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EVALUATING PERSONAL DEDUCTIONS IN AN INCOME TAX—THE IDEAL

William J. Turnier†

The dynamics of the political process have produced an income tax structure sharply at variance with the system that most tax theorists would design. Nonetheless, in recent years theoretical studies of tax reform have had an increasing impact on political discussions dealing with basic tax reform. Much of the theoretical discussion has emanated from those who advocate a comprehensive tax base and the tax expenditure budget.

The role of personal deductions in our income tax system has generated considerable debate among individuals who have criticized personal deductions as unwarranted erosions of the tax base.[1] Implicit in this criticism is the view that the government should tax all income. These critics commonly characterize personal deductions as subsidies for the wealthy that Congress, through tax reform legislation, should eliminate.[2] Underlying this approach is the assumption that all deductions stem from the economic self-interest of politically powerful groups.[3] Personal

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[1] *See, e.g.*, R. FREEMAN, TAX LOOPHOLES: THE LEGEND AND THE REALITY (1973) COMPREHENSIVE INCOME TAXATION (J. Pechman ed. 1977); P. STERN, THE GREAT TREASURY RAID (1964); S. SURREY, PATHWAYS TO TAX REFORM (1973); Aaron, *What is a Comprehensive Tax Base Anyway?*, 22 NAT'L TAX J. 543 (1969); Brown, *Towards Equity and Efficiency in Federal Taxation,* 36 U. PITT. L. REV. 835 (1975); Surrey & Hellmuth, *The Tax Expenditure Budget—Response to Professor Bittker,* 22 NAT. TAX J. 528 (1969).

This critical view of personal deductions appears in the annual tax expenditure budget and the Canadian White Paper and, to a lesser extent, in the Treasury's blueprints for tax reform. *See* OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSIS, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1980 183 (1979); ROYAL COMMISSION ON TAXATION, REPORT (1966); U.S. TREASURY DEP'T, BLUEPRINTS FOR BASIC TAX REFORM (1977).

[2] *See, e.g.*, R. FREEMAN, *supra* note 1, at 13; S. SURREY *supra* note 1, at 37.

[3] Professor Surrey, who has made a major contribution to the debate over tax reform by advocating the development of a expenditure budget, has always suggested that even if deductions erode the income tax base, additional factors may still justify deductions. *See* S. SURREY, *supra* note 1, at 31. Unfortunately, much of the discussion of these additional factors by both proponents and opponents of tax reform has focused almost exlusively on matters such as the role of deductions as incentives for carrying out private conduct that the government wishes to encourage. *See, e.g.*, Stone, *Tax Incentives as a Solution to Urban Problems,* 10 WM. & MARY L. REV. 647 (1969); Surrey, *Tax Incentives as a Device for Implementing Government Expenditures,* 83 HARV. L. REV. 705 (1970).

deductions are also, in the opinion of some commentators, inefficient means of attaining nonrevenue ends.

This dim view of personal deductions is unwarranted for a number of reasons. First, although critics generally agree on the definition of income, they have failed to define its key components. As a result, they leave unresolved the question of whether personal deductions are necessary to assure that only income is taxed.[4] Moreover, in focusing exclusively on the extensiveness of an income tax, these critics overlook the role that our society intends this tax to play. Consequently, critics ignore the capacity of deductions to insure that the base is compatible with the principal reasons underlying society's adopting the income tax. Finally, critics also ignore the role that personal deductions can play in insuring the primacy of fundamental social, economic, and political values. In so doing, these critics elevate values implicit in a comprehensive income tax above all other values.

This Article proposes a three-tiered test to evaluate the propriety of personal deductions. First, one should measure all deductions against a generally accepted definition of income to determine if they are essential in arriving at the goal of taxing income.[5] Second, an examination of deductions is necessary to determine whether their continued existence is related to the basic reasons why our society adopted and maintains an income tax. Third, one should ascertain whether deductions are required to insure the primacy of fundamental social, economic, and political values. Judging the validity of a given deduction involves balancing all the above factors; none of them alone should be determinative.

[4] *But see* Andrews, *Personal Deductions in An Ideal Tax,* 86 HARV. L. REV. 309 (1972). The approach suggested by this Article differs somewhat from that suggested by Professor Andrews in terms of this author's willingness to offer a definition rather than a discussion of consumption and to include factors other than definition of the income tax base as appropriate in deriving the ideal tax base.

[5] This article adopts the Haig-Simons definition of income. Professor Henry Simons has defined income as the sum of personal consumption and the increase (or decrease) in net worth between two points in time. H. SIMONS, PERSONAL INCOME TAXATION 61-62 (1938). In its broadest sense income includes the imputed income derived from services an individual performs for himself and from employing property for his own use. *Id.* 110-124. Other items of consumption that might be regarded as income are the public benefits available to citizens, such as public primary and secondary education. Professor Bittker suggests that such benefits are income, but does not advocate their taxation. *See* Bittker, *A "Comprehensive Tax Base" As a Goal of Income Tax Reform,* 80 HARV. L. REV. 925 (1967). Professor Aaron criticizes this view on the ground that the Haig-Simons definition should only include private benefits in its calculation of consumption. Aaron, *supra* note 1. *See* notes 43-49 and accompanying text *infra.*

The deduction for state and local taxes[6] provides a helpful paradigm for the application of the proposed test. This deduction, provided by section 164 of the Internal Revenue Code, is the largest personal deduction. According to the Tax Expenditure Budget for fiscal year 1979-1980, section 164 will result in a diminution of $6,615,000,000 due to the deductibility of property tax on owner-occupied residences, and $12,450,000,000 due to the deductibility of all other nonbusiness state and local taxes.[7] The latter figure alone exceeds the expected revenue loss from either the mortgage interest deduction or the favored treatment accorded long term capital gains.[8] Despite its striking fiscal importance, section 164 has attracted limited interest from scholars.[9]

I

History of the Deduction for Taxes

It is necessary to explore the legislative history of personal deductions for taxes to understand the principal functions of section 164. A grasp of the purposes of section 164 is essential to the application of the proposed three-tiered test. The first federal income tax,[10] enacted in 1861 to help finance the Civil War,[11] allowed a deduction for federal, state, and local taxes incurred as a business expense.[12] The Revenue Act of 1864, as amended in

[6] I.R.C. § 164.

[7] The deductibility of property taxes on owner-occupied residences may result in a diminuation in federal revenues of $6,615,000,000.00. The deductibility of other taxes may account for an additional loss of $12,450,000.00. *See* Office of Management and Budget, *supra* note 1, at 208, 211.

[8] The tax expenditure budget estimates that the mortgage interest deduction, the second most important personal deduction, produces a revenue loss of $9.29 billion. Current treatment of long term capital gain costs the federal government $10.15 billion. *Id.* at 208.

[9] Between 1968 and 1978, the CCH Fed. Tax Articles index contained only 12 entries under § 164, none of which involved a policy-oriented analysis of the deduction.

[10] Many of the colonies imposed a "faculty tax" that presumed that certain trades or professions would generate given income levels. Individuals in those trades were taxed accordingly, although the assessor often had discretion to make upward or downward adjustments based on his judgment of an individual's earnings. *See* E. Seligman, The Income Tax, 367-87 (1911). In 1840, Pennsylvania imposed what may have been the first American income tax. *Id.* at 400. Originally, Pennsylvania only imposed this tax on the salaries of state employees and dividends of state banks. In 1841, the scope of the tax was broadened to include compensation paid by all state chartered corporations. *See* 1840 Pa. Laws 612-613, *amended by* 1841 Pa. Laws 307, 310.

[11] Because it was repealed prior to the payment date of June 30, 1862 and replaced by the Revenue Act of 1862, no revenue was ever raised under the 1861 Act. *See* Act of July 1, 1862, ch. 119, §§ 89-93, 12 Stat. 473.

[12] *See* Act of Aug. 5, 1861, ch. 45, § 49, 12 Stat. 309, which provided: "That, in estimating said income, all national, state, or local taxes assessed upon the property, from which the income is derived, shall be first deducted."

1865, provided the first personal deduction for taxes.[13] Although the legislative history is inconclusive, some commentators have suggested that Congress enacted the deduction out of a desire to avoid imposing a tax on a tax. However, more subtle factors also may have been at work.

Because the imputed income attributable to owner-occupied residences was escaping taxation,[14] Congress apparently sought to achieve equity between homeowners and renters in 1863 by providing a deduction for the amount paid for rent of a personal residence.[15] The Revenue Act of 1864 explicitly excluded from taxable income the imputed income attributable to the rental value of an owner-occupied residence and continued the deduction for rental of a personal residence.[16] The deduction for taxes

[13] *See* Act of June 30, 1864, ch. 173, § 117, 13 Stat. 281 *as amended by* Act of March 3, 1865, ch. 78, 13 Stat. 479. The 1865 amendment to the 1864 Revenue Act provided: "[A]ll national, state, county, and municipal taxes paid within the year shall be deducted from the gains, profits, or income of the person who has actually paid the same, whether owner, tenant, or mortgagor."

Prior to its amendment, the 1864 Act had allowed a deduction for "all national, state, and municipal taxes, other than the national income tax lawfully assessed....upon the property or sources of income of any person....from which said annual gains, profits or income is or should be derived...." *See* Act of June 30, 1864, ch. 173, § 117, 13 Stat. 281. Two observations should be made in contrasting this language with the statute as amended. First, the original 1864 language is capable of being construed to allow a deduction only for business taxes and taxes on income producing property. Second, the original language did not allow a deduction for the federal income tax in computing that tax. An early ruling, however, construed the provision as allowing a deduction for all taxes. *See* G. BOUTWELL, A MANUAL OF THE DIRECT AND EXCISE TAX SYSTEM OF THE UNITED STATES 105, 153 (1864).

The subsequent 1865 amendment to the 1864 Act changed the language to indicate clearly that the deduction for taxes includes nonbusiness taxes and to include the federal income tax in the category of deductible taxes. *See* Act of March 3, 1865, ch. 78, 13 Stat. 479. No explanation for either the Treasury's Ruling or Congress' acquiescence to it in 1865 was found.

