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ALTERNATIVES TO UTILIZATION OF THE FEDERAL INCOME TAX SYSTEM TO MEET SOCIAL PROBLEMS

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As the urgency of meeting the nation's pressing social problems mounts, it is not surprising that proposals to utilize the tax system as a means of funding the various responsive efforts proliferate. The effort to reform our federal income tax system that culminated in the Tax Reform Act of 1969¹ shed considerable light on the potential of, and limitations inherent in, the use of the tax system as a tool for meeting social needs. Proposals to use the tax system to meet non-tax objectives must be evaluated by Americans in their dual roles as taxpayers and as citizens concerned with solving social problems. An informed judgment thus requires an understanding of the impact on the tax system—and hence on all taxpayers—of using tax measures for solving such problems.

The great cost of dealing with pollution, unemployment, education, housing, health care and other contemporary problems has led many concerned individuals and political leaders to examine and propose the use of what are generally referred to by their proponents as "tax incentives." Consideration of the merits of these proposals is better undertaken by examining a somewhat different concept—"tax expenditures." The phrase "tax incentives" tends to beg one of the significant questions to be answered in any federally financed project which requires cooperation of the private sector. Will persons

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¹ Pub. L. No. 91-172, Dec. 30, 1969, 1 U.S. Code Cong. & Ad. News 509-822 (1969) (codified at scattered sections of the Int. Rev. Code of 1954).

in private enterprise in fact be motivated to address themselves to a given problem, such as pollution, if federal funds are made available? Utilization of the concept of tax incentives by definition implies an affirmative answer to this critical question. Also, some theorists posit the federal income tax as a disincentive, so that selective modification of the tax burden for a given purpose would merely constitute removal of this disincentive effect, not a positive incentive. In this discussion, then, it will be more helpful to refer to the neutral and more descriptive term "tax expenditures." After outlining the tax expenditure concept and the impact of tax expenditures in general on the federal income tax system, this article will analyze the implications of the use of tax expenditures to solve three social problems: education, pollution and housing.

I. THE TAX EXPENDITURE CONCEPT

A. *The Analytical Framework*

Tax expenditures may take the form of tax deductions, tax credits, deferrals of tax, preferential rates or exemptions from tax. Many of the deductions in the tax Code arose out of a conscious effort to encourage a particular type of activity. The deduction for charitable contributions² appears to be such a provision. On the other hand, many of the present tax preferences have arisen more by accident than by design, frequently because policymakers or administrators did not fully recognize the implications of their actions. The deduction for percentage depletion³ and preferential tax rules for farmers⁴ are examples of this kind of special tax benefit. Interestingly, these latter tax preferences are now defended by their beneficiaries as needed incentives for the particular economic activity affected.

The adverse effects of these tax preferences on the equity of the federal income tax system have long been recognized by tax theorists.⁵ But another consequence has only recently been recognized and brought to public attention—that these tax preferences in fact constitute public expenditures just as much as direct expenditures of federal funds resulting from the normal congressional appropriations process. This analysis was articulated by former Secretary of the Treasury Joseph Barr in testimony before the Joint Economic Com-

² Int. Rev. Code of 1954, § 170.

³ Int. Rev. Code of 1954, §§ 611-14.

⁴ See, e.g., Int. Rev. Code of 1954, §§ 175, 182. For an excellent discussion of these rules, see Davenport, *A Bountiful Tax Harvest*, 48 Texas L. Rev. 1 (1969).

⁵ See, e.g., Blum, *Federal Tax Reform—Twenty Questions*, 41 Taxes 672 (1963); Kurtz, *Federal Income Tax Reform—Their Use and Misuse*, U. So. Cal. 1968 Tax Inst. 1; Stone, *Tax Incentives as a Solution to Urban Problems*, 10 Wm. & Mary L. Rev. 647 (1969); Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison With Direct Government Expenditures*, 83 Harv. L. Rev. 705 (1970).

mittee in January, 1969,⁶ and in the 1968 *Annual Report of the Secretary of the Treasury*.⁷ Simply stated, the Treasury thesis is that a tax preference item can be viewed as if the Internal Revenue Service had collected the tax from the taxpayer claiming the tax benefit and then Congress had appropriated the funds for payment in the amount of the tax preference for the specified purpose.

The inequity of tax preferences can be seen by examining the deduction for interest paid on home mortgages⁸—a provision which has been considered an incentive to encourage home ownership. This tax benefit, when viewed as a tax expenditure, in effect says that if a married couple has more than \$200,000 of income, then for each \$100 of interest liability that is incurred on their home mortgage, the federal government will pay \$70 to the savings and loan association if the homeowner will contribute \$30. This result, of course, merely reflects the after-tax impact of the interest deduction for a 70 percent bracket taxpayer. But for the taxpayer in the 20 percent bracket, present tax expenditure policy provides that the homeowner must pay the lending institution \$80 in interest in order to obtain a \$20 matching grant from the federal government. And if a person with little income who does not earn enough to pay federal income tax buys a house, the federal government will not contribute anything through the tax expenditure mechanism to assist in his interest payments.

Tax expenditure analysis thus confronts the policymaker with the question whether the result described represents a rational approach to encourage home ownership by our citizens. More pointedly, would Congress enact a system which would provide for direct payment of the government's share of the interest expense in the proportions that result under our present tax rules?

Other tax preferences can be similarly recast as tax expenditures. Thus, the percentage depletion allowance⁹ can be viewed as a tax expenditure to encourage drilling activity; the preferential rate for capital gains¹⁰ as a subsidy for entrepreneurial business activity; and the medical expense deduction¹¹ as a federal program to share medical costs. The mode of federal participation in a particular transaction

⁶ Hearings on the 1969 Economic Report of the President Before the Joint Economic Comm., 91st Cong., 1st Sess. 8-44 (1969).

⁷ 1968 Sec'y Treas. Ann. Rep. on the State of the Finances 326-30. For a debate on the validity of the Treasury thesis, see Bittker, Accounting for Federal "Tax Subsidies" in the National Budget, 22 Nat'l Tax J. 244 (1969); Surrey & Hellmuth, The Tax Expenditure Budget—Response to Professor Bittker, 22 Nat'l Tax J. 528 (1969).

⁸ Int. Rev. Code of 1954, § 163.

⁹ Int. Rev. Code of 1954, §§ 611-14.

¹⁰ Int. Rev. Code of 1954, § 1201.

¹¹ Int. Rev. Code of 1954, § 213.

through tax expenditures may vary depending on the form in which the tax benefit is cast. The federal contribution may resemble a low cost loan program, an interest subsidy or a direct or matching grant system. But a tax expenditure may always be recast in the form of a direct non-tax financial benefit conferred by the government.

B. *Identifying the Tax Expenditure*

Once the operation of a tax expenditure has been described, it becomes necessary to differentiate between provisions in the tax laws which constitute tax expenditures and provisions which are an integral part of the tax structure. In order to establish differentiating criteria one fundamental judgment must be accepted—a tax system has an internal logic that results from the values society has determined inhere in a fair tax system. Society may employ different values in choosing its variety of tax systems. For example, the federal individual income tax system expresses society's judgment that this fundamental tax should be progressive; the more income one receives, the higher rate of tax he should pay on his last dollar of income. A different value judgment underlies sales taxes, however, which bear on all persons in proportion to their taxable purchases regardless of income. The point is that certain criteria can be articulated which will differentiate provisions that merely involve a working out of the implications of society's judgments about the nature of the tax system from provisions which in fact are antithetical to the fundamental precept of the particular tax system.¹²

Within the context of the federal income tax system, the following criteria are suggested to identify tax expenditures:

1. Any item determined to be income that is exempt from tax.
2. Any item that reduces progressivity.
3. Any item that can be restated as a program of direct financial assistance without violating the precepts of a progressive income tax system.

These three principles overlap, but each deals with a somewhat different problem. The first criterion deals with the question of exemptions from tax. In the federal income tax system, society has chosen to tax "income." Thus, variations in the tax load resulting from determinations of what kinds of receipts are treated as income do not constitute tax expenditures. A determination by Congress or the courts that a given receipt of money or property constitutes a return of capital, and not income, does no violence to the internal

¹² The analysis that follows relies in substantial part on the formulation developed by Professor Surrey in the article cited in note 5 *supra*.

logic of the income tax system. Similarly, the rule that a recovery of taxes previously paid does not constitute income is entirely consistent with the logic of an income tax system, and exclusion of such an item from the tax base will do no violence to progressivity, since this conclusion is consistent with an economic view that there has been no net accretion in wealth that would justify treating the item as income.¹³ On the other hand, once an item is determined to be income, such as interest on state and local bonds, then exemption from tax violates the logical demands of an income tax system. Exemption of state and local bond interest from tax,¹⁴ therefore, would constitute a tax expenditure under any income tax system whether progressive or proportional.

