

## WAS IT LOST?: PERSONAL DEDUCTIONS UNDER TAX REFORM

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IT is my pleasure to be able to contribute to an issue of the SMU Law Review dedicated to Charles O. Galvin. Dean Galvin has had a long career of honorable service to the law, and more specifically, to tax law. He is associated with many ideas, prominently, the argument for a comprehensive tax base.<sup>1</sup>

A comprehensive tax base is very good idea. Extending the tax base lowers tax rates. Divide the given revenue by a narrow base and the rates are high; divide given revenue by a broader base and the rates are necessarily lower. Expanding the tax base also reduces tax avoidance opportunities. All taxes move money from the taxpayer to government, but tax systems cause excess burden to the taxpayer without benefit to the Treasury as taxpayers avoid the tax. Avoided taxes are loss-loss situations. Avoided taxes do harm because the taxpayers bear costs and damage to their desires in the avoidance, but avoided taxes give the Treasury none of the revenue it needs to pay the war debts, close the deficit, or whatever. The worst tax system is one with necessarily high rates on some activities and exemptions for close substitutes. Both in reducing rates and in reducing avoidance, a comprehensive tax base reduces the harm that a tax system does to the private economy.

The recent *Report of the President's Advisory Panel on Federal Tax Reform* gave lip service to broadening the tax base. The Executive Summary praised base-broadening quite well:

Tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers create complexity and instability, impose large compliance costs, and can lead to an inefficient use of resources. A rational system would favor a broad tax base, providing special treatment only where it can be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies higher taxes paid by all taxpayers.<sup>2</sup>

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1. Charles O. Galvin, *More on Boris Bittker and the Comprehensive Tax Base*, 81 HARV. L. REV. 1016 (1968).

2. PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM, xii (2005) [hereinafter ADVISORY PANEL REPORT]. Heidi Glenn, *Tax Reform: The Best and Worst of 2005*, 110 TAX NOTES 28 (2005) has a fine overview of the Advisory Panel's process.

Looking beyond the Executive Summary, however, the Advisory Panel's (the "Panel") actual proposals cannot fairly be described as comprehensive tax, even overall, because the report makes too many proposals that create or widen gaping holes in the tax base. The Panel, for example, made a number of proposals that would create or expand tax shelters, defined here as transactions with real tax rates of less than zero.<sup>3</sup>

For example, within what it calls a "Simplified Income Tax Plan,"<sup>4</sup> the Panel would create new, strongly negative tax rates for small businesses. Small businesses would be able to expense business investments, defer noncash income, exclude borrowing, and deduct interest.<sup>5</sup> That regime, in combination, means tax of considerably less than zero.<sup>6</sup> Subsidies of less than zero tax need to go into the federal budget to ensure that the costs get the scrutiny they deserve. This is not a simplification issue: if expenses are recorded at all, electronic accounting systems can do all the rest of the work. One should not use "small business" as an honorific title to hide the evils of terrible system of tax shelter subsidy. Small business income, sheltered by the proposal, is available for high-class, even frivolous, luxurious consumption, and high-class consumption is a wonderful thing to tax.

Similarly, leveraged investments in equipment, under the plan, would create generous tax shelters by combining very low effective tax rates on the equipment with interest deductions. Under one set of assumptions, the proposed depreciation would reduce real tax by ninety percent and then interest deductions would turn tax into strong shelter.<sup>7</sup> If we praise the free market for its pricing system that allocates capital efficiently, we must, therefore, condemn this depreciation system. Shelters make investments that are nonsense in the free untaxed market into investments that will go forward solely because of the tax they destroy. The issue in depreciation policy is not a matter of simplicity; a smaller number in the per-

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3. Calvin H. Johnson, *What's a Tax Shelter?*, 68 TAX NOTES 879, 879 (1995), argued for a first definition of "tax shelter" as an investment that would do worse if tax were repealed, because the transaction saves taxes under the tax law in place.

4. ADVISORY PANEL REPORT, *supra* note 2, at 95.

5. *Id.* The proposal would not allow expensing of land and buildings, which however most small businesses rent anyway. *Id.*

6. Calvin Johnson, *Destroying Tax Base: The Proposed INDOPCO Capitalization Regulations*, 99 TAX NOTES 1381 (2003), is critical of expanded opportunities to expense intangibles. Calvin Johnson, *Tax Shelter Gain: The Mismatch of Debt and Supply Side Depreciation*, 61 TEX. L. REV. 1013, 1013-14 (1983), shows that an immediate deduction of investments is inconsistent with our tax treatment of borrowing or leverage. Expensing of investments combined with interest deductions will turn a 35% nominal tax rate into a system that shelters outside income, wiping out 35%, that is, a negative 35%.

7. The ADVISORY PANEL REPORT would allow an annual 30% deduction for the adjusted basis of all assets used in agriculture, mining, manufacturing, trade, and service. ADVISORY PANEL REPORT, *supra* note 2, at 132. Depreciation that is 30% of adjusted basis reduces the real tax burden or effective tax rate from 35% to 3.5% for a fifteen year asset. Leveraged purchases bear a negative 31.5% effective tax rate. Calculations, on file with the SMU Law Review, are in accord with logic of Calvin H. Johnson, *Depreciation Policy During Carnival: The New 50 Percent Bonus Depreciation*, 100 TAX NOTES 713, 714 (2003) (praising the free market pricing system and condemning equipment shelters built upon generous depreciation).

cent of basis allowed for annual depreciation under the plan would have fixed the problem. Subsidies of less than zero tax need to go into the federal budget to be subjected to strict, even nasty scrutiny that we use for real costs. One should not use the wonderful goal of “simplicity” as an honorific to hide awful tax shelters.

The Panel also decided to continue a loophole available under current law for gifts of appreciated inventory to charity.<sup>8</sup> Deduction of the appreciation on inventory is an accounting error: it shelters from tax moneys the donor has kept for selfish purposes. The money given to charity is adequately described by deducting basis only. The extra shelter benefit is contingent on giving, but it is difficult to see why there is any special merit to an appreciation or to the things that get the extra tax shelter beyond a neutral description of what was given up. A *tax reform* proposal would have removed the loophole.<sup>9</sup>

The tax base is assaulted day-by-day, and hour-by-hour by teams of highly motivated, even vicious tax planners and by eager-to-please legislators. The public’s interest in a sound comprehensive tax base is under-defended. Indeed, the common good and public interest in a sound tax base almost always loses out to the assaults on the tax base for the benefit of a well-organized few. The problems of collective action imply that the public always loses. The tax base needs a zealous defense, a better defense than the Panel report gives it. This Panel was too fond of loopholes to have done its duty.

Others have noted that the report makes inappropriate assumptions about what is the baseline of current law, and therefore, would increase the harmful deficit and shift the burden of tax downward from richer to poorer.<sup>10</sup> To draw legitimacy from the democracy, proposals need to be clear and transparent. On the issues of fostering shelters, on too high deficits, and on shifting the tax burden downward, the Advisory Panel Report is opaque, even sneaky.

That said, the Advisory Panel makes a number of interesting proposals related to personal or itemized deductions, which are the focus of this note. The Panel would end any personal deduction for state and local taxes, it would convert the itemized deduction for home mortgage interest into a limited fifteen percent tax credit, and it would leave charitable deductions alone.<sup>11</sup> The problems of distinguishing a true loss, properly deducted, from amounts that are not lost, are common to all three areas, but it is not clear that the solutions the Panel proposes are consistent and principled.

The Tax Advisory Panel report is politicians’ work, with compromises and trade-offs too early in the process. It is not an academic plan. Secre-

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8. ADVISORY PANEL REPORT, *supra* note 2, at 77.

9. *Id.* at 77.

10. Leonard E. Burman & William G. Gale, *A Preliminary Evaluation of the Tax Reform Panel’s Report*, 109 TAX NOTES 1349, 1349-50 (2005).

11. ADVISORY PANEL REPORT, *supra* note 2, at 61, 75.

tary of Treasury John Snow reacted to the report by saying that “[y]ou have to always think about the Congress and the interest groups and how the legislative process will respond to the tax proposals.”<sup>12</sup> “[Having] academic tax proposals that are dead on arrival doesn’t really advance the cause of tax reform.”<sup>13</sup> What is missing from the Tax Advisory Panel is academic work, that is, the consistent application of principle. As Dean Galvin said, “[the] suggestion of ad hoc settlements will get us nowhere. We have had a surfeit of patchwork and piecemeal efforts; a normative concept must be sought from which we can move on to subsidiary considerations.”<sup>14</sup> This note tries to be a principled discussion of the problems of personal or itemized deductions raised by the Advisory Panel Report.

Both an income tax and a consumption tax need to tax the consumption or standard of living of a taxpayer. Income is consumption plus or minus investment value.<sup>15</sup> Consumption tax ignores the investment element, but has all the problems of an income tax in computing the consumption element. For a majority of people, taxation of investments do not substantially matter because they have no substantial savings. The Tax Advisory Panel proposed two alternatives: one basically an income tax plan, with some subtractions from and additions to current law, and the other basically a consumption tax plan, but with a fifteen percent tax on capital income.<sup>16</sup> As to personal deductions, the Panel suggestions are identical in both plans.<sup>17</sup> Almost a generation ago, William Andrews insisted that we must look at our income tax as consisting of a consumption element and an investment element.<sup>18</sup> This note adopts Andrews’s binoculars and indeed this note is plausibly just a footnote to his lovely piece.

### I. WAS IT LOST?

This note defends the norm that proper tax deductions represent a loss to the taxpayer for which the taxpayer gets no benefit in return. Losses need to be deducted even in a progressive tax because a loss diminishes the standard of living or ability to pay of the taxpayer. To the extent the taxpayer gets a benefit in return, however, the expenditure is not lost and is not properly deducted. Sometimes it is ambiguous as to whether the taxpayer has a loss, but without resolving all questions of what is a loss, it is fair to be critical of deductions of expenditures that are not lost. Delivery of subsidies by way of deductions has an inappropriate, even repre-

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12. Robert J. Wells, *Is Snow Giving Tax Reform Panel Report the Cold Shoulder?*, 109 TAX NOTES 989, 989 (2005).

13. *Id.*

14. Galvin, *supra* note 1, at 1019.

15. HENRY C. SIMONS, *PERSONAL INCOME TAX: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* 50 (1938).

16. ADVISORY PANEL REPORT, *supra* note 2, at xiii-xiv. The income tax proposal was called the Simplified Income Tax Plan and the consumption tax proposal was called the Growth and Investment Tax Plan, but both plans depart from the ideal. *Id.*

17. *Id.* at xvii.

