The Hidden Cost of Federal Tax Policy

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CHAPTER 2
What Can Be Learned from the Tax Reform Act of 1986?

This chapter provides an analysis of federal tax expenditures around the time of the Tax Reform Act of 1986 (TRA86) in conjunction with an examination of the contemporary US tax code. The analysis measures the effects of tax expenditures through the criteria of efficiency, equity, and simplicity. TRA86 was selected as a point of comparison with the contemporary tax code because it is generally considered the most successful effort, to date, to lower standard marginal tax rates and broaden the tax base through elimination of tax expenditures. However, many of the goals of TRA86 were not achieved, and even its few successes quickly unraveled. TRA86's temporary successes were undone by the income tax system's inherent nature to favor deductions and credits. At the time, TRA86's passage seemed like a great success for federal tax reform. The debate leading up to passage of TRA86 was contentious and, like today, major tax reform was considered politically impossible. Yet TRA86 garnered significant bipartisan support, with final passage in the Senate on a 97–3 vote. TRA86 achieved strong bipartisan support by improving three aspects of the tax code: efficiency, equity, and simplicity. All three goals were accomplished in some measure by reducing standard tax rates, increasing the standard deduction, and ending various tax expenditures that distributed resources to less efficient production purposes.

Looking at the tax code today, taxpayers would be hard pressed to find the aspects of efficiency, equity, and simplicity that were improved by TRA86. In contrast to the 25 expiring expenditures in the 1985 tax code, in 2010 some 141 provisions were due to expire within two years.[1] Tax expenditures have returned and multiplied in number since the enactment of TRA86 because the income tax system remains easily subject to capture by lobbyists and special interests. Still, in December 2014, Congress passed—and President Barack Obama signed into law—the Tax Increase Prevention Act of 2014, a temporary one-year retroactive extension of 50 popular tax provisions that had expired at the end of calendar year 2013.[2]

What has happened over the nearly 30 years since TRA86 became law? How quickly did the reforms of TRA86 unravel and why? This chapter examines the act's goals of efficiency, equity, and simplicity to find the failures and lasting successes of TRA86. Now, nearly 30 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 applies to tax reform, too. Those who wish to reform the federal tax code today would be wise to learn from the past.

BACKGROUND: TAX EXPENDITURES IN THE BUDGET PROCESS

Scholars disagree over what is and is not a tax expenditure.[3] What they do generally agree on is that tax expenditures obscure the size of government spending. Certain preferences in the US 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."[4] Marron provides an exemplification originally offered by Princeton economist David Bradford:

> Suppose that policymakers wanted to slash defense procurement and reduce taxes, but did not want to undermine America'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.[5]

Relying solely on government outlays (spending) as a measure of the size of the federal government underestimates its true and larger size 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 resources and are effectively exempted from the competitive process of seeking scarce government outlays.[6] 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 defends the budget process. Zelinsky argues that the homogeneous orientation of nontax congressional committees made committee members more vulnerable to capture by rent-seekers, whereas the heterogeneous interests of the members of the House Ways and Means Committee and the Senate Finance Committee made them less vulnerable to capture.[7] In other words, when a congressional committee consists of members with like-minded interests, it is more prone to lobbying influence as a group than is a committee whose members have diverse interests. For example, according to Zelinsky's research, each member of the Senate Committee on Agriculture, Nutrition, and Forestry received on average more than seven times the campaign contributions as members of the Senate Finance Committee from agricultural political action committees. Moreover, outlays for agriculture clientele from the Senate Committee on Agriculture substantially exceeded tax expenditures.[8] Zelinsky concludes that the heterogeneous interests of tax-writing committees may better serve US interests in allocating federal subsidies.

However, Zelinsky's theory of rent-seeking does not address the budgetary consequences of tax expenditures. Paul McDaniel, director of the graduate tax program at New York University School of Law, finds that tax expenditures have been written on an ad hoc basis without regard to federal spending: "Tax expenditures are largely uncontrolled by the budget process because no effective limits are imposed on them. . . . [T]here is virtually no coordination between tax expenditures and actions by the authorization-appropriations committees in the same budget area."[9] In fact, tax-writing committees will overappropriate tax expenditures so that committee members can later claim to be tax cutters.[10]

