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The Future of Tax Reform: A Rejoinder to Professor Zelinsky

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THE FUTURE OF TAX REFORM: A REJOINDER TO PROFESSOR ZELINSKY

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INTRODUCTION

IN response to my article on the past and future of tax reform, Professor Zelinsky restates several of his positions on federal income tax policy that I had criticized in my earlier article.[1] Professor Zelinsky's reply raises a new issue, however, which he believes underlies our disagreements on tax policy: the proper scope of federal activity in attacking social ills.[2] In Professor Zelinsky's view, my opposition to tax expenditures does not derive primarily from considerations of technical tax policy, but instead reflects a fundamental skepticism about federal intervention in the market that is shared by advocates of supply-side economics.[3] Professor Zelinsky distinguishes himself from this position by identifying with the proponents of a more liberal, interventionist national government, such as the late Senators Hubert Humphrey and Paul Douglas.[4]

The main purpose of this rejoinder is to reject the identification of my position on tax incentives with supply-side economics and to show that even proponents of a liberal, interventionist federal government have strong reasons to prefer direct subsidies to tax incentives as the means of attacking major social problems. Part I shows that previous articles on the relationship between tax and efficiency had focused almost entirely on the use of the Internal Revenue Code ("the Code") to improve allocative efficiency. In his response, Professor Zelinsky, while continuing to endorse the selective enactment of tax incentives, accepts virtually all of my specific criticisms of pre-1986 and existing tax incentives on the grounds of allocative efficiency. Part II points out that the focus of Professor Zelinsky's concerns seems to have shifted from the use of tax incentives to achieve allocative efficiency to their use to achieve

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1. In his original article, Professor Zelinsky argued that there is no general reason to prefer direct subsidy programs over tax incentives on the grounds of technical efficiency, including relative effects on taxpayer morale, ease of administration, and degree of legislative review. *See* Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 Tex. L. Rev. 973, 1026-30 (1986) [hereinafter Zelinsky, *Rehabilitation*]. In my original article, I challenged the case for tax incentives on grounds of technical efficiency. *See* Yorio, *Equity, Efficiency, and the Tax Reform Act of 1986*, 55 Fordham L. Rev. 410-13 nn.74-97 (1987). In his reply, Professor Zelinsky restates and elaborates on the case for tax incentives from the perspective of technical efficiency. *See* Zelinsky, *The Tax Reform Act of 1986: A Response to Professor Yorio and His Vision of the Future of the Internal Revenue Code of 1986*, 55 Fordham L. Rev. 885 (1987) [hereinafter Zelinsky, *Response*].
2. *See* Zelinsky, *Response*, *supra* note 1, at 885-86 nn. 6-9.
3. *See id.* at 888-89 nn. 28-32, 894 nn. 71-73.
4. *See id.* at 886-87 nn. 10-16, 889 nn. 31-32.

redistribution of societal resources. Part III argues that, even if redistribution is the goal of a particular federal policy, a direct subsidy program will usually be a more efficient and equitable vehicle for effectuating the policy than a tax incentive.[5]

I. ALLOCATIVE EFFICIENCY AND THE INTERNAL REVENUE CODE

Prior to the publication of Professor Zelinsky's original article, scholars almost universally condemned tax incentives for inducing overproduction or overconsumption of tax-favored goods or services, thereby distorting the allocation of resources in society.[6] Using economic models based primarily on the Accelerated Cost Recovery System and the mortgage interest deduction, Professor Zelinsky demonstrated that a tax incentive may actually improve efficiency under certain circumstances by curing imperfections in the market, such as barriers to entry and positive externalities.[7]

In the article to which Professor Zelinsky responds in this issue, I agreed with him that, on a theoretical level, a case could be made for tax incentives as cures for market failure.[8] I demonstrated, however, that the incentives contained in the Code prior to the passage of the Tax Reform Act of 1986 ("the 1986 Act") were not intended and did not operate in fact to remedy market failures[9] and that as a practical matter, few, if any, tax incentives could be justified on that basis.[10] I also advocated

5. I recognize, of course, that the most direct method of achieving redistribution of income in society may be the adoption of a progressive income tax. With all other things being equal, the greater the degree of progression in income tax rates, the greater is the amount of redistribution of income. My earlier article demonstrated, however, that a tension exists between progressive tax rates and tax equity and economic efficiency. High marginal tax rates exacerbate tax inequity between taxpayers with the same amount of income, increase allocative distortions by inducing taxpayers to pursue tax preferences, and generate transaction costs in tax-planning to avoid the effects of progression. *See* Yorio, *supra* note 1, at 441-42 nn. 327-331.

