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THE ANNUAL JOHN RANDOLPH TUCKER LECTURE

TAX REFORM—YESTERDAY, TODAY, AND TOMORROW*

BORIS I. BITTKER**

Next year, we will celebrate the 200th anniversary of the Philadelphia convention of 1787, which proposed our Constitution for ratification by the states. Ninety-nine years ago, at the mid-point between those proceedings at Philadelphia and what will no doubt be an explosion of celebrations rivalling the recent unveiling of the refurbished Statue of Liberty, John Randolph Tucker gave an address on the Constitutional Convention to the graduating class of the Yale Law School.¹

His remarks on that occasion are perhaps not as widely known as they should be, judging from the fact that the yellowing pages of the pamphlet containing his address are still in relatively good condition; but I am living evidence that his address has not been forgotten. He said many wise and inspiring things on that occasion, though he was not quite as concise as today's commencement speakers think prudent. His comments on taxation, however, were brief, though impassioned. He warned, even inveighed, against indirect taxation, because it enables the Congress to be profligate with funds that the taxpayer is "entirely unconscious" of giving up. I cannot report that Mr. Tucker was especially enthusiastic about direct taxation either; but as between the two, he favored direct taxes because taxpayers know that they are paying them, and, hence, they will exert their democratic right to vote the wastrels out of office if the burden is excessive. Since taxpayers are "entirely unconscious" of the burden of indirect taxes, however, they will not be sufficiently alert to complain.

Mr. Tucker did not lay down a line, bright or otherwise, to enable us to distinguish between indirect taxes, which have the "fearful consequences" just described, and direct taxes, which are a bit less objectionable; and the Framers of the Constitution, who required direct but not indirect taxes to be apportioned among the states in proportion to population, also failed to define their terms. (It was, after all, a Constitution, not a dictionary, that they were writing.) Less than 10 years ago after Mr. Tucker's New Haven address, however, the Supreme Court held in *Pollock v. Farmers Loan and Trust*² that taxes on dividends, interest, and rents are indirect,

* This article is based on Professor Bittker's remarks made at the 38th annual John Randolph Tucker Lecture, Washington and Lee University School of Law, October 17, 1986.

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1. J. Tucker, *The History of the Federal Convention of 1787 and Its Work* (1887) (pamphlet available at Yale Law School Library).

2. *Pollock v. Farmers Loan & Trust Co.*, 157 U.S. 429, *modified*, 158 U.S. 601 (1895).

and hence are subject to the apportionment clause of the Constitution.

On consulting Mr. Tucker's 1899 commentaries on the Constitution, I find that he was more than a bit skeptical about the *Pollock* decision.³ I applaud that skepticism; but it seems to imply that Mr. Tucker would have classed the federal income tax as an indirect tax, that is, one that is likely to be ignored by taxpayers because it does not come to their conscious attention.

That may have been true when Mr. Tucker delivered his commencement address in 1887 at the Yale Law School, but there has been some consciousness-raising since then. When Jimmy Carter accepted the Democratic nomination for President in 1976—always an occasion for a rousing call for non-controversial action—he said:

It's time for a complete overhaul of our income tax system. I still tell you it's a disgrace to the human race. All my life I have heard promises of tax reform, but it never quite happens. With your help, we are finally going to make it happen and you can depend on it.⁴

President Carter got the hostages back from Teheran; but as for income tax reform, he had to pass the torch to President Reagan, whose consciousness-raising rhetoric was even more spirited:

Death and taxes may be inevitable, but unjust taxes are not. The first American Revolution was sparked by an unshakable conviction: Taxation without representation is tyranny. Two centuries later a second American Revolution for hope and opportunity is gathering force again, a peaceful revolution but born of popular resentment against a tax system that is unwise, unwanted and unfair.

