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Efficiency and Income Taxes: The Rehabilitation of Tax Incentives

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I. Introduction

This Article explores two prominent issues in current legal literature: the propriety of tax incentives in the federal income tax and the use of economic analysis to examine questions of concern to academic lawyers. One premise of this Article is that there is a connection between these two topics.

During the last fifteen years, many academics, government officials, journalists, and public interest advocates have concluded that the federal income tax ought be purged of provisions identified as "tax incentives" or "tax expenditures."[1] The fundamental argument against tax incentives is that they involve government outlays in the form of foregone revenues. Such outlays ought not be made or are made more appropriately through direct public expenditure programs.[2] An important ele-

* Professor of Law, Benjamin N. Cardozo School of Law, Yeshiva University. I received many helpful observations from colleagues at the Benjamin N. Cardozo Law School, in particular, Professors Lester Brickman, James B. Lewis, Paul Shupack, Stewart Sterk, and Elliott J. Weiss. I also received helpful comments from Judge Richard A. Posner and Professor Harry L. Gutman of the University of Pennsylvania. Needless to say, none of this collection of independent-minded persons necessarily agrees with all (or very much) of what I have to say.

1. *See, e.g.*, THE PRESIDENT'S TAX PROPOSALS TO CONGRESS FOR FAIRNESS, GROWTH AND SIMPLICITY (1985) (proposing the elimination or reformation of tax credits) [hereinafter cited as THE PRESIDENT'S TAX PROPOSALS]; S. SURREY, PATHWAYS TO TAX REFORM, THE CONCEPT OF TAX EXPENDITURES (1973) (thoroughly discussing tax expenditures; urging elimination of many such exceptions and reform of tax system in general); Baker, *Fundamental Tax Reform: An Analysis of the President's Proposals*, 27 S. TEX. L.J. 1, 18-23 (1985) (explaining the President's proposed elimination or reformation of tax credits); McIntyre, *Lessons for Tax Reformers from the History of the Energy Tax Incentives in the Windfall Profit Tax Act of 1980*, 22 B.C.L. REV. 705, 726 (1981) (criticizing energy tax credits); Phyphers, *A Businessman's View of Tax Reform*, 38 NAT'L TAX J. 285 (1985) (generally discussing the reform efforts of the Treasury Department and Reagan Administration); *Trained by Nader, This Populist Tax Lobbyist Takes Aim at Big Businesses that Avoid Taxes*, Wall St. J., May 2, 1985, at 62, col. 1 (Southwest ed.) (describing Robert McIntyre's efforts to end tax preferences for corporations); *see also* Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison With Direct Government Expenditures*, 83 HARV. L. REV. 705, 734 (1970) (advocating direct expenditures over tax incentives).

2. *See, e.g.*, S. SURREY, *supra* note 1, at 126-54 (comparing tax expenditures with direct expenditures; concluding that direct expenditures are a better method of implementing social policy, and that tax expenditures are generally wasteful, inefficient, and inequitable); Doernberg, *A Workable Flat Rate Consumption Tax*, 70 IOWA L. REV. 425, 425-26 (1985) (characterizing the current tax system of exclusions and preferences as inefficient because it encourages resources to flow to tax-preferred activities from activities with higher pretax returns, thereby reducing economic output); Madden & Morris, *Tax Incentives: Employment and Training of the Disadvantaged*, in TAX INSTI-

ment of this critique is that tax incentives are economically inefficient.[3] The assumed inefficiency of tax expenditures has played an important role in the substance and rhetoric of the tax revision effort that was stimulated by the Treasury Department's 1984 reform proposals and ultimately culminated in a sweeping revision of the Internal Revenue Code.[4] The efficiency critique of tax incentives will be addressed in this Article.[5]

In the debate about tax incentives, the concept of economic efficiency has played a relatively noncontroversial role. Most scholars have assumed that efficiency is a legitimate criterion for analysis of law in general.[6] The definition of efficiency generally has been taken as self-evident. Indeed, most legal commentators concerned about the economic aspects of tax incentives apparently believe there is little to discuss: the inefficiency of tax incentives is, by and large, treated as obvious and well established.[7]

TUTE OF AMERICA, TAX INCENTIVES 231 (1969) (endorsing only limited and temporary use of tax incentives and noting defects of ineentives) [hereinafter cited as TAX INCENTIVES]; Surrey, *supra* note 1 at 726-27 (concluding that the disadvantages of waste, inefficiency, and inequity are found in most tax expenditures); Surrey & McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C.L. REV. 225, 256 (1979) (discussing the inefficiencies in programs supported by "tax shelter" deductions).

3. *See* THE PRESIDENT'S TAX PROPOSALS, *supra* note 1, at 2; Auerbach, *The New Economics of Accelerated Depreciation*, 23 B.C.L. REV. 1327, 1342-54 (1982) (examining the efficiency of ACRS under the same economic criteria used to analyze the efficiency of investment incentives); Block, *Personal Deductions Under the Bradley-Gephardt Fair Tax Act: Necessary Departures From the Ideal?*, 29 ST. LOUIS U.L.J. 921, 928-29 (1985).

4. TREASURY DEPARTMENT, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH (1984), *reprinted in* FED. TAXES (P-H) Bulletin 51 (Nov. 29, 1984) (containing "Volume 1 — Overview") [hereinafter cited as TREASURY DEPT., REFORM FOR FAIRNESS, SIMPLICITY, AND GROWTH] *and* Bulletin 52 (Dec. 6, 1984) (containing "Volume 2 — General Explanation of the Treasury Department Proposals"). The Treasury Department's report, of course, began the protracted effort which culminated in the Tax Reform Act of 1986, Pub. L. No. 99-514 [hereinafter cited as The 1986 Act, by section number only].

Throughout the Treasury Department's report to the President, the economic inefficiencies of the tax system, with its tax deductions and incentives, are given as a primary reason for tax reform. Secretary Regan, in his letter to President Reagan accompanying the report, states at several points that the tax system interferes with economic choices, and that such interference must be eliminated. TREASURY DEPT., TAX REFORM FOR FAIRNESS, SIMPLICITY, AND GROWTH, *supra*, at iii-iv. In his public statement during a news conference at the Treasury, Secretary Regan continued this theme stating that "our other mandates were to develop a tax system that was fairer and more economically efficient. We do this by eliminating many of the deductions, special credits and loopholes . . . ." *Id.* at vi(d); *see also id.* at vii (summary of proposals listing economic inefficiency inherent in tax incentives as reason for reform).

5. This Article does, however, discuss tax incentives from perspectives other than efficiency. *See infra* text accompanying notes 107-24.

6. *See, e.g.*, Posner, *Some Uses and Abuses of Economics in Law*, 46 U. CHI. L. REV. 281, 288-91 (1979) (discussing the efficiency hypothesis of the common law which postulates that common law rules promote efficiency by bringing the economic system closer to producing the results that frec market competition would produce).

7. *See, e.g.*, Auerbach, *supra* note 3, at 343 (recognizing as a basic rule that taxes that distort production activity by taxing different types of investment at different rates are relatively inefficient); Doernberg, *supra* note 2, at 426 (supporting Hall-Rabushka plan because, unlike system containing tax incentives, it does not interfere with the marketplace); McIntyre, *supra* note 1, at 730 (stating

Simultaneously with the debate about tax incentives, academic lawyers have been conducting an essentially separate discussion as to the use of economics in the analysis of contracts, property, torts, and other traditional common-law subjects.[8] In this debate, the propriety of efficiency as a policy criterion has been hotly contested.[9] Indeed, the very definition of efficiency has been the subject of great controversy.[10]

Although these two debates have certain characteristics in common, it is striking that the concept of efficiency has played a dramatically different role in discussion of tax incentives than in what here is termed the common-law debate. The common-law debate may contribute profitably to the analysis of tax incentives. Although the definition of efficiency has become a central question in the common-law debate, that definition generally has not been explored in the context of discussion about tax incentives. When viewed in that context, it is clear that the concept of efficiency has been used in the tax incentive debate in three distinctly different ways which this Article labels "universal market efficiency," "sectoral efficiency," and "technical efficiency."[11] None of these concepts of efficiency is necessarily compatible with the other. Moreover, the economic case against tax incentives—their alleged inefficiency—is subject to assumptions and restrictions which often go unrecognized.

This Article is thus a dissent from the prevailing consensus that condemns tax incentives as invariably inefficient. Depending upon the specific incentive in question, the assumptions made in the analysis, and the definition of efficiency utilized, a particular tax incentive may or may not be efficient. Moreover, tax incentives may be more efficient for the im-

that the "best evidence" indicates that one main effect of investment tax credits is to change the allocation of capital stock in ways which hinder productivity and growth); Rosow, *The Treasury's Reform Proposals: Not a "Fair" Tax*, 3 YALE L. & POL'Y REV. 58, 64 (1984) (referring to ease with which tax incentives can be abused).

8. *See, e.g.*, R. POSNER, ECONOMIC ANALYSIS OF LAW (2d ed. 1977) (an introduction to the application of economic principles to the legal system); Coleman, *The Economics Analysis of Law*, in ETHICS, ECONOMICS AND THE LAW (1982) (analysis of efficiency theories); Posner, *supra* note 6 (positive economic theory of law); *Symposium on Law and Economics*, 85 COLUM. L. REV. 899 (1985) (discussing applications of economic analysis to criminal, tort, and property law).

9. *See, e.g., Symposium on Efficiency as a Legal Concern*, 8 HOFSTRA L. REV. 485 (1980) (presenting varying views on the application of economic efficiency analysis to various legal issues); *A Response to the Efficiency Symposium*, 8 HOFSTRA L. REV. 811 (1980) (presenting critiques of economic efficiency as a normative goal).

10. *Compare* N. MERCURO & T. RYAN, LAW, ECONOMICS, AND PUBLIC POLICY 7-9, 25-26, 45-47 (1984) (defining efficiency in the Pareto optimal sense as when one player in the economy cannot improve his status without hurting someone else) *with* Coleman, *supra* note 8, at 86 (defining efficiency in the Pareto superior sense as when the economy is functioning at a point on the production possibility frontier).

11. These separate uses of the concept of efficiency are discussed in detail *infra* subparts II(B)-(D).

plementation of government policies than direct expenditure programs because of lower transactions costs.

A surprisingly large number of provisions considered tax expenditures by the Treasury have survived tax reform in whole or in part. It is thus opportune to examine the efficiency critique of tax incentives, not merely because of the influenced exerted by that critique to date, but because of the possibilities of future efficiency-based crusades on remaining tax expenditures if Congress choses to continue its reforming handiwork.

Those who would abolish tax incentives on economic grounds typically argue for the elimination of the deduction for home mortgage interest, a deduction which has largely survived Congress' revision of the Code.[12] Using the interest deduction as the archetype of a tax incentive desigued to encourage particular consumption activities, this Article demonstrates that the case against such incentives is overstated. Indeed, the deduction for home mortgage interest may actually move the economy towards an efficient use of its resources.

Although the deduction for home mortgage interest is one of the oldest provisions of the Internal Revenue Code, one of the newest (and most heavily criticized) is the system of accelerated depreciation deductions known as the Accelerated Cost Recovery System (ACRS).[13] In modified form, accelerated depreciation also survived tax reform. Using

12. Since its initial adoption in 1913, the modern personal federal income tax has always contained a deduction for personal interest paid or accrued by the taxpayer. Congress' original motivation for establishing the interest deduction is not clear. Recently, however, the deduction has served principally as a federal subsidy for home ownership. Of all existing tax incentives, the deduction for personal interest has been one of the largest. Most of that interest has represented payments on residential mortgages. *See* TAX BREAKS: AN INTRODUCTION TO TAX EXPENDITURES (W. Barnes ed. 1985) [hereinafter cited as TAX BREAKS]; Berger, *Simple Interest and Complex Taxes*, 81 COLUM. L. REV. 217, 246-47 (1981); McIntyre, *An Inquiry Into the Special Status of Interest Payments*, 1981 DUKE L.J. 765, 768. Recent tax legislation reaffirms the deductibility of interest on mortgages to acquire and improve first and second homes. *See* The 1986 Act § 511 (to be codified at I.R.C. § 163(h)).

13. Although advocates of ACRS deny it is a tax incentive, opponents argue that it is a tax incentive of the worst sort, a measure reducing the after-tax price of certain capital goods at the expense of more labor-intensive production technologies and at the expense of other capital-intensive technologies that receive less favorable tax treatment. ACRS, according to this critique, interferes with producers' choices among different production techniques and therefore makes the economy inefficient. The argument concludes that abolition of ACRS would advance economic efficiency.

An original defense of ACRS was the necessity of accelerated depreciation to accurately account for capital consumption in an era of rapid inflation. *See* Baker, *supra* note 1, at 20. That rationale no longer applies in the relatively noninflationary environment of 1986. *See* Kempler, *Transitional Rules as a Tool for Effective Tax Reform*, 36 BAYLOR L. REV. 765, 797-99 (1984). Moreover, there are more direct methods for addressing inflation in the context of capital recovery. *See* THE PRESIDENT'S TAX PROPOSALS, *supra* note 1, at 131. For one pre-ACRS analysis of accelerated depreciation and its economic propriety, see Blum, *Accelerated Depreciation: A Proper Allowance for Measuring Net Income ?!!*, 78 MICH. L. REV. 1172 (1980). For the modified version of ACRS, see The 1986 Act § 201 (amending I.R.C. § 168 (1982 & Supp. III 1985)).

ACRS as the model of a tax incentive designed to stimulate production, this Article demonstrates that the economic argument against ACRS, and similar incentives, is subject to the same criticisms and limitations leveled against the critique of the mortgage interest deduction. The abolition of ACRS could actually deflect the economy from efficient operation.

This Article suggests that the case against tax incentives consists of two arguments, one substantive, the other procedural in nature. The first attacks the substantive propriety of federal intervention in the domestic economy, the second challenges the use of the tax system once such intervention is agreed upon. From the perspective of economic efficiency, the case against tax incentives is, in both respects, an uneasy one, compelling in some instances (*e.g.*, ACRS for machinery and equipment), not so in others (*e.g.*, the mortgage interest deduction). Moreover, once federal intervention in the economy is determined to be acceptable, the transaction costs of using the tax system to implement government policies may be less, particularly with respect to small businesses and middle-income taxpayers, than the cost of implementing direct expenditure programs. The income tax system may be viewed as a relatively inexpensive method of communicating federal policies and programs to those persons whose behavior Congress seeks to affect.

In a world of uncertainty and imperfect information, a world in which most significant policy decisions rest on assumptions and conjectures, certain reasonable suppositions lead to the conclusion that tax incentives can serve the cause of efficiency. Consequently, this Article concludes that tax incentives should be rehabilitated. They are potentially appropriate and legitimate instruments of federal policy.

The analysis advanced here will be presented in three steps. Part II of this Article discusses the concept of the tax incentive and identifies the three different ways in which the notion of efficiency has been used in the tax incentive debate. Part III illustrates the weaknesses of the economic case against tax incentives once the concept of efficiency has been scrutinized rather than merely assumed. That Part demonstrates that the oft-repeated case against the home mortgage interest deduction, ACRS, and other tax incentives is subject to assumptions, qualifications, and limitations which often go unrecognized. It also shows that the economic case against tax incentives has been largely constructed by ignoring two ideas central to the common-law debate: externalities and transactions costs. Part IV relates the three notions of efficiency used in the discussion of tax incentives to the definitions current in the common-law debate.

II. Tax Incentives and Three Definitions of Efficiency

A. Tax Incentives

The concept of the tax incentive is a child of the 1960s now blossoming into an influential adulthood. As originally propounded by the late Professor Stanley Surrey, the notion of the tax incentive involves the classification of Internal Revenue Code provisions into two categories: those structurally necessary for the measurement and taxation of income and those representing deviations from this normative tax.[14] In this view, a deduction for salaries paid to employees is a provision structurally necessary to transform a taxpayer's gross receipts into his net income. In contrast, the deduction for home mortgage interest is a tax incentive, a subsidy for personal consumption rather than an appropriate part of a normative income tax.

Professor Surrey's concerns were, in large measure, a response to the perceived tendency of Congress to utilize the Internal Revenue Code in lieu of direct government expenditure programs.[15] Under this line of analysis, the tax credit given employers for hiring the chronically unemployed is merely a substitute for a system of direct cash grants from the government to these employers. And, in the analysis of Professors Surrey, Wolfman, and others, the tax incentive is generally a poorer means of achieving public policy than the direct expenditure program.[16]

This line of reasoning has not been without its detractors. Some have argued that the basic premise of tax incentive analysis—the classification of provisions as either normative or incentive—is inherently unworkable: one man's incentive is another man's normative deduction.[17]

14. *See* S. SURREY *supra* note 1, at 129-30; Surrey, *supra* note 1, at 711-13; Surrey & MacDaniel, *supra* note 2, at 227-29. For a complete list of Professor Surrey's writings, see *In Memoriam: Stanley S. Surrey*, 98 HARV. L. REV. 329 (1984). For an early article which presaged Professor Surrey's concerns, see Wolfman, *Federal Tax Policy and the Support of Science*, 20 B.C.L. REV. 225 (1965); *see also* Goode, *The Economic Definition of Income*, in COMPREHENSIVE INCOME TAXATION 26 (J. Pechman ed. 1977) [hereinafter cited as COMPREHENSIVE INCOME TAXATION]; TAX BREAKS: AN INTRODUCTION TO TAX EXPENDITURES (W. Barnes ed. 1985).

15. Although the concept of the tax incentive gained its popularity during the late 1960s and early 1970s, forerunners of that notion can be found as far back as the seminal writings of Robert Murray Haig. *See* Haig, *The Concept of Income—Economic and Legal Aspects*, in AMERICAN ECONOMIC ASSOCIATION, READINGS IN THE ECONOMICS OF TAXATION 54, 72-73 (1959).

16. *See* Surrey, *supra* note 1; Wolfman, *supra* note 14; *see also* Doernberg, *supra* note 2, at 435 (noting that current tax law "increasingly has weighted down our nation's economy with a hodgepodge of inefficient, distortive provisions"); McIntyre, *supra* note 1, at 720 (discussing the difficulty of defining tax expenditures and proposing a method for identifying them that avoids a general, all-purpose definition); Pomp, *Mortgage Interest and Property Tax Deduction: A Tax Expenditure Analysis*, CAN. TAX'N, Fall 1979, 23, 26-27 (noting that mortgage interest and property taxes paid by homeowners can be subsidized by direct subsidy or tax deductions, and proponents of tax deduction have the burden of proving that method is better).

17. *See* McIntyre, *A Solution to the Problem of Defining a Tax Expenditure*, 14 U.C.D. L. REV. 79, 80-81 (1980).

A second criticism is that the notion of the tax incentive implicitly assumes that all income belongs to the government; that the government, when it refrains from taxing, is not engaging in behavior appropriately labeled an expenditure but rather is respecting private property by leaving it alone.[18]

The first criticism has a certain amount of force. Many of the choices made in the design of an income tax involve close and essentially unresolvable questions: Should the child care costs of a working parent be treated as nondeductible personal expenses or as deductible job-related outlays?[19] When a family moves because one parent has a new job, are the resulting expenses personal (nondeductible) or business-related (deductible against gross income)?[20] Because we do not know the economically useful life of a trademark or of the start-up costs of a new business, should the costs of defending trademarks and start-up expenses be capitalized and recovered upon ultimate disposition or amortized over some arbitrarily selected period?[21] Do charitable contributions reflect a deductible diminution of the taxpayer's personal resources or a form of consumption properly characterized as nondeductible?[22] In short, the starting premise of tax expenditure analysis—the existence of an ideal, normative tax against which to measure expenditure-type deviations—ignores a great many value-laden choices inherent in the design of an income tax.

There is less substance to the second criticism. A review of the tax expenditure literature makes clear that the term "tax expenditure" is largely metaphorical, designed to emphasize the economic consequences of various income tax provisions. No proponent of tax expenditure anal-

18. *See* Madden & Morris, *supra* note 2, at 234-35 ("The contention that tax incentives are essentially the same as government expenditures—are indeed 'tax expenditures'—rests on the presumption that government has a preeminent claim on income and resources."); Neuhaus, *What The Fundamentalists Want*, COMMENTARY, May 1985, at 41, 45; Wall St. J., Apr. 18, 1985, at 30, col. 5 (reporting Senator Moynihan's comment that the term " 'tax expenditure' . . . implies that if the federal government lets you keep some of your income, it is somehow giving you that income."); *see also* TAX BREAKS, *supra* note 12, at 3.

19. *Compare* I.R.C. § 21 (Supp. III 1985) (child care credit declining with taxpayer's income) *with* THE PRESIDENT'S TAX PROPOSALS, *supra* note 1, at 19 (child care expenses deductible as they "constitute legitimate costs of earning income").

20. *See* I.R.C. § 217 (1982).

21. *See* I.R.C. § 195 (Supp. III 1985). *See also* The 1986 Act § 241 (repealing I.R.C. § 177 (1982)).

