

The Case for Tax Credits
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Revised May 3, 2007

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Introduction

Despite perennial calls from politicians, policy analysts, and populists for a major individual income tax overhaul that would cleanse the tax system by eliminating its eclectic collection of tax incentives and preferences, the ideal of tax base purity has yet to be realized and seems unlikely to find its way to fruition in the foreseeable future.

Middle-class Americans appear to be simply too fond of their tax preferences for expenses such as home mortgage interest, health insurance, and charitable contributions to let go, as evidenced by the reluctance of savvy politicians to put forward a serious

reform package that eliminates those tax benefits.¹ For the 2007 fiscal year, the largest 25 tax expenditures reported in the President’s Budget were expected to have a total value of over \$750 billion in terms of foregone revenue.² By comparison, the entire amount of revenue raised by the federal individual income tax during the same period was only \$1.096 trillion,³ meaning that total revenue would be over 70 percent higher without these tax preferences if current tax rates were unchanged.⁴

Given that this most prominent feature of the federal tax landscape is apparently here to stay in one form or another, the pertinent policy question becomes whether there is a better way to implement tax preferences and incentives through deductions, exemptions, and exclusions. One proposal that has been advanced and implemented with greater regularity in recent years—and that received prominent notice with the reforms proposed in 2005 by the President’s Advisory Panel on Tax Reform⁵—is the conversion of existing deductions and exclusions into partial tax credits (i.e. credits for some fraction of eligible expenditure).⁶

¹ Neither of the tax reform plans put forward by the President’s Advisory Panel on Federal Tax Reform eliminated preferences for these preference items, although the Panel did propose a credit-based alternatives to the current home mortgage interest deduction as well as to the . See PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, & PRO-GROWTH: PROPOSALS TO FIX AMERICA’S TAX SYSTEM 108, 157 (2005) [hereinafter TAX PANEL REPORT]. Similarly, the Kemp Commission “waffled” on the home mortgage interest and state and local tax deductions, ultimately suggesting a “national discussion” on the best way to achieve the goals of these deductions. See William Gale, *The Kemp Commission and the Future of Tax Reform*, 70 TAX NOTES 717, 718 (1996).

² Author’s calculations, based on OFFICE OF MANAGEMENT AND BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2007: ANALYTICAL PERSPECTIVES 296 (2006) [hereinafter FY2007 BUDGET].

³ FY2007 BUDGET, *supra* note 2, at 237.

⁴ Estimates drawn from the tax expenditure budget do not necessarily equal the change in federal revenues that would result from eliminating particular provisions. First, the estimates do not account for behavioral responses to incentives created by the provisions in question. Moreover, tax expenditures estimates are interdependent, so repeal of a single provision will affect revenue generated or lost through other provisions. FY2007 BUDGET, *supra* note 2, at 286.

⁵ See TAX PANEL REPORT, *supra* note 1, at 108, 157.

⁶ Unless otherwise noted, the term ‘credit’ as used in this paper refers to a partial credit.

Converting a deduction into a credit fairly straightforward in light of the basic equivalence between credits and deductions. For a taxpayer in the 15 percent tax bracket with positive tax liability, the replacement of a deduction for a particular expenditure with a 15 percent tax credit for the same expenditure should be a matter of indifference since it leaves the taxpayer's tax bill unchanged.⁷ On the other hand, where the taxpayer's marginal tax rate exceeds the credit rate, the conversion of a deduction into a credit results in a higher final tax bill. Where the rates are below 15 percent, the credit is more attractive than the deduction. Nevertheless, it is the basic equivalence between credits and deductions where the credit rate and taxpayer's marginal tax rate are the same that, as a matter of tax mechanics, makes possible proposals to transform deductions into credits.

An awareness of the equivalence of deductions and credits under certain conditions is evident in the tax policy literature at least as early as the middle of last century, but the credit alternative did not gain serious currency until more recent decades. Although the foreign tax credit has existed from 1919,⁸ it was not until 1948 that Prof. William Vickery, motivated by equity concerns, suggested replacing an existing deduction with a tax credit.⁹ Vickery did not extend his proposal beyond the charitable deduction, however, and it was not until the early 1970s that serious discussion of these

⁷ Here it is assumed that the deduction is an above-the-line deduction so that the taxpayer can take full advantage of the deduction regardless of whether he or she chooses to claim the standard deduction.

⁸ 40 Stat. 1080 (1919). The purpose of the foreign tax credit is to eliminate double taxation that can result where foreign source income is subject to tax in both the United States and a foreign jurisdiction. The implementation of a tax expenditure as a credit rather than a deduction is motivated by different concerns.

⁹ See William J. Turner & Douglas G. Kelly, *The Economic Equivalence of Standard Tax Credits, Deductions, and Exemptions*, 36 U. FLA. L. REV. 1003, 1005 (1984); WILLIAM VICKERY, AGENDA FOR PROGRESSIVE TAXATION 131 (1947). Turner and Kelly point to Vickery's proposal that the deduction for charitable contributions be replaced by a 25 percent credit as the first suggestion by a commentator that a credit replace a deduction.

alternatives appeared in the literature.¹⁰ Even then, Stanley Surrey gave only brief notice to the relative advantages of credits over deductions in his seminal 1973 book on tax expenditures, *Pathways to Tax Reform*, instead focusing his analysis on the shortcomings of tax expenditures understood as deductions and exclusions

In the mid-1970s, Congress began to create a constellation of credits available to individual taxpayers. Most of these credits have been of relatively minor magnitudes, however, compared to the largest tax expenditures. In an early example of a credit substituted for a deduction, Congress in 1976 implemented a child care credit in place of a pre-existing deduction, citing equity considerations as a reason for the change.¹¹ In 1984, the concept of replacing deductions with credits earned a significant endorsement from Senator Bill Bradley and Representative Dick Gephardt, who proposed a tax reform package would have allowed all itemized deductions—including the home mortgage interest deduction, the deductions for state and local income and real property taxes, and the charitable contribution deduction—to be taken only against the 14 percent bottom bracket.¹² This proposed mechanism is the mathematical equivalent of converting all itemized deductions (excluding the standard deduction) into 14 percent tax credits.

Since the late 20th century, credits have proliferated where deductions might previously have been used, including tax credits for adoption expenses,¹³ education

¹⁰ See Turnier & Kelly, *supra* note 9, at 1005; Murray L. Weidenbaum, The Advantages of Credits on the Personal Income Tax, 42 GEO. WASH. L. REV. 516 (1974).

¹¹ See Turnier & Kelly, *supra* note 9, at 1007; Staff of the Joint Comm. On Tax, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976 124 (Comm. Print. 1976). *But see* Gerard M. Brannon & Elliott R. Morss, *The Tax Allowance for Dependents: Deductions Versus Credits*, 26 NAT'L TAX J. 599 (1973) (arguing that the move to a credit for dependant care actually reduced equity since the departure of one dependent costs a high income taxpayer more than a low income taxpayer and that a deduction for child care properly results in taxation of only above poverty income).

¹² CONGRESSIONAL BUDGET OFFICE, FEDERAL INCOME TAX REFORM: A REVIEW OF TWO PROPOSALS (1984).

¹³ See I.R.C. § 23 (2006).

expenses,¹⁴ fuel cells,¹⁵ and alternative motor fuel vehicles.¹⁶ Despite this proliferation of mostly minor credits, however, the tax expenditure budget continues to be dominated by deductions and exclusions. Of the top 25 tax expenditures ranked by foregone revenue for FY2007, only two tax expenditures—the child tax credit and the earned income tax credit (EITC)—were credits.¹⁷ Notably, those two tax preferences are not even intuitively susceptible of implementation as deductions or exclusions since a primary characteristic of both the child credit and the EITC is “refundability,” a design feature that allows taxpayers to receive the benefit of a credit even where the value of the credit exceeds pre-credit tax liability. The largest items, including preferences for health insurance, mortgage interest, retirement savings, and state and local taxes, are all deductions and exclusions.

In the face of the continuing sideline status of tax credits as an option for implementing tax incentives, the President’s Advisory Panel on Federal Tax Reform recently generated discussion by offering a limited endorsement of the strategy of converting some major existing deductions into partial credits. Notably, the Panel did not adopt an across-the-board strategy of converting deductions to credits but, instead, appears to have individually considered the most appropriate form for a variety of existing deductions. Citing primarily equity considerations, the Panel recommended the replacement of the home mortgage interest deduction with a Home Credit equal to 15 percent of mortgage interest paid.¹⁸ In justifying this choice, the Panel noted

¹⁴ See I.R.C. § 25A (2006).

¹⁵ See I.R.C. § 25D (2006).

¹⁶ See I.R.C. § 30B (2006).

¹⁷ See FY2007 BUDGET, *supra* note 2, at 296.

¹⁸ See TAX PANEL REPORT, *supra* note 1, at 70-75. The value of the Home Credit would be limited to the average regional price of housing, with limits ranging from about \$227,000 to \$412,000.

simplification benefits from eliminating the need to itemize to obtain the mortgage interest deduction. The Panel more strongly emphasized, however, the fairness gains from a credit that would allow both itemizers and non-itemizers to share in the tax benefits connected with home ownership (and to do so at the same rate) and that would allow total benefits to be easily capped.¹⁹ For charitable giving, on the other hand, the Panel specifically recommended that the tax incentive take the form of a deduction “to provide incremental incentives to higher-income donors, an important source of charitable deductions.”²⁰ The Panel also recommended preserving (but capping) the exclusion for health insurance premiums but—after acknowledging that under the current system most of the tax benefits from the exclusion flow to high-bracket individuals—failed to explain why the exclusion was preferable to a credit.²¹

With the notable exception of the 1984 Bradley-Gephardt tax reform plan, most proposals for reforming tax expenditures have mirrored the approach of the Tax Panel, focusing on one tax incentive at a time in considering the relative advantages of a credit over a deduction mechanism.²² Tax credits have been favored in particular contexts for the perception that they eliminate what Stanley Surrey identified as the inequitable “upside-down subsidy” effect whereby the pattern of benefits generated by a deduction skews to taxpayers in the highest brackets.²³ Credits have also been touted for

¹⁹ *Id.* at 73-74.

²⁰ *Id.* at 75.

²¹ *Id.* at 78-82.

²² See, e.g., Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA L. REV. 1389 (2004); Kevin M. Yamamoto, *A Proposal for the Elimination of the Exclusion for State Bond Interest*, 50 FLA. L. REV. 145 (1998); Gene Steurle, *The Problem With Converting Itemized Deductions to Credits*, 74 TAX NOTES 427 (1997); Gerard M. Brannon & Elliott R. Morss, *The Tax Allowance for Dependents: Deductions Versus Credits*, 26 NAT'L TAX J. 599 (1973). But see Murray L. Weidenbaum, *The Advantages of Credits on the Personal Income Tax*, 42 GEO. WASH. L. REV. 516 (1974).

²³ SURREY, *supra* note **Error! Bookmark not defined.**, at 134-136.

eliminating the deduction's preference for itemizers over non-itemizers and because credits have certain efficiency properties that deductions and exclusions lack. In some particular cases, a deduction remains the only viable option: In the design of retirement savings incentives, for example, an exclusion or deduction is necessary if the goal is to postpone tax until funds are used for consumption, as would be the case in a consumption tax. Still, the question of whether there is a general case for the use of tax credits rather than deductions, or even whether there is even a systematic approach for choosing between credits and deductions in a particular context, has remained largely unaddressed.

This paper attempts to fill the gap in the academic and policy literature by systematically examining the general case for implementing tax expenditures as credits rather than deductions and by proposing a framework for choosing between credits and deductions. Prof. Lily Batchelder, together with Fred Goldberg and Peter Orszag, recently made a case for making tax credits refundable but left largely unaddressed the prior question of when tax incentives should be implemented as credits. Nonetheless, the two questions are closely related, and some of the analysis of Batchelder and her colleagues will find useful application in this paper.²⁴ In the foregoing, the more abstract question of whether a deduction (as opposed to a credit) is required for the sake of accurate income measurement will be set aside. Since the major tax expenditures appear primarily to be incentives to engage in certain behavior, they will be evaluated on that basis.

Part I examines the tax equity issues associated with deductions and credits, including the upside-down subsidy issue, with reference to the traditional tax policy

²⁴ See Lily Batchelder, Fred Goldberg & Peter Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23 (2006).

concepts of horizontal and vertical equity. Part II explores the efficiency implications of the choice between implementing tax incentives in the form of credits as compared to deductions or exclusions, employing a number of different concepts of efficiency. Part III evaluates the generality of the case for credits instead of deductions, analyzing how far the credit model can be extended and presenting a set of considerations for policymakers faced with this design choice. In Part IV, these considerations are applied to evaluate the design of some of the largest tax expenditures currently in the federal budget. Part V concludes.

I. Equity Considerations in Tax Expenditure Design

Equity has always been one of the fundamental criteria for evaluating a tax system. Particularly in recent years, a central focus of tax debate has been the equity or inequity of particular provisions of the tax code, as well as of the federal tax system as a whole. Issues of equity are central to the discussion each time there is a proposal for modification of a particular provision of the tax code, as in the case of the Bush Administration's proposals for Lifetime Savings Accounts and Retirement Savings Accounts, which were frequently criticized as providing the greatest benefits to the wealthy.²⁵ Equity considerations are paramount in the context of more sweeping changes to the tax system, which inevitably result in a back-and-forth flurry of distributional tables showing tax shares, effective tax rates, changes in total tax burdens, and

²⁵ See Robert Greenstein & Joel Friedman, President's Savings Proposals Likely to Swell Long-Term Deficits, Reduce National Saving, and Primarily Benefit Those With Substantial Wealth, May 25, 2005, <http://www.cbpp.org/1-20-04tax.htm>.

tabulations of “winners” and “losers.”²⁶ Sometimes in this process policymakers develop a myopia in their use of distributional tables that causes them to lose sight of important normative goals of the tax system or mistake transitory annual tax incidence for a more meaningful lifetime incidence measure.²⁷ Nonetheless, unless any given change or bundled set of changes to the tax system can be shown to maintain or increase progressivity, at least as measured by a distributional table with a five-year budget window, its chances of surviving the ensuing political hailstorm are slim to none.²⁸

The question whether a particular tax expenditure should be implemented as a credit or a deduction is also frequently evaluated in light of its implications for fairness. Indeed, the original suggestion by William Vickery for the replacement of a deduction—the charitable deduction—by a credit was justified as an equity-enhancing measure.²⁹ As noted above, the Panel on Tax Reform cited fairness as a primary motivation for recommending the substitution of a home ownership credit for the existing mortgage interest deduction.³⁰ Such fairness judgments appear to be grounded in a notion of vertical equity. As will be explored below, however, these judgments may rest on a shaky foundation.

