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The Case for Tax Loopholes

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The Case for Tax Loopholes

by Murray L. Weidenbaum

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This booklet is one in a series designed to enhance the understanding of the private enterprise system and the key forces affecting it. The series will provide a forum for considering vital current issues in public policy and for communicating these views to a wide audience in the business, government, and academic communities. Publications will include papers and speeches, conference proceedings, and other research results of the Center for the Study of American Business.

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THE CASE FOR TAX LOOPHOLES

Presenting the case in favor of tax loopholes may seem to be an example of trying to defend the indefensible. *Loophole*, of course, is a perjorative term indicating some special advantage that a person or group has achieved, presumably at the expense of the public welfare. And, as we are told repeatedly, eliminating all of the loopholes would permit a massive reduction in tax rates without any overall decline in revenues.

The implicit trade-off sounds so desirable that we may wonder why the change has not been made before. An obvious answer of course quickly comes to mind: the special interests have prevented it. Although that may be the popular answer, a quite different one will be presented here, one which is based on a broader view of public policy. We will examine the role of these special tax provisions in the light of the totality of governmental tax, expenditure, and regulatory activities, especially as these affect the relationship of public to private activities in the United States.* But before doing so, we will cover some preliminary material. It will be helpful to examine the nature of the various loophole arrangements and their impacts on the tax system of which they have become so basic a part.

Technically, the term *loophole*—at least in my understanding—applies to that broad and disparate range of specific provisions in the tax code which permits one or more taxpayers to depart from the general structure used for taxing income. To clear the air at the outset, I am not about to defend every "raid" on the Treasury. That is, I will not be supporting the desirability of each and every special provision of the Internal Revenue Code. As a general proposition, I do favor the economic notion of "horizontal equity"—that is, equal treatment of taxpayers in similar circumstances. And it should be recognized that a "cleaner" tax code—one with fewer special provisions—likely would help to achieve a greater degree of horizontal equity.

Yet, it needs to be acknowledged that there is room for a good degree of legitimate quibbling as to who are the equals to be treated equally. The taxpayer who devotes a portion of his or her income to voluntary contributions to

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eleemosynary institutions may quite properly be viewed a bit differently than the taxpayer with identical income who devotes all of that income to his or her personal gratifications. This would seem to be one of the many instances in life where sensible results are more likely to be achieved by carefully balancing a variety of important considerations, rather than single-mindedly attempting to pursue just one.

In this brief examination of the composition of tax loopholes I will, of course, try to avoid the obvious distinction that those special tax provisions which benefit me are essential to the public welfare, but those that benefit you are just low priority giveaways. As Professor Boris Bittker explained on this campus on an earlier occasion, there are very few tax provisions which meet the formal dictionary definition of loophole, that is, "an ambiguity or omission in a statute, etc., which affords opportunity for evading its intention."[1] In the main, tax loopholes are not the product of an ingenious attorney or accountant laboriously examining the minutia of the Internal Revenue Code. Rather, the typical loophole was deliberately placed there by the Congress to achieve a public purpose, a purpose of which you or I may speak good or ill. Even as enthusiastic a critic of these special tax provisions as Professor Stanley Surrey has been moved to note that many of them "were expressly adopted to induce actions which the Congress considered in the national interest."[2]

To belabor the obvious, the charitable deduction was not inserted in the tax system to provide windfall gains to the wealthy but, in Professor Surrey's words, "to foster philanthropy." As we are about to see, however, the providers of that philanthropy constitute a varied lot.

THE NATURE AND COMPOSITION OF TAX EXPENDITURES

As it turns out, there is a classification of special tax provisions which is available for our use. In recent years, the term *tax expenditures* has been applied to those features of the tax law which have often been labeled as loopholes. A formal definition is more descriptive, albeit somewhat formidable: revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income, or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.

Before turning to the data, however, a critique of the tax expenditure concept is in order. On its surface, that dreadful phrase may seem to be an anomaly: either something is a tax or it is an expenditure. According to Professor Surrey, who is generally acknowledged to be the father of the tax expenditure concept, "The term 'tax expenditure' has been used to describe those special provisions of the federal tax system which represent government expenditures made through that system to achieve various social and economic objectives."[3] The notion that the tax incentive device involves the expenditure of government funds is, in my opinion, a fundamental error, however, and one that leads to all sorts of erroneous public policy.