The merits of using progressive tax rates to achieve redistribution are not considered by Professor Zelinsky's reply. Indeed, by generally supporting the 1986 Act, Professor Zelinsky implicitly seems to endorse the dramatic reduction in marginal tax rates brought about by that Act. *See* Zelinsky, *Response*, *supra* note 1, at 885, 888 n.29. The critical issue raised by Professor Zelinsky's reply is whether government *spending* to achieve redistribution should take the form of tax expenditures or direct subsidies. *See infra* text accompanying notes 31-33.

6. *See, e.g.*, Auerbach, *The New Economics of Accelerated Depreciation*, 23 B.C.L. Rev. 1327, 1345-50 (1982) (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, *The Impact of Tax Reform on the Slope of the Playing Field*, 31 Tax Notes 1107, 1107-08 (1986) (incentives tilt the playing field in favor of certain industries); Yorio, *The President's Tax Proposals: A Major Step in the Right Direction*, 53 Fordham L. Rev. 1255, 1286-88 (1985) (criticism of various tax incentives for causing economic distortions).

7. *See* Zelinsky, *Rehabilitation*, *supra* note 1, at 996-1009.

8. *See* Yorio, *supra* note 1, at 417 n.132.

9. *See id.* at 415-17 nn.117-32.

10. *See id.* at 419-21 nn.151-65.

the repeal (or restriction) of many of the preferences surviving in the Code after the 1986 Act on the ground (among others) that they distort resource allocation without operating to cure market failures.[11]

Professor Zelinsky indicates in his response that he accepts virtually all of my conclusions regarding the inefficiency of prior and existing tax incentives.[12] He agrees, for example, that pre-1986 tax expenditures were "an amalgam of incoherent special interest legislation";[13] that inside build-up of interest on life insurance policies should be recognized as income;[14] that the exclusions for tax-exempt bonds and fringe benefits, even as reformed by the 1986 Act, are troubling;[15] and that the current mortgage interest deduction should be replaced by a deduction for a limited amount of interest on a taxpayer's principal residence.[16]

Having accepted my criticisms of these specific tax incentives, Professor Zelinsky need not embrace my general skepticism about using tax incentives as cures for market failure. In his view, Congress is not condemned to repeat the mistakes of the past because tax expenditures analysis has alerted it to the dangers posed by certain types of tax incentives.[17] The task for Congress and the public is to craft different tax incentives that meet the objections of tax expenditure critics.[18]

II. Redistribution and the Internal Revenue Code

To the extent that Professor Zelinsky is again raising the theoretical possibility that a tax incentive may be an effective cure for market failure, I, of course, agree.[19] Unlike Professor Zelinsky, I remain convinced that, even with the advent of tax expenditure analysis, the difficulty of quantifying the benefits of a tax incentive and of assessing the effects of other government programs make it unlikely that a particular tax incentive could be convincingly defended as a cure for market failure.[20] Moreover, my own skepticism about market failure defenses of tax incentives is implicitly supported by the absence in Professor Zelinsky's response of any justification based on market failure for federal intervention in the two areas of his primary concern, low-income housing and jobs for the poor.

11. *See id.* at 441-57 nn.324-449.

12. *See* Zelinsky, *Response*, *supra* note 1, at 894 n.71. Regarding my proposals for reform, Professor Zelinsky indicates that he holds a different position only with respect to the deductions for state and local taxes and charitable contributions. *See id.* at 26 n.84 (nn.82-84). He has, however, criticized the deduction for state and local taxes in its current form on other grounds. *See* Zelinsky, *The Deductibility of State and Local Taxes: Income Measurement, Tax Expenditures and Partial, Functional Deductibility*, 7 *Am. J. Tax Policy (forthcoming)*.

