1985), 3.
[60] Surrey and McDaniel, *Tax Expenditures* (1985), 187–8.

In the same year they published *Tax Expenditures*, McDaniel and Surrey[61] also co-edited their study on the *International Aspects of Tax Expenditures* which analysed the tax systems of six countries to identify and quantify the tax expenditures within each of those systems. The purpose of this study, discussed earlier in the context of the function of classification, chose the countries Canada, France, the Netherlands, Sweden, the United Kingdom and the United States for the purposes of the comparative study. Whilst this study did little in the way of contributing to the theoretical underpinnings of the tax expenditure concept, it arguably laid the foundation for future comparative studies and the recognition of the divergent approaches to the normative tax base as defined by various developed nations.

Ultimately, Surrey continued to argue that the benchmark for income tax should be the Schanz–Haig–Simons definition of comprehensive income. His co-author, McDaniel, continued to vehemently defend this adoption up until his recent death in 2010.[62] Further, this is a definition which, whilst facing a great deal of criticism, has endured and is generally adopted at a broad level by jurisdictions which engage in tax expenditure reporting and analysis. This definition has not only received support via revenue authority adoption, which is discussed in Chapter 3, but as is noted later in this chapter, has received more recent support from authors such as Fleming and Peroni. However, this definition has not been without its detractors.

2.5.2 Forty years of criticism of the 'normative tax base'

Surrey's work almost immediately came under criticism on the basis that his definition of tax expenditures was framed by reference to a normative taxation system grounded upon a consensus of tax experts where that consensus simply does not exist. Essentially it was proffered that Surrey's model was an elitist one that failed to take into account political and social philosophy. The initial criticism which directly followed Surrey's original work, was maintained during the intervening period of this sole authored work and endured through to his later work with McDaniel. Criticism subsequent to the later work continues today. The most notable of critics

[61] Surrey unfortunately passed away in 1984.

[62] McDaniel, 'The Staff of the Joint Committee on Taxation Revision of Tax Expenditure Classification Methodology: What Is to Be Made of a Change that Makes No Changes?' (2011).

was Boris Bittker who, in 1969, criticised what he believed to be the subjective element of the tax base so defined. In his view, 'a systematic compilation of revenue losses requires an agreed starting point, departures from which can be identified'.[63] Bittker did not consider that Surrey's tax expenditures list was based on such an identified starting point but rather was of the view that it provided an ad hoc list of tax provisions. He believed that what was needed was '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 reported as "tax expenditures" '.[64] Bittker went on to state:

> the trouble is that, aside from the many ambiguities that become apparent as soon as one attempts to apply the Haig-Simons definition to the protean stream of economic life, any system of income taxation is an aggregation of decisions about a host of structural issues that the Haig-Simons definition does not even purport to settle. As to these, one could lock forty tax experts in a room for forty days, and get no agreement – except as a surrender to hunger or boredom – even if they could all recite the complete works of Henry Simons by heart.[65]

Bittker, by suggesting that objectivity was not achievable, identified a key element to understanding the tax expenditure concept – the inherently political nature of the concept encapsulating moral philosophy. As Weisbach and Nussim explain, Bittker is suggesting that not only are there inconsistencies in the definition but even more of an issue is the fact that implicit policy judgements are being made leading to a great deal of subjectivity.[66] Bittker's criticism of the normative tax base so defined was followed by further attacks not only on the works of Surrey but the Tax Expenditure Budgets that were a product of his work. The strongest criticisms continued in the vein of Bittker's argument that the normative base was subjective and ultimately political whilst at the same time, as Kahn and Lehman suggest, adopting a tone of moral absolutism.[67] In fact, Kahn and Lehman took Bittker's criticisms one step further arguing that tax expenditure analysis creates 'an illusion of value-free scientific precisions in a heavily politicized domain'.[68] Again, it is the political nature that is highlighted but not embraced.

63 Bittker, 'Accounting for Federal Tax Subsidies in the National Budget' (1969).
64 Bittker, 'Accounting for Federal Tax Subsidies in the National Budget' (1969), 247.
65 Bittker, 'Accounting for Federal Tax Subsidies in the National Budget' (1969), 260.
66 Weisbach and Nussim, 'The Integration of Tax and Spending Programs' (2004), 974.
67 Kahn and Lehman, 'Tax Expenditure Budgets: A Critical View' (1992), 1662.
68 Kahn and Lehman, 'Tax Expenditure Budgets: A Critical View' (1992), 1663.

Whilst some authors aimed criticism at Surrey's model, others accepted that tax expenditure analysis was a worthwhile task and a useful tool but disputed the methodology involved in identifying provisions of the tax regime as tax expenditures. To this end, several alternative proposals have been suggested, although none has gained broad favour either from academics or tax authorities alike.[69]

McIntyre, in his 1980 paper entitled 'A Solution to the Problem of Defining a Tax Expenditure',[70] proposed an entirely new methodology for identifying tax expenditures. McIntyre relies on a linguistic approach to ascertaining which provisions of the tax regime are considered tax expenditures and postulates that the definition of a tax expenditure may be different for different purposes. His solution to what he sees as the definitional issues is to 'apply tax expenditure analysis to any tax provision defended on non-tax grounds'.[71] That is, the determination of whether a tax provision is in fact a tax expenditure requires a consideration of the policy goals of the provision. As McIntyre states, 'assertion that the tax rule under examination promotes a spending goal triggers a tax expenditure analysis'.[72] In particular, he argues that his model is superior to the required normative baseline of Surrey's model as it bypasses the problem of obtaining consensus on the features of the normal tax structure.[73] This argument is based on the premise that the 'complex theoretical problem of developing a general, all-purpose definition of a tax expenditure' is avoided because the identification of tax expenditures is only for a limited purpose.[74]

McIntyre's suggested linguistics approach was followed in 1988 by Thuronyi's 'substitutable tax provisions' methodology. Thuronyi was also of the view that Surrey's normative income tax base, due to the significant departures for economic income to accommodate political and administrative concerns, was 'so inherently subjective that it deprives the tax expenditure concept of its persuasive force'.[75] His suggested alternative was one which considered whether the tax provision was a tax law provision 'whose purposes a non-tax-based federal program can achieve at

