

Article

The Integration of Tax and Spending Programs

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INTRODUCTION

This Article provides a new theory of tax expenditures.¹ Its argument is that the decision to implement a “nontax” program through the “tax system”² has little or nothing to do with tax policy. Instead, the tax expenditure decision, which we will also call the integration decision or the decision to combine tax and spending programs, is solely a matter of institutional design. It is about assigning projects such as tax collection, education, defense, or housing to specific units of government. Different groupings of activities will perform differently, and we should use those groupings that yield the best possible performance. The problem is similar to the problem of splitting up a corporation into divisions.

Suppose, for example, that we are considering whether an education subsidy should be implemented through the tax system or through a direct expenditure. The government might use a tax exclusion, deduction, or credit implemented by the IRS or, alternatively, it might use a direct grant implemented by the Department of Education.³

The two leading theories that purport to address this question of how to allocate government largesse both focus on tax policy. The most widely accepted theory, the comprehensive tax base theory, argues that a broad tax base distorts economic decisionmaking less than a narrow base and is also much simpler to administer.⁴ To ensure that the tax base is as broad as possible, this theory suggests that spending and regulatory programs should not be implemented through the tax system; instead, they should be assigned to other agencies or departments. Integrating a spending program into the tax system, for example through a deduction, exclusion, or credit for some special activity, narrows the tax base and makes the tax system

1. The term “tax expenditures” is subject to much dispute; Part II below discusses the term in some detail. The discussion in this Article does not depend on any particular definition of tax expenditures. Instead, it considers how to divide government activities among units or agencies of the state. This question arguably applies to any potential segmentation of the government. Thus, to the extent that we use the term “tax expenditures” in the text, it is sufficient to define that term as encompassing any spending program that is implemented through the tax system—with the understanding that the extent of activities that the term defines remains in controversy.

2. We use quotation marks because there is no exogenous definition of the tax system. Instead, the tax system is whatever activities end up being optimal to group together due to their tax-like functions. We use the term “tax system” as a relatively compact way of referring to the traditional tax collection function.

3. There are some education subsidies built into the tax system. *See infra* note 14. There are also numerous sources of direct education funding, ranging from items as ubiquitous as public schools to specific grants such as Pell Grants. *See infra* note 13. Many of these tax and direct spending alternatives are close substitutes for one another.

4. The comprehensive tax base literature is vast. Major works include Boris I. Bittker, *A “Comprehensive Tax Base” as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967); R.A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44 (1967); and Joseph A. Pechman, *Comprehensive Income Taxation: A Comment*, 81 HARV. L. REV. 63 (1967). *See also* sources cited *infra* note 28.

more complex. The standard or default response according to a comprehensive tax base theory, therefore, is that government spending programs, such as the education subsidy in our example above, should not be implemented through the tax system.

The other leading theory, the theory of tax expenditures, focuses partially on institutional design, but it, too, is ultimately a theory of taxation.⁵ The key insight of this theory is to recognize the functional equivalence of putting a program in the tax system or somewhere else. While this insight relates to institutional design, the theory ultimately falls back on tax policy for recommendations. For example, the distributional effects of a policy are said to depend on whether it is correctly considered part of the tax base. The tax expenditure theory, just like the comprehensive tax base theory, would conclude that the education subsidy should not be implemented through the tax system.

In contrast to these theories, which focus on taxation, our theory focuses on institutional design—the question of how the government chooses to compartmentalize its functions. It is entirely irrelevant whether some piece of government policy complies with independent tax norms.⁶ If the underlying policy is held constant, there are no effects of putting a program into or taking a program out of the tax system even if doing so hurts or enhances traditional notions of tax policy. Welfare is the same regardless of whether the program is formally part of the tax system or is located somewhere else in the government. If we mistakenly look only at the tax system instead of overall government policy, we will draw the wrong conclusions. Putting a program into the tax system makes the tax system look more complicated, but there is unseen simplification elsewhere. The tax system will seem less efficient, but the efficiency of government policy is unchanged.

The institutional design question is about dividing the government into units that will provide the best possible set of public policies and government services. Different groupings of government services will perform differently. Consider, for example, a proposal to have the IRS run the country's defense system, replacing the Department of Defense. The proposal is not as silly as it sounds. It would not mean that bespectacled revenue agents would be parachuting into the Hindu Kush wearing night goggles, camouflage, and pocket protectors. Instead, an intelligent

5. Major works arguing for the tax expenditure approach include STANLEY S. SURREY, *PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES* (1973); and STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* (1985).

6. Analysis similar to the approach taken here has begun to make its way into the economic literature. See Eric J. Toder, *Tax Cuts or Spending—Does It Make a Difference?*, 53 *NAT'L TAX J.* 361 (2000). There is also some foreshadowing of our themes in the legal literature. See, e.g., Douglas A. Kahn & Jeffrey S. Lehman, *Tax Expenditure Budgets: A Critical Review*, 54 *TAX NOTES* 1661 (1992).

Commissioner of Internal Revenue would allow his employees to specialize. Revenue agents would specialize in reading financial statements and soldiers would specialize in fighting. Policies under such a proposal might very well continue much as they do today. The reason why the proposal is not a good idea is that there are no benefits to coordinating these two functions of tax administration and defense. Moreover, there would be additional costs because at the very top level, where functions must be combined, administrators would be unable to specialize in these relatively distinct functions.

Consider instead a proposal to implement all federal welfare-type programs through the IRS. Proposals of this sort have been made frequently, often under the rubric of a negative income tax.⁷ This may make sense, if there are benefits to putting welfare and tax into the same organizational unit: Both programs rely on income or wealth measurement, both need large-scale information and financial processing, and both have substantive policies, such as the policy of redistribution, that overlap significantly. The two programs thus might benefit significantly from coordination by a single agency.

The key variables from this perspective have nothing to do with tax policy. Instead, they have to do with the benefits of coordination between and specialization within various types of activities performed by the government. The Department of Defense needs highly specialized operatives, and thus benefits little from coordination with the revenue collection function. Welfare programs, on the other hand, may gain much from coordination with tax collection, and there may be low costs to losing the utility of separate units that can specialize in each function. The question is one of tradeoffs between the benefits of specialization on the one hand and the benefits of coordination on the other.

7. See, e.g., MILTON FRIEDMAN, CAPITALISM AND FREEDOM 191-93 (1962); MILTON FRIEDMAN & ROSE FRIEDMAN, FREE TO CHOOSE 91-127 (1980); CHRISTOPHER GREEN, NEGATIVE TAXES AND THE POVERTY PROBLEM 160-76 (1967); Michael R. Asimow & William A. Klein, *The Negative Income Tax: Accounting Problems and a Proposed Solution*, 8 HARV. J. ON LEGIS. 1 (1970); William A. Klein, *The Definition of "Income" Under a Negative Income Tax*, 2 FLA. ST. U. L. REV. 449 (1974); William D. Popkin, *Administration of a Negative Income Tax*, 78 YALE L.J. 388 (1969); James Tobin, *On Improving the Economic Status of the Negro*, 94 DAEDALUS 878 (1965); James Tobin et al., *Is a Negative Income Tax Practical?*, 77 YALE L.J. 1 (1967).

A version of the negative income tax (NIT) called the Family Assistance Plan was proposed by President Nixon, but it failed. See DANIEL P. MOYNIHAN, THE POLITICS OF A GUARANTEED INCOME: THE NIXON ADMINISTRATION AND THE FAMILY ASSISTANCE PLAN (1973). President Carter considered a similar plan, named the Program for Better Jobs and Income. See CONG. BUDGET OFFICE, THE ADMINISTRATION'S WELFARE REFORM PROPOSAL: AN ANALYSIS OF THE PROGRAM FOR BETTER JOBS AND INCOME (1978). For notes on the NIT, see Dennis J. Ventry, Jr., *The Collision of Tax and Welfare Politics: The Political History of the Earned Income Tax Credit, 1969-99*, 53 NAT'L TAX J. 983 (2000).

This intuition strongly contrasts with the usual tax arguments. For example, the Flat Tax is an attempt to provide a comprehensive consumption tax base. All the extraneous, nontax elements of current tax law would be removed.⁸ The Flat Tax is said to be very simple, and it may be if one looks only at the tax system. But limiting the tax system to this one measurement would force other government programs to take up the slack: Programs of all sorts that are now embedded in the tax system will have to be implemented by other government agencies. Viewing the Flat Tax (or any comprehensive tax base) as simple requires ignoring the rest of government, relegating the complexity and mess of government spending and regulation to somebody else's backyard. There is no reason to believe, however, that the tax collection function should necessarily be separated from other functions of government—and there may be good reasons to believe that it should not be. The same is true for virtually all proposed fundamental tax reforms.

This Article expands on these intuitions. Part I frames the question as one of institutional design rather than tax policy. Part II discusses the comprehensive tax base and tax expenditures literatures. We argue that neither literature provides a convincing answer to the question of how government spending programs should be organized. The comprehensive tax base argument is the more prevalent of the two, but it ignores the basic problem of organization: It takes a completely tax-centric view of government and, therefore, leads to faulty conclusions. The tax expenditures literature addresses the problem—at least to some extent—as one of institutional design, but its analysis is neither complete nor convincing.

Part III approaches the problem from an institutional design standpoint. The study of organizations is old and deep, extending into sociology, economics, political science, and even anthropology and psychology. Covering even a small portion of this literature is well beyond the scope of one paper, but the problem can be divided into three more manageable pieces. First, we can view organizations as devices for coordinating specialized functions and, in particular, for separating production processes into tasks or divisions in the most efficient manner possible. Second, we can view organizations as a way to solve agency problems. Third, we can view the design of public organizations as a method of resolving public choice problems. The volume of literature in each of these areas is very large, and the more informal literature generally mixes these areas together. The portions that relate directly to the problem of divisions, however, are reasonably manageable and in some cases quite sparse. In this Article we address only the first of these three questions—the specialized production

8. See ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* 52-82 (2d ed. 1995).

part of the puzzle. We intend to address the agency and public choice elements of organizational theory in subsequent work.

The key intuition on specialization of production is that there are benefits to both specialization in particular activities and coordination between activities. Putting a set of activities into a governmental agency promotes specialization within that set of activities and coordination among the activities. But at the same time, doing so makes it more difficult to coordinate between the activities in that agency and the activities of other agencies. Part III develops this intuition by surveying the literature in the area of organizational structure.

To demonstrate the worth of these intuitions, Part IV works through several examples, evaluating government programs from the standpoint of institutional design. In particular, it examines two federal programs—the food stamp program and the Earned Income Tax Credit (EITC)—and considers whether either should be implemented as part of the tax system. There are good reasons to think both should be: They are both transfer programs based on income, and the IRS may be the agency that is best able to perform this income-based redistribution. Nevertheless, we conclude that the food stamp program may not function as well if it is made part of the tax system, because the tax system cannot respond in a sufficiently timely fashion to the needs served by the food stamp program. The EITC, by contrast, works reasonably well within the tax system. The difference between the two programs is the degree to which their functions complement those performed by the tax system. Part V concludes.

I. FRAMING THE QUESTION

The central question of this Article is how to determine the best way to implement a government program, given that such a program is going to be implemented. As Stanley Surrey noted in his tax expenditures analysis, virtually any program can be implemented in at least two ways.⁹ It can be implemented through a direct spending program¹⁰ or through a tax program. The question is how to make this choice.

For example, suppose that the government wants to provide an education incentive. The incentive might, for example, take the form of a voucher program, providing money for students to use in choosing high

9. See, e.g., SURREY, *supra* note 5, at 1-6, 129-30; SURREY & MCDANIEL, *supra* note 5, at 1-3, 99.

10. The term “direct spending” is a budgetary term of art referring (in the Budget Enforcement Act of 1990) to mandatory spending. See 2 U.S.C. § 900(c)(8) (2000). We do not use it in this technical sense. Instead, we use it in a colloquial sense to mean a program implemented through a government agency incurring outlays rather than one implemented by means of an offset to tax revenue.

schools. Alternatively, the incentive might try to reduce the cost of saving or borrowing money to pay for college, as do the recently enacted college savings plans and income-contingent student loans.¹¹ In either case, the grant might be based on attendance at an appropriate institution, income, citizenship, race, lack of criminal convictions, grades, or a variety of other attributes.¹²

Such a program can be implemented through an expenditure program that distributes money to individuals meeting the criteria. The department implementing the program, say the Department of Education, would have to create an application process, a certification or audit process (both for students and schools), a process for handing out money, and, if appropriate, a process for collecting payments.¹³ Setting up such a program would be complex and would take significant resources. Alternatively, a similar program could be implemented through the tax system by allowing individuals to subtract or add the same amounts to their taxes (or if their taxes are not sufficient, by requiring the Department of the Treasury to

11. A Qualified Tuition Program (QTP or "section 529 plan"), for instance, is a program set up to allow an individual to prepay—or contribute to an account established to pay—a student's qualified higher education expenses at an eligible educational institution. A QTP can be established by the state or by eligible educational institutions. A distribution from a QTP can be excluded from income if the amount distributed is used to pay qualified higher education expenses (earnings of educational institutions' QTPs will be exempt only starting in 2004). *See* I.R.C. § 529. The Department of Education also provides Direct Stafford Loans, which offer several repayment plans. One such plan—the income-contingent repayment plan—bases the monthly payment on annual income, family size, interest rate, and loan amount. As income rises or falls, so do the payments. *See* 20 U.S.C. § 1087e(2), (4)-(5).

12. For example, the nonrefundable Hope Scholarship Credit can be claimed against federal income taxes for the qualified tuition and related expenses of each student in the taxpayer's family (i.e., the taxpayer, his spouse, or any eligible dependent). The student has to be enrolled at least half-time in one of the first two years of postsecondary education in a program leading to a degree, certificate, or other recognized educational credential. An eligible student must also be free of any conviction for a federal or state felony offense consisting of the possession or distribution of a controlled substance. The college, university, vocational school, or other postsecondary educational institution where the student is enrolled must be an institution that is described in section 481 of the Higher Education Act of 1965, 20 U.S.C. § 1088, and therefore be eligible to participate in the student aid programs administered by the Department of Education. The credit amount is phased out with income. Additionally, in general, the credit is not available to nonresident aliens. For the details of these requirements, see I.R.C. § 25A.

The Pell Grant is awarded on the basis of need, which is calculated as a function of the costs of attending school and the family's expected contribution to education expenses. The latter is a measure of family income. An eligible student must have a high school diploma or a General Educational Development (GED) Certificate, must be enrolled or accepted for enrollment as a regular student working toward a degree or certificate in an eligible program, and must continually meet the school's written standard of satisfactory progress. In addition, eligible males have to register with the Selective Service. *See* 20 U.S.C. § 1091.

13. For general information on student aid programs offered by the Department of Education, see U.S. Dep't of Educ., Student Aid on the Web, at <http://studentaid.ed.gov/PORTALSWebApp/students/english/index.jsp> (last visited Oct. 7, 2003). A few examples are Pell Grants, 20 U.S.C. § 1070a, Direct Stafford Loans, *id.* § 1078, and PLUS loans, *id.* § 1078-2. *See also* COLL. BD., TRENDS IN STUDENT AID (2002), <http://www.collegeboard.com/press/cost02/html/CBTrendsAid02.pdf>.

write a check to the individual based on a claim made on his tax form).¹⁴ Similar application, certification, and auditing requirements could be imposed. The additional requirements imposed on the tax system would also be significant, making the tax system much more complex. As a final alternative, the program could be split between the tax system and another agency, with each agency providing services related to its expertise and some coordination between the operations.¹⁵

Similarly, suppose the government wants to provide welfare to a subset of the poor. For example, the government may want to provide welfare to those poor who work a certain amount. Such a welfare program can be implemented through the tax system. The EITC does exactly this: It provides a tax credit for individuals if their labor earnings are within a certain range, subject to a variety of other criteria (for example, different credits are granted to the married, the unmarried, those with and without children, and those with earnings from sources other than labor).¹⁶ A similar program could also be implemented outside the tax system, through a direct grant of aid based on similar criteria.¹⁷

The question is how we should decide which is the better method of implementing these programs in each of their circumstances. The key is to

14. The tax system contains more than a few education subsidies. *See, e.g.*, I.R.C. § 25A(b) (the Hope Scholarship Credit); *id.* § 25A(c) (the nonrefundable Lifetime Learning Credit for postsecondary education); *id.* § 221 (the student loan interest deduction for qualified higher education expenses); *id.* § 222 (a deduction for tuition and fees associated with higher education); *id.* § 529 (the QTP, discussed *supra* note 11); *id.* § 530 (the Coverdell Education Savings Account, formerly the Education IRA, which provides for tax-free withdrawals from saving accounts designated for elementary school, secondary school, and higher education expenses); *see also id.* § 72(t)(2)(E) (an exemption from the ten-percent additional tax for early IRA withdrawals when the withdrawals are made for qualified education expenses); *id.* § 117(b) (the exemption of scholarships and fellowships such as the Pell Grant and Fulbright); *id.* § 117(d) (the qualified tuition reduction, which enables an employer to provide employees with tax-free education benefits); *id.* § 144(b) (the Education Savings Bond Program, which exempts some or all of the interest earned on qualified U.S. saving bonds used for qualified higher education expenses). For an academic description of tax education subsidies, see Albert J. Davis, *Choice Complexity in Tax Benefits for Higher Education*, 55 NAT'L TAX J. 509 (2002).

15. This type of program is not uncommon. The Hope Scholarship Credit, for example, is available only to individuals attending schools meeting the requirements of 20 U.S.C. § 1088, which is administered by the Department of Education. *See* I.R.C. § 25A(f)(2). On the other side, a few of the student financial assistance programs managed by the Department of Education (e.g., Pell Grants, subsidized Stafford Loans, Perkins Loans, and Supplemental Educational Opportunity Grants) use tax filing status to simplify their need criteria. For example, if an independent student or dependent student's parents are not required to file tax returns or are eligible for 1040A or 1040EZ forms, then a simplified formula is applied. *See* 20 U.S.C. § 1087ss. Another example is the income-contingent repayment plan, *see supra* note 11, which uses data on adjusted gross income communicated by the IRS to the Department of Education, *see* 20 U.S.C. § 1087e(e).

16. *See* I.R.C. § 32. For a description and discussion of the EITC, see V. Joseph Hotz & John Karl Scholz, *The Earned Income Tax Credit, in* MEANS-TESTED TRANSFER PROGRAMS IN THE UNITED STATES 141 (Robert A. Moffitt ed., 2003).

17. Major direct spending programs designed mainly around financial status and household structure are the Temporary Assistance for Needy Families (TANF) Program, formerly the Aid to Families with Dependent Children (AFDC) Program, 42 U.S.C. §§ 601-619, the Section 8 Voucher Program, *id.* § 1437f, and the Child Care and Development Fund, *id.* §§ 9858-9858q.

assume that a program of some sort will be implemented, so that it is not an option to say that these are bad ideas and we should do nothing. They may very well be bad ideas, and actual programs implemented by the government may be even worse, but unless one is going to admit no role for the government other than the most minimal functions, these sorts of programs and problems will arise. The government will, sometimes for the better and sometimes for the worse, subsidize, penalize, or regulate various activities, and we must decide how this should be done.¹⁸

We need not belabor the importance of the question. As Surrey—and others before and after—have established, there are a vast number of programs implemented through the tax system.¹⁹ Both the executive and Congress make annual estimates of the size of these expenditures, and the amounts are large. For example, the Bush Administration's 2004 budget estimates that in 2003, the exclusion of employer-provided contributions for medical insurance reduced tax revenues by \$108.5 billion, and the deduction for mortgage interest on owner-occupied homes cost \$65.5 billion.²⁰ The same budget lists fourteen different education programs in the tax code.²¹ The EITC is one of the largest welfare programs, having grown faster than any other program over most of the last decade.²² Whether programs such as these should be implemented through the tax system is thus an important question, and one that has commanded significant scholarly attention.

There are four important limitations to our framing of the question. First, we generally will discuss only comparisons between direct grants and tax subsidies, although a similar analysis could be applied to regulatory programs. Regulatory programs can be implemented through tax or expenditure programs: For example, although we could directly regulate executive salaries, we instead impose tax penalties for executive salaries that do not conform to certain requirements.²³ Similarly, tax and expenditure programs can be implemented through regulation: The minimum wage, for example, can be viewed as a combination of a tax

18. Many tax expenditures are bad policy, and those arguing against expenditures of this sort likely are assuming that eliminating them from the tax system means eliminating them altogether. As one example, Surrey has traced the origin of a few major exemptions and deductions in the tax code, showing that they "have arisen almost fortuitously." See Stanley S. Surrey, *The Federal Income Tax Base for Individuals*, 58 COLUM. L. REV. 815, 828 (1958). This may often be true, but these arguments should then be framed as arguments against the underlying policy rather than as arguments against implementation of the policy through the tax system.

19. See, e.g., sources cited *infra* notes 28, 42.

20. OFFICE OF MGMT. & BUDGET, ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2004, at 103 tbl.6-1 (2003).

21. *Id.* at 104 tbl.6-2.

22. See ROBERT MOFFITT, ECONOMIC EFFECTS OF MEANS-TESTED TRANSFERS IN THE U.S. 4 (Nat'l Bureau of Econ. Research, Working Paper No. 8730, 2002), <http://papers.nber.org/papers/w8730.pdf>.

23. See I.R.C. § 162(m) (2000).

and a spending program—taxing employers and providing grants to employees—that has been implemented through regulations.²⁴ We are not even sure that there is a clear dividing line between spending, regulation, and taxation, and we do not wish to imply that the analysis of government programs must be limited by any such taxonomy. Nevertheless, our examples tend to focus on the comparison between direct grants and taxes, and there may be differences in the context of regulatory programs that we gloss over.²⁵

Second, there are both bureaucratic and legislative components to the implementation of any program that typically (but not always) move in tandem. Putting a program into the tax system generally (but not always) involves delegating the program to the IRS and also at least partially delegating legislative jurisdiction to the tax-writing committees. Putting the program into another agency generally involves delegating legislative jurisdiction to the appropriate oversight committee for that agency.

The interaction between the committee structure, the legislative floor, the agency, and the President can be very complex. Problems of legislative organization raise unique questions because legislatures cannot choose their members and have a low tolerance for hierarchies. The internal design of a legislature might, therefore, differ from the stand-alone optimal design of a bureaucracy. The interaction of legislative design with oversight requirements may affect bureaucratic design.²⁶

24. See Daniel Shaviro, *The Minimum Wage, the Earned Income Tax Credit, and Optimal Subsidy Policy*, 64 U. CHI. L. REV. 405, 411-17 (1997). For a similar discussion in the context of excise taxes, see SURREY, *supra* note 5, at 155-74; and Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C. L. REV. 225, 246-52 (1979).

25. There is extensive writing on the choice between taxes and regulation. The debate between Ronald Coase and Arthur Pigou can be seen as a debate over the merits of taxation and regulatory regimes (as reflected by property rights in this case). Compare R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960), with A.C. PIGOU, *THE ECONOMICS OF WELFARE* (4th ed. 1932). The discussion by Lawrence Summers of the choice between mandated benefits and taxation also reflects this problem. See Lawrence H. Summers, *Some Simple Economics of Mandated Benefits*, 79 AM. ECON. REV. 177 (1989). Similarly, the exchange between Martin L. Weitzman and Louis Kaplow and Steven Shavell over the merits of environmental taxes can be seen in this light. Compare Martin L. Weitzman, *Prices vs. Quantities*, 41 REV. ECON. STUD. 477 (1974), and WILLIAM J. BAUMOL & WALLACE E. OATES, *THE THEORY OF ENVIRONMENTAL POLICY* (2d ed. 1988) (advocating the use of both price and quantity controls), with Louis Kaplow & Steven Shavell, *On the Superiority of Corrective Taxes to Quantity Regulation*, 4 AM. L. & ECON. REV. 1 (2002) (arguing for the dominance of price controls). Many of these writings illustrate that there may be differences between taxes and regulation that appear to be unrelated to the organizational structure of government, and instead are usually related to how government policy harnesses the information available to individual actors and to the government at large. We thus suspect that the differences in taxes and regulation found in the literature relate to underlying policies and not to whether they are called taxes or to which agency implements them.

26. The work on congressional oversight of bureaucrats is extensive. For a typical sample of models of this problem, see DAVID EPSTEIN & SHARYN O'HALLORAN, *DELEGATING POWERS: A TRANSACTION COST POLITICS APPROACH TO POLICY MAKING UNDER SEPARATE POWERS*

To simplify the problem, our focus will generally be on agencies rather than other political actors. Principal-agent problems between the legislature and agencies, between the Executive and agencies, and within the legislature are likely to be a central piece of the integration issue, but in this Article we focus only on how to organize specialized production across potential implementing agencies, ignoring these principal-agent problems for now.

The third simplification is that we will ignore agency capture, interest group activity, and other problems of public choice. Agency capture is in a sense just a variant on the principal-agent problem, where the agent's preferences coincide with the preferences of the regulated industry and do not align with the preferences of the principals. The difference is that agency capture arises because of problems of collective action (such as monitoring of the agency by large groups of individuals). The same is true of many of the public choice problems that arise with respect to agencies. These issues have important consequences for the design of agencies; for example, scholars have considered the use of tax expenditures as a way to limit capture of congressional committees.²⁷ While agency capture and other public choice considerations are likely to be important in considering whether to put programs in the tax system, we put the issue to one side.

Fourth, we generally take the limits and boundaries of current institutions as given. We assume, for example, that both the tax system and the education system exist as they are, and that the question is how to implement an educational program, rather than how to restructure one or both systems to make them run more efficiently. The framework we set forth could apply more generally to wholesale reorganizations of the government and its agencies, but in our examples, and to some extent in our thinking, we have confined ourselves to a smaller goal—namely, to determine how to allocate a program across existing institutions, treating the merits and flaws of those institutions as largely fixed.

