

EPIC EXPLAINER: Fix the Measurement of Tax Expenditures

Tax Expenditures are Loopholes

Tax expenditures are special tax deductions, credits, and exemptions. The [U.S. Treasury Department](#), the [Joint Committee on Taxation \(JCT\)](#), and the [Congressional Budget Office \(CBO\)](#) report on tax expenditures, measured against a “normal law” tax baseline.

Policymakers should end special carveouts in the tax code and adopt fair, pro-growth policies. However, the baseline for how tax policies are reported must be fixed so that actual loopholes are ended.

Measurement of Tax Expenditures Must be Fixed

The definition of tax expenditures that is codified in the Congressional Budget Act as deviations from “gross income” is flawed and highly misleading. The baseline way that tax policies are described is biased in a direction that favors higher taxes and economically harmful outcomes.

[Sec. 3\(3\) of the Congressional Budget Act](#) defines “tax expenditures” as “those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.”

The “gross income” baseline definition of a theoretically comprehensive income tax base that underlies the tax expenditure analysis by the Treasury, the JCT, and the CBO is based on the work of professors from the 1920’s and ‘30’s, Robert Haig and Henry Simons. The academics believed in using taxation to [redistribute income](#), and their definitions advanced the cause. The standard imbues biases into the tax code, pushing it away from neutrality.

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Norman Ture, Undersecretary of the Treasury in the Reagan administration, [said](#) that “almost everything bad in the Tax Code is there because of Haig-Simons.”

The Haig-Simons conception of what the “normal” reference tax base should be is economically harmful. It assumes that double taxation of savings and investment is “normal.” This means that “reduced” rates on capital gains and dividends, the exclusion of capital gains taxation of principal residences, and individual retirement accounts are all considered tax expenditures. Expensing of business investments, which simply removes the tax bias against savings, is also listed as a tax expenditure. The Haig-Simons definition also fails to account for inflation eroding the value of money over time.

Flawed Definition is Used to Justify Wealth Tax

Taken to the extreme, this concept is used to claim that taxing unrealized capital gains would be closing a loophole, as argued by the Biden-Harris Administration. That is because the assumed “normal” base of the income tax is “the sum of consumption and the change in net wealth.”

Consumed Income Should be the Standard

The definition of the baseline from which tax expenditures is measured should instead be “consumed income.” A consumption tax base is neutral, fair, and would maximize economic growth because it is not biased against investment and savings.