The Surrey view seems to be based on the implicit assumption that the state is entitled to as much of the taxpayers' income as it desires. Hence, the citizen's claim on his or her own income is secondary or residual. Thus, any reduction in that flow of private income to the public Treasury is viewed as an act of grace by a benevolent sovereign. To the contrary, a tax expenditure—if the concept is to have any justification—signifies less taking of private funds by government. This is a simple but powerful point. In my view, tax expenditures should be seen in the context of the substantial taxes which are being paid by private individuals and corporations. To tell a person who is paying out over a third of his or her income in federal taxes that he or she is unduly benefiting from some tax expenditure reflects a strange view of tax equity. And to be told that by a beneficiary of the low income allowance compounds the insult.

Tax expenditures or tax incentives are designed to alter private behavior in an economy already strongly influenced by government; they are intended specifically to increase private expenditure on a particular item or category. From a purely fiscal viewpoint, a dollar less paid in taxes has the same effect on the budget position as a dollar more disbursed by government. But, a variety of different consequences may flow from choosing the tax or the expenditure route for achieving public purposes.

An important shortcoming of the tax expenditure concept arises from the method used in estimating the dollar magnitudes. The data reported do not take any of the indirect effects from the operation of each of these special tax provisions into account.[4] Many of the tax expenditures alter taxpayer behavior and economic conditions. In many cases that is their purpose. Their elimination also might require offsetting changes in federal expenditure programs or in other aspects of the tax system in order to avoid obviously undesirable effects—but thus preventing the Treasury from recapturing the full revenue loss. The tax exemption of interest received on state and local bonds is an interesting case in point. On the surface, this provision appears merely to provide tax relief to the high bracket holders of these securities. And numerous tax reformers urge the prompt elimination of this "loophole" on that basis. But, on reflection, the tax exemption enables the states and localities to issue bonds at lower interest rates than other borrowers of comparable risk categories. (Certainly, the purchasers of these securities would turn to higher yield issues if the interest were to become taxable.)

Thus, some of the tax expenditure also implicitly involves a substantial subsidy to the governmental units issuing these securities. In fact, the more sophisticated tax reform proposals designed to eliminate or reduce the use of the tax-exempt securities do provide for the payment of federal subsidies to state and local governments to offset the higher interest payments that they would have to make in order to sell their securities in the "taxable market." Depending on the subsidy level, there could be a net loss or a net gain to the Treasury from the combination of closing the tax-exemption loophole and simultaneously subsidizing state and local governments to enable them to continue selling bonds at low interest costs.[5]

Despite these and other shortcomings, the available data on tax expenditures are useful in making some rough approximations of the distribution of the beneficiaries of tax loopholes. The results may well come as a surprise to many of the enthusiastic but less critical supporters of the concept.

Some of the "tax expenditures" are well known and have become notorious. A few ready examples are depletion allowances, the tax exemption of the interest on state and local bonds, and those provisions which have been used to shelter certain types of real estate income (such as expensing of interest and taxes paid during the construction of buildings). However, it may come as a surprise to many that these items comprise a relatively small portion of the $95 billion of tax expenditures—losses in revenue—reported by the Treasury Department in the fiscal year 1976.[6] The great bulk of the $95 billion, rather, consists of items which I suspect the vast majority of the public never thinks of as a loophole.

Among the largest tax expenditures, for example, are the deductibility of mortgage interest and property taxes on owner-occupied residences. The tax treatment of these two items of personal expense of the typical homeowner accounts for a total of $8.9 billion of revenue foregone in the fiscal year 1976. Other significant special provisions include deducting charitable contributions ($5.4 billion revenue loss to the Treasury), personal, state, and local taxes, other than on homes ($8.0 billion) and excluding from taxation employer and self-employed contributions to employee pensions ($8.4 billion), medical insurance premiums and medical care programs for employees ($4.5 billion), as well as social security and unemployment benefits ($7.0 billion).

However, merely reciting specific examples such as these may give a distorted picture of the total reality. Tables 2.1 and 2.2, therefore, are an attempt to show the overall distribution of tax expenditures by income class. The data on tax expenditures are taken from the official tabulation in the annual federal budget. The assignment of tax expenditure benefit to income classes is based on a Treasury Department study of 1971 data prepared for the Joint Economic Committee.[7] I have divided the data into three categories—benefits to the lower-income groups, to middle-income groups, and to upper-income groups.

