RUMINATIONS ON THE 1986 ACT

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INTRODUCTION

THERE HAS RECENTLY BEEN RENEWED INTEREST in tax reform. In these ruminations on the Tax Reform Act of 1986 ('86 Act), I discuss the economic and political environment in which tax reform occurred, describe administration precursors to the '86 Act, summarize the most important features of the Act, list factors that may help explain "how the impossible became the inevitable," and comment on the present economic and political environment and the prospects for fundamental tax reform.

THE ECONOMIC AND POLITICAL ENVIRONMENT

Setting The Stage: The 1981 Act

To understand the economic and political environment in which tax reform occurred it is necessary to begin with salient features of the Economic Recovery Tax Act of 1981 (ERTA), a point that Minarik (1987) and Steuerle (1992) emphasize. First, ERTA reduced tax rates across the board; but, by failing to increase the zero-bracket amount, which had been eroded by the inflation of the 1970s, it left many families with incomes below the poverty line subject to taxation (Steuerle, 1992) Moreover, the relative increase in after-tax income at the margin was far greater at the top of the income scale than at the bottom.[1]

Second, ERTA included investment incentives (the Accelerated Cost Recovery System, or ACRS, and the Investment Tax Credit, or ITC) that were highly non-neutral in their impact on various kinds of investment and, at then-prevailing rates of inflation, were equivalent to (or more generous than) expensing for some investments. Thus, the marginal effective tax rate was zero (or negative) for some equity-financed investments and negative for debt-financed investments. As a result, many profitable corporations paid little or no tax. Indeed, "safe harbor leasing" made it possible for taxpayers with excess deductions and credits to sell them to others, thereby "zeroing out" tax liabilities, a spectacle Citizens for Tax Justice publicized (On the activities of CTJ, see McIntyre, 2011.) Moreover, in combination with other provisions, including the deduction for nominal interest expense, the preferential treatment of capital gains, and "pass-through" of partnership losses, the incentives led to a flourishing tax shelter industry that added to the perception that the tax system was grossly unfair. Between 1972 and 1985 the American public went from considering the federal income tax the fairest of all major taxes to considering it the least fair (Birnbaum and Murray, 1987).

Third, the rate reductions and investment incentives combined to produce an enormous drop in revenue. Although tax legislation enacted in 1982 and 1984 clawed back a great deal of this revenue, (due in part to increases in spending, especially on defense), the budget deficit remained at 5.1 percent of GDP in 1985, a figure not equaled between 1946 and 1982.

Finally, many nominal figures in the individual income tax, most notably bracket limits, personal exemptions, and the standard deduction, were indexed for inflation beginning in 1985. Besides preventing "bracket creep" from pushing those with unchanged real income into higher tax brackets, indexation meant that Congress could no longer use an "inflation dividend" to finance additional tax breaks. If the federal budget deficit was not to be increased, future tax reforms not matched by spending cuts would need to be revenue neutral (Steuerle, 1992).

Congressional Precursors To The 1986 Act

In the early 1980s hardly any politicians were thinking about fundamental tax reform. The notable exception was Senator Bill Bradley. Like many Democrats, Bradley had become obsessed with the need to close loopholes. But unlike other Democrats, Bradley did not envisage keeping the same rate structure while broadening the tax base in order to increase progressivity. Rather, he would reduce rates so as to keep both revenues and their distribution among income classes constant[2] (On Bradley's efforts, see Birnbaum and Murray, 1987; Minarik, 1987.)

Bradley's ideas did not get traction with his fellow Democrats, but did gain the attention of supply-siders such as Congressman Jack Kemp – a driving force behind the lower rates and investment incentives in ERTA. While perhaps not interested in tax reform for its own sake, supply-siders were attracted by the lower rates that base broadening would make possible. Kemp and his cosponsor, Senator Robert Kasten, produced a plan for tax reform that resembled that of Bradley and his cosponsor, Congressman Richard Gephardt, but was not revenue neutral because it retained many tax preferences (Birnbaum and Murray, 1987).

