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WHEN ARE TAX EXPENDITURES REALLY SPENDING? A Look at Tax Expenditures and Lessons from the Tax Reform Act of 1986

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ABSTRACT

The 1986 Tax Reform Act (TRA86) sought to promote greater efficiency, equity, and simplicity in the tax code. However, TRA86 eliminated only the most politically vulnerable tax expenditures while retaining the tax expenditures with the most vehement political support and greatest economic cost: exclusion of employer-provided health insurance and pension benefits and the home mortgage-interest deduction. Today, unchecked tax expenditures obscure honest public-policy conversations about the size of government. Even a tax system that allows for only a few substantial tax expenditures keeps the door open for high annual compliance costs as taxpayers continue to seek professional assistance to reduce tax liabilities.

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I. Introduction

This paper conducts an analysis of tax expenditures around the time of the 1986 Tax Reform Act (TRA86) in conjunction with an examination of the contemporary tax code. The analysis measures tax expenditures' effects through the criteria of simplicity, equity, and efficiency. TRA86 was selected as a point of comparison with the contemporary tax code because TRA86 is generally considered the most successful U.S. effort to lower standard marginal tax rates and broaden the base through elimination of tax expenditures. However, many of the goals of TRA86 were not achieved, and even the few successes quickly unraveled. TRA86's temporary success was undone by the income-tax system's inherent nature to favor deductions and credits.

TRA86 achieved significant bipartisan support for improving upon 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. 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 the passage of TRA86. 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.[1] University of Southern California economist Edward D. Kleinbard

[1] Senate Committee on Finance, *How Did the 1986 Tax Reform Act Attract So Much Support?*111th Cong., 2d sess., September 23, 2010, 8–9, http://finance.senate.gov/imo/media/doc/92310RWTEST1.pdf. Many of these provisions were renewed with the passage of the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010*, Public Law 111-312, 111th Cong., 2d sess. (December 17, 2010).

calculates that 2008 tax expenditures reached 8.6 percent of gross domestic product (GDP), "very close to the situation in 1985, just before the Tax Reform Act of 1986, when tax expenditures amounted to 8.7 percent of GDP."[2] Tax expenditures returned and multiplied because the income-tax system remains easily subject to capture by lobbyists and special interests.

Section II of this paper offers a broad examination of tax-expenditure formation and finds that tax expenditures lack the same level of public debate as direct spending programs for determining government outlays. Many tax expenditures are determined by the few elites on tax-writing committees and often go unmonitored as they disappear into the annual baseline for revenues.[3] Sections III through V provide greater detail by contrasting TRA86's efficiency, equity, and simplicity reforms with the problems of tax expenditures in today's tax code. Contrasting characteristics of the tax code over a 25-year timeframe allows an objective observation of which tax-expenditure reforms were successful and which were not. Section VI examines the income-tax system through the lens of public-choice theory and offers an argument for why a consumption-based tax might reduce rent-seeking behavior.

Section VII contrasts Martin Feldstein's 2 percent tax expenditure solution with lessons from TRA86. As promoted by Feldstein, a tax-expenditure ceiling seems to offer significant gains in terms of simplicity and efficiency, although equity could be a major concern.[4] Additionally, the speed at which TRA86 unraveled suggests that a tax-expenditure ceiling limit may be unlikely to last in the long-run. Yale University law professor Michael Graetz analyzed the tax code in 2007 and explained the failure of TRA86, noting, "The Tax Reform Act of 1986

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[2] Edward D. Kleinbard, "The Congress within the Congress: How Tax Expenditures Distort Our Budget and Our Political Processes," *Ohio Northern University Law Review* 36 (2010): 15.
[3] Ibid., 22.
[4] Martin Feldstein, Daniel Feenburg, and Maya MacGuineas, "Capping Individual Tax Expenditure Benefits" (National Bureau of Economic Research [NBER] Working Paper 16291, Cambridge, MA, April 2011), http://www.nber.org/papers/w16921.pdf.

has not proved a stable outcome: Congress has since narrowed the tax base and raised income tax rates."[5] Section VIII concludes that tax-reform efforts should focus on structural changes to reform or remove many of the tax expenditures from the tax code and to make it difficult for future tax expenditures to flourish.

II. <u>Background: Tax Expenditures in the Budget Process</u>

Scholars disagree over what is and is not a tax expenditure.[6]What they do generally agree upon is that tax expenditures obscure the size of government spending. Certain preferences in the tax code are labeled tax expenditures because they are very similar to government spending. As Donald Marron, former acting director of the Congressional Budget Office, points out, "The rationale for viewing the preferences as expenditures, rather than mere tax breaks, was (and is) that their budgetary, economic, and distributional effects are often indistinguishable from those of spending programs."[7] Marron provides as an illustration an example originally offered by Princeton economist David Bradford:

> "Suppose that policy makers wanted to slash defense procurement and reduce taxes, but did not want to undermine American's national security. They could square that circle by offering defense firms a refundable 'weapons-supply tax credit' for producing desired weapons systems. The military would still get the weapons deemed essential to national security, defense contractors would get a tax cut, and politicians would get to boast about cutting both taxes and spending. But nothing would have changed meaningfully."[8]

Relying solely on government outlays (spending) as a measure of the size of government underestimates the true and larger size of government by excluding tax expenditure items that should rightly be considered spending. Because many tax expenditures are best described as a form of subsidy, some spending programs receive a preemptive allocation of government

[5] Michael J. Graetz, "Tax Reform Unraveling," *Journal of Economic Perspectives* 21, no. 1 (Winter 2007): 86, accessed through EconLit.
[6] For a good discussion of what is and is not a tax expenditure, see Donald B. Marron, "Spending in Disguise," *National Affairs*, Summer 2011.
[7] Ibid.
[8] Ibid.

resources and are effectively exempted from the competitive process of seeking scarce government outlays.[9] Nonetheless, in some cases tax expenditures can be a useful mechanism for economic growth and can be preferable to federal outlays.