The amounts shown in the category "lower-income groups" are based on

the proportion of each tax expenditure in 1971 received by those taxpayers with adjusted gross income of $10,000 or less. The data for the "middle-income groups" are based on the proportion of each tax expenditure in the base year going to taxpayers with adjusted gross income of $10,000 to $50,000. Frankly, I would have preferred using a lower top limit for the middle grouping, but the Treasury did not split up the category, $20,000 to $50,000. Nevertheless, the bulk of the tax expenditures (56 percent in 1971) was received by the bottom half of the middle group—those reporting adjusted gross incomes of $10,000 to $20,000. The "upper-income groups" in these tables consist of taxpayers with adjusted gross incomes of $50,000 and over. I have made no attempt to trace through the incidence of the tax expenditures received by corporations, although I would expect that a substantial portion of the ultimate benefit is received by lower-income and middle-income groups.

The public finance literature provides a variety of viewpoints. Personally, I subscribe to a mixed case, in which some of the benefits are shifted forward to consumers in the form of lower prices, some are shifted backward to employees in the form of higher incomes and fringe benefits, and some significant amount benefits the shareholders. Examples of probable backward shifting, although relatively small, may be the most apparent. I have in mind here the tax credit for employing welfare recipients and the increase in the investment credit for the companies that use the proceeds to finance employee stock ownership plans.

Table 2.1

SUMMARY OF TAX EXPENDITURES, FISCAL YEAR 1976
(in billions of dollars)

	Amount	Percent of Total
Estimated benefits to lower income groups	$17.9	19
Estimated benefits to middle income groups	38.6	40
Estimated benefits to upper income groups	15.9	17
Estimated benefits to corporations	22.9	24
Total	95.3	100

Source: Summary of details shown in Table 2.2

As shown in Table 2.1, the bulk of all the estimated tax expenditures are received by lower- and middle-income taxpayers—$56.5 billion out of $95.3 billion in 1976, or 59 percent of the total. By and large, the major recipients of the tax expenditure benefits received by personal (as contrasted to corporate) taxpayers are those in the middle-class category—$38.6 billion compared to $17.9 billion for the lower-income category and $15.9 billion for the upper-income category.

Several large tax expenditures benefit primarily lower-income taxpayers. Among these are the tax exemption of various government transfer or benefit payments which are received primarily by low-income people who would otherwise have to pay taxes on such income, e.g., veteran's disability compensation payments ($595 million of revenue foregone), social security benefits ($2.7 billion), and unemployment benefits ($3.3 billion).

To be sure, several important types of tax expenditures tend to benefit primarily corporations and investors and other relatively high-bracket income earners. Examples in this category include the special tax treatment of capital gains ($7.9 billion), the investment credit ($9.5 billion), the exclusion of interest on state and local debt ($4.8 billion), and the excess of percentage over cost depletion ($1.3 billion). Clearly, the $95.3 billion of tax expenditures in the fiscal year 1976 cannot be characterized as merely an array of depletion allowances and other very specialized or esoteric tax provisions.

Table 2.2 shows the great variety of the specific tax expenditures for which the Treasury Department publishes estimated dollar magnitudes. A detailed analysis of the derivation of the income class distributions is contained in the statistical appendix.

Table 2.2

ESTIMATED TAX EXPENDITURES, FISCAL YEAR 1976
(in millions of dollars)

Item of Tax Expenditure	*Benefit To Income Group*				
	Lower Income	*Middle Income*	*Upper Income*	*Corporations*	*Total*
Benefit Primarily to Lower-Income Group					
Exclusion of benefits and allowances to armed forces personnel	765	245	10	–	1,020
Disability insurance benefits	277	46	7	–	330
Exclusion of social security benefits	2,153	491	81	–	2,725
Additional exemption for the blind	14	6	–	–	20
Exclusion of sick pay	101	90	4	–	195
Exclusion of unemployment benefits	1,968	1,334	33	–	3,335
Exclusion of public assistance benefits	95	–	–	–	95
Deduction and credit for child and dependent care expenses	241	49	–	–	290
Exclusion of scholarships and fellowships	144	51	–	–	195
Exclusion of veteran's disability compensation	309	280	6	–	595
Excess of percent standard deduction over low-income allowance	855	274	11	–	1,140
Earned income credit	165	53	2	–	220
Subtotal	7,087	2,919	154	–	10,160

