TAX FOUNDATION

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The Economics of Section 1071: The FCC Tax Certificate Program

House Ways & Means Committee Testimony

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The following testimony was presented by Dr. Foster before the House Ways & Means Committee on January 27, 1995.

Madam Chairwoman and Members of the Committee, my name is J.D. Foster and I am the Executive Director and Chief Economist of the Tax Foundation. The Tax Foundation is a nonprofit, nonpartisan research and public education organization that has been monitoring fiscal policy at all levels of government since 1937. I would like to emphasize to the Committee that the Tax Foundation is not a "grass-roots" organization, a trade association, or a lobbying organization. We do not take positions on specific legislation or legislative proposals. Our goal is to explain as precisely and clearly as we can the current state of fiscal policy and the consequences of particular legislation in the light of specific tax principles so that you, the policy makers, may make informed decisions.

Even at a time when such fiscally colossal issues like a balanced budget amendment and the "Contract with America" dominate our attention, there remain many important issues that should not be neglected, even though they may never appear above the fold on the morning paper.

I appreciate the opportunity to appear before you today to discuss Section 1071 of the Internal Revenue Code which allows the Federal Communications Commission (FCC) to grant tax relief with respect to the sales of radio, television, and other properties under certain circumstances. This demonstrates, I think, that even at a time when such fiscally colossal issues like a balanced budget amendment and the "Contract with America" dominate our attention, there remain many important issues that should not be neglected, even though they may never appear above the fold on the morning paper. I commend the Committee for taking the time to address this issue.

I will restrict my remarks to the economic aspects of this issue and leave the debate about the social and communications policy to others more familiar with those aspects. It is not my purpose today to argue in favor of or against the program, or for or against any changes in the program, but rather to present its underlying economics as best as I have been able to determine them.

The FCC Tax Certificate Program

Under Section 1071, the FCC has the authority to grant a tax certificate to the former owners of certain broadcast facilities when the sale or exchange of those facilities is certified by the FCC "to be necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, the Commission with respect to the ownership and control of radio broadcasting stations..." Since 1978, the FCC has used this provision as a tool for its announced policy of promoting minority ownership of broadcast facilities. The tax certificate gives the taxpayer the right to elect to treat the sale or exchange as an involuntary conversion under Code Section 1033. The tax benefit generally is to allow the former owner to defer the realization of capital gain on the sale or exchange of the asset if the proceeds from the sale are used to purchase similar property. To the extent the taxpayer does not utilize the involuntary conversion rules, the capital gain resulting from the sale or exchange of the asset shall nevertheless not be recognized, if the taxpayer so elects, because the taxpayer may reduce the basis for determining gain or loss on sale or exchange of property if the property would qualify for depreciation under I.R.C. Section 167.

Tax Neutrality

When it was founded some 58 years ago the Tax Foundation established six Principles of Taxation to guide its analysis. One of these principles was that the tax code should not be used to micro-manage the economy. That is, the tax code should be as neutral as possible with respect to economic decision making. Tax neutrality is important because when taxes distort how resources are employed, the net result is almost always a lowering of wages, fewer jobs, and lost output. Thus, a non-neutral tax removes resources from the private sector in two ways: through the collection of the tax itself and through the income lost because of the misallocation of resources—what is called the deadweight loss.

Border tariffs offer a classic example of the deadweight loss from taxation. Tariffs are external taxes and, as such, distort the prices of foreign goods and services relative to domestic goods and services, thereby distorting the allocation of domestic resources like capital and labor. The history of modern trade policy is a nearly continuous effort to reduce tariffs because to do so results in an expansion of trade and an expansion of national output through the more productive use of resources.

Another example of a non-neutral tax and its deadweight loss involves the taxation of capital. Some states, for example, impose a specific tax on plant and equipment located within the state. These taxes on real capital reduce the amount of capital employed. Consequently, the workers in those states have less capital with which to work. We know that workers are generally paid more as the tools they work with improve (a fisherman generally will catch more fish with a net than with a single line, for example), so one consequence of this tax is that wages in these states are depressed relative to what they would otherwise be.