13. *See* Zelinsky, *Response*, *supra* note 1, at 894 n.71.

14. *See id.* at 896 n.83.

15. *See id.* at 896 n.84.

16. *See id.* at 895 n.74.

17. *See id.* at 894 nn.71-72, 27.

18. *See id.* at 895-97.

19. *See supra* text accompanying note 8.

20. *See* Yorio, *supra* note 1, at 418-21 nn.143-65.

With respect to housing, Professor Zelinsky states simply that "there generally is not enough profit in low-income housing to entice private providers."[21] As I understand this argument, the problem with regard to low-income housing is not market failure, but that the poor do not command sufficient resources to afford decent housing. With respect to jobs, Professor Zelinsky states that "the problem of structural unemployment is a serious one that the market should not to be expected to solve on its own."[22] Whether he is alluding to problems of market failure is doubtful, however, because he adduces no specific evidence of failure in the employment market.[23]

At this point, I should make clear that I regard the lack of affordable housing and jobs for the poor as a very real and disturbing social problem for which some form of government intervention may be necessary. In that respect, I reject Professor Zelinsky's characterization of my position on income tax policy as an aversion to government intervention in "softening the rougher edges of a market economy."[24] But I would not rest the case for programs to benefit the poor on the grounds of market failure. I recognize, of course, that it is possible to craft market failure defenses for government intervention in the employment market.[25] Trade unions and licensing or educational requirements might operate as barriers to entry in certain job markets;[26] unemployment might lead some of the poor to resort to crime, thereby creating a negative externality for the remainder of the population.[27] Government intervention in the job market thus could be defended as a means of overcoming barriers to entry or of reducing the costs of a negative externality.[28]

Although Professor Zelinsky's response may implicitly rely on arguments of this type to justify federal intervention in the employment and housing markets, I interpret the absence of specific market failure rationales in the response as an implicit admission that the case for government intervention rests primarily on ethical rather than economic grounds.[29] Indeed, even if there was absolutely no evidence that problems of market failure were associated with the scarcity of housing

21. *See* Zelinsky, *Response*, *supra* note 1, at 895 n.78.

22. *See id.* at 896 nn.79-80.

23. Although Professor Zelinsky's earlier article noted that minimum wage laws operate as a barrier to entry in the employment market, *see* Zelinsky, *Rehabilitation*, *supra* note 1, at 1034 & n.133, this problem results not from the market itself, but from government interference in the market's operation.

24. *See* Zelinsky, *Response*, *supra* note 1, at 887 n.12.

25. *Cf.* R. Posner, Economic Analysis of Law 439-41 (3d ed. 1986) (welfare programs may be defended as a means of overcoming free-rider problems).

26. *See* A. Schotter, Free Market Economics 69 (1985). For a government-imposed barrier to entry in the labor market, see *supra* note 23.

27. *See* R. Posner, supra note 25, at 439; A. Schotter, *supra* note 26, at 76-77.

28. *See* Schotter, *supra* note 26, at 78-80.

29. *Cf.* Donohue & Ayre, *Posner's Symphony No. 3: Thinking About the Unthinkable*, 39 Stan. L. Rev. 791, 799 (1987) ("[W]ealth maximization is devoid of normative significance. This realization permits us to return to the fundamentally sounder notion that poverty is bad because it hurts the poor.").

and jobs for the poor, I suspect that he (and I) would endorse some form of government intervention on their behalf.[30] I believe, therefore, that the fundamental issue raised by Professor Zelinsky's response is not allocative efficiency, but the proper level of federal activity in redistributing societal resources for the benefit of the poor.[31] On this issue, individual judgments will surely differ, as Professor Zelinsky himself suggests.[32] But if I am correct that the case for certain tax incentives derives from ethical rather than economic considerations, we should face the question of redistribution directly, recognizing that economic models of market failure are unlikely to produce a scientifically "correct" result.[33]

