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EQUITABLE IMPLEMENTATION OF TAX EXPENDITURES

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EQUITABLE IMPLEMENTATION OF TAX EXPENDITURES

Yoseph Edrey* & Howard Abrams**

A good tax system distributes the cost of government equitably.¹ The requirement that each taxpayer pay a fair share finds support both as an ethical principle and as an economic vehicle to achieve efficiency.² Of course, the determination of what is equitable is subject to dispute. The premise of an income tax — more accurately, of a Haig-Simons accretion income tax³ — is that the burden of taxation should fall in proportion to disposable income.

In this country we have had for the last 70 years⁴ not only an income tax but a progressive income tax. That is, our system reflects the belief that each taxpayer's fair share of the tax burden should not only depend on relative income but also that as the amount of income increases, so should the rate of taxation. Progressive income taxation can be defended — and attacked — on both ethical and efficiency grounds.⁵

The wisdom of progressive rates has been debated in other forums.⁶ We do not seek to add to that debate here. Rather, we as-

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⁴ Actually, the first discussion concerning a progressive income tax in the United States occurred during the Civil War. See The Congressional Globe, May 1864, pp. 2514-2520. In 1913, the progressive tax rates applied only to the surtax. See C.C.H. Federal Tax Course ¶ 104 (1988).


sume that progressive taxation is appropriate and then consider how tax relief provisions — tax expenditures — can be fit into a progressive scheme. It is known that the economic benefit derived from tax deductions (and from exclusions, which have the same effect as deductions) is greater for higher marginal rate taxpayers than for lower marginal rate taxpayers. To the extent that such deductions substitute for direct government expenditures, these deductions provide the largest subsidies to the wealthiest taxpayers. We, as have others before us, find such subsidies inequitable and misleading.

To avoid this inequity and misrepresentation, it often is suggested that tax credits be used to implement tax expenditures in lieu of deductions and exclusions. Tax credits provide equal after-tax benefits to all taxpayers independent of tax bracket. We show, however, that tax credits — like deductions and exclusions — fail to implement tax expenditures properly. We then suggest ways in which equitable tax relief can be effected through an appropriately-tailored system of tax deductions, exemptions and credits, ways which ensure that the progressive tax rates presented in section 1 are not changed indirectly.

The individual tax burden is calculated by applying the statutory progressive rates to taxable income. Tax relief targeted to a specific class of taxpayers can be achieved in either of two ways: a direct reduction of the net tax burden by use of a tax credit or indirectly by reduction of taxable income by use of a deduction or exclusion. By “tax relief” we mean to include all intended deviations from the Haig-Simons accretion concept of taxable income.

The boundaries of tax relief in this sense are quite fuzzy, and reasonable persons can disagree over whether one particular tax provision or another is tax relief or a refinement of the definition of income. For this Article the precise outer limits of “tax relief”

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9 See infra notes 21-22 and accompanying text.
10 See Surrey & McDaniel, supra note 8, at 256-67.
11 I.R.C. § 1.
12 For some of the difficulties in distinguishing between a tax expenditure and a refinement of the income tax base, see, e.g., Andrews, supra note 1; Bittker, Income Tax Deductions, Credits and Subsidies for Personal Expenditure, 16 Law & Econ. 193 (1973); Halperin, Business Deduction for Personal Living Expenses: A Unitary Approach to an Un-
are not essential. All that we require is that the set of tax relief provisions not be empty, or, in other words, that there exist "tax rules [which] represent departure from the net income concept and balanced tax structure to provide relief, assistance, incentives, or what you will for a particular group or activity."

Deductions and exclusions are poor tools for granting tax relief for two reasons. First, because the after-tax value of a deduction (or exclusion) is the amount of the deduction times the taxpayer's marginal tax rate, the greatest benefit of tax relief provided in this form is reaped by the highest rate taxpayers, taxpayers who necessarily have the greatest taxable incomes. Second, these tax relief provisions having regressive effects implicitly undermine the progressive tax rates conspicuously presented to the public in section 1.