22. *Compare* Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 346-55 (1972) (arguing that a charitable contribution of funds shifts the consumption of goods and services represented by the funds to the donee and, consequently, that consumption should not be taxed at the donor's rate) *with* Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an 'Ideal' Income Tax and Why They Fit Worse in a Far from Ideal World*, 31 STAN. L. REV. 831, 835-38 (1979) (arguing that a charitable contribution is a consumption by the donor and therefore should not be deductible).

ysis actually claims that the government has a preeminent claim on the society's resources. Indeed, tax expenditure analysis may be understood to embody the opposite orientation, a presumption against government intervention in the domestic economy.[23]

For purposes of this Article, the merits of these arguments are less important than the overriding fact that the notion of the tax incentive is now a permanent element of our academic and political analysis of the Internal Revenue Code. The production of a tax expenditure budget (similar to Professor Surrey's initial work at the Treasury in the 1960s) has become a central part of the tax policy process.[24] The tax reform proposals advanced by the Treasury and President Reagan and largely accepted by Congress reflect, in both their rhetoric and substance, the impact of tax expenditure analysis.[25]

B. Universal Market Efficiency

Commentators employ three distinct notions of efficiency in the tax incentive debate. In some instances, those opposing tax incentives on economic grounds implicitly rely on a concept that might be labelled "universal market efficiency." These commentators assume the normative propriety of an economy universally characterized by perfectly competitive markets.[26] Such markets, in this view, lead to the optimal

23. *See infra* text accompanying notes 84-88.

24. *See* 2 U.S.C. § 622(3) (1982) (defining "tax expenditure budget" as an "enumeration of tax expenditures"); 31 U.S.C. § 1105(a)(16) (1982) (requiring the "level of tax expenditures under existing law in the tax expenditure budget" to be included in the budget submitted by the President to Congress). On the use by Massachusetts of a tax expenditure budget, see *Study Finds Tax Breaks Surpass 100*, New Haven Reg., Jan. 24, 1985, at 20, col. 1.

25. In his introductory note to Congress accompanying his tax proposals, President Reagan stated that the current tax code "slows economic growth and job creation, and hinders technological advancement by interfering with free markets and diverting productive investment into tax shelters and tax avoidance schemes." THE PRESIDENT'S TAX PROPOSALS, *supra* note 1, at I. Similarly, the summary of the proposals averred that the current tax system "needlessly *impedes growth*" by, *inter alia*, "encouraging investment for purposes of tax reduction rather than for independently worthy economic purposes" thereby causing economic inefficiences. *Id.* at 2; *see also supra* note 4 (dismissing statements in Treasury Department's report).

26. It bears emphasis that the terminology of universal market efficiency is that of this Article and is not necessarily one with which those whose views are being analyzed would agree. Indeed, the persons whose views are discussed might deny their analysis of tax incentives assumes the normative propriety of perfectly competitive markets. It is a fair inference, however, that this is the direction in which their rhetoric points. For example, Professor Doernberg contrasts the current incentive-laden income tax with a "pareto optimal state," which many would identify with conditions of perfect competition. Doernberg, *supra* note 2, at 484. Journalists occasionally appear to base their opinions on notions of universal market efficiency as well:

> A "loophole" is not merely a crime but a blunder; it is not only unfair but a misallocation of resources likely to slow growth. The Ways and Means and Finance committees have enough to do without trying to play industrial planner. The formula for growth is to try to make the code as neutral as possible among various pursuits. If distortions are removed from the tax laws, the markets will find the path to growth.

allocation of the society's total resources. This ideal allocation is unacceptably marred by tax incentives, an obvious deviation from the norm of perfect competition. The universal market definition of efficiency underpins substantive opposition to tax incentives. This opposition does not eschew tax incentives in favor of direct expenditure programs, but wishes to avoid them per se because governmental intervention deflects the domestic economy from optimal resource allocation.

In its 1984 report on tax simplification, the Treasury Department's rhetoric at times seemed to embrace universal market efficiency and the consequent economic case against tax incentives. The public was told that if the Treasury's proposals, such as the repeal of ACRS and restriction of the interest deduction, were adopted

> [n]o longer will the allocation of the Nation's scarce economic resources—its labor, its capital, its land, and its inventive genius—be distorted by the biases of the current tax system. Instead, under the economically neutral tax system proposed by the Treasury Department, market forces will direct resources to those activities where returns are greatest. The result will be more productive investment and thus greater output.[27]

Essentially the same rhetoric had been advanced previously by the proponents of accelerated depreciation. In 1974, one advocate of faster depreciation deductions appealed to the notion of universal market efficiency when he argued that

Wall St. J., Apr. 3, 1985, at 28, col. 1 (Southwestern ed.).

The tax literature often calls for a more perfectly competitive economy. *See, e.g.*, TAX BREAKS, *supra* note 12, at 62 (decrying "inefficient . . . impacts of many present provisions" of the tax code); Block, *supra* note 3, at 928 & n.36 ("As a tax policy objective, economic efficiency demands that our tax system interfere as little as possible with the natural allocation of resources in the marketplace . . . . This objective is also sometimes referred to as 'free market compatibility.' "); Rosow, *supra* note 7, at 65 ("Economic neutrality is an affirmation of faith in the free market economy. More particularly, it is an assertion that those private actors who control economic development will make the 'right' choices for society without government involvement."); Comment, *The Bradley-Gephart Fair Tax Plan: Is It Fair to Corporations and Individual Shareholders*, 29 ST. LOUIS U.L.J. 1253, 1253 (1985) (criticizing the "economic inefficiencies resulting from a system overloaded with special preferences and complex provisions"); *see also* Baker, *supra* note 1, at 6 (asserting that tax reform "will help restore free-market principles to economic decision making"); Freilich, Greenhagen & Lamkin, *The Demise of the Tenth Amendment: An Analysis of Supreme Court Decisions Affecting Constitutional Federalism*, 17 URB. LAW. 651, 675 (1985) ("Neutral efficiency means that resources flow to where they are most needed based upon market forces, and the decisions which shape these market forces are made without regard to tax consequences."); Graetz & McDowell, *Tax Reform 1985: The Quest for a Fairer, More Efficient and Simpler Income Tax*, 3 YALE L. & POL'Y REV. 5, 7 (1984) ("The modified flat-rate tax, according to its proponents, offers several advantages over the current income tax. The first is greater economic efficiency or economic neutrality. A tax with fewer preferences and lower rates than the current tax is less likely to distort economic decisionmaking."); Jensen, *The Uneasy Justification For Special Treatment of Like-Kind Exchanges*, 4 AM. J. TAX POL'Y 193, 213 (1985).

27. TREASURY DEPT., TAX REFORM FOR FAIRNESS, SIMPLICITY, AND GROWTH, *supra* note 4, at 42.

> [t]he present system of taxing business income, especially as applied to corporations, has many faults. High taxes on business impede the process of income creation. Business decisions are distorted from what would be best when judged on the basis of economic productivity. Too much investment goes into forms with less burdensome tax consequences; too little goes where taxes will be high but production is needed. Productive capacity is not allocated to the use and in the proportions, *which are fundamentally best.*[28]

In the context of the tax incentive debate, the case for the perfectly competitive market acquires its normative force when we examine the results of interfering with the price schedule for a particular good or service prevailing under perfect competition. Assume this price schedule, P_1P_1, reflecting the true cost of producing the good or service in question, is hidden from the consumer (see figure 1). Further suppose, as a result of government regulation, that producers are forbidden to charge a higher price than the government-established P_2P_2.[29]

Confronted with the false price signal P_2P_2, the consumer overconsumes, that is, he moves to point B associated with quantity DF rather than the optimal quantity under a regime of perfect competition, point A associated with quantity DE. Hence, resources otherwise devoted to nonregulated goods and services are drawn into the production of the good or service subject to government control. The resulting loss in consumer welfare is purportedly measured by the area ACB.[30]

Opposition to tax incentives premised upon universal market efficiency holds that tax incentives cause the consumer to confront false price signals like P_2P_2. Thus, the deduction for home mortgage interest

28. Chapman, *The American Tax Structure—A Business View*, in TAX FOUNDATION, ESSAYS ON TAXATION 13 (1974) (emphasis added).

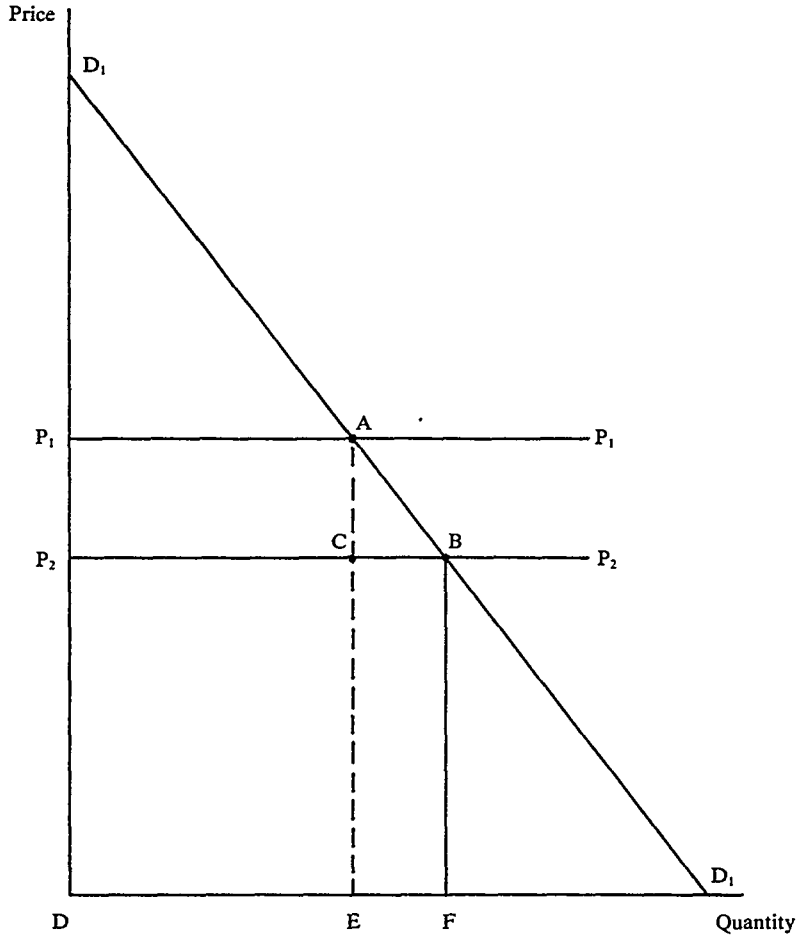
29. In the perfectly competitive market, consumers confront prices that reflect the actual costs of the goods and services available in the economy. Hence, the consumer, if fully informed and left to his own devices, will consume each good and service to precisely the appropriate point maximizing his welfare.

Illustrated graphically, line P_1P_1 represents the relationship of price and quantity in a perfectly competitive economy from the perspective of the individual consumer. Under the hypothesis of perfect competition, the consumer's own activity in the market is too insignificant to affect the price of the goods and services he can buy. Hence, by assumption, the consumer in a competitive economy can purchase any quantity of any good or service at the market price. That price, in turn, reflects the cost of producing the good or service in question.

From the consumer's perspective, as the price of the good or service goes down the quantity he is willing to buy goes up. Thus, line D_1D_1, representing the consumer's demand schedule, reflects the consumer's willingness to buy more if the price declines. Point A represents the intersection of the consumer's demand schedule with the market price. Consequently, the consumer will purchase quantity DE of this particular good or service at the price established by P_1P_1 and the economic resources represented by the rectangle P_1AED will be devoted to the goods utilized by this consumer.

30. *Cf.* E. MANSFIELD, MICROECONOMICS: THEORY AND APPLICATION 292 (4th ed. 1982) (defining this area as the cost to society of overpricing and underconsumption in monopoly conditions as opposed to perfect competition).

FIGURE 1



insulates the consumer from the true cost of housing. In this case, *DE* represents the amount of housing a consumer would purchase in a competitive economy, an amount reflecting the optimal allocation of housing for him and the economy as a whole. The mortgage interest deduction, however, gives the consumer a false price signal: the effective price the consumer confronts is the economic price, P_1P_1, minus the tax savings generated by the interest deduction, namely, P_2P_2. The result is overcon-

sumption of housing measured by the excess of DF over DE.[31]

To examine universal market efficiency from the producer's perspective, assume a perfectly competitive economy except that the government requires the suppliers of one hypothetical industry to supply each firm in that industry at reduced rates. Initially, this will not affect the prevailing price, P_1P_1, (see figure 2) of the goods made by the subsidized industry.[32] It will, however, affect the cost calculations confronting each producer in the subsidized industry. Each firm will be sheltered from the true average and marginal costs of its activities, MC_1 and AC_1. Instead, each firm will confront new and more favorable average and marginal cost conditions, MC_2 and AC_2, reflecting the government-mandated sub-

31. One writer has detailed the consequences of such overconsumption:

> It is almost impossible to overestimate the twists and distortions caused by the present law. For example, it is virtually mandatory for families earning professional incomes to have some real estate investments to take advantage of the mortgage tax deductions. A substantial part of the nation's savings is thereby channeled into second homes or skiing condominiums at grossly inflated prices, with dubious effects on national competitiveness.

Morris, *Tax Plan Offers Needed, Modernized Reform*, New Haven Reg., Dec. 20, 1984, at 15, col. 1; *see also* Block, *supra* note 3, at 950 ("[T]he home mortgage interest deduction favors one type of economic activity over another. It, therefore, plainly violates the tax policy objective of economic efficiency.").

If, under the federal income tax, gross income included the imputed rental value of owner-occupied housing, the deduction for mortgage interest would not constitute a tax preference but an appropriate deduction for transforming gross rental value into net income. *See* Hellmuth, *Homeowner Preferences*, in COMPREHENSIVE INCOME TAXATION, *supra* note 14, at 169. The federal income tax has never included the imputed value of owner-occupied housing within the definition of gross income. Other nations' tax systems, however, have included this imputed value. *Id.* at 170.

32. From the producer's perspective, under conditions of perfect competition, each producer is able to sell at the market price P_1P_1. That price will not be affected by the producer's individual decision to sell more or less because, by definition, a perfectly competitive market is one in which any single producer has insufficient volume to affect the market's price. In this competitive economy, each firm will produce until the point at which the marginal cost of its last unit of production equals the market price. At this point, the producer has squeezed out all of the profit available to it at the existing market price.

Hence, if P_1P_1 represents the price to a particular industry in a perfectly competitive economy and MC_1 represents the producer's marginal costs for each unit of production, point A, the intersection of P_1P_1 and MC_1, is the place at which a producer will operate in a perfectly competitive economy.

If, in the short run, price P_1P_1 yields a rate of return higher than that available in other sectors of this perfectly competitive economy, new firms will enter the industry and thereby increase the industry's total output. This collective expansion of output depresses price P_1P_1 until the industry's rate of return reaches that prevailing in the economy as a whole. Similarly, if P_1P_1 yields an inadequate rate of return, *i.e.*, one below that prevailing in the economy, firms will leave the industry, thus collectively contracting the industry's output and raising the industry's price. This process continues until the industry has a rate of return equal to that of other industries in the economy.

When an industry is experiencing the rate of return prevailing in the economy as a whole, each producer will, under assumptions of perfect competition, produce at the point at which its marginal cost and average cost equal the market price for the industry's good or service. E. MANSFIELD, *supra* note 30, at 222.

In this situation, AC_1 represents the firm's average costs. Hence, at point A the optimal allocation of resources is achieved: the firm is now maximizing its profit, and, because the industry's rate of return equals the prevailing rate in the economy, there is no more productive place for the resources currently being used by this industry.

FIGURE 2

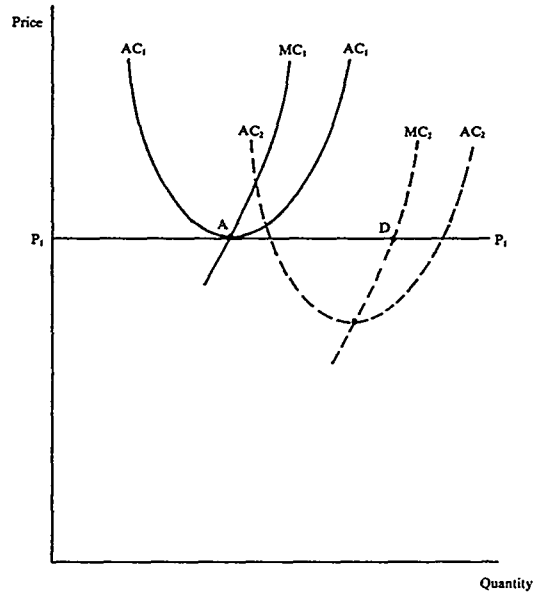
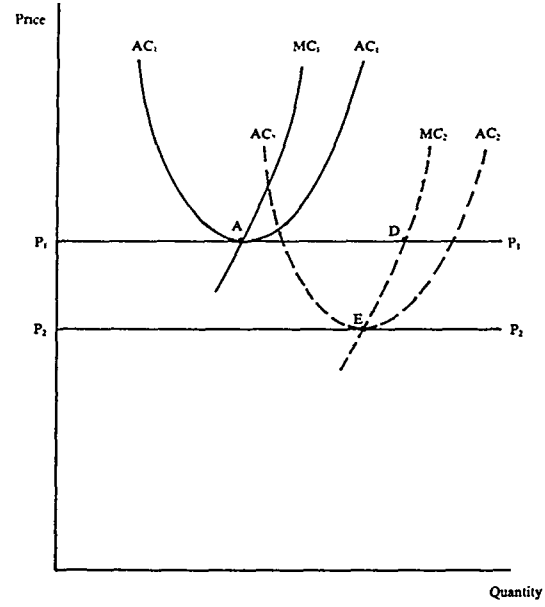


FIGURE 3



sidy from suppliers. As an initial response to artificially lowered costs, each firm will move to point *D*, reflecting an expansion of output over presubsidy point *A*. Because every firm in the industry will move to point *D*, the industry's collective output will gradually expand and the price of its product will be depressed to P_2P_2 (see figure 3). Thus, the long-term result of the government's policy will be each firm operating at point *E*.

A moment's reflection indicates why point *E* is less optimal than point *A* under the regime of universal market efficiency. Point *E* has been reached by expanding production at the expense of other industries in the economy. Consequently, output has been constricted in these non-subsidized industries and prices have been inflated. The subsidized industry has expanded its output beyond the level justified by the competitive market, causing underpricing and overconsumption of its product.

Those who rely on the concept of universal market efficiency argue that ACRS is a government-mandated subsidy of particular industries that similarly causes them to expand production beyond, and lower price under, the point of optimal economic allocation. Under ACRS, however, the immediate subsidy comes not from the firm's suppliers, but from the federal treasury. Lowering the taxes of firms buying tax-favored equipment and buildings effectively reduces the price and expands the output of firms assisted by ACRS and artifically increases the price and restricts the output of those firms not favored by ACRS.

C. Sectoral Efficiency

The notion of perfect competition central to universal market efficiency is a seductive one: an economy of no imperfections; all consumers, firms, and industries in an optimizing equilibrium; a single rate of return prevailing throughout the entire economy; and consumers making precisely balanced choices among all of the goods and services in the economy.[33] Those unseduced have frequently used a concept in the tax incentive debate which could be called "sectoral efficiency."

Sectoral efficiency does not rely on assumptions about the universe of economic activity, the competitiveness of the entire economy, or the existence of optimal allocation points. Rather, sectoral efficiency compares discrete parts of the economy to determine if profitability could be increased or consumers' choices improved as between them. No claim is made about the nature of conditions in the sectors being analyzed or in

33. *See* E. MANSFIELD, *supra* note 30, at 222.

the economy as a whole. All that need be assumed is that every relevant sector of the economy has been identified, that there are no externalities resulting from the goods or services being produced or consumed in each sector, and that there is free movement of capital and consumption between the sectors being analyzed.

Opposition to tax incentives premised on sectoral efficiency does possess one important characteristic in common with opposition based on universal market efficiency: the sectoral case against tax incentives is not an argument for direct expenditure programs, but rather embodies substantive rejection of government intervention in the domestic economy. Concern for sectoral efficiency leads to the conclusion that the government ought not be intervening in the economy at all.

