Cornell Law Review

Volume 68
Issue 4 *April 1983*

Article 5

Ages and Themes of Income Taxation: Savings and Investment

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THE AGES AND THEMES OF INCOME TAXATION: SAVINGS AND INVESTMENT*

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This article discusses certain provisions of the Economic Recovery Tax Act of 1981 (ERTA)[1] as they relate to the three major themes of federal income taxation: revenue-income, subsidization, and regulation. The article first develops a typology of these themes based on current law and ideology. It then briefly describes certain of the ERTA provisions that Congress designed to encourage savings and critically evaluates the arguments of Professor Andrews favoring movement of the income tax toward a consumption tax model. Finally, the article suggests that the ERTA changes, rather than moving toward a consumption tax, instead resemble various programs launched in Britain,

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1 Pub. L. No. 97-34, 95 Stat. 172 (1981).

Sweden, and France to encourage or produce national investment in particular industries or in the business sector generally.

I
THEMES

For years there has been doubt, perhaps even cynicism,[2] whether federal income taxation, as reflected in the Internal Revenue Code, is legal either in nature or content. Perhaps taxation embodies accounting or administrative notions operating in the substratum of public finance economics, but it is not hard and fast law, like an offer and an acceptance creating a contract. Even the doubters concede, however, the legal aspects of taxation; the criminal sanctions and the common law development in the corporate taxation area are two examples. Apart from these and a few other exceptions, the Code as a whole is not accepted as a legal construct.

Congress's rapid-fire passage of major revenue legislation in seven of the past nine years reinforces the doubts. One possible response is to assert that the Code embodies only a few fundamental rules.[3] Another response is to slog away in isolation with contented and mostly docile students, happy to receive concrete and practical learning. A third response, which I will develop below by discussing a few changes made by the 1981 and 1982 acts, is based on the perception that the Code has three major themes and that tax lawyers are uniquely positioned to evaluate how the vast mass of rules in the Code relates to those themes. The three current themes date from separate ages in the history of the Code and to some extent center on different substantive areas of tax law.

A. Revenue-Income

The first theme of the Code is to raise revenue through taxation of income when appropriate. This was the central concern of both the sixteenth amendment and the Revenue Act of 1913 which established the federal income tax. Congress made fundamental choices in defining income. Although most accretions to wealth are income, gifts[4] and the proceeds of life insurance paid as a result of the insured's death[5] are not. For a variety of reasons—prudence and hardship being the most important—other accretions to wealth are also excluded from the recipient's

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2 Although it is difficult to prove this assertion, the notion that taxation is not quite "law" is very common among legal commentators. It may be its instability or its primacy as an economic tool that has caused this cynicism. For an expression of similar sentiments, see Hickman, *Where to Go From Here: A Lawyer's View,* 35 NAT'L TAX J. 269 (1982); Royster, *Our Inconstant Lawgivers,* Wall St. J., Jan. 26, 1983, at 30, col. 3.

3 J. FREELAND, S. LIND & R. STEPHENS, CASES AND MATERIALS ON FUNDAMENTALS OF FEDERAL INCOME TAXATION xxiii (4th ed. 1982).

4 I.R.C. § 102(a) (1976).

5 *Id.* § 101(a)(1) (1976 & West Supp. 1983).

income. For example, the Code does not tax unrealized appreciation until a disposition of the underlying asset occurs,[6] and ignores the growth of the savings element in annuities until payment.[7]

The precise meaning of the revenue-income theme of the statute continues to unfold. Vigorous debate continues about the tax treatment of fringe benefits,[8] universally conceded to be accretions to wealth but thus far largely left out of the tax net because of administrative complexity or the political power of the recipients. Critics attack the failure to tax all the earnings[9] of a foreign, wholly owned subsidiary to its domestic shareholders. Although this treatment is consistent with domestic shareholder taxation,[10] the critics[11] maintain that the subsidiary's earnings, particularly if it operates in a low- or no-tax jurisdiction, are an accretion to the wealth of a controlling shareholder.

Discussions of the revenue-income theme tend to overlook the two distinct income tax regimes in the Code; one governing individuals in their personal capacity, the other investors and businesses.[12] Most commentators characterize the individual income tax, in theory, as an accretion tax on income above a minimum level established by the personal exemption and zero bracket amount.[13] This theory fails descriptively because it neglects the overt subsidization provisions discussed below. The investor-business income tax, by contrast, taxes net income, which is computed after deducting the cost of doing business or owning the asset. Some adjustments are made annually against income, such as salaries paid to employees.[14] Other expenditures, such as an attorney's fee

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6 *Id.* § 1001 (1976 & Supp. V 1981).

7 *Id.* § 72(a) (1976) recognizes the inherent-gain element in an annuity only as payments are "received."

8 Section 801 of ERTA prohibits the issuance in final form before January 1, 1984, of any "regulation providing for the inclusion of any fringe benefits in gross income." Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 801, 95 Stat. 172, 349.

9 I.R.C. § 951 (1976) only requires recognition of certain types of income, labelled Subpart F income, to a United States shareholder. A United States shareholder is defined as a person or entity that owns 10% "or more of the total combined voting power of all classes of stock . . . ." *Id.* § 951(b) (1976). Other income is not recognized until there is a distribution by the foreign subsidiary.

10 Shareholders in a domestic corporation may be in receipt of income only if there is a "distribution of property." *Id.* § 301(a) (1976).

11 P. MCDANIEL & H. AULT, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 201-03 (2d ed. 1981).

12 Alan Feld's article in this symposium issue is an exception. Feld, *Fairness in Rate Cuts in the Individual Income Tax,* 68 CORNELL L. REV. 429 (1983). A prime example of the tensions this dichotomy creates is determining which educational expenses are deductible under I.R.C. § 162 (1976) and Treas. Reg. 1.162-5 (1967). *See, e.g.,* Marlin v. Commissioner, 54 T.C. 560 (1970) (deductibility of edueational travel expenses).

13 1 S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, FEDERAL INCOME TAXATION 239-98 (1972). The authors also indicate that certain hardship deductions, sueh as the medical expense deduction, may allow a better measuring of "income" because the experience is usually an involuntary expenditure. *Id.* at 247.

14 I.R.C. § 162(a)(1) (1976).

incurred to search a title when an investor acquires property are recouped only on a disposition.[15]

The dichotomy in the revenue-income theme between personal income and business-investment gains results in part from the difficulties of defining and measuring income. The relationship between personal expenses and the production of income is too tenuous to be used to evaluate deductibility as in the business-investment context.[16] This article focuses on the personal income of individuals in analyzing whether the ERTA provisions embody a consumption tax ideal as some commentators assert. Businesses and investors have long had, in the form of depreciation allowances,[17] a mechanism which relieves the "need" for a deduction for savings.

B. Subsidization

The second theme of the Code, a controversial one, is the subsidization of certain taxpayer activities.[18] Subsidization occurs through tax deferral, delayed recognition of income, or a permanent forgiveness. The provisions dealing with domestic international sales corporations (DISCs) are an example of subsidization through delayed recognition. A DISC is not a taxable entity.[19] Although its shareholders are taxable,[20] a portion of DISC income, computed by reference to a formula which weights[21] increasing export sales, is not taxed to the shareholder until the DISC shares are sold or otherwise disposed of,[22] the earnings are distributed, or the DISC is disqualified.[23]

Forgiveness is the least common method of subsidization. The residential energy credit is an example: If a taxpayer installs a more efficient oil burner in his home, he may claim a credit of 15% of the cost of

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15 Treas. Reg. § 1.263(a)-2(c) (1958).

16 *See* I.R.C. § 262 (1976) (disallowing deductions for personal expenditures). Consumption-tax advocates have argued that one of the advantages of their approach would be to eliminate some of the line-drawing necessitated by the dichotomy. Bradford, *The Possibilities for an Expenditure Tax,* 35 NAT'L TAX J. 243, 246 (1982).

17 I.R.C. § 167 (1976, Supp. V 1981 & West Supp. 1983); *id.* § 168 (Supp. V 1981 & West Supp. 1983).

18 For example, until December 31, 1981, if a taxpayer substantially rehabilitated a certified historic structure or a structure located in a registered historic district, he received a faster write off of the rehabilitation costs than if he rehabilitated a 1950s plant. I.R.C. §§ 167(o), 191 (1976); Tax Reform Act of 1976, Pub. L. No. 94-455, §§ 2124(a)(1), (d)(1), 90 Stat. 1520, 1916-19, *repealed by* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172, 239-40. ERTA replaced these provisions with a liberalized investment tax credit (25%) for the costs of rehabilitating a certified historic structure. I.R.C. §§ 46(a)(2)(A)(iv), 46(a)(2)(F)(i), 48(g)(2)(B)(iv) (Supp. V 1981). A less generous credit is available for rehabilitation of structures at least 30 years (15%) or 40 years (20%) old. *Id.* § 46(a)(2)(F).

19 I.R.C. § 991 (1976).

20 *Id.* § 995 (1976 & Supp. V 1981).

21 *Id.* § 995(e) (1976).

22 *Id.* § 995(c), (g) (1976 & Supp. V 1981).

23 *Id.* § 995(b)(2) (1976).

the burner up to $2,000.[24] This has the effect of reducing the taxpayer's liability for that year by up to $300.

A number of current Code rules which delay taxation may arguably be characterized either as a subsidy or as the correct determination of a difficult timing question. A good example is the general rule that corporate reorganizations[25] with continuity of ownership[26] and enterprise[27] are not recognition events, as long as an investor begins and ends with similar certificates of interest. On the one hand, the investor terminates his interest in one entity and commences to own part of a new one. On the other hand, the old entity has been subsumed, and continues to exist in the new entity.

