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Cover Page Footnote

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EQUITY, EFFICIENCY, AND THE TAX REFORM ACT OF 1986

*EDWARD YORIO**

INTRODUCTION

ON October 22, 1986, President Reagan signed the Tax Reform Act of 1986 ("the 1986 Act"),[1] the final stage in a long and arduous administrative and legislative battle to revise the rules of federal income taxation.[2] Because there are signs that this may not be the end of the war between the proponents and opponents of tax revision,[3] it is appropriate

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1. Tax Reform Act of 1986, Pub. L. No. 99-514, 1986 U.S. Code Cong. & Admin. News Special Pamphlet No. 9A (100 Stat.) 1.

2. In his 1984 State of the Union Address, President Reagan requested that the Treasury Department prepare a report on the federal tax system. *See* President Reagan's 1984 State of the Union Address, 20 Weekly Comp. Pres. Doc. 87, 90 (Jan. 25, 1984). Shortly after the 1984 elections, the Treasury Department submitted its report. *See* Department of the Treasury, The Treasury Department Report to the President: Tax Reform for Fairness, Simplicity, and Economic Growth (Nov. 1984) [hereinafter *Treasury Report*]. On May 29, 1985, the President sent Congress his proposals for tax revision. *See* The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (May 29, 1985) [hereinafter *President's Proposals*].

The road through Congress was tortuous. On Dec. 11, 1985, the President lost a key procedural vote on the floor of the House of Representatives that appeared to doom tax revision. *See* N.Y. Times, Dec. 12, 1985, at A1, col. 4. To save the bill, President Reagan made a personal appeal to wavering representatives. *See* N.Y. Times, Dec. 17, 1985, at A1, col. 6. In response, the House reversed itself, passing a bill less than a week after the procedural defeat. *See* N.Y. Times, Dec. 18, 1985, at A1, col. 6. The deliberations in the Senate Finance Committee, in which provisions to retain many tax preferences were approved, threatened to undermine, if not doom, the movement for tax reform. *See* N.Y. Times, Apr. 17, 1986, at D1, col. 1. But in response to the efforts of Senator Packwood, the Committee Chairman, the Finance Committee ultimately approved proposals for sweeping tax revisions. *See* N.Y. Times, May 7, 1986, at A1, col. 1. The bill passed the full Senate within two months. *See* N.Y. Times, June 25, 1986, at A1, col. 6. After extensive deliberations, conferees from the House and Senate approved the tax bill. *See* N.Y. Times, Aug. 17, 1986, at A1, col. 6. The bill passed the full House on Sept. 25, 1986. *See* N.Y. Times, Sept. 26, 1986, at A1, col. 6. Two days later, the bill passed the Senate. *See* N.Y. Times, Sept. 28, 1986, at A1, col. 6. The bill became law when signed by the President on Oct. 22, 1986. *See* N.Y. Times, Oct. 23, 1986, at D1, col. 6.

3. Proposals for further changes in the federal tax system are legion. Shortly before the tax bill passed Congress, Rep. Rostenkowski, the Chairman of the House Ways and Means Committee, suggested that tax rates might be raised to reduce the deficit. *See* N.Y. Times, Sept. 17, 1986, at D2, col. 4; *id.*, Sept. 6, 1986, at D1, col. 1. The Speaker of the House of Representatives, Rep. Jim Wright, has suggested that marginal tax rates might not be reduced in accordance with the provisions of the 1986 Act. *See* N.Y. Times, Dec. 9, 1986, at A1, col. 1. To raise additional revenue, Senator Packwood has suggested instead that Congress "abolish more deductions and other tax preferences." *See* N.Y.

to assess now what was achieved by the 1986 Act and what, if anything, remains to be done. Many of my general views on federal tax policy were previously presented in an article that appeared in this law review.[4] At that time, I commented on the President's proposals to Congress for tax reform, offering a generally positive assessment of the program from the perspectives of equity and efficiency.[5] Subsequently, two law review articles were published that endorsed different standards for determining the equity or efficiency of a federal income tax provision, which, if valid, would place in doubt some of my conclusions regarding the tax preferences found in the Internal Revenue Code of 1954 ("the pre-1986 Code").[6]

The purpose of this Article is to consider the merits of these different standards and, in light of this analysis, to judge the success of the 1986 Act in promoting equity and efficiency. Part I analyzes and compares the standards set out in these articles to the tax policy criteria and the specific recommendations for reform contained in my previous article. Part II presents a brief overview of the major features of the 1986 Act. Drawing on the analysis in my previous article and in Part I of this Article, Part III evaluates the 1986 Act as it affects individual income taxpayers. Part IV discusses some of the major deficiencies remaining after the 1986 Act and makes a number of recommendations for reform of the Internal Revenue Code of 1986 ("the Code").

I. STANDARDS OF EQUITY AND EFFICIENCY

A. *Equity*

My earlier article surveyed various methods by which taxpayers could reduce or avoid taxes on income from capital prior to the passage of the 1986 Act.[7] Without pretending to exhaust the list of possible avoidance devices, the article identified five primary sources of tax avoidance on income from capital: the exclusion of certain forms of income (such as interest on state and local government bonds);[8] the creation of artificial entities (such as trusts) to shift income from higher- to lower-bracket

Times, Sept. 17, 1986, at D2, col. 4. A number of Congressmen have endorsed a value-added or consumption-type tax as a supplement to the income tax. *See, e.g.*, N.Y. Times, Mar. 23, 1986, § 3, at 2, col. 3 (article by Sen. Roth); Wall St. J., Dec. 15, 1986, at 26, col. 4 (article by Rep. N. Gingrich); *see also* Hanlon, *Stage Set for Next Year's Battle Over Using Tax Reform Bill to Raise Revenue*, 33 Tax Notes 134 (1986) (discussion of various revenue options available to Congress).

4. *See* Yorio, *The President's Tax Proposals: A Major Step in the Right Direction*, 53 Fordham L. Rev. 1255 (1985) [hereinafter Yorio I].

5. *See id.* at 1265-88.

6. *See* Cooper, *The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance*, 85 Colum. L. Rev. 657 (1985); Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 Tex. L. Rev. 973 (1986).

7. *See* Yorio I, *supra* note 4, at 1270-74, 1282-88.

8. *See id.* at 1270-73.

taxpayers;[9] the deferral of income through accelerated deductions or credits (such as those permitted by the Accelerated Cost Recovery System ("ACRS"));[10] the deductibility of 60% of an individual taxpayer's long-term capital gains;[11] and the use of leveraging by which a taxpayer borrows to invest in a tax-favored activity and deducts the interest to offset other sources of income.[12] The article also noted that the last three of these avoidance devices, which permit deferral, rate conversion, and leveraging, constitute the major ingredients of the typical tax shelter.[13]

The article condemned these tax avoidance techniques on the grounds that each violates what was labeled the "equality criterion" of federal tax policy,[14] which requires that income be taxed at approximately the same rate for taxpayers with the same amount of income.[15] In an incisive article on tax avoidance that appeared subsequent to the writing of my article, George Cooper distinguishes among the various devices for reducing taxation on income from capital[16] and concludes that not all of these devices are offensive from the standpoint of tax equity.[17] If this conclusion is valid, it suggests that my criticism of some of the devices listed above may have been unfounded.

1. Implicit Tax and the Market Pricing Mechanism

The concept of an "implicit tax" plays a central role in Cooper's analy-

9. *See id.* at 1282-83.
10. *See id.* at 1286-87.
11. *See id.* at 1283-86.
12. *See id.* at 1286.
13. *See id.*
14. *See id.* at 1270-88.
15. *See id.* at 1257.
16. *See* Cooper, *supra* note 6.
17. *See id.* at 707-14.

Cooper's analysis of the equity issue follows an informative historical survey in which he demonstrates that virtually all of the tax minimization techniques at issue in the recent debates on tax reform have been with us in somewhat disguised form from the inception of the income tax. *See id.* at 663-67. He also establishes that congressional attempts to outlaw tax avoidance have lasted nearly as long and have proven to be generally unsuccessful in preventing taxpayers from exploiting opportunities to reduce taxes. *See id.* at 663-67, 702-05. Cooper's clear and detailed explanation of the mechanics and tax advantages of the modern tax shelter (deferral, rate conversion, and leveraging) serves as a particularly graphic illustration of Congress's repeated failure (at least prior to the 1986 Act) to overcome this problem. *See id.* at 667-94. He demonstrates, moreover, that these attempts failed because Congress never developed clear guidelines for identifying unacceptable methods of tax avoidance. *See id.* at 693-94, 721. Rather, Congress dealt with the problem on an ad hoc basis, responding generally to particular instances of abuse that shocked its conscience or that of the public. *See id.* at 660, 718-21. This piecemeal approach was bound to fail, not only because it ignored the underlying problem, but also because it tolerated the simultaneous enactment of other Code provisions that opened the door to further, albeit generally different, forms of tax avoidance. *See id.* at 679, 691. Against this background of history and analysis, Cooper sets out a unified and consistent perspective on tax avoidance with the primary goal of providing guidelines for distinguishing between tax devices that represent unacceptable avoidance and devices that are relatively benign. *See id.* at 694-718.

sis of tax avoidance from an equity perspective.[18] Taxpayers who invest in tax-favored capital sometimes pay a price for the tax advantages in the form of reduced economic returns on their investments. Tax-exempt state and local government bonds provide perhaps the clearest illustration of this phenomenon. It is generally acknowledged that the rate of return on these bonds is lower than the rate of return on comparable, fully-taxable investments of equivalent risk.[19] To the extent of the difference between those rates of return, the investor is in effect paying an "implicit tax."[20] To the governmental entity issuing the bonds, that difference represents the tax subsidy afforded by virtue of the federal tax exemption.[21] If, for example, the interest rate on a municipal bond is 7% and the rate on a fully-taxable bond is 10%, the investor is paying an implicit tax of 3% of the principal and the issuing government is receiving a subsidy in the same amount.

The existence of an implicit tax on many tax-favored investments derives from a simple principle of economics. When an investment is subject to favorable tax treatment, demand for it increases and the price of the investment rises accordingly.[22] As a consequence of this market pricing mechanism, the rate of return on the tax-favored investment declines, resulting in an implicit tax.[23]

The implications of this phenomenon from the standpoint of tax equity are significant. To the extent that the market imposes an implicit tax on an investment favored by the Code, it reduces the difference in the after-tax rate of return between the investment and a fully-taxable investment, thereby mitigating tax inequity.[24] Moreover, if the implicit tax equals the actual tax on a fully-taxable investment, the market pricing mechanism would have the effect of eliminating any inequity.[25]

According to Cooper, not all tax advantages provided by the pre-1986

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18. *See id.* at 698-701. The possibility that an "implicit tax" may mitigate tax inequity has been noted previously by other commentators. *See, e.g.*, Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?*, 16 San Diego L. Rev. 735, 738 (1979); Surrey & McDaniel, *The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 B.C. Indus. & Com. L. Rev. 679, 702-06 (1976); *see also* Yorio I, *supra* note 4, at 1259 (no tax inequity if the rate of return on tax-favored investments is no greater than the after-tax return on fully taxable bonds).

19. *See, e.g.*, Bailey, *Progressivity and Investment Yields Under U.S. Income Taxation*, 82 J. Pol. Econ. 1157, 1159-60 (1974); Galper & Zimmerman, *Preferential Taxation and Portfolio Choice: Some Empirical Evidence*, 30 Nat'l Tax J. 387, 388-89 (1977).

20. *See* Cooper, *supra* note 6, at 698-99.

21. *See* Ackerman & Ott, *An Analysis of the Revenue Effects of Proposed Substitutes for Tax Exemption of State and Local Bonds*, 23 Nat'l Tax J. 397, 397-400 (1970).

22. *See* Galper & Zimmerman, *supra* note 19, at 396.

23. *See id.* at 388.

24. *See* Cooper, *supra* note 6, at 700-01.

25. With respect to a newly-enacted tax preference, the first investors who pursue the preference will gain a tax advantage. *See* Bittker, *Tax Shelters and Tax Capitalization or Does the Early Bird Get a Free Lunch?*, 28 Nat'l Tax J. 416, 417 (1975). But the consequent inequity may last only until the market pricing mechanism operates to raise the price of the tax-preferred investment. *See id.*

Code were subject to mitigation by the market pricing mechanism.[26] Since the supply of artificial entities (such as trusts) for the purposes of tax avoidance is virtually limitless, an increase in demand for these entities caused by tax motives generally will not affect the rate of return or result in an implicit tax.[27] Moreover, since constraints on the internal leveraging of real estate tax shelters are minimal, the market finds it difficult to capitalize the tax benefits of those shelters.[28] Consequently, the rate of return received by an investor will be reduced minimally, if at all, by an implicit tax.

Cooper draws a fundamental distinction between tax avoidance devices that are subject to the market pricing mechanism and those that are not.[29] Because the latter do not contain an implicit tax, they are the most serious sources of tax inequity.[30] Opponents of tax avoidance are thus enjoined to concentrate their efforts on these "real equity problems," and to accept the "market pricing mechanism" as "a powerful weapon eliminating the equity effects of most [other] avoidance efforts."[31] Consistent with this analysis, Cooper makes a number of intriguing proposals for eliminating the tax benefits of avoidance devices not subject to the market pricing mechanism.[32]

The potential significance of Cooper's analysis, if correct,[33] is hard to overstate. Because of the effect of the market pricing mechanism in reducing their tax advantages, scores of pre-1986 tax preferences, including the deduction for long-term capital gains,[34] the accelerated deductions made possible by the ACRS rules,[35] the Investment Tax Credit,[36] and the

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26. *See* Cooper, *supra* note 6, at 701, 710-14. This Article assumes arguendo that Professor Cooper is correct in his view that certain tax shelters are not subject to the market pricing mechanism. Some market constraints may, however, operate with regard to all tax shelters. Consider, for example, a rational investor who is in the market for a tax shelter. In deciding whether to invest in a municipal bond or in an investment that, in Professor Cooper's view, is not subject to the market pricing mechanism, that investor would compare the rates of return, the degrees of risk, and the effects on liquidity of each tax shelter. Only after making those comparisons would the investor choose the investment allegedly not subject to the market pricing mechanism. If, as seems almost certain, the investment is subjected to such comparisons, it is questionable whether the investment can be considered not subject to the market pricing mechanism.

27. *See id.* at 701.

28. *See id.* at 675-76. Internal leveraging occurs when a real estate transaction is financed by the seller on a non-recourse basis. *See id.* at 710-11. In such cases, the seller and the purchaser may artificially inflate the purchase price to enable the purchaser to deduct higher depreciation and other expenses. As long as the financing is on a non-recourse basis, the buyer will usually not be harmed by the inflated price. *See id.* at 710-14.

29. *See id.* at 698-705.

30. *See id.* at 714-15.

31. *See id.* at 725.

32. *See id.* at 714-26.

33. This Article assumes arguendo that Professor Cooper is correct that certain tax shelters are not subject to the market pricing mechanism. *See supra* note 26.

34. I.R.C. § 1202(a) (1982) (deduction for 60% of an individual taxpayer's "net capital gain") (repealed 1986).

35. *Id.* § 168 (1982 & Supp. III 1985) (amended 1986).

exclusion for interest on state and local government bonds,[37] may be tolerable from the standpoint of tax equity. With the weakening of equity as an argument for reform, the case for repeal or limitation of those preferences (and many others) would turn almost exclusively on considerations of efficiency or revenue-raising. Equally important, the course of future tax policy might reflect the judgment that tax equity should not be a major concern of Congress in enacting a tax preference, so long as the preference is subject to the market pricing mechanism.

2. Evaluation

To evaluate Cooper's claim that tax-favored investments subject to the market pricing mechanism do not raise serious equitable concerns, this Article focuses primarily on the exclusion for interest on state and local government bonds.[38] Although the market price reflects the exclusion to a certain extent, the implicit tax rate on municipal bonds has remained substantially lower than the highest marginal federal tax rate.[39] In 1983, for example, the interest rate on prime municipal bonds was 8%; the interest rate on comparable, fully-taxable bonds was 12%, resulting in an implicit tax of approximately 33⅓%.[40] Since the highest federal tax rate at that time was 50%,[41] a taxpayer in the highest bracket paid effectively one-third less in taxes on income generated by a municipal bond (33%) than on income generated by a fully-taxable bond (50%).

Although Cooper concedes that a comparison between the after-tax returns on municipal bonds and comparable fully-taxable investments would reveal serious problems of inequity,[42] he believes that this comparison overstates the inequity caused by tax-exempt bonds because it fails to consider the alternative tax-sheltered opportunities open to the municipal bond investor.[43] In a world in which a tax-conscious investor could invest in a leveraged real estate shelter, which might produce a negative tax rate by allowing the investor to use interest deductions to offset other income, the tax-exempt bond seems relatively benign by comparison.[44] Cooper argues, in addition, that the reason municipal bonds did not carry with them an implicit tax equal to or approaching the maximum tax rate was the availability of alternative and more attractive tax preferences that were not subject to the market pricing mechanism.[45] Buyers

36. *Id.* §§ 46-48 (amended 1986).
37. *Id.* § 103 (amended 1986).
38. *Id.* § 103 (West Spec. Pam. 1987).
39. *See* Cooper, *supra* note 6, at 698-99.
40. *See* Salomon Brothers, 1983-84 Bond Market 33 (1984). The figures are taken from the week of Oct. 14, 1983 and are representative of the rates of return on tax-exempt and fully-taxable bonds for 1983. *See id.*
41. *See* I.R.C. § 1 (1982).
42. *See* Cooper, *supra* note 6, at 698-99.
43. *See id.* at 699-700.
44. *See id.* at 674, 699-700.
45. *See id.* at 699-700.

of tax-exempt bonds gain an equitable advantage only to the extent that "the implicit tax burden on these bonds is less than the effective burden on investment generally, and the evidence suggests that it is questionable whether any such advantage exists."[46]

But Cooper's comparison between tax-exempt bonds and other investment opportunities ignores the fact that, for many taxpayers, income consists solely or primarily of salary or other earned income.[47] Because the implicit tax on tax-exempt bonds was lower in 1983 than the highest marginal tax bracket, purchasers of these bonds received a tax advantage compared to taxpayers whose income consisted solely of salary or other earned income.[48] Although Cooper may be correct that other tax preferences produce greater inequities than tax-exempt bonds, significant tax inequity between municipal bond investors and wage earners exists to the extent of the difference between the maximum tax rate and the implicit tax on state and local government bonds.[49]

a. *The Demand Curve and the Implicit Tax*

Cooper's analysis may be strengthened by making an assumption,

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46. *See id.* at 700.

47. Professor Bittker has argued that high-bracket taxpayers who invest in fully-taxable bonds cannot complain of tax inequity because they can blame only themselves for failing to exploit the lower implicit tax on tax-exempt bonds. *See* Bittker, *supra* note 18, at 742-44. For purposes of analysis in the text, I accept the validity of Professor Bittker's argument as applied to holders of capital. But high-bracket wage-earners who cannot avail themselves of the lower implicit tax on certain tax-preferred investments have a valid claim that their wages are taxed at an inequitably high rate. *See infra* text accompanying note 48.

48. Professor Cooper presents some casual empirical evidence that supports his view that the market operates to price out certain tax preferences. *See* Cooper, *supra* note 6, at 708-10 (preferences for yachts and real estate). The evidence with respect to tax-exempt bonds indicates the contrary. *See supra* notes 39-41 and accompanying text. Moreover, this Article demonstrates that merely abolishing tax preferences that are not subject to the market pricing mechanism will not eliminate this inequity. *See infra* notes 54-65 and accompanying text.

49. It is possible, of course, that income from capital generally *should* be taxed at a lower rate than earned income. A number of commentators have in fact proposed that a consumption-type tax be enacted on equitable grounds as a way of avoiding a "double tax" on capital. *See, e.g.*, N. Kaldor, An Expenditure Tax 21-53 (1955); Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 Harv. L. Rev. 1113 (1974); *see also* Cooper, *supra* note 6, at 706-07 (author refers to commentators advocating a consumption tax, but does not adopt the position himself). But that position is different from the argument that tax preferences on certain forms of income from capital do not create inequities within the context of an income tax.

Moreover, there are plausible arguments for taxing wages at a *lower* rate than income from capital. First, to earn wages one necessarily forgoes leisure. A lower rate of tax on wages may be defended as an indirect means of taxing the imputed income from leisure that a taxpayer with the same amount of income from capital is able to enjoy. *See* E. Seligman, The Income Tax 23-24 (1911). Second, the wage-earner's ability to pay is arguably less than a capitalist's ability to pay with the same amount of income because the latter has a stock of capital to protect against future contingencies. The wage-earner, by contrast, has a greater need to save income to guard against future contingencies.

which seems to be implicit in his argument,[50] that the repeal of shelters not subject to the market pricing mechanism would raise the implicit tax on remaining preferences sufficiently to eliminate, or virtually eliminate, inequities. If those more egregious shelters were eliminated, tax-conscious investors might be forced to bid up the price of the remaining tax-preferred investments, including municipal bonds, thereby raising the implicit tax. If the implicit tax were driven high enough, problems of inequity would vanish.

In order to evaluate this scenario, it is necessary to explore the reasons for the discrepancy between the highest tax bracket under the pre-1986 Code and the implicit tax on municipal bonds. Like any commodity, the price of a municipal bond depends on the supply and demand for the bond.[51] In Figure 1, D_1D_1 represents the demand schedule for tax-exempt bonds under the assumption that alternative investments not subject to the market pricing mechanism are available; SS represents the supply schedule for the same bonds. The equilibrium point (P_1Q_1) at which those schedules intersect determines the price (P_1) and quantity (Q_1) of tax-exempt bonds that will be sold.[52] In 1983, the equilibrium price produced a rate of return that was about 66⅔% of the rate of return on fully-taxable bonds of equivalent risk. Thus, with all other things being equal,[53] a taxpayer in 1983 in the 33⅓% tax bracket would be indifferent as between purchasing a municipal bond and a fully-taxable bond. For a taxpayer in the 50% bracket, however, the equilibrium price on a municipal bond produced a windfall measured by the difference between the price (P_x) at which that taxpayer would be indifferent as between purchasing a municipal and a taxable bond and the actual equilibrium price in the market. That surplus (P_x-P_1) represents, in economic terms, the inequity seemingly caused by the exclusion for interest on municipal bonds.

The crucial question is whether the surplus generated for the 50% bracket taxpayer in municipal bonds can be eliminated by repealing the tax preferences available on investments that are not subject to the market pricing mechanism. Cooper's argument[54] seems to assume that, without those preferences, the demand for municipal bonds would increase to the extent that the new equilibrium price (P_2) would equal, or at least closely approximate, P_x, the price at which the 50%-bracket tax-

50. Cooper attributes the difference between the maximum tax rate and the implicit tax on tax-exempt bonds to the availability of investments that are not subject to the market pricing mechanism. *See id.* at 700. This argument implies that without such investments, the discrepancy between the maximum tax rate and the implicit tax on municipal bonds would vanish.

51. *See* J. Hirshleifer, Price Theory and Applications 22-24 (1976).

52. *See id.* at 25.

53. Specifically, the municipal bond and fully-taxable bond must be equally risky and equally liquid. For a discussion of the relationship between the risk of an investment and an investor's indifference curve, see *id.* at 70-71.