The second criterion is that any provision in the federal income tax laws that reduces progressivity constitutes a tax expenditure. This principle would also apply to tax exemption once the definitional hurdle is cleared, but is useful primarily in analyzing deductions and deferrals of tax. Business deductions¹⁵ and deductions related to the cost of producing income¹⁶ are not tax expenditures. The internal logic of a tax on net income dictates that these deductions do not adversely affect progressivity, but rather flow from society's judgment that the tax is imposed on net income. This second criterion is concerned with three types of tax provisions: (1) personal deductions, such as charitable contributions,¹⁷ (2) tax provisions which alter the timing of deductions so as to permit a mismatching of income and the expense of producing that income, such as accelerated depreciation of real estate,¹⁸ and (3) deductions in amounts which exceed the cost of producing income, such as percentage depletion.¹⁹ Each of these three provisions does violence to the fundamental precepts of a progressive income tax system in two ways. First, these provisions permit two taxpayers with the same amount of economic income to pay different amounts of tax. Second, a person with a larger income may pay the same or a lower amount of tax than another taxpayer with less income.

The third criterion is that a tax expenditure is any item which

¹³ No attempt is made here to define the processes by which agreement is reached that a particular receipt constitutes income. For purposes of this article the Simons definition is accepted as normative: "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." H. Simons, *Personal Income Taxation* 50 (1938).

¹⁴ Int. Rev. Code of 1954, § 103.

¹⁵ Int. Rev. Code of 1954, § 162.

¹⁶ Int. Rev. Code of 1954, § 212.

¹⁷ Int. Rev. Code of 1954, § 170.

¹⁸ Int. Rev. Code of 1954, § 167.

¹⁹ Int. Rev. Code of 1954, §§ 611-14.

can be restated in terms of a direct government program of financial assistance, *without violating the progressivity concept*. The italicized portion of this criterion is necessary in order to account for rate differentials in a progressive tax system. If an exemption of an income item constitutes a tax expenditure, it might be argued that a rate differential also constitutes a tax expenditure to the person who pays at the lower rate. For example, assuming two individuals, one with an effective tax rate of 50 percent, and the other of 20 percent, would tax expenditure analysis assert that the 20 percent rate can be viewed as if the government had collected tax at a 50 percent rate and made a direct grant back to the lower income individual of the taxes represented by the 30 percent differential? The answer to this question is no, because, as so restated, the direct expenditure assumes a principle that is directly antithetical to a progressive tax system—a proportional income tax system which utilizes a 50 percent rate. Thus, under the proposed criterion, the rate differentials in a progressive tax system do not constitute tax expenditures.

The personal exemption²⁰ is another provision which is not conceptually a tax expenditure. The personal exemption simply constitutes a dollar amount of income which is taxed at a zero rate. So viewed, a basic personal exemption is not a tax expenditure, since taxing a given amount of income at a zero rate is no more regressive than taxing it at 1 percent or 14 percent. This point would be patently clear if the tax system employed negative rates.

On the other hand, the additional exemptions for the elderly²¹ and the blind²² do constitute tax expenditures. These exemptions are awarded on the basis of a factor unrelated to income, namely, age or physical condition, and thus violate both the logical integrity of an income tax system and the principle of progressivity. Also, the basic personal exemption in present law can be viewed as containing a partial tax expenditure element to the extent the amount varies with family size. While it is logically defensible to tax a given amount of income at a zero rate, the size of that income bracket should not vary on account of a factor unrelated to income, namely, the size of the family.²³

C. Arguments Against Tax Expenditures

The fundamental argument against tax expenditures from the standpoint of tax theorists is that each tax preference reduces the

²⁰ Int. Rev. Code of 1954, §§ 151(b), (e).

²¹ Int. Rev. Code of 1954, § 151(c).

²² Int. Rev. Code of 1954, § 151(d).

²³ The underlying problem here is, of course, defining the basic economic unit to be taxed. Is it a single person, a married couple with no children, or some other family size?

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fairness of the tax system. No tax expenditure has yet been proposed that avoids this criticism. The tax preferences in the present system, and those which have been proposed, either provide a greater benefit to those in the 70 percent bracket than to those in the 20 percent bracket, or permit different taxpayers with the same income to bear a dissimilar tax burden on account of factors extraneous to the production of income. And, of course, tax incentives provide no benefit to a person who is not on the tax rolls.

The other major defects cited by opponents of tax expenditures are by now well known,²⁴ and will be only mentioned here. The weight of these objections can be better evaluated in the context of the particular tax provisions discussed below. Tax expenditures constitute, as Chairman Mills has asserted, "backdoor" spending,²⁵ for these expenditures are insulated from annual congressional review in the appropriations process. Thus, this form of federal expenditure tends to remain imbedded in our economic structure long after its usefulness or desirability has ceased. Tax expenditures are inefficient to the extent that they reward taxpayers for engaging in a course of conduct they would have followed in any event. In addition, funds may be expended in low rather than high priority areas, since there is generally no control over allocation of funds.

Tax expenditures, it is also urged, result in a misallocation of resources, both public and private. In the private sector, tax incentives encourage capital to be utilized in a manner which will maximize the tax benefit. But the resulting allocation of capital may not be directed to the most efficient or even the most desirable solutions to the problem addressed. In short, the existence of tax preferences distorts the normal businessman's decision making process. From a national standpoint, since tax expenditures are not subject to the appropriations process, tax expenditures automatically assume a role of first priority for our national expenditures in an amount determined solely by the beneficiaries of each preference. The 1968 *Treasury Study* identified over \$40 billion in annual tax expenditures.²⁶ This is a very substantial amount of federal funds to expend each year without any congressional review, especially when these expenditures result in other taxpayers paying high rates of tax to provide revenues needed for direct federal programs.

D. *Arguments for Tax Expenditures*

To list the arguments *against* expenditures through tax preferences is in a sense to set forth the arguments *in favor of* the use of

²⁴ See Surrey, *supra* note 5.

²⁵ Address by Hon. Wilbur D. Mills, Meeting of the American Institute of Certified Public Accountants, Washington, D.C., Oct. 18, 1968.

²⁶ 1968 Sec'y Treas. Ann. Rep. on the State of the Finances 339-40.

tax incentives. For example, in answer to those who assert that tax expenditures are not reviewed by Congress, proponents of tax expenditures argue that one of the benefits is that taxpayers can plan their affairs with the certainty that the rules of the game will not be quickly changed, and the level of funding will not ride the appropriations "roller coaster" which marks so many federal programs. Similarly, it is argued that federal expenditures through tax incentives leave room for private initiative and decision making, free of bureaucratic constraints and lack of imagination. Tax incentives, so viewed, represent a commitment to private enterprise in our economic system, and, if properly structured, need lose little in terms of efficiency or effectiveness. Proponents also argue that tax incentives are simple and do not involve the red tape that is the hallmark of federal programs. Finally, and of direct interest to the present discussion, tax incentives can involve private business and individuals in the solution of the country's social problems.

E. Toward a Resolution of the Conflict

The foregoing analysis of the nature of tax expenditures and the arguments for and against their use permit certain conclusions. First, the difference between tax expenditures and direct expenditures is that the use of tax expenditures will impair the fairness of the income tax system. Second, any tax expenditure can be translated into and effected by a direct expenditure of appropriated funds and still satisfy the asserted advantages of a tax preference. For example, a direct federal grant or loan program can be drafted and operated as simply, and with the same degree of freedom from government control as a tax expenditure, if these are determined to be the overriding criteria for the program. Third any direct expenditure program can be drafted as a tax expenditure program in such a way as to avoid the disadvantages that opponents of tax incentives cite. For example, a one-year termination date can be placed on tax expenditures to insure annual congressional review in the light of budgetary needs and priority controls. Fourth, it is clear that an argument for tax incentives is not really an argument for any inherent advantages of federal spending through the tax system. It is in fact an argument in favor of federal spending for specific purposes as opposed to less or no federal spending for those purposes. The asserted advantages of tax incentives are quite independent of the tax system and can be as easily realized in a direct expenditure program.

If these conclusions are valid, then the conflict between the two positions can be seen in more fundamental terms. Those who oppose use of the tax system to meet social or economic problems do so not

because they oppose expenditure of federal funds for the desired purpose, but because they do not want to see the funds expended in a manner which will impinge on one of the fundamental values of our society—a progressive income tax system.

Proponents of tax incentives, on the other hand, feel that the social need of the proposed object of the federal expenditure overrides the value to society of a fair tax system in the particular area of their concern. It is so important that funds be expended for the prescribed purpose that any means of securing the funds must be adopted. But as social needs multiply, these demands in the aggregate can undermine society's value judgment that a progressive tax system is the fair and proper measure of each citizen's contribution to government.