To summarize, we frame our question as a choice among implementation methods for a program that is going to be adopted. The choice involves picking which government agency or agencies should implement the program, with the primary focus on whether it should be the tax system or some other agency. We focus on the organization of production within the government bureaucracy and the effects of

(1999); KEITH KREHBIEL, *INFORMATION AND LEGISLATIVE ORGANIZATION* (1991); and POSITIVE THEORIES OF CONGRESSIONAL INSTITUTIONS (Kenneth A. Shepsle & Barry R. Weingast eds., 1995).

27. E.g., Dhammika Dharmapala, *Comparing Tax Expenditures and Direct Subsidies: The Role of Legislative Committee Structure*, 72 J. PUB. ECON. 421 (1999) (making this argument in a formal framework); Edward A. Zelinsky, *James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions*, 102 YALE L.J. 1165 (1993).

coordination and specialization—leaving aside questions about the legislature, principal-agent problems, and agency capture.

II. DO THE COMPREHENSIVE TAX BASE AND TAX EXPENDITURES LITERATURES ANSWER THE QUESTION?

A. *The Comprehensive Tax Base*

The goal of comprehensive tax base (CTB) advocates is to provide a broad tax base that has few or no exceptions, preferences, or loopholes.²⁸ CTBs generally come in two flavors: income CTBs and consumption CTBs.²⁹ An income CTB attempts to tax some comprehensive measure of income, the details of which depend on each advocate's taste for purity over administrative complexity (or any other sufficiently important consideration). A consumption CTB attempts to tax a comprehensive measure of consumption.

The arguments favoring either an income CTB or a consumption CTB are based on both efficiency and fairness. The efficiency argument is that a broad tax base is more neutral between activities than is a narrow base. For example, the current income tax does not tax owner-occupied homes but does tax corporate capital. By providing a relative disincentive to invest in corporate capital over owner-occupied homes, these differential tax rates change where individuals allocate capital and, therefore, distort markets. A CTB would be neutral between investments in owner-occupied homes and corporations, and would therefore lead to a more efficient allocation of capital. Moreover, with fewer "leakages" tax rates would be lower, which would mean that inefficiencies would be further reduced. The fairness argument is similar: Individuals would be taxed the same regardless of their preferences for engaging in different sorts of activities.

The CTB agenda, if followed, almost surely would lead to substantial improvement in government policy. Many, if not most, of the exemptions to

28. The following are a few sources of the CTB literature: STAFF OF HOUSE COMM. ON WAYS & MEANS, 86TH CONG., TAX REVISION COMPENDIUM: COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE (Comm. Print 1959) [hereinafter TAX REVISION COMPENDIUM]; REPORT OF THE ROYAL COMMISSION ON TAXATION (1966); BORIS I. BITTKER ET AL., A COMPREHENSIVE INCOME TAX BASE? A DEBATE (1968); COMPREHENSIVE INCOME TAXATION (Joseph A. Pechman ed., 1977); JOSEPH A. PECHMAN, TAX REFORM, THE RICH AND THE POOR 55-64 (1989); Henry Aaron, *What Is a Comprehensive Tax Base Anyway?*, 22 NAT'L TAX J. 543 (1969); J. Gregory Ballentine, *Broadening Our Approach to Income Tax Reform*, 5 AM. J. TAX POL'Y 1 (1986); Boris I. Bittker, *Comprehensive Income Taxation: A Response*, 81 HARV. L. REV. 1032 (1968); Bittker, *supra* note 4; Charles O. Galvin, *More on Boris Bittker and the Comprehensive Tax Base: The Practicalities of Tax Reform and the ABA's CSTR*, 81 HARV. L. REV. 1016 (1968); Musgrave, *supra* note 4; Pechman, *supra* note 4; and Surrey, *supra* note 18.

29. See generally DAVID F. BRADFORD & U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM (2d ed. rev. 1984) (describing the two comprehensive bases).

the tax base are unwarranted, and broadening the tax base will often lead to a more efficient, fairer, and simpler set of policies. We have no quarrel with much of the agenda of CTB advocates and applaud much of their work.

The CTB literature, however, has nothing to say about the question posed here.³⁰ If we are going to have a program and the only choice is how it is going to be implemented, the efficiency and fairness arguments in the CTB literature completely fail. If we hold the content of the policy fixed, the efficiency and fairness arguments in the CTB literature completely fail. If we hold the content of the policy fixed, the efficiency implications are the same regardless of whether the tax agency or some other agency implements it. Similarly, the fairness of the policy is the same regardless of whether the tax agency or another agency administers it. If one considers a program that is going to be implemented one way or another, the conclusions of the CTB literature may be completely wrong. There is no a priori reason to believe that a broader tax base is better in such a situation.

It is possible that CTB advocates believe that government should never subsidize, penalize, or regulate activities. Broadening the tax base, then, would not cause similar programs to be implemented elsewhere. Instead, it would cause them to be eliminated. In many cases this may be desirable and a good description of the effect of broadening the tax base. For example, many of the base-broadening provisions of the 1986 tax reform did not result in the creation of substitute programs in other agencies. But this view is unlikely to be either desirable or a good prediction about government policy in all cases. If we are going to have a program, the CTB literature simply has nothing to say about where it should be administered.

As far as we can tell, the only way one can make the arguments made by CTB advocates is to treat the tax system as separate from the rest of the government. Under this view, ensuring the efficiency and fairness of the tax system, taken alone, should be the goal of tax reformers. This produces the odd result that removing a program from the tax system and replacing it with an identical program implemented by another agency produces an efficiency and fairness gain, notwithstanding that no behavior has changed and no policy has been altered. Kyle Logue has called this view

30. Given the vast scope of the CTB literature, however, such an assertion is necessarily overbroad, and we are sure that there are individual commentators who are more nuanced. Moreover, much of the CTB literature argues that particular incentives are inefficient and would do away with them altogether rather than replace them with spending programs. We have no quarrel with this result, as indicated in the text. Nevertheless, we believe that the statement fairly characterizes the literature as a whole. For example, Joseph Pechman, one of the leading advocates of the CTB, argues that “[t]he solution to [the complexity of the tax system] is to simplify the tax laws by repealing *all* the special provisions and tax income on a comprehensive basis.” PECHMAN, *supra* note 28, at 59. Similarly, one of the most widely respected documents on the CTB is the Tax Revision Compendium compiled by the House Committee on Ways and Means. TAX REVISION COMPENDIUM, *supra* note 28. In its three volumes and 2381 pages, we did not find anyone who purported to answer the question we pose here.

“tax-exceptionalism.”³¹ Another name might be NIMBY, or Not In My Back Yard. CTB advocates want their backyard to be clean but don’t seem to care about where else the trash might be put.

Some CTB advocates make a political (as opposed to an efficiency or fairness) argument against integrating spending programs into the tax system. The idea is that one tax loophole leads to another. As Walter Blum puts it,

There is nothing about the combination of rate reduction and base broadening which dictates that all preferential provisions be eliminated, but there are potent reasons for leaning over backwards before allowing any of them to remain in the law. . . . [T]he existence of any one special dispensation makes it easier to argue on behalf of others. . . . [A] Spartan attitude toward defending the integrity of the base will aid in creating the impression that the reform plan is intended to improve the system as a whole, with the chips falling as they may, and is not calculated to benefit certain identifiable groups possessing political strength.³²

This argument, however, is unpersuasive. Shifting programs from the tax system to other parts of the government does not change the amount of government largesse. If handing out goodies to one group makes it difficult to say “no” to another group, then putting a program in another agency does little to make it easier.

One possible reason that it may be more difficult to limit largesse in the tax system may be that tax programs are less visible than direct spending.³³ This argument is at least on the right track, in the sense that it compares different ways of implementing a program. The visibility argument, however, is not convincing. Between the tax expenditure budget³⁴ and the

31. Kyle D. Logue, *If Taxpayers Can't Be Fooled, Maybe Congress Can: A Public Choice Perspective on the Tax Transition Debate*, 67 U. CHI. L. REV. 1507, 1524 (2000) (reviewing DANIEL SHAVIRO, *WHEN RULES CHANGE: AN ECONOMIC AND POLITICAL ANALYSIS OF TRANSITION RELIEF AND RETROACTIVITY* (2000)).

32. Walter J. Blum, *Federal Income Tax Reform—Twenty Questions*, 41 TAXES 672, 679 (1963); see also William L. Cary, *Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws*, 68 HARV. L. REV. 745 (1955) (showing how pressure groups create tax expenditures); Joseph A. Pechman, *Erosion of the Individual Income Tax*, 10 NAT'L TAX J. 1, 2 (1957) (same); Joseph Sneed, *Major Objectives of and Guides for Income Tax Reform*, in 1 TAX REVISION COMPENDIUM, *supra* note 28, at 61, 64-65 (same).

33. See Boris I. Bittker, *Accounting for Federal 'Tax Subsidies' in the National Budget*, 22 NAT'L TAX J. 244, 244-45 (1969); Walter J. Blum, *Tax Policy and Preferential Provisions in the Income Tax Base*, in 1 TAX REVISION COMPENDIUM, *supra* note 28, at 77, 83. Even in the presence of the tax expenditure budget (discussed *infra* note 34) the visibility argument is still alive. See SURREY & MCDANIEL, *supra* note 5, at 104-05.

34. The tax expenditure budget is a list of “nontax” provisions included in the tax law and an estimate of their cost. See OFFICE OF MGMT. & BUDGET, *supra* note 20, at 101-40; *infra* note 57 and accompanying text.

wide variety of articles and books discussing tax breaks,³⁵ there is no reason to believe that individuals are not as well-informed about tax breaks as direct subsidies. In many cases, it is hard to believe that tax expenditures are less visible than other government programs. For example, there is little reason to believe that the home mortgage interest deduction³⁶ is less visible than, say, the implicit guarantee the government provides to Fannie Mae and Freddie Mac to lower mortgage costs. It is similarly unclear why tax deductions for brownfields cleanup³⁷ would be less visible than any implicit subsidies one might find in other environmental rules.

Perhaps endowment effects make expenditures through the tax system less visible than direct expenditures. People may perceive a reduction in taxes for engaging in a specified activity differently from an identical direct grant: They may perceive a tax subsidy as merely letting them keep their money, even while they perceive an identical program that taxes them and gives the money back through programs or services to be a subsidy.³⁸ Attempts to publicize the extent of tax subsidies through budgets or books will not be able to overcome this flaw in our reasoning ability.

We are not sure of the extent to which such a flaw exists or is a problem. There does not seem to be a framing effect among those who study or work with the tax system; lobbyists and their clients fully understand the benefits of tax credits or deductions.³⁹ If there is a framing effect, it can be overcome. The argument is really that the *hoi polloi* are too stupid to understand the equivalence between a tax benefit and direct spending.⁴⁰ But if the argument relies on stupidity, it is hard to see how the

35. *E.g.*, JEFFREY H. BIRNBAUM & ALAN S. MURRAY, *SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM* (1987).

36. Section 163 of the Internal Revenue Code authorizes a deduction for "qualified residence interest." *See* I.R.C. § 163(h) (2000).

37. *See id.* § 198.

38. *See* SHAVIRO, *supra* note 31, at 87-88.

39. One example comes from early writings by Surrey. *See* Stanley S. Surrey, *The Congress and the Tax Lobbyist—How Special Tax Provisions Get Enacted*, 70 HARV. L. REV. 1145 (1957); *see also* Cary, *supra* note 32. For a more recent example, *see* Richard L. Doernberg & Fred S. McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 MINN. L. REV. 913 (1987).

40. Louis Eisenstein contends:

Concededly, a good deal of tax law is exceedingly technical and abstruse. But no one claims that voters can be magically transformed into tax experts in several easy lessons. The question rather is whether they would grasp the basic essentials of tax policy if the issues were adequately presented to them. The real difficulty, I suspect, is that they might understand too well. If this second reason is tenable, then most Americans should not be concerned with the social problems of atomic energy, because nuclear physics is beyond their comprehension. In any event, where taxes are involved, our Congressmen and others of authority are noticeably reluctant to speak informatively for general consumption. The discourse, as a rule, is on a high level of platitude. If the public is unenlightened, the fault is not theirs.

LOUIS EISENSTEIN, *THE IDEOLOGIES OF TAXATION* 227-28 (1961). Edward Zelinsky also suggests that the tax legislative process may be more visible than its nontax counterparts, and offers some evidence. *See* Zelinsky, *supra* note 27, at 1179-80, 1205-07.

same individuals will understand or even know about the vast number of direct spending programs, many of which have very subtle and indirect effects.

For example, it is hard to believe that individuals understand the subsidies for driving created by federal highway spending any better than they understand the subsidies for driving created by tax benefits for oil companies. Both are very complex programs that only indirectly affect the consumer. Neither shows up in a form or application that individuals see. Most individuals probably never think about the huge subsidies given to their automobiles. To the extent that they do, it is hard to believe that they understand the direct expenditure better than the tax expenditure. Psychological problems may prevent individuals from properly processing information, but this does not mean that such cognitive biases are dominant, or even important, in this context.⁴¹ Moreover, it is not clear in which direction these biases operate.

To the extent we believe the visibility argument, it may actually lead to a legislative preference for direct spending over tax programs rather than the other way around. For example, if a congressman can fight for either tax reductions or direct spending, and if constituents perceive direct spending dollars to be greater than equivalent amounts of tax reductions, then the congressman may prefer direct spending. The congressman gets more constituent bang for the same budgetary buck. In addition, direct spending may be socially preferable for rent-seeking programs, since it will take fewer direct spending dollars to satisfy the rent seeker who is subject to framing. Alternatively, lack of visibility may be a good thing rather than a bad thing. If the program is desirable but also one that individuals tend to resist (like eating your vegetables), putting it into the tax system could reduce opposition by making it invisible due to framing effects. There is no general theory of psychology and politics implying that the comprehensive tax base is either a good or a bad idea.

To summarize, if programs are going to exist, the CTB literature has nothing to say about where or how they should be implemented. To be fair to CTB advocates, many of the base-broadening (and base-shrinking)

41. A different psychological argument against tax expenditures has been made based on public awareness as opposed to unawareness. The idea is that public resentment of tax benefits (due to inevitable controversies surrounding these benefits or perceptions of unfairness) is interrelated with regular tax provisions, which in turn undermines taxpayers' morale and compliance. See SURREY & MCDANIEL, *supra* note 5, at 107; Paul R. McDaniel, *Evaluation of Particular Tax Expenditures*, 8 TAX NOTES 619, 625 (1979). Replacing tax expenditures with direct spending assists in redirecting public resentment away from the revenue collecting system. See Edward Yorio, *Equity, Efficiency, and the Tax Reform Act of 1986*, 55 FORDHAM L. REV. 395, 425-26 (1987). *But see* Edward A. Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 TEX. L. REV. 973, 1026-28 (1986) [hereinafter Zelinsky, *Efficiency and Income Taxes*]; Edward A. Zelinsky, *The Tax Reform Act of 1986: A Response to Professor Yorio and His Vision of the Future of the Internal Revenue Code*, 55 FORDHAM L. REV. 885, 891-92 (1987).

proposals make sense, and we do not mean to claim that the literature is not valuable. But at the same time, CTB theory focuses exclusively on the tax system, essentially assuming the answer to the integration question.

B. *Tax Expenditures*

The tax expenditures literature, although related to the CTB literature, focuses directly on the integration question.⁴² It offers many potential insights into that question, but it is also seriously flawed. We break our discussion of tax expenditures into three parts. First, we briefly review the basic idea of tax expenditures. We then review the chief criticism of the idea, the problem of the definition of tax expenditures. Finally, we discuss the merits of the substantive arguments made by the literature, concluding that one of the core intuitions has merit but that most of the details are unconvincing.

The basic idea behind tax expenditures is that any government program can be implemented through a direct expenditure or through the tax system. Any time the government uses the tax system as opposed to a direct spending program, the government has created what is labeled a “tax expenditure.”⁴³ The tax expenditures literature, primarily through the writings of Stanley Surrey, did three things with this insight. First, it tried to define the notion of tax expenditures. The core definition is that any deviation from a “normative income tax” is a tax expenditure.⁴⁴ Thus, any deduction, exclusion, or credit that would not be allowed under some

42. The following is a partial list of the literature: SURREY, *supra* note 5; SURREY & MCDANIEL, *supra* note 5; Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533 (1995); William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972); Bittker, *supra* note 33; Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an ‘Ideal’ Income Tax and Why They Fit Worse in a Far from Ideal World*, 31 STAN. L. REV. 831 (1979); Stanley S. Surrey & William F. Hellmuth, *The Tax Expenditure Budget—Response to Professor Bittker*, 22 NAT’L TAX J. 528 (1969); Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 B.C. INDUS. & COM. L. REV. 679 (1976); Surrey & McDaniel, *supra* note 24; Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 DUKE L.J. 1155; Toder, *supra* note 6; Yorio, *supra* note 41; Edward Yorio, *The Future of Tax Reform: A Rejoinder to Professor Zelinsky*, 55 FORDHAM L. REV. 899 (1987); and Zelinsky, *Efficiency and Income Taxes*, *supra* note 41. For a review of tax expenditures in OECD countries, see ORG. FOR ECON. CO-OPERATION & DEV., *TAX EXPENDITURES: RECENT EXPERIENCES* (1996). A comparative study of tax expenditures and an attempt at unifying the concepts is found in SURREY & MCDANIEL, *supra* note 5, at 156-83.

43. The “tax expenditure” notion was looming in the CTB literature. See, e.g., Blum, *supra* note 33; Joseph P. McKenna, *Tax Loopholes: A Procedural Proposal*, 16 NAT’L TAX J. 63 (1963); Musgrave, *supra* note 4, at 52; Pechman, *supra* note 32.

44. SURREY, *supra* note 5, at vii, 6-7; SURREY & MCDANIEL, *supra* note 5, at 188; Surrey & Hellmuth, *supra* note 42, at 528-29; see also OFFICE OF MGMT. & BUDGET, *ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2003*, at 95-127 (2002) (discussing the concept of tax expenditures and estimating the tax expenditure items); Surrey & McDaniel, *supra* note 24, at 227-32; Surrey & McDaniel, *supra* note 42, at 682-88.

definition of income is equivalent to a direct expenditure.⁴⁵ Second, it argued that the budget rules as then in effect distorted the process toward tax expenditures, particularly by hiding information about the costs of tax expenditures and by having more lenient procedures for enactment. The goal of the tax expenditures literature in this regard was to create a budgetary accounting for tax expenditures that mirrored that of direct expenditures, thereby reducing the budgetary incentives to use tax expenditures. Third, the tax expenditures literature discussed the merits of tax expenditures, generally concluding that they are an inferior method of implementing policy.

The definition of tax expenditures has been frequently debated in the literature.⁴⁶ A tax expenditure is said to be any deviation from a “normative” tax base. The normative tax base is defined as an amended version of the comprehensive income tax base,⁴⁷ but the particular details vary by individual tax expert.⁴⁸ In the theory of tax expenditures, much

45. Likewise, any excess taxation over the normative tax base would be a “tax penalty” or “negative tax expenditure.” See SURREY & MCDANIEL, *supra* note 5, at 43-44, 222-26; Surrey & McDaniel, *supra* note 24, at 242-45. “Negative tax expenditures” have not been estimated so far in U.S. budgets. An initial study toward such an estimation was presented in the budget for fiscal year 2004. See OFFICE OF MGMT. & BUDGET, *supra* note 20, at 101, 139-40 tbls.1-3.

46. See Bittker, *supra* note 33; Walter Blum, Book Review, 1 J. CORP. TAX’N 486 (1975) (reviewing SURREY, *supra* note 5); Kahn & Lehman, *supra* note 6; see also Douglas A. Kahn, *Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income*, 78 MICH. L. REV. 1 (1979) (focusing on the difficulty of agreeing on deductions—in particular, depreciation—that constitute a “proper” notion of net income); Charles E. McLure, Jr., *The Budget Process and Tax Simplification/Complication*, 45 TAX L. REV. 25, 54-56 (1989) (noting possible inaccuracies in the actual tax expenditure budget); Edward A. Zelinsky, *The Tax Treatment of Qualified Plans: A Classic Defense of the Status Quo*, 66 N.C. L. REV. 315 (1988) (taking the bold position that following acceptable considerations of a “normative” tax structure—e.g., liquidity, administrability, measurability—deductions for qualified pension plans can be regarded as part of that structure rather than a tax expenditure).

The President’s budget also shows doubt about the determinacy and merit of the income tax base definition. See OFFICE OF MGMT. & BUDGET, *supra* note 44, at 95-97; see also Bittker, *supra* note 28 (providing a similar critique of the comprehensive tax base).

47. The CTB is only the starting point. Practical considerations—e.g., administrability and political constraints—require a departure from the pure Haig-Simons definition of income. See Surrey & Hellmuth, *supra* note 42, at 530 (“The purpose of the tax expenditure budget is not to show what deviations from some ‘ideal tax base’ cost It is not aimed directly at a comprehensive tax base.”); *id.* at 531 (“But the Treasury discussion and analysis at no point adopted H-S [Haig-Simons] as the model for the tax expenditure study . . .”).

48. Surrey has referred to a convention concerning a “normative” income tax base. SURREY, *supra* note 5, at 7. He has invoked notions of “widely accepted definitions of income and standards of business accounting,” *id.* at 12 (quoting U.S. TREASURY DEP’T, ANNUAL REPORT OF THE SECRETARY OF THE TREASURY ON THE STATE OF THE FINANCES FOR THE FISCAL YEAR ENDED JUNE 30, 1968, at 327 (1969)), a “generally accepted structure of an income tax,” *id.* (quoting U.S. TREASURY DEP’T, *supra*, at 327), and consensus among tax experts, *id.* at 17; see also Surrey & Hellmuth, *supra* note 42, at 530. But no such consensus necessarily exists. Indeed, Bittker argues that “every man can create his own set of ‘tax expenditures,’ but it will be no more than his collection of disparities between the income tax law as it is, and as he thinks it ought to be.” Bittker, *supra* note 33, at 260. Even in the case of very specific tax policies, experts have been known to reach different conclusions about the same Code provisions. For one example, compare the analyses of medical expenses and charitable contributions by Andrews,

rides on such differences in definition: If a particular deduction or credit falls within the bounds of the normative tax base, none of the consequences of being a tax expenditure applies, while if it falls outside of the normative tax base, all of the consequences apply.⁴⁹

Bittker is the most prominent critic of this approach.⁵⁰ He argues that a comprehensive definition of income would include many items not contained in the “normative tax base” of tax expenditure proponents. For example the tax expenditure supporters do not include the benefit of the cash method of accounting, the realization requirement, and imputed income from assets and housework in their normative tax base. Moreover, Bittker argues that even among supporters of a tax expenditure theory, there is no widely accepted definition of the proper tax base. For example, there is no broad consensus regarding the acceptable degree of progressivity or of the scope of a family.⁵¹

Bittker is not merely accusing tax expenditure theorists of inconsistency in defining tax expenditures. Instead, he is accusing them of making implicit policy judgments. If all of these exceptions from the tax expenditures list are based on policy judgments, then so are the items on the list. Policy judgments, however, do not come from definitions. Instead, Bittker concludes that, short of a coherent conceptual model, each

supra note 42, at 331-75; SURREY, *supra* note 5, at 20-22; and Kelman, *supra* note 42, at 835-79. Another useful comparison is that between the analyses of accelerated depreciation by Kahn, *supra* note 46; and SURREY, *supra* note 5, at 100-03, and the analysis of qualified pension plans by Zelinsky, *supra* note 46. For the different treatment of pension plans in OECD countries, see ORG. FOR ECON. CO-OPERATION & DEV., *supra* note 42, at 12. These analyses were conducted within Surrey's definitional framework yet deviate from his “normative” income tax base. Further, Seymour Fiekowsky, Assistant Director in the Treasury's Office of Tax Analysis, argues that the capital gains tax preference and accelerated depreciations should not be considered tax expenditures. See Seymour Fiekowsky, *The Relation of Tax Expenditures to the Distribution of the Fiscal Burden*, 2 CAN. TAX'N 211, 215-16 (1980).

For a description of this controversy within the Reagan Administration, see Paul F. Harstad, *Treasury and OMB Clash on Tax Expenditure Concept*, 13 TAX NOTES 1407 (1981). In addition, since 1983 the Executive has prepared a separate (narrower) list of tax expenditures, following a different income tax baseline from that of the Joint Committee on Taxation. See OFFICE OF MGMT. & BUDGET, *supra* note 44, at 97-113. The experience in other countries also shows that the definition and categorization of tax expenditures vary substantially. See ORG. FOR ECON. CO-OPERATION & DEV., *supra* note 42.

49. Following the goal of Surrey's work, the principal consequence of categorizing a program as a tax expenditure is the application of regular government budgetary analysis and scrutiny. Surrey & Hellmuth, *supra* note 42, at 530.

50. Bittker, *supra* note 33.

51. Regardless of any potential success in defining a normative tax base, other important features of a tax system do not necessarily follow from such a definition—that is to say, the Haig-Simons definition of income does not serve as a complete prescription of an income tax base. In particular, such a definition is independent of the tax rate structure, the proper measurement period, the proper taxable unit, allowable deductions, the dividing line between personal and business expenses, and the method of taxation for organizations of individuals (e.g., how to tax corporations and shareholders). See, e.g., Bittker, *supra* note 4, at 950-85; Pechman, *supra* note 4, at 65-66.

exemption from the tax base must be examined and evaluated on its own merits.⁵²

Stated in the language we are using here, it is hard to see how the organization of a bureaucracy should depend on a definition of income. For example, if we are going to subsidize medical expenses, whether it is desirable to do so through the tax system should not depend on whether a medical expense deduction meets the definition of income. Debates about the matter seem completely beside the point.⁵³ Similarly, Surrey's upside-down subsidy argument, discussed below, only applies to items not meeting the definition of income.⁵⁴ It is hard to imagine that the distributional effects of a provision depend on meeting a definition.

