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The Cost of Unstable Tax Laws

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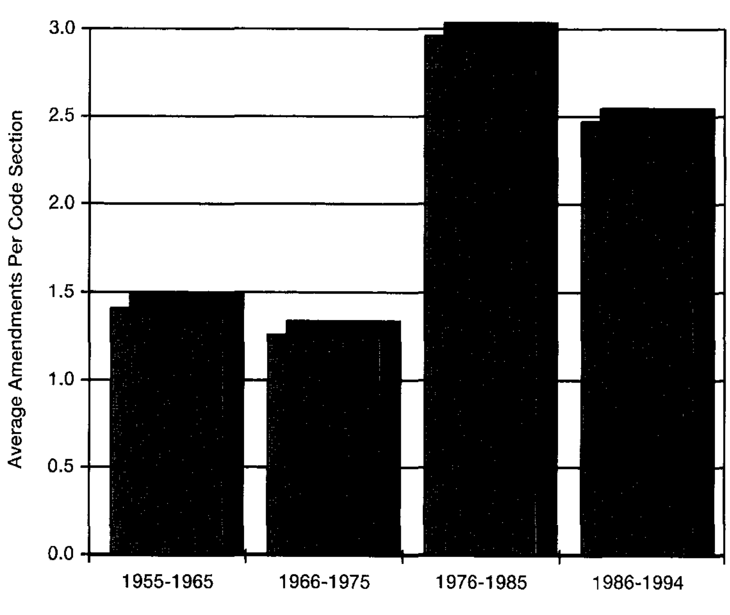
The Internal Revenue Act of 1954 was landmark legislation that, for the first time, placed the income tax at the core of the federal tax system. In the 40 years since the passage of that Act, 31 significant federal tax enactments have taken place. On average, that amounts to a substantial amendment to the federal tax code every 1.3 years. Such instability in the tax code creates economic uncertainty among taxpayers, which, in turn, generates economic costs.

Table 1 provides a more detailed measure of how unstable the federal income tax code has been since the Internal Revenue Act of 1954. It lists a sample of the core sections of the federal income tax code (approximately one-fifth of all sections) relating to rates of tax, credits against tax, and base of tax for individuals, partnerships, and corporations doing business both within and outside the United States. In compiling *Table 1*, no attempt was made to select code sections that have been the most amended. Indeed, selecting only core sections resulted in the omission of some of the most frequently amended code sections.

Along with the number of times each of the selected code sections have been amended (broken down into 10-year increments), *Table 1* also provides an "instability ratio" for each section. This ratio divides the number of times a code section has been amended by the number of years it has existed. The higher the ratio, the more unstable the code section. The average instability ratio for the entire sample is 0.24, indicating that each section in the sample, on average, has been amended once for every four years it has existed within the tax code.

Figure 1 summarizes, in 10-year increments, the average number of times the Table 1 sample of income tax code sections have been amended. It reveals that the income tax code has become much more unstable during the past 20 years than it was during the 20 years immediately following the 1954 Act. The greatest instability came in the 1976 to 1985 period in which the average income tax code section from the sample was amended almost three times, or once every 3.3 years. Taxpayers in this 10-year period witnessed the passage of seven major tax bills. Taxpayers in the most recent period, 1986 to 1994, have witnessed the passage of six major tax bills.

Figure 1
Instability in the Federal Income Tax Code Based on Selected Code Items



Source: Tax Foundation compilation from U.S. Code Annotated (Titled 26).

Table 1
Selected Income Tax Code Sections and The Number of Times They Have Been Amended

