

DUNWODY DISTINGUISHED LECTURE IN LAW
THE TRUTH ABOUT TAX REFORM

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I. INTRODUCTION

The Tax Reform Act of 1986 has been widely heralded as the most important tax legislation since the income tax was converted to a tax on the masses during the Second World War. Since his favorite proposal for a constitutional amendment — the one calling for a balanced budget — was not adopted, the 1986 Tax Reform Act clearly will be

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the major domestic achievement of Ronald Reagan's presidency. This law even produced the new Internal Revenue Code of 1986; no more Internal Revenue Code of 1954, as amended. It took until the very end of 1987 until we were forced to add that felicitous phrase "as amended" to the 1986 Code.

The near term future of the income tax — and, perhaps, even its long-term destiny — will be shaped by the Tax Reform Act of 1986. It is, to be sure, significant legislation, some would even say unique, massive both in its scope and in its detail — at least a 9.1 if we had a Richter scale for this sort of thing. What seems most unique to me about this legislation, however, is the character of the commentary it has inspired, commentary marked by hyperbole. Hyperbole about the 1986 Act from the politicians and the press is, of course, unexceptional; hyperbole, after all, is their stock in trade. I am surprised, however, that nobody even asked President Reagan, "Are you sure?" when he described the 1986 Tax Act as "the best anti-poverty measure, the best pro-family measure and the best job-creation measure ever to come out of the Congress of the United States." Wrong. Wrong. Wrong. Zero for three, Mr. President.

Even people who should know better have gotten carried away. Reading the academic literature on the 1986 Act has a quality reminiscent of watching a Tennessee Williams' play: you know there is something very wrong here, but nobody's *talking* about it. The Brookings Institution, for example, published an article heralding the 1986 Tax Reform Act as "The Impossible Dream Comes True."¹ Surely that title says more about the poor author's dreams than about the 1986 Tax Act. The 1986 Act has generated a flood of commentary and, necessarily, an enormous amount of technical analysis, but it has inspired very little real evaluation of its merits and demerits. The time has come to tell the truth about this tax reform.

II. THE SORRY STATE OF PRIOR LAW

First, that this legislation is such a major event is surely more a testament to the sorry state of prior law than to the wondrous and delightful quality of the new statute. The federal income tax was increasingly criticized in the 1980s as inequitable, economically inefficient, and unnecessarily complex. In 1972, a plurality of Americans had considered the federal income tax the fairest of all the major taxes

1. Aaron, *The Impossible Dream Comes True: The New Tax Reform Act*, 5 BROOKINGS REV. 3 (1987).

used by the various levels of government; from 1979 to 1983, a plurality rated the income tax as the least fair.²

This sentiment was attributed in part to the widespread perception that "everybody else" was engaging in tax avoidance or outright tax evasion. For example, 69 percent of respondents in a 1978 survey agreed that "most people who have a higher income than I do manage to get away with paying less than their fair share of taxes." Inflation also contributed to the unpopularity of the income tax by producing "bracket creep" that taxed individuals at higher marginal rates each year regardless of whether they had experienced any increase in their purchasing power.

Moreover, capital was running around the country like the Keystone Cops, looking for the most tax-favored investments. Much of the nation's innovative energies, entrepreneurial spirit, and marketing imagination had become concentrated in the creation, production, and selling of "tax shelter" investments. High income individuals thought they had finally discovered the golden-egg goose. Unfortunately it was the taxpaying middle class that was being plucked. There was hardly an airline pilot or dentist in the country who believed it was better just to earn a dollar, pay fifty cents in taxes and keep fifty cents, than to throw the dollar at a tax shelter in the hopes of keeping it all. P.T. Barnum would have loved it. The game was so silly that tax shelters had emerged in a wide variety of products hardly crucial to the national economy, such as jojoba beans. Even I got calls from tax shelter promoters. My favorite call was from someone selling a tax shelter in chinchilla farms. An investment not only allowed the investor to be included among the nation's ever increasing group of financially troubled small family farmers, but also promised a chinchilla coat. If they had only had one in my size, I might have "invested." Who could ask for anything more?

III. THE POLITICAL MIRACLE

I now believe that the silence of critics concerning the 1986 Act is due to a combination of shock that this legislation actually got enacted and a quiet recognition that it was the product of a very uneasy marriage of two contrary ideological and political camps.

The growing antipathy toward the income tax had not gone unnoticed by the nation's politicians. Many "tax reform" bills were introduced in Congress in the early 1980s, most notably the "Fair Tax" of

2. Goode, *Overview of the U.S. Tax System*, in *THE PROMISE OF TAX REFORM* 14-15 (Pechman ed. 1985).

Democratic Senator Bill Bradley and Representative Richard Gephardt, and the "Fair and Simple Tax" (FAST) of Republican Representative Jack Kemp and Senator Robert Kasten. Also, President Reagan asked the Treasury in his 1984 State of the Union message to prepare a "plan for action to simplify the entire tax code so all taxpayers, big and small, are treated more fairly."

A number of proposals — principally by academics, but also by some members of Congress — would have replaced the income tax with consumption taxes, but by late 1984, the leading proposals of both Republicans and Democrats would apply a reduced and "flattened" rate structure to a broadened income tax base that would include many preference items that have previously gone untaxed. A three volume document of analysis and income tax reform proposals was released by the Treasury Department in November 1984.³

The Treasury proposal was similar in many respects to the two leading congressional proposals for a broader-based, flatter-rate income tax. The Treasury proposal departed from the Bradley-Gephardt and Kemp-Kasten proposals, however, both by including more items of income in the tax base and by eliminating more deductions, and also by attempting to redress such basic structural problems of the income tax as the distortions of income measurement due to inflation and the "double" taxation of corporate profits distributed to shareholders as dividends. In addition, although the Treasury Plan was revenue-neutral overall, it did contain a corporate tax increase that was used to finance tax reductions for individuals. Like the Bradley-Gephardt and Kemp-Kasten plans, the Treasury proposal relied not only on the elimination of many existing tax preferences to discourage tax shelters, but also proposed lower rates both as a fundamental trade-off for base broadening and to make such tax shelter deductions less attractive to potential investors. On May 29, 1985, President Reagan submitted his tax reform proposals to Congress. Although these recommendations differed in some important respects from all three predecessor plans, they embraced the general principles of a broader-based flatter-rate income tax that ultimately were enacted in the 1986 Tax Reform Act.

