



Volume 32

1978

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Recommended Citation

Charles O. Galvin, *A Response*, 32 Sw L.J. 1067 (1978)
<http://scholar.smu.edu/smulr/vol32/iss5/6>

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A RESPONSE

by

Charles O. Galvin*

THERE is no way to respond adequately to the over-generous and thoughtful personal comments made by my good friends and colleagues. Suffice it to say that I am human enough to want to believe every word, but I am realistic enough to know better.

Personal comments about the past pluck the chords of memory about many things. Because of my long-standing professional concern about tax reform, it is in this area that I am prompted to make some reflective comments.

In 1941 I completed a thesis for my Master of Business Administration degree at Northwestern University on the special tax rules of the oil and gas industry relating to the deductions for percentage depletion and intangible drilling and development costs. This thesis was published as a student comment in the *Texas Law Review* in 1943 while I was in the Navy and before I finished law school.¹ I was so bold as to advance the proposition that cost and price in the industry ought to be established by the operation of free market mechanisms rather than by special tax arrangements. This was a brash and audacious assertion by anyone, anywhere, anytime, but especially in the *Texas Law Review* in the middle of World War II. Only a law student with youthful exuberance and no common sense would in the environment of that time have suggested changes in tax rules that were considered significantly disadvantageous to the industry affected.

The sequel to the story, thirty-six years later, however, may have vindicated that youthful exuberance in ways few envisioned. In this connection, consider some general assumptions. Suppose that there had been no special tax preferences for oil and gas investment, drilling and development, and operation. Suppose further that the price of natural gas had not been regulated. What would have been the economic history of the industry since World War II? Without dealing in detail with particular random economic dysfunctions of a transitory nature, is it not fair to assert that the price of petroleum products would have steadily moved upward so that consumers would have paid the true economic cost of these resources? Would not such a gradual and orderly increase in price have encouraged

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1. Comment, *Federal Income Tax—Percentage Depletion of Oil and Gas Wells*, 21 TEXAS L. REV. 410 (1943). The editors wisely offered a distinguished member of the oil and gas and tax bar an opportunity to reply. See Jackson, *Federal Income Tax—Percentage Depletion of Oil and Gas Wells—Another View*, 21 TEXAS L. REV. 798 (1943).

the entry into the market of other, higher cost, competing energy sources such as oil shale, tar sands, lignite, gassification of coal, geothermal, wind, and solar power, and the like? And would not the use of all these possible energy sources have provided a rational and logical employment of all our total resources in our best national interest?²

Instead, we created an artificially cheap price for petroleum products by price control and special tax preferences. With no restraints on demand, the nation entered upon a period of wasteful consumption of a scarce commodity and was denied the option of using other effective, competing sources of energy. Moreover, in hindsight we must admit that we had sufficient forewarning of our current energy crisis to know better than to underprice petroleum products. As far back as the early fifties both industry and government spokesmen were predicting the diminution of domestic reserves and a greater dependency on foreign sources, and we were further warned that such foreign sources could become unreliable or even unavailable. Yet these warnings went generally unheeded.

It would, of course, be too simplistic to say that price controls and special tax provisions were the only factors leading to our present energy difficulties, but a more orderly adjustment in price structure in response to the free market would at least have avoided much of the hastily contrived efforts which have been put forth to solve our energy crisis and to combat inflation.

Now why does this historical vignette about the special tax rules for one industry have relevance to tax reform and simplification? The answer is that so long as special tax rules are tailored to particular transactions or particular groups, there will be pressures on the Congress to enlarge the class of transactions or groups affected if the rules are perceived as beneficial, or to narrow the field of application if the rules are perceived as harmful. Presently, the Internal Revenue Code is so riddled with these special rules that the administrability of the system is threatened, and the allocation of resources within the economy is influenced by tax gimmickry rather than by sound economic motives.