Tax Code Section	Year Enacted[a]	Description of Section	Number of Times Amended 1955-1965	1966-1975	1976-1985	1986-1994	Total	Code Section Instability Ratio[b]
1	1954	Individual Tax Imposed	1	2	4	5	12	0.30
11	1954	Corporate Tax Imposed	2	3	5	4	14	0.35
21	1976	Expenses for Household and Dependent Care Services Necessary for Gainful Employment	0	0	4	3	7	0.39
27	1976	Taxes of Foreign Countries and Possessions of the U.S.; Possession Tax Credit	0	0	2	0	2	0.11
32	1976	Individual Earned Income Credit	0	1	5	4	10	0.56
38	1978	General Business Credit	0	0	1	5	6	0.38
39	1984	Carryback and Carryforward of Unused Business Credits	0	0	0	5	5	0.50
46	1962	Amount of Business Investment Credit	1	6	6	4	17	0.53
51	1977	Amount of Tax Credit for Targeted Jobs	0	0	6	7	13	0.76
53	1986	Credit for Prior Year Minimum Tax Liability	0	0	0	4	4	0.50
55	1986	Alternative Minimum Tax Imposed	0	0	0	4	4	0.50
57	1986	AMT Items of Tax Preference	0	0	0	5	5	0.63
61	1954	Gross Income Defined	0	0	1	0	1	0.03
62	1954	Adjusted Gross Income Defined	2	2	6	5	15	0.38
63	1954	Taxable Income Defined	0	0	3	4	7	0.18
71	1954	Rules for Alimoney and Separate Maintenance Payments	0	0	1	1	2	0.05
74	1954	Rules for Prizes and Awards	0	0	0	1	1	0.03
103	1954	Rules for Interest on State and Local Bonds	0	4	7	1	12	0.30
111	1954	Rules for Recovery of Tax Benefit Items	0	0	3	1	4	0.10
118	1954	Rules for Contributions to the Capital of a Corporation	0	0	4	1	5	0.13
141	1986	Rules for Private Activity Bond; Qualified Bond	0	0	0	2	2	0.25
142	1986	Rules for Exempt Facility Bond	0	0	0	3	3	0.38
148	1986	Rules for Arbitrage	0	0	0	3	3	0.38
151	1954	Allowance of Deductions for Personal Exemptions	3	3	2	5	13	0.33
161	1954	Allowance of Itemized Deductions	0	0	1	0	1	0.03
162	1954	Itemized Deductions for Trade or Business Expenses	3	2	4	7	16	0.40
163	1954	Itemized Deductions for Interest	2	1	3	5	11	0.28
164	1954	Itemized Deductions for Taxes	2	1	5	2	10	0.25
165	1954	Itemized Deductions for Losses	3	4	3	2	12	0.30
166	1954	Itemized Deductions for Bad Debts	1	2	2	2	7	0.18
167	1954	Itemized Deductions for Depreciation	2	5	7	4	18	0.45
168	1981	Itemized Deductions for Accelerated Cost Recovery System	0	0	4	4	8	0.62
170	1954	Itemized Deductions for Charitable, Etc., Contributions and Gifts	5	2	8	5	20	0.50
172	1954	Itemized Deductions for Net Operating Loss	3	3	7	5	18	0.45
174	1954	Itemized Deductions for Research and Experimental Expenditures	0	0	2	2	4	0.10
195	1980	Itemized Deductions for Start-up Business Expenditures	0	0	1	0	1	0.07
212	1954	Itemized Deductions for Indiv. Expenses for Production of Income	0	0	0	0	0	0.00
219	1974	Itemized Deductions for Individual Retirement Savings	0	0	7	4	11	0.55
243	1954	Special Deductions for Dividends Received by Corporations	3	3	3	4	13	0.33
248	1954	Special Deductions for Organizational Expenditures	0	0	1	0	1	0.03
263	1954	Non-deductible Business Capital Expenditures	4	2	7	3	16	0.40
263A	1986	Non-deductible Business Capitalization and Inclusion in Inventory Costs for Certain Expenses	0	0	0	2	2	0.25
291	1982	Special Rules Relating to Corporate Preference Items	0	0	3	3	6	0.50
301	1954	Effects on Recipients of Corporate Distributions of Property	2	3	3	3	11	0.28
302	1954	Effects on Recipients of Distributions in Redemption of Stock	0	0	4	0	4	0.10
311	1954	Taxability of Corporation on Distribution	0	1	5	2	8	0.20
316	1954	Dividend Defined	2	0	2	0	4	0.10
331	1954	Effects on Recipients of Gain or Loss to Shareholders in Corporate Liquidations	1	0	2	0	3	0.08
336	1986	Effects on Corporation of Gain or Loss Recognized on Property Distributed in Complete Liquidation	0	0	0	1	1	0.13
341	1954	Collapsible Corporations	3	2	4	2	11	0.28
351	1954	Transfer to Corporation Controlled by Transferor	0	1	3	3	7	0.18
354	1954	Exchanges of Stock and Securities in Certain Reorganizations	0	0	3	1	4	0.10
361	1954	Nonrecognition of Gain or Loss to Corporations; Treatment of Distributions	0	0	0	3	3	0.08
367	1954	Special Rules for Organization/Reorganization of Foreign Corporations	0	1	3	3	7	0.18
381	1954	Carryovers in Certain Corporate Acquisitions	6	3	8	6	23	0.58
401	1954	General Rule for Qualified Pension, Profit-Sharing, and Stock Bonus Plans	3	3	7	7	20	0.50
404	1954	Deduction for Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation Under a Deferred-Payment Plan	2	3	6	6	17	0.43
415	1974	Limitations on Benefits and Contributions Under Qualified Plans	0	0	7	4	11	0.55
421	1954	General Rules for Certain Stock Options	2	0	1	1	4	0.10
441	1954	Period for Computation of Taxable Income	1	0	3	2	6	0.15
446	1954	General Rule for Methods of Accounting	0	0	2	0	2	0.05
451	1954	General Rule for Taxable Year of Inclusion	1	1	1	2	5	0.13
453	1980	Rules for Installment Accounting Method	0	0	3	3	6	0.43
461	1954	General Rule for Taxable Year of Deduction for Which Deductions Taken	3	0	2	5	10	0.25
471	1954	General Rule for Inventories	0	0	1	1	2	0.05

