

LESSONS FOR TAX REFORMERS FROM THE HISTORY OF THE ENERGY TAX INCENTIVES IN THE WINDFALL PROFIT TAX ACT OF 1980†

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On March 27, 1980, after almost a year of consideration, Congress approved a windfall profit tax on the increased revenues which oil producers will realize from decontrol of domestic oil prices.¹ Included in this legislation are a

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¹ The Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-233 (1980). According to the Joint Committee on Taxation staff economists, the oil companies and royalty owners stand to garner an additional \$938 billion in gross revenues over the 1980-90 period (net of \$87 billion in assumed additional production costs), and to realize a net gain before federal taxes of \$783 billion. (Federal and state royalties will take \$51 billion and state and local taxes will slice off \$104 billion.) See R.S. McIntyre, *The \$300 Billion Windfall*, PEOPLE & TAXES, March 1980, at 1, 3. The Joint Committee staff estimates postulate, among other things, a \$30 per barrel price for uncontrolled oil at the end of 1979 and price increases of two percentage points over the inflation rate annually in succeeding years. See Staff of the Joint Comm. on Taxation, GENERAL EXPLANATION OF THE CRUDE OIL WINDFALL PROFIT TAX ACT OF 1980, at 9 (1981). The assumptions are artificial, and James Wetzler, the chief economist for the Joint Committee, says that his tax revenue estimates could be inaccurate by as much as \$100 billion in either direction. See R. Samuelson, *The \$100 Billion Mistake — Is the 'Windfall' Revenue Estimate Too High?* NATIONAL JOURNAL, April 26, 1980, at 677.

Based on the historical record and various theoretical constructs, the federal income tax by itself could have been relied on to recapture only about \$157 billion of the remaining \$783 billion "windfall." See, e.g., *Crude Oil Tax: Hearings Before the Senate Comm. on Finance on H.R. 3919*, 96th Cong., 1st Sess. 644 (July 18, 1979) (statement of Robert S. McIntyre). This would have left the oil producers with some \$626 billion in added after-tax profits over the next decade, a sum which would have at least tripled their current, already high profit levels. See R.S. McIntyre, *The \$300 Billion Windfall*, PEOPLE & TAXES, March 1980, at 1, 4. For analyses of the high profitability of the oil producers in terms of return on equity, see, e.g., *id.* (return on equity of the top 20 companies in 1979 was 44% above the average for the other 1160 largest companies in the U.S.); PEOPLE & TAXES, May 1980, at 12 (annualized return on equity for top 20 oil companies in the first quarter of 1980 was 30%, almost double that of other large companies); Citizen/Labor Energy Coalition, Energy Action Educational Foundation, and Tax Reform Research Group, OIL COMPANY PROFITS: WHAT THEY MEAN AND WHERE THEY GO, Nov. 14, 1979 (reported oil company profits are understated by at least one-third).

The primary purpose of the windfall profit tax, in former President Carter's words, is to recover a substantial share of the new producer profits for the commonweal, to avoid putting "an undue burden on people who can hardly make ends meet as it is." Energy Address by President Carter at 1, 3 (April 5, 1979). The windfall tax which was ultimately approved can be praised for the size of the amount it effectively recovers — about \$330 billion, or 53% of the \$626 billion the oil producers would have kept without the tax — or criticized for what it leaves the oil companies — \$296 billion, or a doubling of their current annual profits. See R.S. McIntyre, *The \$300 Billion Windfall*, PEOPLE & TAXES, March 1980, at 1.

number of new or expanded income tax preferences designed either to stimulate the development of alternative energy sources or to promote conservation.² This article relates the tugging and hauling with Congress which produced these new energy tax incentives, analyzes the merits of a number of the proposals, and attempts to draw some lessons about legislative strategy for those who are concerned about the rapid growth of tax expenditures³ and the increasing popularity of tax subsidy programs.

Part I points out the sharp conflict between the House and Senate over the desirability of added energy tax benefits, and outlines the final compromise, which rejected or limited many of the proposals favored by the Senate. Part II offers a critical history of the congressional debates, and includes a detailed evaluation, based on the now-familiar tax expenditure analysis, of the arguments made for and against the various tax credit proposals. In particular, the tax incentive approaches are compared to the direct spending alternatives which were also available to Congress and which to some extent were adopted instead of added tax incentives. Based on this evaluation, uniformly negative conclusions are drawn about the merits of energy tax preferences as policy tools. Part II concludes by noting a rather clear lesson which can be drawn from the experience with the energy tax proposals for those who generally oppose the use of the tax system as a vehicle for government subsidies. That lesson is that Congress will be more responsive to arguments that a direct spending approach is preferable if such an alternative is actually available, rather than merely hypothetical. It therefore behooves reformers to ally themselves with proponents of direct subsidies when the goal — but not the means — of a proposed new tax expenditure seems a worthy one.

These estimates differ from the "official" tallies, because the Joint Committee on Taxation staff assumed an "effective" income tax rate of 45%. There were respectable technical and tactical reasons for this assumption, but it is implausible in real life. See, e.g., *Crude Oil Tax: Hearings Before the Senate Comm. on Finance on H.R. 3919*, 96th Cong., 1st Sess. 644 (July 18, 1979) (statement of Robert S. McIntyre). In any event, the Joint Committee staff estimate of the effective windfall tax rate on what the oil companies would otherwise have netted is also 53%, equal to \$227.7 billion in "net" windfall tax (the \$410.5 billion in gross tax reduced by the presumed 45% income tax offset) divided by the \$431 billion in profits the oil companies would otherwise have kept using the 45% income tax rate assumption (\$783 billion times 0.55 equals \$431 billion).

² Pub. L. No. 96-223, §§ 201 *et seq.* (1980), amending I.R.C. §§ 44C, 46, 48.

³ When the first tax expenditure budget was drawn up in 1968, there were 40 separate items involving a revenue cost of about \$44 billion. See *A Review of Selected Tax Expenditures: Investment Tax Credit: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 96th Cong., 1st Sess. (1979) [hereinafter *Investment Tax Credit Hearings*], at 37 (statement of Paul R. McDaniel). For Fiscal 1982, the tax expenditure budget includes about 100 items, and totals \$266 billion. Staff of the Joint Comm. on Taxation, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1981-86 (Mar. 16, 1981) [hereinafter J.T. COMM. — TAX EXPENDITURES], at 8-15. As Professor McDaniel has noted, "[e]ven taking into account that part of the increase in the number of items is due to more refined budget presentation techniques . . . , there has obviously been an enormous increase over the past decade in the extent to which tax expenditures are employed." *Investment Tax Credit Hearings*, *supra*, at 58.

Part III of this article draws a more subtle and perhaps more important lesson from the congressional debates over the energy tax incentive proposals. This lesson involves the limits to tax expenditure analysis, especially as it is understood in the legislative arena. To evaluate tax preferences within the same framework employed for direct spending programs is useful, but it does not offer a complete basis for analyzing tax provisions. The failure to realize this limitation has led recently to the use of tax expenditure analysis in ways its creators never intended. Proposed new loopholes have been evaluated — and sometimes enacted — purely on spending grounds, while other important tax policy issues have been ignored. Tax reformers should be aware of this phenomenon, and should begin again to stress the tax policy arguments — primarily fairness and administrability — which tax expenditure analysis has tended to relegate to inferior status.

I. THE NEW ENERGY TAX PREFERENCES: WHAT THEY ARE AND WHAT THEY MIGHT HAVE BEEN

As finally accepted by the conferees and the Congress, the energy tax incentives included in the windfall profit tax bill are relatively paltry. Table A, below, tells much of the story. On the residential side, the increased credits are projected to reduce federal revenues by a mere \$600 million over the 1980-85 period,⁴ after which they are supposed to terminate. All but 11 percent of this reduction in tax collections is due to a provision raising the solar, wind, and geothermal credit to 40 percent (of up to \$10,000 in expenditures per residence).⁵ Between 1980 and 1985, this \$600 million represents only 0.6 percent of the projected "net" windfall profit tax revenues,⁶ 0.2 percent of the total estimated increase in government funds due to oil decontrol,⁷ and approximately 0.03 percent of personal tax receipts.⁸ On the business side, the new tax subsidies are larger, but still amount to only \$8.3 billion between 1980 and

⁴ CONF. REP. ON H.R. 3919, 96th Cong., 2d Sess. 164-65 (1980).

⁵ This credit previously had been 30% of the first \$2,000 in expenditures and 20% of the next \$8,000, for a maximum of \$2,200. I.R.C. § 44C(b)(2) as enacted by the Energy Tax Act of 1978, 95th Cong., 2d Sess. § 101(a) (1978). The remaining \$67 million in residential credits reflects landlords' share of the increase in the business solar and wind energy credit to 15%, from 10%. Pub. L. No. 96-223, § 221 (1980); I.R.C. § 46(a)(2)(C).

⁶ The "net" figure used here is the Joint Committee on Taxation staff estimate of \$103.7 billion between 1980 and 1985. See CONF. REP. ON H.R. 3919, 96th Cong., 2d Sess. 164 (1980).

⁷ Between 1980 and 1990, it is estimated that \$51 billion in federal and state royalties, \$104 billion in state and local taxes, \$75 billion in federal income taxes, and \$410.5 billion in gross windfall profit tax will be collected as a result of decontrol, for a total of \$640 billion. See R.S. McIntyre, *The \$300 Billion Windfall*, PEOPLE & TAXES, March 1980, at 3. The total addition to government revenues between 1980 and 1985 is approximately \$291 billion.

⁸ In fiscal 1980, the individual income tax raised \$244 billion. Office of Management and Budget, *Fiscal Year 1982 Budget Revisions* (March 1981), at 122. The assumption used here is that this amount will grow by about 10% annually in succeeding years. Cf. *id.* (showing a 10.3% annual increase between 1980 and 1986).

1990 — equal to 3.6 percent of the “net” windfall tax collections,⁹ 1.3 percent of the increase in government revenues from decontrol,¹⁰ and approximately 0.9 percent of projected corporate income tax receipts¹¹ over those eleven years.

These energy tax benefits were not always set at such a low level, however. The bill reported by the Senate included almost \$26 billion in new energy tax incentives over the 1980-90 period — \$8.7 billion to residences and \$17.2 billion to businesses. This represented over 14 percent of the “net” revenues expected to be garnered by the Senate’s weak version of the windfall tax.¹² Moreover, at one time in its consideration of the windfall bill, the Senate Finance Committee had tentatively approved almost \$100 billion in new energy credits — \$54 billion to businesses and \$46 billion to homeowners.¹³ Under the oil price estimates then being used and in conjunction with the many exceptions to the windfall tax which the Finance Committee had created,¹⁴ these credits would have cost \$35 billion more than the Committee’s windfall tax would have raised.¹⁵

⁹ The “net” figure used here is the Joint Committee on Taxation staff estimate of \$227.7 billion for the 1980-90 period. CONF. REP. ON H.R. 3919, 96th Cong., 2d Sess. 165 (1980).

¹⁰ \$626 billion. See note 1 *supra*.

¹¹ The corporate income tax currently raises under \$70 billion a year. Office of Management and Budget, *Fiscal Year 1982 Budget Revisions* (March 1981), at 122. In light of the many proposals to provide massive reductions in corporate tax through depreciation “reform,” this figure is unlikely to increase substantially over the 1980-90 period. See, e.g., *id.* (showing corporate income tax revenues averaging only \$68 billion from 1980 through 1986).

¹² Staff of the Joint Comm. on Taxation, CONFERENCE COMPARISON ON H.R. 3919, Dec. 18, 1979, at 48. The Joint Committee on Taxation staff estimated that the Senate bill would have collected \$177.8 billion over the 1980-90 period. *Id.*

¹³ The Finance Committee began marking up the windfall tax bill in earnest on September 18, 1979. By September 27, the Committee had approved increases in the residential solar and conservation credits to 50%, with \$5,000 and \$1,000 maximum credits respectively, and had added to the list of eligible investments heat pumps, wood stoves, replacement furnaces, and various other items. On the business side, a 40% credit for solar, geothermal, hydro, ocean thermal, wind, and biomass had been approved. See *The Washington Post*, Sept. 26 and 27, 1979; *The Wall Street Journal*, Sept. 20 and 21, 1979.

¹⁴ By September 27, 1979, the Committee had approved \$25.4 billion in windfall tax reductions, including exemptions for heavy, newly discovered, and tertiary oil. See *The Washington Post*, Sept. 28, 1979.

¹⁵ Until October 19, 1979, the Joint Committee on Taxation revenue estimates were based on an assumed \$22/barrel price for uncontrolled oil in the third quarter of 1979, growing at the rate of inflation plus one percent a year. See Senate Committee on Finance, Press Release No. 151 (Oct. 19, 1979). This put the 1980-90 net revenue gain from the House bill at \$104 billion, and that from the Finance Committee bill, as of September 27, 1979, at \$69 billion. On October 19, the Finance Committee agreed to increase the price estimates to \$30/barrel as of the last quarter of 1979, growing at 2% over inflation annually. See Senate Committee on Finance, Press Release No. 151 (Oct. 19, 1979). This change increased the 1980-90 estimate for the House windfall tax to \$277 billion, and the estimate for the Finance Committee bill to \$138 billion. (The estimate for the Finance Committee exemptions to the House tax was increased to \$139 billion.) See CRUDE OIL WINDFALL PROFIT TAX ACT OF 1979: REPORT OF THE SENATE COMM. ON FINANCE ON H.R. 3919, S. REP. NO. 96-394, 96th Cong., 1st Sess. 14-15 (1979).

Unlike the Senate, the House of Representatives — following the lead of the Ways and Means Committee — had not included any energy tax preferences in its version of the windfall profit tax bill. As a result, in the House-Senate conference on the windfall bill, the House conferees insisted on sharp reductions in both the scope and the cost of the Senate's proposed new tax credits. Ultimately, the conferees agreed to delete a number of the Senate proposals, and to reduce the size and limit the duration of most of the remaining items. The result of these changes — detailed in Table A, below — was to cut the estimated cost of the new tax incentives over the 1980-90 period by almost two-thirds — or \$17 billion. This is certainly a significant change; it may, however, somewhat overstate the actual cutbacks in the Senate measures achieved by the House conferees. Crucial to much of the apparent reduction in the cost of the new incentives is the application of a 1985 termination date to a number of major tax credits — as opposed to 1990 or later expiration dates in the Senate bill.¹⁶ If past practice holds true, many — or most — of the "limited" effective dates will be extended perfunctorily, thereby negating many of the House "victories."¹⁷

The press had great fun mocking the Finance Committee's profligacy. *See, e.g.*, The Washington Post, Sept. 27, 1979 ("The Senate Finance Committee yesterday broke the bank . . ."); The Wall Street Journal, Sept. 25, 1979 ("Senate Unit Has 'Spent' Funds From Tax on Windfall Profits Before Passing Bill").

¹⁶ Provisions so limited included the residential solar, wind, and geothermal credit and the business solar and wind, geothermal, ocean thermal, small scale hydro, and biomass credits.

¹⁷ *See, e.g.*, the "temporary" increase in the investment tax credit (I.R.C. § 46) to 10% in the 1975 Tax Reduction Act, § 301 of Pub. L. No. 94-12, which was extended to January 1, 1981 in the Tax Reform Act of 1976, § 802 of Pub. L. No. 94-455, and made permanent in the Revenue Act of 1978, § 311 of Pub. L. No. 95-600; the "temporary" increase in the corporate surtax exemption (I.R.C. § 11) in § 303 of Pub. L. No. 94-12 (1975) which was extended to January 1, 1981 in § 901(a) of Pub. L. No. 94-455 (1976) and then in essence expanded and made permanent in § 301(a) of Pub. L. No. 95-600 (1978); the "temporary" five-year amortization for child care facilities (I.R.C. § 188) in the Revenue Act of 1971, § 303 of Pub. L. No. 92-178, which was extended to January 1, 1982 in the Tax Reduction and Simplification Act of 1977, § 402(a) of Pub. L. No. 95-30; the "temporary" five-year amortization for pollution control facilities (I.R.C. § 169) in the Tax Reform Act of 1969, § 704(a) of Pub. L. No. 91-172, which was extended to January 1, 1976 in the "Pins and Needles" Bill of 1974, § 3(a) of Pub. L. No. 93-625 (1975), and made permanent in § 2112(b) of Pub. L. No. 94-455 (1976); and the "temporary" five-year amortization for rehabilitation of low-income housing (I.R.C. § 167(k)) in § 521(a) of Pub. L. No. 91-172 (1969), which was extended to January 1, 1976 in § 3(c) of Pub. L. No. 93-625 (1975), extended to January 1, 1978 in § 203(a) of Pub. L. No. 94-455 (1976), extended to January 1, 1979 in § 4(a) of Pub. L. No. 95-171 (1977), and extended to January 1, 1982 in § 367 of Pub. L. No. 95-600 (1978). *But compare* the five-year amortization for railroad rolling stock (I.R.C. § 184) in § 705(a) of Pub. L. No. 91-172 (1969), which was extended to January 1, 1976 in § 3(b) of Pub. L. No. 93-625 (1975), but which has not been further extended; the five-year amortization for coal mining safety equipment (former I.R.C. § 187) in § 707(a) of Pub. L. No. 91-172 (1969), which was extended to January 1, 1976 in § 3(d) of Pub. L. No. 93-625 (1975), but repealed in the "deadwood" title of Pub. L. No. 94-455 (1976), § 1901(a)(31); and five-year amortization of on-the-job training facilities (formerly in I.R.C. § 188) in § 303 of Pub. L. No. 92-178, which was dropped when the child care provision of § 188 was extended in Pub. L. No. 95-30 (1977).