The debate over whether to characterize decisions to delay the imposition of tax as subsidies or mere timing considerations does not imply that the accounting aspect of the revenue-income theme is inseparable from the subsidization theme. For example, the acceleration of write-offs for certified historic structures[28] cannot be justified on the basis of a "true" income tax accounting scheme. Conversely, not requiring a cash basis taxpayer to take into income a future pension right in which he has no vested interest, involves no subsidization.[29]

A school of tax academics led by Professor Surrey has pushed subsidization analysis to its limits.[30] Yet even adherents of the Surrey approach concede that many rules which demonstrably affect tax incidence, such as the foreign tax credit of section 901 and the exemption of certain organizations from taxation by section 501, are not subsidies.[31]

Subsidization also may be negative; the Code may alter the application of a general principle of taxation to a class of transactions thought to be undesirable for nontax reasons. For instance, one may not amortize the cost of, or take a loss on account of, the demolition of a certified historic structure.[32] From January 1, 1977, until December 31, 1981, a taxpayer could only deduct expenses incurred in attending up to

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24 I.R.C. § 44C(b)(1) (Supp. V 1981 & West Supp. 1983).

25 I.R.C. § 368(a) (1976, Supp. V 1981 & West Supp. 1983) defines the types of reorganizations which are granted nonrecognition treatment under I.R.C. §§ 354, 355, 356, 361, or 362.

26 The continuity of ownership requirement has both a statutory basis in some reorganization definitions, *e.g.*, I.R.C. § 368(a)(1)(B) (1976), and a general common law basis, now reflected in Treas. Reg. § 1.368-2(a) (1976).

27 Treas. Reg. § 1.368-1(b) (1980).

28 *See supra* note 18 and accompanying text.

29 I.R.C. § 402 (1976, Supp. V 1981 & West Supp. 1983) thus is reconcilable in this context with the "normal" Code rule set out in I.R.C. § 83(a) (1976 & West Supp. 1983).

30 *See* 1 S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, *supra* note 14, at 239-98.

31 *Id.* at 242-43 (foreign tax credit and exempt organizations not listed in tax expenditure budget); *see also* S. SURREY, PATHWAYS TO TAX REFORM 346 n.24 (1973).

32 I.R.C. § 280B (1976, Supp. V 1981 & West Supp. 1983).

two conventions outside the United States and certain of its possessions.[33]

Some of the negative subsidization provisions, such as the foreign convention limitation, are attributable in part to the difficulties of applying one or more of the basic tax rules. For example, was it "ordinary and necessary," within the meaning of section 162, that the American Bar Association meet in London? The rules may also reflect a legislative redetermination of a factual issue on which the courts have gone astray. Under one view, for example, foreign conventions are inherently vacations and deductions for such vacations should not be permitted to diminish revenues on a case-by-case basis.[34]

Many negative subsidization provisions merely are attempts to discourage undesirable activities by calling off normal tax rules. For example, bribes and kickbacks, which are illegal under American law, are not deductible even if paid to a foreign official in a jurisdiction that permits such payments.[35]

C. Regulation

The third theme of the tax law is to regulate certain areas of national concern. The regulatory theme can only be related to revenue generation in a tortured fashion. The Code presents three major examples of this in the provisions relating to exempt organizations. There is no satisfactory rationale to connect congressional concern for controlling and regulating charities with the exempt organization regime of the Code. Self-dealing by a manager of a foundation, which negatively affects the foundation's tax status, does not relate logically to the foundation's tax exemption.[36] Self-dealing is primarily an issue of trust or charity law, which until the Tax Reform Act of 1969,[37] was a matter of state concern.

Another example of the regulatory use of the tax law is the vast and intricate system of rules which governs pensions and other forms of deferred and current compensation. A fundamental precept of most of these rules present in the pension area since 1942, is that benefits must

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33 I.R.C. § 274(h) (1976), Tax Reform Act of 1976, Pub. L. No. 94-455, § 602(a), 90 Stat. 1520, 1572, *amended by* Taxation—Individuals Living Abroad, Pub. L. No. 96-608, 94 Stat. 3550, 3552-53 (1980).

34 I.R.C. § 274(h) (1976).

35 *Id.* § 162(c)(1) (1976 & West Supp. 1983).

36 I.R.C. § 4941 (1976, Supp. V 1981 & West Supp. 1983) punishes such self-dealing.

37 In a recent series of articles, Professor Hansmann has suggested a reconstitution of the state and federal regimes as they relate to the variety of nonprofit institutions that would have the effect of reinvigorating the states' role. *See* Hansmann, *Reforming Nonprofit Corporation Law,* 129 U. PA. L. REV. 497 (1981); Hansmann, *The Role of Nonprofit Enterprise,* 89 YALE L.J. 835 (1980); Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation,* 91 YALE L.J. 54 (1981).

be awarded on a nondiscriminatory basis.[38] Nondiscrimination does not flow logically from the deduction provided for contributions and the nonincludability of benefits. A company, arguably, should be able to discriminate in awarding pensions[39] since it may discriminate in setting compensation and still get a deduction. The nondiscrimination principle is based on a congressional determination that discrimination against lower paid people is unfair.

The discrimination issue also can be discussed in terms of the Code's subsidization theme. Although Congress has decided to subsidize only nondiscriminatory plans, the vastness of subchapter D, including the prohibited transaction rules, demonstrates that subsidization is not the sole concern. The primary goal of the regime is the regulation of employee benefit plans. The cases that have arisen since the Pension Reform Act in 1974, involving dereliction by plan trustees or sponsors in the maintenance of their plan or observance of certain Code rules, support this view. The Code's penalty for a number of these infractions is disqualification of the offending plan[40] with attendant nullification of the various tax benefits accorded the plan's sponsor and its beneficiaries. This sanction is rarely imposed; the Labor Department or the Service typically seeks remedies short of deprivation of the tax benefits.[41] The tax benefits thus have become automatic and irrevocable, and the other regulatory tax rules are enforced by sanctions other than the forfeiture of those benefits.

A third regulatory regime centers on sections 103 and 103A, which govern the permissible uses of the proceeds of tax exempt obligations. This regime, similar to the charity and pension schemes, is characterized by a subsidy that flows primarily to someone other than the exempted activity or entity. Although the charitable contribution provides a subsidy to wealthy donors, it operates, through its connection with the private-foundation rules,[42] to regulate the activities of the recipient. Charities, pension trusts, and state and local governments also receive a subsidy. State and local obligations, for example, sell at a lower coupon

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38 I.R.C. § 401(a)(4) (1976, Supp. V 1981 & West Supp. 1983) (qualified pensions); *id.* § 105(h)(2) (Supp. V 1981 & West Supp. 1983) (medical expense reimbursement plans); *id.* § 120(c)(1) (1976 & West Supp. 1983) (group legal services plans).

39 One permissible form of benefit discrimination is that benefits may vary according to income. *Id.* § 402(a)(5) (1976, Supp. V 1981 & West Supp. 1983); Treas. Reg. § 1.401-4(a)(2)(i) (1963).

40 For instance, a plan ceases to be qualified if it does not conform to the participation rules, I.R.C. § 410 (1976, Supp. V 1981 & West Supp. 1983), or vestig rules, *id.* § 411.

41 This phenomenon is illustrated by the conduct of both the Service and the Department of Labor in dealing with the numerous violations of law related to one of the Teamster plans. *See, e.g.,* Central States, Southeast & Southwest Areas Health & Welfare Fund v. Old Sec. Life Ins. Co., 600 F.2d 671 (7th Cir. 1979).

42 I.R.C. § 170(b)(1)(A)(vii), (b)(1)(C) (1976).

rate because of their tax exemption. A significant portion of such subsidy, however, goes to someone other than the exempt activity or entity.[43]

Control over the uses of the proceeds of state and local obligations also constitutes a regulatory regime because of the extensiveness of the nonrevenue rules. Sections 103 and 103A limit the amounts of such proceeds which can be used for industrial facilities,[44] residential mortgage financing,[45] and arbitrage.[46] In comparison, the Code exempts sports facilities,[47] qualified mass commuting vehicles,[48] and certain other favored projects[49] from these limitations. The large number of private ruling letters issued under sections 103 and 103A[50] demonstrates the regulatory scope of these rules.

A recent ruling, Revenue Ruling 83-7,[51] illustrates the complexity of the rules governing state and local obligations and their unrelatedness to revenue generation. The ruling demonstrates further, how exceptions to the Code's denials of tax exemption threaten to swallow up such denials.

Section 103 denies the federal exemption to obligations of a state or local government if they are "industrial development bonds."[52] Industrial development bonds are bonds whose proceeds will be used directly or indirectly in a trade or business carried on by a nonexempt person and whose servicing is tied "in whole or in major part" to a property used in a trade or business or is made from payments "in respect of [the] property."[53] This provision is designed to prevent local governments from passing their exempt-interest benefit through to nonexempt activities.

Sections 103(b)(4), (5), and (6) call off the denial in the case of certain favored projects. Although Revenue Ruling 83-7 does not identify the particular project involved, the ruling notes that the project is within the section 103(b)(4) sports facilities category. Section 103(b)(4) requires that "substantially all of the proceeds" of an excepted issuance be applied to the favored purpose. The regulations,[54] apparently as a gloss on the words "issued" and "used to provide," call off the exception

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43 Indeed, the cost of the subsidy to the United States can exceed the net benefit to the subsidized activity. *See infra* note 58 and accompanying text.

44 I.R.C. § 103(b) (1976, Supp. V 1981 & West Supp. 1983).

45 *Id.* § 103A (Supp. V 1981 & West Supp. 1983).

46 *Id.* § 103(c) (1976, Supp. V 1981 & West Supp. 1983).

47 *Id.* § 103(b)(4)(B) (1976 & West Supp. 1983).

48 *Id.* § 103(b)(4)(I), (b)(9) (Supp. V 1981 & West Supp. 1983).

49 *See id.* § 103(b)(4) (1976, Supp. V 1981 & West Supp. 1983).

50 Lexis research shows 253 I.R.C. § 103 private letter rulings during 1981.

51 1983-2 I.R.B. 6.

52 I.R.C. § 103(b)(1) (1976 & West Supp. 1983).

53 *Id.* § 103(b)(2).