III. Direct Subsidies and Tax Incentives

Assuming that a particular social problem requires government intervention, the next issue is whether intervention should take the form of direct subsidies or tax incentives.[34] Professor Zelinsky argues that the choice between a direct subsidy and a tax expenditure will vary depending on the problem and the audience that the government expects to influence.[35] He contrasts this position with what he interprets as my implacable opposition to tax incentives as a device for implementing government policy.[36]

As with other parts of his analysis,[37] it is impossible to disagree, in theory, with Professor Zelinsky's argument that a tax incentive may be a more efficient method of accomplishing a *particular* governmental objective than a direct subsidy. But on a practical level, the case constructed

30. That state intervention may be proper even when the market operates perfectly is a point recently made by Professor Owen Fiss in a context very different from federal income taxation. *See* Fiss, *Why the State?*, 100 Harv. L. Rev. 781, 787-88 (1987). Noting that competition among the large and powerful media of communication is far from perfect, he recognizes that state intervention may be useful in improving the market in public discourse. *See id.* at 787. But even a perfectly competitive market in speech would not reflect society's need for an informed electorate. *See id.* at 788. Thus, Professor Fiss argues that state intervention is necessary not "to perfect the market (as it would under a theory of market failure), but rather to supplement it." "The state is to act as the corrective *for* the market" by allowing issues and viewpoints to be raised and debated that otherwise might be systematically ignored or stifled. *See id.*

31. My conclusion that redistribution, not allocative efficiency, is primarily at issue in Professor Zelinsky's response is also bolstered by his identification with the positions of "liberal" political figures, such as the late Senators Humphrey and Douglas. *See* Zelinsky, *Response*, *supra* note 1, at 886-87 nn.10-16. *See supra* text accompanying note 4.

32. *See* Zelinsky, *Response*, *supra* note 1, at 894-95.

33. The economist Henry Simons advocated similar intellectual candor in a related context. Although a supporter of progressive taxation, he rejected as spurious various scientifically-based justifications for progression. He preferred, instead, to admit that the case for progressive taxation rested on ethical or esthetic grounds. *See* H. Simons, Personal Income Taxation 16-19 (1938).

34. *See* Yorio, *supra* note 1, at 421 nn.165-66 (analysis of whether direct subsidy or tax incentive is better means of curing market failure).

35. *See* Zelinsky, *Response*, *supra* note 1, at 891-94 nn.55-70.

36. *See id.* at 890 n.40, 894 nn.70-71.

37. *See supra* text accompanying note 8.

by Professor Zelinsky for tax incentives depends on Congress's undergoing two implausible metamorphoses: resisting its prior urge to imbibe the nectar of tax incentives;[38] and reforming its procedures to give committees other than the House Ways and Means and the Senate Finance Committees a substantial input in the process of drafting and approving tax legislation.[39] In my previous article, I explained that the political ease of enacting tax incentives makes it unlikely that tax incentives would be subjected to the same cost-benefit analysis applied to direct expenditure programs.[40] I agree with Professor Zelinsky that if Congress is contemplating a particular tax incentive, non-tax committees should review and approve the legislation. But until Congress actually reforms its procedures in this respect, tax incentives are unlikely to be as carefully crafted and controlled as direct subsidies.[41]

In my earlier article, I also criticized tax incentives for eroding taxpayer confidence in the fairness of the tax system and for undermining a self-assessment system of raising revenue.[42] I argued that dissatisfaction with direct subsidy programs is less likely to affect taxpayer compliance than a pervasive feeling that the tax system is unfair because the nexus between direct subsidies and the tax system is more remote.[43] In his response, Professor Zelinsky counters that "taxpayers perceive a connection between the taxes they pay and and the public outlays others receive"[44] and that resentment about direct subsidy programs "[is] also likely to cause noncompliance with the tax system."[45] Without denying that many, perhaps even all, taxpayers grasp the connection between taxes and expenditures and that dissatisfaction with direct subsidy programs may affect taxpayer compliance to *some* extent, I perceive the issue to be which form of disenchantment has a *greater* deleterious effect on taxpayer compliance. On this issue, I place considerable weight on the testimony of the Commissioner of Internal Revenue,[46] on the Treasury Report to the President,[47] and on empirical evidence,[48] all of which point to a strong correlation between the level of taxpayer compliance