Thus, the strategy for those who desire to maintain the integrity and purpose of a progressive income tax system is becoming increasingly clear. To prevent the use of or to effect the removal of tax preferences in order to attain a fair tax system, tax reformers must not only point out the deleterious effects of tax incentives, but must also point the way to funding a solution of the social need giving rise to the demand for tax expenditures. This requires that the tax purist be able to identify and quantify the contours of the demand being made in each area of social need and suggest alternatives which will satisfy these desiderata while preserving a fair income tax system.

It is instructive to examine the use of tax incentives in three areas of social need—education, pollution, and housing—and to analyze the impact of those provisions in light of the tax expenditure concept. If the above analysis is correct, this discussion should suggest alternative solutions which will meet the dual moral imperative: a fair tax system, and federal financial assistance to meet these specific social problems.

II. TAX EXPENDITURES FOR EDUCATION

Present tax laws provide federal financial assistance to education at several different levels. A charitable contribution deduction is granted to individuals who contribute to educational institutions.²⁷ Tax exemption is accorded to qualifying educational organizations.²⁸ A personal exemption is accorded to the parents of a student even though he is over age 18 and has some income of his own.²⁹ Receipts constituting scholarships or fellowships are excluded from income.³⁰

²⁷ Int. Rev. Code of 1954, § 170.

²⁸ Int. Rev. Code of 1954, § 501.

²⁹ Int. Rev. Code of 1954, § 151(e)(1)(B)(ii).

³⁰ Int. Rev. Code of 1954, § 117.

This article will focus primarily upon the most significant federal tax expenditure for higher education—the charitable contribution deduction.

The charitable contribution deduction clearly constitutes a tax expenditure. A \$100 cash gift to his college by an individual in the 70 percent bracket is equivalent to an expenditure by the federal government of \$70, with a net cost to the donor of \$30. But if a 25 percent bracket taxpayer gives \$100 to the same college, the government will only bear \$25 of the cost of this gift. An individual who does not itemize his deductions or who pays no federal income tax assumes the full burden of his \$100 gift.

If one views this system as a matching federal grant system its inherent irrationality is striking. A direct grant statute modeled on present tax rules would provide that the federal government would match the gift of married individuals who have more than \$200,000 of income on the basis of \$7 for each \$3 they contribute to charity. For those with \$52,000 of income, the federal matching formula is \$5 for each \$5 donated. If the donor's income is \$16,000, for each \$7.50 given, the government would pay \$2.50 to the charitable recipient. If this direct matching system were presented to Congress as the proper incentive for charitable giving, it is safe to predict that it would receive short shrift. Yet this is precisely the effect of the present expenditure mechanism embodied in federal income tax laws.

The impact of this system on the tax laws is directly inverse to the theory of a progressive tax system. The underlying rationale of present rules is that the more money a person has with which to make charitable gifts, the less it costs him to make the gift. Conversely, the less money he has with which to make charitable gifts, the more out-of-pocket expense he must absorb.

The situation is aggravated when gifts are made in the form of appreciated property. In this transaction, not only is a deduction granted for the full fair market value of the property, but the income represented by the gain is not subject to tax. This combination of exemption of income plus full deduction produces even more peculiar results as an expenditure policy. For example, if a 70 percent bracket donor makes a gift of property worth \$100 with a basis of zero, the government grants a \$70 tax reduction via the deduction plus a \$35 tax reduction in the form of a forgiven capital gains tax.⁸¹ A corresponding direct expenditure system would look as follows: If a married donor with more than \$200,000 of income makes a gift of \$30 to charity, the government will make a grant to the charity of

⁸¹ This example assumes that the donor has more than \$50,000 in gain and the provisions of § 1201 for taxable years beginning in 1972 apply.

\$70 and return \$35 of tax to the donor. In other words, the government will pay \$105 to encourage a \$100 gift to charity if the donor is in the highest tax bracket. On the other hand, a married donor with \$52,000 of income wishing to benefit his college in the amount of \$100 would have to make a gift of \$50 to charity, which the government would match with \$50, and would return only \$25 to the donor. In this latter case, it costs the government only \$75 to induce the \$100 charitable donation.

This analysis not only indicates the unfairness inherent in the tax rules governing charitable gifts of appreciated property, but also delineates the unequal treatment given to gifts of cash, even though the dollar benefit the charity receives is identical. The difference in treatment in terms of direct expenditure analysis is that the donor of appreciated property pays no tax on the income from which the gift is paid, whereas the donor of cash makes his gift out of after-tax income.

Tax expenditure analysis thus demonstrates the irrationality and unfairness of the present system of providing tax incentives to education through the charitable contribution deduction. Why then is such a system continued? The answer can be found in the testimony of the colleges and universities, and some wealthy donors, before the Senate Finance Committee in connection with proposed changes in the tax reform bill⁸² affecting the charitable contribution deduction.⁸³ Attention in the Senate primarily was concentrated on proposed changes in the treatment of gifts of appreciated property and on indirect methods of limiting the benefits of the charitable contribution deduction provision, such as through the minimum tax proposal.⁸⁴

Colleges and universities presented a highly organized front in the hearings before the Senate Finance Committee. Their position can be simply stated.⁸⁵ Education is of critical importance to the social, economic and political progress of the United States; institutions of higher learning must have ever increasing funds to meet educational needs; the charitable contribution deduction helps provide funds. Therefore, colleges and universities oppose any change in tax

⁸² H.R. 13270, 91st Cong., 1st Sess. (1969).

⁸³ See, e.g., Hearings on H.R. 13270 Before the Senate Comm. on Finance, 91st Cong., 1st Sess., pt. 3, at 2009-20 (1969) (statement of John D. Rockefeller III) [hereinafter cited as *Hearings*]; id. at 2041-73 (statement of Dr. Ernest L. Wilkinson, President, Brigham Young University, on behalf of the American Association of Independent College and University Presidents); id. pt. 4, at 3342-67 (statement of Hon. Douglas Dillon, former Secretary of the Treasury).

⁸⁴ See §§ 301-02 of H.R. 13270, 91st Cong., 1st Sess. (1969), as passed by the House of Representatives. See also H.R. Rep. No. 413, 91st Cong., 1st Sess., pt. 1, 77-80 (1969).

⁸⁵ The testimony before the Senate Finance Committee, which the following discussion summarizes, appears at *Hearings*, pt. 3, at 2009-20, 2041-2277, 2493-2664.

provisions which might result in reduced amounts being donated to them by private individuals.

Colleges and universities made two basic arguments to support their contention that changes in the rules for the charitable contribution deduction would impair their financial condition. First, they argued that the tax deduction generally, and the special treatment for gifts of appreciated property in particular, constitute incentives to charitable giving. They concluded that any diminution in the tax incentive would correspondingly reduce funds available for education. Second, they asserted that private support of education is important in a pluralistic society, and that the tax laws should encourage participation by the private sector. It is important to evaluate these arguments since they highlight the dimensions that a more rational federal tax policy must assume.

In 1967 individuals claimed charitable contribution deductions of over \$9 billion.³⁶ Of this amount, 92 percent was given in the form of cash and only 8 percent in the form of property. These figures reflect only gifts by persons who itemized their deductions; additional gifts by persons claiming the standard deduction are estimated to be approximately \$4 billion.³⁷ Identification of the disincentive argument by charities is difficult. It is clear that the tax laws provide no incentive for giving by non-itemizers. It is reasonable to expect that their charitable gifts would remain the same regardless of changes in the deduction. Some studies have also indicated that nontax considerations primarily motivate donors who itemize in income tax brackets below 40 percent.³⁸

Thus, the disincentive argument of the colleges and universities would appear to be confined largely to taxpayers above the 40 percent bracket, and to the special treatment accorded gifts of appreciated property. Less than 1.5 million taxpayers out of over 27 million contributors fall in these high income brackets, but they contribute about one-fourth of the \$9 billion in itemized charitable contributions and almost two-thirds of the gifts of appreciated property.³⁹

Colleges and universities maintain that they would be seriously affected by any changes because they are especially reliant on large gifts by wealthy donors and on gifts of appreciated property. The present difficulty is that there is no reliable quantification of the dis-

³⁶ Internal Revenue Service, U.S. Treas. Dep't, 1966 Statistics of Income, Individual Income Tax Returns 50 (1968).

³⁷ This estimate is based on data appearing in U.S. Treasury Dep't, Tax Reform Studies and Proposals, pt. 2, at 194-200 (reprinted by House Ways and Means Committee & Senate Finance Committee 1969) [hereinafter cited as *Studies*].

³⁸ C. Kahn, *Personal Deductions in the Federal Income Tax* 62 (1960).

³⁹ Internal Revenue Service, *supra* note 36, at 50.

incentive effect on these donors of changes in the tax rules. It is uncertain whether charitable contributions would be reduced by \$1, \$.50 or \$.25 for each \$1 of additional taxes that were required to be paid. Presumably there is a role for systems analysis in this situation to provide some insight as to the probable effects of any proposed changes. What is significant for the present discussion is that this possibility of reduced contributions to colleges and universities must be taken into account as one parameter of any proposed new system of encouraging charitable giving.

