On a Clear Day What Can Be Seen Ahead for the Federal Income Tax?

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In general terms, the question I am to address is whether the Tax Reform Act of 1986 signals the direction that major tax changes during the next half dozen years can be expected to take. More specifically, the question is whether the 1986 trade-off of broadening the individual income tax base in exchange for reducing the marginal rates of that tax will be a major feature in at least one more significant round of tax overhauls. My answers, I believe, are in harmony with the spirit of the challenge.

A short answer is perhaps the best even though it probably seems too pat. There are so many factors at work in the political and legislative process of taxation that prediction of things to come in six years is treacherous. I have, to be sure, long felt safe in prognosticating that the income tax provisions of the Internal Revenue Code would grow by at least five percent a year, the quantity of regulatory language would increase at a faster rate, tax practitioners would somehow spring up to keep pace with the rising word count and the income tax law would achieve new heights in complexity. These successful peeks into the crystal ball were essentially only cheap shots. I surely did not foresee the 1986 Reform Act; and my earlier serious projections scored best when dealing with proposals that would not be enacted rather than with those that would become law.

Conditional predictions about major tax changes are of a different order. It is a good bet that if we were to become involved in a large scale war, income tax rates would rise and be more highly graduated. If a wave of populism were to dominate voter preferences, the income tax would be more redistributive, and so on. Foretelling the start of a war or a new surge of populism, however, is no easier a task than foreseeing major shifts in the income tax viewed apart from such developments.

A somewhat longer answer to the question at hand is that the 1986 Act was an event that grew out of extraordinary circumstances. To reach agreement on a trade-off of base broadening against reduction of marginal rates, an unusual coalition of unlikely partners was brought together. There were those who favored base broadening because it improved horizontal equity among taxpayers—meaning that persons with roughly equal amounts of economic income would be called upon to pay more nearly equal dollars of tax. There were those who approved of base broadening because a more comprehensive tax base eventually could be used to support a greater degree of income redistribution from the more to the less affluent members of society. There were those who advocated base broadening in order to make the tax more neutral with respect to alternative investment opportunities. There were those who championed reduced marginal rates because they thought lower marginal rates would encourage greater private savings, investment, and work effort. And there were those who insisted that a broader base and lower marginal rates would result in a simpler income tax—whatever that might mean.

This coalition might never have formed in the absence of an overarching rule imposed on the process by the political leaders. Unlike the ground rules for past major tax legislation, the whole package was to be revenue neutral for a period of five years. By accepting some black box magic in

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coming up with the projected revenue figures, a somewhat curious presentation of revenue estimates over the years ahead, and some heroic assumptions, it could be said with a straight face that the overall deal would neither increase nor reduce income tax revenues.

The coalition required yet another glue. Estimated revenues lost by reducing individual marginal rates would be greater than those gained by broadening the base. To stay within the self-imposed revenue neutrality constraint the opposite prescription was invoked for corporate tax. Estimated revenues gained from base broadening would exceed those lost by rate reduction. In effect, corporate tax dollars were to be substituted for individual tax dollars. Such a rare environment seems hard to recreate.

The fullest answer to the question whether we should anticipate one more swap of base broadening for lower marginal rates may be the least persuasive but easily the most thought provoking. It focuses on the interaction of the possible sources of additional base broadening and the likelihood of a revenue-neutral constraint in designing the legislation.

Not much searching is needed to uncover the main areas that could produce potentially large additional revenues through base expansion. These are the main candidates: (1) Repeal the deduction for state and local property taxes not connected with a trade or business. (2) Repeal or dramatically cut back the deduction for charitable contributions. (3) Strengthen the minimum tax applicable to individuals by raising the rate and/or toughening the definition of taxable income for purposes of the minimum tax. (4) Eliminate or significantly cut back the deduction for interest payable on home mortgages. (5) Greatly reduce the fringe benefits that are now excluded from the tax base of employees (and are deducted in computing the tax base of employers). (6) Reduce substantially the amount of earned income that can be set aside through qualified retirement plans on a pre-tax or tax deductible basis. (7) Treat transfer of assets at death as sales at fair market value, thus taking a decedent's gain or loss on the assets into account. (8) End the exemption for interest on new state and municipal bonds.