Not all particular aspects of the tax-expenditure process produce suboptimal budgeting allocations. In 1994, tax-law expert Edward Zelinsky published a paper on public choice and tax expenditures that defended the budget process. Zelinsky argued that the homogeneous orientation of nontax committees made its members more vulnerable to capture of rent-seeking behavior, while the heterogeneous interests of members on the Ways and Means Committee and on the Finance Committee were less vulnerable to capture.[10] In other words, when a congressional committee consists of members with likeminded interests, it is more prone to lobbying influence as a group than committees whose members have diverse interests. For example, the average member of the Senate Agriculture Committee received over seven times the campaign contributions as the average member of the Finance Committee from agricultural political action committees, and outlays for agriculture clienteles from the Senate Agriculture Committee substantially exceeded tax expenditures.[11] Zelinsky concludes that the heterogeneous interests of tax-expenditure-writing bodies may better serve U.S. interests in allocating federal subsidies.

However, Zelinsky's theory of rent seeking did not address the budgetary consequences of tax expenditures. Paul McDaniel, director of the graduate tax program at the New York University School of Law, found tax expenditures were written on an ad hoc basis without regard to federal spending. "Tax expenditures are largely uncontrolled by the budget process because no

[9] Kleinbard, "The Congress within the Congress," 29.
[10] Edward A. Zelinsky, "James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions," *The Yale Law Journal* 102, no. 5 (March 1993): 1176–77, accessed through JSTOR.
[11] Ibid., 1182–83.

effective limits are imposed on them . . . there is virtually no coordination between tax expenditures and actions by the authorization-appropriations committees in the same budget area."[12] In fact, tax-writing committees will over-appropriate tax expenditures because committee members can claim to be tax cutters.[13] Rather than adhering to Zelinsky's theory that a diverse group of interests among the tax-writing committees will make them less prone to special-interest pressure, the ability to pass tax expenditures without counting them as spending grants committee members a "special status of a *Congress within the Congress*" that can determine its own spending policies while appearing to cut taxes.[14] In a separate paper, Kleinbard suggests that "the ever-increasing reliance on tax expenditures to deliver government programs is a symptom of an institutional weakness in the design of current federal budget processes."[15] The primary consequence of unchecked tax expenditures is that the size of government subsidization becomes obscured, and honest public-policy conversations about the size of government are not straightforward. As Kleinbard writes, "Tax expenditures augment fiscal illusion, and fiscal illusion in turn drives poor policy."[16]

III. Efficiency

Greater efficiency was achieved with enactment of TRA86 by eliminating tax expenditures and lowering the standard rate, but many additional potential 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.

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[12] Paul McDaniel, "Tax Expenditures as Tolls of Government Action," in *Beyond Privatization: The Tools of Government Action*, ed. Lester M. Salamon (Washington, DC: Urban Institute Press, 1989), 178, accessed through Google Books.
[13] Kleinbard, "The Congress within the Congress," 18.
[14] Ibid, 18.
[15] Edward D. Kleinbard, "Tax Expenditure Framework Legislation" (Law Economics Working Paper 109, University of Southern California Law School, Los Angeles, 2010), 4, http://law.bepress.com/cgi/viewcontent.cgi?article=1148&context=usclwps.
[16] Kleinbard, "The Congress within the Congress," 21.

Economists Jane Gravelle and Laurence Kotlikoff developed a model finding 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.[17] A reduction in the standard corporate rate and removal of many special-preference items encouraged corporations 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 and mortgage-interest deduction were untouched due to popular political support and special-interest lobbying. This section proceeds by examining one temporary efficiency success of TRA86 and then examines how and why the act's tax code cleanup efforts did not go far enough.

One primary success of TRA86 was to treat capital gains, dividends, and ordinary income more equitably by broadening the base and lowering the corporate standard rate. Equalizing these tax rates encourages businesses and individuals to pursue investment strategies that maximize long-term growth and productivity rather than short-run gains from exploiting tax preferences. Prior to TRA86, capital gains were taxed at a lower rate than corporate earnings. The preferential rate for capital gains incentivized business to retain earnings to drive up share prices and build up capital gains as a means of saving on tax liability to shareholders. According to Don Fullerton and Yolanda Henderson, the efficient allocation of capital increased by 0.5 percent after TRA86 became law.[18]

Despite reforms treating corporate assets more equally, the act left one glaring corporate-tax preference untouched. Research and development (R&D) expenditures continued to be taxed

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[17] Jane G. Gravelle and Laurence J. Kotlikoff, "Corporate Taxation and the Efficiency Gains of the 1986 Tax Reform Act," *Economic Theory* 6, no. 1 (February 1995): 52, accessed through EconLit.

