WORKING PAPER

LESSONS FROM THE 1986 TAX REFORM ACT: What Policy Makers Need to Learn to Avoid the Mistakes of the Past

By Jason Fichtner and Jacob Feldman

MERCATUS CENTER
George Mason University

The ideas presented in this research are the authors’ and do not represent official positions of the Mercatus Center at George Mason University.
Lessons from the 1986 Tax Reform Act: What Policy Makers Need to Learn to Avoid the Mistakes of the Past

The 1986 Tax Reform Act (TRA86) was designed to improve three aspects of the tax code: efficiency, equity, and simplicity. TRA86 accomplished all three goals in some measure by reducing the standard rates, increasing the standard deduction, and ending various tax expenditures that distributed resources to less efficient production purposes that sometimes served as the proverbial “tax haven.” The debate leading up to passage of TRA86 was contentious and, like today, tax reform was seen as being politically impossible. However, TRA86 achieved significant bipartisan support with final passage in the Senate on a 97–3 vote.

At the time, TRA86’s passage seemed like a great success for tax reform. However, looking at the 2011 tax code, taxpayers would be hard pressed to find the aspects of efficiency, equity, and simplicity that were improved with passage of TRA86. The principles embodied in the tax reform of 1986 did not last. Tax reform expert and current Yale University law professor Michael Graetz analyzed the tax code in 2007 and exclaimed the failure of TRA86, noting “The Tax Reform Act of 1986 has not proved a stable outcome: Congress has since narrowed the tax base and raised income tax rates.”\(^1\) Additionally, stability can be judged by the number of temporary provisions in the tax code. In contrast to the 25 expiring expenditures in the 1985 tax code, 2010 had over 141 provisions that would expire within the next two years.\(^2\) Many of these provisions were renewed again with the passing of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.


What happened over the past quarter of a century? How quickly did the reforms of TRA86 unravel and why? This paper examines the act’s goals of efficiency, equity, and simplicity, to find the lasting successes and failures of TRA86. Now, 25 years later, the federal tax code is again in dire need of reform. The old saying that those who ignore history are doomed to repeat it also applies to tax reform. Those wishing to reform the tax system today would be wise to learn from the past.

**Efficiency**

Greater efficiency was achieved by TRA86, but many additional gains were left untouched. Whether the provisions in the tax code apply to corporations or individuals, efficiency affects the salaries, jobs, and prices of goods and services across the country. Economists Jane Gravelle and Laurence Kotlikoff developed a model that found TRA86’s approach of broadening the corporate base and lowering the corporate rate reduced the annual excess burden of the U.S. tax structure by $31 billion, based on the 1988 level of U.S. consumption. A reduction in the corporate effective tax rate and illumination of many special-preference items affected business decisions and encouraged firms to pursue a more efficient allocation of resources between production, investment, and payment of dividends. Unfortunately, loopholes for many special preferences such as the investment tax credit (ITC) and mortgage interest deduction were untouched due to popular political support and lobbying by special-interest groups.

One primary success of TRA86 was to treat capital gains, dividends, and ordinary income more equitably across the board by broadening the base and lowering the corporate standard rate.

---

Equalization of effective tax rates across assets encourages businesses to pursue investment strategies that maximize long-term growth, productivity, and profit, rather than extracting short-run gains from the tax code.

The second major reform that improved efficiency was the equal treatment of capital gains and ordinary income through dividend payments. Prior to TRA86, capital gains were taxed at a lower rate than corporate earnings. The preferential rate for capital gains encouraged investment that drove up share prices to build up capital gains as a means of saving on tax liability, rather than encouraging an efficient distribution of resources between investment, production, and paying out shareholder dividends. According to Fullerton and Henderson, the efficient allocation of capital increased by 0.5 percent after enacting TRA86.\(^4\)

However, despite these reforms treating corporate assets more equally, one glaring tax preference went untouched by the act. Research and development (R&D) expenditures continued to be taxed at effective tax rates that were below other assets due to the corporate R&D tax credit. Eliminating the investment tax credit without touching the R&D tax credit made investment in capital, production, and shareholder payouts relatively more expensive compared to R&D investments.\(^5\) After TRA86, R&D had an effective tax rate that was lower than the new equalized rates for alternative business investments. The R&D tax credit remained and incentivized firms to overemphasize R&D by transforming prior-subsidized investment in plants and equipment into R&D expenditures.