[69] Apart from the short-lived adoption of an alternative baseline by the United States Joint Committee of Taxation in 2008, which is discussed in this section.
[70] McIntyre, 'A Solution to the Problem of Defining a Tax Expenditure' (1980–81).
[71] McIntyre, 'A Solution to the Problem of Defining a Tax Expenditure' (1980–81), 101.
[72] McIntyre, 'A Solution to the Problem of Defining a Tax Expenditure' (1980–81), 100.
[73] McIntyre, 'A Solution to the Problem of Defining a Tax Expenditure' (1980–81), 82.
[74] McIntyre, 'A Solution to the Problem of Defining a Tax Expenditure' (1980–81), 82.
[75] Thuronyi, 'Tax Expenditures: A Reassessment' (1988), 1155.

least as effectively'.[76] Maintaining that there is no single definition of tax expenditures that can serve all purposes, Thuronyi argued that it is 'best not to attempt to draw a bright line between tax and spending programs' when considering provisions which may not be tax-based subsidies but rather serve other purposes.[77]

In the early 1990s, criticism of the tax expenditure concept came from Kahn and Lehman. Their criticism was not specifically aimed at Surrey's work, but rather at the United States tax expenditure budget resulting from the initial proposals by Surrey. Specifically, Kahn and Lehman's criticism of the tax expenditure budget is its claim of distinguishing what is 'normal' with what is 'deviant'.[78] Their argument is in line with the caution which must be given in relation to the stigma that can attach to a provision labelled a tax expenditure. In the context of the language, Kahn and Lehman hold the view that:

> it suggests that provisions that fit within the implicit baseline of the tax expenditure budget are somehow pure, safe and good. They should not be changed because 'neutral' principles have blessed them. Conversely, the language suggests that provisions that fall outside the implicit baseline of the tax expenditure budget (tax expenditures) are somehow corrupt, dangerous and evil. They should be changed as soon as possible to conform with the 'neutral' position.[79]

The language, they argue, suggests that to flirt with tax expenditures calls one's probity into question.[80] Kahn and Lehman go further than simply criticising the development of this stigma and believe that the provisions of the tax regime should not be immune from political discussion[81] and tax expenditures analysis should not be obviated by 'one particularized vision of the "normal" or "ideal" tax base'.[82] Again, we see the recognition of the highly political nature of tax expenditure management entering the debate.

Much more recently, we have continued to see an attempt to shift away from a defined normative base towards an approach that continues to argue for the adoption of a fiscal language or descriptive method of identifying tax expenditures. Shaviro, in 2004, asked the question in relation

76 Thuronyi, 'Tax Expenditures: A Reassessment' (1988), 1156.
77 Thuronyi, 'Tax Expenditures: A Reassessment' (1988), 1206.
78 Kahn and Lehman, 'Tax Expenditure Budgets: A Critical View' (1992), 1662.
79 Kahn and Lehman, 'Tax Expenditure Budgets: A Critical View' (1992), 1662–3.
80 Kahn and Lehman, 'Tax Expenditure Budgets: A Critical View' (1992), 1662–1163.
81 Kahn and Lehman, 'Tax Expenditure Budgets: A Critical View' (1992), 1663.
82 Kahn and Lehman, 'Tax Expenditure Budgets: A Critical View' (1992), 1665.

to Surrey's work that 'even if one accepts his normative goals, one may rightly ask to what extent a mere fiscal language innovation either can or should categorically shape political outcomes'.[83] He went on to state that 'perhaps more disappointing, therefore, is the repetitive and misdirected conversation that the concept has generated in the tax policy community, too narrowly focused on the defensibility of using a canonical "reference tax base" in identifying tax expenditures'.[84] Shaviro argues that rather than classifying tax expenditures in terms of 'spending' programmes, a more sound base from which to classify tax expenditures is according to the Richard Musgrave classification of any tax system into allocative and distributional branches. That is, tax expenditures should be considered as rules which are part of the allocative branch of the tax system. In stating this, however, Shaviro believes that:

> the allocative or distributional character of a given rule is a matter both of degree and, in some cases more than others, reasonably contested opinion. Tax expenditure analysis ought to be more flexible and varied in its groupings than it is in the Surrey tradition, where each rule is canonically classified as tax expenditure or not relative to a specified reference tax base that itself reflects both contestable distributional judgments and a set of administrative compromises.[85]

Shaviro, the most prominent of recent authors to contend that tax expenditure analysis has gone 'off the rails', argues that 'where tax expenditure analysis went off the rails … was not in its aim of identifying 'special provisions … but in its means of doing so, through the identification of a supposedly canonical, yet in practice under-theorized … definition of the "normative income tax base" '.[86] He goes on to suggest that the 'prevailing fiscal language is too manipulable in some respects and too rigid in others'.[87] Like the earlier criticisms, Shaviro's attack is on the use of the normative tax base to identify tax expenditures. His specific criticism goes to the claim that the normative tax base is objective despite its fundamentally subjective nature. He provides that this 'connotation is so pervasive that fiscal language has a dual character. It is

83 Shaviro, 'Rethinking Tax Expenditures and Fiscal Language' (2004), 188. Shaviro, at p. 187, likens tax expenditure analysis to a 'hardy plant with shallow roots that spreads widely, resisting the occasional effort to extirpate it, while having little if any effect on the soils in which it sprouts'.

84 Shaviro, 'Rethinking Tax Expenditures and Fiscal Language' (2004), 188.

85 Shaviro, 'Rethinking Tax Expenditures and Fiscal Language' (2004), 188.

86 Shaviro, 'Rethinking Tax Expenditures and Fiscal Language' (2004), 199.

87 Shaviro, 'Rethinking Tax Expenditures and Fiscal Language' (2004), 192.

both a purportedly objective descriptive tool and a weapon of political combat.'[88] It is not so much the process of identification that Shaviro sees as subjective, but rather its subsequent use once provisions are identified as tax expenditure. He then sees the process as potentially being meaningless. Shaviro states:

> its use as a political weapon, however, is parasitic on its claim to offer objective description. For example, if calling a proposed rule a tax is recognized as merely a matter of convention, rather than reflecting something significant about a rule's substance, then any inference we are being invited to draw from the label, such as that it is an example of 'big government', is unlikely to persuade.[89]