Notwithstanding bipartisan support for the idea of income tax reform, probably the most remarkable thing about this legislation is that it happened.⁴ According to conventional wisdom, major tax reform

3. DEPARTMENT OF THE TREASURY, REPORT TO THE PRESIDENT, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH (1984).

4. For an excellent description of how the 1986 Tax Reform Act made it through Congress, see J. BIRNBAUM & A. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM (1st ed. 1987). See also Minarik, *How Tax Reform Came About*, 37 TAX NOTES (TAX ANALYSTS) 1359 (Dec. 12, 1987).

legislation cannot be enacted unless three forces coalesce: Presidential initiative, enthusiasm from the tax writing committees' chairmen, and strong and vocal support from the populace. So much for conventional wisdom. How on earth was this tax reform enacted?

First, Ronald Reagan and his Republican colleagues became surprising leaders of a tax reform movement. The Democratic party in its political platforms had long supported base-broadening income tax reform, but many Democrats doubted the wisdom of that position. The Bradley-Gephardt plan, for example, was not embraced by Walter Mondale in his 1984 presidential campaign, and the tax reform rhetoric produced very little by the way of legislation. Jimmy Carter in 1978 had pronounced the income tax "a disgrace to the human race" and called for its "complete overhaul." Instead of an overhaul, however, all he got was the usual oil change and lubrication. The Republicans, on the other hand, had never been known as great advocates of broadening the income tax base.

Ronald Reagan had described the progressive income tax as having come "direct from Karl Marx" who, according to Reagan, "designed it as the prime essential of a socialist state."⁵ Yet President Reagan made tax revision his highest domestic priority, attempted with many trips and speeches to foment public support, and, by going personally to Congress at a critical moment, rescued the bill from destruction by the House Republicans.

President Reagan's key congressional ally ultimately proved to be Senator Robert Packwood, then the Republican Chair of the Senate Finance Committee, who had so often praised the prior tax code and urged new loopholes that the *New Republic* magazine had dubbed him "Senator Hackwood." He seemed to share a very limited ambition with Dan Rostenkowski, the Democrat Chairman of the Ways and Means Committee — a man notorious for having little substantive interest in the tax law. But neither wanted to be known as the person who killed tax reform.

Congressional ennui mirrored public disinterest. Unlike 1969, for example, when Congress received more letters on tax reform than on any other issue (including the Vietnam war), the 1986 tax reform faced public silence. Although it remained something of an apple pie issue — everyone supports tax simplification and reform in the abstract — no groundswell of support for the President's proposal emerged. On June 25, 1986, the day after the Senate had passed the Tax Reform

5. Reagan, *Encroaching Control: Keep Government Poor and Remain Free*, 27 VITAL SPEECHES OF THE DAY 677 (1961), quoted in Chirelstein, *Back from the Dead: President Reagan Saved the Income Tax*, 14 FLA. ST. U.L. REV. 207 (1986).

Bill by a 97-3 vote, *The New York Times* reported results of a telephone poll: less than one-third of the American public believed that the Senate bill would either produce a fairer tax system or reduce their taxes. Political momentum was bipartisan, but tepid.

IV. THE CRITICAL IDEA

Typically one of two dominant concerns supplies the motivation for tax reform: fairness (either in the overall level or distribution of the tax burden) or short-term fiscal policy needs. This time, neither provided the impetus. Congress did hear public concern about high-income individuals who had found shelter from tax and about corporations that had managed to combine high book profits with little or no tax liability, but the prospect of improving fairness in the distribution of the overall tax burden was inadequate to the task of tax reform. Other than the goal of removing people at the poverty level from the income tax rolls, distributional fairness issues generated little enthusiasm; "distributional neutrality" became the guiding principle.

Likewise, notwithstanding some efforts to sell tax reform on the ground that it would reduce taxes for a majority of Americans by increasing taxes of corporations or someone else, no one regarded the current endeavor as an occasion for an overall tax reduction. The great tax reducing momentum of the 1970s that inspired California's Proposition 13 and similar changes dramatically reducing state taxes and that had served as the fulcrum for the federal tax legislation of 1981, was absent. Moreover, tax reform this time was isolated from the most critical issue for short-term economic well-being: deficit reduction. Hopes for simplification offered some stimulus, but deregulation of the economy is the idea that seems to have provided the greatest push for this tax reform effort.

By 1986, reducing the size of government and deregulating the national economy had become an article of faith within the Reagan administration and within the Republican party generally. The intellectual motivation for deregulating the economy, restricting the government's role in influencing economic decisionmaking in the private sector, argues strongly for broadening the tax base and lowering tax rates. Incremental tax revisions like those of previous years simply are incapable of performing any substantial deregulation function. Only a major base-broadening change could advance deregulation ambitions. Although the goal of greater neutrality in affecting economic decisions has long been claimed for tax revision legislation, this tax reform seems genuinely to have been designed in substantial part to serve deregulation, an unconventional tax policy idea.