Another way to see the problem with the definitional approach is to consider the integration question with respect to nontax agencies, as suggested by Professors Douglas Kahn and Jeffrey Lehman.⁵⁵ Suppose, for example, we are trying to determine whether a conservation program should be put into the Department of the Interior, the Environmental Protection Agency, the Army Corps of Engineers, or somewhere else in the government. The answer depends on institutional factors, not on definitions.⁵⁶ The same should be true for deciding whether a spending program should be put into the IRS.

The most heated offshoot of this debate about definitions is the debate about the scope of the tax expenditure budget. At the time Surrey was writing, tax programs and direct spending programs were treated very differently by the budget system (and they still are). The budget reported the amounts spent on direct expenditures but did not report amounts spent through virtually identical programs in the tax system. The differences in the budget rules were liable to distort outcomes. To remedy this, Surrey called for a "full accounting" of tax expenditures, and the result was the tax expenditure budget, which lists the costs of various items in the tax law.⁵⁷

52. Bittker summarizes his position as follows: "At bottom . . . every tax structure, whether on the books or projected, is an assemblage of value judgments on scores of issues that could plausibly have been decided differently. To bestow the label 'correct' on any of these human creations is to misuse the term." Boris I. Bittker, *The Tax Expenditure Budget—A Reply to Professors Surrey and Hellmuth*, 22 NAT'L TAX J. 538, 542 (1969).

53. Compare, e.g., Andrews, *supra* note 42, with SURREY, *supra* note 5, at 20-21.

54. See *infra* text accompanying note 64.

55. See Kahn & Lehman, *supra* note 6, at 1661, 1665.

56. For a similar discussion, see HERBERT A. SIMON, ADMINISTRATIVE BEHAVIOR 33-35 (1947).

57. A "tax expenditures" budget was first adopted by the Treasury Department in 1968. See U.S. TREASURY DEP'T, ANNUAL REPORT OF THE SECRETARY OF THE TREASURY ON THE STATE OF THE FINANCES 326-40 (1969). Congress mandated that the tax expenditures budget be prepared in the Congressional Budget Act of 1974, Pub. L. No. 93-344, 88 Stat. 297 (codified as amended in scattered sections of 2 and 31 U.S.C.). See also 31 U.S.C. § 1105(a)(16) (2000) (requiring that the budget include a list of tax expenditures).

Some sort of definition of tax expenditures is necessary to have a tax expenditure budget: We must have some method of measuring tax expenditures if they are to be reported in the full accounting. As noted above and by numerous commentators, however, there is no a priori definition of the tax system. There is no such thing as a normative tax base.

The simultaneous need for a definition and the lack of grounding for any particular definition make the tax expenditure budget problematic. For example, we must decide whether accelerated depreciation is a tax expenditure. It provides faster cost recovery than economic depreciation but slower cost recovery than expensing. It can alternatively be viewed as a tax expenditure or a tax penalty depending on whether one's baseline is an income tax or a consumption tax.⁵⁸ Critics claim that such problems with definitions are fatal to the exercise of constructing a tax expenditure budget.

Perhaps the reason for the heated debate is the normative consequences associated with labeling a tax provision as a tax expenditure. Surrey's arguments, as well as those of the comprehensive tax base literature, generally condemn tax expenditures, so such labeling becomes extremely important. Being put on the tax expenditures list indicates that a provision is a subsidy or government largesse, while staying off that list indicates that a provision has the patina of good tax policy.⁵⁹

If we reject the normative consequence of the label, however, the problem becomes much simpler. The problem is one of determining what information would be useful.⁶⁰ For example, it would be useful to know both how much tax revenue would go up if accelerated depreciation were to be replaced with straight-line or economic depreciation and how much it would cost to replace it with expensing. One does not have to answer the question about which way of looking at the issue is right.

The decision about what information to release will be difficult and problematic. It will inevitably have normative and political components.⁶¹ But it would be a significantly lesser problem than deciding what to include

58. Adopting an income tax base obviously does not provide a final answer. See Harstad, *supra* note 48; Kahn, *supra* note 46.

59. See, for example, Professor Thuronyi's description of the embarrassment in the Reagan Administration caused by the inclusion of the Accelerated Cost Recovery System (ACRS) in the tax expenditure budget. Thuronyi, *supra* note 42, at 1184; see also DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 240-41 (1986) (describing the tension in the Reagan Administration due to the separation of the "special" tax provisions in the tax expenditure budget).

60. For a similar approach, see Michael J. McIntyre, *A Solution to the Problem of Defining a Tax Expenditure*, 14 U.C. DAVIS L. REV. 79 (1980). Others have hinted at such an approach. See, e.g., Bittker, *supra* note 33, at 260-61; Carl S. Shoup, *Surrey's Pathways to Tax Reform—A Review Article*, 30 J. FIN. 1329, 1332-34 (1975) (reviewing SURREY, *supra* note 5).

61. Indeed, it will be susceptible to Bittker's original critique that exposing only some tax expenditures will act to conceal other undiscovered tax expenditures. See Bittker, *supra* note 33, at 258-59, 261. Surrey believed that "the understanding to be gained through the tax expenditure approach outweighs this risk by far." SURREY, *supra* note 5, at 19. We tend to agree with Surrey on this point.

in the one true tax expenditures list. For example, information could be presented in a variety of nonevaluative ways under an “information usefulness” rationale, whereas there is only one correct (and strongly evaluative) method to present the same information under a traditional tax expenditures rationale.⁶² Similarly, as has been suggested by others, information would only need to be provided for those elements of the tax system that could conceivably be replaced with a direct expenditure program, because only these programs can be distorted through budgetary nonneutrality.⁶³ Surrey’s argument that the budget process could skew outcomes was correct; we should not let unrelated problems with his arguments get in the way of this truly valuable contribution.

Much of the debate about tax expenditures has focused on these definitional problems. Although Surrey apparently believed and cared about the definitional parts of his argument, this focus on definitions distracts from the underlying substantive arguments surrounding tax expenditures. Once definitions are put aside, the tax expenditures question really is the integration question. We believe that many of the substantive arguments made in the tax expenditures literature about integration are unconvincing, but that there is a core, unstated intuition that remains valuable.

Surrey’s substantive argument is that tax expenditures are an inferior method of implementing policy. Instead, he claims, the government should use direct spending programs. The reason is that tax expenditures tend to have a variety of features that lead to poor implementation. For example, Surrey argues that tax expenditures create so-called upside-down subsidies.⁶⁴ Upside-down subsidies are created because the value of tax deductions increases with the marginal tax rate, so that wealthy individuals with high marginal tax rates will receive more for a given deduction than individuals with lower incomes and lower marginal tax rates. If one views tax expenditures as equivalent to the government handing out money, wealthy individuals get bigger handouts than the poor.

62. For a hint of this approach, see OFFICE OF MGMT. & BUDGET, *supra* note 44, at 95-97.

63. See, e.g., Fiekowsky, *supra* note 48, at 215; Thuronyi, *supra* note 42, at 1186-205. The “substitutability” approach, however, is still problematic since, at least theoretically, every policy is substitutable. Others have suggested additional arguments about the definition of tax expenditures. See Richard Goode, *The Economic Definition of Income*, in COMPREHENSIVE INCOME TAXATION, *supra* note 28, at 1, 28 (suggesting an alternative to the tax expenditure budget that would include only those provisions for which there is evidence in the legislative history that the dominant motivation was to encourage or reward certain behavior or to compensate for a particular hardship); McIntyre, *supra* note 60, at 86 (proposing a purpose-dependent definition of tax expenditures); see also ROGER S. SMITH, TAX EXPENDITURES: AN EXAMINATION OF TAX INCENTIVES AND TAX PREFERENCES IN THE CANADIAN FEDERAL INCOME TAX SYSTEM (Canadian Tax Found., Canadian Tax Paper No. 61, 1979) (developing for the Canadian tax system a tax expenditures list based on an approximate comprehensive tax base definition).

64. SURREY, *supra* note 5, at 134-38; SURREY & MCDANIEL, *supra* note 5, at 71-82.

Tax expenditures also possess other traits that tend to make them open to inefficiency or abuse. First, they place no limits on the amount of tax benefits a taxpayer may receive,⁶⁵ and hence are not capped.⁶⁶ Second, because they are part of the Internal Revenue Code, tax expenditures do not require an annual appropriation (as agency programs do);⁶⁷ rather, they are like direct expenditures that are automatically appropriated absent some contrary congressional action.⁶⁸ Third, tax expenditures tend to have relatively loose eligibility requirements, in the sense that individuals self-declare their eligibility and are challenged only if they happen to be audited. And finally, as Surrey argues, tax expenditures in general create more complexity than direct expenditures.⁶⁹

The immediate response to such arguments is that we can overcome these flaws by designing tax expenditures to be implemented in the same manner as direct expenditures. Indeed, Surrey begins his argument by assuming that tax expenditures could be applied in a way that is basically

65. SURREY, *supra* note 5, at 140. Certification by another agency can limit the problem. See SURREY & MCDANIEL, *supra* note 5, at 102-03.

66. Although it is possible to cap the tax expenditures themselves, it probably would be more complicated. See, e.g., I.R.C. § 42(h) (2000) (providing for a Low-Income Housing Tax Credit); Zelinsky, *Efficiency and Income Taxes*, *supra* note 41, at 1030-31.

67. "Sunsetting" tax expenditures (and other procedural methods) would subject them to periodic review analogous to that of direct expenditures. (Under a "sunset" provision, a tax expenditure program automatically expires on a specified date unless renewed.) For a discussion of "sunset" provisions, see SURREY & MCDANIEL, *supra* note 5, at 54-65; Paul R. McDaniel, *Institutional Procedures for Congressional Review of Tax Expenditures*, 8 TAX NOTES 659, 660 (1979); Michael J. McIntyre, *The Sunset Bill: A Periodic Review for Tax Expenditures*, TAX NOTES, Aug. 9, 1976, at 3; and Surrey & McDaniel, *supra* note 24, at 330-35. For counterarguments, see Zelinsky, *Efficiency and Income Taxes*, *supra* note 41, at 1029-30. Michael Graetz and Jerry Mashaw also suggest that a stable long-term source of financing—of the sort currently provided by the tax system, but which sunset provisions would undermine—can be beneficial to some policies such as Social Security. See MICHAEL J. GRAETZ & JERRY L. MASHAW, *TRUE SECURITY: RETHINKING AMERICAN SOCIAL INSURANCE* 302 (1999).

68. Surrey & McDaniel, *supra* note 24, at 232. A few principal direct spending welfare programs, such as Social Security, Medicare, and Food Stamps, are also designed as entitlements in this manner (and thus not subject to annual legislative approval).

69. Surrey makes a host of other arguments as well. Tax expenditures permit windfalls by paying taxpayers for doing what they would do anyway. SURREY, *supra* note 5, at 134; SURREY & MCDANIEL, *supra* note 5, at 82-83. Some tax expenditures are inefficient because the tax subsidies exceed the value of the induced activity. SURREY & MCDANIEL, *supra* note 5, at 83. Tax expenditures may provide tax savings to middlemen with a potential for tax sheltering activity. *Id.* at 83-85. Legislative committees and executive departments responsible for creating tax expenditures lack the expertise necessary to create effective incentives, and tax service providers—i.e., lawyers and accountants—lack the requisite expertise to take advantage of them. SURREY, *supra* note 5, at 141-43; SURREY & MCDANIEL, *supra* note 5, at 96. Tax expenditures create a risk of logrolling within legislative committees, and suffer from a lack of coordination with the overall handling of direct spending. SURREY, *supra* note 5, at 142-44. Tax expenditures enjoy an unjustified budgetary priority. SURREY & MCDANIEL, *supra* note 5, at 32-33. They add second-level complexity produced by the responses of the market and counterresponses of the tax authorities (referred to by others as "transactional complexity"). *Id.* at 93. They create detrimental psychological effects. *Id.* at 96-97. And finally, tax expenditures distort choices and "keep tax rates high by constricting the tax base and thereby reducing revenues." SURREY, *supra* note 5, at 138-40.

identical to direct expenditures.⁷⁰ If direct and tax expenditures have the same content, however, these criticisms do not apply. For example, if a tax expenditure has the same content as a direct spending program, it will not have the upside-down subsidy effect, it will not be open-ended, its eligibility criteria will be the same as those of a direct expenditure, and it will not be more complex than the direct spending program.⁷¹ Moreover, many new tax expenditures are designed to be more similar to direct spending programs than prior tax expenditures were. Congress now tends to use credits rather than deductions and has, where it has thought it appropriate, limited the size of the expenditure or the eligibility for the expenditure.

It is curious that someone as sophisticated as Surrey would make such an obvious mistake. While Surrey states that he wants to compare identical tax and direct expenditures, if he truly did so, his conclusion would have to be that the two programs are identical. Instead, Surrey concludes that direct expenditures are superior to tax expenditures. He does so by comparing different programs, notwithstanding his assertion that the programs can be made identical. Yet he does not justify why he compares different programs.

Perhaps Surrey compares different programs merely because that is what he observed. But we believe that there is a key, unstated intuition driving him toward this approach: Institutions matter. If institutions matter, policies will be different when implemented by different institutions.⁷² Thus, tax expenditures and direct expenditures will tend to have different features and should not be compared as if they were identical.

For example, the use of exclusions or deductions to implement tax expenditures may create an upside-down subsidy effect,⁷³ but doing so also

70. "It follows that a meaningful comparison between the tax incentive technique and the direct expenditure technique must involve *similar substantive programs*." SURREY, *supra* note 5, at 130; *see also* McDaniel, *supra* note 41, at 622 ("[I]t is clear that many differences that some persons purport to see between tax and direct expenditures are not actually differences inherent in the two techniques. . . . [T]hese differences are largely matters of program design. . . . Most debates over using a tax expenditure versus a direct expenditure approach to a problem are at bottom debates about two differently designed programs.").

71. Surrey acknowledges the possibility of designing tax expenditures to be identical to direct spending by using taxable, refundable credits, SURREY, *supra* note 5, at 137-38; SURREY & MCDANIEL, *supra* note 5, at 108-11, "sunset" provisions, SURREY & MCDANIEL, *supra* note 5, at 55-63; Surrey & McDaniel, *supra* note 24, at 330-35, and subsidy limitations, SURREY, *supra* note 5, at 247-82; *see also* Yoseph Edrey & Howard Abrams, *Equitable Implementation of Tax Expenditures*, 9 VA. TAX REV. 109 (1989) (discussing equivalent designs of credits and deductions).

72. Surrey explicitly considered institutions in his detailed review of the budgetary process, *see* SURREY & MCDANIEL, *supra* note 5, at 31-68, and in his brief references to the issue of substantive specialization, *see* SURREY, *supra* note 5, at 141-46; SURREY & MCDANIEL, *supra* note 5, at 96.

73. Surrey was not necessarily accurate in his description of the distributional effects of tax expenditures. *See* Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343 (1989); *see also* Gerard M. Brannon, *Tax Expenditures and Income*

has an important offsetting feature: An exclusion is an incredibly simple method of implementing policy and a deduction is only a little bit more complicated. Similarly, self-declared eligibility is much simpler than other methods of implementing policy.

While these features could be made part of a direct spending program, they are a key benefit of integration into the tax system because they take advantage of the existing infrastructure of tax collection. That is, integration allows for economies of scope in policy implementation with the resulting savings in administering and complying with the system. We would not necessarily want to design tax expenditures to be the same as direct expenditures. If we did, we would defeat the purpose behind putting a program into the tax system. We would lose the benefits of integration.

For example, if we want to subsidize the development of human capital, we can create direct spending programs that might subsidize training or education. An alternative is to defer taxation of the returns to education.⁷⁴ Exclusion and deferral have many flaws, but a key—perhaps decisive—advantage is that they are incredibly simple. The current system is transparent to individuals. Integration of the education subsidy with the tax system achieves this transparency better than a direct spending education program with identical substance.

One way to frame the choice between tax and direct spending is to begin with a set of broad policy objectives and allow complete freedom in designing a program to meet them. The objectives can be met in a variety of institutional settings, and we should compare the best possible program that can be implemented in each of these different settings. Integration, for example, allows coordination of programs and the use of a common infrastructure for administering programs. But in integrating two programs, we might give up making each of them as accurate as possible with a specialized agency. We choose the method of implementation that offers the best results.

Surrey, then, had the key idea right even if it was not explained: We should not compare identical programs when making the integration

Distribution: A Theoretical Analysis of the Upside-Down Subsidy Argument, in THE ECONOMICS OF TAXATION 87 (Henry J. Aaron & Michael J. Boskin eds., 1980) (arguing that a socially desirable incentive design may include some upside-down subsidies). Blum offers a way to justify some upside-down subsidies. See Blum, *supra* note 46, at 490. Zelinsky further argues that in some circumstances an upside-down subsidy will be more efficient. See Zelinsky, *Efficiency and Income Taxes*, *supra* note 41, at 1024-26. And Martin Feldstein asserts that in the case of charitable contributions, tax expenditures are more efficient than direct spending. Yet he compares a somewhat different mechanism of transfers. See Martin Feldstein, *A Contribution to the Theory of Tax Expenditures: The Case of Charitable Giving*, in THE ECONOMICS OF TAXATION, *supra*, at 99.

74. See Louis Kaplow, *Human Capital Under an Ideal Income Tax*, 80 VA. L. REV. 1477 (1994) (explaining how the current taxation of education provides an implicit subsidy to education); Louis Kaplow, *On the Divergence Between 'Ideal' and Conventional Income-Tax Treatment of Human Capital*, 86 AM. ECON. REV. 347 (1996) (same).

decision. We should compare programs that are best designed for each institutional structure and choose the best from among these.

Consider for example, Anne Alstott's discussion of the integration of welfare programs with the tax system.⁷⁵ She focuses on whether the EITC, which can be viewed as a substitute for more traditional welfare programs, is a good idea, but her arguments have broader application. Integrating welfare and tax systems may greatly simplify government policy by utilizing the existing institutions of the federal income tax.⁷⁶ But the benefit of a stand-alone welfare program would be that it could test eligibility and provide benefits over short periods, in order to account for the fact that individuals' welfare needs can vary dramatically over short periods of time. If one uses the institutional structure of the tax system to implement a welfare program, one must almost inevitably use an annual accounting period. Therefore, one of the tradeoffs of integration is that the program is less well-tailored to its needs—that is, it will be less accurate. The tradeoff is between the simplicity benefits of integration and the accuracy benefits of separation.

Note that this turns the usual complexity/simplicity argument on its head. The usual argument is that putting programs into the tax system increases complexity. This argument is correct if one looks only at the tax system.⁷⁷ But if one considers government policy as a whole, integration

75. See Alstott, *supra* note 42.

76. *Id.* at 564-65. Later, however, Alstott doubts the potential of tax simplicity for other reasons. See *id.* at 567-68.

77. Surrey has not conducted any concentrated discussion of complexity, but assertions on the subject are scattered throughout his works, and his overall conclusion is unambiguous: Integration increases complexity.

Surrey mostly adopted a tax-centric view of complexity. In one passage, for example, he explains: “[T]he tax system is complex enough as it is, and to have a large number of tax incentives side by side with the provisions making up the structure of the tax itself can only cause confusion and a blurring of concepts and objectives.” SURREY, *supra* note 5, at 146; see also *id.* at 33-35 (explaining how tax expenditures complicate the tax system); SURREY & MCDANIEL, *supra* note 5, at 105-06 (arguing that tax expenditures burden administrative and compliance efforts); Thuronyi, *supra* note 42, at 1161 (noting that tax expenditures complicate the tax laws by “straining the tax system’s administrative resources”).

In other passages, Surrey indicates an awareness of the flaws of a tax-centric view and considers the complexity of the entire fiscal system. For example, Surrey and McDaniel concede that “the question is whether overall governmental simplification would be achieved if most of the tax expenditures were eliminated. . . . If they were replaced with direct programs, the answer depends in part on whether the direct programs in themselves would be more complex. . . .” SURREY & MCDANIEL, *supra* note 5, at 93. They acknowledge that a government-wide attitude is required in considering public policies’ complexity. But then, without any apparent reason or evidence, they conclude that disintegration reduces complexity: “Although the dispersal of programs and resulting forms would increase complexity elsewhere, the reduced complexity in the income tax system could still produce a net gain in cost-benefit ratios.” *Id.* at 94.

Wherever the complexity of the entire fiscal system is considered, the authors conclude that integration involves higher complexity, and that aggregate complexity would be reduced if direct transfers replaced tax expenditures. See, e.g., *id.* at 93-94; Surrey & McDaniel, *supra* note 24, at 276-77. Others, like Yorio, seem to sympathize with this view. See, e.g., Yorio, *supra* note 41, at

with the tax system may often be a choice for simplicity. Integration is a choice to take advantage of the infrastructure of the tax system at the cost of less accuracy in program design than would be achieved through a separate agency.

Surrey's arguments do not hold up well under this type of analysis because he does not consider the benefits of the design features that he observes. For example, the open-endedness and eligibility declaration criteria that he criticizes greatly simplify the system. He argues that we do not find these features in direct expenditure programs, so they must be undesirable. But whether they are found in direct expenditure programs is entirely beside the point. The decision to put a program into the tax system can be seen as a decision that the accuracy costs of these features are outweighed by the simplicity benefits of integration for those particular programs. We should expect to see different features in tax expenditures and direct expenditures. In fact, we should expect to see different features in tax expenditures and direct expenditures for precisely the reason that Surrey provides in comparing different programs—because design features will and should vary with the institution implementing the program.

To summarize, the tax expenditures literature focuses on the integration question and does not take a NIMBY-type attitude, unlike the CTB literature. It gets confounded in unnecessary definitional debates, but it provides a key insight: 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 this 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.

426-28. But the conclusion that integration involves more complexity is based solely on intuition, without any concrete evidence provided in the text.

In addition, Surrey and McDaniel contend that tax expenditures add a second-level complexity, produced by the cyclical counterresponses of the market and the tax authorities. Beneficiaries of tax expenditures attempt to overutilize tax concessions while the authorities fight to limit the effect of these concessions. See SURREY & MCDANIEL, *supra* note 5, at 93. We fail to see why this phenomenon would be unique to the tax system (or to tax expenditures).

III. THE INTEGRATION QUESTION AS ORGANIZATIONAL THEORY: COORDINATION AND SPECIALIZATION IN PRODUCTION

We view the integration question as one of how best to organize the government rather than a question of tax policy. This means that the relevant place to look is in the organizational literature rather than in the tax policy literature. The literature on organizations is vast, going back to Taylor's scientific management,⁷⁸ Weber's studies of bureaucracy,⁷⁹ Coase's theory of the firm,⁸⁰ Simon's theory of administrative organizations,⁸¹ Chandler and Williamson's M and U theories,⁸² Marschak and Radner's theory of teams,⁸³ and Niskanen's models of self-serving bureaucrats.⁸⁴ It continues today in modern information processing models,⁸⁵ agency models,⁸⁶ and positive political science models.⁸⁷

We address here only a relatively narrow question of organizational theory. The question we must ask is how we should optimally split up an organization into divisions. If one thinks of a hierarchy as an upside-down tree, the question is the placement of vertical lines that split it into divisions or agencies. Much of the literature is on the number of layers or horizontal lines, which is related but not directly on point.⁸⁸ Other portions of the

78. See, e.g., FREDERICK WINSLOW TAYLOR, *THE PRINCIPLES OF SCIENTIFIC MANAGEMENT* (1913); FREDERICK WINSLOW TAYLOR, *SCIENTIFIC MANAGEMENT* (Greenwood Press 1972) (1947); FREDERICK WINSLOW TAYLOR, *SHOP MANAGEMENT* (1912).

79. See, e.g., MAX WEBER, *Bureaucracy*, in 3 *ECONOMY AND SOCIETY: AN OUTLINE OF INTERPRETIVE SOCIOLOGY* 956 (Guenther Roth & Claus Wittich eds., 1968).

80. See R.H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937).

81. See SIMON, *supra* note 56.

82. See ALFRED D. CHANDLER, JR., *STRATEGY AND STRUCTURE: CHAPTERS IN THE HISTORY OF THE INDUSTRIAL ENTERPRISE* (1962); OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* (1975).

83. See JACOB MARSCHAK & ROY RADNER, *ECONOMIC THEORY OF TEAMS* (1972).

84. See WILLIAM A. NISKANEN, JR., *BUREAUCRACY AND REPRESENTATIVE GOVERNMENT* (1971).

85. This area is also known as the economics of management. Hierarchies are common organizational features in these models. This literature is extensive. See, e.g., Masahiko Aoki, *Horizontal vs. Vertical Information Structure of the Firm*, 76 *AM. ECON. REV.* 971 (1986); Patrick Bolton & Mathias Dewatripont, *The Firm as a Communication Network*, 109 *Q.J. ECON.* 809 (1994); Luis Garicano, *Hierarchies and the Organization of Knowledge in Production*, 108 *J. POL. ECON.* 874 (2000); John Geanakoplos & Paul Milgrom, *A Theory of Hierarchies Based on Limited Managerial Attention*, 5 *J. JAPANESE & INT'L ECON.* 205 (1991); Roy Radner, *Hierarchy: The Economics of Managing*, 30 *J. ECON. LIT.* 1382 (1992).