54. *See supra* note 50 and accompanying text.

payer would no longer have a surplus by investing in a municipal bond. In Figure 1, the increase in demand required by this argument is reflected by a rightward shift in the demand schedule to D_2D_2.

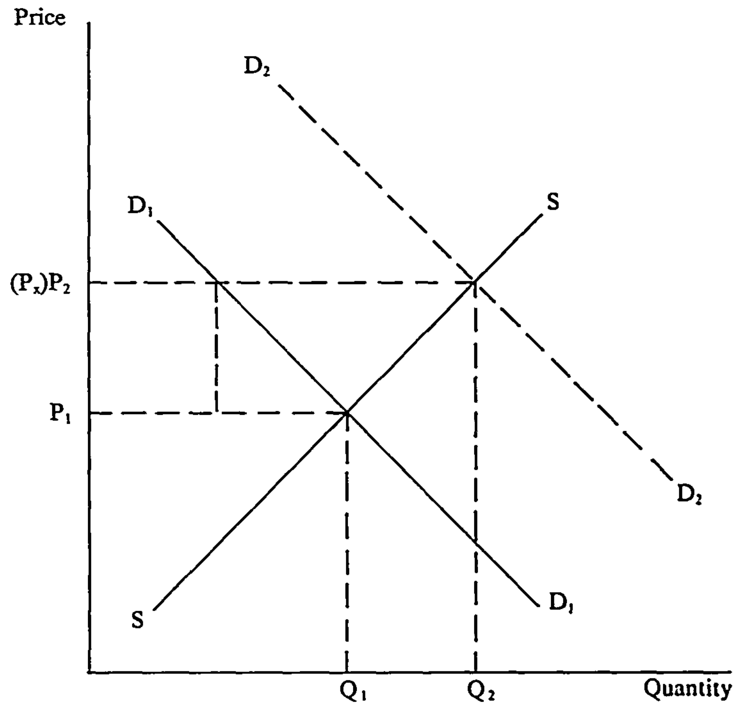

figure 1

Assuming that municipal bonds and tax preferences not subject to the market pricing mechanism are substitutes for each other, it is probable that the elimination of preferences not subject to the market pricing mechanism will cause *some* increase in demand for municipal bonds.[55] No evidence has been adduced, however, to support the contention that the *magnitude* of the increase in demand will be sufficient to drive up the equilibrium price to a point at which a taxpayer in the highest bracket will no longer enjoy the surplus. Indeed, there is strong reason to believe that the extent of the shift in the demand curve will be minimal at best. All other things being equal, the shift in demand for one good caused by the elimination of the substitute good depends on the relative share of the combined market held by the substitute.[56] In the market for tax-favored

55. *See* J. Hirshleifer, *supra* note 51, at 116.

56. This point may be understood by considering a simple illustration. Assume that the market in tax-favored investments consists solely of tax-exempt bonds and real estate; tax-exempt bonds comprise 90% of the market and real estate comprises 10%. If municipal bonds and real estate are not substitutes at all, the repeal of the tax preferences for real estate will have no effect on the demand curve for municipal bonds. If municipal

investments, the shift in demand for any remaining tax preferences caused by the repeal of substitute tax preferences will turn on the share of the total market in preferences held by the repealed preferences.

Prior to the enactment of the 1986 Act, the market in tax-favored investments was, of course, substantial, including, among other preferences, property subject to favorable capital gains rates,[57] property benefiting from the Investment Tax Credit[58] or accelerated depreciation deductions,[59] tax-deferred savings,[60] and property generating tax-exempt income, such as state and local government bonds.[61] Of this overall market, the share held by investments not subject to the market pricing mechanism was small.[62] Although repealing favorable tax treatment of

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bonds and real estate are perfect substitutes and if all other things remain constant, investors in real estate would move the 10% of the market that is now comprised of real estate into tax-exempt bonds. The share of the market held by tax-exempt bonds after the repeal of the real estate preferences would be 100%, producing a shift of only 11 1/9% in the demand curve for tax-exempt bonds.

If, on the other hand, tax-exempt bonds comprise only 10% and real estate 90% of the tax-shelter market, the effect on the shift in the demand curve for tax-exempt bonds would be much greater if the preferences for real estate were repealed. If the two investments are perfect substitutes and if all other things remain constant, the 90% of the market previously consisting of real estate investment would move into state and local government bonds, raising their share of the market from 10% to 100% and producing a 900% shift in the demand curve for municipal bonds.

In reality, the degree of substitution between two investments is neither nil, nor perfect. The greater the degree of substitution between investments, the greater is the shift in the demand curve for one investment caused by the elimination of the other. *See* J. Hirshleifer, *supra* note 51, at 116.

57. *See* I.R.C. § 1202(a) (1982) (deduction for 60% of an individual taxpayer's "net capital gain") (repealed 1986).

58. *See id.* §§ 46-48 (amended 1986) (though these sections were technically "amended" in 1986, they were effectively repealed).

59. *See id.* § 168 (amended 1986).

60. *See, e.g., id.* § 219 (1982 & Supp. III 1985) (deduction for contributions to individual retirement accounts) (amended 1986).

61. *See id.* § 103 (exclusion for interest on state and local government bonds) (amended 1986).

62. Assuming that the revenue lost from various investment tax preferences (or the revenue gained from their repeal) is a reasonable surrogate for the amount of investment in each preference, the point in the text may be established by comparing the revenue gain from the repeal by the 1986 Act of tax preferences for investments not subject to the market pricing mechanism with the revenue loss attributable to other tax preferences. The creation of Clifford Trusts and the leveraging of losses generated by tax shelters (particularly real estate) to offset other income are the two investment tax preferences not subject to the market pricing mechanism that figure most prominently in Cooper's analysis. *See* Cooper, *supra* note 6, at 675-76, 701, 710-14, 720, 724. The revenue gain in fiscal year 1990 from repeal of the Clifford Trust rules (and other methods of shifting income to low-bracket taxpayers) is projected at approximately $500 million. *See* Conference Comm. Rep., Tax Reform Act of 1986, H.R. Rep. No. 841, 99th Cong., 2d Sess. II-880 to -881 (1986). The revenue gain in 1990 from the provisions of the 1986 Act designed to preclude leveraging of tax shelters (including the application of the "at-risk" rules to real estate and the disallowance of passive investment losses) is projected at approximately $11.4 billion. *See id.* at II-870.

Although the sum of the revenue gains from virtual repeal of these preferences for investments not subject to the market pricing mechanism is large ($11.9 billion), it pales these investments would likely increase demand for other preferences, that increase in demand would be spread among all the remaining preferences. Thus, the effect in increasing the equilibrium price of any particular preference would be relatively insignificant.[63]

The preceding analysis indicates that the repeal of tax preferences for investments not governed by the market pricing mechanism will not solve the problems of inequity caused by tax advantages bestowed on other investments such as municipal bonds. If, as seems virtually certain, the equilibrium price for remaining investment preferences does not rise sufficiently to eliminate the surplus for higher-bracket taxpayers,[64] other taxpayers, notably salaried employees, will continue to pay a tax on their income that exceeds the implicit tax on tax-preferred investments.[65]

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in comparison with the total revenue losses caused by other investment tax incentives. For 1990, the following estimates were projected (prior to the passage of the 1986 Act) for the losses in revenue from individual taxpayers attributable to other major investment tax preferences: favorable treatment of capital gains, $34.0 billion; IRAs, $18.7 billion; the exclusion for interest on state and local government bonds, $13.6 billion; the Investment Tax Credit, $8.0 billion; the exclusion for life insurance interest, $7.0 billion; the exclusion for capital gains at death, $6.1 billion; accelerated depreciation on buildings other than rental housing, $5.9 billion; tax incentives for the preservation of historic structures, $1.9 billion; accelerated depreciation on equipment, $1.8 billion; accelerated depreciation on rental housing, $1.6 billion; intangible drilling costs, $1.5 billion; percentage depletion on oil and gas, $1.1 billion; deferral of interest on savings bonds, $1.1 billion; capital gains treatment of certain agricultural income, $0.8 billion; installment sales treatment, $0.8 billion; dividend exclusion, $0.6 billion; amortization of business start-up costs, $0.5 billion; investment credit for buildings other than historic structures, $0.4 billion. *See* Staff of Joint Comm. on Taxation, 99th Cong., 1st Sess., Estimates of Federal Tax Expenditures for Fiscal Years 1986-1990 10-21 (Joint Comm. Print 1985). The sum of these revenue losses, which represent part, but not all, of the revenue losses caused by investment tax preferences, is $105.4 billion.

Using these projections of revenue gains and losses as surrogates for the amount invested in each tax-preferred investment, investments not subject to the market pricing mechanism probably comprised about 10% ($11.9 billion of a total of $117.3 billion) of the total market in tax-preferred investments for individual taxpayers.

There is, of course, some overlap between investments not subject to the market pricing mechanism and the other tax-preferred investments listed above. Real estate, for example, is affected both by the exemption from the "at risk" rules and by accelerated depreciation on buildings. It is proper, however, to determine the magnitude of the revenue losses attributable to real estate tax preferences other than leveraging and to include real estate to that extent among other tax-preferred investments, because repeal of only the leveraging advantages of real estate shelters would still leave real estate with a share of the overall market in tax preferences. This assumes, as does this entire analysis, that the revenue loss from a preference is a reasonable surrogate for the amount invested in a tax-preferred investment.

63. Investments not subject to the market pricing mechanism probably comprised about 10% of the market in tax-preferred investments prior to the passage of the 1986 Act. *See supra* note 62. Their repeal was thus unlikely to cause more than a 11 1/9% shift in the demand curve for any remaining tax-preferred investment. *See supra* note 56 and accompanying text.

64. *See supra* text accompanying notes 55-63.

65. *See supra* text accompanying notes 47-49.

b. *The Demand Curve and Marginal Tax Brackets*

To understand why the market pricing mechanism does not operate to eliminate all inequities, it is helpful to analyze the demand schedule (D_1D_1) for municipal bonds represented in Figure 2. As with virtually any commodity, this schedule is downward sloping,[66] indicating that, for any decrease in the price of municipal bonds, the quantity demanded increases. With all other things being equal,[67] it is possible to conceive of each point (P_yQ_y) on the demand schedule as the quantity of bonds (Q_y) demanded by taxpayers in a particular marginal tax bracket (y%) and in all higher tax brackets.[68] As the price of the bond declines below P_y and the rate of return therefore increases, lower-bracket taxpayers have an incentive to enter the market and take advantage of the exclusion provided for interest on the bonds. Consequently, the quantity of bonds demanded increases. If the equilibrium price (P_x) produces a rate of return that equals the after-tax rate of return on a fully-taxable bond for a taxpayer in the x% tax-bracket, all taxpayers whose marginal tax bracket exceeds x% derive a surplus from purchasing municipal bonds. The surplus for a taxpayer in the highest tax bracket (z1%) is equal to the difference between P_{z1}—the price at which he would be indifferent as between purchasing a tax-exempt bond and a taxable bond—and P_x.[69]

Viewing the demand schedule for tax-exempt bonds from this perspective makes it possible to identify a major reason for the inability of the market to eliminate tax inequities caused by the interest exclusion. Because the equilibrium price for these bonds is determined by a demand schedule that reflects differences in marginal tax rates, taxpayers in the highest tax-bracket are likely to continue to derive a surplus from the exclusion even after the repeal of preferences not subject to the market pricing mechanism.[70]

66. *See* J. Hirshleifer, *supra* note 61, at 22-23.

67. The argument that follows in the text assumes that investors are the same in all respects other than their marginal tax brackets and specifically that investor preferences as to liquidity, risk, and return do not vary across marginal tax brackets. A taxpayer's marginal tax bracket would be the sole determinant of the price that he would be willing to pay for municipal bonds. Assuming that taxpayers in lower brackets lose interest in bonds at or above a certain price, each point (P_yQ_y) represents quantity of bonds demanded at that price by taxpayers in a particular bracket (y%) and in all higher brackets. I recognize, however, that barriers to entry, such as minimum investment requirements, may prevent low-bracket taxpayers from participating in certain investments.

68. In Figure 2, the demand curve for municipal bonds is pictured as a straight line. This is not strictly accurate if all things other than marginal tax brackets are considered equal, as is assumed in the text. *See supra* note 73 and accompanying text. Under that assumption, the demand curve for these bonds would not be continuous, but would contain steps corresponding to each marginal tax bracket.

69. *See supra* text accompanying notes 53-54.

70. For a similar argument that differences in marginal tax rates explain the surplus enjoyed by upper-bracket taxpayers in state and local government bonds, see Ackerman & Ott, *supra* note 21, at 398.

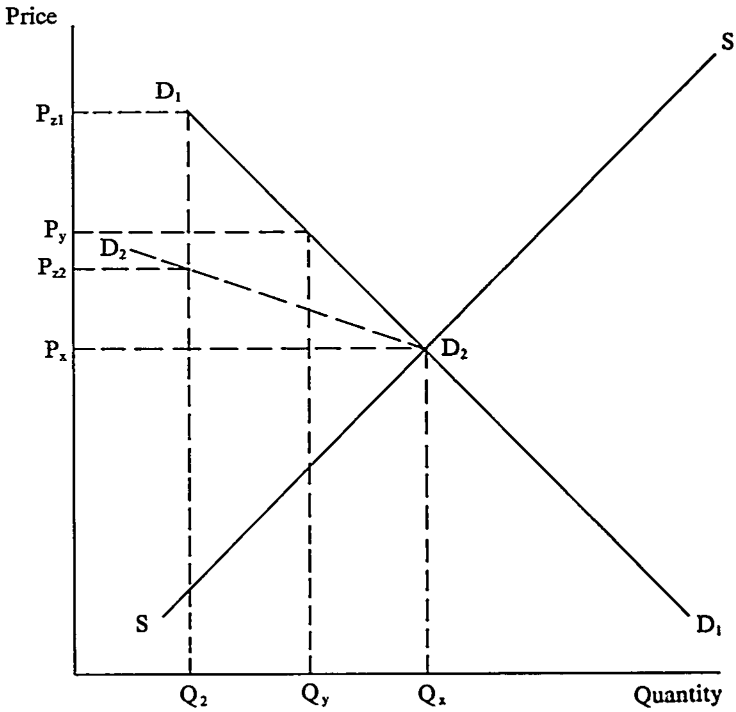

figure 2

The relationship between the demand schedule for tax-exempt bonds and marginal tax brackets provides an additional important insight for tax reform efforts. If the demand schedule for municipal bonds is conceived as points corresponding to the quantity of bonds demanded by taxpayers in a particular marginal tax bracket and all higher tax brackets, the enactment of a tax provision that reduces the disparity among marginal tax brackets by lowering tax rates above x% would have the effect of flattening the demand schedule (D_2D_2).[71] With a flatter demand schedule, the price (P_{z2}) at which taxpayers in the highest tax-bracket

71. This argument may be understood by assuming that tax-exempt and taxable bonds are perfect substitutes differing only in the tax exclusion provided for the former. Under that assumption, taxpayers in the maximum tax bracket (z1%) would be indifferent as between purchasing tax-exempt and taxable bonds when the rate of return on tax-exempts is (100 - z1)% of the rate on taxable bonds, i.e., when the rate of return on tax-exempts equals the after-tax rate of return on taxable bonds. If, for example, taxable bonds offer an interest rate of 10% and the highest tax bracket is 60%, taxpayers in that bracket would be indifferent as between purchasing tax-exempt and taxable bonds when tax-exempts offer a rate of return of 4%.

Assume now that the maximum rate is lowered to z2% and that all other things remain constant. Under this assumption, taxpayers in the highest tax bracket would be indifferent as between tax-exempt and taxable bonds when the rate of return on tax-exempts is (100 - z2)% of the rate on taxable bonds. If, for example, taxable bonds offer a 10% return and the new maximum tax rate is 40%, taxpayers in that bracket would be would be indifferent between tax-exempt bonds and taxable bonds would be lower, thereby reducing from (P_{z1}-P_x) to (P_{z2}-P_x) the surplus from purchasing tax-exempt bonds for those taxpayers. Thus, the effect of a reduction in differences among marginal tax rates would be to minimize the tax inequity between investors in tax-exempt bonds and other taxpayers in the same tax bracket.[72]

c. *The Importance of Wholesale Repeal of Tax Preferences*

The best method for further reducing the inequity caused by the municipal bond exemption is to repeal as many other tax preferences as possible, rather than to limit reform efforts to investments not governed by the market pricing mechanism. To understand why tax equity will be improved by a wholesale attack on preferences, assume that in Figure 3, D_1D_1 represents the demand schedule for municipal bonds in a world with a plethora of other preferences; P_1 is the equilibrium price; and (P_y-P_1) is the surplus enjoyed by a taxpayer in the top tax-bracket on municipal bonds. The repeal of any preference that is a substitute for tax-exempt bonds will increase demand for the latter, resulting in a shift to the right in the demand schedule for municipal bonds (D_2D_2).[73] The more substitute preferences that are repealed, the greater is the probable shift in the demand schedule for tax-exempt bonds (D_xD_x).

The effect of each shift in the demand curve is to improve tax equity. Before the repeal of other preferences, the equilibrium price for tax-exempt bonds was P_1; after the repeal of one tax preference, the equilibrium price increases to P_2; with the repeal of other preferences, the equilibrium price moves even higher to P_x. Although the cumulative effect of the elimination of these other preferences may still leave the new equilibrium price for tax-exempt bonds lower than P_y and thus enable the highest bracket taxpayer to continue to enjoy a surplus from investing in tax-exempt bonds, that surplus will have declined from (P_y-P_1) to (P_y-P_x),

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indifferent between tax-exempt and taxable bonds when the rate of return on tax-exempts is 6%.

The base price (P_{z2}) of a tax-exempt bond offering a rate of return of 6% is of course lower than the price (P_{z1}) of a tax-exempt bond providing a 4% return, assuming that the amount of interest generated by each is the same. By lowering the price at which taxpayers in the highest tax bracket would be indifferent between tax-exempt and taxable bonds, the effect of a reduction in the highest tax rate is to flatten the demand curve for municipal bonds. For the same reasons, a reduction in the marginal tax rate applicable to *any* class of taxpayers has the effect both of lowering the price at which those taxpayers would be indifferent as between tax-exempt and taxable bonds and of flattening the demand curve for tax-exempt bonds.

72. Of course, a reduction in the higher tax rates might be criticized from the perspective of the fairness criterion for reducing the degree of progression of the income tax. *See infra* text accompanying notes 299-305; *see also* Yorio I, *supra* note 4, at 1260-61 (discussing the fairness criterion and the level of progressivity of an income tax). Thus, the argument in the text is directed towards the issue of horizontal equity rather than vertical equity, as was Cooper's analysis of tax avoidance from an equity perspective. *See* Cooper, *supra* note 6, at 707-14.

73. *See supra* text accompanying note 55.

thereby reducing the inequity between investors in tax-exempt bonds and other taxpayers in the same tax-bracket.

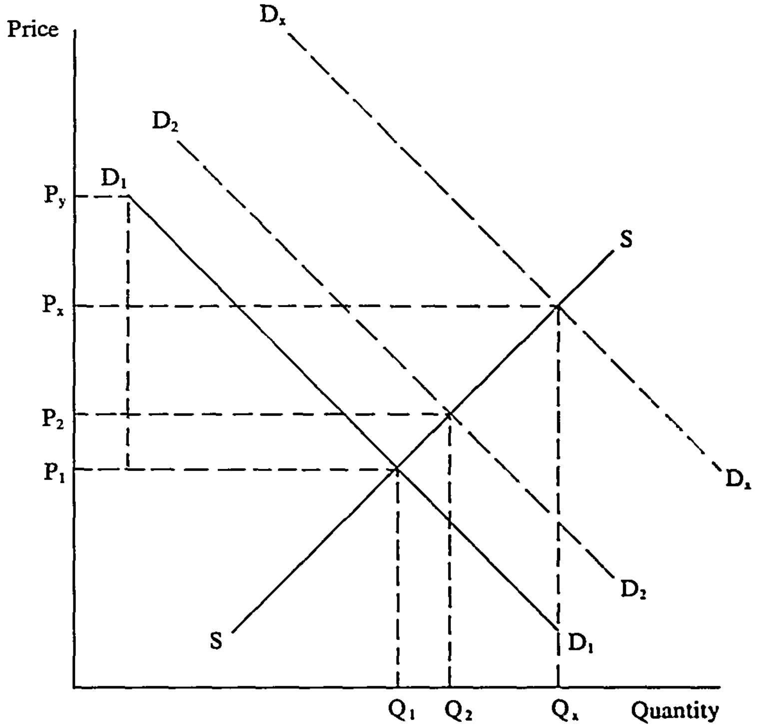

figure 3

3. Summary

The concepts of an implicit tax and the market pricing mechanism contain important insights for efforts to improve the equity of the federal income tax system. The lesson to be learned is not, however, that Congress should be content to limit reform to investments that escape the effect of the market pricing mechanism; serious inequities are likely to persist even after the repeal of tax preferences on such investments. Tax inequity will be substantially improved by following two very different courses: first, reducing marginal tax rates and, second, eliminating as many preferences as possible. As will be shown in Part II, Congress, by enacting the 1986 Act, has heeded the true lessons of the market pricing mechanism and recognized the centrality of reducing marginal tax rates to mitigating tax inequity.

