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What Has Happened to the Tax Legislative Process?

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SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS AND THE UNLIKELY TRIUMPH OF TAX REFORM. By *Jeffrey H. Birnbaum* and *Alan S. Murray*. New York: Random House. 1987. Pp. xxii, 309. $18.95.

What do you think of the Tax Reform Act of 1986? Whatever your present opinion, it will likely be better informed after reading *Showdown at Gucci Gulch.*[1] Jeffrey Birnbaum and Alan Murray are reporters for the *Wall Street Journal* who covered the political process leading to the enactment of the Tax Reform Act of 1986. These writers have embellished their newspaper coverage from 1984 through 1986 with extensive personal interviews of all major participants in the tax reform process except President Reagan (p. xix). In *Showdown at Gucci Gulch* they present a chronological, *political* narrative of the events leading to the enactment of the Tax Reform Act of 1986. They begin with Senator Bill Bradley's introduction of the Fair Tax Act in 1982 and end with President Reagan's signing of the 1986 Act on the South Lawn of the White House.

Several themes emerge from their political narrative: (1) the significance of the personalities, attitudes, and leadership qualities of individuals with major roles in the tax legislative process; (2) the impact of lobbyists and sources of campaign funds on the members of the tax writing congressional committees; and (3) the practical constraints imposed on the process by the desire of the President and others not to use the reform process to raise income taxes.

Other themes could have been drawn from their narrative but were not: What happened to the objective of simplification in the income tax system? Was the 1986 Act distributionally neutral across income classes? What happened to the so-called "tax expenditure budget"?

In this review, I will address each of these included and omitted themes. I will not summarize the authors' chronological narrative, but will draw on pertinent parts of their narrative to develop my dis-

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1. The name "Gucci Gulch" refers to the hallway outside the Senate Finance Committee room, which is filled with lobbyists during tax legislation hearings. This name first appeared in 1982 in reference to the expensive Italian shoes that were worn by the lobbyists. P. 32.

cussion of themes. Their well-told story awaits the reader of the book itself.

I. Themes Important to the Authors

A. *Force of Personality*

> *Mr. President, you came to this* [tax reform] *because you were an actor who paid at the 90-percent rate; that's why you want a lower rate. I came to this because I was a depreciable asset.* [p. 26; Senator Bill Bradley to President Ronald Reagan]

> *There was going to be a bill, Representative Dan Rostenkowski, Chairman of House Ways and Means Committee said, and as chairman, he would decide who got — and who didn't get — transition rules.* [p. 146]

The bookends of the authors' chronological, political narrative are appropriately Senator Bill Bradley and President Reagan. In between also appears an interesting story about other major figures in the executive and legislative branches. According to Birnbaum and Murray, these individuals' force of personality was critical to the enactment of the 1986 Act.[2]

Senator Bradley is described as developing a distaste for the tax system when he became a professional basketball player and was asked by his attorney during his first contract negotiation: "How much do you want to pay in taxes?" (p. 26). It was explained to Senator Bradley that he could take his compensation in various forms, many of which would avoid current tax. Senator Bradley's aversion to the income tax turned into a significant legislative effort to modify, fairly radically, the income tax. Several objectives of his tax reform plan distinguished it from previous reform efforts:

(1) The plan was *revenue neutral,* neither raising nor lowering total income tax receipts, in order to avoid ideological battles.

(2) The plan was *distributionally neutral* across income classes, except for providing some tax relief to the poor.

(3) The plan did not raise taxes on corporations in order to pay for individual tax cuts.

(4) The top rate was sharply reduced — down to at least 30 percent — without providing a windfall to the wealthy (p. 29).

Few people noticed when Senator Bradley introduced his bill for a Fair Tax Act in 1982. His political prescience established, however, the practical ground rules upon which any future, successful tax reform effort had to be based. The 1986 Act *purportedly* had all of these four characteristics except the third, because it shifted a significant

2. Pp. 133, 286-87. It was accomplished by the force of male personality alone: no woman plays any important role in the White House, in the Treasury Department, in Congress, or on staffs of the tax-writing committees.

portion of income tax receipts from individuals to corporations. These various constraints are elaborated upon below.

President Reagan was the single other most important personality in the tax reform process. The quantity of tax legislation during the eight years of the Reagan presidency will be one of the administration's most remarkable legislative legacies.[3] Significant tax acts were passed in 1981, 1982, 1984, and 1986. Not only is the number of major acts impressive, but the scope of the acts has been impressive as well: they have affected several thousands of subsections of the Internal Revenue Code. For example, it was estimated that the 1984 Act alone modified 2,245 subsections of the Code.[4]

Aside from their quantity and pervasiveness, these acts made dramatic adjustments in the income tax. The primary concerns about the income tax in the 1960s and early 1970s had been fairness and equity. When President Reagan entered office in 1981, the concerns about the income tax had shifted to efficiency and capital formation. It was argued that lower tax rates would enhance savings and capital accumulation, and this, in turn, would lead to greater productivity and growth.[5] This shift in concern is not surprising if one observes the economic statistics in President Carter's final economic report: The real gross national product declined 0.3 percent in 1980; unemployment was 7.1 percent; and the consumer price index rose 12.9 percent in the twelve month period ending November, 1980.[6]

President Reagan made lower taxes a major domestic policy objective in his first administration.[7] This objective was so important that the White House orchestrated the tax efforts, rather than leaving them to the Treasury Department. The administration's efforts immediately paid off. In 1981, Congress enacted the largest income tax cut in U.S. history:[8] individual income tax rates were reduced approximately 23 percent, the maximum marginal individual tax rate was reduced from 70 percent to 50 percent, and corporate tax rates were reduced indirectly by lowering to approximately zero the effective tax rates on in-

3. I am also willing to predict that another will be the free trade agreement with Canada.

4. Apolinsky, *The Changes Just Cost Money*, Wash. Post, Apr. 6, 1986, at C8, col. 1. I am waiting for someone to calculate that number for the 1986 Act, but without question, it will be similarly large.

