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TAX INCENTIVES AS A DEVICE FOR IMPLEMENTING GOVERNMENT POLICY: A COMPARISON WITH DIRECT GOVERNMENT EXPENDITURES

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The tax code contains a great number of special provisions which provide credits, deductions, and other tax advantages intended to achieve non-tax goals considered desirable by Congress. In fiscal 1968, these provisions represented tax expenditures of over 45 billion dollars. Professor Surrey argues that the tax incentive is generally inferior to the direct subsidy as a means of achieving social goals: that incentives are usually less equitable, since they benefit persons in high tax brackets most, and more difficult to develop and administer, since they are handled by tax committees and administrative agencies which have little expertise in non-tax social policy. He suggests a strong presumption against their use.

SUGGESTIONS are constantly being made that many of our pressing social problems can be solved, or partially met, through the use of income tax incentives. Moreover, the present federal income tax is replete with tax incentive provisions. Some were adopted to assist particular industries, business activities, or financial transactions. Others were adopted to encourage non-business activities considered socially useful, such as contributions to charity. This article will deal with the question of whether tax incentives are as useful or efficient an implement of social policy as direct government expenditures, such as grants, loans, interest subsidies, and guarantees of loans. The discussion will be in terms of the federal income tax, but it is intended to be helpful for other jurisdictions and other forms of taxation as well.

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I. THE NATURE AND EXTENT OF EXISTING TAX INCENTIVES

The term "tax expenditure" has been used to describe those special provisions of the federal income tax system which represent government expenditures made through that system to achieve various social and economic objectives. These special provisions provide deductions, credits, exclusions, exemptions, deferrals, and preferential rates, and serve ends similar in nature to those served by direct government expenditures or loan programs. In any specific functional area the Government may use direct expenditures, interest subsidies, direct federal loans, and federal insurance or guarantee of private loans as alternative methods to accomplish the purposes which the special tax provision seeks to achieve or encourage.

The use of the phrase "special provisions" clearly involves a major definitional question: which tax rules are special provisions and therefore tax expenditures, and which tax rules are just tax rules; simply part of the warp and woof of a tax structure? The description and analysis of tax expenditures contained in the fiscal 1968 report to the Secretary of the Treasury used these guidelines: [1]

> [The analysis] lists the major respects in which the current income tax bases deviate from widely accepted definitions of income and standards of business accounting and from the generally accepted structure of an income tax . . . .
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> * * *
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> The study does not attempt a complete listing of all the tax provisions which vary from a strict definition of net income. Various items that could have been added have been excluded for one or more of several reasons:
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> (a) Some items were excluded where there is no available indication of the precise magnitude of the implicit subsidy. This

[1] 1968 SEC'Y TREAS. ANN. REP. ON THE STATE OF THE FINANCES 326–30; *see* Statement of Joseph W. Barr, Secretary of the Treasury, in *Hearings on the 1969 Economic Report of the President Before the Joint Economic Comm.*, 91st Cong., 1st Sess. 8–44 (1969) (containing a "Comparison of Budget Outlays and Tax Expenditures by Function Fiscal Year 1970"). *See also* Statement by Stanley S. Surrey on the Tax Expenditure Budget, in *Hearings on Economic Analyses and Efficiency in Government Before the Subcomm. on Economy in Government of the Joint Economic Comm.*, 91st Cong., 1st Sess. (Sept. 16, 1969). For a discussion of the definitional task, see Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT. TAX J. 244 (1969), and Surrey & Hellmuth, *The Tax Expenditure Budget—Response to Professor Bittker*, 22 NAT. TAX J. (to be published). The latter article also discusses the relevance of the tax expenditure concept to taxes other than the income tax. *See also* Wolfman, *Federal Tax Policy and the Support of Science*, 114 U. PA. L. REV. 171, 173–74 (1965).

is the case, for example, with depreciation on machinery and equipment where the accelerated tax methods may provide an allowance beyond that appropriate to the measurement of net income but where it is difficult to measure that difference because the true economic deterioration or obsolescence factor cannot be readily determined.

(b) Some items were excluded where the case for their inclusion in the income base stands on relatively technical or theoretical tax arguments. This is the case, for example, with the imputed rent on owner-occupied homes, which involves not only a conceptual problem but difficult practical problems such as those of measurement.

(c) Some items were omitted because of their relatively small quantitative importance.

Other features of our income tax system are considered not as variations from the generally accepted measure of net income or as tax preference but as part of the structure of an income tax system based on ability to pay. Such features include personal exemptions and the rate schedules under the individual income tax, including the income splitting allowed for married couples filing joint returns or for heads of households. A discussion of income splitting and the dependent's personal exemption is thus considered outside the scope of this study on tax expenditures.

It must be recognized that these exclusions are to some extent arbitrary . . . . The immediate objective, however, of this study is to provide a list of items that would be generally recognized as more or less intended use of the tax system to achieve results commonly obtained by government expenditures. The design of the list seems best served by constructing what seemed a minimum list rather than including highly complicated or controversial items that would becloud the utility of this special analysis.

* * *

. . . The assumption inherent in current law, that corporations are separate entities and subject to income taxation independently from their shareholders, is adhered to in this analysis.

These guidelines readily identify a significant number of provisions in existing law which we can all agree are "special" and represent tax expenditures: tax benefits for the aged, natural resources provisions such as percentage depletion allowances, the investment credit, excessive real estate depreciation. These provisions are identifiable as tax expenditures for the additional reason that they have been defended, either by their beneficiaries or by Congress in adopting them, on the grounds that they achieve a particular purpose, claimed to be desirable, other than the measurement of net income under an income tax.

On the basis of these guidelines, the Treasury analysis iden-

tified a long list of tax expenditures, with estimates in terms of fiscal year 1968. The expenditures were classified according to the functional categories of government expenditures used in the budget, with the addition of two special categories: Aid to State and Local Governments, and Capital Gains: [2]

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[2] Statement of Joseph W. Barr, *supra* note 1. Footnotes are here omitted. The Tax Reform Act of 1969, Pub. L. No. 91-172 (Dec. 30, 1969), cut back a number of these expenditures, and added a few new ones. *See* p. 713 and pp. 736-37 nn. 39-41 *infra*.

No significant tax expenditures are made in the budget categories of Space, Interest, and General Government.

The Treasury analysis contained the following comments on revenue estimates:

> All estimates of tax expenditures resulting from special tax provisions represent revenues lost on an annual basis. The estimates of revenue foregone are, in general, based on the assumption that such provisions never existed, or, alternatively, that such provisions have been withdrawn sufficiently long ago that we are now beyond the period needed to permit an equitable transition to a new tax situation.
>
> The revenue cost estimated for these special provisions is not in many cases the revenue change which would result in the first full year if these provisions were withdrawn. Replacement of some or all of these provisions by direct expenditures or lending programs might change the level and composition of economic activity. The revenue cost of each special tax provision presented for 1968 would, of course, generally vary over time with growth in the economy and changes in various parts of the tax base. Also, a realistic approach to any change in these provisions would provide in many situations transition arrangements which would effect the revenue change gradually over a period of years.
>
> Another key assumption is that economic activity for the year would not have been affected by the absence of these special provisions. This, of course, is a simplifying assumption for tax expenditures undoubtedly have significant effects on the composition and perhaps the level of economic activity. Also, in the absence of these tax benefits, there would doubtless have been changes in Government direct spending and net lending to accomplish some of the objectives of the existing provisions. No attempt has been made to speculate how the budget and the economy might differ if none of these provisions were in the law.

Statement of Joseph W. Barr, *supra* note 1, at 34. Thus, in effect the estimating techniques used are similar to the "first effect" estimates typically given by the Treasury to indicate the revenue effect of any proposed change.

Professor Henry Aaron has compiled another inventory of existing tax incentives, arranged according to the types of economic decisions which the tax provision influences. Aaron, *Inventory of Existing Tax Incentives: Federal*, in TAX INSTITUTE OF AMERICA, SYMPOSIUM ON TAX INCENTIVES (to be published) [hereinafter cited as INCENTIVES SYMPOSIUM]. He uses the term tax incentive to denote any tax provision which is "defended or advocated primarily because it so alters resource allocation as to improve economic efficiency." He excludes "tax provisions defended primarily because they are alleged to have favorable effects on the distribution of income by income class, family status, age groups or other socio-economic categories." Thus, he would exclude tax expenditures for the aged and the blind. His tax incentives fall into three main categories: those influencing *household behavior* — spending patterns (for example the charitable contributions deduction), place of employment (for example the exemption of certain income earned abroad), or portfolio choice (for example capital gains); *business behavior* — investment in capital (for example the investment credit), composition of the wage offer (for example the exclusion of employer contributions to pension plans), industrial composition (for example the tax benefits to agriculture and natural

Tax Expenditures by Budget Function	Revenue Cost Millions of Dollars
National Defense	
Exclusion of Military benefits and allowances	$500
International Affairs and Finance	
Individual taxation:	
Exemption for certain income earned abroad by U.S. citizens	40
Exclusion of income earned in U.S. possessions	10
Corporate taxation:	
Western Hemisphere trade corporations	50
Exclusion of gross-up on dividends of less developed country corporations	50
Exclusion of controlled foreign subsidiaries	150
Exclusion of income earned in U.S. possessions	70
Total	370
Agriculture and Agricultural Resources	
Farming: Expensing and capital gains treatment	800
Timber: Capital gains treatment for certain income	130
Total	930
Natural Resources	
Expensing of exploration and development costs	300
Excess of percentage over cost depletion	1,300
Capital gains treatment of royalties on coal and iron ore	5
Total	1,605
Commerce and Transportation	
Investment credit	2,300
Excess depreciation on buildings	500
Dividend exclusion	225
Capital gains: Corporations (other than agricultural and natural resources)	500
Excess bad debt reserves of financial institutions	600
Exemption of credit unions	40
Deductibility of interest on consumer credit	1,300
Expensing of research and development expenditures	500
$25,000 surtax exemption	1,800
Deferral of tax on shipping companies	10
Total	7,775
Community Development and Housing	
Owner-occupied homes, deductibility of:	
Interest on mortgages	1,900
Property taxes	1,800

resources), business location (for example the Western Hemisphere Trade Corporations provision); and *state and local government behavior*—sources of finance (for example deductibility of state and local taxes).