TABLE A*

**Comparison of the Energy Tax Incentives in the Senate Version
of the Windfall Profit Tax Bill and Those Finally Approved in
Conference, with Estimated Revenue Effects, 1980-90
(Dollars in Millions)**

RESIDENTIAL CREDITS:				
Senate Bill			Conference Agreement	
Item (termination date)	Cost	Action	Cost of Conference Provision	Change In Cost From Senate Bill
<i>Conservation:</i>				
15% Energy Saving Credit:				
Make heat pumps eligible (1985)	\$ 404	Deleted	\$ 0	\$ - 404
Make wood stoves eligible (1982)	189	Deleted	0	- 189
Make wood furnaces eligible (1982)	35	Deleted	0	- 35
Make replacement oil & gas furnaces eligible (1985)	1,561	Deleted	0	- 1,561
Eliminate principal residence rule (1985)	39	Deleted	0	- 39
25% credit for coal furnaces (1982)	133	Deleted	0	- 133
10% credit for landlords (1985)	382	Deleted	0	- 382
<i>Solar, Wind, & Geothermal:</i>				
Raise credit to 50% (2000)	4,667	Raise to 40% through 1985	533	- 4,134
Eliminate principal residence rule (1999)	71	Deleted	0	- 71
40% credit for landlords (1999)	846	Deleted. Land- lord's share of 15% business credit	67	- 779
Builders' passive solar credit (1985)	321	Deleted	0	- 321
Total Residential Credits:	\$8,668		\$600	\$ - 8,068

* Source: Staff of the Joint Comm. on Taxation, Conference Comparison on H.R. 3919 (Dec. 18, 1979); Windfall Profit Tax Act of 1980, Conference Report on H.R. 3919, 96th Cong., 2d Sess. (1980).

BUSINESS INCENTIVES:

Senate Bill		Conference Agreement		
Item (expiration date)	Cost	Action	Cost of Conference Provision	Change In Cost From Senate Bill
<i>Energy Investment Credits:</i>				
Solar & wind credit to 20% (1990)	\$ 4,251	15% through 1985	\$1,058	\$ - 3,193
Geothermal credit to 20% (1990)	442	15% through 1985	29	- 413
Ocean thermal credit of 20% (1990)	311	15% through 1985	5	- 306
Small-scale hydro, 10% credit	1,086	11% through 1985, other changes	1,797	+ 711
Small-scale hydro, ADR life to 20 from 50	92	Deleted	0	- 92
Cogeneration, 10% credit (1982)	427	Amended	356	- 71
Cogeneration at major fuel burning installations (1982)	65	Deleted	0	- 65
Modifications to alumina electrolyte cells, 10% credit (1982)	12	Same	12	0
Industrial heat pumps, 10% credit (1982)	46	Deleted	46	- 46
Petroleum coke & pitch, 10% credit (1982)	635	Amended	532	- 103
Biomass, 20% credit (1990)	2,886	10% through 1985	648	- 2,238
Transition rule	1,152	Same	1,152	0
Electric cars, 10% credit (1985)	54	Deleted	0	- 54
Truck wind shields, 10% credit (1982)	20	Deleted	0	- 20
Intercity buses, 10% credit for added capacity (1985)	36	Same	20	0
Coke ovens, 10% credit (1982)	277	Same	277	0
Feedstock equipment, 10% credit (1982)	110	Same	110	0
Subtotal	\$11,902		\$6,012	\$ - 5,890
<i>Alcohol fuels</i>	2,172	Amended	1,574	- 598
<i>Alternative Fuels Credits</i>	167	Amended	160	- 7
<i>Tertiary Injectants</i>	79	Same	79	0

Industrial Development Bonds:

Solid waste disposal facilities	263	Amended	48	- 215
Small-scale hydro	1,420	Amended	283	- 1,137
Alcohol from solid waste	7	Same	7	0
State renewable resource programs	67	Same	67	0
Additions to certain hydro	66	Same	66	0
Pumped storage facilities	971	Deleted	0	- 971
Cogeneration	77	Deleted	0	- 77
Subtotal, IDBs:	<u>\$2,872</u>		<u>\$ 472</u>	<u>\$ - 2,400</u>
Total Business Incentives:	\$17,192		\$8,297	\$ - 8,895
Total Residential and Business				
Tax Incentives:	\$25,860		\$8,897	\$ - 16,963

The potential for such a future reversal of the House gains is especially great on the business side. Here, the conference cut the size of the Senate's tax subsidies by more than half over the 1980-90 period, but the reduction through 1985 is only 26 percent. Thus, extension of effective dates could have a very significant impact. In particular, the conference's limitation on effective dates is crucial with respect to four major business tax credits — for solar and wind technology, geothermal devices, ocean thermal applications, and biomass. The conference changes in these four provisions are responsible for 69 percent of the revenue savings achieved on the business side over the 1980-90 period. Eighty-eight percent of this reduction, however, is due to their termination in 1985. In contrast, their cost over the first six years of this decade was reduced by only one-third. If it turns out that these four credits are extended through 1990, the \$8.9 billion reduction in the size of the Senate's business energy incentives achieved in conference could shrink by as much as \$4 billion.

On the residential side, the conference reductions are not quite so dependent upon termination dates. Even over the 1980-85 period, the cost of the Senate's residential credits was slashed by 86 percent — or \$4.2 billion — primarily because the House conferees refused to accept ten energy saving items which the Senate bill would have added to the list of those eligible for tax breaks. On the other hand, a 1985 termination date is responsible for over 90 percent of the \$4 billion conference reduction in the 1980-90 cost of one major residential item — the residential solar, wind, and geothermal credit. If this single tax preference is extended, as much as \$3 billion of the conference cost savings may disappear.

In sum, the \$17 billion reduction in the Senate's energy incentives achieved in conference could shrink by almost \$9 billion — or over half — if several items are extended beyond their 1985 termination date.¹⁸ Nevertheless,

¹⁸ See the remarks of Ways and Means Chairman Al Ullman during the House debate on the motion to instruct the House conferees to accept all of the Senate's energy tax incentives,

one should not cynically denigrate the value of "sunsetting" these tax expenditures. By 1985, it is likely that experience will offer better insights into the efficacy of the credits, and it is even possible that Congress will consider these insights in deciding whether the credits should be extended.

II. THE CONGRESSIONAL DEBATES: A CRITICAL HISTORY

A. *The House Ways and Means Committee — Holding the Fort*

The dramatic slashes in the size of the tax incentives from their early scope was largely due to the disillusionment of most House Ways and Means Committee members with tax credits — and in particular energy tax credits — as effective tools to accomplish social policy goals. Disillusionment, of course, is necessarily preceded by illusion, and, in fact, the Ways and Means Committee had enthusiastically approved a number of tax-based subsidies for conservation and alternative energy in 1975 — provisions which ironically failed to gain Senate acquiescence.¹⁹ By 1977, however, when President Carter put forward his National Energy Plan,²⁰ with its numerous new tax incentives,²¹ many Ways and Means members were already beginning to doubt the efficacy of such programs.²² Nevertheless, in the spirit of national — and, for the

126 CONG. REC., H1065 (daily ed. Feb. 20, 1980).

¹⁹ The Energy Conservation and Conversion Act, H.R. 6860, 94th Cong., 1st Sess. (1975), which was approved by the Ways and Means Committee and passed by the House, but never enacted, included a 30% tax credit for up to \$500 in expenditures for insulation, storm windows, and similar conservation devices; a 25% solar credit on up to \$8,000 in expenditures; a 25% electric car credit on up to \$3,000 in expenditures; five-year amortization on equipment involved with biomass, recycling, shale oil, coal liquification, coal slurry pipelines, solar energy, and deep coal mining; and extension of the investment tax credit to structural components of buildings such as insulation and solar equipment.

²⁰ Title II of H.R. 6831, 95th Cong., 1st Sess. (1977).

²¹ President Carter's energy program was centered on a proposed "crude oil equalization tax" — in essence decontrol of oil prices with a 100% windfall tax on already discovered oil. *Id.* § 1401 *et seq.* It also included, however, a number of tax incentives and penalties intended to encourage conservation, alternative energy development, oil drilling, and mass transit, and to discourage the use of oil and gas and fuel-wasting automobiles. *Id.*, Parts A-C, E, & F. The tax credit proposals included a residential conservation credit of 25% of the first \$800 in expenditures and 15% of the next \$1,400; a residential solar energy credit of 40% of the first \$1,000 in expenditures and 25% of the next \$6,400; and a business 10% tax credit for insulation, solar energy, and other energy saving equipment.

²² The energy program was generally seen as an embarrassment to the Treasury Department, which was forced to defend the tax credits in spite of the fact that it was also preparing a tax reform program with simplification as a major goal. A number of Ways and Means members pointed out the inconsistency. *See, e.g., Tax Aspects of President Carter's Energy Program: Hearings Before the House Comm. on Ways and Means*, 95th Cong., 1st Sess. 119 (May 1977), (statement of Barber Conable (R-N.Y.)): "The evidence we have available from private and public sources raises serious questions about the energy savings potential of this incredibly complicated structure of taxes, rebates, credits, and so forth. . . . This, from an administration whose leader has called the Internal Revenue Code a 'disgrace' and has repeatedly called for a promised tax simplification."; *id.* at 175 (statement of Bill Frenzel (R-Minn.)): "It strikes me as being a complicated program which will be bewildering to our constituents in terms of trying to weigh the incentives." Others questioned the need for the credits, *see, e.g., id.* at 688 (statement of Andrew

Democrats, party — unity, the Committee did approve versions of the President's tax credit proposals,²³ and with some further modifications they were ultimately adopted by the full Congress.²⁴

One of the energy tax credits endorsed by the Ways and Means Committee in 1977 was a 20% credit for home insulation.²⁵ In agreeing to this provision, the Committee reluctantly ignored predictions by tax reform groups that insulation manufacturers would take advantage of the tax break to increase prices.²⁶ When the cost of insulation went up by over 20 percent soon after Ways and Means approval of the credit,²⁷ however, the Committee's antagonism toward energy tax subsidies began to harden. In fact, many members were almost ready to reconsider and withdraw the insulation tax break, but felt trapped by their commitment to taxpayers who had paid the increased prices in reliance on the promised federal subsidy. The members vowed, however, to avoid the enactment of such credits in the future.

Consequently, during the 1979 Ways and Means hearings on President Carter's proposals to provide still more energy tax credits²⁸ — as part of the windfall tax legislation — energy tax incentives were the subject of much derision. For example, the existing credit for solar space heating was criticized by

Jacobs, Jr. (D-Ind.)) or questioned its design, *see, e.g., id.* at 170 (statement of J.J. Pickle (D-Tex.)).

²³ The Committee approved a 20% residential insulation credit for the first \$2,000 in expenditures, a solar credit of 30% of the first \$1,500 in expenditures and 20% of the next \$8,500, and a 10% business credit for solar and other energy saving equipment. ENERGY TAX ACT OF 1977, REPORT OF THE HOUSE COMM. ON WAYS AND MEANS ON TITLE II OF H.R. 6831, H. REP. NO. 95-496, Part III, 95th Cong., 1st Sess. 3-4 (1977).

²⁴ As finally approved by Congress, the major energy tax credits included: a 15% (up to \$300) residential conservation credit; a residential solar, wind, and geothermal of 30% of the first \$2,000 in expenditures and 20% of the next \$8,000; and a 10% business energy tax credit for solar, wind, and geothermal. Energy Tax Act of 1978, Pub. L. No. 95-618, §§ 101, 301 (1978); I.R.C. §§ 44C, 46(a)(2), 48(l).

²⁵ The insulation credit finally approved by Congress was set at 15%. *Id.*

²⁶ Such a likelihood was suggested in the testimony of Robert M. Brandon, Director of Public Citizen's Tax Reform Research Group, before the Ways and Means Committee, *The Tax Aspects of President Carter's Energy Program: Hearings Before the House Comm. on Ways and Means*, 95th Cong., 1st Sess. 570, 587 (1977) (statement of Robert M. Brandon) ("As you know, just looking at the insulation industry, they can't meet the demands created by the recent price increases in heating oil") and later, as the problem became more obvious, pressed with more vigor in conversations with members. The Federal Trade Commission made a similar prediction. *See id.* at 386, 400 (Letter of May 26, 1977 from Michael Pertschuk, Chairman of the Federal Trade Commission, to Ways and Means Chairman Al Ullman (D-Ore.)) ("The obvious effect of a sudden upward shift in demand will be higher prices for fiberglass home insulation.").

²⁷ The cost of R-11, 3½" fiberglass insulation, for example, went from about 12 cents per square foot to about 15 cents per square foot almost overnight. *See* 126 CONG. REC. H1069, (daily ed. Feb. 20, 1980) (Mr. Moore: "I served on the Energy Subcommittee for 3 years. We looked into the situation of giving tax credits then for insulation. We found only so much insulation could be produced in this country and that a tax credit was not going to cause any increase in its production. There was only so much in the marketplace to be bought and all that was going to happen, and in fact did happen, is that the cost of those materials went up. The consumer paid more after the credit than before.").

²⁸ *See The President's Energy Program, Phase III: Hearings Before the House Comm. on Ways and Means*, 96th Cong., 1st Sess. 27-30 (July 20, 24, and 25, 1979) [hereinafter cited as *Phase III Hearings*].

Barber Conable (R-N.Y.) as "a kind of rich man's plaything."²⁹ Sam Gibbons (D-Fla.) satirically asked whether a proposed tax break for awnings would apply to "hats with a broad brim."³⁰ The much sought-after wood stove credit was compared to a foolish tax break the Ways and Means Committee once had approved for garden tools.³¹ Representative Bill Frenzel (R-Minn.) aptly summed up the prevailing view on the Committee with respect to energy tax subsidies:

The principal tax credit bill we passed last year does not seem to have given great incentive in the marketplace. . . . [P]eople did not flock to take advantage of it. The tax credit tends to be a reward for economic action that was forced by other factors. The tax credit does not motivate, but rather simply occurs at the end of the year when the fellow finds there was a tax credit available. And I do not think that is a very efficient and effective stimulus.³²

As one pro-credit witness wistfully stated, "obviously most folks here are not convinced tax credits work, and that they in fact expedite energy conservation."³³ When it came time for the Committee to mark up the energy incentive proposals, it took only about an hour for the entire package to be literally laughed down.³⁴

²⁹ *Id.* at 34.

³⁰ *Id.* at 315.

³¹ *Id.* at 314-315. In 1975, the Committee had included, and the full House had approved, a 7% tax credit on the first \$100 spent by an individual taxpayer on garden tools as § 1801 of H.R. 10612, 94th Cong., 1st Sess. 1975, the bill which became the Tax Reform Act of 1976, Pub. L. No. 94-455. According to the Committee's report, the credit was intended to help deal with the rising cost of groceries by taking "some initiative . . . in encouraging the private production of food." H.R. REP. NO. 94-658 on H.R. 10612, 94th Cong., 1st Sess. 371 (Nov. 12, 1975). The Finance Committee deleted this silly measure, "because it would add complexity to the tax form[,] . . . because the Internal Revenue Service would not be able to verify whether people actually made the expenditures on which the credit would be based," S. REP. 94-938, ON H.R. 10612, 94th Cong., 2nd Sess. 490 (June 10, 1976), and because the provision threatened to make a laughing stock of Congress.

