

Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?

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The standard traditionally employed by tax theorists in assessing the federal income tax is equity, but a new generation of theorists argues that ostensible inequities are converted by the market into inefficiencies. These opposing theories are based on divergent behavioral assumptions: equity theorists usually assume that the economic burden of the tax falls on the nominal taxpayer, while efficiency theorists usually assume that the burden is partly or wholly shifted by the nominal taxpayer to customers, suppliers, or others. This article examines the relationship of these conflicting assumptions to the conclusions reached by equity and efficiency theorists.

Traditionally, equity has been the standard applied by tax theorists to the structural details of the federal income tax. Equity theorists ask whether existing law treats equals equally (horizontal equity) and whether it differentiates appropriately among une-

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quals (vertical equity). To determine whether taxpayers or groups of taxpayers are equals or unequals, equity theorists compare their pretax economic incomes. When equity theorists subject the Internal Revenue Code to this mode of analysis, most if not all of them find it woefully defective.

Equity is now being supplemented, even supplanted, by efficiency as the goal of economic policy. This mode of analysis asks whether the tax allowances of existing law promote or inhibit the efficient allocation of resources. Viewing existing tax law from this vantage point, efficiency theorists are as critical of its numerous exclusions, deductions, credits, and other allowances as are equity theorists.

Although the verdicts of these two schools of income tax analysis converge, I hope to show first, that the behavioral assumptions on which their conclusions rest are so contradictory that their independent verdicts challenge—rather than reinforce—each other; second, that efficiency theory, if valid, calls into question the methodology employed by equity analysis in testing for horizontal and vertical equity; and third, that a fundamental task of income tax theory is to integrate these normative standards into a general theory.

In calling equity the “traditional normative standard” for judging the propriety of exclusions, deductions, credits, and other tax allowances, I have in mind such honored names as Seligman, Haig, and, above all, Henry Simons—the only one of the three who wrote long enough after the vaguely defined “income tax” had been converted into a statutory reality to have a detailed charter before him for systematic analysis.

The influence of equity analysis has been pervasive. Examples of its application include the original McGovern tax plan, Treasury studies of the tax liabilities of taxpayer economic income over \$200,000, the minimum tax on tax preferences, and countless other tax reform proposals.¹ Although equity theory is primarily concerned with the individual income tax, it also has inspired recent studies of the divergent tax rates to which corporations in different industries are subject.²

1. For the McGovern plan, see Bittker, *Income Tax “Loopholes” and Political Rhetoric*, 71 MICH. L. REV. 1099, 1123-27 (1973); for high-income, low-tax individuals, see S. REP. NO. 938, 94th Cong., 2d Sess., reprinted in [1976] U.S. CODE CONG. & AD. NEWS 2897, 3439-4117, and in 1976-3 C.B. 49; HOUSE COMMITTEE ON WAYS AND MEANS AND SENATE FINANCE COMMITTEE, 91ST CONG., 1ST SESS., TAX REFORM STUDIES AND PROPOSALS, pt. 1, at 79 (Comm. Print 1969); for the minimum tax on tax preferences, see I.R.C. §§ 56-58.

2. See OFFICE OF TAX ANALYSIS, TREASURY DEP'T, EFFECTIVE INCOME TAX RATES PAID BY U.S. CORPORATIONS IN 1972 (1978); Kaplan, *Effective Corporate Tax*

Whereas equity theorists condemn most tax allowances for imposing divergent tax burdens on taxpayers with equal economic incomes, efficiency theorists blame many of the same allowances for causing the misallocation of resources. An important difference so far as public attention is concerned, however, is that efficiency theorists have not succeeded in coining any passionate slogans to rival those contributed by equity theorists, such as "upside-down subsidies" and "tax relief for the rich." The dominant tone of efficiency analysis is prudence, stemming from worries about the misallocation of resources, and this attitude is not easily converted into a fighting creed.