Our first concern can be demonstrated by an example. Section 117(a) provides an exclusion for certain scholarships and fellowships. To the extent that this provision expresses a concern for the needs of poor students, it is misguided. To see this, observe that a $10,000 exclusion under §117(a) will benefit the poorest student (one who has only $10,000 of income) by only $750. The same exclusion will provide an after-tax benefit of $3,300 for a student having an additional $71,900 of taxable income. If the concern of §117(a) is for needy students, presumably the richer student should receive no benefit and the poorer student a larger benefit. Yes, so long as the tax relief is provided in the form of an exclusion, the dollar value of the benefit will inversely correlate with taxable income.

This upside-down aspect of tax relief provided as exclusions or deductions has led to the suggestion that a system of tax credits should be used instead. Yet, careful scrutiny of the credit system reveals that credits also fail to implement tax expenditures equitably. Tax relief framed as deductions are inequitable because they


13 S. Surrey, Pathways to Tax Reform 4 (1973) (quoting speech by Assistant Secretary of the Treasury for Tax Policy entitled, "The United States Income Tax System—the Need for a Full Accounting" (1976)).

14 For a discussion of the need to maintain the progressive tax rates in section 1, see infra notes 21-22 and accompanying text.

distribute government expenditures unfairly, giving more to the wealthy than to the poor. As explained below, tax credits have the same flaw, albeit on a lesser scale.\textsuperscript{16}

By "tax relief" we mean any tax expenditure; that is, a subsidy implemented through the tax system in lieu of a direct government grant. The equivalence of a tax expenditure and a direct government grant is most obvious in the case of a tax credit. Conceptually, after a taxpayer's income is fixed and the appropriate tax on that income is calculated and collected, a tax credit is a \textit{tax free} grant given by the government to the taxpayer. A tax credit is the precise equivalent of collecting the full tax and then remitting the value of the credit as an explicit grant.

Equating a tax credit with a direct grant also makes obvious that which often is overlooked: the amount of the tax credit should be taxable to the recipient. An explicit grant would be taxable because all accessions to wealth are part of the Haig-Simons tax base.\textsuperscript{17} Excluding a tax credit from the recipient's taxable income understates income just as surely as excluding salary, rents or

\textsuperscript{16} See Surrey & McDaniel, supra note 8, at 272.

\textsuperscript{17} It has been suggested that some tax credits might not be includible in the taxable income of the recipient but rather should result in a basis adjustment. See Surrey & McDaniel, supra note 8, at 272-73. The example used, a tax credit akin to the investment tax credit, "would appear to constitute a contribution to capital" under the tests laid down in United States v. Chicago, Burlington & Quincy R.R. Co., 412 U.S. 401 (1973). Id. at 273. Yet, a nonshareholder contribution to capital produces no basis change, see I.R.C. § 118; indeed, it is the absence of the upward basis adjustment associated with taxable receipts which ensures that nonshareholder contributions to capital produce deferred income rather than an exemption.

The issue posed by Professors Surrey and McDaniel is thus whether receipt of a direct grant in lieu of a tax expenditure should go unrecognized as analogous to unrealized appreciation. We think the answer is a clear no: the realization doctrine is the administrative recognition that some economic accessions to wealth cannot be currently captured by the income tax without excessive burden. It is a deviation from the ideal that should extend no further than the circumstances which necessitate it.

The ideal income tax would require each taxpayer to discount to present value the future income stream of all owned assets. Yet, there simply are too many uncertainties in evaluating this stream of income (doubts about the interest rate, uncertain useful lives of most assets, etc.) to make it practical. Accordingly, we adopt the second best alternative: we trade assumptions and uncertain evaluations for deferred taxation on the actual income received. Thus, the realization requirement represents a concession made on behalf of certainty. And as a concession, the realization doctrine should be extended no further than its underlying rationale demands. In the case of tax expenditures provided as tax credits, the amount of the accession is known with precision and no cash outlay is required of the taxpayer in excess of the pre-credit tax liability.
dividends.