Table 2.2 continued

Benefit Primarily to Middle-Income Group					
Exclusion of military disability pensions	22	48	20	–	90
Exclusion of veterans' pensions	7	16	7	–	30
Exclusion of G.I. Bill benefits	73	162	70	–	305
Additional exemption for over 65	275	607	263	–	1,145
Retirement income credit and credit for the elderly	26	58	26	–	110
Exclusion of capital gain on home if over 65	10	21	9	–	40
Exclusion of railroad retirement system benefits	46	101	43	–	190
Benefits for dependents and survivors	155	342	148	–	645
Exclusion of special benefits for disabled coal miners	12	27	11	–	50
Exclusion of income earned abroad by U.S. citizens	32	110	3	–	145
Expensing of certain capital outlays by farmers	159	241	55	85	540
Capital gains treatment of certain income of farmers	110	167	38	10	325
Dividend exclusion	90	288	52	–	430
Deduction of interest on consumer credit	316	1,684	105	–	2,105
Deduction of mortgage interest on residences	779	3,799	292	–	4,870
Deduction of property taxes on residences	564	2,902	564	–	4,030
Depreciation on rental housing in excess of straight line	49	194	162	100	505
Housing rehabilitation	3	15	7	15	40
Exclusion of workers' compensation benefits	283	295	12	–	590
Exclusion of pension contributions and earnings	1,980	5,383	987	–	8,350
Exclusion of employer-paid premiums on accident and life insurance	217	556	57	–	830
Exclusion of employer-paid medical insurance premiums and medical care	1,212	3,008	270	–	4,490
Exclusion of employer provided meals and lodging	133	164	13	–	310
Exclusion of income of trusts to finance supplementary unemployment benefits	4	6	–	–	10
Exclusion of interest on life insurance savings	215	1,225	215	–	1,655
Deduction of charitable contributions	531	2,496	1,843	540	5,410
Deduction of medical expenses	764	1,389	162	–	2,315
Deduction of casualty losses	84	167	59	–	310

Table 2.2 continued

Parental personal exemptions for students, age 19 and over	209	418	93	—	720
Deduction of nonbusiness state and local taxes	823	4,584	2,558	—	7,965
Credit and deduction for political contributions	8	19	8	—	35
Deferral of capital gain on home sale	135	659	51	—	845
Credit for purchase of new home	104	507	39	—	650
Deferral of interest on savings bonds	132	292	126	—	550
Excess first-year depreciation	29	94	17	40	180
Maximum tax on earned income	145	321	139	—	605
Subtotal	9,736	32,365	8,524	790	51,415
Benefit Primarily to Upper Income Group					
Capital gains	439	1,830	5,051	545	7,865
Capital gains treatment of royalties on coal and iron ore	2	10	28	15	55
Subtotal	441	1,840	5,079	560	7,920
Benefit Primarily to Corporations					
Investment credit	507	923	380	7,685	9,495
Credit for employing AFDC and public assistance recipients	—	—	—	10	10
Depreciation on buildings (other than housing) in excess of straight line	24	96	80	225	425
Employee stock ownership plans financed through investment credit	—	—	—	25	25
Exemption of credit unions	—	—	—	145	145
Exclusion of certain income of cooperatives	-33	-104	-18	410	255
Corporate surtax exemption	—	—	—	4,170	4,170
Capital gains treatment of certain timber income	11	28	56	290	385
Expensing of exploration and development costs	14	59	87	640	800
Excess of percentage over cost depletion	23	105	157	1,010	1,295
Exclusion of interest on state and local debt	17	263	1,365	3,115	4,760
Expensing of research and development	5	17	3	1,325	1,350
Expensing of construction period interest and taxes	52	114	49	415	630
Exclusion of gross-up on dividends of LDC corporations	—	—	—	40	40
Deferral of income of Domestic International Sales Corporations	—	—	—	1,220	1,220
Special tax rate for western hemisphere trade corporations	—	—	—	50	50
Deferral of tax on shipping companies	—	—	—	110	110

Table 2.2 continued

Railroad rolling stock five-year amortization	—	—	—	-25	-25
Excess bad debt reserve of financial institutions	—	—	—	485	485
Credit for corporations in U.S. possessions	—	—	—	240	240
Subtotal	620	1,501	2,159	21,585	25,865
Total	17,884	38,625	15,916	22,935	95,360

Source: Data in total column and for corporations taken from *Special Analyses, Budget of the United States Government, Fiscal Year 1978.*

JUSTIFICATIONS FOR TAX INCENTIVES

Many justifications have been put forward for the various special tax provisions. Typical national objectives cited by the proponents have ranged from fostering employment and economic growth, to enhancing equity, to supporting worthy private institutions and state and local governments. The specific weight given to any of these objectives is, of course, a rather subjective matter.

