

## Tax Reform: Lessons From History

By C. Eugene Steuerle



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### A. Introduction

Many tax and budget reforms know no ideological or party boundaries. While legitimate debates transpire on degrees of progressivity or the size of government, no one favors the unequal justice, inefficiency, and complexity we see in our tax code today. Neither does anyone really favor the ways that tomorrow's scheduled deficits — over and beyond any amount related to the recession — threaten economic slowdown and place unfair burdens on our children. As current budget pressure forces us to consider tax reform as a means of raising revenue, past reforms provide us some valuable lessons.

With hindsight, commentators typically note how serendipitous circumstances allowed past tax and budget reform to happen. With foresight, they are more likely, as in the early 1980s and today, to be writing books and articles calling that reform "the impossible dream." Yet, those reforms begin with a consensus that something is broken and that while we disagree on the perfect solution, a variety of fixes would be better than what we have. It was that type of bipartisan agreement that led to past successful tax reforms, such as in 1986, 1969, and 1954. That also was the consensus of close to two-thirds of the members of President Obama's recent debt commission.

The more general point is that most civil servants, policy analysts, and elected officials are usu-

ally about the same business: trying to find ways that government can best serve the public. Anyone working in a tax or budget office also knows that perhaps four-fifths of the proposals they concoct fit into both conservative and liberal agendas, because they identify areas of the law that are inefficient, inequitable, unadministrable, or simply broken. Another dirty little secret of tax and budget politics is that while enormous attention is given to a decades-old fight over whether government should be 17 percent of GDP or 23 percent of GDP, good government at either 17 percent or 23 percent of GDP trumps bad government at both levels.

### B. Understanding How We Got Here

If reform always seems within reach, why do we perennially fail to grasp it? When Theseus, the mythical founder-king of Athens, went into the Labyrinth to slay the half-bull Minotaur, he was able to escape only by following a ball of string back to where he had entered. If we are ever to escape the tax labyrinth into which we have journeyed, we must first figure out how we got here.

I suggest that four factors have contributed significantly to the mess that has become our tax code today and our seeming inability to fix it: (1) the sometimes disorganized growth of domestic policy during what I view as modern government's adolescence; (2) the political ascendancy of the "two Santas at the same time" era; (3) misleading budget accounting; and (4) jurisdictional limitations within the executive branch and across congressional committees.

**1. Seeking adulthood.** For most of U.S. history, the spending side of government was addressed to items such as defense and public works, along with a government infrastructure of administration and justice. Transfers were few, and tax issues revolved around what source of revenues might best be used to pay for those public goods. With the vast expansion of the domestic side of government over the 20th century, as well as the higher subsidy values that accompanied deductions and exclusions as tax rates rose, tax policy increasingly became inseparable from other domestic policy — in particular, transfers in areas like health, Social Security, pensions, housing, and welfare. From an economist's viewpoint, transfers are merely negative taxes, and taxes are negative transfers. As those transfers came increasingly to dominate a growing domestic

spending budget, it is not surprising that they came to dominate the tax side as well.

Thus, a simple explanation of the tax code's evolution in recent decades is that it broke away from its narrow revenue-raising function and began to evolve much like the spending side of the budget. To say one is for tax reform today is like saying one is for spending reform: In neither case does it tell us very much. Is the goal stimulus, lower rates, incentives, revenue raising, deficit reduction, base broadening, progressivity, redistribution, simplification, capital formation, or preferences for favored ventures or groups? As one consequence, today around a quarter of all spending items are in the tax code, and, what is equally important but given little attention, a huge number of the tax rates people face are hidden in phaseouts of both direct spending and tax subsidies. Thus, we have massive tax expenditures and several expenditure taxes. While we can explain that development as a consequence of government's movement through adolescence, we have yet to develop the processes and laws more applicable to adulthood.