A. Vertical Equity

²⁶ See Michael J. Graetz, *Paint-by-Numbers Tax Lawmaking*, 95 COLUM. L. REV. 609, 611-14 (1995); Jason J. Fichtner, "Distribution Tables and Federal Tax Policy: A Scoring Index as a Method for Evaluation," October 31, 2005, <http://ssrn.com/abstract=869419>.

²⁷ See Graetz, *supra* note 26, at 613-14; DON FULLERTON & DIANE LIM ROGERS, WHO BEARS THE LIFETIME BURDEN? 4-7 (1993).

²⁸ Both of the Tax Panel's proposals met this distributional standard of acceptability. See TAX PANEL REPORT, *supra* note 1, at 136-42, 175-82.

²⁹ See Turnier & Kelly, *supra* note 9, at 1005.

³⁰ See TAX PANEL REPORT, *supra* note 1, at 70-75.

1. An Upside-Down Benefit...

In the broadest sense, vertical equity as an attribute of a tax system suggests that individuals with greater amounts of resources should pay a greater share of those resources in tax than individuals with fewer resources. In the context of an *income* tax system, vertical equity implies at a minimum that higher earners should shoulder a proportionately larger share of income taxes than lower earners. Beyond these very broad prescriptions, however, the details of the vertical equity concept as practically applied become increasingly vague.³¹ While one can easily identify a tax system that violates the criterion of vertical equity, it is much harder to use the term in a positive sense to represent that a tax system meets a widely acknowledged standard of fairness. At that point, a fuller concept of distributive justice must supplement the vertical equity notion and narrow the range of acceptable tax systems on the basis of fairness. “Ability to pay,” a broader but even less well-defined concept, is frequently the next step.

Although the vertical equity concept itself may be imprecisely defined, some related notion of fairness seems to have formed the basis for Stanley Surrey’s critique of tax expenditures implemented in the form of deductions. In *Pathways to Tax Reform*, Surrey—viewing tax incentives as equivalent to direct subsidies—finds those incentives’ pattern of benefits inequitable: “[T]hey are worth more to the high-income taxpayer than the low-income taxpayer; they do not benefit those who are outside the tax system because their incomes are low, they have losses, or they are exempt from tax.”³² This sort of “upside-down benefit”³³ is an artifact of the interaction of tax incentives that

³¹ MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 27-28 (5th. ed. 2005).

³² SURREY, *supra* note **Error! Bookmark not defined.**, at 134-35.

³³ *See id.*, at 136.

directly reduce the amount of income subject to tax and a graduated rate structure applied to taxable income.

To understand the basis of Surrey’s claim that tax expenditures implemented as deductions are inequitable, consider the value of the mortgage interest deduction to two taxpayers with equal mortgage interest expense but different tax rates. To the higher-income taxpayer in a 50 percent tax bracket with \$100 in deductible mortgage interest, the deduction reduces taxable income by \$100, consequently reducing final tax liability by \$50. To the lower-income taxpayer who also has \$100 of deductible mortgage interest but who is in a 25 percent tax bracket, the deduction also reduces taxable income by \$100. For that taxpayer, however, final tax liability only falls by \$25 since his taxable income is only subject to a 25 percent rate at the margin. Surrey identified this phenomenon—that the deduction is worth more to the higher-income taxpayer than the lower-income taxpayer—as an inequity that Congress would never have intentionally designed.

The inequity of a deduction’s peculiar pattern of benefits appears even starker when viewed as a “windfall” to certain taxpayers. In particular, even though a taxpayer may not alter her behavior in response to a tax incentive like the home mortgage interest deduction, that taxpayer can nonetheless reap the benefit of the deduction if she happens to independently engage in the favored activity. Moreover, the amount of the windfall to this taxpayer is directly determined by the taxpayer’s marginal rate bracket, with the highest-bracket taxpayers receiving the largest windfall from the government. Viewed in this light, the distributional consequences of a deduction may seem particularly irrational.

In contrast to the upside-down benefits a deduction generates for higher-earners, Surrey acknowledged that a credit—which doesn’t allow the tax benefit to be determined by the taxpayer’s marginal tax rate—“is a priori more appropriate for the tax expenditure operation.”³⁴ He pointed to the credit for assistance of the elderly, which provided to elderly taxpayers a capped credit for 15% of their retirement income, as a laudable example of a tax expenditure without perverse implications for tax equity.³⁵ Indeed, because such a credit is applied to offset the final amount of tax owed after the progressive rate schedule has been applied to taxable income in the calculation of preliminary tax liability, the amount of reduction in taxes is the same for taxpayers at all marginal tax rates.³⁶

Two complicating issues potentially undermine the argument that credits are more equitable than deductions, but both can be remedied through credit design modifications. First, if the credit exceeds tax liability for a lower-income taxpayer but not a higher-income taxpayer, vertical inequities may again arise. This potential inequity can easily be remedied if the credit is made refundable against tax, meaning that the excess of credit value over tax liability is actually paid by the government to the taxpayer.³⁷ Second, as noted by Surrey and others, a credit that is itself tax-exempt—as are all credits that have actually been implemented to date in the United States—has greater value to taxpayers at higher marginal rates than lower marginal rates.³⁸ This effect may be better understood by recognizing that a tax credit is equivalent to a government grant that is excluded from

³⁴ *See id.*, at 136.

³⁵ *Id.* at 97.

³⁶ This conclusion holds as long as the credit itself is not taxable, in which case the post-tax value of the credit would vary according to a taxpayer’s marginal rate bracket.

³⁷ Batchelder et al. argue that refundable credits are the most efficient default form of credits. Batchelder et al., *supra* note 24, at 27.

³⁸ *Id.* at 99-100.

taxable income. Like a deduction, such an exclusion benefits higher-bracket individuals more than lower-bracket individuals. This issue, too, can at least theoretically be remedied by appropriate modifications to credit design, in this case by making the credit taxable, although one might question whether the concept of a taxable credit is too difficult for the taxpaying public to understand.³⁹

2. ...Or a Myopic Perspective?

The “upside-down benefit” argument in favor of credits over deductions might be utterly persuasive as a vertical equity critique if tax expenditures were viewed in isolation from the rest of the tax code, but the reality is that credits and deductions are part of a larger tax system.⁴⁰ The Joint Committee on Taxation and the Treasury’s Office of Tax Analysis frequently produce tables showing the distribution of tax burdens across income groups, and nearly every high-revenue-impact change to the tax code proposed by the Administration or a member of Congress is supported by distributional analysis showing the effect of the proposed change on the entire distribution of federal tax burdens.⁴¹ Although a particular deduction or exclusion viewed in isolation may reveal a pattern of benefits that favors higher-income taxpayers, the overall pattern of tax burdens is in fact progressive.⁴² Moreover, major legislative changes to the tax system typically involve a number of simultaneous discrete changes, some of which favor higher-income taxpayers and some of which favor lower-income taxpayers. For example, in crafting the Tax

³⁹ See, e.g., Yoseph Edrey & Howard Abrams, *Equitable Implementation of Tax Expenditures*, 9 VA. TAX REV. 109 (1989).

⁴⁰ See generally Boris I. Bittker, *Accounting for Federal “Tax Subsidies” in the National Budget*, 22 National Tax Journal 244, 252 (1969).

⁴¹ See Fichtner, *supra* note 26, at 1-2.

⁴² See, e.g., TAX PANEL REPORT, *supra* note 1, at 137.

Reform Act of 1986, Congressional staff and decisionmakers consciously used revenue and distributional data to produce a package that lowered statutory tax rates while accomplishing other discrete policy goals in an overall distributionally neutral framework.⁴³

Deductions and credits are not just elements of a larger tax system, however; they are actually pieces in a massive system of resource allocation and distribution of which the tax system is merely a component. Recent critiques of the tax expenditure literature have noted that “[t]he basic claim of tax expenditure analysis, that certain rules are ‘really’ spending, is not quite correct, because ‘taxes’ and ‘spending’ are not coherent categories to begin with.”⁴⁴ The foundation for this critique is Richard Musgrave’s earlier distinction between the allocative and distributional aspects of the fiscal system.⁴⁵ In Musgrave’s schema, allocation refers to how resources are put to use in society while distribution refers to who uses those resources.⁴⁶ Tax and spending are two sides of the same coin, and there is no well-defined correspondence between these nominal categories and the more theoretically coherent categories of allocation and distribution. With this understanding in mind, David Weisbach and Jacob Nussim have rejected the NIMBY approach of tax system purists who shun the use of the tax system to accomplish non-tax ends and have argued for an approach to the design of spending programs and tax expenditures that focuses on the “benefits of coordination between and specialization

⁴³ See Graetz, *supra* note 26, at 611.

⁴⁴ Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187 (2004).

⁴⁵ See *id.*

⁴⁶ See RICHARD A. MUSGRAVE, *THE THEORY OF PUBLIC FINANCE: A STUDY IN PUBLIC ECONOMY* 5 (1959).

within various types of activities performed by the government,” i.e. institutional competence.⁴⁷

With the recognition that tax expenditures are just a small piece in a large system, it is important to specify precisely the fairness question being posed. This paper ponders whether credits are superior to deductions from an equity standpoint even if the overall distribution of taxes is held constant through rate adjustments. That is, is there something inherently unfair about an “upside-down benefit” even if a tax expenditure does not shift the overall tax burden in a regressive direction? The question has particular salience in the context of tax reform, where the overall distribution of taxes will almost certainly be unrelated to the choice to implement tax expenditures as credits or deductions.⁴⁸ Of course, where tax rates are raised to balance the regressivity of deductions, policymakers must keep in mind the fact that the efficiency cost of taxation increases proportionally to the square of the marginal tax rate.⁴⁹

Notwithstanding the bare accounting truth that financial flows between the government and an individual can theoretically all be measured and netted, resulting in a single number that can be evaluated across individuals, there may still exist sub-domains of public policy for which it is appropriate to make equity assessments.⁵⁰ Tax expenditures are the primary levers by which policy goals are implemented in many such sub-domains, including retirement security, the charitable and housing sectors, and public health. A reasonable argument can be made that equity requires an independent

⁴⁷ David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 Yale L.J. 955, 957-59 (2004).

⁴⁸ The plans proposed by the Tax Reform Panel maintained the progressivity of the current tax system while adjusting the rate structure. *See generally* TAX PANEL REPORT, *supra* note 1.

⁴⁹ *See generally* Edgar K. Browning, *On the Marginal Welfare Cost of Taxation*, 77 AM. ECON. REV. 11 (1987).

⁵⁰ Special thanks go to Prof. Michael Graetz for pushing my thinking on this point.

evaluation of the fairness implications of government action in each of these sub-domains.

A series of questions may illuminate the proposition that equity is more than the netted total of government taxes and transfers. Would no sense of equity be violated by a government program that provided the wealthy incentives for retirement saving (and, consequently, independent living in retirement) but offered no such inducement to the poor, reasoning that the latter group is more than adequately compensated by means-tested transfer payments? Are the demands of distributive justice are satisfied by a government policy that provides substantial incentives for the most well-off to purchase luxurious homes, justifying the differential treatment of the poorer classes by the fact that they endure a comparatively low average tax rate or enjoy access to public housing? What about a policy that matches charitable contributions of high-income taxpayers but not the working classes?⁵¹ In each of these cases, intuition suggests some dignitary value is offended by a program that embodies paternalistic judgments about the goals that can or should be pursued by the rich and by the poor. In the context of tax expenditures which implement policy in each of these sub-domains, this intuition is most appropriately expressed by a judgment that credits better uphold ideals of vertical equity than do deductions that systematically offer differential benefits to taxpayers in different marginal brackets. If these intuitions are widely shared—as no doubt they are—implementing tax expenditures in the more vertically equitable credit form may have important implications for taxpayer morale and tax compliance, as well.⁵²

⁵¹ The special case of the charitable deduction is analyzed at Subsection I.A.3 *infra*.

⁵² See *infra* note 58 and accompanying text for a discussion of compliance and taxpayer morale.

3. Democratic Considerations

Regardless of whether deductions are judged vertically inequitable as a matter or pure resource allocation, some deductions—most notably, the charitable deduction—might also be called vertically inequitable as a matter of democratic values.

Tax expenditures like deductions and credits can be understood as “discounts” or “rebates” from the government to taxpayers for favored spending. When a taxpayer takes a deduction for some favored activity such as charitable giving, for example, that person’s tax liability is reduced by her marginal tax rate times the amount of charitable contribution, in effect giving the taxpayer a “discount” on their charity at a rate equal to the marginal tax rate. Alternately, the deduction can be conceived of as a “rebate” since the reduction in tax liability follows the reporting of the charitable contribution on the taxpayer’s income tax return. Thus, a taxpayer facing a 25 percent marginal rate who gives \$100 to charity receives a \$25 rebate or discount on that giving from the government while a taxpayer at a 50 percent marginal rate receives \$50 and a taxpayer in the zero bracket receives nothing.

Understood as a rebate or discount for charitable giving, the charitable deduction represents a cooperation by the government with an individual taxpayer’s philanthropy and may act as a subsidy for cultural pluralism.⁵³ Through the charitable deduction, a private citizen effectively directs the use of government funds to non-federal organizations. Although the operation of the deduction is not as stark as if a 25 percent marginal rate taxpayer wishing to direct \$100 to her favorite cause wrote a \$75 check to the charity herself and then instructed the government to write a \$25 check on her behalf,

⁵³ In the political science literature, cultural pluralism is valued, among other reasons, for creating multiple centers of power that may deter the emergence of a tyrannical majority. *See, e.g.*, NANCY L. ROSENBLUM, *MEMBERSHIP AND MORALS: THE PERSONAL USES OF PLURALISM IN AMERICA* 4, 25 (2000).

the final distribution of resources in the case of the deduction is the same as if the government were writing checks on behalf of private citizens.⁵⁴ The government has \$25 less than it would without the deduction, and the charity has an additional \$25.

In reality, the incremental giving in response to the presence of a deduction for giving will not necessarily equal the full value of the deduction. A taxpayer may choose to spend part of her increased wealth from the deduction on something other than charitable giving. To illustrate this point, ask whether, if the charitable deduction reduces the cost of giving from \$1 to 60 cents, a taxpayer who gave \$3 to charity before tax would with the incentive of the deduction would give \$5 (keeping his out-of-pocket expenses at \$3) or would reduce his out-of-pocket expenses to \$1.80, maintaining the benefit to charity of \$3.⁵⁵ Even though less than the full value of the deduction may flow to charity, there remain real equity concerns about an effective transfer of resources from the government to another party at the behest of an individual taxpayer. Moreover, the amount of government resources that may be transferred by a single taxpayer is only limited by that taxpayer's adjusted gross income.

Because the charitable deduction can be understood as taxpayer-directed government spending, the deduction is in a sense a direct participation by the taxpayer in the political process. When a taxpayer contributes to a charitable organization and receives a deduction, that organization may do work such as the performance of social services that the government might otherwise do itself or hire another party to do. In the quid pro quo of tax preference in exchange for a contribution to a tax-exempt

⁵⁴ The taxpayer in this example must nominally contribute \$100 to charity in order to receive \$25 from the government and make a "net" contribution of \$75. That is, the operation of the deduction is effectively tax inclusive, as is the income tax generally.