³² *Phase III Hearings*, *supra* note 28 at 317.

³³ *Phase III Hearings*, *supra* note 28 at 245.

³⁴ See *The Washington Post*, August 1, 1979, at 1:

Panel Laughs Off Carter Proposals For Tax Credits

By Art Pine

President Carter's proposals for \$2.4 billion worth of tax credits to help spur development of new energy sources were all but hooted out of the Capitol yesterday by the House Ways and Means Committee.

In what was intended to be the start of a two day drafting session, panel members took turns criticizing the package for its complexity, poking fun at individual proposals and questioning whether the credits were needed.

Members ridiculed various elements of the package, particularly tax credits for installing wood-burning stoves and for angling solar collectors so they face the south side of a building.

[Rep. Henson] Moore [(R-La.)] proposed a tax credit for thermal underwear. Rep. William Brodhead (D-Mich.) raised the possibility that providing a tax break for wood-burning stoves might make it necessary to "post guards around our trees."

Although the Committee's verdict against energy tax credits was virtually unanimous, it came close to being overruled by the full House. A motion to instruct the House windfall conferees to accept the Senate's entire \$26 billion package of energy tax preferences failed by only a 195-207 margin, with Democrats evenly split (131-131) and Republicans supporting the Committee's position by a narrow margin (76-64).³⁵ Many House members who usually supported tax reform, including Toby Moffett (D-Conn.), Al Gore (D-Tenn.), and Elizabeth Holtzman (D-N.Y.), voted in favor of adopting the Senate provisions.³⁶ Notably, however, only four Ways and Means members — Representatives Thomas Downey (D-N.Y.), Wyche Fowler (D-Ga.), Frank Guarini (D-N.J.), and Ed Jenkins (D-Ga.) — challenged the Committee's judgment, and with the exception of Jenkins, all were first year members.³⁷

The Ways and Means Committee majority was so convinced of the obvious correctness of its antagonism toward energy credits that most of the leading opponents of the measures did not even participate in the House floor debate on the motion to instruct the conferees. Jim Corman (D-Cal.) did point out some of the tax fairness and complexity problems with the Senate's tax credit package,³⁸ and Henson Moore (R-La.) perfunctorily recited an entire litany of drawbacks to the proposed tax subsidies,³⁹ but neither representative was able to communicate to the other members just how deep, broad, and well-considered the Ways and Means Committee opposition to energy credits actually was. It was only after a motion to table the motion to instruct had failed overwhelmingly that an "astounded" Sam Gibbons, who had been the most effective at the Committee mark-up in ridiculing the credits, appeared on the House floor.⁴⁰ Combining anger and sarcasm, Representative Gibbons was able to plead successfully with House members to defer to the judgment of the Ways and Means conferees.⁴¹

[Rep. Sam] Gibbons [(D-Fla.)] suggested providing a tax credit for whatever energy might be produced by "burning the Treasury's proposals." And Rep. Andy Jacobs (D-Ind.) branded the computation formula [for the passive solar credit] as simple, "if you could read it in the original Greek."

The thrust of the committee's objections appeared to be based on a view that the tax credits were not needed, particularly in the wake of Carter's decision to lift oil price controls.

The barrage of sarcasm was one of the most hostile receptions that any of Carter's tax proposals have received from the panel. The committee was more sympathetic to his quickly rejected plan to tax the "three martini lunch."

Id.

³⁵ 126 CONG. REC. H1078 (daily ed. Feb. 20, 1980). The instruction would have been non-binding.

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.* at H1074.

³⁹ *Id.* at H1068-69.

⁴⁰ *Id.* at H1078.

⁴¹ Rep. Gibbons noted: "The gentleman from New Hampshire [Norman D'Armours, sponsor of the motion to instruct] wanted wood-burning stoves, and he got wood-burning stoves and a bunch of biomass along with it." *Id.*

B. *The Popular Arguments for the Credits — Disappointingly Frivolous*

With the exception of Ways and Means Committee members, most of the members of Congress who publicly addressed the issue of energy tax subsidies did so in a manner which can at best be termed disappointing. For example, during the House floor debate on the motion to instruct the conferees to accept the Senate's full tax incentive package, Jim Jeffords (R-Vt.) advocated a retroactive (to April 1977) credit for wood-burning stoves — as an incentive for what, he did not explain — and tried to justify the stoves credit as a jobs program.⁴² Using similar logic, Beverly Byron (D-Md.) maintained that wood stoves should get a tax credit because, among other things, they are already popular⁴³ — an argument which would seem to cut the other way.⁴⁴

Further instances of such frivolous reasoning are commonplace in the records of the congressional debates on the energy tax subsidies. It is probably no coincidence that the most detailed examples of flawed analysis of the proposed energy tax credits were provided by their leading champion, Senator Bob Packwood (R-Ore.), who is also an unabashed advocate of tax subsidies for almost everything which he perceives as good.⁴⁵ In the energy area, Senator Packwood has been heavily influenced by groups such as the Solar Lobby⁴⁶ and books like the Harvard Business School's *Energy Future*.⁴⁷ Moreover, he was looking toward improving his standing in Oregon in preparation for his, since successful, 1980 reelection campaign. Since the mid-1970s, Oregon, along with other Northwest states, has faced an energy crunch, with demand for cheap hydroelectric power beginning to outstrip supply. As part of its attempt to avoid the expensive nuclear and coal options, the state has instituted a major program to encourage residential conservation.⁴⁸ During the Finance Commit-

⁴² 126 CONG. REC. H1068 (daily ed. Feb. 20, 1980).

⁴³ *Id.* at H1072.

⁴⁴ Unless the goal is to pay people for doing what they would do anyway, subsidies for already popular items appear to be misdirected.

⁴⁵ See, e.g., the exchange between myself and Senator Packwood in *Charitable Contribution Deductions: Hearings Before the Subcomm. on Taxation and Debt Management Generally of the Senate Comm. on Finance on S. 219*, 96th Cong., 2d Sess. 199 (1980).

Senator PACKWOOD. Generally, Public Citizen's philosophy bends toward the simplified tax form and against tax expenditures, does it not?

MR. MCINTYRE. Yes

Senator PACKWOOD. That is a respectable philosophy, but not one that I agree with.

⁴⁶ The Solar Lobby is a Washington-based public interest group which works for added federal support for solar energy development.

⁴⁷ ENERGY FUTURE: REPORT OF THE ENERGY PROJECT AT THE HARVARD BUSINESS SCHOOL (R. Stobaugh and D. Yergin, eds., 1979) [hereinafter ENERGY FUTURE]. For a critique of the tax proposals in this book, see R. McIntyre, *A Solar Future: Tax Credits Won't Make it Happen, but a Proposed Solar Bank Might*, PEOPLE & TAXES, Feb. 1980, at 3, [hereinafter R. McIntyre, *A Solar Future*], reprinted as *Federal Loans Compared With Tax Credits As A Spur To Solar Energy Development*, TAX NOTES, March 10, 1980, at 315.

⁴⁸ Under the "Oregon Plan," which was devised by Pacific Power & Light and has since been implemented in Washington, Montana, and Ohio as well, the utility actually makes conservation investments in residential buildings. The expenditures are treated as a "zero in-

tee's consideration of the windfall profit tax legislation, Senator Packwood attempted to further Oregon's efforts by proposing a series of new energy tax credits — many of which ended up in the Senate version of the bill. These credits could have resulted in the federal government picking up half the tab for Oregon's innovative program, and, in the Senator's opinion, would also have been of great benefit to the entire country.

In promoting the various energy tax incentives which he favored, Senator Packwood frequently pointed to the dramatic and inexpensive energy savings which he maintained would result from their enactment. Were the Senator's extravagant claims accurate, only a true misanthrope could have opposed his plans. Unfortunately, in spite of the fact that many on Capitol Hill seem to have accepted the Senator's energy savings estimates,⁴⁹ a quick analysis shows that they were based upon a very faulty methodology. The problems with Senator Packwood's estimating technique can be illustrated by focussing on a table which he distributed during the windfall profit tax conference. Entitled *Cost and Energy Savings of Renewable Energy Tax Credits (Packwood Provisions of H.R. 3919)*, it included a list of 13 items which the Senator had succeeded in attaching to the Senate windfall bill,⁵⁰ along with their revenue costs and his estimates of the oil which they would save. To illustrate:

PROVISION	1980-90 Revenue Loss (\$ millions)	Oil Saved by Investment (million barrels)	Cost of Energy (1979 Dollars To Save A Barrel of Oil)
10% landlord credit	382	546	\$ 7/barrel
Heat pumps [15% credit]	404	192	14/barrel

Those who have dealt with Senator Packwood know that he did not intend to deceive anyone with this table. It is equally clear, however, that the table did mislead many of those who examined it. In part, this was due both to inadequate labeling of the columns and to insufficient care on the part of readers. It

terest, deferred principle loan" to the homeowner, the investments are included in the utility's rate base, and the loan is repaid only when the house is sold. The program has been in existence since late 1978. Telephone interview by author with Gary DeLoss, Environmental Policy Center.

⁴⁹ The staff of the Ways and Means Oversight Subcommittee used the Packwood approach in an analysis of the energy credits in the Senate windfall profit tax bill prepared in January of 1980, although the staff's recommendations were generally negative on the proposed credits anyway. Staff of the Oversight Subcomm. of the House Ways and Means Comm., *Analysis of the Energy Tax Credits in the Senate Version of H.R. 3919* (untitled) (1980) [hereinafter OVERSIGHT ANALYSIS]. See also the statement of Rep. Floyd Fithian (D-Ind.) during the debate on the motion to instruct the House windfall profit tax conferees to accept the entire Senate tax incentive package, 126 CONG. REC. H1072 (daily ed. Feb. 20, 1980).

⁵⁰ The entire list of the "Packwood Provisions" included: A 10% conservation credit for landlords; deletion of the limitation of the residential credits to primary residences; at 15% credit for heat pumps; a 50% solar, wind, and geothermal credit for homeowners; a 40% solar, wind, and geothermal credit for landlords; and business credits for solar and wind, geothermal, ocean thermal, hydroelectric power, cogeneration, industrial heat pumps, and non-wood biomass. Senator Packwood estimated the total oil savings from these provisions to be just over 4 billion barrels. Packwood, *Cost and Energy Savings of Renewable Energy Tax Credits*. (Packwood Provisions of H.R. 3919) (1980).

was primarily due, however, to a method of computation so bizzare that no one could reasonably have suspected it had been used.

The labeling problem led to a common mistake by many who quickly perused the table. That error was to assume — in reliance on the traditional left-to-right convention — that the “Cost of Energy” figures in the third column were the important figures, and that they had been computed on the basis of the numbers in the first two columns. A careful reading of the footnotes to the chart, however, indicates otherwise. Rather than having been calculated by the Senator, these “Cost of Energy” figures actually were assumed, based on a variety of outside sources — including, in some cases, the manufacturers of the items which the Senator’s credits would have subsidized.

The real key figures in the table turn out to be those in the second, “Oil Saved” column. It was here that the major flaw in the Senator’s analysis came into play. To compute these figures, the Senator or his staff began with the heroic premise that, without the tax incentives, there would be zero investment in the items he proposed to subsidize. In other words, Senator Packwood postulated that, in the absence of his tax credits, there would be no purchases of heat pumps, no insulation of apartment buildings, no solar installations, no investments in small-scale hydroelectric facilities, and so on.

Once this rather peculiar assumption was made, the calculations proceeded in a fairly straightforward manner. First, the Senator divided the estimated revenue loss from a particular credit, listed in column one,⁵¹ by the percentage rate of the credit, yielding what he apparently believed would be the new investment induced by the credit. He then divided this figure by the estimated cost of saving a barrel of oil using the particular process or device, as listed in column three. For example, to compute the amount of oil which would be saved by the 10 percent conservation credit for landlords, Senator Packwood took the following steps. First, he divided the estimated revenue loss of \$382 million by the credit rate of 0.10 to compute the alleged “induced investment” — \$3,820 million. Next, he divided this figure by the \$7 per barrel cost of saving oil by conservation, which he had obtained from a June 30, 1979 *Weekly Memo* (to the President) from the Administrator of the EPA. The result was a predicted saving of 546 million barrels of oil between 1980 and 1990. Similarly, to compute the putative energy savings from the 15 percent credit for heat pumps, the Senator divided the \$404 million estimated revenue loss by 0.15, yielding \$2.7 billion in “added” investments in heat pumps. Next, he divided this number by \$14 per barrel, a figure which he obtained from General Electric (a manufacturer of heat pumps), to yield an oil saving of 192 million barrels.

Having computed these colossal energy savings, Senator Packwood then could work backwards to show the miniscule cost to the federal government per

⁵¹ The revenue estimates were provided by the staff of the Joint Committee on Taxation.

barrel of oil saved. The cost of the landlord credit to the Treasury, for example, comes to a mere 70 cents per barrel of oil saved using Senator Packwood's computations.⁵² For the heat pump credit, the cost per barrel is only slightly larger, at \$2.10.⁵³

Senator Packwood's assumption that there would be no investment in the items he wanted to encourage in the absence of his tax credits, is, of course, false.⁵⁴ To make such an assumption begs the key question — namely, what portion of the energy credits will be spent subsidizing projects which would have been undertaken anyway and what portion will go toward inducing additional energy saving investments. If 99 percent of the investments would be made without the tax benefit, then Packwood's credits are obviously a very wasteful use of the taxpayers' money. Such credits would purchase oil alternatives at a cost, for example, of \$70 per barrel equivalent in the case of the landlord credit and \$210 per barrel in the case of heat pumps. If a much lower percentage of the revenue loss relates to projects which would be undertaken anyway, then the taxpayers would apparently derive greater benefit.

Somewhat ironically, the figures in the third column of Senator Packwood's chart actually do suggest an answer to the key question of how much investment is likely to be induced — but the answer tends to undercut the Senator's position in support of the tax subsidies. If the Senator's assumptions in column three as to the costs of saving energy through the various processes he favors are accurate, then the likely amount of induced investment from the Senator's tax credits would appear to be very small indeed, perhaps close to zero. For example, Senator Packwood maintains that the cost of saving oil through insulating is only \$7 per barrel. If so, with the market price of crude oil running at close to \$40 per barrel and with heating oil costing well over \$70 per barrel, it is hard to see how additional price incentives, such as a 10 percent insulation credit, will be helpful in encouraging conservation. The price incentives are already overwhelming. As is discussed below, other programs are available which direct themselves to what are probably the main stumbling blocks to more investment in conservation and alternative energy.

⁵² This figure can be calculated by dividing the 3,820 million barrels of oil which would allegedly be saved by "added" insulation into the \$382 million estimated cost to the Treasury of the tax credit. Alternatively, one can bypass most of Senator Packwood's calculations and simply multiply the 10% rate of the landlord credit by the \$7 per barrel cost of saving oil by insulating. This latter method explicitly relies on Senator Packwood's fallacious assumption that without the tax incentive there would be zero investment by landlords in apartment insulation.

⁵³ Senator Packwood did not include in his table figures on the alleged cost to the Treasury per barrel of oil saved, but he did refer to such figures in arguing for his proposals. Written estimates, based on Senator Packwood's table and his faulty assumptions, of the revenue loss per barrel of oil saved were provided in a document circulated during the windfall tax conference by the staff of the Ways and Means Oversight Subcommittee. OVERSIGHT ANALYSIS, *supra* note 49.

⁵⁴ Since the Joint Committee on Taxation staff's revenue estimates which Senator Packwood used in his computations are based largely on current investments and trends in these areas, the Senator's assumption is also statistically amusing.