B. *Efficiency*

My previous article identified four primary inefficiencies that may result from the enactment of a tax incentive. First, an incentive may stimulate excessive production of a tax-favored good or service.[74] Second, an incentive may stimulate excessive consumption of a tax-favored good or service, causing a misallocation of resources and a decline in overall utility.[75] Third, an incentive may provide tax benefits that are greater than necessary to accomplish the government's objective in enacting the incentive.[76] Fourth, the enactment of an incentive may increase the transaction costs of compliance and planning incurred by taxpayers and the costs of administering and enforcing the law incurred by the government.[77] Using these standards, I concluded that many of the incentives found in the pre-1986 Code generated inefficiencies.[78] Two recent law review articles propose different standards for judging the efficiency of a federal income tax provision which, if valid, place in doubt my original conclusions.[79]

1. Efficiency Defined in Terms of Congressional Decisions

George Cooper, in the article discussed earlier, addresses indirectly the first two of my efficiency concerns by distinguishing between tax incentives that operate in the way that Congress intended and tax incentives that provide benefits to taxpayers in an amount greater than Congress envisioned.[80] Although Cooper recognizes that both classes of incentives affect the allocation of resources in society,[81] he concludes that, with regard to the former, the incentive is efficient in the "larger social and economic policy sense" that "society has gotten something in return" for the tax revenues lost due to the incentive.[82] By contrast, when the incentive produces tax savings in unintended amounts, the incentive cannot be justified on the basis of this expanded concept of efficiency because it cannot be assumed that the social benefits of the incentive are worth its costs in reduced revenues.[83]

This perspective broadens the efficiency debate by raising the possibility that the social benefits arising from the enactment of an incentive justify a seeming misallocation in resources caused by the incentive. But a test for distinguishing between efficient and inefficient tax incentives based on intended and unintended effects is often unworkable in practice because of the difficulty of determining whether the effects of an incentive extend beyond those that Congress intended.[84] Consider, for example,

74. *See* Yorio I, *supra* note 4, at 1262, 1287.
75. *See id.* at 1262, 1273-74.
76. *See id.* at 1276.
77. *See id.* at 1269-70.
78. *See id.* at 1284, 1286-88.
79. *See* Cooper, *supra* note 6; Zelinsky, *supra* note 6.
80. *See* Cooper, *supra* note 6, at 696-97.
81. *See id.* at 695-96, 705-06.
82. *See id.* at 697.
83. *See id.*
84. Cooper himself recognizes that distinguishing between incentives with intended and unintended effects is an inquiry often posing "large and complex questions with uncertain answers." *See id.* He also states that the inquiry "resembles that made under tax

the tax treatment of real estate prior to the passage of the 1986 Act. By failing to subject real estate to the "at risk" rules governing other investments,[85] by providing generous ACRS allowances for real estate,[86] and by allowing taxpayers to convert ordinary income deductions into favorably-taxed capital gains income upon the disposition of most real estate,[87] Congress created a combination of tax incentives that has had the effect of shifting capital from other investments into real estate.[88] Since the tax advantages of the ACRS rules (deferral) and of the capital gains provisions (rate conversion) are straightforward and readily comprehensible, Congress presumably understood the revenue and other implications of their enactment.[89] The effect of the exemption of real estate from the "at-risk" rules is more abstruse because the tax advantages are indirect: taxpayers are permitted to leverage real estate investments and thereby shelter other income with the deductions or losses generated by real estate ventures.[90] For this reason, it is possible that Congress failed to appreciate the effects of the exemption.[91] On the other hand, Congress, in first enacting and then extending the "at risk" rules, specifically decided to exempt real estate.[92] Subsequently, Congress strengthened the "at risk" rules on two separate occasions without extending the rules to

expenditure analysis, insofar as it calls for a cost-benefit calculation of any subsidy." *See id.* at 697 n.159. But if something like a cost-benefit analysis is required, it makes more sense simply to subject the preference to a traditional cost-benefit calculation rather than to try to determine whether the preference produces effects different from those intended by Congress. *See infra* notes 95-97 and accompanying text.

85. *See* I.R.C. § 465(c)(3)(D) (1982) (repealed 1986).

86. *See id.* §§ 168(b)(2)(A), 168(c)(2)(D) (1982 & Supp. 1985) (18-year depreciation period for most buildings) (amended 1986).

87. Generally described, the pre-1986 Code recaptured as ordinary income only the excess of depreciation taken on real estate over straight-line depreciation. *See id.* §§ 1250(a), 1250(b)(1) (amended 1986). The remaining gain was generally taxable as capital gain. *See id.* § 1202(a) (1982) (repealed 1986).

88. *See* Hendershott, *The Impact of Tax Reform on the Slope of the Playing Field*, 31 Tax Notes 1107 (1986). Congress has also provided tax incentives for real estate on the consumption side, which have the effect of diverting resources into owner-occupied housing. *See* R. Goode, The Individual Income Tax 125 (1964); E. Mills, Urban Economics 129-30 (2d ed. 1980); *see also infra* text accompanying notes 146-51 (listing direct and indirect tax incentives for homeownership).

89. *See* Cooper, *supra* note 6, at 671 (implications of deferral understood by Congress).

90. *See id.* at 672-76; Yorio, *supra* note 4, at 1286.

91. *See* Cooper, *supra* note 6, at 706-07 (benefits of leveraging unintended by Congress).

92. In 1976, the House Ways and Means Committee proposed that limitations on artificial losses from real estate be enacted to prevent investors in real estate shelters from using artificial losses to offset other income. *See generally* H.R. Rep. No. 658, 94th Cong., 2d Sess. 29-37, *reprinted in* 1976 U.S. Code Cong. & Admin. News 2897, 2922-31. The Senate Finance Committee rejected this provision. *See* S. Rep. No. 938, 94th Cong., 2d Sess. 39, *reprinted in* 1976 U.S. Code Cong. & Admin. News 3439, 3475. The Joint Conference Committee decided to limit deductions from certain activities, to the amount "at-risk," but excluded real estate. *See generally* H.R. Conf. Rep. No. 1515, 94th Cong., 2d Sess. 411-12, *reprinted in* 1976 U.S. Code Cong. & Admin. News 4118, 4122-24. With real estate exempted, these "at-risk" rules were enacted by Congress. *See* Tax Reform

cover real estate.[93] In light of this legislative history, it seems doubtful that the effects of the real estate exemption were unintended. Rather, it is at least possible that Congress, cognizant of the tax effects, concluded that the social benefits of increased real estate investment were worth the costs of even an egregious tax shelter.[94]

In addition to the practical problem of distinguishing between incentives with intended and unintended effects, a test of efficiency that defers to congressional decision-making is suspect on theoretical grounds. Consider again the congeries of tax incentives previously provided for real estate. Even if Congress understood the full implications of these provisions, the provisions may not be efficient in the broader social policy sense if their enactment reflected not a rational calculation of the costs and benefits to society in general, but rather the response of a legislature to pressure brought by a powerful constituency for favorable tax treatment.[95] If this more skeptical interpretation is valid, or even plausible, a test of efficiency that defers to congressional judgments is suspect because it assumes that favorable tax treatment results from a sound analysis of societal costs and benefits, rather than of the costs and benefits of a powerful interest group or indeed of Congress itself.[96] To minimize the risk of inefficiency, *every* tax incentive, including those with known and intended effects, should be carefully scrutinized from an economic

Act of 1976, Pub. L. No. 94-455, § 204(a), 90 Stat. 1525, 1531-32 (codified as amended at I.R.C. § 465 (1982)).

In 1978, the Conference Committee proposed to extend the "at risk" rules to virtually all activities other than real estate. *See* H.R. Conf. Rep. No. 1800, 95th Cong., 2d Sess. 219-20, *reprinted in* 1978 U.S. Code Cong. & Admin. News 7198, 7222-23. The extension (with the real estate exception) was enacted by Congress. *See* Revenue Act of 1978, Pub. L. No. 95-600, §§ 201(a), 201(c)(1), 202, 203, 701(k)(2), 92 Stat. 2763, 2814-17, 2906 (1978). In the same year, Congress extended the "at risk" rules to geothermal properties. *See* Energy Tax Act of 1978, Pub. L. No. 95-618, § 402(d), 92 Stat. 3174, 3202-03 (1978).

93. In 1979, Congress considered and enacted various technical amendments designed to strengthen the "at risk" rules without extending the rules to real estate. *See* Technical Corrections Act of 1979, Pub. L. No. 96-222, § 102(a)(1), 94 Stat. 194, 206-08 (1980); *see also* S. Rep. No. 498, 96th Cong., 2d Sess. 42-46, *reprinted in* 1980 U.S. Code Cong. & Admin. News 316, 353-57 (legislative history of the tax shelter provisions of the Technical Corrections Act of 1979).

In 1984, Congress considered and enacted other changes designed to strengthen the "at risk" rules. The exemption for real estate, however, was not affected. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 432(a)-(c), 721(x)(2), 1984 U.S. Code Cong. & Admin. News (98 Stat.) 811-15, 971 (codified as amended at I.R.C. § 463(c) (1982); *see also* H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1120, *reprinted in* 1984 U.S. Code Cong. & Admin. News 1445, 1808-10 (legislative history of the "at-risk" provisions of the Deficit Reduction Act of 1984).

94. Cooper himself seems to admit the possibility that the tax benefits accorded real estate may have been intended by Congress. *See* Cooper, *supra* note 6, at 679.

95. For a discussion of the power and operation of the real estate lobby with respect to tax legislation, see Farnsworth, *Charge! They Whose Tax Oxen Have Been Gored*, N.Y. Times, May 9, 1986, at 22, col. 3; *see also Tax Reform: Real Estate Groups Combine to Protest Provisions in Packwood Draft Bill*, 56 Daily Tax Rep. (BNA), at G-6 (March 24, 1986) (real estate groups combine to protest tax measures affecting real estate).

96. The interests of the real estate lobby and of certain legislators may coincide if, for

perspective.[97]

2. Market Failure

A different perspective on the efficiency debate is contained in an important and insightful article by Professor Edward Zelinsky, who identifies three distinct concepts of efficiency in the literature of tax incentives: universal market efficiency, sectoral efficiency, and technical efficiency.[98] Within this conceptual framework, the claim in my earlier article that a tax subsidy distorts resource allocation by encouraging production or consumption of the tax-favored good or service[99] is founded on a notion of sectoral efficiency.[100] The argument that a tax incentive costs the government more in lost revenues than the benefit produced and that it generates unproductive transaction costs[101] are criticisms grounded in what Professor Zelinsky labels "technical efficiency."[102]

a. *Sectoral Efficiency and Market Failure*

With respect to sectoral efficiency, Professor Zelinsky does not dispute that tax incentives affect resource allocation in society.[103] Nevertheless, he argues that the incentive may be defensible on efficiency grounds if its effect is to remedy a market failure. Under this assumption, the incentive does not cause a *mis*allocation of resources, but rather makes the market more efficient than it would be in the absence of the incentive.[104] Although other commentators have recognized that tax rules may be designed to remedy market imperfections,[105] Professor Zelinsky's article offers the most systematic and plausible defense of tax incentives from this perspective.

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example, the lobby can aid the legislators' reelection efforts through political contributions.

The possibility that legislators act to maximize their own, rather than society's, interests is a subject explored by the theorists of public choice. *See, e.g.*, Buchanan, *Politics Without Romance: A Sketch of Positive Public Choice Theory and its Normative Implications*, in The Theory of Public Choice-II 11, 18-19 (J. Buchanan & R. Tollison ed. 1984).

97. Even defenders of tax incentives from an efficiency perspective recognize that there are certain tax incentives with known and intended effects that operate inefficiently. *See, e.g.*, Zelinsky, *supra* note 6, at 1035 (criticism of exclusion for interest on state and local government bonds as inefficient). *See infra* note 117 and accompanying text.

98. *See* Zelinsky, *supra* note 6, at 975, 980-95.

99. *See supra* text accompanying notes 74-76.

100. *See* Zelinsky, *supra* note 6, at 986-92.

101. *See supra* text accompanying notes 76-77.

102. *See* Zelinsky, *supra* note 6, at 992-95. Professor Zelinsky may be the first person to use the term "technical efficiency" in the context of income tax policy. *See id.* at 992 n.40.

103. *See id.* at 987-92.

104. *See id.* at 1002-05.

105. *See, e.g.*, R. Posner, Economic Analysis of Law 280-81 (2d ed. 1977) (discussing the imposition of an excise tax on pollution equal to its societal costs); A. Okun, Equality and Efficiency 11, 12 (1975) (rationale for government intervention rests on externalities); Yorio I, *supra* note 4, at 1261 n.52 (same).

It is impossible to do complete justice to Professor Zelinsky's rich analysis of sectoral efficiency within the confines of this Article. Two illustrations may suffice, however, to give the reader a sense of his fundamental thesis. Assume that in the widget industry, significant barriers to entry prevent the production of an optimal amount of widgets. If the industry is given a tax incentive, its effect will be to draw capital from other industries. With the instillation of additional capital in the industry, production of widgets will move closer to the optimal level. Although the incentive has changed the allocation of resources in society, its effect is to improve efficiency if it remedies the market failure caused by barriers to entry in the widget market.[106]

Analogous market imperfections may justify the enactment of a tax incentive to spur consumption. Suppose, for example, that the demand for owner-occupied housing is lower than optimal because many potential buyers face obstacles in obtaining requisite financing. To overcome that barrier to entry, a mortgage interest deduction may be enacted to raise the demand for owner-occupied housing to a more efficient level.[107]

Drawing on the literature of the law and economics movement,[108] Professor Zelinsky points out that production or consumption activities may generate positive or negative externalities for which the market fails to compensate.[109] The enactment of a tax incentive may be defended as a means of compensating for the market's inability to internalize the costs of these externalities.[110] Once again, two examples may help to clarify this insight. Suppose that an indigenous and vital steel industry is essential to meeting the Nation's defense needs domestically in times of war when foreign sources of supply may be cut off. Although the survival of the industry generates a significant positive externality in the form of national security, American producers will be unable to reflect the benefit of that externality in their prices without losing customers to foreign competition. A tax incentive may be enacted to remedy the market's failure to compensate for the increase in societal utility generated by the survival of domestic steel producers.[111]

Similar externalities may flow from consumption activities. Owner-occupied housing may be desirable because homeowners are likely to

106. *See* Zelinsky, *supra* note 6, at 1002-04.

107. *See id.* at 1004-05.

108. The literature of the law and economics movement is voluminous. Two seminal articles were published in the early 1960's. *See* Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts,* 70 Yale L.J. 499 (1961); Coase, *The Problem of Social Cost,* 3 J. L. & Econ. 1 (1960). Among the more influential and oft cited books are G. Calabresi, The Costs of Accidents (1970); R. Posner, Economic Analysis of Law (3d ed. 1986).

109. *See* Zelinsky, *supra* note 6, at 1005-08.

110. *See id.* Other commentators have previously suggested that tax rules might be designed to compensate for the market's inability to internalize externalities. *See, e.g.*, Wiedenbeck, *Paternalism and Income Tax Reform,* 33 U. Kansas L. Rev. 675, 683-84 (1985); Yorio I, *supra* note 4, at 1261 n.52, 1276 n.187.

111. *See* Zelinsky, *supra* note 6, at 1006-07.

take better care of their property, or because homeowners are more inclined than renters to participate in anti-crime efforts or to assume other civic responsibilities, thus generating positive externalities for the community.[112] Because the market is unable to compensate for the benefits generated by these externalities, society may suffer an overall loss in utility unless owner-occupied housing is encouraged by the enactment of a tax incentive such as the mortgage interest deduction.[113]

b. *Market Failure as a Defense of Pre-1986 Federal Tax Incentives*

Although Professor Zelinsky's analysis can be used to defend tax incentives on efficiency grounds, his own conclusions with regard to the actual efficiency of tax incentives are somewhat tentative.[114] Indeed, his primary argument is not that tax incentives are generally efficient, but simply that a case can be made for particular tax incentives on grounds of efficiency.[115] Consistent with this view, he defends the mortgage interest deduction,[116] but criticizes the exclusion for interest on state and local government bonds.[117] Despite the tentativeness of his conclusions, it is important to determine whether remedying market failures provides a convincing explanation for the tax incentives found in the pre-1986 Code.

Two facts indicate that the tax incentives found in the pre-1986 Code were not intended and did not operate in general to remedy market failures. First, few, if any, of the incentives were explicitly defended in the legislative debates as remedies for specific market failures.[118] Although it is possible that Congress was intuitively aware of market failures and responded by enacting incentives as cures,[119] the virtual absence of direct evidence of that purpose suggests that remedying market failures was probably not a prime concern of Congress in providing tax incentives.

Second, the generality of many of the most criticized of the pre-1986 incentives belies an argument that they were enacted as remedies for spe-

112. *See id.* at 1007.

113. *See id.* at 1007-08.

114. *See id.* at 1019-20.

115. *See id.* at 1036.

116. *See id.* at 1024-26. Professor Zelinsky notes that the effects of the deduction, while efficient, are unpalatable. *See id.* at 1026.

117. *See id.* at 1035. Other commentators agree that the exclusion for interest on state and local government bonds is inefficient. *See, e.g.*, Ackerman & Ott, *supra* note 21, at 398; Toder & Neubig, *Revenue Cost Estimates of Tax Expenditures: The Case of Tax-Exempt Bonds*, 38 Nat'l Tax J. 395 (1985).

118. This point is admittedly difficult to prove with certainty without reading every page of the legislative history of every tax incentive provided by federal tax law. But in the course of his elaborate and lengthy defense of tax incentives as remedies for market failure, Professor Zelinsky adduces not a single reference to the legislative history of *any* tax incentive as empirical support for his thesis. *See* Zelinsky, *supra* note 6. I, too, am unaware of evidence in the legislative history of federal income tax incentives that would support the view that these incentives are designed to remedy market failures.

119. *Cf. id.* at 1036 (Congressional enactment of tax subsidy may reflect "intuitive" awareness of the procedural efficiency of the tax system).

cific market failures.[120] To be sure, the Code does contain certain provisions that are sufficiently narrow in scope to support an argument that they were enacted to remedy specific market failures. Five-year amortization of the basis of qualifying pollution control facilities,[121] for example, might be defended as a method of rectifying the market's inability to force a polluter to internalize the costs of the negative externalities imposed on society by the pollution.[122] Special tax credits for the rehabilitation of historic structures[123] might be justified on the grounds that renovation of an historic building generates considerable positive externalities for which the owner would not be compensated by the market. Whether these tax provisions actually operate to improve efficiency is an issue that is likely to be difficult to resolve,[124] but their narrowness at least suggests that they may have been enacted by Congress to cure specific market failures.

By contrast, the broad scope of the majority pre-1986 tax incentives makes it extremely unlikely that they were designed to remedy specific market failures. With respect to investment and production incentives, for example, the most important Code provisions were virtually universal in their reach: the capital gains provisions applied to almost all investment property;[125] the Investment Tax Credit applied to investments in virtually all machinery and equipment;[126] and the ACRS rules applied to all property within certain classes.[127] Similarly, deductions for items of consumption were simply too broad to support an argument that curing market failures was their justification: virtually all state and local taxes were deductible, not just property taxes on owner-occupied housing;[128]

120. *Cf.* R. Goode, *supra* note 88, at 126:

> There is no evidence that the present income tax treatment of owner-occupied houses was deliberately devised to promote housing and homeownership. The personal deductions for interest and tax payments are general allowances. Nor does the omission of imputed rent indicate special concern for housing, since other imputed income is also omitted.

121. *See* I.R.C. § 169 (1982).

122. *Cf.* R. Posner, *supra* note 108, at 353-58 (to force polluter to internalize the costs of pollution, a tax may be imposed).

123. *See* I.R.C. §§ 46(a), 46(b)(4) (amended 1986), 48(g)(3) (1982 & Supp. III 1985).

124. *See infra* text accompanying notes 133-65.

125. *See* I.R.C. §§ 1202(a) (repealed 1986), 1221 (1982).

126. *See id.* § 48(a)(1) (1982 & Supp. III 1985) (definition of property qualifying for investment tax credit). Certain property did qualify for a larger tax credit, however. *See, e.g., id.* § 46(b)(2), (4) (amended 1986) (certain energy-related property and certain rehabilitation expenses). With respect to such property, the claim is more plausible that the additional credit was provided to remedy a market failure. *See supra* text accompanying note 123.

127. *See* I.R.C. § 168(c)(1), (2) (1982 & Supp. III 1985) (amended 1986).

The universality of the incentives discussed in the text accompanying notes 125-27 *supra* did not keep them from causing serious distortions in resource-allocation, in part because the impact of the incentives varied from industry to industry. For studies demonstrating the inefficiency of various pre-1986 investment tax incentives, see sources cited in note 323 *infra*.

128. *See* I.R.C. § 164(a) (1982) (amended 1986); *cf.* R. Goode, *supra* note 88, at 126-27

interest was deductible on all loans to finance personal consumption, not just on mortgages on owner-occupied housing.[129] Moreover, each of these deductions or credits was available to all taxpayers, not just to taxpayers who might be faced with barriers to entry in the market.[130] The revenue losses and incentive effects associated with these tax incentives were presumably much greater than those of narrower provisions that could have operated as cures for specific market failures.[131] Hence, it is reasonably safe to conclude that the general effect of the tax incentives found in the pre-1986 Code was to distort resource allocation without offsetting efficiency gains.

c. *Market Failure as a Defense of a Particular Tax Incentive*

Even if the pre-1986 tax incentives were not intended and did not operate in general to remedy market failures, it is possible that a *particular* tax incentive may have the effect of rectifying market imperfections.[132] In practice, however, an efficiency analysis of a specific tax incentive in terms of market failure is likely to prove inconclusive, as Professor Zelinsky himself concedes.[133] Consider, for example, the deduction for interest on mortgages used to finance the purchase of owner-occupied houses. Professor Zelinsky makes an appealing case for this particular tax incentive on the grounds that the deduction serves to counteract sectoral inefficiencies such as barriers to entry in the market[134] and that owner-occupied housing generates positive externalities in the form of heightened civic responsibility and increased values for surrounding property.[135]

Despite these persuasive arguments, evidence that owner-occupied housing generates significant negative externalities weakens the case for

(generality of tax preferences belies deliberate congressional design to subsidize owner-occupied housing).

129. *See* I.R.C. § 163(a) (1982).

130. *See* sources cited *supra* notes 125-29. Indeed, because of graduated tax rates, the primary benefit of many of the preferences (for example, the mortgage income deduction) flows to upper-income taxpayers who face *lower* barriers to entry in the market because of their high income levels. *See infra* text accompanying notes 162 & 183-85; *cf.* Makin & Allison, *Tax Reform 1986: A Fragile Victory*, 34 Tax Notes 251, 258 (1987) ("affluent who already own homes, not the young seeking to buy homes," benefit heavily from preferences for homeownership).

131. For 1986, the following revenue losses were projected for the various investment tax incentives discussed in the text: Investment Tax Credit, $30.9 billion; accelerated depreciation deductions, $4.0 billion; favorable treatment of capital gains, $30.3 billion; special credits for historic structures, $125 million; five-year amortization of pollution control facilities, $115 million. *See* Congressional Budget Office, 97th Cong., 1st Sess., Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1982-86 81-84 (1981).

132. *See* Zelinsky, *supra* note 6, at 1036.

133. *See id.* at 1023, 1035-36.

134. *See id.* at 998-1001, 1007.

135. *See id.* at 1007.

the mortgage interest deduction as a remedy for market failure.[136] By facilitating the purchase of suburban and exurban homes, the deduction may lead to a decline in central cities as centers of culture and community identification.[137] Dispersal of the population may also result in increased dependence on oil,[138] a once scarce and potentially critical resource, and may make American foreign policy subject to control or influence by oil-producing nations. Moreover, because the poorest members of society are unable to take advantage of the deduction,[139] the incentive may lead to greater racial or class segregation.[140]

In addition to generating negative externalities, owner-occupied housing may be more costly than rental housing in two other respects. First, specialization of function within the economy usually minimizes costs.[141] If the housing market resembles other industries in this respect, landlords, as specialists, may be able to provide services at a lower cost than homeowners.[142] Second, rental housing benefits from economies of scale that are usually unobtainable in communities of owner-occupied homes.[143] By skewing resource allocation towards owner-occupied housing, the mortgage interest deduction may prevent the market from satisfying demands for housing at minimal cost.

Moreover, if it were assumed that market failure justifies some government intervention in the market for owner-occupied housing, enacting (or preserving) a mortgage interest deduction may be inefficient if other forms of government subsidies—either direct or indirect—already operate to remedy the market failure. Thus, an efficiency analysis of the deduction would have to include direct government subsidies provided for owner-occupied housing, such as government-insured mortgages[144] and real estate tax abatements for certain classes of homeowners.[145] Moreover, federal tax law itself provides substantial subsidies to homeownership apart from the mortgage-interest deduction. To begin with, the

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136. Professor Zelinsky recognizes that owner-occupied housing may generate negative externalities, but his catalogue of those externalities is quite limited. *Compare id.* at 1007-08 (acknowledging one possible negative externality of homeownership) *with infra* text accompanying notes 137-40 (discussing three other negative externalities of homeownership).