The proposal I am putting forth tonight for America's future will free us from the grip of special interests and create a binding commitment to the only special interest that counts, you, the people who pay America's bills. It will create millions of new jobs for working people and it will replace the politics of envy with a spirit of partnership, the opportunity for everyone to hitch their wagon to a star and set out to reach the American dream.⁵

President Reagan made these remarks less than 18 months ago, and we are now about to get the Tax Reform Act of 1986. Its provisions are not quite what the President originally proposed to the Congress, but they are close; and, as the journalists have been asserting, the Act makes dramatic changes that were widely thought unattainable up to the last legislative minute, when the house and Senate conferees reached an agreement that resolved their differences.

3. J. TUCKER, *THE CONSTITUTION OF THE UNITED STATES* 463 (1899).

4. Carter, Acceptance Speech (July 15, 1976), *reprinted in* 32 CONG. Q. ALMANAC 852 (1976).

5. R. Reagan, Overhauling the Tax System (May 28, 1985) (speech delivered to American people), *reprinted in* VITAL SPEECHES OF THE DAY, Vol. LI, No. 17, pp. 1-2 (June 15, 1985).

The bill's movement through Congress has been marked by paradox after paradox. It commanded overwhelming bipartisan support in the House of Representatives—itsself a paradox for this type of legislation—but the paradox was heightened by the fact that many of the Democrats signed on not because they liked the bill, but because they did not want to be blamed for its defeat; and many of the Republicans found it equally distasteful, but thought it would be revised by their fellow Republicans in the Senate. It then went to the Senate Finance Committee, whose chairman, Senator Packwood, was widely regarded as lukewarm, if not hostile, to major tax reform—indeed, his hostility earned (or at least got him) the name “Hackwood”—but he then experienced, according to newspaper reports, a sudden conversion to the seemingly lost cause.

Moreover, Senator Packwood's conversion was attributed to the very forces that, according to the conventional wisdom, made comprehensive tax reform impossible—the Washington lobbyists for so-called special interests. In their clamor for Senator Packwood's attention, these miracle-workers evidently insured the defeat of each other's pet projects by demonstrating the truth of the old political maxim that for every government sinecure, there are ten applicants; and when you pick one, you make nine enemies and one ingrate. In any event, Senator Packwood warded off the plague of locusts by abolishing many of the sinecures.

These paradoxes in the political process are not merely matched but, in my opinion, are overshadowed by a paradox in the intellectual history of the Tax Reform Act of 1986, which reflects the confluence of two fundamentally different schools of tax reform.

First, from the end of World War II, and increasingly since about 1960, tax theorists belonging to what might loosely be called the “comprehensive tax base” or “base-broadening” group have denounced the erosion of the tax base by preferences, loopholes, and special allowances. Their targets have been provisions that treat income differently depending on the source from which it is derived (like the exemption of interest on state and municipal bonds); that grant tax allowances to one industry that are not allowed to other industries (like percentage depletion); or that allow deductions for one type of personal expenditure (like interest on home mortgages) that are not allowed for other expenditures.

The rallying cry of these base-broadening theorists of the federal income tax has been “equity”—equal treatment for all similarly-situated taxpayers. In pursuit of this goal, they criticized existing law vigorously, and with passion; and occasionally they used colorful phrases—like “upside-down subsidies,” “a welfare program for the rich,” and “dipping deep with a sieve”—that might lead outside observers to think that they favored scrapping the income tax and shifting to another taxing system.

Nothing could be farther from the truth. Their criticisms were the anguished cries of the lover at the violation of an ideal; they wanted the income tax to be purged of its imperfections and to remain as the centerpiece of the federal fiscal system. Moreover, although base-broadening has no necessary connection with a progressive rate schedule, with any particular

aggregate revenue goal, or with the level of federal expenditures, most base-broadening theorists believed in progression and favored large federal expenditures for social programs. Indeed, one of their persistent complaints was that the progressive rate schedule of existing law was being undermined because it applied to a smaller and smaller tax base ("dipping deep with a sieve"); and when they computed the size of the tax base if purged of its special allowances, they often also computed the increase in tax revenue that could be achieved by applying the existing rate schedule to the expanded base. Although these dramatic demonstrations usually were accompanied by computations showing that, in the alternative, a broadened base would permit the tax rates to be drastically *lowered* if revenue-neutrality were desired, I think it is fair to say that this pallid outcome was not their first policy choice. At any rate, let me confess that it was not mine.