Contrary to Zelinsky's theory that a diverse group of interests among members of congressional tax-writing committees will make members less prone to special-interest pressures, the ability to pass tax expenditures without counting them as spending gives committee members a "special status of a *Congress within the Congress*" that can determine its own spending policies while appearing to cut taxes.[11] Edward 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."[12] 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."[13]

EFFICIENCY

With the enactment of TRA86, greater efficiency was achieved by eliminating tax expenditures and lowering the standard tax rate, but many additional potential gains were left untouched. Whether the provisions in the US tax code apply to corporations or to 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 that TRA86's approach of broadening the corporate tax base and lowering the corporate tax rate reduces the annual excess burden of the US tax structure by $31 billion, based on the 1988 level of US consumption (equivalent to $61 billion in 2013).[14] By reducing the standard corporate tax rate and removing many special-preference items, TRA86 encouraged corporations to pursue a more efficient allocation of resources among production, investment, and payment of dividends. Unfortunately, loopholes for many special preferences, such as the investment tax credit and mortgage interest deduction, were untouched by TRA86 owing to popular political support and special-interest lobbying efforts. We now examine one temporary efficiency success of TRA86 before analyzing 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 tax base and lowering the corporate standard tax 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 the enactment of TRA86, capital gains were taxed at a lower rate than corporate earnings. The preferential rate for capital gains created an incentive for businesses to retain earnings so as to drive up share prices and build up capital gains to save on their 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.[15]

Despite reforms to treat corporate assets more equally, TRA86 left one glaring corporate tax preference untouched. Research and development (R&D) expenditures continued to be taxed at effective rates that were lower than those applying to other assets as a result of 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 investment.[16] This tax credit overemphasized R&D by transforming previously subsidized investment in plant and equipment into R&D expenditures.

Inefficiency was a problem not only 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 inflates the demand for and prices of housing across the country.[17] Calling it the last tax shelter, Douglas Holtz-Eakin, former director of the Congressional Budget Office, claims that "owner-occupied housing in the United States may grow at the expense of more productive investments elsewhere in the economy."[18] In testimony before the Senate Committee on Finance in September 2010 on lessons learned from TRA86, John Chapoton, assistant secretary for tax policy at the Department of Treasury during the Reagan administration, affirmed the inefficiency of the mortgage interest deduction and claimed that the tax expenditure is clearly a factor in the recent subprime mortgage crisis.[19]

By providing tax expenditures, the government allocates a significant amount of resources via the US 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 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.[20]

Tax subsidies exist for many sectors of the economy. In 2013 alone, the health care industry received a tax subsidy of 1.1 percent of GDP for employee coverage (see table 2.1). 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.[21]

Most of the items that the federal government lists as tax expenditures should be counted as spending because they violate equity by favoring specific activities; however, 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, whereas the preferential treatment of capital gains is designed to offset some of the inequitable double taxation of capital gains that exists, because capital gains are taxed first at the corporate level and then again at the individual level. The taxation of capital gains is an important 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. Consider 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 a month consumes $2,000 of housing per month. Now consider a person who purchased a house 10 years ago with a fixed 30-year mortgage payment of $1,500 per month. Assume this homeowner is able to rent the house at a market

Table 2.1. Ten Largest Individual Tax Expenditures

	2013 AMOUNT ($ MILLIONS)	SHARE OF GDP (%)
Exclusion of employer contributions for medical insurance premiums and medical care	185,330	1.10
Exclusion of net imputed rental income	72,440	0.43
Deductibility of mortgage interest for owner-occupied homes	69,020	0.41
Tax treatment of capital gains (except agriculture, timber, iron ore, and coal)	68,860	0.41
Net exclusion of pension contributions and earnings to 401(k) plans	50,670	0.30
Deductibility of nonbusiness state and local taxes other than on owner-occupied homes	44,020	0.26
Deductibility of charitable contributions, other than education and health	39,620	0.23
Net exclusion of pension earnings and contributions to employer plans	37,860	0.23
Capital gains exclusion on home sales	34,270	0.20
Exclusion of interest on public-purpose state and local bonds	28,440	0.17
Total of top 10 individual tax expenditures	630,170	3.75

Source: Office of Management and Budget, *Fiscal Year 2015: Analytical Perspectives—Budget of the United States Government* (Washington, DC: Government Printing Office).

rate of $2,000 per month while paying the $1,500 monthly mortgage payment. The homeowner would then be 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. The tax expenditure "exclusion of imputed rental income" attempts to measure such income. It is easy to see why many people do not consider such amounts to be income in the traditional sense, because the "income" is imputed and not based on real money receipts.[22]