5. *See* Gann, *Neutral Taxation of Capital Income: An Achievable Goal?*, LAW & CONTEMP. PROBS., Autumn 1985, at 77.

6. *See* ECONOMIC REPORT OF THE PRESIDENT 138, 271, 293, (1981).

7. On February 5, 1981, President Reagan presented a televised address from the White House in which he proposed a reduction in individual taxes of 30% over a three-year period. He also recommended accelerated depreciation to encourage investment and growth. *See Address to the Nation on the Economy*, 1981 PUB. PAPERS 79, 82 (Feb. 5, 1981). On February 18, he sent the details of his tax cut proposal to the Congress. *See White House Report on the Program for Economic Recovery*, 1981 PUB. PAPERS 116-32 (Feb. 18, 1981).

8. J. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 221 (1985).

come earned on tangible personal property.[9] Capital-intensive, profitable corporations could become tax-exempt. Corporations without profits were nevertheless permitted to take advantage of these capital investment incentives through so-called "safe harbor leasing," a method by which capital investment incentives could be transferred to nonprofitable taxpayers on a basis that purportedly equalized the utility of these benefits to both profitable and nonprofitable firms.[10]

These changes were packaged in an act called the "Economic Recovery Tax Act of 1981."[11] Because of the recession, it was almost immediately recognized that revenue receipts would be far too small under the 1981 Act. In response, Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982[12] (an excessively self-congratulatory title even by congressional standards), which substantially reduced the accelerated depreciation benefits of the 1981 Act and repealed safe-harbor leasing.

Two important factors emerged from the 1981-1982 tax legislative process. First, the President's 1981 objectives — to lower individual rates by 30 percent over three years and to lower the effective corporate tax rate paid by corporations through accelerated capital recovery allowances — had to be achieved politically in exchange for a congressional laundry list of special interest tax benefits, which punctured further holes in the tax base. Second, the tax cuts significantly reduced total tax receipts, so that the income tax could be modified in a more dramatic way: the *same* amount of revenue could be raised by lowering the rates to at least 30 percent and broadening the base. The stage had been established for Senator Bradley's tax reform plan. Special interest groups could be ignored if the rates were low enough, and a bipartisan group for tax reform in Congress might be forged between those who favored lower rates and those who wanted to get rid of tax expenditures in the tax base.

Largely out of political concerns that the Democrats would make tax policy an issue in the presidential election, President Reagan announced in his 1984 State of the Union Address that he was asking Treasury Department Secretary Donald Regan to make recommendations by December 1984 for tax reform to "make the tax base broader, so that personal tax rates could come down, not go up" (p. 41). Applying his characteristic management style, President Reagan then delegated the entire responsibility for a low rate, broad-based tax reform proposal to the Treasury Department, which managed to stay out of the political limelight during the 1984 election year (pp. 43, 46).

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9. *See* Gann, *supra* note 5, at 97.

10. *See* Auerbach & Warren, Jr., *Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing*, 95 HARV. L. REV. 1752 (1982).

11. Pub. L. No. 97-34, 95 Stat. 172 (codified as amended in scattered sections of 26 U.S.C.).

12. Pub. L. No. 97-248, 96 Stat. 324 (codified as amended in scattered sections of 26 U.S.C.).

The Treasury's efforts were directed by Secretary Regan, Assistant Secretary for Tax Policy Ronald Pearlman, and Deputy Assistant Secretary for Tax Analysis Charles McLure. With no restrictions imposed upon them, except the commitment of President Reagan not to touch the mortgage interest deduction (p. 57), they proceeded to produce an elegant, low-rate (35 percent maximum marginal individual rate), broad-based income tax reform proposal, later known as "Treasury I."

Treasury I's most interesting features were the attempt to measure correctly income from capital (which required measurement of economic depreciation), indexing the tax base for inflation, repeal of the special lower rate for capital gains, and elimination of the double taxation on corporate earnings. In contrast, Senator Bradley's proposal reduced capital allowance recovery incentives and repealed the special rate for capital gains, but it did not attempt any of the other necessary features of an income tax that attempts to measure capital income correctly.[13]

Treasury I also had two additional, controversial features: first, it proposed to repeal the deduction for all state and local taxes, a major base-broadening proposal, and, second, in order to keep individual tax rates low, it shifted from individuals to corporations approximately $150 billion of taxes over a five-year period (pp. 48, 60).

This proposal sharply contrasted with the 1981 Act, which had lowered to zero the effective corporate tax on capital intensive industries through accelerated capital recovery allowances. This earlier legislative largess would be reversed in exchange for a lower across-the-board corporate tax rate of 33 percent under Treasury I (p. 59). The Treasury Department's shift in emphasis notwithstanding, President Reagan remained committed to the idea of tax reform, largely because of his emphasis on lowered marginal individual tax rates. He directed his new Treasury Secretary, James Baker, to adjust Treasury I to make it more politically palatable.

The so-called Treasury II plan resulted from a politically pragmatic group in Treasury led by Secretary Baker. This proposal was less pristine than Treasury I, measuring capital income far less perfectly and retaining several of the Code's special interest provisions. It also had the flaws of losing revenue and providing the highest average tax rate percentage reductions for the wealthiest individuals. Treasury II was therefore neither revenue nor distributionally neutral (pp. 86-89).

Two extremely important facts emerged from the executive branch work during 1984 and 1985: President Reagan still strongly supported

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13. *See* Gann, *supra* note 5, at 135-48 (comparing the provisions concerning taxation of capital income in Treasury I with those in Senator Bradley's Fair Tax Act).

tax reform, and the basic thrust of the reform was still substantially to lower rates and to broaden the base. This was exactly the approach earlier adopted by Senator Bradley.

The remainder of *Showdown at Gucci Gulch* tracks the bill through the congressional process. Here too, personalities were significant. House Ways and Means Committee Chairman Dan Rostenkowski (D-Ill.) had decided to support the tax reform efforts. He viewed tax reform as a "Democratic" issue, emphasizing fairness and simplicity of the tax laws (p. 99). He also felt that tax legislation during President Reagan's first term had largely been determined by Senator Robert Dole, then chairman of the Senate Finance Committee. Rostenkowski wanted to reestablish the importance of the House Ways and Means Committee and himself as its head (pp. 102-03).