The special treatment of the major tax expenditures received by upper-income taxpayers and corporations—capital gains, the investment credit, and similar items—is justified by the need to promote investment and hence achieve a growing economy, which will provide both more employment and a rising standard of living for the public as a whole. We need to recall also that the special tax treatment of capital gains was instituted prior to the insertion of the income-averaging concept into the Internal Revenue Code. In that earlier period, were capital gains to have been taxed at ordinary income rates, many taxpayers would have been paying taxes on long-term gains far higher than the brackets that would correspond to their income levels during the period in which those gains were accruing (that is the "bunching" phenomenon). Now that income averaging has been extended to capital gains, the primary justification for differential treatment must be viewed in other terms—providing desired inducements to investment. We should be aware of the obvious: to the extent that the private sector is unable to raise the funds to finance economic growth, pressure rises for greater governmental involvement in business affairs.

Surely in recent years the federal government has become an important competitor for investment funds. The Treasury's financing of budget deficits plus a growing array of federally owned or federally sponsored credit agencies have obtained one-third or more of the total funds flowing through the nation's capital markets.[8] Viewed from this prospective, the various tax expenditures devoted to encouraging private investment may merely offset the deleterious effects of the government's own expenditure and borrowing activities.

Turning to another major tax expenditure, the deductibility of state and local taxes furthers the objective of strengthening the other levels of government through the federal government's sharing the burden of the taxes levied by these jurisdictions. This can be viewed as an early "revenue sharing" effort. Moreover—in the absence of this deduction or a provision with similar effect—the combination of federal, state, and local income taxes for some taxpayers could result in a total rate close to 100 percent of income, thus bordering on sheer confiscation. When the top bracket of the federal income tax was 93 percent, this was a very real possibility.

Numerous reasons are cited for the tax deductibility of charitable contributions. The voluntary, private institutions thus supported provide diversity and free choice. They can experiment and enter fields too controversial for government agencies. They often take on responsibilities which otherwise would be financed entirely by tax revenues.[9]

The deductibility of interest paid by individuals (that is, interest on personal as opposed to business indebtedness) is a more complicated matter. The largest portion is interest on mortgages on owner-occupied homes. The deterioration of many central cities in recent years has strengthened the justification of enhancing family and neighborhood stability by encouraging individual home ownership. The deductibility of interest on general consumer debt may be more difficult to defend. Personally, I find it hard to see why the general taxpayer should subsidize the families that wish to go into debt to buy new refrigerators or second cars. In contrast, the interest that individuals receive on their savings is, of course, fully taxable. Perhaps, although unintentionally, this provision also illustrates the tendency of the tax system to tilt in favor of consumption rather than saving.

Some personal deductions are really reasonable refinements of gross income in order to obtain a fair and equitable concept of a taxable income base. Cases in point are the deductions of expenses related to earning income, such as union dues, child care for working wives, work clothing, and fees on safe deposit boxes for securities. A few corporate tax exemptions—notably the exemption of credit unions and some of the income of cooperatives—are an aid to those nonprofit institutions organized in the corporate form.

As in each of the other cases cited here, I am making no attempt to assess the adequacy of these justifications, but merely to emphasize that there is another side to the traditional tax reform arguments. Although most popular discussions of tax reform tend to ignore the substantive purposes of many of these special tax provisions, the underlying literature of public finance does not. In the most definitive study of personal tax deductions, for example, Professor C. Harry Kahn states that these tax provisions are designed to "differentiate between taxpayers whose incomes, though apparently equal, are of different sizes in some relevant sense."[10]

Thus, without prejudging their effectiveness, we should note that at least some special tax provisions (perhaps the additional exemption for the blind or the deduction of casualty losses) are intended to further the achievement of horizontal equity—equal treatment of equals. Professor Kahn goes on to state that "care must be taken not to designate the tax equivalents [the revenue foregone from personal deductions] as simple tax losses. If intended to spur private expenditures, for instance, in the philanthropic domain, the figures represent more accurately the tax cost to the government of encouraging expenditures which might otherwise have to be undertaken by government."[11]

SHORTCOMINGS OF THE TAX INCENTIVE APPROACH

Surely the Internal Revenue Code contains numerous "marginal" subsidies, in which modest tax benefits enable the private sector to continue some worthy undertakings (hospitals or orphanages, for example) at a fraction of the cost which the federal Treasury would have to bear should the activities be run by the state. But there also are tax "shelters" in the Code which provide an inordinate amount of benefit to the recipients or cost to the Treasury, far out of proportion to their value to society as a whole.