86. See, e.g., Philippe Aghion & Jean Tirole, *Formal and Real Authority in Organizations*, 105 *J. POL. ECON.* 1 (1997); Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 *AM. ECON. REV.* 777 (1972); Martin J. Beckmann, *Management Production Functions and the Theory of the Firm*, 14 *J. ECON. THEORY* 1 (1977); Guillermo A. Calvo & Stanislaw Wellisz, *Supervision, Loss of Control, and the Optimum Size of the Firm*, 86 *J. POL. ECON.* 943 (1978); R. Joseph Mosen, Jr. & Anthony Downs, *A Theory of Large Managerial Firms*, 73 *J. POL. ECON.* 221 (1965); Oliver E. Williamson, *Hierarchical Control and Optimum Firm Size*, 75 *J. POL. ECON.* 123 (1967).

87. See sources cited *supra* note 26.

88. See SIMON, *supra* note 56, at 26-28; Calvo & Wellisz, *supra* note 86; Michael Keren & David Levhari, *The Internal Organization of the Firm and the Shape of Average Costs*, 14 *BELL J.*

literature on the nature of leadership within organizations are also not relevant. Theories of the firm are about boundaries, but the boundaries are usually between the market and the firm, not within the firm. It turns out that only a very small portion of the literature focuses on the issue of optimal divisions within an organization.

We can break the applicable literature into three parts. The first part includes theories that assume away any divergence of preferences among individual agents. Following Marschak and Radner,⁸⁹ we generally refer to this line of literature as team theory. Hierarchy arises in team theory because of limitations on information processing. Hierarchies split up the decisionmaking or information processing tasks into subunits and allow coordination of these subunits through higher tiers in the hierarchy. The shape of the hierarchy usually depends on the gains from specialization and the costs of coordination. Most of the team theory literature, however, focuses on the “horizontal” dimensions of hierarchy, such as the number of layers in a hierarchy or the span of control for a manager. Our problem is how to divide the organization into divisions rather than how many layers of management it should have. Nevertheless, the intuitions from the literature about the tradeoff between specialization and coordination may be applicable.

The second and largest part of the literature focuses on incentives. This literature assumes agents have some specialized knowledge that makes delegation attractive and, in addition, that agents have preferences that diverge from those of their principals. The goal is to set up a hierarchy that gets the benefit of organized production (e.g., agents’ expertise) while minimizing shirking.⁹⁰ We can think of most tax expenditures as split delegations, where part of a policy is delegated to a specialized agency and part to the IRS. For example, much education policy is administered by the Department of Education, but some is administered by the IRS.⁹¹ Similarly, welfare is split between specialized welfare agencies and the IRS. The integration question thus can be seen as a question of when the use of multiple agents is desirable.⁹²

ECON. 474 (1983); Mosen & Downs, *supra* note 86; Yingyi Qian, *Incentives and Loss of Control in an Optimal Hierarchy*, 61 REV. ECON. STUD. 527 (1994); Sherwin Rosen, *Authority, Control, and the Distribution of Earnings*, 13 BELL J. ECON. 311 (1982); Williamson, *supra* note 86.

89. See MARSCHAK & RADNER, *supra* note 83.

90. See sources cited *supra* note 86.

91. See *supra* notes 11-14.

92. The literature on the use of multiple government agencies dates to Martin Landau, *Redundancy, Rationality, and the Problem of Duplication and Overlap*, 29 PUB. ADMIN. REV. 346 (1969). See also JONATHAN B. BENDOR, *PARALLEL SYSTEMS: REDUNDANCY IN GOVERNMENT* (1985) (exploring the benefits of redundancy in government). These arguments, however, largely concern the benefit of fail-safe systems, such as Landau’s example of redundant safety systems on aircraft. Articles taking an agency theory approach to multiple government agencies include Michael M. Ting, *A Strategic Theory of Bureaucratic Redundancy*, 47 AM. J. POL. SCI. 274

The last portion of the literature focuses on collective action or public choice problems. Much of this work is closely related to the agency literature in that it generally assumes that a politician or bureaucrat cannot be fully monitored by the public, but the focus of this branch of inquiry is on the problem of decisionmaking or monitoring when there are a large number of diverse principals rather than one or a few principals.

In this Article we focus only on team theory as applied to the problem of divisions. The question is how we can organize a bureaucracy to best facilitate specialized production when there is no divergence of preferences between agencies, the individuals who make up the agencies, and the legislature or principal. This Part begins by addressing the problem in a general context and then by turning to how the analysis applies to bureaucracies and tax expenditures. The next Part applies the analysis to two examples—Food Stamps and the EITC.

A. *The General Problem of Divisions*

There is a tradeoff in deciding whether to assign a function to a separate division. Separating a function from the rest of the firm in this manner allows specialization and coordination of activities within the division, but increases coordination costs between that division and other activities of the firm. Think of a hotel company that separates the operation of its luxury hotels from its value hotels. The separation allows each division to specialize in providing a particular type of service and to coordinate those activities cheaply. But the separation means that coordination between the divisions will be more difficult. If coordination among activities is particularly important—say, because adopting common standards or operating procedures will save costs—the benefit of specialization and coordination within an activity may not be worthwhile. Conversely, the more valuable specialization and coordination are within a group of activities, and the less important coordination is among different groups, the more likely it will be a good idea to separate those groups.

Much has been written on these questions, going back at least to Adam Smith.⁹³ Specialization adds value because it allows an individual or

(2003); and Jean Tirole, *The Internal Organization of Government*, 46 OXFORD ECON. PAPERS 1 (1994).

93. See, e.g., KENNETH J. ARROW, *THE LIMITS OF ORGANIZATION* (1974); DAVID RICARDO, *THE PRINCIPLES OF POLITICAL ECONOMY AND TAXATION* (Empiricus Books 2002) (1817); ADAM SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* (Edwin Cannan ed., Random House 1937) (1776); XIAOKAI YANG & YEW-KWANG NG, *SPECIALIZATION AND ECONOMIC ORGANIZATION: A NEW CLASSICAL MICROECONOMIC FRAMEWORK* (1993); Kenneth J. Arrow, *The Division of Labor in the Economy, the Polity, and Society*, in ADAM SMITH AND MODERN POLITICAL ECONOMY: BICENTENNIAL ESSAYS ON *THE WEALTH OF NATIONS* 153 (Gerald P. O'Driscoll, Jr. ed., 1979); Yoram Barzel & Ben T. Yu, *The Effect of the Utilization Rate on the Division of Labor*, 22 ECON. INQUIRY 18 (1984); Gary S. Becker & Kevin M.

organization to perform the same activity more rapidly, more accurately, or better in some other dimension. Smith uses the example of a pin factory. A single individual can make very few pins in a given time period. A group of individuals, each specializing in a single aspect of making pins, can vastly increase output.⁹⁴ The reason why is that specialization in particular elements of pinmaking allows individuals to perform their particular tasks more efficiently.

The key question is what limits specialization. Why not have a separate division for each individual function performed by the firm? The answer, as illustrated by Becker and Murphy, is that specialization is limited by the costs of coordination.⁹⁵ Too much specialization means that coordination of the specialized activities becomes difficult.⁹⁶ For example, pediatricians generally do not specialize in particular childhood diseases. While they would learn more about a disease through specialization, the additional knowledge would require greater expenses in coordinating their care with other pediatricians. The increased costs to individual patients of dealing with multiple specialists usually would outweigh the benefit. But we expect to see specialization when the benefit is sufficient. Thus, for example, we see specialization in certain very complex and serious childhood diseases such as cancer.

These simple intuitions go a long way. Divisions in a corporation or agencies in government are like the workers in the pin factory, specializing in particular tasks but limited in their specialization by the problem of coordination. Our problem, however, goes further. We must decide not only how many groupings to have but also which activities to group together. For example, even if we knew that a company should be divided into six divisions, we would still have to decide which activities are to be put into each division. There is, to our knowledge, almost no formal literature on

Murphy, *The Division of Labor, Coordination Costs, and Knowledge*, 107 Q.J. ECON. 1137 (1992); H.S. Houthakker, *Economics and Biology: Specialization and Speciation*, 9 KYKLOS 181 (1956); Sherwin Rosen, *Substitution and Division of Labour*, 45 ECONOMICA 235 (1978); George J. Stigler, *The Division of Labor Is Limited by the Extent of the Market*, 59 J. POL. ECON. 185 (1951); Allyn A. Young, *Increasing Returns and Economic Progress*, 38 ECON. J. 527 (1928).

94. SMITH, *supra* note 93, at 4-5; *see also* Rosen, *supra* note 93.

95. *See* Becker & Murphy, *supra* note 93.

96. Note that coordination can take the form of either cooperation costs in team production processes or transaction costs in trading final goods. Coordination is required among specialized workers producing a single product or among specialized units in a roundabout production. For example, various units of one organization producing different electronic components of a single household appliance product must coordinate their production (e.g., adopt common production standards). Coordination also may be required between trading parties (e.g., consumers and manufacturers). Becker and Murphy focus on the first form of coordination while Houthakker emphasizes the latter form. *See* Becker & Murphy, *supra* note 93, at 1142-49; Houthakker, *supra* note 93, at 184-86. For examples of the first form of coordination, *see* ARROW, *supra* note 93, at 39-40, 55-58; and Alchian & Demsetz, *supra* note 86. Harold Hotelling's model, *see* Harold Hotelling, *Stability in Competition*, 39 ECON. J. 41 (1929), and George Stigler's model, *see* Stigler, *supra* note 93, can be perceived as examples of the latter form.

this topic.⁹⁷ Instead, the relevant literature dates back to the informal discussions of organizations from the 1970s and earlier. The classic works are the historical studies of businesses by Chandler and the institutional economics of Williamson.⁹⁸ The key idea is complementarity, which posits that activities that benefit most from coordination should be grouped together.

Chandler observed that corporations were often originally organized functionally. Functional organization divides the firm into departments in charge of specific functions: sales, production, purchasing, etc. This functional organization was later termed “U-form,” with the U standing for unitary.

The U-form has many advantages. It helps promote coordination and specialization within the functional areas. But Chandler observed that as corporations grew, they discovered several problems with the U-form. One problem was that central management became overloaded with decisions about daily operations and coordination of the functional units, and it could not focus on strategic decisions. In addition, functional units created agency problems. Employees tended to concentrate on their functional specialties at the expense of the overall profitability of the firm. There was no easy way to monitor employee performance; management could not accurately determine profitability of functional subunits because the subunits did not produce a marketable product on which to base transfer prices.

To resolve these problems, growing corporations tended to reorganize into a divisional structure, with each division organized around a product or product line. This form was later termed the “M-form,” with the M standing for multidivisional. The divisions themselves could be organized along

97. There are two notable exceptions. See OLIVER HART & JOHN MOORE, ON THE DESIGN OF HIERARCHIES: COORDINATION VERSUS SPECIALIZATION (Nat'l Bureau of Econ. Research, Working Paper No. 7388, 1999), <http://papers.nber.org/papers/w7388.pdf> (formalizing the optimal degree of organizational decentralization); Jacques Cremer, *A Partial Theory of the Optimal Organization of a Bureaucracy*, 11 BELL J. ECON. 683 (1980) (providing a mathematical formula to apply when choosing an organizational structure). Modern hierarchy literature is of very limited assistance due to its focus on specialization in management (or decisionmaking) rather than specialization in production tasks. Herbert Simon makes a parallel distinction between vertical and horizontal specialization. See SIMON, *supra* note 56, at 9. Hierarchical models, by and large, ignore the production level of organizations, or provide only a narrow consideration of it.

98. CHANDLER, *supra* note 82; WILLIAMSON, *supra* note 82. Others, in work on a quite similar subject, termed the issue the “departmentalization problem.” This informal literature investigates the way in which tasks or production processes are grouped together into organizational units, and hence how the divisionalized organization is formed. See, e.g., JAMES G. MARCH & HERBERT A. SIMON, ORGANIZATIONS 12-33 (1958) (providing an informal analysis of the issue); Luther Gulick, *Notes on the Theory of Organization*, in PAPERS ON THE SCIENCE OF ADMINISTRATION I (Luther Gulick & L. Urwick eds., 1937); see also JAMES A. BRICKLEY ET AL., MANAGERIAL ECONOMICS AND ORGANIZATIONAL ARCHITECTURE 313-37 (2d ed. 2001) (describing how to divide a company into divisions).

functional or U-form grounds, so that the firm resembled a collection of smaller U-form companies.⁹⁹

The M-form was thought to have solved many of the problems with the U-form. It separated strategic and operational functions so that management could focus on broad strategy, and the operational functions could be coordinated within each division. It also allowed better monitoring of the performance of managers because divisions could be measured by profits, unlike functional pieces.¹⁰⁰

The government is largely organized along the M-form—that is, by purpose. Congressional committees, executive branch agencies, and departments are like operating divisions. Each provides a “product” to the public, such as tax collection, national security, or education. Like most corporations, the government is not purely M-form. There are a few functional elements, such as a common payroll and pension system, but as a whole, the government resembles an M-form company.

The conclusions from the M-form and U-form literature get us part of the way to an answer. To the extent the M-form is better, we should divide an organization along product lines rather than by function. But the theory does not tell us how to determine the extent of a “product line.” Instead, it assumes that there will be some natural or obvious breakdown of the business into product lines. This, however, is not always the case. Indeed, the scope of a “product line” is precisely the core problem of this Article.

99. Earlier organizational theory described these forms of organization as process and purpose organizations. Luther Gulick, for example, addressed the question of grouping workers into departments. Gulick presented four factors for grouping work units—purpose, process, clientele, and place. Gulick, *supra* note 98, at 15. Organization by purpose, for instance, indicates assortment by the rendered service or manufactured product. All workers (or more generally, capital) required for a particular service product would be grouped in one department. *Id.* at 21-23. Organization by process, on the other hand, implies grouping all individuals who make use of the same special skill, knowledge, or technology. *Id.* at 23-25. Gulick’s purpose and process bases of groupings correspond to Chandler’s M and U classifications. The tradeoff between specialization and coordination in the design of organizational divisions is also discussed by Gulick. For a summary of the classical departmentalization theory, particularly a description of Gulick’s work, see MARCH & SIMON, *supra* note 98, at 22-30.

100. More recent empirical studies confirm Chandler’s observations. See, e.g., RICHARD P. RUMELT, STRATEGY, STRUCTURE, AND ECONOMIC PERFORMANCE (1974) (finding similar trends among two hundred Fortune 500 companies); Henry O. Armour & David J. Teece, *Organizational Structure and Economic Performance: A Test of the Multidivisional Hypothesis*, 9 BELL J. ECON. 106 (1978) (reporting similar findings for petroleum firms from 1955 to 1973); Charles W.L. Hill, *Internal Organization and Enterprise Performance: Some UK Evidence*, 6 MANAGERIAL & DECISION ECON. 210 (1985) (cataloguing support for Chandler from the experience of large U.K. firms); Robert E. Hoskisson & Craig S. Galbraith, *The Effect of Quantum Versus Incremental M-Form Reorganization on Performance: A Time-Series Exploration of Intervention Dynamics*, 11 J. MGMT. 55 (1985) (finding the same in automobile, petroleum, and retail trade firms); Peter Steer & John Cable, *Internal Organization and Profit: An Empirical Analysis of Large U.K. Companies*, 27 J. INDUS. ECON. 13 (1978); R.S. Thompson, *Internal Organization and Profit: A Note*, 30 J. INDUS. ECON. 201 (1981) (finding the M-form superior). For a survey of the literature, see Richard E. Caves, *Industrial Organization, Corporate Strategy and Structure*, 18 J. ECON. LIT. 64 (1980).

For example, it is not clear whether luxury and value hotels are separate products or whether particular types of services offered by pediatricians are separate products. And it is not clear whether various governmental programs should be part of the same “product line” as taxes.

The idea implicit in the literature is that there should be a benefit to grouping activities together. The activities must be complementary. There must be some economy (e.g., economies of scope) to combining them. For example, Chandler quotes an internal memorandum from DuPont, which was then in the process of reorganization:

“The most efficient results are obtained at least expense when we coordinate related effort and segregate unrelated effort. For example, purchase of materials is unrelated to the sale of a finished product in a much greater degree than manufacture and sales, or manufacture and purchasing; and legal work is still more unrelated to either of those before mentioned.”¹⁰¹

This intuition is nothing more than the realization that the benefits of coordination of two functions, such as complementarity in performance, can outweigh the benefits of keeping them separate, such as economies of scale or expertise.¹⁰²

Williamson, one of the most prominent proponents of the M-theory, has only a brief discussion of how a company should set up its divisions. In the end, he offers nothing more than the intuition from the DuPont memorandum.¹⁰³ In an example, Williamson considers a company that produces five distinct final products. There are three activity stages to producing these products—an early production stage, an intermediate stage in which production is completed, and a marketing stage. He assumes that all products originate in a common first stage. From there, four distinct intermediate stage processes lead to the five distinct final products. This is represented in Figure 1.¹⁰⁴ Note that A_1 and A_2 are the same product, and V_1 and V_2 are the same intermediate production process.

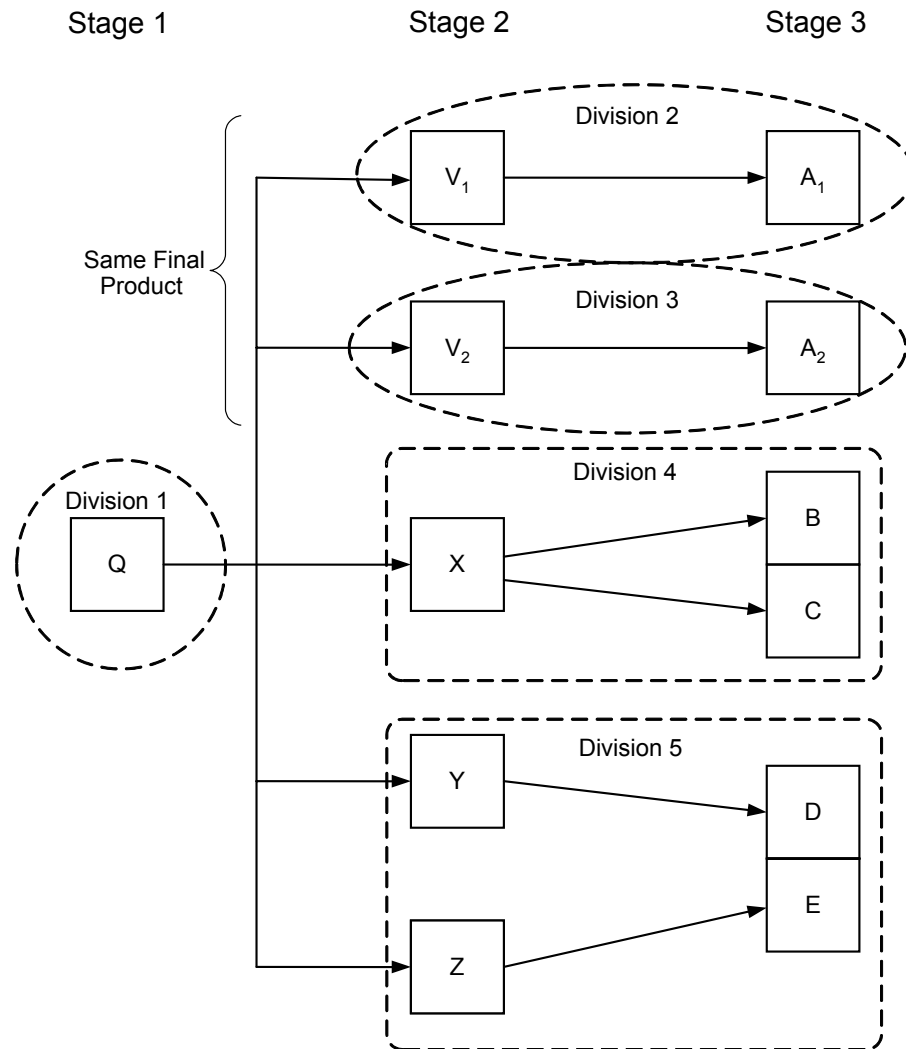
101. CHANDLER, *supra* note 82, at 69 (quoting an internal DuPont report of March 31, 1919). Similar statements have been made by other companies.

102. Jack Hirshleifer also discusses such complementarities. Yet his framework assumes a given divisional structure under which coordination techniques are considered. *See* Jack Hirshleifer, *Economics of the Divisionalized Firm*, 30 J. BUS. 96 (1957); Jack Hirshleifer, *On the Economics of Transfer Pricing*, 29 J. BUS. 172 (1956).

103. WILLIAMSON, *supra* note 82, at 136-41.

104. Figure 1 reproduces Figure 7 in Williamson but uses simplified notation. *See id.* at 139 fig.7.

FIGURE 1. WILLIAMSON DIVISIONS



Williamson then discusses how the company should be broken down into divisions. First, he separates the initial stage of production into a division on the theory that at this stage the economies of scale outweigh the benefits of separate production within each division. Then, he combines the intermediate stages and the final stages into a set of divisions on the theory that there needs to be a high degree of coordination between these stages. Product A is split into two divisions on territorial grounds, each combined

with an intermediate stage of production. Next, he assumes that there are economies of scope for the intermediate stage of products B and C and, therefore, combines them into a single division with a single intermediate stage.¹⁰⁵ Finally, products D and E are assumed to be complements, so they should be marketed together even though they are produced at the intermediate stage by separate plants. Therefore, he combines D and E along with each of their intermediate stages into a single division.

Williamson offers no clear theory for making these decisions. But his intuitions are similar to those expressed in the DuPont memorandum. Grouping activities together allows coordination of the activities but reduces the benefits of specialization. We want to provide a partition or set of groups that best takes advantage of coordination while minimizing the loss in specialization.¹⁰⁶

These intuitions can be confirmed in a variety of common contexts. Consider how doctors design specialties. Doctors may specialize in eyes, in

105. Economies of scope are a form of complementarity in production:

There are economies of scope where it is less costly to combine two or more product lines in one firm than to produce them separately

.

Whenever the costs of providing the services of the sharable input to two or more product lines are *subadditive* (i.e., less than the total costs of providing these services for each product line separately), the multi-product cost function exhibits economies of scope.

John C. Panzar & Robert D. Willig, *Economies of Scope*, 71 AM. ECON. REV. 268, 268 (1981). Economies of scale describe the relationship between scales of inputs and outputs. Scale effects can be found by measuring the output consequences of input replication. If, for example, doubling all inputs brings about more than doubled output, then economies of scale are present.

106. Simon came to very similar conclusions (though in the analysis of decisionmaking): “Any division of labor among decisional subsystems creates externalities, which arise out of the interdependencies among the subsystems that are ignored. What is wanted is a factorization that minimizes these externalities” Herbert A. Simon, *Applying Information Technology to Organization Design*, 33 PUB. ADMIN. REV. 268, 270 (1973).

There have been limited attempts to model the problem more formally. One of the models that comes closest to our approach is Cremer, *supra* note 97, at 683. The organization, in Cremer’s model, faces uncertainty in both future cost functions of its various production processes and future demand. Furthermore, coordination (here modeled as a transfer of resources to solve a problem) in the short run is not possible across departments but only within departments. Optimal organization of divisions minimizes the adverse effects of future uncertainties or maximizes the organization’s ability to eliminate such effects. Thus, “related” production tasks are those among which future optimal transfers suffer larger uncertainties; these tasks would benefit most from improved “real-time” (or short-run) coordination. The solution is intuitive: Production tasks should be grouped together if transfers among them are sensitive to future uncertainties; additionally, production processes that face high uncertainty should be grouped with other substitutable processes.

One might suspect that business school textbooks would address this problem, as it is a problem that managers must face on a daily basis. The one that comes closest to doing so is BRICKLEY ET AL., *supra* note 98, at 313-37. The discussion there largely parallels the discussion in the text. For example, the authors argue that “[g]rouping people together within a subunit lowers the communication and coordination costs among the people *within the subunit*. . . . Managers, however, must devise methods of coordinating activities *across the subunits*.” *Id.* at 318; see also PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION, AND MANAGEMENT* 538-84 (1992).

feet, or in cancers, but they rarely combine these specialties. It is common, however, for doctors to combine the knowledge of ears, nose, and throat problems into a single practice. How can we explain this? Specializing only in eyes allows doctors to gain the benefits of specialization and coordination of knowledge about eyes with few of the problems of coordinating with other medical knowledge. Specializing in both eyes and feet seems ridiculous because there are few benefits to coordinating these activities or having specialized knowledge in both. But it makes sense to combine ears, nose, and throat practices because they are important to coordinate—problems in one area may be related to problems in other areas. These breakdowns in practice areas, which seem perfectly natural to us, reflect the basic logic of coordination and specialization.

The same is true within businesses. Recall from the hotel example that separation of luxury hotels into a separate division allows specialization in providing luxury hotels and coordination of those types of activities. At the same time, it makes coordination of luxury hotels and value hotels more difficult. The tradeoff is whether the benefits from specialization and coordination within the luxury hotel market are greater than the costs of coordination with other parts of the company's business.

To summarize, the basic tradeoff is an old one between specialization and coordination. Creating more divisions promotes specialization and coordination within divisions but increases coordination costs between them. In deciding how to place tasks within a division or how many divisions to divide a task among, we have to look at the benefits of the various groupings given these costs; the result is that we should group complementary functions together.

B. *Departmentalization in a Governmental Context*

The departmentalization literature largely focuses on the organization of entities competing in the market.¹⁰⁷ Our problem is slightly different: We want to determine the best organization of a government bureaucracy that is producing and administering policy. This Section develops intuitions about the organization of bureaucracies. As in the market context, the intuitions are based on the benefits of specialization and coordination when different groupings of activities are applied.

The key difference between government and market contexts is that there is no obvious measure to determine how well the government is doing (unlike, say, profits or stock price in the market context). Ultimately, we should measure government output in terms of how well the government

107. For two exceptions, see SIMON, *supra* note 56; and Gulick, *supra* note 98.

produces and implements policy. There is, however, no uniformly agreed-upon metric for measuring the effectiveness of government policy.