[14] The concept of taxing the imputed income derived from owner-occupied residence is hardly novel. The 1799 British income tax, which was the first modern income tax and a direct economic consequence of the British military reaction to the French Revolution, listed "Income of Lands occupied by the Owner" and "Houses and Buildings occupied by the Owner" as the first and second items of income on Schedule A and taxed an owner of such property on the value it would bring if rented by the owner to a third party. 39 GEORGE III, ch. 13 § 22 (1799)

[15] *See* Act of March 3, 1863, ch. 74, § 11, 12 Stat. 723 ("That in estimating the annual gains, profits, or income, of any person....the amount actually paid by such person for the rent of the *dwelling-house* or estate on which he resides shall be first deducted from the gains, profit, or income of such person.") (emphasis in original).

[16] *See* Act of June 30, 1864, ch. 173, § 117, 13 Stat. 281.

> The amount paid by any person for the rent of the homestead used or occupied by himself or his family, and the rental value of any homestead used or occupied by any person, or by his family, in his own right or in the right of

may have represented an attempt to provide the homeowner with a deduction equal to the amount of the property tax component of the rent charged by a landlord, and for which the tenant was indirectly receiving a deduction.[17] The genesis of the deduction for state and local taxes can perhaps be viewed as an attempt to inject an element of equity into the tax system by equalizing the tax treatment of renters and homeowners. Even if Congress did not intend this result, it is undeniable that the deduction for taxes, when coupled with the deduction for interest added by the Revenue Act of 1870,[18] had this effect.

In 1872 Congress repealed the income tax. When reinstituted in 1894, the tax bore only a partial similarity to the foregoing features of its predecessor. Gone were the rental deductions and all references to the imputed income stemming from the value of owner-occupied residences, with exclusion of the latter apparently taken for granted. Present, however, was the provision allowing unrestricted deduction of all federal, state, and local taxes.[19] Because of the removal of the rental deduction, the deduction for state and local taxes could no longer be justified as a measure to affect rough tax equity between renters and homeowners.

Nineteen years after the Supreme Court held the 1894 tax unconstitutional,[20] Congress, exercising the powers given it by the sixteenth amendment, passed the Revenue Act of 1913.[21] The

> his wife, shall not be included and assessed as part of the income of such person.

Id.

[17] Because taxes other than those on residences are deductible, one might reject this suggestion. However, most nonbusiness taxes at the time were property taxes on residences and their contents. If one views deductibility of the federal income tax as the equivalent of a rate reduction (*see* note 25 *infra*), it is apparent that the 1865 Act provided little in the way of a personal deduction for taxes other than real property taxes.

[18] *See* Act of July 14, 1870, ch. 255, § 9, 16 Stat. 258.

[19] *See* Act of Aug. 27, 1894, ch. 349, § 27, 28 State. 553. The Act also contained a number of features found in earlier Revenue Acts, including: the exemption for farm produce consumed by producers and their families (originally added in 1867); the deduction for all interest paid (originally added in 1870); and the deduction for losses arising from fires, storms, or shipwrecks or losses from worthless debts (originally added in 1870). *See* Act of March 2, 1867, ch. 169, § 13, 14 Stat. 478; Act of July 14, 1870, ch. 255, § 9, 16 Stat. 258.

[20] *See* Pollock v. Farmer's Loan & Trust Co., 157 U.S. 429 (1895).

[21] Act of Oct. 3, 1913, ch. 16, § II(B), 38 Stat. 167. The Act provided a deduction for "[a]ll national, state, country, school and municipal taxes paid within the year, not including those assessed against local benefits." The exclusion of taxes assessed against local benefits represented the only change in deductions provided by the Revenue Act of 1894.

new Act closely resembled the Revenue Act of 1894 and, like its predecessor, allowed a deduction for taxes. The only reason Congress articulated for the deduction was that because these levies reduced ability to pay, equity warranted excluding them from the tax base.[22] In 1916, Congress broadened the category of deductible taxes to include foreign taxes.[23]

The Revenue Act of 1917 repealed the deduction for federal income taxes.[24] Until this congressional action, taxpayers had claimed a deduction for federal income taxes paid or incurred in each year. Faced with the need to raise revenue to finance the country's entry into World War I, Congress considered raising the rates substantially, but settled on removing the deduction for federal income taxes. It should be noted that if a tax is deductible in computing the tax itself, one rate is a function of the other. It is therefore possible to design a rate schedule for a "non-deductible" tax that will produce the same revenue as a seemingly higher rate schedule would produce if the tax were deductible from the base.[25] Viewed in this light, one can characterize the 1917 changes as nothing more than a significant increase in the tax rate, effected by removing a deduction that was a function of the existing tax structure.

In 1934 Congress excluded from the category of deductible taxes all estate, inheritance, and gift taxes,[26] reasoning that they "are not incurred in the production of income, and liability for them attaches regardless of whether there is any income."[27] If

[22] *See* 55 CONG. REC. 6317-18 (1917) (Remarks of Sen. McCumber, member, Finance Committee).

[23] Act of Sept. 8, 1916, ch. 463, § 5(a), 39 Stat. 759.

[24] Act of Oct. 3, 1917, ch. 63, § 1200, 40 Stat. 330.

[25] *See* 55 CONG. REC. 6322 (1917) (Remarks of Sen. Smoot). For example, an accrual basis taxpayer who is taxed at the rate of 33.3% under a non-deductible tax will pay the same total tax as he would if he were taxed at the rate of 50%, with the tax allowed as a deduction. One can compute the tax rate under a deductible tax system that will yield a tax equal to the tax yielded under a system in which the tax is not deductible, using the following formula: $A=B+AB$. A stands for the rate under the deductible system and B stands for the rate under the non-deductible system. Although it is possible in theory to view a nondeductible tax as equivalent to a deductible tax that employs somewhat higher rates, practical problems arise. For example, assume a cash basis taxpayer pays his tax on his 1981 income in 1982 and that a decline in earnings puts him in a lower tax bracket in 1982. Unless cash basis accounting rules are altered, it is a practical impossibility to produce the same tax result for him under a deductible and a non-deductible tax system in which the rates have been developed pursuant to the above formula.

[26] *See* Revenue Act of 1934, ch. 277 § 23(c)(3), 48 Stat. 688.

[27] H.R. REP. No. 704, 73rd Cong., 2d Sess. 22 (1934).

Congress strictly applied this rationale it might have disallowed as personal deductions all but income taxes. That this step was not considered may indicate that Congress was responding to the existing exclusion of gratuitous conveyances from income and attempting to confine any adjustments to the tax base and effective rates arising from gratuitous conveyances to the estate and gift taxes.[28]

The next major revision of deductions for taxes took place in 1964. From 1865 to 1964, Congress had permitted the deduction of all taxes except those it specifically excluded. In 1964, Congress retained the list of nondeductable taxes,[29] but added a new section to the Code that allowed personal deductions only for certain designated taxes,[30] thereby decreasing considerably the number of taxes for which a personal deduction would be allowed.[31] The amended Code allowed a personal deduction for the following state and local taxes: real and personal property taxes, income, war, and excess profits, and gasoline and motor fuel taxes. In addition, Congress permitted a personal deduction for foreign real property, income, war, and excess profits taxes. Congress also retained the deductibility of state and local income taxes as "an important means of accommodation where both the state and local governments on one hand and the federal government on the other hand tap this same revenue source . . . ."[32] Congress's unwillingness to produce a dramatic shift in the existing pattern of distribution of the federal tax burden between homeowners and non-homeowners prompted its refusal to remove the deduction for property taxes.[33] Congress retained the deduction for sales and gasoline taxes because it believed that by extending deductions to all major revenue producing state and local taxes, states could freely structure their tax systems in a neutral environment.[34]

[28] *See, e.g.*, I.R.C. §§ 2001(b), 2011, 2012, 2053(d).

[29] *See* Revenue Act of 1964, Pub. L. No. 88-272, § 275, 78 Stat. 42.

[30] *Id.* § 207, 78 Stat. at 40.

[31] The principal additional taxes that § 164 disallowed as deductions were state and local auto license taxes, alcoholic beverage, cigarette, and selected excise taxes. *See* H.R. Rep. No. 749, 88th Cong., 1st Sess. 3 (1963).

[32] *Id.* at 48.

[33] *Id.* The notion that equity should bar the removal of inequitable provisions because taxpayers have come to rely on them is a recurring one in the tax area. For a discussion of certain aspects of this problem, see Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. Pa. L. Rev. 47 (1977).

[34] H.R. Rep. No. 749, *supra* note 31, at 48-50; S. Rep. No. 830, 88th Cong., 2d Sess. 54-55 (1964).

The last major revision of tax deductions[35] took place in 1978, when Congress eliminated the deduction for state gasoline and motor fuel taxes. In prior unsuccessful attempts to repeal the gasoline tax deduction,[36] proponents had stressed problems of enforcement, the possibility of financing an across-the-board rate cut using the revenue gained from disallowance, and the undesirable encouragement of gasoline use that stemmed from the deduction.[37] The main reàson articulated by Congress in 1978 for repealing the tax deduction was that the tax was fundamentally a user fee—a tax on a personal expense for automobile travel—and as such, was distinguishable from the income tax and other general state and local taxes.[38] Congress noted the difficulty of verifying the amount claimed for gasoline taxes as well as the inappropriateness of such a deduction at a time when conservation of energy and reduction of oil imports were important national goals.

In summary, the personal deduction for taxes probably arose out of a desire to equalize the tax treatment of renters and nonrenters; the continuation of the deduction for real property taxes and the removal of the deduction for renters gives rise to one of the principal inequities in the treatment of renters and homeowners in our Code. Moreover, Congress has left the deductibility of the state income tax firmly intact for what it believes to be good reasons. Finally, having reached that decision, a desire to preserve the *de facto* ability of the states to shape their revenue raising programs has led Congress to retain the deductible status of most of the major sources of state revenue. These considerations acquire added importance in the analysis of the deduction for state and local taxes.

[35] In 1974 Congress amended § 275 to include the taxes imposed by cbapters 42 and 43 on certain activities involving private foundations. *See* Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 1016(a)(1), 88 Stat. 929, *amending* I.R.C. § 275. In 1972, Congress amended § 164(b)(2) by including subsection (E), which specifies that when the rate of sales tax on motor vehicles exceeds the general sales tax rate, the general rate will be treated as the rate of tax. *See* Act of Oct. 27, 1972, Pub. L. No. 92-580, § 4, 86 Stat. 177.

[36] *See* S. REP. No. 938, 94th Cong., 2d Sess. 122 (1976); H.R. REP. No. 749, 88th Cong., 2d Sess. 47 (1964).

