

1987

The Tax Reform Act of 1986: A Response to Professor Yorio and His Vision of the Future of the Internal Revenue Code

Edward A. Zelinsky

Follow this and additional works at: <https://ir.lawnet.fordham.edu/flr>



Part of the [Law Commons](#)

Recommended Citation

Edward A. Zelinsky, *The Tax Reform Act of 1986: A Response to Professor Yorio and His Vision of the Future of the Internal Revenue Code*, 55 Fordham L. Rev. 885 (1987).

Available at: <https://ir.lawnet.fordham.edu/flr/vol55/iss6/1>

This Article is brought to you for free and open access by FLASH: The Fordham Law Archive of Scholarship and History. It has been accepted for inclusion in Fordham Law Review by an authorized editor of FLASH: The Fordham Law Archive of Scholarship and History. For more information, please contact tmelnick@law.fordham.edu.

The Tax Reform Act of 1986: A Response to Professor Yorio and His Vision of the Future of the Internal Revenue Code

Cover Page Footnote

* Professor of Law, Benjamin N. Cardozo School of Law, Yeshiva University. I would like to thank my colleagues at the Benjamin Cardozo School of Law, Paul Shupack and Stewart Sterk, as well as my most critical reader, Doris Zelinsky.

THE TAX REFORM ACT OF 1986: A RESPONSE TO PROFESSOR YORIO AND HIS VISION OF THE FUTURE OF THE INTERNAL REVENUE CODE

EDWARD A. ZELINSKY*

INTRODUCTION

THE legal literature on federal tax policy generally endorses the premise that tax incentives are undesirable and should be avoided.¹ In an article published soon after the passage of the Tax Reform Act of 1986 ("the 1986 Act"), I dissented from this view² and suggested that, in some cases, tax incentives may be efficient and appropriate instruments of federal policy.³

In his recent article about the 1986 Act, Professor Edward Yorio undertakes a friendly, but ultimately critical, analysis of these recent ruminations of mine.⁴ Professor Yorio and I agree the 1986 Act was, on balance, a substantial improvement over prior law. We also share, in part, a common vision for further reform efforts. In important ways, however, we differ as to the future of the Internal Revenue Code from this point on. Professor Yorio's recipe for further reform efforts is essentially more of the same. I think this neither feasible nor entirely desirable.

As to tax policy issues raising principally questions of equity and the adequacy of revenues, Professor Yorio and I are basically in agreement. To that extent, we would both continue the trend of the 1986 Act. However, as to proposals that raise a different issue—the scope of federal activity—we disagree. In evaluating my defense of tax incentives, Professor Yorio seemingly takes a procedural approach,⁵ challenging the use of the tax system as a means of government intervention.⁶ However, a substantive challenge to government intervention of any sort is implicit in Professor Yorio's analysis.⁷

* Professor of Law, Benjamin N. Cardozo School of Law, Yeshiva University. I would like to thank my colleagues at the Benjamin Cardozo School of Law, Paul Shupack and Stewart Sterk, as well as my most critical reader, Doris Zelinsky.

1. See Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 Tex. L. Rev. 973, 973 (1986) (listing many academics, government officials, journalists and public interest advocates who oppose tax incentives).

2. See *id.* at 977.

3. See *id.*

4. See Yorio, *Equity, Efficiency, and the Tax Reform Act of 1986*, 55 Fordham L. Rev. 395 (1987).

5. See Zelinsky, *supra* note 1, at 977.

6. See Yorio, *supra* note 4, at 428-29 nn.208-09.

7. Professor Yorio appears to limit government intervention alternatives to direct subsidies, see Yorio, *supra* note 4, at 428-29 nn.208-09, tax expenditures as they existed

Professor Yorio limits our alternatives to tax expenditures as they existed before the 1986 Act or no tax expenditures at all. He, thus, denies we might develop future tax expenditures that avoid the pitfalls of the past. I, on the other hand, am willing to design new tax expenditures in light of our past experience and the teachings of tax expenditure analysis. Our differences reflect a fundamental disagreement about the role of the federal government in American life, a disagreement transcending technical tax considerations. Our dialogue is incomplete without a discussion of these issues.