38. *See* Zelinsky, *Response*, *supra* note 1, at 894 nn.70-72.
39. *See id.* at 891 nn.47-51.
40. *See* Yorio, *supra* note 1, at 424-25 nn.187-95.
41. *See id.* at 425 nn.193-95.
42. *See id.* at 425-26 nn.196-99.
43. *See id.* at 426 n.198.
44. *See* Zelinsky, *Response*, *supra* note 1, at 891 n.54.
45. *See id.* at 891 nn.53-54.
46. *See New IRS Commissioner Gibbs Sees Tax Compliance Benefits from Overhaul Bill*, 176 Daily Tax Rep. (BNA), at K-1 (Sept. 11, 1986) (comments of IRS Commissioner Gibbs that perceptions of fairness will increase compliance).
47. *See* 1 Department of the Treasury, The Treasury Department Report to the President: Tax Reform for Fairness, Simplicity, and Economic Growth 16 (1984) (perception of unfairness is different when tax system, rather than subsidy program, is regarded as unfair).
48. *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) (taxpayer attitudes about the system affect the level of compliance).

and attitudes about the fairness of the tax system, and on the absence of evidence showing a similar correlation between taxpayer compliance and disenchantment with direct subsidy programs.

In his reply,[49] Professor Zelinsky elaborates on his earlier argument that direct subsidy programs may generate transaction costs exceeding the costs of equivalent tax expenditures.[50] He admits, however, that with respect to large businesses, direct subsidies will normally be less costly than tax incentives[51] and that the costs of operating parallel direct subsidy and tax expenditure programs will be greater than the costs generated by a single, direct subsidy program.[52] These admissions severely undercut the case for tax incentives. The success of many governmental programs may require the participation of large businesses simply because of their great control over societal resources.[53] Moreover, I do not envision a time in the immediate future when the federal government will eliminate existing direct subsidy programs addressed to major social ills, such as the scarcity of housing and jobs for the poor. If these programs survive, the issue then becomes whether Congress should enact (or preserve) tax legislation that adds to the bureaucracies of the Department of Labor and the Department of Housing and Urban Development another level of bureaucracy, in the Internal Revenue Service, devoted to the problems of low-income housing and structural unemployment. By positing the continued existence of an elaborate professional tax network and then comparing the *marginal* costs of direct subsidies and tax expenditures,[54] Professor Zelinsky fails to address my primary argument that *overall* transactions costs would be reduced by eliminating tax subsidies and consolidating governmental efforts to overcome social problems in direct subsidies programs.[55]

Perhaps the best way of illustrating my disagreements with Professor Zelinsky on the relative merits of direct subsidies and tax incentives is to consider his proposals to retain tax credits for low-income housing and to exempt these credits from the recently enacted limitations on the deduct-

49. *See* Zelinsky, *Response*, *supra* note 1, at 891-93 nn.55-69.

50. *See* Zelinsky, *Rehabilitation*, *supra* note 1, at 1010-12.

51. *See* Zelinsky, *Response*, *supra* note 1, at 893 n.64.

52. *See id.* at 893 nn.68-69.

53. *See* Yorio, *supra* note 1, at 427-28 nn.206-07. With respect to creating jobs for the disadvantaged, for example, I cannot imagine a government program, be it a tax incentive or direct subsidy, that would not require the participation of large businesses. Professor Zelinsky counters that most new jobs in the economy are generated by small businesses. *See* Zelinsky, *Response*, *supra* note 1, at 24 (n.80); *see also* Zelinsky, *Rehabilitation*, *supra* note 1, at 1034 ("current growth of employment in this country stems from predominantly small businesses"). That argument, even if valid, may simply be a reflection of the preponderance of small businesses in the American economy. In any event, the argument does not refute my contention that large businesses, because of the great control they exercise over societal resources, are likely participants in any government program designed to alleviate unemployment among the poor.