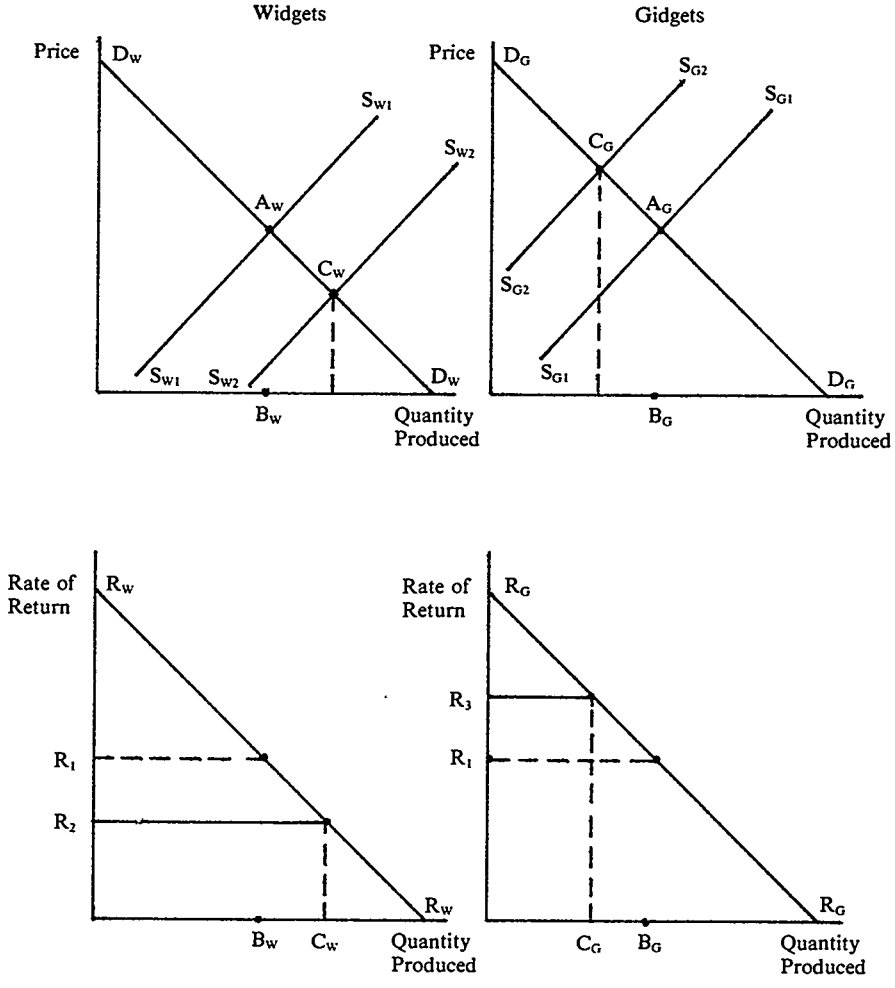
The case for sectoral efficiency can best be illustrated by assuming two industries which, in the time-honored tradition of the economics profession, will be labelled widgets and gidgets and which, except for the interference of the tax system, will be assumed to satisfy the conditions for sectoral efficiency.[34] Further suppose that the tax code is amended to provide special incentives for only the manufacturers of widgets. Assume that, for each widget sold, the manufacturer receives a federal income tax deduction. As a result of this tax incentive, manufacturers of widgets confront a tax-subsidized supply schedule, $S_{W2}S_{W2}$ (see figure 4). At any given level of production, the cost of producing widgets is the economic cost, reflected in $S_{W1}S_{W1}$, minus the tax subsidy received for

34. Under the assumption of sectoral efficiency, the widget and gidget industries will have the same rate of return. If returns were higher in gidgets than in widgets, investors would move capital out of widgets and into gidgets. This would cause the output of gidgets to rise, leading to a drop in the price of gidgets and a consequent decline iu the return to gidget manufacturers. The movement of capital from widget manufacturing to gidget manufacturing would, in corresponding fashion, cause widget production to decline. As a result, widget prices would rise and the rate of return to widget manufacturers would increase concomitantly. This adjustment process would continue until the return to widget manufacturers equalled the return to gidget manufacturers. At this point, capital would cease flowing from gidget production into widget production because there would be no incentive to do so.

In figure 4, D_WD_W represents the demand schedule for the widget industry and $S_{W1}S_{W1}$ constitutes the initial supply conditions prevailing in that industry before the institution of any tax incentives. Similarly, D_GD_G represents the demand conditions prevailing in the gidget industry and $S_{G1}S_{G1}$ is the initial supply schedule for gidgets. Line R_WR_W, in the lower left panel, represents the rate of return to widgets. That line is negatively sloped because increased output is associated with lower prices and reduced rates of return. Similarly, R_GR_G, in the lower right panel, represents the rate of return to gidgets, also inversely related to ouput.

Before the implementation of any tax incentives, the widgets industry operates at point A_W resulting in quantity B_W. Turning to the lower left panel, quantity B_W is associated with the rate of return R_1. The gidget industry operates at point A_G producing quantity B_G. Quantity B_G is also associated with rate of return R_1. It is, of course, no accident that both the widget and gidget industries operate at the same rate of return: if they had different rates of return, the movement of capital between them would eliminate the discrepancy. *See* Rabushka, *The Corporate Income-Tax Mystery: Who Pays*, Wall St. J., Apr. 15, 1985, at 26, col. 3 (Southwest ed.) (decrying "intersectoral distortion" of the corporate income tax).

FIGURE 4



that level of production. From the industry's perspective, the supply curve to consider in actual operation is $S_{W2}S_{W2}$, embodying the industry's after-tax costs. Hence, after introduction of the incentive, the output of widgets increases from B_W to C_W. This result is not surprising: the reason for giving the tax incentive is to expand production.

The expansion of widget production has, by hypothesis, been accomplished by drawing capital and other resources from the gidget industry. Reference to the lower left panel of figure 4 shows that the pretax rate of return to the widget industry has declined from R_1 to R_2, reflecting the tax-induced infusion of new capital from gidget production

to widget production and the consequent drop in the pretax rate of return to investors in widgets. The gidget industry makes adjustments converse to those of the widget industry. Now forced to pay more for scarce resources, the gidget industry faces higher costs, specifically, $S_{G2}S_{G2}$. Gidget production contracts to point C_G associated with the higher rate of return R_3.

To label this result inefficient is not to make any universal claim about the competitiveness of these or any other markets, nor is it to postulate that there is an optimal point of allocation for these industries. Rather, it is to assert that the tax-caused shift of capital from the gidgets industry to the widgets industry has moved capital from a higher pretax return in gidgets to a lower pretax return in widgets.[35]

Some opponents of ACRS suggest that this is how that system of rapid depreciation works, driving resources from profitable uses and industries to less profitable, but tax-favored, uses and industries. These opponents of ACRS are not making sweeping assertions about the nature of the economy or the ultimate optimization of the economy's resources. Instead they are advancing the more modest claim that, in the absence of ACRS, capital would flow between various industries in a fashion that would maximize total pretax profits given the existing state of the economy. Professor Auerbach aptly summarized the sectoral case against ACRS when he declared:

> [I]t is relatively inefficient to raise revenue through a distortion of production activity. Such a distortion would arise in the allocation of capital, for example, if different types of investment income were taxed at different rates. This differential taxation would cause a shift of investment into the more lightly taxed types of assets.
>
> . . . .
>
> . . . ACRS therefore constitutes a substantial stimulus to investment, but one which is very distortionary in its distribution across different assets . . . .[36]

35. Assume for a moment that, after the institution of the tax incentive for widget production, $10,000,000 migrated from the manufacture of gidgets to the manufacture of widgets and that R_1, the rate of return prevailing before the tax incentive, was 8%. Suppose further that the new rate of return in widgets, R_2, is 6%. On these facts, the tax incentive has cost the economy $200,000, the difference between R_1 and R_2.

36. Auerbach, *supra* note 3, at 1343-50; *see also* THE PRESIDENT'S TAX PROPOSALS, *supra* note 1, at 135-37 (discussing distortions created by ACRS, especially during periods of low inflation); Graetz & McDowell, *supra* note 26, at 17-18 ("These rules have produced tax burdens that vary widely both among industries and among companies within the same industry and have thereby produced inequities and encouraged the inefficient allocation of resources."); Jorgenson & Sullivan, *Reforming Capital Recovery Under the Corporate Income Tax*, 12 TAX NOTES 1397, 1397 (1981) ("The U.S. corporate income tax imposes significantly different effective tax rates on different assets, resulting in serious misallocation of capital."); McIntyre & Tipps, *Inequity and Decline: How the Reagan Tax Policies Are Affecting the American Taxpayer and the Economy* (1983), *reprinted in* READINGS IN FEDERAL TAXATION 269, 275 (2d ed. 1983) (ACRS compounds the investment dis-

The notion of sectoral efficiency is equally applicable to the analysis of consumers' decisions about goods and services. Assume a consumer who can freely choose between widgets and gidgets. Also assume a tax incentive designed to increase consumption selectively: for each gidget (though not each widget) consumed, the consumer can take a federal income tax deduction. As a result, the consumer confronts an artificially-lowered after-tax price for gidgets, P_3P_3: the consumer's effective price is the market price, P_2P_2, minus the tax reduction associated with each gidget consumed (see figure 5). In response to the incentive, the quantity of gidgets consumed increases from J_GK_G to J_GM_G.[37]

By the additional consumption of gidgets, the consumer achieves a lower level of marginal utility than he otherwise would have reached.[38] The consumer consumes gidgets down to utility level X_2 after the introduction of the incentive. After the tax incentive is in place, the last gidget consumed generates less utility per dollar than the final gidget consumed before the tax incentive went into effect.

tortion problem by sharply increasing the bias against long-term investment); McMahon, *Reforming Cost Recovery Allowances for Debt Financed Depreciable Property*, 29 ST. LOUIS U.L.J. 1029, 1056 (1985) ("If effective rates of tax are unequal, the equilibrium achieved by the equalization of after-tax rates of return of investment alternatives will result in a misallocation of capital, which will result in an efficiency loss to the economy."); Warren & Auerbach, *Tax Policy and Equipment Leasing After TEFRA*, 96 HARV. L. REV. 1579, 1584 (1983) ("ACRS and the ITC should be regarded not as a tax exemption, but as an investment subsidy administered through the tax system . . . ."); Yorio, *The President's Tax Proposals: A Major Step in the Right Direction*, 53 FORDHAM L. REV. 1255, 1287 (1985) ("Preferential tax treatment of certain activities . . . results in economic distortions by interfering with a market-determined allocation of resources."); Kodlec, *Put Capitalism Back in Capital Formation*, Wall St. J., Apr. 2, 1985, at 28, col. 3 ("Targeted tax incentives are, by definition, a form of industrial policy: Capital is steered toward investments favored by Congress at the expense of other sections of the economy.").

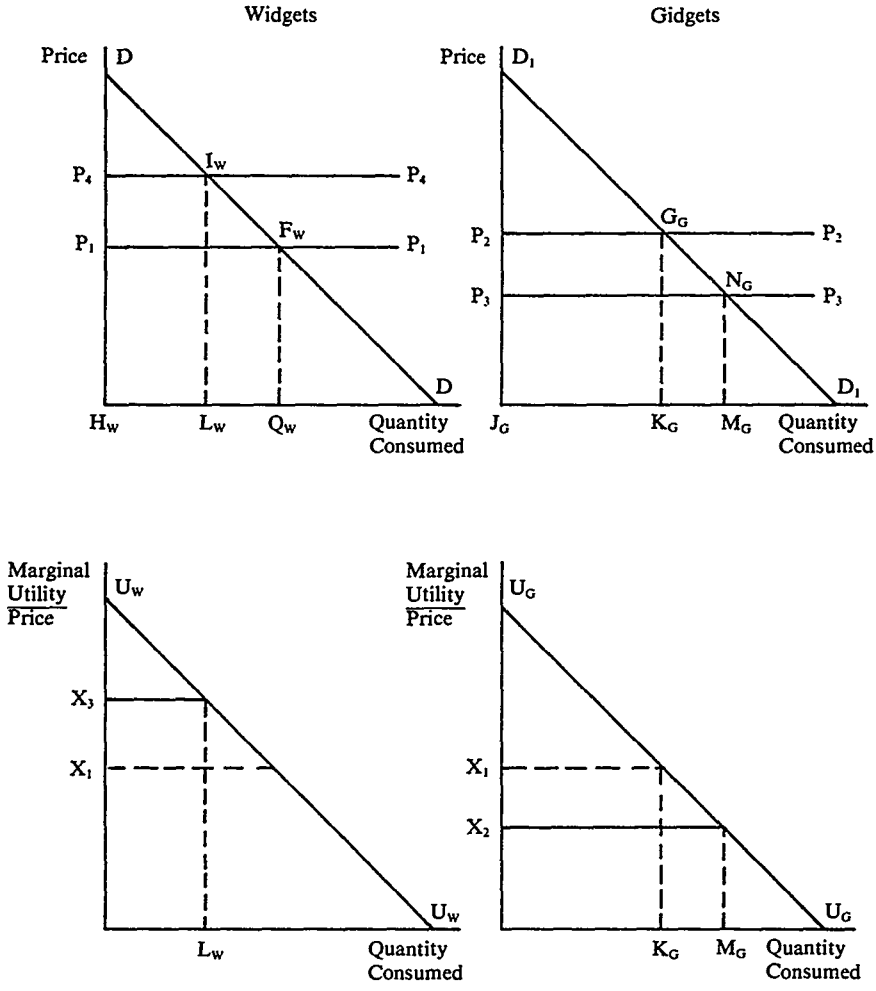
37. Line P_IP_I represents the supply of widgets available to the consumer at the prevailing price P_I. Because the consumer is a negligible factor in the market place, he can buy essentially any quantity of widgets he chooses at this price. The consumer's demand schedule for widgets is reflected in line DD, resulting in the consumption of widgets measured by quantity H_WL_W. Similarly, the consumer is able to purchase any reasonable quantity of gidgets at price P_2P_2. The consumers' demand schedule for gidgets is represented by D_ID_I and J_GK_G represents the amount of gidgets consumed before the institution of any tax incentive.

Corresponding to the rate of return is the consumer's measure of satisfaction or, in the now controversial parlance of microeconomics, his marginal utility. U_WU_W represents the increase in the consumer's utility per dollar expended as his consumption of widgets goes up. Similarly, U_GU_G represents the increase in the consumer's utility per dollar expended as his consumption of gidgets rises. Both U_WU_W and U_GU_G are downward sloping because, under conventional assumptions, each additional widget or gidget consumed yields less additional satisfaction than the unit that preceded it. To complete our initial analysis, consumption of widgets at point F_W and of gidgets at G_G results in utility level X_I.

A consumer seeking to maximize his overall utility will consume gidgets and widgets to the point where the marginal utility per dollar of each is the same. If the utility per dollar derived from consuming the last gidget is higher than that obtained from the last widget, the consumer will eliminate the last widget consumed and substitute another gidget. This process will continue until nothing is gained by substituting widgets for gidgets, *i.e.*, until the marginal utility per dollar of the last widget consumed equals that of the last gidget consumed.

38. P. SAMUELSON, ECONOMICS 408 (11th ed. 1980).

FIGURE 5



The tax incentive affects the consumer's widget consumption conversely. The incentive effectively increases the price of widgets to P_4P_4 and contracts the consumer's consumption of widgets to the quantity measured by H_WL_W. The consumer's marginal utility per dollar from the last widget consumed rises from X_1 to X_3, a level higher than X_1 or X_2. The consumer has thus been induced by the tax incentive to forego higher marginal utility widgets for lower marginal utility gidgets. The consumer is deflected from a pattern of consumption which maximizes his overall utility. This, in sum, is the economic case against the mort-

gage interest deduction when efficiency is defined as sectoral efficiency: the mortgage deduction induces overconsumption of housing and concomitant underconsumption of other goods, resulting in a loss of utility as lower utility housing is exchanged for higher utility goods other than housing. In Professor Bossons' assessment, the interest deduction creates an unacceptable bias in favor of owner-occupied housing.[39]

D. Technical Efficiency

A third manner in which the concept of efficiency has been used in the analysis of tax incentives can be labelled "technical efficiency."[40] Technical efficiency, unlike universal market efficiency, involves no claims as to the optimum allocation of the economy's total resources or as to the competitiveness of the entire economy. Unlike sectoral efficiency, it does not involve the more limited assertion that welfare can be maximized as between two or more sectors of the economy. Indeed, technical efficiency is not concerned with the allocational effects of tax incentives. Rather, technical efficiency is a means of viewing tax incentives from the perspective of the government as purchaser of economic behavior: what is the cheapest way the government can induce additional production of a particular good or encourage increased consumption of a specific service? To the extent a tax incentive rewards a producer for production in which he would have engaged anyway, or reimburses a consumer for consumption he would have undertaken in any event, the government has acted inefficiently by giving up revenue without inducing more activity. One commentator, referring to energy-related tax credits, aptly summarized considerations of technical effi-

39. Bossons, *Indexing for Inflation and the Interest Deduction*, 30 WAYNE L. REV. 945, 957 (1984); *see also* TAX BREAKS, *supra* note 12, at 18, 54 (discussing alleged overconsumption of housing with particular emphasis on second homes); Andrews, *supra* note 22, at 341-42 (acknowledging a similar critique of the income tax deduction for medical expenses); Doernberg, *supra* note 2, at 480 (stating that if the home mortgage interest deduction were eliminated, a grandfather clause protecting existing homeowners might be appropriate even though such a clause "cannot be justified on a sound economic or tax ground"); Dyer, *The Relative Fairness of the Consumption and Accretion Tax Basis*, 1978 UTAH L. REV. 457, 478 (comparing effects of direct government subsidies on municipal bonds and indirect subsidies through tax exemptions); Katz & Mankiw, *How Should Fringe Benefits Be Taxed*, 38 NAT'L TAX J. 37 (1985) (discussing the efficiency effects of tax-free fringe benefits); Taubman & Rasche, *The Income Tax and Real Estate Investment*, in TAX INCENTIVES, *supra* note 2, at 133-36 (maintaining that subsidies for minimum levels of housing would have less of an artificial market effect than subsidies for an overall minimum standard of living).

40. It should be emphasized that as used here the term technical efficiency is unique to this Article and is not one to which those being discussed would necessarily ascribe. Furthermore, by technical efficiency this Article means something different than it does to those commentators who use that expression to describe economies of scale in the provision of public services. *See, e.g.*, Bahl, *Estimating the Equity and Budgetary Effects of Financial Assumption*, 29 NAT'L TAX J. 54, 55 (1976) (arguing that the financial assumption of urban governmental duties by a state authority results in efficiency loss to city residents).

ciency when he observed that "[t]he key question [is] what portion of the energy credit will be spent subsidizing projects which would have been undertaken anyway and what portion will go toward inducing additional energy saving investment."[41] Opposition to tax incentives premised on the technical definition of efficiency does not challenge the substantive propriety of intervention in the domestic economy. Rather, consideration of technical efficiency reflects procedural concerns; that is, how expensive is intervention?

Suppose, for example, the government decides to expand the production of a particular industry from quantity *KB* to quantity *KC* by means of a tax deduction for each unit produced (see figure 6). The industry would thus confront after-tax supply schedule S_AS_J, reflecting the government's subsidy of each unit produced, rather than its pretax supply schedule, S_AS_I. The industry would move from point *A* associated with quantity *KB* to point *D* associated with quantity *KC*, the government's target quantity.

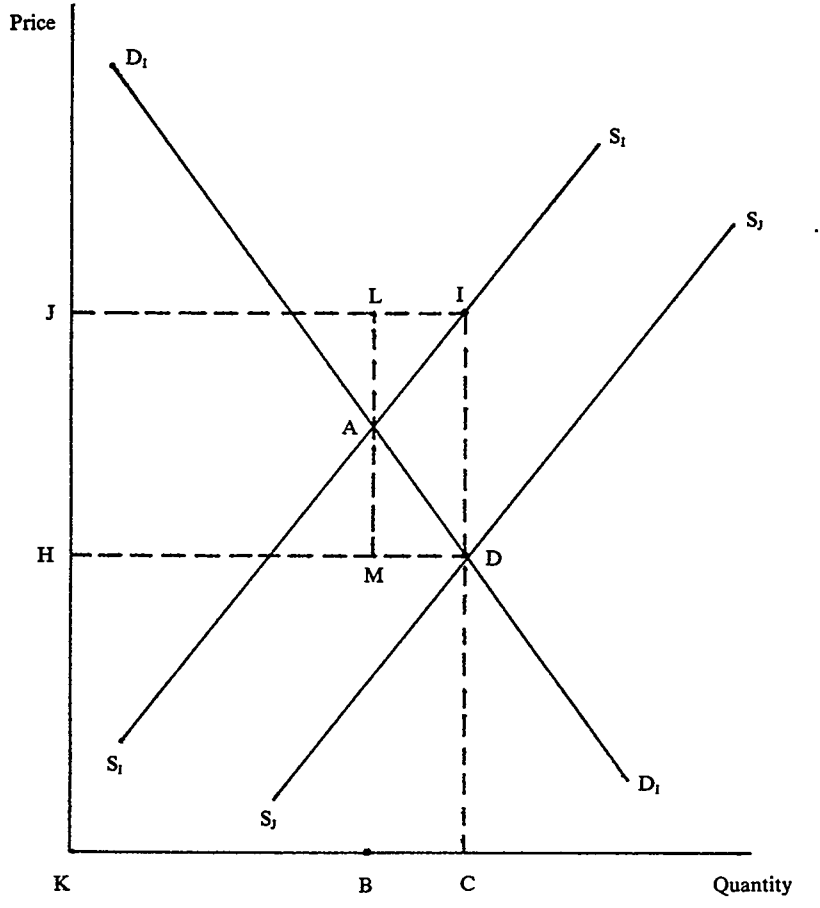
Consumers (now indirectly subsidized by the tax system) will pay to the industry the amount represented by the rectangle *HKCD*. The government, through the tax incentive, will "pay" the industry the amount represented by the rectangle *HDIJ*, the amount of revenue the government would have received had the industry produced quantity *KC* without a tax incentive. Of the amount represented by *HDIJ*, however, a portion (*JHML*) constitutes a reward for producing quantity *KB*, although the industry would have produced this amount anyway. Viewing the government as a purchaser interested in minimizing its costs, the government should, at most, pay *LMDI* for the additional production it wants. ACRS may be criticized along these lines insofar as accelerated depreciation rewards investment that would have taken place anyway.