C. *The Serious Arguments for Energy Tax Credits — Still Unpersuasive*

Where the cost of a particular conservation or alternative energy device is already much lower than the market price of oil, it seems difficult to make a convincing argument that additional price incentives will be effective in stimulating such alternatives. There are some serious arguments, however, for subsidizing *expensive* alternative energy sources which are *not* cost-efficient under current market conditions — in particular, solar energy. The first argument is that creating an artificial market for promising alternatives which are currently too expensive can give a boost to an industry and eventually, through the traditional learning curve, result in lower prices which *are* competitive with oil.⁵⁵ This reasoning is frequently buttressed, at least in the case of solar energy, by claims that the major energy companies are intentionally undercutting the development of alternative energy sources, motivated by their desire to maintain the value of their oil reserves, to retain their economic power over consumers by keeping electrical generation centralized, to protect their investments in nuclear energy, and so on.⁵⁶

A second, perhaps more compelling argument for subsidizing *expensive* energy alternatives is based on the thesis that the market is not functioning properly and that the *marginal* cost of the imported oil which alternatives could displace far exceeds its average cost.⁵⁷ For example, suppose the United States imports 8 million barrels of oil per day at \$30 per barrel, for an annual cost of \$88 billion. It is argued that a reduction of 7 million barrels per day not only would save one-eighth of the cost — or \$11 billion — but also could reduce the price which foreign governments are able to charge for their oil — or force them to forego otherwise possible price increases. If the price reduction were, say, 10 percent, then a 12½ percent reduction in imports could lower our foreign oil bill by \$19 billion, making the marginal cost of the last million barrels per day \$51 per barrel. Therefore, it is argued, it makes sense to save oil by conservation or by production of an oil substitute such as solar energy until the total cost per barrel-equivalent of the oil alternative exceeds \$50. With a 40 percent federal subsidy, for example, solar power costing \$50 per barrel of oil saved could be made competitive with \$30-per-barrel foreign oil, and the country would be better off.⁵⁸ When the national security and international trade balance aspects of heavy reliance on foreign oil are factored in, not to mention the possible effects on *domestic* oil prices, this argument for subsidizing expensive energy alternatives becomes even more powerful.

⁵⁵ See, e.g., ENERGY FUTURE, *supra* note 47, at 197, 207-10.

⁵⁶ See, e.g., *id.* at 195-96.

⁵⁷ See, e.g., *id.* at 51-52, 196 n.36.

⁵⁸ A similar argument is made frequently with regard to electric power, even where oil is not involved. It is argued that the marginal cost of increased electric utility output — that is, new power plants — far exceeds the average cost of production from existing plants, thereby justifying a subsidy for alternatives to new construction of plants. This argument is the justification for the conservation subsidies in the "Oregon Plan," *supra* note 48.

If one accepts the notion that government subsidies for alternative energy development and conservation can be well-advised in some cases, the question still remains as to what is the best way to implement such subsidies. Proponents of tax credits, when they choose to explain why they have selected the tax system as their vehicle,⁵⁹ usually point to ease of administration as the primary reason. If the goal is to hand out government funds to virtually anyone who alleges that he or she has fulfilled the eligibility conditions, with almost no investigation of the truth of the claims, there does seem to be a modest validity to this justification. It does appear to be somewhat cheaper for individuals to deduct, say, \$300 from their tax bills than for the government to mail \$300 to anyone who writes in and asks for it. In 1980, for example, approximately 4½ million individual taxpayers claimed energy credits, averaging just under \$100, on their 1979 tax returns.⁶⁰ The cost of administering a system based upon individual requests rather than tax credits might have been as high as 1 percent of the funds disbursed, or about \$5 million.⁶¹ The tax route is administratively simpler and less expensive, however, only if the government desires neither serious checks on abuses nor serious efforts to assure that the program achieves goals other than fund disbursement.⁶²

⁵⁹ In *ENERGY FUTURE*, *supra* note 47, the authors, who recommend tax incentives for alternative energy sources and conservation dozens of times in the text, offer a token disclaimer for their fascination with tax subsidies in a lengthy footnote: "By suggesting tax credits," they maintain, "it is not our intent to argue the merits of one policy instrument over another The potential perversities of tax credits, deductions, and direct grants or subsidies, . . . as well as the ranking of their political feasibility are beyond the scope of this work." *Id.* at 322, n.38. They then continue, however, by explaining the "three simple reasons" why tax credits are their "preferred policy instrument": "(1) . . . [T]hey enjoy wide political support; (2) the California experience [with solar tax credits] indicates that a substantial tax credit can be a major stimulus to the adoption of solar technology; and (3) a tax credit is simple to administer, since the fund distribution system (the Internal Revenue Service in this case) is already operative." *Id.* For a refutation of each of these claims, see *R. McIntyre, A Solar Future*, *supra* note 47.

⁶⁰ Internal Revenue Service, 1979 Statistics of Income, Individual Income Tax Returns (forthcoming). The 4.5 million returns represent about 5% of the individual returns filed and about 7% of taxable returns. The total residential conservation and solar credits claimed for 1979 were \$441 million, for an average per return of \$98. Claims were down from the previous year, when 6.0 million taxpayers utilized \$573 million in energy credits on their 1978 returns (for an average per return of \$99). Internal Revenue Service, 1978 Statistics of Income, Individual Tax Returns, at 87 (1981).

⁶¹ On the other hand, some people might not have taken the trouble to apply for the federal grant if a separate application were required, which could mean that the tax credit is actually *more* expensive.

⁶² Cf. Kurtz, *Notes to a New Commissioner of Internal Revenue*, TAX NOTES, June 1, 1981, at 1199:

Incentives supplied through the tax system too often are attractive to lawmakers because they are seen as efficient, simple, and costless. They are said to be efficient and simple compared to similar direct expenditure programs because the tax incentives seem relatively free of red tape. But red tape is only a name applied to controls The absence of red tape, in other words, results not from the decision to use the tax system but rather from a decision to dispense with most standards and controls.

The conflict between the alleged simplicity of energy tax incentives and the countervailing need for "bureaucratic" controls of subsidy programs can be illustrated by looking at President Carter's proposed \$2,000 tax credit for builders of passive solar dwellings.⁶³ This plan — the goal of which has particular appeal⁶⁴ — originally was drafted as a tax subsidy almost by happenstance. When pressed, however, its proponents have argued that the tax credit approach is preferable because many builders would be reluctant to take the time and effort to apply for a direct federal subsidy, while a tax credit is so intrinsically uncumbersome that more builders would take advantage of it. Those who would prefer a direct subsidy in this area argued that Internal Revenue Service agents are unqualified to judge whether a building meets passive solar standards, even in the unlikely event that a builder is audited, and that more stringent controls are necessary for a successful program.⁶⁵ They would allow the subsidy only after a solar expert has inspected both the plans and the completed building to be sure that the project qualified.⁶⁶

On balance, the arguments for direct, rather than tax subsidies for the construction of passive solar dwellings appear to be persuasive;⁶⁷ yet providing a \$2,000-per-building direct expenditure received little initial consideration.⁶⁸ One reason, of course, was jurisdictional. Once a tax subsidy proposal is before the Ways and Means or Finance Committee, the members of the committee have no power to convert it into a direct spending program. They can only accept or reject it.⁶⁹ Another factor is that added federal spending — other than for defense or corporate subsidies — is currently unpopular in many quarters.

⁶³ See *Phase III Hearings*, *supra* note 28, at 20.

⁶⁴ There is some evidence that the extra cost of passive solar construction for single-family homes is about \$2,000 per residence — a trivial amount compared to the potential energy savings — but that builders do not believe they can recover this extra cost from homebuyers. See *e.g.*, *Phase III Hearings*, *supra* note 28, at 54-58.

⁶⁵ See, *e.g.*, R. McIntyre, *A Solar Future*, *supra* note 47, at 8.

⁶⁶ *Id.* Opponents of writing a blank check for homebuilders also pointed to the high percentage of "aggressive" taxpayers in the real estate industry, and consequent need for especially careful surveillance, which the IRS would have great difficulty supplying.

⁶⁷ Although it proposed the \$2,000 passive solar subsidy in the form of a tax credit, the Carter administration apparently understood the need for quality and performance controls. Trying to draft such standards for inclusion in the Internal Revenue Code, however, proved difficult. See note 138 *infra* and accompanying text.

⁶⁸ The Solar and Conservation Bank Act does authorize direct subsidies to builders of passive solar dwellings of up to 40% of the added cost, § 512 of Pub. L. No. 96-294 (1980).

⁶⁹ In rejecting the passive solar credit in the windfall profit tax bill, the Ways and Means conferees acted in part on the advice of their Oversight Subcommittee staff that the plan was "a good concept, but better done as a direct spending program." OVERSIGHT ANALYSIS *supra* note 49. The Carter Administration failed to take the hint, however, and instead endorsed the tax expenditure approach again in September of 1980. See *Passive Solar Credit Draws Broad Support*, TAX NOTES, Sept. 15, 1980, at 547. The measure did not pass Congress in 1980, but has been reintroduced in the 97th Congress as S. 498. See Staff of the Joint Comm. on Taxation, DESCRIPTION OF MISCELLANEOUS ENERGY TAX BILLS 8-12, June 11, 1981.

In connection with the 1977 energy legislation, the House attempted to deal with the jurisdictional problem by establishing an *ad hoc* energy committee to reconcile the various tax and non-tax proposals. The Senate did not use such a unified approach. See Surrey & McDaniel, *The*

In spite of over ten years of learning on the tax expenditure concept, there are many who mistakenly continue to see tax spending as somehow cheaper than direct outlays.⁷⁰

Although members of the tax-writing committees typically do not have a direct spending option before them when a tax expenditure for a meritorious cause, which might be better served by a conventional appropriation,⁷¹ is proposed, the situation was quite different when Congress debated the energy

Tax Expenditure Concept and the Legislative Process, in *THE ECONOMICS OF TAXATION* 136-37 (Aaron & Boskin eds. 1980).

⁷⁰ This view of the cost of tax expenditures is, of course, untrue. Consider a simple example: Assume there are only two taxpayers, A and B, each contributing \$100 to support the government. The government decides to give A a \$40 subsidy for some activity. To do so with direct spending, it would have to raise an additional \$40 in revenue, which presumably would come in equal measure from A and B. If the government decides to use a tax expenditure approach, it still needs to recover the \$40 in lost revenue. The sources from whom it can do so are still A and B. In fact, tax expenditures actually tend to be *more* costly to the government than direct spending, assuming that the former are tax-exempt and the latter are taxable. A recent publication by the Treasury's Office of Tax Analysis explains the reason why this is true:

[T]ax subsidy programs almost always involve higher resource costs than direct subsidy programs that stimulate the subsidized activity to the same degree. Taxable [direct] subsidy payments stimulate productive activity in the same way as higher revenues from the sale of products in the market. Producers, in both cases, experience an increase in their before-tax returns, and the resulting increase in after-tax returns depends upon their particular marginal tax brackets. In other words, taxable subsidy payments, like income from the sale of goods on the market, provide lower after-tax returns to high bracket than to low bracket taxpayers.

Tax-exempt subsidy payments can be set at a level sufficient to provide the same increase in income after tax as a market payment or a taxable subsidy *only to producers in one particular marginal tax bracket*. If a producer is in a higher marginal tax bracket than this break-even bracket, tax-exempt payments provide a higher after-tax return than that available from market payments. Thus, if the tax-exempt subsidy is high enough to induce low bracket producers to engage in the subsidized activity, it would provide high income, high bracket taxpayers with a greater after-tax return than they would require from the market. The costs of these higher-than-required payments to high income producers do not arise in the case of taxable subsidies; it is for this reason that tax-exempt subsidies are a less effective and more costly subsidy mechanism.

Office of Tax Analysis, Dept. of the Treasury, *THE USE OF TAX SUBSIDIES FOR THE COST OF COMPLIANCE WITH SAFETY AND HEALTH REGULATIONS* 23 (January, 1981).

Tax expenditures tend to raise the general tax burden, for the majority who do not benefit from the subsidies, just as much as or more than do direct spending programs. In spite of this apparent fact, many "spending cutters," or those who pose as such, are strong supporters of tax expenditures. *See, e.g.*, the Republican Platform for 1980, *reprinted in* 126 CONG. REC. S10379 *et seq.* (daily ed., July 31, 1980), which includes proposals for new tax expenditures totalling over \$100 billion a year, while at the same time calling for "less spending, and a balanced budget." *Id.* at S10393.

⁷¹ With tax expenditures running at an estimated \$266 billion for fiscal 1982, *see* JT. COMM. — TAX EXPENDITURES, *supra* note 3, at 15, or about 28% of total direct and tax-implemented federal spending, it may no longer be appropriate to call direct outlays more "conventional" than tax spending. (The Reagan administration is estimating about \$700 billion in direct spending in fiscal 1982. Office of Management and Budget, *Fiscal Year 1982 Budget Revisions* 124 (Mar., 1981).

credits put forward for inclusion in the windfall profit tax bill. In fact, a stark confrontation between direct spending programs and tax expenditures actually did exist. Working their way through other congressional committees at the same time that the energy credits were being weighed were plans to establish a Solar and Conservation Bank, designed to work with local lending institutions and utilities in providing reduced rate loans for solar and conservation installations.⁷² As finally approved by Congress, the Bank will make direct grants to lenders which can cut monthly payments on such loans by 20 to 50 percent for conservation projects and 40 to 60 percent for solar devices.⁷³ For example, if an individual seeks a \$10,000 loan to install a solar heating system, the Solar Bank might provide a grant to the lender of \$5,000, so that the payments of the loan would be cut from \$120 per month to only \$60 (on a 15-year note with an interest rate of 12 percent).

Given the budget constraints facing Congress, it was obvious during the windfall tax debate that the Bank would be competing with the energy tax credits for funds.⁷⁴ It also seems apparent that directing federal subsidies

⁷² Enacted as Title V of Pub. L. No. 96-294 (1980).

⁷³ The maximum grants to lenders which the Solar and Conservation Bank can provide are as follows:

Conservation loans:

1. For owners and tenants of 1-4 unit buildings, the subsidies are limited to borrowers with incomes less than or equal to 150% of the median income in their area. For those who qualify, the maximum subsidies are as follows:

Income level of borrower	Maximum Subsidy Levels				
	Percent	1 unit	2 units	3 units	4 units
Less than 80% of median	50%	\$1,250	\$2,000	\$2,750	\$3,500
80 to 100% of median	35%	875	1,390	1,915	2,440
100 to 120% of median	30%	750	1,200	1,650	2,100
120 to 150% of median	20%	50	800	1,100	1,440

2. For commercial buildings or residential buildings with more than 4 units, the maximum subsidy is 20% of the cost, with a dollar cap of \$5,000 for commercial buildings and \$400 per unit for residential buildings.

Solar loans:

1. For owners or tenants of residential buildings, the maximum subsidies are as follows:

Income level of borrower	Maximum Subsidy Levels				
	Percent	1 unit	2 units	3-4 units	Over 4 units
Less than 80% of median	60%	\$5,000	\$7,500	\$10,000	\$2,500/unit
80 to 160% of median	50%	"	"	"	"
Over 160% of median	40%	"	"	"	"

2. For commercial buildings, the maximum subsidy is 40% of the cost, with a \$100,000 cap.

Summary: S. 932, Energy Security Act As Agreed to by the Senate-House Conferees on June 16, 1980, 126 CONG. REC. S7404, 7407 (daily ed., June 19, 1980).

⁷⁴ The competition between the Bank and the tax credits continues. In its first economic message, the Reagan administration proposed elimination of the Bank, because "[s]ubstantial economic incentives already exist for [solar and conservation] investments as a result of rising energy prices and significant tax credits for residential energy conservation improvements (15%)

through the Bank has many advantages over using the tax expenditure route. First, tax credits generally do not assist lower-income homeowners — of whom there are a surprisingly large number⁷⁵ — since they pay little or no income tax. This is not only unfair, but inefficient, since lower-income homeowners are exactly the ones for whom financial barriers may be the most substantial — even for cost-effective energy projects. In contrast, a loan program can reach such people in many instances, especially if they can provide security in the form of a second mortgage.

Second, since tax credits pay only a portion of the cost of installing a solar system or insulation, homeowners and businesses still need to negotiate loans — or come up with large amounts of cash — to pay the remaining cost of their projects. Further, especially in the case of individuals, a tax credit typically provides a benefit only when a tax return is filed and a refund is paid, which may take place as much as a year and a half after expenditures are made. This means that interim financing may be needed. In contrast, the Solar and Conservation Bank's direct subsidies are immediately and directly tied to financing. Moreover, this direct subsidy program should make banks and savings and loan associations more interested in setting up solar and conservation loan programs, since it most likely will create a substantial market.

Third, there are very serious problems, especially in the case of solar power, in assuring that a system is installed correctly. In a 1978 study of 100 solar water heating installations in New England, only 15 percent were found to have operated properly in their first year. A variety of problems, with such things as pipes, valves, controllers, and the sizing of the units — primarily installation difficulties — were said to be the cause of the poor results.⁷⁶ Yet tax credits, because of their "simple" administrative system, tend to preclude safeguards against homeowner ignorance and poor installation, providing no means of policing installers or their methods. In contrast, the act establishing the Solar and Conservation Bank includes numerous safeguards designed to maximize the energy savings from the program. For example, local banks are required to have an energy audit performed on a building before a loan can be granted. From this audit, it can be determined whether other measures, such as the installation of more cost-effective insulation, must be taken before the

and solar technology measures (40%). There is no reason to create yet another Federal program with Federal overhead to promote these same objectives." *America's New Beginning: A Program for Economic Recovery*, 4-24 (Feb. 18, 1981).