18. William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 309 (1972).

hensible pattern. If we mean to subsidize or encourage an expenditure that is not a loss, a deduction, or exclusion from a progressive tax system is not the way to do it. The principle that lost expenditures, but only lost items, need to be deducted has surprising strength across the entire tax system.

An ideal tax system would define the taxpayer's consumption or standard of living and adjust the tax called for to the standard of living. Subsistence consumption needs to be exempted from tax and high-class consumption is a wonderful thing to tax. Compare two fictitious taxpayers, a poor one, the Little Match Girl, and a rich one, Uncle Scrouge McDuck. Take a dollar away from the Little Match Girl and she will freeze to death.<sup>19</sup> As a citizen's budget expands above the freeze-to-death point, however, ever more dollars of a larger budget can be spent for ever less desperate needs. Tier upon tier, as money is available for the ever less desperate needs, a larger proportion of the higher tier of money is appropriately available to help carry the given tax burden.<sup>20</sup> For Uncle Scrouge McDuck, the richest man in the universe, a single dollar is not a matter of life and death. Uncle Scrouge is equal to the Little Match Girl in both a democracy and in the sight of God. But Uncle Scrouge has \$50 billion over which to spread his total utility and the Little Match Girl has only her one dollar. For the Match Girl, her last dollar has infinite value, and for Uncle Scrouge, the value of a dollar, one over \$50 billion, approaches zero. We might just send out troops to collect tax dollars from whatever source they could find. The Continental Army came close to doing that in the darkest days of the Revolutionary War.<sup>21</sup> But taking an extra dollar of necessary revenue from Uncle Scrouge rather than the Match girl reduces the damage that taxes do to human needs and wants. Judging that the Match Girl gets more value from a dollar than Uncle Scrouge indeed requires a much-dreaded, interpersonal comparison, but the issue is not close.

In adjusting tax to reach high-class consumption, it is important to make the tax unavoidable. Avoidable taxes do more harm than good because they induce costs in the avoiding, but generate no revenue in the avoiding. Optimal tax theory implies taxes should have a maximum tax rate of 20%-30% if workers' response to extra tax is high and climb to 50%-60% if we assume that taxpayer response is inelastic.<sup>22</sup> Tax systems

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19. HANS CHRISTIAN ANDERSEN, *THE LITTLE MATCH GIRL* (Houghton Mifflin 1968) (1848).

20. The idea that an increasing proportion of income can be taxed, tier upon tier, as income grows, originated with a 1966 Canadian Commission on Tax Reform. See, e.g., Walter J. Blum, *Progressive Taxation Reconsidered—North of the Border*, 45 *TAXES* 718 (1967), for one praise.

21. E. WAYNE CARP, *TO STARVE THE ARMY AT PLEASURE: CONTINENTAL ARMY ADMINISTRATION AND AMERICAN POLITICAL CULTURE 1777-98* (1984) (describing seizures of supplies, softened by a probably worthless promissory note).

22. Nicholas Stern, *On the Specification of Models of Optimum Income Taxation*, 6 *J. OF PUB. ECON.* 123, 161 (1976). The seminal work is James Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, *REV. OF ECON. STUD.*, 175, 175 (1971).

have to be comprehensive to make taxpayer response less elastic. Taxes sometimes reduce incentives, but sometimes taxes drive taxpayers to work harder and save more to meet their targets. Whatever motivates Uncle Scrouge, in any event, it cannot be the real value of an extra dollar he earns because, in truth, Uncle Scrouge has trouble getting much extra utility from the last dollar he received on top of the \$50 billion pile he already had.

Some personal or itemized deductions are consistent with a broad-based, progressive tax. Income is roughly synonymous with business profits, that is, business revenue or receipts, less business expenses. But profit from business or investment does not always contribute to a taxpayer's standard of living. Some deductions are justified to take account of losses that reduce the taxpayer's consumable amount or standard of living below the taxpayer's business profit.

Take a theft loss, for instance. Suppose a taxpayer cashes his October paycheck for \$3,000 and on the way home, he is held up and robbed of the full \$3,000. Robbery losses off the job site have no connection with business. The victim's profit or income from work is his salary, no matter what happens to it afterwards. Salary turned into cash is income in any system. The robbery was not an expense for profit or in business and it was not a cause of greater income. Still, in determining the taxpayer's standard of living, the theft victim has a standard of living or consumable amount for the year that make him like a taxpayer with only eleven months of paychecks. He is not like the taxpayers who got the benefit of twelve monthly paychecks because he got no benefit nor even potential to use the October paycheck.

For a taxpayer in a 34% tax bracket, a deduction for the \$3,000 October check would be worth \$1,020 and for a taxpayer in the 10% bracket the deduction would be worth only \$300. In a progressive tax system, however, the tax rate is determined by the taxpayer's standard of living. The lost October paycheck need to be deducted or excluded from income to get down to the eleven months worth of paychecks to figure out what was left, even for a rich person. At the very least, a rich man who has had all his wealth stolen is not a rich man any more. Even for non-gigantic losses—and one month or 8.3% of salary is not “gigantic,”—taxing our taxpayer as if he consumed twelve paychecks, rather than the eleven, overstates his standard of living.

Under current law, theft loss deductions are subject to thresholds or floors that limit the deduction of theft losses to large losses: a theft loss is ignored if it is less than \$100.<sup>23</sup> Theft and other loss deductions are allowed only to the extent that aggregate losses exceed 10% of the taxpayer's adjusted gross income.<sup>24</sup> Even the excess over 10% adjusted gross income is taken into account only if the taxpayer does not take the

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23. I.R.C. § 165(h)(1) (West 2002).

24. *Id.* § 165(h)(2).

standard deduction.<sup>25</sup> The floors simplify the tax law because the taxpayer does not need to keep records and the IRS does not need to audit. *De minimis* or immaterial losses that do not *noticeably* affect the standard of living can be stripped from the tax calculations because they do not make much difference. Routine small losses are part of the breaks of life and they are arguably covered by personal exemptions. The thresholds, taking away theft loss deductions, are probably too high, however, even under the simplicity and *de minimis* rationales. The taxpayer who had his October paycheck stolen would be under the radar and would get no tax recognition for the loss. Still, the deductions for theft losses are proper losses to determine the taxpayer's standard of living or ability to pay tax.

Amounts that are not lost, by contrast, need to be made nondeductible. When a taxpayer pays for goods and services, the benefits received in return prevent the expenditure from being a loss. Thus, a taxpayer who uses his income for meat and potatoes can not deduct the cost, even though he has lost his cash. The meat and potatoes that come back for the expenditure make the expenditure a non-loss. We disallow the deduction for the cost of meat and potatoes, indeed, in order to tax and reduce the consumption of meat and potatoes. Money used for consumption is taxed so as to suppress private consumption and free resources for public use.<sup>26</sup>

We also respect consumer sovereignty enough to say that amounts paid in a voluntary exchange are not a loss. Lutfisk, gefelte fish, anchovies, and gold fish are all acquired tastes. One man's fish feast is another man's gagging. But the consumer would not buy the fish unless it was worth at least what he paid for it, and most purchases give at least some extra value above the cost. The initial purchase decision will have to do to determine that the purchase was not a loss.

Allowing a deduction for some consumption within a general world in which consumption is taxed inevitably causes deadweight losses. Taxpayers shift from taxed to untaxed forms of consumption and keep consuming with untaxed money when they do not get a dollar's worth of value out of a dollar spent. Suppose a taxpayer had a choice between using a \$100 salary for some nondeductible consumption and \$100 in tax free consumption. Given that salary is taxable, and consumption ordinarily is taxed, a taxpayer in a 34% tax bracket can get on \$66 after tax (Table 1, column (A)). Meals consumed while away from home on business are deductible,<sup>27</sup> however, and that means a taxpayer may consume the meal with untaxed money. Before any reaction to the situation, the taxpayer gets \$100 from the untaxed meal (Table 1, column (B)).

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25. *Id.* § 151(c). The standard deduction is now at \$5,100 per taxpayer with the I.R.C. §151(c) inflation adjustments. Rev. Proc. 2005-70, 2005-47 I.R.B. 979.

26. Andrews, *supra* note 18, at 314-15 (stating that income tax should be viewed as tax on use of the money, with the intent to tax and reduce private consumption, so as to free resources for public use).

27. I.R.C. § 162(a)(2) (allowing deduction of reasonable meals and lodging while away from home on business).

Table 1: After tax benefit from \$100		
	Taxable cash	Tax exempt meal
Benefit received	\$100	\$100
Tax at 34%	(\$34)	—
After tax benefit	\$66	\$100

Table 1 is not in equilibrium. At the next opportunity, and by fits and jumps, the taxpayer will shift his \$100 amounts from column (A) to column (B) to take advantage of the exemption. It is possible that the taxpayer may shift too far: Some fancy \$100 meals have low worth or are a burden to the diner. But in equilibrium, the taxpayer will move \$100 amounts from taxable consumption cash to meals away from home until the meal gives only a bit over \$66 value that the taxpayer got from the case:

Table 2: \$100 meal drops to equilibrium		
	Taxable cash	Tax exempt meal
Benefit received	\$100	\$66+
Tax at 34%	(\$34)	—
After tax benefit	\$66	\$66+

Table 2 is privately rational for the taxpayer. The taxpayer got a hair more value out of the meal than he would from the cash compensation after tax. But Table 2 is terrible for the nation at large because the difference between the \$100 cost in column (B) and the value the taxpayer got in equilibrium was a dead weight loss. It is as if the waiter came to the table and said he had to spill or evaporate just under \$34 worth of wine. Sometimes the deadweight loss represents tax planning costs the taxpayer is willing to bear. Whether by loss in utility or tax planning, the deadweight loss is inevitable when taxed and nontaxable consumption are available in competition with each other. Plus when taxpayers use column (B), the government does not collect its \$34 tax on the \$100 devoted to consumption and must go to some other presumably inferior source. Taxing the \$100 cost in column (B) will end the problem. The taxpayer would then have to insist that every dollar gave a dollar's worth of benefit, just as a taxpayer insists that every dollar of after tax salary in column (A) gives a dollar's worth.