EQUITY

One defining characteristic of tax expenditures in the US income tax system is the propagation of vertical or horizontal inequities among taxpayers. Owing 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 than those with lower incomes. The former is considered horizontal equity, and the latter vertical equity. For example, if two taxpayers have exactly the same income but one owns a home and deducts mortgage interest payments and the other rents, the taxpayer taking advantage of the mortgage interest deduction will likely pay less in income taxes than the person who rents. This situation 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 income taxes because of the mortgage interest deduction. In this case, there would be vertical inequity because the taxpayer who earns more is paying less in income tax. We next examine the successes and failures of equity promotion in the aftermath of TRA86 and then examine equity in the federal tax code.

Congress considered both horizontal and vertical equity 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 finds that TRA86 decreased progressivity in the United States.[23] Horizontal equity was one of the centerpiece concerns of the act because individuals with equal incomes were often paying different tax amounts. Citing President Ronald Reagan's tax reform proposal (the recommendation was called Treasury II), tax economists Alan 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."[24]

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

Table 2.2. Gallup Polling Question Results, 1986 and 1990: Fairer Distribution of Tax Load

Question: "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?"

	SHARE OF RESPONDENTS (%)			
YEAR	FAIRER	NOT MUCH DIFFERENT	LESS FAIR	NO OPINION
1986	27	36	20	17
1990	9	40	37	14

Source: Gallup, *The Gallup Poll Monthly*, March 1990, 6–8.

"same" distribution of the tax load among all taxpayers. Within only four years, the share of taxpayers answering "more fair" fell from 27 percent to 9 percent, and the share of taxpayers answering "less fair" rose from 20 percent to 37 percent (see table 2.2).

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 was with a few significant inequities that were untouched by reform. Polling suggests that the public realized that TRA86 had not dealt with fundamental horizontal inequities or even intergenerational inequity. These inequities continue today and are often a focus of tax reform debates.

The first inequity was that employer-provided benefits remained untaxed under TRA86. Employees of a business that provided health care or pension benefits were likely taxed less than other taxpayers consuming a similar bundle of goods that was not provided by their employer. Today, businesses may still claim deductions for providing employee health care and pension benefits, rather than subjecting those expenditures to income and payroll taxes. Consequently, there is a roughly 30 percent price difference between employer-provided health insurance premiums and individual premiums.[25] The tax code's subsidization of employer-provided health care benefits not only creates different tax liabilities for individuals with otherwise equal incomes but also contributes to higher health care costs across the economy as a result of an overinvestment in tax-deductible benefits.[26] 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."[27]

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

> 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.[28]

Although TRA86 eliminated many of the exemptions that generated inequity, the remaining tax expenditures became accentuated as inequities in the tax code. The most politically vulnerable tax deductions were eliminated, but the deductions with some of the greatest political support and economic cost—exclusion of employer-provided medical benefits and the mortgage interest deduction—were retained. President Obama's budget for fiscal year 2015 projected that these two provisions alone will decrease federal revenue between 2015 and 2019 by $1.15 trillion and $456 billion, respectively.[29] A 2009 study by the Urban Institute–Brookings Institution Tax Policy Center study estimates that owner-occupied housing, medical care, and retirement savings—as subsidized by existing tax expenditures—represent 47 percent of all tax expenditures, an incredible 3 percent of GDP.[30]

The third inequity not addressed by TRA86 was intergenerational equity. A strong reason TRA86 was able to become law was that it was revenue neutral, meaning it neither added to nor subtracted from the deficit. As Auerbach and Slemrod note, "The debate about tax reform proceeded separately from the discussion of what, if anything, to do about the large deficits of the time."[31] The five-year scoring focus on tax reform in the 1980s centered on equity concerns for current taxpayers, but it 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 federal tax code focuses on the financial interests of current taxpayers, individuals have a vested interest in the financial well-being of their children and grandchildren and the economic future their descendants will inherit. A tax break today without an offsetting spending cut may be seen as a future tax increase.[32] This economic future includes the national debt, which was caused in part by federal 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 brackets. Hence, equity concerns about eliminating tax expenditures are vital when considering the rate reductions that would likely accompany tax reform. As Chapoton testified, "If all tax expenditures were suddenly removed from the law, there could be a 34 percent reduction in tax rates across the board."[33] An across-the-board reduction would not lead to the same distribution of the tax burden following such a reform, though. To maintain the vertical equity of the present progressive tax system, all tax rates should be reduced by the same number of percentage points rather than by the same percentage, because high-income taxpayers benefit disproportionately from tax expenditures. Economists Leonard Burman, Christopher Geissler, and Eric Toder find 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."[34]