Whether the objective is aid to the oil and gas industry or the housing industry, the encouragement of venture capital in new enterprises, the creation of new jobs, or other desirable economic goals, the operative rules should preserve in the private sector the free exercise of choice for businessmen and investors in a tax environment that is as nearly neutral as it is possible to achieve. Similarly, in the public sector, resources for welfare,

2. I tried to elaborate further on these issues in Galvin, *Federal Tax Policy Affecting the Extractive Industries*, in SOUTHERN METHODIST UNIVERSITY, *ESSAYS ON PETROLEUM CONSERVATION* 57 (1960); Galvin, *The 'Ought' and 'Is' of Oil and Gas Taxation*, 73 HARV. L. REV. 1441 (1960); Galvin, *The Deduction for Percentage Depletion and Exploration and Development Costs*, in 2 HOUSE COMM. ON WAYS AND MEANS, 86TH CONG., 1ST SESS., *TAX REVISION COMPENDIUM* 933 (Comm. Print 1960). See also D. McDONALD, *FEDERAL TAX TREATMENT OF INCOME FROM OIL AND GAS* (1963); Musgrave, *Another Look at Depletion*, 15 NAT'L TAX J. 205 (1962); NATIONAL TAX ASSOCIATION—TAX INSTITUTE OF AMERICA, *SYMPOSIUM—ENERGY TAXATION—CONFLICTING FEDERAL, STATE AND LOCAL INTEREST* (1978).

disadvantaged groups, special government programs, and the like should be allocated by direct expenditures and not hidden in the provisions of a revenue act.³

With these principles in mind there has evolved a school of reformist thought that has favored a comprehensive tax base with low, gently graduated rates.⁴ These reformists have envisaged a system for raising revenues that would leave the allocation of resources within the private sector to general market forces and the allocation in the public sector to appropriation procedures through the normal executive, administrative, and legislative channels. Stated in its best light it all sounds so appealing and logical, but the pathway to tax reform has been a tortuous one indeed.

In earlier days, the theoretical and analytical discussion of tax systems was contained in the economic literature. Indeed, the classic concept of income, which is the starting point for the comprehensive tax base advocates, is from the Haig-Simons definition; that is, that income is the net accretion in wealth between two points in time, plus consumption.⁵ Tax articles in the legal periodicals generally dealt with the law as it was, that is, the technical rules and their application, rather than the law as it ought to have been. Legal literature dealing with reform was generally concerned with recommendations for technical changes to make the status quo work better. By the middle fifties, however, a much larger group of professionals began to be concerned about long-range substantive tax reform. In 1955 a subcommittee of the Joint Committee on the Economic Report invited a large group of tax practitioners and academicians to submit discussion papers on tax policy, and in 1960 the House Committee on Ways and Means published a three-volume Tax Revision Compendium⁶ which still retains an astounding vitality.

Many organizations began moving into the arena, and, as Mr. Asbill notes in his statement, the Section of Taxation of the American Bar Association organized a Special Committee on Substantive Tax Reform to consider basic reform. This was the first time that an association of private

3. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970).

4. B. BITTKER, C. GALVIN, R. MUSGRAVE & J. PECHMAN, *A COMPREHENSIVE INCOME TAX? A DEBATE* (1968) [hereinafter cited as *A DEBATE*]; G. BREAK & J. PECHMAN, *FEDERAL TAX REFORM—THE IMPOSSIBLE DREAM?* (1975); C. GALVIN & B. BITTKER, *THE INCOME TAX: HOW PROGRESSIVE SHOULD IT BE?* (1969); J. PECHMAN, *COMPREHENSIVE INCOME TAXATION* (1977); S. SURREY, *PATHWAYS TO TAX REFORM* (1973); *COMMISSION TO REVISE THE TAX STRUCTURE, REFORMING THE FEDERAL TAX STRUCTURE* (1973); *STUDIES IN SUBSTANTIVE TAX REFORM* (A. Willis ed. 1969).

5. H. SIMONS, *PERSONAL INCOME TAXATION* 61-62, 206 (1938); Haig, *The Concept of Income—Economic and Legal Aspects*, in *THE FEDERAL INCOME TAX* 7 (R. Haig ed. 1921); see 3 REPORT OF THE ROYAL COMM'N ON TAXATION (Canada) 39 (1966):

The comprehensive tax base has been defined as the sum of the market value of goods and services consumed or given away in the taxation year by the tax unit Fortunately, the comprehensive tax base can be restated in such a way that most of the compliance and enforcement problems can be substantially solved without a major departure from the basic concept.