Under a Haig-Simons definition of income, *all* accessions to wealth are taxable. To provide a tax credit is simply to implement a government expenditure through the tax system. To *exclude* a tax credit — like excluding a direct government grant — is, itself, a second tax expenditure. And this exclusion, like all tax relief provided in the form of exclusions or deductions, is more beneficial to high bracket taxpayers.

Because it is the federal government that is both providing the tax relief and collecting the taxes, it might seem as though the excludible tax credit simply reflects a netting of an implicit taxable credit with the tax due on that credit. That is, the nominal tax credit made available to taxpayers might be viewed as the net income of an implicit gross credit subject to tax. This gross credit, the true tax expenditure, is an amount equal to the net credit "grossed up" by the recipient taxpayer's marginal tax rate. Of course, because we have progressive marginal tax rates, the gross credit computed in this way produces a larger gross credit for high bracket taxpayers.

For example, suppose a $100 tax credit is given to all full-time college students. For a student in the 15% tax bracket, the gross value of this credit is $117.65. That is, a direct taxable grant of $117.65 to this student would produce the same after-tax advantage as the nominal $100 credit because the tax on $117.65 (assuming a 15% tax rate), is $17.65. For a student in the 28% tax bracket, the same $100 nominal credit works out to a gross value of $138.89 because the tax on $138.89, assuming a tax rate of 28%, produces an after-tax benefit of $100. The following table lists the taxable grant equivalent to a tax-free credit of $100 for a variety of marginal tax rates.

<table>
<thead>
<tr>
<th>Marginal Tax Rate</th>
<th>Taxable Grant Equivalent</th>
</tr>
</thead>
<tbody>
<tr>
<td>15%</td>
<td>$117.65</td>
</tr>
<tr>
<td>28%</td>
<td>$138.89</td>
</tr>
<tr>
<td>35%</td>
<td>$200.00</td>
</tr>
</tbody>
</table>

If the recipient of the tax credit has income equal to $I$, excluding the tax credit, and if the amount of the net tax credit is $N$ while the amount of the gross tax credit is $G$, and assuming that the average tax rate on income between $I$ and $(I + G)$ is $t$, then the relationship between the net tax credit and the gross tax credit is $N = (1-t)*G$, or, solving for $G$, $G = N/(1-t)$.
Table 1

<table>
<thead>
<tr>
<th>Marginal Tax Rate</th>
<th>Taxable Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>15%</td>
<td>$117.65</td>
</tr>
<tr>
<td>25%</td>
<td>133.33</td>
</tr>
<tr>
<td>33%</td>
<td>150.00</td>
</tr>
<tr>
<td>50%</td>
<td>200.00</td>
</tr>
<tr>
<td>70%</td>
<td>333.33</td>
</tr>
</tbody>
</table>

This analysis of tax credits can be extended to deductions and shows that tax expenditures provided as deductions or exclusions are subject to greater criticism than may first appear. For example, consider a $100 deduction given to two taxpayers, one in a 25% marginal tax bracket and the other in a 50% marginal tax bracket. The after-tax value of the deduction is $25 for the first taxpayer and $50 for the second, suggesting that the higher-bracket taxpayer has received twice as much government assistance as the first.

In fact, the second taxpayer has received three times the assistance as the first. For the 25% bracket taxpayer, a deduction of $100 is equivalent to a tax-free credit of $25. From Table 1, that tax-free credit is the after-tax equivalent of a taxable government grant of $33.33. For the 50% taxpayer, the deduction of $100 is worth $50 after taxes, and that is the equivalent of a $100.00 taxable grant. Thus, in terms of direct government expenditures, the $100 deduction to the 50% bracket taxpayer amounts to three times the government support provided to the 25% bracket taxpayer.