The federal tax system is replete with non-neutralities, almost all of which result in less output, fewer jobs, and lower wages. Some of these, such as the heavy tax burden on saving, are very broad in application and carry steep price tags. Others are much narrower, such as the FCC tax certificates which are the subject of this hearing.

It is important to note that there are occasions when the tax code is non-neutral by design. In many instances, the underlying policy is an attempt to address an economic externality through the tax code. An externality arises when the individuals involved in an activity are unable to enjoy all the economic benefits or do not bear all the economic costs of an activity. An example of the former would be a software manufacturer whose products are pirated; an example of the latter would be a restaurant which has a band that plays music so loud that it drives away customers from the restaurant next door.

The Research and Experimentation Tax Credit exemplifies a tax provision enacted in recognition of a positive externality. Even with patent and copyright protection, many of the economic benefits that follow from R & E activity cannot be captured through product sales or pricing by the company doing the work. As a result, a lower level of R & E activity is performed than would be socially desirable. This is an externality which the tax credit seeks to offset.

There are also many examples of taxes imposed to address negative externalities. One such is the gasoline excise which attempts to force the users of gasoline to pay for the amount of the resource they consume through the product's price, but also for the economic cost of the pollution that is thereby generated through the gasoline excise.

To summarize, through its non-neutralities the current tax code severely distorts the allocation of national resources, thereby reducing output, wages, and employment. While most of the non-neutral provisions in the tax code are the by-products of other policy choices (a desire for a progressive tax system, the choice of income as a tax basis, and so forth), some are deliberate attempts to use the tax code to capture economic externalities. Good tax policy should seek to eliminate the former and to target the latter most carefully.

The Taxation of Capital Gains

In general and in most cases, the taxation of capital gains is highly distortionary. Except in instances in which the capital gain arises directly as a result of reinvesting income, such as corporate retained earnings, the capital gains tax is a levy on capital and not on the income accruing to capital. As a direct tax on capital, the capital gains tax reduces the incentives to save and invest. Therefore, broad-based reductions in the tax improve the neutrality of the tax code.

The capital gains tax can be reduced in three ways: by reducing the tax rate which is applied to taxable gains, by reducing the amount of a taxable gain that is subject to tax (either through a percentage exclusion, by indexing the basis for inflation, or by a simple increase in the basis), or by allowing the taxpayer to defer the recognition of the capital gain. Deferral arises most notably when home owners sell one home and buy another, though it also arises in private saving arrangements such as Individual Retirement Accounts. The deferral of tax is one of the tax benefits conferred on qualifying sales of broadcast stations. A step-up in basis, which occurs in the tax code most notably in levying the estate tax, is a second tax benefit recipients of FCC tax certificates enjoy.

Targeted reductions in the capital gains tax on the one hand improve the neutrality of the tax system by reducing the distortion against saving and investing. On the other hand, however, targeted reductions in the capital gains tax can distort the allocation of capital by shifting capital to tax-favored uses. In general, such a targeted tax benefit would generally only be warranted on purely economic grounds if it were used to offset some externality as discussed above.

To the extent the FCC tax certificate program is attempts to capture an externality, and in this regard is similar to attempts to address other externalities such as polluting emissions, it must be recognized that the program seeks to address a *social condition* and not an *economic externality*, in which case economic arguments do not apply. Increasing minority ownership of broadcast facilities is social policy and not a response to an economic externality. Lacking any externality aspects, therefore, the FCC tax certificate program represents an instance of micro-management of the economy which cannot be supported on the basis of the need to offset an anomalous economic condition.

The FCC tax certificate program reflects three policy decisions: to increase the number of minority owned broadcast facilities, to compensate the former owners of the facility for the loss of control of their property when the sale was made involuntarily, and to subsidize the purchase of broadcast facilities through the shared tax benefits granted by the tax certificates.

Property Rights and the Certificate Program

Property rights are the very backbone of our economic system. Much of our judicial system exists to protect private property from confiscation or loss of value through the actions of either individuals or governmental entities. Whenever an individual believes his or her private property can be taken without due process and just compensation, their economic energy and vitality diminishes.