⁵⁵ GRAETZ & SCHENK, *supra* note 31, at 440.

organization, the taxpayer effectively “votes” for her preferred use of government resources (with each dollar of contribution representing a vote), and the government effectively delegates that resource allocation decision to the taxpayer. For this reason, Prof. Saul Levmore proposed the concept of “taxes as ballots” and the charitable deduction as a social choice mechanism.⁵⁶ Prof. Levmore sees certain advantages to this kind form of social choice mechanism as a method of gathering information about majoritarian or other preferences.⁵⁷ In particular, such a process holds the potential to foster greater cultural pluralism in the use of government resources than would otherwise result in a representative democracy in which voters choose among candidates who represent a bundle of issue positions.

Although Prof. Lemore considered only the charitable deduction when exploring his “taxes as ballots” notion, other tax expenditures may also represent an opportunity for taxpayers to participate in the political process by directing the use of government resources. In particular, the deductions for state and local property taxes and income taxes also results in a third party—in this case, states and localities—receiving federal resources through the action of individual taxpayers and doing work the federal government would have done itself in the absence of the deduction or exclusion. Granting that in this case the taxpayer doesn’t choose to pay local taxes in the same way she chooses to give to a charity, there is still an element of taxpayer choice to the extent the taxpayer can choose, as in the Tiebout model, to live in one of a variety of different communities offering different schedules of tax burdens and government services.⁵⁸

⁵⁶ Saul Levmore, *Taxes as Ballots*, 65 U. Chi. L. Rev. 387, 404-05 (1998).

⁵⁷ *Id.* at 409-12.

⁵⁸ See Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956).

If tax expenditures are means of participation in the political process, the use of the deduction mechanism may generate substantial inequities from a democratic perspective. In fact, a deduction may compromise the “one person, one vote” ideal in three different ways. For concreteness, let us again consider the charitable deduction. First, simply by virtue of their higher incomes, certain taxpayers have a greater capacity to direct government resources by giving to charity and deducting their expenditures. Second, and perhaps even more troubling, each dollar contributed by a higher-bracket taxpayer effectively directs a greater amount of government resources than a dollar contributed by a taxpayer subject to a lower marginal tax rate. Under current law, taxpayer in the highest bracket effectively receives a 35 percent rebate on charitable contributions while a taxpayer in the lowest bracket only receives a 10 percent rebate on each dollar contributed. Finally, taxpayers who do not itemize their deductions at all because the standard deduction exceeds the total value of the deductions they could itemize effectively have no “vote” over the use of government resources. Their gifts to charity generate no rebate at all from the government. In 2004, about 35.5 percent of taxpayers were non-itemizers in this “disenfranchised” position.

Better tax expenditure design, including the use of a credit instead of a deduction, could remedy some of the more undemocratic aspects of the charitable and state and local deductions. The inequity with respect to non-itemizers could also be reduced without the use of a credit if the deduction were a so-called “above-the-line” deduction taken as part of the computation of adjusted gross income (AGI) rather than a “below-the-line” itemized deduction available only if the standard deduction is declined. A credit would also avoid the consequence of the current-law deduction the fact that dollar-for-dollar,

higher-bracket taxpayers' contributions command a greater amount of government resources than lower-bracket taxpayers.⁵⁹ The President's Panel on Tax Reform adopted the above-the-line deduction approach, allowing taxpayers to deduct all charitable contributions beyond the first 1 percent of contributions regardless of whether they elect the standard deduction.⁶⁰ The Panel opted for the deduction over the credit without much discussion—a point that will be discussed in the next Section.

B. Horizontal Equity

Another traditional equitable touchstone of good tax policy, horizontal equity, demands that similarly situated individuals be treated similarly.⁶¹ In practice, this criterion of equity might be even more difficult to apply than vertical equity, given the complexities involved in ascertaining what it means for taxpayers to be similarly situated. The problem can be especially acute in the area of tax expenditures, where unobserved differences among taxpayers' in innate proclivities to engage in activities that happen to be favored by the tax system can generate disparities in tax benefits.

Although the horizontal equity concept has been criticized as lacking a substantial theoretical foundation⁶² and may be difficult to rigorously define, most commentators affirm the intuition behind the notion. Moreover, there is a plausible argument that

⁵⁹ As Levmore notes, the use of a full credit would create perverse incentives for taxpayers to eliminate their entire tax liability through charitable contributions at no cost to the taxpayer. *See* Levmore, *supra* note 56, at 416.

⁶⁰ *See* TAX PANEL REPORT, *supra* note 1, at 75-76.

⁶¹ There is substantial controversy in the literature as to whether horizontal equity represents an independent norm or is merely derivative of the vertical equity norm. Prof. Richard Musgrave has advanced the former view, Richard A. Musgrave, *Horizontal Equity, Once More*, 43 NAT'L TAX J. 113 (1990), Prof. Louis Kaplow has argued the latter. Louis Kaplow, A Note on Horizontal Equity, 1 Fla. Tax Rev. 191 (1992).

⁶² David Elkins, *Horizontal Equity as a Principle of Tax Theory*, 24 YALE L. & POL'Y REV. 43 (2006).

horizontal inequities, whether or not condemned by any consistent philosophical system, are damaging to the “taxpayer morale” critical to a self-assessment tax system such as employed in the United States. In its report on Tax Simplification and Reform, the Treasury observed that “[t]axpayers resent paying substantially more tax than their neighbors who have equal or higher incomes. This is true even if the neighbor reduces taxes through available and perfectly legal exclusions...rather than by questionable or illegal means.”⁶³

When tax expenditures create differential tax liability for taxpayers based on factors unrelated to income or ability to pay tax, horizontal inequities may frequently follow. Consider, for example, the tax exclusion for employer-provided health insurance. Suppose that while taxpayer A’s employer offers A health insurance worth \$1000, taxpayer B’s employer is smaller and less able to spread risk and so offers no health insurance option to B. Suppose further that both A and B are subject to a 25 percent marginal tax rate on their taxable income. Thanks to the employer-provided health insurance exclusion, A’s income tax liability is \$250 lower than it would otherwise be even though B’s tax liability is the same with or without the exclusion. Because A has an employer who provides health insurance while B does not, the exclusion results in a tax relief windfall to B with no comparable benefit for A.

Although both credits and deductions can generate tax disparities among similarly situated taxpayers, deductions allow the disparities to increase with increasing income.⁶⁴

The reason underlying this phenomenon is the same as the basis for the so-called upside-

⁶³ TREASURY DEPARTMENT, REPORT TO THE PRESIDENT: TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 9 (1984).

⁶⁴ This critique implicates both horizontal and vertical equity norms but is fundamentally a statement about how deductions exacerbate relative to credits horizontal inequities generated by any tax incentive.

down benefit; that is, a graduated rate structure makes a given deduction more valuable to a taxpayer at a higher marginal rate than to a taxpayer at a lower marginal rate. Consider again the example of the health insurance exclusion. If the marginal tax rates of both A and B were 50 percent instead of 25 percent but the rest of the details were the same, the exclusion would impart a tax benefit of \$500 to A and nothing to B, a significantly larger difference than the \$250 disparity in tax benefits when marginal tax rates were 25 percent. In contrast to the effect of this deduction, a 25 percent credit for health insurance would ensure that A's tax benefit from the exclusion was \$250 no matter the level of marginal tax rates. In this sense, a credit may be advantageous from a horizontal equity standpoint since the disparity among similarly situated taxpayers remains constant for taxpayers at all income levels.⁶⁵

Above-the-line deductions may also seem horizontally inequitable due to the impact of regional cost-of-living differences on itemization rates. As discussed in more detail in Subsection II.C.1, itemization rates are driven in large part by the value of the home mortgage interest and state and local tax deductions, both of which are heavily influenced by regional cost of living variation. All else equal, itemizers are better situated than non-itemizers since the former receive a marginal tax benefit from their deductible expenses while the latter do not. Thus, it might seem as if those in high cost-of-living areas receive a sort of windfall benefit from being able to itemize deductible expenses. In light of the possibility of migration across regions, however, this apparent inequity is actually illusory. Prof. Louis Kaplow has shown that in a model allowing for

⁶⁵ This conclusion depends on the choice of marginal tax rates under a deduction option and the credit rate under the credit option. In particular, one could imagine a tax system where the credit rate is higher than the highest marginal tax rate and the critique levied in this subsection does not apply. Nevertheless, given current and likely future tax rates, it seems probable that a deduction cause greater horizontal inequities at higher income levels than would prevail under any credit likely to be enacted.

migration across regions in response to regional utility differences, individuals of equal ability will achieve equal utility regardless of differences in living costs and taxes.⁶⁶ In light of this conclusion and the fact that interregional migration is very much a reality in the United States⁶⁷, it is reasonable to conclude that regional differences in itemization rates are—at least as a matter of averages at equilibrium—not working major inequities.

The consequences for the tax system of horizontal inequity—whether real or perceived—are indeed serious. The practical problem of horizontal inequities is their potentially deleterious effect on taxpayer morale. As the 1984 Treasury report on tax reform put it, “[t]axpayers resent paying substantially more tax than their neighbors who have equal or higher incomes.” If the effect of tax expenditures is that certain taxpayers pay substantially more taxes than their equally well-heeled neighbors, then the horizontal inequities resulting from tax expenditures matter. Where deductions exacerbate the tax system’s horizontal inequities among similarly situated taxpayers at higher income levels, credits have an advantage over deductions as a matter of horizontal equity.

II. Efficiency of Credits and Alternatives

⁶⁶ See Louis Kaplow, *Regional Cost-of-Living Adjustments in Tax/Transfer Schemes*, 51 TAX L. REV. 175, 180-181 (1996). See also Michael S. Knoll & Thomas D. Griffith, *Taxing Sunny Days: Adjusting Taxes for Regional Living Costs and Amenities*, 116 HARV. L. REV. 987, 988 (“In our view, fairness arguments—either for or against adjusting the tax burden to account for differences in regional living costs—are uneasy at best because competition from interregional migration tends to eliminate differences in living standards for individuals with similar skills and drive.”)

⁶⁷ See MARC J. PERRY, DOMESTIC NET MIGRATION IN THE UNITED STATES: 2000 TO 2004 2 (2006), <http://www.census.gov/prod/2006pubs/p25-1135.pdf> (reporting average annual regional migration rates between -5.5% and 6.9%).

In the evaluation of the tax system and proposals for reform, the only other normative standard that is advanced as frequently as equity is the criterion of efficiency.⁶⁸ In fact, the recent report of the President's Advisory Panel on Tax Reform Panel and the 1984 report by Treasury on reform each included the words "fairness" and "growth" in their titles. When the general public is to be included in a discussion about tax policy, the term "growth" is usually used as code for efficiency since the term "efficiency," while beloved by economists, has never succeeded as political rhetoric in warming many hearts.⁶⁹

Efficiency is central to the question of tax expenditure design, in particular the question about the relative advantages of credits and deductions. In order to begin exploring those questions, it is first necessary to be precise about what it means to say that a particular tax expenditure is more efficient than another.

A. Efficiency in the Context of Tax Expenditures

Although the concept of efficiency is regularly invoked in discussions of tax policy, it is used in so many different senses and contexts that its meaning in any given setting can be obscured. In the most basic economist's understanding of the term, efficiency refers to the optimality of resource allocation in society, i.e. whether society's resources are being put to their most productive uses. Although the term has its firmest grounding when used to describe resource allocations, certain rules and institutions which

⁶⁸ Simplicity is also frequently mentioned as an important criterion for the evaluation of tax policy, especially on the individual side of the tax system, but simplicity is less fundamental than equity or efficiency since it can be understood in terms of those other two criteria.

⁶⁹ Efficiency generally refers to the allocation of resources among uses in society, while "growth" refers to the rate of increase of national output. While more efficient resource use can increase an economy's growth rate, efficiency and growth are not synonymous. The following discussion refers to efficiency as such.

affect the allocation of resources in society are also said to be efficient or inefficient. In the context of the modern regulatory state, it is practically impossible to isolate a single aspect of the larger system and evaluate in terms of its efficiency in an absolute sense. Nonetheless, statements about comparative efficiency are often possible and appropriate.

In an effort to bring precision and clarity to the concept of efficiency as applied to the tax system in general and tax expenditures in particular, Prof. Edward Zelinsky has proposed a taxonomy of efficiency for the tax policy world.⁷⁰ In Zelinsky's analysis of the tax expenditure literature, he finds three distinct uses of the efficiency concept which he dubs "universal market efficiency," "sectoral efficiency," and "technical efficiency," respectively.⁷¹ The first efficiency concept, universal market efficiency, is the norm employed by commentators who assume that all markets are identified and are perfectly competitive and who conclude that any government intervention in the economy, whether accomplished through tax expenditures or direct spending, represents an unacceptable deviation from an otherwise optimal allocation of labor, capital, and land. Rejecting tax expenditures completely, this concept has little or no relevance to the question of whether a particular tax expenditure is better implemented as a credit or a deduction.

The sectoral efficiency concept, on the other hand, entails less sweeping assumptions about the overall competitiveness of markets, instead comparing "discrete parts of the economy to determine if profitability could be increased or consumers' choices improved as between them."⁷² Analysis under this view of efficiency would consider, for example, the impact of a particular tax expenditure on the capital stock in

⁷⁰ See Edward A. Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 Tex. L. Rev. 973 (1986).

⁷¹ *Id.* at 975.

⁷² *Id.* at 986.

two sectors of the economy relative to the capital stocks which are determined solely by pretax returns to capital investment in the respective sectors. Sectoral inefficiency has played an important role in the analysis of tax code features such as investment tax credits and depreciation.⁷³ The concept could also potentially be a useful analytic for the question of tax expenditure design to the extent that the choice of a credit over a deduction, for example, mitigates the tax-induced distortion of resources between two sectors induced by a particular tax expenditure.⁷⁴ As Zelinsky notes, however, claims of inefficiency based on the sectoral efficiency require the maintenance of several substantial assumptions, including free movement between and entry into different sectors, no externalities, and the identification of all relevant sectors.⁷⁵

The final efficiency concept in Zelinsky's tripartite taxonomy, technical efficiency, is a much narrower concept than universal or sectoral efficiency and is the concept best suited to analysis of the relative advantages of credits and deductions for implementation of tax expenditures. In considering a particular tax expenditure, the technical efficiency question is whether the government is "purchasing" the largest possible marginal change in taxpayer production or consumption for each marginal dollar of revenue foregone—i.e. the most "bang for the buck."⁷⁶ It is possible, for example, that for a given amount of government resources available for incentivizing a particular taxpayer behavior, a rearrangement of incentives among taxpayers may produce a higher overall amount of the incentivized activity. Accordingly, the technical efficiency concept

⁷³ See, e.g., Alan J. Auerbach, *The Deadweight Loss from 'Nonneutral' Capital Income Taxation* 1-3 (Nat'l Bureau of Econ. Research Working Paper No. 2510, 1988).