V. AN UNEASY MARRIAGE

Ultimately then, what moved the 1986 tax revision was an uneasy marriage of two very different agendas. The conventional tax reformers — who principally were interested in improving tax equity by broadening the income tax base so that income would be treated in similar fashion for tax purposes regardless of its source — joined together with supply-siders and deregulators who principally were interested in enacting lower tax rates “to get government off the backs” of the American public and American businesses. Without a substantial reduction in the tax preference and incentive provisions of the tax code, deregulation of the American economy would necessarily have remained incomplete, and a massive reduction of tax rates had long been the supply-siders’ dream.

That this marriage could occur in Congress was due in large part to the divergent effects of the 1986 tax reform on the business community. Some businesses, such as service and high technology businesses, enjoy a substantial tax reduction principally due to the lowering of the top corporate rate from 46 to 34 percent; others face a significant tax increase, either because of repeal of special industry-specific tax breaks or, more generally because of the repeal of the investment tax credit. As a result, the business community was split politically, with some major corporations fighting the tax reform every step of the way, but with others playing a strong supporting role.

This is a very uneasy marriage. The ink was hardly dry on the 1986 Act before divorce proceedings started. Some Democrats, most notably the Speaker of the House James Wright, started talking immediately about delaying rate reductions scheduled to go into effect in 1988 to reduce the federal deficit. But that did not happen, and the majority of Democrats do not seem so politically stupid to push for an income tax rate increase immediately. The only Democrat who “stood up” for tax increases, Bruce Babbitt, was promptly given his exit pass from the Presidential race. Likewise, the supply-siders are already expressing concerns about the effect of the Tax Reform Act on savings and investment, and are readying new tax incentive ideas and preparing to resurrect old ones. Only the large size of the federal deficit seems likely, at least temporarily, to keep both of these forces at bay.

VI. THE TWIN TOWERS: REVENUE NEUTRALITY AND DISTRIBUTIONAL NEUTRALITY

Prior to 1982, conventional wisdom held that tax reform could be enacted only in connection with an overall tax reduction. The basic

premise was that elimination of special tax privileges had to be bought through a reduction in the level of taxes. The Tax Equity and Fiscal Responsibility Act of 1982 turned this conventional wisdom on its head. That year Congress enacted a series of "loophole-closing" provisions to increase federal revenues and narrow future deficits. The 1982 experience led many people to believe that tax reform proposals could succeed only if they contributed significantly to federal revenues thereby lowering deficits.

By contrast, the linchpin of the 1986 Act was *revenue neutrality*. By insisting on revenue neutrality, both the Administration and the Congressional leadership were able to demand that amendments to the tax bill should be offered only if any revenue losses were offset by revenue gains. This remarkable procedural use of the revenue neutrality requirement served with great effect both in the House and Senate tax writing committees and on the Senate floor. As one Senator remarked during the Finance Committee's markup, an important constituent felt quite differently about an amendment that would have restored a 100 percent deduction for business entertainment expenses when that change was explicitly coupled with an increase of one point in the corporate tax rate. By the same token, Senators themselves behaved quite differently in this novel environment; to pay Peter, they had to be explicit and exact in stating how they intended to rob Paul.

For the would-be-seer, the crucial role of revenue neutrality in shaping this legislation should cause consternation. It is now possible to believe that substantial tax reform can be accomplished only in the context of revenue neutrality or, alternatively, to believe that significant tax revision is now possible whether revenues are reduced, increased, or left unchanged.

Tax reform started out not only revenue neutral, but also distributionally neutral; that is, the view predominated that this tax reform should not become an occasion for significant shifts in the distribution of income tax burdens among income classes. By the time the 1986 tax reform finally made its way through Congress, the pure distributional neutrality of the original Bradley-Gephardt bill had been abandoned.⁶ Corporate taxes were raised somewhat from their low levels of the early 1980s to finance individual income tax reductions for middle and lower income people, but the 1986 Act never became an occasion for any important shift in the distribution of the income tax burden across income classes. The singular distributional achievement

6. See Minarik, *supra* note 4, at 1365-66.

of this legislation is the widely-heralded removal of six million poverty level families from the income tax rolls. But as one wag has already pointed out, these are the same six million people who Congress originally removed from the tax rolls in 1969 and again from time to time throughout the 1970s and who kept finding themselves subject to income tax because of the effect of inflation in increasing their level of taxable income. Distributional neutrality, along with revenue neutrality comprised the guiding principles for this legislation.

VII. THE OVERALL EFFECTS OF THE 1986 ACT

A tax act forged from a concerted effort to be *neutral* both in terms of the total federal revenue and the distribution of the tax burden simply will not have massive economic effects on the American economy, no matter what the politicians, the journalists, or some economists would have you believe. This tax bill will therefore likely neither revitalize American productivity, as some of its admirers suggest, nor destroy it, as many of its detractors contend. Recent economic estimates suggest that the 1986 Act will spur perhaps a one percent increase in hours worked, a genuine benefit, but no new American revolution.

The 1986 legislation increases taxes on the income from new business investment because the repeal of the investment tax credit, depreciation revisions, and other corporate tax increases were not fully offset by lower corporate tax rates. Both the base-broadening and the lower rates should tend to inspire investment decisions guided more by economic than tax considerations. By lowering significantly the wide disparities of prior law in the tax burdens of corporations in different industries, improvements should occur in the allocation of resources and this should have some positive long-term effect on the American economy. There should be some increase in the efficiency of the use of capital. Debates will, no doubt, rage for years about how successful are the 1986 Act's efforts to reduce tax distortions of investment decisions and thereby improve the efficiency of the American economy. In any event, the immediate effects of this tax reform on the overall state of the American economy should be small — dwarfed in fact by general fiscal and monetary policies. For example, reduction of overall interest rates of 0.8 percentage points would fully offset the increase in the cost of capital caused by the 1986 Act's revisions of the corporate tax.

