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# TAX INCENTIVES AS A SOLUTION TO URBAN PROBLEMS

LAWRENCE M. STONE\*

An historian could compile a good list of the troubles of our current American society by studying the numerous proposals for tax incentives. Tax incentives have been proposed to encourage small political contributions to improve the ethics of our political system; to assist in financing higher education costs by allowing deductions for various expenditures by parents and students; to provide an inducement for the enactment of new or higher state income taxes; to aid in the medical problems of the aged; to increase our exports or U.S. travel and thus to assist our balance of payments; and to encourage industry to curtail air and water pollution. Even the numerous "negative income tax" systems which are suggested as substitutions for current welfare systems can be included in the category of "tax incentive" if we define that phrase broadly enough to include *non-revenue* uses of the tax system. Therefore, it is not surprising that many have suggested the use of tax incentives in solving the problems of our cities. In the latter category are tax incentives to encourage the hiring and training of the unemployed; to encourage the rebuilding and rehabilitation of slums; and to encourage the location of businesses in ghetto areas.

Since support for such proposals comes from a surprisingly wide variety of political groups in our society, they must be taken quite seriously. President Nixon made such tax incentives one of the major proposals during the campaign. The late Senator Robert F. Kennedy urged such proposals.<sup>1</sup> President Johnson's Commission on Civil Disorders recommended the possible use of such incentives. Both President Johnson, in 1966, and the prestigious Committee for Economic Development, in December of 1968, have proposed the use of tax incentives to encourage political contributions by small givers.

## ORIGINS OF SUPPORT FOR TAX INCENTIVES

The origins of this rather widespread interest in use of tax incentives

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1. See *Hearings on S. 2100, Before the Senate Committee on Finance*, 90th Cong., 1st Sess. (1967).

are interesting. For some groups, it simply stems from an aversion to increasing government expenditures combined with a realistic recognition that private action alone cannot solve many of our critical problems. Thus, many businessmen opposed to the idea of government subsidies will argue "let us use our money." For others, it is an impatience with government's inability to solve some of these problems directly. In some cases there is a political judgment that direct expenditures are not likely to be forthcoming; that indirect funds through tax incentives may be attainable; and that we must make do with second best. In a few, it is nothing more than an effort to capitalize on a situation by obtaining more for themselves. In this category are a number of proposals to give tax credits for existing expenditures, such as general employee training costs, which could only be remotely related to the precise problem, employment of the hard-core unemployed.

Undoubtedly a major impetus to the tax incentive has been the generally high marginal tax rates that have prevailed in this country since the Second World War. Why not harness all the energies that go into avoiding these high rates to socially desirable goals?

Perhaps the most significant encouragement can be traced to the introduction by the Kennedy Administration, in 1962, of enormous tax incentives for investment in industrial machinery and equipment. These were the investment tax credit and the depreciation guidelines. Ironically, since then the Treasury Department has been an ardent and intelligent but almost solitary force against the incessant cries for more tax incentives. The employment of the tax system by the Kennedy-Johnson Administrations to achieve other economic goals through the Interest Equalization Act and, in some respects, the foreign "tax haven" provisions of the Revenue Act of 1962 undoubtedly compounded the problem for the Treasury. The former was designed to stem the flow of United States funds into investments abroad and the latter was, in part at least, intended to do the same. The Foreign Investors Tax Act of 1966 was advertised as a tax encouragement to investment by foreigners in the United States and thus was also pointed to as a use of the tax system to improve our balance of payments situation. In the case of the 1962 "tax haven" provisions and the 1966 Foreign Investors Tax Act, it may be argued that they were merely intended to correct existing loopholes or inequities, but the public may not be that discriminating in its reading of the publicity.

The continued existence of many significant tax incentives in our

tax laws and their relative immunity from attack are also major encouragements to proponents of new benefits. Not the least of these are the various benefits enjoyed by the oil and mineral industries, the exemption of interest paid on municipal and state bonds, special debt reserves enjoyed by financial institutions, the capital gains provisions and other benefits to property owners, and the numerous tax benefits conferred on many exempt organizations and their donors. So long as neither the Treasury nor the Congress seriously attack these, proponents of new incentives can argue persuasively that the tax system lost its virginity long ago, remains unrepentant and, therefore, "why not us sinners also?" This cry is especially cogent when the cause is obviously much more deserving than, say, oil percentage depletion.

