How Did the 1986 Tax Reform Act Attract So Much Support?

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Chairman Baucus, Senator Grassley, and members of the Committee, my name is Randall Weiss. I am the Managing Director of Economic Research at The Conference Board in New York City. The views I express in this testimony are my own, and should not be construed to reflect any position of the Trustees or staff of The Conference Board.

It's a great honor to be speaking to you today on the lessons of the 1986 Tax Reform Act. Many members of Congress, their staffs, and executive branch personnel worked very hard to make it happen. They knew that the income tax generated the major share of Federal tax revenue and that the income tax carried the burden of raising this substantial revenue in a way that the public would believe was fair. This is still true today. It is important for Congress to periodically review the income tax in order to raise the necessary revenue as fairly and efficiently as possible. The advantage of a comprehensive tax reform initiative is that many tax provisions can be changed at the same time, thus allowing a package to be shaped that accomplishes these objectives. This is much more difficult to do in piecemeal tax bills that deal with only a few provisions at a time.

What made it possible to enact this legislation, versions of which passed the Senate Finance Committee by a 20 to 0 vote and the full Senate by a 97 to 3 vote, with such overwhelming bipartisan support? I believe that two features of the Act were critical – (1) substantial rate reduction and (2) significant improvement in the public's perception of the fairness of the tax. Also important were two other aspects of the shaping of the Act – revenue neutrality and de-emphasis on adjusting the tax's distribution by income class. I believe that all of these considerations would be important for, and allow the success of, a tax reform effort in the current environment. Not only would a new tax reform initiative deal with the fairness issue and the economic distortion that result from excessive tax expenditures, but it also could help to resolve the extraordinary degree of uncertainty about what the tax law will be in the very near future.

In my testimony today, I will further describe these major features of the Act and explain why they made it so popular in the economic and political environment of the mid-1980s. I will then discuss why those features match the tax policy environment in which we find ourselves today. Of course, my views reflect the experiences I had as the Deputy Chief of Staff of the Joint Committee on Taxation during the legislative battles that shaped the Act. I had the privilege of participating in virtually every meeting that the Senate Finance Committee, the House Ways and Means Committee, and the Conference Committee conducted, as well as many smaller meetings with members. I was able to witness firsthand the issues, conflicts, and compromises that members had to wrestle with in order to put the legislation together. A few years before, I had become familiar with tax reform issues when I was part of the core group of staff that worked with Senator Bradley and Congressman Gephardt to develop their tax reform proposal, which was a precursor of the Act in many respects.

Rate Reduction and Fairness

Achieving rate reduction and improving the perception of fairness were key accomplishments of the '86 Act. The popularity of low tax rates had been demonstrated during the elections and tax debates that took place in the early and mid-1980s.Taxes are very complicated, but most people understand how important tax rates are in determining how much they pay to the government. President Reagan had made tax rate cuts a focus of his 1980 election campaign, and the subsequent Economic Recovery Tax Act (ERTA) of 1981 featured large individual tax rate cuts and indexing of brackets. The tax rate issue arose again during the 1984 presidential election. Rate increases were avoided in fashioning the substantial revenue increases that Congress legislated in 1982, 1983, and 1984. Instead, the income tax base was broadened by scaling back deductions, exclusions, and credits.

The public's perception that the income tax was unfair – driven by countless stories of high-income individuals and large corporations that paid little or no tax – was pervasive during the early 1980s. It is hard to overemphasize how important this perception was in driving the progress of the Act. Congress had begun to demonstrate concern about this in 1982, when it repealed safe-harbor leasing, a provision of ERTA that allowed companies to sell their newly expanded investment tax benefits for investment to other companies that could use them. The unfairness problem had become so serious, and the Act's attack on it sufficiently compelling, that even members who were not enthusiastic about the substance of the Act felt that they had to avoid being blamed if it failed to become law.

Base broadening

Both of these key features of the Act – low rates and perceived fairness -- were accomplished by substantial broadening of the tax base, that is, scaling back deductions, exclusions and credits so that the computation of tax liability more closely matched the taxpayer's actual income. Base broadening allowed Congress to lowering the rates. At the same time, by reducing the large variation among taxpayers in their tax liability's relationship to their actual income, base broadening was the key to dealing with the perception of unfairness. The Act implemented numerous cutbacks on tax benefits and on tax benefit transfers (such as the passive loss rules). Although many of these cutbacks were challenged by influential constituents, members felt that the vast popularity of low rates and the improved perception of fairness outweighed the potential tax increases that these taxpayers would experience.