Thus, cries of fear for the American economy because of the 1986 increase in corporate taxes seem greatly overstated. The 1986 Act's increase in corporate taxes simply halted what was becoming one of the world's great disappearing acts; the corporate tax had declined

from more than 28 percent of federal revenues in 1953 to about 6½ percent in 1983. Even after the 1986 changes, the corporate income tax is expected to account for only about 11 percent of federal revenues and the share of total income taxes paid by corporations will continue to be below pre-1980 levels.

Even the dramatic reduction in the maximum individual tax rate by the 1986 Act, to 28 percent, does not seem likely to have major *economic* significance. The last time income tax rates were this low was the period 1925-1932 when Secretary of the Treasury Andrew Mellon set the model for Ronald Reagan by lowering the top rate from its high of 73 percent in 1921 (when he took office) to 25 percent in 1925. President Reagan started three points lower, at 70 percent in 1981, and ended three points higher, at 28 percent in 1986, so there may still be something left for George Bush to do. Of course, the period of the 25 percent top rate from 1925 to 1932 was something of a mixed economic bag: times were very good for a while, then times became very bad. During the subsequent five decades from 1932 to 1982, also a period of some very good years and some bad ones, the top rate never dropped below 63 percent. The notion that low maximum tax rates are good — indeed, critical to the American economy — is an article of faith in some quarters, principally Republican ones, and that faith is unshakable. Historical facts are merely accidents to true believers.

VIII. THE DEMISE OF FEDERAL TAX PROGRESSIVITY

The reduction in the top rate, notwithstanding its likely minimal impact on the American economy, nevertheless is the most significant aspect of the 1986 Act. First, it signals, at least for now, the demise of progressivity as the guiding principle for fairness in the distribution of tax burdens in the federal tax system. This elimination of progressivity as a potent normative ideal, no doubt, largely accounts for President Reagan's joy upon signing the 1986 Act. In combination with the continuing escalation of payroll tax revenues and the 1981 emasculation of the estate and gift taxes,⁷ the 1986 Act's rate changes essentially eliminated progressivity from the federal tax system. Reagan had long regarded progressivity as morally wrong and had stated that it conflicted with the proportionality of the Biblical tithe, 10 percent from rich and poor alike. Reagan also, as I have indicated,

7. See generally Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 259 (1983); see also Graetz & McDowell, *Tax Reform 1985: The Quest for a Fairer, More Efficient and Simpler Income Tax*, 3 YALE L. & POL'Y REV. 5, 16-23 (1984).

had asserted that the idea "came directly from Karl Marx," ignoring such earlier radical proponents of tax progressivity as Adam Smith.

The demise of progressivity was aided and abetted in Congress by the widespread notion that no one paid taxes at the top rates because of the proliferation of tax shelters during the 1970s and early 1980s. Boris Bittker has shown this notion to be wrong in his calculations that about 15 percent of the revenues generated by the income tax came from income taxed at either a 49 or 50 percent rate in 1982.⁸

Even more importantly, the impact of the destruction of progressivity in the rate structure as the proper normative principle for income tax fairness has been masked by the cloak of the "distributional neutrality" principle. In terms of actual short-term distributional consequences, the distributional neutrality criterion meant little change in the post-1986 Act progressivity of the burden of the income tax, although the removal of six million poverty-level people from the income tax roll did increase progressivity at the bottom and Congress did attempt somewhat to target tax reductions to the middle class. How everyone else fared depends on the distribution of the burdens of the corporate tax changes. If the corporate income tax is a burden on capital — as many economists believe, at least in the short run — the higher income classes did not achieve a great tax reduction. On the other hand, if the corporate tax burden is passed on to consumers in the form of higher prices — as most business people believe — both the middle class and progressivity took something of a beating. More importantly, however, by looking to 1985 law as the normative guide rather than to some other normative benchmark grounded in notions about fairness in the distribution of taxes, the distributional neutrality principle had the effect both of blessing the substantial reduction in progressivity that had been achieved in the 1981 federal tax legislation and, in effect, of ratifying the tax reductions that high-income dentists and others had managed to achieve through tax shelter investments.

The genuinely interesting question, of course, is whether this most recent demise of progressive income tax rates will prove more stable than that wrought by Andrew Mellon in the 1920s (even though seven years with a top rate of 28 percent may be long enough for the rich to get considerably richer). As before, it may take some massive economic shock or even a war to produce significantly higher income tax rates, although the deficit seems to mean that top rates will not

8. Bittker, *Letter to the Editor*, in *NEW YORK REVIEW OF BOOKS*, July 16, 1987, at 49-50.

get lower than they are today. This is a *very* good year for earning income. My guess is that the resurrection of progressive income tax rates will occur slowly, if at all.

IX. THE TENUOUS CAPITAL GAIN LINCHPIN

Ironically, the greatest threat to the low top rates fashioned by the 1986 Act currently comes from proposals to reduce capital gains taxes. No issue better reflects the tension in the 1986 marriage of the traditional tax reformers and the supply-siders than their attitudes toward taxation of capital gains. Beginning with the 1969 Tax Reform Act, which eliminated the top 25 percent rate that had previously been applicable to capital gains, and continuing through the 1976 Tax Reform Act, proponents of tax reform had succeeded in narrowing the gap between tax rates on capital gains and ordinary income. Under the 1976 Act, the potential top rate on capital gains was 49.9 percent, compared to a 50 percent maximum rate on earned income (and a 70 percent rate on unearned income). In 1978, the Treasury Department, under President Carter, had developed major tax reform proposals that resembled closely the 1984 Treasury recommendations. The thrust of those proposals was a major cutback on itemized deductions, a top income tax rate of 50 percent, and equal taxation of capital gains and ordinary income.