#### ABSENCE OF BASIC PRINCIPLES PRECLUDING NON-REVENUE USES OF TAX SYSTEM

The Treasury has little to argue about on some of the existing uses of the tax system. In fact, were the matter the sole responsibility of the Treasury—Democratic or Republican—many of these existing non-revenue uses would be eliminated. However, it strongly denies that the investment tax credit is a precedent for other tax incentives. The Treasury argues that the investment tax credit is a general encouragement to all taxpayers like a general tax increase or decrease. However, that is subject to question. For example, the credit only applies to those who make long-term equipment investments. Thus, it is no help to a service industry with little investment in long-lived equipment. Nor is the credit helpful to retail merchants whose principal investments are inventory and credit advances.

Furthermore, the credit applies only to those who have taxable income. It is of no help or incentive to a loss railroad or a small, struggling entrepreneur with large deductions and little or no tax liability. Thus, those who may need the help most may not get any. This is a weakness of many tax incentives that the Treasury often points to in other circumstances.

The investment credit helps a taxpayer who would invest without a credit as well as one who invests only because of the credit. In the latter case, it is inefficient. Again, this is one of the most serious criticisms of tax incentives generally.

Finally, it continues to apply even though our economy may be caught in an inflationary tide of serious dimensions which might call

for less investment. Thus, like other tax incentives the investment credit may continue on the books long after the need for it has disappeared.

The foregoing leads one to suspect strongly that there is no open and shut case based upon "principles of taxation" for or against the use of the tax system to achieve non-revenue goals or in particular for the use of tax incentives to encourage certain economic behavior. If such principles exist, they have been honored so much in the breach as to render them unreliable for the present at least.

How then are we to judge the value of different tax incentives and whether they are useful, in general, and capable of solving the problems of our cities, in particular? We cannot argue that they will violate general tax principles and thus distort the tax system. And it is clear from the foregoing that it is difficult to argue that tax incentives are inevitably subject to certain defects, even though this may be true, because our tax system is so interlaced with such non-revenue uses already. Any forthright appraisal of the political situation makes it unrealistic to argue that we shall soon, if ever, eliminate these existing deviations from our income tax laws. Absent such a realistic promise of comprehensive reform in the reasonable future, which promise might justify holding the line against all new non-revenue uses of the income tax, we must look carefully at each proposal and accept or reject it on its merits. Unfortunately this is a difficult task and may, paradoxically, be the starting point for a true ground swell for reform in the Congress. The forthcoming significant debates on tax incentives may very well make cynicism about the possibilities for reform an inaccurate prediction of the future. There is already encouraging evidence of this from the fact that the chairmen of both tax committees of the Congress have now publicly joined the opponents of further use of tax incentives. Also, the Chairman of a House Committee, the Committee on Ways and Means, with the support of the ranking Republican and possibly the President, has called hearings to consider in 1969 comprehensive reforms of the tax system.

#### STANDARDS FOR EVALUATING TAX INCENTIVES

In spite of the absence of clear principles that would preclude tax incentives, most tax incentives suffer by comparison with other approaches and will fail to receive approval if carefully analyzed. Certain standards can be posed to select those situations in which proposed

tax incentives should be enacted. These should include the following questions: (1) Will the tax incentive be effective to accomplish the desired goal? (2) Are other potentially more efficient efforts not likely to be enacted? And if enacted, not likely to succeed for various reasons (such as the alleged reluctance of business to apply for direct subsidies)? (3) Are the goals sought, in terms of their priority, important enough to compound the already existing evils of the tax system? (4) And finally, perhaps most important, are the goals sought of such clear national priority as to justify increasing the difficulties of budgeting under a system of direct expenditures and hidden indirect expenditures? Since the use of tax incentives of our urban problems would, in my opinion, clearly satisfy the third test, the issue seems to narrow to the first two and the fourth criteria—"will they work?", "are they the best *available* alternative?", and "will they seriously compound our serious national difficulties in establishing priorities?"

#### EXAMINATION OF ALTERNATIVE TAX INCENTIVES FOR URBAN PROBLEMS

In analyzing any proposal under these or similar tests, it is useful to note that there are several categories of "tax incentives" and these may have different effects. We might affect the supplier or the user. The approach can be surgically precise or at the other extreme, designed to improve the supplier or user's overall economic picture. The incentive can be a tax *penalty* to be imposed if the undesired behavior is not avoided. The approach might be through a vital middleman—the bank or insurance company.