54 Treas. Reg. § 1.103-8(a)(5)(iv) (1980).

to denial of the section 103(a) exemption to industrial revenue bonds if a pre-issuance "substantial user" of a facility continues to use it.[55] The substantial user requirement was developed to prevent the use of the section 103 exceptions to refinance an existing facility and provide working capital to an entity already engaged in a trade or business at a facility.[56]

The ruling recites that corporation *Y*, a nonexempt person, decided to buy a facility from corporation *X*, also nonexempt, with the borrowed proceeds of a qualifying section 103(b)(4) offering. Although this is accomplished, corporation *X* is unable to move out, and instead rents and occupies the facility for 120 days after the issuance. Corporation *X* finally moves out when its new facility is completed. The general question presented is whether corporation *X*, clearly a substantial user of the facility before the issuance, has remained a substantial user after the issuance (e.g., during the rental period). The resolution of this question hinges on whether corporation *X* has violated a specific guideline of the substantial user rules that prohibits the same entity from being a substantial user in both the five-year period before the issuance and the five-year period after the issuance.

The ruling holds that corporation *X*, because of the temporary nature of its occupation, is not a "substantial user" after the issuance.[57] This ruling would make sense if the Service were a regulatory agency permitted to waive rules in the face of hardship. The ruling, however, when viewed from the perspective of a regulation that reasonably interprets clear statutory language, appears misguided. Intent to move, or temporariness of occupation, cannot turn a use that is clearly substantial into one that is not.

Section 103 obviously subsidizes the issuance of qualifying state and local obligations. The section thus is properly categorizable as a subsidy that contains some intricate qualification rules. Revenue Ruling 83-7 demonstrates that such a view of section 103 and, for that matter, the charitable and pension regimes, oversimplifies and distorts the operation and application of those provisions. The Service's application of the section 103 rules does not support notions that revenue considerations or the accretion ideal remains preeminent or even central. In deciding that corporation *X* was not a substantial user after the issuance of bonds, the Service holds, in effect, that continued involuntary occupation of the facility is waivable in view of the "controlling" statutory objective, e.g., that the proceeds of the issuance be used for acquisition or construction of a facility by a new user. As a result, the Service ignores the rule that section 103, like all exemption and deduction provisions, is

55 Treas. Reg. § 1.103-8 (1980).
56 Rev. Rul. 83-7, 1983-2 I.R.B. 6, 7.
57 *Id.*

to be applied narrowly in light of the revenue-income theme. The only explanation for the ruling is that the Service views itself as an agency charged with protecting certain nonrevenue-raising regulatory objectives.

D. Tax Expenditure Analysis

A description of the three major themes of the Code does not disclose a clear path for future action. Scholarly analysis generally has focused on the revenue-income and subsidization issues. A major contribution of the tax expenditure school has been to ensure that any kind of subsidization should be openly admitted and then to scrutinize any such subsidy in light of two questions. The first question is whether the loss of revenue from subsidization equals the social benefit received? For example, the exclusion provided for interest earned on state and local obligations is criticized because the revenue lost by the federal treasury exceeds the interest savings to the state and local governments in the case of some investors.[58] The second major question is whether the tax benefits flow evenly among income groups? Although particular tax benefits may be targeted at worthwhile nontaxation goals, this facet of tax expenditure analysis demands consideration of the effect of the benefits on horizontal equity. For example, the deduction provided for mortgage interest[59] is attacked on a number of grounds. First, the benefit flows to upper-income groups and property owners, but not to renters. Second, the bigger one's mortgage, which is often related to the size of both the house and the owner's income, the bigger the absolute and relative benefits, assuming ascending tax brackets.

Tax expenditure analysis thus seeks to focus the subsidization question by reference to the revenue-income theme. Tax expenditure analysis fails, however, to explain adequately Congress's enactment of new subsidies and retention of almost all of the old ones. The curtailment of the casualty[60] and medical expense[61] deductions in the 1982 Act and the very complex tightening of the charitable contribution[62] deduction over the years are among the few contrary examples. One of the successful legislative control techniques, which tax expenditure analysis has produced, is the notion of placing time limits on new deductions. For ex-

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58 If a taxable corporate bond of $1,000 face amount sells at par with a 12% coupon and a tax exempt New York bond sells for 10%, it costs the United States at least $500 in lost revenue in the case of a 50% taxpayer. New York, in turn, saves only $200, assuming that the New York corporate bond is of similar quality. The subsidy cost thus exceeds the benefit to New York by $300.

59 1 S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, *supra* note 13, at 569-72. I.R.C. § 163 grants the deduction.

60 I.R.C. § 165(c) (West Supp. 1983).

61 *Id.* § 213.

62 The Tax Reform Act of 1969 significantly amended I.R.C. § 170, Pub. L. No. 91-172, 83 Stat. 487.

ample, the residential energy credits[63] and all saver certificate provisions,[64] have expiration dates. Another improvement generated by tax expenditure analysis has been the gradual effort to replace existing deductions with tax credits that are rate bracket neutral.[65]

Tax expenditure analysis also has been an inadequate tool for dealing with the regulatory theme of the Code. To attack the charitable contribution as a subsidy paid to rich people who make contributions to elite-controlled charities, although perhaps true, is almost too fundamental a criticism. What would be done to control and regulate big charities if their tax advantages were limited or curtailed? Would they disappear? If they would, is it likely that Congress would let this happen? Tax expenditure analysis thus provides a fundamental criticism of the pension and charitable schemes that is not terribly helpful.

Some commentators,[66] who focus on the revenue-income theme rather than tax expenditure analysis, also have attacked both the charitable deduction and the pension tax benefits. One criticism is that as soon as an employer gets a deduction for a pension plan contribution, the beneficiary-employee, if identified and vested, should be in receipt of income.[67] A pension right is as clear an accretion to wealth as an income-producing transfer to an employee of a noncoupon bond due on the participant's sixty-fifth birthday.[68]

A problem with this criticism is its focus on the revenue aspect of the Code in a context in which the Code's role is in large part regulatory. If Congress repealed the rule of nonincludability contained in section 402 in furtherance of the accretion ideal, the regulatory provisions would also be eliminated. Although the labor title of the 1974 Pension Reform Act provides an available, alternative statutory scheme,[69] neither Congress nor many commentators have contemplated the curtailment of the major tax benefits accorded to pension plans, their sponsors, and beneficiaries. This reluctance is attributable in part to the superior skill of the Treasury Department in handling employee benefit regulation as compared to the Labor Department.[70]

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63 I.R.C. § 44C (Supp. V 1981 & West Supp. 1983) does not apply to expenditures made after December 31, 1985.

64 All saver certificates must have been purchased before January 1, 1983. *Id.* § 128(c)(1)(A).

65 For instance, the old child care deduction has been changed into a credit along with certain other alternatives. *see, e.g., id.* § 44A (1976, Supp. V 1981 & West Supp. 1983) (old child care deduction is now a credit).

66 Blum, *More on Twenty Questions,* 42 TAXES 180, 181 (1964).

67 This criticism is consistent with I.R.C. § 83(h) (1976 & West Supp. 1983) and § 404(a)(5) (1976).

68 Such a transfer would be income under *id.* § 83(a) (1976 & West Supp. 1983).

69 29 U.S.C. § 1001 (1976 & Supp. V 1981).

70 For political reasons, no major figure has ever stated this publicly. The statements by Secretary Donovan to the Advisory Council on Employee Welfare and Benefit Plans on February 17, 1982, that ERISA was on his Department's "front burner" and that it would get a

Identification of the three major themes in the Code, revenue-income, subsidization, and regulation, does not imply that they are reconcilable. The tax benefits accorded to qualified pension arrangements may be inconsistent with the accretion ideal, yet their regulatory content is so significant that Congress tolerates the inconsistency. This regime, and the two others, thus involve a trade-off, a trade-off which cannot be explained solely in terms of subsidization. Although some subsidies are administered in the Code for nontax reasons, simple subsidies, such as the historic preservation benefits, are distinguishable from more extensive regulatory efforts in which the subsidy idea has become secondary.

II
ERTA CHANGES

Whether our income tax should accord savings greater immunity, or whether it should be restructured to tax consumption and exempt savings entirely have been the subjects of significant scholarly inquiry by economists and tax commentators.[71] Economists and certain publicists have pointed to what, until recently, appeared to be an abnormally low rate of savings by United States citizens and residents.[72] Some commentators, led by Professor Andrews, have argued for a "cash-flow personal income tax." This new regime would define income as receipts (excluding gratuitous transfers but including liquidated savings), less new savings, or alternatively, as consumption.[73] Andrews argues that such a tax base would eliminate a number of the problems of the current system.[74]

The consumption tax idea has not made much headway in the United States, but the notion that the income tax penalizes savers or savings has found a mass audience.[75] Most discussion of this issue has focused on the appropriate rate, holding period, and methodology for

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"lot of action" show some appreciation of the unfavorable comparison. 5 PENS. PLAN GUIDE (CCH) ¶ 25,432, at 27,011-18.

71 *See* articles cited in Bradford, *supra* note 16, at 243; *see also* N. KALDOR, AN EXPENDITURE TAX 79-101 (1969); N. TURE & B. SANDEN, THE EFFECTS OF TAX POLICY ON CAPITAL FORMATION 57-137 (1977).

72 N. TURE & B. SANDEN, *supra* note 71, at 38-43. The authors' own data ironically show the rate of savings increasing steadily from 1948 to 1975. The authors also derive a "shortage" from a projection of capital needed in the future, rather than from any proof of a current shortage.

73 Andrews, *A Consumption-Type or Cash Flow Personal Income Tax,* 87 HARV. L. REV. 1113, 1120 (1974).

74 *Id.* at 1128-48. Although, like others, I am not convinced by the purported administrative convenience inherent in Andrews's approach, *see, e.g.,* Gunn, *The Case for an Income Tax,* 46 U. CHI. L. REV. 370, 388-96 (1979); Minarik, *The Future of the Individual Income Tax,* 35 NAT'L TAX J. 231, 233-35 (1982), this article focuses on the theoretical underpinnings of the decision not to tax net savings.