Shaviro's criticism should not lead the reader to believe that he argues that tax expenditure analysis has no merit. Rather, he argues that there is merit in such a process but it is the current classification which falters as 'classifications must seem meaningful in order to associate broader inferences with them'.[90] His contention with the current state of tax expenditure analysis is that the characteristics which underlie the fiscal language categories, that is the normative tax base, are often purely formal, rather than meaningful.[91] Whilst criticising the current methods associated with tax expenditure analysis, Shaviro claims its value as an exercise lies in its ability to address the 'confusion in public policy debate that may occur when proponents of placing particular allocative rules in the tax system exploit the common tendency to define "taxes" and "spending" entirely formally, and yet to treat the categories as genuinely meaningful'.[92]

Shaviro suggests that a meaningful baseline would exist where the alternative method of identifying tax expenditures using the fiscal language of allocative and distributional rules is adopted. He argues that political warfare over that language would still exist, and baselines would look normative; however, a meaningful baseline would be apparent.[93] No doubt, again, as Shaviro suggests, this would be a conceptually complicated process and as such accepts that the use of the current 'cruder and more formal' means of identifying tax expenditures is unsurprising. Even if Shaviro's alternative measure is not accepted, he believes that 'more

88 Shaviro, 'Rethinking Tax Expenditures and Fiscal Language' (2004), 190.
89 Shaviro, 'Rethinking Tax Expenditures and Fiscal Language' (2004), 190.
90 Shaviro, 'Rethinking Tax Expenditures and Fiscal Language' (2004), 191.
91 Shaviro, 'Rethinking Tax Expenditures and Fiscal Language' (2004), 191.
92 Shaviro, 'Rethinking Tax Expenditures and Fiscal Language' (2004), 189.
93 Shaviro, 'Rethinking Tax Expenditures and Fiscal Language' (2004), 192.

ought to be done in developing the substantive measures … although the ones used now could be improved as well as used more thoughtfully".[94]

In 2004, the same year that Shaviro suggested his new method of identifying tax expenditures, Weisbach and Nussim proposed a new theory of tax expenditure analysis by arguing that the tax expenditure decision is purely one of institutional design. In doing so, they rejected the leading two theories underlying tax expenditure analysis (the comprehensive tax base and functional equivalence), arguing that the focus should not be on taxation policy but rather should focus on how the government chooses to compartmentalise its functions.[95] Weisbach and Nussim base their argument on the premise that, assuming the underlying policy remains the same, there are no effects to putting a programme in or out of the tax regime. As such, their focus is on the broader question of government policy as contrasted with the more traditional approach of focusing on the effects on the tax system in isolation. The real issue, they argue, is one of how government spending should be organised.[96] Central to Weisbach and Nussim's thesis is the underlying question of how to determine the best way to implement a government programme. However, we would argue that they do not address the preliminary question of whether the programme should be implemented in the first place. What Weisbach and Nussim suggest is that 'the attempt to identify tax expenditures should be abandoned, and that all tax provisions should be compared with equivalent expenditure programs in order to decide how best to achieve their aims'.[97] Their view is that there is no such thing as a normative tax base.[98]

Weisbach and Nussim refer to the 1969 work of Bittker to support their argument that the broader organisation of a bureaucracy should not depend on a definition of income. Rather, if the question is one of how to implement a government programme they see the definition of income as entirely irrelevant. However, having expressed the view that the underlying definitional issues of the tax base are flawed, Weisbach and Nussim recognise Surrey's valuable contribution and focus on what they describe as the substantive argument surrounding tax expenditures being that of integration.[99] Yet, despite their acknowledgement of Surrey's contribution, they argue that the direct comparison approach of Surrey is

94 Shaviro, 'Rethinking Tax Expenditures and Fiscal Language' (2004), 192.
95 Weisbach and Nussim, 'The Integration of Tax and Spending Programs' (2004), 958.
96 Weisbach and Nussim, 'The Integration of Tax and Spending Programs' (2004), 960.
97 Heady, 'Tax Expenditures: Definitional and Policy Issues' (2011), 2:3.
98 Weisbach and Nussim, 'The Integration of Tax and Spending Programs' (2004), 976.
99 Weisbach and Nussim, 'The Integration of Tax and Spending Programs' (2004), 977.

fundamentally flawed on the basis that what Surrey did was not comparing identical tax expenditures and direct expenditures but rather comparing different programmes. Their reasoning is that tax expenditures and direct expenditures, implemented by different institutions with different policies, will have different features and as such cannot be treated as identical for comparative purposes.[100]

The alternative to a direct comparative analysis, as suggested by Weisbach and Nussim, is to set broad policy objectives and then decide which institutional setting provides the best results.[101] Essentially, their thesis differs from Surrey's design of tax expenditure analysis by arguing that it is not the expenditure itself which is to be compared, but rather the programmes which are best designed for the relevant institutional settings.[102] They state:

> When comparing methods of implementing policy, we should not compare identical programs, but instead should compare how a policy is likely to be implemented in any given institutional structure. The contribution of this framework is significant, but the arguments of the tax expenditures literature are unconvincing precisely because they fail to take full advantage of the framework. Tax expenditure theory fails to account for the inherent benefits of integration, and instead focuses on a tax-centric consideration of complexity. In so doing, tax expenditure theorists blind themselves to the differences that matter most between tax and direct expenditures: the simplification that the tax system provides on the one hand, and the tailoring and accuracy that direct spending programs provide on the other.

The criticisms levelled at tax expenditure analysis generally, and the normative tax base specifically, by prominent authors such as those discussed above has recently been the subject of analysis by Fleming and Peroni, leading advocates for the reinvigoration of tax expenditure analysis.[103] In particular, Fleming and Peroni are critics of the methodologies proposed by McIntyre, as well as Weisbach and Nussim. Fleming and Peroni's latest work on tax expenditure analysis can be placed in the context of the recent rejection of the use of the Schanz–Haig–Simons definition of the income base by the Staff of the Joint Committee on Taxation of the United States Congress. In 2008, the Joint Committee abandoned the use of the

[100] Weisbach and Nussim, 'The Integration of Tax and Spending Programs' (2004), 979.
[101] Weisbach and Nussim, 'The Integration of Tax and Spending Programs' (2004), 980.
[102] Weisbach and Nussim, 'The Integration of Tax and Spending Programs' (2004), 981.
[103] See Fleming and Peroni, 'Reinvigorating Tax Expenditure Analysis and its International Dimension' (2008).