The equity-motivated school of tax reform has great success in the classroom, but it was less effective on Capitol Hill.

In the meantime, a second wave of tax reform theorists came to the fore. These Johnny-come-latelies were no less critical of the existing law than the base-broadeners, and indeed they used some of the same rhetoric; but their watchword was "efficiency" rather than "equity." Their primary objection to tax loopholes, exceptions, and special allowances was not that they are inequitable, but that they interfere with market forces by attracting investment that would not be profitable save for the tax incentives, and hence by reducing investment in non-favored activities. The resulting shifts in business and investment behavior are "inefficient" in the sense that they cause us to produce "too much" of the tax-subsidized product and "too little" of the unsubsidized product—for example, too much oil and gas as compared with coal; or, turning to the investment behavior of personal householders, that we stimulate people to buy homes because they can deduct their interest mortgage and local real property taxes, when they would be better off, were it not for these deductions, as tenants than as home-owners.

Thus, both the older "equity" reformers and the latter day "efficiency" reformers objected to the erosion of the tax base by legislative allowances, and both prescribed the same remedy: broadening the base so that all income will be treated alike, regardless of the source from which it is derived or the use to which it is put by the recipient.

This is the "confluence" of the two schools of tax reform to which I referred earlier. Allow me now to explain why I described this confluence as paradoxical. The "equity" complaint against tax allowances has traditionally rested on a static view of taxpayer behavior, that is, it has assumed that the enactment of a tax incentive does not alter the economic yield generated by the tax-favored activity, and that persons engaging in that activity therefore receive a higher yield than taxpayers who are engaged in unsubsidized activities entailing comparable business or investment risks.

Efficiency theorists, by contrast, make exactly the opposite behavioral assumption, viz., that taxpayers will flock to the tax-favored area, inspiring more and more low-yield activities until the net return, after taking the tax

incentive into account, is equal to the net after-tax return in activities that do not benefit from tax incentives. If and when the after-tax returns in the two areas are equalized, however, all taxpayers are treated the same; there is, in short, no inequity to complain about. The efficiency complaint, however, remains—indeed, this *is* the efficiency complaint; tax-subsidized activities have expanded and unsubsidized activities have declined, although the former are less economically efficient, save for the tax incentive, than the latter.

Let me illustrate this point with a simple numerical example. Assume, if you will, that copper and iron are interchangeable minerals; that mining either yields a 10% annual return on one's investment; and that all taxpayers are subject to a 50% income tax rate. Thus, an investment of \$100,000 produces income of \$10,000 per year, on which the tax is \$5,000, leaving an after-tax return of \$5,000, whether the taxpayer mines copper or iron. Now assume that Congress, for whatever reason, provides that income from copper mining shall be tax-exempt. If nothing more happens, taxpayers continue to realize \$10,000 of income per year on an investment of \$100,000 in either type of mining, but the copper miner retains the entire \$10,000, while the iron miner, whose return remains taxable, is left with only \$5,000. From the perspective of an "equity" tax theorist, this is unfair, because the taxpayers are similarly situated, but their taxes are not the same.

The "efficiency" theorist, however, would argue that this comparison is unrealistic, except in the short run, because the exemption for copper mining will lead rational taxpayers to gravitate from iron mining to copper until the after-tax yields from the two activities are equalized. At the new equilibrium, the (tax-free) return from copper mining will drop—for example, to 6%, because miners will find it worthwhile to dig deeper and refine more low-quality copper ore—while high-cost iron mines will be closed down until the only iron mines kept in service are those that can produce a (taxable) return of 12%. At this new equilibrium, copper miners will realize \$6,000 of tax-free income on an investment of \$100,000, while such an investment in iron mining will produce \$12,000 of taxable income, of which the entrepreneur will retain \$6,000. Once this market trade-off has been achieved, the efficiency theorist would say that there is no inequity—since taxpayers are left with a 6% return on their investment, whether they mine copper or iron—but that the efficiency of the national economy has suffered, because too much low-quality copper is being mined instead of higher-quality iron.

