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Provisions in the Income Tax Base*

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I

Any study of the possibilities of establishing a broader income tax base must be concerned in large part with the numerous preferential provisions in the law which allow some taxpayers to accumulate wealth or enjoy personal consumption without paying the full tax. But of a review of preferential provisions by the Committee on Ways and Means, two things should be said at the outset: It is most unlikely that any new insights or ideas, to say nothing of new legislation, will be developed as a result of the endeavor. Nevertheless, such a study is highly worthwhile because the income tax base, viewed as a whole, most certainly deserves the attention of Congress.

I have good cause to be confident that virtually everything which will be said by the experts about preferences in the tax base during these discussions, excepting the presentation of recent statistics, has been asserted before, and almost all of it appears somewhere in records of congressional hearings. The central issues are by now well-aged and have been fought over repeatedly. While it is true that history has moved on and the statistics are now different, the changes have only tangential bearing on the pivotal arguments urged in support of the various preferential provisions which create gaps in the income tax base. Take the matter of twenty-seven and one-half percent depletion for oil as illustration. In the past decade the composition of known and accessible oil reserves has undergone dramatic modification, the relative economic position of domestic oil has been greatly

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transformed, the role of oil for military purposes appears to be in the process of a considerable shift, and yet the basic arguments which are currently offered for retaining the twenty-seven and one-half percent depletion rate are (except for some minor alterations in rhetoric and statistics) very similar to those proffered ten years ago. The explanation is not hard to come by. The ultimate defenses for the tax preference for oil are essentially value judgments which are highly impervious to changes in circumstances. If one happens to believe that lower taxes on oil operations are good, he is likely to persevere in this thought regardless of what goes on in the rest of the world. Moreover, only slight shifts in exposition will be required to adjust his position to new conditions as they appear. Virtually the same comments are applicable to the preferential treatment for capital gains, interest on state and municipal bonds, the use value of owner occupied homes, the interest component in life insurance, and the whole host of preferred items which give our income tax base its distinctive coloration. So long as the underlying value judgments remain constant, we are not likely to find radically new thoughts entering the field.

But the constancy of the old refrains must not dull our senses. Taxation is important; and the distribution of the income tax burden is close to the core of economic justice in our society. While the familiar briefs of the special pleaders and the tomes of the academic neutrals might easily become boring, a periodic reconsideration of tax policy is a part of good government, and proper democratic process calls for public hearings despite the high probability of sheer repetition. In any event the durability of arguments should not be a sufficient ground for maintaining existing policy decisions intact. Even if changed circumstances do not alter the old arguments, they might suggest that the responses be reexamined. And even absent new circumstances, it is always possible that a broadly conceived review might indicate that the original decision to carve out some special exception was a mistake.

Thus I repeat that I welcome a panoramic study of the income tax base, though convinced that it will consist largely of a rehash of old themes and that neither new thoughts nor new legislation will emerge from it.
II

Any study of preferences in the tax base must concern itself mainly with the merits of particular issues. The matter of oil depletion—again taken only as an illustration—properly should be considered in terms of whether there is a convincing case for granting special treatment to various segments of the oil industry. Before reaching the merits of particular preferences, however, there are a series of more general points, cutting across the individual issues, that are relevant to a study of policy. It is to these which I address my attention.

A widespread misconception first should be dispelled. Often the elimination of a preferential provision from the base is discussed as though the question were whether introduction of such a preference is warranted. While these issues are similar they are not identical. In respect to taxation there is, generally speaking, considerable gain in merely preserving ancient rules intact and avoiding change. The adoption of a new special dispensation calls for an educational effort on the part of taxpayers, their advisers, and tax administrators. Almost any new tax rule raises additional problems of interpretation and application which somehow must be answered or finessed. To the extent that the new provision draws distinctions in terms of form or intent, as is so often the situation under our income tax, it encourages tax-motivated conduct which departs from previous patterns of activity and thereby sets up a chain reaction with which the law must deal. These phenomena in a sense are reversed where a preferential provision of long standing is repealed. In that event the tax world would be in need of what might be regarded as negative education. Established modes of planning and ordering affairs would have to be discarded; existing arrangements would have to be altered or terminated; old advice would have to be retracted. Very likely the reasonable expectations of some taxpayers unavoidably would be frustrated by the repeal. The degree to which these unwanted byproducts might make an appearance clearly could vary greatly depending on which special dispensation was rescinded. My own rough estimate is that such costs would be considerable for almost all the major preferences now in the law, especially for those to which we have become accustomed through the passage of time. Somewhat reluctantly
I pass over the repercussions of repeal on law book publishers and tax institutes. All I want to emphasize here is that since we must pay a price for legislative change, we should not advocate a revision of the tax base without taking the full measure of the cost into account.