For an inventory of incentives in state and local taxes, see Slater, in INCENTIVES SYMPOSIUM.

Tax Expenditures by Budget Function	Revenue Cost Millions of Dollars
Rental housing–excess depreciation	250
Total	3,950
Health and Welfare	
Aged, blind, and disabled:	
Additional exemption, retirement income credit and exclusion of OASDHI for aged	2,300
Additional exemption for blind	10
Exclusion for sick pay	85
Exclusion of unemployment insurance benefits	300
Exclusion of workmen's compensation benefits	150
Exclusion of public assistance benefits	50
Exclusion for employee pensions	3,000
Deduction for self-employed retirement	60
Exclusion of other employee benefits:	
Premiums on group term life insurance	400
Accident and death benefits	25
Medical insurance premiums and medical care	1,100
Privately financed supplementary unemployment benefits	25
Meals and lodging	150
Exclusion of interest on life insurance savings	900
Deductibility by individuals of charitable contributions (other than education) including untaxed appreciation	2,200
Deductibility of medical expenses	1,500
Deductibility of child and dependent care expenses	25
Deductibility of casualty losses	70
Standard deduction	3,200
Total	15,550
Education and Manpower	
Additional personal exemption for students	500
Deductibility of contributions by individuals to educational institutions	170
Exclusion of scholarships and fellowships	50
Total	720
Veterans Benefits	
Exclusion of certain benefits	550
Aid to State and Local Government Financing	
Exemption of interest on State and local debt obligations	1,800
Deductibility of nonbusiness State and local taxes (other than on owner-occupied homes):	
Individual income tax	1,350
General sales taxes	775
Gasoline taxes	400
Personal property taxes	150
Other taxes	125
Total	2,800

Tax Expenditures by Budget Function	Revenue Cost Millions of Dollars
Property taxes on owner-occupied homes (included under community development and housing)	1,800
Total, all State and local nonbusiness taxes	4,600
Capital Gains — Individual Income Tax	
Special provisions (increase in basis at death; exclusion of one-half of long-term gains; maximum tax rates of 25% on long-term gains)	5,500–8,500

The analysis also showed the relationship of tax expenditures to direct expenditures for these budget categories. In some cases the tax expenditures exceeded or were close to budget expenditures (Community Development and Housing, 204%; Commerce and Transportation, 114%; Natural Resources, 90%; Health and Welfare, 37%) (fiscal 1969 figures). In none of the categories listed above except for National Defense and Veterans were the tax expenditures less than 10% of budget expenditures. The total of the estimated tax expenditures, in a round number, was $45 billion.

If we take as our definition of tax incentive a tax expenditure which induces certain activities or behavior in response to the monetary benefit available, almost all of the tax expenditures included in the above analysis can be considered tax incentives. Many of the tax expenditures were expressly adopted to induce action which the Congress considered in the national interest. For example, the investment credit was intended to encourage the purchase of machinery and equipment; excessive bad debt reserves for some financial institutions were allowed to encourage the growth of savings and loan associations and mutual savings banks; the charitable deduction was intended to foster philanthropy; the preferential tax treatment of qualified pension plans was intended to foster broad pension plan coverage; and the corporate surtax exemption was intended to foster small business.[3] Other tax expenditures whose origins are cloudy are now defended as incentives to home ownership, as in the case of the deduction for mortgage interest and property taxes, or as aids to state and local governments' tax bases, as in the case of the deduction for state and local taxes. Other tax expenditure pro-

[3] Other tax expenditures in this class include the treatment under the foreign tax credit of dividends paid by the corporations of less developed countries, capital gains treatment in general, the exemption of credit unions, the special treatment of timber capital gains, the hundred dollar dividend exclusion, and the deduction for one-half of medical insurance premiums, group term life insurance, and income earned abroad. Accelerated depreciation on real estate probably is another example, although it was adopted largely as a happenstance along with accelerated depreciation provisions designed to encourage investment in personal property.

visions were adopted as relief provisions to ease "tax hardships," or were adopted to simplify tax computations. Some of these provisions have come to be defended on the basis of their incentive effects: for example, the intangible drilling expenses deduction, the percentage depletion allowance, the Western Hemisphere Trade Corporation preferential rate, and the research and development expense deduction.[4] Moreover, to the extent that such tax relief — *i.e.*, tax treatment that is special and not required by the concept and general standards of a net income tax — is granted for an activity that is voluntary, the relief is in effect an incentive to engage in that activity, even though the provisions may not be defended on incentive grounds. For example, if meals and lodging furnished an employee on the premises of an employer are not taxed, the effect is to make employees more likely to choose such employment. If coal and iron royalties receive capital gains treatment and other royalties do not, investment preferences will be affected.[5]

The only tax expenditures that are not tax incentives, as we are using the expression, are expenditures related to involuntary activities of taxpayers. Most such provisions are designed to provide tax reduction in order to relieve misfortune or hardship — situations involving "personal hardships," as contrasted with the "tax hardships" that have brought about other special tax provisions, chiefly for business activities. The extra exemption for the blind is one example. The extra exemption for the aged is another — we can't grow old any faster because of the exemption.[6] Special provisions of this character are relatively few in

[4] Additional examples include the bad debt reserves for banks, the cash method of accounting for farmers, and the special personal exemption for students.

[5] Incentive effects are also produced by the exemption of military pay earned in combat zones.

[6] Perhaps the other tax benefits for the aged — the retirement credit and the social security exemption — also fall in this non-incentive category, though this is not so clear. The retirement credit provides some incentive to retire. Also, favoring retirement income may encourage saving for retirement. The employee sick pay exclusion may be in the non-incentive class, since sickness is presumably involuntary, yet the provision can have the incentive effect of inducing employers to provide such plans or unions to negotiate for such plans. The general medical expense deduction similarly has non-incentive characteristics, yet the presence of the deduction does tend to induce the purchase of health insurance and the greater use of medical services and equipment. The exclusion of unemployment insurance and public assistance benefits also has non-incentive characteristics, if we regard unemployment and need for public assistance as essentially involuntary conditions. Yet for some individuals the generality will not hold, and the tax result will add to the monetary inducement which makes the condition acceptable. The casualty loss deduction is also generally not an incentive, though in particular cases it may induce certain action that would otherwise be too risky, such as self-insurance, or ownership of a house in a hurricane area.

number. By and large, therefore, the classification guidelines in the Treasury Analysis which separate tax expenditures from other tax provisions also serve to identify existing tax incentives.

The recently considered tax expenditures are all in the tax incentive category. They include pollution control machinery credits, manpower training credits, educational expense credits, tax benefits for investing in low income housing, and tax benefits for business investment in central cities or rural areas. In all these situations the direct purpose of the proposed tax change is to provide monetary assistance or benefit through the tax laws so as to make the desired course of action financially more palatable to taxpayers involved, and thereby induce them to take that action. Whatever the purpose of the economic benefit involved — be it to make an expensive activity less costly, to reduce its risk, or to increase the rate of after-tax profit — the incentive effect is the desired effect.

II. Comparison of Tax Incentives with Direct Expenditures

This section of the discussion is concerned with criteria for evaluating the use of tax incentives as compared to the use of direct government expenditures. This evaluation does not involve the issue whether we should seek to achieve the particular goals for which tax incentives are now used or suggested. We can assume it is understood that each incentive must serve purposes which the nation wants to achieve and is willing to finance, rather than let the marketplace determine the extent to which the result will obtain. This is not to say that every proposal for a tax incentive is presented or defended with a careful analysis along these lines. Far from it — many sponsors of tax incentives simply assume that if the benefit sought is helpful to them in reaching a desired result, the incentive is in the public interest. But this discussion assumes that these issues have been decided. Therefore, we are assessing the use of tax incentives as a technique to provide the government assistance. The discussion is applicable to those tax expenditures intended to alleviate personal hardships, although we have indicated that they might not be classified as tax incentives.