Senator Bob Packwood (R-Ore.) chaired the Senate Finance Committee. He seemed particularly ill-suited to direct a tax bill that would substantially broaden the tax base. Senator Packwood was identified as a supporter of using the tax laws to accomplish social policy objectives and had been particularly active in supporting fringe benefit and timber industry provisions in the Code (pp. 183, 189). He had been quoted earlier as stating, "I sort of like the tax code the way it is." Nevertheless, as a member of the Republican party, he could not oppose President Reagan's desire to proceed with a tax bill.

The book provides a detailed account of the agonizing start-up problems faced by both Chairmen: Few committee members really supported new tax legislation, and few were committed to broadening the base and eliminating special interest provisions. Early in its process, the Ways and Means Committee passed a provision *increasing* the bad-debt reserve deduction for banks. Chairman Rostenkowski was livid and threw down his pencil in disgust. Meanwhile, it was reported that the bank lobbyist's cry of victory — "We won! We won!" — echoed in the hall (p. 125).

Ultimately, both Rostenkowski and Packwood relied upon four factors to succeed. First, each viewed this tax reform effort as propelled by negative motivation. That is, few members of Congress really wanted to support this tax legislation, but they were *more* concerned with being tagged with failure (pp. 127, 223, 237). Both Chairmen played on this negative motivation to keep the reform process in motion. Second, both Chairmen insisted that their bills had to be revenue neutral and that any Committee member offering an amendment that lost revenue had to be willing to swap this offer for another that raised an equivalent amount of revenue (pp. 123, 229-30, 237). Third, both Chairmen took great pains to manage the bill on the floors of their respective houses (pp. 154-75, 243-52).

Finally, to an unprecedented degree, both Packwood and Rostenkowski were willing to agree to so-called "targeted transitional provisions" to guarantee votes in support of their bills (pp. 146, 240-43, 277). These legislative provisions are designed to give tax relief to *specific* taxpayers supported by a particular Representative or Senator. They are usually written in such a way that the targeted beneficiary is not identifiable on the face of the statute. For example, a special rule for General Motors refers to "an automobile manufacturer that was incorporated in Delaware on October 13, 1916" (p. 241). These rules then typically provide a special grandfather clause that exempts particular companies, assets, or transactions from a provision in the new legislation. Such special transitional rules result from political horse trading. The targeted transitional provisions of the bill divided taxpayers between those with special access to particular members of Congress who, in turn, had a particular relationship with Chairmen Rostenkowski and Packwood, and those similarly situated taxpayers without such access or without the political savvy to seek it. These unsavory, targeted tax expenditures, explained by public choice theory, established an unfortunate quantitative precedent which likely will be hard to resist in future tax legislative processes.[14]

B. *Lobbyists and Campaign Financing*

> *It's not clear yet what the tax-reform fight is going to mean for the average taxpayer, but Washington special-interest lobbyists have just landed in hog heaven.* [p. 177; Fred Wertheimer, President of Common Cause]

Beneficiaries of special income tax provisions find it worthwhile to pay "Gucci-clad" lobbyists and to make campaign contributions to influence votes for the retention or exclusion of particular tax provisions. With almost all special interest tax legislation up for grabs in 1985 and 1986, the number of lobbyists was immense (pp. 177-79). The money contributed to congressional campaigns during the tax reform process was staggering, and the largest sums of money were given to the members of the tax-writing committees. Chairman Bob Packwood received approximately $1 million from special interest political action committees (PACs) from January 1, 1985 to June 30, 1986 (p. 182). In 1985 (a nonelection year), congressional tax writers received $19.8 million in campaign contributions. The twenty members of the Senate Finance Committee received $11.8 million, and the thirty-six members of the Ways and Means Committee received nearly $8 million (p. 180).

In addition to campaign contributions, congressional tax writers were favorite speakers around the country, for which they received "honoraria." In 1985, Bob Dole was the top honoraria recipient in the

14. *See, e.g.*, 37 TAX NOTES 523 (1987) (summarizing taxpayer-specific provisions contained in the Omnibus Budget Reconciliation Act of 1987, a bill reported out by the House Ways and Means Committee).

Senate, receiving approximately $128,000 (pp. 181-82), and the twenty members of the Senate Finance Committee earned more than $660,000 in honoraria.

Birnbaum and Murray provide the reader with these impressive figures and sprinkle their tale with anecdotal evidence of direct relationships between lobbying, campaign contributions, honoraria, and voting. The writers intend for the reader to conclude from this abundant information that such efforts typically pay off: lobbyists successfully bought votes from the selling tax-writing committee members. The authors commend the 1986 Act, however, as a triumph over most lobbyists for special interest groups (pp. 287-88).

More cautious writers correctly note that this type of evidence illustrates that lobbyists played some role in the 1986 tax-writing process, but that an exact cause-and-effect analysis is difficult to prove.[15] Nevertheless, the story told by Birnbaum and Murray vividly illustrates that, like the clown fish and the sea anemone, lobbyists and tax writers have developed a symbiotic, economic relationship that did not end with the 1986 Act.

C. *Revenue Neutrality Constraint*

We're getting misinformation, inaccurate information, untrustworthy information. We can no longer rely on what we're getting. [p. 275; Senator Bob Packwood criticizing David Brockway, Director of the Joint Committee on Taxation]

Everyone is entitled to his own opinion, but not his own facts. [p. 275; Senator Patrick Moynihan, a member of the Senate Finance Committee]

The budget deficit prevented serious consideration of any tax reform proposal that lost revenue. The need to develop bipartisan support for tax reform prevented serious consideration of any tax reform proposal that increased revenue. Consequently, both the Treasury Department and the tax-writing committees worked under the constraint of revenue neutrality. This in turn put tremendous pressure on the small group of revenue estimators in the Treasury Department and in the Joint Committee on Taxation.