Thus, implementing tax expenditures as deductions, exemptions or credits undermines the progressivity of our current tax rates. One might argue that because there is no absolute and decisive proof that the current progressive tax scale is optimal, there is no need to protect its integrity. Professor Bittker has presented this argument in a very clear way:

> What Congress has enacted is a progressive structure with deductions; you cannot hold up one as the authentic voice of the people, and condemn the other as a craven surrender to special privilege. . . A rate schedule that is itself the product of compromise and judgment — born of experience rather than logic — cannot be turned into a standard by which the "logic" of deduction can be judged. With equal if not greater warrant, one might argue that the durable and central features of the Code are its deductions and the pro-
gression is secondary and expendable.\footnote{Bittker, Charitable Contributions: Tax Deductions or Matching Grants?, 28 Tax L. Rev. 37, 54 (1972).}

Most now agree that progressive rates cannot be defended as an inherent component of a fair income tax.\footnote{See W. Blum & H. Kalven, supra note 6; Blum, Revisiting the Uneasy Case for Progressive Taxation, 60 Taxes 16 (1982).} Is Professor Bittker correct that progressive rates also cannot be defended as something which is essential to our income tax? We believe not.

Whatever a fair tax should be, our income tax can be fair only if taxpayers generally believe it to be so.\footnote{See Porcano, Distributive Justice and Tax Policy, 59 The Accounting Review 619 (1984).} What the legislators say about the income tax, and what the general public believes about it, tell us much more about the fairness of our tax than what a small cadre of experts determine is the real import of the tax. In particular, progressive rates have been a mainstay of the federal income tax and, perhaps more importantly, are easily understood and accepted by the general public. Surely the continued presence of progressive rates in our income tax tells us that Congress believes progressive taxation is fair even if — especially if — complex provisions of the Code sometimes produce flat or regressive effective rates for some taxpayers under some circumstances.

That is, the government provides the public with goods and services, and the public must pay for them. It seems to us essential that the public be furnished with simple, accessible and accurate information as to the costs of these goods and services and of the cost distribution among the taxpaying public. Thus, it becomes undemocratic if not immoral for Congress to present a system of tax rates in section 1 which does not apply to a large percentage of taxpayers.\footnote{Further support for progressive taxation can be derived from the assumption of a declining marginal social utility of money. See R. Musgrave & P. Musgrave, Public Finance in Theory and Practice 243-44 (4th ed. 1984).}

Thus concluding that the integrity of the current progressive rates is worth protecting, we return to the basic question: Is it possible to resolve the conflict between maintaining a progressive tax scale and providing tax relief? One solution would be to replace all tax relief with direct government expenditures. Such expenditures, if includible in income, would be fully consonant with progressive
rates of taxation. We present an alternative which also fully pro-
tects the integrity of progressive tax rates while still allowing gov-
ernment expenditures to be implemented in the form of tax relief.

We do not mean to suggest that our alternative is better than
replacing tax expenditures with direct grants, or even that it is as
good. Tax expenditures carry with them a host of problems unre-
lated to progressive tax rates, and tax scholars have long advocated
the abolition of tax expenditures for reasons unrelated to progres-
sive tax rates. Political and practical realities compel us to con-
clude that tax expenditures are unlikely to be eliminated or even
substantially curtailed, and thus our proposal is intended to show
how what we inevitably will have can be made somewhat better.

Equity requires that government grants provided for non-tax
reasons — tax expenditures — should not be dependent on a re-
cipient's tax rate. That is, the pre-tax value of the government
grant should be independent of tax rate. Under an income tax with
progressive rates, however, equal pre-tax government grants should
turn into unequal post-tax benefits, with the greatest benefit re-
tained by the lowest bracket taxpayer. Thus, an equitable system
of tax expenditures must have the characteristic that the after-tax
value of the expenditure varies inversely with taxable income. Tax
expenditures implemented as credits, by providing equal after-tax
benefits to all taxpayers, undermines the efficacy of progressive tax
rates. Tax expenditures implemented as deductions and exclusions
benefit high bracket taxpayers more than low bracket taxpayers
and thus stand progressive rates on their head. What is needed is a
mechanism of tax expenditure that has the opposite effect of a
deduction.

