

Why Laws Sometimes Restrict Even When They Can't Be Fully Enforced

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Debates over tax policy and administration often proceed as if there is a "right" answer to every policy question. All we need to do, the thinking goes, is choose the right tax base and tax rates, grant the right exceptions, put in the right administrative rules, and we will get the right policy outcomes. Such an attitude dodges one of the basic facts of life recognized in almost all nonpolicy environments: that there are true dilemmas for which there are no perfectly right answers. Yet there are many wrong answers and choices must still be made.

Here I wish to deal with examples where some legal restriction is appropriate even when it cannot strictly be enforced or enforced well. One consequence is a variety of inequities among those who fall on one side or another of a bright line, but who, for all practical purposes, deserve the same treatment under the law. A related consequence is that distortions arise from the concentration of activity on the unenforceable side of the bright line, often near the border. Despite those costs, removal of the line is likely only to add even greater amounts of inequity and distortion, although sometimes of a different character.

It is not hard to think of examples in all parts of the law, but here I will focus on the tax laws. Let's begin with rules that attempt to restrict tax shelters. Historically many of these laws have attempted mainly to prevent the widespread selling and marketing of shelters. A primary method was to deny taxpayers the ability to offset capital income against income derived from wages, salaries, and unrelated self-employment income. The selling of shelters to professional businessmen and -women, doctors, lawyers, and managers was thereby curtailed.

In truth, however, shelters were still available to some investors. Take many of the privately held real estate companies with substantial ownership of property. It has always been possible for these companies to offset positive income from one real estate investment with a leveraged shelter in another. By keeping the level of debt sufficiently high relative to assets, these companies could still bet on offsetting total capital gains with substantial amounts of interest deductions. (This was especially true in an inflationary environment where capital gains could be expected to increase with inflation. With lower rates of inflation, shelter opportunities have declined substantially.)

Another example is the attempt to limit the amount of lobbying that can be subsidized directly or indirectly through use of a charitable deduction. The goal is to ensure that a charitable deduction is indeed used for charitable purposes. Without any limit at all, individuals could lobby directly on their own behalf and take charitable deductions for the effort. For instance, I could set up Gene Steuerle Advocates, Inc., a nonprofit organization whose sole purpose is to lobby on behalf of tax breaks available only to myself. Then I would give charitable contributions to the lobbying organization and argue that it served a charitable purpose by educating the public on the merits of tax breaks.

Once society decides that it is not going to subsidize Gene Steuerle, Inc., it must go further and decide which types of lobbying activities are going to be denied a charitable deduction. The difficulty is that the line between lobbying and educating is a difficult one, in many cases demanding a separation that is almost impossible to make. If I don't like to pay estate tax or, alternatively, want to ensure that the rich pay tax and I do not, for example, I can contribute money to "research" organizations that oppose the estate tax or favor its increase as a means to reduce other taxes. It is doubtful that the tax laws can ever stop me from channeling funds in this manner.

Transfer pricing is a third area of the tax law that we can't seem to do with and can't seem to do without. How does one deal with "transfers" of ideas and technology from one part of an international firm to another? Once one has an income tax, then some geographic designation is required of where that income is earned. When it comes to the world of ideas and technology, however, any geographic designation is arbitrary. Ideas are not

geographically bound. Accordingly, set any legal rule, and companies will find ways to move income around and attribute at least some of it at source to other countries. Remove all rules and procedures, however, and a company could simply claim that all income was earned in low-tax-rate countries and avoid almost all taxation. As long as boundaries exist, nation-states will have incentives to collect taxes for themselves from those companies that operate within their borders. Thus the geographical boundaries that define nations inevitably conflict with the boundaryless nature of many business activities in the modern world.

In sum, lines must be drawn even when they cannot be drawn well. Limits on tax shelters, the use of charitable deductions for lobbying expenses, or the transfer of income and tax liability to low-tax-rate countries are only a few examples. Despite the lack of enforceability of each of these lines at various levels, an imperfect line is still better than none at all.

Sometimes a counter-argument is made by pointing to particular reforms that remove all government activities in the areas under question. If we replaced all income taxes with consumption taxes, then rules for traditional tax shelters would not be required. Similarly, companies would not be required to allocate their business-level income among countries. If we eliminate the charitable deduction and tax-exempt status for organizations, then the tax law also no longer would need to deal with restrictions on lobbying.

These types of alternatives simply dodge the issue. When the tax rate on capital income is reduced to zero, then it matters less where or how capital income is earned. When the subsidy for charitable contributions is reduced to zero, then it is less important, at least for tax purposes, what is a charity and what is not. Even then, other boundary problems exist for the taxes and expenditures that remain. Reduce all expenditures and taxes to zero, while removing all government regulations, and most government-induced dividing lines can be eliminated. This is like saying that fishing rights seldom have to be defined in the desert. It is the movement of government into any activity that forces the requirement to define what that activity is.

The law requires objective standards even when it is approximating subjective goals. Sometimes there are true dilemmas, so that any choice will raise some costs that we would just as soon avoid. An honest recognition of those dilemmas may not so much resolve them as reduce the constant demand that the law be changed continually in an attempt to remove the inevitable tension.

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