75 *See, e.g.,* N. TURE & B. SANDEN, *supra* note 71, at 58-61.

taxing gains and losses on capital assets.[76] Congress in 1978 increased the excluded portion of long-term capital gains to 60%[77] in response to the claim that the United States' income tax discouraged savings or investment. Several provisions in ERTA also reflect Congress's desire to encourage savings and investment.[78]

A. IRAs

The 1981 Act took an indirect step toward the consumption tax idea[79] in what appears to be an odd place. In 1974, as part of the Pension Reform Act, Congress had provided that individuals who were not "active participants" in a qualified plan could establish and contribute to an individual retirement account (IRA) the lesser of 15% or $1,500 a year.[80] Thus, an individual not currently participating in a private pension plan could create a modest retirement fund on his own. Once he went to work for a private employer with a regular plan, however, he could not contribute anything to his IRA on account of any year in which he was an active participant in the employer's plan.[81] The 1981 Act eliminated this active participation rule.

The 1981 Act cut IRAs loose from the larger regime for regulating pensions in several other ways as well. For example, any employed person may now establish and contribute the lesser of $2,000 or 100% of his compensation to his IRA without regard to his participation in any other tax-favored pension arrangement, except for another IRA or a special IRA hybrid, the simplified employer plan.[82] In addition, contributions to the IRA do not count against the maximum contribution[83] or targeted benefit limitations[84] applicable in the case of an individual's participation in regular tax-favored pension arrangements. A compre-

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76 *See, e.g., id.* at 64-66; *see also* M. DAVID, ALTERNATIVE APPROACHES TO CAPITAL GAINS TAXATION 116-44 (1968).

77 I.R.C. § 1202(a) (Supp. V 1981).

78 *See infra* notes 79-97 and accompanying text.

79 Professor Bradford agrees. Bradford, *supra* note 16, at 243. He argues that the trend began with the 1978 Act after the defeat of President Carter's tax reform program that aimed at equalizing taxation for all types of savings income. *Id.; see also* Hickman, *supra* note 2, at 272-73.

80 The deduction was provided for in I.R.C. § 219 (1976). The vehicle, in three separate forms, is defined by I.R.C. § 408 (1976, Supp. V 1981 & West Supp. 1983).

81 *See* Osgood, *Qualified Pension and Profit-Sharing Plan Vesting: Revolution Not Reform,* 59 B.U.L. REV. 452, 466 (1979) ("A critical IRA rule is that *any* level of participation in a qualified pension or profit-sharing plan precludes IRA participation.") (emphasis in original) (footnote omitted).

82 I.R.C. § 219(b) (Supp. V 1981). The Code counts "qualified voluntary employee contributions" by an employee-participant to a qualified plan against the IRA contribution limit. *Id.* § 219(b)(3)(B).

83 *Id.* § 415(c) (1976, Supp. V 1981 & West Supp. 1983). Excluding IRAs and equivalents from the list of covered vehicles contained in *id.* § 415(a)(2) achieves this result.

84 *Id.* § 415(b) (1976 & West Supp. 1983).

hensive set of rules establishes and regulates the limitations and aggregates commonly controlled enterprises[85] to the end that each individual cannot accumulate unlimited sums in a tax-favored plan.

Congress deleted the active participation rule partly for a reason "internal" to the pension rules of the Code; it operated harshly in the case of a person whose unvested interest in a plan remained unvested either because he had already terminated service or definitely intended to do so.[86] Such people could not establish and contribute to an IRA even though their participation in the qualified plan was illusory. The primary reason, however, for the change in the IRA rule was to further savings. Indeed, the House Conference Report on the 1981 Act categorized the IRA change in a portion of the report entitled "Savings Incentives Provisions."[87] Congress also grouped provisions for all saver certificates[88] and certain dividend reinvestment plans in the same section of the Report.[89]

B. All Saver Certificates

The 1981 Act exempted from taxation up to $1,000 per person of interest income earned on certain certificates ("all saver certificates") issued by savings banks and other depository institutions before January 1, 1983.[90] The tax benefit provided is a permanent forgiveness of the $1,000 of income and is thus unlike the IRA deduction, which defers recognition until an actual or deemed distribution.[91]

Section 128(d)(1) requires institutions issuing such certificates to maintain certain levels of investments in "qualified residential financing." Congress had thus hoped that all saver certificates would stabilize savings-industry institutions and at the same time provide more funds for housing.[92] This brief experiment probably will end after 1983 because it has failed to generate sufficient new deposits.[93]

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85 *Id.* § 414(b)-(c) (Supp. V 1981).

86 *See, e.g.,* Orzechowski v. Commissioner, 592 F.2d 677, 678 (2d Cir. 1979) (contribution to an IRA by an "active participant" in employer's qualified pension plan made after learning of imminent discharge from that employment disallowed as deduction).

87 *See* H.R. REP. NO. 215, 97th Cong., 1st Sess. 195, 239-44, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 285, 327-32 [hereinafter cited as HOUSE REPORT].

88 I.R.C. § 128 (Supp. V 1981).

89 *See* HOUSE REPORT, *supra* note 87, at 239-46, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 327-34.

90 The exemption was for $1,000 per person over the life of the program, not for each year. I.R.C. § 128(b)(1) (Supp. V 1981). Each spouse was deemed to receive one half of any interest income on an all saver certificate and reported on a joint return. *Id.* § 128(b)(2).

91 *Id.* § 408(d) (1976 & Supp. V 1981) (actual distributions), (e)(2)(B), (e)(4) (1976) (deemed distributions).

92 HOUSE REPORT, *supra* note 87, at 243-44, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 285, 332.

93 N.Y. Times, Dec. 27, 1982, at D1, col. 1. On its expiration a new I.R.C. § 128 will spring up which will exclude up to $3,000 of interest income per individual in any year.

C. Qualified Reinvested Dividend Plans

The 1981 Act also defers recognition of up to $750 of dividends, per individual, if reinvested in newly issued common stock of certain public utilities. This provision, which is scheduled to expire on December 31, 1985,[94] reflects Congress's fear that the amount of capital available in nondebt form is insufficient to ensure the stability of these utilities.[95] The plan provides only a partial forgiveness for reinvested dividend income. Section 305(e)(7)(A) assigns the newly acquired stock a zero basis, and there is no adjustment of the utility's earnings and profits account.[96] Section 305(e)(7)(B) taxes any gain on a sale after one year as a long-term capital gain rather than as a dividend subject to ordinary income treatment.[97]

III

SAVINGS AND INCOME TAXATION

Congress presented the changes in IRA eligibility, all saver certificates, and reinvested utility dividend plans as a means to encourage savings.[98] Several commentators nonetheless view them as an experiment with the consumption tax.[99] I will evaluate this experiment by considering the three provisions in light of the three themes of income taxation developed in the first part of this article.

A. Revenue-Income

Professor Andrews has pointed out that although the present income tax is based on the accretion ideal, it strays quite far from that ideal in a number of important respects related to savings.[100] For example, appreciation in a capital asset held throughout a given tax year goes unrecognized.[101] This is the case even where such appreciation may represent immediate enrichment available to the owner in the form of loan collateral and is still unrecognized. Conversely, if the asset yields interest, dividends, or rent, the owner is to that extent in receipt of income.

The income tax's present ideology thus is not internally consistent. In concluding that the present tax resembles to a significant degree a consumption tax, Professor Andrews relies mainly on its failure to tax

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94 I.R.C. § 305(e)(12) (Supp. V 1981).

95 HOUSE REPORT, *supra* note 87, at 245-46, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 285, 334.

96 I.R.C. § 305(e)(7)(A) (Supp. V 1981) (basis); HOUSE REPORT, *supra* note 87, at 245-46, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 285, 334 (earnings and profits).

97 I.R.C. § 305(e)(7)(B) (Supp. V 1981).

98 *See supra* text accompanying note 87.

99 *See supra* text accompanying note 79.

100 Andrews, *supra* note 73, at 1117.

101 *Id.* at 1118-20.

unrealized capital asset appreciation and contributions to qualified pension and other deferred compensation arrangements.[102] Andrews does not stop with this observation but goes on to argue for a consumption tax. Unlike Nicholas Kaldor,[103] Andrews does not take issue with the notion that it is "income" which should be taxed.[104] Nor does he disagree that income should be taxed because it is a major indicium of wealth and thus an appropriate target of annual taxation.[105]

Administrative considerations aside, Andrews makes three arguments for a consumption tax. First, because savings merely represent deferred consumption, the present rules, which tax both earnings *and* the income yield on savings, place a heavier burden on deferred consumption than on present consumption, and thus a heavier burden on savings.[106] His position here mirrors John Stuart Mill's double taxation on savings argument.[107] Andrews indicates that an ideal income tax should make a taxpayer indifferent as between current or deferred consumption, putting aside all nontax considerations. A consumption tax thus recognizes income based on lifetime consumption without distorting individual preferences as to the timing of consumption. Second, Andrews argues that exempting savings from current taxation is merely a timing decision.[108] Third, although taxing wealth may be desirable for political or other reasons, an income tax, even a pure accretion-type tax, is at best an indirect way of taxing wealth.[109] Directly taxing wealth by an accessions tax or a strengthened estate and gift tax system would be preferable.[110]

In a thoughtful comment,[111] Professor Warren has challenged Andrews's justifications for selecting a consumption tax. Warren agrees that the obvious effect of the accretion ideal is the curtailment of future consumption by taxing it at the point of saving and again when income on the saved amounts is recognized.[112] Warren argues, however, that in

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102 *Id.* at 1117.

103 N. KALDOR, *supra* note 71, at 24-25.

104 Andrews, *supra* note 73, at 1119-20.

105 *Id.* at 1169.

106 *Id.* at 1167. Charles McLure, Jr. recently noted the discontinuity between Andrews's terms and framework and most economic thinking. Not all savings represents deferred consumption. Yet, in describing the advantages of a consumption tax, that identity is assumed and is crucial. *See* McClure, *Taxes, Savings and Welfare: Theory and Evidence,* 33 NAT'L TAX J. 311, 318 (1980).