There are, of course, as stated earlier, a variety of ways to provide government financial assistance — direct grants, loans, interest subsidies, guarantees of loan repayment or interest payments, insurance on investments, and so on. These methods are here called budgetary or direct expenditures. Skilled tax tech-

nicians and budgetary experts can take any tax expenditure and devise a budgetary expenditure approach to serve the same goals as a direct expenditure.[7] For example, the British for some years used an approach under their tax law somewhat similar to our 7% investment credit to encourage the acquisition of machinery and equipment. They subsequently dropped the tax technique and substituted direct cash payments.[8] The existing tax incentive for charitable giving could also be structured as a direct expenditure program, under which the Government would match an individual's contribution to charity with a proportional contribution of its own to the same charity.[9] Tax credits to an employer for manpower training could be structured as grants or contract payments to the employer. Tax benefits to the aged can be structured as cash to the aged. And so on.

It follows that a meaningful comparison between the tax incentive technique and the direct expenditure technique must involve *similar substantive programs*. There is no point to saying that in a particular situation a tax incentive is a more useful approach because it involves no government supervision over the details of the action to be induced, whereas a direct expenditure involves detailed supervision. To say so is not to compare a tax incentive with a direct expenditure but simply to compare a loosely controlled method of paying out government funds with a tightly controlled method. Direct expenditures can involve loose as well as tight supervision. Once we decide which substantive program we want then we can go on to decide which technique, tax incentive or direct expenditure, is preferable for that program.

The matter of what type of substantive program is best calculated to achieve the desired goal lies in the fields of cost-benefit and cost-effectiveness analyses. These methods are being used more and more to devise and test direct expenditures, and they should a priori be equally applicable to programs using a tax in-

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[7] *See* Stone, *Tax Incentives as a Solution to Urban Problems*, 10 WM. & MARY L. REV. 647, 651–53 (1969) (describing possible assistance devices for urban housing). *See also* Slitor, *Tax Incentives and Urban Blight*, in INCENTIVES SYMPOSIUM (generally defending tax incentives). For other discussions of tax incentives, see Blum, *Federal Income Tax Reform—Twenty Questions*, 41 TAXES 672 (1963); Kurtz, *Tax Incentives: Their Use and Misuse*, U. SO. CAL. 1968 TAX INSTITUTE 1.

[8] The tax provision was the Finance Act of 1954, 2 & 3 Eliz. 2, c. 44, § 16, repealed by the Finance Act of 1966, c. 18, § 35. Direct grants were instituted by the Industrial Development Act of 1966, c. 34, § 1.

[9] Where the charity was a religious institution, a direct government contribution would raise serious questions under the establishment of religion clause of the first amendment. But such a direct subsidy should be considered constitutional if the present tax provision is, since there is no practical difference between the two.

centive technique.[10] For present purposes I am assuming that the substantive analysis, as respects methodological approach, use of econometric techniques, and the like, should be of the same order whether a tax incentive or a direct expenditure is involved. This is not to say that this has been true with regard to tax incentives in the past. Far from it — and therein lie many of the problems with tax incentives. Nor can we say that it will be true as to future tax incentives, nor can we say that all direct expenditure programs are carefully thought through.

A meaningful comparison between the two techniques must also be *realistic*. Thus, it must recognize that a tax incentive does involve the expenditure of government funds. It is often said that a tax incentive is more useful than a direct expenditure because people do not like or will not respond to "subsidies." Such statements always assume that the direct expenditure is the "subsidy," whereas the tax benefit obtained in the tax incentive — the lower tax — is not so regarded. Perhaps we may find that this fiscal illusion has its usefulness, but we should at least be aware of what is the reality and what is the illusion.[11]

A. Some Asserted Virtues of Tax Incentives — Falsely Claimed

Against this general background we can now consider some of the virtues and defects generally claimed for tax incentives and, on the other side of the coin, for direct expenditures. The first level of consideration relates to virtues claimed for tax incentives, but, in light of the above background, falsely claimed.

1. Tax Incentives Encourage the Private Sector to Participate in Social Programs. — Frequently a tax incentive is urged on the ground that the particular problem to be met is great and that the Government must assist in its solution by enlisting the par-

[10] For recent examples of such studies applied to tax incentives relating to natural resources, see Consad Research Corp., *The Economic Factors Affecting the Level of Domestic Petroleum Reserves*, in HOUSE WAYS & MEANS COMM. & SENATE COMM. ON FINANCE, 91ST CONG., 1ST SESS., UNITED STATES TREASURY DEPARTMENT, TAX REFORM STUDIES AND PROPOSALS (Comm. Print 1969); Mid-Continent Oil and Gas Association, Analysis and Comment Relating to the Consad Report on the Influence of U.S. Petroleum Taxation on the Level of Reserves, April 25, 1969; Consad Research Corp., *Comments on Mid-Continent (MC) Oil and Gas Association Critique*, 115 CONG. REC. S14290–91 (daily ed. Nov. 13, 1969). As to buildings, see Taubman and Rausche, *The Income Tax and Real Estate Investment*, in INCENTIVES SYMPOSIUM; Taubman and Rausche, *Economic and Tax Depreciation of Office Buildings*, 22 NAT. TAX J. 334 (1969). As to the investment credit, see Brannon, *A Requiem for the Investment Tax Credit*, in INCENTIVES SYMPOSIUM (describing existing studies on the credit).

[11] Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 602–03 (1965).

ticipation of the private sector — generally business. The need for Government to participate can be fulfilled by a tax incentive, and this is asserted as a virtue of tax incentives — they provide government assistance. Thus, a tax incentive for manpower training proposed in the Senate was defended in these terms: [12]

> Tax incentives [are proposed] to encourage the fullest participation of the private sector in employment, upgrading, and training of less skilled people.
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> . . . .
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> . . . A tax incentive program should [make] . . . it economically possible for American business to play an important role in our manpower program.
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> . . . .
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> I understand the objections that are at times put forward to the use of the tax system for social purposes. However, I think it is time we realized that in order to encourage business to participate in programs of this nature, Government must be willing to meet business half way. The most convenient form for subsidizing a businessman is through his income tax.
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> . . . [This bill] enlists the job-creating potential of private enterprise by realistically recognizing the high initial costs involved in hiring, training, and providing supportive services for low-skilled individuals.

But all this is a non-sequitur; it points not to the virtue of tax incentives but to the need for government assistance. The existence of that need has no relevance to the question whether the need should be met by an incentive or by a direct expenditure.

2. *Tax Incentives Are Simple and Involve Far Less Governmental Supervision and Detail.* — A whole swirl of virtues claimed for tax incentives is summed up in the general observation that they keep Government — that is, the government bureaucracy — out of the picture: that they involve less negotiation of the arrangements, less supervision, less red tape, no new bureaucracy, and so on. The manpower proposal referred to above was supported by this argument: [13]

> The advantages to a tax credit approach are numerous. The most important, however, is that the program can go into effect immediately upon enactment. Employment programs in the past have taken months and years to become operative. . . . Employers who participate in the program will receive a tax credit of 75 percent of the wages paid to the employee for the first 4

[12] 115 CONG. REC. S5329, S5330 (daily ed. May 16, 1969) (statement of Senator Percy). The bill is S. 2192, 91st Cong., 1st Sess. (1969).

[13] 115 CONG. REC. S5329, S5330 (daily ed. May 16, 1969) (statement of Senator Percy).

> months of employment, 50 percent for the next 4 months, and 25 percent for the balance of the individual's first year of employment. This is an uncomplicated program with the minimum of redtape. Any employer who hires a certified employee is eligible for the tax credit — it is as simple as that.

But this merely comes down to saying: "Let's have a manpower program under which the Government pays an employer who hires a certified employee an amount calculated as a percentage of the employee's wage." There is nothing so far that indicates whether the payment should be by way of a tax credit or a direct expenditure. If the employer can obtain government funds (*i.e.*, a reduction in tax through the tax credit) for his employment activities by filling out a schedule on a tax return, a manpower program could be devised instead under which he would receive the same monetary assistance by filling out the exact same schedule on a piece of paper that had "Department of Labor" at the top in place of "Internal Revenue Service."

A government that decides it is wise to pay out tax credit money via a simple tax schedule would be highly irrational if it also decided that it would be unwise to pay the same amount directly on the same basis. A dollar is a dollar — both for the person who receives it and the government that pays it, whether the dollar comes with a tax credit label or a direct expenditure label. Nor is a new bureaucracy needed to pay out these amounts as a direct expenditure — a check-writing process is all that would be needed in keeping with the parallel to the tax credit. Nor, similarly, must there be long negotiations, complex contracts, and the like. It is not the tax route that makes the program simple — it is a substantive decision to have a simple program. In many cases, it is true, direct expenditure programs are probably overstructured and the urging of tax incentives is a reaction to, and a valid criticism of, badly designed expenditure programs. The cure lies of course in better designed expenditure programs.