⁷⁵ According to the staff of the Joint Committee on Taxation, in 1977, 48.6% of households with incomes between \$7,000 and \$9,999 owned their own homes, and 67.1% of the households in the \$10,000 to \$14,999 income class were home owners. Staff of the Joint Comm. on Taxation, BACKGROUND AND ISSUES REGARDING H.R. 3712, May 25, 1980, at 22. The current income tax liability of a typical family of four with \$10,000 in income is only \$372, which does not allow very much against which to offset energy tax credits.

⁷⁶ Robert O. Smith and Associates, *Summary of Performance Problems of 100 Residential Solar Water Heaters installed by the New England Electric Company subsidiaries in 1976-77*, Boston, 1978, summarized in ENERGY FUTURE, *supra* note 47, at 320 n.31.

solar installation loan will be approved.⁷⁷ In addition, installations will have to be inspected to assure that they work. Warranties on performance also will be required. An installer's credentials will have to be established, and those with bad records can be effectively prohibited from working on subsidized projects.⁷⁸

Furthermore, unlike "blind" tax credits, the Bank's board can allocate funds toward energy-saving methods with the greatest potential, and can vary the subsidy levels — subject to the legislative maximums — to take account of the amounts needed for different types of conservation and solar techniques and by loan applicants with different income levels.⁷⁹ Lastly, the Bank is required to engage in a major program of publicity and promotion, in which it will be assisted by local lenders and utilities.⁸⁰ To stimulate some of the more cost-effective energy-saving techniques, publicity may be virtually all that is needed.⁸¹

⁷⁷ This is a crucially important requirement. Suppose, for example, that the price of a barrel of oil is \$30, the cost of saving a barrel by conservation is \$6-15, and the cost to produce a barrel equivalent by solar power is \$16-50, depending upon technique and geographic area. If the government provides a 40% subsidy for solar power, thereby making the most expensive solar competitive with oil, it has not only provided windfalls for some solar users, it has also made less expensive solar more attractive than conservation in many instances. It is therefore of some importance that applicants for energy subsidies be required to use the cheapest available oil saving techniques first, before a subsidy is granted for a more expensive one. Cf. the remarks of Rep. J.J. Pickle (D-Tex.) in *Tax Aspects of President Carter's Energy Program: Hearings Before the House Comm. on Ways and Means*, 95th Cong., 1st Sess. 170 (1977):

Now with respect to insulation and solar equipment, I am not sure how you would work it. I express a feeling that perhaps we ought to give these credits . . . only if you put in the insulation first.

It seems to me that credits would be dependent on insulation. I don't know if we benefit a whole lot if we don't insulate these homes at the beginning; it may be tied together but I think that is a point we ought to be certain of, otherwise we defeat ourselves. If you put in equipment and if the house is not prepared to receive it, we waste energy.

One of the more intriguing tax credit proposals, put forward by Kaiser Aluminum and sponsored by Rep. Cecil Heftel (D-Ha.) and Senator Malcolm Wallop (R-Wyo.), attempts to avoid the windfall problem but fails to ensure that the cheapest techniques will be used first. It establishes complicated rules, based on rate of return on investment, so that subsidies are available only to non-cost-effective projects. Yet, as the Treasury pointed out in opposition to the bill, the measure would provide a perverse incentive to "gold plate" the cost of projects and to choose expensive over cheap energy-saving methods. See *Hearings Before the Subcomm. On Taxation and Debt Management Generally of the Senate Comm. on Finance on S. 3006, The Industrial Energy And Efficiency Fuel Conversion Tax Incentive Act of 1980*, 96th Cong., 2d Sess. (Sept. 29, 1980). The concept might be better implemented in a direct spending program, where "bureaucrats" could use their discretion to avoid such unwelcome results.

⁷⁸ Pub. L. No. 96-294, § 515 (1980).

⁷⁹ *Id.*

⁸⁰ *Id.* at § 518.

⁸¹ See *Tax Aspects of President Carter's Energy Program: Hearings Before the House Comm. on Ways and Means*, 95th Cong., 1st Sess. 688 (1977) (statement of Rep. Andrew Jacobs, Jr.) ("Try this out: The average house which is not now insulated, . . . if the overhead were insulated, it might bring about as much as one-third savings in the consumption of fuel . . . Now it seems to me that the average rational person — and I believe that is most people in this country — who understand that if they could finance it, get it done some way or other, they would probably do

Administering an alternative energy subsidy program through the Solar and Conservation Bank thus has several advantages over routing the subsidies through the tax code. The Bank can provide funds for energy saving regardless of the irrelevant factor of an individual's tax liability; its subsidies are timely and are integrated with financing; it can monitor the effectiveness of the various conservation and alternative energy measures used; and it can allocate funds in accordance with priorities and need. All of these benefits are beyond the ken or the inclination of the Internal Revenue Service, which administers tax credits.

Besides the clear advantages of the Solar and Conservation Bank loan program, another drawback to the use of tax-based alternative energy subsidies is illustrated by the most recent data on the use of the energy tax credits enacted in 1978.⁸² This evidence suggests that the tax expenditure approach may be less effective in inducing alternative energy use and conservation than even its harshest critics had originally thought. On the residential side, energy credits were claimed on only 7 percent of individual returns for 1978, and on only 5 percent for 1979.⁸³ The consensus is that almost all of these claims were for expenditures which would have been made anyway.⁸⁴

On the business side, where the proponents of energy tax incentives have been most optimistic, the response has been even more disappointing. According to the tax credit enthusiasts, while individual homeowners may fail to calculate properly the advantages of alternatives to oil or may face obstacles in obtaining access to capital, corporate enterprises can be expected to give full weight to tax incentives as they make the cold economic decisions to invest in the areas which will maximize their profits. As a commentator in *Energy Future* confidently noted, "To such signals [as tax credits] businessmen habitually respond."⁸⁵ Furthermore, there *have* been claims that business has shown more sensitivity than have individuals to the increasing price of energy since 1973,⁸⁶

that. That would be quite an incentive if they thought about it That is, an incentive without a tax credit is what I am saying." Cf. *id.* at 601 (statement of Robert M. Brandon) (The credit "probably provides more of a psychological stimulus than anything else."); *id.* (statement of William Pietz) ("We think a smaller credit would probably achieve about as much as the larger credit because the mere presence of it and the impacts as a psychological gimmick which would be seized upon by advertisers.").

⁸² Energy Tax Act of 1978, Pub. L. No. 95-618 (1978).

⁸³ See note 60, *supra*.

⁸⁴ See, e.g., the views of Rep. Bill Frenzel (R-Minn.), in *Phase III Hearings*, *supra* note 19, at 317, and Rep. Henson Moore (R-La.), 126 CONG. REC. H1069 (daily ed. Feb. 20, 1980).

⁸⁵ ENERGY FUTURE, *supra* note 47, at 181.

⁸⁶ Testifying on behalf of the Chamber of Commerce in mid-1979, Edwin S. Cohen maintained that, since 1973, business and industry had reduced their total consumption of energy by almost 17%, while increasing output by over 21%. *Phase III Hearings*, *supra* note 28, at 303. According to the Treasury Department, however, energy used per dollar of constant-dollar Gross National Product (GNP) has been declining steadily since its peak year of 1970 in both the economy as a whole and in the industrial sector. The decline was 11.8% in industry and 11.4% in the economy as a whole, hardly a significant difference. In spite of the increased efficiency, overall energy use increased by 17.6% in the economy overall and 13.7% in the industrial sector.

and acceptance of such contentions may be what prompts tax credit proponents to conclude that business also will have a stronger reaction to tax incentives.

So far, however, the corporate community's response to energy tax credits has been almost nonexistent. The 1978 Energy Tax Act provided a 10 percent tax credit — in addition to the existing 10 percent investment credit — for business investments in solar, wind, and geothermal equipment.⁸⁷ Only 2,223 corporations applied for this credit in 1979 and only 6,506 applied in 1980.⁸⁸ Its cost to the Treasury was a meager \$1.7 million in the first year and \$8.3 million in the second.⁸⁹ Similarly, the 50 percent increase in the business solar, wind, and geothermal credit — to 15 percent — enacted in the windfall profit tax act⁹⁰ is also unlikely to stimulate a significant increase in business use of alternative energy. The staff of the Joint Committee on Taxation estimated the revenue cost of this change to be only \$10 million in 1980 and \$19 million in 1981.

Two mistaken responses to this data on the low utilization of the business energy credits are possible. Some observers might adopt a "who cares" attitude — that is, they might feel that since the credits cost so little, a great deal of concern over their enactment is unwarranted. Conversely, proponents of the credits have predictably maintained that the data merely indicate that the credit rate was, and remains, too low.⁹¹

To those who may be sanguine about the cost of the credits based upon the historical record, a closer look is recommended. What the Joint Committee staff estimates indicate is not that the credits will always be low in cost, but that they are unlikely to result in investments in expensive and experimental alternative energy projects until the market dictates that those investments are safe and should be made. When those market signals do occur, as oil prices continue to rise and alternative energy technology advances, such investments should increase. This view apparently underlies the Joint Committee staff's estimates of the longer-term costs of the various business tax credits, which show dramatic increases in the future.⁹² The 15 percent solar and wind credit,

Furthermore, the average annual improvement in efficiency in the industrial sector since 1973 was only 1.2%, compared to 1.5% in the economy as a whole. See *Tax Cut Proposals: Hearings Before the Senate Comm. on Finance*, 96th Cong., 2d Sess. 23, 106 (July 23, 1980) (statement of G. William Miller, Secretary of the Treasury).

⁸⁷ Energy Tax Act of 1978, Pub. L. No. 95-618 (1978), § 301; I.R.C. §§ 46, 48.

⁸⁸ Internal Revenue Service, 1978 Statistics of Income, Corporate Income Tax Returns (forthcoming); Internal Revenue Service, 1979 Statistics of Income, Corporate Income Tax Returns (forthcoming). There are over a million active corporations in the country.

⁸⁹ *Id.* The average credit claimed in 1979 (for tax year 1978) was \$772. In 1980 (for tax year 1979), it was \$1,277.

⁹⁰ Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 221 (1980).

⁹¹ See, e.g., ENERGY FUTURE, *supra* note 47, at 228, 230 n.23; *Phase III Hearings*, *supra* note 28, at 190-91 (statement of Sheldon H. Cady, Mineral Insulation Manufacturers' Association, Inc.).

⁹² Cf. FEDERAL TAX REFORM FOR 1976 (Surrey, McDaniel, & Pechman eds. 1976), at 168-69 ("The [initial] cost [of a solar tax credit] will be minor because the credit will be almost

for example, is expected to cost \$497 million by 1985.⁹³ The 10 percent biomass credit is said to cost virtually nothing through 1983, but is predicted to jump to \$352 million in 1985.⁹⁴

Those who advocate higher credits have failed to learn the lesson which should have been taught by our experience with other business tax incentives. The investment tax credit, for example, is supposed "to increase the nation's productive capacity by enlarging the capital stock,"⁹⁵ particularly when the economy is slack.⁹⁶ In spite of the credit, however, investment as a share of the GNP has been remarkably stable,⁹⁷ and variations in investment levels have paralleled demand, just as they did before the enactment of the credit.⁹⁸ The best evidence indicates that the main effects of this enormous tax expenditure⁹⁹ have been to reward companies for doing what they would have done anyway¹⁰⁰ and to change the allocation of the capital stock in ways which have hindered productivity growth.¹⁰¹ The investment tax credit has certainly been

totally ineffectual. But . . . as the technical problems of solar energy are solved . . . the revenue losses from the solar energy credit could become very large. Thus, the credit, which fails to spur energy research now when we face difficult technological problems, constitutes a fiscal time bomb set to go off as soon as those problems are solved and government help is no longer needed."').

⁹³ CRUDE OIL WINDFALL PROFIT TAX ACT OF 1980; CONF. REP. TO H.R. 3919, 96th Cong., 2d Sess. 172 (1980).

⁹⁴ *Id.*

⁹⁵ A. Auerbach and L. Summers, *The Investment Tax Credit: An Evaluation*, Harvard Institute of Economic Research (Nov. 1978), reprinted in *Investment Credit Hearings*, *supra* note 3, at 416. See *Investment Credit Hearings*, *supra* note 3, at 166 (statement of Emil M. Sunley, Deputy Assistant Secretary of the Treasury for Tax Policy); *id.* at 347 (statement of Allen Sinai).

⁹⁶ See, e.g., *Investment Credit Hearings*, *supra* note 3, at 432 (statement of Alan J. Auerbach and Lawrence H. Summers).

⁹⁷ See ECONOMIC REPORT OF THE PRESIDENT, Table B-86, col. 1, p. 331 (Jan. 1981).

⁹⁸ See, e.g., *id.*, columns 1 and 2 (showing a rough correlation between business investment levels and capacity utilization rates); *Investment Credit Hearings*, *supra* note 3, at 343 (statement of Robert Eisner).

⁹⁹ The investment tax credit is estimated to reduce federal revenues by \$20.6 billion in fiscal 1981. J.T. COMM. — TAX EXPENDITURES, *supra* note 3, at 11-12.

¹⁰⁰ See, e.g., *Investment Credit Hearings*, *supra* note 3, at 345 (statement of Robert Eisner) ("The current 10-percent credit goes to firms in major part for equipment investment that they would have undertaken anyway, without the credit"); *id.* at 161 (statement of Emil M. Sunley) ("repealing the investment credit [in 1969] did not have a major impact on the total amount of investment").

¹⁰¹ *Id.* at 439 (statement of Alan J. Auerbach and Lawrence Summers) ("[T]he investment tax credit has had and continues to have an undesirable effect on the economy. The primary long-run effect of the credit is to reallocate capital from structures to equipment."). Because the investment credit is heavily biased against long-lived assets, it distorts the allocation of investment in favor of shorter-lived equipment. See Bradford, *Tax Neutrality and the Investment Tax Credit*, in *THE ECONOMICS OF TAXATION* (H. Aaron and M. Boskin, eds. 1980) at 281, 295, 298; Harberger, *Tax Neutrality in Investment Incentives*, in *id.*, at 299; Sunley, *Tax Neutrality between Capital Services Provided by Long-Lived and Short-Lived Assets*, in U.S. Dept. of the Treasury, *OTA PAPERS, VOL. 1: COMPILATION OF OTA PAPERS* (1978). Dale Jorgenson and Martin Sullivan have found "the loss in efficiency of capital allocation due to differences in effective tax rates among assets" — a result primarily due to the investment tax credit — to be "very large,"

a very significant factor in the continuing shift of the tax burden away from corporations,¹⁰² but this is not a goal usually emphasized by proponents of the credit — although, for many, it may be the primary intent.

Even with historical data such as that available on the 1978 business and residential energy credits, it will never be possible to resolve conclusively disputes about their efficacy.¹⁰³ The evidence does suggest, however, that alternative approaches should be tried. Serious solar advocates were concerned, therefore, when for a time it appeared that the enactment of expanded energy tax credits might prevent the Solar and Conservation Bank — the leading alternative — from granting most loans. This was because the anti-“double-dipping” rule in the legislation establishing the Bank reduces the loan subsidy by the amount of any tax credits for which an applicant can qualify.¹⁰⁴ At the last minute, however, the legislative language of the tax provisions was amended to allow taxpayers who want subsidized loans to waive their eligibility for the tax credits.¹⁰⁵

The pendency of the Solar and Conservation Bank bill during congressional consideration of the energy tax credit proposals was without doubt a key factor in Congress’s ultimate decision to enact only relatively small increases in the existing tax credits.¹⁰⁶ This points out an important tactical lesson for those

lowering the marginal return on investment by almost half in some years. D. Jorgenson and M. Sullivan, *Inflation and Corporate Capital Recovery* 42 (Harvard Institute of Economic Research, March 1981).