Similar considerations obtain when analyzing taxed-induced increases in consumption from the viewpoint of technical efficiency. Assume a tax incentive which rewards a consumer for each widget he consumes (see figure 7).[42] The consumer thus confronts after-tax price schedule, S_DS_D, reflecting the market cost to the consumer, S_CS_C, less the tax benefits associated with widget consumption. Hence, the consumer's

41. McIntyre, *supra* note 1, at 720; *see also* Slitor, *Tax Incentives and Urban Blight*, in TAX INCENTIVES, *supra* note 2 at 257, 267 (discussing forms of tax incentive to help urban centers).

42. Assume an individual who consumes widgets. D_CD_C represents the consumer's demand schedule for widgets. S_CS_C represents the pretax incentive supply of widgets available to our consumer. S_CS_C is horizontal because our consumer is a negligible factor in the marketplace and can consume as many widgets as he wants without affecting their price. Before the introduction of any tax incentives, consumption is at point *A* associated with quantity *NB*.

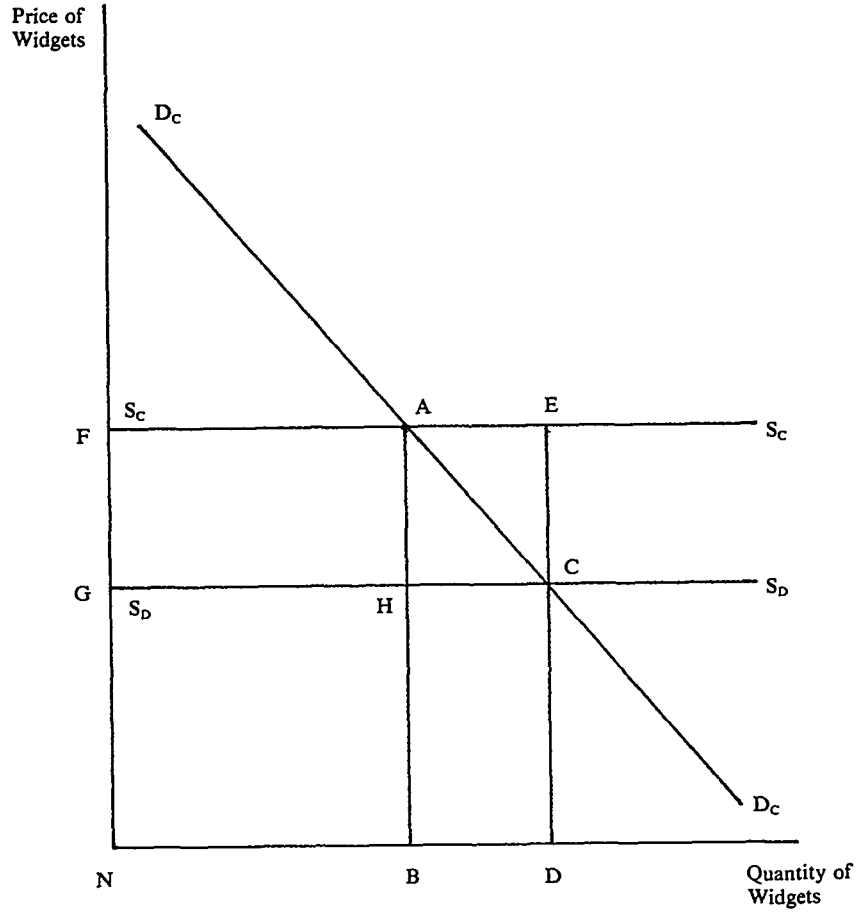
FIGURE 6



widget consumption is determined by point *C* (rather than pretax point *A*) and widget consumption, as planned, increases from *NB* to *ND*.

That this arrangement is technically inefficient can be seen by examining the price paid by the government in foregone revenues with the additional consumption for which the government has paid. The government has subsidized the consumer to the extent represented by the rectangle *FGCE*. However, the portion of that amount represented by *FGHA* bought the government nothing: quantity *NB* would have been purchased by the consumer had there been no tax incentive.

FIGURE 7



The home mortgage interest deduction has been indicted along these lines. It assists homeowners to buy the housing they would have bought anyway as well as the incremental housing for which the tax subsidy was necessary. Professor Richard Pomp, in his critique of the mortgage interest deduction as a tax incentive, appealed to technical efficiency when he observed that "[u]pper-income taxpapers, who derive the most benefit for the deduction . . . would very likely own homes even in the absence of the incentives" the deduction provides.[43]

43. Pomp, *supra* note 16, at 24.

III. A Critique of Efficiency

A. Overview

This Article initially suggested that the common-law debate has an important lesson for discussion of tax incentives. A central question of the common-law debate is the meaning of efficiency. When asked in the context of the tax incentive debate, it is clear that the notion of efficiency has been used in three distinct ways. It is also clear that some opposition to tax incentives reflects a substantive rejection of governmental intervention in the domestic economy while other opposition to tax incentives accepts the premise of government intervention but questions the costs involved.

The need to clarify the concept of efficiency is an important lesson drawn from the common-law debate. Matters should not rest there, however, for further analysis suggests that each of these definitions of efficiency has significant limitations. Indeed, the prevailing consensus tending to condemn tax incentives as invariably inefficient may stand on less solid footing than is widely believed. All three definitions rest on assumptions that when plausibly contested, lead to a different perspective on tax expenditures.

B. Universal Market Efficiency and the Theory of the Second Best

Those opposing tax incentives under the banner of universal market efficiency confront a problem in their analysis: the model of perfect competition is an obviously inaccurate description of the contemporary American economy.[44] A plausible response is that, if perfect competition is the ultimate ideal, more competition is preferable to less competition. This inference leads to the conclusion that, if a noncompetitive market can be made more competitive, even if not perfectly competitive, society's optimal allocation of resources is more closely approached if not attained.[45]

Economists now recognize, under the theory of the second best, that

44. For the classic statement of this position, see J. GALBRAITH, THE NEW INDUSTRIAL STATE 6-7 (1967).

45. Indeed, this seems to be the position held by Treasury Secretary James Baker:

> The free market is the best method for allocating resources in the most efficient manner. It provides the best signals for investors, consumers, savers and businesses.
>
> But right now, our economy in some respects can be severely distorted because what should be economic decisions are decisions driven instead by tax considerations. While a pure, economically neutral income tax may be unattainable, we should make every effort to devise a system as unbiased and economically efficient as possible.

Speech of James Baker to the Houston Chamber of Commerce (May 14, 1985), *reprinted in* 27 TAX NOTES 872, 874 (1985); *see also Hearing on the President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity Before the House Ways and Means Committee*, 99th Cong., 1st Sess. 71

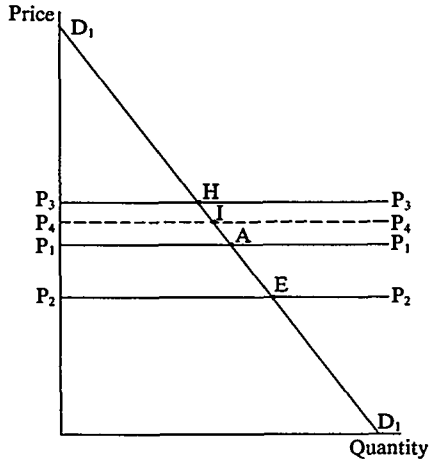
this assumption is not necessarily correct: Making a noncompetitive economy more competitive does not guarantee an improved allocation of resources and may, indeed, have the opposite effect.[46] The theory of the second best holds that, unless all conditions of perfect competition are established, creating more of those conditions may not move the economy closer to its point of optimal allocation. Indeed, making the economy more competitive may actually propel the economy from its place of optimal allocation.[47] The theory of the second best does not hold that

(1985) (statement of James Baker, Secretary of the Treasury, asserting that the President's tax proposals will help restore free-market principles to economic decision making).

46. For an introduction to the theory of the second best, see E. MANSFIELD, *supra* note 30, at 437; N. MERCURO & T. RYAN, *supra* note 10, at 53-54. The seminal technical exposition of the theory is Lipsey & Lancaster, *The General Theory of the Second Best*, in REVIEW OF ECONOMIC STUDIES 11 (1956). For two interesting discussions of the theory of the second best in the context of the common-law debate, see Huber, *Safety and the Second Best: The Hazards of Public Risk Management in the Courts*, 85 COLUM. L. REV. 277 (1985); Markovitz, *A Basic Structure for Microeconomic Policy Analysis in Our Worst than Second Best World*, 1975 WIS. L. REV. 950.

47. Although the theory of the second best takes the form of a series of complicated mathematical equations, for the purposes of this Article, the implications of the theory for the debate about tax incentives may best be illustrated with reference to an example discussed earlier. That example assumed that an otherwise perfectly competitive market was afflicted with a single imperfection, causing the price confronted by the consumer to decline from P_1P_1 to P_2P_2 (see figure 1). Now assume that this market has another imperfection that would cause the price to rise to P_3P_3. Because the two imperfections work at cross-purposes (one increasing the price, the other depressing it), the price actually confronting the consumer is P_4P_4 (see figure A).

FIGURE A



P_4P_4 is not the competitive market price, but the result of two offsetting imperfections in the market. Consequently, the allocation of resources resulting from P_4P_4 is less than optimal: the intersection of the consumer's demand schedule D_1D_1 with P_4P_4 at point I indicates that less than the optimal quantity will be consumed under these conditions. In this situation, perfect competition would be the best alternative so that the consumer consumes at point A.

The second best alternative, however, is the retention of the status quo: removing either market imperfection propels the consumer into a worse situation than if both were left in place. If only the

less competitive markets are preferable to more competitive ones. The theory is essentially agnostic: one cannot propound a prescription for moving towards the point of optimal allocation in any particular case. The theory suggests that the economic claims advanced by opponents of tax incentives premised upon universal market efficiency cannot survive close scrutiny.

In light of the theory of the second best, reconsider opposition to the mortgage interest deduction based on universal market efficiency. Recall the argument that the interest deduction, by lowering the price of housing, causes overconsumption of housing and consequent underconsumption of other goods and services, driving the economy from the optimal allocation of its resources. My contention is not that this position is correct or incorrect, but that it is unknowable: when efficiency is defined as universal market efficiency it is impossible to know whether the economy is moving from or towards the point of optimal allocation. The elimination of one market imperfection, while leaving others in place, may actually drive the economy from its point of optimal allocation.

The theory of the second best is particularly useful to the analysis of the home mortgage interest deduction. The interest deduction is only one of the ways in which the housing market deviates from the model of perfect competition. The most noticeable imperfection in the housing market is the restrictive zoning control exercised by local governments. Building and fire codes and environmental laws similarly retard the supply of housing and increase its price.[48] The existence of powerful trade unions in the construction industry may also depress the availability of

market imperfection which depresses the price is eliminated, the prices rises to P_3P_3. The consumer consequently consumes at point H, a position worse than point I. If the market imperfection increasing price is removed, the actual price confronting the consumer in effect overshoots its optimal location, resulting in P_3P_2 and consumption at point E, also worse than point I.

Thus, paradoxically, making a market more competitive (by removing one imperfection) results in a worse situation than if the market is left with two offsetting flaws.

48. Perhaps the most interesting discussion of these matters is found in a decision of the New Jersey Supreme Court. Southern Burlington County NAACP v. Township of Mount Laurel, 92 N.J. 158, 456 A.2d 390 (1983). The *Mount Laurel* decision has spawned a vast literature. *See, e.g.*, Buchsbaum, *No Wrong Without a Remedy: The New Jersey Supreme Court's Effort to Bar Exclusionary Zoning*, 17 URB. LAW. 59 (1985) (discussing the extraordinary lengths taken by the New Jersey court to provide a legal basis for encouraging low-income housing); *Symposium*—Mount Laurel II *and Development in New Jersey*, 15 RUTGERS L.J. 513 (1984) (containing an extensive analysis of the *Mount Laurel* decision and its implications). For a discussion of exclusionary zoning in the context of the federal constitution, see Bauman, *The Supreme Court, Inverse Condemnation and the Fifth Amendment: Justice Brennan Confronts the Inevitable in Land Use Controls*, 15 RUTGERS L.J. 15, 86-90 (1983); *see also* Nelson, *A Breath of Free Markets in Zoning*, Wall St. J., May 22, 1985, at 30, col. 4 (Southwest ed.) (concerning "high housing costs and other adverse impacts of restrictive zoning").

housing by inflating its cost.[49] It is possible that the deduction for home mortgage interest, by lowering the taxpayer's after-tax cost of housing, merely offsets these other supply-depressing, price-inflating restrictions and thus moves the housing market towards its point of optimal allocation.[50]

Assume that P_1P_1 is the price of housing under perfect market conditions (see figure 8). Further suppose that P_2P_2 reflects the impact of zoning restrictions, that P_3P_3 embodies the cumulative effects of zoning and building, fire and environmental codes and that P_4P_4 reflects the additional impact on price of construction trade unions. In the absence of the deduction for mortgage interest, P_4P_4 will be the observed price of housing and D will be the point at which the housing market price and demand schedules intersect.

Now assume introduction of the mortgage interest deduction. The deduction decreases the after-tax price of housing to the consumer and thus creates a new price, P_5P_5, reflecting the effects of zoning, unions and building, fire and environmental codes partially offset by the countervailing impact of the mortgage deduction. On these assumptions, the consumer in the housing market finally moves to point E, a position closer to A, the place of optimal allocation, than point D. Hence, the interest deduction, admittedly a deviation from the norms of perfect competition, improves the allocation of resources under the regime of universal market efficiency.

One possible objection to this line of analysis is that the deduction for home mortgage interest may significantly overcompensate for the effects of zoning, unions and building, fire and environmental codes. Assume, for example, that the impact of these market imperfections is less pronounced than indicated in figure 8 and thus the theoretical prices P_2P_2, P_3P_3, and P_4P_4 are reasonably close to P_1P_1, the price that would obtain under perfect competition (see figure 9). Also suppose that the net effect of the interest deduction is an after-tax price for housing, P_5P_5, far below the price which would be established under conditions of perfect competition. Under these assumptions, the abolition of the deduc-

49. For a discussion of the impact of restrictive labor practices in the construction industry, see M. MCFARLAND, FEDERAL GOVERNMENT AND URBAN PROBLEMS 185 (1978).

50. A qualification should be added to this analysis. Insofar as zoning or other restrictions accurately cause the internalization of externalities in the housing market, they may enhance the market's efficiency. *See* Ellickson, *Alternatives to Zoning: Covenants, Nuisance Rules, and Fines as Land Use Controls*, 40 U. CHI. L. REV. 681, 691-99 (1973). All of this indicates that we do not have a very good idea whether any particular intervention in the housing market is encouraging or retarding universal market efficiency. For a discussion of zoning and externalities from the perspective of municipal corporation law, see F. MICHELMAN & T. SANDALOW, MATERIALS ON GOVERNMENT IN URBAN AREAS 270 (1970).

FIGURE 8

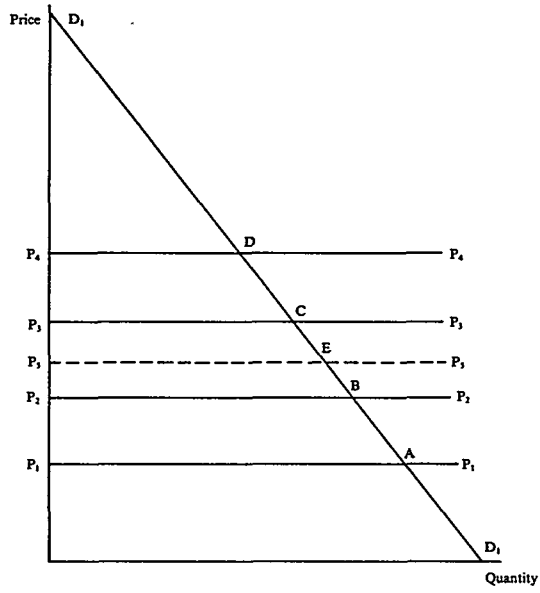
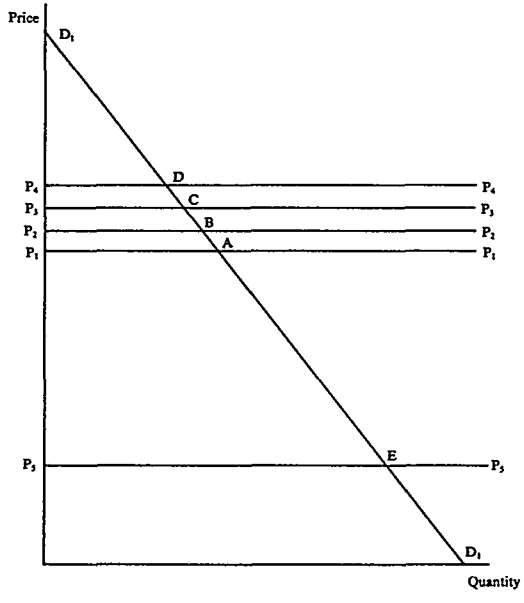


FIGURE 9



tion for home mortgage interest would move the economy closer to optimal resource allocation because point *D*, reflecting the cumulative impact of zoning, unions and environmental, building and fire codes (and no interest deduction), is closer to optimal allocation than is point *E*, reflecting the overpowering effect of the interest deduction.

Rather than refuting the position advanced here, this line of analysis supports it. The argument at this stage is not that the mortgage deduction (or any other tax incentive) should be retained (or abolished). It is that the notion of optimal resource allocation under the regime of universal market efficiency cannot give an answer one way or the other. The norms of perfect competition provide no practical guide for action because we do not, and indeed cannot, know in practice where points *A*, *D*, and *E* are located. Thus, no reason exists to believe that the deduction for home mortgage interest per se moves the economy closer to (or farther away from) the point of optimal allocation.

In short, those opposing the deduction for home mortgage interest under the aegis of universal market efficiency ultimately base their position on three unarticulated assumptions about the housing market. They assume that they know (1) the price and quantity of housing that would exist under conditions of perfect competition (point *A*); (2) the price and quantity of housing that would exist if the interest deduction were abolished (point *D*); and (3) that price and quantity without an interest deduction are closer to the terms of perfect competition than are price and quantity with the mortgage interest deduction.

For similar reasons, the concept of universal market efficiency cannot play a decisive role in determining the economic propriety of ACRS or comparable incentives. Assume that MC_1 is the marginal cost schedule for a representative firm under conditions of perfect competition, P_1P_1 is the price established under these conditions and AC_1 is the firm's average cost schedule (see figure 10). In these circumstances, the firm produces at point *A* associated with quantity *KM*. Suppose also, before the introduction of ACRS, an imperfection in the perfectly competitive conditions under which this firm would otherwise exist, *e.g.*, the firm's equipment suppliers are oligopolistic, constricting output and increasing prices. Hence, the representative firm confronts marginal cost schedule MC_2, average cost schedule AC_2, and price P_2P_2. The firm will now operate at point *B*, resulting in reduced output and higher price than is associated with point *A*.

Now assume an additional market imperfection: the laborers who operate the machines used by the representative firm belong to a powerful union. Increased wage rates further elevate the firm's costs to MC_3

and AC_3, resulting in price P_3P_3 and production at point C. Finally, assume the introduction of ACRS, a market imperfection which partially countervails the effects of the other two market flaws by reducing after-tax costs. The representative firm consequently operates at point D, a position less than optimal (only point A is that) but one which is preferable to point C, the practical alternative. Eliminating ACRS would drive the firm to C, far from the optimal place under the regime of universal market efficiency (point A).

An opponent of ACRS, however, could argue an alternative scenario. Suppose that the effects of unions and oligopolistic suppliers are less pronounced, that consequently points B and C are closer to point A than indicated in figure 10 and that ACRS significantly overcompensates, that is, drives the price to P_4P_4 far below P_1P_1 (see figure 11). In this case, repeal of ACRS would move the economy towards the point of optimal allocation as point C (reflecting the impact of unions and oligopolistic suppliers but not ACRS) is closer to point A than is point D, the position to which ACRS drives the representative firm. Hence, the argument concludes, ACRS should be repealed.

The opponent of ACRS would be correct in his premise but not his conclusion. Although one could imagine such a situation, one could just as easily hypothesize the alternative, that ACRS moves the economy closer to its point of optimal allocation. The argument is not that ACRS is good or bad but rather that the economic argument against (or on behalf of) ACRS or any similar incentive cannot be established with any certainty when efficiency is defined as universal market efficiency. There is no reason to believe that eliminating ACRS per se moves the economy towards its optimal allocation of resources.