It should be added, parenthetically, that the alleged simplicity of tax incentives is likely to be illusory. Thus, the argument quoted above states that "[a]ny employer who hires a certified employee is eligible for the tax credit — it is as simple as that." But this is not really so, because the legislation actually proposed would have required the employer to be certified by the Secretary of Labor, and to be eligible for certification an employer would have had to prove that the employment program would not impair or depress the wages, working standards, or opportunities of present employees; that the business was not affected by strike, lockout, or similar conditions; that the employees in the program would be afforded an equal opportunity for full-time employment

after the expiration of the credit period; that a formal on-the-job training program would be available; and that there would be no discrimination on account of race, color, religion, or national origin. Further complexities were involved in the proposed system for determining the creditable wage base, which was to be defined as the higher of the minimum wage or the wage customarily paid by the employer for such services.[14] Similarly, the low income housing tax incentive legislation discussed in 1967 and 1968 was studded with requirements of "approval by the Secretary of Housing and Urban Development."

The tape was thus present in the tax credit program and its color was red. This is not to criticize the particular programs, but rather to observe that those who design tax incentive programs, just as those who design direct expenditure programs, may find that complex requirements become desirable.

3. Tax Incentives Promote Private Decisionmaking Rather Than Government-Centered Decisionmaking. — It is said that better progress will be made towards the solution of many social problems if individual decisionmaking is promoted, and that since tax incentives promote this they should be preferred to approaches that underscore government-centered decisionmaking. Senator Ribicoff, for example, has expressed the view that "[r]ecognition that tax incentives can account for real Federal expenditures should not obscure the fact that such programs can eliminate the need for additional bureaucratic apparatus while promoting the use of private capital and initiative toward socially useful projects." [15]

We need not discuss the merits of private enterprise as a device for solving social problems, except to note in passing that many business groups who in urging tax incentives stress the virtues of private enterprise overlook the fact that they are really stressing private enterprise *plus* government assistance. But wise or unwise, the contention that private enterprise should be allowed free play, without government interference, tells us nothing as to the choice between tax incentives and direct expenditures, given the same substantive program. This contention is really a variant of the previous "red tape" argument. Just as we could design a direct expenditure program that provides for reduction of red tape, so we could design one that provides more flexibility for private decisionmaking and less scope for government control.

[14] S. 2192, 91st Cong., 1st Sess. (1969). *See* p. 716 *supra*.

[15] JOINT ECONOMIC COMM., 1969 JOINT ECONOMIC REPORT, H.R. REP. NO. 142, 91st Cong., 1st Sess. 20 (asterisk footnote). *See also id.* at 80 (views of Senator Talmadge); 3 CITY, April, 1969, at 5 (quoting Norman Ture to the effect that "incentives can bring into play previously unused or under-utilized resources most efficiently").

For example, the deduction for charitable contributions is sometimes cited as a method of government assistance that promotes private decisionmaking — the taxpayer, and not the Government, selects the charity and determines how much to give. But a direct expenditure program under which the Government matched with its grants, on a no-questions-asked and no-second-thoughts basis, the gifts of private individuals to the charities they selected, would equally preserve private decisionmaking. Similarly, the freedom of choice that states and local governments have as to how to use the funds they borrow with the assistance of the tax exemption for the interest on their bonds can be preserved by a direct expenditure program in which the federal government pays a part of the interest cost.[16]

It is true that many of the existing tax incentives are less structured than direct expenditure programs. But in part this reflects lack of scrutiny and foresight when the tax incentives were being planned or considered. If after a careful consideration it is decided that a simple structure is wise, then it would assume considerable irrationality to say that the simple structure will necessarily be kept if a tax incentive is used but scrapped in favor of a more complicated structure if a direct expenditure is used.

B. Some Asserted Defects of Tax Incentives

1. Tax Incentives Permit Windfalls by Paying Taxpayers for Doing What They Would Do Anyway. — It is generally argued that tax incentives are wasteful because some of the tax benefits go to taxpayers for activities which they would have performed without the benefits. When this happens, the tax credit or other benefit is a pleasant windfall, and stimulates no additional activity. With respect to many existing and proposed incentives this criticism is well taken, and indeed it is often difficult to structure a tax credit system which avoids this problem without increasing complexity and introducing arbitrariness. But this also is a problem not unique to the tax incentive technique. A direct expenditure program similarly structured would be equally open to the charge. For example, grants or contract payments made to employers who hire unskilled employees as part of a manpower program may go to employers who for one reason or another would have hired those employees anyway.

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[16] *See* Surrey, *Federal Income Taxation of State and Local Government Obligations*, 36 TAX POLICY, May-June 1969, at 3; Healy, *The Assault on Tax-Exempt Bonds*, 36 TAX POLICY, July-August, 1969, at 2; Surrey, *The Tax Treatment of State and Local Government Obligations — Some Further Observations*, 36 TAX POLICY, Sept.-Oct. 1969.

It may be desirable in particular programs to tolerate this inefficiency or windfall. Or it may be desirable to attempt to eliminate it, perhaps by constructing a program under which taxpayers bid for the government assistance needed and the assistance goes to the lowest bidders if otherwise qualified, just as in direct government purchasing. It may be that such a substantive program is difficult to operate through the tax technique, but other ways of reaching only the marginal decision could be built into a tax incentive. The significant question is what sort of substantive program is desired.

2. *Tax Incentives Are Inequitable: They Are Worth More to the High Income Taxpayer than the Low Income Taxpayer; They Do Not Benefit Those Who Are Outside the Tax System Because Their Incomes Are Low, They Have Losses, or They Are Exempt from Tax.* — This criticism of tax incentives in terms of their inequitable effects is properly levied against most of the existing tax incentives, and probably most of the proposed incentives. The existing incentives were never really carefully structured and in many instances just grew up, without serious thought ever having been given to the question whether they were fair in these terms. The entire process was molded by the fact that the positive tax structure was being affected, and within that structure tax benefits — deductions and exclusions — had these effects as a matter of course. The deductions and exclusions of the tax incentive provisions and their inequitable effects took on the protective coloration of the deductions and exclusions that were a part of the basic tax structure.

The fact that tax benefits for the aged and the sick provide no benefits for those aged or ill who are too poor to pay income taxes was not even thought of as a difficulty, since the focus was, as in any positive tax system, on writing the rules for *taxpayers*.[17] The problem was sometimes thought about in the context of an individual who fell outside the tax system because of current losses, and at times a carry-forward of incentive benefits was provided. Thought was occasionally given to the fact that the deduction of mortgage interest or charitable contributions is worth more to the top bracket taxpayer than the low bracket taxpayer, but the disparity was generally dismissed on the grounds that all deductions had that effect. Sometimes this matter was regarded as worrisome, and a tax credit was used instead

[17] The fact that deductions and exemptions benefit only taxpayers is, to take the large view, a product of the fact that we have only a *positive* income tax system. If we had a *negative* income tax as well, then direct expenditures would benefit those whose incomes were below the level of positive tax, and a continuum in treatment would prevail.

of a deduction, as in the case of the retirement income credit for the aged.

This unfairness persists even in recently proposed tax incentives. The proposed tax credit for educational expenses [18] would not have helped poor families with incomes below the taxable level. The proposed manpower training credit [19] would not help a new business experiencing initial losses and struggling to stay alive, or it would help only by deferring into the future, through a carry-forward provision, benefits needed at once.[20] No assistance is provided to a tax-exempt organization or local government incurring added expenses under its participation in manpower training activities.[21]

Thus, the lesson is hard to learn. The recent tax reform legislation contained a tax incentive for the rehabilitation of low income housing, using the device of five-year amortization of capital expenditures [22] which otherwise would be depreciated over a longer period. This device, which was proposed by the Treasury Department, has these interesting effects for individual taxpayers: for a taxpayer in the 70% bracket, the benefit is the equivalent of a 19% investment credit (assuming an expenditure with a 20-year life and discount rate of 10%); for a taxpayer in the 20% bracket it is the equivalent of a 5% credit. In terms of interest costs on a loan made for rehabilitation purposes, the benefit of five-year amortization is equivalent for the 70% bracket taxpayer to reducing an 8% interest charge to 3%; for the 20% bracket taxpayer it is equivalent to reducing the 8% charge to 7%. The inequitable effect of this tax incentive device is not mentioned either in the proposal or in the committee reports explaining it.[23]

It is thus clear that most tax incentives have decidedly adverse effects on equity as between taxpayers on the same income level, and also, with respect to the individual income tax, between taxpayers on different income levels. As a consequence of these inequitable effects, many tax incentives look, and are, highly ir-

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[18] Tax Reform Bill of 1969, H.R. 13,270, 91st Cong., 1st Sess. § 917 (1969). The provision was not retained in the final legislation.

[19] A similar unfairness existed in the proposed deduction for transportation expenses of handicapped persons. Tax Reform Bill of 1969, H.R. 13,270, 91st Cong., 1st Sess. § 915 (1969). This provision was not retained in the final legislation.

[20] S. 2192, 91st Cong., 1st Sess. (1969).

[21] Canada appears to be shifting from tax incentives to direct expenditures in providing government assistance to regional economic expansion. Regional Development Incentives Act of 1968–69, c. 56. One reason given is the ineffectiveness of tax incentives when new ventures are involved.

[22] Tax Reform Act of 1969, Pub. L. No. 91–172, § 521(a) (U.S. CODE CONG. & AD. NEWS No. 12 (Dec. 30, 1969)), *amending* INT. REV. CODE OF 1954 § 167.