Most striking about this list is the degree of opposition that each of the indicated moves would undoubtedly engender. Eliminating the deduction for non-business property taxes would sharply depress the value of homes because the tax deduction to an extent is already impounded in the market values. Cutting back the deduction for interest on home loans would reduce the ability of homeowners to carry their existing mortgages and of potential purchasers to finance acquisitions, again putting a downward pressure on home values. Narrowing the categories of excludable fringe benefits would significantly reduce the after-tax income of workers—and have an adverse effect on the utilization of health and life insurance—especially in heavily unionized sectors of employment. Putting substantially lower ceilings on pre-tax retirement accumulations would run up against the popular notion that

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the government should encourage private retirement arrangements to take pressure off the social security system and to encourage more private savings. Taxing gains at death (particularly now that capital gains are to be taxed at ordinary income rates) would rally those who have invested in real assets and equities, and in the process would be likely to reopen the status of the time honored realization doctrine in our scheme of things. A ratcheting-up of the minimum tax would arouse those still in a position to benefit from preferential provisions that are in the law. Taxing interest on state and municipal obligations would raise howls from the issuing governments and the bond industry. There is ample cause to wonder about the appetite of Congress to take on a combination of some or all of this formidable array of interests—bearing in mind that each is well organized and articulate and that most of these preferences are widely enjoyed by the middle class and are not generally regarded as abusive or scandalous.

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On top of this practical concern is the fact that most of these base broadening possibilities have been on the legislative table in the not-too-distant past. After having traveled the long road leading to the 1986 Reform Act there will surely be considerable reluctance to reexamine them again soon, particularly in the context of creating offsets to another reduction in marginal rates.

Other considerations strongly reinforce this view. Included among the special ground rules for the 1986 enactment was the political understanding that, except for those at the lower end of the taxable income scale who would be dropped altogether as taxpayers, the relative tax burdens of the various income classes would by and large remain about the same as before. The reconstruction of the tax, in other words, was to be distributionally neutral. It is doubtful that one could accomplish such a result in working with the various base broadening measures that have a potential for raising large revenues. Without distributional neutrality as a goal, however, hammering out a swap of base broadening for rate reduction might seem to many a much less inviting project.

The foreseeable difficulties in reaching agreement on so-called tax reform while keeping within the revenue and distributional neutrality constraints suggest that political leaders will not be eager to embrace these shackles again soon. If there is a move to prune further the preferential treatment list, I predict that the effort will be associated with an increase in total revenues to be raised from the income tax system. We might well see base broadening but not as part of a package that calls for another reduction in marginal rates. The case for cutting back on preferential provisions in order to raise greater revenues might turn out to be more appealing than doing so in order to reduce marginal rates further.

What reason is there to think the tax base might be significantly broadened? After all, during the sixties and seventies and early eighties the movement was decidedly in the other direction. The favorite route of Congress to reduce overall income tax revenues was not to cut marginal tax rates but to narrow the tax base. Various observers forcefully assert that legislators have more to gain in terms of funds or status by doing something for certain of their constituents rather than for their constituency in general. A seat on a tax writing committee can be a valuable asset. Is there any good reason to expect that congressmen will be guided by a different calculus in the future?

My response is a tentative maybe. At the moment I detect a broad feeling (even in Washington) that prior to the 1986 Reform Act the base shrinking game had simply gotten out of hand; to such an extent that more and more taxpayers perceived the system to be unfair, perhaps leading to a growing reluctance to comply with the law. This assessment of the situation, if correct, may well dampen enthusiasm for another burst of preferential provisions (call them tax expenditures) for some time to come.