⁷⁴ A tax expenditure such as the home mortgage interest deduction, for example, diverts investment into the housing sector and away from other sectors. Conversion of the deduction to a credit could affect the magnitude of the distortion by altering the marginal incentives for investment in housing faced by individuals in different tax brackets.

⁷⁵ *Id.* at 1001-10.

⁷⁶ *Id.* at 1009.

is useful for ascertaining whether a credit, deduction, or other device is best suited to the accomplishment of a particular government goal through the tax system or even whether it may be better accomplished through a government expenditure program.

B. Tax Expenditure Design and the Deadweight Loss from Taxation

It is well established that income taxation entails an efficiency cost that depends on a taxpayer's marginal tax rate. This cost results from the fact that marginal tax rates alter the pre-tax price of consumption and production, resulting in patterns of consumption and production that deviate from those that would obtain in the absence of a tax system. Thus, for example, the taxation of income from market work may, by decreasing the return to work, result in less hours spent in the labor force and more hours spent in leisure than would obtain if each marginal dollar earned were tax-free—in the schema described above, a sectoral inefficiency.⁷⁷ This tax-induced shift in the allocation of resources across the market and non-market sectors generates an inefficiency that economists refer to as the deadweight loss of taxation, a measure which represents the lost social value from the resource misallocation. Critical for efficiency analysis of the tax system is the theoretical insight that the deadweight loss of taxation increases proportionally to the square of the marginal tax rate.⁷⁸ Thus, provisions of the tax code that increase or decrease a taxpayer's effective marginal tax rate have non-trivial implications for the overall social cost of the tax system.

⁷⁷ This “substitution effect” could be offset to some degree by an “income effect” if the loss of after-tax income resulting from a higher tax rate causes a taxpayer to increase work effort to offset the loss of income.

⁷⁸ See generally Browning, *supra* note 49.

Although credits and deductions may be designed such that they entail an equivalent cost in terms of foregone revenue, these two devices operate in very different ways to reduce an individual taxpayer's liability. This difference has potentially significant implications for taxpayers' effective marginal tax rates and for the deadweight cost of taxation. In particular, whereas deductions reduce final tax liability by reducing the amount of income subject to taxation according to the graduated rate structure, credits reduce final tax liability not by reducing taxable income but by directly reducing final tax liability after the graduated rate structure has been applied to taxable income. The consequence of this operational difference is that a deduction can potentially lower a given taxpayer's marginal tax rate while a credit can never do so. The disadvantage of a credit in this regard can be illustrated by a comparison to a lump sum tax. Whereas a lump sum tax is superior to a marginal tax from an efficiency standpoint because the lump sum tax generates revenue without distorting marginal incentives, by the same token a credit—which is effectively a lump-sum subsidy, the opposite of a lump sum tax—reduces revenue without improving marginal incentives.⁷⁹ By contrast, a deduction may actually “buy” a reduction in the deadweight cost of taxation with the foregone revenue it causes.

The extent to which a deduction can reduce individual marginal tax rates and, by extension, the deadweight cost of taxation, is an empirical question. The answer depends both on the total value of a taxpayer's itemized deductions and the difference between a taxpayer's pre-deduction taxable income and the income cutoff for the taxpayer's next-

⁷⁹ A lump sum tax is a tax imposed without regard to any characteristic over which the taxpayer has control. A head tax that imposes the same amount of tax on each citizen is one example of a lump sum tax. By contrast, the term marginal tax, as used here, refers to a tax that varies according to some factor under the control of the taxpayer. Thus, an income tax is a marginal tax since the amount of tax imposed varies according to a taxpayer's income—a factor which the taxpayer may control.

lowest tax bracket. If tax rates rose continuously with taxable income, any deduction would reduce marginal tax rates, but since progressivity in the tax system is accomplished with discrete brackets, the distance between brackets cutoff points is relevant. To gauge the potential reduction in marginal tax rates from deductions, note that for single filers, the first five brackets of 10 percent, 15 percent, 25 percent, 28 percent, and 33 percent have widths of \$7,500, \$23,100, \$43,550, \$80,600, and \$181,750, respectively.⁸⁰ For comparison, the average itemized deduction for taxpayers with AGI of less than \$200,000 who elected to itemize was just over \$18,000.⁸¹ Thus, deductions have a considerable potential to push a taxpayer into a lower tax bracket, reducing the deadweight cost of taxation.

Several objections may be levied against this asserted efficiency advantage of deductions over credits. One such objection is that the marginal tax rate schedule is set with the knowledge that taxpayers will take deductions, meaning marginal tax rates would be the same on average for particular groups even without the deduction. In this view of tax policymaking, legislators have a preconceived idea about how many taxpayers should occupy each tax bracket. This argument is unpersuasive, however, if the bottom line for legislators is not marginal tax rates but instead is revenue generated; deductions allow lower average marginal tax rates for the same revenue cost, an attractive option for a politician.⁸² A potentially weightier objection is that the reductions in marginal tax rates resulting from deductions are simply not of a large enough

⁸⁰ See Rev. Proc. 2005-70, 2005-47 I.R.B. 979.

⁸¹ Author's calculation based on Internal Revenue Service, SOI Tax Stats – Individual Income Tax Returns, Table 3 -- Individual Income Tax Returns with Itemized Deductions, 2004 (last visited Oct. 7, 2006).

⁸² Prof. Boris Bittker, in his debate with Stanley Surrey about tax expenditures, notes the ease with which many deductions, credits, and other allowances can be converted into rate reductions. Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 *National Tax Journal* 244, 252 (1969).

magnitude—especially at current rates, which are lower and flatter than in the past—to have a substantial effect on marginal incentives and the deadweight cost of taxation. That is, even if a taxpayer has \$11,000 of itemized deductions that push her taxable income from \$10,000 above the lower bracket point for the 25 percent bracket to \$1,000 below it, an additional \$1,000 of income will put her back in the 25 percent bracket. How much taxpayers actually respond to such minor marginal incentives is a debatable, although it is clear that in theory at least, deductions retain this efficiency advantage over credits.

C. Deductions as an Imprecise Tool of Policymaking

Most of the major tax incentives currently found in the tax code very clearly evince a purpose of incentivizing specific types of behavior.⁸³ Certainly that is the situation with big-ticket items such as the home mortgage interest deduction, the exclusion for employer-provided health insurance, and the charitable contribution deduction which—no matter what other political or distributional motives may have influenced their creation and their longevity—indisputably appear designed to incentivize homeownership, employer provision of health insurance to employees, and contributions to charity, respectively. But in choosing as its instruments deductions and exclusions that generate seemingly irrational differences in incentive structures for different taxpayers, has Congress chosen the most precise tool available for accomplishing its goals? This subsection considers the suitability of deductions and exclusions relative to credits as

⁸³ Not all of the tax incentives found in the tax code are meant as incentives, of course. The state and local tax deduction, discussed *infra*, is one example of tax expenditure that does not seem intended as a tax incentive.

means of accomplishing Congress' policy goals, noting the strange pattern of incentives generated by deductions and exclusions, exploring possible justifications for the use of these devices, and considering the efficiency implications where their use is not justified.

1. The Incentive Pattern of an Itemized Deduction

In critiquing the distributional anomalies of tax expenditures implemented as deductions, Stanley Surrey pointed out that no government spending program would ever produce what he considered the perversely regressive pattern of benefits generated by a typical deduction.⁸⁴ Surrey's equitable concerns about the strange pattern of tax benefits generated by a deduction also have force as an efficiency-based critique of the deduction as a means of inducing desired behavior in a cost-effective way. What designer of a spending program would intentionally vary incentives based on the distinctions among taxpayers created by the typical deduction? Relative to a refundable credit, a deduction provides differential incentives for taxpayers along at least four notable dimensions: filers vs. non-filers, itemizers vs. non-itemizers, among taxpayers in different marginal rate brackets, and among taxpayers with different annual income volatilities.

Consider first the case of non-filers. Due in part to recent tax legislative changes that have increased tax relief at lower income levels through devices such as the refundable child credit, a substantial group of Americans has no federal income tax liability or will receive a net payment from the government through the tax system. For tax year 2006, it is projected that 43.4 million tax returns, representing 91 million individuals, will have zero or negative tax liability and that another 15 million households and will file no tax return at all. In total, approximately 121 million Americans, or about

⁸⁴ See SURREY, *supra* note **Error! Bookmark not defined.**, at 136.

41 percent of the population of the United States, will find themselves outside of the federal income tax system—or inside it solely to collect refunds.⁸⁵ For a large portion of this group, a marginal dollar of deductions from adjusted gross income will have no effect on final tax liability at all.⁸⁶ Consequently, deductions designed to induce desired behavior will have no effect on these individuals. A non-refundable credit will not reach these individuals either, but a credit that is made refundable will.

Another major group of taxpayers who cannot be induced to undertake certain activities by a tax incentive implemented as an itemized deduction is the group that chooses not to itemize at all. The vast majority of deductions—including the highest revenue cost items such as deductions for home mortgage interest, charitable contributions, and state and local taxes—are so-called “below-the-line” deductions which may be deducted from adjusted gross income (AGI) in lieu of a standard deduction (which was \$5,000 for single filers in 2005). In contrast, “above-the-line” deductions, which affect the calculation of AGI, typically relate to the measurement of income or exist to address disparities affecting the tax treatment of the self-employed or employees whose employers don’t offer certain tax-favored benefits. Typically, a taxpayer will choose to itemize deductions when the combined value of available deductions exceeds the value of the standard deduction or when the burden of documenting itemized deductions is too great. In 2004, 35.5 percent of taxpayers nationwide chose to itemize,

⁸⁵ Scott A. Hodge, *Number of Americans Paying Zero Federal Income Tax Grows to 43.4 Million*, <http://www.taxfoundation.org/publications/show/1410.html> (last accessed Oct. 7, 2006).

⁸⁶ Individuals with positive tax liability before refundable credits but zero or negative liability after refundable credits could in fact benefit from a deduction that reduces their positive tax liability.

leaving a majority of taxpayers unaffected by tax incentives structured as itemized deductions.⁸⁷

One important side-effect of the differential impact of itemized deductions based on itemization status is substantial regional variation in the efficacy of deduction. This regional variation follows from similar variation in itemization rates. In 2001, for example, when the national proportion of itemizers was 32.9 percent, itemization rates ranged between 17 percent in South Dakota and 48 percent in Maryland.⁸⁸ States along the Eastern seaboard and on the West coast generally had the highest itemization rates while the lowest rates were found in the South and the North Central plains. Differences in itemization rates are linked to regional cost of living differences, particularly as reflected in income and housing prices, the drivers of the itemized deductions generating the greatest foregone revenue: home mortgage interest and state and local taxes.⁸⁹ Thus, the use of a below-the-line deduction means certain regions of the country where itemization rates are low due to cost-of-living differences should be less impacted by a tax incentive than other regions.⁹⁰

Unlike a below-the-line deduction, a credit is available regardless of whether a taxpayer elects to take the benefit of the standard deduction. Consequently, a credit will be as effective in incentivizing non-itemizers as itemizers. An above-the-line deduction

⁸⁷ Author's calculations based on Internal Revenue Service, Statistics of Income, Individual Income Tax Returns With Exemptions and Itemized Deductions, http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96978.00.html#_grp2 (last accessed Sept. 30, 2006).

⁸⁸ Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA L. Rev. 1389, 1412 (2004).

⁸⁹ *See id.* at 1412-13. The President's Advisory Panel on Federal Tax Reform proposed replacing the home mortgage interest deduction with a credit subject to a cap corresponding to the average regional price of housing. *See* TAX PANEL REPORT, *supra* note 1, at 61.

⁹⁰ If this hypothesis is correct, one would expect lower homeownership rates in low cost-of-living regions. Time-series research suggests, however, that the value of the deduction has little impact on homeownership rates. *See* Edward L. Glaeser & Jesse M. Shapiro, *The Benefits of the Home Mortgage Interest Deduction 3* (Nat'l Bureau of Econ. Research Working Paper No. 9284, 2002)

would accomplish the same goal but is currently a rarity in the federal individual income tax, perhaps in light of the apparent purpose of the standard deduction as a substitute for itemized deductions. The President’s Advisory Panel on Tax Reform chose to overcome this conflict by simply instituting a family credit that would replace the standard deduction, personal exemption, and child credit. Remaining deductions such as the deduction for charitable giving could be taken without prejudice to the family credit.⁹¹

Even for taxpayers who file returns and who itemize, a tax incentive structured as a deduction still has differential incentive effects on taxpayers based on their marginal tax rate (i.e. their income). As discussed in Part I, because a deduction operates by reducing the amount of taxable income subject to taxation at graduated rates, the value of a deduction in terms of reduced tax liability is simply the amount of the deduction multiplied by the taxpayer’s marginal rate. Thus, taxpayers in the top bracket—who receive in effect a 35 percent “discount” on the behavior incentivized by the deduction—are significantly more incentivized than taxpayers in the lowest bracket who receive a 10 percent discount on the same behavior. Since there are six different marginal rates in the current rate structure, a deduction may have one of six different values.⁹² In contrast, a taxable credit has the same marginal value for every taxpayer, and in fact it would require a system of six different credit rates to replicate the incentive structure created by a deduction.

Finally, taking a longer-term perspective than the annual tax accounting period, it is evident that tax incentives structured as deductions have different impacts on taxpayers

⁹¹ See TAX PANEL REPORT, *supra* note 1, at 61.

⁹² See Rev. Proc. 2005-70, 2005-47 I.R.B. 979.

with equal lifetime incomes but varying degrees of income volatility from year to year.⁹³ In particular, taxpayers with more variable incomes face a situation where the marginal value of a particular tax incentive may vary from year to year along with their marginal tax rate brackets. For a taxpayer with the same lifetime income as the variable-income taxpayer but who occupies the same marginal rate bracket each year, the marginal incentive generated by a deduction will be constant over time. By contrast to a deduction, the marginal incentive generated by a refundable credit remains constant each year a taxpayer has positive tax liability.

2. The Case for Neutrality

Although some tax expenditures may serve a distributional function, the vast majority are properly understood as tax incentives with a primary purpose of eliciting a desired behavior from taxpayers. In the most common case, the government uses tax expenditures as an indirect means of securing the provision of a public good that would otherwise be undersupplied. For purposes of this discussion, the public good can be thought of as taking one of two forms. The public good may be of an additive form, in which case the identity of the contributor to the public good doesn't matter because the total value of the public good is simply the sum of all the contributions by all individuals. One such public good is a national defense; it simply doesn't matter who writes the check for the necessary tanks and planes as long as the check is written. The public good may also be of a non-additive form, in which case there is a diminishing public benefit to a given person's contribution to the public good. The public health is an example of one such public good. At some level of a given taxpayer's spending on his own healthcare,

⁹³ See Batchelder et al., *supra* note 24, at 55 (2006).

his contribution to the overall public good of public health begins to diminish. The public health as a public good is better served where the entire population has certain basic health needs met than where a portion of the otherwise healthy population is able to obtain Lasik surgery while others lack important vaccinations.