I shall proceed initially by analyzing in Part I the forces that made possible the 1986 Act, suggesting the 1986 Act was feasible because liberal and supply-side visions of tax reform were brought into a temporary, and productive, truce. The differences between Professor Yorio's and my views, in large measure, reflect the differences in these visions. In Part II, I demonstrate that on the bona fide technical issue dividing us, i.e., the relative merits of direct as opposed to tax expenditures, the case for tax expenditures is better than Professor Yorio maintains. In Part III, I demonstrate that sub silentio the underlying issue dividing Professor Yorio and me is the scope of federal activity and I put forward my initial prescriptions for the Tax Reform Act of 1987.

I. THE TAX REFORM ACT OF 1986: HOW DID IT HAPPEN?

With the passage of time, many historic achievements acquire an aura of inevitability they do not deserve. Before this happens to the Tax Reform Act of 1986, it is useful to identify the forces that coalesced to produce this legislation.⁸

A major impulse behind the 1986 Act was the view of the federal income tax espoused by such figures as Senators Paul Douglas and Hubert Humphrey, apostles of New Deal liberalism in its classic form.⁹ The starting premise for this perspective is an activist, redistributive federal government softening the rougher edges of a market economy.¹⁰ Broadening the income tax base, for those holding this perspective, reflects both the need for equity among taxpayers and the revenue requirements of a vigorous federal government.¹¹ In terms of tax policy, this has meant opposition to such alleged loopholes as the percentage depletion

before the 1986 Act, *see id.* at 442 n.331, or no tax expenditures at all. *See id.* at 408-10 nn.72-74.

8. It does not diminish the achievement of the President, his administration or the tax writers in Congress to explain the 1986 Act in terms of larger forces. It takes personal skill to put together historic coalitions. Nonetheless, an analysis of broader currents is more helpful for our present purposes since the particular individuals responsible for the 1986 Act may not be present in the future, while the question of tax reform will.

9. *See* P. Douglas, *In the Fullness of Time*, 423-61 (1972); C. Solberg, *Hubert Humphrey* 145-47, 463 (1984).

10. *See* P. Douglas, *supra* note 9, at 350-57; C. Solberg, *supra* note 9, at 463.

11. *See* P. Douglas, *supra* note 9, at 426.

allowance¹² and perceived excesses in qualified pension and profit sharing plans.¹³ It has also meant support for tax provisions ostensibly pursuing social welfare in the New Deal sense, e.g., the exclusion from income of employer-provided medical insurance.¹⁴

By 1986, those adhering to this view confronted a choice between their interests in tax equity and adequate revenue and their preference for interventionist government. To no small extent, the preferences eroding the income tax base before the 1986 Act resulted from the pursuit of liberal objectives, such as accelerated depreciation for low-income housing.¹⁵ Such preferences created the appearance, and perhaps the reality, of an inequitable tax.¹⁶

Equally essential to the adoption of the 1986 Act was the perspective popularly labeled "supply-side economics."¹⁷ Fundamental to this view is the desire to lower marginal tax rates. High taxes, it is argued, reduce incentives for work and savings and distort the allocation of resources.¹⁸ The supply-side critique defines the prime task of government as facilitating markets as engines of economic well-being, not mitigating markets' unpleasant side effects.¹⁹ According to this view, the problem with the income tax before the 1986 Act was its inhibiting effect on the entrance of people, goods and services into productive markets.²⁰

In its original incarnation, supply-side theory promised that income tax rate reductions would unleash enough economic growth to pay for themselves.²¹ By 1986, that had ceased to be a credible contention. Consequently, those favoring lower tax rates were forced to choose between no tax legislation and legislation paying for lower rates by reduced deductions, credits and exclusions from income. Such legislation meant reviving the corporate income tax and imposing effectively heavier taxes on some high- and middle-income individuals.

A third factor leading to the 1986 Act was the pervasive influence

12. See I.R.C. § 613 (West Spec. Pam. 1987).

13. See *id.* § 401(a).

14. See *id.* § 106.

15. See *id.* § 168(b)(4)(A) (Supp. III 1985).

16. As Professor Yorio notes, Professor Cooper and others have suggested that market forces do much to eliminate ostensible inequities in the tax law. See Yorio, *supra* note 4, at 397-98 nn.14-18 & n.18.

17. For a general discussion of supply-side economics, see P. Roberts, *The Supply-Side Revolution* (1984). For a less sympathetic account, see H. Stein, *Presidential Economics* (1984).