traditional income base and devised a system which provided for two main categories of what it had previously considered tax expenditures: 'tax subsidies' and 'tax-induced structural distortions'. It was argued that this revised approach removed both the necessity to rely on a normative tax base and the implicit criticism of the present law as to what was 'normal'. This approach received support from some prominent academics such as Kleinbard who argued that the redefining of tax expenditures by the Joint Committee on Taxation in a more objective fashion 'satisfied a critical precondition to bringing tax expenditures more effectively within budget framework legislation'.[104]

The first category of tax expenditures, known as tax subsidies, was somewhat based on the work done by Seymour Fiekowsky in 1980 where he argued that the Schanz–Haig–Simons baseline should be abandoned. The Joint Committee on Taxation defined a ' "tax subsidy" as a specific tax provision that is deliberately inconsistent with an identifiable general rule of the present tax law (not a hypothetical "normal" tax), and that collects less revenue than does the general rule'.[105] The second category of tax expenditures, known as tax-induced structural distortions, were supposedly introduced to compensate for the inappropriately narrow definition of tax expenditures and were defined as 'elements of the Internal Revenue Code (not deviations from any clearly identifiable general tax rule and thus not Tax Subsidies) that materially affect economic decisions in a manner that imposes substantial economic efficiency costs'.[106]

The replacement by the Joint Committee on Taxation of the Schanz–Haig–Simons baseline in 2008 was followed by, as Fleming and Peroni describe, the 'denouement of the "new paradigm" '[107] and a reversal of the decision to abandon the normative approach. In their 2010 paper, Fleming and Peroni correctly point out that 'this event is a manifestation of the practical and theoretical difficulties involved in the critically important, longstanding TEA baseline controversy and it merits close analysis to see what light it sheds on the correct resolution of that controversy'.[108] Interestingly though, is that after more than 40 years of controversy it is the Surrey model of relying on a normative baseline as a definition of tax

[104] Kleinbard, *Tax Expenditure Framework Legislation* (2010), 3.
[105] United States of America, *A Reconsideration of Tax Expenditure Analysis* (2008), 9.
[106] United States of America, *A Reconsideration of Tax Expenditure Analysis* (2008), 10.
[107] Fleming and Peroni, 'Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base?: A Critique of the "New Paradigm" and its Denouement' (2010), 180.
[108] Fleming and Peroni, 'Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base?: A Critique of the "New Paradigm" and its Denouement' (2010), 147.

expenditures that the Joint Committee on Taxation returned to despite those decades of controversy. Fleming and Peroni, whilst applauding the return by the Joint Committee on Taxation to the Schanz–Haig–Simons baseline, view the proper baseline as one which includes not only the concept of Schanz–Haig–Simons, but is also grounded in the principles of ability to pay and neutrality.[109] We agree.

The consequence of the debate that has continued for over 40 years is that, while criticisms of the benchmark as defined by Surrey abound, a more appropriate model has not been devised. There is no doubting that Surrey's model is one which can be labelled 'elitist'; however, when the political philosophy of a jurisdiction is taken into account, it can also be modified to a baseline which takes account of a nation's own policies.

2.5.3 *Identifying the benchmark*

It is clearly established that the definition of tax expenditures is controversial and that controversy is unlikely to be resolved. Despite this, we propose that history has demonstrated that tax expenditure reporting and analysis requires a benchmark or normative tax system so that tax expenditures are defined as deviations from that base however defined. In addition to defining the theoretical benchmark, identifying tax expenditures also requires a consideration of the attributes specific to a particular jurisdiction which are considered to be part of the base itself, or what are generally regarded as structural elements of the benchmark. This is often simply a matter for domestic jurisdictions and generally not controversial on the international stage. Below, we discuss the more pragmatic elements to the identification of the normative tax base, with the incorporated structural elements.

As part of the process of tax expenditure management, where the benchmark, so defined, uses the Schanz–Haig–Simons model of income it will generally correspond to a position representing the standard tax treatment that applies to similar taxpayers or similar types of activities. In pragmatic terms, jurisdictions will consider the benchmark as representing this standard treatment, such as the comprehensive tax benchmark, with structural elements then incorporated to take into account the difficulties in simply adopting the standard treatment as the benchmark. The structural elements take into account integral design features

[109] Fleming and Peroni, 'Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base?: A Critique of the "New Paradigm" and its Denouement' (2010), 164.

of individual tax regimes and may vary significantly across both time and jurisdictions. Consequently, it is only possible to consider the questions which a jurisdiction, in its consideration of what constitutes the benchmark for its own purposes, may ask in order to ascertain those structural elements. Each nation must answer these questions in view of the influences of its own political philosophy. Despite the criticisms levelled at Surrey and McDaniel, in 1985 they clearly recognised that the Schanz–Haig–Simons definition of income was only the starting point for defining the benchmark and suggested that the identification of the normative tax structure could be ascertained by determining whether a tax provision is responsive to one of a series of questions.[110] Whilst the Surrey and McDaniel list may arguably be too narrow to take into account all of the factors needed to ascertain a jurisdiction's benchmark, it does provide a sound platform from which to commence as this allows many of the various unique elements of any tax regime to be taken into account. The outcome being that if a particular provision was not responsive, it was not part of the tax base. Their suggested questions are:

(1) Is the provision necessary to determine the base of the tax, normatively defined, in accordance with the fundamental nature of the tax?
(2) Is the provision part of the generally applicable rate structure?
(3) Is the provision necessary to define the taxable units liable for the tax?
(4) Is the provision necessary to assure that the tax is determined within the time period selected for imposition of the tax?
(5) Is the provision necessary to implement the tax in international transactions?
(6) Is the provision necessary to administer tax?[111]

A consideration of these questions reveals that such elements as the selection of the tax base, the taxpayer/entity to which the tax base applies, the time for the imposition of the tax liability, jurisdictional rules defining a jurisdiction's claim to tax, the tax rate structure along with any minimum tax free threshold, and tax administration costs are all structural elements of the benchmark.

[110] McDaniel and Surrey, *International Aspects of Tax Expenditures: A Comparative Study* (1985), 9.
[111] McDaniel and Surrey, *International Aspects of Tax Expenditures: A Comparative Study* (1985), 9.