By 1978, however, Congress was less concerned about ensuring that high-income individuals paid their fair share of tax and more concerned about redressing overtaxation due to inflation and increasing investment and "capital formation." (It was the supply-siders' opening day.) The tax burden on capital gains was unacceptably high in light of these concerns, and the Revenue Act of 1978 lowered the top capital gains rate to the now magic number of 28 percent. This was done, first, by increasing the exclusion of capital gains from income from 50 to 60 percent of long-term gains, and second, by changes in the minimum tax provisions. The Economic Recovery Tax Act of 1981 lowered the maximum rate on all ordinary income from 70 percent to 50 percent. As a result, the highest marginal rate on capital gains became 20 percent, a top 50 percent rate applied to the included 40 percent of capital gains. (This was the supply-siders' heyday.)

The 1986 Act eliminated the preferential tax treatment of capital gains, which means that like ordinary income, capital gains beginning in 1988 are taxed at a top average rate of 28 percent, although the top marginal rate may be as high as 33 percent. As a signal of the likely stability of this abolition of the capital gain advantage, Congress retained the entire pre-1986 statutory structure for distinguishing capital gains and losses from ordinary gains and losses.

The elimination of the capital gains preference was a key aspect of the 1986 Act. It meant that the distributional consequences of lowering the top rate to 28 percent were not unacceptable to the traditional tax reformers. It restrained the 1986 tax reductions for the highest bracket taxpayers and, at the same time, the increase in the top capital gains rate from 20 to 28 percent was estimated to produce some revenue to finance the overall rate reduction.

Several bills were introduced in Congress in 1987 to lower the capital gains rate. President Reagan expressed his desire for lower capital gains rates in his legislative message to Congress accompanying the 1988 State of the Union Address. George Bush has crisscrossed America urging a reduction in the rate on capital gains to 15 percent.

The huge federal deficit now serves as the barrier generally precluding tax reduction proposals from being taken seriously in Congress, but capital gains has a certain magical quality that may allow it to elude this force. Congress may predict a revenue gain any time it changes capital gain taxation, whether by lowering or increasing rates. It all depends on what Congress assumes that the rate change will do to people's realizations of capital gains. Both in 1978 when capital gain taxes were reduced, and again in 1986 when they were increased, Congress predicted increased federal revenues. Absent any revenue constraint, only concerns about the fairness of further tax reductions for high income taxpayers obstruct reintroduction of the capital gains preference into the income tax.

Of course, once the capital gain tax rate is lowered, the magic disappears from the 28 percent top rate. It is the taxation of capital gains at the same rate as ordinary income that effectively caps the top rate at 28 percent. Eliminate the linkage between capital gains and ordinary income and you eliminate the main glue that keeps the top rate on ordinary income from going higher. The uneasy political marriage would turn into an angry divorce. It would be ironic indeed if the supply-side proponents of lower taxes on capital gains were to succeed in lowering that rate and, in so doing, pave the political path to higher and more progressive tax rates on ordinary income.

X. A GREAT LEAP FORWARD FOR TAX FAIRNESS?

Admirers of this tax reform consider its greatest achievement to be in redressing and reversing the inequities of prior law. Both the base-broadening provisions and the lower tax rates have been widely heralded as ushering in a new era of income tax fairness. I would agree that the real merits of this legislation must be located in its improvements in tax equity, particularly in its promotion of greater

“horizontal equity” among taxpayers — the idea that people with similar incomes should pay similar amounts of tax. Once again, however, the achievements of the 1986 Act seem to have been exaggerated.

Probably the most significant accomplishment of the 1986 Act in improving tax equity is one that has been little remarked upon; the restructuring of the taxation of family investment income. Structural changes in the taxation of families were made possible in 1986, as they had been nearly 40 years earlier in 1948 when the joint return provisions for married couples were ushered in, by the lowering and flattening of the rate structure.

For example, the deduction of prior law for married couples applicable when both spouses work was repealed by the 1986 Act, but this was defended as a consequence of the flattening of the rate schedule rather than as a statement of social policy. According to the Report of the Senate Finance Committee, “[a]djustments made in the relationships of the standard deductions and rate schedules for unmarried individuals and married couples filing joint returns compensate for the repeal of this provision.”⁹ The economist, Harvey Rosen, investigating the truth of this assertion for married couples in different income classes with different ratios of spousal earnings, however, has concluded that although both the percentage of families paying a positive marriage tax and its size will be lower than under the old law, some families will still be paying substantial penalties for being married. In 1988, he estimated that about 40 percent of U.S. families will pay an average marriage tax of \$1100, a total of about \$24 billion. At the same time, he determined that about 53 percent of the families will receive a marriage subsidy averaging \$609 per family, a total of \$17.4 billion.¹⁰ Again, benefits of the 1986 legislation have been overstated. The 1986 Act is a long way from neutral with respect to the treatment of married and unmarried people with differing divisions of income. It does appear, however, that single parents with children did quite well by this legislation, particularly at lower and middle income levels.

On a more positive note, the 1986 Act did narrow dramatically opportunities of prior law for lowering taxes within families on investment income, a change that was long overdue. The flattening of the rate schedule and reduction of the top rate had an important impact in significantly decreasing the tax savings possible from shifting income among family members. More importantly, however, the Tax Reform

9. Report of The Senate Finance Committee on H.R. 3838, 99th Cong., 2d Sess. 41 (1986).

10. Rosen, *The Marriage Tax is Down, But Not Out*, 40 NATL TAX J. 567 (1988).

Act restricts intrafamily income shifting opportunities by eliminating major tax advantages previously available to trusts and by aggregating the unearned income of young children with the income of their parents in determining the applicable tax rate. The 1987 legislation redressed a similar tax advantage by eliminating graduated tax rates for professional corporations. Structural changes of this sort tend to acquire a certain permanence despite subsequent movements in the rate structure.