18. See Roberts, *supra* note 17, at 5-6, 12-13, 25. The supply-side critique of high income tax rates sometimes is characterized as a new doctrine of the 1980's. Just as starlets were once found at Hollywood drugstores, the origin of supply-side tax policy is picturesquely attributed to Professor Laffer's scribbles on napkins. The reality is more complex. Almost two generations ago, Henry Simons was complaining about Congress' tendency to impose increasingly high rates on too narrow a tax base. See H. Simons, *Federal Tax Reform* 12 (1950).

19. See P. Roberts, *supra* note 17, at 25.

20. See *id.*

21. See *id.* at 27.

among tax professionals of tax expenditure analysis. While the links between academic theory and political action usually are unclear or nonexistent, in this case they were apparent and direct. In November of 1984, the Department of Treasury put forward a comprehensive reform proposal²² embracing the rhetoric and substance advanced by Professor Surrey, Joseph Pechman and other influential commentators.²³ Although subsequently modified by the President²⁴ and the Congress,²⁵ that blueprint, and its accompanying rhetoric, largely molded the legislative process that followed.²⁶

In the 1986 Act, liberal and supply-side forces effectively came to a productive truce. In the Democratic House, equity was deemed more important than activism. Thus, the House modified the Treasury proposals so as to protect fringe benefit exclusions and restrict qualified plans.²⁷ The latter was an area largely left untouched in the President's and the Treasury's recommendations.²⁸ On these terms, the House accepted the withdrawal of the federal government from certain areas of American life in return for a broader income tax base. In the Republican Senate, rate reductions were deemed paramount. The President and the Senate swallowed increases in corporate income taxes and in effective rates for some affluent taxpayers in return for reduced rate schedules.²⁹ Tax expenditure rhetoric papered over the compromise being made, implicitly assuring one side that an activist government still could use direct outlays, promising the other a more neutral tax system and, thus, less government intervention.

The legislative process giving rise to the 1986 Act was, in short, a *tour de force* that, on balance, improved the Internal Revenue Code. However, liberal reformers made no irrevocable commitment to a reduced

22. See Department of Treasury, *The Treasury Department Report to the President: Tax Reform for Fairness, Simplicity, and Economic Growth* (Nov. 1984) [hereinafter *Treasury Report*].

23. See S. Surrey & P. McDaniel, *Tax Expenditures* (1985).

24. See *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May 1985).

25. See *Tax Reform Act of 1986*, Pub. L. No. 99-514, 1986 U.S. Code Cong. & Admin. News Special Pamphlet No. 9A (100 Stat.) 1. For a capsule legislative history of the 1986 Act, see Yorio, *supra* note 4, at 395 n.2.

26. See *supra* notes 24-25. One of my observations, not addressed by Professor Yorio, is that tax expenditure analysis is compatible with both the liberal and supply side versions of tax reform. For those concerned with tax equity and an activist government, tax expenditure analysis provides a vision of a federal government, well-financed by all of its citizens, pursuing policies through direct expenditure programs. For those interested in reducing the impact of the federal government, tax expenditure analysis holds out the prospect of an economically neutral tax permitting markets to function without interference from Washington.

27. Compare 2 *Treasury Report*, *supra* note 22, at 20-50, 336-56 (proposal to repeal the exclusion of most statutory fringe benefits from income) with H.R. 3838, 99th Cong., 1st Sess. § 1101-04, 1111-16, 1121-23, 1151, 1161-63, 1171-76 (1985) (proposals to protect fringe benefit exclusions and to restrict qualified plans).

28. See 2 *Treasury Report*, *supra* note 22, at 336.

29. See I.R.C. § 1 (West Spec. Pam. 1987).

role for the federal government nor did supply-side reformers permanently renounce their commitment to a more market-oriented view of the American polity. In tax law as in war, there is a difference between a truce and a peace treaty.

The differences between Professor Yorio's perspective and mine reflect the underlying conflicts between the forces that produced the 1986 Act. It would oversimplify to cast Professor Yorio as merely an advocate of supply-side tax reform and myself as a spokesman for the liberal version. Professor Yorio, for example, has a deep concern with the adequacy of federal revenues,³⁰ a concern not always evident among supply-side reformers. Similarly, I am more respectful of properly functioning markets than many advancing the liberal view of tax reform.³¹ Nevertheless, in Professor Yorio's approach, the supply-side elements are preeminent, while in mine, the liberal commitment to an activist government is more prominent.