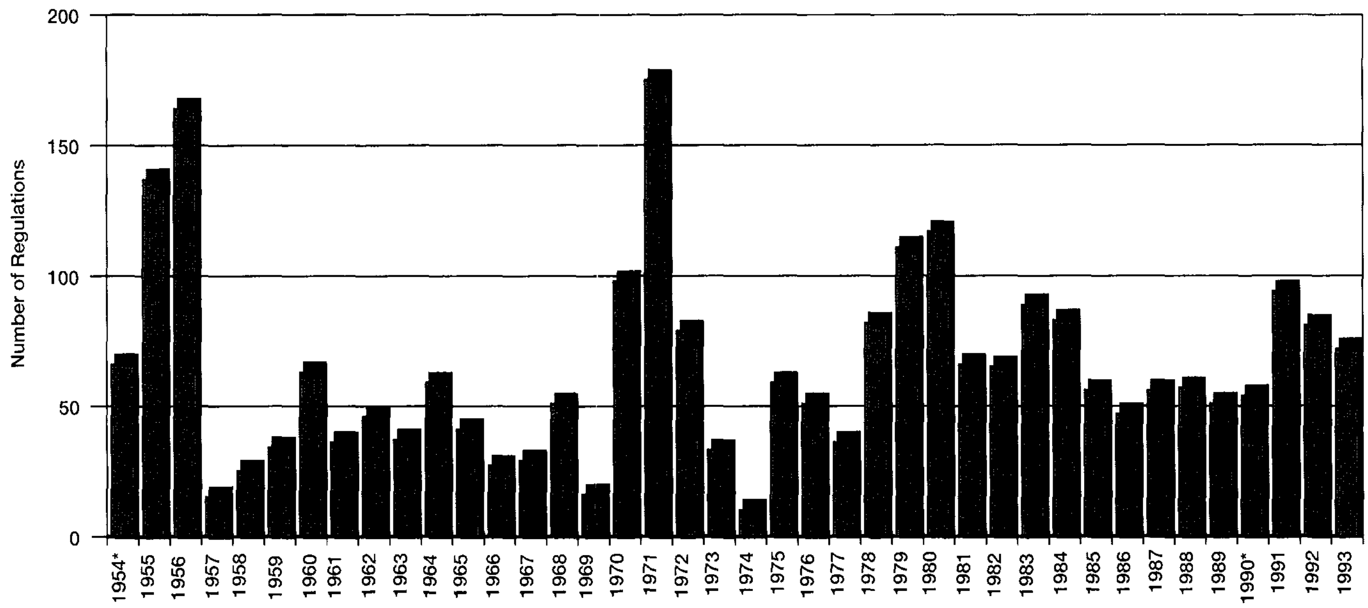
Table 1-Continued
Selected Income Tax Code Sections and The Number of Times They Have Been Amended