The second tenet of the colleges and universities is that private philanthropy must be encouraged through the tax system to insure pluralism in our total educational effort. But the American Council on Education testified that only 1 percent of all donors gave 75 percent of the gifts to higher education in 1967-1968.⁴⁰ Since these gifts obviously come from the wealthiest members of society, from the standpoint of tax reformers it appeared that the tax preferences involved in the charitable deduction rules were a very high price to pay for a very minimal amount of pluralism. Nonetheless, any proposal for change must reflect the underlying concern that private individuals need to be involved in and have the right to select the objects of their philanthropy.

In sum, opponents of tax expenditures through the charitable contribution deduction argue that the present system is defective on several counts. For the vast majority of givers, the deduction is simply a windfall which pays them to make gifts they would make in any event. In some cases, the cost of the gift to the government is greater than the amount the charity receives. As such, the federal expenditure is inefficient and wasteful. The present tax rules are inequitable, giving a larger benefit to the wealthy than to lower income taxpayers and manifesting a marked preference for those who can make their charitable gifts by using appreciated property as compared to those who must use cash.

Proponents of present tax incentives for charitable giving essentially are concerned that badly needed sources of revenue for education will be removed with elimination of the tax preferences. They want to encourage private involvement in education and to be free of the vagaries of government control and the annual appropriations process.

In the consideration of the Tax Reform Bill these two positions passed each other without making constructive contact. Tax reformers reacted adversely to the general refusal of charities to consider seriously the inequities inherent in present tax rules. On the other hand,

⁴⁰ Hearings, pt. 3, at 2186 (statement of Prof. Julian Levi, University of Chicago).

colleges and universities seemed generally to conclude that insistence on removal of tax preferences implied a lack of concern for education.⁴¹ Nonetheless, out of this debate emerges the contours of a viable new system that can satisfy the legitimate concerns of each of these positions.

From the standpoint of tax equity, the answer is that the deduction for charitable contributions must be eliminated, and that transfers of appreciated property will constitute taxable transactions. But, as suggested above, advancement of this proposition imposes the responsibility on tax reformers of proposing an alternative means of meeting the social problem—here education. It was the failure to provide such an alternative that led to the defeat of many of the admittedly limited reforms advocated for the Tax Reform Bill. But the testimony of colleges and universities and of philanthropists suggests at least the conditions which must be met by such non-tax alternatives. First, educational institutions must be assured that present and projected levels of support equal that which they can reasonably anticipate from the present tax expenditure system. Second, the process must be free of federal control. Third, private donors must have a voice in determining the recipients of charitable support. These criteria can be met without impairing the equity of the income tax system.

The proposal suggested for consideration is a shift to a direct federal matching grant system. A formula would be employed through which the federal government would automatically match all or a portion of a contributor's gift to charity. The proper index for the formula would appear to be the proportion of a taxpayer's total economic income that he gives to charity. For example, the new system could provide that if a person gives 10 percent of his total economic income to charity, the Treasury will match his gift, dollar for dollar. The taxpayer who gives 5 percent of his income to charity would have one-half of his gift matched by the Treasury, and so on. Detailed analysis would be required to determine the exact formula needed to provide funds to charity of the magnitude required and at a level consistent with projected federal revenue needs.

Such a system would introduce equity into our federal tax system while still encouraging charitable giving, for, under the proposal, the low income individual who gives a large share of his income to charity will have his gift matched on the same basis as a wealthy individual who gives the same percentage of his income. As noted above, this is not the result under the present tax expenditure system.

The proposal, of course, means that charitable institutions re-

⁴¹ See, e.g., the exchanges at Hearings, pt. 3, at 2045-50, 2192-94, 2237-43.

ceiving gifts from the vast majority of givers who are not tax motivated will benefit more from these gifts than they do at the present time. There is no reason to expect that changes in the tax rules will result in a significant reduction in the level of giving by these individuals. On the other hand, educational institutions may derive somewhat less benefit from gifts by wealthy individuals. For example, a \$100 gift by a 70 percent taxpayer now costs him only \$30. If we assume that he will reduce his gift with the removal of the tax benefit to his present \$30 cost, his college could only get a maximum of \$60 if a dollar for dollar matching system were adopted as the upper limit of the Treasury contribution. To transfer the same \$100 to his college, this taxpayer would have to increase the out-of-pocket cost of his gift to at least \$50.

To preserve individual choice and involvement, each donor would be entitled to designate on his tax return the organizations which are to receive the matching gifts triggered by his donations. The donor could also specify the amounts each designated institution is to receive. Further, a permanent appropriation could be provided for the federal matching funds triggered by the formula. This would provide certainty to charities and freedom from problems of the annual appropriations process.⁴²

A liberal period of time would be required during the transition to the new system to insure stable levels of receipts for charitable organizations. In addition, during the transition period, one deviation from equity might be considered to ease the problems of institutions of higher education which rely heavily on large gifts. The top matching formula might be triggered by any gift in excess of a substantial minimum amount, regardless of the percentage of the donor's income represented by the gift.

The proposed system would facilitate consideration of the relative priorities society might wish to place on various charitable activ-

⁴² Federal incentives for charitable giving, recast in this mold, present rather interesting implications for the role of private foundations. If private foundations were to continue to qualify as charitable recipients, Congress would be squarely faced with the implications of the following pattern: A wealthy donor could create a private foundation. Upon making a gift to that foundation, he would trigger a matching grant by the federal government to his foundation. The federal portion would then be fully controlled by the trustees of the foundation who would only be required to meet the income payout and other foundation rules passed by Congress. It is interesting to speculate whether Congress would acquiesce in a system that permanently placed federal funds in the hands of a foundation created by the donor and insulated from publicly determined priorities. But, of course, as Senator Gore of Tennessee pointed out in his proposal to limit the tax exempt life of foundations to 40 years, this is precisely the system we now have via the tax expenditure mechanism. 115 Cong. Rec. S. 12,232-5 (daily ed. Oct. 9, 1969). The direct matching proposal at least permits Congress to face squarely the implications of channeling charitable contributions through the medium of private foundations.

ities. If education is of first priority, then a higher matching formula could be provided for it than for a lower priority charitable activity. The present tax system accomplishes this result in a rough fashion by placing differing limits on deductible contributions, but the direct matching system would enable Congress to make more sophisticated judgments.

This proposal seems to satisfy the requirements of tax reformers and educational institutions alike. Further analysis is, of course, required. The attempt here is simply to provide a framework within which those concerned with two vital social needs can cooperatively achieve their respective goals—tax equity, and insuring funds sufficient to meet our pressing educational requirements.

III. TAX EXPENDITURES FOR POLLUTION CONTROL

With the quality of the environment occupying stage center of our social and political awareness, demands for funding of antipollution efforts through tax incentives are inevitable. Tax expenditures specifically for antipollution efforts had their genesis with the suspension of the investment credit in 1966 when an exception was made continuing the 7 percent investment credit for pollution control facilities during the suspension period.⁴³ Pollution control facilities also were granted an exception to the repeal of the tax exempt status of industrial development bonds in 1968.⁴⁴ Thus it was not too surprising that, when President Nixon recommended repeal of the 7 percent investment credit in April, 1969,⁴⁵ testimony submitted to the House Ways and Means Committee suggested that an exception be made for pollution abatement facilities.⁴⁶

The Treasury and the Department of Health, Education and Welfare (HEW) opposed any exception to preserve the investment credit for antipollution devices. From the Treasury standpoint, of course, creation of this exception would merely invite other exceptions, and thus erode the effectiveness of repeal of the investment credit as an antiinflationary measure. But Secretary Finch, in a letter to the Committee, spelled out objections to such an exception from the standpoint of the nation's pollution control efforts.⁴⁷ He argued that the tax expenditure would not be a stimulus to pollution abatement.

⁴³ Act of Nov. 8, 1966, Pub. L. No. 89-800, § 1(a), 80 Stat. 1508, 1511-12, formerly Int. Rev. Code of 1954, § 48(h)(12).

⁴⁴ Int. Rev. Code of 1954, § 103(c)(4)(F).

⁴⁵ Message from the President of the United States Regarding Tax Reform, H.R. Doc. No. 103, 91st Cong., 1st Sess. (1969).

⁴⁶ See, e.g., Hearings Before the House Ways and Means Committee on the President's Proposal to Repeal Investment Tax Credit and to Extend Tax Surcharge and Certain Excise Tax Rates, 91st Cong., 1st Sess. 158, 167, 193, 202, 309 (1969).

⁴⁷ *Id.* at 129-30.

Since the necessary equipment yields little or no return, alternative uses of funds would be economically more attractive. Hence any "incentive" effect of a tax preference was doubtful. Further, HEW argued, the prime incentive for industry to engage in pollution abatement efforts arises from state and local regulatory requirements. Thus, the tax expenditure was simply paying businesses to do what they would have to do in any event.