For the government seeking to provide certain public goods by way of tax incentives, technical efficiency is the criterion by which such a tax expenditure's effectiveness must be judged. In the technical efficiency paradigm, the government can be understood as a purchaser of behavior, and the question is whether a particular provision of the tax code represents the most cost-effective means of inducing the behavior that generates the public benefit.

For the technical efficiency of a credit or deduction, it is crucial to note that most consumers/taxpayers can reasonably be assumed to have convex preferences. For the consumer with convex preferences, the marginal utility of purchasing some good or service that generates a public benefit will diminish as the amount of that good or service purchased increases. As the marginal utility of that good decreases, the price the consumer is willing to pay for an additional unit of that good also decreases. In the context of tax incentives for the purchase of a certain type of good, this diminishing marginal utility means the marginal incentive required to induce a particular taxpayer to purchase a certain good rises as that taxpayer's consumption of that good rises.

Assuming that the responsiveness of taxpayers to tax incentives and that the marginal social benefits generated by taxpayer behavior do not vary by income level, the diminishing marginal utility of consumption means that the government can most cost-effectively induce its desired behavior by offering the marginal incentive at as low a rate

as possible to as broad a group as possible. This conclusion holds regardless of the form of the public good. If the public good is additive, the taxpayers who are responsive to the offered incentive will contribute to the public good until the marginal (subsidized) price of doing so equals the private marginal benefit, and it may be the case that a relatively small group provides most of the public good. Narrowing eligibility for the incentive will simply raise the marginal incentive rate necessary to generate the desired level of public good, thus raising the cost to the government. If the public good is non-additive, it may be necessary to offer a higher marginal incentive to contribute to the public good in order to induce a broader range of individuals to undertake the activity that generates the public good. Nonetheless, the same result attains. Narrowing the group eligible for the incentive impacts provision of the public good both directly by reducing the number of contributors and indirectly by raising the necessary marginal incentive and consequently the cost to the government.

If the government's goal in providing a particular tax incentive is to induce the provision of some public good in the most revenue-effective way possible, deductions providing differential incentives to taxpayers on bases unrelated to their responsiveness to incentives are not obviously the appropriately policy tool.⁹⁴ Below-the-line deductions differentiate among individuals based on whether they file tax returns or not, based on whether they itemize deductions or not, and based on their marginal tax rate. The distinctions based on filing and itemization have the effect of directly narrowing the number of recipients in contradiction to the government's optimal strategy, described above, of offering marginal incentives to as large a group as possible. The deduction's

⁹⁴ The most commonly mentioned potential exception to an optimal strategy of uniformity of incentives for all taxpayers is the charitable deduction, discussed *infra* at note 98 and accompanying text.

provision of differential marginal benefits based on a taxpayer's marginal tax rate also contradicts the government's optimal strategy by offering in some cases a higher marginal incentive than necessary to induce desired behavior, resulting in an inefficient and inequitable windfall to certain taxpayers. For a tax expenditure to be cost effective, taxpayers should collectively be offered the minimum marginal incentive necessary to assure desired provision of the public good sought by way of the tax expenditure.

A tax incentive that applies uniformly across taxpayers of all different statuses has the further efficiency advantage that it generally minimizes the expected error in the application of the incentive. Where taxpayers differ in their responsiveness to tax incentives based on unobserved or unobservable characteristics, any tax incentive will get it wrong part of the time by either underincentivizing or overincentivizing taxpayers. That is, any incentive will sometimes either pay too much for production of the desired public good or failing to pay enough where paying more would generate social benefits in excess of the cost. Prof. Lily Batchelder and her co-authors mathematically demonstrate that in the case of a subsidy that generates positive externalities, the subsidy that minimizes the deadweight loss associated with this inaccurate incentivization should be uniform across households. Any non-uniform incentive structure risks compounding the inefficiencies of inaccurate incentive targeting by giving larger incentives to groups that should get smaller ones, and vice versa.⁹⁵

3. Justifications for Non-Neutrality?

Are there sound arguments for non-neutrality? A possible caveat to the preliminary conclusion in favor of uniform subsidies to as large a group as possible is

⁹⁵ See Batchelder, Goldberg & Orszag, *supra* note 24, at 47-49.

that taxpayers may systematically vary by income class in their response to tax incentives—as some apparently believe is the case for charitable giving incentives.⁹⁶ As a theoretical matter, if taxpayers at higher income levels respond to incentives in systematically different ways than lower-income taxpayers, a pattern of tax incentives such as that generated by a deduction may be efficient. In support of the possibility of different levels of responsiveness, one might conjecture that lower-income taxpayers face tighter budget constraints and are consequently more price-sensitive than higher income taxpayers. In this case, a deduction would allow a very rough form of price discrimination, providing a lower marginal incentive to the lower-income taxpayers who will respond to that incentive and providing a higher marginal incentive to the higher-income taxpayers who need a greater degree of motivation to undertake the desired behavior. From a technical efficiency perspective, then, a deduction might even be superior to a credit that provides the same incentive to everyone even if that incentive is greater than necessary for some people.

Another theoretical possibility justifying differential incentivization based on income levels is that certain behavior generates greater positive externalities when undertaken by higher-income individuals than lower-income individuals. This situation might arise if certain expenditures or investments have a higher social value when undertaken in larger discrete “chunks” that only higher-income taxpayers have the capacity to undertake. Consider, for example, a billionaire philanthropist who, like a venture capitalist does in the commercial context, provides seed money to new or innovative projects for which more conventional funding sources are unavailable. Positive externalities from a certain type of behavior might also vary if higher-income

⁹⁶ See *infra* note 98 and accompanying text.

individuals have information advantages that make their expenditure or investment more valuable from a social perspective.⁹⁷ In this case, a deduction would nominally be available to everyone but would provide the strongest incentives to those high-income taxpayers whose marginal contributions to the public good add the greatest social value.

The President's Advisory Panel on Tax Reform, in recommending the retention of the current incentive for charitable giving in the form of a deduction instead of a credit, seems to have adopted some form of the assumption that "the rich really are different." How exactly the Panel thinks the rich are different is not clear from its final report, which offers only this hint of an explanation: "The Panel also recommends that the tax benefit be structured as a deduction to provide incremental incentives to higher-income donors, an important source of charitable donations."⁹⁸ The Panel does not explain whether it believes that higher-income donors actually require greater incentives to contribute to charity or whether it believes contributions by higher-income individuals are more valuable because they generate greater social benefits. One possibility is that pre-existing charitable giving (i.e. giving absent any tax incentive) is substantially higher as a fraction of potential giving for lower-income individuals than higher-income individuals so that incentivizing lower-income individuals at the same high rate as their higher-income counterparts would merely reward existing giving rather than incentivize large amounts of new giving.

Even if the rich really are different in either their responsiveness to tax incentives or the social benefits their behavior generates, however, the deduction is not clearly the right choice for tailoring incentives to responsiveness. A deduction provides a marginal

⁹⁷ See *infra* note 137 and accompanying text for evidence about how taxpayers at different income levels give to different types of charitable beneficiaries.

⁹⁸ See TAX PANEL REPORT, *supra* note 1, at 75.

incentive equal to a taxpayer's marginal tax rate, but the marginal tax rate itself is a highly arbitrary value, typically the result of political compromise and the federal government's revenue needs. A credit, by contrast, theoretically can be more precisely tailored by setting the credit rate based on information about the responsiveness of certain groups to marginal incentives. More realistically, however, economic science is simply not precise enough to measure fine variations in responsiveness based on income levels. Batchelder et al. have argued that in a case such as this, the burden of proof should be upon advocates of a non-uniform subsidy to show that demonstrate systematic difference across income classes.⁹⁹ Even if such variations exist, responsiveness is unlikely to vary in a discontinuous fashion as do marginal rate brackets. Ultimately, to presume that a tax incentive could be tailored to follow the contours of income-based variations in behavioral responses would seem to be an exercise in technocratic hubris.

A stronger, albeit limited, case for the use of deductions over credits arises where the tax code provides a deduction or exclusion for a substitute activity. Frequently, such a deduction or exclusion may be implicit and exist for reasons of administrative necessity. In one example of such an administratively necessary exclusion, what economists refer to as home production—i.e. activities that would be compensated in a market context but are conducted in a non-market setting—is effectively excluded from income tax under the current system since such activity generates no actual cash income that can be taxed. Given that this effective exclusion exists, it must be taken into account when designing other tax incentives. This situation arises especially where policymakers seek to incentivize purchase in the market of some good or service that can be produced at home and enjoy the benefit of the effective exclusion.

⁹⁹ See Batchelder, Goldberg & Orszag, *supra* note 24, at 28.

Gene Steurle has used the example of incentives for child care to illustrate effects of a de facto exclusion on other areas of the tax code, noting that for the tax system to maintain neutrality between child care provided in the home and child care provided outside the home, a deduction is necessary for child care expenses purchased in the market.¹⁰⁰ If a credit were used for child care expenses instead of a deduction and if the credit rate were greater than the taxpayer's marginal tax rate, the tax system would favor purchase of childcare care outside the home rather than the "home production" alternative. If the credit rate were lower than the taxpayer's marginal tax rate, the tax bias would swing in the other direction so that on the basis of tax considerations alone, non-market alternatives to sending the kids to day care would be preferable. Other areas of the tax code are influenced by de facto exclusions as well, the charitable deduction being a prime example: the replacement of the charitable giving deduction with a comparable credit could shift the balance in favor of donation of time (i.e. services) for individuals in some tax brackets and in favor of donation of money or assets for individuals in other brackets.

While the use of credits in certain contexts may indeed shift the balance between do-it-yourself production and purchases in the marketplace, this consideration will generally not be completely determinative in any given context. The fact that tax expenditures implemented as credits generate biases along one dimension must be balanced against other biases generated by the use of deductions, which have a differential impact on filers vs. non-filers and on itemizers vs. non-itemizers. The comparative magnitudes of each of these biases must be considered when assessing

¹⁰⁰ See Gene Steurle, *The Problem With Converting Itemized Deductions to Credits*, 74 Tax Notes 427, 428 (1997).

whether a credit or deduction is superior from the standpoints of technical and sectoral efficiency.

4. The Efficiency Consequences of Credit Transparency

The preceding discussion of the relative technical efficiency of credits and deductions presumes that taxpayers know their marginal tax rates and understand the effect of a deduction or a credit on their tax liability. For a variety of reasons discussed below, however, taxpayers may not know their marginal tax rates or may be mistaken about those rates. What are the implications of such information failures for the efficiency of tax expenditures? Do credits, which have a marginal value independent of a taxpayer's marginal tax rate, have an efficiency advantage over deductions by virtue of the greater transparency of their operation on final tax liability? This subsection will explore the accuracy of taxpayers' beliefs about their marginal tax rates and the consequences of those beliefs for the efficacy of tax incentives.

There are many reasons to suppose that taxpayers may not be aware of their marginal income tax rates—assuming that the average taxpayer knows the difference between a marginal rate and an average rate. A prime reason for this ignorance is that relatively few taxpayers actually prepare their tax returns by themselves without any assistance. Over 62 percent of taxpayers used paid preparers in tax year 2003 while an additional 25 percent used tax preparation software, leaving only 13 percent of taxpayers who did it the old-fashioned way, sitting down with pen, calculator, tax forms, and a box of receipts to compute their tax liability.¹⁰¹ Moreover, among taxpayers who did

¹⁰¹ John L. Guyton et al., *The Effect of Tax Software and Paid Preparers on Compliance Costs 1* (2005), <http://www.urban.org/publications/1000802.html>.

compute their tax liability without outside assistance, those taxpayers with less than \$100,000 of taxable income never actually needed to know or use their marginal tax rate in computing their federal income tax liability since the IRS provides tax tables for those taxpayers to compute their liability from their taxable income. Additionally, even if a taxpayer does know her marginal tax rate when she computes her tax return once a year, there is no certainty that the taxpayer will remember their rate at any given point in the year.

Perhaps the most significant reason an individual may not be aware of their marginal rate, however, is that for even the average taxpayer, the relationship between income and marginal tax rate can be extraordinarily complex. Due to particular features of the tax code, the statutory marginal tax rate is rarely the same as a taxpayer's effective marginal rate. Effective marginal tax rates do not move smoothly from lower to higher incomes; rather, there are a number of intermediate peaks or bubbles along the way that can result in taxpayers in the middle of the income distribution facing some of the highest marginal rates.¹⁰² In concluding that the actual marginal rate schedule is highly complex, Professor Elliott Manning and Laurence Andress note the impact on marginal rates of the following bevy of tax code features: (i) the standard deduction, (ii) the personal exemptions and their phase-out, (iii) the overall limitation on itemized deduction, (iv) the floors on specified itemized deduction that are integral parts of the 'income' tax statutory structure, (v) the earned income tax credit (EITC) that, confusingly, is a direct part of the 'income' tax, (vi) the tax on social security benefits that is imposed by the income tax

¹⁰² Elliott Manning & Laurence M. Andress, *The 1996 Marginal Federal Income Tax Rates: the Image and the Reality*, 73 Tax Notes 1585, 1586 (1996).

system.¹⁰³ The complexity resulting from these complicated provisions would certainly obscure almost any taxpayer's perception of their marginal rate.

Empirical investigation confirms that taxpayers' perceived marginal tax rates differ substantially from their actual rates. One study compared survey respondents' beliefs about their marginal tax rates with those respondents' actual tax returns and found that just less than a third of respondents could accurately cite their marginal tax rate within five percentage points.¹⁰⁴ Taxpayers who have higher incomes, who do not receive professional tax preparation assistance, and who do receive professional financial advice from a consultant were more likely to be accurate in their estimate.¹⁰⁵ Approximately twice as many of those who inaccurately recalled their marginal tax rate overestimated the rate in their response as underestimated the rate, with overestimators off target by 12 percentage points on average and underestimators off by 10 percentage points.¹⁰⁶

Taxpayers' misapprehensions about their marginal tax rates may have implications for the effectiveness of deductions and credits as incentives to undertake certain behaviors. A person's marginal tax rate represents the price of—or, rather, the government-subsidized discount for—engaging in certain activities which the government has chosen to subsidize by means of a deduction. If that person's belief about their marginal tax rate is wrong—or if the person simply doesn't know their marginal tax rate—then that person is unlikely to respond to a deduction in the way the architect of the deduction may have intended. In contrast, the effect on final tax liability

¹⁰³ *Id.*

¹⁰⁴ Timothy J. Rupert & Carol M. Fischer, An Empirical Investigation of Taxpayer Awareness of Marginal Tax Rates, 17 *J. Am. Tax. Ass'n* 36, 49 (1995).