Inefficiency was not only a problem in the corporate sector. One long-standing and significant example of inefficiency in the personal-income tax is the mortgage interest deduction

for owner-occupied housing. By making home ownership relatively less expensive relative to other long-run capital assets, an overinvestment in homes artificially inflated the demand for and prices of housing across the country.\(^6\) Calling it the “last tax shelter,” former Director of the Congressional Budget Office Douglas Holtz-Eakin claimed that “owner-occupied housing in the United States may grow at the expense of more productive investments elsewhere in the economy.”\(^7\) In testimony before the Senate Finance Committee in September 2010 on the lessons learned from TRA86, John Chapoton, former Assistant Secretary for tax policy at the U.S. Department of Treasury under President Reagan, affirmed the inefficiency of the mortgage interest deduction and claimed the expenditure is a clearly in factor in today’s housing crisis.\(^8\)

**Equity**

Due to the progressive nature of the income-tax system, equity is generally concerned with concepts of fairness and whether taxpayers with similar incomes pay similar tax amounts and those of greater incomes pay proportionately more in taxes than those with lower incomes. The former is considered horizontal equity and the latter vertical equity. For example, if two different taxpayers have exactly the same income but one owns a home and deducts mortgage interest while the other rents, the taxpayer taking advantage of the home-mortgage interest deduction would likely pay less in taxes than the person that rents. This could be viewed as a violation of horizontal equity. Additionally, suppose now that the taxpayer with the mortgage deduction earns more in income than the renter, but still pays less in tax due to the mortgage

\(^6\) Additionally, federal subsidization of home-mortgage interest rates through Fannie Mae and Freddie Mac also contributed to overinvestment of housing.


interest deduction. In this case, there would be vertical inequity because the taxpayer that earns more in income is paying less in tax.

While drafting TRA86, both horizontal and vertical equity were considered. A 2004 study by Li and Sarte found that TRA86 decreased progressivity in the United States, although TRA86’s adjustment in vertical equity appeared to be a consequence of other primary concerns that drove tax reform. Horizontal equity was one such concern because individuals with equal incomes were often paying widely different amounts in taxes. Citing the president’s tax reform proposal at the time (Treasury II), tax economists Auerbach and Slemrod portrayed horizontal equity as a driving political concern, “‘[people] can't understand the logic or equity of people in seemingly similar situations paying dramatically different amounts of tax.’ The president's proposal was promoted as “[reducing] the number of economically healthy income-earning individuals and corporations who . . . escape taxation altogether’ (p. 8).” However, although many economists believed TRA86 promoted greater horizontal equity, the public did not agree. A 1986 and 1990 Gallop poll asked if TRA86 made for a more fair, less fair, or same distribution of the tax load among all taxpayers. Within only four years, the share of taxpayers who answered fairer had fallen from 27 percent to 9 percent, and the share of taxpayers who answered less fair had risen from 20 percent to 37 percent.

“Do you think the Tax Reform Act of 1986 has made for a fairer distribution of the tax load among all taxpayers, one that’s less fair or hasn’t it been much different from the previous system? (percentage of responses)

<table>
<thead>
<tr>
<th></th>
<th>Fairer</th>
<th>Not Much Different</th>
<th>Less Fair</th>
<th>No Opinion</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>27</td>
<td>36</td>
<td>20</td>
<td>17</td>
</tr>
<tr>
<td>1990</td>
<td>9</td>
<td>40</td>
<td>37</td>
<td>14</td>
</tr>
</tbody>
</table>

Source: The Gallup Poll Monthly (Marg. 1990, pp. 6-8)

Why did TRA86 fall short of the public expectations? Progressivity had not substantially decreased and taxpayers with similar incomes were paying more equal amounts. The problem lay with a few significant inequities untouched by reform. The public realized that TRA86 had not gone far enough in promoting horizontal equity. A couple of arguments may explain why the public was disappointed with tax reform.