Under this analysis the proposal to provide an investment credit for pollution control facilities simply amounted to cost-sharing by the federal government. The testimony before the Ways and Means Committee by industry representatives by and large confirmed this view. Virtually without exception private industry representatives argued that they were being forced by local regulations to install pollution equipment, that the equipment would not increase profits and was being installed for the public good, and therefore the public should bear part of the cost through the mechanism of an investment credit.

Several questions immediately arise. Is the cost sharing really needed? If so, is industrial investment in depreciable hardware the best form of investment for effective pollution control? And, finally, who should properly bear the cost of cleaning up industrial pollution?

Secretary Finch pointed out that the cost to industry of effective pollution control efforts is quite small.⁴⁸ A 1967 Report by an inter-agency Working Committee on Economic Incentives entitled *Cost Sharing With Industry?*, concluded that the annual cost of effective air and water pollution abatement would be less than one third percent of value-added by all manufacturing and electric power industries.⁴⁹ This relatively small cost did not appear to warrant federal cost-sharing.

The federal subsidy through the investment credit was also considered an inefficient and, in the long run, possibly undesirable approach to pollution abatement. The investment credit could only be available for investment in end-of-the-line hardware. Thus, there would be a marked incentive for businesses to use hardware as a solution to every pollution problem, precluding concentration on changes in fuel, processing techniques, or changes in raw materials utilization, none of which could qualify for federal tax cost-sharing funds. Technically, these latter methods appear to offer sounder long range approaches to pollution abatement, and Secretary Finch therefore argued that the tax

⁴⁸ Id. at 129.

⁴⁹ *Cost Sharing With Industry—Summary Report of the Working Committee on Economic Incentives* (Revised) 3 (Nov. 20, 1967). The Working Committee is one of several committees under the aegis of the Federal Coordinating Committee on the Economic Impact of Pollution Abatement.

credit would subsidize the more inefficient and ineffective techniques.⁵⁰

Despite Treasury and HEW opposition, and with no substantive supporting study, the Ways and Means Committee voted a special five-year rapid amortization provision for certified pollution control facilities.⁵¹ Under this provision, a taxpayer could deduct his total cost in five years even though normal tax depreciation rules would establish a longer useful life for the property. While this provision was intended as a substitute for the repeal of the 7 percent investment credit, interestingly enough, some long-lived equipment would have received a tax benefit from the new rapid write-off provision equal to a 20 percent investment credit. Through this new provision the tax writing committee of the House in effect appropriated \$400 million annually to share costs for an effort that from the evidence available needed no subsidy, and for an approach which would in the long run be ineffective and inefficient. Further, consideration of pollution efforts by the substantive congressional committees had indicated that the money would be better spent on basic research, in assisting state and local government efforts.⁵² As evidence arises that pollution efforts must be mounted on a regional basis, the tax incentive becomes even less appropriate. Nevertheless, the Senate also adopted this new tax preference, but with changes which cut the annual cost to an estimated \$120 million.⁵³

The federal tax expenditure as it emerged in the Act⁵⁴ can be viewed as an interest-free loan in the amount of the taxes which would have been paid had normal depreciation been taken for tax purposes during the five-year rapid write-off period. Repayment of the loan is effected by taking less than normal depreciation in subsequent years. This loan is, in effect, available only to those corporations which are in a profit position; loss corporations must borrow their funds from commercial sources at prevailing interest rates.

⁵⁰ Hearings on the President's Proposal to Repeal Investment Tax Credit, *supra* note 46, at 130.

⁵¹ Report of the Comm. on Ways and Means to Accompany H.R. 13270, H.R. Rep. No. 413, 91st Cong., 1st Sess., pt. 1, 196-200 (1969).

⁵² Bills introduced by Senator Muskie, for example, direct federal funds to these areas. See S. 3546, S. 3678, S. 3688, 91st Cong., 2nd Sess. (1970).

⁵³ Report of the Comm. on Finance to Accompany H.R. 13270, S. Rep. No. 552, 91st Cong., 1st Sess. 248-52 (1969). Under the Senate version, the 5-year amortization is allowed only for the proportion of the cost of the facility attributable to the first 15 years of its normal useful life. If a facility has a normal life of 15 years or less the entire cost is eligible for the 5-year write-off. If, however, the useful life is more than 15 years, the taxpayer treats his facility as 2 separate facilities. One facility (representing the cost attributable to the first 15 years of its life) is eligible for the 5-year write-off while the other facility (representing the remaining cost) can be depreciated concurrently by regular methods over its entire useful life.

⁵⁴ Tax Reform Act of 1969, Pub. L. No. 91-172, § 704(a), 1 U.S. Code Cong. & Ad. News 729-32 (1969) (codified at Int. Rev. Code of 1954, § 169).

Alternatively, this tax expenditure can be viewed as a federal loan program for the full capital cost of the facilities, but at a reduced interest rate. So analyzed, this results in a reduction in the corporation's borrowing costs by some 2 to 3 percent depending on the useful life of the property and the amount the corporation can otherwise earn on its money.⁵⁵ Again, the loss corporation receives no reduction in its interest costs; it must pay the going rate of interest.

As a means of financing the antipollution effort, the five-year rapid write-off provision shares all the infirmities noted by Secretary Finch with respect to granting an investment credit for pollution abatement facilities. From the standpoint of the tax system, the special provision also produces problems. The corporate tax system does not rely on a progressive rate structure. Nonetheless tax incentives in the corporate system produce inequities just as in the individual tax system.

The fundamental precept of the corporate tax system is that a flat rate of tax will be imposed on corporate net income. Those corporations with the same net income should pay the same tax. But the rapid amortization provision violates this precept. Assume that Corporation *A* has depreciable assets which are not pollution control facilities, and after all deductions, has taxable income of \$500,000. Corporation *B* has an identical cost basis in depreciable assets, part of which are certified pollution control facilities. In the absence of the rapid amortization provision, Corporation *B* would have the same taxable income as Corporation *A* and pay the same federal income tax. Solely because of the special tax provision, Corporation *B* will now pay a lower tax for five years than Corporation *A*. And because the federal loan is interest free, this represents a permanent financial gain for Corporation *B* relative to Corporation *A*.

Thus, under the definition offered above, the rapid write-off provision is a tax expenditure. It creates differing tax results on a basis wholly apart from proper rules of accounting for the cost of producing income. Like other tax expenditures, it is irrational in operation. It assists only profitable polluters; the loss corporation gets no federal cost-sharing solely because it cannot meet the basic requirement for obtaining the interest free federal loan, namely profit. Even though a loss corporation might demonstrate that it faces a more serious pollution control problem than its profitable counterpart it would get no federal aid through the tax system.

Similarly, large corporations would be entitled to a larger loan

⁵⁵ Address by Douglas B. Wilson, U.S. Bureau of the Budget, Tax Institute of America Symposium, Princeton, N.J., Nov. 21, 1969.

than small corporations.⁵⁶ The tax benefit of rapid amortization is, for a small corporation, only 22 percent of the amount written off. A large corporation benefits to the extent of 48 percent of its write-off.⁵⁷ Again, the amount of the government loan has no relation to the problem of pollution control or indeed no necessary correlation to the size of the business operation, since heavy losses could conceivably place a very large business in the lower tax bracket.

Congress, interestingly enough, recognized the adverse impact on tax equity of the new tax preference by providing that the new minimum tax be applied to the excess of rapid amortization over straight-line depreciation.⁵⁸ The minimum tax might thus be viewed as the "interest" which the government is charging for its "loan." But again the amount and incidence of this "tax interest" is highly arbitrary and erratic in operation. Also, Congress was sufficiently concerned about the provision to provide an automatic termination date in 5 years in order to insure review and evaluation of the rule.

Whatever the uneven operation of tax expenditures for pollution abatement, it is clear that the tax expenditure is based on the assumption that the public should bear a significant part of the cost of industrial pollution abatement. Tax expenditure analysis thus raises the question who should bear this cost. Industry representatives argued before the Senate Finance Committee that pollution abatement was for the public good and that the public should therefore bear the cost.⁵⁹ Indeed some proposals for additional tax benefits submitted to the Committee would have resulted in the public bearing over 46 percent of the capital cost of industrial pollution abatement facilities.⁶⁰

The public is already providing cost-sharing benefits to industry in programs, quite apart from special tax incentives, through research, low cost loans and direct grants. Many economists feel that the direct cost of abating industrial pollution should be borne largely by industry.⁶¹ Thus, expenditures for pollution control efforts would either be absorbed by the corporations themselves or be passed on to consumers of the industrial products in the form of higher prices. If industry is presently keeping its costs or prices down because it is using the public air and water in a manner which creates pollution,

⁵⁶ A small corporation is herein defined as a corporation with taxable income of less than \$25,000, see Int. Rev. Code of 1954, § 11(d).