But measuring the progressivity of tax expenditures may be inappropriate. Although tax expenditures benefit high-income taxpayers more in absolute terms and relative to income, low-income taxpayers benefit more relative to taxes paid.[35] Burman, Geissler, and 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.[36]

An increase or decrease of vertical equity will depend on the rate reductions that would likely accompany tax expenditure elimination.

SIMPLICITY

The US tax code increases in complexity as the number and use of tax expenditures and tax preferences increase. The financial goal of simplicity is to reduce compliance costs, whether those costs are incurred in the process of filing income tax returns or in complying with various tax laws on a day-to-day basis. TRA86 set this goal 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 filings would potentially reduce the overall compliance costs of the tax system (estimated to be between $215 billion and $987 billion annually, as noted in chapter 1). In addition, part of the simplicity generated by TRA86 was in going from 15 marginal tax brackets to only three. Even for taxpayers who itemize, TRA86 was meant to reduce the complexity of filing and the economic costs of personal time and professional tax assistance. We next examine what TRA86's achievements are purported to be, how the reforms failed to accomplish their intended goals, and how TRA86 failed to prevent an even more complicated tax code today.

Turning around the concept of complexity from the previous paragraph, we can illustrate the simplicity of a tax code by considering how many tax expenditure provisions are present and the extent to which those expenditures are used. Holtz-Eakin claims that three significant aspects reduced taxpayer compliance costs under TRA86: (a) the combined increase in personal exemptions and standard deductions, which reduced the number of filers who itemize; (b) the equalization of capital gains with ordinary income, which reduced portfolio planning; and (c) the combination of increased deductions and exemptions with a lower tax rate, which discouraged tax evasion.[37]

In terms of calculating the number of tax filers who itemize deductions, Holtz-Eakin is correct. By increasing the standard deduction and lowering tax rates, TRA86 reduced the percentage of taxpayers who itemize from 39.47 in 1986 to 28.44 in 1989. Additionally, the number of tax filers who were subject to the complicated AMT fell from 608,906 in 1986 to 101,176 in 1989.[38] However, despite the decrease in the number of tax filers who itemized deductions, tax returns with a paid preparer's signature increased slightly to 47.03 percent in 1989 from 46.63 percent in 1986.[39] This finding suggests that tax expenditure elimination was not substantial enough to decrease the need for professional preparer assistance. A 1992 survey by Marsha Blumenthal and Joel Slemrod finds that the average amount of time households spent preparing tax returns between 1982 and 1989 increased from 21.7 hours to 27.4 hours and that average expenditures for professional tax assistance increased from $42 to $66.[40] These numbers offer a compelling case against the notion that compliance costs decreased under TRA86 even though the federal tax code had been made simpler. Holtz-Eakin remarks that eliminating some expenditures—such as income averaging—has had little effect on compliance costs, saying that "simpler does not necessarily mean better."[41] In other words, as long as substantial tax expenditures exist that encourage professional tax planning, compliance costs may be expected to remain high.

In the 1990 Gallup poll referenced earlier, respondents were asked whether TRA86 had made tax filing "less complicated," "more complicated," or "the same." 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 said "more complicated" had risen from 17 percent to 31 percent (see table 2.3). On one hand, the results are surprising considering the decrease in the number of filers who itemized deductions. On the other

Table 2.3. Gallup Polling Question Results, 1986 and 1990: Complexity of Tax Code

Question: "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?"

	SHARE OF RESPONDENTS (%)			
YEAR	LESS COMPLICATED	ABOUT THE SAME	MORE COMPLICATED	NO OPINION
1986	19	51	17	13
1990	12	48	31	9

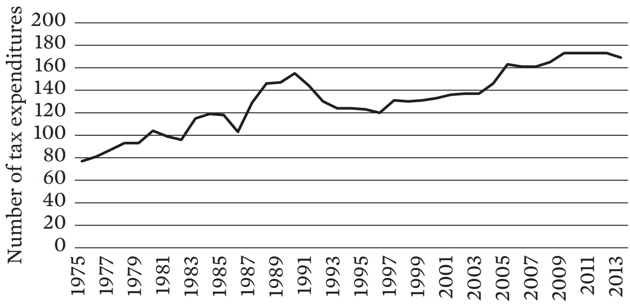
Source: Gallup, *The Gallup Poll Monthly*, March 1990, 6–8.

hand, perhaps the results are not surprising given the increased spending on professional tax assistance after TRA86's enactment.