The amount involved is significant: if it could improve the value of everything from sixty-six cents on the dollar to a dollar of value overnight, then the real gross national product of the country would improve overnight. One should presume that all deductions or exclusions that do not represent losses will generate similar deadweight losses, as inevitably as water runs downhill.



The norm that losses alone are allowed as deductions works in the calculation of business income as well. The paradigm is the inventory method of accounting. Under the inventory method of accounting, the taxpayer counts inventory at the end of the tax year. Everything sold and all mysterious disappearances are deducted because the taxpayer has lost it. But the inventory still in taxpayer's possession by the count creates basis, not deductions.<sup>28</sup>

Similarly, in the language of generally accepted accounting principles ("GAAP"), business expenses are allowed only when they expire.<sup>29</sup> Costs that contribute to future income are not lost, and they are treated as assets or "basis" carried over to future years to be matched with and deducted against future income.<sup>30</sup> Finally, in a world without tax shelters, depreciation deductions measure loss in the investment value of the asset. Everything not lost should remain as adjusted basis.<sup>31</sup>

To accept the norm that losses alone are properly deducted does not settle all tax questions because it does not identify what is a loss. One of the big unsettled questions is whether medical expenditures are losses.<sup>32</sup> Current law allows a deduction for "extraordinary" medical costs, defining "extraordinary" as costs above a threshold of 7.5% of adjusted gross income.<sup>33</sup> Smaller expenditures are just ordinary living expenses covered, if at all, only by the zero tax or low tax bracket amounts.<sup>34</sup> One might view a medical expense as like a repair. The repair cost is an ac-

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28. See *Thor Power Tool Co. v. Comm'r*, 439 US 522, 535-36 (1979) (disallowing deduction of closing inventory in failure of showing that value was lower than cost).

29. PAUL GRADY, *INVENTORY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES—ACCOUNTING RESEARCH STUDY NO. 7* 45 (1965); Robert R. Sterling, *Elements of Pure Accounting Theory*, 24 *ACCT. REV.*, 62, 62 (1967).

30. See, e.g., *NCNB v. United States*, 651 F. 2d 942, 948-49 (4th Cir. 1981) (panel decision), *rev'd en banc*, 684 F.2d 285 (4th Cir. 1981) (panel decision applies theory of accounting matching to capitalize bank expansion costs).

31. The seminal piece is Paul A. Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 *J. POL. ECON.* 604, 604-05 (1964). See also Calvin H. Johnson, *Tax Shelter Gain: The Mismatch of Debt and Supply Side Depreciation*, *supra* note 6, at 1019-20; Alvin Warren, *Accelerated Capital Recovery, Debt, and Tax Arbitrage*, 38 *TAX LAW* 549, 549 (1985). Investments that cannot be sold nonetheless have an internal or investment value measured by the discounted present value of future cash flows from the investment.

32. Compare Andrews, *supra* note 18, at 333 (taking the position that medical deductions were reasonably allowed) with Mark Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an Ideal Income Tax and Why They Fit Worse in a Far from Ideal World*, 31 *STAN. L. REV.* 831, 834, 882 (1979) (arguing that preclusive use of resources has to be understood as consumption) and JOSEPH M. DODGE, *THE LOGIC OF TAX—FEDERAL INCOME TAX THEORY & POLICY* 290 (1989) (arguing that "the medical expense deduction, even if it might be sound on fairness (ability-to-pay) grounds, [but it] is a tax expenditure insofar as it diverts economic resources into the health-care industry and away from the preventative-care and other industries competing for the consumer dollars").

33. I.R.C. § 213(a) (West 2006).

34. For example, in 2006 for married couples filing jointly, two \$3,300 personal exemptions and a \$10,300 standard deduction mean that \$16,900 of income has no tax on it. For the same couple, 10% tax-rate tax brackets extend to \$15,100 and the 15% tax bracket extends to \$61,300 so that a total of \$68,300 of income is taxed at a 15% tax rate or under. Rev. Proc. 2005-70, 2005-47 I.R.B. 979 (issuing inflation adjusted levels for tax brackets, standard deductions, and personal exemptions for 2006).

ceptable measure of a casualty loss.<sup>35</sup> How much a taxpayer pays to fix a casualty is not a bad measure of how much he thought he lost. A medical expense, similarly, might be viewed as proof of loss to one's body, and deductible under the principle that losses to standard of living are deductible.

A medical cost, however, also reflects a bargained-for payment for goods and services used exclusively by the buyer. The amount of medical costs undertaken by taxpayers seems to be highly responsive to the tax benefits that are available.<sup>36</sup> That implies that medical expenses are highly discretionary payments. In 1990, Congress took away a deduction for elective cosmetic surgery, reflecting the judgment that discretionary payments were like payments for food and clothing, even if the payment goes to doctors and hospitals.<sup>37</sup> Under the "is-it-loss?" norm, the question of whether medical expenses are losses would settle whether or not medical expenses *should* be deducted.

Ambiguities as to whether costs are lost or still valuable shows up in charitable donations and state and local taxes as well, as discussed below.

## II. TAX ADVISORY PROPOSALS ON PERSONAL DEDUCTIONS.

The Panel proposed take away itemized deductions for state and local taxes.<sup>38</sup> The Panel left the charitable deduction alone, leaving in place some current-law errors that it should have proposed to fixed.<sup>39</sup> It also proposed to turn the current-law deduction for interest on home mortgage into a 15% tax credit, limited also by the interest on a mortgage for an average house in the area.<sup>40</sup>

### A. STATE AND LOCAL TAXES

The Panel recommended ending the itemized deduction for state and local taxes on the grounds that the deduction "provides a federal tax subsidy for public services provided by state and local governments."<sup>41</sup> "Subsidy," as a conclusionary word, requires the assumption that state and local taxes are non-losses because they buy services, just like expenditures for food and clothing:

Taxpayers who claim the state and local tax deduction pay for these services with tax-free dollars. These services, which are determined through the political process, represent a substantial personal benefit

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35. Treas. Reg. § 1.165-7(a)(2)(ii) (1977).

36. Miguel Gouveia & Robert Strauss, *Income Taxes and Medical Expenses*, NAT'L TAX ASS'N PROCEEDINGS 232 (2004), available at [http://www.andrew.cmu.edu/user/rs9f/nta\\_2004.pdf](http://www.andrew.cmu.edu/user/rs9f/nta_2004.pdf).

37. S. FIN. COMM. REP. ON PUB. L. NO. 101-508, 104 Stat. 1388 (Omnibus Budget Reconciliation Act of 1990), at 189.

38. ADVISORY PANEL REPORT, *supra* note 2, at 83.

39. *Id.* at 75.

40. *Id.* at 73.

41. *Id.* at 83.

to the state or local residents who receive them—either by delivering the service directly or by supporting a better quality of life in their community. The Panel concluded that these expenditures should be treated like any other nondeductible personal expense, such as food or clothing, and that the cost of those services should be borne by those who want them—not by every taxpayer in the country.<sup>42</sup>

Sometimes the assumption that the taxpayer is getting a personal benefit for the state and local taxes seems fully justified, but sometimes the taxes are redistributive and the benefits go to someone else.

The connection between tax and benefit is sometimes quite strong. In 1978, Congress disallowed the deduction of state gasoline taxes, unless the gasoline was a necessary business or profit-making expense.<sup>43</sup> “Congress believes,” the Staff of the Joint Committee on Taxation explained,

“that State-local gasoline taxes essentially constitute charges for the use of highways . . . . Therefore, these taxes are more like personal expenses for automobile travel (as are highway tolls or the cost of gasoline itself) . . . . To allow deduction of the gasoline tax is inconsistent with the user-charge nature of the tax, in that deductibility serves to shift part of the cost from the highway user to the general taxpayer.”<sup>44</sup>

Gasoline taxes collect the tax needed to pay for roads more efficiently than do toll booths, which stop traffic, and can be avoided. Pleasure trips are personal consumption, which we can tax by disallowing the deduction of the costs of the trip, including the gas and gas tax. The gas tax is not strictly proportional to road use. For instance, a gas guzzler car will not go as far and might not be any harder on a road than a fuel efficient vehicle. But the connection between road use and gas use is strong enough to treat gas tax as a cost of use of the roads. Gas tax and gas used to generate business profit remained deductible after 1978 as ordinary business expenses, which are lost to gain the profit.<sup>45</sup> In the discussion that follows, it is assumed that costs of benefits devoted to making profit would continue to be deducted even if we consider that the tax should in general be made nondeductible.

The connection between tax and benefit is not always so tight as it is for gas taxes. Taxes to pay for schools, for instance, are usually part of local property taxes, but they do not vary according to use of the schools. A neighbor with six school-age children gets more value from schools than a childless couple in the identical-value house next door. There is a transfer of value from the childless to the many-child family, and a strict accounting for benefit would give the childless couple a loss and the many-child family a gain. Police and fire departments might be viewed as protecting property, proportional to its value, so that property taxes do

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42. *Id.*

43. Revenue Act of 1978, Pub. L. No. 95-600, § 111, 92 Stat. 2763, 2777.

44. STAFF OF THE J. COMM. ON TAXATION, 95TH CONG., GENERAL EXPLANATION OF THE REVENUE ACT OF 1978 56 (Comm. Print 1979).

45. I.R.C. § 162 (West 2006).

match the benefit to the payment for the services. Police protection might be viewed as primarily benefiting people, however, in which case a tax that measured benefit would be a head tax, equaling the number of persons protected.

State and local taxes are also sometimes reasonably treated as non-losses, even if the government services paid for by the taxes go to someone else, because the taxpayer was willing to pay them. Assume, for example, a visitor passing through a distant city sees and buys an expensive boat to haul back home, and pays \$24,000 in local sales taxes (at six percent) to the city in which he found the boat. The retail taxes, we might assume, go to pay for municipal services of the city the boat was purchased in, and the boat buyer was there for too short a time to get any appreciable value for his taxes. Nonetheless, the taxpayer was willing to pay for the boat, including the extraordinary sales taxes, and consumer sovereignty implies that the taxpayer got a boat at least worth what the buyer paid for it. The taxpayer might not have gotten local-government services, but he got a boat for what he gave. The boat buyer did not lose any of the price, including tax, or he would have walked away from the purchase.