Tax Code Section	Year Enacted[a]	Description of Section	Number of Times Amended 1955-1965	1966-1975	1976-1985	1986-1994	Total	Code Section Instability Ratio[b]
482	1954	Allocation of Income and Deductions Among Taxpayers Relating to Inventory Adjustments	0	0	0	1	1	0.03
501	1954	General Rule on Exemption from Tax on Corporations, Certain Trusts, Etc.	3	7	7	5	22	0.55
511	1954	Imposition of Tax on Unrelated Business Income of Charitable, Etc., Organizations	1	2	3	1	7	0.18
512	1954	Unrelated Business Taxable Income	2	3	4	5	14	0.35
535	1954	Accumulated Taxable Income for Corporations Improperly Accumulating Surplus	3	2	3	2	10	0.25
541	1954	Imposition of Personal Holding Company Tax	1	0	1	3	5	0.13
542	1954	Definition of Personal Holding Company	4	3	4	1	12	0.30
552	1954	Definition of Foreign Personal Holding Company	0	0	2	2	4	0.10
553	1954	Foreign Personal Holding Company Income	2	0	1	1	4	0.10
561	1954	Definition for Deduction for Dividends Paid	1	0	1	0	2	0.05
582	1954	Rules for Bad Debts, Losses, and Gains with Respect to Securities Held by Financial Institutions	1	1	2	3	7	0.18
585	1969	Rules for Reserves for Losses on Loans of Banks	0	0	2	4	6	0.24
593	1954	Reserves for Losses on Loans of Mutual Savings Banks	1	1	3	4	9	0.23
611	1954	Allowance of Deduction for Depletion of Natural Resources	1	0	1	0	2	0.05
612	1954	Tax Basis for Cost Depletion of Natural Resources	0	0	0	0	0	0.00
613	1954	Percentage Depletion of Natural Resources	4	4	2	2	12	0.30
614	1954	Definition of Property	2	0	2	1	5	0.13
616	1954	Deductions for Natural Resource Development Expenditures	0	0	2	2	4	0.10
617	1966	Deduction and Recapture of Certain Mining Exploration Expenditures	0	1	2	3	6	0.21
641	1954	Imposition of Income Tax on Estates and Trusts	0	1	2	0	3	0.08
671	1954	Trust Income, Deductions, and Credits Attributable to Grantors and Others as Substantial Owners	0	0	0	0	0	0.00
702	1954	Determination of Income and Credits of Partner in Partnership	1	0	6	1	8	0.20
704	1954	Determination of Partner's Distributive Share	0	0	3	2	5	0.13
721	1954	Nonrecognition of Gain or Loss on Contribution to a Partnership	0	0	1	0	1	0.03
731	1954	Extent of Recognition of Gain or Loss on Distribution by Partnership	0	0	0	1	1	0.03
751	1954	Partnership Rules for Unrealized Receivables and Inventory Items	2	2	4	2	10	0.25
801	1954	Tax Imposed on Life Insurance Companies	3	0	1	0	4	0.10
805	1984	General Deductions for Life Insurance Companies	0	0	0	2	2	0.20
807	1984	Tax Rules for Certain Reserves of Life Insurance Companies	0	0	0	3	3	0.30
811	1984	Accounting Provisions for Life Insurance Companies	0	0	1	1	2	0.20
832	1954	Insurance Company Taxable Income	3	3	3	3	12	0.30
844	1969	Special Loss Carryover Rules for Insurance Companies	0	0	2	2	4	0.16
852	1954	Taxation of Regulated Investment Companies and Their Shareholders	4	1	5	4	14	0.35
857	1960	Taxation of Real Estate Investment Trusts and Their Beneficiaries	1	2	5	3	11	0.32
861	1954	Determination of Income from Sources Within the United States	2	4	5	5	16	0.40
862	1954	Determination of Income from Sources Without the United States	0	1	3	3	7	0.18
882	1954	Tax on Income of Foreign Corporations Connected with U.S. Business	0	1	5	2	8	0.20
901	1954	Taxes of Foreign Countries and Possessions of the United States	3	5	4	4	16	0.40
902	1954	Deemed Paid Credit Where Domestic Corporation Owns 10 Percent or More of Voting Stock of Foreign Corporation	2	2	1	2	7	0.18
904	1954	Limitation of Foreign Tax Credit	4	3	7	3	17	0.43
960	1962	Special Rules for Foreign Tax Credit	0	0	1	2	3	0.09
991	1971	Taxation of Domestic International Sales Corporation	0	0	0	0	0	0.00
1001	1954	Determination of Amount of and Recognition of Gain or Loss on the Disposition of Property	0	1	4	1	6	0.15
1011	1954	Adjusted Basis for Determining Gain or Loss on Disposition of Property	0	1	0	0	1	0.03
1031	1954	Rules for Exchange of Property Held for Productive Use or Investment	2	1	1	3	7	0.18
1033	1954	Rules for Involuntary Conversions	3	1	4	2	10	0.25
1201	1954	Alternative Tax for Corporation on Capital Gains	3	1	4	3	11	0.28
1211	1954	Limitation on Capital Losses	0	1	2	1	4	0.10
1212	1954	Capital Loss Carrybacks and Carryovers	1	1	6	2	10	0.25
1221	1954	Capital Asset Defined	1	1	5	2	9	0.23
1231	1954	Determining Capital Gains and Losses on Property Used in the Trade of Business and Involuntary Conversions	2	1	4	0	7	0.18
1361	1982	S Corporation Defined	0	0	1	3	4	0.33
1366	1982	Pass-Thru Items to Shareholders of S Corporation	0	0	1	3	4	0.33
1501	1954	Privilege to File Consolidated Returns	0	0	0	0	0	0.00
1503	1954	Computation and Payment of Tax on Consolidated Returns	2	0	1	5	8	0.20
Total			128	122	332	296	878	
Average			1.41	1.26	2.96	2.47	7.32	0.24

(a) Year relates to code provision not necessarily section number, which may have changed from original.
(b) The instability ratio represents the number of times a code provision has been amended divided by the number of years the provision has existed. An instability ratio of one would represent a provision that has been amended ever year it has existed.