137. *See* Lowry, *The Dismal Future of Central Cities*, in The Prospective City 160-203 (A. Solomon ed. 1980).

138. *See* E. Mills, *supra* note 88, at 202; *The Prospective City* 260 (A. Solomon ed. 1980).

139. *See infra* note 161 and accompanying text.

140. *See* E. Mills, *supra* note 88, at 126-27; *cf.* Pettigrew, *Racial Change and the Intrametropolitan Distribution of Black Americans*, in The Prospective City 62-65 (A. Solomon ed. 1980) (discussing segregation in metropolitan areas).

141. *See, e.g.*, J. Hirshleifer, *supra* note 51, at 218-19, 227 (discussing cost reduction due to specialization).

142. *See* R. Goode, *supra* note 88, at 127.

143. For an analysis of economies of scale, see J. Hirshleifer, *supra* note 51, at 258-62.

144. *See, e.g.*, 12 U.S.C. §§ 1707-15 (1982 & Supp. 1983) (federal mortgage insurance).

145. *See, e.g.*, N.Y. Real Prop. Tax Law §§ 458-59, 467 (McKinney 1984 & Supp. 1987) (real estate tax exemptions for veterans, the disabled, and senior citizens).

Code permits homeowners to deduct real property taxes,[146] which would otherwise be a nondeductible consumption expense.[147] Federal tax law provides an additional, implicit subsidy by not taxing the "net imputed rental value" of owner occupied housing.[148] The Code also allows certain taxpayers to exclude up to $125,000 of the gain on the sale of a home[149] and permits all taxpayers to defer tax on the gain from the sale of a home if certain conditions are satisfied.[150] Given the magnitude of these direct and indirect subsidies to homeownership,[151] the mortgage interest deduction may actually cause a misallocation of resources in society by overcompensating for any market failure that might exist in the absence of government subsidies.

Where, then, does the case for the deduction as a cure for market failure stand? It is generally agreed that the deduction shifts resources from rental housing and other investments into owner-occupied housing.[152] That apparent distortion may be illusory, however, if owner-occupied housing would otherwise be produced in a less than optimal amount because of sectoral inefficiencies or if owner-occupied housing generates positive externalities for which the market fails to compensate.[153] On the other hand, the deduction may be attacked on the grounds that it generates negative externalities, increases the costs of providing housing, and overcompensates for the effects, if any, of market failure when combined with other subsidies for owner-occupied housing.[154]

In light of these arguments for and against the deduction, a rigorous economic analysis of the deduction would require that a dollar amount

146. *See* I.R.C. § 164(a)(1) (1982).

147. *See id.* § 262.

148. *See* B. Bittker, L. Stone, & W. Klein, Federal Income Taxation 114 (6th ed. 1984).

If the imputed income from owner-occupied housing were taxed, the homeowner would be entitled to a deduction for all costs incurred to generate that imputed income (including mortgage interest and real estate taxes). *See* Yorio I, *supra* note 4, at 1273 n.163. Thus, the subsidy from failing to tax imputed income is not the entire imputed rental value of the home, but only the "net imputed rental value," i.e., the excess of the imputed rental value over the costs of maintaining the home.

149. *See* I.R.C. § 121 (1982).

150. *See id.* § 1034 (1982 & Supp. III 1985) (amended 1986).

151. The federal tax subsidy for homeownership is quite large even without the mortgage interest deduction. For fiscal year 1979, the revenue loss from failing to tax the net imputed rental income of owner-occupied housing was estimated at $14 billion to $17 billion. *See* Congressional Budget Office, 97th Cong., 2d Sess., The Tax Treatment of Homeownership: Issues and Options 20 (1981). For fiscal year 1987, the estimated revenue loss due to the deductibility of real property taxes has been estimated at $11.7 billion; the loss due to the exclusion of gain on certain home sales, at $2.1 billion; the loss due to the deferral of gain on home sales, at $6.4 billion. *See* Staff of Joint Comm. on Taxation, 99th Cong., 1st Sess., Estimates of Federal Tax Expenditures for Fiscal Years 1986-90 13 (Joint Comm. Print 1985).

152. *See, e.g.*, B. Bittker, L. Stone, & W. Klein, *supra* note 148, at 114-15; E. Mills, *supra* note 88, at 130.

153. *See* Zelinsky, *supra* note 6, at 998-1001, 1007.

154. *See supra* notes 136-51 and accompanying text.

be assigned to each of the positive and negative externalities generated by the deduction and that empirical evidence be adduced on the relative costs of providing owner-occupied and rental housing, on the degree of sectoral inefficiency, if any, that exists in the market without a deduction, and on the effect of other government subsidies in curing any sectoral inefficiency or in compensating for any externality. Since it is virtually certain that Congress will not be presented with evidence of this nature in its deliberations with regard to any proposed or existing tax incentive,[155] neither the proponents nor the opponents of the deduction are likely to establish their case.

Given the probability that the evidence adduced with respect to the efficiency of a particular tax incentive will be inconclusive, Professor Zelinsky asserts that the crucial issue may be on whom to place the burden of proof and that opinions may vary on this issue depending on an individual's general predilections towards government intervention in the economy.[156] With respect to the mortgage interest deduction, he apparently would place the burden of proof on those "asserting the inefficiency" of the incentive,[157] in part because "externalities and barriers to entry" exist in the housing market.[158]

For various reasons, it is difficult to accept the view that the opponents of the mortgage interest deduction should have the burden of proving its inefficiency. To begin with, the deduction has been estimated to cost the federal government $30.3 billion in lost revenues for fiscal year 1987.[159] Were a direct subsidy in the same amount proposed for owner-occupied housing, it would seem reasonable to expect the proponents of the subsidy to bear the burden of demonstrating that the benefits of the subsidy exceed its cost.[160] Moreover, the poorest members of the population generally get no benefit from the subsidy provided by the mortgage-interest deduction for a number of reasons: they cannot afford owner-occupied housing; they do not itemize their personal deductions; or they have no income tax liability.[161] With respect to the remainder of the population, the benefits of this tax subsidy flow in proportionately greater amounts to

155. *Cf.* Zelinsky, *supra* note 6, at 1023 (difficult to quantify barriers to entry, externalities, and transaction costs).

156. *See id.* at 1023-24.

157. *See id.* at 1026.

158. *See id.* at 1024, 1026. Professor Zelinsky also defends the deduction as a technically efficient method of curing market failures associated with owner-occupied housing. *See id.* at 1026. *See generally* text accompanying notes 166-208 (discussing the technical efficiency of tax incentives and direct subsidies). For a discussion of the technical efficiency of income tax incentives, see generally *infra* text accompanying notes 166-208.

159. *See* Staff of Joint Comm. on Taxation, 99th Cong., 1st Sess., Estimates of Federal Tax Expenditures for Fiscal Years 1986-90 13 (Joint Comm. Print 1985).

160. The arguments in the text assume, of course, that tax expenditures *ought* to be treated the same as direct subsidies in terms of the cost-benefit analysis required to justify them. Professor Zelinsky seems to agree. *See* Zelinsky, *supra* note 6, at 1029-33. *See infra* notes 186-89 and accompanying text.

161. *See* Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 Harv. L. Rev. 705, 720-25 (1970).

upper-middle and upper-income taxpayers because of graduated tax rates.[162] Since it is likely that the proponents of a similar direct subsidy for owner-occupied housing would bear the burden of proof, it seems highly unlikely that the opponents of a tax incentive would be required to shoulder the burden of proving its inefficiency.[163]

The mortgage interest deduction is used in Professor Zelinsky's analysis as an archetypical tax incentive to support the thesis that certain tax incentives may be justified as cures for market failures.[164] The preceding discussion reveals, however, that the case for the deduction on efficiency grounds is uneasy at best. Without denying that the possibility of market failure may be relevant to an efficiency analysis of certain tax incentives,[165] market-failure justifications may have limited practical utility if they fail to convince in the archetypical case.

3. Technical Efficiency

If the assumption is made that a case for government intervention in *some* form exists to achieve a societal goal, such as remedying market failure, the question then becomes which form of government intervention, tax incentive or direct subsidy, is a more efficient means of accomplishing the government's objective. Critics of tax expenditures have identified four primary inefficiencies that may result from using the tax law to bring about societal goals. First, tax incentives frequently reward taxpayers for doing what they would do anyway.[166] To the extent that taxpayers do in fact receive a windfall, the government is deprived of tax revenues without offsetting societal benefits. Second, tax expenditures are more likely to escape rigorous cost-benefit analysis than direct subsidies. This is partly because the passage (or retention) of a tax preference is politically easy and partly because tax subsidies are not enacted or administered by the Congressional committees and executive agencies that are most familiar with the underlying problem that justifies government intervention.[167] Third, a tax system containing preferences benefiting certain classes of taxpayers is likely to increase the resentment of other taxpayers. Perceptions of inequity may induce disgruntled taxpay-

162. For taxpayers in the 28% bracket, the cost to the government of every dollar of interest deducted is $0.28; for taxpayers in 15% bracket, the cost to the government is only $0.15. *See* M. Chirelstein, Federal Income Taxation 143-44 (4th ed. 1985); Andrews, *Personal Deductions in an Ideal Income Tax*, 86 Harv. L. Rev. 309, 310 (1972); Surrey, *supra* note 161, at 720-25.

163. *Cf.* R. Goode, *supra* note 88, at 127 (homeownership subsidy should be designed to benefit low- and middle-income taxpayers).

164. *See* Zelinsky, *supra* note 6, at 976.

165. *See supra* text accompanying notes 120-23 and *infra* text accompanying notes 370-72, 379-80.

166. *See* Surrey, *supra* note 161, at 719-20; Yorio I, *supra* note 4, at 1276.

167. *See* Surrey *supra* note 161, at 728-31; *cf.* Berger, *In Behalf of a Single-Rate Flat Tax*, 29 St. Louis U.L.J. 993, 1020 (1985) (direct subsidies have "higher visibility, accountability, and prospect for periodic review" than tax incentives). *See infra* notes 189-90 and accompanying text.

ers to cheat on their returns, leading to losses in revenue and further erosion of confidence in the system.[168] Fourth, the enactment of a tax incentive generates unproductive transaction costs in the form of planning and compliance by taxpayers and in the form of enforcement and administration by government.[169]

Although Professor Zelinsky admits that certain tax incentives may generate technical inefficiencies,[170] he correctly argues that the critical issue is not whether tax expenditures are occasionally inefficient, but whether in a *particular* case a tax expenditure would be more or less inefficient than a direct subsidy in accomplishing the government's objective.[171] Further, he argues that all the inefficiencies associated with tax expenditures may also result from a direct subsidy program: government grants occasionally reward recipients for what they would do anyway;[172] direct subsidy programs sometimes escape rigorous cost-benefit analysis;[173] citizens resent government largesse in the form of direct grants if it is perceived to be excessive;[174] and a direct subsidy program frequently results in considerable costs both to recipients in qualifying for a grant and in complying with its terms, and to the government in administering the program.[175] Finally, in what is probably his most acute and counterintuitive contribution to the debate about technical efficiency, Professor Zelinsky contends that tax expenditures may actually *reduce* transaction costs by enabling the government and citizens to utilize the existing tax system, at relatively low marginal cost, to disseminate and obtain information about government policies.[176]

a. *The Problem of Design*

One of the most serious and frequent criticisms leveled against tax incentives is that they reward taxpayers for engaging in activities that they would engage in without the benefit of a tax preference.[177] Perhaps the simplest illustration is the deduction for charitable contributions. Since *some* charitable giving would occur without favorable tax treatment, the deduction, by allowing taxpayers who itemize to deduct the *full* amount of their charitable contributions during the taxable year, provides tax relief that is greater than necessary to accomplish the government's presumed goal of encouraging charitable giving. To the extent that the

168. *See* 1 *Treasury Report*, *supra* note 2, at 9, 16; *President's Proposals*, *supra* note 2, at 2; Caplin, *The Travel and Entertainment Expense Problem*, 39 Taxes 947, 963 (1961); Yorio I, *supra* note 4, at 1256.

169. *See* Yorio I, *supra* note 4, at 1256-57; *cf.* R. Posner, *supra* note 108, at 473-74 (progressive rates and tax loopholes increase costs of planning).

170. *See* Zelinsky, *supra* note 6, at 1009-10.

171. *See id.* at 1026-33.

172. *See id.* at 1032.

173. *See id.* at 1029-30.

174. *See id.* at 1027 & n.106.

175. *See id.* at 1011-12.

176. *See id.* at 1010-12.

177. *See supra* note 166 and accompanying text.

government is deprived of tax revenues without an offsetting incentive effect, the deduction may be regarded as inefficient.[178] Defenders of tax incentives argue, however, that a direct subsidy program might be equally inefficient.[179] Subsidies to charities again provide the simplest example. If the deduction for charitable contributions were repealed and a matching-grant program were enacted in its stead, the government would be called upon to match contributions that might have been made without the program. As with the deduction, the government incurs a cost without an offsetting benefit in the form of increased charitable giving.

Although it is true that windfalls may result from both tax incentives and direct grant programs, the risk is usually less when government intervention takes the form of a direct subsidy. A subsidy program can be targeted precisely to the particular regions, states, groups, or individuals who are in need of government help or whose behavior the government wants to influence.[180] The design of tax incentives, by contrast, suffers almost inevitably from overbreadth or underbreadth or both. Tax incentives are often broader than necessary to accomplish the government's objective because drawing distinctions among states or regions of the country is difficult in a nationwide income-tax system or because restricting preferences to certain industries or classes of taxpayers may produce a tax system of daunting complexity.[181] Tax incentives are frequently narrower than necessary because they can affect the behavior only of citizens and corporations who are within the tax system and subject to federal income tax liability.[182]

A significant risk of design inefficiency is also inherent in many tax subsidies because of the way in which their incentive effect is distributed among income groups. The value of an income tax deduction depends on a taxpayer's marginal tax bracket: the higher the bracket, the greater the tax savings from obtaining a deduction.[183] The incentive to engage in conduct desired by the government thus increases as income rises whenever a tax incentive takes the form of a deduction. Although attempts have been made to justify this "upside-down" incentive effect in particular cases,[184] tax deductions tend to be inefficient in design because they provide the greatest tax benefits to taxpayers who, even without an incentive, can afford to engage in the activity that the government is seeking to

178. *See* Yorio I, *supra* note 4, at 1276-77.

179. *See* Zelinsky, *supra* note 6, at 1032.

180. *See* Gephardt & Wessel, *Tax Reform: A "But-For" Test*, 29 St. Louis U.L.J. 895, 908 (1985).

181. *Cf.* Surrey, *supra* note 161, at 731 (incentives "cause confusion and a blurring of concepts and objectives").

182. *See, e.g.*, Andrews, *supra* note 162, at 311 n.4 (relief provided by an investment tax credit is confined to person having a positive tax liability).

183. *See supra* note 162 and accompanying text.

184. *See* Zelinsky, *supra* note 6, at 1025 (positive externalities generated by housing owned by the rich may be greater).

encourage.[185]

b. *Cost-Benefit Analysis*

Defenders of tax incentives argue that the availability of the data contained in the tax-expenditure budget has reduced, if not eliminated, the risk that a tax subsidy will survive if its cost, in the form of lost revenues, exceeds its benefits. That risk is, in any event, no greater than the risk that a direct subsidy program will fail the test of a rigorous cost-benefit analysis.[186] Critics of tax incentives are enjoined to accept the consequences of their own identification of tax expenditures with direct subsidies by treating the two forms of government intervention as functional equivalents.[187] Defenders of indirect tax subsidies also argue that the survival of so many tax expenditures after the advent of tax expenditure analysis evinces Congress's conclusion that the benefits produced outweigh the costs in lower revenues.[188]

Although the information made available in the last twenty years regarding the true costs of tax expenditures has undeniably had a positive effect by enabling Congress to subject these indirect subsidies to closer scrutiny, it is wrong to conclude that tax expenditures may now be equated with direct subsidies for all purposes. There is no reason to assume that, merely because the cost of a tax expenditure is known, the tax preference is as difficult to enact (or preserve) as a direct subsidy program. Despite the recent debates over tax reform and the heightened public awareness about tax preferences, it probably remains politically easier for Congress to provide an indirect subsidy through the tax system than to provide an equivalent direct subsidy. A direct-subsidy program requires Congress to engage in a two-step process: first, it must raise revenues to fund the program; then, it must enact the program. A tax expenditure, by contrast, requires only one step and that step is seemingly benign: Congress enacts a tax preference that simply lets the earner of income keep it. It is, in sum, more difficult for government to wrest

185. *See* Andrews, *supra* note 162, at 309-10; Yorio I, *supra* note 4, at 1275-76.

Professor Zelinsky points out, however, that direct subsidies may also confer the greatest benefits on upper-income taxpayers. *See* Zelinsky, *supra* note 6, at 1031-32. But while the "upside-down" effect is not structurally inevitable with a direct subsidy program, it is inevitable with a tax deduction. Of course, it is possible to provide tax incentives in the form of credits or vanishing deductions that will not operate to favor upper-income taxpayers. *See* Surrey, *supra* note 161, at 723-24; Zelinsky, *supra* note 6, at 1032. Nonetheless, even if all tax deductions were converted into credits to avoid the "upside-down" effect, the inability to influence the behavior of citizens outside of the tax system would remain a serious objection to the use of tax incentives rather than direct subsidies. *See supra* note 182 and accompanying text.

186. *See* Zelinsky, *supra* note 6, at 1029-33.

187. *See id.* at 1032-33.

188. *See id.* at 1033. This argument resembles the argument criticized earlier in the text that a tax incentive with known and intended effects is efficient in the larger social policy sense that Congress presumably concluded, in enacting the incentive, that its overall social benefits were worth the costs in reduced revenues. *See supra* text accompanying notes 80-96.

income from certain taxpayers and redistribute it to other taxpayers than it is to permit the latter simply to keep their own income by virtue of a tax preference. This fact seems to have been grasped by certain proponents of tax preferences, who defend these indirect subsidies because they enable government to accomplish objectives that would be difficult, if not impossible, to fund directly.[189] The point remains, however, that the degree of difficulty in enacting a tax preference and the rigor of the cost-benefit analysis applied to a tax expenditure are likely to be less severe than for an equivalent direct subsidy program.[190]

The process by which tax subsidies are enacted and administered also increases the risk that they would fail a cost-benefit test. To begin with, a tax subsidy enters the Code after review primarily by the House Ways and Means Committee and the Senate Finance Committee.[191] Charged principally with matters of tax and finance, both committees are usually less informed about the specifics of the problems justifying government intervention than those Congressional committees that grapple regularly with the problems.[192] Moreover, the duty of administering tax subsidies is left to the Internal Revenue Service (IRS), which generally has no particular expertise with respect to the problem that the preference was enacted to remedy.[193] Although it may be theoretically possible for the relevant tax committees and the IRS to obtain and digest the information required to make a rational cost-benefit decision about a specific tax expenditure,[194] the process of education and learning is likely to be haphazard and incomplete. As a practical matter, it is virtually impossible for two congressional committees and one administrative agency to master the plethora and diversity of proposals for using the Code to accomplish societal goals.[195]

c. *The Cost of Taxpayer Disaffection*

The defenders of tax expenditures point out that citizens may be disaffected whenever they perceive that other citizens are obtaining excessive benefits from the government whether in the form of tax expenditures or direct subsidies.[196] But the concern of many who criticize the use of the Code to achieve societal goals other than a proper distribution of the tax burden is not simply that taxpayers are disaffected by perceived injus-

189. *See* Wiedenbeck, *supra* note 110, at 680-81, 688-92; *see also* Berger, *supra* note 167, at 1005 (discussing the view that voter support for government programs would diminish if they understood the costs of indirect tax expenditures); Surrey, *supra* note 161, at 733-34 (same).

190. *See* Andrews, *supra* note 162, at 311 n.4 (tax provisions tend "not to be subjected to the same budgetary and appropriations procedures as are applied to equivalent direct expenditure programs"); Surrey, *supra* note 161, at 733-34.

191. *See* Surrey, *supra* note 161, at 728.

192. *See id.*

193. *See id.* at 729.

194. *See* Zelinsky, *supra* note 6, at 1030.

195. *Cf.* Gephardt & Wessel, *supra* note 180, at 904.

196. *See* Zelinsky, *supra* note 6, at 1027-28.

tices. Rather, the more immediate problem caused by a perception that the tax system is unfair is that taxpayers may act on their disenchantment by failing to carry out one of the essential duties of citizenship, the payment of taxes to support government activities for the common good.[197] Although citizens may be dismayed by the payment of direct subsidies to farmers or other interest groups, the nexus between the subsidies and the payment of taxes is sufficiently remote that its effect on taxpayer compliance with the tax laws is minimal.[198] A pervasive feeling that the tax system is unfair, by contrast, seems more likely to convince taxpayers to avoid or evade the tax laws as a way of rectifying the inequities of favors bestowed on other taxpayers. The effect is not only to deprive the government of revenues, but also to undermine the entire self-assessment system of determining tax liability.[199]

d. *The Problem of Transaction Costs*

Critics of tax expenditures argue that the enactment of tax incentives, by increasing the complexity of the tax system, generates unproductive transaction costs in planning and compliance by taxpayers and in administration and enforcement by government.[200] In response, Professor Zelinsky argues that using tax incentives to achieve societal goals may actually generate *lower* transaction costs than direct subsidy programs.[201] Professor Zelinsky's analysis starts with the premise that the tax system represents an information and communication network that can be exploited at relatively low marginal cost to communicate information about government policies.[202] Both taxpayers and the government necessarily engage in the process of filing and auditing tax returns on an annual basis. As part of that process, the government may be able to reduce the

197. *See* 1 *Treasury Report*, *supra* note 2, at 9; Caplin, *supra* note 168, at 947, 963; Gephardt & Wessel, *supra* note 180, at 909; Yorio I, *supra* note 4, at 1256; *cf.* Yorio, *Federal Income Tax Rulemaking: An Economic Approach*, 51 Fordham L. Rev. 1, 32 (1982) [hereinafter Yorio II] (costs of legal error include taxpayer disaffection with the system).

198. By contrast, taxpayer attitudes towards the income tax do affect the level of compliance. *See* Witte & Woodbury, *The Effect of Tax Laws and Tax Administration on Tax Compliance: The Case of the U.S. Individual Income Tax*, 38 Nat'l Tax J. 1, 9 (1985); *New IRS Commissioner Gibbs Sees Tax Compliance Benefits From Overhaul Bill*, 176 Daily Tax Rep. (BNA), at K-1 (Sept. 11, 1986) (comments of I.R.S. Commissioner Gibbs that perceptions of fairness will increase compliance); *cf.* 1 *Treasury Report*, *supra* note 2, at 16 (perception of unfairness "is different when the tax system, rather than direct spending, is used to provide subsidies").

199. *See* 1 *Treasury Report*, *supra* note 2, at 9; *President's Proposals*, *supra* note 2, at 2; Yorio II, *supra* note 197, at 47-48. For empirical evidence that taxpayers regard the federal income tax as unfair, see Weinstein & Gross, *Tax Bill Gives Federalism Another Chance*, Wall St. J., Dec. 10, 1986, at 34, col. 4 (40% of taxpayers regard the federal income tax as "the least fair of all taxes"). For empirical evidence that taxpayer attitudes affect the level of compliance, see Witte & Woodbury, *supra* note 198, at 6-9.