[18] Don Fullerton and Yolanda Henderson, "The Impact of Fundamental Tax Reform on the Allocation of Resources," (National Bureau of Economic Research [NBER] Working Paper 1904, Cambridge, MA, April 1986), http://www.nber.org/papers/w1904

at effective tax rates below other assets due to a corporate R&D tax credit. Eliminating the investment tax credit without touching the R&D tax credit made investment in physical capital, production, and shareholder payouts relatively more expensive compared to R&D investments.[19] The R&D tax credit overemphasized R&D by transforming previously subsidized investment in plants and equipment into R&D expenditures.

Inefficiency was not only a problem in the corporate sector but also for individual tax expenditures. One long-standing and significant example of inefficiency in the personal income tax is the mortgage-interest deduction for owner-occupied housing. By making homeownership less expensive relative to other long-run capital assets, tax subsidization of homes artificially inflated the demand for and prices of housing across the country.[20] 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."[21] In testimony before the Senate Finance Committee in September 2010 on the lessons learned from TRA86, John Chapoton, assistant secretary for tax policy at the U.S. Department of Treasury under President Ronald Reagan, affirmed the inefficiency of the mortgage-interest deduction and claimed the tax expenditure is clearly a factor in today's housing crisis.[22]

Government provision of tax expenditures allocates a significant amount of resources via the tax code to many different sectors of the economy. Kleinbard writes, "One discovers that our nondefense, non-safety net annual spending through tax subsidies is about 275 percent of the amount of explicit Government outlays in . . . education, transportation, scientific research, and

[19] Ibid, 80.
[20] The implicit federal subsidization of home mortgage-interest rates through Fannie Mae and Freddie Mac also contributed to overinvestment in housing.
[21] Holtz-Eakin, "The Tax Reform Act of 1986," 80–81.
[22] Senate Committee on Finance, *Statement of John E. Chapoton*, *Lessons from the Tax Reform Act of 1986*, 111th Cong., 2d sess., September 23, 2010, 9, http://finance.senate.gov/imo/media/doc/92310JCTEST.pdf.

every other activity by which the Federal Government touches the day-to-day lives of middle class and affluent Americans under the age of 65."[23]

Table 1 - Ten Largest 2010 Tax Expenditures in $Millions	2010 Amount	% of GDP
Exclusion of employer contributions for medical-insurance premiums and medical care	$ 159,868.00	1.09%
Deductibility of mortgage interest for owner-occupied homes	$ 92,180.00	0.63%
Net exclusion of pension contributions and earning to 401(k) plans	$ 53,549.00	0.36%
Capital gains (except agriculture, timber, iron ore, and coal)	$ 45,360.00	0.31%
Net exclusion of pension contributions and earning to employer plans	$ 41,360.00	0.28%
Exceptions from imputed interest rules	$ 38,012.00	0.26%
Deductibility of charitable contributions, other than education and health	$ 37,720.00	0.26%
Step-up basis of capital gains at death	$ 36,740.00	0.25%
Deductibility of nonbusiness state and local taxes other than on owner-occupied homes	$ 33,920.00	0.23%
Exclusion of net imputed rental income	$ 32,530.00	0.22%
Total of top ten tax expenditures	$ 571,239.00	3.89%

Tax subsidies occur in many sectors across the economy. In 2010 alone, the health care industry received a tax subsidy of 1.09 percent of GDP for employee coverage (see table 1). In theory, each tax subsidy creates higher prices for the subsidized goods or services and causes a misallocation of resources as suppliers meet government-induced demand.[24]

While most of the items the federal government lists as tax expenditures should be counted as spending, as they violate equity by favoring specific activities, other items remove existing inequities created by the current tax code. For example, the exclusion of employer contributions for medical-insurance premiums might be considered a tax expenditure that increases spending on health care, while the preferential treatment of capital gains is designed to offset some of the inequitable double taxation of capital gains that exists since capital gains are

[23] Kleinbard, "The Congress within the Congress," 14.
[24] One proposed reform that addresses efficiency is Martin Feldstein's 2 percent tax-expenditure ceiling; this will be considered in section VII.

taxed first at the corporate level and then again at the individual level. The taxation of capital gains is an important tax-policy issue, but it is not spending disguised in the tax code.

Additionally, some items considered tax expenditures seemingly have no place in the tax code. For example, consider the tax expenditure of net imputed rental income. Many durable goods provide a flow of net value attributable to their consumption value. For example, a person who rents a house for a market price of $2,000 per month consumes $2,000 per month of housing. However, consider a person who owns a home purchased 10 years ago with a fixed 30-year mortgage payment of $1,500 per month. Also, assume that the homeowner could rent his house for the current market rate of $2,000 per month. Since the homeowner could presumably rent the house for $2,000 per month while paying a $1,500 mortgage payment, the homeowner is consuming $2,000 of house per month but paying only $1,500—a difference of $500, which could be "imputed" as income to the homeowner. This is what the tax expenditure "exclusion of imputed rental income" is attempting to measure. It is not hard to imagine why many people would not consider this to be income in the traditional sense, since "income" is imputed and not based on real money income.[25]

IV. Equity

One defining characteristic of tax expenditures in the income-tax system is to propagate vertical or horizontal inequities among taxpayers. Due to the progressive nature of the income-tax system, equity is generally concerned with concepts of fairness: whether taxpayers with similar incomes pay similar tax amounts and whether higher-income taxpayers pay proportionately more in taxes than those with lower incomes. The former is considered

[25] For a good discussion of the treatment of imputed income in tax policy, see Jason J. Fichtner, "A Comparison of Tax Distribution Tables: How Missing or Incomplete Information Distorts Perspectives," in *The Secret Chamber or the Public Square: What Can Be Done to Make Tax Analysis and Revenue Estimation More Transparent and Accurate?* ed. Dan R. Mastromarco, David R. Burton, and William R. Beach (Washington, DC: The Heritage Foundation, 2005).