Because our question is about bureaucratic organization, we can assume that the basic policy that we are considering is fixed, having been set by the principal (the executive or the legislature). We can then measure how well the bureaucracy implements that policy by measuring how accurate the implementation is for a given cost.¹⁰⁸ A more accurate policy better distinguishes between different individuals or different actions. It comes closer to the optimum. Accuracy, however, is expensive, which means that no policy will be implemented with perfect accuracy.

There are a number of prior works that discuss the tradeoff between accuracy and the costs of producing accuracy, commonly labeled complexity.¹⁰⁹ For our purposes, we can simply think of the problem as trading off marginal benefits and marginal costs. For example, a single speed limit for all roads would be highly inaccurate. We can increase accuracy by posting separate speed limits for different roads, although this increases costs. We could make the speed limit policy more accurate by posting different speed limits for individual roads under various weather and traffic conditions, but this would further increase costs. At some point, the marginal cost is not worth the marginal benefit of the increase in accuracy.

This approach, however, considers only the costs and benefits of different levels of accuracy within a given institution. The issue presented here is slightly different—namely, the assignment of policies across different agencies. Because the costs of producing accurate policy will vary with institutional structure, the independent variable is not how much accuracy to produce given some cost of production. Instead, the independent variable is the institutional structure itself, which then determines the tradeoff between accuracy and complexity.

Given this setup, the analysis works basically the same way that it does in the private sector. Grouping activities together allows coordination of

108. A more general metric would be a social welfare function. Ultimately, welfare is the only relevant goal in this context. We use accuracy as a surrogate because it is simpler to measure and can be applied more easily to practical situations. One way to think about this approach is as dividing the execution of public policy into planning and implementing. We are interested here in the second stage. Bureaucratic performance is measured, then, relative to a perfectly accurate plan.

There are other metrics that might be important. For example, procedural theories might count the process by which we reach policy decisions as important and might be willing to trade off some accuracy to achieve procedural goals.

109. See Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65 (1983); Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257 (1974); Louis Kaplow, *Accuracy, Complexity, and the Income Tax*, 14 J.L. ECON. & ORG. 61 (1998); John Douglas Wilson, *On the Optimal Tax Base for Commodity Taxation*, 79 AM. ECON. REV. 1196 (1989); Shlomo Yitzhaki, *A Note on Optimal Taxation and Administrative Costs*, 69 AM. ECON. REV. 475 (1979).

those activities but reduces coordination of those activities with others. Smaller groupings allow more specialization; larger groupings, more coordination. The key is to group activities that are related—that is, there are large benefits to coordination and low costs to the loss of specialization.

For example, consider the IRS and the Department of Agriculture. The IRS can presumably measure income at a given level of accuracy better than the Department of Agriculture, because of specialization by the IRS in income measurement. Similarly, the Department of Agriculture can presumably best measure items related to agriculture, such as the value of various farming techniques or the safety of various methods of preparing food. Separating these activities allows this specialization, but also creates coordination problems. While the lack of coordination between these activities will look like bad policymaking, it may in fact be optimal: Setting up the bureaucracy in a way that instead coordinated the activities of the USDA and the IRS would reduce the benefit of each of these agencies specializing in its own activities.

Analyses that look only at one aspect of the problem rather than overall government policy can be faulty. For example, Victor Thuronyi notes:

The dairy farmer subsidies include accelerated depreciation deductions on livestock and equipment and the acceptance of “cash accounting,” both of which defer tax liability with no interest. While these tax provisions subsidize production and encourage herd expansion, the Department of Agriculture, on the other hand, pays dairy farmers to curtail production and slaughter their herds.¹¹⁰

Thuronyi presents this clash of policies as if it is necessarily a bad idea. It may, however, be the result of the best possible choice of organizational form. The IRS might be the best agency for providing investment subsidies, and the Department of Agriculture is probably the best agency for regulating farmers. Certainly, neither agency would seem to be best at doing both activities. Therefore separate agencies for each function, and the resulting lack of coordination, could be optimal.¹¹¹ Any other organizational

110. Thuronyi, *supra* note 42, at 1161. As McDaniel points out, failures of coordination can lead to the duplication of similar programs, to the pursuit of different policies in the same area with no apparent reason for the differences, and even to the implementation of diametrically opposite programs. See McDaniel, *supra* note 67, at 660.

111. Several scholars have provided general descriptions of the lack of coordination within government. See SURREY, *supra* note 5, at 141-42 (expressing skepticism about any potential coordination); SURREY & MCDANIEL, *supra* note 5, at 106-07 (stating that coordination will be “incomplete and cumbersome”); McDaniel, *supra* note 67 (describing the need for coordination and examining various coordination-promoting procedures); Karla W. Simon, *The Budget Process and the Tax Law*, 40 TAX NOTES 627 (1988) (stressing the need for coordination in the budgetary process and suggesting some options for better coordination); Surrey & McDaniel, *supra* note 42, at 717-22; Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept and the Legislative Process*, in *THE ECONOMICS OF TAXATION*, *supra* note 73, at 123, 136-39, 143-44

form, including one that coordinated these conflicting policies, might be worse. It is not that we should applaud the end result as directly desirable; indeed, this particular example may be the result of a failing of process or design rather than a result of optimal organizational structure. We need to recognize, however, that desirable separation of functions into divisions is going to lead to lack of coordination. An organizational form that produces better coordination may very well be inferior on other grounds and, therefore, the lack of coordination may be optimal.

This analysis flips the usual complaint about tax expenditures on its head. Many claim that tax expenditures increase the complexity of the tax system.¹¹² Under the analysis here, however, a decision to have separate tax and spending programs is a decision to have specialization in each program, presumably with more accurate and detailed measurements within each program—i.e., greater complexity. A decision to consolidate spending programs into the tax system, by contrast, is a decision to coordinate the programs with less fine-tuned accuracy in each program. Therefore, putting a program into the tax system can be seen as a decision for simplicity.

To see this, consider another example. Suppose we are considering whether parts of the welfare system should be integrated into the tax system, as the EITC is. We must compare the benefits of having two programs and two administrative agencies (a special agency to administer the welfare part of fiscal policy and the tax agency to administer the tax part) to the benefits of having a single agency administering both programs.

If we have separate programs, each program can be more easily tailored to meet its specific goals. For example, if it is desirable to have monthly accounting periods for welfare and annual accounting periods for tax, each program can adopt the desired period. Similarly, if the welfare system requires one measurement of “need” and the tax system optimally uses a different measurement of “ability to pay,” each program can adopt the required definition. Separation may enable administrative specialization in the specific requirements of each policy, and hence improve its accuracy.

The disadvantage of separate agencies is that the various welfare programs and the tax system may not be coordinated very well. For example, welfare programs typically contain phase-outs, which act as a marginal tax on income. Failing to coordinate these phase-outs can lead to very high effective marginal rates and a marginal rate structure that seems random.¹¹³

(describing the legislative process and suggesting mechanisms of coordination); Surrey & McDaniel, *supra* note 24, at 335-36; Thuronyi, *supra* note 42, at 1170-72 (highlighting the lack of coordination within the executive branch).

112. See *supra* note 77 and accompanying text.

113. See, e.g., FRANK SAMMARTINO ET AL., PROVIDING FEDERAL ASSISTANCE FOR LOW-INCOME FAMILIES THROUGH THE TAX SYSTEM: A PRIMER 10-11 (Urban Inst., Discussion Paper No. 4, 2002), <http://www.urban.org/UploadedPDF/410526.pdf>; Michael Keane & Robert

In addition, each welfare program might use its own eligibility test, which would mean that individuals would end up providing similar but slightly different information to various government agencies. For example, the same child might qualify as a family member under one program but not under another, or various elements of income might be included in one program but not in another, creating enormous complexity for individuals.¹¹⁴

We can generalize this example. Which integrated transfer programs are likely to be successful? Programs where the coordination benefits between the tax system and the other program are high and the specialization benefits of separate programs are low. Thus, we want to integrate programs that have close complementarities with the tax system—e.g., programs that measure along similar margins. This is why welfare and tax are such an obvious pairing. They measure along very similar boundaries.

One scholar, Eric Toder, recently provided a list of the features that make a program a good or bad fit for administration by the IRS.¹¹⁵ Several items on this list relate to budgetary aspects of the problem, which we do not deal with here. Most of the remaining items relate to the benefits of coordination and specialization and can be explained by our framework. For example, Toder argues that if the agency has a high degree of discretion in setting policies, implementing the program through the tax system may be unwise.¹¹⁶ The reason must be that if the agency has discretion, it will be using expertise to make determinations, which means that the value of specialization is high.¹¹⁷ Toder also argues that the more that the spending program uses tax return data for eligibility, the more desirable integration is.¹¹⁸ This easily fits within our framework—the IRS has expertise in measuring along those margins, and it exhibits economies of scope in such measurement. Toder argues that programs that have

Moffitt, *A Structural Model of Multiple Welfare Program Participation and Labor Supply*, 39 INT'L ECON. REV. 553 (1998); Daniel N. Shaviro, *Effective Marginal Tax Rates on Low-Income Households*, 84 TAX NOTES 1191 (1999).

114. For example, the “qualified child” requirement of the EITC is different from dependency requirements of other welfare programs. Unfortunately, the EITC’s qualified child definition is also different from dependency requirements for purposes of the child tax credit and dependent exemption. See George K. Yin et al., *Improving the Delivery of Benefits to the Working Poor: Proposals To Reform the Earned Income Tax Credit Program*, 11 AM. J. TAX POL’Y 225, 268-70 (1994). In fact, Janet McCubbin estimates that there is not much of an actual difference between the EITC definition of a qualified child and the tax system’s definition of children or dependents. That is, adopting the dependent definition for EITC purposes may not impair the program’s accuracy considerably. See Janet McCubbin, *EITC Noncompliance: The Determinants of the Misreporting of Children*, 53 NAT’L TAX J. 1135, 1141-42 (2000).

115. See Toder, *supra* note 6.

116. *Id.* at 366-67, 369; see also OFFICE OF MGMT. & BUDGET, *supra* note 44, at 114.

117. See EPSTEIN & O’HALLORAN, *supra* note 26; KREHBIEL, *supra* note 26 (providing an explanation of delegation based on expertise).

118. Toder, *supra* note 6, at 369.

open-ended eligibility are better suited to the tax system than other programs.¹¹⁹ The reason is that the tax system uses end-of-year filing, so that programs requiring up-front eligibility testing would need specialization that would not be complementary with that of the IRS. Toder's suggestions seem eminently sensible within our framework.

The problem with these intuitions is that the terms are extremely vague and are at a very high level of generality. Translating these terms into measurable formula for making decisions is far from an easy task. But relatively crude ideas about accuracy, complexity, specialization, and coordination can help policymakers muddle through the problems they face. To see this, in the next Part we go through two examples in detail.

IV. APPLICATIONS: THE EARNED INCOME TAX CREDIT AND THE FOOD STAMP PROGRAM

This Part applies the framework developed above to two major welfare programs—the Earned Income Tax Credit and the food stamp program (FSP). The welfare system is of special interest in the analysis of the integration question. In 1998, about \$400 billion was spent on more than eighty means-tested programs in the United States.¹²⁰ Total spending on cash and in-kind welfare benefits was more than five times higher in 1998 than in 1968 (adjusted for inflation), while the U.S. population increased 35% during the same period.¹²¹ The share of the federal budget used for means-tested programs rose from 6.4% in 1968 to 16.8% in 1998.¹²² In addition, the composition of tax expenditures changed significantly over the last two decades of the twentieth century. Social tax expenditures as a percentage of GDP increased over 40% during this period while business tax expenditures were cut in half. Social tax expenditures accounted for 79% of all tax expenditures in 1999, compared to 57% in 1980.¹²³ These

119. *Id.*

120. See VEE BURKE, CONG. RESEARCH SERV., CASH AND NONCASH BENEFITS FOR PERSONS WITH LIMITED INCOME: ELIGIBILITY RULES, RECIPIENT AND EXPENDITURE DATA, FY1996-FY1998, at 1 (1999). Note that these figures do not include tax transfers (besides the EITC). See also GEN. ACCOUNTING OFFICE, GAO-02-58, MEANS-TESTED PROGRAMS: DETERMINING FINANCIAL ELIGIBILITY IS CUMBERSOME AND CAN BE SIMPLIFIED (2001) (investigating the variations in the major means-tested programs, their sources, and their consequences). As a comparison, in 1975 there were more than 100 income maintenance programs, not including tax transfers. See Irene Lurie, *Integrating Income Maintenance Programs: Problems and Solutions*, in INTEGRATING INCOME MAINTENANCE PROGRAMS 1, 4-5 (Irene Lurie ed., 1975).

121. BURKE, *supra* note 120, at 5-7.

122. COMM. ON WAYS & MEANS, U.S. HOUSE OF REPRESENTATIVES, 2000 GREEN BOOK: BACKGROUND MATERIAL AND DATA ON PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS 1401 tbl.K-5 (Comm. print 2000).

123. See Eric Toder, *The Changing Composition of Tax Incentives: 1980-1999*, in PROCEEDINGS: 91ST ANNUAL CONFERENCE ON TAXATION 411, 412 (Howard Chernick ed.,

trends underscore the importance and relevance of the integration problem to welfare reform.

We choose to compare the EITC to the FSP for three reasons. First, the programs are to some extent similar, yet one is integrated into the tax system and one is not.¹²⁴ Comparison of the performance of the two programs gives us some sense of the costs and benefits of integration.

Second, plausible cases can be made for integrating both programs with the tax system primarily because their eligibility criteria are income-based. In addition, there are serious problems with integrating each of the programs with the tax system. Therefore, they make for interesting programs to study.

Finally, these two programs are among the largest welfare programs in the United States.¹²⁵ Accordingly (and perhaps also for the other two reasons discussed above), there have been a large number of studies on the delivery of these sorts of benefits through the tax system, so rather than building from scratch, we can analyze the conclusions of these studies within our framework.¹²⁶ Much of the earlier work on combining tax and

1999). Note that “social tax expenditures” are defined broadly by Toder and include more than merely low-income assistance.

124. Both programs are intended to help the indigent or the less fortunate and therefore use similar eligibility requirements. There are, of course, important differences in the programs. The EITC is intended as a work incentive while the FSP is designed to reduce hunger. In addition, the EITC is a cash benefit while food stamps are in-kind. There may also be essentially random differences in the programs—differences that do not follow from institutional structure. For example, the USDA applies a quality control system to the FSP. A decision to have a quality control system may not be related to institutional expertise, but instead to other nonsystematic variables such as tradition or organizational behavior. Because of these differences, data comparing the two programs must be interpreted with caution.

125. In fiscal year 1998, for example, the EITC was the third-largest welfare transfer program in the United States (after Medicaid and Supplemental Security Income (SSI)), and the FSP immediately followed as the fourth-largest (measured in annual dollar expenditures). See BURKE, *supra* note 120, at 4 tbl.2.

126. Recent papers include Alstott, *supra* note 42; and Lisa Barrow & Leslie McGranahan, *The Effects of the Earned Income Credit on the Seasonality of Household Expenditures*, 53 NAT'L TAX J. 1211 (2000). For resources focusing specifically on the FSP, see Janet Currie, *U.S. Food and Nutrition Programs*, in MEANS-TESTED TRANSFER PROGRAMS IN THE UNITED STATES, *supra* note 16, at 199; Janet Holtzblatt, *Choosing Between Refundable Tax Credits and Spending Programs*, in PROCEEDINGS: 93RD ANNUAL CONFERENCE ON TAXATION 116 (James R. Hines, Jr. ed., 2001); The Brookings Institution, at <http://www.brook.edu> (last visited Dec. 3, 2003); Food & Nutrition Serv., U.S. Dep't of Agric., Food Stamp Program, at <http://www.fns.usda.gov/fsp/default.htm> (last visited Dec. 3, 2003); Joint Center for Poverty Research, Northwestern University/University of Chicago, at <http://www.jcpr.org> (last visited Dec. 3, 2003); David Super & Kathy Patcham, Ctr. on Budget & Policy Priorities, *The Food Stamp Program: Important Sources of Information on the Program and Policy*, at <http://www.cbpp.org/12-19-01fa.htm> (last visited Dec. 3, 2003); and The Urban Institute, at <http://www.urban.org> (last visited Dec. 3, 2003). For papers focusing on the EITC, see David T. Ellwood, *The Impact of the Earned Income Tax Credit and Social Policy Reforms on Work, Marriage, and Living Arrangements*, 53 NAT'L TAX J. 1063 (2000); Holtzblatt, *supra*; Janet Holtzblatt & Robert Rebelein, *Measuring the Effect of the EITC on Marriage Penalties and Bonuses*, 53 NAT'L TAX J. 1107 (2000); Jeffrey B. Liebman, *Who Are the Ineligible EITC Recipients?*, 53 NAT'L TAX J. 1165 (2000); McCubbin, *supra* note 114; Diane Lim Rogers & Alan Weil, *Welfare Reform and the Role of Tax Policy*, 53 NAT'L TAX

transfer systems concerned the negative income tax, with the basic claim being that benefits can be distributed more efficiently through the tax system.¹²⁷ We agree with the idea that some benefits can best be distributed through the tax system and, in particular, believe that provision of the EITC through the tax system makes sense. But we argue, contrary to the thrust of the negative income tax literature, that some welfare policies are best implemented separately because of institutional considerations.

Our analysis follows in part Anne Alstott's work on the EITC. She is critical of arguments in favor of integrating tax and transfer systems, arguing that the tax system cannot adequately perform many functions of the transfer system. For example, she argues that the tax system cannot respond as quickly to emergencies as the transfer system. Alstott's arguments can be analyzed within our framework and are largely consistent with it. Our conclusions in many places are different from hers, but to a great extent the particular conclusions are less important than the mode of analysis. Therefore, we use her work as a focus of our discussion.¹²⁸

We begin with background information on each of the programs and discuss the reasons for integrating the tax and transfer systems. We then turn to the details of each program and conclude with a brief discussion of negative income taxes more generally.

A. Background

The FSP is an in-kind transfer program¹²⁹ jointly administered by the USDA and state agencies.¹³⁰ It provides food assistance to families and

J. 385 (2000); Jennifer L. Romich & Thomas Weisner, *How Families View and Use the EITC: Advance Payment Versus Lump Sum Delivery*, 53 NAT'L TAX J. 1245 (2000); John Karl Scholz, *The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness*, 47 NAT'L TAX J. 63 (1994); Timothy M. Smeeding et al., *The EITC: Expectation, Knowledge, Use, and Economic and Social Mobility*, 53 NAT'L TAX J. 1187 (2000); Toder, *supra* note 6; and Yin et al., *supra* note 114.

127. See sources cited *supra* note 7.

128. Others make arguments similar to those made by Alstott. See, e.g., Asimow & Klein, *supra* note 7; Rogers & Weil, *supra* note 126; Toder, *supra* note 6; Yin et al., *supra* note 114.

129. Scholars view the FSP as an in-kind transfer. See, e.g., MOFFITT, *supra* note 22, at 5. In fact, the FSP can also be viewed as a voucher program because the government does not actually provide food to recipients, but instead gives individuals coupons that can only be used to buy food at certified establishments. The analytical distinction between in-kind provision and vouchers that can only be used at approved places, however, is unclear. This distinction is accordingly not well defined in public economics textbooks. Joseph Stiglitz identifies food stamps as an in-kind program. JOSEPH E. STIGLITZ, *ECONOMICS OF THE PUBLIC SECTOR* 388-89 (3d ed. 2000). Harvey Rosen identifies FSP as a voucher program, though he later analyzes it as an in-kind program. HARVEY S. ROSEN, *PUBLIC FINANCE* 175-76 (5th ed. 1999). As David Bradford and Daniel Shaviro argue, the precise location of the definitional boundary between voucher programs and in-kind programs is of little importance; what matters instead is the programs' actual effects given their characteristics. See David F. Bradford & Daniel N. Shaviro, *The Economics of Vouchers*, in *VOUCHERS AND THE PROVISION OF PUBLIC SERVICES* 40 (C. Eugene Steuerle et al. eds., 2000). Most descriptions of the FSP describe it as providing in-kind benefits, so we use that language.

individuals based on monthly income, assets, and family structure. Monthly income is effectively equivalent to cash income, subject to several exemptions and deductions.¹³¹ To qualify for the FSP, the applicant's monthly income must be below a threshold that varies with family size and composition. Household assets typically cannot exceed \$2000,¹³² excluding certain assets (e.g., a house and lot, vehicles of specific use or of limited value, and most retirement pension plans).¹³³ Benefit levels vary according to family size and composition, such as whether a family member is elderly or disabled; they are calculated by taking the maximum benefit for a household of a given size and composition and subtracting thirty percent of its net income, effectively imposing a thirty percent tax rate on beneficiaries.¹³⁴

Eligibility for food stamps is determined in advance. To apply for benefits, food stamp applicants must visit a state office in person during regular business hours. Applicants must fill out a detailed and often lengthy application and provide supporting documentation.¹³⁵ Over forty percent of food stamp applicants make two or more trips to the state office to complete the initial application process. Eligibility must be recertified throughout the

130. For descriptions of the FSP, see KAREN CUNNINGHAM, CHARACTERISTICS OF FOOD STAMP HOUSEHOLDS: FISCAL YEAR 2000 (Office of Analysis, Nutrition & Evaluation, U.S. Dep't of Agric., Food Stamp Program Report No. FSP-01-CHAR, 2001), <http://www.fns.usda.gov/oane/menu/published/fsp/files/participation/2000characteristics.pdf>; and Currie, *supra* note 126, at 205-13.

131. See 7 U.S.C. § 2014(c)-(e) (2000).

132. See *id.* § 2014(g)(1). The threshold for households with an elderly member is \$3000. *Id.*

133. The included assets are mostly cash and other assets that can be easily converted into cash (e.g., money in checking or savings accounts, savings certificates, and stocks or bonds). Vehicles are only narrowly included (excluding, for example, vehicles used to produce earned income), and then only if valued over a specified dollar threshold. See *id.* § 2014(g)(2)(B)(iv), (g)(2)(C). The valuation of vehicles has proved to be a major hurdle for state agencies and has been constantly simplified. See *infra* note 177. The asset rule in other means-tested programs is similar—i.e., it includes mostly cash and cash-like assets. See GEN. ACCOUNTING OFFICE, *supra* note 120, at 18-20.

134. Additionally, families are required to meet two income eligibility standards—a gross income standard and a net income standard. See 7 U.S.C. § 2014(c)-(g).

135. See MICHAEL PONZA ET AL., U.S. DEP'T OF AGRIC., CUSTOMER SERVICE IN THE FOOD STAMP PROGRAM 3-4, 38-51 (1999), <http://www.fns.usda.gov/oane/MENU/Published/FSP/FILES/ProgramOperations/fspcust.pdf>; Holtzblatt, *supra* note 126, at 119. The Indiana application, for example, while only two pages long, requires applicants to provide extensive documentation including records showing: place of birth; marriage certificates; life and medical insurance policies and premium payment book; bank statements; records of stocks, bonds, and other assets; make, model, and age of (and amount owed on) any vehicle; records of all income including social security benefits, child support, contribution, and earnings (pay stubs must give the employer's name, the place of employment, and the employer's statement); and receipts for all expenses, including child care, shelter costs (such as rent, utilities, and tax statements), medical expenses, (such as doctors' bills, prescription receipts, and insurance premium book reimbursements), and child support (including the court order showing the amount ordered). See State Form 30,465, Application for Assistance: Food Stamps, Cash Assistance, Health Coverage (Jan. 2003) [hereinafter Indiana State Form], <http://www.in.gov/icpr/webfile/formsdiv/30465.pdf>. Collecting this documentation is a formidable task.

year, often on a monthly basis and often requiring return visits to the state offices.¹³⁶

The EITC is a wage subsidy implemented as a refundable tax credit. As wages rise to specified levels, the credit increases, eventually plateaus, and then phases out. The levels of the phase-ins and phase-outs depend on family size, with larger families generally receiving more generous benefits.¹³⁷ Participants claim eligibility on their tax return without any prior certification process. Participants are, however, subject to ex post audits through both data matching and other auditing techniques.¹³⁸ Typically, benefits are paid once a year after the individual files a tax return. To the extent the credit offsets taxes otherwise due, individuals can adjust their wage withholding to get some of the benefits during the year. In addition, the credit can be obtained during the year through an advance payment system,¹³⁹ although, as discussed below, this option is rarely used.¹⁴⁰

The argument for the integration of transfer programs such as the EITC and the FSP into the tax system is that integration enhances administrative efficiency by reducing bureaucratic costs and complexity.¹⁴¹ In the language of the framework proposed here, there are benefits to specialization and to coordination from integration.

The benefits to coordination arise because the FSP and the EITC (and, for that matter, virtually all means-tested welfare programs) rely on similar criteria, such as income. The IRS is specialized in measuring these criteria and is therefore likely to be able to take these measurements more accurately and more cheaply than other agencies, such as the USDA.¹⁴² In

136. See DOROTHY ROSENBAUM, CTR. ON BUDGET & POLICY PRIORITIES, IMPROVING ACCESS TO FOOD STAMPS: NEW REPORTING OPTIONS CAN REDUCE ADMINISTRATIVE BURDENS AND ERROR RATES (2000), <http://www.cbpp.org/9-1-00fs.pdf>.

137. See Hotz & Scholz, *supra* note 16.

138. Auditing for the EITC is quite extensive as the IRS continually attempts to lower the rate of overpayments. For a discussion of the IRS enforcement efforts, see *id.* at 12-15; and Liebman, *supra* note 126, at 1171-72.