Local property taxes can also quite reasonably be viewed as voluntary payments, and hence, non-losses, even if we think that there is a shift in benefit to other residents of the town. Charles Tiebout argued that citizens move to a town that gives them the best ratio of desirable benefits to tax costs.<sup>46</sup> Citizens vote with their feet by moving into the suburb that provides them the kind of services and level of taxes they prefer and away from places where the taxes exceed the value of the services.<sup>47</sup> There is product differentiation among townships.<sup>48</sup> People with children tend to look for good schools, but people without children tend to look instead for easy commutes or access to good entertainment and recreation.<sup>49</sup>

Local taxes within the Tiebout model look more like theater tickets than involuntary losses. Movie theaters can exclude, and by being able to exclude, they can also charge for admission. Suburbs, like movie theaters, can exclude by seizing property to pay taxes. Those who enter and stay do so voluntarily. Under the Tiebout model, the ability of suburbs to sort themselves out by services, and exclude those who do not pay means that they can, like private market suppliers, reach a level of government services that meets the real demand.

There is some room under a Tiebout model to provide too few services or too much tax because moving is not cost free. The difference between tax and lower benefits can not exceed the costs of moving or people would move out. Indeed, to convince people to undertake the costs of

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46. Charles Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 418 (1956).

47. *Id.* at 481.

48. *Id.* at 420.

49. *Id.*

moving in, the township has to provide services that exceed the taxes by more than the cost of moving. For someone who is going to have to move into one township or the other at equal costs, the cost of moving drops out of the balance of the calculations.

A local government can also be viewed as a club for the joint consumption of services and it can collect dues from the members in part by throwing out the people who do not pay and seizing their property.<sup>50</sup> Thus, a childless couple who settles in a town with high school taxes joins the club voluntarily. Towns with good schools may attract good people the childless couple likes to be around. There was something about the club that made them want to belong. They might try to limit the dues the club requires by voting against all school bonds and school taxes. But as long as they stay, they are getting value of some sort for their costs of the house, which include the school taxes. Assume that a bird watcher joins a motorcycle gang and is willing to pay its dues. We might think that bird watchers would not get much from a motorcycle club, but if they stay and pay the dues, then who is to say what they got? Under the Tiebout model, all taxes of the town or city in which the taxpayer lives can be treated as nonlosses.

Redistributional taxes seem properly treated as losses and some taxes are properly viewed as necessary expenses for business income. Assume, for example, a New Jersey resident who commutes to New York City to work as an investment banker. Assume that New York imposes a \$101,000 tax on the commuter's large salary in New York. The commuter uses the sidewalks of New York and benefits from police and fire protection, but he does not use public hospitals, the New York college system, subways, elementary schools, or public welfare. The sidewalk is old, the bank has its own security guards, so let us assume arbitrarily that the value of *all* the services the commuter gets from New York is \$1,000 per year. The rest, or \$100,000 of his taxes were redistributional, that is, the benefit of the tax payments went to New York residents and were lost to the commuter.

For the commuter, the \$100,000 portion of the taxes not offset by benefits is a reduction in his standard of living. He did not get to vote to decide the taxes and he would have opposed them. From his perspective, New York has stolen from Peter to pay Paul, and he is Peter. He might not even like Paul. From his perspective, all he needs to get a just deduction for his losses is a small extension of the theft loss allowance to cover this form of legalized theft.

For the commuter, the \$100,000 New York tax is also plausibly just a business expense. Assume the banker is all business in New York and all personal at home in New Jersey. He has to commute into Wall Street to make his fabulous salary. The taxes he pays to New Jersey might be viewed as paying for services that enhance or support his standard of liv-

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50. The metaphor of the local government as a club is from James Buchanan, *An Economic Theory of Clubs*, 32 *ECONOMETRICA* 1 (1965).

ing, but the costs across the Hudson River support his office and business world. The banker helps support the security guards at his bank at least indirectly, but that is a business cost. The costs for the New York police and firemen look much like the deductible costs for the bank security guard. Expenses to make a salary are incurred for the purpose of making a profit and they are ordinarily deductible.<sup>51</sup>

Tiebout-model taxes are never redistributive. No one joins or stays in a club or movie house that is going to take your dues and return no benefits in return. Townships competing for residents by giving services worth their taxes probably end up with citizens with a fairly uniform economic status because a competitive township cannot use money from one citizen to pay for another. The tastes within a township will tend toward homogeneous because you can not pay for benefits that are useless for citizens and still compete for their residency. Some taxes, however, are business or redistributive taxes and they do not fit the Tiebout model.

From the base of the norm that losses to standard of living should be deducted, the failure to allow the \$100,000 commuter tax as a deduction yields a penalty. If the deduction is not allowed, the federal government has added a hefty penalty to the commuter's tax by taxing non-existent standard of living. It is not that the deduction is a subsidy, but rather that the absence of the deduction is a penalty. Federal taxes on amounts used to pay the \$100,000 commuter tax are moreover not deductible, which means that the penalty must be grossed up to include the federal tax. If we assume the commuter is in a 34% tax bracket, then the commuter must derive income of  $\$100,000/(1-34\%)$  or \$152,000 in order to pay 34% federal tax and be able to pay the New York tax of \$100,000. For taxpayers in a lesser federal tax bracket, the gross up is less of a penalty. Still, why should the penalty imposed on the New York tax be dependent on the tax bracket of the commuter?

There is a literature that says that redistributive taxes work best if they are imposed by the largest jurisdiction, the federal government, rather than the state or local government.<sup>52</sup> The rationale is that taxes should be unavoidable and taxes imposed in small jurisdictions can be avoided too easily by moving out of them. Perhaps, thus, we can ignore the redistributive element of taxes small jurisdictions because we can

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51. I.R.C. § 162(a)(1) (West 2006).

52. Edward M. Gramlich, *The Economics of Fiscal Federalism and Its Reform*, in *THE CHANGING FACE OF FISCAL FEDERALISM* 152 (Thomas R. Swartz & John E. Peck eds., 1990) (explaining taxes with a high redistribution content from rich to poor should be imposed over a large jurisdiction from which emigration or immigration are costly: "If not the rich can leave to where ever they are not so heavily taxed."); George J. Stigler, *The Tenable Range of Functions of Local Governments*, in *PANELISTS APPEARING BEFORE THE SUB-COMM. ON FISCAL POLICY, J. ECON. COMM., 85TH CONG., FEDERAL EXPENDITURE POLICY FOR ECONOMIC GROWTH AND STABILITY* 213, 217 (Comm. Print 1957), *reprinted in THE ECONOMICS OF FISCAL FEDERALISM AND LOCAL FINANCE* 8 (Wallace E. Oates ed., 1998) (given the mobility of the rich and the mobility of the poor, redistribution is intrinsically a national policy).

presume that citizens, voting with their feet, destroy any redistributive taxes.

Even if the federal tax system is a better place for redistributive taxes than states, it does not follow that the federal government should impose such an extraordinary 52% penalty on nonfederal redistributive taxes. There can be very large variations in the taste for redistribution between regions of the country and very large variations in the ability to enforce redistribution. Blue states might well look more favorably on redistribution than red states. If the states are supposed to be the laboratories of the democracy, then the difference should be allowed without penalties.

We might be able to distinguish (deductible) redistributive taxes from taxes that are not lost with sufficient reliability to build it into the tax system. Under the logic of the Tiebout model, all local taxes would be nondeductible. All sales taxes and all taxes hidden in the sales price would be nondeductible. Whether the tax is separately stated or hidden, the purchaser was willing to pay the tax because of the value the goods purchased. Property taxes contingent on ownership of property are best considered to be a cost of ownership of the property.

By contrast, income taxes paid by commuters who live in a different jurisdiction from the place the tax is collected would be deductible, either because the benefits go to others or because the taxes support the taxpayer in his business or money-making capacity rather than in his consumption or standard of living capacity. When the jurisdiction imposing the tax is large and diverse, we can no longer be sure that voting with one's feet is preventing any redistribution because the costs of moving out are so high. If a citizen accepts redistributive taxes in order to make more profit, then the taxes seem to be business expenses.

## B. CHARITABLE DONATIONS

### 1. *Is it a Loss?*

Current law allows deductions for donations to charities.<sup>53</sup> Many charitable donations satisfy the is-it-lost norm because the donor has lost the payment and there is some other beneficiary who is the more plausible candidate for tax. A gift in relief of poverty, for example, diminishes the standard of living of the donor and increases the standard of living of the recipient. When Good King Wenceslas sees the poor man gathering winter fuel and gives him aid, the standard of living of the good king has been reduced and the pain of the poor man has been alleviated. If Good King Wenceslas is in a top bracket, and the poor man has only subsistence income, the poor man's tax status is the appropriate determiner of tax rate. It was the poor man who consumed the aid, presumably for desperate needs. Good King Wenceslas received satisfaction for sure. Still, tax should follow the cash where it can, and between King Wenceslas and the poor man, the poor man is the better candidate for tax because he got the

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53. See generally I.R.C. § 170.

cash.<sup>54</sup> Taxing them *both* on what is essentially but one “harvest” from some source and one consumer of the food seems like double tax on the same income or same consumption. We can treat the good king’s satisfaction as free and nontaxable, much like a beautiful day and good friendships. Current law allows a charitable deduction for relief of poverty, although it does impose controls and records by requiring that the gift go through an organization that has qualified as exclusively dedicated to charity.<sup>55</sup> Gifts not through a qualified charity are treated as just a taxpayer’s normal decision as to how to use his money and they are not treated as losses.

It would not be unreasonable to allow all cash gifts, charitable or not, to be deducted by the donor household and included in the income of the donee household. The cash is part of the standard of living of the donee household and no longer part of the standard of living of the donor. Alimony payments are appropriately taxed by allowing a deduction to the payer and including the receipts income.<sup>56</sup> The recipient is the taxpayer who consumes that alimony.<sup>57</sup> So long as the gift is in cash, there is no valuation problem that might lead us to think that the donee had the gift imposed on him and got less than full value from the gift. Non-charitable gifts are not now deductible and *that* is sometimes a reasonable model. We might presume cynically, from the tenets of self-serving economics, that gifts outside of one’s genetic heirs always entail an expectation of something in return. It is not always easy to distinguish altruistic gifts from circumstances in which reciprocal benefits mean there was no loss. Still, if deductions for non-reciprocal non-charitable gifts or alimony are plausible, then some deductions for charitable gifts do not need heroic assumptions to be justified.