200. *See* R. Posner, *supra* note 108, at 474; Yorio I, *supra* note 4, at 1256-57; Yorio II, *supra* note 192, at 49.

201. *See* Zelinsky, *supra* note 6, at 1010-12.

202. *See id.* at 1010.

costs of communicating information about its policies by enacting a tax incentive and including information about the incentive in the annual tax return materials.[203] The marginal costs to taxpayers of obtaining information about government policies may also be relatively low if government intervention takes the form of a tax incentive because taxpayers already engage lawyers and other experts to facilitate the filing of yearly tax returns.[204] To the extent that the marginal communication costs of a tax incentive are lower than those generated by a direct subsidy program, the incentive may be more efficient than a direct subsidy.

Despite these powerful arguments, there are strong reasons to doubt that tax incentives actually reduce transaction costs. For taxpayers who have a network for obtaining information about direct subsidy programs, the marginal costs of digesting information about a new subsidy are probably no higher than the costs of assimilating similar information about a tax incentive.[205] Moreover, if the government already disseminates information about direct grants through an existing communication channel and has pared the list of potential grant recipients, the marginal costs to the government of disseminating information about a new grant program through the same channel may very well be lower than the costs of communicating information about a similar tax incentive, to *all* taxpayers, through the annual tax return process. To meet these objections, the benefits of certain tax incentives might be limited to small businesses and middle-income taxpayers who generally lack networks for the assimilation of information about direct grant programs and whose marginal costs of obtaining information about government policies would consequently be lower when government intervention takes the form of a tax incentive.[206]

With this limitation on the scope of tax incentives, the marginal costs associated with a recently-enacted tax incentive might be lower than the costs of communicating and acquiring information about a comparable direct-subsidy program. But limiting the benefits of a tax expenditure to certain taxpayers may be hard to explain to taxpayers who are not the beneficiaries of the incentive. It may increase taxpayer disaffection and undermine confidence in the self-assessment system. Moreover, if the government's goal in enacting a tax incentive is truly desirable, limiting its scope to small businesses and middle-income taxpayers deprives the government of the ability to affect the behavior of those large businesses and upper-income taxpayers whose control over resources enables them to have a proportionately greater effect in accomplishing the govern-

203. *See id.* at 1011.

204. *See id.*

205. Professor Zelinsky seems to accept this point since he advocates limiting certain tax incentives to taxpayers whose contact with the government is primarily through the annual tax return process. *See id.* at 1011, 1033-34. *See infra* text accompanying notes 206-07.

206. *See* Zelinsky, *supra* note 6, at 1034, 1037.

ment's objectives. Although both of these objections to limiting incentives to small businesses and middle-income taxpayers may be met by the creation of a parallel direct subsidy program for other taxpayers, the functioning of two programs simultaneously, each addressed to the same government objective, may actually increase total transaction costs beyond the costs of a single, direct subsidy program.[207]

In light of these considerations, the argument that the existing tax system is a relatively efficient means of conveying information about recently adopted government policies is at least questionable. Moreover, by comparing the *marginal* costs of conveying this information through the tax system and through direct subsidy programs, the argument fails to address the more critical issue of whether the replacement of tax incentives with direct subsidy programs would reduce the *overall* transaction costs of accomplishing government objectives. Even assuming that the existing tax system is a resource that may profitably be exploited at low marginal cost, the cost of maintaining that resource in the form of fees paid to lawyers and accountants and salaries paid to government officials is high, in part because of the plethora of tax incentives contained within the current Code.[208] Thus, critics of tax expenditures are likely to remain convinced that the repeal of tax incentives would reduce the overall transaction costs of the tax system in an amount greater than any possible savings in marginal transaction costs from using the *existing* tax system, instead of direct subsidy programs, to convey information about government policies.

4. Summary

The defenders of tax expenditures have made a major contribution by broadening the debate over the efficiency of tax incentives. They have explored the possibility that tax incentives may be used to remedy sectoral inefficiencies or to compensate for externalities, and the possibility that tax incentives may be more efficient than direct subsidies in accomplishing government objectives. The preceding analysis reveals, however, that the case for most tax incentives on efficiency grounds re-

207. Although Professor Zelinsky anticipates this objection, *see id.* at 1034, he nevertheless concludes his article by recommending that tax incentives "be designed for middle-income persons and small businesses" and that large corporations and high-income families "participate in direct expenditure programs." *See id.* at 1037. In addressing any *single* societal goal, adoption of this recommendation would seem to require the creation of parallel tax expenditure and direct subsidy programs.

Of course, different government objectives may require the participation of different segments of the population. If so, it may be possible, as Professor Zelinsky suggests, to tailor the form of government intervention to suit the intended audience. *See id.* at 1033. Whether this suggestion would lead to the adoption of many tax incentives seems doubtful, however, because the participation of large corporations and upper-income taxpayers, who have proportionately greater control over economic resources, may often be essential in accomplishing the government's goal. *See supra* text accompanying notes 205-06.

208. *See* 1 *Treasury Report*, *supra* note 2, at 3; Gephardt & Wessel, *supra* note 180, at 907.

mains dubious for several reasons: even those incentives that appear easy to justify as cures for market failure may in fact cause misallocations of societal resources; efficient tax incentives are more difficult to design than direct subsidies; tax incentives are less likely to be subjected to rigorous cost-benefit analysis than direct subsidies; the enactment of tax incentives undermines a self-assessment system of taxation; and the transaction costs generated by tax incentives are likely to be equal to or higher than the costs associated with direct subsidy programs.

II. Overview of the 1986 Act

A. *The Major Features*

In its basic design, the 1986 Act represents a series of trade-offs between tax reductions for certain taxpayers and tax increases for others.[209] Individual taxpayers receive an overall tax reduction, which is offset by an approximately equal increase in taxes owed by corporations.[210] With respect to individuals, tax reduction takes primarily the form of a reduction in marginal tax rates and an increase in the standard deduction and the personal exemption.[211] The loss in revenue caused by the adoption of these provisions is partly offset by: the repeal (or restriction) of certain exclusions, deductions, and credits; the prevention of certain forms of income-splitting for tax purposes; the elimination of the benefits of many tax shelters; the repeal of income-averaging; and the strengthening of the alternative minimum tax.[212] With respect to corporations, tax reduction takes the form of a reduction in marginal tax rates.[213] Taxes paid by corporations will increase overall, however, because of the repeal (or restriction) of certain exclusions, deductions, and credits and because of the replacement of the corporate minimum tax by a more potent alternative minimum tax.[214]

B. *Individual Taxpayers*

1. Rate Reduction, Personal Exemption, Standard Deduction, and Earned Income Credit

The centerpiece of the 1986 Act as it affects individual taxpayers is the replacement of the old rate structure based on fifteen marginal tax brack-

209. Part II analyzes the 1986 Act in its fully effective form and ignores the many transition rules adopted by Congress to delay the immediate impact of the tax changes wrought by the Act. *See, e.g.*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 501(a), 1986 U.S. Code Cong. & Admin. News Special Pamphlet No. 9A (100 Stat.) 149, I.R.C. § 469(l) (CCH 1986) (phase-in of "passive loss" restrictions).

210. *See* Conference Comm. Report, Tax Reform Act of 1986, H.R. Rep. No. 841, 99th Cong., 2d Sess. II-884 (1986).

211. *See id.* at II-866 to -867.

212. *See id.* at II-866 to -881.

213. *See id.* at II-871.

214. *See id.* at II-866 to -881.

ets with a new rate structure containing only two marginal rates (15% and 28%).[215] Although the maximum tax bracket declines from 50% to 28%, a large group of upper-middle-income taxpayers will be subject to an effective marginal tax rate of 33% due to a phase-out of the benefits of the 15% bracket and a phase-out of the personal exemptions when taxable income exceeds certain amounts.[216] Tax relief for low- and middle-income taxpayers includes an increase in the amount of the personal exemption to $2,000,[217] a more generous standard deduction ($5,000 for married taxpayers filing jointly) replacing the zero bracket amount,[218] and an increase in the amount (and future indexing for inflation) of the earned income credit.[219]

2. Exclusion, Credits, and Deductions

To recoup in part the revenue losses caused by rate reduction and tax relief for low- and middle-income individual taxpayers, the 1986 Act repeals or restricts a plethora of exclusions, credits, and deductions. With limited exceptions, the exclusions for unemployment compensation[220] and for prizes and awards[221] are repealed; the partial exclusion for dividends received by individual taxpayers is repealed;[222] and the exclusion for scholarships is repealed for non-degree candidates and is generally limited to tuition, fees, and books for degree candidates.[223] The credit for political contributions is repealed.[224]

Even more numerous are the changes affecting income tax deductions. The deduction for state and local sales taxes has been repealed,[225] as has the deduction for adoption expenses.[226] The charitable deduction for taxpayers who do not itemize has been allowed to expire at the end of 1986 in accordance with prior law.[227] The deduction for personal interest, other than interest on debt secured by the taxpayer's principal residence or second residence, has generally been eliminated.[228] The floor on deductible medical expenses has been increased from 5% to 7.5% of ad-

215. *See* I.R.C. § 1 (West Spec. Pam. 1987).
216. *See id.* § 1(g).
217. *See id.* § 151(d)(1)(c).
218. *See id.* § 63(c)(2).
219. *See id.* § 32(a), (i).
220. *See id.* § 85.
221. *See id.* § 74.
222. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 612(a), 1986 U.S. Code Cong. & Admin. News Special Pamphlet No. 9A (100 Stat.) 166.
223. *See* I.R.C. § 117 (West Spec. Pam. 1987).
224. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 112(a), 1986 U.S. Code Cong. & Admin. News Special Pamphlet No. 9A (100 Stat.) 24.
225. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 134(a), 1986 U.S. Code Cong. & Admin. News Special Pamphlet No. 9A (100 Stat.) 32.
226. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 135(a), 1986 U.S. Code Cong. & Admin. News Special Pamphlet No. 9A (100 Stat.) 32.
227. *See* I.R.C. § 170(i)(4) (1982).
228. *See id.* § 163(h)(1) (West Spec. Pam. 1987). "Personal interest" is defined to *exclude* interest incurred in connection with a trade or business, investment interest, inter-

justed gross income.[229] A floor of 2% of adjusted gross income has been imposed on miscellaneous itemized deductions, including unreimbursed employee business expenses and expenses for the production of income and for tax advice.[230] The deduction for business meals and entertainment expenses is generally limited to 80% of cost[231] with additional restrictions placed on the deduction for specific forms of business entertainment.[232] The expenses of travel as a form of education are generally nondeductible.[233]

By virtue of the repeal of the capital gains deduction,[234] long-term capital gains will be taxed at the same rate as ordinary income. The deduction for two-earner married couples[235] and income-averaging[236] have both been repealed. The deduction for contributions to Individual Retirement Accounts has been eliminated (or limited) for certain taxpayers[237] and the amount of the maximum deduction for contributions to so-called "section 401k plans" has been reduced from $30,000 to $7,000 annually.[238]

3. Tax Shelters

Various provisions of the 1986 Act that apply generally to all investments also curtail two of the advantages of tax shelters—rate conversion and deferral. Repeal of the capital gains deduction[239] prevents taxpayers from converting ordinary income into capital gain. Repeal (or restriction) of various deductions or credits[240] precludes investors in certain tax-shelters from deferring tax on income. The advantages of both deferral and leveraging—the third primary benefit of tax shelters—are reduced by specific provisions directed against tax-shelter abuses, including the following: the "at-risk" rules have been extended to apply to most real estate investments;[241] restrictions have been placed on the deductibil-

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est on passive investment activities, interest on debt secured by a principal or second residence, and interest payable on certain estate tax deficiencies. *See id.* § 163(h)(2).

229. *See id.* § 213(a).

230. *See id.* § 67(a), (b).

231. *See id.* § 274(n).

232. *See, e.g., id.* § 274(l)(2) (limitations placed on amount deductible for entertainment tickets and skybox rentals).

233. *See id.* § 274(m)(2).

234. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 301(a), 1986 U.S. Code Cong. & Admin. News Special Pamphlet No. 9A (100 Stat.) 132.

235. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 131(a), 1986 U.S. Code Cong. & Admin. News Special Pamphlet No. 9A (100 Stat.) 29.

236. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 141(a), 1986 U.S. Code Cong. & Admin. News Special Pamphlet No. 9A (100 Stat.) 33.

237. *See* I.R.C. § 219(g) (West Spec. Pam. 1987).

238. *See id.* § 402(g)(1).

239. *See supra* note 234 and accompanying text.

240. *See infra* notes 267-72 and accompanying text.

241. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 503(a), 1986 U.S. Code Cong. & Admin. News Special Pamphlet No. 9A (100 Stat.) 159 (repeal of exception for most real estate from at-risk rules).

ity of passive investment losses;[242] and the deduction for investment interest has generally been limited to the amount of net investment income.[243]

4. Income-Splitting

The 1986 Act limits the opportunities for shifting income from high- to low-bracket taxpayers in two primary ways. Under pre-1986 law, a taxpayer could shift income to a trust (or to its beneficiaries) by placing income-producing property in the trust and retaining a reversionary interest in the corpus after ten years (a so-called "Clifford Trust").[244] To eliminate this tax advantage, the 1986 Act generally taxes income of a trust to the grantor if the grantor or the grantor's spouse has a reversionary interest exceeding 5% of the value of the trust in either the corpus or income of the trust.[245] Under pre-1986 law, income on property transferred to children was taxable to the child at his or her marginal tax rate.[246] Under the 1986 Act, unearned income of a child under fourteen years of age in excess of $500 will generally be taxed to the child as if the income had been received by the child's parents,[247] which reduces the incentive to transfer income-producing property to a child to take advantage of the child's lower marginal tax bracket.

5. Fringe Benefits

Aside from tightening and unifying the rule requiring non-discrimination among employees,[248] the 1986 Act makes few changes in the taxation of fringe benefits. Thus, the exclusions for up to $50,000 of group-term life insurance,[249] for $5,000 of employee death benefits,[250] for cafeteria plans,[251] for employer-provided health insurance,[252] and for the

242. *See* I.R.C. § 469 (West Spec. Pam. 1987).
243. *See id.* § 163(d)(1).
244. *See* Helvering v. Clifford, 309 U.S. 331, 335 (1940) (short-term trust held ineffective to shift income from grantor). After the *Clifford* case was decided, Congress enacted specific statutory provisions designed to prevent income-splitting. *See* I.R.C. §§ 671-77 (1982) (amended 1986). But the provisions did not succeed in preventing income-splitting by the creation of trusts in which grantors would retain a reversionary interest *after* ten years. *See id.* § 673(a) (amended 1986). These trusts were frequently referred to as "Clifford Trusts." *See, e.g., President's Proposals, supra* note 2, at 88.
245. *See* I.R.C. §§ 672(e), 673(a) (West Spec. Pam. 1987). There is a limited exception for a trust in which the grantor or the grantor's spouse has a reversionary interest that takes effect only upon the death of a beneficiary before the age of 21 who is a lineal descendant of the grantor and who holds all the present interests in the trust. *See. id.* § 673(b).
246. *See* Yorio I, *supra* note 4, at 1282-83.
247. *See* I.R.C. § 1(i) (West Spec. Pam. 1987). But since the child is entitled to a $500 standard deduction, a total of $1,000 of unearned income may be shielded from tax at the parent's marginal rate. *See id.* § 63(c)(5).
248. *See id.* § 89.
249. *See id.* § 79(a) (1982).
250. *See id.* § 101(b) (1982 & Supp. III 1985).
251. *See id.* § 125 (West Spec. Pam. 1987).

rental value of parsonages remain effective.[253] Although the exclusion for dependent care assistance expenses has been limited to $5,000 per year,[254] the exclusions for educational assistance[255] and for group legal services plans,[256] which were due to expire at the end of 1985, have been extended through 1987. The exclusion for employer-provided commutation has been allowed to expire at the end of 1985.[257]

6. Alternative Minimum Tax

In addressing many of the remaining preferences available to individual taxpayers, the 1986 Act strengthens generally the alternative minimum tax on items of tax-preference income.[258] First, the tax rate on alternative minimum taxable income increases from 20% to 21% for taxpayers other than corporations.[259] Second, the exemption from the alternative minimum tax for $40,000 of preference income is phased out when alternative minimum taxable income exceeds certain levels.[260] Third, the definition of alternative minimum taxable income is broadened to include (among other items) tax-exempt interest on newly-issued private activity bonds[261] and untaxed appreciation on charitable contributions of appreciated property.[262] Fourth, the amount of intangible drilling costs treated as alternative minimum taxable income is increased.[263] Fifth, two methods of accounting that are permissible in computing income for regular tax purposes—the completed contract method and the installment sales method—may not be used for the purpose of computing alternative taxable income.[264]

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252. *See id.* § 105(b), (c) (1982 & Supp. III 1985).
253. *See id.* § 107 (1982).
254. *See id.* § 129(a)(2) (West Spec. Pam. 1987).
255. *See id.* § 127(d).
256. *See id.* § 120(e).
257. *See id.* § 124(e) (1982).
258. *See infra* text accompanying notes 259-64.

The 1986 Act, however, liberalizes the tax treatment of preference income in one respect. A taxpayer who has paid, in any taxable year, an alternative minimum tax that is attributable to certain types of preference income is entitled, in subsequent taxable years, to a tax credit in the amount of the prior alternative minimum tax paid. The credit is limited to the excess of the taxpayer's regular tax liability over the "tentative minimum tax" in the subsequent year. *See* I.R.C. § 53 (West Spec. Pam. 1987).

Because the repeal of tax preferences on certain items of income now subjects that income to full taxation, the income is no longer treated as a preference for purposes of computing alternative minimum taxable income. *See, e.g.*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 301(a), 1986 U.S. Code Cong. & Admin. News Special Pamphlet No. 9A (100 Stat.) 132 (repeal of the capital gains deduction); *cf.* I.R.C. § 57(a)(9)(A) (1982) (capital gains deduction treated as item of tax preference) (repealed 1986).

259. *See* I.R.C. § 55(b)(1)(A) (West Spec. Pam. 1987).
260. *See id.* § 55(d)(3).
261. *See id.* § 57(a)(5).
262. *See id.* § 57(a)(6).
263. *See id.* § 57(a)(2).
264. *See id.* § 56(a)(3), (6). Since liability under the alternative minimum tax is the greater of (1) 21% of alternative minimum taxable income or (2) the regular tax owed, *see supra* note 259 and accompanying text, the effect of prohibiting these accounting

C. *Corporate Taxpayers*

1. Rate Reduction

As with individual taxpayers, corporations benefit from the elimination of tax brackets and from rate reduction under the 1986 Act. In place of a five-step corporate rate structure, the 1986 Act contains only three marginal tax brackets, with the highest corporate tax rate declining from 46% to 34%.[265]

2. Exclusions, Credits, and Deductions

To compensate for the losses in revenue caused by individual income tax reduction and by corporate rate reduction, the 1986 Act repeals (or restricts) a host of exclusions, deductions, and credits primarily used by corporate taxpayers.[266] The Investment Tax Credit has been repealed[267] and the amount of other, less costly, credits has been reduced compared to pre-1986 law.[268] The benefits of ACRS depreciation for real estate have been substantially reduced by lengthening the periods over which real estate may be depreciated.[269] The depreciation periods for certain other assets have also been extended,[270] but, for some of these, the disadvantages of longer depreciation periods have been offset by a faster rate of depreciation.[271] Provisions of the 1986 Act increase the tax liability of specific industries by repealing (or restricting) the amortization of certain costs[272] or by recapturing as income certain prior tax benefits.[273]

The amount of the corporate dividends-received deduction has been reduced from 85% to 80%.[274] Pursuant to a statutory repeal of the *General Utilities* doctrine,[275] a corporation is now generally subject to a tax

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methods in computing alternative minimum taxable income is to increase the potential amount of alternative minimum tax liability.

265. *See* I.R.C. § 11(b) (West Spec. Pam. 1987).

266. *See infra* text accompanying notes 267-76.

267. *See* I.R.C. § 49(a) (West Spec. Pam. 1987).

268. *See, e.g., id.* § 46(b)(4)(A) (credit for building rehabilitation costs reduced to either 20% or 10%).

269. *See id.* § 168(c) (depreciation period for most rental real estate either 27.5 or 31.5 years).

270. *See, e.g., id.* § 168(e)(3)(B)(i) (recovery period for automobile or light truck extended from 3 to 5 years).

271. *See id.* § 168(b)(1)(A) (depreciation method for certain property changed to 200% declining balance from 150% declining balance).

272. *See, e.g.,* Tax Reform Act of 1986, Pub. L. No. 99-514, § 242(a), 1986 U.S. Code Cong. & Admin. News Special Pamphlet No. 9A (100 Stat.) 97 (repeal of amortization of railroad grading and tunnel bores).

273. *See* I.R.C. § 1254 (West Spec. Pam. 1987) (tightening of the recapture provision for oil and gas and hard minerals).

274. *See id.* § 243(a)(1).

275. *See* General Utilities & Operating Co. v. Helvering, 296 U.S. 200, 206 (1935) (corporation realizes no income (or loss) upon distribution of assets to shareholders). As applied to the distribution or sale of assets in connection with the complete liquidation of a corporation, the *General Utilities* rule was codified in I.R.C. §§ 336(a), 337(b) (1982) (amended 1986). There were, however, limited statutory exceptions. *See id.* § 336(b)

at the corporate level on gains on property distributed to shareholders in liquidation of the corporation.[276]

3. Alternative Minimum Tax

The 1986 Act makes corporations subject to an alternative minimum tax, which replaces the prior and less potent corporate minimum tax. The rate of the alternative minimum tax is 20%[277] compared with 15% for the corporate minimum tax.[278] The amount of preference income subject to the minimum tax is no longer reduced by the amount of regular taxes paid.[279] Instead, corporations are given an exemption for the first $40,000 of alternative minimum taxable income, but the exemption is phased out when alternative minimum taxable income exceeds $150,000.[280] The definition of alternative minimum taxable income is broadened to include many of the additions to alternative minimum taxable income discussed earlier in connection with individual taxpayers.[281] Corporations are also now subject to a provision that treats as alternative minimum taxable income a percentage of the excess of the corporation's "adjusted net book income" (after 1989, "adjusted current earnings") over its alternative minimum taxable income, computed without regard to this adjustment.[282]

III. Evaluation of the 1986 Act

My earlier article set forth and analyzed criteria for a rational federal income tax policy and measured the President's proposals for tax reform against those criteria.[283] In evaluating the 1986 Act as it affects individual income taxpayers, this Part will draw both on the analysis of the criteria of federal tax policy contained in the earlier article and on the discussion of equity and efficiency in Part I of this Article.[284]

(amended 1986) (gain recognized to corporation on distribution in liquidation of certain LIFO inventory).

276. *See* I.R.C. § 336(a) (1982) (amended 1986).

277. *See id.* § 55(a), (b)(1)(A).

278. *See id.* § 56(a).

279. *See id.* § 56(a)(2).