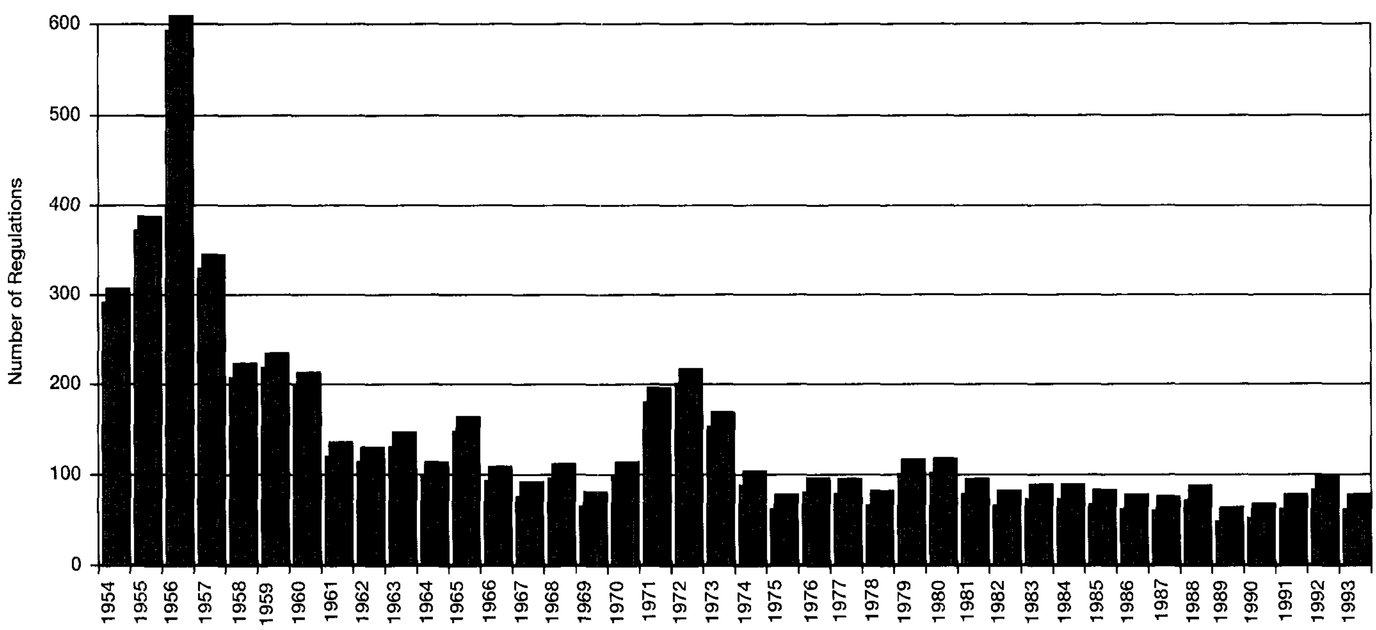
Source: Tax Foundation compilation from U.S. Code Annotated (Title 26)

Figure 2
Total Tax Regulations Proposed and Published by the Internal Revenue Service



Source: Federal Register.

Figure 3
Total Tax Regulations Finalized by the Internal Revenue Service



Source: Federal Register.

Disincentive Costs and Compliance Costs

Two different types of costs are imposed on the U.S. economy when taxpayers face uncertainty about tax laws. First, uncertain tax laws (or the uncertainty of pending tax legislation) interrupt, distort, or stifle economic activity. Second, uncertainty adds to tax law complexity, which forces the private economy to expend valuable resources on the economically sterile exercise of tax research and planning, as well as tax compliance and litigation.

In 1988, Professor Jonathan Skinner of the University of Virginia, using data from 1929 through 1975, calculated that uncertainty with regard to the federal taxation of wage and investment income costs the U.S. economy 0.4 percent of national income per year. For example, applying Professor Skinner's cost figure to 1993 national income, the widespread taxpayer uncertainty that accompanied the tax changes embodied in the Revenue Reconciliation Act of 1993 cost the U.S. economy an estimated $20.5 billion.

Such economic costs result from the effects tax policy uncertainty has on people's decisions about working, spending, saving, and investing. However, despite Professor Skinner's estimate, taxation is only one of an array of interrelated factors that motivates people's economic decisions.

Too often, economic research provides ambiguous evidence about the effects of taxes on the economy because researchers disregard the costs of compliance with and the enforcement of tax laws. The "when-and-how" feature of the way in which people and businesses deal with tax law uncertainty (and taxation in general) can be crucial. For example, by administrative necessity, the federal income tax must be a system of rules that impose taxes on identifiable transactions. Since the transactions provide the focal point of the administration and enforcement of tax laws, altering the nature, timing, or reporting of a given transaction offers a viable — and legal — way for taxpayers to respond to the disincentive effects of taxation. Such taxpayer responses form the essence of tax law planning and compliance.