This example can be used to illustrate another paradox. If the hypothetical tax exemption for copper mining did *not* alter the economic behavior of taxpayers—that is, if copper mining and iron mining continued at the same level as before—then it would produce no inefficiencies. Conversely, if the two types of mining reach a new economic equilibrium so that each generates the same after-tax profit, the resulting inefficiency would eliminate completely any inequity. Thus, if equity and efficiency tax theorists could exchange assumptions about economic behavior, each relinquishing his own and adopting the other's, *neither* would have any reason to complain about tax allowances.

For a variety of reasons, however, including our less-than-perfect market and the time it takes for economic adjustments to compensate for legislative interventions, my numerical example presents an unrealistically sharp contrast between the "equity" and "efficiency" effects of special tax allowances. In the real world, and in the time frame used by ordinary observers, it is likely that tax incentives are competed away only in part, and that the usual residue is a combination of inequities and inefficiencies. At any rate, legislators and even tax theorists routinely object to tax allowances on both grounds; and, except in the macro-economic stratosphere of mathematical models, it is impossible to establish that their competing complaints are wholly inconsistent with each other.

In this thumb-nail sketch of tax theory,⁶ I have focused on ideas generated and debated in academia and in off-campus centers for the analysis of public policy. The ideas, however, soon moved from the intellectual forum to the political arena, where they spawned a score of so-called flat tax proposals, of which the best known are the Bradley-Gebhardt and Kemp-Kasten bills. Pruned of some of their gaudy promises, like a single tax rate of only 15% and a tax return no larger than a postal card, these legislative proposals reflected with great fidelity the equity and efficiency complaints about existing law; and so did two influential Treasury studies commissioned by President Reagan. The same intellectual sources are readily visible in the Tax Reform Act of 1986, which reflects the same confluence of fundamentally divergent schools of thought.

Where are we now? Assuming passage of the bill by the Senate and signature of the President—both foregone conclusions—will the tax reform process have run its course? Has the Internal Revenue Code been converted from "a disgrace to the human race," to use President Carter's epithet, into one of the crowning glories of Anglo-American jurisprudence—"a star," in President Reagan's words, to which we can all hitch our wagons, "free from the grip of special interests?"

One of the hopes—shall I call it a dream?—of tax reformers has been an income tax base so purified of special-interest legislation that it will command universal respect and will be able to withstand any attempt to restore any part of the status quo ante. The behavioral or political theory on which this "sacred ark of the covenant" mentality rests is that all good citizens and their representatives will rise up in their wrath and defeat any proposal to erode the newly-purified tax base, because they will realize that a successful first strike will open the tax base to an endless series of further attacks.

I may be guilty of verbalizing this hope in a way that evokes skepticism, if not guffaws; but it is, alas, one of those ideas that refutes itself. The Tax Reform Act of 1986, however many good features it may contain—and they are not inconsiderable in number—is the product of a political

6. See Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities*, 16 SAN. DIEGO L. REV. 735 (1979) (detailed analysis of tax theory).

process, which is not known for unswerving allegiance to neat theories; and the Act carries forward many tax allowances that have been denounced by equity and efficiency theorists alike—allowances for the oil and gas industry, for timber (Senator Packwood, we must remember, is from Oregon; and missionaries usually work best in *partibus infidelibus*), for interest from state and municipal bonds, for some state taxes, and for interest on most home mortgages.

The preservation of many features of existing law should not surprise us; what is astonishing is that so many tax allowances were terminated, including the popular investment tax credit, the reduced rate on long-term capital gains, and the itemized deduction for state and local sales taxes.