The first was that fringe benefits remained untaxed. If you were fortunate to work for a company that provided health care you were likely better off and taxed less than a taxpayer making a similar salary. Still today, companies can take deductions for providing employee health care and pensions rather than subjecting those expenditures to taxes. The tax code subsidization of company-provided health care not only creates different tax liabilities for those with otherwise equal incomes, but also contributes to higher health-care costs across the economy due to an overinvestment in tax deductible fringe benefits.\(^\text{11}\)

The second reason the public may have been disappointed relates to the elimination of the consumer interest deduction, for example interest on credit card debt, but not the elimination of the mortgage interest deduction. This reform treated renters and homeowners with equal income differently. Douglas Holtz-Eakin described the conflict, “Because consumer interest is no longer deductible, but mortgage interest remains deductible, homeowners have an incentive to borrow against their homes to purchase durable goods. The effect is to subsidize the interest costs of homeowners, but offer no equal subsidy to those individuals who rent.”\(^\text{12}\) Although the tax code was cleaned up and eliminated, many of the exemptions that created inequity and complicated the code, the remaining expenditures became accentuated and an even more prominent aspect of

\(^{11}\) Joseph Bankman, “Reforming the Tax Preference for Employer Health Insurance,” New York University School of Law Colloquium on Tax Policy and Public Finance, Spring 2011, pp. 4

the remaining inequities within the tax code. The most politically vulnerable tax deductions were eliminated but the deductions with the strongest and most vehement political support (and economic cost) were retained: exclusion of employer-provided medical benefits and the home-mortgage interest deduction. The FY2011 Obama budget projects that these two provisions will decrease revenues between 2011–2015 by $1.053 trillion and $637.56 billion, respectively.13

The third inequity that went unaddressed by TRA86 was intergenerational equity. A strong reason for TRA86’s passage was that it was revenue neutral, meaning it neither added nor subtracted from the deficit. Auerbach and Slemrod noted that “The debate about tax reform proceeded separately from the discussion of what, if anything, to do about the large deficits of the time.” The five-year scoring focus on tax reform in the 1980s centered on equity concerns for current taxpayers, but not the future taxpayers who would be responsible for paying off the interest payments and debt of accelerated government spending. However, although the tax code focuses on the financial interests of current taxpayers, these individuals and families also have a vested interest in the financial well-being of their children and the economic future they inherit.

**Simplicity**

The financial goal of simplicity is to reduce the transaction costs associated with the tax system, whether these costs are expended in the process of filing tax returns or complying with the various tax laws in everyday life. TRA86 set about this goal by reducing the number of individuals who would itemize deductions and who would be subject to the alternative minimum tax (AMT). Even for itemized filers, TRA86 was meant to reduce the complexity of filing and the economic costs of personal time and professional tax assistance. In addition, some believed

that part of the simplicity generated by the TRA86 was going from 15 marginal-tax brackets to only 3.

The simplicity of a tax code may be best represented by some combination of how many tax-expenditure provisions are present and the extent to which those expenditures are utilized. Holtz-Eakin claimed three significant aspects reduced taxpayer compliance costs after passing TRA86: (1) the combined increase in personal exemptions and standard deductions that reduced the number of itemized filers, (2) the equalization of capital gains with ordinary income which reduces portfolio planning, and (3) the combination of increased deductions and exemptions with a lower tax rate that discouraged tax evasion.14

In terms of calculating the number of tax filers using itemized deductions, Holtz-Eakin is correct. By increasing the standard deduction and lowering the tax rates, TRA86 reduced the percentage of itemizers from 39.47 percent in 1986 to 28.44 percent by 1989. Additionally, the number of tax filers subject to the complicated AMT in 1989 had fallen from 608,906 in 1986 to 101,176.15 However, despite the decrease in the number of tax filers using itemized deductions, the fraction of returns with a paid preparer signature increased slightly to 47.03 percent in 1989 from 46.63 percent in 1986.16 This suggests that the tax code is too complicated for many to do without professional assistance. A 1992 survey by economists Blumenthal and Slemrod found that the average time households spent on filing taxes increased from 21.7 hours to 27.4 hours

between 1982 and 1989, and average expenditures on professional tax assistance increased from $42 to $66.17

These numbers offer a compelling case against the notion that TRA86 achieved the financial impact of reducing compliance costs even though the tax code was simpler. Holtz-Eakin remarks that eliminating some expenditures, such as income averaging, will have little effect on compliance costs, “Simpler does not necessarily mean better.”18 In other words, as long as substantial tax expenditures exist that encourage professional tax planning, compliance costs may be expected to remain high.

Returning to the 1990 Gallup poll referenced previously, respondents were asked whether TRA86 had made it less complicated, more complicated, or just the same as prior to reform. Within only four years, the share of taxpayers who answered less complicated had fallen from 19 percent to 12 percent and the share of taxpayers who answered more complicated had risen from 17 percent to 31 percent. On one hand, the results are surprising considering the number of filers using itemized deductions had decreased, but not so surprising considering that itemized filers experienced increasing professional tax assistance costs after TRA86’s enactment.