139. See I.R.C. § 3507.

140. See *infra* note 226 and accompanying text.

141. See, e.g., sources cited *supra* note 7; see also Alstott, *supra* note 42, at 533, 564-65. Others have made an argument for integration based on stigma; the idea is that providing transfer benefits through the tax system will reduce the stigma associated with welfare. See *infra* notes 152, 178. We do not address this argument here.

142. For example, almost half of all FSP payment errors are due to an incorrect determination of the household's income, and that figure is even higher when FSP recipients earn no income. GEN. ACCOUNTING OFFICE, GAO-02-409, FOOD STAMP PROGRAM: STATES' USE OF OPTIONS AND WAIVERS TO IMPROVE PROGRAM ADMINISTRATION AND PROMOTE ACCESS 7-8 (2002). The definition of family used in the FSP—a group of people who live together and customarily purchase food and prepare meals together—is different from the definitions found in the tax law, but it is not necessarily more accurate. Moreover, if the specific FSP definition of family is important for some reason, it could be added to the long list of family definitions already found in the tax law. See, e.g., I.R.C. § 1(a)-(b), (d) (defining the taxable family unit); *id.* § 21 (defining a household for purposes of the personal credit for household and dependent care); *id.* § 24(c)

addition, as a form of coordination, integration would save the costs of processing the same or similar information more than once by making use of a single preexisting measurement system. Integration would also confer savings on recipients, eliminating the need to fill out multiple forms and visit multiple government offices.¹⁴³

Further benefits to coordination arise through the interaction of tax and transfer programs on a variety of margins. For example, phase-outs of means-tested programs increase effective marginal tax rates, and failure to coordinate phase-outs can create extremely high rates for low-income individuals.¹⁴⁴ Similarly, the amount of benefits for any program should depend on amounts provided by other programs. A family receiving the EITC might, as a result, have less need for food stamps or vice versa.¹⁴⁵ Definitions of marriage and family also need to be coordinated. Both the tax law and welfare programs can create marriage penalties or bonuses. Coordination of these programs to limit the effects on marriage may therefore be important.¹⁴⁶

Empirical evidence on the accuracy and complexity¹⁴⁷ of the EITC and the FSP further support the argument for integration. Subject to data and

(defining dependents for purposes of the child tax credit); *id.* § 32(c)(3) (defining dependents somewhat differently for purposes of the EITC); *id.* § 73 (defining a parent for purposes of taxing services by children); *id.* § 152 (defining dependents for purposes of dependent deductions); *id.* § 267(b)(1), (c)(4) (defining a family for purposes of limitations on deductions and constructive ownership rules).

143. The GAO reports that a low-income family applying for the eleven major assistance programs in the United States would need to complete anywhere from six to eight applications (all requesting much of the same information) and visit up to six offices. *See* GEN. ACCOUNTING OFFICE, *supra* note 120, at 3.

144. *See* sources cited *supra* note 113.

145. Cross-inclusion (or -exclusion) of benefits in different transfer programs affects both the cumulative marginal tax rate and the total benefits provided by various transfer programs. For example, the FSP's deduction for shelter expenses functions as an additional housing subsidy for food stamp recipients. *See, e.g.,* Henry J. Aaron, *Alternative Ways To Increase Work Effort Under Income Maintenance Systems*, in INTEGRATING INCOME MAINTENANCE PROGRAMS, *supra* note 120, at 161; Thad W. Mirer, *Alternative Approaches to Integrating Income Transfer Programs*, in INTEGRATING INCOME MAINTENANCE PROGRAMS, *supra* note 120, at 147.

146. Other possible interactions can affect, among other things, out-of-wedlock childbearing, fertility, living arrangements, investment in assets, and savings.

A striking example of miscoordination across government agencies is the absence of nonintegrated welfare programs from the government's distributional schedules. None of the congressional or Treasury Department staffs (the Joint Committee on Taxation, the Congressional Budget Office, or the Treasury's Office of Tax Analysis) includes in its distributional schedules nontax assistance programs. *See* Michael J. Graetz, *Paint-by-Numbers Tax Lawmaking*, 95 COLUM. L. REV. 609 (1995). Overlooking nontax welfare policy inevitably induces erroneous analysis of redistribution, efficiency, and stabilization factors, and hence produces misguided fiscal policy and outcomes. *See, e.g.,* EDGAR K. BROWNING, REDISTRIBUTION AND THE WELFARE SYSTEM 7-30 (1975); R. Glenn Hubbard, *On the Use of "Distributional Tables" in the Tax Policy Process*, 46 NAT'L TAX J. 527, 527-32 (1993).

147. Complexity of the fiscal system, or of any single fiscal policy, can be measured by the amount of economic resources required by all constituents (i.e., administrative and fiscal units) to implement that system or policy. That is, administrative and compliance costs are the components of fiscal complexity. *See* Joel Slemrod, *Did the Tax Reform Act of 1986 Simplify Tax Matters?*,

conceptual limitations, the key facts are that the FSP costs more to implement than the EITC by an order of magnitude, but the FSP is not any more accurate than the EITC (although it produces a very different pattern of errors).

In particular, annual administrative costs of the FSP are estimated to be about \$4 billion per year.¹⁴⁸ Individual compliance costs are also likely to be high because of the certification, recertification, and reporting requirements.¹⁴⁹ There are no firm estimates for the administrative costs of implementing the EITC because the IRS does not separately account for the cost of administering the program. About ninety-five percent of EITC claimants would file tax returns even if not eligible for the EITC, which means that the IRS would process most of the information and individuals would incur the cost of filing returns anyway.¹⁵⁰ Individuals must file an extra form with their return to claim the EITC, which increases their costs somewhat. The EITC also creates additional audits, which impose costs on both the government and individuals. In light of these facts, estimates have put the administrative costs of the EITC at about \$320 million, or less than one-tenth the amount spent on the FSP.¹⁵¹ Even at this lower cost, the EITC is substantially larger than the FSP.¹⁵²

J. ECON. PERSP., Winter 1992, at 45; Joel Slemrod, *Optimal Tax Simplification: Toward a Framework for Analysis*, in PROCEEDINGS OF THE 76TH ANNUAL CONFERENCE ON TAXATION 158 (Stanley J. Bowers ed., 1984); Joel Slemrod, *Optimal Taxation and Optimal Tax Systems*, J. ECON. PERSP., Winter 1990, at 157. Janet Holtzblatt, for example, applies Slemrod's complexity index. See Holtzblatt, *supra* note 126, at 119. Note that other measures of complexity (e.g., the number of volumes, sections, regulations, words, and letters required to create and govern a given program) cannot constitute a reliable and coherent measure of complexity.

148. These costs constitute 19% of FSP costs, Holtzblatt, *supra* note 126, at 121, or about 24% of distributed benefits for fiscal year 1998. For similar estimates, see Hotz & Scholz, *supra* note 16, at 12. To get a better grip on these costs, compare them to the annual administrative costs of managing the whole tax system: The entire IRS budget in fiscal year 1998 was \$7.3 billion, and the IRS served over 122 million individual taxpayers and 5 million corporations. Holtzblatt, *supra* note 126, at 121.

149. For a description of these procedural requirements, see ROSENBAUM, *supra* note 136. Unfortunately, the only data on FSP compliance costs are survey or qualitative data. See SUSAN BARTLETT ET AL., THE FOOD STAMP APPLICATION PROCESS: OFFICE OPERATIONS AND CLIENT EXPERIENCES 31-69 (1992) (describing the results of a client survey); PONZA ET AL., *supra* note 135, at 38-49 (providing qualitative measures of applicants' compliance costs); Holtzblatt, *supra* note 126, at 119-21 (same). These measures show that the cost of complying with the FSP is much higher than the cost of complying with the EITC. In addition, a verification process increases compliance costs for related third parties, such as employers. Acknowledging these problems, the USDA has been moving toward a simplified measurement system. See GEN. ACCOUNTING OFFICE, GAO-01-272, FOOD STAMP PROGRAM: STATES SEEK TO REDUCE PAYMENT ERRORS AND PROGRAM COMPLEXITY (2001); GEN. ACCOUNTING OFFICE, *supra* note 142, at 2-3; ROSENBAUM, *supra* note 136; see also *infra* notes 221-222 and accompanying text.

150. See Holtzblatt, *supra* note 126, at 121; Hotz & Scholz, *supra* note 16, at 167 (citing *Earned Income Tax Credit Compliance Study: Hearing Before the House Comm. on Ways & Means*, 105th Cong. (1997) (testimony of John K. Scholz, Deputy Assistant Secretary of Tax Analysis, U.S. Department of the Treasury), 1997 WL 10571026).

151. The administrative costs of the EITC have been calculated to be one percent of its distributed benefits. GEN. ACCOUNTING OFFICE, GAO/T-GGD-95-179, EARNED INCOME CREDIT: NONCOMPLIANCE AND POTENTIAL ELIGIBILITY REVISIONS 5 (1995) (reprinting *Earned Income*

Notwithstanding the vastly higher administrative and compliance costs of the FSP, it is not clear that it is any more accurate.¹⁵³ The FSP has a lower error rate than the EITC, but also a much lower participation rate. EITC overpayments are around 27%,¹⁵⁴ while FSP overpayments are around 7%.¹⁵⁵ Underpayment rates are similar between the two programs: EITC underpayments are below 2.5%,¹⁵⁶ and the FSP's are around 2.9%.¹⁵⁷ On the other hand, the EITC participation rate is about 89%,¹⁵⁸ while FSP

Tax Credit: Hearing Before the Senate Comm. on Fin., 104th Cong. (1995) (testimony of Lynda D. Willis, Associate Director for Tax Policy and Administrative Issues, U.S. General Accounting Office), 1995 WL 347319). Jeffrey Liebman also estimates EITC administrative costs to be less than one percent of transferred benefits. Jeffrey B. Liebman, *The EITC Compliance Problem*, JOINT CTR. FOR POVERTY RES. NEWS, Summer 1998, at <http://www.ksg.harvard.edu/jeffreyliebman/jcprsurvey.htm>. For comparison (or for another method of estimating the administrative costs of distributing the EITC), the IRS's overall administrative costs of tax collection are around 0.45% of collected revenue. See INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, INTERNAL REVENUE SERVICE 2002 DATA BOOK 37 tbl.30 (2002).

152. See MOFFITT, *supra* note 22, at tbl.2. Scholars have also argued that tax transfers may prove less stigmatizing. See, e.g., DAVID T. ELLWOOD, POOR SUPPORT 115 (1988); PAUL SAMUELSON, ECONOMICS 762 (11th ed. 1980); Rogers & Weil, *supra* note 126, at 396-97. Some evidence of stigma effects has been found for the provision of food stamps and AFDC (now TANF). See JAMES C. OHLS & HAROLD BEEBOUT, MATHEMATICA POLICY RESEARCH, INC., THE FOOD STAMP PROGRAM: DESIGN TRADEOFFS, POLICY, AND IMPACTS 59-60 (1993); PONZA ET AL., *supra* note 135, at 66-70; Robert Moffitt, *An Economic Model of Welfare Stigma*, 73 AM. ECON. REV. 1023, 1023 (1983). But stigma effects may arise under the tax system as well. See Smeeding et al., *supra* note 126, at 1189. It is hard to assess the effect of stigma; in addition, a large part of its effect may already be reflected in programs' participation numbers.

153. It is difficult to measure accuracy directly. Accuracy is usually measured by looking at under- and overprovision of benefits, and we follow that tradition here.

154. The IRS has collected EITC compliance data for several years. See INTERNAL REVENUE SERVICE, DEP'T OF THE TREASURY, STUDY OF EITC FILERS FOR TAX YEAR 1994, at 7 (1997) (finding an overpayment of 23.5% for tax year 1994); INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, COMPLIANCE ESTIMATES FOR EARNED INCOME TAX CREDIT CLAIMED ON 1999 RETURNS 3 (2002) [hereinafter IRS 1999 COMPLIANCE ESTIMATES] (estimating overpayments of 23.8% to 25.6% for tax year 1997 and from 27.0% to 31.7% for tax year 1999). Taking a simple average of these studies, we estimate an overpayment rate of 27%. Notice also that estimates of overpayments in 1997 and 1999 may have been exaggerated, since they did not account for offsetting errors in regard to the adjusted gross income tiebreaker rule (which resolves "ties" of complicated living arrangements such as when a child is a qualifying child of more than one person). This tiebreaker rule may have caused a maximum overestimation of 17% of total errors. See, e.g., IRS 1999 COMPLIANCE ESTIMATES, *supra*, at 14. Additionally, steps undertaken since 1999 may have improved EITC compliance. See, e.g., *id.*, at 21-22; Hotz & Scholz, *supra* note 16, at 15.

155. GEN. ACCOUNTING OFFICE, *supra* note 149, app. II at 26 tbl.2 (reporting fiscal year 1999 data). The numbers are similar for other fiscal years.

156. See INTERNAL REVENUE SERVICE, DEP'T OF THE TREASURY, COMPLIANCE ESTIMATES FOR EARNED INCOME TAX CREDIT CLAIMED ON 1997 RETURNS 8 tbl.1 (2000) [hereinafter IRS 1997 COMPLIANCE ESTIMATES]; IRS 1999 COMPLIANCE ESTIMATES, *supra* note 154, at 11 tbl.1.

157. GEN. ACCOUNTING OFFICE, *supra* note 149, app. II, at 26 tbl.2.

158. GEN. ACCOUNTING OFFICE, GAO-02-290R, EARNED INCOME TAX CREDIT ELIGIBILITY AND PARTICIPATION 3 (2001) ("The amount [of 1999 EITC benefits] foregone by nonparticipating households represented about 11.1 percent of the total credit that households were eligible to claim."). All other studies of the participation rate of the EITC measured household participation rather than the total dollar benefits claimed by eligible households. See Scholz, *supra* note 126, at 70-71 (calculating participation rates between 80% and 86.4%); Marsha Blumenthal et al., Participation and Compliance with the Earned Income Tax Credit 32-35

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participation is around 70%.¹⁵⁹ Combining each program's underparticipation rate with its underpayment rate to determine an overall underprovision rate, we get the following picture:

TABLE 1. COMPARISON OF THE EITC AND FSP

	Underprovision	Overprovision	Accuracy (equal weights)
EITC	13.5%	27%	59.5%
FSP	33%	7%	56%

Note: The aggregate accuracy measure of the FSP also includes a 4% inaccuracy due to food stamp trafficking. *See supra* note 159.

We may not weigh these types of errors equally, so we cannot say for certain how these numbers compare, but we see no overwhelming reason why the FSP error rate should be preferable (and we argue below that in fact the EITC error rate is actually preferable).¹⁶⁰ Indeed, both the USDA

(2003) (unpublished manuscript, on file with authors) (simulating a participation rate of 94.2% among households with legal filing requirements and 50% among households without filing requirements). Note that both studies used different methods and were applied to different time periods. As a suggestive comparison to these studies, the mentioned GAO study estimates a 75% participation rate among households—what would seem to be a rather conservative estimate. *See* GEN. ACCOUNTING OFFICE, *supra*, at 2.

159. KAREN CUNNINGHAM, TRENDS IN FOOD STAMP PROGRAM PARTICIPATION RATES: 1994-2000, at 2-5 (2002), <http://www.fns.usda.gov/oane/MENU/Published/FSP/FILES/Participation/Trends94-00.pdf>. This rate excludes three outstanding years, 1994 to 1996. Participation rates among households, rather than in dollar amounts, are typically around 60%. *See* MOFFITT, *supra* note 22, at 19. There is also trafficking in food stamps of about 4% of the total amount awarded. It is not clear how to count this. It could be counted as overpayments because a payment goes to an ineligible individual, but it could also be counted as underpayments because the eligible recipient (who has sold his food stamps for cash) is not receiving the intended benefit. The right answer is probably somewhere in between. Studies of food stamp trafficking in retail stores can be found in THEODORE F. MACALUSO, U.S. DEP'T OF AGRIC., THE EXTENT OF TRAFFICKING IN THE FOOD STAMP PROGRAM (1995), <http://www.nal.usda.gov/foodstamp/FOODSTAMPREPORTS/FSP-95.PDF>; and THEODORE F. MACALUSO, THE EXTENT OF TRAFFICKING IN THE FOOD STAMP PROGRAM: AN UPDATE (Office of Analysis, Nutrition & Evaluation, U.S. Dep't of Agric., Food Stamp Program Report No. FSP-03-TRAF, 2000), <http://www.fns.usda.gov/oane/MENU/Published/FSP/FILES/ProgramIntegrity/Trafficking1999-2002.pdf>. These studies found that 4% and 3.5% of issued food stamps were trafficked in retail stores during fiscal year 1993 and fiscal years 1996-1998, respectively. *See* the latter study for some caveats. There are no data on the extent of food stamp trafficking between individuals outside the retail store setting.

160. Think, for example, of the following two kinds of errors: (1) a well-off household (say, with a monthly income of \$10,000) enjoying an erroneous fiscal windfall of \$100; and (2) a needy family, who can hardly sustain a reasonable shelter and enough nutritious food during any month,

and the GAO, in analyzing the FSP, weight the two types of errors equally.¹⁶¹ Therefore, when accuracy is measured based on under- and overprovision, the FSP, while generating a different type of error than the EITC, cannot be said to be more accurate than the EITC, even though it costs ten times as much to administer and is only one-half the size.

The question posed is whether a change in institutional structure can improve the performance of either the EITC or the FSP. The argument here is similar to that invoked to support a negative income tax: The idea is that a single approach to need or to well-being should be used in the tax and transfer system. A consistent methodology makes sense from a policy perspective—need is need, and there is no reason to change the approach when a tax goes from positive to negative. There is nothing special about zero. In addition, there are great institutional advantages to a single system, such as the savings of administrative and compliance costs.¹⁶² The concern, addressed in the next Section, is that integration would undermine the benefits of specialization that come from addressing the particular administrative problems presented by food stamps.

B. *Food Stamps*

Given these reasons for integrating the FSP into the tax system, one might think that the answer is clear. There are, however, a number of aspects of the FSP that are not complementary to the tax system. Integration might involve compromises to these aspects of program design.

There are four areas of concern, three of them found in Alstott's discussion of the EITC, and a fourth not applicable to the EITC, and therefore not discussed by Alstott.¹⁶³ First, there are important differences in eligibility measurements and criteria between the tax system and the FSP. Arguably, an ideal transfer system might use different measurements

missing by error a monthly payment of \$100. The question is what kind of error requires more public scrutiny. See Alstott, *supra* note 42, at 569 n.138 (hinting at a similar intuition). Indeed, looking at the adverse impact on needy recipients, one might well consider the error of underprovision, even in a small portion of cases, to be significantly worse than that of overprovision—a fact that commends the EITC's pattern of error rather than the FSP's.

161. For example, the USDA operates a quality control system to monitor states' operations of their food stamp provision in order to improve accuracy in implementation. The USDA determines either fiscal sanctions or enhanced funding for each state annually according to its error rate. The USDA's common practice is to combine under- and overpayments, weighting them equally, into a cumulative measure of error. See ROSENBAUM, *supra* note 136, at 4-5; QUALITY CONTROL BRANCH, U.S. DEP'T OF AGRIC., FOOD STAMP PROGRAM QUALITY CONTROL ANNUAL REPORT: FISCAL YEAR 1998, at 3-13 (2000). This practice is also followed in the GAO report on FSP errors. See GEN. ACCOUNTING OFFICE, *supra* note 149, at 5-7.

162. See *supra* notes 141-146 and accompanying text.

163. Although the focus of her paper is on the EITC, Alstott notes that her arguments also apply to other means-tested transfer programs. See Alstott, *supra* note 42, at 535-36. Similar arguments can be found in Rogers & Weil, *supra* note 126, at 394-98.

from an ideal tax system. If the systems were integrated, they would use a single set of criteria, so that integrating the two would involve a loss of accuracy. Second, the pattern of errors between compliance and participation is different in the two systems. Integrating the FSP into the tax system would likely substitute the tax pattern of errors for the FSP pattern of errors. Third, the tax system tends to use long measurement periods to measure permanent changes in well-being, while welfare systems use short prospective measurement periods to be responsive to temporary changes in circumstances. The fourth concern, not mentioned by Alstott because she focuses on the EITC, is that food stamps are provided in-kind while the tax system is specialized in collecting and distributing cash.

We review these considerations below, showing how they relate to issues of specialization and coordination, and how they fit within the general framework discussed above. Each of these potential areas of concern can be seen as a problem of accuracy. The question is whether a specialized food stamp program is necessary to provide that accuracy or whether coordination with the tax system and the use of the tax system's resources—which are specialized to handle income measurement—is superior. Our conclusions differ somewhat from Alstott's conclusion regarding similar issues with respect to the EITC. In particular, we conclude that only the responsiveness problem—the problem of measurement periods—presents an obstacle to integration of food stamps into the tax system. The data on responsiveness are mixed, and we are uncertain of what the costs to responsiveness from integration would be, but there is at least a significant chance that the responsiveness problem is sufficiently serious to merit caution in integrating the programs. We do not want to put too much stress on these differences, however. Instead, our goal is to show how the analysis fits directly into the institutional framework we posed above.

1. *Measurement Criteria*

On the surface, the tax system and the FSP (as well as almost all means-tested transfer programs) use similar eligibility criteria—usually income, assets, and family composition (including whether a family member has a special status, such as disability or advanced age). This commonality is the primary reason that integration of welfare policy seems potentially attractive. Nevertheless, as Alstott notes, there are important differences.

In particular, Alstott argues that the income tax system tends to use a less accurate measurement of income and other resources than traditional

transfer programs.¹⁶⁴ Most transfer programs attempt to measure all sources of cash available to meet the living expenses of a family, with limited deductions. For example, the eligibility criteria for food stamps look to all cash income, allowing deductions (other than standard deductions and a fixed deduction against earned income) mainly for dependent care, medical expenses, and excess shelter costs.¹⁶⁵ The tax system, however, excludes many sources of wealth, such as retirement benefits¹⁶⁶ and interest on state and local bonds.¹⁶⁷

Transfer programs also tend to measure the value of recipients' assets, which is not generally done in the tax system. Thus, food stamps limit eligibility to families with less than \$2000 in certain assets, with some adjustments for vehicles.¹⁶⁸ By contrast, the EITC does not have an asset or wealth test.

The definition of a family is likewise more nuanced under welfare programs than under the tax system.¹⁶⁹ Current tax law has a very narrow definition of family, generally treating even children in the same household as separate taxpayers. Income transfer programs, in contrast, adopt a broader definition of family that includes most individuals who live together. For example, the FSP defines a household as a group of people who live together and customarily purchase food and prepare meals together.¹⁷⁰

Adopting these tax definitions might create problems for a transfer system. As Alstott notes, in the 1960s and 1970s, when the negative income tax was receiving serious academic attention, scholars argued that the income definition in the tax law was inadequate for transfer programs.¹⁷¹ The tax system's measurement of income is sufficiently crude that some families have received the EITC even though their incomes, if measured using a comprehensive base, could be as much as \$75,000.¹⁷²

This conclusion argues against integration. One of the main advantages to integrating transfer programs such as the FSP into the tax system is to use common definitions and infrastructure. In our framework, integration can take advantage of the specialized income measurement resources of the tax system and gain the benefits of coordination with the tax system.

164. See Alstott, *supra* note 42, at 566-79.

165. The definition of gross income in the FSP does, however, exclude some sources of income. See 7 U.S.C. § 2014(d) (2000).

166. See I.R.C. § 401.

167. See *id.* § 103.

168. See *supra* notes 131-134 and accompanying text.

169. See Alstott, *supra* note 42, at 576-79.

170. See 7 U.S.C. § 2012(i).

171. See Alstott, *supra* note 42, at 572-73.

172. *Id.* at 575.

But using tax definitions might result in a significant loss of accuracy for the FSP.

There are several responses to these arguments. First, it is not clear why transfer systems and the tax system use different definitions. Alstott merely observes that they do and argues that integration would involve a compromise of current practices. But to determine the social cost of such a change, we need to understand why the different programs use different definitions in the first place. There is nothing special about welfare programs that should make us want to use different definitions: It is not clear why we should care more about accuracy when giving very small sums as transfers to a poor individual than when taking thousands or millions in taxes from a very wealthy individual.¹⁷³

Second, assuming that the tax system is inaccurate, we must weigh the value of accuracy against its cost. If the savings from integration are substantial, it may be worth the loss in accuracy. Merely noting that there might be a loss in accuracy is insufficient.

Third, even if transfer programs use more accurate definitions of income, they are unlikely to be very good at measurement. In fact, notwithstanding attempts to measure well-being carefully in the FSP, about half of all FSP payment errors are due to an incorrect determination of the household's income.¹⁷⁴ The tax system, on the other hand, specializes in income measurement and has invested billions of dollars in this expertise, including in computer systems that can match income reports and in agents trained to ferret out fraud. There are, of course, substantial mismeasurements by the tax system, but our guess is that for any given measure of income, the specialization of the tax system is likely to result in better measurement per dollar spent. It is not clear that the attempt at higher accuracy in transfer systems such as the FSP actually succeeds.

Finally, even if different definitions of well-being are necessary for food stamps and taxes, the IRS might still be best at measuring along those margins. That is, merely because we are going to have the complexity of different definitions of well-being for different programs does not mean that integration does not make sense.¹⁷⁵ For example, the FSP measures wealth to determine eligibility while the EITC does not.¹⁷⁶ Under FSP rules,

173. It appears to be the case politically that we treat the two scenarios differently. We are not sure why this is so.

174. GEN. ACCOUNTING OFFICE, *supra* note 142, at 8.

175. The IRS actually uses different definitions and identifies various taxable entities for different purposes. We do not see why modifying the tax system to take these new criteria into account would require "radical and costly changes in the tax system." Alstott, *supra* note 42, at 568. It would obviously be costly, but we believe, for the reasons stated in the text, that the result would still be cheaper than a nonintegrated implementation of the FSP.