The other and more widely heralded tax equity measures of the 1986 Act seem more suspect. The 1986 Act — principally through the new “passive loss” rules, which restrict the ability of taxpayers to use losses from tax shelter investments to reduce taxes on earned income or “portfolio” income (such as interest and dividends) and a strengthened minimum tax — has been said to have eliminated tax shelters. Such an assertion is overstated at best. Tax shelters have been wounded, to be sure, but seem far from dead. Even in New Haven, Connecticut, low income housing is being placed in historic rehabilitation projects to obtain two tax credits instead of one. People are giving historic easements to charity and thereby combining charitable deductions with tax credits. Interest and dividends, now “portfolio” income, are being converted into rents because “passive” income can be offset with tax shelter losses, and so on. I can hardly wait to learn what is happening in Beverly Hills, the tax shelter capital of the world. The American personality seems to have become an addictive one; some are unable to give up drugs, others cannot say “no” to a tax shelter. Only a costly tax audit, combined with unsuccessful litigation and the payment of huge sums of back taxes, interest, and penalties seem to be an effective cure.

Congress, too, still has a monkey on its back. If anyone actually thought that the 1986 legislation meant that Congress had forsaken using the income tax as a blunt instrument of other public policies, the 1987 denial of foreign tax credits for South African taxes surely proves otherwise. The 1986 Act does not mark the end of tax incentive provisions. It may simply be a low point. To be sure, the tax incentive provisions have become more complex. The low-income housing tax credit (a new concept in the 1986 Act), for example, combines the worst aspects of a tax incentive with many of the worst features of direct subsidies. One must apply to state housing agencies to obtain allocations of low income housing tax credits that the passive loss rules may well preclude one from using. This cannot be a stable situation.

Legislation has already been introduced that would exempt the low-income housing tax credit from the passive loss rules. Other candidates for special favorable treatment will soon emerge. The income

tax will continue to be what it has always been — a source for contests among different groups with different interests for the privilege of paying less taxes.

Ultimately, the 1986 Act fails in what has been claimed to be its shining achievement — the restoration of horizontal equity to the income tax. One can search long and hard for a unifying horizontal equity theme in the 1986 legislation and, although there are hopeful glimmers here and there, what has been produced instead is a series of complex, unwieldy, and often inequitable political compromises.

To be sure, the ability to use tax shelters was restricted; they are no longer available as readily as before. Capital gains and ordinary income are, for the moment at least, taxed at identical tax rates. Opportunities for income shifting were restricted. But how close does the 1986 Act bring us to genuine income tax neutrality? There are many new inequities that will result from this legislation. For example:

(1) The creation of the passive loss concept, as well as such things as the many new limits on interest deductions, move the income tax much closer to a schedular tax system where one's tax liability turns on the *kinds* of income a taxpayer has rather than simply on the amount of the taxpayer's net income.

(2) The 1986 Act's minimum tax rules introduce as many as three separate income tax bases, subject to three separate rate schedules; these provisions surely will result in different taxes for people with identical economic income.

(3) Many devices for tax-free investment income remain; municipal bonds and life insurance products are but two prominent examples.

(4) No attempt was made in the 1986 Act to address the many horizontal inequities in the income tax that result from fringe benefit exemptions; instead, nondiscrimination among employees by employers was relied upon as a guarantee of a modicum of vertical equity.

(5) Under the 1986 Act, many families are given a tax reduction when their children reach age 14; this new distinction in the taxation of families no doubt is to offset the additional costs from having adolescents in the house.

(6) Deductions for expenses of producing investment income are subject to a variety of arbitrary disallowances under the 1986 Act, most notably a new floor on these deductions equal to 2 percent of adjusted gross income. These provisions inevitably will produce many unwarranted and inequitable variations in tax burdens. To take but one example, employees with reimbursed business expenses will do better than identically situated employees without such reimbursements.

(7) The longstanding income tax disparity between homeowners and renters was increased by the new interest deductibility rules of the 1986 Act (and modifications in the 1987 Act) that, for example, now allow homeowners, but not renters, to deduct interest on their purchases of consumer goods.

(8) Many company-by-company or individual "transition rules" give benefits to one company or individual while denying them to other taxpayers in identical circumstances.

The basic point of this litany is that, despite claims to the contrary, the 1986 Act does *not* reflect a coherent or consistent reintroduction of horizontal equity into the tax code. As with an extremely popular children's toy, illusion seems to be the ultimate weapon. The 1986 Act seems, at least in large measure, to have substituted a norm of "perceptions of equity" for the horizontal equity norm. If, in some general way, the populace can be convinced to believe the income tax is fair, that now seems to suffice. The kinds of unjustifiable tax differences of the sorts I have just enumerated are not regarded as serious drawbacks.

Taxpayer perceptions of tax unfairness may well be of independent concern, particularly in a tax system such as ours that is based on self-assessments of tax. Low or middle income taxpayers seem quite justified when they simply cannot understand why the corporations and its officers or the individual employers for whom they work pay less tax on a higher level of economic income than the workers pay on their salary. Such taxpayer perceptions of inequity often result from genuine unfairness in the income tax, but *alleviating* the *perceptions* of inequity can not become an excuse for not redressing the underlying problems. There can be no substitute for attacking and preventing horizontal inequities. The 1986 Act does not deserve unbridled plaudits on this score.

XI. SIMPLIFICATION

There should be little argument that the 1986 tax reform fails as a simplification measure. Nearly ten years ago the Simplification Committee of the American Bar Association's Tax Section reported that the path to major income tax simplification lies in applying lower rates to a broader income tax base. Congress lowered rates and broadened the base, but somehow lost the way to simplification.