Revenue estimating is an inherently difficult task which requires

15. *Compare* Reuben, *Tax and PACs: Drawing the Connection,* 29 TAX NOTES 1335, 1336 (1985) (arguing that the complexity of the elective and legislative processes makes the drawing of a causal relationship between contributions and votes suspect); Schroedel, *Campaign Contributions and Legislative Outcomes,* 39 WESTERN POL. Q. 371 (1986) (asserting that whether contributions affect votes depends upon the type of legislation) *and* Wright, *PACs, Contributions and Roll Calls: An Organizational Perspective,* 79 AM. POL. SCI. REV. 400 (1985) (demonstrating the limited nature of PAC influence on congressional voting), *with* Doernberg & McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform,* 71 MINN. L. REV. 913, 942-45 (1987) (abundant anecdotal evidence exists to show that legislation is bought and sold, although there can be no conclusive proof).

that *behavioral* adjustments to tax law changes be estimated and taken into account. The degree of these behavioral responses can be widely misjudged. In 1981, for example, Treasury estimated that a proposed change to liberalize the availability of individual retirement accounts (IRAs) would cost $5.5 billion over three years. Instead, the enacted change lost $32 billion, almost six times more than the estimate, largely due to the significant marketing of IRAs by banks (pp. 86-87). The estimates simply failed to anticipate accurately the size of the behavioral response to the tax change.[16]

Problems with revenue estimates plagued the Treasury Department (pp. 90-93, 107), the Ways and Means Committee (p. 148), the Finance Committee (pp. 260-61), and the Conference Committee (pp. 272-75). In frustration, Senator Packwood publicly lashed out at David Brockway, the director of the Joint Committee on Taxation, claiming that the Joint Committee was providing misinformation (p. 275). The problem peaked during the tense reconciliation negotiations of the Conference Committee when new economic forecasts caused the Joint Committee staff to *lower* the expected revenues to be collected under the 1986 Act. Revenue estimates will continue to play an important role in the budget process because of budget deficits. A debate likely will occur over whether the econometric modeling process by which these estimates are made should be subject to any public scrutiny.[17]

The concept of revenue neutrality may have been an essential constraint for the enactment of the 1986 Act. It led, however, to some rather bizarre gimmicks to compensate for revenue shortfalls, ones which would never have been considered without the imposition of this constraint. First, Treasury II contained a special "recapture" tax on sales of depreciable property. The recapture provisions were based on the argument that corporations would receive a windfall on sales of old equipment, since the equipment had been fully depreciated at a 46 percent corporate tax rate, and any gain on the equipment sale would be taxed at a substantially lower corporate tax rate. Notwithstanding some merit to the argument, it was quickly dropped by the Ways and Means Committee. The Treasury II provision was designed to raise $56 billion, an amount determined by the revenue shortfall of the re-

16. For an excellent discussion of the likely failure of revenue estimators adequately to account for behavioral responses to the 1986 Act, see Schmalbeck, *The Tax Reform Act of 1986: The Impact on Support of Public Goods and Services*, 5 DUKE L. MAG. 22 (1987) (detailed account of the estimate of revenue gained by elimination of the deduction for state and local sales taxes). *See also* Nester, *A Guide to Interpreting the Dynamic Elements of Revenue Estimates*, in COMPENDIUM OF TAX RESEARCH 1987 at 13 (Office of Tax Analysis, Dept. of the Treasury) (1987).

17. *See* Rosen, *Tech Corrections May Be Delayed Until 1989; Revenue Estimating Generates Controversy*, 38 TAX NOTES 435 (1988).

maining provisions of Treasury II, and in excess of any amount that the theory of the "recapture tax" would possibly raise (pp. 91-92, 108).

When the Finance Committee faced a revenue shortfall, Senator Packwood proposed to repeal the business expense deduction for payment of excise taxes and tariffs (p. 195). This proposal was quickly rejected, however, when other committee members did not agree with the argument that these expenses were not ordinary costs of doing business.

Two other gimmicks survived the process. Citizens for Tax Justice, a largely labor-supported organization, had publicized the fact that because of the capital investment incentives in the 1981 Act, large numbers of U.S. corporations reported profits in their financial statements but paid no federal income taxes. In response to this problem, Congress enacted a stiff corporate minimum tax regime (which applies a 20 percent rate to a tax base defined more closely to economic income than is "taxable income"). Congress further enacted a tax on one-half of the excess of the income reported by corporations for financial accounting purposes over the income determined under the alternative minimum tax. Thus, for the sake of appearance and the need for more revenue (p. 263), Congress imposed a tax regime on corporations that does not necessarily have any relationship to defining an appropriate income tax base.

In an even more bizarre move, the 1986 Act only *appears* to enact a top marginal tax rate of 28 percent, instead, imposing a top marginal tax rate of 33 percent. This top rate is not even imposed on the wealthiest taxpayers as it ought to be under a schedule of graduated rates (pp. 89, 220, 263, 279). The 1986 Act rate schedule is divided into two brackets of 15 percent and 28 percent. The gimmick phases out the benefit of the lower 15 percent tax bracket and personal exemptions for taxpayers having taxable income exceeding specified levels. The income tax liability of these taxpayers is increased by a 5 percent surtax on a specified amount of their taxable income until the tax benefit of the 15 percent tax rate has been recaptured. Thus, the marginal tax rate on the income subjected to the 5 percent surtax is 33 percent, the sum of the regular marginal tax rate of 28 percent plus the 5 percent surtax. The rate adjustment begins at $71,900 of taxable income for married individuals, and $43,150 of taxable income for single individuals, and ends at points that vary with the number of personal exemptions. A single person with $44,000 taxable income pays a marginal tax rate of 33 percent, while a single person with taxable income of $1 million taxable income pays a marginal tax rate of 28 percent! This gimmick was chosen because it yielded the appearance of a top marginal rate of 28 percent, but raised enough revenue to cover the estimated revenue shortfall predicted by the Conference Committee (p. 279).

Congress again applied the constraint of revenue neutrality in the Omnibus Budget Reconciliation Act of 1987. If the revenue estimates are correct, the Act is revenue neutral, but the Act's miscellany of income tax provisions was selected as much for the specific revenue that each provision would raise as for the contribution that it made to the design of a coherent income tax.