Administration Interest In Tax Reform

President Ronald Reagan, who had hated high tax rates since his days in Hollywood, may have been attracted by the Kemp proposal, but not enough to endorse it. But the While House was concerned that Senator Walter Mondale would make tax reform a key issue in the 1984 election (Birnbaum and Murray, 1987; Conlon et al., 1990). To disarm such a threat, Reagan instructed Treasury Secretary Donald Regan to prepare "a plan for action to simplify the entire tax code so that all taxpayers, big and small, are treated more fairly" in his 1984 State of the Union message. That November, the Treasury released *Tax Reform for Fairness, Simplicity, and Economic Growth* – commonly known as Treasury I because Regan said it was written on a word processor and could be altered. Treasury I helped define the agenda and set the ground rules for the tax reform process that culminated in the '86 Act (Conlon et al., 1990).

TREASURY I AND *THE PRESIDENT'S PROPOSALS*

Treasury I

Treasury I reflected two key political decisions. First, tax reform should be both distributional neutral and revenue neutral, so as not to conflate technical issues of tax structure (economic neutrality, horizontal equity, and simplification) with deficit reduction and vertical equity — issues politicians could address by choosing higher rates or a different rate structure (For more on the process that led to Treasury I, see Birnbaum and Murray, 1987.)

Second, tax rates must be lowered dramatically to mobilize taxpayers who paid their fair share of taxes against those who did not. Otherwise those with concentrated interests in tax preferences would easily beat back reform efforts, as they typically had. The marginal tax rates proposed were 15, 25, and 35 percent for individuals and 33 percent for corporations, compared to the then-current top rates for individuals and corporations of 50 percent and 46 percent.

Treasury I's basic idea was to tax all real economic income uniformly and consistently, at much lower rates. This implied a wholesale assault on virtually all tax loopholes and preferences, including the 60 percent exclusion of capital gains, ACRS, the ITC, percentage depletion, expensing of intangible drilling costs, and shifting of income to children. Treasury I would also eliminate or limit tax benefits that many might not consider loopholes, such as the deductions for state and local taxes, charitable contributions, and the exclusion of employer-provided health insurance in excess of a floor, other fringe benefits, and inside build-up in life insurance. On the other hand, Treasury I would leave in place some important tax preferences, including the deduction for home mortgage interest (because of a promise President Reagan made to the National Association of Realtors) and the exclusion of social security benefits.

Ad hoc inflation adjustments were proposed for depreciation allowances, the basis of capital gains, and interest income and expense.[3] Real capital gains would be taxed as ordinary income. Fifty percent of dividends paid would be deductible to reduce double taxation of distributed corporate-source income. If all these reforms were implemented the alternative minimum tax (AMT), which then only applied to a short list of tax preferences benefitting primarily high-income taxpayers could be repealed. Treasury I's approach was not only required to produce horizontal equity and economic neutrality; it was believed also to be conducive to simplification, despite the complexity of inflation adjustment.

Personal exemptions and the standard deduction would be increased enough to eliminate income tax on six million taxpayers with income below the poverty level. Otherwise, tax rates were chosen to maintain revenue neutrality, as well as distributional neutrality among individuals. Inherent in the proposed tax rates, though, was a substantial shift of tax liabilities from individuals to corporations. Minarik (1987) stresses that the lower individual tax rates this shift made possible may have been important in gaining Reagan's support for Treasury I. Because the corporate tax increases were not attributed to individuals in tables showing the distributional effects of tax reform, the shift had the political benefit of increasing the apparent number of individual winners and reducing the number of losers.[4]

The tax base underlying Treasury I was essentially the Haig-Simon definition of income (That definition did not, however, include integration of the corporate and individual income taxes or inflation adjustment in the measurement of income.) It was not consumed income, to the consternation of many economists who advocated a consumption-based tax. There were several reasons for this choice: the American public might dislike the fact that the young and the old would pay more under the income tax; bequests might not be included in taxable income, producing a tax on only consumption rather than on lifetime income or endowments; if the proceeds of borrowing were not included in the tax base, as required under a consumption-based tax, the problems associated with ERTA would recur; there were troubling international issues, including the possibility of new methods of tax evasion and the need to renegotiate tax treaties; transition would be difficult; and other unforeseen "show-stoppers" such as insurmountable administrative challenges might be discovered late, leaving Treasury without a coherent proposal[5] (McLure and Zodrow, 1987). Nor did the Hall-Rabushka flat tax receive serious attention, in part for the reasons just listed (or analogous ones, including fear that interest might not be non-deductible). Moreover, a flat rate, whether imposed on income or the flat tax base, would drastically alter the distribution of tax burdens by reducing liabilities at the very top of the income scale.