107 J.S. MILL, PRINCIPLES OF POLITICAL ECONOMY bk. V, ch. II, § 3, at 806-10 (W.J. Ashley ed. 1965).

108 Andrews, *supra* note 73, at 1120.

109 Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren,* 88 HARV. L. REV. 947, 956-58 (1975).

110 *See, e.g.,* Andrews, *The Accessions Tax Proposal,* 22 TAX L. REV. 589 (1967).

111 Warren, *Comment: Fairness and a Consumption-Type or Cash Flow Personal Income Tax,* 88 HARV. L. REV. 931 (1975).

112 *Id.* at 932-34.

defining fairness by reference to a characteristic of a consumption tax, Andrews has failed to make a principled argument against the accretion ideal. Warren also challenges Andrews on the substantiality of the effect,[113] by arguing that curtailing savings, and hence future consumption, presumptively forces interest rates higher over the long run; the effect of the heavier tax burden thus is moderated by the more generous rewards it generates on savings.

Revenue-income considerations suggest reasons why an income tax should not distinguish between a use of current income for savings versus consumption. First, an income tax is premised on the notion that those with greater incomes should pay more tax in absolute dollar terms. This conclusion is not derived from economic analysis but moral philosophy. As wealth increases, it is just for the absolute[114] level of taxation to increase as well.

Two major justifications for increasing individual taxation as wealth increases have been made. First, individuals with greater wealth derive greater public benefits (e.g., more peace and protection) than people with less wealth. It therefore is appropriate to tax them more heavily.[115] The consensus among modern commentators, however, is that there is no proportional relationship between wealth and social benefits.[116]

A second justification proceeds from several assumptions. Each incremental dollar above a subsistence level of income has (taking into account all individuals in a society) less value or utility to the recipient than the preceding dollar.[117] Value or utility is defined as happiness or satisfaction. A society may determine public needs to be paid for by taxes and also may exempt from taxation individuals living below a subsistence level.[118] Those who earn income above a subsistence level should contribute more in absolute terms as their incomes increase and perhaps even more in proportional terms because doing so deprives them of less utility than a flat tax would, such as one based on citizenship.[119]

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113 *Id.* at 934-41.

114 "Absolute" means the total dollars, not percentages. It does not necessarily follow, nor is there any consensus, that taxation should increase more than proportionally. *See, e.g.,* J.S. MILL, *supra* note 107, bk. V, ch. II, at 802-22.

115 *See, e.g.,* W. KLEIN, POLICY ANALYSIS OF THE FEDERAL INCOME TAX 2-8 (1976).

116 *See, e.g.,* J.S. MILL, *supra* note 107, bk. V, ch. II, § 2, at 804.

117 *See* P. SAMUELSON, ECONOMICS 433-35 (10th ed. 1976).

118 J.S. MILL, *supra* note 107, bk. V, ch. III, § 5, at 829. Jeremy Bentham wrote two essays explicitly concerned with taxation, one attacking "law-taxes" (e.g., legal filing fees), and the other endorsing a wider ambit for death escheats of wealth. In his article on law taxes, Bentham attacked "law-taxes" because they are not taxes on "affluence" which, according to Bentham, is what all taxes should be. 2 J. BENTHAM, WORKS 573 (J. Bowring ed. 1843). He also condemned consumption taxes that fall on necessities such as justice or bread. *Id.*

119 These two views represent those who defend a proportional income tax, and those

Because both of these arguments are premised on an assessment of utility or benefit from an individual perspective, they may ignore, to some extent, aggregate social utility. For instance, if it could be shown that saving is necessary for the long-term health of society and that saving is done primarily by wealthy individuals with their last dollars of income, a society may need to weigh this nonindividual utility factor in desiguing its fiscal system.[120]

The two theories differ in one subterranean aspect. Adherents of the second theory imply that wealth comes haphazardly to people.[121] Some people do not "earn" it in a tough-minded sense. Rather, they inherit it or do something fortuitous such as invest in Xerox at an opportune moment. Few individuals work and save their way to wealth completely unaided by luck or happenstance. Taking away their wealth, thus, far from being a brutal seizure, is merely an effort to re-award some portion of wealth according to a socially acceptable mechanism.[122]

According to both schools of thought, income is a major form of wealth. Income taxation thus is initially justifiable as a tax on wealth.[123] But as Andrews and others have pointed out, it is an indirect tax on wealth,[124] taxing directly current command over income without regard to use or application.

A justification of the income tax on the ground that it reaches a primary form of wealth does not explain its inconsistencies. The traditional explanation for the distinction between the treatment of unrealized capital appreciation and wages is that the income tax focuses consciously and unconsciously on the notion that income must be "derived"; there must be a severance, most commonly in the form of a disposition.[125] The notion that a taxpayer must have changed his position to justify imposing a tax derogates from the accretion ideal. The ease, however, of tax collection upon such a severance supports this deroga-

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who defend a progressive income tax. *Compare, e.g.,* Gunn, *supra* note 74, at 378-88 (proportional income tax) *with* W. BLUM & H. KALVEN, THE UNEASY CASE FOR PROGRESSIVE INCOME TAXATION (2d ed. 1963) (progressive income tax).

120 Mill favored exempting savings from income taxation, but also favored higher rates of taxation on passive investment income than on active business income. J.S. MILL, *supra* note 107, bk. V, ch. II, at 802-22.

121 Professor Gunn has formulated a variation of this argument. Gunn argues that wealth taxation is less desirable than income taxation because individuals have a "stronger social claim" to their property than to their current year's income. Gunn, *supra* note 74, at 381. Although I may disagree with this proposition, Gunn is correct in noting that a wealth tax would be more socially disruptive than an income tax.

122 J.S. MILL, *supra* note 107, bk. V, chs. I & II, §§ 1-2, at 795-805.

123 This final step is frequcntly taken by circular reasoning that disguises this conclusion in the formulation of a "fairness methodology." According to this view, an income tax is defensible because it is based on "ability to pay." *See* Gunn, *supra* note 74, at 386-88. Wealthy people with no income, of course, are able to pay but are not taxed.

124 Andrcws, *supra* note 109, at 956-58.

125 1 S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, *supra* note 13, at 923-36.

tion from the accretion ideal.[126] The difficulty in valuing an asset, together with its annual appreciation, apart from an actual sale or disposition, further justifies the distinction between unrealized capital appreciation and wages.[127]

Andrews's second major example of the current system's[128] departure from the accretion ideal cannot be explained by reference to such practical considerations. Money in the form of a pension contribution, or income on an invested contribution, is taxable. Deferral of taxation on pension contributions, however, may be explained by the dichotomy in the present income tax between the personal and business-investor regimes discussed earlier.[129] The special pension provisions may be interpreted, within the limits prescribed by the Code, as an additional personal exemption.[130] Under this view, retirement savings are outside the accretion concept until distributed because of the economic necessity of such savings. Through the pension system, the income tax may be providing an offset for the necessary provision of taxable post-retirement income. This is similar to the current $1,000 personal exemption which has the effect of treating as disposable only income above that level.

In sum, if the income tax aims to tax wealth, the removal of net savings from the concept of income would be a major change. Because savings and investment increase an individual's wealth, the use of income for savings rather than constituting a basis for deferring taxation, supports the decision to tax.[131] Andrews counters that the failure to tax income that is saved or invested is nothing more than a delay or deferral, not a forgiveness; in the same article,[132] however, he describes the

126 Although the taxpayer does not receive cash in an exchange of properties, such an exchange still may constitute a realization under I.R.C. § 1001. Such exchanges are relatively infrequent and special rules such as I.R.C. § 1031 accord certain exchanges nonrecognition treatment.

127 M. CHIRELSTEIN, FEDERAL INCOME TAXATION 71 (3d ed. 1982).

128 Andrews, *supra* note 73, at 1115.

129 *See supra* text accompanying notes 12-14.

130 This argument focuses on the participants and ignores the benefits that accrue to the employer as a result of current deductibility under I.R.C. § 402, and the trust exemption of I.R.C. § 501(a). Section 83 would provide a deduction to the employer if the benefits are vested and, therefore, it is not clear that the I.R.C. § 404(a) deduction is a benefit to an employer. I.R.C. § 83(h) (1976). To the extent that exempted trust income, under I.R.C. § 501(a), accrues to the participants, it benefits them, not the employer, and, therefore, is not a benefit to the employer.

131 A recent article by Geoffrey Brennan and David Nellor attempts to weigh the "extra" or "psychic" benefits of wealth and accumulation—in the form of savings as opposed to consumption. Many people who reject the consumption tax have asserted that these benefits invalidate the present versus future consumption-neutrality argument used by consumption tax proponents. Brennan and Nellor conclude that if such psychic benefits exist and are quantifiable, then neither a "pure" income tax nor a consumption tax is "neutral." According to this view, only a labor income tax is neutral. Brennan & Nellor, *Wealth, Consumption and Tax Neutrality*, 35 NAT'L TAX J. 427, 435 (1982).

132 Andrews, *supra* note 73, at 1123-28.

special benefits of deferral.

A second major reason why an income tax should not differentiate between savings and consumption is macroeconomic. At various times, savings may be more or less desirable from a national economic perspective.[133] In the depths of a depression saving is less desirable than extra consumption,[134] yet at such moments people may be afraid to spend for fear of impoverishment. Conversely, in the hysteria of an inflationary spiral, consumption appears more attractive than savings because commodities, including inventory, look as if they will hold their worth better than money saved.[135] Market economics, however, do affect the economic and pyschological components of the decision to save or consume.[136] As a depression deepens, rates of return on savings fall and consumption becomes increasingly attractive. At an inflationary apogee, interest rates should rise to the point that investors will be encouraged to save rather than consume.

The attractiveness of savings and consumption thus depends on the cyclical position of an economy. The tax system in a mixed economy[137] in which cyclical business performance is considered to be endemic should remain neutral toward savings and consumption in order to maximize efficiency.