⁵⁷ Int. Rev. Code of 1954, § 11.

⁵⁸ Tax Reform Act of 1969, Pub. L. No. 91-172, § 301(a), 1 U.S. Code Cong. & Ad. News 624 (1969) (codified at Int. Rev. Code of 1954, § 57(a)(4)).

⁵⁹ See, e.g., Hearings, pt. 2 at 1247 (statement of Lester W. Brann, Jr., Exec. V.P. Ill. State Chamber of Commerce); *id.* at pt. 6, at 5223 (statement of Donald H. Gleason, National Ass'n of Mfrs.).

⁶⁰ Wilson, *supra* note 55.

⁶¹ Hearings, pt. 5, at 4714 (statement of Dan Throop Smith, Professor of Finance Emeritus, Harvard University).

then this economic view would appear to be correct. The cost of proper use of air and water should be borne either by investors in the industry in the form of lower profits or by the consumers of the products in the form of higher prices. These are the groups which benefit from the use of the public air and water, and they should absorb the costs of utilizing these natural resources in a manner that does not create an unacceptable level of pollution.

President Nixon's pollution proposals appear to have accepted this analysis in part.⁶² In the proposal for creation of adequate municipal waste treatment plants, the President has suggested that federally funded plants impose user charges on industries so that the cost of treating industrial waste will be absorbed by industry. In effect this proposal reflects a policy decision that the general public should not be required to bear the costs of industrial pollution abatement.

Some have gone further and called for imposition of effluent charges and emission fees on those industries creating pollution at levels above standards determined to be acceptable.⁶³ The charges would have to be set at such a level that an industry could not economically afford to continue polluting air or water. In other words, the charges must be so burdensome that industry is required to convert to lower cost pollution abatement practices. The financial burden of industrial pollution control under this plan is also placed on industry. Again, either the investor or the consumer will bear these costs, with the relative burden that each group absorbs varying from industry to industry. Senator Proxmire has introduced legislation to implement a national system of effluent charges to combat water pollution.⁶⁴ Some localities have tried such a system, apparently with considerable success.⁶⁵ One of the advantages claimed for a national system is that it provides financing for concerted regional attacks on pollution, a step which pollution experts now generally consider essential.⁶⁶

From the economists' standpoint, there is considerable agreement that the cost of dealing with industrial pollution is properly placed on industry. Charges for keeping the public air and water free of industrial pollution are simply a part of the cost of doing business, which costs industry has improperly avoided thus far at the expense of the

⁶² President Nixon's Message on the Environment, H.R. Doc. No. 225, 91st Cong., 2nd Sess. (1970), also appearing in 1970 U.S. Code Cong. & Ad. News No. 2, at 112-23.

⁶³ See 115 Cong. Rec. S. 14,971-77 (daily ed. Nov. 25, 1969) (remarks of Senator Proxmire).

⁶⁴ S. 3181, 91st Cong., 2nd Sess. (1970).

⁶⁵ 115 Cong. Rec. S. 14,973 (daily ed. Nov. 25, 1969) (remarks of Senator Proxmire).

⁶⁶ See S. 3471, 91st Cong., 2nd Sess. (1970) (the Nixon Administration bill) and S. 3687, 91st Cong. 2nd Sess. (1970) (Senator Muskie's bill), which incorporate this view.

public. However, technology and politics have not yet reached a point where the economists' solution can be satisfactorily implemented. Difficult measurement and standards problems must be resolved by those dealing with the technical problems of pollution. Politically, there is yet little agreement on the proper allocation of the cost of controlling industrial pollution among the public, the investors and consumers. Further, the contours of effective political action are still evolving to determine the proper roles of federal, state and local and regional political authority. Undoubtedly, the foregoing reasons were responsible for President Nixon's omission of any mention of effluent charges or emission fees from his pollution control program, although the 1967 Interagency Study Group had recommended such action as an appropriate step, at least on an experimental basis.⁸⁷

The contours of a substitute program for present expenditures for pollution control facilities do not emerge as clearly as in the case of a substitute program for tax provisions affecting charitable giving. The absence of a viable alternative to the tax incentive was reflected in the debate on the Tax Reform Bill of 1969. Proponents of strong pollution control efforts, such as Senator Muskie, recognized the adverse impact on the tax laws of the rapid amortization rule. But they saw no alternative available which would insure direction of federal funds to this high priority social problem. Hence, they opposed any effort to strike this new tax preference from the bill.⁸⁸

Despite the lack of complete clarity, certain features of an alternative approach to the present tax expenditure emerge. First, the special provision for rapid amortization of the cost of pollution control facilities in the Tax Reform Act of 1969 should be repealed. It violates the integrity of the corporate tax system and it is an inappropriate and ineffective expenditure of federal funds for abatement of industrial pollution. Second, a significant portion of costs of clearing industrial pollution should be absorbed by industry and not by the general public, whether through tax or direct expenditures. The present tax incentive is inconsistent with this principle. Third, the costs of reducing industrial pollution to acceptable levels appear well within the capacity of most industry groups to absorb without undue burden on profits or excessive upward pressure on prices. In the case of loss or marginal profit situations low cost loans should be employed. Tax incentives are again undesirable since they provide maximum aid to industries needing no financial assistance, and little or no aid to those needing assistance. Economic analysis indicates that a system of effluent and emission charges, both to control pollution and to help finance the

⁸⁷ Cost Sharing with Industry, *supra* note 49, at 34-5.

⁸⁸ See Senate floor debate on H.R. 13270, 115 Cong. Rec. S. 16,202-207 (daily ed. Dec. 9, 1969).

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general pollution effort, should be implemented. Here the dimensions of the political and technological response are still unclear. However, the use of tax incentives appears to offer little assistance in resolving these problems, and probably will prove a positive hindrance. Finally, adequate political and financing techniques must be developed if regional approaches to pollution abatement are to be employed.

IV. TAX EXPENDITURES FOR HOUSING

The contours of an alternative to tax incentives for charitable donations have emerged with some clarity from tax expenditure analysis. In the case of pollution abatement, the dimensions of an alternative to tax preferences are developing but are not yet in sharp focus. In the final area of social need under consideration in this article, housing, the criteria for an alternative to present tax preferences for real estate investment are shadowy at best. Tax expenditure analysis in this area so far points mostly in the direction of questions to be considered rather than definitive answers.

Present tax laws contain a number of preferential provisions to encourage investment in housing. At the level of individual home ownership, the primary tax benefit is the deduction for interest on home mortgages.⁶⁹ Mention has previously been made of the upside-down effect of this provision, whereby home ownership for the wealthy receives a much greater federal boost than homeownership for the poor. The deduction for local property taxes⁷⁰ has a similar effect. By contrast, Section 235 of the Federal Housing Act⁷¹ is a program of direct federal financial assistance to facilitate home ownership by low income families.

Attention on the nation's housing needs has primarily focused on the shortage of low and moderate income rental housing. Programs under Sections 221⁷² and 236⁷³ of the Federal Housing Act are directed specifically at this target group. Several of the provisions in the Tax Reform Act of 1969 reflect a similar concern.⁷⁴

The extent of the housing problem facing the United States cannot be overstated. Although it has been estimated that there are presently some 70 million housing units in the country, over 7 million of these are classified as substandard.⁷⁵ With the recent economic decline in the housing industry, new housing starts as of January, 1970, were

⁶⁹ Int. Rev. Code of 1954, § 163.

⁷⁰ Int. Rev. Code of 1954, § 164.

⁷¹ 12 U.S.C. § 1715z (Supp. IV, 1969).

⁷² 12 U.S.C. § 1715l (Supp. IV, 1969).

⁷³ 12 U.S.C. § 1715z-1 (Supp. IV, 1969).

⁷⁴ See Pub. L. No. 91-172, §§ 521, 910, 1 U.S. Code Cong. & Ad. News 706-13, 793-98 (1969) (codified at Int. Rev. Code of 1954, §§ 167, 1250(a),(b), 1039, 1250(d)).

⁷⁵ Hearings, pt. 5, at 4904 (statement of Charles Davenport).

down to about 1 million per year.⁷⁶ Yet the nation will need some 26 million new units by 1978.⁷⁷ This failure to provide an adequate supply of decent housing bears most heavily on low and moderate income families.

Much of the discussion during consideration of the Tax Reform Act with respect to tax provisions affecting real estate arose out of the very legitimate concern that the level of federal funding to encourage development of more low and middle income housing must be increased.⁷⁸ The Department of Housing and Urban Development (HUD) therefore campaigned vigorously not only to retain present tax preferences for housing, but to provide new ones for lower income residential property.⁷⁹

Tax reformers shared HUD's concern with the housing problem. But they were also concerned with the inequities the various preferences create in the tax system, and seriously questioned whether the tax expenditure approach was an effective and efficient utilization of admittedly limited federal funds.⁸⁰

The principal tax incentive for investment in rental residential real property is the right to compute the depreciation deduction on one of the permissible accelerated methods, notably the double declining balance method.⁸¹ This special provision permits the equity investor to recover much more of his investment in the early years of the life of the property than he otherwise could under normal straight line or sinking fund depreciation.⁸² The Tax Reform Act retained this privilege for investment in residential housing,⁸³ while cutting back on the benefits of accelerated depreciation for nonresidential real property.⁸⁴

⁷⁶ Joint Economic Comm., Economic Indicators 21 (April 1970). Housing starts rose to 1.383 million by March, 1970.