For gifts for the diffuse benefit to the public, for instance, a gift to cure TB, Ebola, or HIV infection, it is reasonable to treat the donor as having lost the award, even if we are unwilling to tax the beneficiaries. We do not generally tax the public that benefits from advancements in health and science, whether the advancement was funded by public or private sources or a mixture of both. The nontaxation of diffused benefits is reasonable enough to remain true even if the source of the advancements got a tax deduction for money lost. So long as the donor receives in return for his donation nothing more tangible than the advancement of health and science that all get, there does not seem to any be need to reduce the amount of the donor’s tax-recognized loss.

We appropriately reduce the charitable deduction by the value of goods and services received in return because the benefits received negate the loss. Thus, donor incentives—a CD or toke bag and the like—

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54. Andrews, *supra* note 18, at 347-51 (making essentially the same argument as this section).

55. I.R.C. § 170(c).

56. I.R.C. §§ 71, 215.

57. *See id.*



appropriately reduce the deduction,<sup>58</sup> just as, for instance, insurance recoveries reduce the loss due to medical costs or casualties.<sup>59</sup> A bid at an auction in which the proceeds go to charity generates some deduction only *if*, and to the extent, the bid exceeds the value of the good bought.<sup>60</sup> No matter how strong the theory is that goods and services in return reduce the loss, there are recurring problems of goods and services provided by charities because taxpayers are always pushing at the border to get their consumption deducted.

Goods and services provided as a quid pro quo for a donation make the payment not a donation, at least in theory, even if the taxpayer is buying meritorious things. Thus in *Hernandez v. Commissioner*, the Supreme Court denied the taxpayer a charitable deduction for payments for services of a Scientology practitioner.<sup>61</sup> Scientology requires that all services be paid for following a prescribed price list.<sup>62</sup> The Scientology services were given one-on-one to the taxpayer who paid for them so that there were no other possible candidates as beneficiaries of the services.<sup>63</sup> Scientology was conclusively categorized as a religion, for the purposes of *Hernandez* litigation, but the religious nature of the services made no difference.<sup>64</sup> The bargain exchange is sufficient proof that that the payment was not a loss and not deductible.<sup>65</sup>

One should not second-guess consumer sovereignty even about highly intangible returns. I have never understood what people got out of tarot card or palm readings; the benefits are highly intangible. But then, music is a matter of taste too. As one wag put it, “Wagner’s music is better than it sounds.”<sup>66</sup> Consistent with *Hernandez*, if I pay a preacher to baptize my child, the payment to the preacher is for intangible religious benefits, but they are not deductible. A family that hires a chaplain to say mass for the family alone has no loss for the salary paid because there is no beneficiary outside the household. The IRS, under Commissioner Fred Goldberg, entered into a closing agreement with the Scientologists allowing them to deduct 80% of the costs the auditing and training costs, but that “policy must be invalidated on the ground that it violates either the Internal Revenue Code or the Establishment Clause” and was incon-

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58. See, e.g., Rev. Rul. 67-246, 1967-2 C.B. 104 for a number of examples of consideration reducing and eliminating the deduction.

59. Treas. Reg. § 1.164-1(d)(2) (1977) (disallowing a deduction where there is claim for reimbursement at year with a reasonable prospect of recovery).

60. See, e.g., *United States v. Am. Bar Endowment*, 477 U.S. 105, 119 (1986) (holding that members buying insurance from the ABA failed to prove that the premium they paid exceeded the value of the insurance coverage).

61. 490 U.S. 680, 692-93 (1989). The IRS had previously ruled that pew fees were merely means by which to make contributions to the church and were deductible. Rev. Rul. 70-47, 1970-1 C.B. 49.

62. *Hernandez*, 490 U.S. at 684-85.

63. *Id.*

64. *Id.* at 692-93.

65. *Id.*

66. Bill Nye (1850-1896), *quoted in* FRANK MUIR, AN IRREVERENT AND THOROUGHLY INCOMPLETE SOCIAL HISTORY OF ALMOST EVERYTHING 41 (1976).

sistent with *Hernandez*.<sup>67</sup> In 1993 Congress required a charity to acknowledge substantial goods and services provided in return by a charity, but excluded “intangible religious benefits.”<sup>68</sup> But the acknowledgement rule was not intended to change underlying law as to what was deductible.<sup>69</sup>

Payments into the collection plate are apparently distinguished from *Hernandez* under current practices. The frontier nonestablishment Protestant denominations welcomed everyone under the tent, so the service was available to all without payment. The preacher was paid by passing the collection plate and, at least in theory, contributions into the plate were voluntary. Payments into the collection plate are, thus, considered a loss without quid pro quo. One might protest that passing the hat works just as well to pay for the services as a ticket, pew rent, or other explicit one-to-one payment arrangement, but if the service is available for nothing, then the donation into the plate is considered a loss to the payor. We do not work very hard to identify how much social pressure or norms turn a free service into one that really must be paid for, and we let a nominally free service mean that the amount put into the plate is a deductible loss.<sup>70</sup>

The rationale for a charitable deduction has to be the non-loss theory because subsidies, unrelated to the definition of standard of living, cannot reasonably be delivered by deductions. Deductions have different values depending upon the tax bracket of the religious participant, and it would be a violation of something sacred to give greater subsidy to a rich person's religion than to a poor person's religion. Assume, for instance, that each of the following taxpayers is a member of a separate Protestant denomination and each pays \$100 to the minister for a service, baptism, or a funeral. Assume that each of the four taxpayers properly deducts the \$100 against income in a different bracket under a tax system in effect, and so receives a reimbursement or subsidy from the government by reduction of tax. Table 3 follows the pretax cost, the subsidy (column (3)) and the after tax cost.

The distribution of subsidy among the denominations according to tax bracket of the donor is not fair. If the subsidy were delivered by a budgeted government check, would we really give Episcopalians over three times the subsidy given to a Baptist? Are not the store front Evangelicals worthy of at least as much subsidy as Presbyterians get? As a matter of theology, it is the widow's mite that is supposed to be the most valuable, and, by the Bible, it is thus the contribution of the poorest that should get

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67. *Sklar v. Comm'r*, 282 F.3d 610, 614 (9th Cir. 2002).

68. Revenue Reconciliation Act of 1993, Pub. Law No. 103-66, § 13172(b), 107 Stat. 312, 455 (enacting I.R.C. § 170(f)(8)(B)).

69. *Conference Committee Report on Revenue Reconciliation Act, Title XIII, Chapter 1, section 13172*, at n.17 (1993).

70. Mark Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1434-43 (1988) has an excellent nuanced discussion of the problems and arguments for deduction of payments for the religious service.

	(1) Bracket	(2) Gift	(3) Tax savings/ reimbursement	(4) After tax cost
Episcopalian	34%	\$100	\$34	\$66
Presbyterian	28%	\$100	\$28	\$72
Baptist	10%	\$100	\$10	\$90
Store Front Evangelical	0	\$100	0	\$100

the most reward.<sup>71</sup> Delivery of subsidy by tax deduction got the subsidy pattern wrong. Even God does not want His subsidies delivered by this pattern.

The *Advisory Panel Report* recommended that that the tax benefits for charitable deductions “be structured as a deduction to provide *incremental incentives to higher-income donors, an important source of charitable donations.*”<sup>72</sup> “Incentives” in the passage is another word for subsidy, and not a synonym for loss. Why do higher-income donors need more incentive subsidies per dollar of gift? Are they nastier, less generous by nature so that they need more reward to give up a dollar? Or are they God’s chosen people in the eyes of the Panel? Why do lower bracket people count less or not all? Under the value judgment of the *Advisory Panel Report*, it is the high income of the donor and not the amount of the gift that justifies the larger incentive for the smaller gifts. Indeed under a deduction system for delivery of the subsidy, the higher bracket donor can get more incentive for doing considerably less good. Thus if our Episcopalian donor in Table 3 gave \$30 to charity, the incentive at 34% of \$30 would be \$10.20, which is more incentive than the Baptist got for giving \$100 to charity.

The decision to support charity by deductions is in contrast with the Panel’s decisions on the home mortgage interest deduction, which would convert the deduction into a 15% tax credit, equally valuable per dollar of payment.<sup>73</sup> One might, for instance, use a tax credit to deliver subsidy to charities, collect all the amounts the government gave up in Table 3, column (3), and use the same money to give a subsidy of an 18% credit to each of the four donors.<sup>74</sup> Indeed one might increase the level of subsidy, as the Panel recommended for housing, with a credit of 20% of each gift.

71. “And Jesus sat over against the treasury, and beheld how the people cast money into the treasury: and many that were rich cast in much. And there came a certain poor widow, and she threw in two mites, which make a farthing. And he called unto him his disciples, and saith unto them, Verily I say unto you, That this poor widow hath cast more in, than all they which have cast into the treasury. For all they did cast in of their abundance; but she of her want did cast in all that she had, even all her living.” *Mark* 12: 41-44 (King James).

72. *ADVISORY PANEL REPORT*, *supra* note 2, at 75 (emphasis added).

73. *Id.*

74. The sum of the tax reimbursements/savings in column (3) of Table (1) is \$34 + \$28 + \$10 or \$72 and \$72/(4\*\$100) is 18%.

Thus, the Panel recommendation is not about the level of support for charity, but structuring the support so as to target rich people's charities more than those of say Methodists or Baptists.

Indeed, the *Advisory Panel Report* decided that the benefits shared by the community by reason of payment of state and local taxes required that it disallow the deduction of state and local tax.<sup>75</sup> The benefits shared by a congregation in a religious service seem at least as significant relative to payment as those shared by a taxed community. That payments into the plate are voluntary, and indeed might mean that each congregant perceived his or herself as getting something special out of the service; a state or local taxpayer has to pay the taxes involuntarily even when he or she thinks there is no value in return. There may well be cross subsidies from within a single congregation because people put different amounts in the collection plate, but there are cross subsidies in the benefits of the spending of local-tax dollars as well; a dollar for dollar connection of tax paid to government benefit is rare in tax once one moves beyond a gas tax.

The Panel's Executive Summary states that it equates the delivery of tax benefits with on-budget government spending: "[W]hether the government spends more or extends a special tax break, the effect is the same: everyone else must pay higher taxes to raise the revenue necessary to run the government."<sup>76</sup> Under that claim, the distribution of money represented by Table 3 is the distribution that the Panel would choose for budgeted government payments. My judgment is that the policy would not put up with a program of government spending that followed the pattern of column (3) of Table 3, and that the Panel itself was not thinking of the distribution of column (3) as real money—or at least the program's distribution is not a program the Baptists and Evangelicals could support. And yet, for charitable donations that represent real losses, with no benefits in return, a deduction is perfectly reasonable.