Suppose, for example, one wished to improve the housing available to ghetto dwellers. If the tax system were to be used to encourage the user, one might give the renter or single home owner a tax incentive. The renter might have a deduction for part of his rent and the home owner a tax deduction for part of his investment, especially in improvements. Or the tax incentive might be given to the supplier, the landlord, to encourage him to build or improve rental facilities in the ghetto. Or it might be given to a developer who buys, improves and resells properties in ghetto areas. Or special tax deductible reserves for lending to or insuring of ghetto housing could be made available.

Furthermore, in each case the incentive could be given by various levels of government with possibly different effects. Thus, the tax incentive might be a local property tax cut rather than a deduction

against federal income or a tax credit against federal tax liability. Since many property owners pay property taxes but do not pay income taxes, this reaches a different group than does an income tax incentive.

Finally, if a "negative tax" system were adopted as an improved and expanded welfare or guaranteed income system, the income of some ghetto dwellers might be increased (through a tax "refund" for unused personal exemptions and other unused deductions). This increased income might enable them to pay more rent and thus to buy better housing in the market. Or somewhat less directly, one might give a tax incentive to employers to hire ghetto dwellers, thereby increasing their economic power and once again allowing them to lease or purchase better housing in the market.

The alternatives in terms of tax actions are further complicated by the fact that existing tax systems may already incorporate certain features which operate against our desired goals. A possible course of "tax incentive action" is, therefore, to remove certain existing tax features which militate in favor of investment in non-ghetto real estate and thereby hope to improve the relative desirability of investment in ghetto housing, or, perhaps more directly, to remove certain existing tax features which may encourage the deterioration of marginal neighborhoods into slums. For example, many believe that the combination of high depreciation deductions on low equity debt-financed property and capital gains taxation on sales encourage the slum owner to hold with a view to a sale in relatively few years and therefore to make little if any repairs or improvements.<sup>2</sup> These same tax factors—unrealistically high tax depreciation deductions combined with ultimate capital gains tax on sale—the familiar "real estate tax shelter"—also encourage investment in new office buildings and high-rise apartments in competition with low income housing needs. The costs of these real estate tax shelters may well be as high as one billion dollars per year in revenues lost. The impact of the property tax on improvements may also discourage improvement and some have suggested that a shift in emphasis, from improvements to land values, is needed.<sup>3</sup>

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2. See, e.g., Slitor, "The Federal Income Tax in Relation to Housing," (Research Report No. 5 prepared for the National Commission of Urban Problems, 1968); ROTHENBURG, *ECONOMIC EVALUATION OF URBAN RENEWAL* 48-49 (The Brookings Institution, 1967).

3. See Netzer, "Impact of the Property Tax: Its Economic Implications for Urban Problems," (Research Report No. 1 prepared for the National Commission on Urban Problems, 1968).

Another course is the tax penalty as an inducement to change. For example, an increase in property taxes if property is allowed to deteriorate below code standards. This would easily be justified on the grounds that such deterioration affects the whole neighborhood and may cost the community much in the long run. Perhaps certain formal methods of depreciation could be denied unless necessary improvements were made. A related possibility is to allow accelerated depreciation only for investments in new or rehabilitated ghetto housing and remove it for new middle-class apartments and Park Avenue office buildings.<sup>4</sup> This would shift the revenue loss now involved in the latter types of investment into the ghetto problem.

#### TAX INCENTIVES MERELY REFLECT VARIOUS DIRECT APPROACHES

The many alternative uses of the tax system to tackle a problem such as slum housing are not always analyzed by those who put forth proposals for a "tax incentive," yet they obviously should be considered and compared. Furthermore, to list them, as done briefly above, gives some insight into the fact that tax incentives are no more than a reflection of the myriad forms of direct spending and enforcement approaches that might be used to attack these same problems. Some of these direct approaches might work and some might not; of those that work some might work better and give better results per dollar, or less adverse side effects per dollar. So too, the alternative tax proposals will produce different results. Too often, unfortunately, the tax incentive proposal is defective not because it is a use of the tax system that violates fundamental principles but because it is simply an ill-considered proposal, a substitute for careful thinking.