Special tax provisions (tax expenditures) have been criticized on numerous grounds. Many of them, especially the deductions from income, are attacked as being regressive, because they reduce the tax burdens of upper-income taxpayers more than those of lower-income taxpayers. Deductions clearly do have that effect. Under the deduction approach, the amount of tax saving per dollar of deductible expenditure depends on the marginal tax bracket of the taxpayer. Thus, an upper-income taxpayer receives a larger tax reduction than does a lower-income taxpayer for making the same dollar amount of charitable contribution or payment of state and local taxes.

In effect, the government subsidizes the taxpayer to the extent of 14 percent of the state and local taxes and charitable contributions for the individual or family in the lowest tax bracket—when they itemize rather than take the standard deduction. In the case of those in the top bracket, the government subsidizes 70 percent of those expenditures, and somewhere in between for the others. The many taxpayers using the standard deductions receive no tax benefits from their contributions.[12]

From the viewpoint of achieving desired public policy objectives, special tax provisions lack some of the compelling characteristics of direct expenditures. Typical—but not all—direct expenditure programs offer the following advantages: the public has a clearer picture of the flow of federal assistance; the Congress can exercise annual control over the size and distribution of the benefits; the financial aid given to private individuals and groups can be weighed against the desirability of government agencies taking direct responsibility for the programs in question. This idyllic view, however, is not readily reconcilable with the reality of trends in the federal budget. In recent years, the relatively "uncontrollable" expenditure programs—social security pensions, interest on the public debt, unemployment compensation, et cetera—have come to dominate total federal spending. In fact, many of these programs do not even appear in the annual appropriation bills but are funded via so-called permanent and indefinite appropriations.[13]

PROSPECTS FOR CHANGE

As pointed out earlier in this paper, this is not a plea for the retention of every special provision in the tax system. To an economist, it is reasonable to contrast the costs and benefits of various mechanisms for achieving public policy objectives. It certainly is conceivable that, in some cases, direct expenditures may be a more desirable alternative than tax incentives. In other cases, credit assistance or regulatory programs or still other approaches may be preferred, such as just letting the market work. There seems to be little need to take a doctrinaire attitude and prohibit public policy from using any one of these alternatives. Rather, the advantages and disadvantages of each mechanism should be weighed, and the most desirable one used to achieve a specific objective, be it the encouragement of business investment or the discouragement of environmental pollution.

However, the implications of moving from indirect support through the tax system to direct federal expenditure subsidies are profound, especially in the many instances of aid to private, state, and local institutions. Taken literally (as has been suggested by some tax reformers), this move would mean putting private hospitals, orphanages, schools, and similar social service and charitable institutions into the federal budget.[14] The opportunities for federal influence and control over the conduct of these private organizations would be obvious and could be very considerable.

Moreover, the constitutional separation of church and state would probably prevent extending such direct general purpose financial support to church-related medical and educational facilities and certainly to the religious institutions themselves. The choice between tax incentives and direct federal expenditures turns out to involve more than the selection among technical financing mechanisms. The choice involves altering the balance between public and private power in our society. The issue is seldom clearly joined, which may explain why the debate gets so heated at times.

However, the use of the tax incentive route does not require adhering to the specific types of tax mechanisms now in use. For example, the deduction from taxable income is not the only way in which the tax system can be used to encourage taxpayers to spend some of their money in a manner which accords with national interests. It is merely an example of the power of the status quo. Deductions have been part of the system since the institution of the income tax law in 1913.

An alternative to the deduction is already available and has been used in various specific instances: the tax credit, which is a deduction from the ultimate tax liability rather than from taxable income. Although the distinction between credits and deductions may be considered to be a technical matter only of interest to specialists, the differences in effects may be very significant for the individual taxpayer. Given the progressive nature of the personal income tax structure, ordinary deductions are implicitly regressive. Credits can be more flexible. A credit can be given in terms of a percentage of an expenditure, and various ceilings may be put on the amount of the credit. Moreover, credits can be extended to that vast portion of low and moderate income taxpayers that do not itemize individual contributions, but use the standard deduction.