The FCC tax certificate program is intended, in part, to diversify ownership of broadcast facilities to encourage greater minority control. To the extent this government policy goal results in the involuntary sale by private individuals of broadcast facilities to any other party, even if at a fair-market price, some form of compensation is appropriate. Thus, in any case where the FCC requires that a private individual or group sell a broadcast facility, for whatever reason, to another individual or group, and the transfer is truly involuntary, then the tax benefits conferred by the FCC tax certificate program could be considered an appropriate form of compensation.

Sharing The Benefit

The tax benefits are conferred on the former owners of broadcast facilities by the FCC tax certificate in the sense that the tax benefits are theirs to claim. In the marketplace, since both the buyer and the seller are aware of the possible tax benefit, the value of the benefit will be considered by both parties in establishing the sales price. For example, suppose the value of a broadcast facility in the absence of capital gains tax deferral is $50 million, and that the value of the deferral to the seller is deemed to be $5 million. The final

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sales price could fall, therefore, anywhere between $45 million, in which case the buyer gets the full benefit of the deferral, or $50 million in which case the seller gets the full benefit. The share of the benefit enjoyed by the seller and the buyer will vary case-by-case, but, it is likely that in nearly every case both the buyer and the seller will enjoy some portion of the tax deferral benefit.

Therefore, the argument that the FCC tax certificate is just compensation for the involuntary nature of the sale or exchange, to the extent it was in fact involuntary, supports the program only to the extent the entire benefit of the tax is conferred on the sellers of the broadcast facilities since it is their loss of the control of the asset which has given rise to the need for the benefit. However, since in most markets it is not possible to guarantee the entire amount of the tax benefit will be retained by the former owner, the tax benefit loses its character of compensation for involuntary conversion and becomes a simple subsidy to the new owners.

Rent-Seeking and the FCC Tax Certificate

The foregoing discussion leads to the conclusion that the FCC tax certificate program can only be justified on economic grounds in those cases in which the sale of the broadcast facility is truly involuntary and in which the entire tax benefit is enjoyed by the seller of the facility. In the absence of any other economic rationale, the tax certificate program becomes the equivalent of any number of subsidy programs designed to benefit some special interest. In other words, except under the narrow conditions described above (involuntary conversion and seller beneficiary), as an economic matter the FCC tax certificate program becomes indistinguishable from farm subsidies or merchant shipping subsidies, except that the beneficiary group is determined by racial rather than by industrial classification.

There are many federal programs which ultimately have a significant rent-seeking quality. (Rent seeking is the economic expression for the actions of any individual or group that seeks special benefits from a governmental entity). Strictly speaking, whether a particular group should be granted special benefits a matter of social policy, rather than economic policy, and to this extent outside the purview of economic analysis.

Common sense provides a simple test, however, of the extent to which a program has a significant rent-bestowing character. This test is unnecessary in most cases since, like farm subsidies, it is easy enough to determine who the rent seekers are, namely the farmers. In the case of the FCC tax certificate program, however, the existence and definition of the rent-seekers is less clear and so the test is more helpful.

The simple rent-seeking test is this: Who favors the program and do they receive a financial benefit from the program? In the case of the FCC tax certificates, this hearing and the testimony given may offer the clearest evidence of who may be rent-seeking, a matter I will leave to the Committee to decide.

Conclusion

The FCC tax certificate program to expand minority ownership of broadcast facilities reflects three policy decisions. The first is to increase the number of minority owned broadcast facilities and, as such, is almost entirely a social policy. The second policy is to compensate the former owners of the facility for the loss of control of their property when the sale was made involuntarily. This compensation arises, however, only to the extent that the purchase price of the facility is not reduced to reflect a sharing of the tax benefit between purchaser and seller.

The third policy reflected by the program is to subsidize the purchase of broadcast facilities through the shared tax benefits granted by the tax certificates. There is no economic justification for such a subsidy program which, like all attempts to subsidize or penalize particular economic activities, distorts the allocation of precious resources. Therefore, the subsidy, too, must be regarded purely as a social policy decision.

The Tax Foundation, a nonprofit, nonpartisan research and public education organization, has been monitoring tax and fiscal activities at all levels of government since 1937.

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