Efficiency analysis is associated primarily with a new generation of tax theorists whose elders tend to be faithful instead to equity analysis. This situation is reminiscent of my colleague Leon Lipson's characterization, a decade ago, of the Yale Law School faculty as a combination of "Old Turks" and "young fogies"—a generation of idealists in their sunset years, still inspired by the ethics of compassion adopted in their youth, and a rising generation of skeptics insisting on the prudent calculation of costs before embarking on new ventures or endorsing old ones. There are, of course, some tax theorists who resist this bipolar classification; every taxonomy is a Procrustean bed. By and large, however, equity and efficiency as modes of tax analysis are separated by a generational line as well as an intellectual one.³ In saying this, I have our own day in mind. Taking a longer view, one might find that today's efficiency theorists differ from their parents but resemble their grandparents.⁴

Rates, 2 J. CORP. TAX. 187 (1975); 124 CONG. REC. E 168 (daily ed. Jan. 26, 1978) (remarks of Rep. Vanik).

3. For what it is worth, I count myself as a troubled Old Turk whose chagrin, if my doubts about conventional equity analysis can be refuted, would be outweighed by the pleasure of having my faith resuscitated.

I am indebted to Henry Aaron for helping to clarify my thinking in this area with an exchange of letters in 1972 and 1973. For a more systematic analysis, see Bailey, *Progressivity and Investment Yields Under U.S. Income Taxation*, 82 J. POLITICAL ECON. 1157 (1974). Bailey concludes that "apparent horizontal inequities [in income tax burdens] as a rule shake out in competitive resource allocation and translate into misuse of resources." *Id.* at 1174. See also Feldstein, *On the Theory of Tax Reform*, 6 J. PUB. ECON. 77, 90-102 (1976) (arguing that optimal tax reforms lead to a different tax structure than optimal de novo design when the effects of current rules on efficiency, horizontal equity, and property rights are taken into account).

4. See, e.g., the views regarding the shifting of "special taxes on income" in E. SELIGMAN, *STUDIES IN PUBLIC FINANCE* 65-68 (1925).

THE COMPETING BEHAVIORAL ASSUMPTIONS

As suggested, equity and efficiency as normative standards rest on divergent assumptions about the effect of tax allowances on the behavior of taxpayers and the citizenry as a whole.

The behavioral effect usually posited by equity-oriented theorists (more often implicitly than explicitly) is either that taxpayers continue to do just what they would have done without the allowances or that any changes in economic conduct to take advantage of the allowances do not significantly alter the pretax yield or other economic benefits produced by the tax-favored behavior. It is assumed, in other words, that the soup need not be watered down, no matter how many taxpayers line up for the free lunch. Indeed, unless the after-tax benefit of a tax-sheltered activity is greater than the after-tax benefits of its unsheltered counterparts, it cannot produce horizontal inequity. Equity theory's behavioral premise is, therefore, reminiscent of the classical theory that the burden of an income tax cannot be shifted and hence remains on the nominal taxpayer.

The basic behavioral assumption of efficiency theory differs from that of equity theory in two respects: It is more likely to be explicit, and it presupposes an increase of tax-favored behavior at the expense of its unfavored alternative until the after-tax benefits of the two are equalized. This equalization assumption is as central to efficiency theory as it is damaging to equity theory.

As a standard for judging the income tax, efficiency does not, of course, *require* the behavioral assumption just described. One can envision an efficiency theorist who, upon inspecting the exclusions, deductions, and other tax allowances of existing law, announces that these allowances do not induce an inefficient misallocation of resources because taxpayers either do not change their behavior under the impetus of the allowances or, if they do, no difference in economic yield results. An efficiency theorist, in short, might hold that the allowances are harmless from a resource-allocation perspective and that, if they are objectionable at all, it is only on equity grounds. Conversely, one can envision the mirror image of this efficiency theorist: an equity theorist who concludes that the allowances are nullified by declines in the pretax yield of the tax-favored activities and that they are, therefore, acceptable from an equity point of view, however much they might distort the allocation of resources.

In real life, however, both schools seem irresistibly drawn to behavioral assumptions that warrant gloomy conclusions: Equity theorists seem drawn to a no-shifting premise that leads them to the conclusion that existing tax law is horizontally and vertically

inequitable; efficiency theorists virtually always discern equalized after-tax yields that are the hallmark of misallocated resources.