Slemrod concludes in his study that the available evidence suggests TRA86 did little to prevent the rising compliance costs of the individual income tax system.[42] Why? The likely answer is that although TRA86 eliminated many tax expenditures, the biggest and most frequently used expenditures went untouched. As shown in figure 2.1, the number of tax expenditures has increased since passage of TRA86.[43] And as other tax expenditures were eliminated, taxpayers looking to reduce their tax liabilities invested in the remaining deductions with more resources.

According to the Congressional Research Service, "[T]ax 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

Figure 2.1. Number of Tax Expenditures, 1975–2013



Source: Data from the budgets of the US government, fiscal years 1977–2013.

broadened the tax base by eliminating several tax expenditures and reduced tax rates."[44] Shortly before passage of TRA86, tax expenditures were estimated to be slightly below 10 percent of GDP, and they declined to under 6 percent by 1989. Since then, total tax expenditures rose slowly to just below 8 percent of GDP by 2008.[45]

For tax reform today to reduce compliance costs, all tax expenditures must be on the table, including the highly protected mortgage interest deduction and the exemption for employer-provided benefits. The arrival to today's labyrinth of a tax code began with the Omnibus Budget Reconciliation Act of 1990 and the Omnibus Budget Reconciliation Act of 1993. The achievements of TRA86 in reducing itemized deductions unraveled quickly, and 14,000 additional changes to federal tax law had occurred by 2005.[46] The Joint Committee on Taxation notes that tax expenditures in 2012 totaled $1.2 trillion—87 percent for individual tax returns and 13 percent ($155 billion) for corporate tax returns.[47] Corporate tax expenditures remained far from insignificant—roughly 64 percent of 2012 corporate tax receipts ($242 billion).[48]

One unexpected lesson from TRA86 is that most tax expenditures eliminated by the law have not returned. Perhaps they have been deemed bad policy or have become politically untouchable. Passive loss exemption (except on housing), the personal consumer interest deduction, income averaging, and restrictions on miscellaneous businesses expenses have not been reinstated. State and local income tax deductions were reinstated in 2004, and the two-earner deduction was added back by the Economic Growth and Tax Relief Reconciliation Act of 2001.

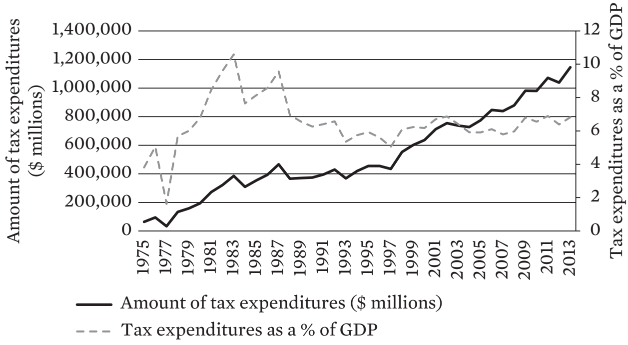
The increase in federal tax expenditures (see figure 2.1) since TRA86 suggests that the political system gravitates toward special interests and is actually innovative in aiding them. Today, the United States continues to have a federal tax code that is riddled with both new exemptions and many tax expenditure fortresses similar to those that existed before TRA86. The economic size of these tax expenditures continues to grow, although the total size relative to GDP is relatively constant (see figure 2.2).[49]

The revenue raised by eliminating these tax expenditures, however, could be even higher than the projected forgone revenue. 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.[50]

Numerous new tax expenditures have increased the complexity of the US tax code and necessitated higher tax rates to achieve certain revenue targets, all else being equal. Tax expenditures have become so prevalent that John Chapoton, former assistant secretary of the treasury, testified that a 34 percent across-the-board reduction in tax rates would result if all tax expenditures were removed.[51]

Figure 2.2. Size of Tax Expenditures, 1975–2013



PUBLIC CHOICE COSTS OF THE INCOME TAX SYSTEM

In addition to the compliance and efficiency costs incurred because of the federal tax code, lobbyists and special-interest groups expend great 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 colleague Gordon Tullock. Such rent-seeking costs are objectionable because these resources carry opportunity costs of productive processes. Economist Randall Holcombe took the ideas of 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 are successfully obtained, additional rent-seeking expenditures are incurred to keep those deductions in place.[53]

Tax specialist James Poterba poses a solution to the lobbying expenditure problem with 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] Although this chapter does not advocate for a national 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 because of 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.