176. Further note that the marginal value of accuracy added by the measurement of countable resources on top of income may be negligible. The USDA reports that 89.5% of households on food stamps have less than \$500 in countable resources, while the limit is \$2000. Only 1.6% have

however, the wealth measurement is largely limited to cash-like assets. These assets—with a clear market value—can be easily measured by the tax system.¹⁷⁷ The IRS might therefore be the best agency to measure each criterion; all that would be required would be to alter the definitions of the tax system to achieve an acceptable level of accuracy. The problem of different measurement criteria is thus not a good argument against integrating the FSP into the tax system.

2. Error Patterns

As noted, food stamps have a low participation rate but also a low overpayment rate. Both facts are likely attributable to the eligibility process. Precertification is very costly for low-income individuals, which discourages FSP applicants but at the same time weeds out false claims.¹⁷⁸ The EITC has a high participation rate but also a high overpayment rate. These facts are likely due to the lack of a precertification process. Individuals need merely to file a tax return to claim the EITC. Most individuals claiming the EITC must file a return anyway, so the additional cost of claiming the EITC is relatively low.¹⁷⁹

Alstott refers to this pattern of errors as a tradeoff between participation and compliance.¹⁸⁰ The FSP chooses to have a high compliance rate at the

between \$1501 and \$2000 in such assets; only 0.7% have over \$2000. See OFFICE OF ANALYSIS, NUTRITION & EVALUATION, *supra* note 130, at 35 tbl.A-3.

177. The one exception may be the measurement of the value of vehicles, which is complicated. The valuation of vehicles has been a difficult task for state agencies, and the inclusion and valuation rules have been made continually less stringent. See, e.g., GEN. ACCOUNTING OFFICE, *supra* note 142, at 11-13. The necessity of valuing motor vehicles, however, seems doubtful. The USDA ran a demonstration program that essentially exempted one vehicle per food stamp household from valuation. The study estimated increases of only 6% in participating households and about 3% in food stamp benefits. See NANCY WEMMERUS & BRUCE GOTTLIEB, MATHEMATICA POLICY RESEARCH, INC., RELAXING THE FSP VEHICLE ASSET TEST: FINDINGS FROM THE NORTH CAROLINA DEMONSTRATION 39-54 (1999), <http://www.mathematica-mpr.com/3rdLevel/relaxing.htm>. Recently, states were allowed greater flexibility in shaping a food stamp vehicle rule that suits their needs. A recent survey found that a little less than half of the states chose essentially to exempt all vehicles of food stamp households; most of the rest used some other lenient rule. See CTR. ON BUDGET & POLICY PRIORITIES, STATES' VEHICLE ASSET POLICIES IN THE FOOD STAMP PROGRAM 3, <http://www.cbpp.org/7-30-01fa.pdf> (last visited Dec. 4, 2003).

178. Additional explanations for low participation rates are informational barriers and stigma. See, e.g., Rebecca M. Blank & Patricia Ruggles, *When Do Women Use Aid to Families with Dependent Children and Food Stamps? The Dynamics of Eligibility Versus Participation*, 31 J. HUM. RESOURCES 57 (1996) (conducting an empirical study of the food stamp program and AFDC, and finding high participation costs and “distaste” for public assistance); Beth Osborne Daponte et al., *Why Do Low-Income Households Not Use Food Stamps? Evidence from an Experiment*, 34 J. HUM. RESOURCES 612 (1999) (observing that ignorance about the food stamp program contributes to nonparticipation).

179. See *supra* text accompanying note 150.

180. See Alstott, *supra* note 42, at 584-89; see also Yin et al., *supra* note 114 (providing an extensive study of EITC participation and compliance).

cost of a low participation rate while the EITC opts for a high participation rate at the cost of a low compliance rate. Given that information is costly, such a tradeoff between participation and compliance seems inevitable.

Alstott takes the existing pattern of welfare programs such as the FSP (low participation, low overpayment) to be desirable. We are not sure we would agree. It is not at all obvious, in light of the tradeoff, which pattern is preferable. As noted above, both the GAO and the USDA weight under- and overpayments equally.¹⁸¹

Although there is no general theory on how to balance under- and overpayments, we can identify three relevant factors. First, how we choose the balance may depend on which individuals fail to receive payments for which they are eligible and which individuals get overpayments. For example, Liebman examines which individuals get EITC overpayments and finds that many overpayments go to families that are quite similar to eligible families.¹⁸² Ineligibility often results from a failure to meet one or more minor requirements rather than because overall income is too high.¹⁸³ In such cases, we may not be concerned by overpayments.

Second, overpayments require higher tax rates, leading to excess burden. We would need to know the marginal cost of funds to determine the size of this effect. Finally, for any given belief about the tradeoff between overpayments and underpayments, we must examine the administrative cost of reaching the desired balance between the two. It will generally be administratively cheaper to have more overpayments but full participation than to prevent overpayments at the cost of less participation. The reason is simple: It takes resources to prevent overpayments.

While the tradeoff between these factors may be complex, if we examine the actual numbers the FSP pattern does not look attractive compared to the EITC pattern, given almost any imaginable views on how to balance these factors. In particular, Janet Holtzblatt reports that if we add overpayments and administrative costs together, the EITC and the FSP both incur costs of about 25 cents on the dollar.¹⁸⁴ This means that, as compared to the EITC (and by extension, the FSP if it were administered through the tax system), it costs the current FSP a dollar of administrative costs to prevent a dollar of overpayments. This cannot be justified. For example, suppose that a welfare program has 100 truly eligible recipients who each receive \$1, and that the tax system creates no administrative costs but has overpayments of 25 cents on the dollar while the FSP has 25 cents on the

181. See *supra* note 161 and accompanying text.

182. See Liebman, *supra* note 126.

183. Such failures seem to be due in particular to “qualifying child” errors. See IRS 1997 COMPLIANCE ESTIMATES, *supra* note 157, at 10 tbl.2; IRS 1999 COMPLIANCE ESTIMATES, *supra* note 154, at 13 tbl.2; Liebman, *supra* note 126, at 1168-69; McCubbin, *supra* note 114, at 1137-41.

184. See Holtzblatt, *supra* note 126, at 119-22.

dollar of administrative costs and no overpayments. The cost of both the FSP and the tax system would be \$125. It is hard to imagine that we would want to essentially throw away the \$25 on administrative costs rather than transfer it to individuals.

Moreover, these numbers may significantly understate the problem. Holtzblatt's study, from which these figures are derived, does not consider compliance costs of participants: As a society, we thus spend more than a dollar to prevent a dollar of overpayments. Holtzblatt also does not consider the social costs of FSP underprovision due to nonparticipation. Once these two additional costs are factored in, the price of preventing overpayments for the FSP seems exorbitant. Finally, factor in the data showing that overpayments under the EITC would go to families that are similar to eligible families. If overpayments under an integrated FSP were similar, there would seem to be no argument for the FSP pattern of errors. Therefore we can conclude that the pattern of errors for the EITC is preferable.¹⁸⁵ The error pattern argument supports integration.

3. *In-Kind Provision of Benefits*

The FSP provides benefits in-kind through a voucher-type system. The government does not directly provide food to individuals on food stamps, unlike, say, those receiving subsidized school lunches.¹⁸⁶ Instead, the government provides individuals with coupons (typically in the form of an electronic card) that can be used only to purchase food at USDA-certified establishments. Authorized retailers must fill out an application showing that they meet the requirements and personally go through a training session. Integrating the FSP into the tax system would probably involve eliminating this in-kind delivery, because the tax system could not easily engage in this certification.¹⁸⁷

The rationale for in-kind transfers has been subject to extensive study. While the merits of such transfers have been considered in detail,¹⁸⁸

185. There could, of course, be intermediate solutions, such as reducing expenditures on compliance with the FSP. The USDA has actually taken steps toward simplifying FSP requirements. For example, the FSP has adopted longer measurement periods which relieve much of the administrative and compliance burdens. *See infra* notes 221-222 and accompanying text. But these steps will inevitably undermine accuracy.

186. The National School Lunch Program provides subsidies (and some additional commodities) to participating schools, which in turn provide meals to eligible students. Eligible children, however, receive coupons from their schools (according to their eligibility status) that can be redeemed for provided meals. For additional details, see Currie, *supra* note 126, at 218-22.

187. An alternative solution, which might allow for the continued provision of in-kind benefits, might be achieved through coordination of the USDA and the tax system. *See infra* notes 196-198 and accompanying text.

188. There is a large literature on in-kind provision of benefits. The literature highlights three reasons for using in-kind benefits. First, providing benefits in kind may promote target efficiency: When recipients' characteristics are imperfectly observable, in-kind benefits may function more

arguments made in these studies might not apply to transfers of food (as opposed to insurance or durable goods). Fortunately, we need not delve into that literature here. The reason why is that the typical food stamp benefit is less than the monthly food budget for most beneficiaries, and is only slightly restricted in its approved food items. In theory, therefore, the program's decision to provide in-kind benefits or cash assistance should have no effect for these beneficiaries; the entire food stamp amount will be spent on food either way. This prediction is generally borne out by observed evidence, although there are small and persistent deviations.¹⁸⁹ The reasons for such deviations are not fully understood.

effectively than cash as a second-best screening tool for the "correct" beneficiaries. Second, in-kind distributions may temper the effects of the Good Samaritan Dilemma, a problem with incentives that causes beneficiaries to use their current benefits inefficiently to better qualify for future benefits. Finally, the provision of benefits in kind may yield more positive externalities than a system that leaves consumption choices entirely to the discretion of recipients. *See, e.g.,* Timothy Besley & Stephen Coate, *Public Provision of Private Goods and the Redistribution of Income*, 81 AM. ECON. REV. 979 (1991); Charles Blackorby & David Donaldson, *Cash Versus Kind, Self-Selection, and Efficient Transfers*, 78 AM. ECON. REV. 691 (1988); Neil Bruce & Michael Waldman, *Transfers in Kind: Why They Can Be Efficient and Nonpaternalistic*, 81 AM. ECON. REV. 1345 (1991); Stephen Coate, *Altruism, the Samaritan's Dilemma, and Government Transfer Policy*, 85 AM. ECON. REV. 46 (1995); Stephen Coate et al., *Pecuniary Redistribution Through In-Kind Programs*, 55 J. PUB. ECON. 19 (1993); Firouz Gahvari, *In-Kind Versus Cash Transfers in the Presence of Distortionary Taxes*, 33 ECON. INQUIRY 45 (1995); Albert L. Nichols & Richard J. Zeckhauser, *Targeting Transfers Through Restrictions on Recipients*, in PAPERS AND PROCEEDINGS OF THE NINETY-FOURTH ANNUAL MEETING OF THE AMERICAN ECONOMICS ASSOCIATION 372 (Robert W. Clower & Wilma St. John eds., 1982).

189. *See* OHLS & BEEBOUT, *supra* note 152, at 97-111; Currie, *supra* note 126, at 271-73. Pre-1990 studies estimated the marginal propensities to spend on food (MPS) out of food stamps and out of cash income (that is, the amount spent on food out of an additional \$1 of food stamp or cash income). Overall, it is estimated that the MPS out of food stamps benefits centers around \$0.25, whereas the MPS out of ordinary cash income is less than \$0.15. *See* Currie, *supra* note 126, at 272 (summarizing the findings of THOMAS M. FRAKER, U.S. DEP'T OF AGRIC., THE EFFECTS OF FOOD STAMPS ON FOOD CONSUMPTION: A REVIEW OF THE LITERATURE (1990)). Additionally, Peter Rossi argues that, overall, various studies show reductions in food expenditures of about "\$0.18-0.28 for each dollar provided in the form of cash, compared with conventional food stamps." PETER H. ROSSI, FEEDING THE POOR: ASSESSING FEDERAL FOOD AID 36 (1998). Rossi concludes, however, that the main effect of food stamps is as an income transfer program. *Id.* at 5. Some researchers have gone so far as to contend that the disparity in the small percentage of constrained households and the estimation of MPS constitutes a puzzle. *See, e.g.,* ROBERT BREUNIG ET AL., EXPLAINING THE FOOD STAMP CASH-OUT PUZZLE (Food & Rural Econ. Div., U.S. Dep't of Agric., Food Assistance and Nutrition Research Report No. 12, 2001). Nonetheless, cash-out experiments and studies that compare food stamps with cash assistance rather than with ordinary cash income do not find any statistically significant difference between coupons and cash assistance. Fraker provides a few reasons why the estimated MPS out of ordinary cash income might actually be lower than an MPS out of food cash assistance, and hence why the mentioned difference in estimated MPS is overestimated. Indeed, few studies compared food stamps with cash assistance rather than with ordinary cash income; these studies reveal no statistically significant difference between coupons and cash assistance. FRAKER, *supra*, at 73-75. Janet Currie discusses the cash-out studies and concludes that they present no clear-cut result. *See* Currie, *supra* note 126, at 272-73. Robert Moffitt reports: "What evidence there is on the cash-equivalent value of in-kind transfers suggest that Food Stamps are very nearly equivalent to cash . . ." Robert A. Moffitt, *Welfare Programs and Labor Supply*, in 4 HANDBOOK OF PUBLIC ECONOMICS 2393, 2396 (Alan J. Auerbach & Martin Feldstein eds., 2002).

Although some may value the increase (if any) in food consumption due to in-kind provision, it is doubtful that any such benefit is worth the cost. If we measure nutritional outcomes as opposed to food intake, we cannot say, based on available evidence, that providing cash assistance rather than food stamps would have any effect.¹⁹⁰ And it is nutrition, not caloric intake, that we should be concerned about with a food program: As the Food Stamp Act itself declares, food stamps are aimed at “raising levels of nutrition among low-income households.”¹⁹¹

“Cashing out” food stamps would also save administrative and compliance costs above and beyond the immediate savings from integrating food stamps into the tax system. An individual wanting to use the value of food stamps for something other than food has an incentive to sell them for cash. This means that the FSP must spend resources to monitor and enforce the use of food stamps, and that individuals (and food retailers) will incur costs to comply with the food stamp police.¹⁹² Some of the costs of enforcement have gone down in recent years with the switch to electronic benefits, which are harder to trade, but the problem is still significant.

Finally, European welfare systems do not have specific food transfer programs.¹⁹³ There is no evidence that their absence leads to systematic effects on food security or nutrition.¹⁹⁴

One argument against cashing out food stamps through integration with the tax system is that it would be too big a change in the purposes of the program. Cashing out the FSP would be like eliminating it and increasing the EITC or TANF by a comparable amount. The argument of this Article is that we should compare institutional performance in meeting previously defined goals. The goal of food stamps might be defined as improving nutrition among the very poor, in which case cashing out would seem to have little effect on the achievement of such a goal. But the FSP’s goal might also be to provide food to the poor. It is not clear why we would opt

190. Currie surveys studies that attempted to measure the nutrient effect of the FSP. See Currie, *supra* note 126, at 258-59. It turns out the evidence is mixed. Additionally, a couple of recent studies have found a positive correlation between food stamp participation and being overweight or obese, particularly among women. See Marilyn S. Townsend et al., *Food Insecurity Is Positively Related to Overweight in Women*, 131 J. NUTRITION 1738 (2001); Diane Gibson, *Food Stamp Program Participation and Obesity* (Jan. 2002) (unpublished manuscript, on file with authors).

191. 7 U.S.C. § 2011 (2000).

192. See, e.g., Currie, *supra* note 126, at 223-26; Elliot Regenstein, Note, *Food Stamp Trafficking: Why Small Groceries Need Judicial Protection from the Department of Agriculture (and from Their Own Employees)*, 96 MICH. L. REV. 2156 (1998).

193. Moffitt, *supra* note 189, at 2396.

194. There may be political reasons why in-kind provision is important. For example, food stamps might very well be an agricultural subsidy as much as a nutritional subsidy. Analysis of both food stamps as an agricultural subsidy and whether agricultural subsidies should be integrated with the tax system can be conducted under the framework presented in this Article, but analysis of the particular details of these issues is beyond its scope.

for a goal of providing food over providing nutrition, but the integration decision must take as given the basic policy goals of the program, and it is not inconceivable that providing food itself is the goal.¹⁹⁵ If so, integration should not change those goals.

Providing food itself (rather than money to be used for food) is obviously not complementary to the services provided by the tax system, which is why we assumed that integrating food stamps into the tax system would mean cashing them out. If the FSP provided food itself rather than vouchers for food, integration with the tax system would probably be completely infeasible. For example, it is hard to imagine the tax system directly providing school lunches. But the FSP uses a voucher system combined with a system for certifying food providers. This structure might be susceptible to a hybrid system in which the tax system provides credits or other benefits for expenditures on food at authorized establishments. A separate agency that has expertise in certifying and monitoring food providers (such as the USDA) could perform the certification function.¹⁹⁶ The Hope and Lifetime Learning tax credits, for example, work exactly this way.¹⁹⁷

Such a hybrid system may not be easy to implement. Individuals would have to keep receipts to prove their expenditures, fraud would be common, and coordinating between the IRS and the other agency might be difficult.¹⁹⁸ Nevertheless, given the enormous costs of implementing food stamps as is, such a change may be beneficial even if it is expensive.

In sum, if the FSP were to be integrated into the tax system, cashing out food stamps would be the easiest course. The tax system could much more

195. One reason might be that providing food can serve the dual purpose of reducing hunger and subsidizing farms. If the FSP is both an agricultural subsidy and a welfare program, such a purpose might make sense.

196. A few plans for a coordinated tax and USDA system providing nutrition tax credits have been suggested. See MICHAEL E. FISHMAN & HAROLD BEEBOUT, MATHEMATICA POLICY RESEARCH, INC., SUPPORTS FOR WORKING POOR FAMILIES: A NEW APPROACH (2001), <http://www.mathematica-mpr.com/PDFs/supportpoor.pdf>. The practicality of such specific proposals may be questionable, but the general notion of using nontax agencies for certification (or regulation) of specialized issues is not foreign to the operation of the tax system.

197. These credits are available for tuition only at educational institutions “described in section 481 of the Higher Education Act of 1965” and that are “eligible to participate in a program under title IV of [that] Act.” I.R.C. § 25A(f)(2) (2000); see also *supra* note 12.

198. Indeed, a hybrid system resembles a U-form mechanism, and the organizational literature teaches us that coordination among divisions is costly. The viability of coordination depends on the extent of interdependency and communication required among divisions. Certification, for example, where applicable, seems to be a rather workable coordination scheme as it requires very limited communication. Other coordination schemes may prove more complicated. For example, the Low-Income Housing Tax Credit (LIHTC) works through a hybrid mechanism. Under the LIHTC, the tax system provides tax credits to developers of housing for low-income families, and the task of monitoring developers is carried out by nontax state agencies. The GAO recently reported coordination problems between the IRS and state agencies in such a setting. See GEN. ACCOUNTING OFFICE, GAO/GGD/RCED-97-55, TAX CREDITS: OPPORTUNITIES TO IMPROVE OVERSIGHT OF THE LOW-INCOME HOUSING PROGRAM (1997).

easily provide cash benefits than in-kind benefits, because it specializes in measuring income and collecting or disbursing cash. Cashing out food stamps would probably not reduce the nutritional benefits of the program and would reduce or eliminate enforcement of its in-kind limits. If the purposes of the FSP cannot be served by cashing out the program, integration may still make sense through a hybrid-type system, but it would have many fewer benefits.

4. *Measurement Periods and Responsiveness*

Responsiveness is by far the most difficult problem with integrating the FSP with the tax system, and we think that it explains why food stamps are not, and perhaps should not be, integrated into the tax system. The problem is that food stamps are provided on a monthly basis and eligibility is determined on a similar time scale, while the tax system operates on a yearly accounting period. Alstott describes this difference as a tradeoff between responding immediately to short-term changes in need and waiting to evaluate the permanency of the changes.¹⁹⁹ Welfare systems such as the FSP tend to respond to short-term changes, acting in some ways as insurance, while the tax system tends to try to measure longer-term changes in well-being.

Responsiveness can be very important to a welfare system. If an individual or family has a short-term but severe drop in income, they can lose housing, go hungry, or otherwise go without basic needs. The effects can be large even if the drop in income is only short-term. In theory, if the drop is only short-term, capital markets (and insurance) could help smooth consumption, but in practice, capital and insurance markets are highly imperfect. Moreover, if the immediate crisis turns out to be a permanent change, capital markets may not be able to help even if responding immediately to the permanent change is vital. Responsiveness is an important function for welfare systems.

The tax system does not value fast responses to changes in well-being. The tax system redistributes income from the wealthy to the poor, thereby increasing the welfare of the poor. In this sense, it is complementary to welfare systems. But the tax system does not generally attempt to provide emergency assistance.²⁰⁰ Instead, as Alstott notes, the tax system tries to

199. Alstott, *supra* note 42, at 579-84. The issue of responsiveness was addressed in the 1960s and 1970s by the negative income tax literature. *See, e.g.,* Asimow & Klein, *supra* note 7, at 6-10 (studying the problem of responsiveness and suggesting mechanisms to alleviate the problem).

200. There are emergency relief provisions in the tax code, such as filing extensions for presidentially declared disaster areas, but they are relatively minor. *See, e.g.,* I.R.C. § 7508A.

measure permanency of changes in well-being.²⁰¹ In fact, the one-year accounting period is arguably too short to measure long-term well-being, and scholars have proposed averaging systems that remedy this shortfall.²⁰²

Integrating food stamps into the tax system, therefore, might mean that it would not be responsive to short-term needs, seriously undermining its performance. In the language of specialization, the FSP specializes in measuring short periods while the tax system specializes in long periods. Integrating the FSP into the tax system would mean losing the benefit of specialized FSP measurements. To understand this problem, we explore three issues. First, we try to assess how important a role responsiveness plays in the FSP. We would like to know whether reducing the responsiveness of the FSP would be a significant problem by itself. Second, we would like to know whether there are good substitutes for the short-term needs fulfilled by food stamps, so that there need be few social losses if the FSP no longer serves this role. Third, we would like to understand how responsive the FSP could be if it were integrated into the tax system.

a. *Emergency Responsiveness Appears To Be Moderately Important to the FSP, but Not Central*

Responsiveness is built into the design of the FSP. The law provides that households are entitled to apply for food stamps on the first day they contact a food stamp office during business hours.²⁰³ States must provide eligible applicants with food stamps as soon as possible, but no later than thirty calendar days following the date the application was filed.²⁰⁴ In addition, households that have very little income or liquid resources can apply for expedited food stamps. If eligible, an applicant must receive them no later than seven days after the date of application.²⁰⁵

There have been lawsuits about whether states are meeting these requirements.²⁰⁶ These suits may merely represent transfers—individuals might sue to speed up the process because sooner is better. But they may also represent real need created by delays in processing. For example, scholars have found that about two-thirds of all people entering the FSP have experienced a twenty percent drop in income in the prior four

201. See Alstott, *supra* note 42, at 580. Additionally, the tax system applies a particular timing pattern which may not correspond with specific needs in a timely fashion. For example, education assistance programs follow an academic rather than fiscal schedule.

202. See, e.g., WILLIAM S. VICKREY, AGENDA FOR PROGRESSIVE TAXATION 164-97 (1947).

203. See 7 U.S.C. § 2020(e)(2)(B)(iii).

204. See *id.* § 2020(e)(3); 7 C.F.R. § 273.2(g) (2004).

205. See 7 U.S.C. § 2020(e)(9); 7 C.F.R. § 273.2(i)(3)(i).

206. See, e.g., Reynolds v. Giuliani, 35 F. Supp. 2d 331 (S.D.N.Y. 1999).

months.²⁰⁷ In reality, the suits probably represent some balance between these two motivations, and indicate that a significant concern in program design is to get food stamps to needy individuals quickly.

Another indicator of the importance of responsiveness is the duration of spells in the FSP. If individuals or families generally have short spells, it would indicate that the system must be responsive—the system would be helping with short-term needs and failing to be responsive would defeat that purpose. If, on the other hand, spells are long, the tax system might be able to help because the program would be responding to more permanent changes in well-being.

The data on spells are mixed. Philip Gleason, Peter Schochet, and Robert Moffitt have done the most extensive study of food stamp spells.²⁰⁸ They examine two samples—one comprised of people who begin a spell of FSP participation during a given calendar period (“entrants”), and the other comprised of all food stamp participants at a given point in time, regardless of when they began receiving food stamps (“cross-sectional”). They report that most entrants exit fairly quickly, with a median participation period of about nine months. Furthermore, fewer than one-third of entrants remain on food stamps for two or more years. Nevertheless, the cross-sectional sample shows that at any given time, individuals on food stamps are likely to have long spells.²⁰⁹ These two samples may lead to the conclusion that a certain group of FSP recipients goes on and off the program repeatedly. Indeed, they estimate that two-thirds of all FSP entrants are repeat entrants, and that many reenter rather quickly after they have exited the program.²¹⁰ Accordingly, if short food stamp spells by individuals who go on and off food stamps are aggregated, the vast majority of spells are relatively long-term.²¹¹

An earlier study by Rebecca Blank and Patricia Ruggles shows similar findings. It reports that much food stamp participation among women occurs during long spells of eligibility.²¹² While there are a relatively large

207. PHILIP GLEASON ET AL., U.S. DEP'T OF AGRIC., THE DYNAMICS OF FOOD STAMP PROGRAM PARTICIPATION IN THE EARLY 1990S, at 35-40 (1998), <http://www.fns.usda.gov/oane/menu/Published/fsp/files/Participation/dynamics.pdf>.

208. *Id.*

209. More than three-quarters of FSP participants (in the cross-sectional sample) have spells longer than two years. *Id.* at 68.