COMPETING THEORIES ILLUSTRATED

An illustration will disclose the conflicting implications of the divergent behavioral assumptions on which the equity and the efficiency standards rest. The standard classroom example of a violation of horizontal equity involves a comparison of *A* and *B*, both subject to a marginal tax rate of 70% and both realizing an additional \$1,000 of interest income. Because *A* invested in taxable industrial bonds, he pays a tax of \$700 and is left with \$300. *B*, being more tax-conscious, invested in tax-exempt bonds of equal risk, so his \$1,000 of interest is unscathed by any tax liability.

Students sometimes ask why they should be disturbed by this comparison, which implies that *A* suffers from a self-inflicted wound. He is a fool, they suggest, not a victim; let him follow *B*'s example, and the alleged inequity will vanish. Whatever may be the reason for the persistent failure of some taxpayers to take advantage of the tax allowances open to them,⁵ the instructor usually answers student objections by asserting that *A* should not be forced into unwanted investments in order to be equal to *B*.

An efficiency theorist, of course, can use this example to demonstrate that the exclusion generates a misallocation of resources rather than horizontal inequity. If *A* gets \$1,000 of interest from a taxable bond paying 10% per year, he must have invested \$10,000. If *B* invested the same amount in tax-exempt bonds, the efficiency theorist points out, *B* gets only \$300 of interest because the after-tax yields of taxable and tax-exempt bonds are the same in a competitive market—3% on a taxable bond is the tax-free equivalent of 10% on a taxable bond if the investor is subject to a 70% marginal tax rate. Because of the resulting equalization of the after-tax receipts of *A* and *B*, no horizontal inequity exists between them; both are in the same boat, as they should be.⁶ But the ability of cities and states to borrow at 3%

5. See text at 744-45 *infra*.

6. The conventional equity criticism can be rehabilitated, in a purely formal sense, by the fact that *B* pays no taxes even if his pretax income drops by the full amount of unpaid taxes. But this quibble, in turn, is rebutted if the tax allowance is viewed as a device for (a) taxing the ostensibly exempt income and (b) transferring the hypothetical tax revenue to the tax-favored borrower. This view of the tax allowance should be congenial to advocates of tax expenditure analysis, which

when taxable projects of equal risk must pay 10% for capital results in a misallocation of resources as funds flow toward exempt projects of lower economic productivity.

At this point, the efficiency theorist's students may note that the horizontal equity to which their instructor points is produced by comparing persons who do not have equal amounts of economic income: *A* receives \$1,000 of interest; *B*, only \$300. If we return to the original hypothesis of two taxpayers each with \$1,000 of income, the equity theorist's complaint that they do not pay the same amount of tax seems to regain its original force.

In rebuttal, however, the efficiency theorist lays profane hands on the sacred ark by asserting that equal economic income, meaning pretax income, is not the proper base for measuring horizontal equity. *A* and *B* are equals, he argues, only if they have the same amount invested at the same risk. Their pretax economic receipts cannot be properly compared because *B*'s pretax income reflects *B*'s tax exemption.

The efficiency theorist, therefore, compares *A* not with *B* but with *C*, who (like *A*) has \$10,000 to invest but who, unlike *A*, buys tax-exempt bonds and gets \$300 of tax-exempt interest. As for *B*, his \$1,000 of tax-exempt interest implies an investment of \$33,333, if the interest rate is 3%. Hence, *B* should be compared not with *A*, who has only \$10,000 invested, but with *D*, who (like *B*) has \$33,333 invested. If *D* invested \$33,333 in taxable bonds with a 10% yield, his after-tax yield is \$1,000 (that is, \$3,333 less 70% of \$3,333), which is the same amount that *B* gets from his tax-exempt bonds. If these are the proper comparisons in testing for horizontal equity, the tax allowance gets a clean bill of health because *A* and *C*, with equal amounts invested, enjoy the same after-tax yield, and so do *B* and *D*.

These comparisons are restricted to investment income. How are they affected when income from personal services is introduced into the examples?