⁷⁷ Hearings, pt. 5, at 4904 (statement of Charles Davenport).

⁷⁸ See Senate floor debate on H.R. 13270, 115 Cong. Rec. S. 16,343-351 (daily ed. Dec. 10, 1969).

⁷⁹ Senate Comm. on Finance Press Release (Oct. 21, 1969).

⁸⁰ See note 78 *supra*.

⁸¹ Int. Rev. Code of 1954, § 167(b)(2). Under this method, the taxpayer is allowed to deduct twice the straight-line rate as applied against the adjusted basis of the property.

⁸² The sinking fund depreciation method requires a person to deduct a lesser amount of depreciation in the earlier years than in the later years of the property's normal useful life.

⁸³ Pub. L. No. 91-172, § 521(a), 1 U.S. Code Cong. & Ad. News 707-08 (1969) (codified at Int. Rev. Code of 1954, § 167(j)(2)).

⁸⁴ Pub. L. No. 91-172, § 521(a), 1 U.S. Code Cong. & Ad. News 706-07 (1969) (codified at Int. Rev. Code of 1954, § 167(j)(1)). Depreciation on new commercial and industrial construction is limited to 150% declining balance. Depreciation of newly acquired used commercial and industrial property is limited to straight-line depreciation. Pub. L. No. 91-172, § 521(a), 1 U.S. Code Cong. & Ad. News 708 (1969) (codified at Int. Rev. Code of 1954, § 167(j)(4)).

Quite obviously, the intent of Congress was to encourage increased investment in housing.

The difficulty with this congressional response is that the direct impact of the tax incentive is confined to the investor group. No direct benefit is conferred on the other members of the typical real estate quadriad: the developer, the financing institution, and the tenants. Renters, for example, get no tax benefit equivalent to the deductions for interest and property taxes available to homeowners.⁸⁵

But even within the investor group, accelerated depreciation has the inverted effect characteristic of other tax incentive provisions; the tax provision is more beneficial to the person who presumably needs it least—the wealthy taxpayer. Here, the high-bracket individual uses the artificially high deduction in the early years of his investment to create a “tax loss” to shelter his other income from tax. For example, the *1968 Treasury Studies on Tax Reform* revealed that, out of a group of thirteen wealthy real estate investors, nine paid no federal income tax and two reduced their tax liability to less than \$25, due to the depreciation deduction. One taxpayer with \$7.5 million in income over a seven-year period paid an effective rate of tax of only 11 percent.⁸⁶ Theoretically, it is true that the investor using accelerated depreciation will pay more taxes in later years as his depreciation falls below what it normally would have been under conventional depreciation methods. In effect, the use of accelerated depreciation is a loan by the government in the early years in the amount of the tax saving. This loan is repaid by the higher taxes in later years, but the loan bears no interest. And if the investor continues to expand his investments in real estate, the loan itself may never be repaid.

The value of an interest free loan varies directly with the taxpayer's bracket, the useful life of the property, and the rate of return the taxpayer could expect if he invested in other property. Assume, for example, that two taxpayers, one in a 70 percent bracket and the other in a 30 percent bracket, who can each earn 10 percent on their money, invest in the same apartment house. The federal government will through the tax system, insure a more profitable investment to the higher bracket investor than to the lower bracket investor. If the accelerated depreciation provision were recast as a direct loan program, the resulting statute would provide that HUD is authorized to loan funds to 70 percent bracket taxpayers at a lower rate of interest than would be available to borrowers in the lower brackets. It is difficult

⁸⁵ For a general discussion of this problem, see Kindahl, *Housing and the Federal Income Tax*, 13 Nat'l Tax J. 376 (1960); White & White, *Horizontal Inequality in the Federal Income Tax Treatment of Homeowners and Tenants*, 18 Nat'l Tax J. 225 (1965).

⁸⁶ 1968 *Treasury Studies on Tax Reform* 443-44 [hereinafter cited as *Studies*].

to conceive that HUD would urge Congress to enact such a system directly, but its sponsorship of tax incentives produced the same result.

The provision for accelerated depreciation suffers other defects when viewed as a program to solve low income housing needs. It is also available for investors in luxury housing. Standing alone, therefore, the provision would seem to offer little inducement for investors to enter the low income housing field. Problems of neighborhood deterioration, collection problems, high property taxes and lack of adequate insurance protection⁸⁷ would appear to create a strong bias for opting to invest in high income housing, since the benefits of accelerated depreciation are equally available. Furthermore, the present tax provision permits no direction of federal funds to areas of greatest need. Creation of additional housing in New York City—where the vacancy rate is less than one percent—gets no higher priority than housing development in areas of the country with less acute housing needs.

Another problem with the use of accelerated depreciation as an incentive for housing investment is the difficulty of ascertaining who does or should ultimately benefit from this expenditure. Does the tax preference simply operate as a floor on the profit margin of the investor, or is it reflected in part in lower rents than would otherwise be charged, so that tenants may be said to derive some benefit? In either case, just how much money is the government putting into each transaction? Would Congress authorize a direct financial assistance program to either group that has the same features as the present tax expenditure program?

Other difficult questions must be also resolved. Does accelerated depreciation simply constitute a windfall to the investor group? Some experts in the housing field assert that no incentive is needed to attract capital to the real estate field. Market demand, they assert, is sufficient to generate the needed funds. Rather, they insist, the real problems inhibiting development of an adequate housing supply are to be found in inequitable property tax structures, zoning regulations, and local building codes.⁸⁸ To the extent this analysis is correct, the tax incentive rewards actions which investors would have taken in any event and diverts funds from other priority areas.

Another difficult problem arises in deciding which group in the typical real estate transaction should receive federal financial aid in order to make the most efficient use of available funds. Typically, the housing development transaction will involve four parties: the builder,

⁸⁷ This problem has been partially solved by federal reinsurance and state pooling arrangements. For an exhaustive study of these recent statutory solutions, see Comment, Insurance in Urban Core Areas: An Analysis of Recent Statutory Solutions, 10 B.C. Ind. & Com. L. Rev. 650 (1969).

⁸⁸ Hearings, pt. 5, at 4904, 4905 (Statement of Charles Davenport).

the financier, the equity investor group, and the tenants. Should direct financial aid be given to builders in the form of "seed money" to reduce building costs? Should programs be expanded to encourage and assist lending institutions to make low cost loans available to builders or investors? Or should programs concentrate more on assisting the tenant group through, for example, rent subsidies? Whatever answer, or combination of answers, might be developed, it seems clear that the present tax expenditure of some \$250 million per year⁸⁹ through accelerated depreciation is a clumsy and inefficient vehicle which falls far short of the sophistication in approach that appears essential.

Given this situation, it was not encouraging that Congress and the Administration recommended creating more tax expenditures in the Tax Reform Bill as a means of meeting our low income housing needs. For example, the Treasury proposed and Congress passed a special five-year rapid amortization provision for rehabilitation of low and moderate income housing.⁹⁰

This provision, which is similar in operation to that provided for investment in pollution control facilities, clearly illustrates the inadvisability of implementing national housing policy through the tax writing committees of Congress. It is estimated that under this provision some \$330 million of federal funds will now be committed to rehabilitation expenditures.⁹¹ Yet HUD apparently has placed so low a priority on rehabilitation that it has never recommended to Congress that funds be directly appropriated for this purpose. And it is obvious that rehabilitation is not going to produce the 26 million new housing units presently needed. There were no studies made to determine the extent of any rehabilitation need, or, if such a need exists, that the lack of funds is the primary factor affecting failure to rehabilitate dilapidated housing.⁹² Nonetheless, through the tax expenditure route, several hundred million dollars in federal funds will now be diverted to a low priority need.

From the standpoint of tax policy, the rehabilitation tax preference suffers from all the defects of any tax incentive. Testimony before the Senate Finance Committee pointed out that the rehabilitation provision, viewed as a loan program, has the effect of reducing a 70 percent bracket taxpayer's interest costs from 8 percent to 3 percent on property with a twenty-year life (assuming a 10 percent discount

⁸⁹ Studies 442.

⁹⁰ Pub. L. No. 91-172, § 521(a), 1 U.S. Code Cong. & Ad. News 709-10 (1969) (codified at Int. Rev. Code of 1954, § 167(k)). See also Proposed Treas. Reg. § 1.167(k), 35 Fed. Reg. 12401 (1970).