6. HOUSE COMM. ON WAYS AND MEANS, 86TH CONG., 1ST SESS., *TAX REVISION COMPENDIUM* (Comm. Print 1960).

practitioners had come to grips with the sensitive issues that would have to be studied critically if substantive tax reform was to become a reality. I take great personal pride in the interim report of that committee of 1963⁷ and the final report of 1964,⁸ for they contain basic guidelines for future action that are as relevant today as they were when written.

The Committee's efforts led to a jointly sponsored pilot project of the American Bar Foundation and Southern Methodist University published in 1969,⁹ and that in turn led to a more comprehensive study by the Fund for Public Policy Research in 1973.¹⁰ These studies demonstrated that corporate taxes could be integrated with the individual income tax system, and that a flat rate of eleven to thirteen percent, or a graduated rate scale of four to fifty-four percent, applied to a comprehensive base would yield the same revenue we now collect.

Some of the technical staff who worked on these studies were employed by the Treasury in producing its study, *Blueprints for Basic Tax Reform*, which was released in January 1977.¹¹ *Blueprints* was the first official statement from the Treasury favoring a broad comprehensive tax base either in the traditional income tax model or in the consumption tax model. The latter contemplates a comprehensive income tax definition, but permits the deduction of saving and investment in calculating the taxable base.¹²

Throughout these evolutionary processes there has been a consistent call for a bipartisan commission that would undertake a major study very much along the lines of the Canadian Royal Commission on Taxation.¹³ This would be particularly appropriate in view of the Treasury release of *Blueprints*, a document that stated in basic outline form major propositions for reform, but left to later study and elaboration the implementation of such propositions. Instead of a long-range study, however, the Congress has thus far opted for a series of major revenue bills that have as their purpose the broadening of the base, closing of loopholes, and promoting equity. These fall far short of the major overhaul that could be possible.

Another reason militating in favor of the long-range study is that tax reformers themselves have fallen somewhat into disarray. The comprehensive tax base advocates are unable to articulate with specificity just how comprehensive the base should be.¹⁴ Thus, one might work with sedulous dedication on the definitions and yet find great difficulty in securing agreement among those who profess support for the comprehensive base in gen-

7. 16 ABA BULL. OF SECTION OF TAXATION, No. 4 July 1963, at 4.

8. 17 ABA BULL. OF SECTION OF TAXATION, No. 4, July 1964, at 286.

9. STUDIES IN SUBSTANTIVE TAX REFORM, *supra* note 4.

10. COMMISSION TO REVISE THE TAX STRUCTURE, *supra* note 4.

11. U.S. DEP'T OF TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (1976).

12. N. KALDOR, AN EXPENDITURE TAX (1955); Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974).

13. REPORT OF THE ROYAL COMM'N TAXATION (Canada) (1966) (also known as the Carter Commission).

14. See A DEBATE, *supra* note 4. These essays originally appeared in Volumes 80 and 81 of *Harvard Law Review*.

eral but would differ on particular items of inclusion or exclusion. Moreover, as has been noted, there has developed within the literature an overarching concern for the encouragement of capital formation, so that some contend that an income tax system should tax only that income which is consumed—eaten, drunk, lived up, or enjoyed—but not that which is saved or invested to create more goods and services and employment.¹⁵ Still further, other reformists propose alternatives such as a value added tax—an excise imposed at the various stages in the production stream of goods and services.¹⁶

These newly developing and varying views as to how the national fisc is to be supplied bespeaks ever more urgently the need for a national commission to study the alternatives. The Section of Taxation of the American Bar Association, the Brookings Institution, the National Tax Association, and many other professional and educational organizations have a serious concern for the problems in this area, but the most effective long-range effort would be a bipartisan commission making substantial findings of fact as to alternative proposals with the concomitant effects not only on national revenues but also on individual income groups.