II. OTHER THEMES FROM THE TAX LEGISLATIVE PROCESS

A. *What Happened to the Objective of Simplification?*

> *Let us go forward with an historic reform for fairness, simplicity, and incentives for growth.* [President Reagan's State of the Union Address, January 25, 1984].[18]

> *I hope you're not going to push simplification for simplification's sake. Simplification for the sake of simplification is to beat your brains out. To go through the whole process and wind up without a dime's dent in the deficit just doesn't make sense.* [p. 189; Senator Bob Packwood speaking to President Reagan]

In President Reagan's 1984 State of the Union address, he asked for a tax plan that was simple, fair, and good for the economy (p. 51). The title for Treasury I was taken from the President's speech: *Tax Reform for Fairness, Simplicity, and Economic Growth* (p. 62). Birnbaum and Murray could have drawn another useful theme from their narrative: What happened to the objective of a simpler income tax system?

Two claims of greater simplification in the 1986 Act can be substantiated. First, because the Act substantially increases the standard deduction and personal exemption, fewer poor individuals will pay any tax at all, and among those who do pay taxes, substantially fewer will file an itemized tax return. Second, because the 1986 Act treats various types of investments more evenhandedly, taxpayers should spend less time trying to avoid paying taxes. Beyond these two simplifications, however, the 1986 Act makes the income tax more complicated.

The failure to achieve increased simplicity results from at least two factors. First, simplicity frequently competes with the other two objectives of fairness and efficiency. Two excellent examples of this phenomenon are the rules dealing with the time value of money and foreign tax credits.[19] Both sets of rules attempt to achieve fairness and

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18. 1984 PUB. PAPERS 87, 90 (Jan. 25, 1984).

19. *See* Lokken, *The Time Value of Money Rules,* 42 TAX L. REV. 1 (1986). An entire issue of the *Review* is devoted to this 292-page article. *See also* Prop. Treas. Reg. § 1.904-6, 52 Fed. Reg. 32242, 32245-53 (1987) (separate application of the foreign tax credit limitation with respect to separate categories of foreign source income); Prop. Treas. Reg. § 1.904-7, 52 Fed. Reg. at 32253-60 (so-called look through rules as applied to controlled foreign corporations); Prop.

efficiency by applying theoretically sound constructs. These rules are so complex, however, that it becomes questionable whether such pristine attacks on sophisticated tax avoidance are worthwhile.

Congressional unwillingness to measure capital income correctly is a second factor causing complexity. Here the trade-off is the substitution of one type of complexity for another. The correct measurement of capital income is attainable, but it requires substantial complexity.[20] Interestingly, Treasury I attempted to measure capital income correctly by applying economic depreciation, indexing the tax base for inflation, repealing the special lower rate for capital gains, and eliminating the double taxation on corporate earnings. In the 1986 Act, Congress chose instead to continue measuring capital income incorrectly, and to incorporate complex provisions (such as the interest limitation rules) to counter the tax avoidance opportunities created by the mismeasurement of capital income.

If income from capital is measured correctly, the interest expense on funds borrowed to make the investment is a correctly deductible expense. However, to the extent that Congress fails to tax income from capital correctly, Congress ought to eliminate correspondingly the deduction for interest expense on funds borrowed to make the investment.[21] For example, if a taxpayer borrows money to invest in state and local government tax-exempt bonds, the interest expense on the borrowed funds is not deductible because the interest income on the bonds is tax-exempt.[22] The 1986 Act substantially limits the interest deduction by requiring identification of the use of borrowed funds and the corresponding appropriateness of allowing an interest expense deduction. In order to apply these interest limitations rules, interest expense must now be divided through tracing rules into five categories: interest expense incurred in a trade or business, an investment activity, a passive activity, a personal activity, and home ownership! Each type of interest expense is then subjected to different limitation rules.[23]

Other complex rules attributable to the failure correctly to tax capital income include the capital gains and losses structure, the rules applicable to passive activity losses, and the alternative minimum tax. It is indeed ironic to read in *Showdown at Gucci Gulch* that when Senator Moynihan asked about the possibility of a one percent increase in the highest marginal tax rate in exchange for the indexing of capital

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Treas. Reg. § 1.904-8, 52 Fed. Reg. at 32260-63 (allocation of taxes to separate categories of income); Prop. Treas. Reg. § 1.904-9, 52 Fed. Reg. at 32263-65 (transition rules). These proposed regulations cover thirty-nine pages in the Prentice-Hall tax service.

20. *See* Gann, *supra* note 5, at 108-35.

21. *Id.* at 116-22.

22. I.R.C. § 265(a)(2) (West Supp. 1988).

23. *See* Temp. Treas. Regs. § 1.163-8T (allocation of interest expense among expenditures), § 1.163-9T (personal interest), § 1.163-10T (qualified residence interest). These temporary regulations cover thirty-seven pages in the Prentice-Hall tax service.

gains, Assistant Secretary Roger Mentz replied that "he feared that it would be too complicated to administer. With that, indexing faded away" (p. 278).

B. *Measuring the Distributional Neutrality of the 1986 Act*

> *By raising corporate taxes,* [Treasury I] *was able to cut not only individual tax* rates, *but also individual tax* bills. *The plan offered taxpayers an average cut of 8.5 percent in their annual payments to Uncle Sam.* [p. 60; emphasis in original]

The theme of distributional neutrality had been established early in the legislative process by both Senator Bradley and President Reagan (pp. 29, 40-41). Distributional neutrality means that tax legislative changes do not adjust the distribution of the tax burden among income groups. Distributional neutrality ostensibly was achieved under the 1986 Act by lowering the rates and at the same time substantially broadening the income tax base to which the rates were applied.[24] Moveover, although the largest drop in marginal tax rates would be made with respect to the wealthy (the marginal tax rate was in fact dropped from 50 percent to 28 percent), it was argued that the corresponding drop in revenues collected from the wealthy would be offset by increased revenues through base broadening, which would have its largest impact on the wealthy.[25]

Birnbaum and Murray do not question the claim that the various tax reform proposals achieved distributional neutrality. Nor do they appear to realize that measuring the distributional burden of income taxes is a very difficult calculation. Perhaps they ought not to be faulted too much for this omission, for the difficulties were largely ignored by the experts in the Treasury Department, the Joint Committee on Taxation, and the staffs of the congressional tax-writing committees as well. Perhaps the problems of measuring distributional burdens are so great that in the rush of writing and enacting legislation the experts deliberately chose to ignore the problems with their calculations. By ignoring them, however, these experts repeatedly made misleading statements that the various tax reform proposals were distributionally neutral. Their calculations were too primitive to support such assertions, for they typically ignored three adjustments: behavioral response to the tax changes, the incidence of the corporate tax, and the existence of so-called implicit taxes.