THE 2 PERCENT TAX EXPENDITURE SOLUTION

One tax expenditure reform, proposed by Martin Feldstein, Daniel Feenberg, and Maya MacGuineas, would cap the use of tax expenditures at 2 percent of aggregate income. These authors claim that such a reform would reduce the number of itemized filers from 48 million to 13 million (a decrease of 75 percent) and would have reduced the fiscal year 2011 deficit by $278 billion dollars, or about 1.8 percent of projected GDP.[58]

Additionally, restricting the use of tax expenditures prevents some tax evasion and maintains a broad tax base. Although Feldstein, Feenberg, and MacGuineas's reform is progressive in absolute terms, it is regressive in terms of taxes paid as a percentage of income for low-income taxpayers. For example, individuals with an aggregate income up to $25,000 would be taxed 3.6 percent more under the 2 percent cap, whereas 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 tax rates accompanied such a reform.[60]

Kleinbard agrees that some type of mechanism is needed to rein in uncapped tax expenditures. He is skeptical, though, about using a cap to limit tax expenditures instead of forcing "a substantive renegotiation of the present tax system."[61] Instead, he believes that 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 tax reform must be centered on cleaning up the tax code rather than restraining a tax code littered with special interests. Although 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 the federal tax code to their liking suggests that policy successes may be short lived as long as the tax code remains so easily manipulated. Moreover, Congress would still be able to increase a cap for tax expenditures or even complicate the tax code further by exempting certain deductions from the cap.

LESSONS FROM TRA86 REGARDING PRESENT-DAY TAX EXPENDITURES

Holtz-Eakin states that one major political statement of TRA86 was 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 tax base and lower tax rates, tax expenditures returned quickly to the tax code and in even greater numbers.

In a Tax Foundation publication, Gerald Prante summarizes the two deepest flaws of TRA86 as follows:

> 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 by 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 rates to finance federal spending and increase global business competitiveness.[65] The federal government needs to examine the potential benefits of completely replacing the income tax system with a broad-based consumption tax. Again, although this chapter does not advocate for a national retail sales tax or VAT, especially combined with income taxes, it is necessary to point out that a consumption tax might promote efficiency and equity, which TRA86 failed to do. Such a tax system would address the costly and economically inefficient employer-provided benefits exemptions and mortgage interest deduction by eliminating these inequities from the federal tax code. Broadening the tax base would not only increase the efficiency of resource distribution but would also be "key to dealing with the perception of unfairness."[66]

A broad-based consumption tax could also restrict opportunities for rent-seeking behavior. A stable and broad tax system could have a lasting effect on decreasing compliance costs and rent-seeking behavior because lobbyists and special-interest groups would have fewer opportunities to riddle the tax code with exemptions and deductions. Michael Graetz identifies 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 McClure Jr. and George Zodrow state that the Treasury plan "showed conclusively just how complex a relatively pure income tax can be, [and that] 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 their tax liabilities.

Successful reform of the US tax code must be based on lessons learned from TRA86—both its accomplishments and its failures. Against an array of special-interest groups, the bipartisan reform that occurred with passage of the act 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, which have since continued to grow. In exchange for lowering tax rates, even those tax expenditures that are considered 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 later. Failure to learn from the lessons of TRA86 will only doom future reform efforts.

range of estimates (corporate: $10 billion to $60 billion; individual: $40 billion to $70 billion) come from the following studies: Martin Sullivan, "Shifting Profits Offshore Costs US Treasury $10 Billion or More," *Tax Notes*, September 27, 2004, 1477–81; Kimberly A. Clausing, "The Revenue Effects of Multinational Firm Income Shifting," *Tax Notes*, March 28, 2011, 1580–86; Joseph Guttentag and Reven Avi-Yonah, "Closing the International Tax Gap," in *Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration*, ed. Max B. Sawicky, 99–110 (Washington, DC: Economic Policy Institute, 2005).