[37] *See* S. REP. No. 938, *supra* note 36.

[38] *See* S. REP. No. 1263, 95th Cong., 2d Sess. 57 (1978).

II

Defining the Base

To determine whether existing personal deductions represent unwarranted erosions of the tax base, it is first essential to establish an acceptable definition of income. Early modern economists agreed that income consists of a flow of satisfactions—of intangible psychological experience.[39] The need to produce an objective measurement of these highly subjective satisfactions caused the theorists to equate the value of the goods and services used to produce these satisfactions with income.[40]

Professor Haig characterized income as "the money value of the net accretion of one's economic power between two points of time."[41] Professor Henry Simons rejected the early concern with sensation and added to Haig's definition the element of consumption, a refinement that he rightly credited Haig with making conceptually, but not literally.[42] The Simons definition posits: "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property right between the beginning and end of the period in question."[43] Explaining the definition in greater detail, Simons observed that:

> Personal income connotes, broadly, the exercise of control over the use of society's scarce resources. It has to do not with sensations, services, or goods but rather with rights which command prices (or to which prices may be imputed). Its calculation implies estimate (a) of the amount by which the value of a person's store of property rights would have increased, as between the beginning and end of the period, if he had consumed (destroyed) nothing, or (b) of the value of rights which he might have exercised in consumption without altering the value of his store of rights. In other words, it implies estimate of consumption and accumulation. Consumption as a quantity denotes the value of rights exercised in a certain way (in destruction of economic goods); accumulation denotes the change in ownership of valuable rights as between the beginning and end of a period.[44]

[39] Haig, *The Concept of Income,* in The Federal Income Tax 7 (R. Haig ed. 1921), *reprinted in* American Economics Ass'n, Readings in the Economics of Taxation 54, 55 (R. Musgrave & C. Sharp eds. 1959).

[40] *Id.* at 9, American Economics Ass'n at 57.

[41] *Id.* at 11, American Economics Ass'n at 59.

[42] H. Simons, *supra* note 5, at 61-62.

[43] *Id.* at 50.

[44] *Id.* at 49-50.

It is significant that, according to Simons, an individual's tax base consists only of the resources he consumes or retains to finance additional consumption. Moreover, in Simons's view, consumption involves the destruction or use of goods (or services) for a private purpose. Taxing an individual on his use of society's scarce resources is understandable in a world in which an ever-growing population competes for a larger share of a finite supply of raw materials.[45] Thus, the destruction of resources for private benefit is one of the key characteristics of consumption in the definition of income.[46]

It is difficult to measure consumption and accumulation. Therefore, it is appropriate to use an individual's inflow of wealth as a tax base and to permit deductions therefrom that are necessary to reflect one's consumption and accumulation. Personal deductions thereby lessen the danger of taxing more than income when the inflow of wealth is substituted for income as the base of our income tax system. Professor Andrews describes the role played by personal deductions as follows:

> An ideal base for distributing personal tax burdens may be aggregate personal consumption plus accumulation of real goods and services. But it is not feasible to measure that quantity directly. We rely on money expenditures to provide a practical measure of the real consumption and accumulation which such spending buys. However, it is not practical to record and audit even personal expenditures directly. Consequently, we rely on the long run equivalence between money income and

[45] Under the auspices of the Club of Rome, a study was conducted at the Massachusetts Institute of Technology of the implications of present population and consumption trends. The study concluded that if present trends continue, the world's entire industrial and agricultural bases will collapse, resulting by the year 2100 in a precipitous drop in population from unchecked disease and starvation. *See* D.H. MEADOWS, D.L. MEADOWS, J. RANDERS, & W. BEHRENS, THE LIMITS OF GROWTH (1972). *But cf.* H. COLE, MODELS OF DOOM (1973).

[46] Some theorists have proposed that gifts be taxed as income because, like most other accretions, they increase in net worth. *See, e.g.,* Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income,* 91 HARV. L. REV. 1177 (1978); H. SIMONS, *supra* note 5, at 125. Taxing gifts seems appropriate because the transferor does not consume transferred assets, but puts them in the hands of the transferee, who may consume or save them. As Professor Bernard Wolfman has observed, a consistent definition of income (and rejection of the sensations approach to income) appears to require that the donor be permitted a deduction from income equal to the amount of the gift. Because this approach would make assignment of income easier than taking spinach away from a two year old child, however, one is tempted to agree with Professor Wolfman that the present system of taxing income and gratuitous transfers separately is preferable to the proposed changes. Address by Bernard Wolfman, Professor of Law, Harvard Law School. University of North Carolina Law School Speaker's Forum (April 6, 1979).

> money expenditures for consumption and accumulation and compute the tax on the basis of the former.
>
> The appropriate role of personal deductions in an ideal income tax base is . . . . to adjust for discrepancies between money income and real consumption and accumulation resulting from expenditures for items that we do not wish to take into account as part of the aggregate personal consumption or accumulation we wish to tax.[47]

The deduction allowed for casualty losses[48] illustrates how personal deductions insure that only income is taxed. Take the case of money or property that has been stolen. Stolen funds represent a dimunition in wealth unrelated to consumation on the part of the taxpayer. Consequently, a deduction equal to their value is necessary to tax only income. In the case of property, one might assert that if not held for business purposes, it simply proved to have a shorter life span than originally anticipated; therefore, its loss can be labeled as consumption. However, because it was only the use of the property to date that represents personal consumption,[49] and because the remaining value of the property had the potential to be converted to business use or transformed into money, it is anomalous to treat the property differently from the funds. Once one concludes that the theft produces a dimunition in net worth that is not classifiable as consumption, some adjustment should be made to insure that only income is taxed. Hence, the casualty loss deduction.[50]

Despite the widespread acceptance of the Haig-Simons definition of income, few scholars have expended effort to define its key component, consumption.[51] If personal deductions are necessary to insure that only income is taxed, then deductions are justified if they represent decreases in net worth that do not con-

[47] Andrews, *supra* note 4, at 327-331. For a criticism of Professor Andrews approach, see 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 (1979).

[48] I.R.C. § 165(c)(3).

[49] Although one might assert that consumption of the property occurred when it was acquired for personal purposes, this view is inconsistent with the Code's general treatment of capital goods used in a trade or business, which requires their cost to be depreciated over their useful lives. *See* I.R.C. §§ 167, 263.

[50] For a similar, although less elaborate, analysis of the role of the deduction provided for casualty losses, see Due, *Personal Deductions,* in COMPREHENSIVE INCOME TAXATION 45 (J. Pechman ed. 1977).

[51] The only prior detailed consideration of the nature and character of consumption found by this autbor is to be found in Andrews, *supra* note 4. Professor Andrews, however, never defines the term.

stitute consumption. To ascertain whether various deductions compensate for nonconsumptive expenditures, it is necessary to derive an acceptable definition of consumption.

Consumption represents the utilization of goods in the satisfaction of wants or in the process of production, resulting in the dimunition or destruction of their utility.[52] The desire to tax each individual on his or her income, as opposed to gross receipts, produces a tax only on the use of goods that create personal benefit. In developing his definition of income, Simon observed that "consumption as a quantity denotes the value of rights exercised in a certain way (in destruction of economic goods) . . . ."[53] It is the use and retention of resources—not their acquisition—that constitutes income.[54] Moreover, if a system seeks to tax consumption, it must tax individuals only on their use or destruction of resources. It is therefore appropriate to include within the definition of consumption a requirement that the use or destruction of the assets be for the purpose of securing a private benefit. Such a requirement also comports with Simon's concern that "personal income connotes. . . .the exercise of control over the use of society's scarce resources."[55] This statement reflects the concern that individuals be taxed only to the extent that they use or destroy society's resources to obtain a personal benefit.[56]

Under this definition of consumption, it is important to determine whether an individual derives a private—and therefore taxable—benefit simply because as a member of the public he benefits from public programs. For example, must the deduction for state income taxes fall merely because a taxpayer obtains some benefit, no matter how small, from various government programs financed by his taxes? Or should the tax system require that the

[52] *See, e.g.,* Webster's Third New International Dictionary 490 (1961).

[53] H. Simons, *supra* note 5, at 49-50.

[54] After paying lip service to the Haig-Simons' definition of income, many theorists label every outflow of resources as consumption. They thereby advocate a system that taxes the acquisition of resources rather than income. These theorists assume that all acquired wealth, less the cost of producing it, will be consumed or used to augument a taxpayer's net worth. This assumption leads to the conclusion that all personal deductions constitute unwarranted erosions of the tax base. The critics ignore questions about what constitutes consumption and whether it is appropriate to label all outflows of wealth as consumption. *See, e.g.,* S. Surrey, *supra* note 1, at 12-24.

[55] H. Simons, *supra* note 5, at 49.

[56] One might question whether the private benefit is commensurate in value with the goods expended to acquire that benefit. However, the market place generally insures that in the absence of an involuntary or a gratuitous transfer, the value of goods expended to acquire a personal benefit will equal the value of that benefit.

benefit for each individual from governmental programs be commensurate with his taxes before eliminating the deductibility of the tax? Because our income tax is an individual, rather than a societal, tax, only the benefit that each individual derives from public programs should be designated as consumption.[57]

As Professor Bittker has observed, a strict application of the Haig-Simons definition of income requires the inclusion in each person's tax base of the public services utilized by that individual.[58] For example, an individual attending a state-supported institution consumes not only the component of the cost of his education represented by his tuition, but also the added cost to the state of providing the education. Although administrative concerns preclude taxing on this basis, the consumption represented by public services that escapes taxation should not be arbitrarily assigned to other parties, namely to those whose taxes provide the public benefits to other members of the society. To do so would be to turn an individual income tax into a societal income tax that arbitrarily places the burden for that tax on persons not actually benefiting from the consumption of resources. It is therefore necessary to adopt a definition of consumption grounded on the view that an out flow of funds resulting in a dimunition of an individual's net worth shall not be deemed consumption if the outflow provides a substantial benefit to the general public and an insignificant private benefit to the party making the expenditure.