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24. The calculation of taxes owed by any individual equals R x (Y − D), where *R* is the tax rate, *Y* is gross income, and *D* is the total of all deductions. For various combinations of R and (Y − D) (the tax base), the same taxes can be collected.

25. *See* 1 U.S. DEPT. OF THE TREAS., TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT 46-61 (1984).

1. *Behavioral Response to Tax Changes*

As described earlier,[26] the econometric models used by revenue estimators attempt to anticipate taxpayer behavioral responses to tax changes in determining whether the proposed legislation is revenue neutral. If taxpayer behavioral adjustments are underestimated, the tax legislation will produce a revenue shortfall. Similarly, if such adjustments are ignored or underestimated, distributional neutrality predictions will typically overstate the tax burden to be paid by various income groups. For example, if the number of persons who would avoid paying the income tax through deposits to an IRA is underestimated, then the revenue cost of the provision is understated and the distributional burden of the tax is overstated.

2. *Incidence of the Corporate Tax*

Corporations are artificial entities that *nominally* pay the corporate tax. The burden, or *incidence,* of all taxes is on individuals. Economists have applied sophisticated analyses to determine the incidence of the corporate tax. For example, the corporation may shift the tax to consumers of its products (through higher prices), to its employees (through lower wages), to its shareholders (through lower after-tax profits), or to all owners of capital (through reestablishment of market equilibrium across all investors in capital after the corporate tax increase).[27]

The 1986 Act is estimated to shift approximately $120 billion in taxes from individuals to nominal payments by corporations.[28] Notwithstanding that the incidence of this increased corporate tax is on individuals, the distributional burden calculations were made solely with respect to the changes in the individual income tax.[29] The failure to account for the incidence of this shift yields statements such as those made by Birnbaum and Murray quoted in Part II, subsection B. By focusing solely on taxes explicitly paid by individuals (their "tax bills"), the estimated tax cuts could only be accidentally correct.

Economist Martin Feldstein has proposed a method to calculate the distributional effects of the increased corporate tax burden of the

26. *See* notes 16-17 *supra* and accompanying text.

27. For a summary of this research, see J. PECHMAN, FEDERAL TAX POLICY 141-46 (5th ed. 1987).

28. JOINT COMM. ON TAXATION, 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 at 1357, Table A-1 (JCS-10-87).

29. *See, e.g., id.* at 17, Table I-2 (JCS-10-87) (showing the percentage change made by the 1986 Act in the distribution of the tax burden by income class, taking into account only changes in the individual income tax provisions). *See also id.* at 18, Table I-3 (showing the *average* income tax rate by income class before and after the 1986 Act, taking into account only changes in the individual income tax provisions).

1986 Act.[30] His calculation imputes the increase in the corporate income tax to individuals, assuming that the entire increase is borne by capital and that all capital bears the tax increase equally.[31] Since owners of capital are likely to be wealthy, one expects his calculations to demonstrate that the 1986 Act is not as distributionally neutral as claimed by the tax-writing committees, but rather redistributes the tax burden to wealthier individuals. His findings are summarized in Table 1.[32]

Column 2 of Table 1 shows the average individual tax liability for 1988 calculated by applying the law prior to the 1986 Act. Column 3 shows the corresponding average individual tax liability for 1988 applying the 1986 Act, conventionally calculated with no allowance made for the distributional impact of the corporate tax increase. Column 4 makes the conventional tax calculation of the average tax change at each income level.[33] The calculation in column 4 is then restated in column 5 as a percentage of the "old law" tax liability.[34] Thus, columns 2-5 state the conventional analysis supplied in reports of the Treasury Department, the Joint Committee on Taxation, and the tax-writing committees.

Columns 6 through 10 present the calculations of the combined individual and corporate tax liabilities, assuming that the incidence of the corporate tax is on individual owners of capital. As expected, the total tax burden is increased because the corporate taxes are included. Column 6 combines the individual income tax from column 2 with the additional imputed corporate tax burden calculated under the law prior to the 1986 Act. Column 7 combines the individual income tax from Column 3 with the additional imputed corporate tax burden calculated under the 1986 Act. The net change is shown in column 8. This change is then restated in column 9 as a percentage of the "old law" individual income tax liability of column 2, and restated again in column 10 as a percentage of the combined old individual and imputed corporate tax liability in column 6.

A comparison of columns 4 and 8 shows the effect of ignoring the distributional burden of the corporate income tax. The increased cor-

30. Feldstein, *Imputing Corporate Tax Liabilities to Individual Taxpayers,* 41 NATL. TAX J. 37 (1988).

31. *Id.* at 3. Calculations of the combined federal and corporate income tax burden, assuming that the corporate income tax is a tax on capital, are provided by Joseph A. Pechman in a letter to the editor. THE NEW YORK REV. OF BOOKS, July 16, 1987, at 50.

32. This table is taken from Feldstein, *supra* note 30, at 54, Table 4.

33. *Cf.* JOINT COMM. ON TAXATION, Table I-3, *supra* note 28, at 18. The Feldstein study shows a decline in total individual tax liabilities in column 4 of only $300 million, rather than the $25 billion individual tax cut estimated by the Joint Committee on Taxation. *See* JOINT COMM. ON TAXATION, *supra* note 28. He suggests reasons for this discrepancy, and states that the reasons for the discrepancy are under investigation. Feldstein, *supra* note 30, at 55.