## 2. *Deduction of Unrealized Appreciation*

One form of incentive for charity is never justifiable under the is-it-lost rationale, and without a justification by the loss rationale, the pattern of distribution of the incentive under a progressive tax structure condemns the deduction. As a matter of accounting logic, the tax deduction for a loss needs to be limited to amounts previously or simultaneously included in income. A combination of exclusion and deduction is a double accounting, not unlike counting dollar expenses twice, and it shelters from tax dollars that the taxpayer can consume and has not in fact lost.

For example, assume a cash-method lawyer properly bills two clients for \$40,000 each, but collects from only one. There can be no deduction for the \$40,000 excluded amount that the lawyer did not receive, no mat-

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75. ADVISORY PANEL REPORT, *supra* note 2, at 75.

76. *Id.* at iv.

ter how offensive the client has been by not paying. The taxpayer has a standard of living of \$40,000 from her practice. One can reach that result only by allowing no deduction for the \$40,000 nonpayment. If we go beyond excluding the nonreceipt and also give the lawyer a \$40,000 loss deduction for the unpaid bill, then the lawyer has cash and consumption of \$40,000 from the client who paid, but no net income. It is an accounting mistake to allow both an exclusion of the unpaid bill and a deduction for it. Current law fixes the problem by allowing a deduction for only basis, and a cash method lawyer has no basis in unreceived client bills.<sup>77</sup> But it is a very common fallacy, an accounting mistake, that the lawyer should get a deduction when the client does not pay.

Similarly, a taxpayer cannot take a deduction for services given to charity. If a taxpayer gives \$40,000 worth of work to charity, the full and complete accounting remedy is to not tax the taxpayer on salaries he does not have. If we *both* exclude the \$40,000 worth of charitable work and allow a deduction for \$40,000, the taxpayer will have \$40,000 worth of cash in hand that can be consumed for selfish and greedy purposes, and the accounting error of deduction of amounts that are already excluded would exempt the greedy consumption from tax. This is not a valuation issue, but a prior accounting-logic issue that says that double counting should not be allowed. She has the \$40,000 worth of cash salary from noncharitable clients and we must tax it, notwithstanding her charitable work. Current law cures the problem by providing that the value of services is not deductible no matter how truly proved up and how valuable the services are.<sup>78</sup>

Giving blood follows the same principle: we do not tax blood you give to charity, but that is sufficient remedy and there is no deduction of the blood either. Allowing a deduction for blood donation would not be to allow a deduction for losses, but rather a deduction for money the donor has kept and consumed and it would misdescribe the donor's standard of living. The exclusion for unpaid work and donated blood is alone sufficient. The issue is not a question of how much the blood is worth—although sleazy overstatements can compound the error. It is that the proper level of deduction for blood donations is zero, so that the true valuation issue is easy.

Subsidizing an activity by deductions that are artificial because they are not losses gives a benefit that depends upon the bracket of the taxpayer. Exempting greedy consumption from tax is useless to a taxpayer too poor to pay tax, but it gives value up to 34% of the consumption for taxpayers in a 34% tax bracket. High income blood is not any more valuable for the medical system than low income blood, even considering the breeding in the high income blood. If the government wants to encourage blood

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77. I.R.C. § 165(b) (West 2006); 1 BORIS BITTER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 25.6, 25; 30 (2d ed. 1989).

78. 26 C.F.R. § 1.170A-1(g) (2005); *Etheridge v. Comm'r*, 36 T.C.M. (CCH) 724 (1977).

donations or other like altruistic activity, it should be done on budget as government spending because only in that manner is the money understood to be real.

Current law allows a deduction of unrealized appreciation on property given to a public charity.<sup>79</sup> The deduction arose and survives from the mistake of not understanding that neutral accounting would allow a deduction only of the basis of property given. In 1920, the predecessor to the IRS ruled that the "amount" of the charitable deduction was basis, and then three years later decided, without any change in the underlying statute, that "amount" referred to value.<sup>80</sup> The "amount" of the deduction if the same property was destroyed was adjusted basis.<sup>81</sup> As an accounting matter, the amount to close the books when the property disappears is only basis. Deduction of value arose as a mistake or, more cynically, because proponents think that the people will make the mistake so that they can fool the people. The Panel would continue the deduction of unrealized appreciation to the extent it is allowed under current law.<sup>82</sup> The Panel worries about overvaluation of property given to charity, but it does not suggest anything effective to use against overvaluation.<sup>83</sup>

The deduction of unrealized appreciation is unprincipled. If I make inventory with a cost of \$40,000 that appreciates to \$80,000, the proper deduction to describe the consumption that I have left is \$40,000, the cost basis of after-tax salary put into making the inventory. The deduction of the unrealized appreciation is like the deduction of a \$40,000 unpaid receivable by a cash method lawyer, that is, a deduction of amounts that have never been included in income. It shelters from tax not amounts the donor has lost, but rather money that the donor has kept within his standard of living.

When the appreciation is capital gain, a taxpayer does have the planning possibility of selling to take advantage of the capital gain rates and then giving the proceeds, succeeding in getting a deduction from ordinary income. Allowing an ordinary deduction for dollars received as capital gain is overly generous to the donor. A dollar in and out of the taxpayer's hands mismatches fifteen tax on the receipt and a thirty-four tax savings on the giving up, for a net savings of nineteen cents less tax for every dollar he has kept for personal consumption. The right answer is no tax savings on the in and out of the dollar because capital gain, is

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79. I.R.C. § (e)(3)-(6).

80. L.O. 979, 2 C.B. 148 (1920) (allowing only adjusted basis allowed as deduction for charitable contribution of property); L.O. 1118, II-2 C.B. 148 (1923) (amount of a charitable deduction is fair market value).

81. Revenue Act of 1918, Pub. L. No. 65-124 § 202(a), 40 Stat. 1057, 1060.

82. ADVISORY PANEL REPORT, *supra*, note 2, at 77.

83. The Panel says that valuation will be tightened and then allows taxpayer to elect to sell property and give the sale proceeds to charity, without paying capital gain tax on the gain. *Id.* Taxpayers who want to cheat on valuation or at least push it as high as they can get away with will of course not use the option to sell and contribute the proceeds, because buyers of the property, having to give real money and not just appraisal opinions, are too stingy and will restrict their payment to real value. *Id.*

supposed to unlock capital for better uses, and not justify lower tax on consumption. Creating an effective remedy for the mismatch, however, seems impossible: a partial remedy is to disallow the charitable deduction to the extent of capital gain. The taxpayer would then only have to realize the capital gain in one year and the charitable deduction in another. Going beyond the year might well put together a gain and a gift that had no known relationship to each other. Allowing both capital gain and an ordinary deduction to an accounting error, but the remedies will probably have to be partial ones. Still, it would aid the administration of the law if the taxpayer really had to sell the capital gain property to get the loophole of capital gain and ordinary loss. At least the value of the deduction would depend upon the real value a buyer is willing to pay, rather than self-reported estimates of sale value. Thus it makes sense simply to allow only basis to be deducted for a charitable gift, just as basis alone is deducted if the property is lost to theft or casualty.

There is also an abuse or loophole in the current law, by which donations of inventory generate sheltering deductions because part of the gain built into the inventory is excluded, but is also deducted.<sup>84</sup> The Panel decided to retain the current-law rules for donations of noncash property because they provide “added incentive.”<sup>85</sup> This decision is a violation of the “is-it-lost” rules. The level of the added incentive depends on tax bracket and size of the appreciation, and not on the charitable need minimizing the government’s tax expenditure losses. A deduction in excess of cost is a deduction not for amounts the taxpayer has given away but a sheltering deduction for amounts the taxpayer has kept. The issue here is not the level of incentive but the opaqueness of the gimmick. Transparent subsidies given on budget are fair disclosure to the democracy, and shelter for the amounts retained are opaque and unfair because they have insufficient disclosure. The democracy can give incentives as budgeted government spending because it understands the costs as real money. Section 170(e)(3), (e)(4) and (e)(5) of the Code do not have fair disclosure of the costs. The Panel’s decision to keep the current rules is best explained by a love of opaque gimmicks. The decision gives insufficient loyalty to the integrity of the tax base. This Panel was far too fond of loopholes to have done its job right.

### C. HOME MORTGAGE

One of the best, but most controversial, proposals in the Panel report is its suggestion to replace the deduction of home mortgage interest with a tax credit of 15% of mortgage interest, cut off for interest exceeding that on the average-price house in the area.<sup>86</sup> The proposed disallowance is

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84. I.R.C. §170(e)(3) (gifts for relief of property or for use in the charity’s purpose or function); I.R.C. § 170(e)(4) (gifts of scientific research property); *id.* § (6) (gift of computers to schools and libraries).

85. ADVISORY PANEL REPORT, *supra* note 2, at 77.

86. *Id.* at 73.

apparently dead politically—President Bush has promised that no one should worry about continuation of the deduction of home mortgage.<sup>87</sup> Even before his announcement the disallowance attracted political lightning.<sup>88</sup> There would be considerably more winners than losers under the Panel's proposals—two thirds of taxpayers do not itemize and can get no value out of the current deduction—but in our democracy, majority is not a very good predictor of outcome. Still, any responsible tax reform effort is going to have to be unkind to owner-occupied housing because it is undertaxed.

The Panel identified the deductibility of interest on a home mortgage as a tax preference and questioned whether housing should enjoy such a disproportionately favorable treatment under the Tax Code.<sup>89</sup> The Report argued that the tax on housing investments is close to zero compared to a tax rate of approximately 22% on business investment, meaning that capital, that moves from business to houses and business investments, that would improve worker productivity, etc., are lost<sup>90</sup> Simulations suggest that either taxing imputed rents or disallowing mortgage interest deductions translates into substantial welfare gains in the long run.<sup>91</sup>

Under current law, we do not tax homes, but rather we have a negative tax or subsidy with a value that can reach as high as 52% of the pre-tax price of a home. We should probably increase the effective tax rate on homes radically so as to reach at least the zero tax level. Giving subsidy to homes should be accomplished by government spending, on budget and subject to strict, mean scrutiny, because on-budget government spending is understood to be real money. Subjected to scrutiny, the subsidy given to homes would surely be better focused to accomplish the goal sought, the goal would be better articulated, and the subsidy would undoubtedly be smaller.