280. *See id.* § 55(d)(2), (d)(3)(A) (West Spec. Pam. 1987).

281. *See supra* text accompanying notes 261-64.

282. *See* I.R.C. § 56(c), (f), (g) (West Spec. Pam. 1987).

283. *See generally* Yorio I, *supra* note 4.

284. For a fuller exposition and analysis of the criteria of federal income tax policy, see Sneed, *The Criteria of Federal Income Tax Policy*, 17 Stan. L. Rev. 567 (1965); Yorio I, at 1256-64.

Two of the criteria of tax policy explored in my earlier article, adequacy and economic growth, will not receive detailed analysis here. Because the 1986 Act is expected to raise as much revenue as its predecessor, the requirements of the adequacy criterion appear to have been met, at least in comparison with prior law. *See* Conference Comm. Report, Tax Reform Act of 1986, H.R. Rep. No. 841, 99th Cong., 2d Sess. II-884 (1986). *But see* Levin, *The Nation's No. 1 Priority*, N.Y. Times, Mar. 9, 1986, § 4, at 21, col. 2 (article by Sen. Levin contending that revenue neutrality is not adequate in light of budget deficit).

With respect to the effect of the 1986 Act on economic growth, opinions among econo-

A. *Simplicity*

The 1986 Act simplifies the income tax system in a number of important respects. The increases in the amount of the standard deduction and of the personal exemption will remove large numbers of taxpayers from the tax rolls entirely, thereby reducing the costs of taxpayer compliance and government administration of the law.[285] By repealing the deduction for sales taxes, increasing the floor on deductible medical expenses, imposing a floor on the deduction for miscellaneous expenses, and by increasing the standard deduction, the 1986 Act will reduce the number of taxpayers who itemize their personal deductions. Since itemizing deductions increases costs for both taxpayers and government, the effect will be to reduce the overall transaction costs of the tax system.[286]

The criterion of simplicity is well served by the provisions of the 1986 Act that reduce the incentive of taxpayers to engage in planning to minimize income tax liability. Foremost among these provisions is the decline in the highest marginal tax rate from 50% to 28%, which reduces the rewards of tax planning for high-income taxpayers[287] and made possible the repeal of the complex income-averaging provisions of the pre-1986 Code.[288] The repeal of the capital gains deduction removes from the Code what was perhaps its single most complicating feature,[289] thereby avoiding the transaction costs of taxpayer attempts to convert ordinary income deductions into capital gains and generally sparing the government the costs of having to distinguish, on audit and in litigation, between ordinary income and capital gain.[290] The transaction costs of planning by taxpayers will also be reduced by those provisions of the 1986 Act that curtail the benefits of tax shelters, that eliminate the advantages of certain income-splitting techniques, and that repeal a number of exclusions, deductions, and credits available under prior law to indi-

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mists vary widely. Some economists predict that growth will contract because of the repeal or restriction of certain tax incentives. *See, e.g.*, N.Y. Times, Sept. 29, 1986, at D5, col. 1 (comments of economist M. Weidenbaum); *Think Tank Says Adverse Impact of Senate Bill Could be Dampened by Easy Money*, 104 Daily Tax Rep. (BNA), at LL-1 (May 30, 1986) (comments of economists J. Prakken, L. Meyer, and C. Varvares). At least one economist believes that the gross national product will increase because of the lower tax rate and fewer economic distortions. *See, e.g.*, N.Y. Times, May 19, 1986, at D5, col. 1 (comments of economist R. Gough).

285. *See President's Proposals*, *supra* note 2, at 6-7; Yorio I, *supra* note 4, at 1268.

286. *See* Yorio I, *supra* note 4, at 1268; *New IRS Commissioner Gibbs Sees Tax Compliance Benefits from Overhaul Bill*, 176 Daily Tax Rep. (BNA), at K-2 (Sept. 11, 1986) (comments of I.R.S. Commissioner Gibbs that the 1986 Act will reduce the number of taxpayers who itemize).

287. *See* Blum & Kalven, *The Uneasy Case for Progressive Taxation*, 19 U. Chi. L. Rev. 417, 430-35 (1952); Yorio II, *supra* note 197, at 50-51.

288. *See* Tax Reform Act of 1986, Pub. L. 99-514, § 141(a) 1986 U.S. Code Cong. & Admin. News Special Pamphlet No. 9A (100 Stat.) 33.

289. *See* Bittker, *Tax Reform and Tax Simplification*, 29 U. Miami L. Rev. 1, 4 (1974).

290. *See* Yorio I, *supra* note 4, at 1269-70. The distinction between capital gain or loss, however, remains important in certain circumstances. *See, e.g.*, I.R.C. § 1211 (CCH 1986) (limitation on the deductibility of capital losses).

vidual income taxpayers.[291]

Although the cumulative effect of these provisions will be to simplify the tax system and thereby reduce transaction costs, there are numerous other provisions of the 1986 Act that are virtually certain to complicate the tax system from the standpoints of both taxpayer compliance and government administration of the Code. In many cases, the added complexity may be justified by tax policy criteria that conflict with the goal of simplicity.[292] In placing limitations on the deductibility of passive investment losses, for example, Congress enacted a statutory provision of considerable complexity,[293] which may be defended only by invoking the competing tax policy criteria of equity and economic neutrality.[294] Similarly, one provision of the 1986 Act, designed to reduce the advantages of income-splitting between parents and children, adds complexity to the Code,[295] but may be justified as a way of eliminating the previous inequity of allowing holders of capital a tax advantage (the ability to shift income) denied to other taxpayers.[296] Other provisions of the 1986 Act complicate the Code without counterbalancing tax policy benefits. The phase-out of the benefits of the 15% tax bracket and of the personal exemption for taxpayers with income above a certain level,[297] for example, adds complexity to the Code that might have been avoided by enacting a slightly higher maximum tax bracket or by adding a third tax bracket to the current two-bracket schedule.

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291. *See* Yorio I, *supra* note 4, at 1268-69.

292. For an attempt to make the choice between competing tax policy criteria a rational one, see Sneed, *supra* note 284, at 601-04; see also Yorio I, *supra* note 4, at 1264 (discussing the compatibility of tax policy criteria).

Part of the complexity and tax planning activity caused by the 1986 Act, at least in the short run, is the result of the need for taxpayers to adjust to sweeping tax changes. *See* Gutfeld, *IRS Predicts Small Business Will Cheat Less*, Wall St. J., Oct. 3, 1986, at 31, col. 3 (comments of tax accountant L. Nad). But other provisions of the 1986 Act may permanently increase the level of tax planning by certain taxpayers. *See* Gottschalk, *Lenders Push Homeowners to Refinance but Tax Bill can Make Loans More Costly*, Wall St. J., Sept. 17, 1986, at 33, col. 4 (discussion of tax planning to avoid restrictions on the deductibility of personal interest); Berton, *Minimum Tax Proposal Touches off Scramble*, Wall St. J., Sept. 10, 1986, at 6, col. 1 (analysis of tax planning to avoid the impact of the corporate alternative minimum tax).

293. *See* I.R.C. § 469 (West Spec. Pam. 1987).

294. *See infra* text accompanying notes 308-09, 311.

295. To prevent holders of capital from transferring income-producing property to children under 14 years of age and thereby getting the benefit of taxation of the income at the child's marginal tax bracket, the 1986 Act taxes the child's income as if it had been received by the parent. *See* I.R.C. § 1(i) (West Spec. Pam. 1987). *See supra* text accompanying notes 246-47. Although this provision can be justified as a method of reducing tax inequity between holders of capital and other taxpayers, it undeniably complicates tax reporting and compliance for those taxpayers affected.

296. *See* M. Chirelstein, *supra* note 162, at 180-82; Yorio I, *supra* note 4, at 1282-83.

297. *See supra* text accompanying note 216.

B. *Fairness*

Because the contents of the fairness criterion[298] may vary from individual to individual depending on one's subjective view of the proper level of progression in an income tax,[299] it is impossible to reach a definitive judgment about the 1986 Act from the standpoint of tax fairness. Nevertheless, it is important to emphasize that the 1986 Act probably does *not* reduce the level of progressivity of the federal income tax despite the fact that the highest tax bracket has declined from 50% to 28%.[300] Although the decline in the top tax bracket will reduce the average rate of tax for many upper-income taxpayers, marginal tax rate reduction is more than offset for other upper-income taxpayers by the repeal (or restriction) of exclusions, deductions, and credits, the strengthening of the alternative minimum tax, the repeal of the capital gains deduction, and the restrictions placed on income-splitting and on tax shelters.[301] Although upper-income taxpayers benefit from generally greater tax savings in *absolute* dollar amounts, the *percentage* reduction in tax burdens under the 1986 Act is greater for low- and middle-income taxpayers,[302] primarily because of the large increases in the amount of the standard deduction and of the personal exemption.[303] Indeed, it is arguable that, by levying higher taxes on corporations to finance individual rate reduction, the 1986 Act actually *increases* the progressivity of the tax system overall[304] because, at least in the short run, corporate

298. The fairness criterion refers to the proper distribution of the tax burden across *different* income levels and specifically to the proper level of progressivity in an income tax. *See* Yorio I, *supra* note 4, at 1260-61. The criterion of equity, by contrast, demands that taxpayers with the *same* level of income pay the same amount of tax. *See supra* note 72.

299. *See* Yorio I, *supra* note 4, at 1260-61. *See generally* Blum & Kalven, *supra* note 287 (best analysis of the arguments for and against progressive taxation).

300. This is supported by figures released by the Joint Committee on Taxation. *See* Report of Joint Committee on Taxation, 33 Tax Notes 73 (1986). For 1988, the average income tax rate for taxpayers with income below $10,000 declines from 1.6% under pre-1986 law to 0.5%; for taxpayers with income between $10,000 and $20,000, the rate declines from 5.7% to 4.4%; for taxpayers with income between $100,000 and $200,000, the rate declines from 19.3% to 18.9%; for taxpayers whose income exceeds $200,000, the rate declines from 22.8% to 22.3%. *See id.* at 74; *see also* Pear, *Tax System to Remain Progressive, Experts Say*, N.Y. Times, Aug. 18, 1986, at B11, col. 1 (new tax system "just about as progressive" as prior law).

301. Among taxpayers whose income exceeds $200,000, 311,000 will receive a tax increase in 1988 compared to 393,000 who will benefit from a tax decrease. *See* Report of Joint Committee on Taxation, 33 Tax Notes 73, 74 (1986).

302. For taxpayers with income below $10,000, the reduction in tax liability in absolute dollars is $39; for taxpayers with income between $10,000 and $20,000, the reduction is $200; for taxpayers with income between $100,000 and $200,000, the reduction is $612; for taxpayers whose income exceeds $200,000, the reduction is $3,362. *See id.* at 74. But the *percentage* reduction is far greater for lower-income taxpayers: income below $10,000, 65.1%; income between $10,000 and $20,000, 22.3%; income between $100,000 and $200,000, 2.2%; income above $200,000, 2.4%. *See id.* at 73.

303. *See supra* notes 207-08 and accompanying text.

304. The 1986 Act may also increase the overall progressivity of combined federal, state, and local taxes by eliminating the deduction for state and local sales taxes if the

taxes may be borne by shareholders, who tend to be upper-income taxpayers.[305]

C. *Equity*

The 1986 Act takes major steps to improve the equity of the federal income tax system by repealing (or restricting) a host of tax preferences previously available to holders of capital, including most importantly the capital gains deduction, the Investment Tax Credit, ACRS depreciation on real estate, tax-shelter leveraging, and income-splitting.[306] Together with the strengthening of the alternative minimum tax,[307] these provisions not only remove (or mitigate) some of the major causes of tax inequity, but also increase indirectly the rate of implicit tax on those substitute preferences left untouched by tax reform.[308] With an increase in the implicit tax, tax inequity between investors in tax preferences and other taxpayers is reduced.[309] Moreover, the decline in marginal tax rates contained in the 1986 Act has the effect of reducing tax inequity by reducing the surplus enjoyed by those taxpayers who are able to take advantage of the preferences remaining in the Code.[310]

D. *Economic Neutrality*

As discussed in Part I, preferential tax treatment of consumption or production activities may distort resource allocation by overstimulating demand or supply of the tax-preferred good or service. The 1986 Act eliminates (or minimizes) tax incentives offered to a host of activities under the pre-1986 Code. On the consumption side, the incentive to purchase on credit and to incur certain other personal expenses is reduced by restrictions imposed on the deductibility of interest and other personal expenses;[311] the incentive to incur business meal and entertainment expenses is reduced by limitations and restrictions imposed on the deductibility of those expenses;[312] the incentive to defer current con-

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effect of repeal of this deduction will be to induce state and local governments to turn away from the sales tax as a source of revenue, *see infra* text accompanying note 385, since sales taxes are generally regarded as regressive. *See, e.g.*, Murray, *Many States Target Wealthy to Bear Tax Burden or New U.S. Law Forces Them to Revamp Codes*, Wall St. J., Feb. 2, 1987, at 50, col. 1.

305. *See* Ballentine, *Where is the Income Tax Rationale for the Shift to Higher Corporate Taxes?*, 30 Tax Notes 443, 445-46 (1986); *see also* N.Y. Times, Aug. 18, 1986, at B11, col. 1 (corporate tax "progressively distributed").

306. *See supra* text accompanying notes 234, 241-43, 245-47, 267-69.

307. *See supra* text accompanying notes 258-64.

308. *See supra* text accompanying notes 73-74.

309. *See supra* text accompanying notes 22-25.

310. *See supra* text accompanying notes 71-72.

311. *See supra* text accompanying notes 225-29, 233.

312. *See supra* text accompanying notes 231-32 and accompanying text. For estimates of the distortion in resource allocation caused by the business meals and entertainment deduction, see Clotfelter, *Tax-Induced Distortions and the Business-Pleasure Borderline*, 73 Am. Econ. Rev. 1053, 1064 (1983).

sumption by contributing to IRAs or to "section 401k" plans is reduced by restrictions placed on both.[313]

On the production side, the 1986 Act's effect on resource allocation is likely to be even more dramatic. The reduction in marginal tax rates may make taxpayers less inclined to substitute leisure for work.[314] In making investment decisions, taxpayers will be less likely to pursue tax objectives both because of lower marginal tax rates and because of the elimination (or restriction) of various tax preferences.[315] Repeal of the capital gains deduction reduces the incentive to invest in high-growth, low-income assets;[316] repeal of the Investment Tax Credit reduces the incentive to invest in machinery and equipment;[317] reducing the benefits of ACRS depreciation for real estate will shift resources into other industries;[318] restrictions on tax shelters, particularly on real estate investments, will have a similar effect;[319] and reducing the tax benefits available to certain industries, in part by strengthening the alternative minimum tax,[320] will make it easier for other industries to attract resources for their production activities.[321] In the absence of convincing evidence that these tax incentives operated generally to remedy market failures,[322] the effect of their repeal is likely to promote efficiency by removing distortions in resource-allocation caused by the pre-1986 Code.[323]

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313. *See supra* text accompanying notes 237-38.

314. *See* R. Posner, *supra* note 108, at 472-73 (analysis of possible inefficiency of tax rule leading to substitution of leisure for work); Blum & Kalven, *supra* note 287, at 437-38 (high marginal rates may deter the most productive citizens from work).

315. For evidence that the 1986 Act will reduce the discrepancies in effective tax rates on various investment assets, see Sheppard, *Economists Analyze the 1986 Act's Corporate Tax Shift*, 34 Tax Notes 536, 537 (1987).

316. *See* Yorio I, *supra* note 4, at 1284; *cf.* R. Posner, *supra* note 108, at 470 (capital gains deduction encourages investment in assets producing low current income).

317. *See Tax-Related Economic Development*, 170 Daily Tax Rep. (BNA), at LL-1 (Sept. 3, 1986) (Conference Board prediction that the repeal of the Investment Tax Credit will affect investment in machinery); Hulten, *The Proposal Strikes a Fair Balance*, N.Y. Times, June 16, 1985, § 3, at 2, col. 3 (article by economist C. Hulten on distortion caused by Investment Tax Credit).

318. *Cf.* Hendershott, *supra* note 88, at 1108-09 (1986) (analysis of distortions caused by real estate tax incentives); Johnson, *Error in the Name of Interest*, 30 Tax Notes 451, 454 (1986) (ACRS tax preference leads to investments that "would not be made without the tax benefits"). *See generally* Sheppard, *Silicon Chips and Stock Gains: Making Sense of Capital Gains Exclusion Repeal*, 31 Tax Notes 647, 650 (1986) (quoting comment of economist J. Makin that the 1986 Act will improve resource allocation).

319. *See* Yorio I, *supra* note 4, at 1287-88.

320. *See, e.g.*, I.R.C. § 57(a)(2) (West Spec. Pam. 1987) (increase in the amount of intangible drilling costs treated as alternative minimum taxable income).

321. *See* Yorio I, *supra* note 4, at 1288.

322. *See supra* text accompanying notes 132-65.

323. There are numerous studies that demonstrate the distortions caused by the investment tax incentives provided by the pre-1986 Code. *See, e.g.*, Auerbach, *The New Economics of Accelerated Depreciation*, 23 B.C.L. Rev. 1327, 1345-50 (1982) (the investment stimulus of ACRS "is very distortionary in its distribution across different assets"); Graetz & McDowell, *Tax Reform 1985: The Quest for a Fairer, More Efficient and Simpler Income Tax*, 3 Yale L. & Pol'y Rev. 5, 17-18 (1984) (incentives encourage "the inefficient allocation of resources"); Hendershott, *supra* note 88, at 1107-08 (incentives

IV. An Agenda for Future Reform

With change as complex and comprehensive as that wrought by the 1986 Act, it is almost inevitable that further legislation will be required to address problems that Congress either did not anticipate or chose to ignore in its desire to pass a tax reform act before the 1986 elections.[324] The prospect of additional tax legislation is enhanced also by the perceived need to reduce the federal deficit and by the view of some legislators and economists that revenue-raising is an appropriate response, if only partial, to the deficit dilemma.[325] Then, too, the tax preferences surviving in the Code despite the 1986 Act create the potential for a renewed attack on the tax system by either the executive or the legislative branch under the banner of tax reform.[326] Indeed, the trumpets of battle have already sounded three discordant themes. Some congressmen believe that marginal tax rates should increase (or at least not be allowed to decline in accord with the 1986 Act) as a means of closing the deficit gap;[327] others endorse some sort of consumption tax to help accomplish the same goal;[328] still others support the reenactment of certain tax in-

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tilt the playing field in favor of certain industries); Jorgenson & Sullivan, *Reforming Capital Recovery under the Corporate Income Tax*, 12 Tax Notes 1397, 1397 (1981) (incentives cause "serious misallocation of capital").

For evidence that the 1986 Act will remove (or reduce) many of these distortions, see Sheppard, *supra* note 315, at 536-37.

324. Legislators may try to make further substantive changes in the Code when considering the technical amendments needed to correct errors or oversights in the 1986 Act. *See, e.g.*, Hanlon, *supra* note 3, at 134; *ESOPS: Senate Tax Writers Warn of Retroactive Changes to Estate Tax Break, Hint at Repeal*, 23 Daily Tax Rep. (BNA), at G-3 to G-5 (Feb. 5, 1987).

325. *See, e.g.*, Levin, *The Nation's No. 1 Priority*, N.Y. Times, Mar. 9, 1986, at sec. 4, p. 21, col. 2 (article by Sen. Levin); Wright, *The Subversive Federal Debt*, N.Y. Times, Jan. 22, 1987, at A27, col. 1 (article by Rep. J. Wright, Speaker of the House); N.Y. Times, Aug. 18, 1986, at B11, col. 1 (comments of Rep. Rostenkowski).

326. *See* Hanlon, *supra* note 324, at 134 (support of Sen. B. Packwood for base-broadening rather than rate increases to reduce deficit). For a list of investment preferences that may be the targets of future legislation, see *U.S. Budget: Extending 1987 Tax Rates for One Year Would Raise $16.8 Billion in FY 1988, CBO Estimates*, 23 Daily Tax Rep. (BNA), at LL-5 to 6 (Feb. 5, 1987) (report of Congressional Budget Office). *See also infra* text accompanying notes 334-421 (proposals for repealing (or restricting) individual income tax preferences).

327. *See, e.g.*, N.Y. Times, Dec. 9, 1986, at A1, col. 1 (proposal by Rep. J. Wright, Speaker of the House, to delay rate reduction); N.Y. Times, Aug. 18, 1986, at B11, col. 1 (proposal by Rep. D. Rostenkowski to raise rates to generate new revenues). To raise revenues through an income tax increase, Congress "might abolish more deductions and other tax preferences" instead of raising marginal tax rates. *See* N.Y. Times, Sept. 17, 1986, at D2, col. 4 (proposal by Sen. B. Packwood).

328. *See, e.g.*, Wall St. J., Dec. 15, 1986, at 26, col. 5 (article by Rep. N. Gingrich proposing value-added tax); 171 Daily Tax Rep. (BNA), at G-3 (Sept. 4, 1986) (comments of Sen. Durenberger endorsing consumption tax); *see also* Bierman & Bierman, *Tax Reform for the Number One Economic Problem in 1987*, 34 Tax Notes 499, 501 (1987) (consumption tax endorsed to increase rate of savings). Instead of imposing a consumption tax or increasing income taxes, Congress might increase excise taxes to raise revenue. *See U.S. Budget: Ways-Means Committee Reconsiders Menu of Excise Taxes to Meet New Deficit-Cutting Target*, 177 Daily Tax Rep. (BNA), at LL-6 to LL-7 (Sept. 12,

centives that were repealed (or restricted) by the 1986 Act.[329]

The analysis in Part I of this Article demonstrates, however, that increasing marginal tax rates or adding tax incentives to the Code will undermine the best features of the 1986 Act from the standpoints of both equity and efficiency. Failure to allow tax rates to decline as provided by the 1986 Act will mean that taxpayers who are able to utilize the remaining preferences in the Code will enjoy a greater surplus from pursuing the preferences, thus exacerbating tax inequity between those and other taxpayers.[330] Higher marginal tax rates will also increase transaction costs by inducing taxpayers to engage in costly tax planning and will distort resource-allocation by encouraging tax-motivated, but otherwise relatively unproductive, investments.[331] Equity and efficiency will suffer, too, if Congress reverses the judgment of the 1986 Act by reenacting tax incentives. Not only does any new preference generate its own inequity and distortion, but each preference added to the Code reduces demand for existing, substitute preferences.[332] As demand for an existing preference declines, the surplus enjoyed by pursuing the preference increases and the implicit tax on the preference decreases.[333] As a consequence, both tax inequity and distortions in resource-allocation are likely to be exacerbated.

Although the linchpins of the 1986 Act, rate reduction and the repeal (or restriction) of tax preferences, merit continued legislative support, a number of Code provisions should be reconsidered by Congress from the perspectives of equity and efficiency. The remainder of this Article makes several recommendations for reform in three areas of concern to individual income taxpayers: exclusions from gross income, personal deductions, and capital gains. The proposed reforms, if enacted, will im-

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1986) (Ways and Means Committee considering menu of excise tax increases to reduce deficit). *See generally* Hanlon & Teuber, *Pay Me Now, Pay Me Later: Congress Looks at Revenue Options*, 32 Tax Notes 1042 (1986) (survey of the various revenue options available to Congress).