34. *Cf.* JOINT COMM. ON TAXATION, Table I-2, *supra* note 28, at 17.

TABLE 1
CHANGES IN 1988 TAX LIABILITIES BY INCOME CLASS*

		Personal Income Tax Liability				Combined Personal and Corporate Tax Liabilities				
									Change as percentage of:	
Income Class	Number of Returns (000) [1]	Old Law [2]	New Law [3]	Change [4]	Average Percentage Change [5]	Old Law [6]	New Law [7]	Change [8]	Old Personal Liability [9]	Old Personal Plus Corporate Liability [10]
To $10,000	31,128	114	44	−70	—	227	187	−40	—	—
$10,000 -	26,284	1,102	958	−144	−15	1,380	1,301	−79	−7	−6
$20,000 -	17,933	2,555	2,425	−130	−5	2,847	2,774	−73	−3	−2
$30,000 -	13,795	4,008	3,816	−192	−5	4,340	4,209	−131	−3	−3
$40,000 -	8,809	5,701	5,402	−299	−6	5,943	5,681	−262	−5	−4
$50,000 -	8,758	8,654	8,800	+146	+2	9,321	9,564	243	3	3
$75,000 -	2,274	14,760	15,500	+740	+5	16,970	18,083	1,113	7	6
$100,000 -	1,603	25,860	28,300	+2,440	+9	30,984	34,319	3,335	13	11
$200,000 +	540	110,500	122,400	+11,900	+10	145,400	164,170	18,770	17	13
All Returns	111,116	3,549	3,546	−3	0	4,095	4,197	102	3	2
Total Dollars All Returns (billions)	—	394.3	394.0	−0.3	—	455.0	466.4	11.4	—	—

* All dollar amounts are estimated 1988 dollars.

porate tax burden reduced by half the reduction in tax burden on individuals with incomes between $10,000 and $20,000. This effect reflects the prevalence of older, retired, or partially retired individuals in these income classes. Comparing columns 5 and 10 at income levels above $100,000 demonstrates that the tax burden increase is higher when both the changes in the individual and corporate taxes are taken into account.

3. *Payment of Implicit Taxes*[35]

The distributional calculations also ignore the effect of implicit taxes. The concept of implicit taxes can be illustrated by a tax-exempt bond example, as it typically is illustrated in law school classes.[36]

Example. Prior to the 1986 Act, Taxpayer *A* had a 50 percent marginal tax rate, the maximum under the "old" law. *A* had the option of investing in a taxable corporate bond bearing a 10 percent interest rate, or in a tax-exempt bond issued by a state government bearing a 6 percent interest rate. The tax-exempt status of the state bond is reflected in its lower interest rate. *A* wisely chose to invest in the tax-exempt bond, yielding a 6 percent tax-exempt return, rather than in the corporate bond, yielding an after-tax 5 percent return (because the 10 percent return is taxed at *A*'s 50 percent marginal tax rate). By this choice, *A* pays no *explicit* tax but pays instead an *implicit* tax of 40 percent in the forgone additional investment return that she would have earned on the corporate bond. This implicit tax can be viewed as a revenue-sharing mechanism — albeit an inefficient one — between the federal and state governments, effectuated through the federal income tax system. By this mechanism, the federal government forgoes a tax on the state bond interest, and a substantial part of this forgone tax inures to the benefit of the state government by lowering its borrowing costs relative to other borrowers.[37] The federal government thereby offers a subsidy for public goods and services provided by the state government. Finally, note that *A* has a 6 percent return to invest or spend as she privately determines.

Under the 1986 Act, *A*'s marginal tax rate drops to 28 percent, the maximum marginal rate applied to wealthy individuals. Because the maximum marginal rate has dropped from 50 percent to 28 percent, the interest paid by state and local governments on tax-exempt bonds

35. The only tax policy discussion of the 1986 Act's impact on implicit taxes that I have seen is in Schmalbeck, *supra* note 16. This subpart draws heavily from his discussion.

36. *See, e.g.,* M. CHIRELSTEIN, FEDERAL INCOME TAXATION: A LAW STUDENT'S GUIDE TO THE LEADING CASES AND CONCEPTS 334-40 (4th ed. 1985) (using the tax-exempt bond example to illustrate the value of a tax preference).

37. In the example given, if the bond principle is $1,000, the federal revenue lost by substituting an exempt bond for a taxable one is $50 per year. The local government interest subsidy is (10% − 6%) x $1,000, or $40 per year. The difference, $50 − $40, is the investor's net tax benefit.

will be a higher percentage of that paid on taxable corporate bonds. Assume that a new market equilibrium is reached, so that the interest rate on corporate bonds is 10 percent and that on tax-exempt bonds is 8 percent. *A* wisely chooses to invest in the tax-exempt bond, yielding an 8 percent tax-exempt return, rather than the corporate bond, yielding an after-tax 7.2 percent return (because the 10 percent return is taxed at *A*'s marginal rate of 28 percent). *A* pays no explicit tax but pays instead an *implicit* tax of 20 percent in the forgone additional interest income that she would have earned on the corporate bond. Because of the 1986 Act, *A*'s implicit tax has decreased from 40 percent to 20 percent, and her investment return has increased from 6 percent to 8 percent.

The federal government collects no *explicit* taxes from *A* either before or after the 1986 Act to spend on public goods and services. The federal government subsidizes the state government by lowering its borrowing costs, but the subsidy has been halved by the 1986 Act because the state government's borrowing costs have been increased from 6 percent to 8 percent. The state government has correspondingly less to spend on *public* goods and services.

Table 2 compares the results under this example before and after the 1986 Act.