II. DIRECT V. TAX EXPENDITURES

Professor Yorio and I differ as to the propriety of using tax incentives when the federal government has decided to spend. Professor Yorio suggests that all federal spending should be through direct expenditure programs.³² This exclusive preference for direct outlays reflects an overly-idealized view of such programs as well as the refusal to consider tax expenditures different from those in existence before the 1986 Act.

Professor Yorio argues that tax incentives cannot be targeted as narrowly as direct outlays³³ and are thus more likely to bestow largesse upon those who are undeserving or who would in any event have undertaken the activity the government seeks to encourage.³⁴ I disagree. As a political matter, it is difficult to target any government subsidy given the need for a legislative majority. Majorities are created by expanding, rather than narrowing, the scope of a program. This is as true of direct expenditures as tax incentives.

As a technical matter, the same criteria used to target direct expenditures can be used for tax provisions. Suppose, for example, the government seeks to subsidize housing in low-income areas. Congress could establish a narrowly-focused direct expenditure program such as a cash payment to housing developers building units in census tracts with below-average incomes. Congress could just as plausibly provide a tax credit to developers building in such tracts. The criteria to be used are interchangeable between a direct expenditure program and its tax equivalent.

30. See Yorio, *supra* note 4, at 435-36 n.284; Yorio, *The President's Tax Proposals: A Major Step in the Right Direction*, 53 Fordham L. Rev. 1255, 1263 (1985).

31. See Zelinsky, *supra* note 1, *passim*.

32. See Yorio, *supra* note 4, at 428-29 nn.208-09.

33. See *id.* at 423 n.180.

34. See *id.* at 422 n.177.

The current tax credits for low-income housing³⁵ and jobs for the disadvantaged³⁶ are as carefully focused as the equivalent direct expenditure programs would be. Section 51 is properly labelled a "targeted jobs credit."³⁷ The resulting statute is, to use Professor Yorio's apt phrase, one of "daunting complexity."³⁸ But a comparable direct expenditure program would be equally so. Complex policies require complex laws.

Professor Yorio also suggests that tax incentives are sometimes too narrowly-focused because only those who owe federal income tax can benefit from them and thus be affected by them.³⁹ As a technical matter, this observation is not convincing. Any tax incentive can be made refundable.⁴⁰ The Treasury can send a check to the taxpayer whose credits and deductions exceed his income.

As a broader matter, Professor Yorio suggests that tax incentives are not well-adapted to influencing the behavior of those too poor to pay tax.⁴¹ There is much truth in this observation. Food stamps are a better approach to the nutritional problems of the poor than a refundable tax credit for food consumption. However, this observation does not affect the validity of my outlook. Professor Yorio's position and mine are not mirror images of one another. Professor Yorio believes that direct expenditures invariably are superior to tax incentives.⁴² I, on the other hand, view tax expenditures as one tool available to the federal government. But I have never argued that tax incentives are always preferable to direct programs. Sometimes they will be the right tool, sometimes not.

Professor Yorio, in a similar vein, recasts the "upside-down" argument of tax expenditure opponents as an efficiency critique. Since a dollar deduction is more valuable to a person in the 28% bracket than to someone paying tax at the 15% rate, tax expenditures are said to provide "upside-down" subsidies, i.e., the greatest assistance to those taxpayers with the highest incomes.⁴³ While this result is usually bemoaned as unfair, Professor Yorio suggests instead that it is inefficient, the affluent taxpayer needing less prodding from the government than his low-income counterpart.⁴⁴

Whether or not Professor Yorio's efficiency critique of the "upside-down" effect is correct,⁴⁵ there is no inherent reason tax expenditures

35. See I.R.C. § 42 (West Spec. Pam. 1987).

36. See *id.* § 51(a).

37. *Id.*

38. See Yorio, *supra* note 4, at 423 n.181.

39. See *id.* at 423 n.182.

40. See, e.g., I.R.C. §§ 32, 34 (West Spec. Pam. 1987) (refundable credits for earned income and certain uses of gasoline and special fuels).