⁹¹ 115 Cong. Rec. S. 17,593 (daily ed. Dec. 22, 1969).

⁹² Research Report No. 5 for the National Commission on Urban Problems explored tax incentives for rehabilitation of older housing but the Commission did not endorse such a plan.

rate). On the other hand, a 20 percent bracket taxpayer would have his interest costs on a similar investment reduced by only one percent.⁹³ It is again almost impossible to conceive that Congress would approve a direct interest subsidy plan with these effects; but through the back door of the tax laws the country now has just such a program.

In sum, then, Congress through the rehabilitation provision has instituted a \$330 million program which has not been shown to have any rational relation to the shortage of low income housing, but which has obvious deleterious effects on the fairness of the federal income tax system. A point of considerable irony is added when it is noted that after the Treasury had proposed this provision, it then felt that the benefits flowing from the rapid write-off should be included as a tax preference for purposes of the minimum tax.⁹⁴ Thus, in a single bill, Congress has enacted a tax preference which, in another provision, it has declared to be of unacceptable magnitude. Senator Gore attacked the rapid amortization provision on the Senate floor during debate of the Tax Reform Bill and attempted to strike it from the bill.⁹⁵ Here again, however, advocates of housing programs apparently felt that this was an attack on the nation's commitment to meet this critical social need. These Senators thus opposed deleting these provisions from the bill, although the effort to remove the unfair tax provision in no way precluded Congress from taking the tax monies so saved and appropriating them directly for housing needs in a rational manner consistent with national priorities.

There are also new provisions in the Tax Reform Act⁹⁶ designed to provide greater tax incentives for investing in the so-called limited dividend housing programs under Sections 221⁹⁷ and 236⁹⁸ of the Federal Housing Act. These programs are designed to produce low income housing by limiting the investors' return to 6 percent and thus maintaining rents at low levels. Opponents of any changes in the tax laws relating to accelerated depreciation argued that the tax benefits to the investor were taken into account in arriving at the 6 percent figure. This argument may be correct, but, if so, it is certainly difficult to ascertain the rational basis for the limited dividend provisions. For, if the tax benefits were determinative, why is a 6 percent return proper for the 30 percent taxpayer, who gets less tax benefit and hence a

⁹³ Hearings, pt. 5, at 4906 (statement of Charles Davenport).

⁹⁴ See Pub. L. No. 91-172, 301(a), 1 U.S. Code Cong. & Ad. News 624 (1969) (codified at Int. Rev. Code of 1954, § 57(a)(2)).

⁹⁵ 115 Cong. Rec. S. 16,202-207 (daily ed. Dec. 9, 1969).

⁹⁶ See Pub. L. No. 91-172, §§ 521(b), 910, 1 U.S. Code Cong. & Ad. News 710-11, 792-98 (1969) (codified at Int. Rev. Code of 1954, §§ 1250(a)(1)(C)(ii), 1039).

⁹⁷ See note 72 *supra*.

⁹⁸ See note 73 *supra*.

lower profit margin, as well as for the 70 percent taxpayer who derives a greater tax benefit from the depreciation deduction? In other words, one wonders if opponents of any change really believe that Congress consciously adopted the principle that taking into account the tax benefit plus the statutory 6 percent, the 70 percent bracket taxpayer is entitled to a higher rate of return than the 30 percent bracket investor. Further, if the tax benefit were determinative, it would be more rational to revise the 6 percent statutory limit upward, or provide direct federal grants to investors to insure an adequate return on their investment.

HUD, rather than considering these alternatives, not only resisted any change in the tax laws, but vigorously pushed for further tax benefits for investors in limited dividend housing projects. This action was even more curious in light of the fact that even under existing tax rules, HUD reportedly had more applications for low income housing projects than it could fund with available direct appropriations. In spite of this, Congress accepted the HUD position. Thus, rules as to recapture of accelerated depreciation are now more liberal for investments in low income housing projects than for other real estate ventures.⁹⁹ And a taxpayer can defer any recognition of gain if he sells one low income housing project to the tenants or to a tax exempt organization and reinvests the proceeds in another low income housing project.¹⁰⁰ The maximum sales price on these government-assisted housing projects is the amount of the investor's equity plus the amount of any mortgage and the taxes payable as the result of the sale.¹⁰¹ The theory of the new tax provision is that the purchase price to occupants of low income housing will be reduced since there will be no federal income tax due on the sale if the investors reinvest in another similar project.

Again, this tax approach providing for tax free sales has very curious results. For example, assume two projects in each of which the respective investor has \$100,000 equity, a \$100,000 mortgage, and would recognize a \$50,000 gain on sale of the property. Assume further that Investor *A* is in the 70 percent bracket and Investor *B* is in the 50 percent bracket. In the absence of the new provision the tenants of Investor *A* would have to pay \$235,000 for their property, and the tenants of Investor *B* would pay \$225,000. Under the new rule, the

⁹⁹ See Pub. L. No. 91-172, § 521(b), 1 U.S. Code Cong. & Ad. News 710-11 (1969) (codified at Int. Rev. Code of 1954, § 1250(a)(1)(C)(ii)).

¹⁰⁰ See Pub. L. No. 91-172, § 910, 1 U.S. Code Cong. & Ad. News 793-98 (1969) (codified at Int. Rev. Code of 1954, § 1039).

¹⁰¹ Report of the Comm. on Finance to Accompany H.R. 13270, S. Rep. No. 552, 91st Cong., 1st Sess. 292 (1969).

occupants of Investor *A*'s project would get a \$35,000 reduction in their purchase price, whereas Investor *B*'s tenants would get only a \$25,000 price reduction. In a rational world it may be that these two occupant groups should pay the same price, but that result would not likely be predicated on the amount of total income that the investor happened to earn.

As in the areas of social concern already considered, present tax incentive policy to encourage development of housing assumes very strange dimensions when viewed as a federal expenditure policy. Present tax rules constitute a serious deviation from tax equity. Although the Tax Reform Act modified much of the inequity, it did not eliminate it. It was the failure of tax reformers to have a viable alternative to the present tax expenditure system which prevented further tax reform. Those whose task it is to promote our national housing policies felt they had no alternative but to fight for the tax preferences if they were offered no other avenue by which the same amount of federal funds would be made available for low and middle income housing. An inefficient and erratic expenditure funding system was viewed as preferable to losing funds represented by tax expenditures altogether.

When one tries to analyze the dimensions of an alternative system, the considerations which should be controlling are not clear. This uncertainty is caused primarily by the lack of information with respect to certain fundamental questions already noted. How much does the federal government contribute to a given housing project under the present tax system? How much should the government contribute to induce developers and investors to invest in housing? Should the financial aid be focused on a particular segment of the housing quadriad, or on some combination? What are the causes of the country's present failure to provide adequate low income housing through the private sector? Does the problem derive from a lack of capital, uncertainty of return, local taxing and regulatory policies, tenant relations problems, or some combination of these problems? What form of financial contribution should the government make if these factors can be analyzed: direct grants, low interest or interest-free loans, or guarantees?

These foregoing questions have not yet been adequately explored. This situation makes it even more undesirable to use the tax mechanism, since it is known that tax incentive provisions are harmful to a fair tax system. But until these questions have been answered, it will be difficult, if not impossible, to convince Congress and HUD that tax reform should proceed further in eliminating tax preferences for housing.

CONCLUSION

The tax expenditure concept is a highly useful, analytical tool for evaluating the impact, effectiveness and efficiency of tax incentive provisions. This discussion has centered on tax incentives for charitable giving, pollution control facilities, and housing. But it is equally applicable to the tax provisions for depletion allowances, intangible drilling expenses, deductions for state and local taxes and medical expenses, and the myriad other provisions in the tax code which have been inserted to achieve nontax purposes.

Tax expenditures cannot be enacted without doing violence to the integrity of the tax system. If a progressive individual income tax system mirrors values to which the country is deeply committed, then proposals to distort that system must be vigorously resisted and present distortions of the system must be removed.

But tax reformers must constantly bear in mind the validity of the values which underlie utilization of the tax system to meet social goals. These values conflict with those inherent in a progressive tax system whenever the tax system is used to solve social problems. This potential conflict is resolved within the political system, and if defenders of the tax system have no viable alternatives for financing programs for meeting pressing social needs outside the tax system, then political realities will inevitably dictate a compromise. This compromise will mean that the tax system will be distorted—but not as much as proposed, and social needs will receive some federal funds—but not as much nor as effectively spent as desired.

As these compromises pyramid over the years, and as the tax system becomes more inequitable, confidence in the tax system will dissipate. The problem is compounded by the fact that social needs which can only be met with federal funds must rely on the tax system to collect the bulk of those funds. If public confidence in that tax system is continuously eroded—albeit ostensibly to achieve highly praiseworthy social or economic objectives—then this country may truly face a “taxpayers’ revolt” where social needs will not be met, either by direct or by tax expenditures.