TABLE 2

Characteristics	Before 1986 Act	After 1986 Act
Return on Corporate Bond	10%	10%
Return on Tax-Exempt Bond	6%	8%
Explicit Tax Paid to Federal Government	0%	0%
Implicit Tax and Subsidy to State Government	40%	20%
Total Amount Available for Public Goods and Services	40%	20%
Total Amount Subject to Taxpayer's Private Control	60%	80%

This type of example can be repeated over and over again with respect to Internal Revenue Code provisions which permit an exclusion from income (like the tax-exempt bond example) or a deduction from income (like a charitable contribution deduction). It is a well-known phenomenon to economists and lawyers engaging in tax policy analysis. Many of these provisions were designed to achieve a social policy objective, such as support for education, implementation of pollution control equipment, rehabilitation of historic structures, or investment in equipment. These provisions are now typically referred to as "tax expenditure" provisions and are summarized as a part of the "actual federal budget."[38] This portion of the budget estimates the amount of forgone federal government revenue that is channeled into various activities through each tax expenditure provision.

The 1986 Act eliminated or reduced the generosity of many tax expenditure provisions. As illustrated by the tax-exempt bond example, even if the Act did not modify a tax expenditure provision, two important phenomena resulted from the substantial lowering of the highest marginal rate from 50 percent to 28 percent: (a) the amount of *implicit* taxes paid by wealthy individuals engaged in the activities covered by tax expenditure provisions has been reduced; and (b) correspondingly, the amount of forgone federal government revenues channeled through these provisions to purchase public goods and services has been reduced. Distributional calculations would look quite different if the lowering of implicit taxes paid by wealthy individuals as a result of the 1986 Act were taken into account. Public finance economists ought to attempt to combine the work of Professor Feldstein, imputing the greater corporate tax burden to individuals, with an additional effort to impute the loss in the implicit tax burden by lowering the maximum marginal tax rates from 50 percent to 28 percent.

III. CONCLUSION

Showdown at Gucci Gulch is an important narrative document that should be studied by those interested in the tax legislative process. Even if one admires the 1986 Act, there is much to disapprove in the legislative process that produced the Act.

Traditionally, the Treasury Department has advocated sound tax policy, based on such touchstone principles as the Haig-Simon comprehensive definition of "income." It has operated as a counterweight to special interest lobbyists who directed their efforts at Congress. Treasury I is an excellent example of this important tradition.[39] Treasury II, however, is a political document produced under the direction of Secretary Baker. Perhaps it was necessary for the Treasury to produce such a document to maintain a serious shot at accomplishing the tax reform legislation that the President desired. Nevertheless, it is an unwelcome trend to the extent that future Treasury Departments may likewise be willing to operate in such a politically driven manner with respect to tax legislation.[40] Congressional legislators ap-

38. *See Special Analysis G,* in SPECIAL ANALYSES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1988 at G-1.

39. Another excellent example is U.S. DEPT. OF TREAS., BLUEPRINTS FOR BASIC TAX REFORM (1977).

40. The Joint Tax Committee estimated that the bill passed by the Senate leading to the 1986

pear also to have developed a voracious appetite to trade tax legislative votes for targeted transitional rules for particular constituents. Perhaps these various adjustments in the tax legislative process are predictable under public choice theory; their predictability does not make them more welcome.

Guidelines of revenue and distributional neutrality constrain the legislative process. Yet, the measurements necessary to apply these concepts of neutrality are very difficult to ascertain. The Treasury Department and the Joint Committee on Taxation presumably have made serious econometric attempts to measure revenue neutrality correctly. Equally excellent efforts have not been directed at the correct measurement of distributional neutrality. Because of the budget deficit, each Congress in the near future is likely to consider revenue legislation under these same neutrality constraints. Debate will inevitably arise over the secrecy of the revenue-estimating process. The distributional analysis needs to be modified if the distributional neutrality constraint continues to be applied. Finally, as income tax revisions increasingly become the captive of the budget reconciliation process, the likelihood of enacting piecemeal legislation to achieve target revenue will increase.[41] This development will come at the expense of more systematic tax reform efforts to improve targeted areas of the Code, such as the rules applied to corporate acquisitions.

As explained in this book, a bipartisan effort at tax reform was forged by the combination of low rates (which attracted conservatives) and a broadened base (which attracted liberals). The 1986 Act has also garnered support from tax policy analysts from both camps. This coalition cannot help being viewed with some irony, however. Professor Boris Bittker has noted the decline and fall of progression through the tenure of the Reagan administration, in which the highest marginal tax rates have dropped from 70 percent to 28 percent for the wealthiest.[42] Nevertheless, Democratic leaders attended the October 27, 1986, ceremony on the South Lawn as President Reagan signed the bill and regaled the crowd with the wonders of low tax rates. Perhaps the liberal Democrats were getting their "just deserts": since they had been loathe to acknowledge that the tax expenditure budget represented an implicit tax on the wealthy, it would hardly do for them now

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Act contained a $21 billion revenue shortfall. The Treasury Department had previously estimated a revenue shortfall of $30 billion, but hid that fact from everyone except Senator Packwood. Its failure to disclose revenue estimates was a switch from traditional practice, in order not to impede the passage of the bill by the Senate. P. 261.

41. *See* Handler, *Budget Reconciliation and the Tax Law: Legislative History or Legislative Hysteria?*, 37 TAX NOTES 1259 (1987).

42. THE NEW YORK REV. OF BOOKS, July 16, 1987, at 49 (letter to the editor). Professor Bittker points out that nominally progressive tax rates were not irrelevant, because reported revenue statistics showed that in 1981, 13% of personal income tax revenues came from income taxed at 50%, and that in 1982, 15% came from income taxed at 49-50%. *Id.*

to complain about the lower explicit tax rates, but the "distributionally neutral" tax, on the wealthy. This irony escaped the writers of *Showdown at Gucci Gulch.*[43]

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43. It also escaped Albert R. Hunt, the Washington bureau chief of the *Wall Street Journal*, who wrote in the introduction to *Showdown at Gucci Gulch:*

> Whatever the economic and political effects, the tax-reform bill is a monumental piece of social legislation. It takes more than four million poor people off the federal income tax rolls, the most important antipoverty measure enacted over the past decade. And the attack on individual and corporate tax shelters makes it unlikely that wealthy individuals or businesses will be able to escape paying any taxes and thus might restore some of the eroding confidence Americans feel in the tax system. P. xvi.