The consumption tax is flawed because even if it is neutral as between present and future consumption over a lifetime or lifetimes, as

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133 *See, e.g.,* P. SAMUELSON, *supra* note 117, at 237-38.

134 Allsopp, *The International Demand Management Problem,* in THE ECONOMIC SYSTEM IN THE U.K. 415 (D. Norris ed. 1979).

135 *See, e.g.,* P. SAMUELSON, *supra* note 117, at 273.

136 Commentators argue that the existence and amount of individual savings varies with income. The poorest individuals typically "dissave" whereas the wealthiest save the most. *See* P. SAMUELSON, *supra* note 117, at 209, fig. 11-1; S. KUZNETS, SHARES OF UPPER INCOME GROUPS IN INCOME AND SAVINGS 225, table 58 (1953). Professor Kuznets's study on savings and income concludes that although the savings of upper income groups is reasonably stable throughout business cycles, the savings patterns of lower income groups are volatile and tend to increase during prosperous periods and disappear in times of economic contraction. Kuznets's findings do not necessarily contradict the thesis that the best form of taxation in a mixed economy that experiences cyclical business performance is a tax that does not distinguish between savings and consumption. *See infra* text accompanying note 137. Beeause the savings of the top tenth of income-earnings units typically produces about three-quarters of all savings, its relative stability when income decreases may be reflected as a relative increase in the rate of savings.

It is troublesome that both Kaldor's and Kuznets's data come from odd periods, immediate post-war Britain and depression-era United States, respectively. A long-term study of savings data is needed.

137 *See generally* D. CREAMER, PERSONAL INCOME DURING BUSINESS CYCLES (1956).

Federal Reserve Bank data for the 1982 recession, which appears to have ended, indicate that the rate of savings went up dramatically during the recession but fell in the early post-recession months to its 1980 pre-recession level. This occurred in the face of the IRA liberalization and other tax changes made in the 1981 Act with the avowed intention of increasing savings and investment. *See Where Have All the Savings Gone?,* N.Y. Times, Sept. 9, 1983, at A18, col. 1.

Andrews asserts, it is not neutral at the moment of decision.[138] A consumption tax inexorably favors savings at all points in time more than the present tax system because people make decisions regarding savings and consumption based in part on the immediate consequences of their decision. People do not think solely in terms of a lifetime flow of consumptions. It is also not clear how people relate deferred consumption needs to savings.[139] Existing data suggest that saving is a function of many factors; patterns of behavior embedded in a culture, and a mix of nonconsumption motives, such as a desire to build a patrimony or a particular power base and future consumption needs, all affect the decision to save.[140]

A third reason for favoring an income tax that does not distinguish between savings and consumption is that the two are not easily distinguishable. Their relationship is so complex and poorly understood that major consequences in a tax system should not flow from making a sharp distinction between the two.[141] Higher consumption requires greater investment at some point. If people buy automobiles rather than save, the automobile industry's rate of return rises and the return on investment increases whether by reinvestment of earnings or new capital issuance.

The liberalized IRA deduction illustrates how the consumption ideal would operate. The following chart demonstrates the value of a decision not to tax saved income. The left column reflects the two major IRA benefits: a current deduction for $1,000 and an exemption of the account's income (at 10%) for six years based on a single $1,000 contribution. The right column shows a similarly situated taxpayer who deposits $1,000, less taxes, into a savings account with the subsequent account interest also diminished by appropriate taxes. Assume the taxpayer pays taxes at a uniform 50% rate.

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138 Joseph Minarik has called an expenditure tax "nearly procyclical." Minarik, *The Future of the Individual Income Tax,* 35 NAT'L TAX J. 231, 232 (1982).

139 *See* Menchik & David, *The Incidence of a Lifetime Consumption Tax,* 35 NAT'L TAX J. 189 (1982) (consumption tax will distort individual decisions about when to save because of primacy of "bequest" planning in such decisions).

140 *See* Howrey & Hymans, *The Measurement and Determination of Loanable Funds Saving,* 3 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 655-85 (1978). *But see* Boskin, *Taxation, Saving, and the Rate of Interest,* 86 J. POL. ECON. S_3 (1978).

141 The complexity and circularity of present economic theory on this subject is demonstrated in chapters 11 through 13 of Professor Samuelson's current textbook. P. SAMUELSON, *supra* note 117, at 205-48.

		IRA Participant	Savings Account Saver
(i)	Year of Contribution (Assume made on 12/31/82)	$1,000	$500
(ii)	End of Yr. 1 - 12/31/83	100	25
(iii)	End of Yr. 2 - 12/31/84	110	26.25
(iv)	End of Yr. 3 - 12/31/85	121	27.5
(v)	End of Yr. 4 - 12/31/86	133.1	28.9
(vi)	End of Yr. 5 - 12/31/87	146.4	30.4
(vii)	End of Yr. 6 - 12/31/88	161	31.9

If the IRA participant receives a distribution at the end of year six of the amount in the account, he must pay the United States about $885.75, and retains $885.75. If the regular saver withdraws the amount in his account, he receives $670.05. The magnifying effect of a double tax exemption, which Andrews has noted,[142] leaves the beneficiary of the tax exemption substantially (32%) better off. Exempting savings until divestment thus increases the amount of money available at that time, assuming constant rates of taxation.

Several comments on the assumptions embedded in the chart are in order. First, some savings, such as pension savings, may be predicated on a decline in the tax rates over an individual's lifetime. Second, because of the price effect, the adoption of a consumption tax might increase the stock of savings and reduce over time the rate of return that would prevail under a nonconsumption tax.[143] Neither of these observations constitutes an argument for a consumption tax. If income tax rates decline, those who save will have more money available. If the rate of return on saving decreases as a result of the adoption of a consumption tax, the comparison made in the foregoing chart would remain valid, but the growth in each case would be appropriately diminished.

The revenue-income theme, informed by the accretion ideal, thus is inconsistent with a deduction from income for savings, as exemplified by the new IRA deduction. This conclusion extends to the new provisions for dividend reinvestment plans and all saver certificates. The complete forgiveness provided by the former and partial forgiveness by the latter cannot be reconciled with a consumption tax. They can be justified, if at all, only as subsidies.

B. Subsidization

Congress frequently uses the income tax to subsidize taxpayers who

142 Andrews, *supra* note 73, at 1121.

143 Andrews does not challenge this, but questions the magnitude of the price effect. Andrews, *supra* note 73, at 1173. Strictly speaking, if projections of future consumption needs hold constant, and that is the sole determinant of saving, *and* if the United States were to adopt a consumption tax, the rate of saving should drop.

engage in favored activities. The liberalized IRA deduction and the provisions for reinvested utility dividends and all saver certificates seem to be a crude effort to encourage saving through subsidization. The IRA deduction is a flawed subsidy because this form of savings is disproportionately utilized by wealthy taxpayers.[144] From a tax expenditure perspective, the IRA deduction constitutes a matching grant to encourage savings among a group of taxpayers whose annual family incomes are well above average. Qualified dividend reinvestment plans provide a subsidy that goes to an even wealthier group of taxpayers: those who own common stock.[145] Finally, all saver certificates require an investment of about $10,000[146] to obtain the full, $1,000 individual exclusion in a single year. In addition, by fixing the certificate rate at 70% of the average Treasury Bill rate at the next preceding auction, the program only benefits taxpayers in higher income tax brackets.[147]

The benefit gained under these three provisions, a potential increase in national savings, has a cost calculable in terms of horizontal tax equity. Because wealthy individuals would be the primary beneficiaries of all three of these provisions, the most noticeable effect, given their modest dimensions, may be to make the rich a bit richer rather than to augment materially national savings.

C. Regulation

The liberalized IRA deduction, qualified dividend reinvestment plans, and all saver certificates are inconsistent with the accretion ideal because they exclude some income from both immediate and eventual taxation. Furthermore, any subsidies these provisions supply, diminish horizontal tax equity. Although these provisions cannot be justified on the basis of the revenue-income or subsidization themes of the Code, they may be justifiable as regulatory measures.

Perhaps the liberalized IRA can be viewed as part of the elaborate Code system for regulating pensions. Although in operation sections 219 and 404 provide deductions that accrue to the benefit of the wealthy, Congress may feel that such inequity is tolerable in order to provide reasonable private pensions for certain employed individuals as a sup-

144 For the calendar year 1979, 51% of all IRA deductions in dollar terms went to taxpaying units whose income was $30,000 or more. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME: 1979 INDIVIDUAL INCOME TAX RETURNS 4, 22 (1982).

145 For the calendar year 1979, 68% of all dividend income was reported on returns with an adjusted gross income of $30,000 or more; only 12% of the returns filed by individuals had adjusted gross income of $30,000 or more. *Id.* at 15.

146 If an individual applied $10,000 toward the purchase of a 10% all saver certificate, the $1,000 exclusion would have been consumed in a single year.

147 If the Treasury Bill rate were 10% and the all saver rate 7%, a 50% bracket taxpayer would gain $20 a year ($100 income less $50 tax versus $70 of income) by investing in a $1,000 all saver certificate. A 25% bracket taxpayer would lose $5 ($100 income less $25 tax versus $70 of income).

plement to social security. Thus, Congress may have concluded that the provision of private pensions through the Code's many regulatory pension rules justifies an exception to the accretion ideal.

The problem with the foregoing argument is that IRAs are now clearly outside the pension regime. If Congress had dropped the active participation rule of section 219, but still included the IRA contributions in the benefit limit rules of section 415, IRAs arguably would have remained part of the pension regime.[148]

Inability to fit the liberalized IRA deduction into the pension regime does not mean that this provision is not part of a larger regulatory effort by Congress. IRA liberalization, all saver certificates, and qualified dividend reinvestment plans may constitute the first steps in the creation of another Code regulatory regime, a regime that provides tax benefits for those investments which Congress feels are desirable as part of a new government effort to control and assist business. Alternatively, these steps may be directed toward the creation of a fourth major theme in the tax law.