¹⁰² The investment credit is estimated to reduce corporate taxes by \$17.3 billion in fiscal 1981. JT. COMM. — TAX EXPENDITURES, *supra* note 3, at 11-12. This represents just over half of the current cost of the various corporate tax reductions enacted in the 1970’s. (Other major corporate reductions included the Domestic International Sales Corporation (DISC) export subsidy — I.R.C. §§ 991 *et seq.*; establishment of the Asset Depreciation Range (ADR) depreciation rules — Treas. Reg. § 1.167(a)-11, as authorized by Pub. L. No. 92-178, § 109 (1971); and various rate cuts). Overall, effective corporate tax rates were reduced by over 30% during the 1970’s. As a result, the corporate share of the federal tax burden dropped from 19.5% in 1969 to 14.1% in 1979 — although pre-tax corporate profits as a share of GNP increased over that period. See *President Reagan’s Tax Proposals: Hearings Before the House Comm. on Ways and Means*, 97th Cong., 1st Sess. (1981) (statement of Robert S. McIntyre). The Reagan administration predicts that the corporate income tax will carry only 7.7% of the federal tax load by fiscal 1986, due primarily to the administration’s proposal to cut corporate taxes by another \$50 billion a year through depreciation changes. Office of Management and Budget, *Fiscal Year 1982 Budget Revisions* 122 (March, 1981).

¹⁰³ Cf. R. BIRD, *INVESTMENT INCENTIVES: THE STATE OF THE ART* (1980) (Like most commentators, Bird has a dim view of the efficacy of tax incentives. He is also resigned, however, to the fact that “yet another report concluding that most investment [tax] incentives have been tried and found wanting” will have little success in “dampening the enthusiasm of the advocates of such devices.” *Id.* at 2.).

¹⁰⁴ Pub. L. No. 96-294, § 515 (1980).

¹⁰⁵ Pub. L. No. 96-223, §§ 203, 223 (1980); I.R.C. §§ 44C(c)(10), 48(l)(11).

¹⁰⁶ See, e.g., Rep. Henson Moore’s statement on the House floor during the debate on a motion to instruct the House windfall profits tax conferees to accept all of the energy credits in the Senate bill:

We already have grants in other bills; we already have loans; we already have a number of incentive programs to help people develop new forms of energy

who generally oppose tax expenditures: If the goal of a tax preference is obviously meritorious, but the tax route is — as is usually the case — a poor way to further that goal, it is important not only to try to devise a more effective direct spending approach but also to attempt to further the passage of such a program in the appropriate congressional committees. Unless a direct spending program is seen as politically feasible as well as theoretically attractive, many members of the tax-writing committees will remain inclined to accept the second-best tax expenditure approach as the only solution available to them.

III. BEYOND TAX EXPENDITURE ANALYSIS

The preceding discussion includes a fair summary of most of the arguments presented to Congress in favor of or in opposition to the various energy tax preferences under consideration for inclusion within the windfall profit tax legislation. Implicitly or explicitly, virtually all of these contentions fit snugly within the framework of what is known as tax expenditure analysis. That is, it was generally conceded by both proponents and opponents that the tax credit proposals were substitutes for direct spending programs, and that they should be analyzed as such.

It is somewhat difficult to imagine the supporters of the energy tax preferences defending their proposals as anything but tax-based spending programs. Certainly it would have been ludicrous to have tried to justify them as an appropriate means of measuring the decline in real incomes suffered by those who enlisted as soldiers in the moral equivalent of war against excessive use of foreign oil. Such a justification would have been even stranger in light of the fact that most of the tax provisions under consideration were in the form of credits against tax liability rather than deductions from taxable income. It is basic that a credit cannot be the correct tool for accurately measuring income.¹⁰⁷

The general concession that the proposed energy preferences should be analyzed as tax expenditures may seem trivial, but it actually represents an unusual phenomenon. In the more typical case, there is a great deal of categorical confusion between assertions about the proper way to measure real incomes and arguments about the best way, if any, to encourage socially useful

So we are going to have a duplication, if we are not careful, of giving tax credits for things that are happening anyway and are already subsidized or stimulated.

126 CONG. REC. H1069 (daily ed., Feb. 20, 1980).

¹⁰⁷ To illustrate: Legitimate business expenses ought to be deductible in computing net income. A credit system could not yield such a fair result, given progressive tax rates. For example, if the business expense deduction were replaced with a 40% credit for such expenses, a taxpayer with \$50,000 in gross earnings and \$20,000 in expenses would have only about one-third the tax liability of a taxpayer with \$100,000 in gross income and \$70,000 in expenses. This point is explored at greater length in M.J. McIntyre, *Evaluating the New Tax Credit for Child Care and Maid Service*, TAX NOTES, May 23, 1977, at 7.

behavior.¹⁰⁸ Sometimes the disagreement about the proper characterization of a particular tax provision — as either a tax expenditure or a tool to help measure income properly — represents a genuine, good faith dispute. For example, the charitable deduction is defended by Professor Andrews as a proper adjustment in determining taxable income.¹⁰⁹ His view is based on the plausible conclusion that funds given away constitute neither consumption nor savings on the part of the donor.¹¹⁰ In contrast, Professor McDaniel criticizes the

¹⁰⁸ For a thorough demystification of the confusion often encountered between tax expenditure and income measurement analysis see M.J. McIntyre, *A Solution to the Problem of Defining a Tax Expenditure*, 14 U.C. DAVIS L. REV. 79 (1980) [hereinafter *M.J. McIntyre*]. My brother notes that disputes over whether a particular tax provision is a tax expenditure or is rather a "normal" tax rule incorrectly assume that the intrinsic nature of the provision in question should determine the analytical framework in which to evaluate it. He argues that a more fruitful approach would be to eschew *a priori* decisions as the proper mode of analysis, and instead in each case to use the analytical method which responds to how a provision is defended. *Id.* at 94. In other words, "the bare assertion that the tax rule under examination promotes a spending goal [should] trigger a tax expenditure analysis," but only for the purpose of evaluating whether the provision in fact promotes that spending goal in an efficient and acceptable manner. *Id.* at 100. "[A] tax expenditure analysis of . . . arguments [that a rule is appropriate in defining 'income,' on the other hand,] would be a useless frivolity." *Id.* at 98. If a tax provision is convincingly defended on income measurement grounds, he suggests, tax expenditure analysis is both unnecessary and inappropriate. *Id.* at 94-95.

The application of tax expenditure analysis only to tax expenditure *arguments* completely avoids the up-until-now controversial problem of defining what is a tax expenditure and what is a "normal" tax rule. The insight which this approach offers also helps cut through the intentional smokescreens, frequently created by proponents of tax provisions, which cannot adequately be justified on either tax policy or spending grounds. See, e.g., the discussion in note 115 *infra*.

¹⁰⁹ See note 110 *infra*.

¹¹⁰ See Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972). Under this analysis, the only rationale for not allowing deductions for *all* gifts and taxing them to the donees is administrative convenience.

While Andrews' approach provides a defensible explanation of the proper treatment of charitable donors, the issue remains as to the proper treatment of the charitable organizations themselves — namely, whether charities should be allowed to pay no taxes on gifts received (assuming those gifts are deductible by the donors).

An income measurement analysis would start with the threshold question of whether charities should be taxed under a comprehensive income tax. Would such a tax on charities be a proxy for taxing the recipients of the charities' largesse, much as the corporate income tax acts as a rough proxy for taxing shareholders on retained earnings (i.e., savings)? In other words, from an analytical perspective, are recipients of gifts from charities the proper taxpayers, since they are the ones who actually consume the funds? But if so, given the presumably low tax brackets of many of said recipients, would a "proxy" tax on charities properly be at a very low rate? Moving further, should administrative expenses be deductible? If a charity uses all its gross "income" to provide information to the general public, are the newly-informed the proper taxpayers, or has the charity spent its entire "income" on administrative costs and is its "net income" therefore zero? Would this mean that only organizations which provide grants to individuals should be treated as having taxable income (based upon the proxy theory)? Should charities with a poor clientele (orphanages) be taxed at a lower rate than those who cater to the more affluent (museums)? The proper answers to these and certainly other questions might cause one to conclude that the tax exemption for charity is sensible under an income measurement analysis.

Alternatively, the tax-exempt status of charities might be defended on spending grounds. Is tax exemption the most appropriate way for government to subsidize such organiza-

write-off for donations to charity on the ground that it is an upside-down subsidy which favors wealthy taxpayers and their chosen causes.¹¹¹ What is sometimes not understood is that, if Professor Andrews is right, Professor McDaniel's argument is irrelevant.¹¹² If Professor Andrews is wrong, then the focus should be concentrated on Professor McDaniel's tax expenditure analysis, which some maintain still results in a favorable report on the charitable deduction.

At the legislative level, proponents of a particular tax measure frequently resist the "tax expenditure" label in an attempt to gain a tactical advantage or to defuse criticism. The former chairman of the Senate Finance Committee, Russell Long (D-La.), for example, used to rail against acceptance of the tax expenditure concept,¹¹³ due in part to his fear that the jurisdiction of his committee might suffer were its legislative proposals generally seen in this light.¹¹⁴ In addition, lobbyists for new tax benefits usually make great efforts to characterize their proposals as necessary to reflect income properly or to deal with some defect in the normative income tax rules, while simultaneously explaining their desperate need for new "incentives." The proposed increases in business depreciation allowances, for example, are alternatively defended by corporate lobbyists as appropriate to obtain an accurate measure of capital income in an inflationary economy and as a needed subsidy to encourage capital investment. This dual characterization allows them to mitigate the perceived pejorative nature of the "tax expenditure" label and to confuse the argument when necessary to respond to difficult-to-refute attacks on their positions.¹¹⁵

tions? Given the pluralistic desire to avoid government interference with charitable activity, one could well answer this question in the affirmative. Certainly, such a tax expenditure is far easier to defend as a subsidy to the charities than it is as a benefit to donors.

¹¹¹ See, e.g., McDaniel, *Study of Federal Matching Grants for Charitable Contributions*, in U.S. COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, DEPT. OF TREASURY, 4 RESEARCH PAPERS TAXES 2417-532 (1977).

¹¹² Professor McDaniel's argument is relevant only to contentions that the charitable deduction is a proper way to subsidize charities and their donors. It does not even attempt to address the income measurement argument put forward by Professor Andrews. See note 66 *supra*.

¹¹³ See, e.g., *Hearings on H.R. 10612 Before the Senate Finance Comm.*, 94th Cong., 2d Sess. 241 (March 1976). More recently, Senator Long has admitted that there is at least "some analogy between a tax program designed to encourage a particular activity and a direct spending program to encourage that activity." R.B. Long, Luncheon Speech, NAT'L TAX JOURNAL, Sept. 1979, at 279.

¹¹⁴ Several of the leading proponents of the tax expenditure concept have suggested that the tax-writing committees should share jurisdiction with other committees where tax "spending" is involved. See, e.g., *Investment Credit Hearings*, *supra* note 2a, at 28 (Statement of Paul McDaniel); *id.* at 125 (statement of Fred Werthheimer for Common Cause); CONG. REC. S5703-09 (daily ed. Apr. 17, 1978) (remarks of Sen. Edward M. Kennedy (D-Mass.)).

¹¹⁵ If an attack is made on the income measurement argument by pointing out, for example, that corporate taxable income is already far less than inflation-adjusted book income, due to the \$49 billion in corporate loopholes, the business lobbyists typically counter by raising the incentive argument. See, e.g., the statement of Charles E. Walker (who represents a large number of Business Roundtable clients) and succeeding colloquy during the Senate Finance Committee hearings on tax cut proposals in July of 1980:

No such confusion occurred in the case of the energy tax incentives proposed for inclusion in the windfall profit bill. Moreover, not only were the proposals defended solely as tax expenditures, but they were also generally styled as tax credits, rather than deductions. At first glance, these two occurrences might seem to represent unmitigated achievements for tax reformers. The "tax expenditure" label apparently puts reformers on their home ground; the use of credits is an approach long advocated by some reformers, since it avoids the "upside-down" effect by which the extent of federal subsidy is dependent upon an individual's tax bracket.¹¹⁶ Unfortunately, these "victories" were not without cost, nor were they clear-cut. As has been illustrated, the level of the congressional debate was not always the highest, and one major negative effect of the credit proponents' concession on the "tax expenditure" label and their general advocacy of credits was to remove some of the arguments which might otherwise have been made against the provisions. Many of the reform-oriented members of Congress and their staffs, schooled only in a rather primitive tax expenditure analysis approach to all tax policy issues, were unprepared to make or to understand further arguments not encompassed within the limited framework with which they are familiar. This problem is illustrated by the large number of normally reform-oriented members who voted in favor of the House motion to instruct the windfall conferees to accept all the Senate's energy credits. Reformers should, therefore, be forced to face up to some of the

Mr. WALKER: [One reason we need faster writeoffs is that] with the under-depreciation that we have seen because of the rapid rates of inflation, the actual corporate tax is much higher than the 46-percent rate.

But when questioned about another proposal (by Professor Dale Jorgensen), which would completely solve the inflation problem but was much less generous than the plan favored by the big business community, Mr. Walker shifted gears:

Mr. WALKER: I don't think we should argue this in terms of theoretical economics, or how many angels can dance on the head of a pin. . . . I say, let's look around the world and see what is happening Other countries have very fast depreciation The people that worked on 10-5-3 [the depreciation scheme favored by Mr. Walker] . . . have as their basic goal to liberalize the depreciation system. Not to offset what inflation has done

Hearings Before the Senate Comm. on Finance on Tax Cut Proposals, 96th Cong., 2d Sess. 855-65 (June 24, 25, 28, 1980). Conversely, if the business lobbyists' tax expenditure analysis is questioned in light of, say, the dismal economic record of the seventies in spite of the \$26 billion in added annual investment tax subsidies, the lobbyists frequently retreat to the inflation/income measurement argument. See, e.g., the comments of Richard W. Rahn, chief economist of the Chamber of Commerce, in response to my article, *Business Tax Cuts In Perspective*, TAX NOTES, Sept. 1, 1980, at 395. Replying to the point made in this article that the 10-5-3 depreciation plan would be more generous than immediate expensing and would therefore cause serious distortions in investment decision-making and generate a huge new tax shelter market, Mr. Rahn states, *inter alia*, that "[e]ven taxpayers who take advantage of maximum acceleration allowed under present law may not be sufficiently compensated for inflation at today's double-digit rates." R. Rahn, *A Critique of the McIntyre Article*, TAX NOTES, Sept. 1, 1980, at 401. (Needless to say, my article had also dealt at length with the inflation argument.)

¹¹⁶ Even tax credits cannot reach those with no tax liability, unless the credits are refundable. It was suggested that some of the energy credits proposed for inclusion in the windfall bill include a refundability feature to remedy this defect.

limits to the scope of tax expenditure analysis, particularly as it is understood in Congress.

The tax expenditure concept is tremendously useful in comparing proposed tax subsidies to direct spending alternatives, and in many cases in illuminating equity problems, particularly when an "upside-down" effect would result from enactment of a proposed tax provision. As a result, tax expenditure analysis has often been an effective lobbying tool in fighting new loopholes. Nevertheless, in recent years, the basic premise of tax expenditure analysis — that loopholes can, and in fact *should*, be analyzed exactly like direct spending programs — has in many instances had the perverse and unintended effect of legitimizing the proliferation of new tax subsidy provisions. This result has occurred due to a number of interrelated factors.

First, it is repeatedly stressed by advocates of the tax expenditure approach that the term is not a pejorative one.¹¹⁷ This position has been taken largely for tactical reasons, for example, to gain support for inclusion of tax expenditures within the budget process and, more recently, as part of the debate over sunset legislation.¹¹⁸ The proposition implicitly suggests, however, at least to most members of Congress, that some proposed loopholes must be acceptable.¹¹⁹

¹¹⁷ The now official view that the "tax expenditure" label is neutral is emphatically stated in Office of Management and Budget, Special Analyses, Budget of the U.S. Government, Fiscal Year 1982, Special Analysis G, at 203 (1981): "It should be emphasized that the listing of specific tax expenditure items does not imply either approval or disapproval of specific provisions of the tax system." See also *Investment Credit Hearings*, *supra* note 3, at 35 (statement of Paul R. McDaniel). In fact, the term "tax expenditure" was intentionally chosen for its non-emotional character. See Davenport, *Tax Expenditure Analysis as a Tool for Policymakers*, TAX NOTES, Dec. 1, 1980, at 1051, 1052.

¹¹⁸ See generally Surrey & McDaniel, *The Tax Expenditure Concept and The Legislative Process*, in THE ECONOMICS OF TAXATION 123 *et seq.* (Aaron & Boskin, eds. 1980).