Negative tax on homes arises because the tax accounting for homes separates the costs and benefits of a home, ignores the benefits, and allows most of the costs to be deducted from ordinary income. A house gives both room to live in and a speculative investment. The right to live in the house is ordinarily the most valuable benefit. The right to live in a house is why it is not self-destructive to take capital from productive investments and buy a house, even if the house is depreciating. Buying a

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87. Nancy Oganavich, *Bush Vows Not to Repeal Tax Deduction for Mortgage Interest*, BNA DAILY TAX REPORT, Feb. 21, 2006, at G-5.

88. Wesley Elmore & Heidi Glenn, *White House Mum on Tax Reform Timetable*, 109 TAX NOTES 1388, 1389 (2005) (former chairman of House and Ways Committee arguing that “[y]ou have no organized activist force that is out there politically pushing to make it happen but an awful lot of people who are saying ‘wait a minute, this is going to hurt tremendously.’”); Heidi Glenn, *Frenzel Criticizes Sunshine Law Governing Tax Panel*, 109 TAX NOTES 1127, 1127 (2005) (Panel member saying that disclosure of proposals ignited realtors and the mortgage bankers, so that “[w]e may have killed that part of the report already.”).

89. ADVISORY PANEL REPORT, *supra* note 2, at 71.

90. *Id.*

91. Martin Gervais, *Housing Taxation and Capital Accumulation*, 49 J. MONETARY ECON. 1461, 1461 (2002).



house erases the cost of monthly rent. Buying a house is not a loss because of the returning benefit, the right to live there. Return to a cost means the cost is not a loss. The return from living in a house is, however, invisible to the tax system.

The gain from the speculative investment in houses, moreover, benefits from a whole series of tax advantage. Houses by nature depreciate over time, but land and location will get more valuable if more people want to move in. Current tax law gives substantial favors to the growth in value of a home. In computing taxable gain on a house, home sellers are entitled to use the full unadjusted basis for the house and lot together, even for that part of the house that has been consumed by depreciation.<sup>92</sup> We give couples a half-million dollar exemption for gain as often as every two years.<sup>93</sup> We forgive all gain from houses at death of the owner.<sup>94</sup> Whatever little remaining gain shows up on the tax return is taxed at most at 15% of gain.<sup>95</sup>

Asymmetrically, most of the costs of a house are deducted from ordinary income. The two biggest costs of a house are interest on the mortgage and property taxes incurred only by reason of ownership of the house. Both are deductible from ordinary income.<sup>96</sup> If the revenue from the benefits of a house were subject to ordinary income, then the costs of the house should be deductible. But expenses are a sponge that derive their character from what they are paid to achieve, and since we exempt the benefits sought from the house, almost entirely, we should symmetrically disallow the costs of the house. The cost of a house is not a loss, within the norm that losses only need be deducted to calculate consumption or standard of living, because of the benefits that come in return.

Disallowing the deduction of the interest and property taxes on a home can often be viewed as a fair proxy to tax the returns that the homeowner gets from owning the house. We can fairly presume that the benefits from a house exceed its costs, in absence of tax, or no one would buy the house. The costs are a pro-taxpayer measure of the benefit because disallowing a deduction for the costs will not reach all of the benefits: Some houses are owned with equity and bear only modest property taxes. Home owners get some surplus out of a home that they do not have to pay for. Houses appreciate unexpectedly in value. Still, the benefits that disallowance of costs does reach are appropriately taxed and exempting

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92. See Richard A. Epstein, *Consumption and Loss of Personal Property Under the Internal Revenue Code* 23 STAN. L. REV. 454, 458 (1971) (arguing that basis in personal assets needs to be reduced as the owner consumes the asset, even though the depreciation is not deductible).

93. Single taxpayers or couples filing separately are entitled to *only* \$250,000 exclusion every two years. I.R.C. § 121 (West 2006).

94. *Id.* § 1014.

95. *Id.* § 1(h)(1)(C) (15% rate for capital gain); *id.* § 1221 (capital asset defined).

96. *Id.* § 163(h)(3) (interest on \$1 million purchase mortgage and another \$100,000 of second mortgage are deductible); *id.* § 164(a)(1) (state and local property taxes).

the benefits subsidizes houses.<sup>97</sup>

Given that benefits exceed cost, the interest and property taxes would allow us a conservative measure of the size of the untaxed benefits and the magnitude of the tax subsidy. If we assume interest cost at 5% of value and property taxes at 2% of value, the homeowner exempts benefits worth 7% of the value of the house per year and also deducts costs of 7% per year. The value of the deduction-exemption depends upon the tax rate. Tax rates rise to 34% for individuals,<sup>98</sup> so the value of the deduction and exemption can be as high as 34% of the deduction-exemption.

The annual tax benefits can be translated into a fraction of the purchase price, however, without regard to the current mortgage rates, because the value of all property is nothing but the value of benefits from it. A tax deduction or exemption for the income from the house can thus be translated into a capitalized net present value of the negative tax subsidy, which will approximate the tax rate times the purchase price of the home. Deduction-exemption of the benefit per year thus translates into an upfront subsidy that is worth as much as 34% of the purchase price of the house.

The capitalized or upfront value will depend upon the tax bracket of the buyers. In high-tax bracket neighborhoods, the value of the subsidy approaches 34% of the value of the house. In more middle class neighborhoods, the subsidy is determined by lower tax brackets, that is, 28% or 31% of the value of the house. Moreover, the tax deductions for interest and property taxes are not available for those who do not itemize and two-thirds of taxpayers use the standard deduction instead.<sup>99</sup>

In-so-far as sellers can capture the tax benefits, the tax treatment of houses creates a kind of economic apartheid separating neighborhoods into tiers by tax bracket. Every seller of a house knows the buyer can exempt benefits and deduct costs. Sellers try to raise prices to capture the tax benefits. In high bracket neighborhoods, sellers try to inflate prices by  $1/(1-34\%)$  or 152% of the price in absence of tax, because they know their buyer will get subsidy from the government of 34% of the price they agree to pay. The inflated, 152% price works because it is a

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97. There is an equity concern in taxing use of a house by disallowing deduction of interest and property taxes in that some taxpayers avoid the costs by buying with equity and or by living in jurisdictions that collect their taxes in other ways. In my judgment, the equity concern does not require us to undertake the difficult job of imputing taxable income from the mere use of the house. I find no appeal in the argument that we cannot disallow interest and property taxes because some home owners do not have those costs. If we had a general equitable principle that no one can pay tax if some taxpayer avoids them, by means fair or foul, then the necessary conclusion is that we can not tax anyone. The consequence disproves the premise. For a longer discussion of the argument see Calvin H. Johnson, *Is an Interest Deduction Inevitable?*, 6 VA. TAX REV. 123, 148-151 (1986).

98. I.R.C. § 1.

99. ADVISORY PANEL REPORT, *supra* note 2, at 26 (only 34% of taxpayers itemized in 2003).

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provided subsidy of 34% of 152%, which reduces the after subsidy cash to just 100% of the pretax price.

In more modest neighborhoods, buyers are in a 31% bracket, which will justify inflation of the price to  $1/(1-.31)$  or 145% of pretax value. Or buyers are in 28% brackets, which will justify inflation to  $1/(1-.28)$  or 139% of pretax value. A 15% tax bracket will justify inflation to  $1/(1-.15)$  or 118% of pretax value, except that itemization is rare in 15% brackets and for taxpayers who do not itemize or who are too poor to pay tax, there is no negative tax and no subsidy.

A home buyer can beat seller's capture of the tax benefits or capitalization if he or she is in a bracket that is higher than the bracket assumed by sellers in capitalizing the tax benefits. A homebuyer in a 34% tax bracket who moves in among neighbors who are in 28% brackets can be expected to get more value from the deduction of interest and property tax than he loses in paying an inflated price. Sellers can not price discriminate to jack up the price for a 34% buyer who gets the stronger subsidy.

For a home buyer in a lower bracket than that assumed by the sellers of the neighborhood, however, capitalization leaves the buyer worse off than if homes were taxed neutrally. A taxpayer in a 15% bracket who could bear a 118% price inflation will find that in the high bracket neighborhoods the inflation of price caused by the tax subsidy is more than that. For a standard deduction taxpayer who is trying to buy into a neighborhood of itemizers, the mortgage and property tax deductions are all bad news, increasing the entry barriers to buying a first house, without generating any personal benefit. The overall lesson imparted by the actual tax treatment of homes is that you can make money by slumming among neighbors who are less rich than you, but the tax law will punish uppity people who try to move in among their tax-bracket betters.

It is difficult to see what is so special about upper-tax bracket housing that the government should inflate its price to 152% of pretax value. That is a pretty intense subsidy. The government will not inflate middle class housing, defined as that for two-thirds of taxpayers, at all. The inflated price represents real resources diverted from other investments and into houses. Houses do not increase productivity in the way that money spent on research and inventions would. Houses may generate some external benefits to immediate neighbors, but the primary benefit of a house is captured selfishly by the owner who lives in it. Houses are essentially a self-serving use of capital. If subsidy were taken away and the price of houses dropped to a mere 100% of the value of the house in absence of tax, the resources from that lost 52% of value would flow to other uses, where they would undoubtedly be more productive.

If the seller cannot capture the tax benefits by inflating prices, then the subsidy acts as a windfall that buyers do not pass on. In other areas, tax

benefits are not captured or passed on very well.<sup>100</sup> If the tax benefits are kept by home buyers in the highest bracket, then they keep the tax benefits equal to 52% of the value of their homes. For \$660,000 or above house, that would be like a government check for government check for \$340,000. There are also windfall gains for 31% bracket and 28% bracket buyers, but none for the two thirds of taxpayers who are nonitemizers. Buyers who keep the capital grant of up to 52% of the value of their homes are undoubtedly grateful for the windfall and they will be a powerful political force when they are crossed. Still, it is difficult to see what the justification is. If they gave up their grants from the negative tax, we could reduce tax rates elsewhere.

Undoubtedly the total value of the negative tax on homes is shared between buyers and sellers of homes, but the subsidy does not seem justified, no matter what proportion goes to buyers or to sellers.