**2. Two Santas at the same time.** Partly because of the large number of spending items in the tax code and effective taxes resulting from the phaseout of various benefits, I no longer divide the budget balance sheet into spending and taxes, but instead into its "giveaway" and "takeaway" sides. Especially after the 1990 and 1993 budget agreements, both political parties have increasingly come to believe that it is political suicide to operate on the takeaway side of the budget even though, over time, the sheet must be balanced. Both deficit reduction and systemic reform require identifying "losers" — those who must give up something to balance the sheets. Over the period from about 1997 to 2010, almost all actions were on the giveaway side. Health reform was a partial exception in that it did include some takeaways, but, even there, controversy tended to center less on whether it worked than on who might be the losers. As a consequence of the political backlash for identifying who pays for government, both political parties over that period for the most part enacted only tax cuts and spending increases while hoping that the other party would enact the tax increases and spending cuts that balance the government's books.

Today everyone recognizes that the situation is no longer viable — in 2011 the government is collecting only \$2 for every \$3 it spent — with stalemate deriving from neither party being willing to identify who is going to pay for government or get less from it.

To make matters worse, both parties think that the reward for that political suicide is only to strengthen the other party's ability to control the

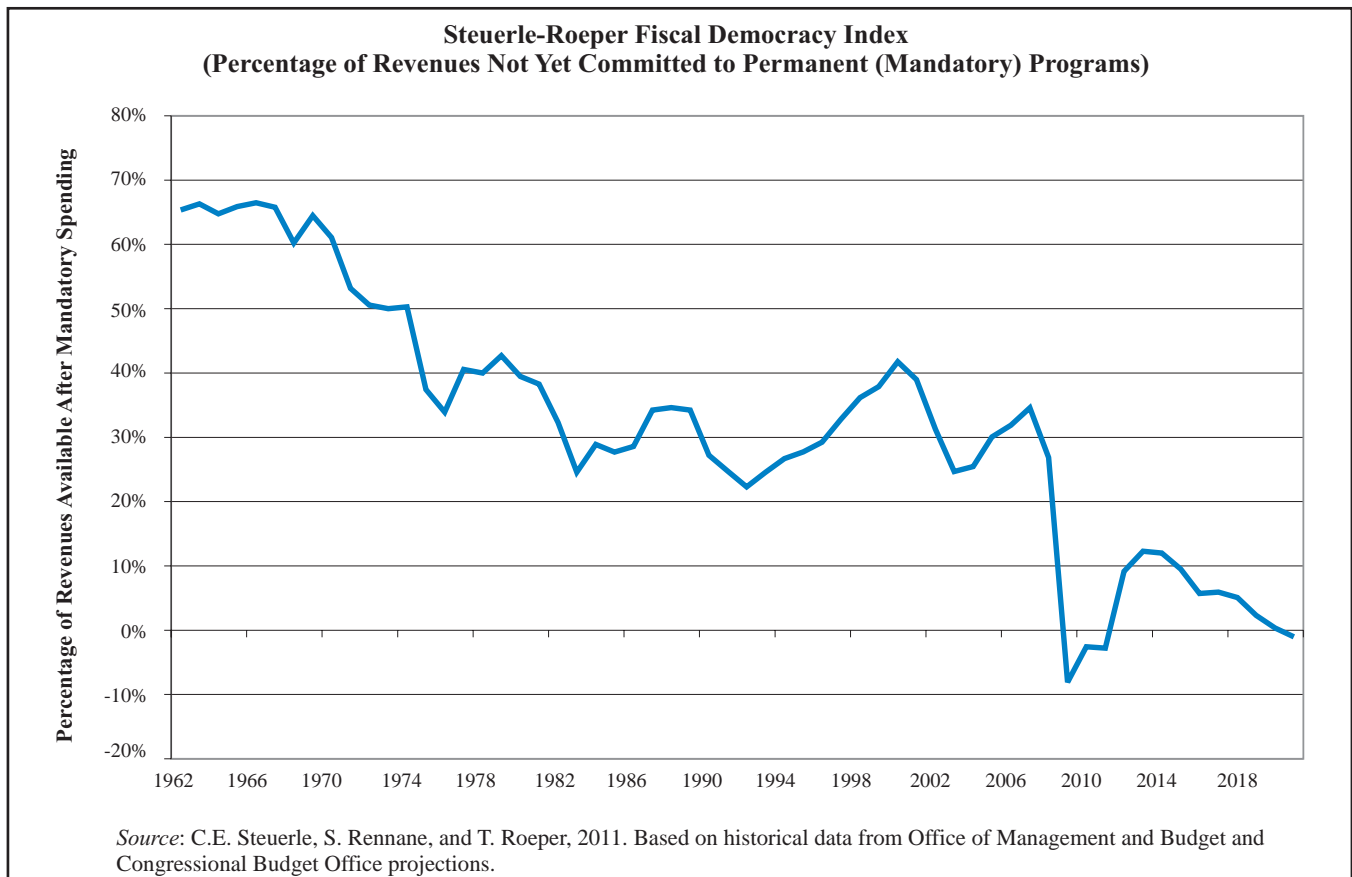
Taxes and Spending Per Household (2011 dollars)		
	2011	2020
Taxes per household	\$18,400	\$27,000
Total spending per household	\$30,700	\$37,000
Tax expenditures per household	\$9,600	\$12,400
Interest spending per household	\$2,000	\$6,200
<i>Source:</i> C.E. Steuerle and S. Rennane, Urban Institute, 2011. Congressional Budget Office budget and Economic Outlook (Jan. 2011). Alternative policy options included.		