To be sure, tax life will be simpler for the six million people removed from the income tax rolls, but, even for many of them, an expanded refundable earned income tax credit provision will introduce new complexities. Likewise, the increase in the standard deduction should allow many more lower and middle income taxpayers to put aside the problems of computing and record keeping associated with

itemized deductions. But for people who believe they may itemize deductions, and for those middle and higher income families who surely will itemize, the new complexities are of staggering proportions.

Shortly after enactment of the 1986 Act, the IRS issued a new W-4 form, the form that wage-earners must complete to inform employers about how much income tax to withhold from their wages. This form was extraordinarily complex and was soon revised, but the debacle over its issuance made it unmistakable that the problems of new complexity are not narrowly confined to large corporations or high-income individuals. The difficulties were so great that the IRS took the unprecedented action of announcing that it would forgive penalties on underwithholding due to the confusion. When Congress talks about simplification, taxpayers may well be reminded of Emerson's comments regarding an acquaintance, "[t]he louder he talked of his honor, the faster we counted our spoons."

Compromise is the root of complexity, and the 1986 Act contains an unending series of political compromises. Congress quite often refused either to eliminate or ratify provisions of dubious merit. Instead, it reduced their benefits or imposed new limitations on their use. Both to compromise and to limit complexity requires a willingness by Congress to enact law that is transparently arbitrary — arbitrary, but relatively simple.

Congress, for example, recognized the folly of actually inquiring about the personal consumption component of business entertainment expenses and instead adopted an arbitrary limit of 80 percent for these deductions. Complaints about the complexity of these limitations are exaggerated. Even if American technology has fallen behind the Japanese, American businesses — even small businesses — can still multiply by 0.8. On the other hand, the interest deduction for individuals, the passive loss limitations, and the individual and corporate alternative minimum tax provisions have become the Brobdingnagians of complexity induced by compromise. For some taxpayers a four-page tax form is now required to calculate the deduction for home mortgage interest.

Indeed, the 1986 Act's approach to the interest deduction takes the "foolish complexity" prize. Since money is fungible, it is the height of foolishness to attempt to trace borrowed funds to particular uses. Futility, however, is no bar to legislation; the 1986 Act distinguishes at least 17 different categories of interest. Home mortgage interest, for example, was a political untouchable, while credit card interest was not, but that is hardly adequate reason to enact tax rules of awesome complexity that may serve principally to inspire large portions of the American public to reconsolidate their consumer, educational,

and other debts into home equity loans. Hard times now may put not only people's credit ratings, but also their homes, at risk.

I shall resist the temptation to fill an entire paper with a litany of 1986 Act complexities. Now that the time has come for filing 1987 tax returns, citizens are being forced to confront prodigious complexities in complying with a wide variety of restrictions on deductions that had saved them taxes in the past. The 1987 tax rates will seem higher than had been advertised because they *are* considerably higher than the 1988 rates. If the new family of W-4's produces widespread underwithholding or if the economy quickly turns sour, no one may be able to prevent the April 15, 1988 deadline from signalling the requiem for the 1986 Act. On the other hand, if the economy remains strong and underwithholding is not significant, the rate reductions of 1988 may be viewed as adequate compensation for any new complexities.

XII. THE 1986 ACT AS A SOLUTION TO THE TAX COMPLIANCE PROBLEM AND OTHER IMPOSSIBLE DREAMS

Tax experts have long maintained that their favorite policy recommendations would induce greater tax compliance. Shortly after enactment, IRS Commissioner Lawrence Gibbs offered his version of the impossible dream: the 1986 Tax Reform Act will solve the tax compliance crisis.

Lower tax rates, everyone's favorite solution to tax compliance, have widely been urged as a compliance stimulant, although there is no good theoretical or empirical evidence for this claim. Experience offers little comfort. The committee reports on the 1969 Tax Reform Act, for example, claimed that lowering the top marginal tax rate on earned income to 50 percent would induce entertainers, professionals, and other high earners to concentrate on their jobs instead of on tax avoidance. The then-new "low" 50 percent top rate was to be the dike holding back the tax shelter industry; Congress apparently believed that at this rate tax shelters would not be worthwhile. Some dike!

Even the recent top capital gains rate of 20 percent has not been sufficiently low to induce compliance. The IRS estimates that capital gains have accounted for a significant proportion — about 11 percent — of unreported income from legal sources.¹¹ Although, like most IRS noncompliance estimates, this number should not be taken literally,

11. Graetz & Wilde, *The Economics of Tax Compliance: Fact and Fantasy*, 38 NAT'L TAX J. 355 (1985).

it is weighty enough to suggest that when people believe they have an opportunity to under-report income with little prospect of detection and penalties, they will — even if the unreported income would only have been subject to a low tax rate. The lowering of the top tax rates by the 1986 Act is no guarantee of greater compliance. In the context of tax compliance, we should substitute for the famous Laffer curve the “compliance checkmark.” Full compliance should be expected only at a zero percent tax rate.

There are other sources of optimism about the improvements in tax compliance that some people expect to result from the 1986 Act. The optimists assert that if only we had a tax system that the people regard as fair, they would comply. Yes, broadening the tax base, for example by eliminating tax shelters, may free a number of IRS personnel for other tasks in striking at noncompliance. One should be slow to believe, however, that people who have heretofore rationalized noncompliance on the ground that the system is unfair will now prefer complying fully to finding — and perhaps even believing in — an alternative reason for not complying.

Simplification, too, has been thought of as a solution to the non-compliance problem, but the newly reformed income tax is hardly simple for upper income individuals and corporations. To be sure, the 1986 Act's elimination of many low income people from the tax rolls should reduce the proportion of nonfilers, but it is a bit much to count this as an improvement in tax compliance.