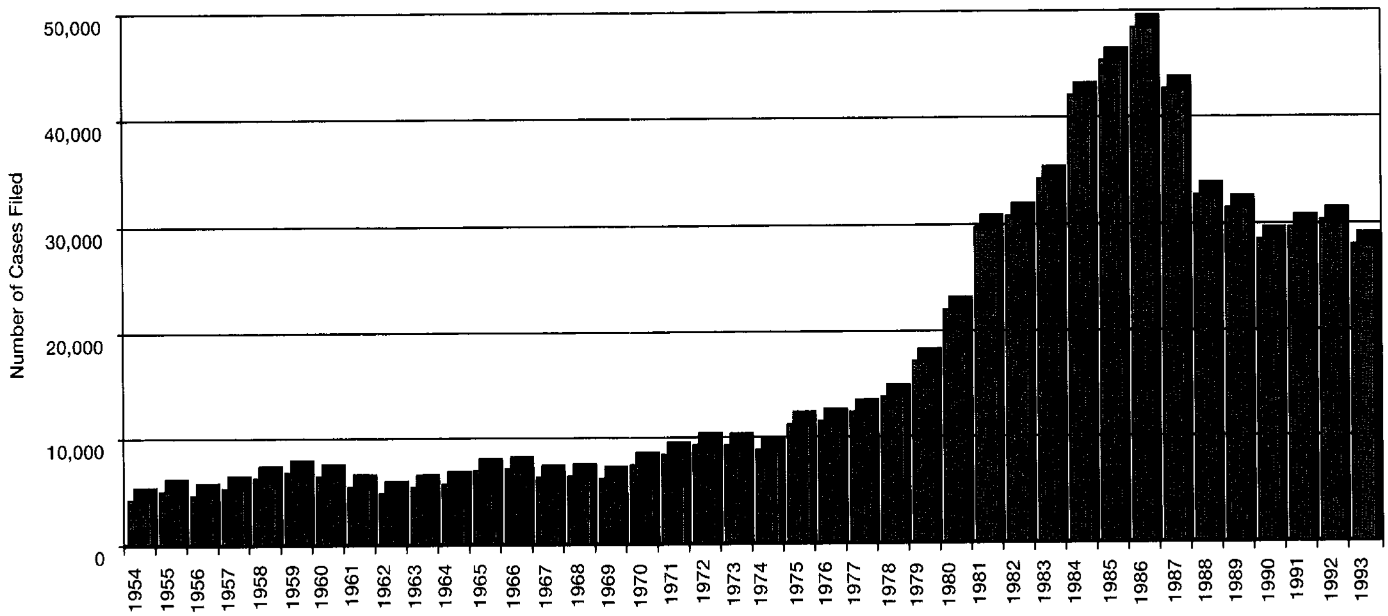
Applying this line of reasoning to the available evidence, Professor Joel Slemrod, Director of the Office of Tax Policy Research at the University of Michigan, has identified a general hierarchy of behavioral responses to taxation: (1) The timing of economic transactions seems to exhibit the most responsiveness to tax incentives; (2) the reorganization of individual or business portfolios (financial and accounting responses) exhibit the next greatest sensitivity to tax incentives; followed by (3) the real economic decisions of people and businesses to work, save, and invest.

Professor Slemrod's hierarchy also helps organize the taxpayers' behavioral response to tax law uncertainty. Professor James Alm of the University of Colorado distinguishes between two types of uncertainty: tax rate uncertainty and tax base uncertainty. Although the ultimate economic effects of the two types of uncertainty are inherently difficult to determine, Professor Alm's calculations show that when taxpayers feel uncertain about income tax rates, but feel certain about the income tax base (i.e., the definition of taxable income), they will act to reduce the tax base. That is, tax rate uncertainty tends to give taxpayers an incentive to seek more itemized deductions, non-taxable benefits, and tax shelters, and it tends to give them a disincentive to work, save, and invest. These are the traditionally identified disincentives associated with taxation.

The economic effects of tax base uncertainty — assuming taxpayers feel certain about tax rates — are more ambiguous. Like tax rate uncertainty, tax base uncertainty tends to create a disincentive to work, save, and invest. However, unlike tax rate uncertainty, Professor Alm's calculations indicate that tax base uncertainty tends to give taxpayers a disincentive to increase itemized deductions, non-taxable benefits, and tax shelters. Taxpayers, it seems, do not want to reduce their consumption possibilities and expose themselves to tax penalties in a questionable effort to minimize their taxable incomes. However, another study offers a different conclusion. Professors Paul Beck and Woon-Oh Jung of the University of Illinois-Champaign find that under "conditions that commonly occur in the United States" an increase in tax base uncertainty "is much more likely to lead to a reduction in reported income."

The authors of both studies admit that the confusion on this issue stems from the fact that, among other things, tax rate and tax base uncertainty are not always clearly distinguishable by taxpayers. As a result, Professor Alm admits that taxpayer responses might change when both tax rate and tax base uncertainty are accounted for simultaneously. But Professor Alm's most important admission is that his calculations ignore "the potentially large administrative costs from variations in the tax base." Recall that the disincentive costs of tax law uncertainty is estimated at $20.5 billion as

Figure 4
Cases Filed in the Tax Court of the United States



Source: Clerk of the Tax Court of the United States.

a result of the tax law changes of 1993.
In comparison, based upon previously published Tax Foundation calculations, the 1993 cost of complying with federal taxes may have been as high as $184 billion. Although only a small fraction of the $184 billion of compliance costs is related explicitly to the uncertainty of pending tax law changes, an actual change in the tax law, particularly with regard to the tax base, will often require a major planning and compliance effort on the part of taxpayers.