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, the taxpayer with the mortgage deduction could earn more in income than the renter but still pay less in taxes due to the mortgage-interest deduction. In this case, there would be vertical inequity because the taxpayer who earns more in income is paying less in tax. This section proceeds by first examining the successes and failures of equity promotion in the aftermath of TRA86, and then it examines equity in the contemporary tax code.

Both horizontal and vertical equity were considered while drafting TRA86, although TRA86's adjustment in vertical equity appeared to be a consequence of other primary concerns that drove tax reform. A 2004 study by Wenli Li and Pierre-Daniel Sarte found that TRA86 decreased progressivity in the United States.[26] Horizontal equity was one of the centerpiece concerns because individuals with equal incomes were often paying different tax amounts. Citing the president's tax-reform proposal at the time (the recommendation was called Treasury II), tax economists Alan J. Auerbach and Joel Slemrod viewed 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.'"[27]

[26] Wenli Li and Pierre-Daniel Sarte, "Progressive Taxation and Long-Run Growth," *The American Economic Review* 94, no. 5 (December 2004): 1705.
[27] Alan J. Auerbach and Joel Slemrod, "The Economic Effects of the Tax Reform Act of 1986," *Journal of Economic Literature* 35, no. 2 (June 1998): 593–94, accessed through EconLit.

Although many economists believed TRA86 promoted greater horizontal equity, the public did not agree. In polls conducted in 1986 and 1990, Gallup 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 answering “fairer” fell from 27 percent to 9 percent, and the share of taxpayers answering “less fair” rose from 20 percent to 37 percent (see table 2).

Table 2. Gallup Polling Question Results, 1986 and 1990:
“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 is it not much different from the previous system?” (percentage of respondents)

	Fairer	Not Much Different	Less Fair	No Opinion
1986	27	36	20	17
1990	9	40	37	14
Source: The Gallup Poll Monthly (March 1990, 6-8)				

Why did TRA86 fall short of the public’s expectations? Progressivity had not decreased substantially and taxpayers with similar incomes were paying more equal amounts. The problem lay with a few significant inequities untouched by reform. Polling suggests that the general public realized that TRA86 had not dealt with fundamental horizontal inequities and even intergenerational inequity. For example, consider three significant inequities: (1) not taxing employer-provided benefits, (2) eliminating the consumer-interest deduction but not the mortgage-interest deduction, and (3) not addressing the next generation’s national-debt inheritance. These inequities continue today and are often a focus of current tax-reform debates.

The first inequity was that employer-provided benefits remained untaxed after TRA86’s enactment. If an employee worked for a company that provided health care benefits or pensions, the employee was likely taxed less than other taxpayers consuming a similar bundle of goods. Today, companies may still take deductions for providing employee health care and pension benefits rather than subjecting those expenditures to income and payroll taxes. Consequently, there is roughly a 30 percent price difference between employer-provided premiums and individual premiums.[28] 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.[29] According to an article in the *Journal of the American Medical Association*, "Tax financing now covers more than 60 percent of U.S. health care costs."[30]

The second inequity pertains to the elimination of the consumer-interest deduction—for example interest on credit-card debt—without the elimination of the mortgage-interest deduction. By eliminating only one deduction, renters and homeowners—all else being equal—are treated differently. Holtz-Eakin described the conflict, writing, "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."[31]

Although the reformed tax code eliminated many of the exemptions that generated inequity, the remaining tax expenditures became accentuated as inequities within the tax code. The most politically vulnerable tax deductions were eliminated, but the deductions with the greatest political support and economic cost—exclusion of employer-provided medical benefits and the home mortgage-interest deduction—were retained. The president's FY2011 budget projects that these two provisions alone will decreases revenues between 2011 and 2015 by

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[28] Katherine Baicker, "Making Health Care More Affordable through Health Insurance Finance Reform," *Business Economics* 42, no. 3 (July 2007): 37.
[29] 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, 4.
[30] Samuel Y. Sessions and Philip R. Lee, "Using Tax Reform to Drive Health Care Reform: Putting the Horse Before the Cart," *The Journal of the American Medical Association* 300, no. 16 (October 2008), accessed through EconLit.
[31] Holtz-Eakin, "The Tax Reform Act of 1986," 77.

$1.05 trillion and $637.56 billion, respectively.[32] According to a 2009 Brookings Tax Policy Center study, tax expenditure subsidized owner-occupied housing, medical care, and retirement savings are estimated to cost about 47 percent of all tax expenditures—an incredible 3 percent of GDP.[33]

The third inequity unaddressed by TRA86 was intergenerational equity. A strong reason TRA86 was able to become law was that it was revenue neutral, meaning it neither added nor subtracted from the deficit. Alan Auerbach and Joel 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."[34] The five-year scoring focus on tax reform in the 1980s centered on equity concerns for current taxpayers, but did not account for the future taxpayers who would be responsible for paying off the interest payments and debt of accelerated government spending. Although the tax code focuses on the financial interests of current taxpayers, individuals have a vested interest in the financial wellbeing of their children and the economic future they inherit. This includes the national federal debt caused in part by tax expenditures. To avoid repeating the mistakes of the past, future tax reform should be accompanied by substantial consideration of national-debt reduction.