[23] *See Hearings on H.R. 13,270 Before the Senate Comm. on Finance*, 91st Cong., 1st Sess., pt. 5, at 4903–08 (1969) (statement of Charles Davenport).

rational when phrased as direct expenditure programs structured the same way. Indeed, it is doubtful that most of our existing tax incentives would ever have been introduced, let alone accepted, if so structured, and many would be laughed out of Congress. What HEW Secretary would propose a medical assistance program for the aged that cost $200 million, and under which $90 million would go to persons with incomes over $50,000, and only $8 million to persons with incomes under $5,000? The tax proposal to remove the 3% floor under the medical expense deductions of persons over 65 would have had just that effect.[24] What HEW Secretary would introduce a program under which Social Security benefits would be unaffected if the recipient's total income including the benefit were under $900, would be automatically increase by 14% if the recipient's income were between $900 and $1,400, by 15% if between $1,400 and $1,900, and so on up to 70% if over $100,000? That is the effect of the present exclusion from income of Social Security benefits. What HUD Secretary would suggest a housing rehabilitation subsidized loan program under which a wealthy person could borrow the funds at 3% interest but a poor person would have to pay 7% or 8%? That is the effect of the five-year amortization of rehabilitation expenditures contained in the recent Tax Reform Act.[25]

This criticism — that tax incentives produce inequitable effects and upside-down benefits — is valid as to the general run of tax incentives.[26] It demonstrates why tax incentives make

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[24] Tax Reform Bill of 1969, H.R. 13,270, 91st Cong., 1st Sess. § 914 (1969). The provision was not enacted.

[25] Tax Reform Act of 1969, Pub. L. No. 91-172, § 521(a) (U.S. CODE CONG. & AD. NEWS No. 12 (Dec. 30, 1969)).

Professor Henry Aaron uses this example:

> Yesterday on the floor of Congress, Senator Blimp introduced legislation to provide cash allowances for most of the aged. Senator Blimp's plan is unique, however, in that it excludes the poor. The largest benefits, $70 per month, are payable to aged couples whose real income exceeds $200,000 per year. The smallest benefits, $14 per month, would be payable to couples with income between $1,600 and $2,600. Widows, widowers, and unmarried aged persons would receive half as much as couples. No benefits would be payable to those with very low incomes.

Professor Aaron states this is a way of describing the (then) additional $600 personal exemption for the aged. Aaron, *Tax Exemptions — The Artful Dodge*, TRANSACTION, March, 1969, at 4.

[26] In the case of the corporate income tax, the absence of the progressive rate structure of the individual income tax makes the tax incentive less inequitable than in the individual income tax situation. Nevertheless, inequities do exist when a tax incentive deduction is used, since the larger corporations receive a 48% benefit (absent the surcharge) and the smaller corporations only a 22% benefit. Corporations incurring losses may receive no benefit. The use of a tax credit rather than a deduction would eliminate the first aspect, but would probably leave the loss corporation without assistance, since tax incentive credits in excess of tax liability typically are not paid out.

high-income individuals still better off and result in the paradox that we achieve our social goals by increasing the number of tax millionaires. The marketplace does not work this way — for the individual who earns his profits, even high profits, by meeting a need or desire of society, finds his rewards subject to the progressive income tax. The economic system is thus functioning as it is intended it should, and the tax system, which acts as a control, is also functioning as intended. But when rewards are in the form of tax incentives, the latter control is eliminated, and tax millionaires are produced.

The financial assistance afforded by the incentive, with the purpose of making profits high enough to induce the desired action by the taxpayer, is not itself included in income. The tax incentive thus provides both financial assistance and freedom from taxation. That freedom itself means much more to the well-to-do individual than to one in the lower brackets. The tax incentive is thus a method of reward and assistance that is just upside-down from the way the country decided — when it adopted a progressive income tax — that the rewards of the marketplace should operate in combination with the income tax. The use that has been made — and is being made — of tax incentives is thus destructive of the equity of a tax system. This is illustrated by the Treasury Department's first proposing a housing rehabilitation tax incentive and then having to suggest that the incentive is a tax preference which must be guarded against by including it in a minimum tax structure designed to prevent the wealthy from escaping all tax burdens.[27] The use of the direct expenditure route would have prevented this particular undermining of the tax system.

In some cases, however, the tax incentive could be fashioned to avoid this criticism, though the result would be a different program and one structured more closely along direct expenditure lines. For example, suppose in the case of the exclusion of Social Security benefits, that a uniform tax credit was used instead of the exclusion, the tax credit was included in taxable income, and any unused credit was paid to the taxpayer. This would be the equivalent of a direct expenditure program for all aged on a per capita basis, with positive taxpayers receiving a diminishing final share depending on their tax bracket, and those aged outside the tax system receiving their full share. The elements of inequity would be removed and the tax incentive technique would

[27] *See* article by Eileen Shanahan in N.Y. Times, Dec. 22, 1969, at 25, col. 4 ("There are four other major new tax preferences in the bill: tax incentives (which is what preferences always are at their birth) aimed at stimulating . . . the rehabilitation of old residential housing . . .").

be on the same footing as a direct expenditure under which each aged person received the same per capita amount. Indeed, this is how tax incentive programs *should* be structured if they are to be equitable and not involve the unfairnesses described. But this approach may only rarely be feasible given its novelty and the difficulties involved in convincing the business community and others who are the beneficiaries of tax incentives, let alone the policymakers in Government, of the appropriateness of making such changes as including the tax incentive amount itself in taxable income.[28]

As an aside, we can here see the importance of distinguishing tax expenditures and tax incentives — so-called special tax provisions — from those provisions considered a proper and necessary part of the structure of an income tax. If an item is *properly* deductible in the latter sense, it does come off at the taxpayer's top tax rate, and its benefits are confined to those who are taxpayers. Given the decision to have an income tax at all, the result is equitable, within the concept of an income tax. An income tax is a tax on *net* income and not a tax on gross receipts; therefore the deductions from gross income required to produce the net income base must be allowed. Those deductions, generally speaking, are the expenses and costs incurred in the process of producing or earning the gross income received by the taxpayer.

Thus, consider the deduction for moving expenses: it is a deduction and so benefits a taxpayer (reduces his tax) in accordance with his marginal tax rate. It also benefits only taxpayers; an employee who incurs moving expenses, but whose income is so low as not to leave him taxable, does not obtain any benefit or assistance. This is the correct result under a positive income tax system if the moving expense should properly be taken into account in the measurement of net income, as it should be if it is an expense in earning income rather than a personal expense. If it is the latter, the deduction is a subsidy or tax expenditure, inequitably cast, to induce labor mobility. Actually, the moving expense deduction is at the frontier of the positive income tax structure; a gradual shift is occurring, and such ex-

[28] Where the tax incentive amount is similar to a contribution to capital, it would not be included in income but would reduce the basis of property related to the contribution. *Compare* INT. REV. CODE OF 1954 §§ 118, 362(c).

There are other ways to structure a special tax provision to eliminate inequities. For example, the system of special bad debt reserves for financial institutions could be handled by allowing the deduction of the special reserve but then requiring the tax savings to be invested in special federal bonds that do not carry interest. This approach is now used in the tax treatment of special reserves for mortgage insurance companies. *See* HOUSE WAYS & MEANS COMM., 91st Cong., 1st Sess., UNITED STATES TREASURY DEPARTMENT, TAX REFORM STUDIES AND PROPOSALS, pt. 3, at 467 (Comm. Print 1969).

penses are coming to be regarded as a factor proper and necessary to the measurement of net income.[29]

3. *Tax Incentives Distort the Choices of the Marketplace and Produce Unneutralities in the Allocation of Resources.* — This criticism is in one sense always valid, because that is what the tax incentive is designed to do. Generally, the critic is also saying or implying that the distortion introduced by the particular incentive is undesirable for various reasons. In large part this criticism is true of many existing incentives for reasons earlier described. The criticism has relevance because the distorting effects of tax incentives often pass unnoticed. But the criticism is of course equally applicable to direct expenditures, some of which certainly are unwise. Again, we are not here concerned with the overall role of government or the extent to which and under what circumstances financial assistance is desirable to induce private action different from what the marketplace would provide. This criticism thus does not per se tell us when one or the other technique should be used.

It is interesting to note that even within the area sought to be benefited by the tax incentive, the design of the incentive may push or pull in unneutral directions, which may or may not be desirable. Thus, a tax credit for pollution control facilities focuses on expenditures for machinery as the method of control to the exclusion of other methods, such as a different choice of materials involved in the manufacturing processes.[30] A tax credit for businesses located in urban slums may focus concentration on monetary assistance to the neglect of the provision of technical assistance.