The basic material for constructing such a reverse deduction can
be either a set of deductions or a set of traditional, tax-free cred-
its. Recall that the pre-tax value of a tax credit is equal to the
nominal credit grossed-up by the recipient's marginal tax rate. If
we define a system of credits such that their grossed up value is
equal for all taxpayers, then we will have the proper form of tax
expenditure. Similarly, we can define a system of deductions hav-

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83 See Surrey & McDaniel, supra note 8, at 261.
84 On the equivalence of deductions, exemptions and credits, see Turnier & Kelly, The
Economic Equivalence of Standard Tax Credits, Deductions and Exemptions, 36 U. Fla. L.
ing an equivalent effect.

In the case of a tax-free credit, the relationship between the nominal (tax-free) credit and the grossed-up (taxable) credit is:

$$G = \frac{N}{1-t}$$

where $G$ is the value of the gross-up credit, $N$ is the value of the nominal (tax-free) credit, and $t$ is the marginal tax rate. To equitably distributed tax expenditures, the grossed-up tax credit should be constant for all taxpayers. To accomplish this, the nominal credit must vary with the recipient's marginal tax bracket. Table 2 illustrates the case of a pre-tax credit of $100 for various marginal tax rates.

<table>
<thead>
<tr>
<th>Tax Rate</th>
<th>Nominal Credit</th>
<th>Grossed-Up Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>15%</td>
<td>$85.00</td>
<td>$100.00</td>
</tr>
<tr>
<td>25%</td>
<td>75.00</td>
<td>100.00</td>
</tr>
<tr>
<td>33%</td>
<td>67.00</td>
<td>100.00</td>
</tr>
<tr>
<td>50%</td>
<td>50.00</td>
<td>100.00</td>
</tr>
<tr>
<td>70%</td>
<td>30.00</td>
<td>100.00</td>
</tr>
</tbody>
</table>

Equivalently, we can fashion a set of decreasing deductions to the same effect. The relationship between a deduction and its implicit grossed-up tax credit is:

$$D = \frac{G(1-t)}{t}$$

where $D$ is the amount of the deduction, $G$ is the amount of the grossed-up (taxable) credit, and $t$ is the marginal tax rate. Once again, equity requires that $G$ be constant for all taxpayers. Table 3 sets forth the appropriate deductions as a function of marginal tax rates for the case of a taxable credit of $100.00.

<table>
<thead>
<tr>
<th>Tax Rate</th>
<th>Nominal Credit</th>
<th>Deduction</th>
<th>Grossed-Up Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>15%</td>
<td>$85.00</td>
<td>$566.67</td>
<td>$100.00</td>
</tr>
<tr>
<td>25%</td>
<td>75.00</td>
<td>300.00</td>
<td>100.00</td>
</tr>
<tr>
<td>33%</td>
<td>67.00</td>
<td>203.03</td>
<td>100.00</td>
</tr>
<tr>
<td>50%</td>
<td>50.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
<tr>
<td>70%</td>
<td>30.00</td>
<td>42.86</td>
<td>100.00</td>
</tr>
</tbody>
</table>

25 The after-tax value of a deduction is $tD$, while the after-tax value of a nominal (tax-free) credit is simply $N$, the amount of the nominal credit. Substituting $tD$ for $N$ in the formula above table 2 produces $tD = G(1-t)$, which is equivalent to the formula in the text.

25 The nominal credit equals the grossed-up credit less the tax on the grossed-up credit.
One difficulty with implementing tax expenditures through a system of graduated deductions is posed by zero-bracket taxpayers. For such taxpayers, no deduction however large will produce an after-tax benefit. There are always zero-bracket taxpayers in any system — at a minimum, taxpayers lacking income are in a zero bracket — and so the treatment of such taxpayers must be an integral part of the tax expenditure system.