future; that is, from one perspective, spending cuts will lead only to tax cuts, and from the other, tax increases will lead only to spending increases. Actually, I think there is some truth on both sides, and each party is trapped in a classic prisoner's dilemma — a complicated situation in which it is always costly to lead and in which making any tough choice *alone* always results in less-than-optimal results.

To give one major example of the consequences, I have developed a fiscal democracy index that shows that in 2009, for the first time in U.S. history, all revenues were committed before the new Congress walked in the door. Effectively all discretionary spending had to be paid for with borrowing, and no new reform could be adopted without rescinding some past promise made to the public for low taxes and high spending.

What is unique in all our history is that stalemate can't help get us out of the problem. Traditionally, receipts rose as the economy grew, while future spending under the law on the books was flat or declining. Unless one party or the other got new spending items or new tax cuts, future budgets went from deficit to surplus. With the spending curve now growing automatically faster than the revenue curve, that option is no longer available — and it explains why so many policymakers are perplexed as to why they can't simply engage in the types of giveaways to which we became accustomed for decades in budget, tax, and spending bills.

**3. Misleading budget accounting.** Regardless of which agency should administer any particular subsidy, one thing is clear: Tax subsidies and spending items put in the tax code mislead the public about the extent of governmental influence over the economy. A tax subsidy effectively raises tax rates that must finance the subsidy in the same way as an equivalent spending item. Put \$1 billion of tax subsidies for farmers in the tax code, and taxpayers must fork over an additional \$1 billion in taxes on their earnings and profits to pay for them. The complication is that the tax subsidies show up in the budget as a *reduction* in taxes, whereas the corresponding spending items show up as an *increase* in



spending. The former looks like smaller government when it is really bigger government in disguise. Accordingly, it is not unusual for a secretary of the Treasury to favor a tax credit on the grounds that an equivalent expenditure item can never get through Congress.

**4. Jurisdiction.** Two anecdotes show how hard it is under current practices to make reforms that cut across jurisdictions. When I served as original organizer and economic coordinator of Treasury's 1984-1986 tax reform effort, some of those assigned to write up reasons for particular reforms suggested that many tax preferences would be better handled as direct expenditures. I explained to them that such an argument had limited application to a tax reform that could only make trade-offs among various tax provisions. For instance, even as successful as many consider the 1986 reform to be, our effort could not, say, replace an education tax credit with a higher Pell grant, because we and the committees to which we submitted our recommendation had no authority over both direct spending and spending hidden in the tax code.

At another time, I was testifying before the House Ways and Means Committee on the possible superiority of direct housing vouchers to low-income housing tax credits. Rep. Charles B. Rangel, D-N.Y., leaned over the podium, smiled down at

me, and said (paraphrased), "You know, when this committee gets jurisdiction over vouchers, we can discuss such trade-offs, but, for now, we'll deal with what is under our control."

Note: In that regard, committees like the Joint Select Committee on Deficit Reduction (the "super-committee") have a unique opportunity to cut across committee jurisdictional lines.