4. *Tax Incentives Keep Tax Rates High by Constricting the Tax Base and Thereby Reducing Revenues.* — This criticism of tax incentives states a fact that many overlook in their advocacy of tax incentives. The lack of an explicit accounting in the federal budget for the tax expenditures involved in tax incentives

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[29] *See* Tax Reform Act of 1969, Pub. L. No. 91–172, § 231 (U.S. CODE CONG. & AD. NEWS No. 12 (Dec. 30, 1969) (expanding the deduction and extending it to include self-employed individuals). There is a hazy line between business expenses properly deducted from income for the purpose of an income tax, and personal expenses, which should not be deducted. Thus, commuting expenses are personal, but the expenses of providing comfortable working conditions in an office are business; wearing nice clothes at work is a personal expense but wearing uniforms is a business expense. The borderlines that evolve are a part of the "generally accepted structure of an income tax" that is used as a standard to identify tax expenditures. We sometimes speak of tax changes designed to provide incentives for taxpayers when what is really involved is the removal of imperfections in the design of a proper tax structure that inhibit their activities. *See, e.g.*, the discussion of the Foreign Investors Tax Act of 1966, in Stone, *supra* note 7, at 648.

[30] *See* Wilson, *Tax Incentives and Pollution*, in INCENTIVES SYMPOSIUM.

and the lack in most cases of an accounting in the tax statistical data combine to cause many to forget that dollars are being spent. As a consequence, the criticism that is made against direct expenditures — that they keep our tax rates high — is often lost sight of when tax incentives are involved. This criticism of tax incentives is thus a useful reminder that government funds are being spent, and that therefore whatever degree of scrutiny and care should be applied to direct expenditures should also be applied to tax incentives.[31] Tax incentives are usually open-ended: they place no limit on how much tax benefit a taxpayer can earn. Hence it is difficult to foretell how much will be spent by the Government through a particular incentive. It is difficult in the nature of things to structure most tax incentives in order to provide a limit on their use. Thus, tax incentives are much like the uncontrollable direct expenditures in the budget.

In the end, the issue is whether, as to any particular area, we want direct government provision of services or goods, government financial assistance (subsidies) to encourage and assist private action to provide the services or goods, or reliance on private action unaided by the Government. If we choose government provision or assistance, then dollars must be spent, and whether they are dollars forgone through lost tax revenues or dollars spent directly through direct expenditures, the effect on tax rates will be the same. So also will the effect on the economy if the government program succeeds, and the resultant effect on the revenue base and tax rates of the increased economic activity that such success may mean.

C. Summary of Asserted Virtues and Vices of Tax Incentives

This description of the virtues and vices of tax incentives yields these conclusions: the *asserted disadvantages* — waste, inefficiency, and inequity — are true of most tax incentives existing or proposed because of the way they are structured or grew up. The whole approach to tax incentives — one of rather careless

[31] Senator Percy's statement on the manpower training bill included, in the section claiming that the proposed program was uncomplicated, the sentence: "This bill would require no Federal appropriations." 115 CONG. REC. S5330 (daily ed. May 16, 1969). If this is intended to convey the idea that government funds are not being used, it is subject to the criticism on this page of the text. If it is intended to convey the thought that such legislation can be passed more quickly than direct expenditure legislation because no appropriation bill is needed, it is really an attack on the whole process of appropriation bills. If it is intended to convey the thought that the Congress will spend tax expenditure dollars but not direct expenditure dollars, it appears to charge the Congress with being irrational, as to which see pp. 732–33 *infra*.

or loose analysis, failure to recognize that dollars are being spent, or to recognize the defects inherent in working within the constraints of the positive tax system — has produced very poor programs. But *if* the problems were recognized and *if* care were taken to design tax incentive programs that one would be willing to defend in substantive terms were the programs cast as direct expenditure programs, then these disadvantages would not be involved, except to the extent that they are inherent in government assistance itself. These are large conditions, and in some cases would be hard to bring about. For example, it would not be easy to give tax benefit assistance to groups outside the tax system but performing desired activities, such as local governments or tax-exempt organizations hiring the disadvantaged — direct payments outside the tax system would be needed. And it would not be easy to design tax incentive programs which were not inequitable as between taxpayers in high and low brackets and between taxpayers and nontaxpayers. Indeed, there is no tax incentive in existence or proposed that meets the above standards. But for purposes of comparison we are here assuming that the standards could be met under some tax incentive programs.

Similarly, the *asserted advantages* of tax incentives — greater reliance on private decisionmaking and less detailed requirements — to the extent that they are true in fact (and they are often only illusory) are really criticisms of the complications and supervision built into direct expenditure programs, or else a reflection of the structural weaknesses of the tax incentive program, depending on the amount of detail and supervision appropriate to the particular program. In a rational world, one should assume that if after careful study it is considered that certain complexities and details are not needed and can be left out of a tax incentive program, then they should and can simply be dropped from the direct expenditure program. Again, this may be a more difficult condition than appearance suggests, but it is probably less difficult to bring about than the conditions for repairing tax incentives, or at least no more difficult. Again, for purposes of comparison, we are also here assuming it can be done in direct expenditure programs.

D. What Is Lost by Using a Tax Incentive Rather Than a Direct Expenditure

Given, under the assumptions just made, the same substantive program, under which government assistance in the same amount is being given in ways and to persons that would be equally acceptable whether tax incentives or direct expenditures were used, what factors should determine the choice of framework for

a particular program? We can approach this question by asking: what is lost if the tax incentive technique is used? There are several answers.

1. Tax Incentives, by Dividing the Consideration and Administration of Government Programs, Confuse and Complicate that Consideration in the Congress, in Administration, and in the Budget Process. — Let us start with the congressional consideration of tax incentive programs. By definition, such programs are designed to induce action to meet a particular social goal — manpower training of the disadvantaged, education, housing, pollution control, or business location in desired areas, to use some recent examples — and would not be a part of the tax structure were they not deliberately cast as tax incentives. Such governmental programs would normally be considered by the appropriate congressional committee charged with the legislative area involved: the House Education and Labor and Senate Labor and Public Welfare Committees, the House and Senate Banking and Currency Committees, the House and Senate Interior and Insular Affairs Committees, the House Interstate and Foreign Commerce and Senate Commerce Committees, and so on. These committees are responsible for overseeing and developing legislation in their jurisdictional fields, and so are able to coordinate the Government's programs and policies. Tax legislation, however, goes to the House Ways and Means Committee and the Senate Finance Committee. These committees would normally not consider the substantive areas involved in tax incentive programs. Tax incentives suddenly charge them with acting on substantive matters outside their fields of responsibility simply because the program uses the tax system. Although tax committees are highly competent in tax matters, they do not have as much insight into these programs as the legislative committees normally handling the programs. A similar situation would prevail if the latter committees were suddenly to legislate on technical tax matters. Moreover, the tax incentive program considered by the tax committees would be isolated from the regular flow of legislation and activity in the field involved, and this isolation would make coordination and the consideration of priorities difficult. The purpose of the congressional committee system is to distribute expertise among the members of Congress. To cast solutions to social problems as tax measures and exchange expertise in those problems for unfamiliarity is, to say the least, both disruptive and unproductive.[32] Moreover, the jumbling of a number of different incentive

[32] The 1969 tax reform act is an example of the hasty judgments that may result from this system. Without any study at all the Ways and Means Committee, in dealing with that measure, committed the Government to an expenditure of nearly

programs in the tax committees would inevitably set in motion a "log-rolling" process, in which careful consideration would be displaced by trading for support among members. Such a process is difficult to control once a committee is operating outside of its area of expertise and with no clear limits of subject matter to restrain it.

These difficulties could perhaps be overcome. Tax committees might refer incentive proposals to the appropriate legislative committees and accept their judgments, or both groups of committees could consider the matter jointly. Approaches like these are sometimes used in areas where a trust fund having earmarked taxes exists. But the system is awkward and leaves unanswered questions — for example, which committee would exert continuing oversight over the program? Given all the trouble and care that must be taken to patch up an arrangement basically at variance with the normal practice, what is gained by choosing that arrangement in the first instance and thereby dividing the governmental consideration of the program?

Much the same can be said about the parallel effect at the administrative level. Social programs are normally administered by executive departments such as Labor, HEW, HUD, and Interior. Taxes are administered by the Internal Revenue Service. A social program cast in tax terms must in the first instance be administered by the IRS, whose expertise does not extend to these other areas. Problems of lack of coordination with other substantive programs would also arise because of the isolation of tax incentive programs. Again, these difficulties could be patched up to some extent — and probably would have to be — by having the appropriate executive department provide some guidance to IRS. But why the divided arrangement in the first place?

At the budgetary level such a division of responsibility makes oversight and control more difficult. Budgetary problems exist even where several relevant executive departments have a hand in the same program or area. The difficulties are compounded when one of the agencies (IRS) really doesn't belong there in the first place, and when it distributes the funds by tax reduction rather than direct expenditure.[33] Our present budgetary process

half a billion dollars for pollution control facilities installed by industry. Without any study at all the Treasury induced the committee to commit the Government to an expenditure of over $300 million for the rehabilitation of rental housing. Neither action was taken with any regard to the overall priorities in the pollution control and housing areas. *See* Surrey, *Federal Tax and Fiscal Policy: Some Aspects of Future Developments*, 48 TAXES 49 (1970).