¹⁰⁵ *Id.* at 52.

¹⁰⁶ *Id.* at 49.

of a tax incentive labeled as a “15 percent credit” is unlikely to be much of a mystery to taxpayers, who could reasonably be expected to respond to such an incentive in approximately the same way they would a 15 percent discount at the cash register. In this sense, the greater transparency of credits relative to deductions may be another point on which credits have a greater technical efficiency than deductions.

III. Sizing Up The General Case for Credits

To the extent that is possible to make general statements about the relative advantages of credits and deductions, the weight of the considerations seem to favor implementation of tax incentives as credits. The case for credits is generally powerful but is not completely without nuance, however, and in fact may admit exceptions in important cases.

When credits and deductions are measured against each other with equity as the primary criterion for evaluation, credits will generally produce a more vertically equitable pattern of benefits across income levels. Although the upside-down subsidy critique may where a deduction is but one tool among many in use in a particular sub-domain of public policy, in general dignitary values will weigh in favor of treating both rich and poor in a similar fashion. This is especially apparent in the case of the charitable deduction, which grants taxpayers effective power to direct government resources to private ends.

When efficiency is the touchstone for the comparison, credits also have a convincing advantage in most cases. Credits are more transparent in their operation than deductions, meaning that taxpayers are likely to respond to credits in a more predictable

way. Moreover, the pattern of marginal incentives generated by deductions—including the exclusion of non-filers and non-itemizers from the scope of the tax incentives and the differential incentives provided by marginal rate bracket—generally can't be justified as more technically efficient than credits that are neutral across all of these groups.

Nonetheless, in certain circumstances where the tax system affords an exclusion for a substitute activity, as in the case of home production, a deduction corresponding to the exclusion may be justified on the grounds that it is the least distortionary alternative for the implementation of a particular tax expenditure.

Fortunately for policymakers looking for direction on how to best design tax expenditures, the above considerations do provide some guidance—albeit guidance that may result in different conclusions from one tax expenditure to another and may not even offer a definitive answer in every case. In the easiest case, equity and efficiency will both favor the credit alternative. Nonetheless, there are situations in which the equity-based case for implementation of tax expenditures as credits may come into conflict with efficiency considerations. In such an instance, whether equity or efficiency concerns prevail is a matter for policymakers to decide. In other cases, there may be conflicting efficiencies and inefficiencies associated with a particular policy choice, and the efficiency analysis will not even be clear-cut. Nonetheless, for purposes of analytical tractability, the policymaker's problem can be expressed as a presumption in favor of the use of credits coupled with two potential circumstances which might weigh against the presumption. Starting from a default position in favor of credits, then, the policymaker should ask of the following two questions:

1) Do individuals vary in their responsiveness to tax incentives in a fashion that would justify providing marginal incentives that increase with income?

If taxpayers do systematically differ according to income, an attempt to tailor tax incentives to the responsiveness of those taxpayers might be justified. In this case, a deduction might be deemed the most politically feasible means of providing higher marginal incentives to higher-bracket taxpayers. For instance, if lower-income taxpayers are unlikely to be affected by charitable giving incentives since they are already giving as much as their budget allows, a below-the-line deduction that avoids subsidizing giving that those taxpayers would have undertaken anyways may have an advantage. Of course the same goal could be accomplished using a credit that applies only to giving over a specified floor if political difficulties allowed such a solution. A deduction with a floor has the additional efficiency advantage that it entails less “buying of the base” (i.e. tax benefits for behavior that would be undertaken in any case).

2) Is the activity intended to be incentivized a substitute for another activity the income from which is excluded from gross income?

If a taxpayer can accomplish a particular goal by either of two methods, one of which is subject to an exclusion, offering a deduction for the other activity will avoid creating any bias in favor of one method over another. This scenario is likely to arise especially in situations where there is a home production alternative, as in the provision of child care or perhaps even the education of children. In such a case, a policymaker must weigh the effects of the bias created by the use of a credit against the biases along other dimensions that would be generated by the use of a deduction.

Although the preceding discussion has focused solely on equity and efficiency criteria in evaluating credits and deductions, political considerations may come into play in practice, as well. For instance, conversion of existing deductions to partial credits may be able to be accomplished in the context of other reforms with an overall savings in revenue that would make credits especially attractive. On the other hand, below-the-line deductions may also be preferred to credits—especially refundable credits—by those who have concerns about an impact of removing taxpayers from the tax rolls on government spending.¹⁰⁷

In another possibility, deductions might be relatively more attractive than credits if deductions allow politicians to provide a sort of covert tax rate relief to middle- and upper-income taxpayers. One could imagine that in the context of political class warfare, the statutory marginal rate structure might have particular symbolic significance or public salience. In particular, politicians could point to the high marginal rates faced by upper-income taxpayers as evidence that those taxpayers really are “paying their fair share.” But since few lay people likely give much thought to the fact that marginal rates are imposed on taxable income rather than a more comprehensive income measure, deductions might allow politicians to reduce both average and marginal tax rates of higher-income taxpayers while maintaining the illusion that those taxpayers are subject to higher average tax rates than they really are. While credits reduce average effective tax

¹⁰⁷ Some commentators have expressed concern that citizens who pay no taxes will fail to perceive a personal cost of higher government spending and will accordingly vote to support spending they would otherwise not support. See *The Non-Taxpaying Class*, WALL ST. J., Nov. 20, 2002, at A20.

rates, as discussed above¹⁰⁸, only deductions or exclusions can reduce a taxpayer's marginal tax rate.

IV. Re-evaluating the Largest Tax Expenditures

Having evaluated the general case for credits and set forth criteria for evaluating the appropriateness of credits and deductions in the context of particular tax expenditures, this Part will apply the foregoing considerations to six of the largest and most controversial tax incentives, all of which are currently implemented as deductions or exclusions. These tax expenditures include the employer-provided health insurance exclusion, the home mortgage interest deduction, the charitable deduction, the state and local tax deduction, the state and local bond interest exclusion, and various savings incentives.¹⁰⁹ In examining these tax preferences, the focus will be on the optimal design of the tax expenditure rather than whether the tax expenditure should exist at all. That is, it will be assumed that the tax preference seeks to encourage the production of an actual public good.

A. Employer-Provided Health Insurance Exclusion

As provided in Section 106 of the Internal Revenue Code, the gross income of an individual does not include the value of health or accident insurance provided by that

¹⁰⁸ See *infra* Section II.B.

¹⁰⁹ See FY2007 BUDGET, *supra* note 2, at 296.

individual's employer.¹¹⁰ This exclusion, which as the largest single tax expenditure will produce a foregone revenue cost of approximately \$147 billion in 2007, has been criticized from many directions.¹¹¹ Among criticisms of this provision, commentators have denounced the exclusion on the basis that it violates principles of vertical equity and that it generates inefficiencies along multiple dimensions.¹¹² In light of the analysis above, such criticisms have considerable merit. There is a strong case for including the value of employer-provided health insurance in gross income and allowing a partial credit for the purchase of health insurance, whether or not employer-provided.

The main equitable criticism of the exclusion for employer-provided health care is that the benefits of the exclusion accrue primarily to certain taxpayers. One reason for this pattern of benefits is that the exclusion generates the “upside-down” pattern of benefits criticized by Surrey and which is common to deductions and exclusions that provide a marginal benefit equal to a taxpayer's marginal tax rate.¹¹³ A second reason for the pattern is that higher-income individuals are more likely to be employed by employers who offer plans and are more likely to have more generous plans which make the exclusion more valuable. In addition to these vertical equity concerns, horizontal inequity results from the fact that large employers are more likely to offer health insurance—and thus the tax advantage of the exclusion—to their employees than are small employers.

¹¹⁰ I.R.C. § 106(a) (2006).

¹¹¹ See FY2007 BUDGET, *supra* note 2, at 296.

¹¹² See, e.g., Bradley W. Joondeph, *Tax Policy and Health Care Reform: Rethinking the Tax Treatment of Employer-Sponsored Health Insurance*, 1995 B.Y.U.L. Rev. 1229 (1995); Gene Steurle, *The Case for a Tax Credit or Voucher for Providing Health Care to the Nonelderly*, 53 TAX NOTES 1219 (1991); TAX PANEL REPORT, *supra* note 1, at 78-82.

¹¹³ See Joondeph, *supra* note 112, at 1243; Steurle, *supra* note 112, at 1219.

The exclusion's creation of greater incentives for the purchase of health insurance by high-bracket taxpayers than by low-bracket taxpayers is difficult to justify. One might rationalize this pattern of benefits by appeal to programs such as Medicaid or federal funding of emergency room services that benefit the poor, but no such federal program that is available to all taxpayers is a meaningful substitute for a health insurance, which typically offers the taxpayer a range of private sector choices and provides a greater sense of independence and security. Moreover, unlike a credit, Medicaid imparts no benefit to ineligible individuals whose employers do not offer health insurance and little benefit on those in low marginal rate brackets even though no case can be made that only high-bracket taxpayers can benefit from health insurance. The vertical inequities associated with incentivizing the purchase of health care only by the highest-income individuals are manifest.

Efficiency criticisms of the exclusion for employer-provided health care tend to focus on the fact that the exclusion results in purchase of health insurance beyond what is needed to secure the government's objectives in promoting public health.¹¹⁴ This observation may indeed be a valid efficiency criticism of the form of the preference for employer-provided health insurance, which provides a 35 percent incentive at the margin for the purchase of health insurance by employers for their employees and could induce the purchase of unnecessarily generous "Cadillac" plans.¹¹⁵ Although accurate as far as it goes, this criticism is actually too narrow. While the exclusion may encourage some of the highest-bracket taxpayers to select excessively generous plans, other lower-bracket taxpayers may actually be under-purchasing health insurance for lack of sufficient

¹¹⁴ See, e.g., Joondeph, *supra* note 112, at 1243; TAX PANEL REPORT, *supra* note 1, at 79-80.

¹¹⁵ See TAX PANEL REPORT, *supra* note 1, at 82.

incentive or not purchasing health insurance at all for lack of employer sponsorship. Presumably, the form of this particular public good—i.e. the public health—is non-additive, meaning the public good is best advanced by as many people as purchasing health insurance, not a few people purchasing a great deal of health insurance. Yet, because the tax preference for health insurance takes the form of an exclusion, the marginal benefit of employer-provided health insurance to low-income individuals will be substantially less than for high-income individuals and will be non-existent where for the many low-income individuals whose employers who do not offer health insurance.¹¹⁶

In contrast to the exclusion for employer-provided health insurance, inclusion of the value of employer-provided insurance coupled with a credit for some amount of health insurance, employer-provided or otherwise, would more efficiently accomplish the government's goal of ensuring a high standard of public health. Looking to the conditions (described in the previous subsection) under which the presumption in favor of a credit could be overcome, neither appears to be satisfied in this case. In particular, there is no evidence that individuals differ in their responsiveness to marginal incentives for the attainment (via selection of a health plan at work or selection of an employer based on health plan offerings) of employer-provided health insurance. Additionally, there is no exclusion in the tax code for any activity that would constitute a close substitute for employer-provided health insurance.

A refundable credit for health insurance makes sense from a cost-effectiveness standpoint since a credit would apply the same marginal incentive to all taxpayers regardless of marginal rate bracket, filing status, or employment status. With a carefully

¹¹⁶ Note, however, that an exclusion does have an advantage over a deduction, at least, since the latter is unavailable to non-itemizers unless it is above-the-line.

chosen credit rate, the government can cost-effectively maximize the number of insured as opposed to merely providing higher-income individuals with an incentive to over-insure. The President's Panel on Tax Reform apparently rejected this option, albeit without explanation, electing instead to merely cap a version of the existing exclusion.¹¹⁷ President Bush himself recently proposed to eliminate the exclusion but replace it with a "standard deduction" for the purchase of health insurance that would retain the pattern of greater marginal incentives for the highest earners.¹¹⁸ One wonders whether the president and the Panel feared a credit would encourage employers to drop health insurance coverage, causing temporary dislocations. In any case, neither the Panel's proposal nor the president's proposal achieves the benefits of a refundable credit discussed above.

B. Home Mortgage Interest Deduction

The tax code contains a number of provisions designed to encourage homeownership, foremost among them a provision excepting interest on home mortgage indebtedness from the general rule of nondeductibility for personal interest. This exception, enshrined in Section 163(h) of the Code,¹¹⁹ is the second largest tax expenditure in the federal income tax and will result in nearly \$80 billion in foregone revenue in 2007.¹²⁰ The deduction for interest on home mortgage indebtedness has been criticized on many of the same grounds on which the employer-provided health insurance

¹¹⁷ See TAX PANEL REPORT, *supra* note 1, at 78-82.

¹¹⁸ See Setting the Record Straight: President Bush's Standard Deduction for Health Insurance Would Save Money for More Than 100 Million Americans, <http://www.whitehouse.gov/news/releases/2007/01/20070122-9.html>.

¹¹⁹ I.R.C. § 163(h) (2006).

¹²⁰ See FY2007 BUDGET, *supra* note 2, at 296.

has been criticized, namely that the pattern of benefits the deduction generates is inequitable and that the deduction encourages overinvestment in housing. The responses to the criticisms are familiar, as is the strength of the case for replacing the deduction with a credit. Apparently the political case for replacing the home mortgage interest deduction with a credit is stronger¹²¹, as well, since the President's Panel on Tax Reform proposed replacing the deduction with a credit while declining to do the same for the employer-provided health insurance exclusion.¹²²

Like many of the other major tax expenditures implemented as deductions, the home mortgage interest deduction has been widely criticized for its regressivity. In this case, the vertical inequity follows from the fact that the benefits of the deduction vary with a taxpayer's marginal tax bracket and the market value of their home, causing those benefits to accrue primarily to higher-income taxpayers who can afford to own homes and for whom the marginal value of the deduction is greatest.¹²³ Given the important dignitary benefits—most notably, independence and security—associated with homeownership, the reservation of the largest benefits to those whose incomes already afford them independence and security and permit them to own homes even without a subsidy seems violative of basic fairness norms. Federal housing assistance is not a substitute for the security or sense of independence generated by homeownership and does not justify the exclusion of lower-earners from homeownership tax subsidies. By contrast, a credit—particularly a refundable credit—would generate no such inequities.

¹²¹ An alternate rationale for the Panel's different treatment of these two tax expenditures is that the Panel was motivated to retain a deduction for health insurance out of a concern that employers would drop coverage under a credit.

¹²² See TAX PANEL REPORT, *supra* note 1, at 61.

¹²³ See, e.g., William F. Hellmuth, *Homeowner Preferences*, in COMPREHENSIVE INCOME TAXATION 163, 194 (Joseph A. Pechman ed., 1977); Roberta F. Mann, *The (Not So) Little House on the Prairie: The Hidden Costs of the Mortgage Interest Deduction*, 32 Ariz. St. L.J. 1347, 1361-62 (2000); TAX PANEL REPORT, *supra* note 1, at 72.