### C. Lessons From 1986 (and 1969 and 1954)

While history never fully repeats itself, lessons from the 1986 reform can still provide guidance to the troubles of today.

**1. Seizing today's 'opportunity.'** Perhaps the most obvious lesson, yet the most ignored, in any reform effort is that one must seize the opportunities at hand. The opportunities of each age differ. In the mid-1980s, individual tax shelters were running amok and threatening the tax system; both the poor and households with children were bearing ever-heavier shares of the tax burden; high tax rates combined with inflation were adding to stagnation by playing havoc with how people invested their money; and the income tax was becoming ever more complex. Tax reform could help deal with all those issues.

Some of those problems repeat today, some do not. The extraordinary growth in permanent or

mandatory programs both on the spending and tax expenditure sides of the budget, along with the low level of revenues raised, are far more serious today than even in the 1980s. As the fiscal democracy index relates, never in our history has there been less give or slack in the budget. In fact, the situation has become so bad that even economic growth can't get us back into the black. Also, in the early 1980s Congress and the president had already begun — admittedly gingerly — tackling the deficit issues through deficit reduction acts in 1982 and 1984 and through Social Security reform in 1983. That provided greater opportunity to propose a deficit-neutral tax reform.

**2. Principles.** On what basis can reform proceed, given so many programs in the tax system? Principles are crucial and must be distinguished from mere goals. Established principles of public finance include equal justice (equal treatment of equals), efficiency (which includes operating within a budget), progressivity, individual equity (one is entitled to the rewards from one's own efforts), and simplicity. There is seldom any excuse for violating equal justice or for establishing programs with open-ended budgets, although both are done all the time. Some principles like progressivity must be balanced against concerns for efficiency, but, even there, it is easy to find examples of programs that simultaneously violate almost every principle.

A simple history of post-World War II budget policy is that when operating on the giveaway side of the budget, first feeding at the trough seems to be a primary way that legislative goals are set, and there is little political price to pay as long as everyone appears to come out ahead. When operating on the takeaway side, however, principles come much more into play because elected officials must justify to skeptical audiences why they made the choices they did. Principles not only guide initial decision-making but also can be used to control the process as it moves along.

**3. Comprehensiveness.** From a public policy perspective, reformers ought first to identify comprehensively what needs fixing before proceeding to the politics. That was a major fight during tax reform; many people did not want us at Treasury to suggest a comprehensive reform, but instead, merely to identify a few items. I pushed for comprehensiveness on three grounds. First, that was our job as public servants. If not then, when did we get around to telling the public just how much was broken? Second, under a "hopper theory of democracy," the more good things that go into the hopper, the more good things that might happen down the road (regardless of the success of any particular reform).

Third, the political cost of major reform is often less than the cost of minor reform. Why? In today's media, editors demand that their reporters provide controversy. That's what sells. That means that the first screaming headline of any reform effort is to identify who pays — who loses some subsidy or pays some more tax on the takeaway side of the budget. But the size of the headline often doesn't change and certainly doesn't change proportionately to the size of the reform.

As for the lobbyists, they suffer from what is called an "agency problem": They represent themselves more than any particular client. That can be turned to the reformer's advantage. Lobbyists will gear up to support and raise money from their funders, but not in any manner proportionate to the issues at hand. Their incentives are to scare their funders and members of their associations, regardless of the amount at stake or whether they should be scared. Therefore, if one is going to take a hit politically, one ought to get as much as possible out of the hit. The reform ought to achieve something quite valuable — a simpler tax code, long-term budgetary balance, a Social Security system without long-run deficits, and so forth.

**4. Shifting the burden of proof.** Comprehensive reform serves another purpose: placing the burden of proof on those who oppose reform. During tax reform, those who fought against reform — with few exceptions — fought to restore provisions that violated standards of equal justice and a comprehensive tax base. They bore the burden of proof. When current law is established as the standard, the burden of proof resides with the reformers, who must justify why they are picking on one group or another.

That last reason compelled me early on to recommend through the staff of the National Commission on Fiscal Responsibility and Reform (the Simpson-Bowles commission) that they put forward a "chairmen's mark" that solved problems such as long-term debt and Social Security imbalances, so that those favoring current practices would have to be put on the defensive. Had that debt commission merely put out a set of options, as have so many past commissions, it would not have succeeded in shifting the burden of proof.