54. *See* Zelinsky, *Response*, *supra* note 1, at 891-93 nn.55-69; Zelinsky, *Rehabilitation*, *supra* note 1, at 1010-12.

55. *See* Yorio, *supra* note 1, at 428 nn.207-08.

ibility of passive losses.[56] I disagree with both proposals. To begin with, market failure does not provide a convincing rationale for either proposal. Rather, the issue raised is whether societal resources should be redistributed to benefit the poor.[57] Viewed from that perspective, it is ironic that Professor Zelinsky's proposals would provide incentives to developers to build or to upper-income professionals to invest in low-income housing, which would have the effect of reducing their marginal tax rates and causing horizontal tax inequity between them and other taxpayers.[58]

In his response, Professor Zelinsky makes, but does not endorse, other suggestions for dealing with the scarcity of low-income housing, including vouchers or refundable tax credits for low-income families to offset, at least in part, the cost of housing.[59] Because they attack the problem of economic inequality directly and avoid horizontal tax inequity, both vouchers and tax credits for the poor are preferable to tax credits to developers or investors in low-income housing. As between a voucher and a refundable tax credit, the case for a voucher seems stronger because it may be inefficient to require certain low-income families to file tax returns solely to obtain a refundable housing credit[60] and because government supervision to ensure that public outlays are actually being spent on housing would probably be less costly if implemented through existing local welfare systems than through the Internal Revenue Service.

CONCLUSION

Professor Zelinsky and I disagree about many aspects of federal income tax policy. Despite our disagreements, we share a common ground in endorsing the basic thrust of the 1986 Act. More importantly from a practical perspective, our agendas for future reform of the income tax contain many of the same proposals.[61] If two students of the income tax with divergent views nevertheless agree that the task of tax reform is incomplete, the message to those in Congress who seek additional revenues, or who seek to reduce marginal tax rates even further, is clear: repeal (or restrict) those preferences surviving in the Code that are in-

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56. *See* Zelinsky, *Response*, *supra* note 1, at 897 nn.88-89.

57. *See supra* text accompanying notes 21-33.

58. Developers and investors will presumably be induced to build or invest in low-income housing only if their after-tax return on low-income housing is greater, by virtue of the tax incentives, than their after-tax return on comparable, alternative investments. The spread between the after-tax returns of tax-preferred and fully-taxable investments is a source of tax inequity between taxpayers who are otherwise similarly-situated. For a fuller treatment of this issue, see Yorio, *supra* note 1, at 397-408 nn.14-73.

59. *See* Zelinsky, *Response*, *supra*. note 1, at 2223 nn.78-79.

60. Professor Zelinsky himself endorses food stamps as "a better approach to the nutritional problems of the poor than a refundable tax credit." *See* Zelinsky, *Response*, *supra* note 1, at 890 nn.39-40. Perhaps his support for food stamps also derives from the seeming inefficiency of requiring the poor to file tax returns solely to obtain refundable credits.

61. *See supra* text accompanying notes 12-16.

defensible from the perspective of both tax equity and efficiency.[62]

Compared to Professor Zelinsky,[63] I am more optimistic that Congress will eventually enact tax reforms that we would both support. To be sure, digesting the reforms contained in the 1986 Act may take time; and taxpayers whose oxen may be gored by future reform of the Code may have more political clout than those taxpayers disadvantaged by the 1986 Act. Neither is a reason to shrink from advocating tax reform, nor, if reform is needed, is there reason to assume that political support will not eventually materialize. As Professor Zelinsky correctly notes, liberals, supply-siders, and tax expenditure critics all have an interest in broadening the income tax base.[64]

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62. *See* Yorio, *supra* note 1, at 413.

63. In his view, further reform efforts like those that culminated in the 1986 Act are "neither feasible nor entirely desirable." *See* Zelinsky, *Response*, *supra* note 1, at 885.

64. *See id.* at 887-88 nn.13-29.