In discussing preferences, sight is also sometimes lost of the fact that our income tax system is working at least tolerably well. No serious breakdown of taxpayer cooperation or morale has been demonstrated, and the crystal balls used by some pessimists seem to have been rather clouded. This is not to deny that some of the existing preferential measures have caused administrative nightmares, or placed heavy strains on the collection of taxes, or complicated the tax law and the reporting forms, or loaded up the courts with controversies, or caused grumbling on the part of commentators, students of taxation, and even some taxpayers. On the contrary, the creaks in the joints can easily be heard and maybe they are getting louder. It certainly has become an annual national pastime to complain about the complexity of the income tax. All the while, however, the tax continues to produce prodigious revenues though we knowingly undernourish the revenue service and fail to adopt procedures, such as withholding on interest payments, which obviously would improve taxpayer compliance in reporting. Under these circumstances I hesitate to infer an attitude of serious resistance to the tax on the part of those who speak out against its complications. My hunch is that the natural aversion to payment of substantial income taxes accounts for much of the grumbling and that voicing complaints about the complexity acts largely as a lightning rod for relieving this feeling. For most taxpayers the complications are at worse a petty annoyance; for some they are a satisfaction-laden obstacle course; and for others they are a spur to consult professional advisers at tax-deductible rates. Perhaps a severe breakdown in the system is just around the corner, but as yet I have been unable to devise equipment with which to detect it.

III

It is worth pausing, however, to consider why the existence of preferential provisions has not been more damaging to taxpayer acceptance of our income tax.
The most potent explanation, I submit, is lack of both interest and knowledge on the part of the great mass of taxpayers. The typical short-form taxpayer, whose tax is almost completely collected through withholding of wages and who makes use of the standard deduction, is not likely to know about capital gains, tax-exempt interest, percentage depletion, or the deduction for various nonbusiness expenses; and he is even less likely to appreciate their dollar significance to others. But even among the small fraction of short-form taxpayers who do have a generally correct understanding of these special dispensations, very few seem to be disturbed by them. Most, apparently, have come to believe that the special rules are justified by economic or social considerations or to accept them because they have been in the law for such a long time.

At the other end of the spectrum of tax sophistication are the numerous taxpayers who are quite aware that they are primarily beneficiaries of the special dispensations. Of course the owner of rights in oil is not apt to be upset over twenty-seven and one-half percent depletion (unless he thinks that the percentage is too low), but there is an important secondary effect in that he is also more likely to be complacent about the special privileges which are not his dish. Perhaps he reasons that since he has special dispensation it would be selfish to object when others receive theirs. Or perhaps he simply looks upon the other beneficiaries as potential allies against heavier taxation. Or maybe the main thought is that it would be a mistake to criticize any preference since an attack on one could easily spill over onto others, including his own. Whatever the logic, some of our preferential rules have manifestly produced strange coalitions among taxpayers.

Another group of knowledgeable taxpayers who seem not unhappy about preferences consists of those who are fundamentally opposed to drastic progressivity in tax rates and therefore welcome the special dispensations as safety valves, whether or not utilizable by them personally. This is not mere cynicism. If one believes that severe graduation of rates is the greatest evil in our income tax system, it is not unreasonable to favor putting holes in the collection dipper. In all probability most of this group would prefer lower rates and a less irregular tax base as con-
trasted to the existing arrangement, but only if they were sufficiently reassured that a tightening up of the tax base would not be followed later by a restoration of high rates. Meanwhile, the proliferation of preferences more likely bolsters than injures their morale.