Defining consumption as an expenditure of funds that produces a private, as opposed to a general public, benefit means that a deduction for state and local income taxes is essential if one is to tax income only. Indeed, Congress in 1964 may have continued the deduction for state and local income taxes precisely because of

[57] To avoid assignment of income problems, an individual's expenditures to finance consumption of another individual (e.g. a family member) should be considered income of the individual in control of the funds. Where, as a result of a gift to a charity, those funds are used to finance consumption on the part of the general public, retention of the charitable contribution deduction is consistent with the Haig-Simons definition of income. For a similar approach to the charitable contribution issue, see Andrews, *supra* note 4, at 344-75. In answering charges that the donor gets the satisfaction of chosing the donee, one should note that Simons viewed income not in terms of psychic satisfaction, but rather as involving the actual destruction or use of goods. *See* H. SIMONS, *supra* note 5.

Whether the Haig-Simons definition of income is of any assistance in determining the proper taxing unit, and consequently whether a family allowance and a return to the joint tax schedule is desirable, is beyond the scope of this Article. For such a discussion, see McIntrye & Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax*, 90 HARV. L. REV. 1573 (1977).

[58] Bittker, *A 'Comprehensive Tax Base' as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967).

such a consideration.[59] A recent Treasury study also concluded that the deduction for state and local income taxes is necessary to reach the proper tax base in an income tax system premised on the Haig-Simons definition of income.[60] Although this rationale seems to support a deduction for federal income taxes, such a deduction is not necessary: the same result can be produced by altering the rate schedule as was done in 1917.[61] Unfortunately, because some states do not tax income, and those that do apply different effective tax rates, adjusting the rate structure will not provide such a result for state and local income taxes.

The deduction for other state and local taxes, however, does not rest on firm theoretical grounds. The now repealed gasoline tax was perhaps the least justifiable of all of the state and local taxes. Because most states used the revenues from gasoline taxes to fund state highway departments, and because operators of motor vehicles paid gasoline taxes that corresponded to their use of the public roads,[62] the deduction for gasoline taxes provided taxpayers with an exclusion from their tax base of a particular type of consumption of public goods. The deduction for gasoline taxes therefore is not an adjustment to receipts necessary to insure that only income is taxed.

The sales and property taxes occupy an uncomfortable position between the income tax and the gasoline tax. On the one hand, the money paid to state and local governments in property and sales taxes, like income tax payments, represents funds that will be used to finance public, rather than private, consumption. Moreover, the public benefits financed by such taxes are in no way proportional to the sales and property taxes individual taxpayers pay.[63] On the other hand, these two taxes constitute the financial consequences of decisions made by individual taxpayers to consume society's scarce resources. For example, a taxpayer's decision to purchase an automobile for personal use may result in a state or local sales tax, and retention of the vehicle for such

[59] *See* note 32 and accompanying text *supra.*

[60] *See* U.S. TREASURY DEP'T, *supra* note 1, at 92-93.

[61] *See* notes 24-25 and accompanying text *supra.*

[62] Given the relationships between the consumption of gasoline and the weight of the automobile, the number of miles driven and the effect of mileage and weight on highway wear produced by passenger vehicles, the gasoline tax comes as close as any tax to being a user fee.

[63] *See* H. AARON, WHO PAYS THE PROPERTY TAX? 1 (1975); B. HERBER, MODERN PUBLIC FINANCE: THE STUDY OF PUBLIC SECTOR ECONOMICS 238-39 (1971). D. NETZER, ECONOMICS OF THE PROPERTY TAX 59-60 (1966).

purposes may result in the imposition of a personal property tax. Such taxes are arguably costs of consumption—a factor that weakens their claim to deductibility on the ground that an adjustment is required to insure that only income is being taxed. Moreover, given the difference in the tax treatment between direct and indirect property taxes, and between various types of taxes on transfers of property at retail, justifying the deductions as necessary to refine the base must be conceded to rest on questionable theoretical grounds. In the final analysis, it is appropriate to suspend judgment temporarily on the issue of the deductibility of sales and property taxes. To resolve the issue, other compelling considerations must be examined.

III

Societal Prime Rationales

A commendable goal of any income tax system is the taxation of all income. But an income tax system must also be consistent with what will be referred to as "societal prime rationales," that is, reasons that prompt a society to embrace an income tax instead of an alternative revenue-raising device. On occasion, society must depart from the goal of taxing all income in order to prevent the tax structure from conflicting with the societal prime rationales underlying the tax system. Personal deductions provide one vehicle for effecting such a departure.

The standards to which our tax system must conform are not a set of platonic criteria derived by philosophers and theoreticians.[64] Rather, the standards are those that society accepts for itself in its decision to implement and maintain a tax system. The legislative history of the tax code, its important distinguishing features, and its principal functions in our economic system demonstrate the societal prime rationales.

The United States employs an income tax as its principal revenue raising device essentially for three reasons. First, an income tax can easily be structured to insure that individuals are burdened in proportion to their ability to pay. Second, the income tax is a very efficient means of raising substantial revenue. Third, an income tax, particularly a progressive one, provides society with an automatic, as well as a discretionary, economic stabilizer.

[64] *See, e.g.*, J. Due & A. Friedlaender, Government Finance 204-208 (6th ed. 1977); B. Herber, *supra* note 63, at 117-130; A. Smith, An Inquiry into the Nature and Causes of the Wealth of Nations, bk.V, ch. 2, pt. II, at 777-79 (Mod. Lib. ed. 1937);

A. *Ability to Pay*

Historically, five different types of taxes have provided the bulk of government revenue. The tax systems in most Western societies have evolved through several fairly well-defined stages.[65] In primitive societies, mere numbers constituted the foundation for tax systems. The head tax, or poll tax, was a principal source of revenue in both early Teutonic societies and in Puritan New England.[66] This mechanism often produced equitable results in societies with relatively light tax burdens and substantially equal distributions of wealth.

With the development of private property systems and a growing disparity in the accumulation of resources, a pronounced shift toward property taxes grew out of an effort to develop a more equitable tax system.[67] During the later Middle Ages, a

Sneed, *The Criteria of Federal Income Tax Policy,* 17 STAN. L. REV. 567 (1965). Judge (then Professor) Sneed blends subjectively-derived criteria with those he claims society applies in formulating its tax system, and suggests that these criteria are:

> (1) to supply *adequate* revenue, (2) to achieve a *practical* and workable income tax system, (3) to impose *equal* taxes upon those who enjoy equal incomes, (4) to assist in achieving economic *stability,* (5) to *reduce economic inequality,* (6) to avoid impairment of the operation of the *market oriented economy* and (7) to accomplish a high degree of harmony between the income tax and the sought-for *political order.*

Id. at 568 (emphasis in original).

This Article posits only three societal prime rationales: (1) ability to pay; (2) countercyclical capacity; and (3) major fund raising efficiency. Nonetheless, these criteria closely resemble those posited by Sneed. Sneed's first two criteria are essentially this author's second criterion. Moreover, if one assumes that a system premised on ability to pay will place equal burdens on those with equal resources, and that it will place geometrically greater burdens on those with greater resources, it is clear that Sneed's third and fifth criteria are subsumed into this author's first criterion. It is this author's view that maintenance of compatibility between the tax system and a free market economy, if it ever was a goal of our tax system, has long since vanished as a principal rationale for an income tax. When one considers the frequent uses of a tax system in this country to manipulate the forces of the free market, one has great difficulty in concluding that this criteria was ever of much importance. Considering the use of the protective tariff to develop an American manufacturing industry and the extensive use of the tax system to invigorate the economy during periods of recession, it is difficult to conclude that maintaining a free market is a societal prime rationale of any American tax system.

Sneed's seventh criterion, harmony of the tax system and the political order, while not a societal prime rationale of our tax system, comports with this author's view that the tax system should be in harmony with the society's fundamental social, political, and economic goals.

The primary congressional motivations for adopting or retaining an income tax suggested here may produce some measure of disagreement. This disagreement about the specific rationales is unimportant. What is important is the acknowledged legitimacy of such an approach.

[65] E. SELIGMAN, THE INCOME TAX 5 (1911).

[66] *Id.*

[67] *Id.* at 6.

shift away from property taxes toward expenditure taxes began to develop.[68] This shift stemmed from the problems of assigning a fair value to property in the contemporary political, economic, and social context. Although expenditure taxes represented an improvement over the arbitrary results produced under most existing property taxes, dissatisfaction began to grow with expenditure taxes because of a lack of equilibrium at the lower end of the economic scale between revenue and expenditure. One of the first orders of business in the French Revolution was to abolish not only the *taille,* or general property tax, but also the entire system of taxing consumption. The product or produce tax filled the void. Under this scheme, government taxed the entire yield of a piece of land, a building, or a business. It was, in essence, a gross receipts tax. Many believed that this method would fairly meet the demands of the tax collector because more valuable properties would produce greater revenues.[69] Because of concerns over the difference between gross receipts and profits, the gross produce tax gave way to a net produce tax, which in turn evolved into an income tax similar to the one assessed today.[70] A unifying theme in the evolution of taxes was the search for a system that, socially and economically, best matched ability to pay with the tax burden ultimately shouldered by the individual.[71]

There is little question that in adopting the income tax, Congress desired to establish a tax system geared to ability to pay. Both politicians[72] and press[73] saluted the 1861 income tax as a measure that would burden individuals in rough proportion to their ability to pay. Although the end of the Civil War, as well as the concern of eastern Congressmen that their constituents had

[68] *Id.* at 10.

[69] *Id.* at 11-13.

[70] *Id.* at 14-15. The renewed interest in previously repudiated expenditure taxes in the form of a tax on value-added is a curious development. *See, e.g.,* S. DRESCH, A. LIN, & D. STOUT, SUBSTITUTING A VALUE-ADDED TAX FOR THE CORPORATE INCOME TAX (1977); R. LINDHOLM, VALUE-ADDED TAX AND OTHER TAX REFORMS (1976). The recent congressional interest in a value-added tax is, however, somewhat consistent with the pattern of evolution. Proponents view the tax as a means to offset the need for further increases in the regressive Social Security tax. Pierson, *Congress Seeks to Cut Social Security Taxes But Retain the Benefits,* Wall St. J., June 8, 1979, at 1, col. 1.

[71] E. SELIGMAN, *supra* note 65, at 5-15.

[72] *See, e.g.,* CONG. GLOBE, 37th Cong., 1st Sess. 252 (1861) (remarks of Mr. Pike), *id.* at 255 (remarks of Mr. Fesenden), *id.* at 301 (remarks of Mr. Wyckliffe).