**5. Liberal-conservative coalitions.** Tax reform in 1986 in no small part was supported by two broad coalitions: (1) pro-poor and pro-family; and (2) lower rates and reduction in tax shelters. Those didn't just appear *deus ex machina*. Before reform, I did some work that got front-page headlines on the extent to which families with children had increasingly borne the largest tax increases in the post-war era. The same work showed that the poor were increasingly subject to tax. The first issue was taken

up especially by social conservatives who believed the family was under attack. Reagan was shown the analysis and came out in favor of increasing the personal exemption. The second was taken up especially by liberals concerned for the poor. Meanwhile, lower rates were always foremost in Reagan's mind, and he didn't object to giving up items like accelerated depreciation or investment credits to get them; while the tax shelters of the day were looking increasingly slimy to everyone.

**6. Presentation.** So many reform efforts fail because little attention or resources are devoted to how information should be gathered and presented in a supportive yet fair manner. The 1984-1986 reform effort succeeded in part because nonpartisan staff worked well ahead of the game on what data to gather, what models to run, and how information could be most honestly presented. As a prime example, distributional tables in 1984 were reported in such a way that many professionals with \$300,000 in professional income and \$290,000 in fake partnership losses showed up in many distributional tables as "low-income taxpayers" with \$10,000 in total income. Raising their taxes would appear as a tax increase on the poor. To deal with that issue, we had to adopt a better measure by which to classify taxpayers. We also worked closely with the IRS for months to provide much more data on the uses of partnerships as tax shelters.

**7. Empowering nonpartisan staffs at Treasury and elsewhere.** Over the past three decades, a belief has arisen that information needs to be centralized and controlled by the White House or the congressional leadership. Why, it is thought, make political enemies by identifying what is not working, especially if those particular issues are not on the president's or a political party's current agenda? Also, why not place more and more political staff over nonpartisan staff and civil servants to please more constituencies and block any news that might offend them? With a few major exceptions, such as the Congressional Budget Office, one consequence has been the multi-decade downgrading of nonpartisan staffs to the point that they are less able to serve the public with the information and knowledge that they have.

The Tax Reform Act of 1986, as well as the Tax Reform Act of 1969, came out of studies that Treasury conducted mainly with nonpartisan staff, with little political interference, and with most political decision-making held off until after the results of the studies could be released. In the 1969 act, hardly a beat was lost as Treasury studies (mainly on foundations and on high-income taxpayers paying no tax) largely conducted under a Democratic president were used to back a reform in 1969 under a Republican one. In 1986 we dug into the heart of

many issues — ranging from ways of arbitraging and gaming the tax system to tunnel bores to the time value of money (essentially borrowing money from government at no cost) — in ways that haven't been repeated. Since then, those well-trained analysts have not really been allowed to do their work; as one piece of evidence, Treasury and the IRS for decades have failed to fulfill the requirement for performance review of the hundreds of programs under their purview.

**8. Leadership.** With the gift of hindsight, many people claim leadership for reforms that go down in history as positive. That was also the case post-1986. In truth, when Reagan first asked for a study in his 1984 State of the Union address, to be delivered conveniently after the 1984 election was over, Congress immediately burst out in laughter. Internally to Treasury, some people thought we would treat it like a lot of other studies that never quite got done. It was clear that the White House initially had little more in mind than to put that request in the State of the Union to keep the tax debate out of the 1984 presidential election. In fact — and this was *good* for reform — the White House didn't want to know what Treasury staff was debating internally, because it didn't want to have to defend it. After Treasury's study was released and there were some initial criticisms, Treasury Secretary Donald Regan started to back off, indicating that it had been written on a word processor and could be changed.

After release, the study itself began to receive praise from many Democrats and Republicans, and both liberal and conservative think tanks. Momentum started to build. James Baker and Richard Darman took the next step of leadership and saw an opportunity to establish an agenda for the president's second term. They came over from the White House to convert the Treasury study into a presidential proposal. At a crucial moment, Reagan and Rep. Dan Rostenkowski came to an agreement that each would not criticize the other if Rostenkowski would advance the ball to the next stage. Also, Reagan didn't get hung up on narrow issues of consistency, such as whether some reforms went against provisions that he favored in 1981 legislation or in the previous election campaigns. Clearly, some members of Congress, particularly Sen. Bill Bradley, had already helped create momentum through bills such as Bradley-Gephardt, Kemp-Kasten, and many others.