53. Joel Slemrod, "Cheating Ourselves: The Economics of Tax Evasion," *Journal of Economic Perspectives* 21, no. 1 (2007): 25–48.
54. Jason J. Fichtner and Jacob Feldman, "The Hidden Costs of Tax Compliance," Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, May 2013.
55. Ibid.

CHAPTER 2: WHAT CAN BE LEARNED FROM THE TAX REFORM ACT OF 1986?

1. *Hearing on Tax Reform: Lessons from the Tax Reform Act of 1986 before the United States Senate Committee on Finance*, 111th Cong., 2nd session (September 23, 2010) (testimony of Randall D. Weiss, managing director of economic research, The Conference Board, New York, "How Did the 1986 Tax Reform Act Attract So Much Support?"). Note: Many of these provisions were renewed with the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.
2. The Joint Committee on Taxation's estimation of the revenue effects of the Tax Increase Prevention Act of 2014 are available at https://www.jct.gov/publications.html?func=startdown&id=4677.
3. For a discussion of what is and is not a tax expenditure, see Donald B. Marron, "Spending in Disguise," *National Affairs* 8 (Summer 2011): 20–34.
4. Ibid, 25–26.
5. Ibid, 26.
6. 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): 1–30, 15.
7. Edward A. Zelinsky, "James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and

Tax Institutions," *Yale Law Journal* 102, no. 5 (March 1993): 1165–207, 1176–77.

8. Ibid., 1182–83.
9. Paul McDaniel, "Tax Expenditures as Tools of Government Action," in *Beyond Privatization: The Tools of Government Action*, ed. Lester M. Salamon (Washington, DC: Urban Institute Press, 1989), 178.
10. Kleinbard, "Congress within the Congress," 18.
11. Ibid.
12. Edward D. Kleinbard, "Tax Expenditure Framework Legislation," Law Economics Working Paper 109, University of Southern California Law School, Los Angeles, 2010, 4.
13. Kleinbard, "Congress within the Congress," 21.
14. Authors' calculations; 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): 51–81, 52.
15. Don Fullerton and Yolanda Henderson, "The Impact of Fundamental Tax Reform on the Allocation of Resources," NBER Working Paper 1904, National Bureau of Economic Research, Cambridge, MA, April 1986.
16. Ibid., 16.
17. The implicit federal subsidization of home mortgage interest rates through Fannie Mae and Freddie Mac also contributed to overinvestment in housing.
18. Douglas Holtz-Eakin, "The Tax Reform Act of 1986: Simplicity, Equity, and Efficiency," *Akron Tax Journal* 4 (1987): 69–82, 80–81.
19. *Hearing on Tax Reform: Lessons from the Tax Reform Act of 1986 before the United States Senate Committee on Finance*, 111th Cong., 2nd session (September 23, 2010) (testimony of John E. Chapoton, strategic advisor, Brown Advisory, Washington, DC).
20. Kleinbard, "Congress within the Congress," 14.
21. One proposed reform that addresses efficiency is Martin Feldstein's 2 percent tax expenditure ceiling, which is considered later in this chapter.
22. For a 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, 257–86 (Washington, DC: Heritage Foundation, 2005).

23. Wenli Li and Pierre-Daniel Sarte, "Progressive Taxation and Long-Run Growth," *American Economic Review* 94, no. 5 (December 2004): 1705–16.
24. 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): 589–632, 593–94.
25. Katherine Baicker, "Making Health Care More Affordable through Health Insurance Finance Reform," *BusinessEconomics* 42, no. 3 (July 2007): 36–37.
26. Joseph Bankman, "Reforming the Tax Preference for Employer Health Insurance," presented at the New York University School of Law Colloquium on Tax Policy and Public Finance, New York, January 20, 2011, 4.
27. Samuel Y. Sessions and Philip R. Lee, "Using Tax Reform to Drive Health Care Reform: Putting the Horse before the Cart," *Journal of the American Medical Association* 300, no. 16 (October 2008): 1929–31.
28. Holtz-Eakin, "Tax Reform Act of 1986," 77.
29. Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2012–2017," Document 78-317, Washington, DC, February 1, 2013.
30. Eric. J. Toder, Benjamin H. Harris, and Katherine Lim, "Distributional Effects of Tax Expenditures," Tax Policy Center, Urban Institute–Brookings Institution, Washington, DC, July 2009, 1–2.
31. Auerbach and Slemrod, "Economic Effects of the Tax Reform Act of 1986," 593.
32. Matthew Mitchell and Andrea Castillo, "What Went Wrong with the Bush Tax Cuts," Mercatus Research Paper, Mercatus Center at George Mason University, Arlington, VA, November 28, 2012.
33. *Hearing on Tax Reform: Lessons from the Tax Reform Act of 1986* (testimony of Chapoton), 9.
34. Leonard E. Burman, Christopher Geissler, and Eric J. Toder, "How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?" *American Economic Review* 98, no. 2 (May 2008): 79–83, 82.
35. Ibid.
36. Ibid., 83.
37. Holtz-Eakin, "Tax Reform Act of 1986," 75.