[73] *See, e.g.,* New York Herald, August 5, 1861, *reprinted in* Ellis, *Public Opinion and the Income Tax, 1860-1900,* 27 MISS. VALLEY HIST. REV. 225, 226 (1940),.which observed that: "Millionaires like Mr. W.B. Astor, Commodore Vanderbilt . . . and others, will henceforth contribute a fair proportion of their wealth to the support of the national government."

borne a disproportionately large tax burden, brought the federal income tax to an end in 1872, intense public interest persisted in the income tax because of its equitable potential.[74] In 1894, when Congress again adopted an income tax, ability to pay loomed as the dominant motivating consideration.[75] In 1913, shortly after passage of the sixteenth amendment, Congress indicated that it adopted the income tax because it was keyed to ability to pay, and therefore was a substantial improvement over the existing high import duties (the government's principal source of revenue at the time), which Congress viewed as an undesirable tax on select forms of consumption.[76] Thus, Congress in 1913 voted to reduce customs duties, which it regarded as regressive, and to substitute for them the progressive income tax system.[77]

Although all may not agree on all the reasons why our society adopted an income tax, ability to pay was considered perhaps the most important factor.[78] Consequently, it is not surprising that Congress has given some consideration to this factor in determining the size of the tax burden of various individuals. The goal of formulating a tax system based on ability to pay most likely lay at the heart of decisions to establish a progressive rate structure, to provide for personal exemptions and dependent deductions, and to allow a deduction for certain expenditures, especially involuntary expenditures such as medical expenses.[79] Moreover, as the earlier discussion of the legislative history of the deduction for state and local taxes indicates, Congress in 1913

[74] *See* Ellis, *supra* note 73, at 230-37.

[75] *See* H.R. REP. No. 276, 53d Cong., 2d Sess. 1-9 (1894); E. SELIGMAN, *supra* note 65, at 407-508.

[76] *See* H.R. REP. No. 5, 63d Cong., 1st Sess. xxxvii (1913).

[77] *Id.*

[78] Leading authorities on public finance universally agree that taxation according to ability to pay is one of the principal characteristics of an income tax. *See, e.g.*, J. DUE & A. FRIEDLAENDER, *supra* note 64, at 206-08; J. PECHMAN, FEDERAL TAX POLICY 54 (3d ed. 1977); B. HERBER, *supra* note 63, at 118-22; R. MUSCRAVE & P. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 215-16 (2d ed. 1976).

[79] Professor Andrews suggests that the deduction for medical expenses is justified because as involuntary expenditures devoid of pleasure, they do not constitute consumption. *See* Andrews, *supra* note 2, at 331-43. It seems more appropriate, however, to label such expenditures consumption because they *do* entail a destruction of resources for personal benefit. Their deductibility is better justified on the ability to pay rationale. For example, take the case of two taxpayers who earn $20,000 each per year, one of whom incurs expenses of $3,000 to repair a broken leg. The latter individual obviously has had his ability to pay substantially impaired while the former has not. The medical expense deduction is defensible as a device for reflecting diminished ability to pay.

originally included that deduction in part because of concerns over ability to pay.[80]

One difficulty with allowing a deduction for involuntary expenditures is that such expenditures may include a broad range of items, including food and shelter, medical services, and certain employer-mandated expenses, such as contributions to pension plans. Moreover, the potential for a taxpayer to arrange for an employer to "require" certain expenditures suggests that it is unwise to permit a deduction for all involuntary expenditures.

It is, in this author's opinion, appropriate to allow a deduction for two types of involuntary expenditures: (1) those that are necessary for survival and basic well-being; and (2) those that do not provide the taxpayer with personal benefit substantially commensurate in value with the amount of the expenditure. It would be unwise to tax the consumption necessary to sustain life and good health. The latter category of deductions is appropriate because it represents involuntary expenditures that are not calculated to avoid taxation.

Basic expenditures for food, shelter, and medical care qualify under the first deduction test.[81] Personal exemptions, dependent deductions, and the zero bracket amount provide an adequate means of allowing for basic expenditures for food and shelter. Due to the arbitrary nature of most disease and injury, and in the absence of a national medical program, provision for necessary medical expenses can only be made by resorting to a personal deduction.[82]

Although ability to pay is often discussed in terms of horizontal equality (treating all taxpayers of the same income levels equally) and vertical equality (treating taxpayers of different income levels differently), the basic prescription of equal sacrifice or loss of welfare that lies at the heart of the ability to pay standard would seem to call for an adjustment in an individual's tax base to reflect certain involuntary consumptions, such as expenditures for medical service, that reduce a taxpayer's net worth. *See* R. MUSGRAVE & P. MUSGRAVE, *supra* note 78, at 215-20.

[80] *See* note 22 and accompanying text *supra.*

[81] It should be noted that with the exception of taxes, most "mandated" expenditures that satisfy the requirements of this test will be allowed as ordinary and necessary business expenses. For example, items such as uniform and travel expenses are deductible under § 162.

[82] Section 213 presently allows a deduction for all expenditures for medical care. It does not distinguish between those expenditures necessary for maintaining good health and those, such as cosmetic surgery, that constitutue medical forms of consumption. The logical solution to this problem may be to limit deductions to those expenditures that are medically necessary. However, the poor history of the Service with such a standard in § 162 does not give one much reason to be hopeful.

The second test for deductions justifies the deduction for state and local income taxes. They represent involuntary expenditures of resources that usually bring little personal benefit to the taxpayer. Taxpayers' abilities to satisfy their federal tax liabilities are somewhat impaired to the extent that they are required to make state or local income tax remittances. Because some states do not tax income and because of the diverse rates in states that do have income taxes, refusing to permit a deduction for such taxes would result in taxpayers with equal levels of receipts having varying abilities to meet their federal income tax liabilities.

Although the principle of ability to pay considerably strengthens the case for deduction of state and local income taxes, it does not justify the deduction for state and local sales and property taxes. These taxes are largely discretionary because they correspond to an individual's consumption of taxed goods. Although imposition of taxes on essential items, such as food and lodging, may tempt analysts to characterize them as involuntary to some degree, personal exemptions, dependent deductions, and the zero bracket amount are probably sufficient to cover the portion of these taxes that is *de facto* involuntary.

B. *Efficient Major Fund Raiser*

An additional important reason for Congress's choice of an income tax is that it efficiently raises vast sums of money. As previously noted, the need to finance the Civil War prompted Congress to adopt the first income tax.[83] Similarly, when Populists and Progressives sought to reduce the burden of the tariff and provide the government with new sources of revenue, they turned to the income tax in 1894 and 1913.[84] In fiscal year 1978, individual and corporate income taxes combined generated almost 70% of all federal tax revenue.[85] Although other taxes, such as a value added tax or a tax on gross receipts, could produce comparable amounts of revenue, none could perform this task without impairing other vital concerns, such as insuring that the tax system is geared toward ability to pay.[86]

[83] *See* S. Ratner, Taxation and Democracy in America 57-99 (1967).

[84] *Id.* at 168-92, 298-336.

[85] In fiscal 1978, the individual income tax produced 53.3% of gross Internal Revenue collections and the corporate income tax produced 16.4%, whereas employment taxes, the estate and gift taxes, and excise taxes produced respectively 24.3%, 1.3%, and 4.7% of federal gross tax revenues. *See* Comm'r I.R.S., Ann. Rep. 9 (1978).

[86] The value added tax may appear regressive, and consequently not geared toward ability to pay. However, this tax may actually represent a step toward greater progressivity

The income tax performs its revenue raising function in a relatively efficient manner. Efficiency as a general goal of taxation dates back at least to Adam Smith, who included in his canons of taxation the maxim: "Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state."[87] This country adopted the income tax in part because of its potential for administrative efficiency.[88] Government data demonstrate the validity of this decision. Although the Internal Revenue Service does not keep separate figures on the cost of administering each tax, the composite governmental administration cost for fiscal year 1978 for all taxes was 49 cents per $100 of revenue raised.[89] The income tax accounts for almost 70% of all federal tax revenue. Thus, even if the entire cost of administering the tax laws was attributable to the income tax, it would only cost 69 cents to raise $100 of revenue—well within the realm of an administratively efficient tax.

The efficiency of a tax, however, is determined not only by the cost of its administration, but also by the cost to the taxpayer of complying with the tax laws.[90] Unfortunately, there is no reliable data on the cost of complying with the federal income tax.[91]

if it is employed as an alternative to the highly regressive Social Security tax. *See* note 70 *supra*.

[87] A. SMITH, *supra* note 64, at 778.

[88] *See* H.R. REP. No. 276, 53d Cong., 2d Sess. 5 (1894), in which the Ways and Means Committee, speaking about the income tax, observed: "It is believed by the committee that this tax can be collected more cheaply than the internal revenue taxes now imposed." *See also* H.R. REP. No. 5, 63d Cong., 1st Sess. xxxvii (1913), in which the Ways and Means Committee noted: "The tax upon incomes is levied according to ability to pay, and it would be difficult to devise a tax fairer or cheaper of collection." Much of the praise of the efficiency of the income tax is now based on the government's expeditious administration of it. *See, e.g.*, J. DUE & A. FRIEDLAENDER, *supra* note 64, at 297. By way of contrast, one might note that per dollar of revenue raised, the British Inland Revenue Service spends four times as much on administration as does the I.R.S. *See* J. KAY & M. KING, THE BRITISH TAX SYSTEM 68 (2d ed. 1980).

[89] *See* COMM'R I.R.S., *supra* note 85, at 103. The reasons for not keeping such figures include the audit agent's responsibility for enforcing all federal taxes, references in official publications and instructions to several kinds of taxes, and conventional cost allocation problems such as appropriate procedures to be used to allocate overhead and other general costs.

[90] In recent years, there has been a growing tendency on the part of government to impose the costs for a variety of socially beneficial programs on the private sector without regard to the cost-benefit ratio of such undertakings. *See* Crandall, *Curbing the Costs of Social Regulation*, 15 THE BROOKINGS BULL. No. 3, at 1 (1979).