Unstable Tax Base and Compliance Costs

Tax law complexity is almost wholly related to tax base questions — that is, questions or uncertainty about the timing of taxable transactions and the definition of taxable income, key aspects of the top two components of Slemrod's tax-responsiveness hierarchy. Along with the rote exercise of recordkeeping, preparing financial statements, filing tax returns, and coping with tax audits, the high cost of tax compliance results from taxpayers' efforts to grapple with, and adjust to, these complex, and frequently changing, tax base questions.

Key sources of compliance cost that pertain especially to an unstable tax code are:

(1) research and planning,
(2) monitoring and participating in the tax legislative and administrative process, and (3) appealing IRS tax decisions and litigating tax disputes.

Estimates based on independent and Tax Foundation-sponsored research by Professors Joel Slemrod and Marsha Blumenthal on individual and business income-tax compliance costs reveal that an average of 40 percent of such costs for individuals (including those who are self employed) falls under these three categories. For the average Fortune 500 company, about 29 percent of the cost of federal income tax compliance falls under these three categories. Assuming that the 29 percent figure holds for all businesses (including sole proprietorships), then conservatively about $62 billion of the estimated $192 billion 1994 total cost of federal tax compliance is related to the above three categories.

Even if federal tax laws never changed, people and businesses would engage in tax planning and research, monitoring of the tax process, and administrative appeals and litigation. These activities take place as financial circumstance, business opportunities, tax regulations, and court decisions change and evolve. So, only a portion of the $62 billion can be attributed solely to the instability of the tax code. Currently, no data exists to compute such a fraction with confidence, but even if that portion is only one percent, the compliance costs associated with tax law instability alone would amount to $620 million in 1994.

Tax Law Changes Promote Regulatory Changes

It seems likely, however, that the incremental compliance cost of tax base uncertainty exceeds $620 million. As tax laws change, so do the rules and regulations that accompany such laws. *Figure 2* shows how surges of regulations proposed and published by the IRS follow major tax enactments. Significant tax legislation has been passed 31 times since the Internal Revenue Act of 1954, particularly comprehensive tax legislation was passed in 1954, 1958, 1969, 1976, 1977, 1978, 1981, 1982, 1984, 1986, 1990, and 1993. As a general rule, *Figure 2* shows surges in proposed IRS regulations for about the first three years after such legislation has been enacted. Evidence is not yet available with regard to the 1993 legislation, but as of July 1994 the IRS had 597 new regulation projects scheduled, many of which are related to the 1993 Act. Indeed, the continuous backlog of regulatory projects that the IRS announces in a given year, but which remain unpublished as proposals in the Federal Register, constitute another source of taxpayer uncertainty.

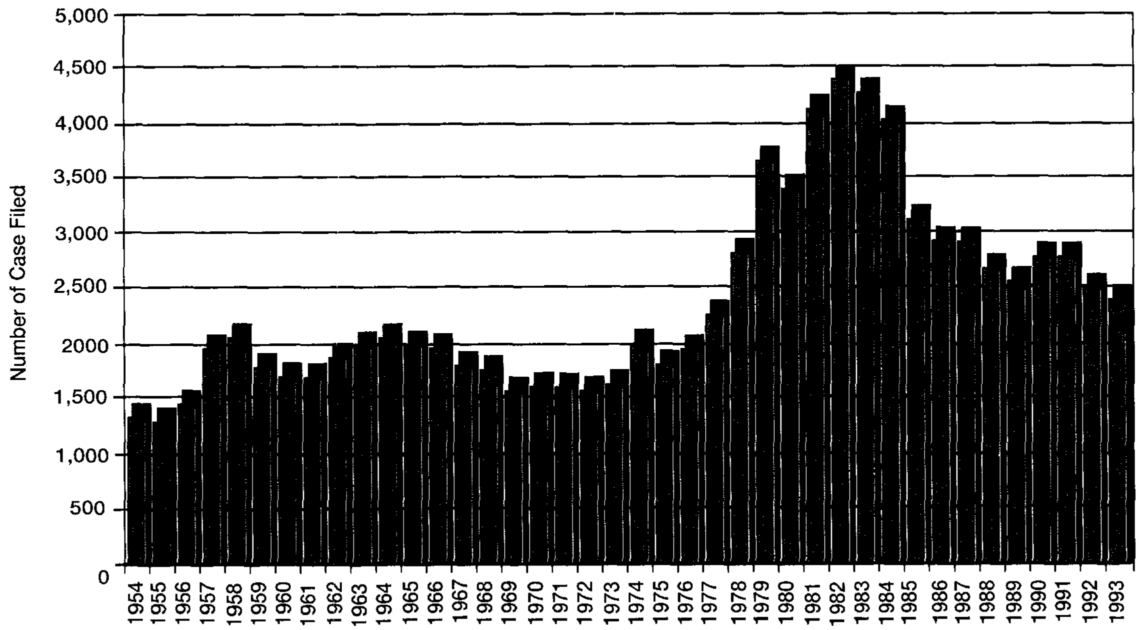
Figure 3 shows the flow of finalized tax regulations produced by the IRS. Although not as pronounced, the pattern of fluctuation in *Figure 3* tracks that of *Figure 2*. The huge outpouring of new tax regulations in the late 1950s (over half of which pertained to the income tax) is not surprising since it follows the landmark Internal Revenue Act of 1954 which attempted to make the income tax a comprehensive scheme forming the core of the federal tax system. Perhaps more importantly, however, is the surge of regulations following the Tax Reform Act of 1969. This Act is commonly pinpointed as the legislation that infused serious complexity into the federal tax code.