The first step in identifying the benchmark is generally to determine the tax base, that is, the activities or transactions subject to the tax. Countries are likely to have many other taxes besides an income tax and it is necessary to determine what is considered a tax for tax expenditure management purposes as well as determining the base of those taxes. Different taxes will have different tax bases. The discussion above focused on the benchmark for income tax which will generally describe the benchmark for taxes on such categories as personal income, business income, capital gains, retirement savings and fringe benefits. On the other hand, a consumption tax benchmark will not rely on the Schanz–Haig–Simons model but rather will likely consider the standard tax arrangements in a particular jurisdiction for any direct or indirect consumption tax on goods and services, whether that be an *ad valorem* (value) or volumetric (quantity) approach. Some jurisdictions may also have an externalities taxation benchmark to take into account the normal taxation arrangements on the external costs of particular activities such as taxes on carbon emissions. From a tax expenditure management perspective, the identification of the tax base and how a country defines that base plays a significant role in what is considered part of the tax expenditure reporting process.

Once the tax base is determined, it is necessary to select the entity, or tax unit, which is liable to pay the tax. The personal income tax system may have as its benchmark unit the individual, joint or family unit. Different jurisdictions adopt a different unit of taxation for personal income with a majority of nations offering some form of joint taxation resulting in income averaging. Whether joint taxation is of itself regarded as a tax expenditure is open to debate. It may be argued that the benchmark should be the individual tax position with joint taxation, which provides for preferential treatment, a deviation from that benchmark.[112] Others may argue that joint taxation merely captures ability to pay.[113] The benchmark unit for corporations can either be a single company or the head entity of a consolidated group. Again, similar arguments may be proffered as to whether the ability to be assessed as a consolidated group, like a joint return, is a deviation from the benchmark or simply founded on 'ability to pay' principles. The interaction of the personal income tax system with the corporate income tax system with the differences in tax rates also leads to questions regarding the benchmark. Countries, such as Australia, which operate a dividend imputation system are likely to regard

112 Heady, 'Tax Expenditures: Definitional and Policy Issues' (2011), 2:5.
113 Heady, 'Tax Expenditures: Definitional and Policy Issues' (2011), 2:5.

corporate tax as equating to a withholding tax with ultimate liability falling to the individual. As such, a lower corporate tax rate is simply part of the benchmark. Alternatively, a jurisdiction which adopts the classical approach of taxing corporations may regard a lower corporate tax rate as providing preferential treatment to a particular category of taxpayers and therefore the lower rate as a tax expenditure.[114]

The tax period, or time frame for tax liability, must also be established as part of the integral design feature of the benchmark. The tax year is considered a structural element of the benchmark, along with the consequences of needing a tax period such as the timing of the recognition of income and deductions. Generally, an assessment will be applied to nominal rather than real income because expenses are deductible at historical cost, and where benefits are realised across more than one tax period they will potentially be pro-rated. Further, income may be recognised either on a cash or accruals basis depending on the taxpayer. Other structural provisions, which are likely to be considered integral design features, are depreciation deductions spread over the life of an asset, and exemptions for some personal gains. Again, each of these integral design features will vary across individual nations.

The design features discussed above are focused purely on domestic taxation principles. In addition, there are jurisdictional rules and international tax arrangements that may also be considered part of the benchmark design. In particular, provisions which prevent double taxation such as the exemption or credit rules contained in domestic legislation, as well as any treaty obligations under international tax agreements, will generally be considered structural elements of a benchmark. International tax arrangements which are potentially incorporated into the benchmark include controlled foreign company rules, transfer pricing rules and thin capitalisation rules, along with variances in interest, dividend and royalty withholding rates and any other variations from domestic legislation due to treaty obligations. Finally, the tax rate, or rate of tax which applies to the base, will be part of the benchmark. It is generally accepted that a progressive rate regime, acknowledged as an integral and long-standing feature of tax regimes around the world, will be part of the income tax benchmark.

This discussion has focused on an income tax baseline, and generally, debate has centred on this particular benchmark. However, it would be remiss to fail to briefly mention alternative baselines which have been

[114] Heady, 'Tax Expenditures: Definitional and Policy Issues' (2011), 2:5.

proposed. The most common alternative is the consumption tax baseline with its advantage cited as being the removal of any bias between saving and current consumption.[115] Unlike the Schanz–Haig–Simons definition of income as the baseline, the consumption tax baseline would exempt savings and investments.[116] Such a baseline would reduce the number of identified tax expenditures for the simple reason that provisions that resulted in reductions in the taxation of savings or investments would no longer be considered tax expenditures.

2.6 The measurement of tax expenditures

The reporting of tax expenditures traditionally involves not only the listing of those provisions considered deviations from the benchmark but also their fiscal measurement. By briefly retracing our steps, it becomes apparent that the significance of this measurement is dependent on the purpose for which a nation categorises provisions of its tax regime as tax expenditures. That is, whether a nation is reporting tax expenditures for the purposes of promoting efficiency within the tax regime and budgetary processes or for the purposes of promoting political engagement and tax reform. The identification of tax expenditures rather than their measurement has received the most criticism within the USA. The reason for this is simple. The original purpose of tax expenditure analysis in the United States was tax reform. And, tax reform depends on tax expenditures being identified rather than quantified. That is, the identification may lead to the conclusion that certain tax expenditures are inequitable and unjustifiable because of the distortion in their distributional effects (the upside-down effect) and, therefore, it is not necessary to get to the point where their fiscal value is relevant for the purpose of analysing them as spending programmes. This can be contrasted with the German approach to tax expenditures where they are viewed as a legitimate means of implementing the government's economic and social policy.[117] Consequently, in Germany definitional issues have received much less attention and the fiscal value

115 See Fleming and Peroni, 'Reinvigorating Tax Expenditure Analysis and its International Dimension' (2008), from p. 508, for a discussion on consumption tax as the norm along with a review of the literature supporting this baseline.

116 For a discussion on the implications of evaluating tax expenditures under a consumption tax baseline, along with the conceptual differences, see Carroll et al., 'Income Versus Consumption Tax Baselines for Tax Expenditures' (2011).

117 Shannon, 'The Tax Expenditure Concept in the United States and Germany: A Comparison' (1986), 204.

becomes paramount to allow for an overview of the cost of this indirect government spending.