If negative income produces a net deduction carry-forward, then it is plausible to treat the lowest non-zero tax bracket as the absolute minimum bracket. Taxpayers who fall in a zero bracket in one year can be expected to fall in a non-zero bracket in a subsequent year, and in that subsequent year the value of prior tax expenditures will be realized. Accordingly, zero bracket taxpayers could receive a tax expenditure deduction equal to that of the lowest non-zero bracket taxpayer.

However, a zero bracket taxpayer in one year might become a high bracket taxpayer in the following year, and allowing such a taxpayer to carry-forward the highest tax expenditure deduction will overstate the taxpayer's proper deduction. In theory, the amount of the deduction should be determined by reference to the taxpayer's marginal tax bracket in the second year. Yet, basic principles of annual accounting militate against tying the tax consequences of an event in one taxable year to the tax rates applicable in a different taxable year.27

Implementing tax expenditures as tax credits does not require deferring the tax expenditure for zero-bracket taxpayers to a subsequent year: even a zero-bracket taxpayer can enjoy a tax credit as easily as a direct expenditure. However, unless the tax credit is refundable, the after-tax value of the credit is a function of income. For example, a non-refundable credit of $100 is really a credit equal to the lesser of $100 and the taxpayer's tax liability. Since explicit government grants would not be conditioned on a minimum level of taxable income, neither should the implicit tax expenditure.28

Refundable credits do exist in the current code al-
though they are far from common.\textsuperscript{29}

One problem common to both implementations of tax expenditures is the treatment of an expenditure which shifts the recipient taxpayer's marginal tax rate. For example, suppose that all income under $25,000 is taxed at 15% while all income in excess of $25,000 is taxed at 40%. If a taxpayer with $24,500 of income is to receive a tax expenditure worth $1,000, should the associated credit or deduction be computed with reference to the 15% rate or to the 40% rate? The answer, described more fully in note 20, is that a blended rate should be used. Unfortunately, computing the correct blended rate for each taxpayer introduces substantial complexity into either implementation of tax expenditures.

Fortunately, this problem evaporates completely if the tax expenditure is implemented by means of a taxable, refundable credit. A taxable credit has the virtue that it need not be scaled for each taxpayer: by including it in gross income and then applying the progressive rates to this greater income, each taxpayer implicitly scales the after-tax value of the credit appropriately. To implement a tax expenditure through a taxable, refundable credit, all Congress need do is specify the amount of tax expenditure applicable to all taxpayers. No schedule of declining credits need be computed or promulgated because the inclusion does all the work. Indeed, a taxable, refundable credit is nothing but a direct expenditure paid through the tax refund/tax reduction mechanism.\textsuperscript{30}

Consider, for example, the exemption provided for interest on state and local bonds. This exemption produces a sliding-scale of after-tax benefits, with the greatest benefit going to the highest-bracket taxpayers. For example, for a taxpayer in the 15% marginal bracket, the exemption is worth only $15 for every $100 of exempt interest received. For a taxpayer in the 33% marginal bracket, though, this exemption produces an after-tax benefit of $33 for every $100 of exempt interest received.

We could replace the exemption with a taxable credit of $17.65 without affecting the 15% taxpayer\textsuperscript{31} or with a taxable credit of

\textsuperscript{29} See, e.g., I.R.C. §32 (earned income credit).

\textsuperscript{30} Surrey & McDaniel, supra note 8, at 275.

\textsuperscript{31} For a taxpayer in the 15% bracket, an includible credit of $17.65 would produce an increase in tax liability of $2.65, which when netted against the credit produces a net after-tax benefit of $15.00.
$50 and thereby continuing the equivalent of full exemption for the 50% taxpayer. The advantage of the refundable, taxable credit in lieu of the exemption is that if the high-bracket taxpayer is given substantial relief, so is the low-bracket taxpayer. Under the alternate credit system the low bracket taxpayer will enjoy a full $50 before-tax benefit from the bond (corresponding to an after-tax benefit of $42.50) so long as the $50 credit is both taxable and refundable. Thus, the traditional system of upside-down subsidization is eliminated in favor of an equal pre-tax subsidy to all taxpayers and a rightside-up after-tax subsidy to low-income taxpayers.