The President's Proposals

Once Treasury I was released, political compromise began, culminating six months later in *The President's Tax Proposals for Fairness, Growth and Simplicity* (hereinafter *The President's Proposals*), which was far less conceptually pure (On the process of compromise, see Birnbaum and Murray, 1987). Among important differences were these: charitable contributions would be fully deductible (only for itemizers); only employer-provided health insurance below a limit, not above a floor, would be taxed; there would be no inflation adjustment in the measurement of income, except for depreciation allowances, which would be less generous than ACRS; only 10 percent of dividends paid would be deductible; one-half of nominal long-term capital gains would continue to be excluded; expensing of intangible drilling costs would be continued; and the AMT would be retained and tightened (For a comparison of key provisions in Treasury I and *The President's Proposals*, see the latter, p. 26-30). The demotion of simplicity from second to third place in the list of objectives in the title of *The President's Proposals* foreshadowed one hallmark of the '86 Act – its complexity.

KEY FEATURES OF THE 1986 ACT

The '86 Act was a gargantuan piece of legislation. While superficially similar to Treasury I, the '86 Act was conceptually different. It combined low-income relief, the closing of loopholes especially for capital income, and a reduction and flattening of tax rates to 15, 33, and 28 percent for individuals and 34 percent for corporations. (Strictly speaking, there were only two rates, 15 and 28 percent. The 33 percent rate was created by the phase-out of the benefit of the 15 percent rate.) The result was less fair, less economically neutral, and far more complex than Treasury I[6] (McLure and Zodrow, 1987).

The '86 Act eliminated or limited many "vanilla" tax preferences that benefit middle-class taxpayers, including the deduction of sales taxes and consumer interest and the ability to use IRAs to postpone tax on retirement savings. Despite retaining accelerated depreciation and favorable treatment of oil and gas, the '86 Act focused on provisions that interact to create opportunities for tax arbitrage or tax shelters. It taxed nominal capital gains as ordinary income, limited deductions for losses from passive investments, and limited deduction of investment interest expense to investment income. The Act rejected indexation in the measurement of income and partial integration of the corporate and individual income taxes.

The '86 Act reduced tax expenditures by some 40 percent, in large part by reducing tax rates, but left many tax preferences intact, including the exclusion of social security benefits, employer-provided health insurance, and inside build-up, as well as the deductions for home mortgage interest (subject to a limit on principal of $1 million), charitable contributions, and income and property taxes. Together these preferences account for substantially more revenue loss than the loopholes that were closed.

The '86 Act retained the individual AMT, changing its character by expanding its base to include middle-class tax preferences and increasing its rate from 20 to 21 percent. Whereas the AMT rate was previously only 40 percent of the top marginal rate (50 percent), the new rate was 75 percent of the top marginal rate (28 percent). Moreover, the exemption and bracket limits were not indexed. Thus, far more households became subject to this unnecessary and complex "stealth tax" that operates in parallel with the regular tax system. Congress must annually enact a "patch," increasing the exemption, to prevent more middle-income taxpayers being subject to it (McLure and Zodrow, 1987).

Like Treasury I and *The President's Proposals*, the '86 Act maintained distributional neutrality among individuals (It also reduced individual taxes and increased corporate taxes.) While recognizing that distributional neutrality may have been a political necessity, Richard Musgrave (1987, p. 65-67) notes that distributional neutrality "legitimizes the pre-reform role of such loopholes" in reducing the progressivity of the income tax and argues that the distribution of tax liabilities across income classes deserves an explicit review. Proposing an increase in progressivity, however, would have branded Treasury I, and thus tax reform, dead on arrival at the White House (For a more realistic appraisal, see Pechman, 1987.)