We argue that whether tax expenditure analysis is undertaken for the purpose of tax reform or as part of the budgetary process, once a provision of the tax regime is identified as a tax expenditure, it is generally accepted that a calculation of the fiscal cost of that expenditure is required to determine whether it is justified. In practice, for the purposes of reporting tax expenditures, it is necessary to determine a basis for measuring the fiscal cost of each expenditure. Whilst not all tax expenditures can be measured in fiscal terms, where it is possible to do so, jurisdictions tend to attempt such an exercise. Although, as indicated above, we argue that measurement only becomes significant when tax expenditure analysis is used for budgetary purposes. When used for tax reform purposes, mere identification is the crucial issue. The measurement of tax expenditures, like other elements of tax expenditure analysis and reporting, has also faced its share of critics. This criticism is directed to both the usefulness of the measurement of tax expenditures in fiscal terms and, where it is accepted that there may be some usefulness, the methodology for determining the measurement.

At the most fundamental level, there are those who argue that the measurement of tax expenditures is not a worthwhile exercise with detractors believing fiscal measurement is not a useful analytical tool. For example, critics of the definition of tax expenditures and its reliance on a normative base, Weisbach and Nussim, also believe that the traditional tax expenditures rationale, with what they describe as the 'only one correct (and strongly evaluative) method' of presenting the information should be replaced with a 'variety of nonevaluative ways under an "information usefulness" rationale', although they do not deny the normative and political components of such an approach.[118] Essentially, the argument becomes one of what information is useful.[119] If, however, it is accepted that there is some analytical value to determining the estimated cost of individual tax expenditures, the difficulty as to methodology arises.

Measurement of individual tax expenditures is often difficult because, whilst there is a theoretical justification for arguing that tax expenditures are the equivalent of direct expenditures, the fiscal costs cannot be directly transposed. The reason being is that stakeholders will modify their behaviour to not only take into account the individual tax expenditure

[118] Weisbach and Nussim, 'The Integration of Tax and Spending Programs' (2004), 976–977.
[119] Weisbach and Nussim, 'The Integration of Tax and Spending Programs' (2004), 976.

but also other related factors. For example, if we assume that a government decides to abolish all tax expenditures for retirement saving by individual taxpayers those taxpayers have several choices to make in relation to the savings which have previously been concessionally taxed. Taxpayers may choose instead to put some of their savings into another concessionally taxed or exempt savings vehicle, such as tax deferred savings or, possibly, put more money into buying a family home, which is frequently exempt from tax. As a result, the savings in tax revenue would be lower than expected which is a major flaw in the quantitative aspect of tax expenditure analysis. In fact, Fleming and Peroni, supporters of the traditional benchmark, believe that the quantitative aspect of tax expenditure analysis is the weakest part of the reporting process due to its static nature.[120] Where tax expenditures are considered the equivalent of direct expenditures, the implication of any quantitative analysis of the cost is that by repealing the tax expenditure a revenue gain of the equivalent amount will occur. However, as indicated, this is an overly simplistic interpretation of any measurements as it fails to take into account second order effects. Fleming and Peroni, pointing out that it is not an accurate measure of the gains to be made from repealing a provision and, as such, is not an accurate measure of the cost of the tax expenditure, note that the fiscal estimate is far from precise,[121] a point that few would dispute.

Where tax expenditure analysis is used as a tool for tax reform the fiscal accuracy of a measured tax expenditure is warranted but may not ultimately be significant in determining whether a provision is justified and equitable. Further, the characteristics of some tax expenditures arguably immediately deem them unacceptable. A case in point is a deduction classified as a tax expenditure and available to all individual taxpayers who are subject to progressive tax rates, as it is inherently biased towards high income earners compared to low income earners. For example, a taxpayer with a marginal tax rate of 20 per cent and a deduction of $100 receives a benefit of $20, while a taxpayer with a marginal rate of 40 per cent and the same deduction of $100 receives a benefit of $40. Further, a taxpayer with income below the tax free threshold will receive no benefit from their $100 deduction. As previously discussed, this is known as the ‘upside-down effect’ or ‘inverted distributional effect’ of many personal

120 Fleming and Peroni, ‘Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base?: A Critique of the “New Paradigm” and its Denouement’ (2010), 178.

121 Fleming and Peroni, ‘Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base?: A Critique of the “New Paradigm” and its Denouement’ (2010), 178.

tax expenditures and no matter what a nation considers to be its good tax policy imperatives, this result will be contrary to the most basic of the principles making up the ability to pay concept.

Where tax expenditure analysis is used as part of the budgetary process, and governments are taking into account the cost of tax expenditures, the accuracy of the fiscal cost of those expenditures becomes much more significant. To this extent, because of the difficulties of measuring the cost of tax expenditures accurately, tax expenditure reports state that they provide estimates rather than precise budget allocations. As a result, they cannot be directly compared with direct budget spending. That is, tax expenditures cannot be 'summed' or added up in the same way as direct expenditures and concerns about tax expenditure estimates are compounded when these estimates are added together to produce a total estimate for government tax expenditures. A total tax expenditure estimate may usefully indicate, very roughly, what proportion of tax expenditures are comprised of government revenues or direct expenditures. However, it must be remembered that this is only a rough estimate and used cautiously in debates about public policy. Users of a tax expenditure report should also be aware that the abolition of a tax expenditure will not necessarily generate additional revenue to the extent implied by the tax expenditure report. This is likely because, as previously indicated, the report might not consider behavioural responses to the abolition of the tax expenditure.

Traditionally there are three methods of calculating the fiscal costs of tax expenditures, whether calculated on a cash or accruals basis: the revenue foregone approach, the revenue gain approach and the outlay equivalence approach. The predominant method of calculating tax expenditures is the 'revenue foregone approach' which calculates the tax which would have been payable without the concession, and assumes that the economic behaviour of the affected taxpayers does not change. However, as identified in numerous reports, there are several alternative approaches which also measure tax expenditures with the 'revenue gain approach' and 'outlay equivalence approach' often offered as those alternative means. The different approaches reflect the different underlying assumptions made about taxpayer behaviour and responses to potential amendment. Pragmatic concerns relate to the measuring of tax expenditures as there is the need for adequate data in tax returns, overall tax revenues and taxpayers. These methods are discussed in Chapter 3 where it is demonstrated that these two further methods, whilst potentially more accurate because of the factoring in of second line effects, require higher quality data.