On the other hand many of the players in the tax field have strong beliefs that the government should do more to guide or influence parts of our economy in what they regard as the right directions. Numerous lawmakers share this attitude. One inviting way of encouraging or discouraging particular economic activity is to provide incentives or disincentives through adjusting the income tax base, which helps explain why legislators often find that these adjustments are advantageous from their point of view. The attraction of managing the economy could quickly cause the immediate past history of the income tax to be forgotten.

Not to be ignored is another force that is apt to keep base-broadening on the front burner. Staff advisers and legislative assistants and their associates play an increasingly important role in the tax law-making process. This is not to suggest that they cast votes or work out deals among congressmen. They do, however, have a high degree of familiarity with the law and are frequently called on to formulate ideas for "improving" the income tax or accomplishing some objective on the agenda of a legislator. It is not
surprising to me that these analysts often lean toward broadening the base if circumstances permit.

Two pulls seem to be notably active. One is the understandable feeling that if you are working for the government you should not give anything away to taxpayers; you should, indeed, favor putting an end to earlier giveaways. This feeling is undoubtedly reinforced by the omnipresence of the tax expenditure list—which can be thought of as an official annual catalog of preferential provisions or subsidies to particular groups of taxpayers by way of tax reductions. The list is sometimes privately labeled the giveaway docket. I would expect that virtually every item on the list is represented by one or more proposals, already embedded in some congressional computer, for ending or curtailing the scope of that tax expenditure.

The other pull stems from the predominant tone of publications by economists dealing with government finance. Henry Simons, my teacher, still is a leader when this group of analysts turns to the personal income tax. Simons contended that equity and economic efficiency will be improved if the base of the tax is defined, to the extent practical, as income in the economic sense, by which he meant consumption plus net savings of each taxpayer during the period when income is being measured. It is not too far off the mark to treat this conception of taxable income as the foundation for the tax expenditure list. Leaving out of the tax base an element of economic income that could feasibly be brought into it is the core of a tax expenditure. The government is seen in effect as spending in the form of a tax subsidy the dollars not collected as a result of having preferential provisions in the tax law.

To be sure, not all public finance economists share the Simons approach to income taxation. Those who favor using the tax system to manage the economy urge a wholly different prescription. But their writings, as yet, do not appear to have the same power to persuade the generations now active on the scene.

Law teachers also buttress the notion of moving in a direction to equate taxable income and economic income. I know from personal experience that a good method of forcing students to map the world of tax rules is to use economic income as a touchstone. This baseline constitutes a fine jumping-off spot for analyzing a set of rules realistically—for figuring out who benefits or is burdened by the law under inspection. Whether or not the exercise works in class as intended, and I think it does, it often also serves to convince students that a Simons type of approach is sound. Many of the congressional legal advisers can very likely trace their own predilections of this kind to their classroom experience in law school.

I should also mention a related point, based mainly on hearsay. Some law teachers do not seem very hesitant to make known their strong attachment to a more rather than a less progressive income tax. Such a viewpoint perhaps also carries over from classroom to government service, although the attractiveness of progression need not originate in a law school course on income taxation. My point is limited to suggesting that many recent graduates in law might be counted on to push for a broader based tax but not necessarily one that encompasses lower marginal rates, feeling that top marginal rates are already too low and cannot provide a sufficient degree of progression.

I have now come close to answering the assigned question. My short, longer, and fullest answers are that during the near future tax changes are unlikely to extend the 1986 tax reform theme of broadening the tax base in exchange for reduction in marginal rates along the whole of the individual income scale. But I must add a final caveat. It is not inconceivable that an altogether new combination of changes, in part involving such a trade-off, can be fashioned that will draw together another successful coalition. To illustrate: perhaps income tax broadening and reductions in marginal rates might be joined with lifting the ceiling on the social security tax base and further increasing the corporate income tax rate. This, however, is a matter more properly for the dream world than for my scientifically based prediction.