1. *A Tax-Based National Enterprise Policy*[149]

This effort to aid business has analogues in Britain, France, and Sweden,[150] where national governments of both rightist and leftist parties have attempted to devise methods of channeling savings into certain enterprises thought to be short of capital. In Britain, the National Enterprise Board, created in 1975, invested general revenues in business enterprises.[151] In Sweden, the newly elected socialist government has advocated using revenues from payroll and excess-profit taxes to finance

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148 One could argue that IRA plans are still within the benefit-limit rules and that their noninclusion merely constitutes a $2,000 addition to those limits. This argument, however, fails to explain the other extraordinary aspects of IRAs. For example, an owner of a business may establish an IRA, contribute up to his limit, and then do nothing for his employees.

149 I will refer to this developing regime or theme as a nascent "national enterprise policy."

150 It also has nontax analogues in this country in the Lockheed and Chrysler bail outs. *See* Chrysler Loan Guarantee Act of 1979, Pub. L. No. 96-185, 93 Stat. 1324 (1980).

151 Morris, *Industrial Policy,* in THE ECONOMIC SYSTEM IN THE U.K. 523-45 (2d ed. 1979). The National Enterprise Board was created by the Industry Act, 1975, ch. 68, which also had as a goal the preservation of British ownership of certain industries.

A national enterprise policy can raise significant intra-industry equity questions. In 1976, the British Secretary of State issued gnidelines designed to ensure that the Board would not favor companies in which the Board had an investment, over other companies in the same industry in which the Board had no stake. *See id.* In Booth & Co. v. National Enter. Bd., [1978] 3 All E.R. 624, a group of non-Board controlled tanning companies, all of which were profitable, brought an action against the Board charging that the Board's investment in an unprofitable tanning company violated the 1976 gnidelines. *See generally* Sharpe, *Unfair Competition by Public Support of Private Enterprises,* 95 LAW Q. REV. 205 (1979).

An article in the London Times of Feb. 27, 1983, at 57, col. 1, noted that the Thatcher government wishes to remove from the Board, renamed the British Technology Group, the power to acquire equity interests in private enterprises.

entities that will gradually acquire Swedish enterprises and provide investment funds.[152] In France,[153] the government recently used considerable sums of public funds to purchase certain industries and businesses.

A national enterprise policy, as the term is used here, is one whereby the government in a mixed economy undertakes to provide capital to industries. Capital can be provided to industries generally or can be targeted to specific industries which are failing but whose longer term survival is thought desirable, or which are promising but unable to raise sufficient capital. In Sweden and France, the policy has an obvious socialist political cast, but the governments of those countries as well as Britain's also justify it as responsive to failures in the capital markets.

Support for national enterprise policies in France, Sweden, and Britain does not necessarily indicate that such a policy will be forthcoming in the United States. On the other hand, if the same basic causes that produced such a phenomenon in those countries are present in the United States, what happened there may be suggestive of the future here.

No one is sure why these countries have moved toward a national enterprise policy. Even Prime Minister Thatcher's conservative government, dominated by free market economic ministers, has been unable to halt the development of a national enterprise policy. Table I[154] suggests an explanation for this trend and indicates why a national enterprise policy, whether tax-based or otherwise, probably will come to the United States. Since 1955, total tax receipts as a percentage of gross domestic product have risen in each of the nations listed in the table. In particular, the level of aggregate taxation in 1980 was approximately fifty percent in Sweden and thirty percent in the United States.

TABLE I

TOTAL TAX RECEIPTS AS PERCENTAGE OF GROSS DOMESTIC PRODUCT AT MARKET PRICES

	1955	1965	1975	1979	1980
Sweden	22.5	35.6	44.2		49.9
United Kingdom		29.8	30.8	36.9	35.9
United States	23.6	26.5	30.2		30.7
France		35.0		41.2	

Taxation preempts both consumption and savings thus decreasing private funds available for investment. If government taxes or borrows a substantial portion of national income, the private funds available for

152 N.Y. Times, Sept. 20, 1982, at A3, col. 1.

153 Borde & Eggleston, *The French Nationalizations,* 68 A.B.A. J. 422 (1982).

154 Table I is compiled from data taken from LONG-TERM TRENDS IN TAX REVENUES OF OECD MEMBER COUNTRIES 1955-1980 (1981) (OECD Studies in Taxation).

investment may prove inadequate. The government may be forced to use a portion of its tax revenue as an investment subsidy to compensate for the funds which otherwise would be invested by the private sector. Reducing high rates of taxation in a country such as Sweden with its fifty percent tax rate would increase private investment and presumably eliminate or at least ameliorate the problem. But no economist or politician is predicting that the rates of taxation will decrease substantially in the major mixed-economy nations. Table I suggests that unless something significant occurs, the public sector will take increasing portions of national income. To the extent investment is desirable, it may have to be government investment or investment subsidized by tax exemption.

This analysis does not support the argument for a consumption tax. My basic premise is that government expenditure in the Western democracies may now be so high that it significantly curtails both consumption and savings. Congress may be forced to subsidize investment and savings, not because it is preferable to consumption, but because most of what government hands back to its citizens by way of benefits represents either transfer payments or consumption-type items, such as national parks or national defense. To balance the ledger, public business investment activity, or tax subsidization of analogous private activity, may be necessary. But Congress should undertake such activity or subsidization only after the kind of scrutiny given the three 1981 Act changes above, and only if they have the counter cyclical capacity of normal fiscal policy.

2. *Other 1981 and 1982 Act Provisions*

Other ERTA provisions, besides those already discussed concerning IRA liberalization, all saver certificates, and qualified dividend reinvestment plans, indicate that Congress may be beginning to channel savings to industry in furtherance of a national enterprise policy. A new rule[155] provides that an investment of IRA funds in a collectible, such as stamps, jewelry, gold, rugs, and similar nonproductive investments, constitutes a distribution of the amount invested. The linkage of IRA liberalization within ERTA to provisions that reflect upon the desirability of the underlying investment in social terms[156] is revealing.

Three unrelated changes made in the 1982 Act also support the argument that Congress is not moving toward the consumption tax model, but rather toward a tax-directed national enterprise policy. First, the 1982 Act imposed on interest and dividends, except in certain hardship cases, a ten percent withholding tax at source if the withholdings will exceed $150 a year for any individual payee of any payor.[157]

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155 I.R.C. § 408(m) (West Supp. 1983).

156 This has not been done in the qualified plan rules.

157 I.R.C. §§ 3451, 3452 (West Supp. 1983). David Bradford thought that Congress

Although domestic-source interest and dividends received by nonresident aliens were subject to withholding prior to the 1982 Act,[158] critics have interpreted the new withholding provisions as a swipe at domestic investors.[159]

The ten percent withholding requirement is more of a fiscal protection measure than a statement of policy on the savings issue. The Treasury is convinced that significant quantities of interest and dividends are not being reported as income.[160] It is also convinced that available compliance resources never will lead to adequate policing of such income reporting. Some modest level of withholding therefore is necessary to encourage reporting or to collect at least some of the tax. For those with higher incomes currently filing declarations of estimated tax, which accurately reflect such interest and dividends, the declaration will merely have to be revised downward. The new withholding requirements, added by the 1982 Act for pensions and other deferred income,[161] are similarly explainable.

Second, the tightening up of the treatment of original issue discount bonds suggests that Congress is interested in encouraging national investment, not savings.[162] Before the 1982 Act, original issue discount bonds, had generated enormous investor interest because of certain lacunae in the Code.[163] The 1982 Act changes the methodology[164] for taxing the accruing (but unpaid) ordinary income interest portion of such bonds in order to reflect accurately the way in which interest compounds. The old rule required ratable accruals of the interest portion, which allowed investors to sell such bonds and convert the compounding benefit, derived by operation of the market value of the bond, into capital gain.[165] This effort to harmonize the treatment of all types of bonds appears inconsistent with the movement to the consumption tax ideal. The reason for the change in original issue discount rules supports the notion that Congress is developing a national enterprise policy. This change is part of the effort to prevent anomalies in the tax treatment of investors in original issue discount or stripped bonds[166] and issuers of discount bonds. Far from being antisavings, the Code now

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would go the other way on this issue. Bradford, *supra* note 16, at 243. And, of course, events occuring as this article goes to press may lead to a reversal of this new withholding.

158 I.R.C. § 1441 (1976).

159 This has, in turn, led to a call for repeal. Ithaca J., Jan. 21, 1983, at 1, col. 2.

160 S. REP. NO. 494, 97th Cong., 2d Sess. 228-29 (1982).

161 I.R.C. §§ 3402(o), 3405, 6047(e), 6704 (West Supp. 1983).

162 *Id.* §§ 1232, 1232A.

163 *See* Nave, *The Impact of the Tax Equity and Fiscal Responsibility Act of 1982 on the Treatment of Zero Coupon Bonds,* 60 TAXES 763 (1982); Walter, *Tax Aspects of Recent Innovative Financings-Strategies for Existing Discount Debt and for New Securities,* 60 TAXES 995 (1982).

164 I.R.C. § 1232A(a) (West Supp. 1983).

165 Nave, *supra* note 163, at 764.

166 I.R.C. § 1232B (West Supp. 1983).

endeavors to treat discount bonds like similar investment vehicles, in particular, coupon bonds. This undertaking can never achieve perfect equality because of the difficulty of accounting separately for market fluctuations in the bond, in the context of a sale, which represent interest rate changes. But new section 1232A at least attempts to generate an accurate cost basis before considering market effects.

The third change made by the 1982 Act, which may further a national enterprise policy, is the curtailment of the contribution[167] and benefit[168] limits of section 415. These limits control the amount that a taxpayer can set aside in any of the tax-favored plans. Congress also harmonized Keogh plans with regular corporate plans,[169] and subjected both sets of plans to new "top-heaviness" rules.[170] A plan that provides sixty percent of its benefits to "key employees," is called top-heavy and must adopt and apply various top-heaviness rules; accrued benefits or accounts in such plans must vest participants faster and the plan must provide minimum benefits.