The Panel's proposal would disallow deduction of home mortgage interest and property taxes on homes.<sup>101</sup> In its place, the panel would allow a tax credit of 15% of home mortgage interest, with a cap determined by the interest on a mortgage to buy an average house in the area.<sup>102</sup> The credit would apply only to primary residences, not second homes, and there would be no credit for second mortgages, that is, using a house as collateral to borrow for other uses.<sup>103</sup> The two-thirds of taxpayers who do not itemize would get the 15% credit, and they get nothing but higher housing prices and higher barriers to overcome out of current law. Two-thirds of taxpayers should be enough people in a real democracy to win the votes necessary for the new credit, although taxpayers do not like to pick on other taxpayers, and organized groups always beat the public, so that a mere two-thirds majority is probably not enough political support to adopt the proposal.

Shifting from a deduction to a tax credit is an improvement for a housing subsidy. There is no reason to conclude, thinking afresh, that a high-bracket neighborhood needs and deserves more government subsidy than lower bracket neighborhoods, and no reason to think that punishing uppityness makes sense. Indeed, Americans generally like social ambition. Perhaps the American people as a whole did not realize they were creating such price barriers to social climbers.

The Panel could have improved the proposal by taking the next step and recommending that the 15% tax credit be replaced with government on-budget spending. Apparently, we judge money critically only when the money is part of big-government on-budget spending. Our judgment of tax reductions, even credits, is too lax. Voting representatives probably consider the tax system to be a treasure trove they can give out for re-

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100. Calvin H. Johnson, *A Thermometer for the Tax System: The Overall Health of the Tax System as Measured by Implicit Tax*, 56 SMU L. REV. 13, 13-14 (2003) (estimating that market captures only at under 10% tax rates).

101. ADVISORY PANEL REPORT, *supra* note 2, at 73.

102. *Id.*

103. *Id.*

election and in fact the voting public probably does not intensely object to any loophole, even a pernicious one, and even one that they do not share in.

Even the Panel shows the symptoms of the “it is free” syndrome, treating tax credits not as real money. If the 15% credit were transferred to a government spending program, so the housing subsidy were considered a real cost, a number of harsh criticisms would be appropriate.

The costs of the subsidy must be compared with the benefits from the subsidy. Subsidies must be designed and redesigned so that they get the maximum benefit per dollar cost. A dollar spent that might be avoided or that could be focused in a better way is a wasted dollar. If the subsidy is real money, one should articulate as clearly as possible, what good is being accomplished. One should frequently come back to see if the dollar spent might be better focused or reduced.

The Advisory Panel Report says that the home credit should “encourage home ownership, not big homes.”<sup>104</sup> My understanding of the argument for subsidy is that home ownership gives externalities to neighbors. Renters apparently let their house become eyesores, maybe even threats to their neighbors, when home owners do not. The benefit, according to the panel, is not in having larger or more expensive homes, but the number of people who move from the renting to ownership.<sup>105</sup> What is needed is more houses, not larger houses or high-bracket neighborhood houses priced at 152% of their pretax value. Any subsidy going to people who would buy their house anyway is a wasted subsidy because it causes no shift from renting to buying. The cost must be compared with the benefit of only the extra houses purchased.

The 15% credit is better than a deduction in directing the costs to focus on the articulated goal. The denial of the credit for interest costs above the level of an average house also saves money and focuses the subsidy. But more needs to be done. We might even phase out the credit as the size of the house grows larger: I do not suppose most neighbors mind terribly much if rich cultured people choose to rent as neighbors because they did not get a subsidy for owning the house. Indeed, if the point is to get more people into houses, the subsidy should be only the minimum amount necessary to switch people from renting to ownership, and it should not be available for anyone who would buy a house anyway. Spending money on people who will buy a house anyway is a waste of taxpayer money.

The 15% credit, however, does not in fact focus the subsidy very well on the panel’s goal “to encourage home ownership, not big homes.”<sup>106</sup> The 15% credit is computed as a percentage of interest, increasing up to the average mortgage for the area. If the point is in fact to get more

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104. *Id.*

105. *Id.*

106. *Id.*

houses rather than bigger houses, the subsidy should not increase as the house gets bigger, but rather should be the same amount *per house*.

It would be more efficient to give the entire subsidy as a fixed sum bonus at the time a house is purchased. Delaying the subsidy lowers its efficiency because time and uncertainty cause buyers to understate the value of future subsidy costs devoted to the purchase. The subsidy also probably needs to be limited to the first house, because it is only extra new homeowners that count. At least, the structure of the subsidy should take away an incentive to buy and sell houses like day traders just to get multiple purchase subsidies. The efficiency of the subsidy, as noted, would also be improved if it were not available to people who already own a house and planned to stay that way. Anything that brings a cost down is a good idea if it is real money we are talking about, because if we are to close the deficit and cut taxes, we need to combat government costs and waste.

The Panel's proposal would increase the average-home cap to reflect the average home in the geographical area.<sup>107</sup> The proposal allows the 15% credit only on interest on a mortgage up to the average purchase price of a home.<sup>108</sup> An owner with a mortgage that is three times the value of an average house would get the credit only on the first third of his interest costs. Using the average house of the geographical area as the cap means that hot market houses in the San Francisco Bay area, New York, Washington, D.C., and Boston would have a higher amount of interest eligible for the 15% credit than would houses in the American heartland that have not faced such an increase in price. The average house is \$411,704 at current levels in desirable markets and only \$227,147 in less favored markets.

The price of houses does reflect real resources diverted from other uses, even in the hot markets. House buyers are buying access to excitement, or job opportunities, or something about the hot markets. A greater subsidy costs more, and does divert more resources to the hot market areas. It is difficult to think that the political system would allow such geographical discrimination in favor of the hot market cities if the tax credit were considered real money.

If the 15% credit was considered real money, then we might even question the case for the subsidy. If there are externalities to home ownership, why are not the neighbors willing to chip in to pay to convince renters to become homeowners? Is it not the responsibility of the neighbors to pay for the externalities they get? Why should people outside the neighborhood have to pay for the benefits they do not get? Why should taxpayers in Alabama pay for good neighbors in San Francisco and New York? Neighbor taxes match the costs and benefits of the externalities more precisely. If the federal government pays, then we can not be sure that the externalities are worth the cost.

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107. *Id.*

108. *Id.*

Under current law, neighbors do not have to pay tax on the externalities they get from living next to a homeowner. The advantage of living next to an owner rather than a renter is not taxed currently because use of a house is never taxed, and because only a sliver of the gain from increases in value of a house are taxed. The tax advantage that neighbors get by excluding the benefits of externalities is probably quite enough subsidy to account for the externalities of home ownership.

Without knowing very much about the issue, I am skeptical that there is much external benefit from a house. A house is a selfish investment. Most of the benefit of owning a house belongs to the owner. The positive externalities from ownership are pretty slim: renters can be perfectly good citizens and neighbors. If more upper-class people rented, then perhaps there would be no difference on the neighborhood between renters and owners.

If housing subsidies were considered real money, we might even worry about the negative externalities from owner-occupied houses. Single house ownership sprawling across the landscape may have made sense when gasoline was cheap, but when gasoline is expensive and foreign-owned, then we need to find ways to discourage our thirst for gasoline. The genius of America may well be mobility—a willingness to move for the best opportunity. Renters are more mobile. To give incentives to mobility, renting should be made more advantageous by cutting off the subsidies to immobility entailed by home ownership. But of course those arguments resonate only if the 15% credit is real money.

The Panel concluded that “in reforming our tax system, tax preferences should be treated like any direct spending program, and should be evaluated by policymakers based on objective criteria, such as their cost, the distribution of their benefits, [and] overall effectiveness.”<sup>109</sup> If it had applied that principle consistently, their continued subsidy for housing would have been different.

### III. THE MISSION OF RESPONSIBLE REFORM

The Panel should have found many clever ways to shift the tax burden upward. Luxury consumption, or at least consumption using a large amount of resources, is a terrific thing to tax because that consumption has so much less utility than subsistence or near-subsistence spending. Much of the populist support for consumption tax is premised on the assumption that people with money can hire lawyers and accountants to beat the income tax. I think there is something to that premise. The tax system has always been as porous as a colander. Without vindictiveness, I do think our upper-class is paying too little tax. *Forbes'* 2003 survey of the richest 400 found that they were paying total tax of “barely” (*Forbes'* word), 1% of wealth.<sup>110</sup> Taxable income or cash income figures are not

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109. *Id.* at 83.

110. William P. Barrett, *Unrealized Riches*, 172 *FORBES* 60 (2003).

reflecting standard of living at the top. Economist Eugene Steuerle found that the wealthiest taxpayers reported annual income on their income tax returns of 1.88% of the wealth reported on their estate tax returns, at a time when corporate bonds were paying 7%-8% interest rates.<sup>111</sup> If one assumes, naturally, that wealth was understated on estate tax returns, then the reported income was even less than 1.88% of real wealth. The wealthiest 1% of the country holds a third of the nations' total wealth, but they pay under a quarter of its total taxes.<sup>112</sup> Wealth plus compensation is the best available indicator, although not a perfect indicator, of diminishing marginal utility of dollars. We need not worry about overtaxing the wealthy when their share of tax is less than proportional to their command over resources. I also suspect we should be harder on second and third-generation money than we are. Taxes on later generations have less impact on the founder than do taxes on the founder. Indeed, most savers are target savers and savers with a goal save more to reach the goal when taxes on savings go up and save less and party more when taxes on savings go down. If we could shift the burden of tax upward to reach the lower utility consumption of our richest taxpayers, we would reduce the harm that taxes do to the sum of human happiness.

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111. See, e.g., U.S. DEP'T OF TREASURY, OFFICE OF TAX ANALYSIS, OTA PAPER 50, THE RELATIONSHIP BETWEEN REALIZED INCOME AND WEALTH 8 (1982), available at <http://www.ustreas.gov/ota/ota50.pdf> (showing that wealthiest taxpayer were reporting 1.88% average return at time when secure corporate bond were paying 8%-9%).

112. To find the majority of wealth, you would need to go down only to the top 4%. To find the majority of total tax paid, you would need to go down to the top 7.5%. Marco Casgetti & Mariacristina De Nardi, *Wealth Inequality: Data and Model*, (4 Fed. Reserve Bank of Chicago, Working Paper No. 2005-10, 2005) (citing Arthur B. Kennickell, *A Rolling Tide: Changes in the Distribution of Wealth in the U.S., 1989-2001* (Survey of Consumer Fins., Working Paper, 2003) and FEDERAL RESERVE SURVEY OF CONSUMER FINANCE (2001)).