

Straying from Tax Policy Principles

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Part One: Defining What It Means to Be Suboptimal

In the ideal, tax policy is driven by concern over a set of principles. These principles, sometimes conflicting in nature, provide a base against which good tax policy can be judged. Unfortunately, a number of principles have been waylaid in recent tax enactments, leading to tax policy that is suboptimal from almost any standpoint, conservative or liberal, Republican or Democrat. No matter how large or small one wants the revenue system, or how much more or less progressive, we could have gotten there with changes that would have been far simpler, efficient, and equitable.

These distinctions are often very hard to explain to reporters and others looking for quick one-line judgments on legislative activity. Where multiple principles are involved, it is necessary, but often complicated, to explain why some compromises are reasonable—even if they do not represent one's own preferences—and others are not. Roughly speaking, there are really two ways in which to attribute positive or negative characteristics to policy actions. The first is that the action enhances or violates some particular goal to which we adhere. It helps the poor or lowers tax rates or achieves some other purpose that we may support or oppose. This forms the core of most of the public discourse. The second is more subtle. It is that the law or bill achieves its purposes in an "optimal" or "suboptimal" manner.

To define what it means to be optimal, I will draw an analogy with economic theory. Think of principles as forming a frontier or border. In modern popular parlance, an economically efficient condition is one in which all "win-win" possibilities have been realized. This efficiency frontier can represent an infinite number of possible choices. That the number of efficient choices is infinite, however, does not mean that all choices are equally good. While there is an infinite number of points on a border, there are even more locations inside the border. If one operates inside the efficiency frontier, economists would assert that there are actions that can be taken that would make at least someone better off without making anyone else worse off. This may sound rather abstract, but in fact most market actions are trades where two parties make an exchange that makes them both better off. If arbitrary rules or circumstances prevent the trade, then it is doubtful that the economy is operating on the efficiency frontier.

The private market choices economists typically address are only those surrounding consumption and the production of consumable goods and services. With policy choices, however, think of items such as fairness as being a service for which people would be willing to pay. For instance, you might be willing to pay for a system that provided equal justice under the law even when the law had no application to you. You exhibit this willingness by voting for taxes to support a court system and paying some of the costs associated with the goals you espouse for the wider society.

Now think more generally of lawmaking in terms of the principles—principles for which you are willing to sacrifice some of your own resources. Only one of the principles may be the narrow type of economic efficiency we noted above. These principles also may conflict: at times adhering more to one means further divergence from the other.

Does this conflict among principles mean that every choice is arbitrary? Hardly. If there are two principles at stake, for instance, one can think of a linear relationship between them. An "optimal" compromise can be defined as falling somewhere on the line—even though each of us may disagree violently where that point is.

If there are three principles at stake, then one can think of them as forming a plane. An optimal compromise then might fall in an infinite number of places, but still within the plane and not in other places in three-dimensional space.

Under these conditions, a suboptimal choice is one that fails to lie on the possibility frontier created by the principles. Being on the frontier doesn't ensure that any decision is best. What it does ensure is that any improvement—greater adherence to one particular principle—can be met only through further violation of another one.

A more understandable way of expressing this last condition is that when choices lie off of the frontier, then it is possible to adhere better to at least one principle without further violation of any other principle. This is where the power of tax policy analysis can really come into play. There are often win-win situations.

What are these principles of policy to which I refer? They include the standard economic principle of efficiency—allowing individuals to make trades that make them better off. Taxes by their very nature distort some economic choices, so the goal is to try to minimize those distortions. One way that government sometimes tries to achieve efficiency is by charging the public for the service or good received. When benefits and costs are equated at each individual's level, then the choice is similar to those that would take place in efficient private markets. Another principle is the equal treatment of those in equal circumstances. In an income tax, this standard has come to mean that those with equal incomes should be taxed equally. Those who favor consumption taxes, on the other hand, define equals in terms of consumption, but the standard still applies.

Progressivity of government, defined as greater net payments by those who are well off, and greater net benefits for those who are less well off, is also a principle or goal espoused by most individuals. A progressive tax rate schedule, whereby tax rates rise with incomes, is one variant on this theme. Still another principle, if it can be called that, is that a tax system must raise revenues. The ultimate goal of taxation, after all, is to pay for the expenditures made by government. Simplicity and ease of administration is a final, but very basic, principle although one can also think of it as a subset of the efficiency criterion. If a tax system cannot be administered, then it doesn't matter how loftily it aspires to meet other principles.

One can see how these principles come into conflict. Progressivity requires taking more from some people than they get back directly in benefits; by distorting choices to work and save, it comes into conflict with efficiency. Simplicity sometimes competes with equal treatment of equals: often the law can be made simpler and more easy to administer if we can use "rough justice" to define precisely who are equals for tax purposes.

Such conflicts are inevitable in most tax legislation. What is not inevitable is the way that political conflict often leads to provisions and laws that are suboptimal by the standards laid out above.

Part Two: Recent Legislation

There are two ways in which tax policy follows or fails to follow a set of principles. The first is that it simply fails to meet a goal, such as increased progressivity or better work and saving incentives. The second is that it makes compromises among principles in a less than optimal way. For example, the same objective could have been achieved in a simpler fashion or in a way that treated taxpayers in similar situations more equally under the law. When claims are made about recent legislation, the popular press usually talks along the first line, while many of those trained in tax policy speak along the second. Even here, however, the division is not pure, as many experts only think linearly about one particular goal or principle. For example, some liberal tax lawyers and economists seem to argue that all provisions of any law should be progressive, while some conservative members of these professions tend to believe that only lower marginal rates are of any importance.