2.7 Contemporary expansions of the traditional concept of tax expenditures

By now, it should be obvious to the reader that tax expenditures take a number of different forms and target a number of different taxpayers and functions. Traditionally, tax expenditures are considered to fall within one of five categories: allowances, exemptions, rate relief, tax deferral and credits.[122] Each tax expenditure under this traditional categorisation is a departure from the normative tax base which is substitutable for a direct spending measure. The historical development of tax expenditure analysis along this line is understandable given Surrey's object of having tax expenditures identified as the equivalent of direct outlay programmes. His use of both the terminology and the categorisation of provisions of the tax regime as 'tax expenditures' was designed to achieve this. Surrey's genius of the concept of a 'tax expenditure' is that it constitutes a rhetorical device intended to expose the framing effect arising from a reluctance or failure to recognise that not gathering revenue from a particular taxpayer is substantively the same as gathering revenue from the taxpayer and then handing the same sum back to that taxpayer.[123] He also believed that this process would achieve a reduction in the number of tax expenditures as they would fail to survive the same level of scrutiny faced by direct spending programmes. However, Surrey was canny enough to know that this rhetorical device was not enough in itself to produce the tax spending retrenchment that he desired. He knew the art of reformist rhetoric enough to know that the success of his tax expenditure project depended upon it being couched in such rhetorically watertight terms as to be a fait accompli. The fixation upon expressly legislated departures from the normative tax framework contributed to the rhetorical force of his project.

It has already been seen that Surrey's definition of tax expenditures has come under significant critical review, specifically in relation to two of its elements, the normative tax base framed upon the consensus of experts and the direct spending substitutability. However, time has demonstrated that the definition of tax expenditures provided by Surrey, along with most subsequent definitions, has also suffered from a third limiting factor; the exclusion of all but expressly legislated tax measures. As will be

122 OECD, *Tax Expenditures in OECD Countries* (2010), 12.

123 For a discussion of framing effects in the context of tax expenditures, see Zelinsky, 'Do Tax Expenditures Create Framing Effects? Volunteer Firefighters, Property Tax Exemptions, and the Paradox of Tax Expenditure Analysis' (2005).

evidenced by the discussion in Chapter 3, this third limitation, the concentration upon expressly legislated tax expenditures, has been adopted without critical scrutiny in countries that have adopted the United States' 'tax expenditure' concept and also countries adopting the 'tax subsidy' nomenclature first adopted in the Republic of Germany.[124] Yet, it is clear that Surrey's rhetorical efforts have not borne the fruit of tax expenditure retrenchment that he desired. In large part this is because Surrey's concept of a tax expenditure was built upon a false dichotomy – the distinction between policy neutral tax provisions 'that are just tax provisions'[125] and 'special provisions representing Government expenditures made through the income tax system to achieve various social and economic objectives'.[126] The subsequent literature regarding the tax expenditure concept has demonstrated the falsity of this dichotomy by showing that all tax rules embody policy tradeoffs and therefore are policy-laden.[127] Further, the literature suggests that the categorisation of rules into 'tax rules', 'regulation' and 'spending' rules is problematic but nevertheless consistent with constitutional and other institutional frameworks. With the benefit of hindsight, it is not surprising that the 'objective' consensus amongst tax experts regarding the normative framework has not materialised. Further, it is not surprising to find that the substitutability requirement has prompted a burgeoning literature demonstrating the absence of platonic public policy forms such that the taxing/spending dichotomy collapses.[128] As such, we argue that, no matter what a nation's adopted purpose of the tax expenditure concept, this third limitation should be abandoned.

Whether a tax expenditure is defined as a deviation from a defined benchmark, considered to be convertible to a direct expenditure, or a provision of the tax legislation which has as its objective the pursuit of social or economic policy, each of the definitions seeks to posit tax expenditures as a deliberate intent by the state. As explained, this is understandable given tax expenditure analysis has been historically designed to result in

124 This may be specifically stated as demonstrated by the definitions previously extracted in this book. Alternatively, work dealing with the tax expenditure concept implicitly may accept that tax expenditures can only arise by express legislative rule. For example, see Zelinsky, 'James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions' (1993); Laity, 'The Corporation as Administrative Agency: Tax Expenditures and Institutional Design' (2008).

125 Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (1973), 15.

126 Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (1973), 15.

127 Eisenstein, *The Ideologies of Taxation* (1961).

128 Shaviro, 'Rethinking Tax Expenditures and Fiscal Language' (2004).

a pragmatic outcome of either budget control or tax reform. Countries by necessity focus on their tax regime and seek to divide the parts of that regime into those provisions which form part of the benchmark and those which are considered deviations. But, the practical consequence is that tax expenditures as defined by both academics and reporting bodies alike tend not to include what may be labelled as implicit or operational tax expenditures. By this, we mean those parts of the broader tax regime which confer on certain taxpayers a 'tax break' which is not otherwise afforded to all taxpayers. Yet, if a 'tax break' is conferred on a group of taxpayers at the exclusion of others, whether or not deliberate, we argue that they should also be considered as part of a broader definition of tax expenditures. In other words, arguably where taxpayers are afforded a tax benefit via a means outside specific legislative intent, those benefits should be regarded as tax expenditures. Implicit or operational tax expenditures fall within the scope of tax expenditures as defined simply because revenue is not collected in circumstances where the benchmark indicates that tax ought to be imposed. Essentially the definition of tax expenditures is then understood to include not only those which are posited but those which are implied, generally through some form of omission, whether administrative or judicial.

There are several significant non-legislative or implicit tax expenditures of note, with the types of tax expenditures that we propose contained within the extended definition falling into two broad categories. These tax expenditures will either be the result of a deliberate administrative or judicial decision, or through an omission to undertake the requisite administrative tasks.[129] Express administrative rulings or behaviour, for example, the exercise of administrative discretion by the revenue collecting authority, such as the discretion to settle a tax dispute, or the granting of dispensation from tax compliance obligations or tax payment obligations, may lead to significant tax expenditures. These are all overt administrative actions that do not necessarily entail the adoption of an administrative rule. By contrast, the interpretation of the law by the same authorities in the granting of an administrative interpretation that departs from the benchmark does entail the adoption of an express legislative rule. It is also possible for an express legislative rule

[129] For a discussion of the consequences of failing to recognise these implicit tax expenditures see Krever, 'Analysing Implicit Tax Expenditures' (2011). Krever argues that tax expenditure analysis will not yield better outcomes until it is extended to recognise implicit tax expenditures as part of the tax expenditure analysis process. See also Krever, 'Taming Complexity in Australian Income Tax' (2003).

to be judicially interpreted in a manner which is inconsistent with the benchmark.