In passing, mention should be made of those whose cynicism over the tax situation puts their morale beyond impairment. The touchstone of their outlook is that the major preferential provisions are sacred cows and that under this assumption there is no way of demonstrating whether new special dispensations for other segments in society increase or decrease overall fairness in the distribution of the tax burden. To the true cynic of this variety, the question of what to do about any specific preference is uninteresting as long as most of the sacred cows remain essentially untouched.

The total of these "complacent" taxpayers is sufficient to account for the prevalence of a generally high level of morale in the face of our numerous preferential rules. We now need to consider whether there are any factors on the horizon today which might cause the situation to deteriorate in the years to come.

In my view, the most likely source of trouble would be a need to raise income tax collections sharply. While most taxpayers seem to have become resigned to the high rates with which we are familiar, any attempt to add substantially to the existing levels is almost sure to meet with resistance unless some grave national emergency were at hand. A proposal to raise rates significantly would, I am confident, immediately call into question many of the preferential provisions which are now tax havens. It is not so much that special dispensations take on more pecuniary value to their beneficiaries as ordinary rates rise. More to the point is that greater attention inevitably would be drawn to the proposition that the dispensations themselves call for higher rates on unpreferred income than would otherwise be required. In short, an increasing number of taxpayers would be alerted to the direct connection between rates and gaps in the tax base.

It is consistent with this view that today the loudest voices for reforming the income tax base are coming from two groups, (1) those who think that federal expenditures—for defense, or housing, or education, or foreign aid, or whatnot—are inadequate
and that the increased spending they champion should be covered by expanded income tax revenues, and (2) those who anticipate that larger federal expenditures will be forthcoming soon and wish to put the income tax in a shape to generate the increase as painlessly as possible when the time of need arrives.

Another possible, but less likely, source of trouble is the increasing dissatisfaction with our mountainous surtax rates at the top end of the income scale. During the past decade the rising average level of real income plus the inflation have brought more and more taxpayers into closer contact with the highflying surtax rates, and the newcomers have not found the tax view at the top particularly congenial. Furthermore, in this country these symbols of equalitarism (and of war finance) appear to be losing in popularity generally. There seems to be both a growing awareness that the peak rates produce relatively small revenues and a growing fear that in the long run they might cause serious impairment of our way of life. For present purposes what is important is that in recent years it has become fashionable in numerous quarters to join together, in discussion, high surtaxes and shortcomings in the tax base. One consequence, I think, is that the growing rejection of high surtaxes is now accompanied by an increasing questioning of the preferential havens.

The potential dissatisfaction with the tax base from this source should not be overstated. The real strength of the case against very steep surtax rates does not stem from the flaws in the tax base, but from the principle involved and the impact of high surtaxes on unprotected income. While it is now fashionable to point out that irregularities in the tax base increase the unevenness with which the graduated rates distribute the tax burden, the serious doubts about progression are independent of this consideration. Were the prospect of trading surtax reduction for broadening the tax base to fade, it would not be surprising if some of the most vocal opponents of high progression were suddenly to lose interest in contracting the scope of the special dispensations. All that can be said is that at the moment there seems to be an alliance of ideas, however unsteady.

Conceivably the most fertile source of trouble over the tax base will stem from efforts of organized labor to rearrange the
distribution of the tax burden. Of course I do not refer here to any insidious plot. It would be quite understandable and in keeping with our political values for labor to put the tax system more into public issue. Labor in the past has frequently taken a position on many of the preferential tax provisions and its views on them are today easily identified. What I now have in mind is not more of the same but a major educational effort among union memberships to stir up interest in (and dissatisfaction with) the main special dispensations. Although we should note this possibility, I doubt that it will materialize soon. It is difficult for me to visualize the typical union member becoming highly exercised over the capital gain rules or the continued exemption of state and municipal bonds. And, anyway, the unions seem to be moving in the direction of carving out more tax-preferred fringe benefits for their own membership rather than preparing to crusade against special tax dispensations in principle and across the board.

A final possible source of trouble is the observable fact that preferential treatment tends to spread, almost as though feeding on itself. Most of the special preserves have themselves grown since inception and surely their very existence has provided fine rhetoric, if not logic for easing the introduction of new preferential dispensations. One need merely call quickly to mind the number of items now getting capital gain treatment to appreciate the thrust of this point. I always feel safe in predicting that next year the tax code will offer more special havens than last year—and I renew my prediction now. If for once I turn out to be wrong, it could well be because this study is currently being undertaken under the auspices of responsible legislators. I trust I will not be misunderstood if I should suggest that the study might be a success if only it were to result in holding the line against further encroachments on the tax base.