HOW DID THE IMPOSSIBLE BECOME THE INEVITABLE?

Birnbaum and Murray (1987, p. 5) call the '86 Act "without a doubt the most significant reform in the history of the income tax." Yet its enactment was hardly pre-ordained. In the only italicized sentence in a long book published in 1985, John Witte (p. 380) had written, "There is nothing, absolutely nothing in the history or politics of the income tax that indicates that any of these schemes have the slightest hope of being enacted in the forms proposed." Thus, Joe Pechman (1987, p. 15) calls the '86 Act "a remarkable event;" Conlon et al. (1990, p. 1) call it "little less than a modern miracle" and "the unlikeliest of long shots;" and Minarik (1987, p. 1372) states, "The passage of tax reform required the most incredible confluence of circumstances – almost like an alignment of the planets." President Reagan noted that a headline in the Washington Post told the whole story: The Impossible Became the Inevitable (quoted in Birnbaum and Murray, 1987).

An intriguing question is thus: "How — and why — did the '86 Act happen?" Among the many attempts to explain this phenomenon are those by Birnbaum and Murray (1987), Conlon et al. (1988), and Pechman (1987). A summary list of possible explanatory factors may be in order:

- Perhaps most important, President Reagan made tax reform the flagship domestic initiative of his second term. Without Reagan's support, it is unlikely that the '86 Act would have garnered the required support of Republican members of Congress.
- Members of both parties advocated tax reform plans cut from the same cloth as the '86 Act, although for significantly different reasons – Senator Bill Bradley to further economic neutrality and horizontal equity and Congressman Jack Kemp to lower rates.
- Fear in the Reagan White House that Walter Mondale would endorse Bradley's proposals, while unfounded, led to the request for Treasury I.
- Rather inexplicably and with only one important exception (Reagan's declaring the home mortgage deduction off-limits), the White House never meddled in the formulation of Treasury I, leaving the Department free to offer a plan that was relatively pure conceptually, setting a high standard against which subsequent proposals were judged.
- Chairmen Dan Rostenkowski of the House Ways and Means Committee and Bob Packwood of the Senate Finance Committee deserve enormous credit (On the legislative process, see Birnbaum and Murray, 1987). Their motivations are unclear, as neither had been a friend of tax reform. Perhaps it was because, as Jeff Birnbaum (1987, p. 358) said, "No one wanted the dog to die on his doorstep."
- Although the public showed little interest in tax reform, the media did. It would have left no doubt on whose doorstep the dog had died.
- ERTA left heavy burdens on low income families, distorted investment, and created the spectacle of tax shelters and profitable corporations paying little or no tax. The system cried out for reform.

- Tax reform had a constituency among policy experts at the Treasury and the tax-writing committees of Congress. Treasury experts pushed for Treasury I's conceptual purity and those on Capitol Hill supported reform when it threatened to falter in committee.
- Some Republicans saw tax reform as the vehicle for a fundamental realignment of party loyalties. While Democrats may have been skeptical, they were afraid to vacate the field.
- Due to the twin constraints of revenue neutrality and distributional neutrality, the tax reform debate focused on horizontal equity and economic neutrality, without being sidetracked by the contentious issues of vertical equity and deficit reduction.
- The decision to attempt fundamental reform, rather than incremental change, meant reductions in tax rates could be large enough to swamp the pleadings of vested interests.
- Tax reform was built on a long tradition of academic analysis. There was no attempt to base reform on new and untried ideas such as the consumed-income tax, the darling of some academic tax professionals, or the flat tax, that of other academics and supply siders.
- The business community did not present a united front, as in 1981. Because lobbyists represented divergent interests, those opposing tax reform could never gain traction.
- Secrecy was important at various stages. Had the White House, let alone Republican supporters, known what Treasury was thinking, it might have reined in the effort. Had Rostenkowski and Packwood not closed some sessions so lobbyists could not see whose ox was being gored and by whom, their committee members may have shown less courage (On Treasury I's reception by the White House and the role of secrecy in Congressional proceedings, see Birnbaum and Murray, 1987.)