210. Nearly half of those who reenter the program do so within the first four months after exiting. *Id.* at 81.

211. For example, within their panel period (of thirty-two months) Gleason and his coauthors found that about 50% of the participants had multiple spells: About 42% had a single spell that lasted more than two years, and less than 3% had a single spell that lasted less than eight months. *Id.* at 92-97. Note additionally that elements of the FSP structure (e.g., high responsiveness) may encourage beneficiaries to go on and off the program, creating a level of endogeneity in the participation measure. See, e.g., Moffitt, *supra* note 189, at 2403-04. An annual measurement system may help to prevent such strategic behavior by welfare recipients.

212. Blank & Ruggles, *supra* note 178.

number of short eligibility spells for food stamps, most of these spells open and close without program participation. In essence, Blank and Ruggles find that there are two groups of women among those eligible for food stamps: "A relatively disadvantaged group with low future income expectations who enroll in public assistance immediately, and another less disadvantaged group who (largely correctly) predict future income increases and who do not seek benefits."²¹³ This suggests that food stamps serve longer-term needs that might be served by the tax system.

One might be tempted to conclude from this data that responsiveness is not important to food stamps. But Blank and Ruggles report that those who take up food stamps do so almost immediately upon eligibility. The tax system, even if able to handle these individuals' long-term needs, might not be able to respond quickly when the individuals first become needy.

If the primary concern is quick responses to long-term needs, we must understand the immediate cause of the problem and the type of population it affects. For example, it is important to know the source of the 20% reduction in income that often triggers a food stamp application. Only 27% of food stamp participants earn their income through wages; the rest have other sources of income, such as SSI (31.7%), TANF (25.8%), and Social Security (25.5%).²¹⁴ If, for example, the reduction in income is mainly due to decreases in earned income, an increase in the size or length of unemployment insurance may be the appropriate short-term response. The little evidence we have found suggests that though only 27% of FSP participants earn income, a decrease in earned income is the most probable trigger for entry.²¹⁵

In addition, retaining the entire food stamp program to solve the immediate needs of a small portion of the population on food stamps may not be desirable. The USDA reports that of 7335 surveyed households receiving food stamps in 2000, 401 were entrants.²¹⁶ This means that responsiveness during the year is important only to about 5.5% of beneficiaries. In addition, in fiscal year 2000, only 6.2% of food stamp recipients used the expedited food stamps option, and about 30% of them were new entrants.²¹⁷ We may be better off responding to these emergencies

213. *Id.* at 59.

214. See OFFICE OF ANALYSIS, NUTRITION & EVALUATION, *supra* note 130, at 33 tbl.A-1.

215. Gleason and his coauthors examine a few possible triggers to FSP entry. They define an income decrease as a 20% decrease in household income from one month to the next during a window period of four months preceding entry. About 40% of entry during the sample period was triggered by a decrease in earned income only. Another 18% was triggered by a decrease in income and changes in household structure (though no separation between earned and unearned income was applied here). About 27% of entry did not account for any trigger event in this study. GLEASON ET AL., *supra* note 207, at 38 tbl.II.3.

216. OFFICE OF ANALYSIS, NUTRITION & EVALUATION, *supra* note 130, at 50 tbl.A-16.

217. *See id.*

in a different way if the benefits from integrating food stamps with the tax system are otherwise large.

In sum, we would like to have more data before claiming that responsiveness is central to food stamps. For example, we would like further study of the length of food stamp participation spells. Additionally, we would like to understand better the reasons households go on food stamps, and what resources they have that could help them to respond to short-term need.²¹⁸

b. *Other Programs, as Currently Constituted, Could Not Adequately Replace Food Stamps*

There is a large system in the United States designed to respond to short-term dire food needs known as the Emergency Food Assistance System (EFAS).²¹⁹ The EFAS consists largely of food kitchens and food pantries (and their wholesale suppliers). Individuals in need can obtain food from either of these sources. The EFAS, however, is only about one-fifth of the size of the FSP and is not as well-targeted.²²⁰ Moreover, the EFAS is not equipped to handle mid-term problems—the individual who needs more than a few nights of assistance but less than several years—which the FSP handles well. The EFAS could be expanded and modified to some extent were food stamps integrated into the tax system, but this would effectively mean less than full integration because some of the functions of food stamps would be transferred to the emergency food programs.

There might be non-food-related responses to short-term need. If, as suggested earlier, cashing out the program would not present serious difficulties, responsiveness needs might be met through quick cash assistance rather than through quick food assistance. Determining that responsiveness is essential to the FSP would then mean determining

218. The USDA regularly studies the profiles of individuals who are on food stamps, but these studies do not examine the events that precipitated the need for food stamps. *See, e.g., id.* In addition, studies show that food stamp usage rises and falls with the economy, so we can guess that unemployment and reduced wages are central to the use of food stamps. *See* M. ROBIN DION & LADONNA PAVETTI, MATHEMATICA POLICY RESEARCH, INC., ACCESS TO AND PARTICIPATION IN MEDICAID AND THE FOOD STAMP PROGRAM: A REVIEW OF THE RECENT LITERATURE 8 (2000), <http://www.mathematica-mpr.com/PDFs/accessfullrpt.pdf>; GEN. ACCOUNTING OFFICE, GAO/RCED-99-185, FOOD STAMP PROGRAM: VARIOUS FACTORS HAVE LED TO DECLINING PARTICIPATION 4, 6 (1999); PARKE WILDE ET AL., THE DECLINE IN FOOD STAMP PROGRAM PARTICIPATION IN THE 1990'S, at 3-4, 7-12, 17-18 (Food & Rural Econ. Div., U.S. Dep't of Agric., Food Assistance and Nutrition Research Report No. 7, 2000), <http://www.ers.usda.gov/publications/FANRR7/fanrr7.pdf>.

219. *See generally* JAMES OHLS & FAZANA SALEEM-ISMAIL, THE EMERGENCY FOOD ASSISTANCE SYSTEM—FINDINGS FROM THE PROVIDER SURVEY (Food Assistance & Nutrition Research, U.S. Dep't of Agric., Food Assistance and Nutrition Research Report No. 16, 2002) (studying the operation and different characteristics of the EFAS).

220. 1 *id.* at 167; 2 *id.* at 2-5, 8, 167 tbl.8.1.

whether existing cash programs (combined with the EFAS) could meet these needs.

c. *The Tax System Could Not Easily Be Made Responsive to Short-Term Food Needs*

We can divide tax system responsiveness into two pieces: the measurement period and the period in which benefits are provided. These can vary. For example, benefits can be provided every month even if eligibility measurements are made only once a year.

The tax system probably could not provide short measurement periods. As noted, it is important for the tax system to use long measurement periods. Reducing the measurement periods in the tax system to allow integration of the FSP and other transfer programs would impose costs on everyone, because shorter periods would require more frequent filings. This could be prohibitively costly.

It is not clear how important short measurement periods are. Short measurement periods, even if otherwise desirable, increase administrative and compliance costs. To the extent short measurement periods increase compliance costs, they reduce participation in the program. Thus, short measurement periods may increase responsiveness for some at the cost of completely eliminating benefits for others.

In fact, because of the difficulties of balancing responsiveness and long-term measurement periods, and because of its low participation rate (due to the high administrative costs of short measurement periods), the FSP has been moving toward longer measurement periods.²²¹ Currently, the frequency of measurement varies across states and can be quarterly, semiannual, annual, or in some cases biannual.²²² Thus, shifting to annual measurement for food stamps would be consistent with the trend of the program.

Monthly provision of benefits is a more difficult problem. It is not inconceivable that the tax system could provide monthly benefits. The EITC is currently available on this basis under the "advance EITC."²²³ The EITC program, however, has a natural intermediary between the IRS and the needy individual: the employer. The individual certifies to her employer

221. See GEN. ACCOUNTING OFFICE, *supra* note 142, at 14-17; ROSENBAUM, *supra* note 136, at 14-37.

222. Households in which all adults are elderly or disabled are allowed twenty-four month certification periods. Other households may not exceed twelve-month certification periods. See GEN. ACCOUNTING OFFICE, *supra* note 142, at 5. For example, the average certification period among all food stamp households in fiscal year 2000 was 9.6 months. CUNNINGHAM, *supra* note 130, at 34 tbl.A-2. Yet additional reporting requirements sometimes apply within the certification period. ROSENBAUM, *supra* note 136, at 14-37.

223. See I.R.C. § 3507 (2000).

that she expects to be eligible for the EITC and receives installment payments of the credit each pay period. The employer advances funds to the individual and receives a credit on its tax return, effectively acting as a financial intermediary. The FSP, however, has no similar intermediary because individuals need not be employed to receive food stamps.²²⁴ Conceivably banks or other financial institutions could fulfill this role, but this would probably require significant monitoring, potentially defeating the benefits of integration.²²⁵

Moreover, the advance EITC, even though easier to imagine than an advance food credit type system, has not worked. The take-up rates for the advance EITC are extremely low. Only 1.1% of EITC recipients used the advance payment option in 1998.²²⁶ We suspect that a similar system for food stamps would be even less successful.²²⁷

d. *Conclusion on Responsiveness*

Combining these considerations, we conclude that the tax system could not be adequately responsive to the needs that the FSP fulfills. In particular, to the extent that immediate response is necessary even for individuals with

224. Notice, however, that recent developments in the U.S. welfare system have provided greater emphasis on work-related incentives. Rebecca Blank reports that federal funds available to support working low-income families increased from \$11 billion in 1988 to \$66.7 billion in 1999, whereas cash welfare support to (largely nonworking) families headed by nonelderly, nondisabled adults fell from \$24 billion in 1988 to \$13 billion by 1999. Rebecca M. Blank, *Evaluating Welfare Reform in the United States*, 40 J. ECON. LIT. 1105, 1108 (2002).

225. Still, a few scholars suggest that other mechanisms might be employed to mitigate the tax system's lack of responsiveness—for example, using providers of goods or services as intermediaries. See GRAETZ & MASHAW, *supra* note 67, at 303; SAMMARTINO ET AL., *supra* note 113, at 44-45.

226. Hotz & Scholz, *supra* note 16, at 58. Similar percentages are found in other fiscal years. A few explanations have been suggested for recipients' hesitancy to use the advance payment option. See GEN. ACCOUNTING OFFICE, GAO/GGD-92-26, EARNED INCOME TAX CREDIT: ADVANCE PAYMENT OPTION IS NOT WIDELY KNOWN OR UNDERSTOOD BY THE PUBLIC 15-20 (1992); Smeeding et al., *supra* note 126, at 1189-90. Behavioral or psychological factors may also affect recipients' choices. There have been studies that recommend improvements to the advance EITC. See, e.g., Yin et al., *supra* note 114. Changing the legal default rule, for example, in a way that obliges employers to participate in advance unless asked not to by the employee may generate a much higher participation level.

The failed attempt does not necessarily prove that tax assistance cannot be provided on a nonannual basis. For instance, the Working Families Tax Credit, an EITC-like program in the United Kingdom, is distributed incrementally during the year through employers. See PAT STRICKLAND, WORKING FAMILIES TAX CREDIT AND FAMILY CREDIT (House of Commons Library, Research Paper No. 98/46, 1998); Janet Holtzblatt & Jeffrey B. Liebman, *The Earned Income Tax Credit Abroad: Implications of the British Working Families Tax Credit for Pay-as-You-Earn Administration*, in PROCEEDINGS: 91ST ANNUAL CONFERENCE ON TAXATION, *supra* note 123, at 198.

227. One way to look at the problem is that an advance payment system requires a prospective determination of whether an individual is eligible. The tax system traditionally works retrospectively—individuals total up their taxable income after the end of the tax year. The advance EITC is retrospective but only on a monthly basis, which is close to a prospective system.

medium- to long-term needs, the tax system may be inadequate. Becoming more responsive would sacrifice too many goals of the tax system, and not becoming more responsive would sacrifice too many goals of the food stamp program.

Nevertheless, we think the issue should be analyzed further. The data on the need for quick responses by the FSP are mixed, and we do not yet know exactly how important that need is. Moreover, we do not know whether other elements of the transfer system, if enhanced, could satisfy this need while allowing us to realize the benefits of integration.

5. *Conclusion*

There would be many benefits to integrating the FSP into the tax system. The two programs have strong complementarities. Integrating the FSP into the tax system would allow the FSP to take advantage of the tax system's specialization in income measurement, including its filing, computer, and audit systems. Moreover, integrating the FSP into the tax system would allow better coordination of the tax system and the welfare system. A crude measure of accuracy reveals no difference between the FSP and EITC, even though the former is at least ten times more expensive to administer (and possibly much more). Nevertheless, if alleviating short-term hunger is an important enough goal of the FSP, integration is probably not desirable because the tax system is not sufficiently specialized in solving short-term problems. The loss in accuracy from integration would outweigh any corresponding benefits.

C. *The Earned Income Tax Credit*

The analysis of the EITC is very similar to the analysis of food stamps. The main differences are that (1) the EITC is a cash rather than an in-kind program, so concerns about providing cash benefits are eliminated, and (2) responsiveness is less important for the EITC than for food stamps. Therefore, we conclude, integration of the EITC and the tax system, as under current law, makes sense.

We need say very little about the benefits of integration of the EITC with the tax system. As noted, measurements for income transfer programs will be closely related to measurements for the tax system, and coordination among income transfer and tax programs is important.

We also need say little about the problem of the use of different measurement criteria. Alstott argues that, ideally, a separate transfer program might use different (more accurate) measurement criteria than an integrated program would. The arguments on this issue are essentially the same as they were in the case of food stamps. Finally, discussion of the

tradeoff between participation and compliance also tracks the arguments made with respect to food stamps.²²⁸

The key difference between the EITC and the FSP, in our view, is the need for responsiveness in each program. We argued that if responsiveness is important for the FSP, integrating that program into the tax system would mean a sufficient sacrifice in responsiveness that integration would not be desirable. We believe that responsiveness is not as important for the EITC and, therefore, integration of the EITC into the tax system makes sense.²²⁹

The core reason we believe this to be true is that the EITC is a wage supplement. Individuals are entitled to the EITC based on their wage income. It provides a supplement only to the working poor; nonworking individuals are not eligible. This is in contrast to food stamps, where eligibility does not depend on employment.²³⁰ The EITC also deviates in this respect from TANF and other transfer programs, for which individuals who do not work remain eligible (subject to incentives in the system to obtain work).²³¹

228. The EITC error pattern may not serve as an ideal illustration of the tax system's accuracy capability. *See supra* notes 153-159 and accompanying text. McCubbin, using the IRS's 1994 compliance study, finds that income reporting does not constitute a significant problem in EITC noncompliance. McCubbin, *supra* note 114, at 1140-41. According to McCubbin, the major area of noncompliance—over 70% of overpayment errors—had to do with “qualifying child” errors. *Id.* at 1138-39; *see also* Liebman, *supra* note 126, at 1168-69. The qualifying child definition is complicated and difficult to measure and enforce. Similar findings of the significance of qualifying child errors are reported by the IRS. *See* IRS 1997 COMPLIANCE ESTIMATES, *supra* note 157, at 9-11; IRS 1999 COMPLIANCE ESTIMATES, *supra* note 154, at 13-14. The qualifying child requirement for the EITC is much more stringent (and accordingly more accurate and complex) than the dependency requirement for the FSP. The common application for food stamps only asks for a list of individuals living together in a single dwelling. *See, e.g.*, Indiana State Form, *supra* note 135; *see also* Janet Holtzblatt & Janet McCubbin, *Issues Affecting Low-Income Filers*, in *THE CRISIS IN TAX ADMINISTRATION* (Henry J. Aaron & Joel Slemrod eds., forthcoming 2004) (manuscript at 5-6, on file with authors) (describing the EITC's “qualifying child” requirements).

229. Joseph Hotz and John Scholz estimate the value of the difference between annual and monthly EITC payment systems, and show that it may not be very large for taxpayers. *See* Hotz & Scholz, *supra* note 16, at 191. Hence, the lack of responsiveness—the failure of the advance EITC initiative—does not necessarily harm the EITC's ability to achieve its purposes (i.e., its accuracy) significantly.

230. There are some negligible work requirements for food stamps. *See* 7 U.S.C. § 2015(d) (2000); 7 C.F.R. § 273.7 (2004); *see also* TERESA CAHALAN ET AL., *THE DECLINE IN FOOD STAMP PARTICIPATION: A REPORT TO CONGRESS* 29-31 (Office of Analysis, Nutrition & Evaluation, U.S. Dep't of Agric., Nutrition Assistance Research Report No. FSP-01-WEL, 2001) (describing the negligible effect of the work requirement); GEN. ACCOUNTING OFFICE, GAO/RCED-00-5, *FOOD STAMP PROGRAM: HOW STATES ARE USING FEDERAL WAIVERS OF THE WORK REQUIREMENT 3* (1999) (describing states' waivers of these requirements).

231. Work requirements in the welfare program (and the accompanying separation of those who can work from those who cannot) are an additional feature of regulating individuals' behavior. The advantage of work requirements is better targeting of the needy. *See, e.g.*, George Akerlof, *The Economics of ‘Tagging’ as Applied to the Optimal Income Tax, Welfare Programs, and Manpower Planning*, 68 AM. ECON. REV. 8 (1978); Timothy Besley & Stephen Coate, *The Design of Income Maintenance Programmes*, 62 REV. ECON. STUD. 187 (1995); Nichols & Zeckhauser, *supra* note 188. Yet there are a few problems with regulating work, such as the broad use of welfare workers' discretion, violation of horizontal equity, and complexity. *See, e.g.*,

As a wage supplement, the EITC is not designed to be, and indeed cannot be, responsive to individuals in dire need. It cannot help individuals who have lost their jobs, who cannot find work, or otherwise need help immediately. Moreover, as a wage supplement, it is not designed to be temporary. Low-wage workers may remain that way for long periods of time, unlike (one hopes) those individuals who need emergency assistance. To this end, the EITC has no time cutoff, unlike TANF.²³²

There is also evidence that the EITC functions well as an annual payment. Several studies indicate that individuals use the EITC as a form of forced savings and tend to invest the lump sum payments in ways that they would have been unlikely to invest monthly payments. For example, Jennifer Romich and Thomas Weisner find that families are more likely to purchase durable goods and make large purchases with the EITC than with other funds.²³³ Other studies have found that the lump sum EITC gives recipients an opportunity to make desirable changes in economic behavior.²³⁴

As with food stamps, we would like to have more information before drawing conclusions about the need for responsiveness in the program. For example, we have been unable to find any information about EITC participation spells comparable to the evidence on food stamp spells. We also cannot conclude from the fact that the EITC is nonresponsive now that it would not be more successful if it were responsive. What we observe may be an artifact of the fact that the program is integrated into the tax system, and may have little to do with its ideal structure.

More importantly, the whole notion of responsiveness of a given program is dependent on other programs. For example, the EITC might be able to be a nonresponsive wage subsidy only because other programs like food stamps and TANF are responsive. The arguments we have made are based on the existing programs rather than on a theory of which programs or how many programs should be responsive to short-term needs. Our conclusion thus remains, to a great extent, contingent on the broader institutional framework of the society within which the EITC operates.

BROWNING, *supra* note 146, at 35-38; Aaron, *supra* note 145, at 166-68. The choice between work requirements (e.g., TANF) and work incentives (e.g., EITC) ultimately falls back on issues of potential accuracy and induced complexity. We do not dwell on this subject here. For a recent survey of “workfare” policies and their effectiveness, see Blank, *supra* note 224.

232. Food stamps also have no time cutoff. The reason appears to be that some individuals, mostly the elderly, remain on food stamps for long periods of time. For a discussion of time cutoff policies, see ROBERT A. MOFFITT & LADONNA A. PAVETTI, TIME LIMITS (Northwestern Univ./Univ. of Chi. Joint Ctr. for Poverty Research, Working Paper No. 91, rev. ed. 1999), http://www.jcpr.org/wpfiles/moffitt_pavetti.pdf.

233. Romich & Weisner, *supra* note 126, at 1260.

234. *E.g.*, Smeeding et al., *supra* note 126, at 1202 (observing that annual EITC benefits advance more strategic long-term goals of recipients); *see also* Barrow & McGranahan, *supra* note 126, at 1242 (noting that annual payments of EITC benefits increase savings).

Nevertheless, given the basic framework of existing programs, integration of the EITC makes sense. Other programs can act to reduce emergency needs, allowing the EITC to be structured as a less responsive, but more efficient, wage subsidy.

D. Summary and Comments on the Relationship to Overall Reform

The arguments on integrating the FSP and the EITC into the tax system depend on specialization and coordination. There are strong reasons why integration makes sense given the specialization of the tax system (in measuring and processing relevant attributes and disbursing funds) and the benefits of coordination. A first approximation of the accuracy and complexity of the FSP and EITC supports this argument. Nevertheless, some elements of transfer programs could not easily be implemented by the IRS because it lacks the required level of expertise—the cost savings from tax system implementation would not be worth the reduced accuracy. In particular, the tax system is not designed to be able to respond quickly to changes in well-being, and some sort of transfer system is likely necessary to do this. To the extent food stamps are a necessary component of a quick response system, integration is not desirable.

More generally, we have tried to show how the integration decision depends on the tradeoff between coordination and specialization. Integrating most or all welfare programs into the tax system, such as through a negative income tax, is attractive because the tax and transfer systems rely on similar variables. A single agency can specialize in those variables and coordinate among the various programs. For example, one can imagine a broad system of refundable tax credits (or a negative income tax of another sort) combined with an emergency welfare system designed to reduce short-term needs.²³⁵ Such a system might be able to take advantage of the benefits of tax-based delivery of funds combined with responsiveness to short-term needs.²³⁶

There may be problems with integration, however, because many elements of the transfer system could not be well-replicated within the tax system without a significant loss of specialization. For food stamps, the problems lie in the provision of in-kind benefits and rapid response. Study of other elements of the transfer system may reveal similar problems.

235. A few general proposals from the 1960s and 1970s provide examples, such as the Guaranteed Annual Income programs, the NIT, and Nixon's Family Assistance Plan. See Ventry, *supra* note 7.

236. Obviously the tax system is a good candidate for integration, but integration of transfer programs into a single nontax welfare agency is another plausible institutional candidate under this framework. Although not discussed here, the advantages and disadvantages of a nontax welfare agency follow from the analysis in this Article.

One problem we can foresee is that the tax system may not have the expertise to exercise significant discretion regarding many problems of the transfer system. That is, a program that requires field agents to make non-income-based decisions about eligibility may not be ideally suited for integration. For example, a program might provide housing benefits for families on the condition that the children make good faith efforts to attend school. If the decision on whether the children have met this requirement involves discretion, integration into the tax system would be a bad idea.

Although the balance in any particular area would depend on the specific program needs and circumstances, integration may be worthwhile notwithstanding these problems. The benefits of specialized measurement and coordination may be greater than the costs. As noted in the comparison of the costs of administering food stamps and the EITC, there may be enormous savings from integration.

CONCLUSION

Rather than summarize what has already been said, let us suggest further avenues for research. First, as noted, we would like to extend the institutional framework to include agency costs and public choice concerns. The departmentalization framework gives us some valuable intuitions but many of these intuitions may change once agency costs and public choice concerns are incorporated.

We suspect, for example, that agency costs might explain some of the structure of government better than team theories of organizations. In particular, tax expenditures tend to be redundant in the sense that they grant to the IRS authority to implement a program that is within the expertise of another agency and often has close substitutes at the other agency. Team theory rationales cannot easily make sense of this pattern. An agency cost analysis, however, might. The idea would be that having multiple agents perform similar tasks allows Congress or the President to monitor the agents better and to have the ability to threaten each one with removal of the program. This might improve performance notwithstanding the increase in specialization and coordination costs. Further research is needed in this area.

Second, we would like to see more examples analyzed. This Article has used the EITC and food stamps as its primary examples. Transfer systems, however, provide a natural case for integration, and analysis of other programs may be more difficult. For example, there are numerous education, healthcare, and housing subsidies in the current law, and analysis of these provisions would be useful both for understanding the merits of the

particular provisions and also for developing intuitions about the tax expenditure problem more generally.²³⁷ In addition, we would like to understand better the mechanisms used to coordinate policy in these areas and also in the private sector.

Third, nothing in this Article's framework limits its application to taxation. The same analysis might be used, for example, to determine whether antitrust policy is best implemented in the Justice Department or the Federal Trade Commission, or both. Similarly, this mode of analysis might help to determine whether environmental policy should be implemented through the Environmental Protection Agency, the Department of the Interior, the Army Corps of Engineers, other agencies, or some combination thereof. Understanding how the analysis applies in these other settings might help in understanding the tax setting, but might also yield interesting insights in those areas themselves.

Finally, the purpose of this paper was to understand the proper scope of the "tax system." The analysis can go in the other direction as well. Perhaps some tax collection functions are best carried out by other agencies. For example, an agency with specialization in farmers might best collect taxes that are particular to farmers. Many countries have more than one tax collection agency,²³⁸ and the analysis presented here might be helpful in explaining this.

More generally, however, the purpose of the framework presented in this Article is to prompt us to question—to reconsider the costs and benefits of our present institutions and to evaluate whether our present allocations of tasks and functions across government agencies make sense. One would hope that in many cases they do; our analysis of the EITC and the FSP suggest such an outcome. But it is also possible that, in some cases, they do not. To the extent that our framework can help to identify successful institutional structures and ferret out examples of misallocated institutional functions, it can help the government to make better use of the public fisc.

237. For example, this Article's framework can be used to analyze potential proposals to consolidate similar tax expenditures such as the various tax transfers for education expenses.

238. England, for example, uses separate agencies to collect its VAT and income tax. HUGH AULT, *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 119 (1999).