Other important categories of noncompliers seem even less likely to be chastened by the 1986 legislation. Take tax protesters, who routinely resort to the flimsiest of legal arguments as grounds for not complying — arguments such as the invalid ratification of the sixteenth amendment or that only payments backed by gold are taxable; they are far more likely to regard judicial penalties, not the 1986 legislation, as a reason for abandoning their protests.

People who have been successfully under-reporting their income in the legal sector of the economy will consider an increase in their marginal tax rate from zero even to 15 percent or 28 percent a burden worth avoiding, and it would be a great surprise if the 1986 legislation induced them to volunteer the correct information. Plumbers do not seem likely to stop offering discounts for cash payments.

As for redressing noncompliance on the part of earners of illegal income, we will have to rely, I fear, on the Big New War on Drugs, not the Tax Reform Act of 1986. Perhaps technology will develop a way to detect tax understatements, as well as cocaine, in the urine.

We, of course, anxiously await evidence about the cumulative effects on tax compliance of the increases in penalties and information

reporting adopted throughout the 1980s, including the bit in this legislation, but opportunities for additional direct assaults on noncompliance are limited. Additional withholding is out — the experience with interest and dividend withholding proved that. Additional information reporting from individuals offers little hope. The IRS already expects more than one billion information reports annually; there is not much readily usable information left to be reported by individuals. Penalty limits for taxpayer misconduct seem to have been reached; notwithstanding the reinvigorated public taste for the death penalty, capital punishment is simply not feasible for tax evasion. Indeed, the future seems likely to involve penalty reductions. Birthday filing, sometimes proposed to stagger the IRS workload, would only serve to ruin birthdays, and might soon be followed by birthday audits. I can just imagine the birthday telegrams the IRS might send. A significant increase in tax audits seems now to offer the best potential for improving tax compliance and closing the “tax gap.”

If the compliance problem endures, more radical remedies should be considered. The Senate version of the 1986 Act showed promise by attempting to convert the IRS into a government “profit center.” But it did not go far enough. An ancient idea involving principles currently in vogue could be revisited: revenue farming. In Greece and Rome, and especially in France (before the revolution), the tax collection process was privatized, farmed out. In modern America, for example, the government might begin by taking bids from accounting or law firms for the amount of revenue they might collect from Fortune 500 companies, and then selling the concessions to the highest bidder. Tax farming should increase compliance while reducing the size of government. At the same time, it would eliminate tax practitioners’ worries that new governmental standards of professional conduct are driving a wedge between them and their clients. With the proper adjustment in the federal budgeting process, revenue farming might also be viewed as a solution to the farm crisis.

XIII. CONCLUSION

I believe that the shortcomings of the 1986 Tax Reform Act detailed here have major implications for the future directions of federal tax legislation. First, the complexity of the 1986 Act, coupled with its failure to adopt and maintain a coherent vision of horizontal equity, render it unstable. Even if it would, Congress cannot resort to principle as a basis for resisting change. Only the compelling need for federal revenues to combat the budget is now serving to bar renewed legislative tinkering.

Second, even a minor economic downturn will produce calls for restoration of investment tax credits and more rapid depreciation allowances. The political fragmentation of the business community, which enabled the 1986 Act to go forward, will not be present in such a circumstance. If the size of the federal deficit should properly bear responsibility for such an economic setback, the failure of the massive 1986 Act to even begin to address the dominant economic issue of its time will contribute to its own downfall. The very revenue neutrality that enabled the Act to go forward may well also have planted the seeds of its undoing.

For the longer term, the 1986 Act may be most important because it reflects a political decision by both Republicans and Democrats to retain and strengthen the income tax rather than to heed calls of economists and conservative (and even some "neoliberal") politicians to replace it with a consumption tax. How much the income tax has actually been strengthened remains to be seen. I, for one, obviously remain somewhat skeptical. In addition to the concerns I have already expressed, the failure of the income tax to address systematically the problem of inflation in the measurement of taxable income — perhaps the dominant income tax problem of the 1970s¹² — is a serious omission. Advantages in accounting for inflation often formed the intellectual grounding of those who argued in the late 1970s for replacing the income tax with a progressive-rate consumption tax or a value-added or retail sales tax.¹³ Congress's choice not to address the fundamental problems of the income tax base caused by inflation may have been reasonable at the low rates of inflation that existed in 1985 and 1986, but seems quite likely to haunt both taxpayers and Congress in the future.

Ultimately, the stubbornness of the federal deficit may drive Congress and the next President to a national tax on consumption either in the form of a retail sales tax or a value-added tax. The alternative of additional income tax base-broadening, perhaps including increased minimum or regular taxes on income of corporations, does not seem to have great appeal. Selective excise taxes, including an oil import fee or gasoline taxes, are temporary measures. Regardless of which party captures the White House this year, a national sales tax will look far better politically than significant increases in income tax *rates*.

12. See, e.g., Graetz & McDowell, *supra* note 7, at 16-23.

13. See, e.g., INSTITUTE FOR FISCAL STUDIES, THE STRUCTURE AND REFORM OF DIRECT TAXATION (Report of a Committee chaired by Professor J.E. Meade, Britain, 1978).

A national sales or value-added tax then would prove to be the fiscal legacy of Reaganomics. Federal tax progressivity would then surely be moribund, if not dead. The nation's tax system would then more closely conform to the original intent of the Founding Fathers. The Supreme Court nomination of Robert Bork will not have been this Administration's only shot at original intent. Alexander Hamilton, to take but one of the founders, had only praise for consumption taxes. He claimed that only with such taxes could people choose how much taxes to pay. As he put it, "the rich may be extravagant, the poor may be frugal." This indeed would be a fitting tax legacy from Mr. Reagan, our second President from California, but our first from Hollywood.