41. See Yorio, *supra* note 4, at 423-24 nn.182-85.

42. See *id.* at 428-29 nn.208-09.

43. See *id.* at 421 & n.162, 423 nn.182-84.

44. See *id.* at 424 n.185.

45. In the absence of empirical evidence, I see no reason to believe Professor Yorio is correct. Conceivably, it may require a greater relative subsidy to influence a taxpayer's outlay of \$1,000,000 than of \$10,000.

must provide "upside-down" assistance. Tax expenditures can be designed as credits giving the same relief regardless of tax bracket. Such expenditures can be phased out as taxpayers' incomes rise, thus providing "rightside-up" assistance, heaviest for those in the lowest brackets.⁴⁶ Indeed, one of the great accomplishments of tax expenditure analysis has been the education of the tax bar, academia and Congress as to these possibilities.⁴⁷

In this and in other respects, tax expenditures should not be compared against an idealized notion of direct expenditures programs. Millionaire farmers receiving government agriculture subsidies indicate that direct outlays may be unfortunately "upside-down" in effect as well.⁴⁸

Professor Yorio suggests that Congress' processes do not scrutinize proposed tax expenditures as effectively as proposed direct outlays.⁴⁹ Tax provisions are reviewed by one committee of each house; direct expenditures programs by two.⁵⁰ The tax writing committees of both houses, according to Professor Yorio, lack the technical and staff expertise to analyze tax expenditures on a substantive level.⁵¹ The congressional experts on housing, for example, are connected with non-tax committees that, under current procedures, do not review housing-related tax expenditures before they are enacted into law.⁵²

Professor Yorio is, at one level, correct. Congress should treat proposed tax expenditures similarly to direct outlays. Tax expenditures should be reviewed by both the tax-writing committees and the appropriate substantive committees, e.g., those pertaining to housing. Given that possibility, Professor Yorio's proposal to eschew tax expenditures is puzzling. Since Congress' procedures are deficient, it is those procedures that should be changed. Sound public policy should not be held hostage to the inadequacies of Congress' internal rules.

In my article, I addressed another mainstay of the tax expenditure critique, the argument that tax expenditures erode taxpayers' morale and ultimately their compliance with the tax system.⁵³ Taxpayers unwilling or unable to use incentives, in this view, resent the lower tax burden of those who do.⁵⁴ This results in reduced willingness to comply with tax laws perceived to be unfair.⁵⁵ In simplest terms, cheating will increase as a manifestation of dissatisfaction.

46. See, e.g., I.R.C. § 21 (West Spec. Pam. 1987) ("rightside-up" credit for household and dependent care services).

47. Cf. Zelinsky, *supra* note 1, at 1024-25 (describing the "upside-down" effect first criticized by Surrey).

48. See *id.* at 1031 & n.125.

49. See Yorio, *supra* note 4, at 425 nn.189-95.

50. See *id.* at 424-25 nn.188-89.

51. See *id.* at 425 nn.191-95.

52. See *id.* at 425 n.192.

53. See Zelinsky, *supra* note 1, at 1027.

54. See Yorio, *supra* note 4, at 425 n.196.

55. See *id.* at 426 n.197.

This is a persuasive argument but one that proves too much. Taxpayers should also resent largesse distributed by the federal government in the form of direct expenditures. Such expenditures are also likely to cause noncompliance with the tax system, the handiest (and perhaps only) way most taxpayers can get even with the federal government. There is, in short, a morale problem that must be addressed by those favoring federal spending. It is not, however, a problem that generates a preference for direct expenditures.

Professor Yorio rejoins that the connection between resented direct expenditures and the tax system financing them is too remote to affect taxpayers' perceptions of and compliance with the tax system.⁵⁶ I am more inclined to believe that taxpayers perceive a connection between the taxes they pay and the public outlays others receive. The reader will consult his own experience as to which of us is correct.

Finally, Professor Yorio rejects as "powerful" but "questionable" my contention that tax incentives will in certain cases be more efficient means of communicating government policies than direct expenditure programs.⁵⁷ Professor Yorio unfairly weights the scale by implicitly comparing an idealized notion of direct expenditure programs with the messy reality of tax incentives⁵⁸ and by implicitly requiring me to demonstrate that tax incentives always have lower transactions costs than direct outlays.⁵⁹ So framed, the outcome of the inquiry, of course, is inevitable.