The problems of our cities are not susceptible to quick or easy or inexpensive solutions. A key to their solution is a resolve on the part of our citizenry to solve them. And this resolve must include a willingness to face the enormous costs and efforts involved and to gear priorities to meet these costs and efforts. The "era of the tax incentive" which we are now entering may simply be another postponement of the day when we face our problems squarely. For a long time we have ignored these problems and hoped they would work themselves out with time. This is a course most now reject for obvious reasons. Yet we may well postpone the hard decisions and revert to wishing our

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4. Cf. Remarks by Assistant Secretary of the Treasury, Stanley S. Surrey, Before the Fifth Annual Development Forum, Urban America, Inc. (October 28, 1968).

problems away if we call on the miracles of ill-planned tax incentives to cure them. Few who mouth the slogan "let's use tax incentives" have the faintest idea of the "how and what" of which they speak. This is not a criticism merely of those who support tax incentives. Much the same applies to proponents of direct programs. The difficulty is that we are dealing here with problems that are new to our society and to which we bring little knowledge and experience.

A rare exception would be the plan of the late Senator Robert Kennedy to encourage housing for urban poverty areas embodied in S. 2100, sponsored by him in 1967. This plan sought to encourage dramatic improvements in poverty area housing through a series of devices—federal income tax benefits, local property tax limits, favorable financing, control over rents and quality and construction costs, incentives to use ghetto management and ultimately to sell to tenant cooperatives. However, even in this well-conceived plan, the tax incentive aspects (an incredible array of magnificent benefits) were the least carefully thought through, unduly complicated, difficult to cost out, and of varying effect on different taxpayers. They, in effect, represented an attempt to spend, through tax rebates, large amounts of federal money which probably could be spent more efficiently through direct plans, and, indeed, even through simpler tax incentives. It is plausible that the more complicated methods were adopted because Senator Kennedy did not think the funds would be forthcoming if sought openly.

However, in budgeting an overall attack on our great urban problems—race, poverty, urban blight, air pollution, and substandard education—this smoked-screened *potpourri* of large indirect expenditures through tax incentives was a questionable approach. In the long run, we clearly will not solve our problems if we entangle our national budget, a system of setting national priorities, in this almost impenetrable jungle of indirect benefits.

#### TAX INCENTIVES AND BUDGETING FOR NATIONAL PRIORITIES

It is ironic that just as economic and management science is being introduced into our national budgeting process—through the Planning-Programming-Budgeting System—support develops for a move in a contrary direction. PPBS would lead us in the direction of more closely gearing our national expenditures to our top priorities. Spending vast amounts indirectly through the tax system in a hidden or difficult-to-measure manner leads us in the contrary direction.

What should be done to bring us to a more rational approach to the use of tax incentives? The critical issue may revolve around accounting for tax benefits as expenditures for purposes of our budget. Put simply, our national budget should estimate annually the revenues lost through existing tax benefits. These should be reflected in the budget as receipts and corresponding expenditures. For example, if we spend dollars directly for the blind and handicapped and also give tax incentives to the blind, we should show in the budget a total expenditure figure consisting of both. Then we should analyze the total expenditures—direct and tax—as we do any other. Thus, we should be concerned with *which* of the blind benefit from the indirect expenditures. We would, of course, find that those with no income receive no benefit, and those with high incomes benefit the most, since this benefit is the double personal \$600 deduction. On the other hand, the extra \$100 minimum standard deduction given to the blind helps only those in low income brackets. An examination of the total distribution of direct and indirect tax benefits might show an undesirable pattern and lead to changes, or it might be shown that the distribution was a proper one. In any event we would know and not operate in ignorance as we now so often do.