[33] One defect in the administration of tax incentives by the IRS is that the IRS agents are "income oriented" and tend to look askance at deductions and credits having no relation to the measurement of income. This attitude could re-

badly compounds these difficulties by giving no recognition or accounting to what is being spent on existing tax expenditures. Until 1968, when the Treasury Department published its analysis of tax expenditure programs and a Tax Expenditure Budget, there was no accounting for the existing tax incentives. The necessary data were not available to the public and not comprehended within the Government. No one really knew what was being spent through the tax system or for what purposes.[34]

An additional problem is the difficulty of coordinating the treatment of tax incentives with the overall handling of direct expenditures. For example, when overall expenditure limits are directed by the Congress or when the President decides to cut expenditures it is essentially impossible to apply the restrictions to tax incentives. So far none of the various expenditure control tax incentives. So far none of the various expenditure control devices, such as those voted in recent years by the Congress, have in any way affected tax expenditures. Yet had these tax programs been structured as direct expenditures, they would have had no such immunity. In substantive terms they do not merit that immunity any more than the direct expenditures, yet their tax clothing shields them. For similar reasons, tax incentives are not covered by the annual budgetary review process; the Bureau of the Budget doesn't even know about many of them, or how much they cost. We do have "uncontrollable" areas in the budget, such as interest on the public debt, and since they can play havoc with a budget, an effort is made to keep them to a minimum, and

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sult in uneven administration of incentive programs. The agents, not seeing the purpose behind the deductions and credits, since they are not tax purposes and so are outside the general expertise and background of the agents, are likely to view the benefits as too generous and to raise audit problems for claimants. This is less likely to occur in the administration of a direct expenditure program since it would be in the hands of an agency interested in the success of the program. Thus the existence of an IRS audit system is not necessarily, contrary to the claim sometimes made, an argument for using tax incentives. Moreover, other agencies, such as the Department of Labor, have inspection or audit systems, and still others could develop them.

[34] *See Hearings on Economic Analysis and Efficiency in Government Before the Subcomm. on Economy in Government of the Joint Economic Comm.*, 91st Cong., 1st Sess. (1969) (statement of Stanley S. Surrey on the Tax Expenditure Budget).

It is sometimes said that a tax incentive has the advantage of "permanency" since tax provisions generally are only infrequently reexamined, whereas direct expenditures are usually reviewed annually, and that some programs to be effective require such permanency. However, if, as a general matter, periodic review of government expenditures is considered desirable, no program should be removed from that scrutiny except for compelling reasons. If in a particular case such reasons are determined to exist, then devices to postpone review are available under the direct expenditure route: for example, longer appropriations and trust funds. There need be no resort to the tax system simply to prevent periodic review.

at least to identify them and try to estimate their effect. But in the budget process this is not done for tax incentives.

Overall, therefore, a resort to tax incentives greatly decreases the ability of the Government to maintain control over the management of its priorities. This is true both as to the substantive programs to be introduced, modified, or dropped and as to the amounts to be spent in particular programs and areas. These consequences run counter to the whole thrust of our concerns with the ordering of national priorities and with the wise allocation of our resources, which we have come to see as limited and therefore in need of careful management.

Some of these difficulties could be met. Tax incentives could be identified, amounts estimated, and the data incorporated in the budget. Unless this is done, comparisons of tax expenditures and direct expenditures must be comparisons of hidden programs with open ones. But even after such clarification, further difficulties would remain. Perhaps the President could be given authority to treat the tax incentive funds as direct expenditures for budgetary control purposes, and the incentives could be structured as far as possible to have them fall in the controllable rather than the uncontrollable expenditure pattern. Perhaps the tax incentive programs could be given yearly or biannual expiration dates, so that they could be reviewed in the same way as direct expenditures under the appropriation and budgetary procedures.

But these solutions, like those available for the problems of congressional consideration and administrative operation, raise the question, what is gained by turning what would normally be a direct expenditure program into a tax incentive program and then trying to structure the program so that it can nevertheless be handled as a direct expenditure program? Why the detour through the tax system? Why inject the tax system into the program, when the program can be effectively structured without it?

2. *Tax Incentives Will Not Improve the Tax System and Are Likely To Damage It Significantly.* — Certainly the tax system does not gain when expenditures are made through tax incentive programs. We have already seen that tax incentives are inimical to the equity of a tax system — indeed, in a sense that is necessary to their purpose and function. Moreover, the 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.[35] Tax incentives make it more and more

[35] It has been pointed out that phrasing the assistance in terms of tax benefits may in some cases make it so difficult for potential beneficiaries to determine their

difficult to distinguish between what is subsidy and what is proper structure. This is especially so where the tax incentive is not identifiable as such but is merged into a provision that has a genuine relationship to the measurement of net income — as is, for example, the subsidy involved in accelerated depreciation for real estate, since some degree of depreciation is appropriate.

It is no answer to say, as do some cynics, that since the tax system today has so many special provisions there should be no objection, when worthwhile programs are involved, to adding still more to the heap. Rather, the effort should persist to contract those existing special provisions that are improper and wasteful. We know from long experience that provisions can be enshrined in tax laws far past their usefulness and long after their defects become clear. We should not, when alternatives are present, freeze in more special provisions, especially since programs in the complex areas of social policy to which many tax incentive proposals relate are essentially experimental in nature.

E. What Is Gained — Allegedly — by Using a Tax Incentive Rather Than a Direct Expenditure

Thus, a great deal is lost when tax incentives are used. What is to be gained by that approach compared with the direct expenditure approach? Some have advanced answers which are essentially political in nature, and, I think, rooted in illusions or irrationalities. Professor Aaron has observed that the popularity of the tax devices "derives from a peculiar alliance among conservatives, who find attractive the alleged reduction in the role of government that would follow from extensive use of tax credits, and liberals anxious to solve social and economic problems — by whatever means — before it is too late." [36] We have already discussed the illusion that tax credits for social purposes are simple and removed from the bureaucratic hand. The second illusion in the above argument is that the Congress will vote dollars through tax incentives that it refuses to appropriate through expenditure programs. Just why a Congress that focuses on the matter should be so inconsistent is not explained. Certainly many members of tax committees, such as Chairman Mills, have recognized that tax incentives do involve expenditures — "back-door expenditures" in his words — and that a legislator concerned with expenditure levels and expenditure control should not, while holding the front door shut, let hidden expenditures in through the back door. But perhaps irrationality will govern; perhaps administrators and

rewards that they will fail to take advantage of them. *Cf.* Stone, *supra* note 7, at 654.

[36] Aaron, *supra* note 25, at 5.

legislators will devise and accept programs structured as tax provisions which they would reject as direct expenditures, or will refuse to improve direct expenditure programs, or will spend money through tax incentives that they would not appropriate as direct expenditures. In that event, rational consideration will not change matters.

There is another answer, which also appears to be irrational or illusory. This is the claim that businessmen respond to tax credits but not to other forms of government assistance; that there is a glamour and magic possessed by dollars of tax reduction that will attract the businessman who would pass up dollars offered through direct expenditures. To the extent that this answer rests on the belief that tax incentives are really simpler, or that complexities can be sheared away only if tax incentives are used, it rests on beliefs already discussed and found either unrealistic or true only if the underlying government policies are themselves irrational. To the extent that the answer rests on the claim that business regards tax incentive dollars as "clean dollars" — just part of a tax computation — but sees direct expenditure dollars as somehow unclean because they are a subsidy, one can only answer that business probably does not respond this way, or that if it does, it is behaving irrationally. Experience with direct subsidies — the SST program for example — suggests that business firms are willing to and do calculate profit prospects in the light of government subsidies. Similarly, the argument that business is familiar with tax credits — though until the investment credit there were no credits widely used in the corporate tax system — but not with other forms of government assistance is certainly not always true. Lack of business familiarity could be overcome by publicizing direct subsidies. The manpower training credit proposal quoted earlier suggested that "the Department of Labor . . . be required to make [the proposal's] provisions known to the unemployed and potential employers in the business community." [37] Such a duty could equally well be placed on that Department if it were administering a direct expenditure program.

There may be an aspect of this asserted preference for tax incentive programs that is not illusion or irrationality, but more serious. It may be that legislators and the beneficiaries of tax incentive programs — businesses receiving accelerated depreciation or percentage depletion, state and local governments receiving tax exemption on their bonds — fear that once the public is fully aware of the amounts involved and can weigh expenditure costs against benefits received by the nation, the tax incentives

[37] 115 CONG. REC. S5329, S5330 (daily ed. May 16, 1969).

will be found wanting in many respects. In this view, the deeper the incentive is buried in tax technicalities and tax terminology, the more it looks like any other technical tax provision, the more it partakes of the protective coloration of the tax law that can be obtained by such outward similarity to ordinary tax provisions, then the more desirable the tax incentive becomes. The public must dig hard and deep to find the subsidy and evaluate it. But such an approach to government expenditures — the preference for the hidden subsidy over the open subsidy — is contrary to all experience with budgets, and to efforts to achieve a rational use of resources. If this is the argument for tax incentives, it should not be accepted.