On the efficiency side, the home mortgage interest deduction is also charged with overincentivizing investment in residential housing. Again, however, the more accurate criticism seems to be both under-incentivization and over-incentivization. As affirmed by the President's Panel on Tax Reform, homeownership is a public value measured by the number of households who own their own homes rather than by the size of the homes owned by a few people.¹²⁴ Research generally supports the proposition that homeownership encourages individuals to invest more time and effort in their homes and communities, thereby generating positive externalities.¹²⁵ Accordingly, it is unclear why this tax incentive's effectiveness would be maximized by providing the highest marginal incentives to the highest earners and little or no incentive to non-filers, non-itemizers, and low-bracket taxpayers—the pattern of benefits generated by the current deduction.

Although a credit would appear better-targeted than a deduction for mortgage interest, the case is not so clear cut. The first possible ground for overcoming the presumption in favor of credits—that taxpayers differ by tax bracket in their responsiveness to homeownership incentives—indeed seems to have no empirical basis in reality. If anything, one might argue that the public good is better promoted by boosting homeownership among lower-income individuals than higher-income individuals; lower-income individuals arguably have the most to gain from the supposed social and psychological benefits of homeownership.¹²⁶

¹²⁴ See TAX PANEL REPORT, *supra* note 1, at 73.

¹²⁵ See, e.g., Glaeser & Shapiro, *supra* note 90, at 5-6 (finding evidence that homeowners take better care of their property, thereby generating positive externalities for their neighborhood, and that homeowners are more likely to participate in local politics, supporting long-term investments in the community); Denise DiPasquale et al., *Incentives and Social Capital: Are Homeowners Better Citizens?*, 50 J. Int'l Econ. 497, 499 (2000) (finding evidence of a causal relationship between homeownership and investment in social capital).

¹²⁶ See William M. Rohe & Victoria Basolo, *Long-Term Effects of Homeownership on the Self-Perceptions and Social Interaction of Low-Income Persons*, 29 ENV'T & BEHAV. 793 (1997).

The second possible ground for overcoming the presumption in favor of credits—that a deduction is needed to correspond to a deduction or exclusion for a substitute activity—has some traction in the case of tax benefits for mortgage interest. In particular, only a deduction makes a taxpayer with assets indifferent between investing in home equity and the alternative of taking out a mortgage on a home and purchasing some alternative investment.¹²⁷ To see this logic concretely, consider a taxpayer with \$100k in assets, a home, and two scenarios: (1) putting the \$100k equity in the home, or (2) taking a \$100k mortgage at 6% on the home and buying a bond with a 6% coupon. Because a taxpayer who finances a home with assets instead of borrowing is untaxed on the hypothetical interest paid to “borrow” his own assets, only a deduction for the mortgage interest payments equalizes the tax treatment of the two scenarios, making a taxpayer indifferent between investing in housing or alternative assets.¹²⁸

In light of the competing efficiency issues, there is no clear case for replacing the home mortgage interest deduction with a credit. A credit for interest on home mortgage indebtedness would more effectively expand the circle of homeownership than does the current law deduction. It would do so by improving the incentives for homeownership at lower income levels while mitigating the incentives for overinvestment in housing at high income levels. For these reasons, the President’s Panel on Tax Reform recommended replacing the mortgage interest deduction with a Home Credit subject to a regionally-

¹²⁷ There is also a more general argument that interest deductibility is necessary for equity between individuals who finance equity with debt and those who finance with assets and are consequently untaxed on the foregone interest income. See MICHAEL J. GRAETZ, *FEDERAL INCOME TAXATION* 451 (2d ed. 1988); M.I. White, *Proper Income Tax Treatment of Deductions for Personal Expense*, in *TAX REVISION COMPENDIUM, COMMITTEE ON WAYS AND MEANS* 365 (1959). Under this view, a deduction rather than a credit is the appropriate treatment for interest used to finance all expenses, including homeownership.

¹²⁸ Special thanks go to Prof. Michael Graetz for this example.

varying cap on benefits.¹²⁹ On the other hand, the use of a credit rather than a deduction could distort investors' decisions as between home equity and other asset classes—a factor that the Panel did not note as a factor in recommending the Home Credit. The magnitude of the distortion and its consequences for the economy are difficult empirical questions and must be balanced with equity considerations favoring a credit.

C. Charitable Contribution Deduction

A distinctive quality of American society as compared to that of other countries is reliance on the voluntary sector for the provision of many services and commodities that could be provided by the government. The income tax—especially the deduction for contributions to charitable and other tax-exempt organizations¹³⁰—plays a central role in this schema, effectively delegating to individual taxpayers the power to direct a government subsidy to a third party engaged in activity generating public benefits. Like many other tax incentives, the charitable giving deduction has been criticized for producing inequitable and inefficient results. In this case, the critics may have a strong case on both counts. A charitable giving credit has been proposed as an alternative,¹³¹ but because of interactions with other parts of the tax system, replacing the deduction with a credit may eliminate some inefficiencies while at the same time producing others. The policymaker deciding on the appropriate form of the tax incentive for charitable

¹²⁹ See TAX PANEL REPORT, *supra* note 1, at 72-75. Although with the assumption of inter-regional migration, the regionally varying cap on mortgage interest is unnecessary for alleviating horizontal inequities, dividing each taxpayer's income by the region's pre-tax salary level may enhance tax system efficiency. Knoll & Griffith, *supra* note 66, at 989.

¹³⁰ I.R.C. § 170 (2006).

¹³¹ Todd Izzo, *A Full Spectrum of Light: Rethinking the Charitable Contribution Deduction*, 141 U. Pa. L. Rev. 2371 (1993).

giving consequently must weigh different public values, some pertaining to equity and others to efficiency. A case can be made for replacing the deduction with a credit, but any case for a deduction or credit will be less than perfect.¹³²

Given the democratic values associated with a system of government subsidy for charitable giving, equity considerations may have special force in the decision of whether to design the charitable giving incentive as a deduction or a credit. In reference to the pattern of tax benefits that Surrey termed an “upside-down” subsidy, the criticism leveled against the charitable deduction is not only that the deduction is regressive, but also that it gives higher-income taxpayers a disproportionately large power to direct government resources to charities of their choice.¹³³ Specifically, a high bracket taxpayer receives a larger “discount” or “matching grant” for every dollar of charitable contribution than does a low bracket taxpayer or non-itemizer, who may receive no benefit at all from a charitable giving deduction.¹³⁴ If the charitable contribution deduction is a form of democratic decision-making and taxes are “ballots”, as Prof. Levmore has argued,¹³⁵ then the deduction could be said to disenfranchise many lower-income individuals.

The disenfranchisement of lower-income taxpayers is not just an equitable consideration, however, but potentially has efficiency consequences, as well. If the

¹³² Prof. William Andrews made a case that progressive personal taxation should be applied only to the “private consumption of goods and services whose consumption by one household precludes their direct enjoyment by others,” and, accordingly, that a deduction should be allowed for charitable contributions that preclude the donor’s private consumption, William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 346 (1972). Such considerations based on the controversial question of the proper measurement of net income are beyond the scope of this paper. Cf. Mark G. 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, 831 (1979) (arguing in response to Andrews that “the tax system ought to treat taxpayers who use their money for charitable contributions or medical care as if they had never received that money at all”).

¹³³ See Izzo, *supra* note 131, at 2374-75; Levmore, *supra* note 56, at 404-06.

¹³⁴ Paul McDaniel actually proposed a government matching grant for private charitable contributions as an alternative to the charitable deduction. Paul R. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 TAX L. REV. 377 (1972).

¹³⁵ See Levmore, *supra* note 56, at 404-09.

purpose of charitable giving incentives is to provide a public good,¹³⁶ and if higher-income and lower-income individuals contribute to that good in different but equally meritorious ways, then the public good is inefficiently secured by a device that only creates incentives for higher-income individuals to contribute. In fact, research indicates that taxpayers tend to favor charitable causes from which they personally derive a benefit. Thus, wealthy taxpayers disproportionately support cultural institutions such as museums, public television, and the performing arts while less well-off taxpayers tend to donate to religious institutions and social welfare organizations.¹³⁷ This “plutocratic bias,” to use William Vickrey’s phrase,¹³⁸ means that a deduction for charitable giving may be an inefficient means of using government resources to foster a cultural pluralism in the non-government sector. The preferred charitable recipients of the wealthiest individuals benefit from proportionally larger government subsidies than the causes favored by lower-income taxpayers.

The foregoing equity and efficiency considerations suggest replacing the charitable giving deduction with a credit that equalizes marginal incentives across taxpayers, but before leaping to that conclusion, one must consider whether charitable giving is a case in which countervailing considerations qualify the case for a credit. One such consideration that may work to overcome the normal presumption in favor of a credit is the possibility that taxpayers systematically differ in their responsiveness to marginal incentives for charitable giving. On this point, nearly all of the researchers who have approached the question have assumed the price elasticity of charitable giving does

¹³⁶ See Charles T. Clotfelter, *Tax-Induced Distortions in the Voluntary Sector*, 39 CASE W. RES. 663 (1989).

¹³⁷ See Izzo, *supra* note 131, at 2391-92.

¹³⁸ William Vickrey, *Agenda for Progressive Taxation* 131 (1947).

not vary across income groups.¹³⁹ While this assumption may not be entirely accurate, income-dependent differences in elasticity are unlikely to be empirically important.¹⁴⁰ Price elasticities do not tell the entire story of taxpayer responsiveness to charitable giving incentives, however. As noted earlier, taxpayers at different income levels do favor very different types of charitable recipients. If policymakers also prefer the beneficiaries favored by high-income taxpayers, a deduction might be preferable to a credit on efficiency grounds.

The second possible factor weighing against the presumption in favor of a credit—that a deduction is appropriate to match a deduction or exclusion elsewhere in the Code for a substitute activity—may actually have traction in this context. Recognizing the charitable giving can take the form of gifts of money or gifts of time, it becomes clear that gifts of time are subject to an effective exclusion. As opposed to a situation in which an individual would be taxed on the imputed value of services provided to a charity, the value of that contribution of time is effectively excluded from gross income. Thus, the use of a credit for contributions of money and property coupled with the use of an exclusion for contributions of time could, depending on a taxpayer's marginal tax rate, create a bias in favor of one form of contribution over another.¹⁴¹

The optimal design of incentives for charitable giving thus requires a weighing of the inequities and inefficiencies associated with the use of a credit and the use of a deduction. While there are democratic concerns associated with the use of a deduction, a

¹³⁹ See generally Gerald E. Auten, Holger Sieg & Charles T. Clotfelter, *Charitable Giving, Income, and Taxes: An Analysis of Panel Data*, 92 AM. ECON. REV. 371 (2002).

¹⁴⁰ See Martin S. Feldstein & Charles T. Clotfelter, *Tax Incentives and Charitable Contributions in the United States: A Microeconomic Analysis*, 5 J. PUB. ECON. 1 (1974).

¹⁴¹ See Gene Steurle, *The Problem With Converting Itemized Deductions to Credits*, 75 TAX NOTES 585, 586 (1997).

credit would introduce a distortion into the choice between gifts of time and gifts of cash or property. Moreover, policymakers may actually prefer to offer greater giving incentives to high-income taxpayers whose charitable causes they also favor.

In its recommendations, the President's Panel on Tax Reform opted to preserve the charitable deduction while extending it to non-itemizers, but in doing so the Panel did not deal directly with any of the considerations discussed here.¹⁴² Instead, the Panel merely cited the importance of providing incremental incentives to higher-income taxpayers without noting that the same goal could be accomplished with a credit.¹⁴³ Given this explanation, one wonders whether the Panel is merely recognizing an unarticulated congressional preference for the type of giving undertaken by higher-bracket taxpayers.

D. State and Local Tax Deduction

Under Section 164 of the Internal Revenue Code, individual taxpayers are permitted an itemized deduction for taxes paid to states and localities.¹⁴⁴ This state and local tax deduction can be understood in a number of ways. To the extent that this provision is justified as an adjustment necessary to properly measure income¹⁴⁵, the question is whether there should be a deduction or no deduction—not whether a credit is a preferable alternative—and is beyond the scope of this paper.¹⁴⁶ To the extent that the

¹⁴² See TAX PANEL REPORT, *supra* note 1, at 75-78.

¹⁴³ *Id.* at 75.

¹⁴⁴ Note that § 164 applies different rules for sales tax deductibility than for deductibility of income and property taxes. I.R.C. § 164. (2006).

¹⁴⁵ Such a rationale would not justify a deduction for sales taxes as under current § 164.

¹⁴⁶ See Edward A. Zelinsky, *The Deductibility of State and Local Taxes: Income Measurement, Tax Expenditures and Partial, Functional Deductibility*, 6 AM. J. TAX POL'Y 9, 9-10 (1987). The case that

provision is regarded as an incentive or subsidy for state and local services that may or may not be substitutes for national services, however, the question is whether or not an incentive for such activities should be structured as a deduction or a credit and is amenable to the analysis undertaken in this paper.

Unlike the other tax expenditures examined here, the state and local tax deduction understood as an incentive for local provision of services appears to be aimed not so much at the taxpayer who directly benefits from the deduction but rather at the state or local entity whose taxes are deductible. The deductibility of state and local taxes effectively reduces the final cost to taxpayers of those taxes, allowing sub-national government entities to impose higher taxes than they would be able to impose in the absence of the deduction. With the governmental entity as the focus of the analysis, the equity and efficiency considerations undertaken in the analysis of other tax expenditures take on a different hue.

To the extent the concept of inequities as between states has any meaning, the main question is whether the regional distribution of federal tax benefits resulting from the state and local tax deduction is equitable. In particular, should high cost-of-living states receive the largest benefit from the state and local tax deduction, as they do? In fact, taxpayers in just two states—California and New York—representing 18 percent of the U.S. population and 22 percent of federal income taxes paid accounted for almost 30 percent of the total value of total federal deductions for state and local taxes in 2004.¹⁴⁷

The disparity between taxes paid by taxpayers in those states and the value of deductions

deduction for state income taxes is required for proper income measurement is stronger than for local taxes since the latter are more typically used to finance services for taxpayers.

¹⁴⁷ Statistics based on authors' calculations from IRS Statistics of Income—Individual Income Tax Return Statistics, <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=98123,00.html>. See also Kim Reuben, *The Impact of Repealing State and Local Tax Deductibility*, 37 STATE TAX NOTES 497, 499 (2005).

attributable to those same taxpayers is due in part to the fact that, as noted above, the proportion of itemizers and high-bracket taxpayers is higher where the regional cost of living is higher. States with a larger share of itemizing high-bracket taxpayers receive a larger effective marginal federal subsidy for the taxes they impose on their citizens.