Eliminating tax expenditures will push some taxpayers into higher marginal tax-rate brackets. Hence, equity concerns about eliminating tax expenditures are vital when considering rate reduction that would likely accompany tax reform. Chapoton testified that, "If all tax expenditures were suddenly removed from the law there could be a 34 percent reduction in tax

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[32] United States Office of Management and Budget, *Analytical Perspectives: Budget of the U.S. Government, Fiscal Year 2011*, 111th Cong., 2d sess., 2010, 210–11, http://www.gpoaccess.gov/usbudget/fy11/pdf/spec.pdf.
[33] Eric. J. Toder, Benjamin H. Harris, and Katherine Lim, "Distributional Effects of Tax Expenditures," Urban-Brookings Tax Policy Center, July 2009, 1–2, www.taxpolicycenter.org/UploadedPDF/411922_expenditures.pdf.
[34] Auerbach and Slemrod, "The Economic Effects of the Tax Reform Act of 1986," 593.

rates across the board."[35] An across-the-board reduction would not lead to the same distribution of the tax burden following reform, though. To maintain the vertical equity of the present progressive tax system, tax rates should be reduced by the same number of percentage points instead of by the same percentage, as high-income taxpayers benefit disproportionately from tax expenditures. Leonard E. Burman, Christopher Geissler, and Eric J. Toder found that "eliminating tax expenditures would reduce after-tax income by 11.4 percent in the top quintile, 6.5 percent in the bottom quintile, and 9.6 percent on average for all income groups."[36]

Measuring the progressivity of tax expenditures may be inappropriate, though. Although tax expenditures benefit high-income taxpayers more in absolute terms and relative to income, low-income taxpayers benefit more relative to taxes paid.[37] Economists Leonard Burman, Christopher Geissler, and Eric Toder write, "With all tax rates reduced by the same percentage, the substitution of rate reductions for tax expenditures would, on average, help high-income taxpayers and hurt lower-income taxpayers. With all tax rates reduced by the same *percentage points*, the substitution of rate reductions for tax expenditures would, on average, help low-income taxpayers and hurt high-income taxpayers."[38] An increase or decrease of vertical equity will depend upon the rates reductions that would likely accompany tax-expenditure elimination.

V. <u>Simplicity</u>

The tax code increases in complexity as the number and use of tax expenditures and tax preferences increases. The financial goal of simplicity is to reduce the compliance costs associated with the tax system, whether those costs are expended in the process of filing tax returns or complying with the various tax laws on a day-to-day basis. TRA86 set about this goal

[35] Senate Committee on Finance, *Statement of John E. Chapoton, Lessons from the Tax Reform Act of 1986*, 9.
[36] Leonard E. Burman, Christopher Geissler, and Eric J. Toder, "How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?" *The American Economic Review* 98, no. 2 (May 2008): 82, accessed through JSTOR.
[37] Ibid., 82.
[38] Ibid., 83.

by reducing the number of individuals who would itemize deductions and who would be subject to the alternative minimum tax (AMT). A significant reduction in itemized filing would potentially reduce compliance costs of the tax system (recently estimated to be $431 billion annually).[39] Even for itemized filers, TRA86 was meant to reduce the complexity of filing and the economic costs of personal time and professional tax assistance. This section examines TRA86's purported achievement, how the reforms failed to achieve their supposed goals, and how TRA86 failed to prevent an even more complicated contemporary tax code.

Turning around the concept of complexity from the previous paragraph, the simplicity of a tax code can be represented by some combination of how many tax-expenditure provisions are present and the extent to which those expenditures are used. 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.[40]

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 in 1989. Additionally, the number of tax filers subject to the complicated AMT fell from 608,906 in 1986 to 101,176 in 1989.[41] 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

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[39] Includes "the costs of [taxpayers'] own time spent filing and complying with the tax code; plus the tax collection costs of the IRS; plus the tax compliance outlays that individuals and businesses pay to help them file their taxes." See Arthur B. Laffer, "The 30-Cent Tax Premium," *Wall Street Journal*, April 18, 2011.
[40] Holtz-Eakin, "The Tax Reform Act of 1986," 75.
[41] Joel Slemrod, "Did the Tax Reform Act of 1986 Simplify Tax Matters?" *Journal of Economic Perspectives* 6, no. 1 (Winter 1992):- 51, accessed through EconLit.

46.63 percent in 1986.[42] This suggests that tax-expenditure elimination was not substantial enough to decrease professional-preparer assistance. A 1992 survey by Marsha Blumenthal and Slemrod found that the average time households spent 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.[43] These numbers offer a compelling case against the notion that compliance costs decreased 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, saying, "Simpler does not necessarily mean better."[44] 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 made tax filing 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 (see table 3). On one hand, the results are surprising considering the decrease in the number of filers using itemized deductions. On the other hand, perhaps the results are not surprising given the increased spending on professional tax assistance after TRA86's enactment.