Traditional equity analysis offers, as further evidence that horizontal equity is violated by the tax exemption accorded to state and municipal bond interest, the case of *X*, a taxpayer who (like *A*, *B*, *C*, and *D*) is subject to a 70% marginal rate of tax and who

treats foregone taxes as tantamount to appropriations to the tax-favored function. See Surrey & McDaniel, *The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 B.C. INDUS. & COM. L. REV. 679, 703 (1976), for the argument that imputing a tax equal to foregone income (that is, the tax-induced reduction in pretax yields on tax-favored investments) is "not a useful analytic technique for the policymaker as part of the determination of effective tax rates," although the authors seemingly accept, *id.* at 704-05, the concept of foregone income to the extent that it buttresses their theory that tax expenditures are inefficient.

earns an additional \$1,000 of income from personal services and who is therefore left with an additional \$300 after taxes. When compared with *B* (\$1,000 of tax-exempt interest), therefore, *X* is a victim of horizontal inequity. But the efficiency theorist argues, I presume, that *X*'s skill, experience, and reputation are comparable to the \$10,000 of capital invested by *A* and *C* in taxable and tax-exempt bonds; that *X*, like them, takes \$300 home; and that *A*, *C*, and *X*, are, therefore, on a plane of horizontal equity.

For a counterpart to *B* (\$1,000 of tax-exempt interest), the efficiency theorist can conjure up *Y*, whose skill, experience, and reputation not only are comparable to the \$33,333 of financial capital invested by *B* and *D* but enable him to earn \$3,333 with the same time and effort that *X* must expend to earn \$1,000. Left with \$1,000 after tax, *Y* occupies the same status as *B* and *D*, with whom (the efficiency theorist argues) he is properly comparable.

The conclusions reached by the foregoing efficiency analysis are shown in Table 1.

Table 1. Effect of Tax Allowance on Taxpayers Subject to 70% Marginal Tax Rate, Assuming Equalized After-Tax Yields of Comparable Alternative Activities.

Taxpayer	Source of Income	Amount Invested	Pretax Yield	Tax	After-Tax Yield
<i>A</i>	Taxable interest	\$10,000	\$1,000	\$ 700	\$ 300
<i>B</i>	Tax-exempt interest	33,333	1,000	—	1,000
<i>C</i>	Tax-exempt interest	10,000	300	—	300
<i>D</i>	Taxable interest	33,333	3,333	2,333	1,000
<i>X</i>	Taxable wages	a	1,000	700	300
<i>Y</i>	Taxable wages	b	3,333	2,333	1,000

^aThe human capital of *X* is equivalent to \$10,000 of financial capital.
^bThe human capital of *Y* is equivalent to \$33,333 of financial capital.

Employing the same methods and standards of comparison, an efficiency theorist finds that the results set out in Table 1 are consistent with vertical, as well as horizontal, equity. For this purpose, assume four taxpayers—*A'*, *D'*, *X'*, and *Y'*—all of whom are subject to a 50% marginal tax rate, and all of whom realize additional income in the same amounts and from the same sources as their 70% counterparts, *A*, *D*, *X*, and *Y*. Their tax liabilities and after-tax incomes are set out in Table 2.

Table 2. Tax Liabilities and After-Tax Incomes of Taxpayers Subject to 50% Marginal Tax Rate

Taxpayer	Source of Income	Amount Invested	Pretax Yield	Tax	After-Tax Yield
<i>A'</i>	Taxable interest	\$10,000	\$1,000	\$ 500	\$ 500
<i>D'</i>	Taxable interest	33,333	3,333	1,667	1,666
<i>X'</i>	Taxable wages	a	1,000	500	500
<i>Y'</i>	Taxable wages	b	3,333	1,667	1,666

^aThe human capital of *X'* is equivalent to \$10,000 of financial capital.

^bThe human capital of *Y'* is equivalent to \$33,333 of financial capital.

When *A'* and *X'* (both having \$500 of after-tax yield from their pretax income of \$1,000) are compared with *A* and *X*, the two pairs are separated by the "proper" distance because the first pair is subject to a 50% tax rate and the second to a 70% rate. Because it is foolish for a taxpayer subject to a 50% marginal rate to invest in tax-exempt bonds paying only 3%, no realistic 50% analogues to *C* exist. But if *A*, *C*, and *X* are on a plane of horizontal equity, all three of them must also occupy a plane of vertical equity when compared with *A'* and *X'*. By a parity of reasoning, because *D'* and *Y'* are properly separated from *D* and *Y*, they are also properly distinguished from *B*.