New proposals should be treated like proposed direct expenditures, and analyzed similarly. For example, suppose we wanted to enable renters to buy better housing through a tax deduction for rents? What will it cost in the aggregate? Who will get the benefits? Is this in line with our first priority? Renters who have no incomes or low incomes will get little or no benefit. Renters with high incomes and high rent will benefit the most from the deduction. So we might have to combine the program with a direct expenditure program designed to aid the poorest. We might have to put a ceiling on the tax deduction or make it a gradually diminishing benefit to keep the program from wasting money on Park Avenue millionaires. Or we might use a different tax incentive—for example, a “negative income tax” that will result in direct cash refunds to the poorest or a tax incentive aimed at the landlord. If we choose the latter route, how do we control against windfalls to landlords? For example, the landlord may not reduce rents or improve quality, or a high bracket landlord may benefit from the incentive more than a low bracket landlord (such as a tax exempt church project to provide housing for the poor). Rent controls? Quality controls for given rentals? If these are the answers then where are the advantages

over direct expenditures for federal housing, or cash rent subsidies to tenants or cash income supplements (such as the negative income tax)? Probably there are none; indeed the absence of extreme market dislocations may more easily be avoided through the latter alternatives than with tax incentives. In each case we are trying to develop a means to cause the private market to do what it is *not natural for it to do*. In one case we tinker with the supply side; in the other with the demand side. Since it is the demand side which is really out of order (*i.e.*, because the poor do not have enough money to call forth ample rental quarters) it is a priori less disruptive to provide subsidies to the demand side until some long-run solution to poverty is achieved while leaving the supply side operating normally.

#### ADMINISTRATION

The virtue of simplicity of administration is often claimed for tax incentives. The red tape of direct government contracts is supposedly avoided. Delay is alleged to be cut down. Supervision is through simple auditing of tax returns by the Internal Revenue Service. It is said that the creation of new agencies is avoided.

The above brief analysis of tax proposals for providing better housing shows that considerable complexity is not necessarily avoided. The claimed simplicity of tax incentives is attainable only if we are willing to tolerate possible extreme waste, inefficiency, and windfalls to unintended beneficiaries. If we were willing *directly* to spend our money in this fashion, we could speed up that process also and make it "automatic" to avoid much red tape. Any "automatic" tax incentive can be converted into an automatic disbursement by the Treasury. But how much support could we generate for such direct expenditures? As we already know, many hastily contrived and uncontrolled "no-strings" direct programs have resulted in just such windfalls and waste. A loose and wasteful indirect program of tax incentives deserves no more support than its counterpart in direct expenditures.

A carefully designed tax incentive would undoubtedly require efforts and skills not now demanded of revenue agents. For example, in recommending tax incentives to encourage employment of the hard-core, the Task Force on Private Enterprise of the President's Commission on Civil Disorders conditioned these on the use of careful controls. These included the identification of the hard-core, a prohibition against "run-away" plants, and control of abuse that might result from frequent turnover. A new agency would be avoided in name only.

Furthermore, the inefficiencies might be great. The Internal Revenue Service's primary mission is revenue raising. Accordingly, it might very well slight this effort until a major scandal arises. The poor experience with I.R.S. supervision of exempt organizations confirms this possibility. Also, trained personnel in other government agencies may very well be duplicated by the Internal Revenue Service to accomplish its new role. Finally, the already present problems of an overabundance of agencies concerned with one job will be increased. For example, a housing program for the poor will continue to involve personnel in the Housing and Urban Development Department and other agencies since government aid in financing, insuring, etc., will still be required in a well-designed program.

#### CONCLUSION

Unless our current tax system is radically reformed so as to be limited largely to equitable revenue raising purposes, it is difficult to argue on principle against using tax incentives in the effort to save our cities. However, the jobs that need doing may very well be better accomplished through other means. Even if a tax incentive is well designed, it is usually possible to achieve the same results through direct means. In other words, while tax incentives have no inherent quality that precludes their use, they also do not have any inherent advantages over direct programs. Since the tax system is already overburdened by complexities (many arising from the non-revenue uses of it) and since national budgeting is extremely difficult when indirect spending occurs through the tax system, the scales should normally tip heavily in favor of the direct method and away from the tax incentive. Furthermore, the adverse effects on the taxpayer morale from the existence of individuals with high incomes and low or no tax liability is another factor that militates strongly against further proliferation of tax incentives. On balance, the more sensible national policy would seem to be in the direction of improving present programs and expanding those that work. For example, in the housing area the Congress has yet adequately to finance the rent subsidy program, and we have not yet begun to feel the impact of other promising programs of the Housing Act of 1968. At the same time it might be well to remove some of the ill-advised tax incentives already enjoyed by the real estate industry which have not done the job of providing low income housing and which, in fact, may run contrary to this goal. These courses of action would seem to be more fruitful than the launching of a whole series of new tax incentive programs.