Because the analysis in Parts I through III of this Article has been limited almost entirely to federal *income* tax policy, Part IV will not consider proposals to adopt a value-added or other consumption-type tax.

329. *See, e.g.*, *Energy: Industry Experts Back Tax Changes to Aid Domestic Oil Producers*, 20 Daily Tax Rep. (BNA), at G-2 (Feb. 2, 1987) (bill introduced by Sens. D. Boren and J. Bingaman to repeal intangible drilling costs recapture rule); *Tax Legislation: Tax Writers Will Fight New Transition Rules to Tax Overhaul Law, Aides Say*, 189 Daily Tax Rep. (BNA), at G-3 (Sept. 30, 1986) (proposal by Sen. L. Bentsen to exempt existing tax shelters from passive loss limitations); *see also* N.Y. Times, Dec. 10, 1986, at A1, col. 1 (proposal by O. Bowen, Sec'y of Health and Human Services, to provide additional tax subsidies for health insurance).

330. *See supra* text accompanying notes 69-72.

331. *See supra* text accompanying notes 287, 314-16.

332. The argument in the text is simply the converse of the point demonstrated earlier that the repeal of any tax preference *increases* demand for substitute preferences. *See supra* notes 55, 73-74 and accompanying text.

333. *See supra* text accompanying notes 54, 73-74.

prove both the equity and efficiency of the tax system and will provide additional revenues to support a further decline in marginal tax rates.

A. *Exclusions from Gross Income*

My earlier article criticized a number of exclusions from gross income for violating the criterion of tax equity and for distorting the allocation of resources in society.[334] Even if the magnitude of the inequities and distortions caused by these provisions is less as a consequence of the 1986 Act,[335] criticism of several of the exclusions on the grounds of equity and efficiency remains valid.

The exclusion for income earned by certain life insurance policies—sometimes referred to as "inside build-up"[336]—enables purchasers of these policies to obtain the advantages of deferring tax on the income as it accrues and of borrowing tax-free against the accrued income.[337] Further, the inside build-up entirely escapes taxation upon death, thereby converting the deferral advantage into complete exemption from tax.[338] Supporters of the exclusion have argued that inside build-up is analogous to unrealized capital appreciation,[339] which also provides tax benefits in the form of deferral,[340] tax-free borrowing against appreciation,[341] and possible exemption from income tax at death.[342] For reasons discussed in my earlier article[343] and elaborated on by other critics of the exclusion,[344] the analogy of inside build-up to unrealized capital appreciation is unconvincing. Because the exclusion causes inequity between insur-

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334. *See* Yorio I, *supra* note 4, at 1270-73.
335. *See supra* text accompanying notes 308-10.
336. *See, e.g., President's Proposals, supra* note 2, at 254-57; Wall St. J., June 17, 1985, at 1, col. 6.
337. *See* Brannon, *Taxation of Inside Buildup on Life Insurance Policies—Interim Report or Post-Mortem?*, 31 Tax Notes 735, 736 (1986); Yorio I, *supra* note 4, at 1271.
338. *See* Yorio I, *supra* note 4, at 1271.
339. *See, e.g.*, 1 B. Bittker, *Federal Taxation of Income, Estates and Gifts*, ¶ 12.2.1, at 12-5 (1981) [hereinafter Bittker I]. Professor Bittker has also argued that taxing inside build-up would be a palliative, not a corrective, unless mortality gains and losses were also recognized for tax purposes. *See* Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 Harv. L. Rev. 925, 944 (1967). One response to this objection is that partial reform reducing the degree of inequity and inefficiency is preferable to no reform at all in this area. *Cf.* Brannon, *supra* note 337, at 739 (proposal to tax inside build-up upon realization or at death). The objection may also be met by taxing mortality gains (and losses). *Cf.* I.R.C. § 72(b) (West Spec. Pam. 1987) (mortality gains and losses on annuities recognized for tax purposes).
340. *See* Eisner v. Macomber, 252 U.S. 189, 211 (1920) (unrealized gains not taxable as income).
341. *See* Woodsam Assocs. v. Commissioner, 198 F.2d 357, 358-59 (2d Cir. 1952) (borrowing against unrealized appreciation does not subject taxpayer to tax on accrued gain).
342. *See* I.R.C. § 1014(a) (1982) (basis of inherited property is fair market value at death).
343. *See* Yorio I, *supra* note 4, at 1271-72.
344. *See* Brannon, *supra* note 337, at 736-37; *see also* Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. Pa. L. Rev. 1111, 1138 (1986) (taxation of inside build-up would be "feasible").

ance policyholders and other taxpayers and distorts resource-allocation by diverting investment funds into life insurance,[345] the exclusion should be repealed.

The exclusion for interest on state and local government bonds provides a tax benefit to holders of capital who are able to invest in these bonds that is unavailable to other taxpayers.[346] Moreover, the evidence is convincing that as a subsidy to state and local governments, the exemption for interest on these bonds is technically inefficient, costing the federal government a greater amount in lost revenues than the benefit obtained by local governments in the form of lower interest on their debt instruments.[347] Outright repeal of the exclusion is unlikely because the subsidy to local governments is substantial,[348] but by subjecting the interest on certain private-activity bonds to the alternative minimum tax,[349] the 1986 Act provides a wedge for subjecting *all* state and local government bond interest to the alternative minimum tax.[350]

The Treasury Report to the President proposed the repeal (or restriction) of exclusions for a host of fringe benefits provided under the pre-1986 Code.[351] The President pared considerably the list of fringe benefits targeted for repeal in his tax reform proposals.[352] In passing the 1986 Act, Congress allowed the exclusions for all but a few fringe benefits to survive intact.[353]

From the perspective of equity, favorable tax treatment of fringe benefits might be tolerable if these benefits were equally available to all taxpayers[354] or if the market completely adjusted for the tax preferences by

345. *See* Brannon, *supra* note 337, at 735-36; Yorio I, *supra* note 4, at 1272.

346. *See supra* text accompanying notes 47-49.

347. *See* sources cited *supra* note 117.

348. *Cf.* Bittker, *Income Tax "Loopholes" and Political Rhetoric*, 71 Mich. L. Rev. 1099, 1122 (1973) (repeal of interest exclusion "not in the cards without a substantial federal subsidy"). Because the activities of state and local governments are associated with market failures, there may be a case for some subsidy of the states by the federal government. *See infra* text accompanying notes 379-80. Whether the subsidy should take the form of a tax incentive that is technically inefficient and disproportionately benefits upper-income taxpayers is doubtful.

349. *See supra* note 261 and accompanying text.

350. *See Tax Reform: Tax-Exempt Bond Market Thrown Into Disarray Over Changes to Sen. Packwood's Tax Plan*, 54 Daily Tax Rep. (BNA), at G-10 to G-11 (March 20, 1986) (proposal of Sen. B. Packwood to subject state and local bond interest to the alternative minimum tax).

351. *See* 2 *Treasury Report*, *supra* note 2, at 23-50 (recommended repeal (or restriction) of employer-provided health insurance, group term life insurance, death benefits, legal services, dependent care services, commuting services, educational assistance, cafeteria plans, stock options, employee awards, military allowances, and parsonage allowances).

352. *See President's Proposals*, *supra* note 2, at 24-32, 47-48 (proposed repeal (or restriction) of employer-provided health insurance, death benefits, commuting services, and employee awards).

353. *See supra* text accompanying notes 248-57.

354. *See* Bittker, *supra* note 18, at 743-44 (taxpayer cannot complain of inequity if taxpayer fails to use available tax preference); Yorio I, *supra* note 4, at 1259-60.

reducing the wages of those employees who benefit disproportionately from the preferences.[355] The evidence indicates, however, that certain taxpayers, notably members of powerful unions and corporate executives, are able to obtain more extensive fringe-benefit packages than other taxpayers.[356] Although the market probably adjusts somewhat in lower wages for these packages,[357] it is doubtful that the tax benefits are recaptured entirely given the fact that unions and corporate executives continue to opt for the fringe benefits in lieu of higher wages.[358]

Because of the tax preference, an employee with a choice will opt for fringe benefits with all other things being equal.[359] An employer, too, will prefer to compensate employees in fringe benefits rather than cash if the employer can capture part of the tax benefit in a lower overall compensation package.[360] Because both parties have an incentive to adopt fringe benefit plans, economic distortions result from the diversion of resources to the production of goods and services qualifying for the tax

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355. *Cf.* Clotfelter, *Equity, Efficiency, and the Tax Treatment of In-Kind Compensation*, 32 Nat'l Tax J. 51 (1979) (equity and efficiency analysis of fringe benefits must consider market compensating mechanisms).

The effect, if any, of the tax preferences for fringe benefits on the wages of benefited employees is analogous to the effect of the tax-exemption on the price of state and local government bonds. *See supra* text accompanying notes 18-25.

356. *See* 1 S. Surrey, W. Warren, P. McDaniel & H. Ault, Federal Income Taxation 139 (1972); *cf.* Comment, *The Tax Bargain in Executive Compensation*, 47 Tex. L. Rev. 405, 405 (1969) (discussing the importance of tax planning by executives and their counsel for executive compensation plans). Of course, if the option of becoming a member of a powerful union or becoming a corporate executive were equally available to all taxpayers, as it almost certainly is not, this objection to tax preferences for fringe benefits would be met.

Exclusions for fringe benefits may also be inequitable by discriminating against those members of labor unions (unmarried members, for example) who would prefer higher wages to fringe benefits, but who may be outvoted by other union members.

357. *Cf. supra* text accompanying notes 55-56 (market adjusts, but not completely, for the tax-exemption for state and local government bonds).

358. It has been argued that definitive conclusions about the inequity caused by tax preferences for fringe benefits are impossible without "knowledge of individual tastes." *See* Clotfelter, *supra* note 355, at 52. Suppose, for example, that the utility derived by a recipient of non-taxable fringe benefits is the same as the utility derived by a wage-earner from after-tax wages in the same pre-tax amount as the value of the fringe benefits. Under that assumption, there is no tax inequity. *See id.* at 52-53. But since interpersonal comparisons of utility are difficult, a rational tax system should assume identical utility functions, at least across large segments of the population. *Cf.* Blum & Kalven, *supra* note 287, at 461-71 (difficulty of defining utility curve to justify progressive taxation). There is, for example, no reason to believe that members of powerful unions who benefit disproportionately from fringe benefits derive less utility from those benefits than nonunion workers. Of course, the tax inequity would disappear if entry into these unions were free, *see* Clotfelter, *supra* note 355, at 52-53, but that is almost certainly not the case. *See supra* note 356 and accompanying text.

359. *See* Adamache & Sloan, *Fringe Benefits: To Tax or Not to Tax?*, 38 Nat'l Tax J. 47, 48 (1985); Katz & Mankiw, *How Should Fringe Benefits be Taxed?*, 38 Nat'l Tax J. 37, 38 (1985).

360. *See* Halperin & Tzur, *The Effects of Nontaxable Employee Benefits on Employer Profits and Employee Work Effort*, 38 Nat'l Tax J. 65, 75 (1985); Katz & Mankiw, *supra* note 359, at 38.

exclusion.[361] Although taxation of fringe benefits presents difficult problems of valuation,[362] Congress should reconsider the reforms in the taxation of fringe benefits proposed in the original Treasury Report to the President.[363] Judicious changes in the taxation of fringe benefits[364] will improve both the efficiency and equity of the Code and at the same time raise revenue to support a further reduction in marginal tax rates.[365]

B. *Personal Deductions*

1. Charitable Contributions

The deduction for contributions to charities has been criticized on four grounds. First, to the extent that the deduction works effectively as a tax incentive, it is skewed to favor the charities of upper-income taxpayers, who derive a greater tax benefit from contributing the same amount than taxpayers in lower tax brackets.[366] Second, the deduction is technically inefficient because it bestows a windfall on taxpayers for doing what they would do even in the absence of a tax incentive.[367] Third, to the extent that a charitable contribution provides the donor with tangible or intangible benefits, a deduction for the contribution violates the criterion of tax equity.[368] Fourth, the deduction may distort the allocation of resources in society by favoring the activities of charities over other activities.[369]

Whether the deduction in fact distorts resource-allocation depends in part on its effect, if any, in remedying market failures. My earlier article noted briefly the possibility that the deduction might operate to cure market failure under certain circumstances, but concluded that the deduction did not appear to have that general effect.[370] Still, a market-failure defense of the deduction deserves further elaboration in light of

361. *See* Clotfelter, *supra* note 355, at 54, 58-59; Halperin & Tzur, *supra* note 360, at 76; Katz & Mankiw, *supra* note 359, at 38.

362. *See generally* Katz & Mankiw, *supra* note 359 (analysis of the valuation of fringe benefits from both a theorectical and practical perspective).

363. *See supra* note 351 and accompanying text.

364. *See generally* Adamache & Sloan, *supra* note 359 (discussion from both a theoretical and practical perspective of the various options for taxing fringe benefits). For proposals for reform, see 2 *Treasury Report*, *supra* note 2, at 23-50; R. Goode, *supra* note 88, at 119.

365. Marginal tax rates could be lowered if certain fringe benefits were repealed (or restricted) because the amount of revenue lost by exclusions for various fringe benefits is quite large. For fiscal year 1987, the revenue drain caused just by the exclusion for employer-provided health insurance has been projected at $26.4 billion. *See* Staff of Joint Comm. on Taxation, 99th Cong., 1st Sess., Estimates of Federal Tax Expenditures for Fiscal Years 1986-90 18 (Joint Comm. Print 1985).

366. *See* Andrews, *supra* note 162, at 310; Surrey, *supra* note 161, at 720-21; Yorio I, *supra* note 4, at 1275-76; *supra* note 162 and accompanying text.

367. *See* Surrey, *supra* note 161, at 719-20; Yorio I, *supra* note 4, at 1276.

368. *See* Yorio I, *supra* note 4, at 1276-77.

369. *See id.* at 1276.

370. *See id.* at 1276 n.187.

Professor Zelinsky's analysis. Many charitable activities generate positive externalities for which the charity would not be compensated in the market.[371] Private schools and universities, for example, produce an educated citizenry that redounds to the benefit not just of purchasers of the school's services, but also of society in general. Other charities (public television, for example) provide services for which it may be impossible or extremely difficult to charge every user.[372] To the extent that the charitable deduction compensates for the market's inability to internalize positive externalities or to charge free-riders, the effect of the deduction may actually be to improve overall efficiency.

But even assuming that the incentive provided by the charitable contribution deduction operates to cure certain market failures, the deduction in its current form may be criticized for bestowing the greatest benefits on the charities of upper-income taxpayers. Without any evidence that these charities are faced with more severe problems of market failure than other charities, a market-failure defense of the current deduction seems implausible. Moreover, the deduction operates inefficiently by allowing a deduction for an individual's *total* contributions for the taxable year, thus granting tax benefits for contributions that would have been made in the absence of the deduction.[373] To eliminate this technical inefficiency, a statutory provision limiting the tax incentive to marginal contributions would be required, but drafting a provision to accomplish that objective seems virtually impossible.[374] Perhaps the most practical solution, based on the reasonable assumption that a certain amount of charitable-giving would occur without a tax incentive, would be to impose a floor on the deduction (perhaps 2% of adjusted gross income) and to allow only the amount of contributions for the taxable year in excess of that floor to be deductible. A statutory floor on the deduction would also serve as a surrogate, albeit imprecise, for the value of charitable contributions that benefit the donor—and for that reason are properly nondeductible—either tangibly in the form of goods or services received by the donor from the charity or intangibly in the form of the power, prestige, or psychic satisfaction that flows from private philanthropy.[375]

2. State and Local Taxes

The deduction for state and local taxes has been criticized on three grounds. First, the deduction provides the greatest tax benefits to upper-

371. *Cf.* Andrews, *supra* note 162, at 357-58 (charities generate "external benefits").

372. *Cf. id.* at 370 (people tend not "to pay voluntarily for the provision of public goods or services up to an optimum level"); R. Posner, *supra* note 108, at 469 (charitable deduction "responds to the free-rider problem").

373. *See supra* text accompanying notes 177-78.

374. *Cf.* Zelinsky, *supra* note 6, at 1009-10 (difficulty of designing technically efficient investment incentive).

375. *See* Yorio I, *supra* note 4, at 1276-77.

income taxpayers.[376] Second, the deduction subsidizes high-tax states and discriminates against low-tax states.[377] Third, the deduction may be inefficient by skewing resource-allocation to favor state and local government activities over other activities or by depriving the federal government of greater revenues than state and local governments gain because of the deduction.[378]

As with the deduction for charitable contributions, it is at least arguable that the deduction for state and local taxes operates under certain circumstances as a cure for market failure.[379] Like charitable organizations, state and local governments provide services, such as education and welfare, that generate positive externalities for which the market does not compensate. Then, too, certain government activities, such as maintaining parks and other recreational facilities, present insoluble free-rider problems of identifying and charging users for the services provided. Like the charitable contribution deduction, therefore, the deduction for state and local taxes may occasionally operate to remedy market failure rather than to distort resource allocation.

Even assuming that the deduction remedies certain market failures, it may still be criticized from the standpoint of technical efficiency for costing the federal government more in lost revenues than state and local governments gain.[380] From the perspective of tax equity, the deduction in its current form is also vulnerable to attack for subsidizing states with high levels of taxation. Moreover, the positive externalities that may be generated by state and local governmental activities are presumably captured, for the most part, by citizens of the political entity engaging in the activity.[381] Thus, to require citizens of other states to subsidize that activity is unfair.[382]

None of these criticisms of the deduction was addressed by the 1986 Act, which repeals only the deduction for state and local sales taxes.[383] Although a distinction between the sales tax and certain other taxes may be drawn on the ground that the sales tax is levied on transactions that are usually voluntary,[384] the decision to single out the sales tax for repeal is objectionable on other grounds: it penalizes states that rely heavily on the sales tax in raising revenue; it skews the tax policy of state and local

376. *See President's Proposals, supra* note 2, at 62-63; *see also* Yorio I, *supra* note 4, at 1277.

377. *See President's Proposals, supra* note 2, at 62-63; *see also* Yorio I, *supra* note 4, at 1277-81.

378. *See President's Proposals, supra* note 2, at 63-64.

379. *See supra* notes 370-72 and accompanying text.

380. *See President's Proposals, supra* note 2, at 63-64.

381. *See* Yorio I, *supra* note 4, at 1278-79. To the extent that an activity of a state and local government produces "spillover" benefits, the case for the deduction of taxes used to finance the activity is stronger. *See id.* at 1279-80; *cf. President's Proposals, supra* note 2, at 64 (evidence of "spillover" benefits not documented).

382. *See* Yorio I, *supra* note 4, at 1279-81.

383. *See supra* note 225 and accompanying text.

384. *See* Yorio I, *supra* note 4, at 1280-81.

governments away from a tax that may be preferable, on balance, to other forms of taxation;[385] and it may lead states to engage in "tax planning" by crafting taxes that formally qualify for deductibility, but resemble in substance a nondeductible sales tax.[386]

Moreover, repeal of the sales tax deduction does not mitigate the discrimination under the pre-1986 Code against states with low levels of taxation. Although many high tax states use a sales tax to generate revenue, the sales tax generally represents a larger percentage of the revenues raised by states with relatively low overall levels of taxation.[387] Because repeal of the sales tax deduction not only fails to solve the problem of subsidization and discrimination among states, but also causes its own additional problems, reform is necessary in this area.[388] The best approach would be to impose a ceiling (perhaps 5% of adjusted gross income) on the amount of state and local taxes (including sales taxes) that may be deducted. Placing a cap on the deduction would reduce the subsidy to high-tax states and mitigate the discrimination under current law against low-tax states and states that rely heavily on the sales tax in raising revenue. Allowing a deduction for taxes up to the ceiling amount would recognize that state and local governments support activities that, despite their worth, might not take place in the market.[389]

3. *Mortgage Interest*

As discussed in Part I, the federal income tax system contains a congeries of preferences benefiting owner-occupied housing.[390] Prominent among these incentives, in terms of the drain on federal revenues,[391] is

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385. *See Sen. Durenberger Releases State/Local Deduction Study*, 1 Tax Documents (Tax Analysts) No. 9, at 913 (Mar. 3, 1986) (comment of Sen. D. Durenberger that repeal of sales tax deduction skews tax policy of states).

386. For an example of a proposal to do exactly what I suggest, see N.Y. Times, Dec. 19, 1986, at B3, col. 4 (proposal of New York Assembly Speaker S. Fink to call motor-vehicle fee and sales tax "personal property tax" to ensure deductibility).

387. In 1985, none of the three states (Alaska, N.Y., Wyo.) with the highest overall levels of taxation relied on the sales tax for more than 15% of its revenues. Of the seven states with the lowest levels of taxation (Ala., Ark., Fla., Mo., N.H., Tenn., and Tex.), all but one (N.H.) used the sales tax to generate more than 20% of their revenues. Three of these states (Ark., Fla., and Tenn.) relied on the sales tax to raise in excess of 30% of their revenues. *See* Gold, *How the State Tax Systems Have Been Changing*, 31 Tax Notes 287, 288-89 (1986).

388. For a survey of the various reform options open to the federal government, see Shanahan, *Searching for Revenue Raisers: Tapping the State and Local Tax Deduction*, 30 Tax Notes 574 (1986).

389. This proposal may be criticized for preserving a technically inefficient subsidy or for tolerating discrimination against states whose level of taxation is lower than the ceiling. *See* Wall St. J., Dec. 10, 1986, at 34, col. 3 (proposal by economists B. Weinstein and H. Gross to repeal the deduction). If discrimination against low-tax states is still regarded as problematic, the ceiling could of course be lowered. Although the subsidy provided by the deduction is technically inefficient, adopting a ceiling would probably reduce the degree of inefficiency.

390. *See supra* notes 146-50 and accompanying text.

391. *See supra* note 159 and accompanying text.

the provision of the Code that generally allows a taxpayer to deduct interest incurred on a mortgage on a first or second home.[392] The deduction has been criticized for creating distortions by skewing resource allocation towards owner-occupied housing[393] and defended on the grounds that it operates to remedy imperfections in the housing market.[394] The analysis in Part I demonstrates, however, that the case for the deduction as a cure for market failure is weak.[395] Moreover, if the market does not fully reflect the tax benefits of this incentive, as seems likely,[396] the deduction is also a source of tax inequity by favoring owner-occupants over renters and a source of tax unfairness by bestowing its greatest benefits on upper-income taxpayers.[397]

As with other features of the federal income tax system, it is easy to identify the problems caused by the mortgage interest deduction, but harder to devise a practical statutory solution.[398] To begin with, it is necessary to recognize that the difficulties associated with the mortgage interest deduction derive primarily from the failure of the Code to tax imputed income. Indeed, if the imputed rental value of owner-occupied housing were taxable, all the costs of generating that income (including mortgage interest) would properly be deductible.[399] In a sense, therefore, the problems associated with the mortgage interest deduction are merely minor symptoms of the inequity and inefficiency caused by the Code's general failure to tax imputed income.[400] The most direct method of eliminating this inequity and inefficiency would be to tax imputed income, as a number of prominent scholars have proposed.[401] But difficulties of valuation and enforcement make it unlikely that Congress will ever tax imputed income.[402] Moreover, any reform in this direction, however sound theoretically, would exact a price in terms of diminished taxpayer morale and comprehension of the income tax system.[403]

392. *See* I.R.C. § 163(a), (h) (West Spec. Pam. 1987). For a more extensive discussion of the details of the mortgage interest deduction, see *infra* text accompanying notes 413-14.