The credit concept is in widespread use in the corporate tax structure, where its use ranges from encouraging the employment of welfare recipients to expanding business plant and equipment. In the individual tax system, credits are now provided for child and dependent care expenses, retirement income, and political contributions—sometimes as a voluntary alternative to the deductions. Suggestions to use tax credits in place of personal exemptions—$750 is the present deduction for each taxpayer and dependent—have been made by President Carter and Vice-President Mondale, among others.

As pointed out earlier, the value of a deductible dollar varies with the taxpayer's bracket. With a fixed percentage credit, in contrast, a given dollar of charitable outlay, for example, would generate the same amount of tax saving, regardless of the taxpayer's income level. Of course, the upper-bracket taxpayers might make a larger donation and thus qualify for a larger absolute tax benefit, but they would receive the same proportional benefit. Depending on the percentage allowed as the credit, such a system could reinforce the progressivity of the personal income tax, since those taxpayers whose marginal rates were below the percentage credit would have their average bill reduced. Those in the higher brackets would find their tax bills raised if credits were substituted for deductions.

The mechanism of a tax credit could be important in strengthening the role of voluntary organizations in our national life by making them more democratic. Because the proposed tax credit would operate to the advantage of lower- and moderate-income taxpayers, it could help to create a potential new constituency for private institutions, freeing many of them from their present dependence on the wealthy few. Unlike the alternative of direct support through government expenditures, substituting tax credits for personal deductions would constitute a modest step toward decentralizing decisionmaking in our society and encouraging diversity in the way that social objectives are achieved.

One would wish to cite a less shopworn metaphor, but the typical tax reformer tends to concentrate on the hole rather than on the doughnut. Unfortunately, the existing situation seems to be a fine example of the Lord (or the Feds, rather) giveth and the Feds taketh away. Private institutions in the United States, of course, were alive, well, and growing prior to their support through the income tax system. No doubt the powerful combination of heavy taxation and the expansion of public philanthropy and functions has adversely affected both the ability and the incentive of private citizens to support private undertakings and has led to the need for offsetting aid via the tax incentive route.

As has been amply demonstrated in another connection, a major long-term barrier to private sector saving and investment is the large governmental budget deficits whose financing is competitive with private undertakings. If the public sector were smaller and its intrusion into the private sector substantially reduced, there might be little need to advocate supporting private institutions via the tax system. To be sure, some private interests—be they business, labor, agriculture, or any other—will always try to enrich themselves at the expense of the public welfare. But that knowledge should not cause us to overlook the fundamentally adverse impacts of government action on the private sector.

Perhaps we have come full circle. The aims of the conventional tax reformers and the objectives of the apparent defenders of the status quo may not be as far apart as they initially appear to be. The reconciliation of the two sets of objectives may lie in the more widespread understanding of the conditions that led to the adoption of so many of the special tax provisions in the first place. The simple elimination of these tax provisions often would leave unfulfilled the objectives that they are designed to foster. Yet a more effective approach to public policy might be in dealing with the basic conditions that often prevent private institutions—business and nonprofit alike—from performing their intended functions, conditions that frequently—and on occasion unwittingly—result from the rapid expansion of governmental activities. Dealing with those basic conditions would have the added advantage of avoiding the revenue losses and the equity problems that may result from using tax incentives.

One example, among many, may help to particularize this general notion. As many studies have demonstrated, the compulsory minimum wage law tends to price low-skilled and less-educated workers, especially teenagers, out of the labor market. To some extent, this adverse effect is offset by tax credits which are intended to encourage employers to give jobs to this target population. I am confident that if *both* programs were eliminated simultaneously,

employment would rise, the budget deficit would be reduced, and the general welfare would be enhanced. But to eliminate the tax expenditure while ignoring the underlying problem, as seems to be the traditional approach to tax reform, would be another exercise in futility.

Similarly, the need for tax incentives to encourage private support of educational institutions arises in large part from the adverse effects of other governmental actions. The rapid expansion of classrooms and educational buildings in public institutions has frequently resulted in much of the higher educational system operating far below capacity and thus pushing up unit costs. (More generous scholarships directly paid to students would have been a far more efficient approach.) These upward cost pressures are in addition to the basic inflation engendered by federal fiscal and monetary policy.

A similar situation arises in the health field. The overly rapid expansion of hospitals has resulted in empty beds with attendant upward pressures on unit costs. And, further, the inflation in health care costs resulting from the government's medicare and medicaid programs has exacerbated the financial squeeze facing private health care institutions.