Advocates of the sunset concept for tax expenditures have sometimes had to tie themselves in knots to maintain their position that they are not biased against tax expenditures *per se*. See, e.g., *Investment Credit Hearings*, *supra* note 3, at 153 (colloquy between Fred Wertheimer of Common Cause and Rep. John Duncan (R-Tenn.)):

Mr. DUNCAN: . . . Mr. Wertheimer, you have referred to "tax incentives [that] have long outlived their usefulness." Would you identify some that you consider obsolete?

Mr. WERTHEIMER: I think our basic concern is there is no way to figure out which incentives have long outlived their usefulness under the present process. As I said earlier, we are not here to support or oppose any particular programs. We do believe that the present process does not leave room for evaluation.

Mr. DUNCAN: You do make a statement, though, that they are obsolete but then can't identify any. Is that your answer?

Mr. WERTHEIMER: I would prefer not to specifically testify on behalf or against any tax incentives right now.

Mr. DUNCAN: I take it you don't know any? Are you saying your statement is incorrect?

Mr. WERTHEIMER: No.

Mr. DUNCAN: But you don't know of any that is obsolete? I am a little amazed

¹¹⁹ If not all tax expenditures are necessarily bad, then, *a fortiori*, some must be good. Of course, the advocates of the tax expenditure concept do not always believe their own rhetoric

Second, tax expenditure analysis has tended to focus the political debate over new loopholes on efficiency issues. Admittedly, most proposed tax preferences fail a dispassionate efficiency evaluation — in fact, it is difficult to recall a single loophole proposal which has passed such a test.¹²⁰ Careful efficiency analysis, however, is not always an important influence on legislative decisionmaking. By agreeing to fight on an efficiency battleground, reformers have increasingly found themselves overwhelmed by the masses of allegedly scientific research and computer printouts which powerful interests now routinely muster on behalf of their favored new loopholes.¹²¹

about the neutrality of the term. At a 1979 conference on tax expenditures, the following exchange occurred between Professor Stanley Surrey and a member of the audience:

Question. Professor Surrey, . . . you mentioned earlier in your presentation that there were good tax expenditures and bad tax expenditures. Could you give us an example of what you regard as a good tax expenditure . . . ?

[Prof. Surrey:] . . . When you press hard as to whether I can see any useful tax expenditures, I am pushed very hard. . . . I do have some difficulties in finding programs I would run, if I were running the government, through the tax system rather than as direct programs.

Tax Expenditure Analysis: A Reply by Professor Surrey and Discussion, CANADIAN TAXATION 26, 28 (Summer 1979).

Before it became fashionable to maintain the neutrality of the tax expenditure concept, Professor Surrey did not need to be prodded to assert his antagonism to virtually all special tax breaks. See, e.g., Surrey, *The Federal Tax System — Current Activities and Future Possibilities* (speech before Boston Economic Club, May 15, 1968), at 26 ("I doubt that any of these special tax treatments could stand the scrutiny of careful program analysis, and I doubt that if these were direct expenditure programs we would tolerate for very long the inefficiencies that such program analysis would reveal."), quoted in Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, NAT'L TAX J., June 1969, at 241 n.11.

¹²⁰ Cf. Professor Surrey's conclusion in note 119 *supra*.

¹²¹ Legislators usually ignore the fact that "one can get almost any answer one wants as to the effects of tax incentives by making sure that the chosen model has specifications appropriate to one's purpose," R. Chirinko & R. Eisner, *THE EFFECTS OF TAX POLICIES ON INVESTMENT IN MACROECONOMETRIC MODELS: FULL MODEL SIMULATIONS*, OTA PAPER 46, U.S. Dept. of the Treasury 26 (Jan. 1981).

¹²² Proposals for major changes in the tax depreciation rules, such as "10-5-3" and the Senate Finance Committee's "4-4-7-10," would so disassociate tax depreciation from financial accounting standards that the concept of a corporate *income* tax would be rendered meaningless, at least for large, capital-intensive companies. Although the Carter Treasury did complain about the loss of linkage between actual and taxable income which these plans would create, see *Miscellaneous Tax Bills III: Hearings Before the Senate Comm. on Finance*, 96th Cong., 1st Sess. 164, 171 (1979) (statement of G. William Miller, Secretary of the Treasury), the significance of this result seems to be lost on most members of Congress. See *Legislating Without a Blackboard*, PEOPLE & TAXES, Aug./Sept. 1980, at 13. It is not lost on some of the proponents of the measures, who hope that, by breaking the link between tax depreciation and service lives, the way will be opened for even further corporate tax reductions in the future. See R.S. McIntyre, *The Beginning of the End of the Corporate Income Tax?*, PEOPLE & TAXES, Oct. 1979, at 3.

The focus in the "three martini lunch" debate ought to have been on the valuable form of income that free meals provide to their recipients. Once this is recognized, it is difficult to justify a 100% exclusion on either tax policy or tax expenditure grounds. Congress, however, never seemed to appreciate this point. Instead, it concentrated on whether a meals exclusion is an appropriate way to subsidize the restaurant industry. Although it is demonstrably not, restaurant employees defended themselves with the usual charts and tables showing such enormous job losses from reform of the meals rules that Congress was almost unanimously opposed to change.

Third, by promoting tax expenditure analysis as the key to evaluating most tax proposals, reformers have created a whole generation of members of Congress and their staffers who are wholly innocent of an understanding of traditional tax policy analysis. Issues like proper income measurement techniques are rarely discussed intelligently in the political arena, and the repercussions have been and are being felt in areas ranging from depreciation "reform" to the "three martini lunch" to the so-called "marriage penalty."¹²²

Fourth, the focus on direct spending comparisons which tax expenditure analysis encourages has tended in practice to result in substantial disregard of the very special need of the Internal Revenue Service for ease of administration and the importance for taxpayers of simplicity. Certainly these factors can be included within a broad-reaching tax expenditure analysis approach,¹²³ but such inclusion tends to contradict the assertion that the "tax expenditure" label is not a pejorative one, especially when proposed loopholes are opposed on complexity grounds alone.¹²⁴

Finally, and most important, the premise of tax expenditure analysis that tax incentive proposals should be treated merely as direct spending substitutes has tended to drastically oversimplify issues of tax equity. Assuming a tax benefit is crafted to avoid "upside-down" effects and made refundable to avoid favoring those with no tax liability, tax expenditure analysis tends to give it a favorable report as far as equity is concerned.¹²⁵ Not everyone is willing, however, to accept the idea that this is all equity entails. Paying to the government one's allotted share of taxes based on an honest report of one's income is never a cheery task, but it becomes positively onerous when one is aware that others have had large chunks of their taxes forgiven — for whatever "incentive" reason. It is all well and good to maintain that a proper appreciation of tax subsidies as merely direct grants routed through the tax system ought to make ordinary taxpayers less critical of the loopholes enjoyed by their betters. The common perception of tax equity in the real world, however, is not so sophisticated. Maintaining a general belief in the fairness of the system is of high importance in ensuring a reasonable level of taxpayer compliance with the

For an outline of how the various arguments should have been presented, see M.J. McIntyre, *supra* n.108, at 98-99.

The "marriage tax" issue ought to revolve around questions about who should be taxed on pooled income. Instead, it has largely centered on claims that the tax system encourages divorce, or that it discourages women from entering the job market. For a discussion of the problems in the current debate, see M.J. McIntyre, *Individual Filing in the Personal Income Tax: Prolegomena to Future Discussion*, 58 N.C.L.REV. 469 (1980).

¹²³ See, e.g., Surrey, *Tax Expenditure Analysis: The Concept and Its Uses*, CANADIAN TAXATION 3, 8-9 (Summer 1979).

¹²⁴ See note 113 *supra*. See text accompanying note 75 *infra*.

¹²⁵ See, e.g., *Investment Credit Hearings*, *supra* note 3, at 35-36 (statement of Paul R. McDaniel) (suggesting that refundable credits solve equity problems, but that administrative considerations may remain).

law¹²⁶ — a factor which reformers who advocate refundable investment credits for giant corporations¹²⁷ tend to discount.

Somewhat ironically, the widely-held belief that the tax laws should be fair has contributed to the pronounced tendency for tax expenditures to expand once they are established. This phenomenon seems to be most evident in the energy area. The historically classic example is percentage depletion,¹²⁸ which was originally enacted only for oil and gas, but eventually grew to cover almost a hundred different “depletable” resources, including gravel, asbestos, peat moss, and clam shells.¹²⁹ The pressures to expand the recently enacted energy credits indicate that they have an expansionary potential which may be of even a higher order than that of percentage depletion.

The potential for energy tax credits to grow can be appreciated by perusing almost any issue of *Tax Notes*, the weekly tax journal. The lead item in the summary of incoming Treasury mail will almost invariably describe a letter or series of letters asking that a mechanized awning, or woodburning stove, or special reflective roof paint, or carburetor jet adjusting device, or almost any conceivable device which happens to save energy be made eligible for an energy tax credit.¹³⁰ The requests are so voluminous that the Treasury Depart-

¹²⁶ See Kurtz, *Notes to a New Commissioner of Internal Revenue*, TAX NOTES, June 1, 1981; at 1195, 1202. Congress has understood the political significance of avoiding gross perceived inequities in the tax system, but at the same time has generally been unwilling to attack loopholes directly. Therefore, it compromised by establishing the minimum tax, I.R.C. §§ 55 *et seq.* — a band-aid measure which pure tax expenditure analysis must necessarily condemn as schizophrenic.

¹²⁷ See, e.g., *Investment Credit Hearings*, *supra* note 3, at 202, 205 (statement of Gerard M. Brannon); *cf. id.* at 162-63 (statement of Emil M. Sunley, Jr.) (suggesting that the non-refundability of the investment credit is largely for “cosmetic” reasons. *But cf. id.* at 180 (statement of Jerome Kurtz, Commissioner of Internal Revenue) (noting that leasing transactions result in a kind of *ad hoc* refundability even under current law).

¹²⁸ I.R.C. §§ 613, 613A.

¹²⁹ Percentage depletion has been allowed for oil and gas since 1926. Beginning in 1932, it was gradually extended, at lower rates, to most other minerals. TAX REFORM ACT OF 1969, REPORT OF THE SENATE COMM. ON FINANCE ON H.R. 13270, S. REP. NO. 91-552, 91st Cong., 1st Sess. 178 (1969). The 1954 Code made percentage depletion generally available, excluding only “soil, sod, turf, water, or mosses” and “minerals from sea water, the air, or similar inexhaustible resources.” B.I. BITTKER AND L.M. STONE, *FEDERAL INCOME, ESTATE, AND GIFT TAXATION* 332 (4th ed. 1972).

¹³⁰ See, e.g., TAX NOTES, Jan. 14, 1980, at 31 (*Residential Energy Credit Requested for Coal Burning Stove; Credit Requested for Heat Exchanges and Wind Turbines; Still Another Residential Energy Credit Request* [— for] ‘Plasticool’; *Sailing, Sailing . . . [A letter asks] whether an ocean-going commercial sailing vessel . . . will be eligible for a tax credit*); *id.*, Jan. 21, 1980, at 77 (*Residential Energy Credit Suggested for Hot Water Heaters; Credits Asked for Zone Control System for Heating and Air Conditioning*); *id.*, Feb. 4, 1980, at 156, (*Credits for Wood Burning Stoves Supported*); *id.*, Feb. 11, 1980, at 196 (*Tax Benefits to Encourage Recycling are Urged*); *id.*, Feb. 25, 1980, at 265 (*Credits Sought for Wood Stoves and Solar Heating Systems*); *id.*, Mar. 3, 1980, at 301 (*New England Senators Urge Woodstove Credit*); *id.*, Mar. 10, 1980, at 349 (*Push Continues for Wood Burning Stove Credits*); *id.*, Mar. 17, 1980, at 375 (*Wood Stove Credits Continue To Be a ‘Burning’ Issue; Why Don’t Awnings Qualify for a Credit?*); *id.*, Mar. 31, 1980, at 455 (*Credits Sought for Wood Stoves, Aluminum Siding, Awnings, and Insulation; Credits*

ment pleaded with Congress to remove its never-exercised discretionary authority to expand the list of items qualifying for tax credits. Congress responded, however, only by establishing hard-to-meet standards for the exercise of that discretion.¹³¹

Sought for Low Temperature Commercial Dishwasher); *id.*, Apr. 7, 1980, at 489 (*Taxpayer Wants to Know Why House Had To Be Completed Before April 20, 1977 To Get Credit for Insulation; Treasury Gets Proposals on Community Recycling Centers*); *id.*, Apr. 14, 1980, at 531 (*Insulation Credit for Landlords Urged; Another Request for Wood Stove Credits*); *id.*, Apr. 21, 1980, at 585 (*Tax Credits for Wood Stoves, Heat Pumps, and Thermocyclers*); *id.*, Apr. 28, 1980, at 623 (*Credits Sought for Temperature Control System*); *id.*, May 5, 1980, at 655 (*Energy Credits Sought for Ground Water Pumps and Other Items*); *id.*, May 12, 1980, at 719 (*Energy Credits Sought for Woodburning Stoves; Qualification for The Business Energy Investment Tax Credit Sought for Solar Cooling System*); *id.*, May 19, 1980, at 751 (*Tax Credit for Wood Stove Sought by Taxpayer; Tax Credit Urged for Wood-Burning Equipment; Company Seeks Insulation Credit for Slag-Type Roofing Material*); *id.*, May 26, 1980, at 793 (*Nine Senators Ask for Wood Stove Credit Meeting; Tax Credit Sought for Small-Scale Hydroelectric Equipment*); *id.*, June 2, 1980, at 831 (*More Letters Are Received Supporting a Credit for Woodburning Stoves*); *id.*, June 9, 1980, at 855 (*Energy Credit Sought for Vapor Compression Hot Water Heaters; Qualification for Tax Credit Sought for Energy Conversion System and for Windmills*); *id.*, June 16, 1980, at 925 (*Viscosity Stabilizer Said To Reduce Fuel Use*); *id.*, June 30, 1980, at 1005 (*Wood Energy Institute Supports Credit for Wood Stoves; Reports on Wood Stove Credit Said To Mislead Homeowners; Fedders Continues to Urge Tax Credits for Vapor Compression Water Heaters*); *id.*, July 7, 1980, at 15 (*Fedders Continues to Urge Tax Credits for Vapor Compression Water Heaters*); *id.*, July 14, 1980, at 75 (*Aluminum Can Eater Said To Qualify for Energy Credit; Energy Credit is Urged for Coal-Fired Furnaces; Treasury Receives More Letters Supporting Wood Energy Credit*); *id.*, July 21, 1980, at 119 (*Treasury Receives Another Inquiry About Energy Credits for Woodburning Stoves; Should Energy-Producing Greenhouses Qualify for Energy Credits?*); *id.*, July 28, 1980, at 161 (*Energy Credit for Coal Burning Furnaces and Boilers Recommended; Woodburning Stove Energy Credit Receives Another Recommendation*); *id.*, Aug. 4, 1980, at 215 (*Taxpayer Seeks Insulation Credit for Second Home; Taxpayer Seeks Amount of Tax Credit for an Unspecified Type of Solar Product*); *id.*, Aug. 11, 1980, at 267 (*Tax Credit Sought for Awnings; Taxpayer Berates Denial of Energy Credit for Gas Furnaces*); *id.*, Aug. 18, 1980, at 323 (*Expansion of Residential Energy Credits Recommended, Specifically for Wood-Burning Stoves and Vapor Compression Water Heaters; Credit Recommended for Energy Saving Window Coatings*); *id.*, Aug. 25, 1980, at 369 (*Heat-Pump Water Heaters, Wood-Burning Stoves, Electric Radiator Heaters, and Evaporative Coolers Recommended for Energy Credits*); *id.*, Sept. 1, 1980, at 407 (*Limits on Energy Credits Opposed; Credit for Hydronic Central Heating Systems Sought; Credit Sought for Geothermal Well With Underground Heat Pump*); *id.*, Sept. 8, 1980, at 465 (*3M Urges Change in Regulations to Permit Credit for Window Coatings; Credits Recommended for Wood-Burning Stoves, Vapor Compression Water Heaters, and Coal Furnaces; More Liberal Energy Credits Recommended As Cure To Energy Problems Of U.S.*); *id.*, Sept. 22, 1980, at 579 (*Energy Credit Recommended for 'Passive Solar Houses'*); *id.*, Sept. 29, 1980, at 631 (*Fedders Applies for Energy Credit for Heat Pump Water Heater*); *id.*, Oct. 6, 1980, at 683 (*Gradison Asks if Saturated Felt Qualifies as 'Roof Insulation'*); *id.*, Oct. 13, 1980, at 739 (*Denials of Energy Credits for Solar Collector and New Furnaces Criticized; Treasury Queried on Eligibility of Thermal Conduction Plates for Energy Credits*). *But cf. id.*, Jan. 7, 1980, at 11; *id.*, Jan. 28, 1980; and *id.*, Sept. 15, 1980, at 531. Through Oct. 13, 1980, these were the only 1980 issues in which there were no energy credit references. These items tend to be at the beginning because the summary is in Internal Revenue Code section order, and credits occur early in the code.