C. Sectoral Efficiency Further Explored

1. The Assumption of Free Movement Between and Entry into Different Sectors.—The limitations of sectoral efficiency initially can be explored by abandoning the assumption that capital is able to move freely between the sectors of the economy being analyzed. Using an earlier example (see figure 4), assume that entry into the gidget industry is impeded while the widget industry suffers from no such impediments. Consequently, before the institution of any tax incentives, the rate of return to capital invested in gidget production will be higher than that in widget production and the output of gidgets will be correspondingly constricted. Capital in this two-sector economy, unable to enter the gidget industry, will by default gravitate to the widget industry leading to an expansion of widget output and a corresponding depression of the rate of

FIGURE 10

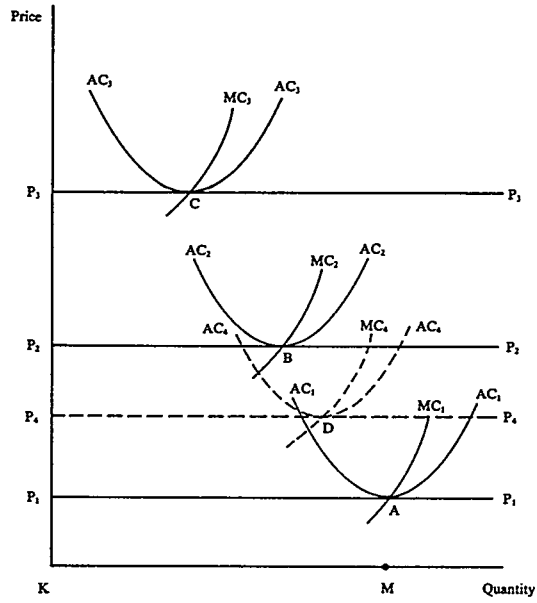
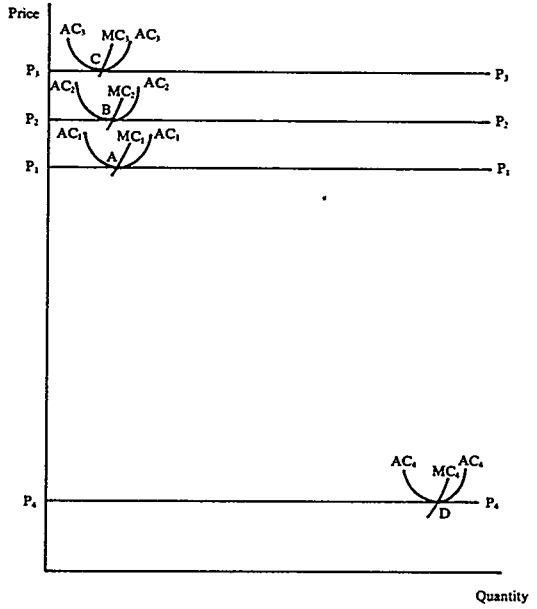


FIGURE 11



return to widget manufacturers. Hence, $S_{G2}S_{G2}$ becomes not the post-incentive supply schedule of the gidget industry, but the supply schedule for the gidget industry before the institution of any tax incentives. $S_{G2}S_{G2}$, associated with production point C_G, yields rate of return R_3.

Because capital is assumed to be impeded from seeking the higher return (R_3) prevailing in gidgets, the result will be overcapitalization of the widget industry in this two-sector economy. Hence, $S_{W2}S_{W2}$ is now the preincentive supply schedule for the widget industry, associated with production point C_W and rate of return R_2.

Those opposing tax incentives from the standpoint of sectoral efficiency implicitly assume this situation cannot occur, that the discrepancy between the return to widgets (R_2) and that to gidgets (R_3) cannot endure. But suppose they are wrong, and because of economies of scale or other barriers to entry, the discrepancy between R_2 and R_3 is not self-correcting. Under these circumstances, a properly designed tax incentive could increase sectoral efficiency by drawing resources from the overcapitalized widget industry to the undercapitalized gidget industry.

In particular, suppose that the gidget industry receives a tax incentive: each gidget produced generates an income tax deduction for the manufacturer of gidgets. Moreover, assume this incentive is financed by a new tax imposed on the widget industry. As a result, the after-tax supply schedule of the widget industry shifts from $S_{W2}S_{W2}$ to $S_{W1}S_{W1}$, reflecting that industry's newly-imposed tax burden, and the widget industry moves to production point A_W. The consequent output reduction raises the widget industry's pretax rate of return to R_1. The gidget industry, now tax-subsidized, confronts after-tax supply schedule $S_{G1}S_{G1}$, resulting in an expansion of gidget production and a decline in that industry's rate of return to R_1. Thus, manipulation of the tax system satisfies the requirements of sectoral efficiency: a single rate of return prevails in both sectors of the economy. Hence, the tax policies postulated here have facilitated rather than retarded sectoral efficiency.[51]

A similar story can be told analyzing sectoral efficiency from the consumer's perspective. A critical premise of sectoral efficiency is that consumers can freely shift their expenditures between the different sectors of the economy. But suppose instead that, because of economies of scale, downpayment requirements, credit market imperfections, or other barriers, consumers cannot freely choose between the consumption of gidgets and widgets. Assume that consumers cannot consume widgets as

51. Jorgenson & Sullivan, *supra* note 36, at 1397 ("The common feature of tax systems leading to an efficient allocation of capital is that they result in the same effective tax rate for all assets.").

easily as gidgets. Thus, P_4P_4 represents the effectively higher price confronting the consumer in the (now restricted) widget market (see figure 5). Associated with price P_4P_4 is point of consumption I_W in turn associated with marginal utility X_3. P_3P_3 now represents the effective price of gidgets, gidgets being available without restriction. Plentiful gidget consumption generates marginal utility X_2.

Assuming that consumption cannot be adjusted freely between sectors, tax incentives may enhance sectoral efficiency. For example, consider a tax which rewards gidget consumption and penalizes widget consumption. The requirements of sectoral efficiency (that both items be consumed to marginal utility level X_1) can be achieved by a tax incentive that suppresses gidget consumption to the quantity J_GK_G and subsidizes widget consumption until it reaches the quantity H_WQ_W. The mortgage interest deduction plausibly can be defended along these lines. Given significant barriers to the purchase of housing, such as the need for downpayments and mortgage availability, the interest deduction may serve to overcome these barriers. Sectoral efficiency is thus enhanced by propelling consumers to purchase the housing they would have consumed in the barriers' absence.

2. The Assumption of No Externalities.—One of the interesting contrasts between the tax incentive debate and the common-law debate is the absence in the former of a concern that has become critical to the latter: the possible presence of externalities arising from particular classes of transactions. Although the concept of externalities has animated much of the literature in the common-law debate relative to the development of efficient tort and property law rules,[52] one searches in

52. For an overview of the literature of the common-law debate on externalities, see N. MERCURO & T. RYAN, *supra* note 10, at 43-44. For an interesting critique of the manner in which the concept of externalities has affected the common-law debate, see Huber, *supra* note 46, at 290; *see also* Ellickson, *Public Property Rights and Liabilities as a Technique for Correcting Intergovernmental Spillovers*, in URBAN INSTITUTE, ESSAYS ON THE LAW AND ECONOMICS OF LOCAL GOVERNMENT 51 (D. Rubinfeld ed. 1979) (urging creation of public rights and responsibilities to resolve problems of externalities) [hereinafter cited as ESSAYS]; Epstein, *Why Restrain Alienation?*, 85 COLUM. L. REV. 970 (1985) (arguing that restraints on alienation and the tort system have a protective function and can be used in combination to control externalities effectively); Rose-Ackerman, *Inalienability and the Theory of Property Rights*, 85 COLUM. L. REV. 931 (1985) (arguing that externality controls are secondary to paternalistic or market-oriented rationales for limitations on the tranferability, ownership, and use of property); Tideman, *Liability Rules, Compulsory Exchange, and Compensated Incentive Compatibility: Toward Improved Management of Urban Externalitites*, in ESSAYS, *supra*, at 105 (confronting problems of "large number" externalities, when economic solutions are less clear cut); White & Wittman, *Long-Run Versus Short-Run Remedies for Spatial Externalities: Liability Rules, Pollution Taxes, and Zoning*, in ESSAYS, *supra*, at 13 (discussing tax liability and zoning policies in resolving problems caused by externalities). For some thoughts on externalities in the context of the controversy about social investing, see Zelinsky, *The Dilemma of the Local Social Investment: An Essay on "Socially Responsible" Investing*, 6 CARDOZO L. REV. 111 (1984).

vain through the legal literature on tax incentives for a comparable awareness that questions of efficiency may be affected by the possibility of externalities. Externalities, it may fairly be said, have been assumed away in the discussion of tax incentives.

The significance of that assumption may be explored by again modifying the two-sector economy of widgets and gidgets. First, relaxing the assumption there are no externalities, suppose that the production and sale of widgets produces positive externalities for persons not affiliated with the widget industry but that gidgets have no comparable effects. Second, assume that the external benefits of widget production fall upon a group too large and disorganized to bargain with the widget industry and that the benefits derived by this group are comparable, in economic effect, to the addition of n to the rate of return of the widgets industry.[53]

On these assumptions, capital, even if freely mobile, will not be allocated between widgets and gidgets to maximize the economy's total profitability. Because it derives no return from the externalities it is generating, the widget industry will produce so that its (private) rate of return, R_1, equals that of the gidget industry. This point, however, does not represent maximum productivity for the economy as a whole. Although private rates of return have been equalized between widgets and gidgets when both are at R_1, the total (social) return to widgets is greater, R_1 *plus* n, implying that resources should be diverted from gidgets to widgets until the return to gidgets equals the total return to widgets, including n. At this latter point, the return to gidgets will be higher than the private rate of return to widgets because the latter does not reflect the yield n generated by externalities.

This result has interesting implications for the oft-repeated complaint that ACRS is sectorally inefficient because it generates different after-tax rates of return for different industries.[54] That two industries have different rates of return does not per se indicate sectoral inefficiency. It must be further established that the industry with the lower return on investment does not generate positive externalities which bring that industry's total return to the higher level of the other industry. This result, moreover, provides a potential economic rationale for using tax

53. As Professor Coase made clear in his classic article, the implications of externalities are different if those affected can reasonably bargain with the person producing the externalities. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1, 18 (1960). For some recent analyses of Professor Coase's article, see Hoffman & Spitzer, *Experimental Law and Economics: An Introduction*, 85 COLUM. L. REV. 991, 1009 (1985); Kelman, *Comment on Hoffman and Spitzer's "Experimental Law and Economics,"* 85 COLUM. L. REV. 1037 (1985).

54. *See* Auerbach, *supra* note 3, at 1343-50; Jorgenson & Sullivan, *supra* note 36, at 1397; Warren & Auerbach, *supra* note 36, at 1597.

incentives to expand the output and lower the private rate of return of those industries which do generate desirable externalities.

A comparable analysis results from an examination of tax incentives aimed at consumption. If gidget consumption generates positive externalities for the consumer's neighbors but widget consumption does not, the equalization of the consumer's per dollar marginal utilities between widgets and gidgets does not maximize total utility in the economy. Under these circumstances, sectoral efficiency could be enhanced by a tax incentive designed to increase gidget consumption at the expense of widgets. Although such an incentive nominally will cause the taxpayer to overconsume gidgets, from a broader perspective, this overconsumption will be efficient as positive externalities are generated. This line of reasoning is particularly relevant to the mortgage interest deduction. It is possible that the allegedly inefficient overconsumption of housing may actually be a sectorally efficient maximization of the externalities generated by housing for neighboring property owners.[55]

The notion of externalities is not without its problems and limitations. It seems reasonably clear that a homeowner upgrading the exterior of his house confers an incidental benefit upon adjoining owners by enhancing property values. Indeed, the externalities generated by property improvements are a major consideration behind zoning and land use codes in urbanized areas.[56] However, matters are not always so simple.

Homeownership argnably has other benefits for the homeowner's neighbors. Some believe that homeowners are more responsible and stable members of the community than tenants. The homeowner, in this view, is more concerned about the quality and costs of public services. He is more attentive to the property rights and concerns of others as he has similar rights and concerns. The homeowner may have a greater interest in the welfare of the neighborhood and community. That interest may manifest itself in a variety of ways, such as more active participation in anti-crime efforts or involvement in civic and political associations. Conceivably, these "citizenship externalities" provide a rationale for subsidizing homeownership.

Others, however, might object that the alleged citizenship externalities of homeownership are nonexistent or are too ephemeral to justify

55. This defense of the interest deduction takes into account that the deduction supports not only new construction and improvements of existing property, but also the purchase of existing real estate. Significant positive externalities may result from a government policy which encourages old owners to sell (rather than abandon) property and which encourages new owners to acquire and care for existing real estate. Indeed, current owners will be more likely to upgrade their properties when they are confident that a future purchaser exists.

56. *See* R. BISH & H. NOURSE, URBAN ECONOMICS AND POLICY ANALYSIS 257 (1975).

subsidizing homeownership.[57] For still others, the citizenship externalities of homeownership might be real but negative: the stabilizing political effects of homeownership might, for instance, be unwelcome to those who prefer an isolated, disinterested citizenry. Much of the common-law debate has been devoted to sorting out these types of questions. For our purposes, however, a definitive resolution of these concerns is not necessary. As long as some externalities exist and can be identified as positive or negative, considerations of sectoral efficiency will require that those externalities be reckoned with when evaluating a tax incentive.

3. The Assumption that All Relevant Sectors Have Been Identified and Analyzed.—An analysis of a tax incentive based on sectoral efficiency is potentially subject to the objection that there exist sectors of the economy not comprehended within that analysis. To explore this critique, assume that, in addition to the widget and gidget industries, there is a third sector in the economy, the midget industry. Further assume that the midget industry is starved for capital and that its current rate of return is substantially in excess of the rates of return for widgets and gidgets. Against this background, the calibration of widget production vis-à-vis gidget production is of diminished significance. It is less compelling to move widget resources to gidget production when, in a broader context, resources from both widgets and gidgets should be flowing into midget production.

A comparable observation is appropriate if the rate of return to midgets is less than that to either widgets or gidgets. In these circumstances, a broad view of the economy implies that resources should be moving from relatively unprofitable midget production into both gidget and widget manufacturing. The effort to increase gidget production at the expense of widgets, or *vice versa*, is of diminished significance when both sectors should be expanding at the expense of midgets.

This problem is illustrated by the observations of one commentator[58] who defended pre-ACRS tax incentives for investment on sectoral grounds because they moved capital from the housing market, with an allegedly low rate of return, to commerical and industrial uses with higher rates of return. He proclaimed those incentives a success on that basis.[59] Buried in his analysis is the assumption that other sectors of the economy are not relevant. Perhaps capital should go to neither housing

57. For example, Richard Goode has characterized "the civic virtues associated" with home ownership as "somewhat vague." R. GOODE, THE INDIVIDUAL INCOME TAX 122 (rev. ed. 1976).

58. Harberger, *Discussion* in TAX INCENTIVES AND CAPITAL SPENDING 263-69 (G. Fromm ed. 1971).

59. *Id.* at 269.

nor industrial machinery and equipment, but instead to consumption or nondepreciable investments such as land. Analysis of particular sectors is always subject to the qualification that, if omitted sectors were considered, the results might change.

4. The Implicit Assumption that Conditions Under Which Efficiency Is Maximized Are Static over Time.—A final critique of sectoral efficiency is that, even if all relevant sectors of the economy have been identified, even if resources can flow freely between all of these sectors and even if there are no externalities to be considered, the pursuit of sectoral efficiency may lead to the short-term maximization of goods and services that, given long-term improvements in the competitiveness of the economy, ought not be maximized. Sectoral efficiency, to continue our example, requires the equalization of rates of return in the widget and gidget industries. Assume underlying conditions in those two industries are radically different. Assume also that the widget industry must buy its supplies from monopolists who restrict output and inflate prices. Further suppose that other suppliers of the widget industry are subject to governmentally imposed price restrictions which increase the prices at which the widget industry buys its inputs.

Under these circumstances, shifting resources from widgets to gidgets may enhance sectoral efficiency. In the short run, resources deployed in the gidget industry may generate a higher rate of return than if retained by widget manufacturers. In the long run, however, the opposite may be true: if antitrust enforcement or technological improvements eliminate monopoly conditions among the suppliers of the widget industry or if governmental price restrictions are removed from the industry's other suppliers, the widget industry will be able profitably to expand its output. The imperatives of sectoral efficiency, however, require that capital be diverted from the widget industry while these developments are awaited.

D. Technical Efficiency Further Explored

1. The Problem of Design.—Considerations of technical efficiency impel us to ask whether a tax incentive can be designed to compensate taxpayers ouly for the marginal consumption and production that would not have occurred but for the presence of the incentive.[60] Because it is in the taxpayer's interest to understate the level of production or consumption he would have engaged in without the tax incentive, it is difficult to

60. *Cf.* Slitor, *supra* note 41, at 267 ("[r]elating the incentive benefit only to investment effort above what would have been done anyway . . . is difficult and complex to implement.").

determine whether he should qualify for the incentive. Presumably, a technically efficient incentive utilizes some objective means of differentiating between activity which should be rewarded and that which should not.

One possibility is the use of the taxpayer's prior history to determine a base level of production or consumption to be treated as the amount undeserving of subsidization. For example, the taxpayer's average annual level of investment for the previous five years could be calculated and, in year six, accelerated depreciation granted only for investment in excess of the prior years' average.[61]

Such a tax incentive still might be inefficient in a technical sense. If the five base years, for example, were years of recession while in year six the economy was booming, the prior years' average would be a poor proxy for investment likely to occur in year six without the incentive. Improving economic conditions alone would have caused increased investment over the prior years' average.[62]

An alternative solution is to develop general industry norms, *e.g.*, all widget manufacturers with previous annual sales of $1,000,000 will be presumed to invest $200,000 in equipment in the next year. Any investment over that level will be deserving of subsidy. Again, any measure along these lines is likely to be crude and inaccurate when applied to all but the most typical of taxpayers.

2. The Question of Transactions Costs.—A second notion playing a significant role in the common-law debate but largely eschewed in discussions of tax incentives is the concept of transactions costs.[63] In the context of technical efficiency, tax incentives may be a more efficient means of implementing government policies than direct expenditure programs because of lower transactions costs. Tax incentives efficiently communicate government policies through an existing information network, that is, the network of professional advice and assistance that exists to comply with the tax law.[64]

61. This was the approach taken in the design of the credit for qualified research expenses. I.R.C. § 30 (West Supp. 1986). However, it was considered and rejected for the investment credit. *See* Lubick & Brannon, *Stanley S. Surrey and the Quality of Tax Policy Argument*, 38 NAT'L TAX J. 251, 252 (1985).

62. By the same token, if the taxpayer's average was based on five strong years and the sixth year was a time of recession, rewarding only that portion of the sixth year's investment exceeding the five year average might defeat the purpose of the incentive. In year six, given the nature of the economy, no investment might occur without the incentive.

63. *See* N. MERCURO & T. RYAN, *supra* note 10, at 56, 83; Coase, *supra* note 53, at 15-19.

64. This analysis presumes that a decision has been made for the federal government to engage in spending and that, therefore, the issue has become one of means: direct expenditures as opposed to tax incentives.

From the government's perspective, a complete measure of technical efficiency must consider the transactions costs of disseminating policies to the taxpayer and securing compliance with those policies. Suppose, for example, the government wants to encourage businesses to hire Vietnam veterans having a difficult time integrating themselves into the economy.[65] Technical efficiency dictates that the government minimize rewarding businesses for hiring veterans whom the businesses would have hired anyway. The government must also minimize transactions costs by communicating its policy to businesses as cheaply as possible. The more expensive it is for an employer to learn of the benefits of hiring Vietnam veterans, the greater those benefits must be to have any effect insofar as some of the benefits will be absorbed by transactions costs incurred by the employer.

Communication through the tax system is frequently the government's cheapest method of conveying its policies, particularly in the case of small businesses and middle-income taxpayers. The taxpayer will incur the costs of complying with and receiving information about the tax system anyway. Middle-class and business taxpayers typically file annual returns. These taxpayers often require professional accounting and legal services to organize their financial data and prepare returns.[66] Given this fixed annual expense of complying with the tax system, the marginal costs of communicating policies through the accounting and legal professions and the tax preparation process frequently would seem to be lower than the alternative.[67]

Consider that alternative in the case of the policy of stimulating the hiring of veterans, namely, some type of direct expenditure program administered through the Department of Labor or other nontax agency. How will businesses learn of the existence of such a program? Many large businesses might shift some of their personnel from their tax offices

65. One such provision is I.R.C. § 51(d)(4) (1982). Congress has extended this credit through 1988. *See* The 1986 Act § 1701 (extending the termination date of this employer credit in I.R.C. § 51(c)(3) (Supp. III 1985)).

66. *Cf.* Doernberg, *supra* note 2, at 431 (discussing the Hall-Rabushka tax plan, one tenet of which is to simplify tax returns so that the taxpayers can fill out their own returns). President Reagan's proposal for a return-free system would initially apply only to taxpayers "with uncomplicated financial transactions." In its final form, the return-free system would be available to more than fifty percent of all taxpayers. The system would be purely voluntary and would depend on some information supplied by the taxpayer. THE PRESIDENT'S TAX PROPOSALS, *supra* note 1, at 115.

67. Professor Gutman has suggested to me that the income tax system could be used to communicate federal policies without the government actually giving tax incentives. Information about direct expenditure programs could be communicated on the federal income tax return with no adjustment made to the taxpayer's tax liability. The idea is an interesting one which probably deserves experimentation. My instinct, however, is that any information which does not affect tax liability is likely to be disregarded.

to departments which will monitor direct government subsidies. For the small businessman, a network of professionals may emerge to inform him about direct government expenditure programs.[68] Such a businessman already has engaged, however, and will continue to engage, a network of professionals to handle his taxes. It would be cheaper for the government to communicate its policies through one rather than two professional networks.