The 1969 Act also ushered in the era of increasing instability. On average, the 1975 to 1985 period contained the greatest number of amendments to the sample of the tax code recorded in *Table 1*. The most recent period, 1986 through 1994, also contains a comparatively large measure of instability. These two periods, respectively, also show the greatest activity in newly proposed tax regulations. In the 1955 to 1965 period, taxpayers witnessed an annual average of 62 newly proposed regulations. The annual average was 56 in the 1966 to 1975 period; 76 in the 1976 to 1985 period; and 63 in the 1986 to 1994 period. The annual average flow of final regulations roughly corresponds with this pattern, except for the particularly large number of new regulations in the late 1950s and those immediately following the Tax Reform Act of 1969.

These surges in IRS regulatory activity, a direct result of tax code instability, add to the cost of planning and compliance in several ways. First, those taxpayers affected by the proposed regulations (in conjunction with the changed tax laws) must, either directly or indirectly through advisors, ascertain how the new tax environment will alter their economic circumstances. Second, many taxpayers (or their advisors) will expend the resources necessary to comment on the proposed regulations. Third, once the proposed regulations become finalized, taxpayers and their advisors must learn how the new tax laws and regulations interact with the existing body of laws and regulations so the taxpayers can most advantageously rearrange their business affairs and portfolios. These rearrangements carry transactions costs in addition to the cost of tax compliance. Finally, if the IRS disputes taxpayers' interpretations of how they could most advantageously adjust their economic circumstances to accord with the new tax law environment, taxpayers may expend resources on administrative appeals and litigation. This process becomes all the more cumbersome and costly when the tax laws constantly change.

Similar to the pattern of surges in IRS regulatory activity, *Figures 4 and 5* portray surges in the amount of tax-related litigation promoted by tax code instability. Typically, taxpayer disputes do not appear on court dockets until about three years after the dispute arises. *Figure 4* shows the number of cases filed each year in the Tax Court of the United States. *Figure 5* shows the number of tax-related civil suits filed in federal district courts and the federal Claims Court. In Tax Court the taxpayer has withheld tax payment from the IRS and does not have to pay an alleged tax liability unless the Court rules in favor of the IRS. In federal district courts and Claims Court, the taxpayer is suing the IRS to have tax payments returned or the IRS is suing a taxpayer over an alleged tax liability.

Figure 5
Tax-Related Civil Suits Filed in Federal Courts



Source: Tax Foundation compilation based on data from the Administrative Office of the United States Courts.

The massive build-up of tax cases filed after the Tax Reform Act of 1976, and the enactments that closely followed it, primarily represent "tax-shelter" cases. In the mid 1970s, marginal income tax rates were as high as 45 percent for taxpayers making $20,000 annually, and the rates gradually increased to 70 percent for the highest income bracket. In the presence of these high tax rates, federal lawmakers tried to steer the U.S. economy by enacting a variety of tax incentives, including tax credits and accelerated depreciation schedules.

Through a continuous series of compliance innovations, tax advisors and entrepreneurs attempted to package a maximum number of the new tax incentives into single investment opportunities — that is, tax shelters. Such investments primarily represented taxpayers' efforts to rearrange their portfolios so as to postpone taxes, receive immediate deductions for investments, and convert ordinary income into capital gains.

The large number of cases filed in court represented disputes over the complex and frequently changing laws and regulations governing these tax shelters. The substantial drop in cases filed after 1986 resulted from two factors. First, new legislation authorized partnerships (a common form of business arrangement to take advantage of tax shelters) to file suit as a single entity rather than requiring that each individual partner in a partnership file an independent suit. Second, the Tax Reform Act of 1986 sought to eliminate most tax shelters.

Despite the comprehensive effort of the Tax Reform Act of 1986 to simplify the federal tax system, the evidence indicates that the federal tax code has become more complex as a result of that Act. Notice the large number of Tax Court cases filed each year after 1986 compared to the number of filings in earlier years. The instability in the tax code since the 1986 Act has probably added substantially to this court activity. Based on the sample in *Table 1*, the 1986 to 1994 period contains a large measure of instability, and some of the provisions with the highest instability ratios were born in the 1986 Act. In addition to the economic and compliance costs, such instability also breeds cynicism and suspicion among taxpayers that could offset efficiency gains that should result from earnest attempts at worthwhile tax reform.

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