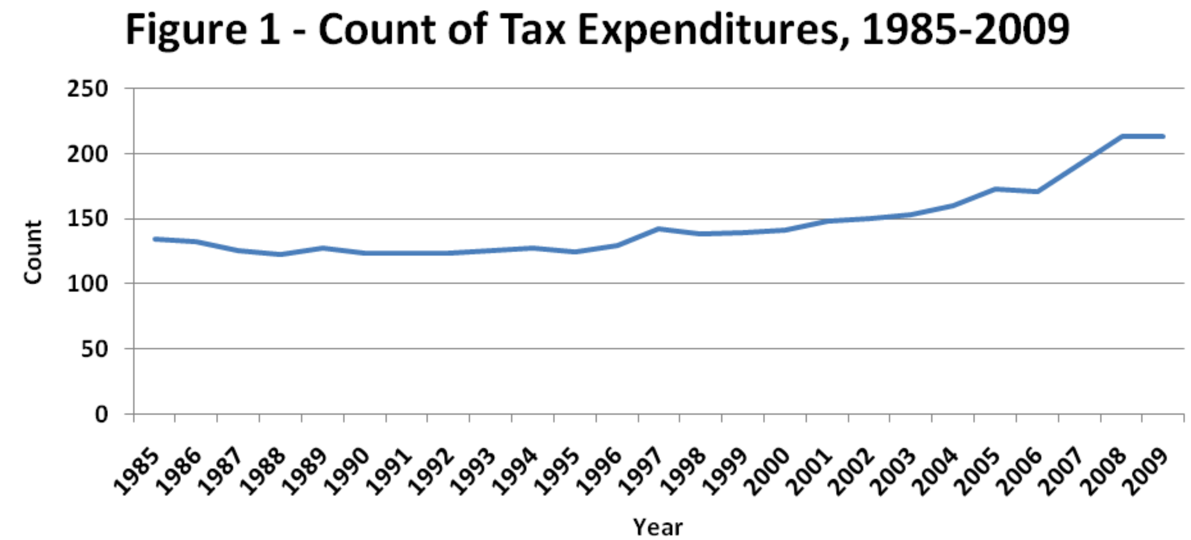
[42] Ibid., 50.
[43] Marsha Blumenthal and Joel Slemrod, "The Compliance Cost of the U.S. Individual Income Tax System: A Second Look after Tax Reform," *National Tax Journal* 45, no. 2 (June 1992): 186, http://ntj.tax.org/wwtax/ntjrec.nsf/32dde1b0157480288525686c00686d0e/$file/v45n2185.pdf.
[44] Holtz-Eakin, "The Tax Reform Act of 1986," 74.

Table 3. Gallup Polling Question Results, 1986 and 1990:
"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 respondents)

	Less Complicated	**About the Same**	**More Complicated**	**No Opinion**
1986	19	51	17	13
1990	12	48	31	9
Source: The Gallup Poll Monthly (March 1990, 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.[45] Why? The likely answer is that although TRA86 had eliminated many tax expenditures, the biggest and most frequently used tax expenditures went untouched. As shown in figure 1, the number of tax expenditures has increased since the passage of TRA86.[46] As other tax expenditures were eliminated, taxpayers looking to reduce their tax liabilities invested in remaining deductions with more resources.

[45] Slemrod, "Did the Tax Reform Act of 1986 Simplify Tax Matters?" 55–566.
[46] "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." See Joint Committee on Taxation, *Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates*, 112th Cong., 1st sess., March 9, 2011, JCX-15-11.

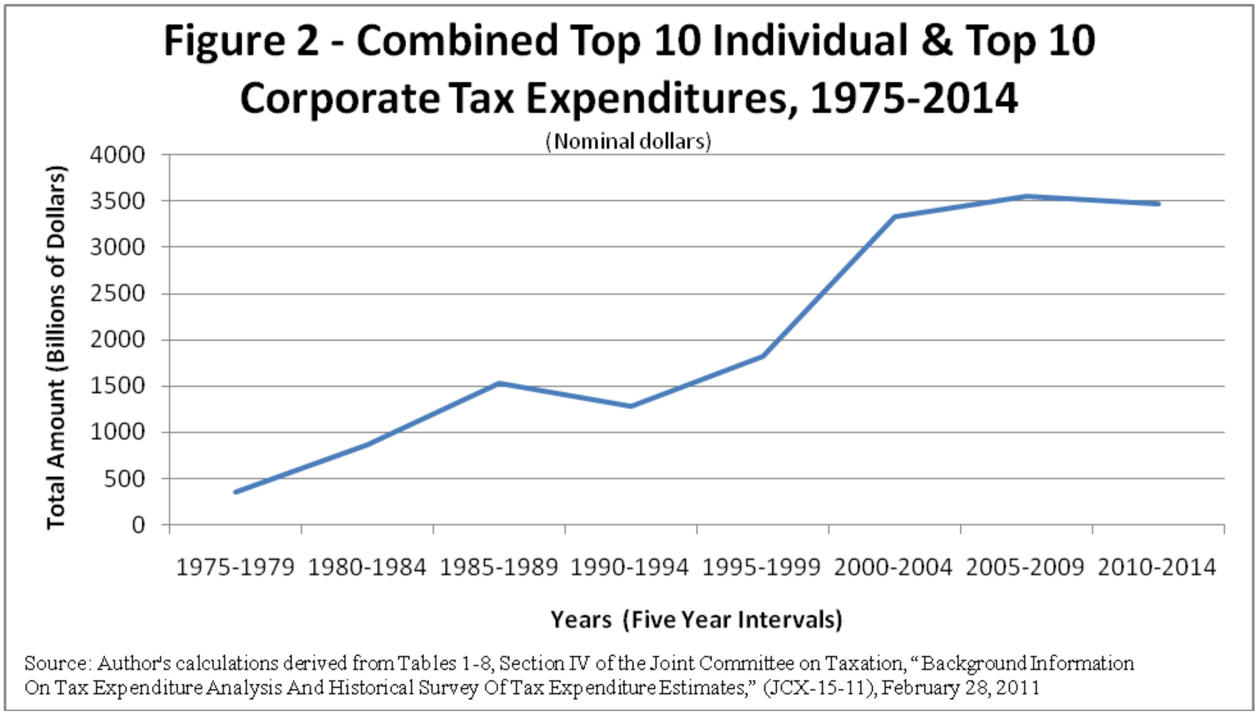


Source: Author's calculations derived from the Joint Committee on Taxation annual pamphlets on tax expenditures, *Estimates of Federal Tax Expenditures for Fiscal Years (1985 - 2009)*, various years