Seen in this light, the annual process of preparing a tax return becomes not merely the procedure for making a yearly contribution to the government's revenue, but a method of inexpensively disseminating government policies. Consider again the credit for hiring Vietnam veterans. A common criticism of such credits is that the taxpayer learns of them when his return is prepared, after he has already engaged in the subsidized hiring.[69] This criticism has validity in the first year the credit is being claimed. But something else is occurring in that first year: the taxpayer is being educated about the credit for the current and future years. It may be cheaper to inform the taxpayer of these policies as part of his annual tax-return process rather than force him to participate in an essentially duplicative procedure for learning about direct expenditure programs.

From this perspective, tax planning, widely condemned by the opponents of tax incentives as a waste of time and energy,[70] acquires a new social virtue. Tax planning may represent the communication and implementation of government policies by technically efficient means, that is, at minimal cost.[71]

68. Or the small business will not learn of the program at all.

69. For a critique of energy-related tax credits along these lines, see McIntyre, *supra* note 1.

70. *See, e.g.*, Aaron & Galper, *A Tax on Consumption, Gifts and Bequests and Other Strategies for Reform*, in OPTIONS FOR TAX REFORM 118 (J. Pechman ed. 1984) ("The result of all this activity has little if any social value); Bird, *Comments on Tax Arbitrage, Inflation, and the Taxation of Interest Payments and Receipts*, 30 WAYNE L. REV. 1015, 1017 (1984) (criticizing "the substantial real costs imposed on the economy by using up so many of society's good minds in the socially useless activity of tax planning"); Doernberg, *supra* note 2, at 426, 451, 484 (arguing that adoption of the Hall-Rabushka tax plan would eliminate the inefficiency and waste of the current tax system); Gephardt & Bryant, *The Fair Tax Act: A Plan for a Simple, Fair, and Economically Rational Tax*, 12 NOTRE DAME J. LEGIS. 129, 132 (1985); Comment, *Capital Gains Taxation and the Fair Tax Act*, 29 ST. LOUIS U.L.J. 1219, 1247 (1985) (decrying the "army of tax professionals" generated by the current Code); Samuelson, *The Urgency of Tax Reform*, NEWSWEEK, June 3, 1985, at 56 ("Not only do [tax incentives] misallocate investment funds, but they misuse the nation's talent. All the bright lawyers, accountants and executives exploiting the tax code for private profit produce no new wealth. They would be better employed in productive work.").

71. And much of the criticism of tax planning more appropriately would be addressed to the substance of the policies being implemented.

IV. The Common-Law Definitions of Efficiency and the Rehabilitation of the Tax Incentive

A. The Common-Law Definitions

Those familiar with the common-law debate may find it unusual that the discussion so far has avoided the vocabulary of Pareto optimality, Pareto superiority, and Kaldor-Hicks efficiency central to the common-law debate.[72] In part, the absence of that terminology here merely mirrors its absence in the tax literature. It also reflects a tactical decision to explore initially the question of efficiency and tax incentives unencumbered by the controversies that have emerged from the common-law debate.

But it is now appropriate to compare the terms of analysis developed here—universal market efficiency, sectoral efficiency, and technical efficiency—with the concepts of the common-law debate. That comparison confirms and clarifies some of the insights derived so far and provides some new perspectives on the question of tax incentives and efficiency.

1. Pareto optimality.—There is a strong, though not perfect, correlation between the notions of universal market efficiency and Pareto optimality. One might characterize universal market efficiency as a large subset of Pareto optimality. According to the notion of Pareto optimality, a given economic state is efficient if, and only if, no actor's position can be improved except at the expense of some other actor.[73] The normative force behind the ideal of the perfectly competitive economy stems from the conclusion that perfect markets will result in such an economic

72. The literature of the common-law debate has become so voluminous that any selection is bound to be arbitrary. *See, e.g.*, R. POSNER, *supra* note 8; Coleman, *supra* note 8; Michelman, *Microeconomic Appraisal of Constitutional Law: A Methodological Preface*, in ESSAYS, *supra* note 52, at 137-79; Posner, *supra* note 6; *Symposium on Law and Economics*, *supra* note 8; *Symposium on Efficiency as a Legal Concern*, *supra* note 9; *A Response to the Efficiency Symposium*, *supra* note 9. For an overview of the common-law debate and its literature, see N. MERCURO & T. RYAN, *supra* note 10. For one journalist's view of the common-law debate, see Wermiel, *Scholars Blend Law, Economics*, Wall St. J., Dec. 18, 1984, at 64. The common-law debate is not the only body of relevant literature which has yet to affect legal discussion of tax incentives. There is extensive economic literature on the use of pollution taxes to abate environmental damage. Many of the economic concerns discussed and identified here have been analyzed in this literature. For an introduction to the economic analysis of pollution taxes, see R. MUSGRAVE & P. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 677 (1973).

73. Phrased alternatively, efficiency has been obtained under Pareto optimality only when the situation is a zero sum game: if one player in the economy can improve his status only by hurting someone else, efficiency, in the Pareto optimality sense, has not yet been obtained. *See* ESSAYS, *supra* note 52, at 7; MERCURO & RYAN, *supra* note 10, at 7-9, 25-26, 45-47; Coleman, *supra* note 8, at 83-84.

state.[74] Markets, however, are theoretically unnecessary for the achievement of Pareto optimality. In principle, an omniscient and omnipotent central planner could arrange affairs to comply with the criteria of Pareto optimality. Perfect competition is thus a sufficient, but not a necessary, condition for Pareto optimality.

The useful, if imperfect, correlation between Pareto optimality and universal market efficiency is revealing in an important respect. A consensus has emerged from the common-law debate that Pareto optimality is not a useful guide for policymakers, in part for reasons similar to those discussed in the context of universal market efficiency,[75] but also because of problems in the transition to the Pareto optimal state.[76] The movement to Pareto optimality paradoxically may diminish the welfare of one or more persons in the economy although the Pareto optimal state, once obtained, may be characterized as an efficient allocation maximizing those persons' welfare.

This paradox can be illustrated by assuming a two-person economy in which X and Y own all the existing resources. Assume initially that this economy is at point A where X owns resources worth QM and Y possesses resources worth QN (see figure 12). The curved line SS represents the outer limits at which the economy could produce given its current capabilities. Point A does not represent a Pareto optimal state. If the economy moves to point H, the welfare of both X and Y would be enhanced, not at each other's expense, but rather by expanding total production in the economy. In this particular setting, Pareto optimality corresponds with the intuitive notion that an economy is not at its most efficient if it produces less than its potential.

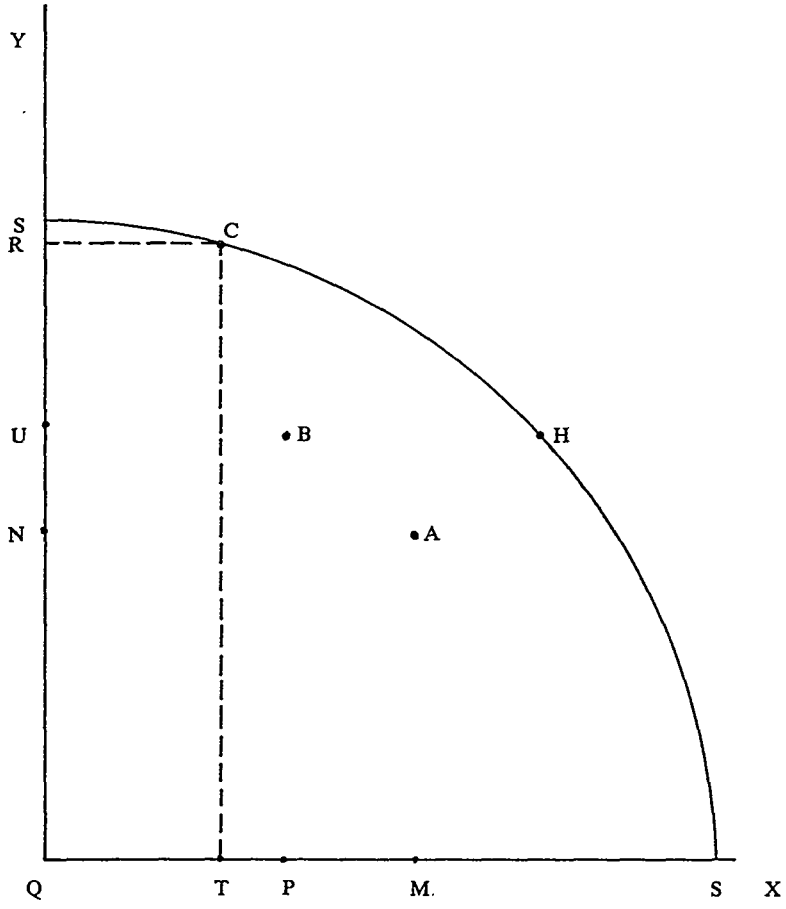
If, however, the economy moves northwest of point A, for example, to point B, the position of Y has been improved while that of X has been diminished. At point B, Y's share of the economy's resources has increased from QN to QU while X's share has declined from QM to QP. When the economy moves to point C, X's welfare is diminished further. Point C, however, like point H, satisfies the criteria of Pareto optimality. At C, the economy is producing on line SS, its maximum. Consequently, Y's welfare can be enhanced further only by moving northwest of point C, a development detrimental to X. The concept of Pareto optimality is limited because it does not take into account X's unwillingness to con-

74. N. MERCURO & T. RYAN, *supra* note 10, at 25-26, 45-47.

75. *See supra* subpart III(B).

76. *See* Coleman, *Efficiency, Utility and Wealth Maximization, Symposium on Efficiency as a Legal Concern*, *supra* note 9, at 509, 540-48 (arguing that "the exercise of liberty [that] leads to Pareto-optimal states of affairs" may be impaired by inadequate information for making choices or by the fact that "some individuals acting freely may make themselves worse off").

FIGURE 12



done the movement of the economy from *A* to *B* to *C*. Pareto optimality is thus an incomplete guide for policymakers because it ignores a central concern: what to do about those harmed by economic change.[77]

The same observations apply for a transition to universal market efficiency. Even if we could identify the optimal allocation of the economy's resources and even if the elimination of a particular tax incentive

77. In contrast, the Pareto-superior definition indicates that those harmed by economic change are to be reimbursed for their losses. *See infra* subpart IV(A)(2). The Kaldor-Hicks concept of efficiency indicates that enough resources must be created through economic change so that, if the losers are to be reimbursed, the resources will exist with which to do so. *See infra* subpart IV(A)(3).

moved the economy toward that allocation, those whose welfare is tied to the previously subsidized industry will be unimpressed by the assertion that universal market efficiency is the most desired state of the economy.

The proponents of sectoral efficiency cannot take comfort in the notion of Pareto optimality either. Sectoral efficiency advocates eschew any claim that it constitutes the optimum allocation of the society's resources. Proponents of sectoral efficiency assert only that, accepting the flaws of the economy, a sectorally efficient economy is one in which profitability and utility are maximized given those flaws. Once sectoral efficiency is achieved, however, there still will be improvements in the economy's performance that could be achieved by reducing the economy's underlying imperfections.[78]

2. Pareto Superiority.—Pareto superiority may be characterized as a response to the inadequacies of Pareto optimality vis-à-vis issues of transition. Under Pareto superiority, a change in the economy is deemed efficient if, and only if, such change improves the welfare of one or more participants in the economy while leaving the other participants at least as well off as before the change was made. Although Pareto optimality is a static notion, defining efficiency from the perspective of the economy's final arrangement of resources, Pareto superiority focuses upon the process of transition, defining efficiency by what occurs during that transition.[79]

From the perspective of Pareto superiority, the movement from A to B to C in figure 12 does not enhance efficiency because Y's welfare is improved at the expense of X. In contrast, the movement of the economy from A to K (see figure 13) is efficient because no one loses in the movement to K, even though K itself is not efficient in the Pareto optimal sense of the term. Under the criteria of Pareto superiority any move from A to a point in the area bounded by ALT is efficient.

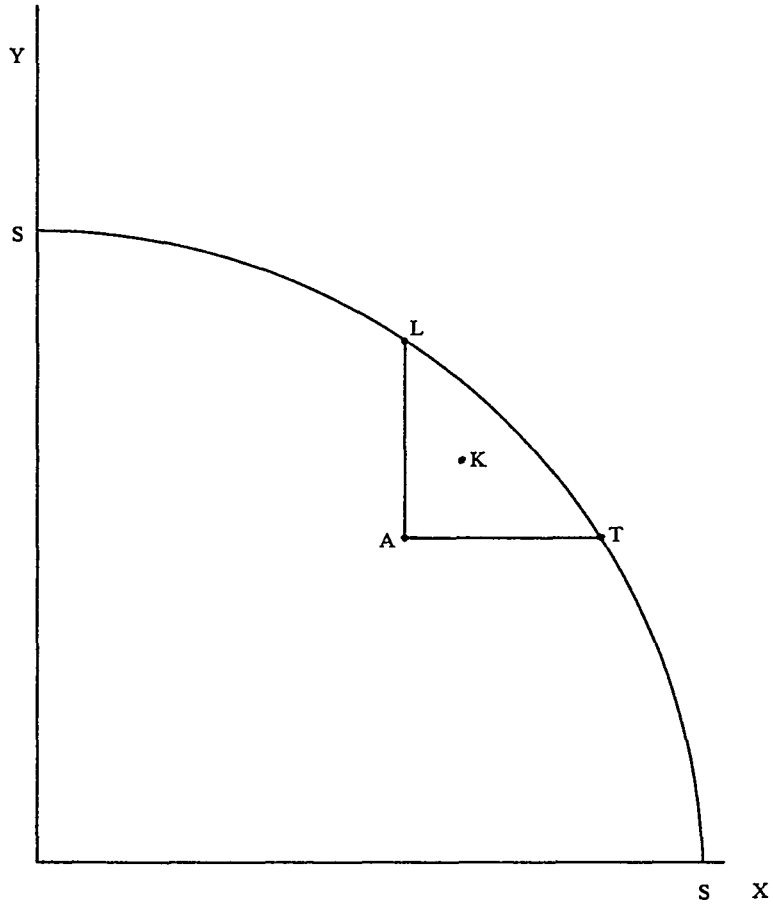
In the context of tax policy, Pareto superiority is a prescription for political paralysis. Movement towards sectoral efficiency is Pareto superior only if each of the persons harmed by the movement is made whole.[80] This implies, *inter alia*, that some of the enhanced profits resulting from the achievement of sectoral efficiency must be taxed and redistributed among those with interests in the previously tax-subsidized

78. See *supra* subpart III(C)(3) (discussing the criticism that sectoral efficiency analysis of a tax incentive ignores relevant sectors of the economy).

79. *See* Coleman, *supra* note 8, at 83-84.

80. This is because a change is Pareto superior only if those not benefiting from the change are at least as well off as before the change. For a discussion of some of these issues, see Kempler, *supra* note 13.

FIGURE 13



industries. Assuming we could identify all of the losers and accurately measure their losses, the notion of Pareto superiority, in effect, recognizes in these subsidized industries a form of property right for which compensation must be granted whenever the government changes the tax law. The notion of Pareto superiority reduces the concept of technical efficiency to a *non sequitor*. The achievement of technical efficiency is Pareto superior only if the savings achieved by the government are used to reimburse completely those affected by the change. It is difficult to see why the government would bother.

3. Kaldor-Hicks Efficiency.—In the common-law debate, no doubt because of the deficiencies of Pareto optimality and Pareto superiority, a third definition of efficiency has become preeminent. Kaldor-Hicks efficiency has been characterized alternatively as potential Pareto superiority or, by then Professor Posner, as "wealth maximization."[81] Under Kaldor-Hicks efficiency, a change from one economic position to another is efficient if, and only if, the increase in one person's welfare is greater than the detriment to those hurt by the change. In other words, Kaldor-Hicks efficiency requires the winners gain enough from a change that, with their increased wealth, they could fully reimburse the losers and still have something left over. Kaldor-Hicks efficiency, however, unlike Pareto superiority, does not require that reimbursement occur but only that enough resources be created so that it could occur if desired.

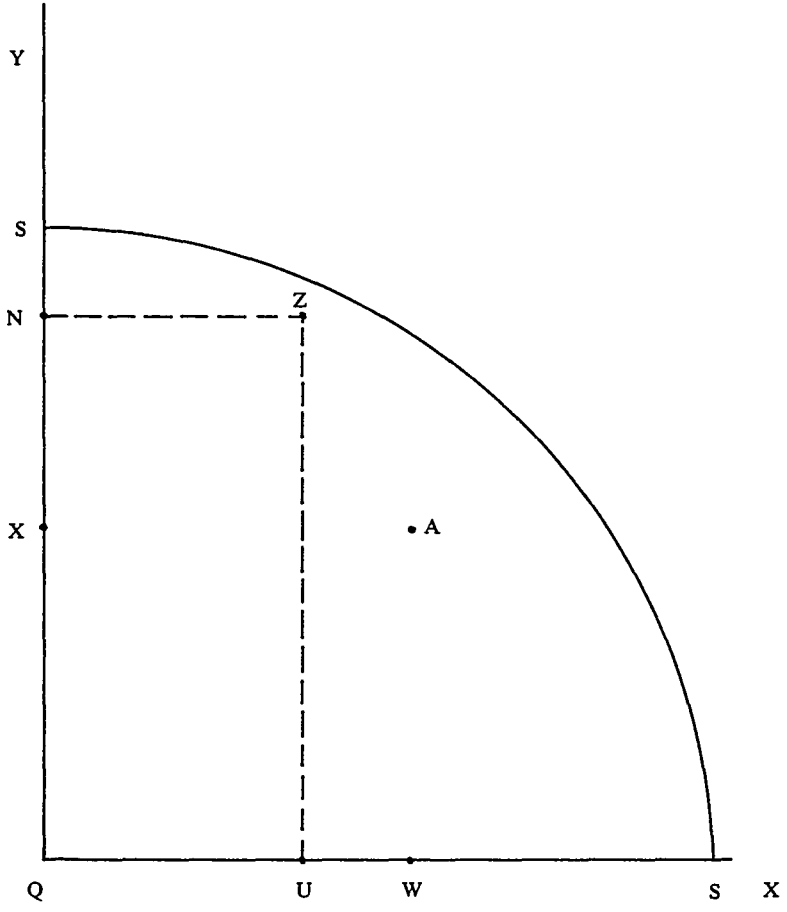
Under the regime of Kaldor-Hicks efficiency, movement from point *A* to *Z* would be efficient (see figure 14). At point *A*, *X* owns the resources measured by *QW* while *Y*'s resources are represented by *QX*. Although the move to point *Z* decreases *X*'s resources by *UW* to *QU*, *Y*'s resources are increased by *XN*. Because *XN* exceeds *UW*, *Y* could, after the change, compensate *X* for all of his loss and still come out ahead. Whether *Y* will make or be required to make this reimbursement is irrelevant under the Kaldor-Hicks regime.

Both sectoral efficiency and technical efficiency are compatible with the Kaldor-Hicks definition. Indeed, the Kaldor-Hicks concept of efficiency is implicit in the policy prescriptions of many who oppose tax incentives on economic grounds: the creation of additional profitability or the maximization of the government's revenue is, for these commentators, a satisfactory improvement from the current state of affairs.[82] The use of the government's newly retained revenue or the identity of the ultimate beneficiaries of the economy's enhanced profitibility is irrelevant to these observers.

81. Posner, *supra* note 6, at 291-95; *see* N. MERCURO & T. RYAN, *supra* note 10, at 8, 70; Coleman, *supra* note 8, at 84; Posner, *The Economic Approach to Law*, 53 TEXAS L. REV. 757, 772-78 (1975).

82. *See, e.g.*, Auerbach, *supra* note 3, at 1342 (suggesting that the importance of the characteristics of a tax incentive rest in their "role in determining how well a given proposal will succeed in increasing productivity and welfare"); *see also* Warren & Auerbach, *supra* note 36 (criticizing the capital recovery and leasing provisions added to the Internal Revenue Code by TEFRA).

FIGURE 14



B. The Uneasy Rehabilitation of the Tax Incentive

Where does this discussion leave the economic case against tax incentives? Over a generation ago, Professors Blum and Kalven, in one of the classics of legal literature, reviewed the case for progressive taxation and pronounced it an "uneasy" one.[83] That designation is a proper label for the claim that tax incentives are inefficient. It is also a fair character-

83. Blum & Kalven, *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417, 519 (1952).

ization of my conclusion that tax incentives deserve rehabilitation as instruments of federal policy.

1. Substance Versus Procedure.—It is necessary to distinguish between two different issues raised by the opponents of tax incentives. The first issue is a substantive one, whether the federal government should intervene in the domestic economy at all. The second issue, raised only if the first is decided affirmatively, is the procedural question of how best to intervene. Notions of universal market and sectoral efficiency relate to the first question, whether the federal government ought interfere with the operation of the economy. The concept of technical efficiency relates to the second issue, how the federal government should intervene once the merits of intervention are established.