Nevertheless, even a cursory analysis of the Act will disclose that it perpetuates a host of old provisions and creates some new ones; both types are certain to evoke plausible claims for refinement and expansion. Thus, I see no reason whatsoever to believe that the new tax base will command such universal approval as to be impregnable for more than a single legislative session, if that.

If it is necessary to provide documentary support for something that common sense tells us, let me offer two excerpts from the Conference Committee's report on the 1986 Act. First, when the House bill was before the Senate, it added a sense-of-the-Congress resolution that all provisions of the Internal Revenue Code that were amended or added should remain unchanged for at least five years from the date of enactment. This self-denying ordinance would obviously have no legal effect; but even so, it was too much for the House conferees to accept, and it was accordingly dropped from the legislation.⁷ Perhaps a moratorium would have been more acceptable if the rate schedules were excluded, since rate increases are on the agenda of many legislators, despite the President's seemingly adamant opposition; but the proposed moratorium was wholly deleted, not merely amended to exclude the rate schedules.

Second, the 1986 Act eliminates the rate differential for long-term capital gains, an achievement that had been thought unattainable; but the rest of the elaborate capital gain/loss statutory structure was carried forward without change, including the definition of the term "capital asset," the distinction between long-term and short-term gains and losses, the restricted deductibility of capital losses, and other more complex distinctions between capital gains and losses and ordinary income and deductions. Commenting on this perpetuation of provisions that a visitor from Mars might think had become as devoid of any function as the human appendix, the conferees explained:

The current statutory structure for capital gains is retained in

7. H.R. REP. NO. 841, 99th Cong., 2d Sess., pt. 2, at 838 [hereinafter Conference Committee Report]; *see also* Feldman v. Commissioner, 791 F.2d 781 (9th Cir. 1986) (Judge Sneed observing that "[c]hange in the tax laws is a way of life," reflecting not only his experience as judge but his earlier life as teacher of tax law).

the Code to facilitate reinstatement of a capital gains rate differential if there is a future tax rate increase.⁸

This warning takes me back to my contrast between the equity and efficiency approaches to federal income tax reform. In my view, the convergence of these approaches, which helped to produce the 1986 Act, reflects an unstable alliance—one that reminds me of a remark attributed to John F. Kennedy: “In politics, you have no friends, only allies.” I said earlier that most adherents of the equity school of tax theory criticized the pre-1986 income tax from the perspective of disappointed lovers. For them, base-broadening was a desideratum not only because it would eliminate inequities, but also because, coupled with the “right” rate schedule, it would generate more revenue for social welfare programs. Most efficiency theorists, by contrast, view the income tax as a necessary evil, disapprove of its use as a redistributive instrument, and favor base-broadening not only because it reduces economic inefficiencies, but also because by spreading the burden, it may increase public resistance to government expenditures. The 1986 Act gives both groups many things that they both want, but it does not reconcile their competing views about the income tax’s proper role in the nation’s fiscal structure; and they surely will continue to speak up for these views in the future.

For want of time, I did not mention earlier another school of thought that also must be reckoned with, and that I should refer to here. As you know, many observers of our national economy think that our level of savings and investment is woefully inadequate; and while these critics often join forces with efficiency theorists in opposing most tax incentives, they feel very differently about provisions that encourage savings and investment and correspondingly curtail consumption. Thus, if it were feasible, they would like to shift from taxing income per se to taxing *consumed* income—and if that route is barred, then they favor income tax incentives having a similar effect, like the investment tax credit, the IRA deduction, and the like. They hardly can be expected to view with equanimity the repeal or reduction of these tax allowances by the 1986 Act, or to refrain from advocating a restoration or expansion of these provisions as soon as the political climate suggests that they may be able to make some headway.

To the extent that these competing hopes are shared by legislators, they suggest that the Tax Reform Act of 1986 will prove to be only one more step in an unending process of political process, not a final chapter in a story that began two centuries ago with the direct tax clause of the Constitution.

8. Conference Committee Report, *supra* note 7, at 107.