

Are Good Times and Good Tax Policy Incompatible?

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When I first came to Washington in the mid-1970s, most people believed that good tax policy and good times went hand in hand. Tax reform was possible, it was thought, only if it could be "bought" with surplus revenues coming in down the road. Yet the history since then has been almost completely the opposite. Although admittedly a generalization, the best tax policy seems to have been accomplished when deficits were the worst, the worst tax policy when surpluses were looming at least a few years into the future.

The past few years certainly are no exception to this recent historical experience. It is almost impossible now to find a top administration official or congressional leader in either party who has taken up the gauntlet of fighting for equal tax treatment of those in equal circumstances, or the equally efficient treatment of similar sources of income or consumption. Simplification seldom gets more than a passing mention, and then it is quickly forgotten as Congress and the administration offer new toys to the public. More than ever before, tax cutting has been displacing direct expenditure programs as the backdoor way to sell some new program—whether it be money for schools, for selected businesses, or for selected groups of individuals seeking special relief for themselves.

What is going on? With extra money lying around, tax reform didn't necessarily have to create losers. If A was treated unfairly relative to B, then tax reform could lower A's taxes without having to raise B's. Or if some benefit had to be taken away, then a general tax cut on top of the base broadening could make the whole package appeal to everyone. In that way, politicians supposedly could meet the political demand to pretend to give something to taxpayers (rather than simply reallocate the taxpayers' own money).

This "theory" about when tax reform is possible fits in closely with the notion that losers care more than winners. Thus, in a revenue-neutral tax reform, "winnings" and "losses" would be approximately equal in size, while in a revenue-raising reform there are net losses. As long as the losers care so much, reform should not be possible.

Why is the easy political science answer to the question of when to achieve good tax policy so wrong? There is only one explanation that I can find. When times appear tough, or there is a real problem that has to be solved, the public seems to care about principles. If something has to be done and somebody is going to have to pay, then the voters demand that decisions be as fair as possible. As for the politicians, they are still loath to make it appear that anyone has to pay for the cost of government or for any reform. But once action takes place in a tight budget situation, they usually want to appeal to some principles to justify their actions, almost as if to exorcise the blame that the public might put on them.

In tax policy, the appeal to principles played out most visibly in the tax increases of 1982 and 1984, and then in the revenue-neutral reform of 1986. In those times, deficits were high and the budgetary outlook was not good. Base broadening became the rule of the day, whether as a matter of deficit reduction or in exchange for the rate reductions of tax reform.

I remember early in President Reagan's administration when Ronald Reagan—who once viewed all tax expenditures as good and arguments against them as excuses to raise taxes—began to accept efforts to go after various tax breaks or "loopholes." The appeal made to him was that loopholes simply didn't treat people equally. At one point he became convinced that one person should not get an uncapped amount of health insurance tax-free while another person with equal or greater needs got no tax break at all. At another point, the Secretary of the Treasury convinced Reagan that it wasn't right for high-income people and corporations, through tax shelters, to pay a much lower tax rate than average-wage workers.

Whatever his understanding of the intricacies of the proposals, the appeal was to a principle. If someone had to pay an identifiable cost, then there had to be a very justifiable reason for taking the action.

Contrast this, if you will, to the 1960s and 1970s, when bill after bill gave away new tax breaks. The case isn't perfect. There were some modest reforms in 1964 and 1969, but if one goes back and examines them closely, there really wasn't much base broadening involved even then. Instead in '64, most attention went toward providing tax cuts to spur the economy in a Keynesian manner; in '69, some new rules for foundations became a primary focus. Regardless, over the period as a whole, the tax code became more riddled with special exceptions and loopholes than ever before.

Thus, there's something about a period of surpluses that causes people to worry less about whether congressional or presidential largess is distributed fairly and less whether action can be justified strictly on principle. When desires rule, wants trump principles; when requirements rule, principles trump wants.

Practicing law without a license, I would also venture to say there is an analogy between "justification" in the tax laws and in the judicial system. When it comes to punishment, strict homage is immediately paid to the principle of equal justice. For instance, although difficult to implement in practice, many procedures are put in place to try to ensure equal punishments for equal crimes. When it comes to rewards—winning extra money in a tort suit, getting some windfall from some government program, or whatever—equal justice seldom gets the same level of attention. And even then, some additional judicial statute is required, such as those dealing with discrimination on the basis of some class—for example, age.

As an economist I find all of this a bit inconsistent. From a balance sheet perspective, I know that for every reward received, there is somebody who pays. Therefore, if the rewards are distributed unfairly, then so are the costs less the rewards, or the net costs of government activity. Therefore, the distinction between punishment and reward, between costs and benefits, between tax increases and tax cuts, is somewhat arbitrary when assessing whether there is equal justice under the law.

Certainly, the recent historical record disproves that good times are necessary for good tax policy and that good tax policy is automatically more likely to take place in good times. But lest we carry this analysis too far, the record we have examined is brief, and it does not prove that good times and good tax policy are always incompatible.

It may be that as a society we need to form a different set of expectations about what government should and should not be doing and to think how procedurally we can bring principles into play early in any legislative process. While that would represent a substantial movement away from what we do today, the task should not be viewed as impossible.

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