[91] The only study of this issue of which this author is aware is a rather dated analysis of the compliance costs of several corporate taxpayers with respect to a variety of taxes,

Political considerations may partly explain the reticence of the Treasury to conduct such a study. However, legitimate concerns about the difficulty of assigning taxpayers' costs hamper efforts to obtain an accurate estimate of compliance costs.[92] Moreover, existing data on compliance with state laws is inconclusive concerning the cost of complying with the federal income tax.[93] Nonetheless, the typical taxpayer who itemizes deductions undoubtedly spends a considerable period of time preparing his annual federal tax return.[94]

The importance of preserving the revenue-raising efficiency of the income tax by reducing the cost of taxpayer compliance is a significant factor in evaluating individual personal deductions. High compliance costs might induce Congress to disallow a deduction otherwise allowable as necessary to perfect the tax base. Any such step, of course, should only be taken after balancing considerations of efficiency against those factors that point to retention of a deduction. For example, persuasive policy reasons can justify two of the most time-consuming personal deductions, those for charitable contributions and medical expenses.[95]

including the federal corporate income tax. *See* Martin, *Costs of Tax Administration—Examples of Compliance Expenses,* 29 BULL. OF NAT'L TAX ASS'N 194 (1944). Because the study indicates that compliance costs vary considerably from taxpayer to taxpayer and because information on how these costs were determined is lacking, the study provides few helpful conclusions.

[92] There are serious questions about what portion of accounting costs should be assigned to tax compliance, because accounting records are kept by businesses for a number of reasons. The valuation of free time used to prepare a tax return presents another problem. For example, how should one account for the free time of a skilled surgeon whose return preparation consumes an inordinate amount of time? His return could be prepared by a lowly-compensated but skilled preparer in a short period of time.

[93] *See* Wicks & Killworth, *Administrative and Compliance Costs of State and Local Taxes,* 20 NAT'L TAX J. 309 (1967). This study of Montana state taxes does not indicate, among other things, how the cost of keeping accounting records was apportioned, or how income tax compliance costs were apportioned between state and federal returns. Moreover, because the Montana income tax rates range from 1.1% to 7.9%, the relatively high cost of compliance for individual taxpayers (almost 20% of revenue) cannot provide any guide to the cost of complying with the federal income tax.

[94] It is with a touch of nostalgia that one reads statements such as the following:

> In view of the many valuable governmental purposes to be subserved, those citizens required to do so can well afford to devote a *brief time during some one day* in each year to the making out of a personal return of income for purposes of taxation. This is done without complaint under the operation of all the general property tax laws of the States. All good citizens, it is therefore believed, will willingly and *cheerfully support* and sustain this, the fairest and cheapest of all taxes, in order to secure to the largest extent equality of tax burdens, and adjustable system of revenue, and in all respects a modernized fiscal system.

H.R. REP. No. 5, 63d Cong., 1st Sess. xxxix (1913) (emphasis added).

[95] *See generally* Andrews, *supra* note 4; Stiglitz & Boskin, *Impact of Recent Developments in Public Finance Theory on Public Policy Decisions,* 67 AM. ECON. REV. 295 (1977).

The deduction for state and local taxes is relatively easy to administer and has virtually nonexistent compliance costs; the amount of income tax deductible is easily ascertained from the withholding statement and the prior year's state and local tax returns. The sales tax is commonly determined by consulting the charts included with the income tax instructions. By examining the taxpayer's bank statement or the tax bill received during the prior year it is easy to calculate the amount of property tax paid. Although the deduction of such state and local taxes does not give rise to a serious administrative or compliance problem, retention of the deduction cannot be promoted on this ground. Nonetheless, Congress should accord more consideration to the issue of administrative efficiency and taxpayer compliance costs than it has in evaluating most tax provisions.[96]

C. *Countercyclical Nature and Capacity*

The government's principal nonrevenue use of the income tax is as a tool of countercyclical management. Most people are familiar with the discretionary use of the income tax for countercyclical purposes that manifests itself in the form of tax cuts during periods of economic slowdown.[97] Under the generally prevailing Keynesian approach to managing the nation's economy, during periods of economic decline the government stimulates the economy by engaging in a program of deficit spending, and during periods of excessive expansion it stems inflation by removing money from the economy.

Less well known is the income tax's function as an automatic economic stablization device. Because economic contraction decreases the government's revenues without necessarily resulting in concomitant cuts in government spending, and because rapid economic expansion increases such revenues without necessarily resulting in proportional increases in spending, the income tax serves as an automatic economic stabilization device.[98] Although other taxes, particularly expenditure taxes, perform this function

[96] Congress has virtually ignored this issue in recent years. Concerns with nonretroactivity and special interests have predominated over concerns with efficient administration and compliance. Various qualifying provisions found in §§ 104, 105 and 1023 are good examples of this. For an amusing analysis of the complicating recent changes made in §§ 104 and 105 (ironically enough, in the name of simplification), see Bittker, *Tax Reform and Disability Pensions—The Equal Treatment of Equals*, 55 TAXES 363 (1977).

[97] J. PECHMAN, FEDERAL TAX POLICY 8-14 (3d ed. 1977).

[98] *Id.* at 11-14; B. HERBER, *supra* note 63, at 566-69.

to some degree, the federal individual income tax is undeniably the leading automatic economic stabilizer. Moreover, because of features such as the zero bracket amount, the progressive rate structure, personal exemptions, and the fixed nature of some deductions such as interest on existing debt, there is a geometric relationship between increases and decreases in personal income and federal individual income tax receipts. For example, under the prevailing rates in calendar year 1977, a ten percent increase or decrease in personal income would have resulted in almost a fifteen percent increase or decrease in federal income tax receipts.[99] Because business profits react more radically to economic cycles than do personal incomes, the corporate income tax performs this role of automatic stabilizer even more effectively.[100] Because of the difference in size between the proceeds of individual and corporate income taxes, however, the former has a substantially more important stabilizing effect than the latter.

To control properly business down cycles government must employ tax cuts as well as spending and transfer programs.[101] The income tax's potential as a discretionary economic stabilizer is one of its principal nonrevenue features. In this capacity, the income tax probably exceeds most other taxes and spending programs in importance.[102]

Although the countercyclical effect of the income tax supports maintaining the tax, it has only a minor bearing on retaining the deduction for state and local taxes. If, as would be expected, the ratio of the decline or increase in a taxpayer's state and local taxes to the decline or increase of his gross income is less than 1.0, the deduction will augment the role of the income tax as an automatic economic stabilizer. For example, if a taxpayer with an income of $20,000 and deductible taxes of $2,000 paid state and local taxes of $1,800 when his income dropped to $15,000, the relative decline in his federal income tax liability would be somewhat greater than if such taxes had not been de-

[99] J. PECHMAN, *supra* note 97, at 12.

[100] *Id. But see* J. DUE & A. FRIEDLAENDER, *supra* note 64, at 320 (additional features of the personal income tax, such as personal exemptions and deductions and a marked progressive rate structure, more than compensate for the greater fluctuations in corporate income experienced during economic cycles).

[101] *See* Musgrave & Miller, *Built-In Flexibility*, in 7 READINGS IN FISCAL POLICY 379 (A. Smithies & J. Butters ed. 1955).

[102] *See, e.g.*, J. DUE & A. FRIEDLAENDER, *supra* note 64, at 519-524; B. HERBER, *supra* note 63, at 569-72; J. PECHMAN, *supra* note 97, at 19-21.

ductible. The impact of the section 164 deduction on this stabilization feature of the income tax varies from state to state, depending on a variety of factors: whether a state's sales tax is imposed on items with a relatively inelastic demand curve such as food; what percentage of the taxpayer's state and local tax burden is composed of relatively inelastic taxes, such as a property tax or a sales tax on goods with a relatively inelastic demand curve; and the degree of progressiveness in the state income tax structure. For example, in a state that derives most of its revenue from a progressive income tax and a sales tax on items with a relatively elastic demand curve (services and consumer durables), the deduction provided by section 164 might actually have a mild negative impact on the automatic stabilization feature of the income tax.

In the final analysis, section 164 has a minimal effect on the stabilization function of the income tax. This relatively mild impact, as well as the availability of better tools (such as rate adjustments) for achieving economic stabilization, suggest that section 164 should be evaluated on the basis of other considerations.

IV

Fundamental Economic, Social, and Political Values

The role of the income tax as a tool of economic and social engineering extends far beyond its use as an economic stabilizer. Given the magnitude of the tax rates and the vast sums of money they raise, it is obvious that the income tax has the potential to affect profoundly our economic, social, and political structures. It is imprudent to ignore the effects upon these structures that stem from numerous decisions concerning our tax laws, including decisions to repeal existing deductions.

An ideal tax system should reflect the fundamental economic, social, and political values of the society. To insist that this not be done is to elevate those values implicit in an income tax system over all other fundamental economic, social, and political values. Consequently, adjustments to the tax base in the form of deductions or exclusions may be required where they promote a society's fundamental values, even if such deductions constitute a departure from the goal of taxing an income. Alternately, when certain deductions are necessary to perfect the tax base or are consistent with the values implicit in an income tax, decisionmakers might decide to disallow those deductions because of their negative impact on fundamental economic, social, or political values.

The impact of the tax structure on a society's fundamental values, and adjustments in the tax base that should be made to accommodate those values, cannot, however, be evaluated without also considering governmental programs that may provide an alternative means of supporting those values. For example, although a desire to maintain a strong federal system suggests the wisdom of section 103's exemption of interest on state and local indebtedness, this goal could also be achieved by allowing state and local governments to elect to issue either tax exempt bonds or taxable bonds with a portion of the interest obligation of the states and localities subsidized by the federal government.[103]

Programs extrinsic to an income tax structure occasionally provide a means of preserving the income tax base while simultaneously harmonizing government spending and taxing programs with basic societal values. However, such alternatives are not always available and occasionally prove less desirable than adjustments to the tax base. For example, assume the deduction for charitable contributions departs from the goal of taxing all income. Repealing the deduction would result in inadequate funding of the social service sector, which could only be remedied by a centralized social services program.[104] Such a program would not, however, enhance diversity in our social service system, which perhaps can best be supported by continuing the deduction.

Personal deductions provide one means of accommodating the tax base to fundamental economic, social, and political values.

[103] *See, e.g.*, S. SURREY, *supra* note 1, at 209-22 and authorities cited therein.