38. Joel Slemrod, "Did the Tax Reform Act of 1986 Simplify Tax Matters?," *Journal of Economic Perspectives* 6, no. 1 (Winter 1992): 47–57, 51.
39. Ibid., 50.
40. 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): 185–202, 186.
41. Holtz-Eakin, "Tax Reform Act of 1986," 74.
42. Slemrod, "Did the Tax Reform Act of 1986 Simplify Tax Matters?," 55–56.
43. The Joint Committee on Taxation states: "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*, JCX-15-11, March 9, 2011.
44. Thomas L. Hungerford, "Tax Expenditures and the Federal Budget," Report RL34622, Congressional Research Service, Washington, DC, September 10, 2008.
45. Ibid.
46. *Hearing on Tax Reform: Lessons from the Tax Reform Act of 1986 before the United States Senate Committee on Finance*, 111th Cong., 2nd session (September 23, 2010) (testimony of Bill Archer, senior policy advisor, PricewaterhouseCoopers).
47. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012–2017*.
48. Office of Management and Budget, "Receipts by Source as Percentages of GDP: 1934–2017," table 2.1, http://www.whitehouse.gov/sites/default/files/omb/budget/fy2015/assets/hist02z1.xls.
49. The top 10 individual tax expenditures are estimated at $3,117.3 billion, and the top 10 corporate tax expenditures are estimated at $351.5 billion, for the five-year period between 2009 and 2014. Joint Committee on Taxation, *Background Information on Tax Expenditure Analysis*.
50. Burman, Geissler, and Toder, "How Big Are Total Individual Income Tax Expenditures?," 81–83.
51. *Hearing on Tax Reform: Lessons from the Tax Reform Act of 1986* (testimony of Chapoton).

52. Not all lobbying is considered rent-seeking behavior per se; the dissemination of educational information is an example. For this chapter, lobbying is classified as rent-seeking behavior if the purpose is mainly to gain or preserve tax preferences or government spending.
53. Randall G. Holcombe, "Tax Policy from a Public Choice Perspective," *National Tax Journal* 51, no. 2 (June 1998), 359–71, 360.
54. James M. Poterba, "Public Finance and Public Choice," *National Tax Journal* 51, no. 2 (June 1998), 391–96, 394.
55. Holcombe, "Tax Policy from a Public Choice Perspective," 364.
56. Slemrod, "Did the Tax Reform Act of 1986 Simplify Tax Matters?," 46.
57. *Hearing on Tax Reform: Lessons from the Tax Reform Act of 1986* (testimony of Weiss).
58. Martin Feldstein, Daniel Feenberg, and Maya MacGuineas, "Capping Individual Tax Expenditure Benefits," NBER Working Paper 16921, National Bureau of Economic Research, Cambridge, MA, April 2011, 3.
59. Ibid., 5, table 1.
60. Burman, Geissler, and Toder, "How Big are Total Individual Income Tax Expenditures?," 83.
61. Kleinbard, "Tax Expenditure Framework Legislation," 41.
62. Ibid., 42.
63. Holtz-Eakin, "Tax Reform Act of 1986," 73.
64. Gerald Prante, "Tax Reform: What Has Changed Since 1986?," Tax Policy Blog, Tax Foundation, October 10, 2006, http://www.taxfoundation.org/commentary/show/1908.html.
65. Michael J. Graetz, "Tax Reform Unraveling," *Journal of Economic Perspectives* 21, no. 1 (Winter 2007): 69–90, 87. See also 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.
66. *Hearing on Tax Reform: Lessons from the Tax Reform Act of 1986* (testimony of Weiss), 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): 35–58, 57.