More Lessons From the 1986 Tax Reform Act

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We read with great interest the excellent *Tax Notes* article ''Tax Reform's Challenge: Lessons From the 1986 Act,'' by Robert Leonard and Kenneth J. Kies,[1] both of whom played an invaluable role in the development of the Tax Reform Act of 1986 and were enormously insightful and educational.

Like the two of them, we also were privileged to be a part of TRA 1986, serving as tax counsel to a Senate Finance Committee member and as the Treasury Department's chief liaison to Capitol Hill during the tax reform debate. Given the perspective that we had from the Senate and Treasury, we would like to add a few comments and observations to Kies's and Leonard's key points and offer a few suggestions of our own.

Presidential Leadership

First, we are in complete agreement that tax reform requires the total commitment of the president and sustained leadership from the White House. President Reagan provided strong and consistent leadership for tax reform during the entire 1986 process despite the concerns of many of his advisers, who thought it was political suicide to take on so many special interest tax provisions. His transmission letter accompanying his proposal was unambiguous as to his commitment:

> Now is the time to build on our success, to redesign the basic structure of our tax system in order to discourage non-productive economic activity, to encourage greater compliance and to liberate incentives still further.
>
> Accordingly, *I hereby submit my proposal* to overhaul our tax code based on principles of simplicity and fairness, opening the way to a generation of growth.[2]

In the end, Reagan's focus on lower tax rates for all Americans provided the catalyst for reform, muting opposition and allowing Congress to eliminate a long list of special tax breaks.

Thinking he was heading off a Democratic presidential election plank, Reagan initiated tax reform in his 1984 State of the Union address by directing the Treasury Department to draft a comprehensive reform plan and report back to him in December of that year. Most people do not realize that in that same speech, Reagan called on Congress to work with him on a bipartisan deficit reduction plan that resulted in the Deficit Reduction Act of 1984 — proof positive that Congress can do deficit reduction contemporaneously with tax reform.

While President Obama has taken a number of steps to highlight the need for tax reform, his commitment to date has been more cautious, and thus, has hampered the effort. Although he used this year's State of the Union speech to call for tax reform, his Economic Recovery Advisory Board produced a tax reform report, and he instructed Treasury to conduct a corporate tax reform study, he has yet to publicly provide a plan. After the conclusion of the debt limit debate, it will be interesting to see if he will more forcefully embrace reform by sending the Treasury white paper to the Hill. Quoting the Old Testament prophet Moses, in regard to the Treasury white paper, we say, ''Mr. President, 'Set my people free.'''

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[1]*Tax Notes*, May 30, 2011, p. 973, *Doc 2011-10165, 2011 TNT 105-9*.

[2]President Ronald Reagan's Transmittal Letter accompanying The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity, May 29, 1985.

Congressional Commitment

Similar to the mid-1980s, congressional support for tax reform is beginning to build. A number of comprehensive tax reform bills have been introduced in the House and Senate, and the tax reform plan included in the Simpson-Bowles report is receiving increased attention in Congress. Most significantly, the chairs of the two taxwriting committees are both strongly committed to tax reform, are both holding a series of hearings on reform issues, and have both directed the Joint Committee on Taxation to undertake a number of studies in preparation for comprehensive reform. In short, the congressional process for reform is underway.

Policy Framework

We also agree that tax reform should be comprehensive, apply to both individual and corporate taxpayers, and be both revenue and distribution neutral. As part of that framework, however, we believe policymakers should be open to considering new sources of revenue for tax reform. Few people remember that the Treasury Department seriously considered a VAT in 1984, and that one of the three volumes of Treasury's report to the president in December 1984 was a 128-page report on the pros and cons of a VAT. Treasury did recommend that a VAT not be adopted as part of tax reform, but there was support in the department for a new consumption tax to allow lower income tax rates for individuals and corporations.

Support for alternative sources of revenue does exist today. Four of the six budget plans submitted by public policy organizations to Pete Peterson's Fiscal Summit last May included tax reform plans funded partially by new sources of revenue, including a national sales tax, a tax on financial transactions, and a tax on carbon. Additionally, it is important to note in the context of the debate on lowering corporate rates that many countries cited as having lower rates have in place some sort of border-adjusted VAT to augment domestic receipts. We are not endorsing or recommending any of these new taxes. But Congress should not rule out a new source of revenue that could facilitate a tax reform plan that lowers rates while preserving select important tax incentives.

Establish Clear Goals

One important lesson of TRA 1986 is the importance of establishing clear, concise goals for tax reform. The tax reform process is complicated, confusing, and painful, so policymakers need to have clear goals for tax reform to garner public support. During the 1986 process, the Reagan administration established three concise goals for its tax reform proposals: fairness, growth, and simplification. In fact, the president's submission to Congress was titled ''The President's Tax Proposal for Fairness, Growth, and Simplicity.'' The administration repeatedly argued that tax reform was needed because the current system was unfair, too complicated, and impeded economic growth. The president's reform proposals were needed to increase economic growth, reduce complexity, and make the system fairer. Those goals resonated with the American people, and the public support for tax reform helped persuade Congress to act.

Changes Have Consequences

Another lesson of TRA 1986 is that major tax policy changes have real consequences, sometimes unintended. One unintended consequence was to contribute to the growth of passthrough businesses. The Reagan administration's original plan proposed reducing the top individual tax rate from 50 to 35 percent and the top corporate tax rate from 46 to 33 percent, keeping the two top tax rates at comparable levels. However, the final version of the bill reduced the top individual rate to 28 percent and the top corporate rate to 34 percent.

The resulting disparity in tax rates made it more attractive — if not a competitive imperative — for many businesses to convert to a passthrough, rather than a C, corporation. Passthrough entities now account for nearly half of all business income, up from only 20 percent in the early 1980s. While other changes contributed to the shift, the disparity between the individual and corporate rates was a major factor. The obvious lesson learned is to try to keep individual and corporate tax rates at comparable levels, but the larger lesson for policymakers is to remember that what might seem insignificant at the time could change the future direction of entire industries.

Focus on Tax Rates

One of the main lessons of the 1986 process is that policymakers need to be bold in putting together a tax reform plan. During the drafting of the Treasury I plan, the number one goal was to reduce tax rates as much as possible. Treasury believed that taxpayers would be willing to forgo special tax breaks if their tax rates could be reduced to low enough levels. For policymakers, it is not worth going through the political pain of cutting popular tax breaks if tax rates are not reduced substantially. That is why tax reform nearly died in the House in late 1985, after a number of deductions and tax breaks were restored and tax rates pushed back up. It is also why tax reform was declared dead in the Senate, only to come back to life as a bold new plan to reduce tax rates and repeal several popular tax breaks. Incremental reform dies from a thousand little cuts; bold reform that offers significantly lower income rates could help deliver historic reform during this Congress.