By the time the 1986 Act was being debated, members of both political parties and both Houses had already become comfortable with enacting base broadening provisions. After the 1981 passage of ERTA, substantial budget deficits were projected “as far as the eye could see,” and both the Administration and Congress embarked on a series of Acts that reduced the deficit. President Reagan insisted on low tax rates, but he did not object to raising revenue; indeed, his Administration proposed substantial base-broadening measures that were incorporated in the 1982 and 1984 tax legislation. Although many of these provisions met with substantial opposition, this experience allowed Congress to understand that broadening the base would not lead to the dire consequences that some had predicted.

Revenue Neutrality and Distribution by Income Class

Two other features of the Act were important during its consideration – revenue neutrality and roughly maintaining the distribution of taxes by income class. The Bradley-Gephardt bill had strictly adopted these goals, and they were an important part of the framework on which the ’86 Act was fashioned. The revenue neutrality constraint was particularly controversial because, as noted above, substantial Congress also was focusing on budget deficit reduction, and some of tax reform’s opponents believed that any major tax bill should reduce the deficit. But the major tax reform proponents, both on Capitol Hill and in the Administration, believed that revenue neutrality was an important part of achieving tax reform. That way, all the revenue of base-broadening could be ploughed into the tangible benefit of rate reduction.

The distributional neutrality of the Bradley-Gephardt bill was ultimately not fully embraced in the ’86 Act; lower-income taxpayers received slightly larger tax reductions that higher-income taxpayers. However, this outcome was not the result of a broad debate about whether the degree of progressivity in the existing tax system was optimal public policy. Rather, the small scale of the distributional changes reflected a political decision that a large change in distribution would add an additional layer of controversy that could derail bipartisan support for the reform.

To sum up, I believe that four aspects of the 1986 Tax Reform Act were key to its support:

1. Substantial reduction in tax rates

2. Moving the tax base closer to actual income

3. Revenue neutrality

4. De-emphasis on distribution by income class

Tax Reform in the Current Environment

Would these features of a new tax reform act generate substantial support today, and would recent Congressional experience help facilitate the process of enacting it? My general answer is – yes.

- Tax rate reduction is still critical and popular. Rates are perhaps the most salient aspect of the income tax, and I believe there would be substantial attractiveness to a tax package which reduces existing rates.

- In the fairness arena, the biggest problem today appears to be not so much a systematic ability of high-income people and companies to avoid paying tax, but rather a kind of randomness in the computation of tax liability. There are so many overlapping incentives that, along with the alternative minimum tax and people's increasing delegation of tax preparation to tax professionals and computers, it is very difficult for many people to understand how their tax liability is determined and to make decisions accordingly. A perception of fairness requires that people see that their tax liability is determined according to some logical principles. A tax reform package that responded to this concern would be popular.

- Revenue neutrality and approximate distributional neutrality would still be useful disciplines to impose on a tax reform process, since they put aside potentially thorny policy issues that could make the process even more difficult than otherwise.

- Concern about the budget deficit has increased, and Congress has begun to examine and adopt base broadening provisions to offset revenue losses from other provisions. This experience has begun to parallel the experience of the early 1980s.

The benefits of tax reform would still be large. As before, minimizing the economic inefficiency that results from high rates (think how high the rates would have gone in the 1990s to meet the revenue requirements of deficit reduction if the 1986 Act hadn't happened) and dealing with the need to maintain the perception of fairness would again be important benefits.

Another issue has emerged that also would be addressed by tax reform -- the extraordinary amount of uncertainty in today's tax rules. One way to measure this development is to count the number of expiring provisions. At the beginning of 1985, 25 provisions were scheduled to expire in the next two years. As of early 1989, after the Act and other legislation resolved some of these issues, there were 14 provisions that expired either that year or the previous one. In contrast, as of early 2010, there were 141 provisions that expired in that year or the previous one. Among the 14 in the earlier period, the largest was the R and D credit, but in the later period, fundamental aspects of the tax system, such as the rate structure and the existence of the estate tax, are in play. This uncertainty is causing great concern among a wide variety of taxpayers, and may be inhibiting the growth of the economy. Tax reform would be an effective process for Congress to make decisions about the long-term fate of these provisions.

In conclusion, I would like to congratulate the Chairman and members of the committee for beginning to consider how to make another round of tax reform happen in the near future. I would be happy to answer any questions.