TAX REFORM REDUX?

The situation today resembles that of 1984-86 in some respects, but differs in others.

Budgetary Imbalance

As in 1984, there is a federal budget deficit, but projected deficits are so large that tax reform cannot sensibly be revenue neutral. Responsible observers agree that one objective of tax reform should be to increase revenues, not by raising rates but by curtailing tax expenditures.

The Nature Of Tax Expenditures

Unlike in 1984, tax breaks benefitting wealthy taxpayers are relatively uncommon. The most important tax expenditures, as then, are for home mortgage interest, pension saving, employer-provided health insurance, state and local taxes, and charitable contributions. It would thus be much harder to pit winners against losers, even if revenue neutral tax reform were contemplated. Since increased revenue is required, there will be relatively few winners, even if part of the increase in the tax base is reflected in lower rates; losers will far outnumber winners.

Bush-Era Tax Cuts

Like ERTA, the tax cuts enacted under President George W. Bush reduced substantially the progressivity of the individual income tax, despite increasing the number of households paying no income tax. Unlike the 1981 changes, the Bush-era tax cuts did not create the spectacle of tax shelters and corporations paying no tax. They lowered taxes on high-income taxpayers, primarily by reducing the top marginal tax rate and cutting the rate applied to dividends and capital gains to 15 percent. The Tax Policy Center estimates that in 2010 the top quintile of taxpayers received almost two-thirds of the benefit of tax reduction and the top 0.1 percent alone received 14.1 percent. After-tax income of the first quintile was only 0.5 percent higher in 2010 than it would otherwise have been (assuming no difference in before-tax income) and that of the middle quintile was 2.6 percent higher, while that of the top quintile was 4.9 percent higher and that of the top 0.1 percent of taxpayers was 7.8 percent higher (Tax Policy Center, 2010.) This regressive shift in the distribution of tax burdens occurred in the context of growing inequality of before-tax income.

Political Polarization

Few of the factors that may explain enactment of the '86 Act are currently in play. More important, there is a huge difference in the political environment between now and 25 years ago. There was not the vitriolic enmity emanating from a seemingly intractable ideological chasm that exists today. It is hard to imagine members of Congress from different parties agreeing on the broad outlines of tax reform or presidential endorsement of a plan offered by the other party. Whether fiscal necessity will force liberals and conservatives to compromise and enact tax reform remains to be seen. On balance, the prospects for tax reform do not look good.

Acknowledgements

The author gratefully acknowledges useful comments Eric Toder and George Zodrow made on earlier drafts.

Notes

[1] Reducing the top marginal rate from 70 percent to 50 percent increased after-tax income at the margin by two-thirds, from 30 percent of before-tax income to 50 percent. Reducing the bottom rate from 14 percent to 12 percent increased after-tax income at the margin by 2.3 percent, from 86 percent to 88 percent. (These comparisons ignore payroll taxes.) These differences in percentage increases are much more dramatic than the reductions in marginal tax rates, two-sevenths and one-seventh.

[2] It is sometimes difficult to know whether a change is revenue and distribution neutral. Effects can be calculated relative to either current policy or current law, which reflects the slated expiration of tax provisions. Also, without revenue neutrality, it is hard to know what distributional neutrality means or how to describe changes in progressivity. See note 1.

[3] The ad hocery of the proposal for piecemeal inflation adjustments, with its attendant complexity, is an important defect of Treasury I. It would have been far better to propose the sophisticated integrated system pioneered in Chile and summarized in Harberger (1988).

[4] It was difficult, however, to know whether distributional neutrality would be achieved overall, because of uncertainty over the incidence of the corporate tax – or even how to define distributional neutrality. See note 2 above and McLure and Zodrow (1987).

[5] Minarik, 1987, p. 1365, mentions the difficulty of explaining the consumed income tax to constituents as one reason Bradley rejected it.

[6] Restrictions on deductions for interest were especially complex. Graetz, 2011, p. 317-18, notes that there are at least 17 different categories of interest. For more on defects of the ’86 Act, see Steuerle, 1992.

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