[104] The social services supported by the deduction could also be maintained by credit programs. This would provide more charitable contributions from people at lower socioeconomic levels and fewer by those at higher ones. Because lower-income taxpayers tend to give disproportionately to churches, whereas upper income taxpayers tend to give disproportionately to health services and educational institutions, the Filer Committee recently concluded that although substitution of a 30% credit for the present deduction would result in an overall 9% increase in charitable contributions, it would also result in an increase of about 14% in gifts to churches and religious institutions and a drop of about 33% in gifts to health services and educational institutions. *See* REPORT OF THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS (1975), *reprinted in* S. WEITHORN, 3A TAX TECHNIQUES FOR FOUNDATIONS AND OTHER EXEMPT ORGANIZATIONS, Appendix C1, at 133 (1977). Before adopting the credit alternative, Congress may wish to determine whether this reallocation of resources in the private social service sector is desirable. It should then weigh this determination against the theoretical case in favor of preserving the deduction to insure the taxation of income. *See* note 57 and accompanying text *supra.*

An added advantage of the deduction over a direct spending program is that for contributions to religious organizations, the deduction provides a workable accommodation between the competing claims of the establishment and free exercise clauses of the first amendment of the Constitution.

The principal problem with providing deductions based on such considerations is that it is extremely difficult to determine: (1) what values are worth preserving in this manner, and (2) whether an erosion of the tax base is the most desirable means of supporting the value in question.

In determining the relative importance of various national goals, decisionmakers should examine our law to assess the value that society has placed on them in other contexts. If these goals are derived from the Constitution, society has accorded them great value. Similarly, government expenditures of significant sums of money in support of particular goals indicate that society deems them to be important. Regulatory programs furthering nonrevenue goals are also good evidence of social support, as is preferential treatment accorded these goals by our courts and lawmakers. Thus, Congress must concur that the eradication of racial discrimination is a national goal of the highest order. In redrafting section 170 of the Internal Revenue Code, which provides for deductions for charitable contributions, Congress might accordingly tailor the deduction to exclude explicitly gifts to organizations that practice racial discrimination.[105] On the other hand, Congress should not make the cost of new automobiles deductible for the purpose of improving our transportation system.[106]

The deduction for state and local taxes arguably promotes a healthy federal system. Because the states are presently weak elements in our federal system, analysts should consider whether repealing section 164 would further impair their vitality. There are at least two ways in which this could occur. First, if the existence of section 164 has facilitated state revenue raising, its repeal could diminish states' ability to fund necessary programs, making them more reliant on the federal government. Second, upon determining that the deduction of the state income tax is essential to reach the proper tax base, one confronts the following problem: if the

[105] The requirement of racial impartiality has already been read into I.R.C. §§ 170(c)(2) & 501(c)(3) by the courts. *See* Green v. Connally, 330 F. Supp. 1150 (D.D.C.), *aff'd sub nom.* Coit v. Green, 404 U.S. 997 (1971).

[106] Although it appears unlikely that Congress will approve such a proposal, in 1975 Congress provided a 5% credit to individuals purchasing new homes. *See* I.R.C. § 44. The avowed purpose of the credit was to help the housing industry through a period of economic difficulty. *See* SEN. COMM. ON FINANCE, REPORT TOGETHER WITH SUPPLEMENTAL VIEWS ON H.R. 2166, TAX REDUCTION ACT OF 1975, S. REP. NO. 36, 90th Cong., 1st Sess. 2, 11-12, 36-38, *reprinted in* 1975 U.S. CODE CONG. & AD. NEWS 54, 55, 64-65, 87-89. *See also* Breisblatt v. Baker-Firestone, Inc., 564 F.2d 11, 12-13 (2d Cir. 1977).

states account for deductibility in structuring their tax systems, repealing the deductibility of some but not all of the major sources of state revenue might substantially diminish the options of the states in structuring their revenue raising programs. Concern with this danger motivated Congress in 1964, as well as a recent ABA study commission, to reject suggestions that the section 164 deduction be severely limited.[107]

In order to determine the role of the deduction for state and local taxes in our federal system, a survey was taken of state tax commissioners in all fifty states.[108] The questionnaire sent to these individuals concerned the role of section 164 in the formulation of state revenue policy. The survey demonstrates that a significant majority of the states consider the issue of deductibility in shaping their tax system.[109] In addition, the survey reveals that the impact of section 164 on the states varies considerably. In slightly more than a majority of the states it has facilitated tax increases.[110] On the other hand, in slightly less than a majority of the states, section 164 motivated legislatures to employ deductible taxes rather than nondeductible taxes or user fees.[111] Al-

[107] *See* notes 38-39 and accompanying text *supra.* A recent ABA committee has reached the conclusion reached by Congress in 1964: that the deduction for state and local income taxes is required to assure that only income is taxed, and that preservation of the deduction for sales and property taxes is therefore essential to insure that our tax laws afford the states and localities freedom to structure their revenue raising systems. *See* ABA Special Comm. on Simplification, *Evaluation of the Proposed Model Comprehensive Income Tax,* 32 TAX. LAW. 563, 653 (1979).

[108] The survey consisted of eight statements, and it requested the commissioners to indicate whether they strongly agreed, agreed, disagreed, or strongly disagreed, with the statements. The rate of response was surprisingly high—49 of 50 commissioners participated; 45 questionnaires were usable. The results of the survey are on file at the *Cornell Law Review* and available on request.

[109] The statement read: (1) "In shaping its tax system your state legislature has considered the fact that certain taxes only (income, sales and property) are deductible for federal income tax purposes."

Three of the 45 respondents indicated that they strongly agreed with this statement, 30 agreed with it, and 12 disagreed with it.

[110] Twenty-four respondents agreed, 19 disagreed and 2 strongly disagreed with the following statement: "The deduction for state and local taxes provided by the Internal Revenue Code has in the past made it easier, than otherwise would have been the case, for your state legislature and local government units to vote new deductible taxes or raise rates on existing deductible taxes."

[111] In response to the statement, "The deduction for state and local taxes provided by the Code has resulted in the use in your state of deductible taxes in preference to nondeductible user fees," 1 commissioner strongly agreed, 18 agreed, 23 disagreed, and 3 strongly disagreed. In response to the statement, "The deduction for state and local taxes provided by the Code has resulted in the use in your state of deductible taxes in preference to nondeductible taxes," 20 commissioners agreed, 21 disagreed, 2 strongly disagreed, and 2 offered no opinion.

though deductibility has a significant impact in shaping some features of the states' tax system, it has little impact in other areas. This lack of impact stems from political considerations. For example, in a significant majority of the states, deductibility has not persuaded legislatures to shift the tax burden from lower-income taxpayers to higher-income ones, on whom the after-tax burden is less.[112] Moreover, removing the deduction for the sales tax would probably not result in a significant shift from the sales tax to the income tax.[113]

Despite differences of opinion with respect to the impact of section 164 on their individual states, the commissioners surveyed overwhelmingly agreed on two points. First, most respondents indicated that a proposal to repeal section 164 would be a matter of significant concern in state houses and city halls.[114] Second, they indicated that allowing a deduction for the principal sources of state and local revenue, thereby according to the states considerable freedom to shape their revenue systems, is desirable in a federal system.[115] In evaluating the role of section 164 in our system of fiscal federalism, one can conclude that although the deduction

[112] The questionnaire posed this statement: "The system of deductibility of state and local taxes has encouraged the shifting, by your legislature, of state taxes away from lower bracket taxpayers, to upper bracket taxpayers, because deductions are more valuable to upper bracket taxpayers." Only 11 of the respondents agreed with this statement; 23 disagreed, 10 strongly disagreed, and 1 did not respond.

Undeniably, the effectiveness of high income groups in the electoral process has much to do with these results. The percentage of eligible voters who participate in the electoral process bears a direct relationship to their income levels. For example, in the 1968 presidential election only 54% of eligible voters with a family income below $3,000 voted, whereas 84% of those with family incomes exceeding $15,000 voted. *See* R. SCANMMON & B. WATTENBERG, THE REAL MAJORITY 54 (1970). In view of the fact that wealthy people contribute disproportionately to political campaigns, it is not surprising that our tax laws reflect their interests. *See, e.g.,* D. ADAMANY, FINANCING POLITICS (1969); H. ALEXANDER, MONEY IN POLITICS (1972).

[113] In response to the statement, "Removal of the sales tax from the list of deductible taxes would probably cause your legislature to shift away from the sales tax toward the income tax," only 9 of the commissioners agreed, 23 disagreed, 10 strongly disagreed, and 3 did not respond. These responses indicate that factors other than deductibility play a large role in a state's decision to employ a sales tax.

[114] The statement read as follows: "A proposal to reveal the deduction for state and local taxes would be a matter of significant concern to state and local governmental figures in your state." Twenty-three of those responding strongly agreed, 14 agreed, 7 disagreed, and 1 expressed no opinion. The intensity of response to this question reveals that a move to repeal § 164 is unlikely to succeed in the near future.

[115] In response to the statement, "The present policy of allowing a deduction for the principal sources of state and local revenue (income, sales and property taxes), thereby according the states considerable freedom to shape their revenue system as they wish, is desirable in a federal system," 7 of the respondents strongly agreed, 34 agreed, 3 disagreed, and I expressed no opinion.

for state and local taxes has facilitated the raising of revenue in many states, repealing the deductibility of one of the taxes would not result in a major restructuring of state tax systems. However, state officials view deductions for all major sources of state revenue as an important, if symbolic, acknowledgment to state sovereignty. Moreover, the states' interests in preserving the deduction is significant enough to make its repeal at present most unlikely.

In determining whether to adjust the tax base to promote fundamental values of society, analysts must consider the impact of a deduction on the tax base, and then weigh this impact against both the availability and cost of alternative programs and the negative effect on fundamental values resulting from a failure to adjust the tax base.

The tax expenditure budget (TEB) sheds light on the financial impact of tax base erosions. In general, the TEB is a listing, although somewhat incomplete, of special treatment accorded certain types of income or expenditures which result in an erosion of the tax base.[116] The TEB estimates the revenue lost from each item on the list, on the assumption that all other items will be left intact.[117] The most recent TEB estimated that the deduction for real property taxes on personal residences would result in lost revenues in fiscal year 1979-1980 of $6,615,000,000, and that the deduction for all other taxes would result in a revenue loss of

[116] *See* Office of Management and Budget, *supra* note 1, at 183-211.