Let us, however, consider the reality of direct expenditures. That tax incentives lead to paperwork, tax planning, accountants' fees and tax lawyers' bills is well-known.⁶⁰ But a properly functioning direct expenditure program can create comparable burdens as well.⁶¹ Applications for federal funds frequently make Form 1040 look like a model of simplicity.⁶² A taxpayer applying for an Urban Development Action Grant goes through a planning process that would do any tax lawyer proud. Grant writers tend to style themselves as consultants and frequently have MBA's. Their fees, however, can make CPA's and lawyers look like bargain basement operators. Hence, in particular cases, the transactions costs of a tax incentive may (or may not) be less than the transactions costs of the equivalent direct expenditure.

Professor Yorio and I agree that, as to large corporations with existing government relations offices, the transactions costs of new direct expendi-

56. *See id.* at 426 n.198.

57. *See id.* at 427 nn.204-05, 428 nn.207-08.

58. *See id.* at 427-28 nn.205-08.

59. *See id.* at 428 nn.207-08.

60. *See id.* at 428 n.208.

61. For an introduction to federal grants and the complexity of the grant approval process, see ACIR, *Categorical Grants: Their Role and Design* (1977); *Federal Grant Law* (M. Mason ed. 1982).

62. *See Settle & Yamada, The Award Process*, in *Federal Grant Law*, *supra* note 61, at 5.

ture programs will frequently be small since these firms are already incurring the basic costs of learning about such programs.⁶³ Professor Yorio also agrees that middle-income households and small businesses do not have government relations offices, but do engage lawyers and accountants to prepare tax returns and handle tax-related matters. These taxpayers, therefore, can be reached at relatively low marginal cost through the professional tax network.⁶⁴ I thus conclude that programs aimed at large corporations should presumptively be structured as direct outlays, those for smaller businesses and middle class households as tax incentives.⁶⁵ If the federal government wants Fortune 500 companies to build low-income housing, direct grants seem most efficient. If Congress wants professionals to invest in low-income housing, tax expenditures probably will be the cheapest way to communicate this policy.

Professor Yorio balks at my conclusion for two reasons, neither of which is persuasive. First, so "limiting the benefit of a tax expenditure to certain taxpayers may be hard to explain to taxpayers who are not the beneficiaries of the incentive."⁶⁶ This may be convincing when confronting an incentive available to the wealthy, but not those less affluent. I, however, suggest the opposite, that tax incentives be made available to middle-income households and small businesses but not large corporations. I am confident that the Secretary of the Treasury can explain to General Motors' Chairman why his company must utilize direct expenditure programs and that General Motors will still pay its federal taxes.

Second, sometimes a federal program will be aimed at both types of audiences, e.g., small and large businesses. In this setting, Professor Yorio contends, duplicative tax and direct expenditure programs may be wasteful.⁶⁷ The federal government, in such cases, should generally use only one approach.⁶⁸ I agree.

Professor Yorio, however, asserts that the efficient approach will always be the direct expenditure program.⁶⁹ Here, the asymmetry of our positions becomes clear again. Sometimes a single direct expenditure program will prove superior, but sometimes the tax incentive will be. There is no way to make this decision other than on a case-by-case basis and there is no reason to believe the cost of grant writers always will be cheaper than the cost of tax professionals.

Perhaps the simplest way to summarize these disagreements between Professor Yorio and me is that I am more confident the lessons of tax expenditure analysis can guide us in the future. Professor Surrey and his followers have performed a service of inestimable value by demonstrating

63. See Yorio, *supra* note 4, at 427 nn.205-06.

64. See *id.*

65. See Zelinsky, *supra* note 1, at 1037.

66. See Yorio, *supra* note 4, at 427-28 nn.206-07.

67. See *id.* at 428 n.207.

68. See *id.*

69. See *id.* at 428-29 nn.208-09.

the equivalence between direct and tax expenditures, exposing the fallacy that tax expenditures are costless, establishing annual accounting of tax expenditures, and highlighting the possible inequities and inefficiencies of such expenditures. The issue now is whether, in light of these lessons, Congress can proceed on a rational, informed basis to make particular choices in particular situations.

Some, like Professor Yorio, view the Congress as a reformed alcoholic, recently recovered from a three-decade binge of tax expenditures.⁷⁰ They have a simple admonition for a now-sobered but ultimately incorrigible Congress: don't touch a drop. In theory, some can drink of tax expenditures moderately and for medicinal purposes. But not you.

My preferred analogy is that of Congress as a reformed glutton. Having overeaten a diet of tax expenditures, the 1986 Act has imposed overdue restraint. Congress, however, should not now choose between a return to obesity and fiscal anorexia. A properly organized and informed legislature should be able to use tax expenditures when appropriate and to avoid them when not.