Suppose I am right that the morale of taxpayers is today not in serious jeopardy. Would there then be any reason for alarm about the sieve-like nature of our income tax base? Several lines of thought require exploration.

It has been argued (by me, among others) that the continual proliferation of preferential provisions is notably costly because
of the demands made on tax administrators, tax advisers, and
the judiciary. There is no doubt that as the tax system gets more
complicated we invite more tax-motivated conduct, we channel
more of our human resources into the tax world, and we reduce
the efficiency of the entire tax collection process. The absolute
magnitude of this social waste seems to be large. It is nowhere
near startling, however, when put into realistic perspective. A
wealthy nation can afford a great deal of waste without disastrous
repercussions, even during a period of a cold war, and the
aggregate extra cost of our tax system must be minuscule as com-
pared with the waste associated with our defense efforts. Some-
times I wonder whether we ought not to regard our elaborate
income tax as a kind of national public monument. Viewed in this
light, its total cost is probably reasonable and certainly not out of
line with that of various public spectacles sponsored by govern-
ments elsewhere in the world.

A more classical line of attack on special dispensations under
the income tax is that they cause a misallocation of economic re-
sources. By taxing (and thus penalizing) certain activities less
than others, the preferential provisions—so the argument goes—
cause more resources to flow into these endeavors than would be
attracted if the tax system were perfectly neutral, and as a result
scarce resources are utilized in less productive combinations. I
concur in the soundness of this reasoning. Over the years it is
clear that our income tax has encouraged the development of
oil and gas wells and other mineral deposits, made it cheaper
for local governments to borrow money, promoted home owner-
ship, stirred up interest in the stock market, and accomplished
other comparable feats. But, again, I doubt that the lost effici-
ency is of shocking proportions. Our society abounds with gov-
ernment actions lacking neutrality. We subsidize farming, truck-
ring, education, foreign trade, and we penalize the production or
consumption of a whole host of specific commodities through
tariffs and special excise taxes. As we have come closer to the
welfare state, the intervention of government in economic life
has been constantly enlarged. This is not to intimate that eco-
nomic productivity now has become unimportant; it, of course,
continues to be the ultimate source of wealth. I wish merely to
stress that the blows it has taken through the preferential provisions in the income tax are not out of harmony with the times and are not particularly heavy.

However, it is worth underscoring that subsidies through the income tax are likely to be especially pernicious. I merely repeat myself and many others in noting that by nature such subsidies tend to be hidden; their magnitudes are very hard to estimate; their efficacy is equally difficult to gage; no agency is charged with watching over and reporting on them; the recipients are by and large unidentified; some of their effects usually are unintended; and they do not appear as expenditures in the government budget. All in all, a less desirable form of administering a subsidy is not easily imagined. But this is a relatively minor point. By economic standards it is the dimensions of the many tax subsidies rather than the shortcomings in the mechanism for administering them which is more significant—and that matter, I trust, has already been put in its proper place.

VI

There remains one other line of criticism of preferential tax provisions: they are undesirable not so much because of the adverse effects they might have on taxpayer morale, of the costs they might impose on operating the tax system, or the inroads they might make on the productivity of our economy; rather, they are undesirable simply because they are unfair. This, I should like to urge, is the fundamental standard by which any preference ultimately should be judged and by which it should stand or fall.

It is possible that we have advanced to the point at which the notion of equality among taxpayers is just another outmoded idea. If in fact we have progressed so far, I respectfully submit that there is little worth talking about in a study such as this. To be sure, evidence could be received regarding the state of taxpayer morale, consideration could be given to tinkering with the law to facilitate particular phases of tax administration, and there could be another review of economic predilections thought to have a bearing on taxation. Except for aspects of broad economic analysis, however, these would be rather low matters of
policy at best and certainly they could be approached in a more direct and narrow fashion. Personally, I choose to believe that the very fact this study is being undertaken is persuasive testimony that the standard of equity retains some vitality in taxation.