Although efficiency analysis thus results in favorable judgments on both vertical and horizontal equity, conventional equity analysis results in entirely different verdicts:

1. Horizontal equity is violated because *B* has the same pretax income as *A* and *X* (\$1,000) and is subject in theory to the same marginal tax rate (70%), but pays no tax.
2. Vertical equity is violated because *A'*, *D'*, *X'*, and *Y'* pay taxes at the marginal rate of 50%, while *B* and *C*, who in theory are subject to a higher rate (70%), pay no taxes.

THE TRICKLE-UP PHENOMENON

A recent analysis of tax-exempt interest offers a trickle-up theory of the exclusion's impact.⁷ A brief examination of the relationship of this theory to equity and efficiency as normative standards is in order. Acknowledging that the benefit of the exclusion is competed away (and inures wholly to the borrowers) if

7. Ackerman & Ott, *An Analysis of the Revenue Effects of Proposed Substitutes for Tax Exemption of State and Local Bonds*, 23 NAT'L TAX J. 397 (1970).

all exempt bonds are purchased by investors subject to the highest marginal rate (currently 70%), trickle-up analysis points out that if bonds must be sold to taxpayers subject to a lower marginal rate (for example, 50%) in order to clear the market, the tax benefit will be competed away only for this group of investors. Thus, to compete with 10% industrial bonds and to attract these 50% taxpayers, the exempt securities must pay 5%. For these taxpayers, therefore, exempt bonds generate no lasting tax benefit; the net yield is 5% whether they buy taxable or exempt bonds. But for investors in the 70% bracket, exempt bonds offer a wind-fall profit of two percentage points above the after-tax yield of taxable bonds (that is, 5% tax-free versus 3% after-tax). Thus, the excess of the interest rate on exempt bonds (5%) over the after-tax yield on taxable bonds (3%) trickles up to these 70% taxpayers.

This phenomenon should arouse the wrath of both efficiency and equity theorists because the tax allowance causes both a misallocation of resources (by diverting funds from investments with a 10% economic yield to investments yielding only 5%) and vertical inequity (that is, the same yield of 5% tax-free to taxpayers whether their marginal tax rate is 50% or 70%). But efficiency theorists should find the resulting misallocation less objectionable than the misallocation that arises when the tax allowance is monopolized by taxpayers subject to a marginal tax rate of 70% because that stimulates borrowing for projects producing an economic yield of only 3%.⁸

The relationship of the trickle-up phenomenon to equity analysis is more complicated. Taxpayers at the 70% marginal rate who buy taxable bonds have only themselves to blame for the resulting disparity between their tax liabilities and those of their compatriots who invest in tax-exempt bonds. By contrast, taxpayers at the 50% level enjoy the same yield (5%) in the hypothetical case just described whether they buy taxable or tax-exempt

8. Equity theorists also offer an "efficiency" objection to tax allowances that trickle up, but it is totally different from the efficiency theorist's misallocation-of-resources criticism, discussed in the text. Equity theorists complain that the trickle-up phenomenon diverts to lenders some of the tax benefit intended by Congress for borrowers. From an allocation-of-resources point of view, however, this is a virtue, not a vice; the less the allowance is passed through to borrowers, the less they will be encouraged to indulge in uneconomic ventures.

bonds; hence, there is no horizontal disparity among these taxpayers.

Vertical inequity, however, is produced by the trickle-up phenomenon; taxpayers subject to a 70% marginal tax rate who invest in tax-exempt bonds get the same net yield (5%) as taxpayers subject to a 50% marginal tax rate who buy either taxable or exempt bonds.

A paradoxical aspect of the trickle-up phenomenon—disregarded by equity theorists, as far as I can recall—is that vertical inequity *increases* in proportion to the tax allowance's popularity with low-income taxpayers. If tax-exempt bonds are offered in such volume that they must be sold to taxpayers subject to a marginal tax rate of, for example, 30%, the resulting interest rate (7%) will result in a windfall of four percentage points to top-bracket taxpayers, in contrast to their two-point advantage when the market in tax-exempt bonds can be cleared by sales to taxpayers subject to a 50% marginal tax rate. For the rich, therefore, the best tax shelters are those that are patronized by the poor; on the other hand, the more exclusive the club, the less reason to join.