III. THE UNDERLYING ISSUE: THE SCOPE OF FEDERAL ACTIVITY

Given the possibility that a properly designed tax incentive could be preferable to a direct expenditure program pursuing the same objective, Professor Yorio's blanket condemnation of all tax incentives reflects *sub silentio* a rejection of federal activity. This is a wholly-legitimate position, but one that should not be disguised as a mere matter of tax policy.

Professor Yorio frames our alternatives as the restoration of incentives in their old form or the exclusion of all incentives from the Code.⁷¹ There is, however, a third possibility: to craft future tax expenditures in light of our prior experience so they are properly focused to legitimate ends. It is the willingness to consider such new alternatives that principally distinguishes my future agenda from Professor Yorio's. This willingness reflects the greater importance I attach to a vigorous federal government.⁷²

Consider, for example, the mortgage interest deduction. Professor Yorio proposes that the deduction be limited to primary residences and to an annual maximum amount per taxpayer.⁷³ I agree with both proposals. Beyond that, Professor Yorio assumes that our only choice is the

70. Professor Yorio correctly observes that most tax expenditures in existence before the 1986 Act could not be justified on the terms I outline in my article. See Yorio, *supra* note 4, at 417 nn.131-32, 421 nn.164-65, 428-29 nn.208-09. Such expenditures were *in toto* an amalgam of incoherent special interest legislation.

71. See *supra* note 7 and accompanying text.

72. Professor Yorio asserts that "it is important to determine whether remedying market failures provides a convincing explanation for the tax incentives found in the pre-1986 Code." See Yorio, *supra* note 4, at 415 nn.117-18. For me, the more pressing issue is whether the decision in 1986 to purge the egregious tax expenditures then in the Code should be viewed as a decision to eschew tax incentives forever.

73. See *id.* at 452 nn.409-11.

deduction as it now exists, so limited.⁷⁴ He leaves little doubt that his preference is complete abolition.⁷⁵

There is, however, an alternative between the old incentive and nothing. We could target an interest deduction to implement federal housing policies. Professor Yorio correctly catalogues the ills besetting America's metropolitan areas.⁷⁶ Why not design a mortgage interest deduction accordingly? We could, for example, designate certain census tracts as the residential equivalents of enterprise zones. Persons moving into such areas could be given an extra incentive, e.g., higher maximums on deductible housing interest. Or we could grant such persons a tax credit for the rehabilitation of housing they will occupy for some minimum period of years. The issue is not the particulars of any incentive but the willingness to consider new alternatives. That difference, I suggest, reflects not a disagreement among tax technicians but divergent views of the role of the federal government.

Professor Yorio also objects that the mortgage interest deduction does not assist those families too poor to pay federal tax.⁷⁷ There are essentially four possible approaches to these families and their housing problems. First, we can do nothing, an alternative I find unacceptable. Without public assistance, there is generally not enough profit in low-income housing to entice private providers. Second, we can undertake direct expenditure programs such as vouchers for the poor to acquire their own shelter, public housing authorities, and cash subsidies to landlords willing to service low-income persons at reasonable rents. Third, we can provide tax incentives to those constructing and operating low-income housing. Fourth, we can enact a refundable tax incentive for low-income families, i.e., a rebate on their tax returns of a percentage of their housing costs.

When an individual identifies himself as an opponent of tax expenditures relative to low-income housing, he can be saying very different things. He can be stating that low-income housing should not be considered a problem, that it is of no consequence or will be adequately provided by the market. Alternatively, he may be saying that the federal government should approach low-income housing through direct expenditure programs. My argument with the first position, unlike the second, is not of a technical nature, but goes to the role of the federal government. I strongly suspect that Professor Yorio's underlying sympathies are with those favoring a more passive government.

Consider the tax expenditure I most explicitly endorse in my article, the targeted jobs credit, a provision scheduled to expire after 1988.⁷⁸ Professor Yorio does not mention this credit. I infer he would let it die as

74. *See id.* at 452-53 nn.411-17.

75. *See id.* at 450 nn.395-97.

76. *See id.* at 418 nn.136-40.

77. *See id.* at 420 n.161.