III. Conclusion

What, then, is the balance sheet regarding these two methods of government assistance, direct expenditures and tax incentives? I conclude from the above observations that, as a generalization, the burden of proof should rest heavily on those proposing the use of the tax incentive method. In any particular situation — certainly any new situation — the first approach should be to explore the various direct expenditure alternatives. Once the most desirable of these alternatives is determined, if one still wishes to consider the tax incentive method for the same substantive program, the question must be what clear advantages can be obtained by using the tax method. Again, as a generalization, I think it unlikely that clear advantages in the tax incentive method will be found. Moreover, I stress strongly that the advantages must be clear and compelling to overcome the losses that accompany the use of the tax incentive, even the well-structured incentive. The problems of achieving a well-structured incentive are in themselves formidable. Even assuming that such problems as unfairness and windfalls are overcome, there are still the losses and drawbacks we have described: confusion and divided authority in the legislative and administrative processes, difficulties in maintaining budgetary control, confusion in perceiving and setting national priorities, and dangers to the tax structure itself.

It could be that a program of government assistance that is broadly based, relatively simple, and properly structured can be more readily administered if joined to the tax system. Some have defended the deductions for charitable contributions and personal interest and taxes on this ground, though pointing to the need to correct abuses and recognizing that the corrections would make the tax incentive more like a direct expenditure program. Others have defended the investment credit for the same reasons,

again with a recognition that improvements can be made.[38] But none of these incentives has had to meet the test of comparison with a carefully structured direct expenditure program. Only after that is done can we reach the point of well-informed choice.

These are general guidelines; there may be particular cases to which they do not apply because special considerations are involved. Even so, care must be taken to look hard at special considerations advanced as reasons for an exception to be made "in this particular case." The legislative halls are crowded with advocates skilled in tying their problems to the last exception and in devising techniques to make each step from the last precedent appear to be only short, logical, and harmless. Our gaze can thus be averted from the constantly widening gap between proper tax structure and each additional special provision.

One question raised by this discussion especially merits more research and thought. Just why is it that in many cases legislators appear willing, with hardly any thought, to accept an expensive tax incentive program when they would just as quickly reject a similar direct expenditure program, even a much smaller one? Why do they require lengthy study and analysis of direct expenditure programs before legislative and appropriation committees while they are ready to enact tax incentives on no more than generalizations and hunches? Is it that they do not realize, or stop to think, that dollars are spent by tax incentives? Is it that tax bills are so complicated that hardly anyone studies them unless prodded by an industry or taxpayer that is hurt, in his tax pocketbook, and that therefore provisions dispensing largesse slide by — although this would be a case of the proper concession of tax expertise to the tax committees papering over their lack of expertise in the areas involved in tax incentives. Is it that the legislators know full well what is involved, despite the complexity of tax bills, but believe the public will not perceive what is being done because of the complexity of tax bills and because tax expenditures do not show up in the budget? To claim this would almost be to claim that any expenditure of funds is acceptable to a legislator — the more money to constituents the better — but most legislators do not follow this principle.

We could ask similar questions about administrative agencies. Just why do administrators of direct expenditure programs allow tax incentive proposals to be pushed when the funds involved

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[38] Indeed, the relative simplicity of the investment credit, which is applied with very little supervision, may have misled businessmen into thinking all tax credits are simple in structure. Yet, as stated earlier, the tax credit proposals in social areas have far more details and complexities. On the investment credit generally, *see* Brannon, *supra* note 10.

in such programs could be used, and probably much better used, as coordinated parts of the direct expenditure programs? Is it that their policy is to accept gratefully contributions from any source? Is it that they will not face up to the need either to improve the direct expenditure program or squarely demonstrate the erratic and wasteful character of the tax incentive proposal? Is it that they are sometimes negligent in their legislative intelligence and are simply left at the legislative starting gate when the tax incentive is adopted? And why should a Treasury Department which is charged with preserving the integrity of the tax system ever willingly propose or accept a tax incentive solution except in the unusual and rare situation when a tax credit may possibly be properly tailored, and better suited to the purpose — conditions which do not appear to exist as to any of the recent proposals?

With *new* situations — that is, new or expanded government programs — we are in a position to follow a rational course in choosing between these methods. During the 1960's, as attention turned increasingly to government financial assistance to meet urgent social problems, almost every problem brought proposals of a tax incentive as the solution; often the tax incentive was the first solution to be advanced. The Treasury Department responded by pressing the White House staff and other agencies to devise, with the Treasury, non-tax alternatives for comparison on a cost-effectiveness basis. For example, the Treasury, with HEW, developed the federal guaranteed student loan program and expanded scholarship and work programs, so that they could be pushed in opposition to a tax credit for college tuition. In the manpower field, the Treasury urged strong and expanding federally-supported training programs which could be advanced instead of a tax incentive. The skepticism with which specialized tax incentives for social problems were regarded by the Treasury together with a realization that a negative answer to proposals of tax incentives did not solve the problems, thus led the Treasury to be a strong force within the Government in developing and pushing direct expenditure programs, both to counter tax incentive proposals and to move forward to meet the problems in other ways.

With *existing* tax incentives, the task is one that falls in the category of "tax reform," where progress is difficult and slow.[39]

[39] The 1969 TAX REFORM STUDIES AND PROPOSALS, *supra* note 10, related in the case of the income tax almost entirely to tax incentives and involved varying degrees of scaling down and restructuring. Only a few of the proposals related to defects in the fitting together of the tax structure proper (for example, multiple corporation provisions and mineral production payment provisions) or changes in the application of that structure, such as elimination or reduction of tax for those

This is especially so with incentives which have long histories. We do learn as the tax years pass by: the newer tax provisions are in general more carefully tailored with an eye to many of these problems than their predecessors. For example, compare the moving expense and medical expense deductions with those for personal interest and taxes as originally adopted. Or compare the structure of the 7% investment credit with the provision for accelerated depreciation for real estate as it appeared in 1954.[40] Unfortunately, we also can forget what we have learned, as the earlier discussion of the upside-down structure of the new five-year amortization for housing rehabilitation expenditures indicates.[41]

It seems likely that tax reform for many existing incentives will be in the direction of contracting the area of incentives by reducing the number of those eligible for benefits, reducing the extent of the benefits, and removing the undue advantages granted upper income groups. The degree of change will presumably vary with the breadth of the incentive: those that involve specific areas and provide tax benefits for a restricted group — for example, accelerated depreciation for real estate and the natural resource provisions — will, or at least should, be subject to serious cutbacks in scope and benefit, whereas incentives with broad reach — for example, the charitable, interest, and tax deductions — will be scrutinized for particular abuses. This, in general, is the tenor of the Tax Reform Act of 1969.

Once we begin to recognize that the existing tax incentives represent expenditures of funds that in many cases should be dispersed directly, we must develop legislative and administrative techniques to move the funds involved — to the extent that government assistance is still considered desirable — from the tax

below or around poverty income levels. This helps place in perspective the whole matter of tax reform. The 1969 tax reform act also follows this pattern, and most of its major reforms consist of reducing the scope of existing tax incentives, such as those relating to real estate, financial institutions, capital gains investment, natural resources, and farm activities.

[40] The investment credit structure itself pointed to problems, such as the precedent effect of a credit of this nature.

Another problem involved under the investment credit is related to the difficulties caused by confining the credit to taxpayers and placing a limit on the credit in terms of tax liabilities, thereby inducing concerns which could not use their credits to "barter" them to others and enlarge the tax abuses in leasing syndicates and similar arrangements. While the "bartering" may have widened the use of the credit by avoiding the limitation based on tax liability and thus corrected what may have been the undesirability of the limit, the detour too generously compensated the middleman lessor.

[41] The 1969 Act introduced other undesirable tax incentives, also using the five-year amortization technique: the provisions for pollution control facilities, railroad cars, and mine safety equipment.

expenditure budget to the regular budget. The tax committees or the Bureau of the Budget could indicate to the Congress and the administrative agencies concerned the amounts involved in particular tax incentive programs. A period of time would then be allowed for the appropriate legislative committees and administrative agencies to develop direct expenditure programs, and a time limit could be put on the duration of the tax incentive programs. At the end of this period the tax incentive would be ended and the new direct expenditure program funded with the dollars returned to the revenue side of the budget. Certainly, new tax incentive programs, if any are to be adopted, should have a time limit set on their operation, to permit such a shift to a direct expenditure program, or at least to permit evaluation of the effectiveness and operation of the tax incentive.[42]

For the present, a de-escalation of existing particular incentives would be progress, though it would leave a set of tax incentives that probably would not be used at all if we were able to treat the problems fully as new problems. But this is the path of tax history and indeed all legislative history. Knowing all this, let us at least attempt not to repeat past mistakes in future solutions.

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[42] The 1969 tax reform act puts five-year termination dates on the new five-year amortization incentives for pollution control facilities, rehabilitation of low income housing, railroad cars, and mine-safety equipment. Tax Reform Act of 1969 Pub. L. No. 91-172-4 § 70, (INT. REV. CODE OF 1954, § 169), § 521 (INT. REV. CODE OF 1954, § 167(k)), § 705 (INT. REV. CODE OF 1954, § 184), § 707 (INT. REV. CODE OF 1954, § 187) (U.S. CODE CONG. & AD. NEWS No. 12 (Dec. 30, 1969)). The more generous provision for recapture of depreciation of federally assisted housing projects also has a five-year termination provision. *Id.* § 521, *amending* § 1250(a)(1)(c)(ii).