“Do you think the Tax Reform Act of 1986 has made it less complicated for you to pay your taxes, more complicated, or about the same as the previous system?” (percentage of responses)

<table>
<thead>
<tr>
<th></th>
<th>Less Complicated</th>
<th>About the Same</th>
<th>More Complicated</th>
<th>No Opinion</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>19</td>
<td>51</td>
<td>17</td>
<td>13</td>
</tr>
<tr>
<td>1990</td>
<td>12</td>
<td>48</td>
<td>31</td>
<td>9</td>
</tr>
</tbody>
</table>

Source: The Gallup Poll Monthly (Marg. 1990, pp. 6-8)

Slemrod concludes in his study that the available evidence suggests that TRA86 did little to prevent the rising compliance costs of the individual income tax system. Why? The likely answer is that although TRA86 had eliminated various tax expenditures, the biggest tax expenditures went untouched. As shown in figure 1, the number of tax expenditures has increased since the passage of TRA86. As other tax expenditures were eliminated, taxpayers looking to reduce their tax liabilities invested in remaining deductions with more resources than before or even began to use deductions for the first time.

According to the Congressional Research Service, “tax expenditures experienced a large decline relative to GDP between 1987 and 1989 largely because of the effects of the Tax Reform Act of 1986, which broadened the tax base by eliminating by eliminating several tax

---


20 “It should be noted that counting the number of tax expenditures involves a certain amount of arbitrariness, since the number of tax expenditures reported in any particular year is sensitive to the level of disaggregation any piece of legislation or set of provisions is judged to warrant.” Source: Joint Committee on Taxation, *Background Information On Tax Expenditure Analysis And Historical Survey Of Tax Expenditure Estimates*, (JCX-15-11), March 09, 2011.
expenditures and reduced tax rates.”\textsuperscript{21} Shortly before passage of TRA86, tax expenditures were estimated to be slightly below 10 percent of GDP and declined to under 6 percent by 1989. Since then, total tax expenditures have slowly risen to just below 8 percent of GDP by 2008.\textsuperscript{22}

If future tax reform is to be serious about reducing compliance costs, all tax expenditures must be on the table, including the highly protected mortgage interest deduction and the exemption to employer-sponsored fringe benefits. To complicate matters further, the growth of less financially significant tax expenditures returned with the Omnibus Reconciliation Act of 1990 and the Omnibus Reconciliation Act of 1993. The achievements of TRA86 in reducing itemized deductions unraveled quickly, and by 2005, 14,000 additional changes to tax law had occurred.\textsuperscript{23}

One unexpected phenomenon is that most tax expenditures that were eliminated by TRA86 have not returned, but new ones have appeared. Perhaps these expenditures were either deemed a bad idea or had become politically untouchable after TRA86. Passive loss exemption (except on housing), the personal consumer interest deduction, the two-earner deduction, income averaging, and restrictions on miscellaneous businesses expenses have not returned since TRA86. The reinstated exemptions from TRA86 included the preferential rate for capital gains (by 1990) and state and local income-tax deduction (by 2004).

The rapid expansion of new itemized deductions suggests that the political system gravitates toward special interests and is innovative at doing so. Today, in 2011, we have returned to a tax code riddled with new exemptions and the same tax expenditure fortresses of


\textsuperscript{22} Ibid.

1986. As shown in figure 2, ranked by dollar amount, the top 10 individual and top 10 corporate tax expenditures combined are estimated to equal almost $3.5 trillion over the five-year period from 2009–2014, with the top 10 individual tax expenditures accounting for approximately $3.1 trillion.24

![Figure 2 - Combined Top 10 Individual & Top 10 Corporate Tax Expenditures, 1975-2014](image)

Numerous tax expenditures lead not only to increased complexity in the tax code, but also to higher tax rates than would otherwise be necessary to achieve the same level of revenue, all else equal. Tax expenditures have become so prevalent that John Chapoton, a former Assistant Secretary of the Treasury, testified “if all tax expenditures were suddenly removed from the law there could be a 34 percent reduction in tax rates across the board.”25

---


Public Choice Costs of the Income Tax System

In addition to compliance and efficiency costs induced by the tax code, lobbyists and special interests expend resources (time, money, etc.) in an attempt to gain or preserve tax preferences, creating a less efficient and less equitable tax code. These lobbying expenditures are known as rent-seeking. Rent-seeking costs emerged from the field of public-choice theory that largely developed due to the works of James Buchanan and Gordon Tullock. These rent-seeking costs are objectionable because these resources carry opportunity costs of productive processes.