Consider articles in the popular press on the Taxpayer Relief Act of 1997. The articles that opposed the legislation generally played on two themes: revenue raising and progressivity. They did not like the extent to which tax reduction increased the deficit or forced more expenditure reduction. They especially opposed the extent to which the act seemed to favor higher-income taxpayers. They would quote experts who thought that the law was not progressive enough. The articles that favored the legislation played on the themes of size of government and costs to taxpayers. Large government was wasteful, and taxpayers were overburdened; tax cuts could help relieve both situations. They would quote experts who worried about such things as the effect of higher capital gains tax rates on capital formation.

The debate itself is a worthy one, but it must be put into perspective. Delicately balancing the costs and benefits of government is a continual task. One can believe in progressive government and still want it to be lean. One can also find good reason to worry about some of the distortions inevitably present in all tax systems or hold that government raises taxes more than an appropriate amount for savers or families with children or capital gains recipients. If there is a peace dividend from the end of the cold war, moreover, it is neither evil nor illogical to argue that it might be shared with taxpayers through either lower taxes or larger expenditures. The debate is necessary as voters and their representatives continually search for the right balance at each point in time.

A worthwhile debate, however, can still be misleading unless it makes important distinctions. There must be norms to which tax policy choices are referenced and, during a political process, constantly tested. The principles of tax policy—efficiency, equal treatment of equals, progressivity, simplicity, revenues sufficient to meet expenditure requirements—are reference points to what is good, and optimal policy seeks to enhance each to the maximum extent without harm to the others.

The most condemning attacks on tax policy are not those that decry its failure to attain any one goal. They are those that note how certain principles were violated essentially for no good reason other than a failed political process. This is what I read into many of the recent analyses of the 1997 legislation. Take two recent articles by Martin Ginsburg (Tax Notes, Sept. 29, 1997, p. 1790) and Nancy Shurtz (Tax Notes, Sept. 29, 1997, p. 1777). Ginsburg protests ways that start-up enterprises could essentially obtain income tax exemption if they take advantage of some of the new provisions. Shurtz attacks a variety of items, ranging from more than 25 different effective dates, the multiplicity of capital gains tax rates, and the requirement to coordinate multiple tax breaks for education. In a sense, it is the sheer waste—unnecessary violations of principles—that most appalls them.

Think back to some of the goals of TRA '97. Spending more on education might have been a worthwhile goal, but to achieve it efficiently meant to devote the money directly to those areas of education where the most value added could be obtained. I know of no one in the education field, including the Department of Education, who actually argued that the bill identified or targeted the most important needs. This debate never took place. Even if higher education were the most appropriate place to put additional money, to achieve that goal in a simple and administrable way means filtering it through an established authority already handling educational assistance—i.e., the Department of Education, not the IRS.

Capital gains relief might have been justified on efficiency or equity grounds as relief from the double taxation of income from business or from the additional tax burden on inflationary gains. If inflation could not be tackled directly, then perhaps a further case could be made for simple rate relief, although with recognition that new distortions, imbalances, and arbitrage opportunities would result from the new distinctions that were going to be required. But no one would argue that any worthy principle was enhanced by the extraordinarily complicated way capital gains relief was provided—in particular, the changing of tax rates merely to hit a budgetary target about 2002.

Similarly, a case might have been built for increasing saving incentives. But it would have been far less complex to try to build on existing incentives than to add more and more new items to a maze that almost no one, including financial advisors, can understand.

We could go on. The point is that these changes were made in less than optimal ways, even given their basic objectives. There is a simple test by which policy can be labeled as suboptimal: the presence of alternatives (including former law) that achieve the same goal with less violation to other principles. Note, by the way, that many suboptimal enactments are the consequence of an unwillingness to change the statutory tax rate structure, so that tax rates are changed indirectly, as through complicated phaseouts of some tax advantages.

This definition of "optimal" policy makes no statement about what is "best" policy. This distinction must always be kept in mind. A number of changes in TRA '97, for example, do operate in an optimal way even if there remains a debate about whether they are best. Take several simplifications in the act, such as an increase in the estate tax exemption and removal of many businesses from the alternative minimum tax. Although taken by themselves these changes might reduce progressivity slightly, given the efficiency (fewer distortions with lower rates) and simplification (fewer filers) principles being advanced, it would be difficult to argue that these changes were suboptimal in the same sense or to the same degree as the educational, capital gains, or savings incentive changes.

The fight for greater adherence to tax policy principles and the search for optimal tax policy has recently been lost in a legislative process that treats tax provisions like bits of food to be passed out at some great bargaining table in which everyone is fed a little bit. Expenditure policy, by the way, is in even worse shape as it winds through a very similar bargaining routine. Disenchantment with government will only increase until the legislative process can be brought back to a higher level, one that gives greater recognition to the role of policy principles and finding optimal ways of achieving different goals.

* Part One appeared on October 13, 1997. Part Two on October 20, 1997. The two parts have been combined for the HTML version.

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