If tax reform today is to reduce compliance costs, all tax expenditures must be on the table, including the highly protected mortgage-interest deduction and the exemption to employer-provided fringe benefits. The arrival to today's labyrinth of a tax code began 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.[47] Joint Committee on Taxation staff found that the 247 tax expenditures in 2008 summed to $1.2 trillion; 90 percent for individual tax returns and 10 percent ($118 billion) for corporation tax returns.[48] Corporation tax expenditures remained far from insignificant, as they comprised roughly 39 percent of 2008 corporate tax receipts ($304 billion) and 32 percent of 2007 corporate tax receipts ($370 billion).[49]

[47] Senate Finance Committee, *Bill Archer, Senior Policy Advisor, PricewaterhouseCoopers, Tax Reform: Lessons from the Tax Reform Act of 1986*, 111th Cong., 2d sess., September 23, 2010, 4, http://finance.senate.gov/imo/media/doc/92310BATEST.pdf.
[48] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2008–2012*, 110th Cong., 2d sess., October 31, 2008, Committee Print 45-156, 50–69 , http://www.jct.gov/s-2-08.pdf.
[49] Kleinbard, "The Congress within the Congress," 13.

One unexpected lesson from TRA86 is that most tax expenditures eliminated by TRA86 did not return. Perhaps those tax expenditures were deemed poor policy or became politically untouchable. 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 state and local income-tax deduction were reinstated in 2004.



The increase in tax expenditures (see figure 1) suggests that the political system gravitates toward special interests and is innovative in aiding them. In 2011, we have returned to a tax code riddled with new exemptions and a tax-expenditure fortress similar to what existed before TRA86. As shown in figure 2, the top-10 individual and top-10 corporate tax expenditures—ranked by dollar amount—combined equal an estimated $3.5 trillion over the five-year period from 2009 to 2014. The top-10 individual tax expenditures account for approximately $3.1 trillion.[50]

However, the revenue raised by eliminating these tax expenditures could be even higher than the projected revenue forgone. Burman, Geissler, and Toder claim that eliminating a large share of nonbusiness individual income-tax expenditures would raise about 8 percent more revenue than the sum of individual estimates for each provision. "The interaction effects are largest for itemized deductions, and reduce instead of increase the combined effect of the separate provisions because, when an itemized deduction is eliminated, taxpayers who are not on the AMT are more likely to take the standard deduction. For example, if the mortgage interest deduction were eliminated, millions fewer taxpayers would itemize deductions and thus would get no benefit from deducting charitable contributions."[51]

Numerous tax expenditures increased complexity in the tax codes and necessitated higher tax rates to achieve certain revenue targets.

VI. Public-Choice Costs of the Income-Tax System

In addition to the compliance and efficiency costs incurred because of the tax code, lobbyists and special interests expend resources (time, money, and so forth) in an attempt to gain or preserve tax preferences. These lobbying expenditures are known as rent-seeking costs.[52] The concept of rent-seeking costs emerged from the field of public-choice theory, largely developed from the work of Nobel Laureate James Buchanan and Gordon Tullock. These rent-seeking costs are objectionable because these resources carry opportunity costs of productive processes.

[50] Top-10 individual tax expenditures estimated at $3,117.3 billion and top-10 corporate tax expenditures estimated at $351.5 billion, over the five-year period 2009–14. Joint Committee on Taxation, *Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates*.
[51] Burman, Geissler, and Toder, "How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?" 81–83.
[52] Not all lobbying is considered rent-seeking per se; the dissemination of educational information is an example. For this paper, we broadly classify lobbying as rent-seeking behavior if the lobbying is mainly to gain or preserve tax preferences or government spending.

Economist Randall Holcombe took the ideas of James Buchanan and applied them to the tax-policy process. He wrote that the easier it is to modify a tax system, the greater the incentive for special interests to pursue rent-seeking behavior. Once tax expenditures were successfully obtained, additional rent-seeking expenditures are incurred to keep those deductions in place.[53]

Tax specialist James Potebra posed a solution to the lobbying expenditure problem by proposing 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."[54] Holcombe conjectures that adopting a broad-based retail tax or value-added tax (VAT) might reduce political expenditures.[55] Though this paper is not advocating for a retail sales tax or VAT, such a reform could plausibly maintain a broad tax base more easily than the income-tax system.

As Slemrod states, "[The] stability of the tax system is an important element of simplicity."[56] The temporary nature of many tax expenditures carries an opportunity cost via uncertainty. Uncertainty potentially restricts the investment decisions of taxpayers and businesses, and has the potential to inhibit economic growth.[57] Public-choice theory predicts that greater uncertainty over the tax code translates into higher rent-seeking expenditures.