What are the prospects for the future? As we move forward through this last quarter of the twentieth century it seems to me that the management of our economy is one of the most difficult assignments ahead and that an orderly, systematic assessment and evaluation of where we are and where we want to be would be of incalculable worth to our national life. The signs, however, are otherwise. The likelihood is that we will continue to experiment, to tinker, to temporize with the tax system. Indeed the process sometimes has become so politicized that measures are voted up or down on the basis of the personalities sponsoring a particular provision or the mood of the legislative committees at the particular time. Can one shrug this off as simply the folkways of a democratic system? Can one's concerns be assuaged that what occurs in the tax area is no different from that which may be observed in dealing with any of our political, social, or economic institutions? Unlike the controlled societies that may engage in five-, seven-, or ten-year plans and then move people lock-step through a predetermined course, the argument runs that a free society should be flexible enough to dart here and there by fits and starts and dips and plunges as exigencies may require. Perhaps, but if this be so, all the more reason that a tax system so pervasive should be designed solely to raise revenue. Encouragement of new production, development of jobs, protection of the environment, conservation of energy, and similar goals, as emphasized to a greater or lesser degree by succeeding national administrations, should be left to private and public institutions independent of the tax raising function.

The ravages of inflation make reform even more difficult. The failure to

15. *Tax Reform (Capital Formation): Hearings Before the House Comm. on Ways and Means, 94th Cong., 1st Sess. (1975).*

16. TAX INSTITUTE OF AMERICA, *TAX POLICY—A VALUE ADDED TAX* (1972).

balance the federal budget creates serious imbalances in the economy, and the system of taxation is used to try to effect corrections. The elaborate proposal for the indexation of capital gains is but a sample of the complications that may result when the taxing system is used to counterbalance deficiencies elsewhere in the management of the economy.

Now, lest I sound too discouraging about what is as contrasted with what might be, let me say a word in defense of what is. Professor Bittker has recently spoken to this subject.¹⁷ In a complex society of over two hundred million people, often influenced by forces outside its borders and beyond its control, it is not possible, as Herbert Hoover supposedly suggested, to have an income tax system as simple as the Ten Commandments. Ingenious and imaginative tax advisers working with sophisticated clients will continue to devise new and different business and investment arrangements. Therefore, ingenious and imaginative government staff personnel must be ever watchful to draft laws and regulations to define the tax consequences of such arrangements, and this inevitably leads to complexity. Statutory proposals are first drafted by the staff of Treasury or the Joint Committee on Internal Revenue. The proposals are then reviewed in committee, hearings are conducted, legislation is passed, regulations are promulgated after notice and hearing, rules are interpreted and applied, and then tested and retested in the courts. Thus, there is currently a somewhat orderly and rational evolution of rules with an abundance of due process and intellectual and critical analysis. Yet all of this does not gain-say the continuing need for just as orderly and rational consideration of wholly new and different alternatives to meet our fiscal requirements.

Furthermore, although many would concede that a tax system for a society such as ours must be complicated, does it have to be *that* complicated?¹⁸ The British have operated a highly sophisticated economy under the authority of a statute with comparatively few words and under regulations that are stated in general terms with relatively little elaboration. The British accord to the civil servants in the Department of Inland Revenue considerable discretion in reaching resolution and settlement of thorny issues. Moreover, the British respect the accounting and tax reports prepared by their chartered accountants as almost unimpeachable. Our own practice with respect to examination of returns was much the same until the post-World War II period when Congress began to overarticulate statutory provisions in order to anticipate every possible tax arrangement. Each succeeding Congress has built upon the intricate latticework already extant. Compounding the problem, the Treasury has had to promulgate a torrent of excessively detailed regulations to explain these successive enactments. The effect of this process has been to minimize the amount of discretion that may be exercised at the local level and maximize the amount of further articulation and elaboration required by statute and regulation.

17. 47 U. CIN. L. REV. 185 (1978).

18. I addressed this problem in Galvin, *Tax Reform and Simplification*, U. SO. CALIF. 30TH TAX INST. 853 (1978).

The advocates of the comprehensive tax base, the consumption tax, or the value-added tax do not contend that the rules would necessarily be simpler; what they do say is that the internal structure of the system would be logical and defensible.

In any event, and whatever way we go, it is most important that those in government, in industry, in the professions and, indeed, all thoughtful members of the citizenry continue a vigorous and extensive dialogue on the tax system and all its ramifications. There are no ultimate truths or eternal verities, but thoughtful people from different vantage points must keep the discussion open, and I am pleased to have been and to continue to be part of this process.