**9. Accountability.** Interestingly, tax reform in those days was declared dead at least three times after Treasury's release of its study. As the effort moved from a Treasury study to a presidential proposal to a Ways and Means bill to a Senate Finance bill to enactment, one person at each step (first Treasury Secretary Regan, then Treasury Secretary Baker,

then Ways and Means Chair Rostenkowski, then Senate Finance Chair Bob Packwood) ended up being held primarily responsible for getting it to the next stage. When the press started reporting during each stage that reform was dead, the onus of failure was placed on specific individuals and became greater than the onus of success. That shame factor is important: Figuring out how to hold particular people (and not a committee) accountable for failure is a crucial ingredient for the success of many reforms.

**10. Empowering someone to be in charge.** Over and beyond a willingness to lead, someone essentially has to be in charge and develop a plan, and the plan has to be viable. Whether we build a glass building or a steel building, the builders should still want the architects and engineers initially to design something that can stand. In a political system, someone needs to be empowered to get reform through the political system without losing its core objectives. Above I related the advantages early on of empowering staff. But planning is also required at the political level. Here I paraphrase comments made by Darman, passed onto me by O. Donald Chapoton, a former assistant secretary of the Treasury. Darman, deputy secretary of the Treasury during the 1985 and 1986 stages of tax reform, emphasized that he and Baker took overall charge, mapped out a strategic plan, relied on their past experience in getting legislation through Congress, operated when necessary in secret, bargained with various interest groups to get their support for reform, and involved the White House only when necessary (partly to avoid too many chefs).

When power is diffused too widely, no one is in charge and seldom does anything — much less anything that fits together — get done.

#### D. Conclusion

How, then, do we escape from the current tax and budget labyrinth and move forward on reform? I suggest, like Theseus, we follow the string back out along the four dimensions I have laid out.

First, we must move into an era of fundamental reform — one that no longer centers simply on growth and multiplication of programs. Large systemic reforms require fundamentally different strategies than those simple tax cuts and benefit expansions that seem only to identify “winners.” Whatever one thinks of the final results, the few major domestic reforms of the past three decades — Social Security reform in 1983, tax reform in 1986, welfare reform in 1996, and healthcare reform in 2010 — are harbingers of the size and types of trade-offs that modern government must increasingly engage.

Second, we must limit how much any political party or any Congress can commit for the future —

before that future arises. In like manner, we should expect that budgets must be roughly balanced over the economic cycle. The only way to achieve those reforms is through agreement among political parties that they will abide by rules that constrain how much of an unknown future either party can control through fore-ordained spending increases or tax cuts.

Third, we must account for and report to the public in a more honest way that doesn't hide the cost of government in tax programs or tax rates in spending programs. We should also report the tax and related burden enacted by each Congress as equal to the revenues it collects plus the taxes necessary to cover the deficits it leaves behind.

Finally, we must cut across jurisdictions in ways that allow us more systematically to reform particular areas of the budget in which both tax subsidies and direct subsidies are used, such as housing, welfare, and jobs programs.

At the same time, I believe that serendipity arises by playing the odds in one's favor. I do not know the day or the hour that tax reform will take place; taking the lessons of history, I do know that its probability of success is increased by:

- seizing today's opportunities;
- basing reform on well-established principles of public finance;
- comprehensively tackling the subject at hand;
- shifting the burden of proof to those who oppose a comprehensive standard based on principles such as equal justice;
- forming coalitions around legitimate liberal and conservative principles;
- preparing well in advance for how information is presented; and
- empowering nonpartisan staff with detailed knowledge of the subject matter to lay out a principled plan for reform before adding on political constraints (that are often contradictory);

and at the political level by:

- exercising leadership;
- holding particular leaders publicly accountable for failure; and
- empowering the right leaders to execute a rigorous plan for how to move through the political minefield.