This conclusion is, of course, wholly contrary to the conventional equity assumption that the most inequitable tax allowances are those that are confined to top-bracket taxpayers.⁹ If the trickle-up theory is valid, an upside-down subsidy (that is, one that goes exclusively to taxpayers subject to the highest marginal tax rate) causes a misallocation of resources but no vertical inequity. From an equity point of view, therefore, converting an upside-down allowance into one that is right side up would create, rather than eliminate, vertical inequity!

DIGRESSION

If the reader will excuse a brief digression, I wish to make two observations that, though not strictly germane to the foregoing discussion, are a byproduct of it:

1. The assumption of the trickle-up phenomenon (that some tax-exempt bonds must be sold to middle-income taxpayers to clear the market) points up a deficiency in equity analysis that I wish to record here, without attempting to pursue it further. Horizontal inequity can arise only if some members of the equal-income class fail to take advantage of the allowance; if *everyone* in a given income class gravitated toward the allowance, they would

9. See, e.g., Galper & Zimmerman, *Preferential Taxation and Portfolio Choice: Some Empirical Evidence*, 30 NAT'L TAX J. 387 (1977).

all fit into the same boat, leaving no one for us to pity. But we do not have an adequate theory explaining the stubborn reluctance of numerous taxpayers in every income class to engage in tax-sheltered activities that, according to equity analysis, confer benefits at no cost. In particular, why is the appetite of top-bracket taxpayers for tax-exempt bonds satiated so quickly? Conversely, why do they buy *any* taxable bonds, if their aggregate income from all sources brings the top marginal rate into force?

My economist friends tell me that the purchase of both taxable and tax-free bonds by top-bracket investors reflects a desire to avoid risks by diversifying their portfolios. Because tax-free bonds offer a wide spectrum of risks, with a higher yield *at every risk level* than the after-tax yields on taxable bonds of equal quality, the diversification theory does not persuade me. I am skeptical also about another explanation; namely, differing judgments about risks. Because the yield on the *safest* tax-free bonds is greater than the after-tax yield on the *riskiest* investment-grade taxable bonds (conservative, middle-term, tax-free bonds currently yield almost 6%, while extremely risky taxable "junk bonds" yield less than 15%, or 4.5% after a 70% tax), only an extremely idiosyncratic judgment about risks could account for a preference for the latter over the former.

2. Section 265(2) of the Internal Revenue Code, which provides that interest on debt incurred to purchase tax-exempt securities cannot be deducted by the borrower, has been a sacred cow in the classroom (including mine) for many years, ranking high on the tax reformer's list of weapons against tax avoidance. If the trickle-up phenomenon is valid, however, equity theorists should call for the repeal of section 265(2). In its absence, top-bracket taxpayers would find it profitable to purchase tax-exempt securities so long as the yield was a shade above the net cost of the borrowed funds—3%, if we assume an interest rate of 10% and a marginal rate on the taxpayer's income from other sources of 70%. The resulting increased demand for exempt securities would force down the rate, thus reducing or eliminating the upward flow of tax benefits. If the demand were large enough, middle- and low-income taxpayers would be outbid, the market could be cleared—on the foregoing assumptions—with a 3% yield, and the entire benefit of the tax exemption would be captured by the issuers.

DOES THE CONFLICT MATTER?

If I am right that there is a fundamental conflict between old-style equity analysis and new-fashioned efficiency analysis, does the conflict matter? If both groups damn what they see and agree on the remedy (for example, a tax law based on the Haig-Simons definition of income), why be concerned if they prefer to reach their common destination by different roads?