78. *See* I.R.C. § 51(c)(3) (West Spec. Pam. 1987).

planned. I would not. The problem of structural unemployment is a serious one that the market should not be expected to solve on its own. I prefer, as I think Professor Yorio does, that the disadvantaged be hired by private industry rather than government as employer of last resort. The private employers creating jobs in this country are largely small firms⁷⁹ that can be reached most efficiently by the federal government through the tax system.⁸⁰

Many difficult questions can be posed to those holding my position. Will Congress henceforth have the discipline to adopt only appropriate tax expenditures or will matters regress to the situation existing before the 1986 Act? Has Congress truly learned the lessons of tax expenditure analysis or is it still inclined to view tax expenditures as costless? Can the legislative process strike a proper balance between an active federal government and an equitable tax system? Perhaps my vision of carefully crafted and controlled tax expenditures ought be dismissed in the same terms with which Dr. Samuel Johnson deprecated second marriages: the triumph of hope over experience. Professor Yorio, however, makes none of these inquiries because he believes that the impropriety of tax incentives before the 1986 Act forecloses the possibility of any tax expenditure thereafter.⁸¹

Professor Yorio and I concur on the post-1986 agenda where a particular provision of the Code serves no legitimate federal policy or does not serve it well. We thus agree, for example, that taxpayers should recognize as income the build-up of life insurance policy cash values.⁸² Similarly, we are both troubled by the Code's provisions, even as reformed, relative to tax-exempt bonds and fringe benefits.⁸³ However, in important respects, I would approach the Tax Reform Act of 1987 differently than would Professor Yorio. In drafting the 1987 Act, Professor Yorio would simply ask how to continue prior efforts to achieve equity and strengthen federal revenues.⁸⁴ I, on the other hand, view federal tax policy as intimately interwoven with our substantive choices about federal activity. I would thus make two additional inquiries. First, what should be our domestic priorities at the federal level? Second, which of these priorities are properly addressed, in whole or in part, via tax expenditures?

My answer to these inquiries is that low-income housing and structural unemployment are areas that the federal government should ad-

79. See Zelinsky, *supra* note 1, at 1034 & n.134.

80. See *id.*

81. See Yorio, *supra* note 4, at 428-29 nn.208-09.

82. See *id.* at 443-44 nn.336-45.

83. See *id.* at 444-46 nn.346-65. The deduction for state and local taxes and the deduction for charitable contributions raise broader issues than can be addressed in this brief reply. For a discussion of these broader issues, see Zelinsky, *The Deductibility of State and Local Taxes: Income Measurement, Tax Expenditures and Partial, Functional Deductibility*, 7 *Am. J. Tax Policy* (forthcoming).

84. See Yorio, *supra* note 4, at 442 n.333.

dress through a combination of direct and tax expenditures. Indeed, it is no accident that the legislative process giving rise to the 1986 Act gave a temporary⁸⁵ reprieve to tax incentives addressing these critical problems.⁸⁶

My version of the Tax Reform Act of 1987, therefore, would retain the targeted jobs⁸⁷ and low income housing credits⁸⁸ as permanent parts of the Code. It also would exempt these credits from the passive loss rules of Section 469.⁸⁹

CONCLUSION

Professor Yorio has done a service by focusing our attention on the future of tax reform after the 1986 Act. We agree there is much work to be done. In important ways, however, we disagree on what that work should be. Fundamental to our differences is Professor Yorio's essential hostility towards federal activity. This is a wholly-legitimate position but one that should not be characterized as a mere matter of tax policy.

The most important contribution of tax expenditure analysis has been the insistence that tax policy choices be made in an open and fully-informed fashion. Tax expenditures are not costless. They should be scrutinized by normal legislative processes. The distributional effects of particular incentives should be made clear before such incentives are adopted or as they are retained. Tax expenditures, like direct outlays, should be continually reviewed as to their efficiency.

The insistence on an open and informed debate should extend to those opposing tax incentives as well as those favoring them. When opposition to a particular incentive reflects, in whole or in part, the belief that the area the incentive addresses is of no substantive concern to the federal government, that view should be expressed openly. By insisting on such truth-in-opposition, the quality of our tax policy debate can only be enhanced.

85. See I.R.C. §§ 42(n)(1), 51(c)(3) (West Spec. Pam. 1987).

86. See *id.* §§ 42, 51.

87. See *id.* § 51.

88. See *id.* § 42.

89. See *id.* § 469.