393. *See, e.g.*, Hendershott, *supra* note 88, at 1108; Sheppard, *supra* note 315, at 537 (comment of economist Y. Henderson).

394. *See* Zelinsky, *supra* note 6, at 998-1001, 1007.

395. *See supra* notes 136-63 and accompanying text.

396. Because taxpayers in marginal tax brackets lower than the 33% tax bracket are in the market for owner-occupied housing, the market is unlikely to reflect fully the tax benefits of the mortgage interest deduction. *See supra* text accompanying notes 66-70.

397. *See supra* text accompanying notes 161-62.

398. *Cf. infra* text accompanying notes 432-33 (difficulty of designing equitable and efficient system for taxing capital assets).

399. *See supra* note 148.

400. *Cf.* R. Posner, *supra* note 108, at 465 (deductibility of mortgage interest unobjectionable if imputed income were taxed).

401. *See id.*; R. Goode, *supra* note 88, at 120-29.

402. *See* Yorio I, *supra* note 4, at 1274; *cf.* 1 B. Bittker I, *supra* note 339, at ¶ 5.3.2, at 5-25 (taxing imputed income would require taxpayer recordkeeping and serious effort by the IRS to verify values set by the taxpayers).

403. *See* Yorio I, *supra* note 4, at 1274. *Cf.* 1 B. Bittker I, *supra* note 339, at ¶ 5.3.2, at 5-25 (taxing imputed income "not likely to command much support . . . among voters").

Assuming that imputed income remains exempt, the issue becomes whether repeal (or restriction) of the mortgage interest deduction would improve the current system of taxing owner-occupied housing. Because any significant restriction on the deduction is likely to reduce the flow of capital investment into owner-occupied housing, the effect in terms of efficiency will be regarded as positive by those who are convinced that the deduction distorts the allocation of resources in society.[404] Repealing (or restricting) the deduction would also reduce the degree of inequity between taxpayers who finance the purchase of a home and taxpayers who rent.[405] On the other hand, taxpayers who purchase their homes for cash would enjoy an undiminished tax advantage over renters.[406] Moreover, repeal (or restriction) of the mortgage interest deduction would create discrimination between taxpayers who must finance the purchase of a home and taxpayers who are able to purchase a home outright.[407]

On balance, however, the case for reform of the mortgage interest deduction is quite potent. Although some concern for the taxpayer who must finance the purchase of a home is warranted, it does not seem to justify retention of a deduction for interest on a mortgage incurred to purchase a *second* home. Even with respect to interest on a principal residence, the degree of one's solicitude for the taxpayer who is required to finance the purchase is likely to lessen as the amount of interest (and presumably the value of the home) increases.[408] Thus, the equity argument for the deduction does not preclude placing a limitation—perhaps

404. *See* sources cited *supra* note 393.

405. The inequity under current law between taxpayers who finance the purchase of a home and taxpayers who rent results from the *sum* of all the tax preferences provided for homeownership, including the mortgage interest deduction. *See supra* text accompanying notes 146-50. Repealing (or restricting) that deduction will lessen the degree of inequity.

406. Taxpayers who purchase their homes for cash obviously do not obtain a tax advantage over renters from the mortgage interest deduction itself. But the Code's failure to tax "net imputed rental income" provides a greater tax advantage to taxpayers who purchase their homes for cash: their "net imputed rental income" is higher because interest is not incurred to generate the imputed income. *See supra* note 148 and accompanying text. Repeal (or restriction) of the mortgage interest deduction thus would not diminish their tax advantage over renters.

407. *See* 2 B. Bittker I, *supra* note 339, ¶ 31.1.1, at 31-2 to -3. This point may be illustrated by a simple hypothetical. Assume that *X* and *Y* purchase roughly comparable homes for $100,000 and that each home generates approximately $10,000 of gross imputed rental income. *X* pays cash; *Y* obtains a $50,000 mortgage at 10% interest to finance the purchase. Putting aside all other expenses, *X* has $10,000 of tax-free imputed income. Although *Y* also has $10,000 of tax-free imputed income, he must pay $5,000 in annual interest to generate that income. Since *Y*'s *net* imputed rental income is only one-half of *X*'s, he would be discriminated against relative to *X* if he were denied all (or part) of his mortgage interest deduction. The only way of eliminating this discrimination would be to tax the imputed rental income of both *X* and *Y* and to allow a deduction for all expenses (including interest) incurred in generating that income. *See supra* text accompanying notes 399-401. *X* would then have $10,000 of taxable imputed income; *Y* would have $5,000 of taxable income.

408. *Cf.* Hendershott, *supra* note 88, at 1108 ("persuasive case for subsidizing owners to occupy larger houses has not been made").

$10,000—on the amount of interest on a principal residence that may be deducted during a single taxable year.[409] Moreover, on the reasonable assumption that upper-income taxpayers purchase a relatively high percentage of second homes and acquire first homes at a higher average price than other taxpayers, repealing the second-home deduction and placing a ceiling of $10,000 on the first-home deduction are likely to reduce the disproportionate tax benefits that upper-income taxpayers obtain from the deduction in its current form.[410]

Capping the mortgage interest deduction at $10,000 is also likely to reduce the flow of capital into owner-occupied housing. However plausible the case may be for *some* incentive to homeownership as an offset to barriers to entry in the housing market or as compensation for positive externalities, the case for encouraging the purchase of second homes or of larger and more expensive principal residences seems weak.[411] With respect to barriers to entry in the market, the fact that a taxpayer has been able to acquire one home weakens the claim that an incentive is needed to facilitate the purchase of a second home. Moreover, once a taxpayer has acquired a modest principal residence with the help of an annual interest deduction of $10,000, the barriers faced by that taxpayer in financing a larger home in the future are probably minimal. Whatever the positive externalities generated by homeownership in terms of heightened civic responsibility, those benefits are likely to increase insignificantly, if at all, by the purchase of a second home or of a more expensive principal residence.[412]

409. Whatever the ceiling amount on the deduction, it should probably be indexed for inflation. *Cf. infra* text accompanying notes 434-36 (capital assets should be indexed for inflation).

410. *See supra* text accompanying notes 161-62. There is, however, one countervailing consideration. Restricting the mortgage interest deduction would discriminate against taxpayers who must finance the purchase of a home relative to taxpayers who are able to purchase a home outright. *See supra* note 407 and accompanying text. Because upper-income taxpayers generally have greater resources at their disposal to purchase a home outright, they might be the major beneficiaries of this discrimination. On the other hand, allowing an annual interest deduction of $10,000 would seem to protect most lower- and middle-income taxpayers against the effects of this discrimination. For the reasons given in the text, disallowing a deduction for interest above that amount and for interest on second homes is likely to impact mainly on upper-income taxpayers.

411. *See* Hendershott, *supra* note 88, at 1108.

412. If homeownership nurtures civic responsibility and commitment, that would be true regardless of the size or cost of the home. Encouraging the purchase of a second home is even less defensible. At best, ownership of a second home will cause the taxpayer to divide his (or her) quota of a civic commitment between two communities. At worst, the second home will lead the taxpayer to loosen his (or her) ties to *either* community.

It is possible, however, that the magnitude of other positive externalities varies directly with the cost of the home. Professor Zelinsky has pointed out that the "upside-down" effect of the mortgage interest deduction might be defended on the grounds that expensive homes owned by wealthy taxpayers generate larger spillover benefits for neighboring property-owners than more modest homes. *See* Zelinsky, *supra* note 6, at 1025. *See supra* text accompanying notes 183-85. It should be noted, however, that Professor Zelinsky is himself uncomfortable with this defense of the mortgage interest deduction. *See* Zelinsky, *supra* note 6, at 1026.

Finally, the deduction in its current form is a tax planner's delight and a tax administrator's nightmare. In repealing the general deduction for personal interest, Congress was apparently concerned that an exception for mortgage interest on a first or second home would give taxpayers an incentive to borrow against their homes to finance other consumer purchases. Thus, Congress generally limited the deduction to interest on a mortgage up to the tax basis of the homes (adjusted by the cost of improvements),[413] but excepted from this limitation interest on refinancing proceeds used to pay qualified medical or educational expenses.[414] Although these rules and exceptions may accommodate the various interests represented in the congressional debates on the interest deduction, they provide opportunities for planning by taxpayers to derive the maximum tax advantage from the deduction.[415] For the IRS, the rules and exceptions create serious problems in ensuring that the amount of interest deducted does not exceed interest on a mortgage up to the basis of the homes and in tracing the proceeds of a refinancing above the basis to ensure that the proceeds were in fact used for medical or educational purposes.[416] Given these difficulties of administration and enforcement, it seems likely that the deduction in its current form will also prove to be a source of tax avoidance or evasion that may undermine taxpayer confidence in the income tax system.[417]

If, by contrast, the deduction were subjected to an annual ceiling of $10,000, the costs generated in tax planning, administration, and enforcement would almost certainly be reduced. Although taxpayers would still have an incentive to finance consumer purchases by mortgaging their principal residences, the annual ceiling would place a cap on the tax benefits of the deduction, thereby reducing the transaction costs of tax planning.[418] With less revenue at stake[419] and with the distinction between medical and educational and other financings eliminated, the IRS could limit its inquiry on an audit to whether the interest deducted was in fact incurred on a mortgage on the taxpayer's principal residence.[420] For reasons both of equity and efficiency, therefore, the case for limiting the

413. *See* I.R.C. § 163(h)(3)(B)(ii)(I) (West Spec. Pam. 1987). If the fair market value of the home is less than the basis, the taxpayer is only allowed to deduct interest on a mortgage up to the fair market value. *See id.* § 163(h)(3)(B)(i).

414. *See* I.R.C. § 163(h)(3)(B)(ii)(II), (h)(4)(A) (West Spec. Pam. 1987).

415. Taxpayers will be induced, for example, to use home equity loans to finance educational and medical expenses or to make home improvements. *See* Wall St. J., Sept. 17, 1986, at 33, col. 4 (proceeds of refinancing may be used to pay off medical or educational expenses or the cost of home improvements).

416. *See id.* ("Monitoring what is deductible mortgage interest . . . will be an added burden for the Internal Revenue Service.").

417. *See supra* text accompanying notes 197-99.

418. *Cf.* Yorio II, *supra* note 197, at 49 (tax rule is inefficient if it induces "otherwise unproductive transaction costs" of tax planning).

419. *Cf. id.* at 46-47 (tax rule minimizing the stakes in controversy reduces transaction costs).

420. *Cf. id.* at 44-45 (tax rule limiting inquiry to one or a few facts reduces transactions costs).

interest deduction to $10,000 on a principal residence[421] is persuasive.

C. *Capital Gains*

My earlier article criticized the deduction for long-term capital gains in the pre-1986 Code for several reasons: first, it caused inequities between taxpayers with large amounts of capital gains and other taxpayers;[422] second, it skewed the allocation of resources in society by encouraging investment in assets likely to produce high growth and low current income;[423] and third, it distorted the policy of corporations with respect to the distribution or retention of corporate earnings.[424] The article noted, however, that outright repeal of the deduction, without other changes in the taxation of capital assets, would be inequitable, because bunching a capital gain in one year in a progressive tax system may result in a higher tax than if the gain had been taxed as it accrued[425] and because a capital gain is unreal to the extent that it merely matches inflation over time.[426] Moreover, repeal of the capital gains deduction in isolation would exacerbate the "lock-in" effect[427] caused by two other features of the federal income tax system—the failure to tax capital appreciation as it accrues and the forgiveness of tax on appreciated property held until death.[428] Because repeal of the deduction increases the

421. If offsetting barriers to entry in the market is regarded as the primary justification for the mortgage interest deduction, it might be appropriate to restrict the deduction to interest incurred on a mortgage to finance the *purchase* of a principal residence. For reasons of practicality, however, it seems preferable to allow the deduction for all interest on a principal residence (up to the ceiling amount), including interest incurred on the proceeds of refinancing the home. *See supra* text accompanying notes 413-20.

422. *See* Yorio I, *supra* note 4, at 1284; *see also* R. Goode, *supra* note 88, at 194-95 (tax progressivity and equity affected by concentration of gains in the hands of high income groups).

423. *See* Yorio I, *supra* note 4, at 1284; *see also* R. Posner, *supra* note 108, at 470 (taxpayers "are led to substitute activities that yield capital gains . . . for equally or more productive activities that yield ordinary income").

424. *See* Yorio I, *supra* note 4, at 1284; *see also* R. Posner, *supra* note 108, at 470 (special treatment of capital gains gives "corporations an incentive to retain rather than distribute earnings," reducing "the discipline of the capital market"); Sheppard, *supra* note 318, at 650 (comment of J. Minarik that repeal of capital gains deduction may induce corporations to distribute earnings).

425. *See* Yorio I, *supra* note 4, at 1284. The point in the text may be illustrated by a simple hypothetical. Assume that a taxpayer who is normally in the 30% marginal tax bracket realizes in one taxable year a $100,000 capital gain that accrued over a five-year period. Because the gain is taxable in one year, the taxpayer is thrust into a higher tax bracket. If the average rate of tax on the gain is 45%, the effect of a progressive tax system is to increase the tax on the gain from $30,000 to $45,000.

With the reduction in the number of tax brackets and in the maximum tax rate to 28%, the untoward effect of bunching a gain in one taxable year in a progressive tax system has been mitigated under current law. *See supra* text accompanying notes 215-16.

426. *See* Yorio I, *supra* note 4, at 1284.

427. *See* B. Bittker, L. Stone & W. Klein, *supra* note 148, at 806; M. Chirelstein, *supra* note 162, ¶ 16.01, at 272-73; Yorio I, *supra* note 4, at 1284.

428. *See supra* notes 340-42 and accompanying text.

marginal tax rate on realized gains,[429] taxpayers will have an even greater incentive to cling to appreciated property for as long as possible.[430]

Despite these objections, Congress elected simply to repeal the capital gains deduction.[431] Although the resulting system for taxing capital assets is still seriously defective, designing a solution for the remaining inequities and inefficiencies will be difficult.[432] At its best, taxation of capital assets is likely, as a practical matter, to include a series of uneasy compromises.[433] Nevertheless, Congress should address three defects in the current system of taxing capital assets that are responsive to feasible (albeit in two cases partial) tax reform.

First, gains that merely match inflation do not constitute an actual increase in a taxpayer's ability to pay.[434] To rectify the inequity of taxing illusory gains, the bases of capital assets should be indexed for inflation, as proposed in the Treasury Report to the President.[435] Indexing capital assets for inflation would also alleviate somewhat the lock-in effect of current rules governing the taxation of capital assets.[436]

Second, venture capitalists have complained that the incentive to invest in risky enterprises has been reduced because of the increase in the marginal tax rate on realized capital gains.[437] Although my earlier arti-

429. Under the pre-1986 Code, the maximum marginal tax rate (without regard to the alternative tax) on long-term capital gains was effectively 20% since the capital gains deduction was 60% and the highest marginal tax rate was 50%. *See* I.R.C. §§ 1, 1202(a) (1982) (repealed 1986). Under the 1986 Code, when fully effective, the maximum tax rate on capital gains will either be 28% or 33%. *See supra* text accompanying notes 215-16, 234.

430. *See* R. Goode, *supra* note 88, at 214; Andrews, *supra* note 54, at 1134; Yorio I, *supra* note 4, at 1284.

431. *See supra* text accompanying note 234. By reducing the number of tax brackets and the maximum tax rate, Congress did address and alleviate (albeit indirectly) the problem in a progressive tax system of bunching a capital gain in one taxable year. *See supra* note 425 and accompanying text.

432. *See* R. Posner, *supra* note 108, at 471; Yorio I, *supra* note 4, at 1284-85.

433. *See infra* text accompanying notes 442-43, 446-49.

434. *See* R. Posner, *supra* note 108, at 471-72. Under certain circumstances, the tax advantage of deferring tax on an unrealized gain may offset the disadvantage of paying a tax on the portion of the gain that is unreal. *See id.* at 471. But that effect would be purely serendipitous. In the case of an asset sold at a loss, for example, the failure to index basis cannot be justified as an offset to the tax advantage of deferral.

435. *See* 2 *Treasury Report*, *supra* note 2, 178-88.

The Treasury Department also proposed that indexing for tax purposes be adopted more generally. *See generally id.* at 152-72, 177-200 (indexing proposals for depreciation, capital assets, inventories, and debt). For criticism of the 1986 Act's failure to index generally for inflation, see Makin & Allison, *supra* note 130, at 252-53, 259-60; Sheppard, *supra* note 315, at 537 ("cadre of economists . . . lament the . . . failure [of the 1986 Act] to index income from capital for inflation").

436. *See* 2 *Treasury Report*, *supra* note 2, at 186-87; Yorio I, *supra* note 4, at 1286.

437. *See, e.g.*, Sheppard, *supra* note 318, at 649 (comment of venture capitalist J. Henry that repeal of the capital gains deduction will reduce incentive to take risks); N.Y. Times, May 9, 1986, at D5, col. 3 (comments of venture capitalists S. Pratt and S. Robertson); *see also* Wall St. J., Sept. 10, 1986, at 32, col. 5 (article by economist L. Lindsey) ("[H]igher capital gains rates will discourage entrepreneurship, impede capital formation and retard economic growth.").

cle rejected the incentive argument for favorable tax treatment of capital gains,[438] investors in risky ventures can legitimately claim unfairness by virtue of the limitations placed by the Code on the deductibility of capital losses.[439] Repeal of the capital gains deduction creates a situation in which the government is effectively a partner, sharing to the extent of the investor's marginal tax bracket, in any gain realized upon the success of an investment.[440] But because of the capital loss limitations, the government generally bears a lesser portion of the loss when a venture fails.[441]

Eliminating this inequity by making capital losses fully deductible would be too generous to taxpayers and might result in substantial revenue losses because of the ability of taxpayers to realize losses selectively while deferring realization of gains.[442] Still, some liberalization of the rules governing the deductibility of capital losses—perhaps by increasing to $10,000 (from $3,000) the maximum amount of capital losses that may be deducted in a single taxable year—seems proper now that realized capital gains are fully taxable.[443] Increasing the maximum amount of the capital loss deduction would also induce certain taxpayers to realize capital losses, thereby mitigating the "lock-in" effect caused by the current loss limitations.

Even after indexing the bases of capital assets and liberalizing the treatment of capital losses, the system of taxing capital assets would remain defective by failing to tax unrealized gains (and losses) as they accrue and by exempting unrealized gains (and losses) from tax consequences upon death. The realization requirement reduces the efficiency and liquidity of the market by inducing taxpayers to cling to ap-

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438. *See* Yorio I, *supra* note 4, at 1285; *see also* Sheppard, *supra* note 318, at 649 (comment of J. Minarik that incentives for venture capital are self-defeating and distortive if the rate of return on a venture is below the market).

439. *See* I.R.C. § 1211(b) (West Spec. Pam. 1987) (capital losses deductible by taxpayers other than corporations only to the extent of the lower of $3,000 or "the excess of such losses over such gains").

440. If, for example, a taxpayer in the 28% marginal tax bracket realizes a gain of $100,000, the government will levy a tax of $28,000 on the gain.

441. The $3,000 yearly limitation on the deductibility of capital losses may prevent a taxpayer from being able to deduct the full amount of a capital loss during the taxpayer's lifetime. At the very least, the annual limitation will defer part of the tax benefit derived from deducting a substantial capital loss. By contrast, the Code treats as immediate income the full amount of a realized gain. *See* I.R.C. § 61(a)(3) (1982).

Many taxpayers are able to avoid the unfavorable effects of the limitation on the deductibility of capital losses by timing realizations of capital assets to ensure that realized losses will be offset by realized gains. *See id.* § 1211(b)(2) (West Spec. Pam. 1987) (capital losses deductible to the extent of capital gains). But with respect to taxpayers who are unable to realize gains commensurate with their realized losses, the capital loss limitation results in tax inequity.

442. *See* Sheppard, *supra* note 318, at 649 (comment of J. Minarik that full deductibility of capital losses would create "huge revenue losses").

443. *Cf. id.* at 649 (comment of J. Minarik that loosening limitations on capital loss deduction " 'would clear the decks, giving venture capital an absolute advantage . . . [because of] its high rates of return' ").

preciated property[444] and causes tax inequity by favoring taxpayers who are able to postpone the realization of gains over taxpayers who must realize gains and taxpayers whose income is comprised of wages or other immediately taxable receipts.[445]

To solve these problems and also eliminate the need for *any* restrictions on the deductibility of capital losses,[446] realized gains (and losses) might be taxed as they accrue. But because of the difficulty of valuing certain assets on an annual basis and because of possible liquidity problems,[447] Congress is unlikely to enact a system of accrual taxation.[448] As a partial solution, Congress should provide that unrealized gains (and losses) be constructively realized and taxed when capital assets are transferred by gift or bequest.[449] Although adoption of the principle of constructive realization would not affect the advantages of deferral during the taxpayer's ownership of an asset, it would eliminate the inequity of permanent exemption from tax upon death and would mitigate the lock-in effect by removing the incentive to hold appreciated property until death to avoid income tax liability.

Conclusion

The case for certain tax preferences on grounds of equity and efficiency has been forcefully presented in two recent articles on federal income tax policy. If valid, the arguments adduced in these articles would also suggest that many provisions of the 1986 Act were not mandated by considerations of equity or efficiency. Although the standards set out in these articles for evaluating federal income tax provisions may have merit in particular cases, this Article has demonstrated that the 1986 Act generally improves both the equity and efficiency of the federal income tax by simultaneously eliminating (or restricting) many tax preferences and by reducing marginal tax rates. Moreover, with respect to individual income taxpayers, the remaining defects in the Code result mainly from the failure of Congress to repeal (or limit) other preferences and to use the revenues thereby generated to reduce marginal tax rates even further.

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444. See B. Bittker, L. Stone, & W. Klein, *supra* note 148, at 806; M. Chirelstein, *supra* note 162, at 272-73; R. Posner, *supra* note 108, at 470; Shakow, *supra* note 344, at 1114.

445. *See* Yorio I, *supra* note 4, at 1284.

446. If capital gains and losses were taxable as they accrue, taxpayers would not be able to obtain the tax advantage of realizing on loss assets while deferring realization on gain assets. Thus, the primary reason for restrictions on the deductibility of capital losses would be eliminated. *See supra* text accompanying note 442.

447. *See* R. Posner, *supra* note 108, at 471 (analysis of valuation and liquidity problems in taxing unrealized gain); Andrews, *supra* note 49, at 1143 (taxing unrealized appreciation might result in forced liquidations); Shakow, *supra* note 344 at 1113 (twin problems of valuation and liquidity never previously solved).

448. *But see* Shakow, *supra* note 344, at 1118-19 (proposal for modified accrual taxation of capital assets).

449. *See* R. Goode, *supra* note 88, at 220-21; J. Pechman, Federal Tax Policy 107-08 (3d ed. 1977).