This difference in emphasis is embodied in the contrasting writings of the most prominent proceduralist opponent of tax incentives[84] and the most recent and influential statement of substantive opposition to tax incentives.[85] Professor Surrey's work, by and large, criticizes tax incentives on methodological grounds as an inferior method of federal intervention once the value of intervention is established. In contrast, the 1984 report of the Treasury, forerunner of Congress' comprehensive revision of the Internal Revenue Code, embodies an essential hostility to government intervention in the economy. Unlike Professor Surrey, the draftsmen of the Treasury report were not exploring the relative merits of tax incentives as opposed to direct expenditure programs. Rather, the Treasury wrote a brief for a policy of nonintervention in the domestic economy.

It is instructive that Professor Surrey viewed revenue sharing by the federal government as a means of aiding states and localities without incurring the disadvantages associated with tax expenditures like municipal bonds.[86] For Professor Surrey, the relevant issue was not one of ends (whether to subsidize states and municipalities) but one of means (tax subsidies through the Internal Revenue Code as opposed to revenue sharing directly from the federal fisc). For the Reagan Treasury, however, opposition to the deductibility of state and local taxes is part of a broader preference for federal nonintervention. The Treasury opposes tax-based

84. S. SURREY, *supra* note 1.

85. *See* TREASURY DEPT., TAX REFORM FOR FAIRNESS, SIMPLICITY, AND GROWTH, *supra* note 4; EXECUTIVE OFFICE OF THE PRESIDENT, THE UNITED STATES BUDGET IN BRIEF, FISCAL YEAR 1986 (Gov't Printing Office, Washington D.C. 1985) [hereinafter cited as 1986 BUDGET].

86. *See* S. SURREY, *supra* note 1, at 222 (not addressing the "wisdom of tax reform" but instead proposing that the tax reform needed in the area of state and local assistance could be achieved by "eliminating the tax expenditure").

subsidies for states and cities and also objects to revenue sharing for states and localities.[87]

Although many opponents of tax expenditure analysis perceive in it an unhealthy bias legitimating the government's control of society's resources,[88] the position developed here places the concept of the tax expenditure in a contrary light. For those opposed to government intervention in the domestic economy, tax expenditure analysis buttresses the preference for a more passive state on sectoral and universal market efficiency grounds. In the hands of the proceduralist opponents of tax incentives, tax expenditure analysis leads to the conclusion that political intervention in the domestic economy, while theoretically acceptable as a substantive matter, must be rejected because the tax system is an imperfect instrument with which to implement goverument policies.

2. Initial Assumptions and Secondary Effects.—The analysis developed here also highlights the extent to which one's conclusions in this area depend upon one's initial (and often subjective) premises. To the extent externalities are viewed as relatively minor factors in the economy or barriers to entry are deemed minimal, opposition to tax incentives based on sectoral efficiency can be quite compelling. Alternatively, if one believes externalities are important factors in parts of the economy or that barriers to entry are a significant problem in certain sectors, the case for goverument intervention, and for tax incentives in particular, acquires corresponding force. Similarly, if one accepts the assumption that the tax system is the cheapest method of communicating with certain taxpayers, the procedural case for tax incentives, as opposed to direct expenditure programs, can be convincing. If, on the other hand, the asserted transactions costs advantage of the tax system cannot be assumed until rigorous empirical data is developed, one's conclusions about tax incentives are likely to be different.

The extent to which one's conclusions in this area depend on one's assumptions can be demonstrated by examining the possible secondary

87. *See, e.g.*, Haider, *Balancing the Federal Budget: The Intergovernmental Casualty and Opportunity* in FINANCING STATE AND LOCAL GOVERNMENTS IN THE 1980S, at 205 (1981) (discussing the effects of Reagan tax policies and reduction of federal financial support for state and local governments, and ways for state and local governments to solve consequent financial problems) [hereinafter cited as FINANCING GOVERNMENTS]; Phyphers, *supra* note 1 (discussing the Reagan administration's tax reform policies).

88. *Compare* S. SURREY, *supra* note 1, at 222 (discussing the treatment of state and local taxes in relation to revenue sharing) *with* 1986 BUDGET, *supra* note 85, at 53 ("The administration is proposing to end general revenue sharing in 1986."). *See generally* Lubick & Brannon, *supra* note 61, at 257-58 (contrasting Professor Surrey's preference for direct expenditure programs with the preference of the Reagan Treasury "for a drastic reduction in [the] social objectives of government").

effects of tax incentives. Implicit in the analysis presented here has been the assumption of *ceteris paribis*. Modifying this assumption may affect the results of the analysis considerably. The mortgage interest deduction, as discussed above, may facilitate homeownership and generate positive externalities by reducing the after-tax price of housing. This result, however, may only be true in the short run. As more families enter the housing market because of the interest deduction, house prices will increase, thus eliminating some or all of the subsidy the mortgage interest deduction is intended to create. Hence, the repeal of the mortgage interest deduction might actually facilitate the purchase of housing by lowering prices. A possible response is that the deduction-induced inflation of housing prices may be of minor significance or may be self-correcting, higher prices evoke increased building and thus eventually lower housing prices.[89]

Similar considerations obtain when we examine the impact of ACRS. Developers, deprived of ACRS, might bargain more aggressively with unions, thus reducing labor costs. Stripped of ACRS, developers might mobilize politically to obtain the repeal of excessively constricting building codes. In either case, lower costs, stimulated by the repeal of ACRS, may move the real estate market closer to the point of optimal allocation. A counterargument is that profit-maximizing developers will seek the lowest possible costs whether or not they benefit from ACRS. Alternatively, the net reduction in after-tax costs associated with ACRS may be greater than the hypothesized reductions triggered by the repeal of ACRS.

The repeal of existing tax incentives or the introduction of new ones may indeed have secondary effects that are, in whole or in part, self-cancelling. This fact, however, does not imperil the basic position advanced here: some tax incentives, given certain assumptions, plausibly may be advanced as legitimate instruments of public policy. In cases in which it is feasible to determine the magnitude and direction of incentives' secondary effects, consideration of those effects will enable a more informed judgment as to the desirability of those incentives. The more common situations, however, may be those in which possible secondary effects can be identified but not measured with a great deal of precision. In those situations, the possibility of countervailing effects ought be a factor, but not necessarily a controlling one, in the decision to retain or institute a tax incentive. In a world of uncertainty, it is usually necessary to make assumptions whose accuracy is open to question. The case

89. For a discussion of some of these issues, see Hellmuth, *Homeowner Preferences*, in COMPREHENSIVE INCOME TAXATION, *supra* note 14, at 163.

against tax incentives, like the case for them, is dependent in many places on such assumptions.

3. Abandoning Universal Market Efficiency.—The analysis developed here also demonstrates the impropriety of premising substantive opposition to tax incentives on the universal market definition of efficiency. There is simply no way of knowing whether a particular incentive is moving the economy from or towards the point of optimal allocation.[90] Moreover, the transition to universal market efficiency has implications that are simply ignored by its definition.[91] Abandoning universal market efficiency weakens the economic case against tax incentives because much of the normative force and political appeal of that case stems from the connection between perfect competition and efficiency in our intellectual culture.[92] To the extent opponents of tax incentives use the term "efficiency" outside the context of perfect competition (as it appears they must), their case loses a notable amount of its normative appeal. And because sectoral efficiency and technical efficiency, constrained by the requirements of Pareto superiority lead to results that are impractical at best, and foolish at worst,[93] what is left for discussion is sectoral efficiency and technical efficiency from a Kaldor-Hicks perspective.

4. The Burden of Proof.—Another conclusion of this analysis is that the outcome of the tax incentive debate depends critically on which side bears the burden of proof. If we initially presume that the tax system is for the raising of revenue only and that the proponents of a particular incentive cannot assume any of the conditions justifying substantive or procedural support for tax incentives, those proponents have the heavy burden of rigorously establishing the efficiency of each particular incentive. Although the presence of barriers to entry[94] and of externalities[95] and the possibilities of lower transactions costs[96] can potentially justify particular tax incentives, it is often difficult to quantify those factors.

A different conclusion obtains if we accept that the tax system can be used legitimately for the implementation of federal policy and that the burden of proof lies with those condemning tax incentives as inefficient.

90. *See supra* subpart III(B).
91. *See supra* subpart IV(A)(1).
92. *See, e.g.*, P. SAMUELSON, *supra* note 38, at 609-11.
93. *See supra* subparts IV(A)(2)-(3).
94. *See supra* subpart III(C)(1).
95. *See supra* subpart III(C)(2).
96. *See supra* subpart III(D)(2).

In a case such as ACRS, its opponents probably can sustain the burden of proving that ACRS is sectorally inefficient insofar as it favors machinery and equipment.[97] A wealth of empirical literature has demonstrated that ACRS results in significant deviations in after-tax rates of return among a wide array of different industries and technologies.[98] There is no particular reason to identify the types of machinery and equipment favored by ACRS with significant externalities. Insofar as ACRS is primarily a subsidy for large, publicly-held corporations, it may be relatively inefficient. In the long run, these corporations have the ability to shift resources between different sectors of the economy. Moreover, it is acceptably efficient for the federal government to communicate with these corporations through direct expenditure programs because of their superior ability to monitor such programs.

The case against a provision like the mortgage interest deduction is another matter. Many observers share the perception that there are significant externalities and barriers to entry in the housing market: real estate values may be powerfully affected by the condition of neighboring properties and obtaining mortgage funds may be difficult, particularly for first-time purchasers.[99] Insofar as the interest deduction is utilized by middle-class households, communication with those households through the tax system may be less expensive than a separate direct expenditure program. Granting these premises, a plausible case can be constructed, on both substantive and procedural grounds, for the interest deduction as a program designed to maximize housing values. The opponents of tax incentives will be hard pressed to overcome that case if the burden is placed on them.[100]

Indeed, at one level, some opponents of tax incentives may not want

97. It should be noted that ACRS for real estate may stand on a different footing than ACRS for plants and equipment because of the externalities generated by tax-subsidized real estate.

98. *See supra* note 36 and accompanying text.

99. On externalities in urbanized areas, see R. MUTH, CITIES AND HOUSING 105, 118 (1969); Ellickson, *supra* note 52; Rose-Ackerman, *supra* note 52, at 958; Tideman, *supra* note 52; White & Wittman, *supra* note 52.

100. In supporting the mortgage interest deduction on both substantive and procedural grounds, I am aware of the tracing problems involved with an interest deduction, *i.e.*, allocating a particular interest deduction to a particular activity such as owner-occupied housing. Nor am I unmindful of the magnification of tax benefits which can result from "interest arbitrage." In short, although there are technical problems with an interest deduction, the point is that there are also good arguments for an interest deduction as a matter of efficiency, and that the benefits of such a deduction may make it worthwhile to cope with other problems such a deduction entails. *See* American Bar Association Section of Taxation Committee on Basic Tax Structure and Simplification, *Bradley-Gephardt and Kemp-Kasten Bills*, 38 TAX LAW. 381, 395 (1985); Cooper, *The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance*, 85 COLUM. L. REV. 657, 673, 716 (1985); McMahon, *supra* note 36, at 1057; Warren, *Accelerated Capital Recovery, Debt and Tax Arbitrage*, 38 TAX LAW. 549 (1985).

to premise their concerns on efficiency considerations. A persistent plaint of those opposing incentives is what Professor Surrey called their "upside-down effect": given even a mildly progressive rate structure, a dollar deduction is worth twenty-eight cents under the reformed Code for a high-income taxpayer; for a middle-income individual the same dollar deduction is worth only fifteen cents in tax relief; for the enlarged group of low-income individuals who need not pay federal income tax, a dollar deduction provides no incentive at all. For Professor Surrey and others, this pattern of subsidy is upside down, providing the greatest assistance to those in the least need and *vice versa*.[101]

The analysis developed here could provide a defense of the "upside-down effect" in certain instances: it may promote efficiency. Consider the neighborhoods in which our high- and middle-income taxpayers may live. Assume the taxpayer in the effective thirty-three percent bracket resides in an exclusive suburb of half-million dollar homes while his less affluent counterpart lives in a predominently blue collar neighborhood of aging tract houses. Viewed strictly from the perspective of efficiency, there may be a case for subsidizing the high-income taxpayer's housing investment more heavily than that of the middle-income taxpayer. Property values in the aging blue collar neighborhood may be less susceptible to enhancement through the tax system than are property values where the high-income taxpayer lives. In the name of efficiency, it may be desirable to encourage the person living in a half-million dollar home to acquire a second mortgage, improve his property and thereby generate externalities which increase the values of surrounding houses. Given the nature of the neighborhood in which the middle-income taxpayer resides, it is possible that potential appreciation in the area is limited. Thus, externalities generated by the taxpayer may be minimal and economic arguments for subsidizing that taxpayer's housing less compelling. Hence, efficiency may require that we subsidize the high-income taxpayer to a significant degree and his middle-income counterpart more modestly or not at all. Indeed, considerations of efficiency could lead us to encourage the high-income taxpayer to buy a second home in order to increase total real estate values.[102] In its reform of the Code, Congress has made pre-

101. *See, e.g.*, Surrey, *supra* note 1, at 720-25 (discussing the disparate effects of tax incentives and their greater worth to high income taxpayers); Pomp, *supra* note 16, at 23 (criticizing the mortgage interest and propery tax deductions). For a journalistic attack on the upside-down effect of the mortgage interest deduction, see THE NEW REPUBLIC, Apr. 29, 1985, at 11; *see also* TAX BREAKS, *supra* note 12, at 12. On the upside-down effect of the mortgage interest deduction, see Hellmuth, *supra* note 89, at 184, 195. For the rates under the recent tax code revision, see The 1986 Act § 101 (amending I.R.C. § 1 (Supp. III 1985) (adopting Rev. Proc. 85-55, 1985-2 C.B. 737)).

102. Here the concept of efficiency is used both sectorally and technically. From a sectoral perspective, the interest deduction would be justified by the externalities created by additional hous-

cisely this decision by providing mortgage interest deductions for second residences.[103]

Although this conclusion may be unpalatable to some (including this author), it must be acknowledged that concern for efficiency may lead in this direction. If inefficiency is an appropriate argument against a tax incentive, it is arbitrary to argue that the possible efficiency of an incentive cannot be considered in its favor.

The possible existence of citizenship externalities also has interesting implications.[104] If such externalities exist, are beneficial, and are substantial, the opposite conclusion may be drawn about the mortgage interest deduction: it may be valuable to encourage in middle- and low-income taxpayers the salutary tendencies associated with homeownership. The owner of a half-million dollar home may be generating all possible citizenship externalities already. Encouraging those less affluent to become or remain property owners may more productively generate additional citizenship externalities. Under this argument, heavier subsidies of homeownership for taxpayers of modest means will have a bigger payoff in increased citizenship externalities.

This Article deviates from the scholarly consensus in holding it presumptively appropriate to use the tax system for the implementation of federal policy in the domestic economy. Thus, the burden of proof should be placed on those asserting the inefficiency of any particular incentive or of incentives in general. This view stems, in part, from the substantive (and admittedly subjective) observation that externalities and barriers to entry do exist in important sectors of our economy. These conditions can justify government intervention. This view also results from the procedural analysis advanced earlier: given the unavoidable annual expenses of the tax system, the transactions costs of transmitting federal policy through the tax system may be less than the cost of communicating with taxpayers separately through a duplicate network of direct expenditure programs.[105]

5. Tax Incentives Versus Direct Expenditures.—The proceduralist opponents of tax incentives have, over the years, developed an analysis

ing investment. From a technical perspective, the deduction would be more productive for the Treasury in the case of the high-income taxpayer because the revenue foregone in his case may result in greater additions to housing values than the deduction for the low-income taxpayer. Also implicit in the analysis is the Kaldor-Hicks perspective: efficiency involves the creation of wealth (in this case housing values) regardless of how distributed.

103. As added by The 1986 Act § 511, I.R.C. § 163(h)(5)(A)(i)(II) provides for the deductibility of mortgage interest for a second residence.

104. *See supra* notes 55-57 and accompanying text.

105. *See supra* subpart III(D)(2).

that in their view justifies the opposite presumption, namely, that the tax system is prima facia to serve only revenue purposes. Their first argument stresses taxpayer morale and perceptions of fairness.[106] Taxpayers who do not or cannot utilize incentives, the argument goes, resent a tax burden apparently greater than that borne by persons similarly or more advantageously situated who do take advantage of incentives. A secretary earning $12,000 a year becomes demoralized when the $1,000 in federal income tax he pays is $1,000 more than the tax of a multi-million dollar corporation skillfully manipulating the system of incentives. The secretary's demoralization is harmful because, *inter alia*, it might affect his compliance with the tax law.

The opponents of tax incentives are justifiably concerned about the morale of the hypothetical secretary. They are wrong, however, to contend that this consideration militates against tax incentives. The secretary's underlying concern is not the tax system, but rather the financial relationship between the federal government and the multi-million dollar corporation. The proceduralist opponents of tax incentives assume the secretary would be assuaged if the corporation sent a substantial check to the IRS but would be indifferent to largesse flowing back from the government in the form of direct expenditure programs. Suppose the corporation paid taxes of $10 million but received $10 million from the Department of Labor for hiring Vietnam veterans. It is difficult to see that this would be less demoralizing than the corporation simply foregoing its tax payment in the first place. The secretary ought be as upset by direct expenditure programs as tax incentives. Consequently, direct ex-

106. "[T]he Code breeds mistrust and envy in those who are not partaking of the Code's preferences and those who believe that others are gaining advantages that they are not. This mistrust may increase the level of noncompliance by those who wish to retain their 'fair' share of their income." Beaudry, *The Flat Rate Tax: Is It a Viable Solution to the Crisis Facing the Internal Revenue Code?*, 9 OKLA. CITY L. REV. 219, 250 (1984). Indeed, President Reagan seems to have embraced this line of reasoning. *See* THE PRESIDENT'S TAX PROPOSALS, *supra* note 1, at 2 ("As dissatisfaction increases, the continued viability of the tax system is threatened—and as it is threatened, so too is the basis of support for essential governmental services and functions."); *see also* TAX BREAKS, *supra* note 12, at 60; Gephardt & Bryant, *supra* note 70, at 131 ("It is clear that taxpayer perceptions of an unjust and inequitable tax system contribute to the increasing level of noncompliance."); Gephardt & Wessel, *Tax Reform: A But For Test*, 29 ST. LOUIS U.L.J. 895, 909 (1985) ("As more and more individuals come to believe that the tax system is unfair and that others are abusing the system, they too will try to avoid as much of their legal tax burden as possible."); Kempler, *supra* note 13, at 770 ("For many taxpayers, the complexity of the system, and its perceived unfairness encourage them to play the 'audit lottery' by failing to report income, by overstating deductions, or by taking aggressive positions on disputed tax issues."); Phypers, *supra* note 1, at 285 ("[T]he perception of fairness in a system of voluntary compliance, is critical."); Purcell, *An Analysis of the Formation of Federal Income Tax Policy*, 18 CREIGHTON L. REV. 653, 682 (1985) (stating that "lack of faith" in the current code "has apparently resulted in an increase in noncompliance with the tax laws"); Yorio, *supra* note 36, at 1256 ("A perception that the system is unfair may lead taxpayers to cheat on their returns with a consequent loss in revenue and a further erosion of taxpayer confidence in the fairness of the system.").

penditures, as a matter of morale, have no advantage over tax incentives. If there is a problem,[107] it is that the federal government is selectively subsidizing some persons and not others, not the form in which the subsidy is occurring.

There is a certain irony to the perception argument: it is the opponents of tax incentives who, by their efforts, have largely publicized the effects of such incentives.[108] It is somewhat paradoxical for the public's perception of the tax system to be invoked as an argument by those who have played a critical role in creating that perception.[109]

A second argument advanced by proceduralist opponents of tax incentives concerns administrability.[110] Complicated laws are difficult to administer and therefore require significant manpower. The adoption of a tax incentive, the argument runs, without a corresponding increase in IRS personnel, enhances possibilities for fraud and abuse.[111] The proceduralist opponents of tax incentives are correct to stress the need for adequate manpower for the IRS. They are wrong, however, to claim that questions of administrability provide a basis for favoring direct expenditure programs over tax incentives. If Congress provides adequate personnel, it ought to make no difference whether those personnel are assigned to the IRS or to nontax federal agencies in charge of direct expenditure programs. If Congress refuses to authorize adequate manpower, there will be problems of enforcement at the IRS or those other agencies. Competent administration is needed whether tax incentives or direct expenditure programs implement government policies.[112]

A third refrain is that tax incentives deviate from the normative definition of income and are therefore suspect per se. Income is income, the argument goes, and taxing less than income is inconsistent with the

107. *But cf.* Kaplan & Reckers, *A Study of Tax Evasion Judgments*, 38 NAT'L TAX J. 97, 102 (1985) (suggesting that perceptions of fairness do not significantly affect taxpayer attitudes towards compliance).

108. *See, e.g., Trained by Nader, This Populist Tax Lobbyist Takes Aim at Big Businesses That Avoid Taxes*, Wall St. J., May 2, 1985, at 62, col. 1.