In response, I argue that each group's zeal for tax reform would (and should) diminish, if not evaporate, if it concluded that the other group's reason for wanting reform was valid. If the inequity perceived by equity theorists in a given tax allowance is in fact converted wholly into a misallocation of resources, a single-minded equity theorist has no reason to favor its repeal unless he also objects to governmental interference with marketplace outcomes. Moreover, some equity theorists might well favor retention of a tax allowance if persuaded that it alters a particular marketplace outcome while producing little or no horizontal inequity. Conversely, a single-minded efficiency theorist has no reason to object on efficiency grounds to a tax allowance changing the distribution of horizontal tax burdens if the tax allowance does not alter economic behavior; and particular tax allowances might be favored by an efficiency theorist who welcomes the resulting change in the distribution of the burden and sees no adverse impact on resource allocations.

TERRA INCOGNITA

In the foregoing discussion, the examples use tax-exempt bond interest because its exclusion from gross income is one of the few tax allowances that has been examined extensively by both equity and efficiency theorists and especially because economists now seem to agree that a significant part of the tax allowance is competed away rather than retained by the taxpayer-lender. It is obvious that wholly different equity and efficiency conclusions would be reached with respect to tax allowances that do not affect taxpayer behavior. The \$1,000 annual tax exemption for blind taxpayers is an example; some economists may think that this allowance encourages some taxpayers to neglect their eyes and that it thereby induces a misallocation of resources (for example, increased dependence on seeing-eye dogs and other after-the-fact palliatives). However, most economists would more likely agree that the blindness exemption does not alter the pretax income of its beneficiaries. If this view is correct, the blindness exemption raises solely equity issues, untingered by any misallocation of resources.

But most tax allowances cannot be readily assigned to one end or the other of the behavioral spectrum. On reviewing the items listed in the Tax Expenditure Budget,¹⁰ for example, I am surprised at the paucity of reliable data about the extent to which the ostensible benefits of particular exclusions, deductions, credits, and other allowances remain with, or pass through, the taxpayers claiming the allowance.¹¹

I have focused here on only one aspect of the problem: the possibility that market forces transfer the economic benefit of a tax allowance from the taxpayer-claimant to others. But one must also consider the possibility that the benefit is impounded by the early birds and does not pass to later claimants; if a tax allowance is capitalized when first granted, any resulting inequity may be a transitional rather than a permanent phenomenon.¹² It should also be noted that tax allowances can acquire a self-destruct device from sources other than market forces. For example, if Congress takes into account the exclusion of social security benefits, military allowances, and other governmental payments from gross income in fixing the amount of these payments, their exemption creates horizontal and vertical inequities only by virtue of the trickle-up phenomenon described earlier.

We know so little that it is perhaps superfluous to mention another source of uncertainty: the difficulty in separating tax allowances from the structural features of a "normal" income tax. For example, if income taxation alters the pretax trade-off between work and leisure, are statutory provisions which reduce the tax on income from personal services (such as the 50% tax ceiling and the earned income credit) commendable features which mitigate a misallocation that is otherwise inherent in the tax itself, or are they sources of affirmative misallocations? The same questions can be asked from an equity point of view: If a "pure" in-

10. See CONGRESSIONAL BUDGET OFFICE, FIVE YEAR BUDGET PROJECTIONS: FISCAL YEARS 1978-82 (1977) (supplement on tax expenditures); OFFICE OF MANAGEMENT AND BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, SPECIAL ANALYSIS G, BUDGET OF THE UNITED STATES GOVERNMENT, 1980, at 183 (1979).

11. Despite the vast body of commentary on the tax shelter epidemic of the last decade, for example, there are no measures by tax economists of the influence of market forces. Was a Texas friend of mine right in saying that any gas or oil shelter that has to be marketed to Scarsdale orthodontists is a sure loser? If so, what does that imply about the ostensible tax benefits promised by the investment?

12. See Bittker, *Tax Shelters and Tax Capitalization, or Does the Early Bird Get a Free Lunch?*, 28 NAT'L TAX J. 416 (1975).

come tax is biased against labor, do these allowances correct, or create, an inequity?

CONCLUSION

It is hard to see how the normative standards favored by either equity or efficiency theorists can be applied with confidence to existing law while the behavioral consequences of most tax allowances remain *terra incognita*. Only when they are mapped will we be able to say with assurance whether particular tax allowances generate inequities, misallocations, or some of each. Until then, intuition and political preferences must be the basis for analysis because scholars, alas, can legitimately claim little more authority than the average citizen.