In addition to express administrative and judicial rule or overt action, there is implied legislative tax expenditure. That is, tax expenditures which arise by legislative omission. In other words, the legislature has not enacted a rule that the normative framework indicated ought to be enacted. Thus, for example, there is no difference between a government specifically exempting capital gains from income tax and a government maintaining an income tax that does not include any provision regarding the taxation of capital gains.[130] Assuming that the normative tax system would impose income tax upon capital gains, in both cases a tax expenditure should be reported. A consistent failure to enforce an existing legislative provision or a departure from a stated tax norm without express rule sanctioning that departure would also be implicit tax expenditures. This form of administrative tax expenditure can be contrasted with an express administrative tax expenditure, which arises where the law can potentially be applied in accordance with the normative taxation system but the administrator exercises a discretion not to apply that law. The most obvious example of an administrative tax expenditure arising from administrative failure is the evasion of tax through the cash economy. Estimates of the 'tax gap' are made in some countries, while others believe that the estimates are too uncertain to be credible.

Given the controversy surrounding the tax expenditure concept in its more traditional form, it is easy to suggest that arguing for an expanded definition of tax expenditures is likely to contribute to, and support, the critics' call for a derailment of the concept itself due to the difficulties surrounding the conservative and traditional definition. Supporters of the tax expenditure concept may argue that rigorous tax expenditure analysis is undertaken for Surrey's pragmatic reason of recognising tax expenditures as being the equivalent of direct spending programmes and, as such, the identification should be limited to express expenditures. Similarly, an efficiency argument may be mounted against the suggested expansion on the grounds of increased costs to taxpayers in the form of compliance as well as government authorities (both legislative and administrative) in the form of identification.

130 It may be argued that in countries where there is no or a limited capital gains tax regime, the failure to legislate to capture capital gains is a departure from the normative tax base.

However, arguing for an expanded definition does not detract from the concept, but rather enhances its legitimacy if we explicitly acknowledge that the nature and purpose of tax expenditure management is governed by one's moral and political philosophy. This argument for expansion is no different to arguments surrounding the traditional definition of tax expenditures and the justifications for tax expenditure management remain the same, with arguably greater integrity to the process. In Chapter 5 we argue that the fiscal and moral significance of tax expenditure management means that how a society deals with the irresolvable controversies regarding tax expenditures provides instructive insights into the political constitution of that society more generally. Such insights may then provide sound reasons for expanding the definition. Each community should be given the choice to take into account the tax expenditures which fall within the scope of the expanded definition of tax expenditures to allow for critical scrutiny. Very little express support for the inclusion of implicit tax expenditures can be found. However, recently in the United States we have seen the recognition of implicit tax expenditures at a policy level, with the Center on Budget and Policy calling for the inclusion of both explicit and implicit tax expenditures in state tax expenditure reports.[131] While implicit tax expenditures are defined narrowly in this document to be 'what is left out of the code, by a reference in the code, or by the code's departure from standard or historical practices',[132] it is significant that they are recognised at all.

2.8 Conclusion

A fundamental problem associated with the categorisation of a provision of a tax regime as a tax expenditure is the negative connotations which accompany that classification. Tax expenditure analysis over the years has tended to stigmatise anything labelled as a tax expenditure as a provision worthy of suspicion and ultimately repeal. Weisbach and Nussim succinctly and accurately describe this as the normative consequences of the label[133] and it is unlikely that many would argue such a stigma does not exist. However, this should not be accepted as an absolute and doing so defeats the purpose of tax expenditure analysis as it is then necessarily

131 Leachman et al., *Promoting State Budget Accountability Through Tax Expenditure Reporting* (2011), 14.

132 Leachman et al., *Promoting State Budget Accountability Through Tax Expenditure Reporting* (2011), 14.

133 Weisbach and Nussim, 'The Integration of Tax and Spending Programs' (2004), 976.

assumed that tax expenditures are 'bad'. Ostensibly, many tax expenditures do warrant an investigation as to their worth. However, the purposes of tax expenditure analysis is not to simply label tax expenditures as 'bad' and all other tax provisions as 'good'. Rather, we suggest that this stigma is a result of the fundamental necessity for the categorisation of tax expenditures discussed here as well as a definition of tax expenditures. Such a view is consistent with mainstream tax expenditure analysis and, to this end, Surrey himself stressed that the 'classification of an item as a tax expenditure does not in itself make that item either a desirable or an undesirable provision; nor does it indicate whether the inclusion of the item in the tax system is good or bad fiscal policy'.[134] As such, an open mind must be kept when considering the categorisation of provisions of a tax regime as tax expenditures, as well as the purposes of tax expenditure identification and analysis. In essence, classifying provisions of a tax regime as tax expenditures cannot and should not be viewed statically. McDaniel and Surrey were correct in 1985 when they stated that the 'classification of provisions as tax expenditures or as parts of the normal tax structure is a dynamic and continuing process'.[135] The concept itself does not imply anything except a particular way to think about or analyse a provision which is classified as a tax expenditure. To this end, the tax expenditure concept is exactly that, a 'concept' which allows us to classify and categorise certain provisions of a tax system. As Brooks explains, 'just because there is some dispute about the precise dividing line between tax expenditures and other tax provisions, and some provisions that are sometimes labelled tax expenditures might also arguably be justified in terms of traditional tax criteria, does not mean the concept is incoherent'.[136] Tax expenditures remain a major part of tax systems around the world and continue to grow in number. As such, the initial aim of tax expenditure analysis is a failure. Yet, it is because the number of tax expenditures is continuing to grow that tax expenditure analysis is so important. To this end, we ask the reader also to keep an open mind as to the tax expenditure concept.

134 Surrey and McDaniel, *Tax Expenditures* (1985), 5.

135 McDaniel and Surrey, *International Aspects of Tax Expenditures: A Comparative Study* (1985), 8.

136 Brooks, 'The Under-Appreciated Implications of the Tax Expenditure Concept' (2009), 234.