Considering the bond from the issuer's perspective introduces an additional advantage of the taxable, refundable credit over the current exemption system. If interest rates for taxable bonds are at 10%, an issuer can compete for a 50% tax bracket investor's money by issuing a 5% tax-exempt bond. For such a taxpayer, the tax exemption produces no net benefit because the value of the exemption has been incorporated into the bond's interest rate. Thus, while it is the bond holder who receives the tax exemption, the economic benefit of the subsidy is captured by the bond issuer in the form of a decrease in its borrowing costs.

If there is insufficient demand for tax exempt bonds by high-bracket taxpayers, the issuer will have to raise its interest rate to compete for the investment dollars of lower bracket taxpayers. For example, to compete with taxable investments paying 10% per year, a tax exempt bond must pay 8.5% per year to attract taxpayers in the 15% bracket. However, if the bond issuer raises the tax exempt interest rate to 8.5%, the high-bracket taxpayer receives a windfall: to the 50% bracket taxpayer, a tax-exempt return of 8.5% is equivalent to a taxable return of 17%, far above the assumed normal market rate of 10%. By raising its interest rate to

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31 Under the current exemption, the taxpayer receives and excludes $100. Under the alternate taxable credit, the taxpayer receives $100 and includes $150, producing a tax liability of $50 that is fully offset by the credit. Thus, in each case the taxpayer retains the full $100 after-tax.

32 The taxpayer will include $150 in income, producing a tax liability of $22.50. The credit will offset that liability and provide a refund of $27.50. Had there been no credit, the taxpayer would have included $100 for a tax liability of $15. Thus, the after-tax benefit of the credit to the 15% bracket taxpayer is $42.50 which corresponds to a pre-tax benefit of $50.

33 See M. Chirelstein, supra note 7, at 345-48.

34 See Abrams, Rethinking Tax Transitions: A Reply to Dr. Shachar, 98 Harv. L. Rev. 1809, 1813 (1985).
Tax Expenditures

compete for low-bracket taxpayers, the issuer allows some of the federal subsidy to leak into the hands of the high-bracket bond holders.36

A taxable credit avoids this leakage. We have already seen that a taxable credit of $50 is the equivalent of full exemption for the 50% bracket taxpayer. Accordingly, the issuer can keep its interest rate at 5% (fully taxable to the holder) and still compete for the high-bracket taxpayer’s investment dollars so long as the bond includes a taxable credit of $50. What is especially nice about the taxable credit is that the same bond will also appeal to low-bracket taxpayers including even zero-bracket taxpayers.

For example, consider a taxpayer in the 15% bracket. If this taxpayer purchases a $1,000 normal bond paying 10% interest, the taxpayer will have $85 after tax. Similarly, if this taxpayer purchases a $1,000 bond paying 5% (taxable) interest and accompanied by a $50 taxable and refundable credit, he will receive $50 in interest and will receive a tax refund of $35,37 producing the same $85.

Because all taxpayers receive the same pre-tax benefit from the taxable credit, there is no market pressure for the bond issuer to raise its interest rate. As a result, the entire subsidy is captured by the bond issuer and none by any high-bracket taxpayers. The taxable credit also allows the federal government to tailor the amount of the subsidy by raising or lowering the amount of the credit. For example, lowering the credit to $40 will reduce the subsidy to the bond issuer (causing its interest rate to rise to 6%) while increasing the credit to $60 will increase the subsidy.

Thus, the taxable, refundable credit has several advantages over other forms of tax expenditures. First and most importantly, the taxable, refundable credit fully protects the efficacy of progressive rates. Second, as compared with a graduated set of tax-free credits or deductions, the taxable, refundable credit is easier to implement. Finally, the taxable, refundable credit allows Congress to target its subsidies more accurately.

See M. Chirelstein, supra note 7, at 348-51.

The taxpayer will include $50 of interest as well as the $50 credit, or $100 total. The tax liability on this amount is $15 subject to the refundable credit of $50, producing a refund of $35.