109. This paradox does not affect my personal belief that it is healthy for this information to receive widespread publicity. It does, however, suggest that we are best served by addressing the total financial relationship between the federal government and affluent persons, not merely the tax aspect of that relationship or questions of perception.

110. *See* Berger, *In Behalf of a Single Rate Flat Tax*, 29 ST. LOUIS U.L.J. 993, 1020 (1985) (praising the "higher visibility, accountability, and prospect for periodic review" of direct expenditure programs); Surrey, *supra* note 1, at 716-18.

111. And the administrative problems of the IRS are real. *See, e.g., IRS Foul-Ups Likely to Continue as Returns Rise and Staff Is Cut*, Wall St. J., May 6, 1985, at 37, col. 3.

112. Many opponents of tax incentives have served in the Treasury Department, no doubt sensitizing them to the administrative problems of the IRS. Presumably, time spent in the Department of Labor would leave one comparably sensitive to the administrative problems of direct expenditure programs.

premise of the tax in its most idealized sense, that it is a levy on all income.[113]

No universally accepted definition of income exists, however, because the construction of an income tax invariably involves many close and essentially arbitrary decisions as to includibility and deductibility.[114] Even if a definition of income such as Haig-Simons[115] is accepted as a satisfactory starting point, in practice not all income so defined is subject to taxation nor is likely to be.[116] Many of the practical departures from idealized notions of income are compelled by concerns of administrability and taxpayer morale. A parent sending a child to a public school (and thereby discharging his legal obligation to educate his offspring) has an economic benefit conferred upon him and has, in an idealized sense, received income. The same is true of the family whose cat is removed from a tree by the town fire department or who attends a free concert sponsored by a local corporation in a neighborhood park.

Confronted with such cases, most opponents of tax incentives invoke considerations of enforceability and taxpayer morale to exclude these economic benefits from the ambit of federal taxation. If deviations from an ideal definition of income can be tolerated for these (very legitimate) reasons, it is difficult to see why an ideal cannot be breached for other equally compelling concerns such as efficiency.

A fourth argument advanced by proceduralist opponents of tax incentives focuses on the legislative process: direct expenditure programs are examined annually by Congress and thus are subject to constant legislative review. Tax incentives, in contrast, do not receive the same yearly scrutiny. Because continual legislative review of expenditures is preferable to uncontrolled spending, direct programs are preferable to tax incentives.[117]

Concern about legislative control of spending is obviously commendable but does not provide a basis for favoring direct expenditure programs over tax incentives. Many direct expenditure programs are not subject to annual review but are funded by open-ended appropriations

113. *See* MacLaury, *Foreward* to COMPREHENSIVE INCOME TAXATION, *supra* note 14, at viii. For a critique of this position, see Bittker, *A Comprehensive Tax Base as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967).

114. *See supra* notes 19-23 and accompanying text.

115. *See* Bittker, *supra* note 113, at 980-84.

116. *See id.*

117. *See* Berger, *supra* note 110, at 1020; Surrey, *supra* note 1, at 731 (concluding that "tax incentives greatly decreas[e] the ability of the Government to maintain control over the management of its priorities"). *But cf.* Wiedenbeck, *Paternalism and Income Tax Reform*, 33 U. KAN. L. REV. 675 (1985) (defending tax incentives because they implement policies that could not be achieved politically through direct expenditure programs).

and trust funds.[118] Moreover, most programs legally constrained by annual appropriations are not, in practice, subject to effective yearly legislative review. Historically, Congress has used the prior year's expenditures as a base for analysis, making marginal changes in federal spending patterns. Annual scrutiny of direct expenditures is thus more apparent than real.[119]

The legislative process argument does not compel rejection of tax incentives per se but of tax incentives which are unrecognized and therefore placed beyond congressional review. Ironically, the opponents of tax incentives may be victims of their own success. Having popularized the notion of the tax expenditure and institutionalized the identification of these items,[120] the opponents of incentives have made them more amenable to congressional control. Tax incentives now seem more subject to effective congressional review than such direct expenditure programs as social security. Contrasting the approach embodied in the Balanced Budget and Emergency Deficit Control Act of 1985—popularly known as Gramm-Rudman—with Congress' comprehensive revision of the Internal Revenue Code, it is by no means clear that Congress can control direct expenditures more easily or effectively than tax incentives. That would seem to be one of the major accomplishments of the tax expenditure movement.

At first blush, direct expenditure programs appear to have one advantage over tax incentives insofar as there is concern about controllability. A direct expenditure program can be "capped" in advance: the agency administering the program is given a limited appropriation and is thus forced to stop spending when that appropriation is exhausted even if the limit set by Congress is reached during the middle of the fiscal year.

An interesting experiment by the State of Connecticut with a capped tax incentive suggests that such incentives can also be designed to expire upon the attainment of a predetermined limit. Under the Connecticut Neighborhood Assistance Act,[121] corporations are permitted credits against their state income tax liability for contributions to certain charitable organizations. Prior to taking the deduction, the donor corporation

118. On the problem of controlling direct expenditure programs funded by open-ended appropriations, see Dommel, *Trends in Intergovernmental Relations: Getting Less But Enjoying It More (Maybe)*, in FINANCING GOVERNMENTS, *supra* note 87, at 97-98.

119. Haider, *Balancing the Federal Budget: The Intergovernmental Casualty and Opportunity*, in FINANCING GOVERNMENTS, *supra* note 87, at 208-09 ("[T]he new [congressional] budget procedures do not appear to have been very successful in reducing deficits or in controlling expenditures. . . . [N]ew laws and procedures cannot compel the Congress to do what it simply does not want to do.").

120. *See supra* note 24 and accompanying text.

121. CONN. GEN. STAT. ANN. §§ 12-631 to -638 (West 1982).

must receive administrative approval; approval is limited by the Connecticut legislature to the first $2,000,000 in donations applied for.[122]

Opponents of tax incentives also invoke the "upside-down effect" to justify their preference for direct expenditure programs.[123] Even if one is unpersuaded by the possible efficiency justification for the upside-down effect,[124] one must question the presumption that direct expenditure programs invariably distribute their benefits more progressively than tax incentives. For example, farm price supports often give the greatest benefit to the wealthiest farmers.[125] Another direct subsidy from the federal treasury that most heavily benefits the affluent is the federal subsidy of aviation.[126]

Indeed, the distributional considerations posed by the proceduralist opponents of tax incentives raise far more fundamental issues than perhaps these opponents realize. A basic dilemma of federal policy[127] is that the government, if it intervenes in the domestic economy, frequently rewards the owners of capital and those who control economic activity by coaxing capital and other economic activity into desired places and uses. The resulting distribution of federal largesse tends to be regressive because those who own capital and control economic activity tend to be the more affluent in American society.

The tax incentives embodied in enterprise zones may have a regres-

122. CONN. GEN. STAT. ANN. § 12-632(c), (i) (West Supp. 1986). The Connecticut experience under the Neighborhood Assistance Act is revealing in one other respect. In the first year of the Act's existence, total proposed donations fell short of the limit set by the legislature. In each succeeding year, the proposed total has increased until it exceeded the statutory limit. To accomodate the increased applications for credit, the legislature increased the statewide limit in 1984 from $1,000,000 to $1,500,000. 1984 Conn. Acts 387, § 1 (Reg. Sess.); *see* Tomeo, *1984 Connecticut Tax Developments*, 59 CONN. B.J. 39, 41 (1985). This limit was increased again in 1985 to $2,000,000. CONN. GEN. STAT. ANN. § 12-632(i) (West Supp. 1986). Undoubtedly, some of this continued increase is attribntable to promotional activity by charitible organizations hoping to receive donations. Part of that increase, however, appears attributable to the acconnting and legal professions' dissemination of information about the Act.

123. *See* TAX BREAKS, *supra* note 12, at 12; Galvin, *The Commissioner's Statistics of Income: Required Reading for Tax Reformers*, 27 TAX NOTES 945, 948 (1985) ("This system involves an upside-down effect of offering more and more subsidy or benefit to those less and less in need of it."); Pomp, *supra* note 16, at 24; Surrey, *supra* note 1, at 722.

124. *See supra* text accompanying notes 101-02.

125. Wadley, *The Future of Government Regulation of Agriculture: Biting the Hand That Feeds Us?*, 3 N. ILL. U.L. REV. 299, 311-12 (1983); Wadley, *Small Farms, the USDA, Rural Communities and Urban Pressures*, 21 WASHBURN L.J. 478, 496 (1982) ("[A] farmer in the top 10% income bracket received, on average, fifty times more aid from the government than the farmer in the lowest 10% bracket."); *see Farm Subsidies Grow Like Weeds*, N.Y. Times, Nov. 4, 1985, at A18, col. 1. For one journalist's views of the distributional effects of farm price supports, see Kondracke, *Washington Diarist: No Dogs or Journalists*, THE NEW REPUBLIC, June 3, 1985, at 43.

126. R. ECKERT, AIRPORTS AND CONGESTION 46, 47, 58 (1972) ("Although federal airport subsidy programs have strong adherents, the case in favor of them is an uneasy one. The beneficiaries of these subsidies are mainly higher income groups.").

127. It is tempting to substitute for the phrase "federal policy" the term "liberal capitalism."

sive distributional impact because those in a position to benefit from the zones' reduced taxes are, by definition, persons with income on which taxes can be abated.[128] However, the direct expenditure equivalent of enterprise zones, the Urban Development Action Grant, has a comparable potential for regressivity: the developers and businesses in a position to utilize this program rarely will be impoverished.[129] In short, the distributional questions raised by the proceduralist opponents of tax incentives pose important concerns but they do not lead to a blanket preference for direct expenditure programs.

In this respect, the opponents of tax incentives may again be victims of their own success. Having identified the potential distributional implications of tax incentives, the proceduralist opponents of tax incentives have caused Congress, when it desires, to design incentives implementing progressive distributional policies. If Congress wants to mitigate or reverse the upside-down effect, it can use credits rather than deductions,[130] reduce incentives as income levels rise,[131] and employ comparable measures. That Congress has, in its recent revision of the Code, eschewed these devices in many cases leaves little hope that equivalent direct expenditure programs would be designed differently.

Finally, proceduralist opponents of tax incentives commonly invoke the problems of designing technically efficient incentives.[132] The same limitations, however, are inherent in direct expenditure programs: if a developer claims that his project cannot go forward without an Urban Development Action Grant, the government must either accept his assertion and risk conferring a windfall, or withhold aid and jeopardize a desirable project.

In sum, the accepted procedural arguments for direct expenditures are unpersuasive. Moreover, the potentially lower transactions costs of tax incentives are a compelling basis for accepting properly designed tax

128. On enterprise zones, see Jacobs & Wasylenko, *Government Policy to Stimulate Economic Development: Enterprise Zones*, in FINANCING GOVERNMENTS, *supra* note 87, at 175. On one state's experience with enterprise zones, see *Urban Policy: Academic, Urban Experts Differ on Effectiveness of Enterprise Zones*, DAILY TAX REP. (BNA), September 11, 1985, at LL 1; *Hartford's Experiment With Enterprise Zones Gaining Mixed Reactions*, N.Y. Times, July 7, 1985, at A23, col. 1; *Local Incentives Draw Industry to Poorer Zones*, N.Y. Times, July 7, 1985, at A24, col. 1.

129. For the statutory framework for Urban Development Action Grants (UDAG), see 42 U.S.C. § 5318 (1982 & Supp. III 1985). On UDAG and enterprise zones, see TAX BREAKS, *supra* note 12, at 12.

130. *See, e.g.*, I.R.C. § 21 (Supp. III 1985) (credits for household services); *see also* TAX BREAKS, *supra* note 12, at 12.

131. *See, e.g.*, I.R.C. § 21(a)(2) (Supp. III 1985) (decreasing credits as income rises).

132. *See supra* subparts II(D) & III(D)(1); *see also* Gephardt & Wessel, *supra* note 106, at 908 ("Direct subsidies are a method of providing relief to those sectors of the economy that public policymakers decide are in need of help.").

incentives as a legitimate means of implementing appropriate federal policies. There is a certain paradox in the oft-repeated assertion that tax incentives are the equivalent of direct expenditure programs. That purported equivalence generally is thought an indictment of tax incentives. However, the notion of equivalence also serves to legitimate tax incentives: if they are comparable to direct expenditure programs, they ought to be as available as an instrument of public policy.

There is, moreover, a paradox to the continued reiteration of the original arguments advanced by Professor Surrey almost twenty years ago. Political and social movements commonly prefer to maintain a reformist posture indefinitely, thus failing to acknowledge the extent to which their agendas have been adopted. To the credit of the proponents of tax expenditure analysis, much (though by no means all) of their program has become part of the status quo. The tax expenditure budget is now a statutorily-mandated part of Congress' legislative process. Tax expenditure analysis has itself received widespread acceptance, including the embrace of the President of the United States. The tax expenditure movement can justly claim to have enhanced our understanding of the federal tax system, to have improved the procedures by which tax legislation is enacted, and to have influenced Congress' reformation of the Internal Revenue Code. If Congress retains and enacts tax incentives under these circumstances, it must be because Congress wants them on substantive or political grounds. At some point, the proceduralist opponents of tax incentives may be forced to acknowledge that Congress, after exposure to a decade's worth of tax expenditure budgets and comprehensive reform proposals, is simply making substantive decisions they do not like.

C. Identifying "Good" Tax Incentives

If the theoretical justification for tax incentives is accepted, how is a "good" tax incentive to be identified? Initially, a tax incentive should implement substantively an appropriate federal policy. In economic terms, a good tax incentive is one that maximizes total profitability or consumer satisfaction after accounting for externalities or barriers to entry. Having passed substantive scrutiny, a good tax incentive must also be procedurally justifiable in contradistinction to a direct expenditure program pursuing the same policy. The analysis developed here suggests that the question of appropriate method may be, in large measure, a question of intended audience. If Congress intends to reach small businesses or middle-income households, the tax system may be a cheaper

method of disseminating federal policy than a direct expenditure program pursuing the same goal.

The credit for hiring economically disadvantaged Vietnam veterans is a tax incentive which can survive both substantive and procedural scrutiny. As a matter of substantive policy, subsidies for hiring such veterans can be justified on economic grounds. Significant barriers make the entry of these persons into the labor market difficult.[133] Finding gainful employment for this group of disadvantaged persons would appear to generate significant externalities as would the hiring of any economically disadvantaged group. Because the current growth of employment in this country stems predominantly from small businesses[134] and because it may be cheaper to communicate with these businesses through tax incentives, such incentives may be an appropriate method of implementing the federal government's policies.

Three caveats must be added to this analysis. First, having concluded that a tax credit is an appropriate method of reaching small businesses, it may also be cheaper to allow large corporations to participate in that program than to establish a separate, direct expenditure equivalent. Second, an overly large collection of "good" tax incentives may amount to less than the sum of its parts. The tax system is potentially a better means of communicating government policies than direct expenditure programs. It is, however, not a perfect method of disseminating information nor one with unlimited capacity. Too many "good" tax incentives could overload the system, preventing any one incentive from being transmitted effectively. Partial tax reform, of the kind Congress has recently undertaken, paradoxically can be justified as leading to more effective communication of the remaining tax incentives.

Third, the tax system communicates but does not do so instantaneously. An accountant may not realize his client is eligible for a credit and thus may neglect to inform the client of the credit's existence. Professional competence varies among the members of the tax bar and accounting profession. Some will communicate with their clients more rapidly than others. Clients do not always understand advice the first time they hear it. Hence, everything else being equal, an old tax incentive is more likely to be a good tax incentive in the sense that its existence is more likely to have been absorbed by the tax bar and accounting profession and communicated to more clients.

133. At least one of these barriers, the federal minimum wage, is government-mandated.

134. Reich, *The Executive's New Clothes*, THE NEW REPUBLIC, May 13, 1985, at 23 ("Since 1970, America's 500 largest industrial corporations together have failed to generate a single new job.").

If the credit for hiring disadvantaged Vietnam veterans is the exemplar of a defensible tax incentive, the exclusion of interest from state and local bonds from gross income[135] stands out as the antithesis, a provision for which it is difficult to construct a plausible case, even as recently modified by Congress.[136] As a substantive matter, the subsidy implicit in the exclusion is available for essentially any type of governmental indebtedness a state or locality desires to incur and for a host of private purposes. There is no requirement that tax-exempt indebtedness support projects generating significant externalities for those residing outside the debtor jurisdiction or satisfy stringent tests of propriety: the most frivolous public expenditure can be underwritten with tax-exempt financing.[137]

As a procedural matter, it is well established that the exclusion for state and local bond interest is technically inefficient. The subsidy received by states and localities, in the form of lower interest rates, is substantially less than the taxes lost by the federal government as a result of the exclusion. It would be cheaper for the federal government to make direct payments to states and localities and abolish tax-exempt bonds.[138]

V. Conclusion

The reader may note that the tone and conclusions of this Article are tentative in many respects. For example, the mortgage interest deduction may be defensible depending upon which side bears the burden of proof; the presence of externalities may establish the sectoral efficiency of particular incentives despite seemingly discrepant rates of return; the lower transactions costs of communicating through the existing tax system may justify some tax incentives from the perspective of technical efficiency. The tenor of this Article contrasts with the spirit in which many opponents of tax incentives approach the question. They appear far more confident that incentives can be condemned generally as inefficient (substantively, procedurally, or both). Perhaps the most important conclusion to be drawn from the analysis presented here is that any overly generalized assertion of this sort is likely to be wrong in a world of great uncertainty, a world in which equally plausible assumptions can

135. I.R.C. § 103 (1982 & Supp. III 1985).

136. *See* The 1986 Act § 1301 (amending I.R.C. § 103 (1982 & Supp. III 1985)).

137. This is not to denigrate the recent reforms. But even as limited by the 1986 Act, tax-exempt bonds raise troubling issues.

138. *See* M. CHIRELSTEIN, FEDERAL INCOME TAXATION 323 (2d ed. 1979); Berger, *supra* note 110, at 1008; Toder & Neubig, *Revenue Cost Estimates of Tax Expenditures: The Case of Tax-Exempt Bonds*, 38 NAT'L TAX J. 395 (1985).

lead to diametrically opposed policy prescriptions.[139]

The analysis developed here indicates that tax incentives deserve rehabilitation as instruments of federal policy. When the meaning of efficiency is scrutinized and some of the insights developed in the common-law debate are taken into account, it becomes clear that some tax incentives deserve to be condemned as inefficient but others do not. It is also clear that efficiency has meant something different to those opposing tax incentives on substantive grounds than to the proceduralist opponents of tax incentives. The latter concede the theoretical propriety of government intervention in the economy but prefer such intervention in the form of direct expenditure programs. As to the proceduralist case against tax incentives, there is an argument that tax incentives potentially permit the dissemination of federal policies at lower transactions costs than direct expenditure programs, particularly with respect to small businesses and middle-income households.

The prevailing consensus tends to attribute continued acceptance of tax incentives by Congress as, at best, a sign of naivete or, at worst, a sign of cynicism. The survival of so many tax expenditures, despite reform efforts of historic dimension,[140] indicates there is much truth to this critique. But there is also a more benign explanation for the congressional impulse to use tax incentives. This impulse embodies an intuitive awareness that, once the federal government decides to intervene affirmatively in the domestic economy, it is efficient to communicate through an existing information network: almost everyone files a federal income tax return; not everyone maintains a lobbyist monitoring direct expenditure programs.

It would be regrettable if the position developed here hardened into a mirror image of the consensus condemning tax incentives. Congress undoubtedly can and has adopted tax incentives deserving of criticism. The safe-harbor leasing fiasco demonstrates that incentives can be structured to swamp potential efficiencies in a morass of transactional com-

139. As Professor Doernberg eloquently observed:

> Those who have advocated tax reform (including the author, before reality intruded on his fantasy) have written incessantly of the inefficiencies and distortions of our current system. Economists have produced studies proving beyond doubt the merits of both sides in every debate on our current laws. For every study demonstrating convincingly that the result of a change will be "A", there is a study that shows the result will be "not A." The reason is simple enough. Life is too complicated and there are too many variables for us to accurately predict what effects our tax system has on the economy.

Doernberg, *Proposed: Tax Stand-Still Act of 1985*, N.Y. Times, July 21, 1985, at F3, col. 2.

140. *See, e.g.*, TREASURY DEPT. TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH, *supra* note 4, at iii-iv (Treasury Secretary Regan characterizing the proposals as bold and sweeping).

plexity,[141] although a direct expenditure program accomplishing the same ends might have been designed in an equally cumbersome fashion. Although this Article provides an externalities-based defense of ACRS for real estate rehabilitation, it probably does not provide comparable support for ACRS for machinery and equipment. The analysis advanced here suggests that tax incentives should presumptively be designed for middle-income persons and small businesses. Large corporations and high-income families, in contrast, should participate in direct expenditure programs.

At its most basic, it is unproductive to compare the messy reality of existing tax incentives with pristine and idealized notions of direct expenditure programs, or of a perfectly competitive economy or of an economy in precise sectoral balance. In their pristine and idealized state, tax incentives can appear just as efficient and desirable.

141. *See e.g.*, Warren & Auerbach, *supra* note 36, at 1580-81 (reviewing modifications of safe-harbor leasing provisions after passage of TEFRA, enacted in response to cases of abuse).