Moving from equity to efficiency considerations, the question to be addressed is whether the regional pattern of marginal benefits generated by the state and local tax deduction is efficient in light of the federal government's purpose in allowing the deduction. If the purpose of the deduction is to promote activity at the sub-national level that might otherwise happen at the national level, it is unclear why states with relatively more taxpayers in high marginal rate brackets should have their taxing activities subsidized at a greater rate. Presumably, the public good of sub-national provision of services is of a form such that the public welfare is no more advanced by an additional dollar spent in California than in Montana. Moreover, the federal government has a variety of means—including block grants and earmarked spending—by which it can direct federal resources to the states for their use. Yet, the effect of the state and local tax deduction is to provide a greater marginal incentive for California to raise taxes than for Montana to do so.

Unlike the current deduction, a credit for state and local taxes paid would equalize the marginal subsidy for state and local taxes across regions. Such a credit would be neutral as between regions in the sense that when Montana and California raise a citizen's income tax by a dollar, the effect on the citizen's combined federal and state tax liability is the same in each state, unlike under the current deduction. Assuming Montana's and California's marginal spending has the same social value to the nation as a whole, a credit

is consequently a more cost-effective means of securing sub-national provision of services than a deduction that subsidizes states at differential rates unrelated to their contribution to the public good.

E. State and Local Bond Interest Exclusion

In addition to the deduction for state and local income taxes, the government subsidizes the activities of sub-national governmental entities by excluding from individuals' gross income all interest received on debt obligations of those entities.¹⁴⁸ The purpose of this exclusion is to allow state and local governments to finance investments in projects such as highways, stadiums, bridges, schools, and other facilities that would otherwise not be funded or would require current increases in state or local taxes.¹⁴⁹ In contrast to a direct subsidy from the federal government to the states, no direct federal intervention is necessary when the subsidy occurs through the state and local interest exclusion. Because the interest on state and local debt instruments is excludable from taxpayers' gross income, those taxpayers are willing to accept a lower interest rate on such an instrument than on an instrument that generates taxable interest. Thus, a taxpayer in the 35 percent bracket who would normally require a 10 percent pre-tax return on a safe bond would be willing to invest in a state bond that has only a 6.5 percent interest rate since, after 35 percent tax on the interest from the 10 percent bond, the returns on the two investments are equivalent. The effect of the exclusion for state and local interest, then, is to lower the borrowing cost of state and local entities.

¹⁴⁸ I.R.C. § 103 (2006).

¹⁴⁹ See Kevin M. Yamamoto, *A Proposal for the Elimination of the Exclusion for State Bond Interest*, 50 FLA. L. REV. 145, 147 (1998).

As have all of the other tax expenditures discussed here, the state and local interest exclusion has been criticized as both inequitable and inefficient. The vertical equity criticism follows from the fact that top bracket taxpayers often derive a tax benefit from investment in state and local bonds that is greater than the benefit received by the entity issuing the bond.¹⁵⁰ Prof. Bittker made this criticism clearly when he pointed out that two taxpayers will both receive the same yield on a state or local bond regardless of their tax rate.¹⁵¹ This criticism may be tempered by the insight that much of the benefit of the current deduction may be shared by lower-bracket taxpayers if the revenue generated by favorable borrowing costs would otherwise be raised by generally applicable taxes.¹⁵² Nonetheless, the fact that high-bracket taxpayers with substantial resources can invest in state and local obligations and reap the windfall of the differential between his marginal tax rate and that of the marginal investor is a serious equity issue that could be resolved through appropriate use of a credit.

The heart of the efficiency argument against the state and local interest exclusion is the fact that certain taxpayers are able to capture a portion of the subsidy intended for state and local governments. This circumstance arises because in general there are not enough taxpayers in the 35 percent bracket who are willing to purchase state and local bonds. Consequently, states must set interest rates on their bonds high enough to make them attractive not only to 35 percent bracket taxpayers but also to taxpayers in lower tax brackets. The result is that tax-free bonds may trade at a discount of less than 35 percent off the taxable bond interest rate, allowing taxpayers in the 35 percent bracket to receive

¹⁵⁰ See *id.* at 179.

¹⁵¹ See Boris I. Bittker, *Equity, Inefficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?*, 16 San Diego L. Rev. 735, 742-44 (1979). See also

¹⁵² See Michael J. Graetz, *Assessing the Distributional Effects of Income Tax Revision: Some Lessons From Incidence Analysis*, 4 J. LEGAL STUD. 351, 359-62 (1975).

a 35 percent tax benefit while suffering a less-than-35 percent foregone interest loss from investing in lower-interest tax-free bonds. In this case, the state and local deduction causes the federal government to lose more in foregone revenue than the state saves in interest cost; a direct subsidy would be more cost efficient.

Although a direct subsidy to states would cost the federal government less, *ceteris paribus*, than the existing deduction, the question this paper addresses is not whether the tax expenditure should exist, but whether the expenditure could be more efficiently designed as a credit than a deduction.¹⁵³ In the methodology of Part III, the starting point for addressing this question is a presumption in favor of implementing a tax incentive as a credit. The principle behind that presumption—that the government’s optimal strategy for incentivizing taxpayers is to equalize marginal incentives at the lowest possible rate to attain the desired behavior—applies quite naturally where the policy goal is purchase of state and local government bonds. Moreover, the grounds for overcoming the presumption are unpersuasive in this case. First, there is no reason to believe rational investors would differ based on non-tax factors in their responsiveness to incentives to purchase such bonds or that purchases by some investors have a greater social benefit than purchases by other investors. Second, although there are exclusions in the tax code for substitute activities—i.e. there are other tax-advantaged investments—there remains a market for taxable investments, and there would also remain a market for state and local bonds.

¹⁵³ Indeed, there may be substantial reasons to prefer subsidizing state and local borrowing via a tax expenditure than a direct subsidy. One possibility is that the use of a tax expenditure better promotes principles of federalism by avoiding direct federal involvement in state projects. Another possibility is that the cost or other burdens of a direct subsidy program would be much higher than those related to the tax expenditure.

Implementing the subsidy for state and local borrowing as a credit rather than a deduction would improve the technical efficiency of the subsidy, eliminating “leakage” of tax benefits to high-bracket taxpayers. The interest rate on state and local obligations would fall by exactly the amount of the credit rate and would not depend on the number of willing investors in each bracket, as it does under the current deduction. Since all taxpayers would receive the same marginal tax benefit from investing in state and local bonds—and that benefit would be exactly offset by the lower-than-market interest rate on such bonds—the entire benefit to taxpayers of investing in such bonds would be passed on to the states. Thus, as a matter of technical efficiency, a partial credit for state and local bond interest would be superior to the current deduction.

The idea of a credit for state bond interest has surfaced numerous times over the last several decades, including in the Carter Administration’s 1978 tax proposals.¹⁵⁴ Under such a plan, the state and local governments would issue bonds at interest rates comparable to rates for debt of similar risk and maturity, and the interest from such bonds would be included in the bondholder’s income. To maintain the desirability of state and local bonds, a credit would be allowed with a credit rate set such that the marginal taxable bond investor would be indifferent between a credit and a deduction.¹⁵⁵ Due to the relative efficiency and equity of these so-called “tax-credit bonds,” there recently have been a number of proposals that various non-federal, non-private entities be allowed to issue bonds eligible for such tax credits.¹⁵⁶

¹⁵⁴ CONGRESSIONAL BUDGET OFFICE, TAX CREDIT BONDS AND THE FEDERAL COST OF FINANCING PUBLIC EXPENDITURES 5-6 (2004).

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* at 2-3/

F. Savings Incentives

The federal income tax contains a variety of incentives for individuals to engage in long-term saving for retirement or other special purposes. As measured by the tax expenditure budget, the largest such saving incentive by far is embodied in employer-sponsored 401(k) plans,¹⁵⁷ which in 2007 are projected to cost the government approximately \$40 billion in foregone revenue.¹⁵⁸ Many other saving incentives exist, as well, including options such as Individual Retirement Accounts (IRAs) for taxpayers who are not employed or whose employers don't sponsor a retirement saving plan.¹⁵⁹ Typically, such saving incentives permit the taxpayer either to deduct the contribution to the tax-preferred savings account at the time of contribution or, as in the case of the Roth IRA,¹⁶⁰ permit exclusion of amounts distributed from the account. Assuming tax rates are the same at the time of contribution and the time of distribution¹⁶¹, the tax benefit of both treatments are equivalent in present value terms. This tax treatment of capital income is equivalent to treatment under a consumption tax, a fact that has prompted the observation that the federal individual income tax is actually a hybrid income-consumption tax.¹⁶²

Whether a credit is an appropriate alternative to deductions and exclusions for saving depends on policymakers' intentions for the current tax system. If the current

¹⁵⁷ I.R.C. § 401(k) (2006).

¹⁵⁸ See FY2007 BUDGET, *supra* note 2, at 296.

¹⁵⁹ I.R.C. § 408 (2006); I.R.C. § 219 (2006).

¹⁶⁰ I.R.C. § 408A (2006).

¹⁶¹ One must also ignore contribution limits, which are typically the same for Roth and traditional IRAs even though the Roth IRA limits should be lower for the two vehicles to provide the same maximum benefit.

¹⁶² See generally William D. Andrews & David F. Bradford, *Savings Incentives in a Hybrid Income Tax*, in UNEASY COMPROMISE 269 (Henry J. Aaron et al. eds., 1988).

system represents a conscious policy judgment to meld elements of consumption and income tax systems into a hybrid, or represents a phase along a progression toward a consumption tax, a deduction or exclusion is the only principled tax treatment for saving. It is only by one of these methods that the supranormal return on capital can be excluded from taxation—the defining feature of a consumption tax.¹⁶³ If, on the other hand, the current system is aspirationally a pure income tax but happens to be speckled with deviations designed to promote saving, it is appropriate to analyze savings incentives through the framework adopted in this paper. For the sake of discussion, the latter assumption will be adopted, but one should not lose sight of the fact that tax-preferred savings accounts may have a larger role in the tax system than merely incentivizing individual saving.

If tax-preferred savings vehicles are viewed purely as saving incentives, deductions and exclusions may not be the most efficient forms for such incentives. In principle, the goal of a policymaker in enacting saving incentives might be either to raise total national saving or to encourage households individually to set aside resources for their own future. Given the contribution limits on all available tax-preferred saving vehicles, however, it seems more than likely these vehicles were intended to promote individual saving for retirement. In other words, the public good sought is widespread retirement security rather than a higher capital stock. As commentators have noted, deductions and exclusions that create the greatest marginal incentives for high-bracket

¹⁶³ By exempting the yield on invested amounts, a Roth IRA excludes the supranormal return on capital from taxation.

taxpayers to save but create little or no incentive for low-bracket taxpayers are an inefficient means to the goal of widespread financial security in retirement.¹⁶⁴

Once again, the presumption in favor of a tax credit over a deduction for efficiently providing a public good is a reasonable starting point. Unlike the existing deductions and exclusions, a credit for saving would generate the same marginal incentive for saving regardless of tax bracket or itemization status rather than providing the largest incentives for high-bracket taxpayers.¹⁶⁵ There is no reason to believe that high-income taxpayers need greater incentives to undertake saving for their retirement; if anything, it would be more reasonable to assume that lower-income individuals facing liquidity constraints need the greatest marginal motivation. Moreover, although there are various tax-preferred financial instruments such as life insurance, annuities, and state and local bonds that are subject to effective exclusion on all or part of their return, there is no close substitute for tax-preferred saving that would make a deduction or exclusion a more appropriate incentive for encouraging long-term saving.

V. Conclusion

Over the last few decades, tax credits have been increasingly relied upon as an alternative to deductions and exclusions in the implementation of tax expenditures, particularly those meant to incentivize certain behaviors. The Earned Income Tax Credit is perhaps the most prominent example, but it is far from the only one. In fact, the tax

¹⁶⁴ See Gary Koenig & Robert Harvey, *Utilization of the Saver's Credit: An Analysis of the First Year*, 58 NAT'L TAX J. 787 (2005).

¹⁶⁵ Although there is no general credit for saving, the Saver's Credit is a non-refundable credit for contributions to existing tax-preferred accounts. The Saver's Credit is subject to income limits and is aimed at low- and middle-income taxpayers.

code contains a whole constellation of less significant credits aimed at encouraging individuals to engage in a variety of different behaviors from adopting children to purchasing alternative fuel vehicles. Nonetheless, the largest tax expenditures affecting the greatest number of people continue to take the form of deductions and exclusions from gross income.

This paper has relied on equity and efficiency criteria to analyze whether existing credits and deductions would more effectively implement the government's goals if they were replaced with comparable credits. In the most general case, credits seem more vertically equitable than deductions and generally exhibit superior technical efficiency properties. With uniform marginal incentives across taxpayers regardless of tax bracket, itemization status, and possibly filing status (if credits are refundable), a credit can give the government its greatest "bang for the buck" of foregone revenue. In contrast, devices that create marginal incentives based on taxpayer's marginal tax rate are more likely to inefficiently overincentivizing some taxpayers while underincentivizing others. These efficiency advantages are general enough to justify a presumption in favor of designing tax incentives as credits, a presumption that seems to hold in the case of benefits for health insurance, state and local taxes, and state and local bond interest—all of which could be more equitably and efficiently implemented as credits. Nonetheless, the presumption in favor of credits is by no means insurmountable. In fact, based on the criteria developed in this paper, there is only a mixed case for converting the home mortgage interest deduction and charitable contribution deduction into credits. In light of these conclusions, it is interesting to note that the President's Advisory Panel on Federal

Tax Reform recommended converting only the home mortgage interest deduction to a credit.

The analysis undertaken in this paper may have implications for tax system design beyond the question of whether credits or deductions are the optimal way to implement tax expenditures. One issue that could be further developed within the framework of this paper is whether floors for credits and deductions are appropriate elements of tax incentive design. The logic of neutrality would seem to argue against floors or other thresholds, but such considerations must be weighed against the administrative conveniences a floor offers (e.g. eliminating many small claims) and the efficiency gains from a reduced need to “buy out the base.” Another issue briefly touched on here is the distinction between above-the-line and below-the-line deductions. A case might be made to allow all deductions as above-the-line deductions (perhaps with a 1% floor to eliminate small claims) on the grounds of equity and efficiency as those considerations were developed in this paper. Design issues such as these could be a fruitful area for future research.

In light of the growing burden of the Alternative Minimum Tax, large-scale tax reform may be on the not-too-distant horizon. In that context, policymakers should consider whether existing deductions are the most effective way to achieve the policy goals and whether credits present an attractive alternative. It is no small matter that credits could easily be structured to reduce the ultimate revenue cost to the federal government by reducing the value of the credits to the wealthiest taxpayers. Ultimately, however, the decision between should be grounded, as in this paper, on rigorous case-by-case analysis of equity and efficiency criteria.