¹³¹ The windfall profit tax bill sets the following criteria for adding energy items to the list of those eligible for a tax credit: Treasury must determine, first, that making the item eligible will result in a reduction in total U.S. consumption of oil and natural gas and that the reduction is sufficient to justify the revenue cost; second, that adding the item cannot result in increased use of anything which is known to be, or reasonably suspected to be, hazardous to the environment or to public health or safety; and, third, that existing federal subsidies are insufficient. Pub. L. No. 96-223, § 201(b) (1980); I.R.C. § 44C(c)(9).

The most obvious reason for the expansionary nature of energy tax expenditures is that there simply is no purely logical stopping place once the principle is established that tax incentives for alternative energy development and conservation are a good idea. If a credit for solar hot water heaters is on the books, what is the argument against extending the credits to greenhouses used in passive solar heating — especially since the greenhouses probably save more energy? Similarly, if a credit for replacing inefficient boiler parts is allowed, why not a credit for replacing the whole furnace? And so on. While some discrimination is expected in direct spending programs, the deeply felt — albeit often violated — principle that the tax laws should be *fair* makes such distinctions seem less justifiable with regard to tax expenditures.¹³²

This special fairness requirement which we impose on tax incentives means that no one should think that we can treat tax preference legislation as fully equivalent to direct spending. Tax expenditure analysis in skilled hands can be a very useful tool, but it does not offer a complete means for evaluating new tax loopholes. The need to maintain public confidence in the tax system and to preserve the tax base from even further erosion cautions against enactment of tax expenditures even when an analysis based purely on efficiency may indicate, at least to Congress, that a tax subsidy is appropriate. This point has not been sufficiently stressed in recent years.¹³³

¹³² This feeling may explain why Jim Jeffords (R-Vt.) wanted to make the wood-burning stove credit retroactive to April, 1977. See text at note 42 *supra*.

There are other reasons why energy tax credits are so prone to expansion. One, which may be applicable to subsidies generally, is that once some energy items are eligible, manufacturers or installers of others find it necessary to gain eligibility in order to remain competitive. If insulation is paid for in part by the Treasury, for example, a product which combines insulation with exterior siding needs a similar subsidy if it is to be saleable. Another reason why energy credits are susceptible to expansion is that the normal opposition to tax expenditures on the part of liberals, who are usually concerned about retaining tax revenues for government social programs, has been particularly weak in the case of energy credits. This is due to several factors. One is that such tax expenditures are advocated by many of the do-good groups which are traditionally linked with liberals. Another is pure politics — many of the liberals are from New England, where the wood-burning stove credit is very popular, since everybody seems to be buying such a device. Still another has to do with the liberal opposition to decontrol of domestic oil prices. Having rejected the most effective means of stimulating solar energy and conservation, many liberals have desperately grasped for any substitute in order to present a pro-conservation, pro-solar image.

Until very recently, a notable exception to the tax reform apostasy of many liberals when it came to energy tax credits was the firm antagonism to the tax expenditure approach maintained by Senator Edward Kennedy (D-Mass.). Senator Kennedy coupled his opposition to oil decontrol with a detailed program of *direct* subsidies for conservation and alternative energy use. See 125 CONG. REC. S11507-13 (daily ed., Aug. 2, 1979). With the election of Ronald Reagan, however, even Senator Kennedy appears ready to abandon this effort. Following reports that the Reagan administration would recommend elimination of the Solar and Conservation Bank, see note 74 *supra*, Senator Kennedy proposed to double the business energy conservation tax incentives. See THE JOURNAL OF COMMERCE (Feb. 12, 1981).

¹³³ Professor McDaniel has pointed out that "public confidence, trust and respect . . . are not likely to survive long intensive hammerings of distrust and disrespect that are engendered by the frequently controversial and emotional areas into which tax expenditures project the

Perhaps the most far-reaching and disappointing result of the failure to appreciate these considerations involved President Carter's 1977 proposals for helping to solve the energy problem with tax subsidies.¹³⁴ Without doubt, these proposals were an important factor in defeating his 1978 tax reform program,¹³⁵ and they have probably set back tax reform many years. Responding to a *People & Taxes* survey on the future of tax reform in the 80's, Professor Stanley Surrey attributed part of the congressional shift away from reform goals to "the Administration's pushing of energy problem solutions that turn on the use of the tax system, especially tax credits (thus giving the Congress the idea that the erosion of the tax base was a target for anyone's goals)."¹³⁶

James Wetzler, chief economist for the Joint Committee on Taxation, offered a similar insight: "By my count, in three years the Administration has already proposed 18 different tax credits, 5 of which have been enacted and 4 of which are now pending in the energy tax bill. With that sort of leadership, it is no wonder that tax reform is in trouble."¹³⁷

Carter Treasury Department officials themselves ruefully admitted that their reform positions were undercut by President Carter's support of the Energy Department's preference for tax-based solutions to the energy problem. Witness the following exchange between Senator Bob Packwood and Deputy Assistant Treasury Secretary Daniel Halperin during a Finance subcommittee hearing on several "miscellaneous" — that is, special interest — tax bills:

Senator PACKWOOD. Mr. Secretary, . . . [y]ou and I have had a lot of go-rounds in the past, sometimes together, sometimes opposed on bills. The only argument that I no longer will accept is the Treasury's argument in opposition to bills because they are complex, because I don't find Treasury offering that argument [concerning] bills they support that are equally complex, and the classic example of course being, and I still wish we had been able to pass it, the classic example being the passive solar explanation by the Treasury Department last summer as to how their own bill worked, and whereupon the Ways and Means Committee threw up its hands

IRS," *Investment Credit Hearings*, *supra* note 3, at 36-37 (statement of Paul R. McDaniel), but he sees this problem as one of tax simplification and administration, rather than an equity issue.

¹³⁴ See note 21 *supra*.

¹³⁵ The details of President Carter's far-reaching tax reform proposals can be found in *The President's 1978 Tax Reduction and Reform Proposals: Hearings Before the House Comm. on Ways and Means*, 95th Cong., 2d Sess. 160 *et seq.* (1978). For a generally favorable analysis of this program, see *PEOPLE & TAXES*, March, 1978.

¹³⁶ *Looking Ahead*, *PEOPLE & TAXES*, Jan., 1980, at 2.

¹³⁷ *Id.* at 3. President Carter's 1977 proposed "National Energy Act" included tax credits for insulation, solar energy equipment, and cogeneration, and tax incentives for drilling geothermal wells. H.R. 6331, 95th Cong., 1st Sess. §§ 1101, 1301, and 1601 (1977). His 1979 program included tax credits for passive solar construction, solar process heat, woodburning stoves, shale oil production, unconventional natural gas, and gasohol. See *Phase III Hearings*, *supra* note 19, at 27-29.

and said it is too complex. And when they say that, it is complex

Mr. HALPERIN I would certainly agree with you on the complexity issue. We are as guilty of not using complexity against our own proposals as others are. We have given a good deal of testimony on that issue, . . . trying to suggest that we will restrain ourselves or try to restrain ourselves if we could get similar cooperation from others interested.¹³⁸

Although the Carter Treasury finally may have been prepared to restrain itself — or to try restraining itself — no such hesitancy to propose complicated new tax expenditures can be expected from the Reagan administration. President Reagan campaigned on a platform which stressed the need to add dozens of new preferences to the tax code, the total cost of which could exceed \$100 billion a year.¹³⁹ His new Treasury Secretary, formerly chief executive officer of Merrill Lynch & Co., appears to share the security industry's view that the tax system should concentrate on incentives rather than fairness,¹⁴⁰ and the new Undersecretary for Tax Policy has exhibited little interest in traditional tax reform goals in the past.¹⁴¹

Furthermore, at a time when budget cutting is at the top of the national agenda, tax expenditures have an almost irresistible political appeal, since they have the simultaneous effects of lowering budget receipts while providing government subsidies for favored activities. Yet the result of such a tax expenditure approach is to maintain the need for high tax rates, and even some members of the President's own party are unwilling to try to perpetrate such a hoax on the American people. Senator Nancy Kassebaum (R-Kans.), for example, has introduced legislation which would limit tax expenditures to 30% of the direct spending budget¹⁴² — a level which they already exceed.¹⁴³

¹³⁸ *Miscellaneous Tax Bills VI: Hearing Before the Subcomm. on Taxation and Debt Management Generally of the Senate Comm. on Finance*, 96th Cong., 2d Sess. 93-94 (April 25, 1980). The explanation of the administration's passive solar credits presented to the House Ways and Means Committee can be found in *Phase III Hearings*, *supra* note 28, at 54-67. For a pithy analysis of this explanation, see the comments of Rep. Andrew Jacobs, Jr. (D-Ind.), at note 34 *supra*.

¹³⁹ The Republican Platform for 1980, *reprinted in* 126 CONG. REC. S10379 *et seq.* (daily ed., July 31, 1980), advocates, at least implicitly, about \$60 billion in added business tax breaks and another \$40 billion in individual tax expenditures. See *PEOPLE & TAXES*, Oct. 1980, at 1.

¹⁴⁰ See, e.g., *Hearings Before the Senate Comm. on Finance*, 97th Cong., 1st Sess., 1981 (statement of Donald T. Regan, Secretary of the Treasury).

¹⁴¹ For example, on March 14, 1978, Norman B. Ture, now the Undersecretary of the Treasury for Tax Policy, cautioned the House Ways and Means Committee not to waste its time on "the petty niceties of conventional tax reform." *The President's 1978 Tax Reduction and Reform Proposals: Hearings Before the House Comm. on Ways and Means*, 95th Cong., 2d Sess. 3389 (1978).

¹⁴² S. 193, introduced by Senator Kassebaum on January 22, 1981, would also give the non-tax committees jurisdiction over tax expenditures designed to subsidize activities within their bailiwicks. See 127 CONG. REC. S553 (daily ed., Jan. 22, 1981).

¹⁴³ For fiscal 1981, tax expenditures total \$229 billion, JT. COMM. — TAX EXPENDITURES, *supra* note 3, at 15. This represents over 38% of the \$600 billion in direct spending estimated for fiscal 1981 by the Reagan administration. Office of Management and Budget, *Fiscal Year 1982 Budget Revisions* 123 (Mar. 1981).

Many members of Congress would be happy, however, to follow through with the Republican platform's policy of substituting tax expenditures for as many direct spending programs as possible.¹⁴⁴ Thus, Jack Kemp's "urban enterprise zones"¹⁴⁵ would replace some of the direct grants to cities. Tuition tax credits would be an alternative to education funding.¹⁴⁶ An above-the-line charitable deduction would substitute for grants to the arts and humanities and some poverty funds.¹⁴⁷ Even some liberal tax reformers are suggesting that it may be futile to fight the tide, and that the best strategy may be to accept the Republican approach and expand tax preferences to replace direct spending programs lost through budget cuts. In particular, some liberal Democrats are already preparing their list of proposed expansions of energy tax credits,¹⁴⁸ in response to the Reagan administration's plans to eliminate most direct subsidies for solar and conservation.¹⁴⁹ If the income tax is to survive this onslaught, tax reformers will have to wage an intensive defensive battle, and the lessons of the windfall profit tax debate ought to be kept in mind.

CONCLUSION

Tax expenditure analysis has always emphasized the comparison of proposed tax expenditures to hypothetical direct spending programs designed to achieve the same goals. The debate over the energy tax incentives proposed for inclusion in the windfall profit tax illustrates that Congress will pay more attention to complaints about the inefficiency and wastefulness of proposed tax preferences when direct spending alternatives are not only conceivable but are

¹⁴⁴ One wag has suggested that the Reagan administration might like to replace the entire budget with tax expenditures. Hilschne, *And That's The Way It Is*, *Wednesday, April 1, 1981*, TAX NOTES, March 30, 1981, at 675. For an analysis of the tax proposals in the Republican platform, see PEOPLE & TAXES, Oct. 1980, at 1.

¹⁴⁵ The Kemp-Garcia Urban Jobs and Enterprise Zone Act would provide a variety of tax incentives — including faster depreciation and reduced property, payroll, capital gains, and corporate income taxes — to firms, employees, and residents in certain distressed areas. See 125 CONG. REC. at S70007 *et seq.* (daily ed. June 13, 1980). The concept is endorsed in the Republican platform. See 126 CONG. REC. at S10385.

¹⁴⁶ The Republican platform's endorsement of tuition tax credits can be found in 126 CONG. REC. at S10384. On June 3, 1981, the Treasury Department endorsed the concept of tuition tax credits at Senate Finance Committee hearings on The Tuition Tax Relief Act of 1981, S. 550. See TAX NOTES, June 8, 1981, at 1327. Some of the Reagan administrations proposed cuts in federal education spending are detailed in Office of Management and Budget, *Fiscal Year 1982 Budget Revisions* 65 (Mar. 1981).

¹⁴⁷ The Reagan administration has proposed a 50% reduction in budget authority for the Arts and Humanities Endowments, *id.* at 65, and the Fine Arts Commission, *id.* at 62. Above-the-line charitable deductions are endorsed by the Republican platform in 126 CONG. REC. at S10385. For critiques of this tax proposal, see *Charitable Contribution Deductions: Hearings Before the Subcomm. on Taxation and Debt Management Generally of the Senate Comm. on Finance on S219*, 96th Cong., 2d Sess. 51 *et seq.* (1980) (statement of Donald C. Lubick, Assistant Treasury Secretary for Tax Policy); *id.* at 197 *et seq.* (statement of Robert S. McIntyre).

¹⁴⁸ See, e.g., note 132 *supra*.

¹⁴⁹ See R. Reagan, *America's New Beginning: A Program for Economic Recovery*, 4—24 (Feb. 18, 1981).

actually available. In general, therefore, those who criticize tax expenditure proposals should try to work out the details of direct spending substitutes with some precision, and, if possible, should attempt to propel them through the appropriate congressional committees. In the current political climate, reformers challenging new tax subsidies have the particular responsibility to defend existing spending programs, when they are defensible, and to propose changes in them when such changes are necessary.

The recent experience with the energy tax credits also indicates the dangers of relying exclusively on tax expenditure analysis in opposing undesirable amendments to the tax code and in promoting desirable changes. Reformers are right in showing that tax proposals advanced for reasons not germane to the purposes of the income tax almost always make bad spending programs. Yet, reformers stand little chance of achieving consistent success in the political arena if they so concentrate their arguments on spending comparisons that traditional fairness and tax policy concerns are relegated to a second class status. Many members of Congress and much of the public seem to believe that tax incentives are magical, and over ten years of exposure to tax expenditure analysis has yet to destroy this belief. Moreover, when the issue is merely spending, particularly spending which does not appear in the budget, Congress finds it difficult to resist the blandishments — and the potential campaign assistance — of the proponents of tax subsidies. Consequently, these proponents have little difficulty in presenting plausible, albeit flawed, justifications for their favored changes.

Reformers should therefore begin to reemphasize the traditional tax policy concerns which have been somewhat neglected in recent years. This means taking the time to explain to members of Congress how some tax provisions should be seen not as spending programs but as crucial tools in measuring incomes, and stressing the real dangers in distorting these basic tax rules. It also involves highlighting the importance of equal treatment of equally situated taxpayers — or horizontal equity — and the need for a tax system generally perceived as fair. Lastly, it demands an increased focus on the special administrative problems of the Internal Revenue Service and the importance of tax simplicity.

Such a reemphasis does not require the abandonment of tax expenditure analysis — which remains the single most valuable tool available to reformers. It does, however, involve dropping the pretense that Congress, in accepting or rejecting tax proposals, is merely making spending decisions. Congress also is deciding whether provisions of the tax code should conflict sharply with popular notions of fairness. If reformers are to defend the integrity of the income tax with any consistent success, they must convince Congress that ignoring these popular perceptions of equity is politically dangerous. To make such an appeal to its fullest degree, reformers must be willing to move beyond tax expenditure analysis.

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