Thus, in my view, the core question of policy as to each of the preferential provisions is whether it is fair that a dollar of economic gain derived from a particular source, or under particular conditions, or in a particular form, should be taxed more heavily than other dollars of economic gain. In the case of percentage depletion, for example, the bedrock question is whether it is fair that a dollar of profit on an oil venture should be more lightly taxed than a dollar earned by serving as a Congressman or law teacher. If the answer is in the negative, as I think it should be in the case of virtually all the special dispensations, two further questions are then reached: First, are there unusual administrative obstacles to be encountered in taxing these dollars of gain the same as other dollars as to render virtual equality of treatment impractical? Second, is there a social or economic objective to be served by the tax preference which cannot be further as well by a non-tax subsidy or penalty? In my judgment, for most preferential provisions, the realistic answer to both questions would be a clear-cut “No.”

Superimposed on these questions in the case of an existing preference is, as I indicated before, the further consideration whether the gain in equity from eliminating it outweighs the costs involved in making the change. For any single preference the net gain might not seem to be sufficient. But I suggest that a wholesale purging of special dispensations from the income tax, assuming an equally drastic reduction in top surtax rates, would so strengthen the fairness of the tax as to justify incurring the costs of change and then holding the line. And I suggest further that not all steps need be taken at once, provided that each is part of a well-understood program to do away with special dispensations generally.

At this juncture I would expect a sharp challenge to my conclusions. If the case against special privilege is so strong, why, it should be asked, has not equality of treatment prevailed before now? This is a proper question and merits a careful re-
sponse. While Congressmen doubtless could lead us closer to the truth than tax experts, a few observations from the outside might help mark the way

It goes without saying that the beneficiaries of preference cannot be expected to assail them as inequitable. Nor ought we to count on their professional advisers to lead the attack, for we should acknowledge that the advisers legitimately have an interest in the affairs of their clients and an investment in the current rules of the game. It is similarly unrealistic to ask the Congress—which after all has special interest groups among its constituents—to be the spearhead in a campaign against the special rules which its predecessors wrote into the law. Perhaps it seems only fitting that in our society the role of speaking out against preferences has generally fallen to a relatively small group of teachers and students of taxation. To some observers, this doubtless seems as natural as assigning to the clergy the job of inveighing against sin.

But if one is serious about improving our tax base, the choice of spokesmen is indeed unfortunate. Not that my colleagues have been unwilling or inarticulate; many of the papers presented by them in the past are highly persuasive, even if only to other scholars. The fact is, however, that legislators have not been responsive to the spokesmen. A sufficient explanation may be that the community of scholars does not have many votes. It seems likely, however, that other considerations have played a part, although minor. I pass quickly over the well-worn thought that academics are impractical and that they fail to comprehend the facts of life which justify the various preferences. Suffice it to say that probably some do and some don’t. Then there is the possibility that a few of us may have been too alarmist in times past. The tax system simply did not collapse after we sounded as though we were predicting its early downfall. Another consideration is that we are quick to reveal our uncertainties about our own positions whereas the pleaders for privilege never seem to be in doubt. It is not easy, we find, to break with the academic tradition of acknowledging the merits of both sides in a controversial matter. Our effectiveness, perhaps, has also suffered because some in our ranks appear not to be against special dispensations in general but only those which they find repugnant.
It is at least a bit awkward to argue against twenty-seven and one-half percent oil depletion while defending a tax subsidy for education.

Let no one think that my purpose is to castigate my colleagues for their good works in trying to maintain the standard of equity. Without them there might have been virtually no defenders of the faith. My purpose is quite otherwise: it is to inject the note of realism that no significant reform will come about under these conditions. In truth there is only one place to which we reasonably should expect to turn for leadership in broadening the tax base and eliminating special dispensations—the Treasury Department itself. Unless the Treasury is disposed actively and consistently to champion equality of treatment as a long-run goal, the hope for constructive reform of our income tax is all but lost.

The present outlook for preferential provisions, which, as I indicate earlier, is for more of the same, might be unfortunate but not catastrophic. Most of those who benefit materially from the special dispensations will not be unhappy, while most of those who pay the price will not even be aware that it is their treat. And as the preferences multiply, it will become increasingly difficult for anyone, including the experts, to tell who is paying for whom.