Both the benefit-limit curtailment and top-heaviness rules reflect enduring themes in the pension area. Qualified plans, which obtain the triple[171] tax benefits of qualification, should not be devices whereby highly paid employees can accumulate vast amounts of tax exempt capital. Unless such plans spread benefits across some reasonable cross section of employees, they are not justifiable. Because Congress need not move consistently on all fronts, Congress's creation of a new regulatory regime embodying a national enterprise policy in the Code does not necessarily mean that it will abandon the regulatory rules contained in subchapter D.

One of the major changes of the 1981 Act, ACRS[172] depreciation, might also appear to be part of a nascent tax policy favoring investment. It departs from the notion that capital expenditures should be accounted for in a fashion that clearly reflects income. The history of ACRS, however, shows that it is another subsidy provision, similar to the investment tax credit,[173] properly scrutinizable by tax expenditure

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167 *Id.* § 415(c)(1)(A).

168 *Id.* § 415(b)(1)(A).

169 This was done by repealing I.R.C. §§ 401(a)(17) (Supp. V 1981) and (18) (1976); Tax Equity and Fiseal Responsibility Act of 1982, Pub. L. No. 97-248, § 237(b), 96 Stat. 327, 511.

170 I.R.C. § 416 (West Supp. 1983).

171 *Id.* §§ 402, 404, 501.

172 *Id.* § 168.

173 The investment tax credit, *id.* §§ 38, 46-50 (1976 & West Supp. 1983), is an extremely complicated subsidy for the acquisition of certain capital goods. Congress has modified the investment tax credit over the years in response to the needs of fiscal policy and also to encompass more types of investments. The tax credit's intricate rules seem on first blush to resemble a regulatory regime, such as the pension regime. There are, however, significant differences. The investment tax credit essentially is concerned with a single moment in time for the particular taxpayer—when he invests. In this sense, it resembles a simple subsidy. Unlike the other regulatory regimes discussed above, and a national enterprise policy, the

analysis, and undertaken to foster the acquisition of capital goods. It also reflects the revenue-income theme, in that it imprecisely attempts to deal with the inflationary effects of historic cost depreciation. ACRS, however, cannot be fitted into the nascent national enterprise policy pattern.

It fairly can be asked whether the three provisions of the 1982 Act, IRA liberalization, all saver certificates, and qualified dividend reinvestment plans, differ materially from past bailouts made in the Code of other troubled industries or companies. Penn Central, for example, obtained a liberalization of the net operating loss carry forward rules,[174] and savings banks, until the Tax Reform Act of 1969[175] began a ten-year phase down, had the benefit of excessively generous, and fixed, deductions for loan loss reserve set asides which were, in effect, a subsidy. Neither of these provisions did much more than reduce a tax bill. Congress intended them to aid financially troubled industries rather than to encourage people to support a particular activity such as savings.

The three provisions of the 1982 Act, by comparison, are designed to do more than merely grant a subsidy to the IRA adopter, all-saver-certificate holder, or dividend-reinvesting shareholder. They attempt to produce investment generally and in two industries in particular. The contrast between the statutory contraction of savings bank reserves and loan loss reserves and the inauguration of all saver certificates is instructive. Congress has repealed a simple subsidy while experimenting with provisions tailored toward the newer goals represented by a national enterprise policy.

The development of a major regime for targeting investment of the magnitude of the charitable or pension rules is far from certain. The 1981 and 1982 Acts do appear, however, to be moving in that direction, and not because of the persuasiveness of the consumption tax idea.

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subsidy goes to the person who acquires the capital good and maybe also in the long run to the seller of the goods by making the goods somewhat less expensive. By contrast, the three regulatory regimes grant a subsidy to *X*, the charitable donor, for example, and then a subsidy to *Y*, the charitable donee, so that something will happen for the nation at large or for some particular class of needy people. In addition, the charitable regime monitors behavior at many points after the point of donation unlike the investment tax credit.

The investment tax credit is distinguishable from a national enterprise policy for another reason. A national enterprise policy, whether focused, as in the case of dividend reinvestment plans, or unfocused, like the liberalized IRA, tries to produce the actual investment in industry. The investment tax credit encourages a business to acquire certain capital goods. Once acquired, the Code becomes indifferent to what follows. A national enterprise policy thus attempts to produce a more durable and generally less specific investment than the Code's more traditional investment subsidies, such as the investment tax credit.

174 *Id.* § 172(b) (West Supp. 1983).

175 *Id.* § 593. Pub. L. No. 94-455, § 1901(a)(84)(A) provided for a reduction in the reverse set aside for loan losses from 60% to 40% of taxable income.

IV
THE FUTURE

Ending this article on a faintly prophetic note would beg the large question implicitly presented here: Should Congress create another major regulatory regime in the Internal Revenue Code, one focused on the generation of investment in selected businesses, or in the business sector generally? The unlikely elimination or curtailment by Congress of the Code's role in achieving substantial regulatory goals, like those of the pension system, does not constitute an argument for allowing another major nonrevenue matter to be imported into the Code, even if the Treasury and its Internal Revenue Service make up the finest regulatory "agency" in the government. Robert Reich in a series of articles, now in book form and titled *The New American Frontier*[176] has called for the use of tax incentives as part of an elaborate new national industrial policy.

The use of the Code and the Internal Revenue Service to further national enterprise policy is inconsistent with the revenue-income theme of the Code. The three arguments concerning the inconsistency of the consumption tax with the revenue-income theme developed earlier apply equally well here.

First, an income tax is premised for philosophical reasons on taxing all income, because income represents a form of disposable wealth. The consumption tax is premised on taxing the consumption of wealth. A tax-based national enterprise policy conflicts with the accretion ideal because it distinguishes, like each of the three ERTA changes, between a socially desirable and a nonsocially desirable application of funds for a nontax purpose which does not reduce wealth.

Second, the macroeconomic argument against a consumption tax also applies to a tax-based national enterprise policy. If savings and national income have some symbiotic relationship, even if not precisely reducible to formula, *and* if certain investments are thought desirable outside of a normal market operation, then the surest way to accomplish this is by honest and direct intervention, along the lines of the British national enterprise policy. The British National Enterprise Board has a budget which it must keep within. It does not operate in the relative obscurity of deductions taken on the returns of wealthy investors craving tax deductions or exemptions. Rather, the Board operates so that issues of social and economic desirability are always on the surface.

Some, no doubt, will argue that any national enterprise policy is undesirable because it interferes with the operation of the "market." The problem with this argument is that our society, like European societies, is not willing to tolerate an untrammeled operation of the market. Thus, pretending that we do not already have a national enterprise pol-

176 *See* Reich, *The New American Frontier,* THE ATLANTIC, Apr. 1983, at 97, 105.

icy, composed of various tax subsidies and some direct programs, like the Chrysler and Lockheed assistance measures, ensures that decisions along these lines will be made at the last minute, on an ad hoc basis, and that national enterprise goals will be accomplished indirectly by tax deductions and loan guarantees rather than by direct investments or subventions to industry.

An additional facet of the macroeconomic argument that distinguishes a national enterprise board from a consumption tax is that it can be funded and operated in a fashion more sensitive to business cycles. A consumption tax always would favor savings and presumably investment. A national enterprise board could be funded heavily in times of inflationary pressure by using the income tax to tamp down demand by taking money out of the economy. This, in effect, is what was done during World War II.

The third argument made against a consumption tax is that because the relationship among savings, consumption, and income is so poorly understood, it is undesirable to desigu or implement a major change in the income tax law based on a fixed notion of the relationship of these aggregates. The same argument applies to a tax-based national enterprise policy. The creation of a national enterprise board in the United States that uses most of its resources to prop up the United States equivalent of a British Leyland would be undesirable. This is not to say that one facet of a national enterprise policy should not be to soften or slow the collapse of major industries. But this objective is only one of the objectives of such a policy. A further policy is the provision of capital to promising new industries and assistance to industries, such as housing, thought to be worthy of long-term social subsidy.

Finally, and by way of qualification, this article does not consider fully the arguments for and against, or the proper institutional design of, a national enterprise policy. We already have such a policy. In terms of the major themes of our income tax, such a policy is better developed by direct activity than by tax subsidies administered in what will, no doubt, develop into a complex regime of rules governing qualification for such subsidies.

The only aspects of a tax-based national enterprise policy that might make it more attractive to Congress than a direct program relate to issues of control and flexibility. A tax-based regime leaves the decision of whether to invest primarily in private, even if preponderantly wealthy, hands. When individuals decline to participate in such a program, as they did with the all saver certificate program, it dies. In contrast, a national enterprise policy administered by a governmental agency inevitably is more decisive. Once a course of action is undertaken, bureaucracies tend to value consistency. Thus, one advantage of a tax-based national enterprise policy, even if constructed haphazardly,

like our nascent policy, is that it does not involve the heavy hand of an institution, but instead represents the aggregate of thousands of uncontrolled, if influenced, decisions.

CONCLUSION

The liberalized IRA deduction and certain other provisions in the 1981 Act point in the direction of a comprehensive tax-directed effort to increase generally national investment with an emphasis on investment in particular industries. The roots of such a "national enterprise policy" are not in the persuasiveness of the argument for a consumption tax, but rather in the growing share of gross domestic product which public expenditures consume. As the public sector takes an increasing portion of national income, it must undertake heretofore private activities such as investment.

The development of a national enterprise policy based wholly or partially in the Internal Revenue Code is undesirable because it awards subsidies disproportionately to higher income people, thus negating the central premise of the tax system; to tax wealth, and therefore income, at least proportionately. The national enterprise policy thus should be removed from the Code and administered directly as a government program along the lines of the British program. The major costs of removing it from the Code ironically are nontax costs; a tax-based policy, because it awards a subsidy based on numerous private acts, leaves the decisions and ownership of the investments in private hands. A thoughtful Congress might endeavor to design innovatively a direct national enterprise policy to obtain these advantages. If a direct policy cannot be structured effectively, Congress should determine forthrightly whether the nontax advantages of a national enterprise policy justify further derogation of the central principles of the income tax.