Randall Holcombe took the ideas of James Buchanan and applied them to the tax-policy process. He wrote that the easier a tax system can be modified, the greater the incentive for special interests to pursue rent-seeking behavior. Once tax expenditures were successful obtained, additional rent-seeking expenditures are incurred to keep those deductions in the tax code. 26 James Potebra posed a solution to the lobbying expenditure problem by instituting a simple, stable, and broad tax system. “In this framework, proportional income taxation, or sales taxes levied at the same rate on all goods, would reduce the opportunity for lobbying.” 27

Holcombe conjectures that adopting a broad-based retail tax or value added tax (VAT) might reduce political expenditures. 28 Though this paper is not advocating for a retail sales tax or VAT, such a conjecture seems plausible as expenditures would likely be narrowed to retailers

rather the seemingly ever broadening field of personal income expenditures. As Joel Slemrod states, “[The] stability of the tax system is an important element of simplicity.”

The temporary nature of many tax expenditures carries an economic cost through uncertainty. Uncertainty potentially restricts the investment decisions of taxpayers and businesses, and has the potential to inhibit economic growth. Public-choice theory predicts that greater uncertainty over the tax code translates into higher rent-seeking expenditures.

**Concluding Historical Lessons from TRA86**

“One major political statement of TRA86 is to reaffirm annual income as the fundamental basis for taxation in the United States for the foreseeable future.” This is the beginning point that tax reform needs to address. Despite TRA86’s overwhelming bipartisan support to broaden the base and lower tax rates, tax expenditures returned quickly and in even greater numbers than before TRA86. In an ever-increasing competitive global economy, federal spending can no longer be financed using the easy to manipulate and complex income tax system. The U.S. needs a stable, simple tax system with a broad base and low tax rates to finance federal spending and increase global business competitiveness. Therefore, federal tax policy needs to examine the potential benefits of completely replacing the income-tax system with a broad-based consumption tax.

---

Research by the Tax Foundation summarized the two deepest flaws of TRA86, “First, while the legislation did close special tax shelters for select individuals—events that often became nightly news stories—the reform did little to close the many significant exemptions that inhibit overall economic growth. Also, much of what passed in 1986 to limit special tax loopholes has already crept back into the system courtesy of politicians quick to give in to whatever lobby fills their pockets.”34

A consumption tax might promote efficiency and equity where TRA86 failed to produce. Such a tax system addresses the costly and economically inefficient fringe-benefit exemptions and mortgage interest deductions by eliminating them from the tax code. Base broadening not only increases efficiency of resource distribution but is “the key to dealing with the perception of unfairness.”35

A broad-based consumption tax with no exemptions may also restrict opportunities for rent-seeking behavior. A stable and broad tax system can have a lasting effect on decreasing compliance costs and rent-seeking because lobbyists and special interest would have less opportunity to riddle the tax code with exemptions and deductions. Former treasury official and Yale law professor Michael Graetz identified one of the inherent weaknesses of TRA86 as being “based on retaining and strengthening the income tax, rather than heeding the calls of many economists and politicians to replace it with some form of consumption tax.”36 McClure and Zodrow summarized that the Treasury plan “showed conclusively just how complex a relatively pure income tax can be, the Tax Reform Act of 1986 makes strikingly clear that a tax that is less

pure is sure to be even more complicated.” Even retaining a tax system that allows for only a few substantial tax expenditures keeps the door open for higher annual tax compliance costs as taxpayers continue to seek professional assistance to reduce tax liability.

Successful tax reform must be based on the lessons of the Tax Reform Act of 1986, both its accomplishments and failures. Against an array of special-interest groups, bipartisan reform occurred that promoted greater efficiency, equity, and simplicity in the tax code. The problem was that TRA86 did not tear down the largest tax expenditures that have since continued to grow. Even those tax expenditures that are considered to be “politically untouchable” must be on the table if the tax code is to promote strong and stable economic growth. Additionally, it might be necessary to create institutional reforms to prevent future tax expenditures from being added. Failure to learn the lessons of TRA86 will only doom future reform efforts.

Acknowledgements

The authors wish to thank Rizqi Rachmat for his research assistance with this paper. Thanks also to Matt Mitchell and our other Mercatus colleagues who reviewed drafts of this paper and provided many helpful suggestions to improve it.