[117] One can criticize the TEB on four separate grounds. First, the measure of foregone revenue implicitly assumes zero elasticities. For example, repeal of the capital gains deduction would not produce the lost revenue shown in the TEB because repeal would likely have a chilling impact on sales of capital assets. Second, the TEB ignores the impact of "direct" spending programs substituted by the government on private spending in an area. For example, some economists have speculated that additional government spending on charitable activities may actually squeeze out private spending in that area. Third, the TEB, it is alleged, assumes that the natural tax base is "income." However, serious economic policy considerations may merit special treatment of an item, such as medical expenses. *See generally* Stiglitz & Boskin, *supra* note 95, at 298-307 and authorities cited therein. Finally, curious anomalies in the list of items included in the TEB, as well as items excluded, cast doubt on the Treasury's definition of income and what standards the Treasury employed to determine what particular items to include in the TEB. For example, although the TEB includes some nonrecognition transactions, such as the roll-over of gain on sale of a personal residence (which results in a relatively minor loss of revenue), it excludes others, such as the nonrecognition treatment of corporate reorganizations that results in an enormous revenue loss. Similarly, although the TEB includes the favorable treatment accorded to certain categories of income, such as capital gains and personal service income, under the maximum tax on earned income it ignores the favorable treatment accorded earned income under the zero bracket amount by § 63(e)(2). *See* Office of Management and Budget, *supra* note 1, at 208-11.

$12,450,000,000 during the same period.[118] Unfortunately, there is no way of breaking down the latter figure into income, sales, and personal and other real property taxes. It is clear, however, that section 164 is a costly way of accommodating the income tax to the interests of the states in a federal system.

Congress might consider replacing the deduction for state and local taxes with either a tax credit or a direct spending program, such as an enhanced revenue sharing program, as an alternative means of supporting fiscal federalism. Credits may be superior to deductions because they are more equitable—the benefit to the taxpayer would not depend on his tax rate.[119] Problems with using a credit stem from two sources. First, because the strength of various economic groups is proportionate to their income levels,[120] if Congress set the credit at a level that would give the states as much indirect political support to impose tax increases as the present system of deductions provides, it would probably have to allow a credit so high that the revenue lost would exceed that lost under the current system. Second, if Congress concluded that at least one of the taxes should remain deductible, it would probably be difficult to design a politically-neutral combined deduction-credit mechanism, unless it again set the credit for the nondeductible taxes at such a high level that the loss in revenue would exceed the amount presently lost.

Although it has some advantages over a credit program, a direct spending alternative, such as a grant-in-aid or a revenue sharing program, also presents special problems. Such a scheme would further exacerbate the weaknesses of the states and their dependence on the central government. Recent threats and proposals to cut back on revenue sharing and grant-in-aid programs adequately illustrate this point.[121]

An alternative approach is to allow individual states to elect whether their state and local taxes should remain deductible.

[118] *See* OFFICE OF MANAGEMENT AND BUDGET, *supra* note 1, at 208-11.

[119] *See generally* S. SURREY, *supra* note 1.

[120] *See* note 112 *supra*.

[121] Political difficulties also inhere in any attempt to modify the present levels of these programs. *See, e.g., States Get New Warning of Cuts in Funds Under A Balanced Budget,* N. Y. Times, Feb. 19, 1979, § 4, at 8, col. 2; *Budget Balances Warned by Muskie, id.,* Feb. 14, 1979, § 1, at 17, col. 1; *Carter Trims Plans on Funds for Cities, id.,* Jan. 4, 1979, § 1 at 13, col. 6; *Carter Weighs Pushing States to Assist Cities, id.,* Feb. 12, 1978, § 1, at 1, col. 5. Divisive regional conflicts result from direct spending programs undertaken by Congress for the benefit of the states. *See South and West Joining Forces in Hope of Outvoting Northeast in Congress, id.,* April 5, 1979, § 2 at 13, col. 1.

States electing nondeductibility (as well as localities within those states) would then become beneficiaries of block grants calculated as a percentage of state and local tax receipts from otherwise deductible taxes. The states could use these funds to finance tax cuts or new spending programs. The percentage used to determine the amount of the block grants could be set at a level that would insure that the funds going to electing states equaled the new revenue received by the federal government by the repeal of the deductibility of state and local taxes. A provision allowing revocation by the states would be an adequate guard against termination of the grant system by the federal government. Such a system would entail a variety of administrative problems, but none would prove insurmountable. Consideration of the impact of such a program on the efficiency of the tax system is essential. Nevertheless, it is likely that the added savings in compliance and administration costs to the taxpayers, who would no longer itemize, and to the government, which would not have to audit as many returns, would exceed the new administration and compliance costs to the government.

Congress would have to determine whether any exception should be allowed for the income tax because its deductibility is theoretically well-grounded. Congress might establish such a program for the sales and property taxes, while allowing the income tax to remain deductible. Moreover, because participation in the program would be voluntary, and states could use the funds to finance various programs—whether selective tax cuts or new social programs—it is clear that a block grant election program better preserves the fiscal neutrality in our federal system.

Section 164 has played a modest, but by no means dominant, role in shaping the revenue raising systems of the states. However, the symbolic role of section 164 in our system of fiscal federalism is so great that in the absence of a satisfactory alternative, such as a block grant election program, total or partial repeal of section 164 is probably ill-advised from both a theoretical and practical point of view.

V

Composite Analysis of the Deduction For State and Local Taxes

Because each of the three tiers in the proposed mode of analysis is of equal weight, it is necessary to balance them in determining whether personal deductions are warranted. This composite analysis is applied here to the deduction for state and local taxes provided by section 164.

Personal deductions exempt from taxation expenditures or losses that do not constitute consumption; receipts, so adjusted, equal income. The deduction for state and local income taxes represents such an essential adjustment. On the other hand, the deduction for state and local gasoline taxes is an example of a deduction that was unwarranted: these expenditures constituted consumption. The deductions for state and local sales and property taxes are not easily categorized. Although such taxes represent funds that are not consumed by the taxpayer, but rather by the general public, they are arguably incidents of consumption. As such, they are similar to many other taxes that are indirectly borne by consumers. Consequently, it is inappropriate to permit the deduction of sales and property taxes simply because of their direct nature, although in the absence of other significant considerations, a line may perhaps just as reasonably be drawn between direct and indirect taxes as between state and local income taxes and all other state and local taxes.

Considering the principal reasons for adopting and maintaining an income tax system, one recognizes the need to insure that our tax structure is geared toward an individual's ability to pay. As a result, the involuntary nature of state and local income taxes makes them ideal candidates for deduction. Both property and sales taxes are involuntary only to the extent they are imposed on true essentials; therefore the deductibility of a vast majority of these taxes cannot be justified on the ground that they impair one's ability to pay. The small percentage of sales and property taxes that should be deductible on such grounds is probably adequately covered by the present personal exemptions, dependent deductions, and the zero bracket amount. Although at least two other reasons support an income tax—its role as an economic stabilizer and its capacity to raise substantial amounts of revenue in an efficient fashion—neither suggests that a further erosion of the tax base is required to accommodate the base to these considerations. A deduction for income, sales, and property taxes does not present substantial administrative and compliance burdens and their continued deductibility cannot be rejected on that ground. Moreover, the continued deductibility of these taxes probably has a mild positive impact on the role of the income tax as an economic stabilizer.

Considering the role of section 164 in a federal system, one must conclude that complete repeal of section 164 would produce a neutral environment in which the states could shape their legislative programs. However, because the existence of section 164 facilitates the states' revenue raising efforts, repeal would probably impair the ability of a number of states to fund programs adequately, thus placing more of the burden of funding programs on the federal government. Partial repeal of the deduction would render some of the states' principal sources of revenue nondeductible and others deductible. Arguably, states should not be subject to this indirect form of pressure in determining the composition of their revenue raising programs. However, because, as the survey revealed, repeal of the sales tax deduction would probably not produce a significant shift away from this tax toward the income tax, this consideration may merit little weight.[122] Nonetheless, strong state feelings on the issue of deductibility indicate that some accommodation must be made to the revenue programs of the states, such as enlarging the revenue sharing program, substituting a tax credit for existing deductible taxes, or instituting a block grant-deduction election program.

.After weighing the above competing considerations, this author suggests retaining the deduction for state and local income taxes. Moreover, because it is unclear whether the state sales and property taxes represent nonconsumption expenditures, and because state finances would be adversely affected if the taxes were repealed, one might conclude that the deduction for sales and property taxes should continue. Ultimate resolution of that issue, however, should hinge on whether another adequate accommodation to the revenue interests of the states can be found. If such an accommodation exists, repeal of the deduction for either the sales or property taxes would probably be desirable. Unless Congress can fashion such an accommodation, however, retaining the deduction in its present form is probably a political reality.[123]

[122] The widespread use of the sales tax and the relatively small amount it constitutes as a personal deduction make it the most likely candidate for congressional repeal. The sales and retailer taxes are so widespread that only three states, Oregon, Montana, and Idaho, do not currently employ either tax. *See* [1979] ALL STATES TAX REPORTER (P-H) § 101.

[123] The system of analysis advocated in this Article should not be viewed as a device for defending the status quo of personal deductions. The deduction for interest on other than investment property, for example, is probably totally indefensible on theoretical grounds. The fact that many of the other personal deductions are theoretically justifiable most likely indicates that they represent serious attempts by Congress to conform the tax system to an accepted set of ideals. Congress is aware of the special status of many of these deductions. For example, the deductions for state and local taxes, medical expenses, and casualty losses are included in the group of itemized deductions that do not give rise to tax preferences. *See* I.R.C. § 57 (b).

CONCLUSION

In recent years proponents of both the tax expenditure budget and the comprehensive tax base have advocated the elimination of almost all personal deductions. Most of these critics characterize personal deductions as subsidies for the wealthy that violate basic precepts of horizontal and vertical equity. Most of the writing in the field of basic tax theory has failed to take adequate account of the diverse functions that personal deductions can legitimately perform in a tax system.

Ideally, personal deductions perform three basic roles. First, they provide a means of adjusting receipts so that the tax base is equal to the taxpayer's income. For any expenditure to qualify as a deduction under this rationale it must be primarily nonconsumptive. The definition of consumption to be employed in making this determination should encompass actions that involve a removal of assets from society's scarce pool of resources, and a use of those assets to produce a private benefit. Second, where taxation of the income base is inconsistent with the societal prime rationales for an income tax system, the bases should be adjusted. Personal deductions provide a means for realizing this goal. Third, where taxation of a particular base will produce results inconsistent with a society's fundamental social, economic, and political values, the base should be adjusted to produce a result in harmony with those values. Personal deductions are a means of accomplishing this goal. Because none of the above three functions can appropriately be deemed primary or controlling, a decision about the validity of various personal deductions can be made only after balancing all the factors involved.