VII. The 2 Percent Tax-Expenditure Solution

One tax expenditure reform, proposed by Martin Feldstein, would cap the use of tax expenditures at 2 percent of aggregate income. Feldstein claims that the reform would reduce the number of itemized filers to 13 million from 48 million (a decrease of 75 percent) and would

[53] Randall G. Holcombe, "Tax Policy from a Public Choice Perspective," *National Tax Journal* 51, no. 2 (June 1998): 360, http://ntj.tax.org/wwtax/ntjrec.nsf/73e7c99147d802c185256afc007f0b7b/$file/v51n2359.pdf.
[54] James M. Potebra, "Public Finance and Public Choice," *National Tax Journal* 51, no. 2 (June 1998): 394, http://ntj.tax.org/wwtax/ntjrec.nsf/3d6a23f4f789590085256afc007f0b18/$file/v51n2391.pdf.
[55] Holcombe, "Tax Policy from a Public Choice Perspective," 364.
[56] Slemrod, "Did the Tax Reform Act of 1986 Simplify Tax Matters?" 46.
[57] Senate Committee on Finance, *How Did the 1986 Tax Reform Act Attract So Much Support?* 8.

reduce the 2011 fiscal deficit by $278 billion dollars or about 1.8 percent of projected GDP.[58] Additionally, restricting the use of tax expenditures prevents some tax-evasive behavior and maintains a broad base. Although the reform is progressive in absolute terms, the reform is regressive when considering taxes paid as a percentage of income for low-income taxpayers. For example, individuals with an aggregate income ranging from $0 to $25,000 would be taxed 3.6 percent more under the 2 percent cap, while individuals making over $500,000 would pay only 2.7 percent more in taxes.[59] However, the 2 percent cap would not necessarily be progressive depending on how rate cuts were enacted, assuming that a cut in standard rates accompanied the reform.[60]

Kleinbard agrees that some type of mechanism is needed to rein in uncapped tax expenditures. However, he is skeptical about using a cap to limit tax expenditures instead of forcing “a substantive renegotiation of the present tax system.”[61] Instead, Kleinbard believes Congress will revisit “[tax expenditures] as a substantive matter when [it] decides it is hungry enough for the revenue or for a more efficient tax system.”[62] For Kleinbard, successful reform must be centered upon cleaning up the tax code rather than restraining a tax code littered with special interests. While a 2 percent solution may have a lasting effect by reducing the number of filed claims, success in terms of efficiency and equity may be short lived. Following TRA86, the innovative approach of special-interest groups to reassemble a tax code suggests that policy success may be short lived as long as the tax code remains so easily manipulated. Congress would still be able to increase the cap for tax expenditures or even complicate the tax code further by exempting certain deductions from the cap.

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[58] Feldstein, Feenburg, and MacGuineas, “Capping Individual Tax Expenditure Benefits,” 3.
[59] Ibid., 5, table 1.
[60] Burman, Geissler, and Toder, “How Big are Total Individual Income Tax Expenditures, and Who Benefits from Them?” 83.
[61] Kleinbard, “Tax Expenditure Framework Legislation,” 41.
[62]Ibid., 42

VIII. Historical Lessons from TRA86 about Present Day Tax Expenditures

Holtz-Eakin states that, "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."[63] This is the beginning point that tax reform needs to address. Despite TRA86's bipartisan support to broaden the base and lower tax rates, tax expenditures returned quickly and in even greater numbers than before the act's passage.

A Tax Foundation publication summarized the two deepest flaws of TRA86, saying, "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."[64]

In an increasingly competitive global economy, federal spending can no longer be financed using the easy-to-manipulate and complex income-tax system. The United States needs a stable, simple tax system with a broad base and low tax rates to finance federal spending and increase global business competitiveness.[65] Therefore, the federal government needs to examine the potential benefits of completely replacing the income-tax system with a broad-based consumption tax. Again, though this paper is not advocating for a retail sales tax or VAT, especially combined with an income tax, it is necessary to point out that a consumption tax might

[63] Holtz-Eakin, "The Tax Reform Act of 1986," 73.
[64] Gerald Prante, "Tax Reform: What Has Changed Since 1986?" The Tax Foundation, October 10, 2006, http://www.taxfoundation.org/commentary/show/1908.html.
[65] Michael J. Graetz, "Tax Reform Unraveling," 87; and Jason J. Fichtner, *Reforming the U.S. Corporate Tax System to Increase Corporate Tax Competitiveness*, report prepared for the Joint Economic Committee, 109th Cong., 1st sess., May 2005, http://www.house.gov/jec/CorporateTaxReform.pdf.

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 deduction 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."[66]

A broad-based consumption tax 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. Graetz identified one of the inherent weaknesses of TRA86 as its 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."[67] Charles E. McClure Jr. and George R. 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."[68] Even a tax system that allows for only a few substantial tax expenditures keeps the door open for high annual compliance costs as taxpayers continue to seek professional assistance to reduce tax liabilities.

Successful tax reform must be based on the lessons learned from TRA86, from 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 is that TRA86 did not establish a principle of opposing tax preferences in general by failing to tear down the largest tax expenditures that have since continued to grow. In exchange for lowering

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[66] Senate Committee on Finance, *How Did the 1986 Tax Reform Act Attract So Much Support?* 5.
[67] Graetz, "Tax Reform Unraveling," 71.
[68] Charles E. McLure Jr. and George R. Zodrow, "Treasury I and the Tax Reform Act of 1986: The Economics and Politics of Tax Reform," *Journal of Economic Perspectives* 1, no. 1, (Summer 1987): 57, accessed through EconLit.

tax rates, even those tax expenditures that are considered to be “politically untouchable” must now be on the table if the tax code is to be fundamentally reformed 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.