It is cavalier, to say the least, for the naive tax reformers to blithely ignore all of the adverse impacts of government action on private institutions and then pick on one of the few areas of public policy—tax expenditures—where the public sector attempts to undo the damage.

CONCLUSIONS

In this paper I have attempted to show that a sympathetic examination of "loopholes" or tax expenditures, to use the more technical and quantifiable term, can be useful. The mechanism of tax expenditures or incentives may serve a variety of public purposes, ranging from promoting business investment and economic growth to encouraging private, voluntary organizations.

Indeed, the growth of tax expenditures may be viewed as a reaction to the severe impacts that the expansion of government power and activities has had on the viability of private sector institutions. But the prompt elimination of those obstacles, such as large deficit financing and pervasive government regulation, seems to be an unrealistic expectation. Hence, the reliance on second-best alternatives, such as tax expenditures, may on occasion be a sensible route.

The survey of the specific tax expenditures undertaken here reveals that, in the main, they are not special benefits to the highest-income classes nor the product of ingenious accountants or attorneys. Rather, the typical tax expenditure benefits primarily middle- and lower-income groups of the population. Nor are the major tax expenditures obtained by engaging in unusual activities. Rather, they are received from such prosaic activities as paying state and local taxes, owning a home, and working for a company that provides group insurance and other fringe benefits.

To be sure, not all tax expenditures are of this nature—and not each one needs to be defended. But the point being made here is that neither should the entire category be condemned and its elimination urged as an unequivocal matter of equity.

As pointed out in this paper, there are reforms which could be instituted—such as more widespread use of the tax credit device—to simultaneously help to achieve greater progressivity in the tax structure and still serve to attain the basic purposes intended by the Congress.

Given the current interest in tax reform, it seems evident that proposed changes should be viewed in a broader context than in the past. Questions of income distribution and macroeconomic policy have tended to dominate the discussion of tax reform. But we must also address such other important aspects as the effects on the respective roles of the public and private sectors and of federal, state, and local governments and the resultant shifts in the distribution of power in the society.

All in all, tax incentives may, in this imperfect world, often be the most realistic available alternative to achieving such important objectives as enhancing economic growth and employment, strengthening state and local governments, and encouraging a diversity of private, voluntary approaches to meeting society's needs.

NOTES

1. Boris I. Bittker, "Income Tax 'Loopholes' And Political Rhetoric," *Michigan Law Review,* May 1973, p. 1102.
2. Stanley S. Surrey, "Tax Incentives as a Device for Implementing Government Policy," *Harvard Law Review,* February 1970, p. 711.
3. *Ibid.,* p. 706.
4. See Stanley S. Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (Cambridge: Harvard University Press, 1973), appendix to chapter 1.
5. See David J. Ott and Attiat F. Ott, "The Tax Subsidy Through Exemption of State and Local Bond Interest," in U.S. Congress, Joint Economic Committee, *Economics of Federal Subsidy Programs,* Part 3, (Washington: Government Printing Office, 1972); Frank E. Morris, "Tax Exemption for State and Local Bonds," *George Washington Law Review,* March 1974, pp. 526-36.
6. "Tax Expenditures," *Special Analyses, Budget of the United States Government, Fiscal Year 1978,* (Washington: Government Printing Office, 1977), pp. 119-42.
7. Statement of Edwin S. Cohen, Under Secretary of the Treasury, before the Joint Economic Committee, July 21, 1972.
8. Murray L. Weidenbaum, *Business, Government, and the Public* (Englewood Cliffs: Prentice-Hall, 1977), p. 138.
9. See *Giving in America,* Report of the Commission on Private Philanthropy and Public Needs, 1975.
10. C. Harry Kahn, *Personal Deductions in the Federal Income Tax* (Princeton: Princeton University Press, 1960), p. 174.
11. *Ibid.,* p. 178.
12. See Murray L. Weidenbaum, "The Advantages of Credits on the Personal Income Tax," *George Washington Law Review,* March 1974, pp. 516-25.
13. Murray L. Weidenbaum, "Institutional Obstacles to Reallocating Government Expenditures," in *Public Expenditures and Policy Analysis,* ed. Robert Haveman and Julius Margolis (Chicago: Markham Publishing Co., 1970), pp. 232-45.
14. Paul R. McDaniel, "Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deductions," *Tax Law Review,* 1972, pp. 409-11.