SPECIAL REPORT

TEN GUIDELINES FOR SYSTEMATIC REFORM

By C. Eugene Steuerle

C. Eugene Steuerle is a senior fellow at the Urban Institute and an economics consultant to *Tax Notes*. He serves as President of the National Tax Association (2001-2) and served as chair of the 1999 Technical Panel advising Social Security on its methods and assumptions.

Table of Contents

You don't know what you don't know.

Systematic tax reform, that ever-elusive but ever-desirable elf, has made some appearances recently before quickly ducking out of sight. Although many tax enactments involve changing the boundaries of the tax system — say, tax rates or deductions or limits — history warns us that seldom has *systematic* reform succeeded. Systematic reform recognizes important societal trade-offs, and trade-offs mean that something must be given up to achieve something better.

For modern examples of systematic reform, tax bills enacted in 1954, 1986, and perhaps 1969 stand out. Indeed, by 1986, attempts at broadening the tax base had failed so many times that some writers were beginning to call it the impossible dream. While it is true that reform requires opportunity, past failures were not due only to the absence of opportunity. Instead, the process itself was often ill-conceived and ineptly carried out.

With this string of failures in mind, I thought it might be useful to set out some broad guidelines for engaging in a *process* that enhances the probability of success. For the record, most of these guidelines for reforming the tax system apply equally well to budgetary and expenditure reform.

I. The Guidelines: A Summary

(1) Listen.
(2) Know the forces at play.
(3) Have an overall vision.
(4) Start with principles.
(5) Balance principles.
(6) Seek some bipartisan consensus.
(7) Plan your snapshots.
(8) Acknowledge that reform involves losers.
(9) Work bottom up and top down.
(10) When stuck between camps, work on common concerns.

(1) Listen

You don't know what you don't know. And you're not going to find out unless you have a built-in system for gathering information and rewarding staff for passing on the bad, as well as the good, news.

The tax code contains thousands of provisions. No one — literally no one — understands most of them, much less their many interactions. When Treasury was working on tax reform in the mid-1980s, it required tens of thousands of staff hours and simultaneous work on a multitude of issues. Each person involved knew some things that others did not, including pitfalls into which the process was likely to fall if it started moving in one direction or the other.

Nothing can disrupt a reform process more than requiring a team of experts to analyze in depth some partially baked, infeasible idea that they know is not going anywhere, but about which they are not allowed to post early warning signs.

When experts identify problems in a particular approach, that should not immediately disqualify it. All approaches will raise some difficult issues, and the cons need to be vetted along with the pros. But much time can be wasted if available information cannot flow quickly and easily into decisionmaking.

The failure to heed this guideline is a primary reason why reform often fails. As only one example, when I talked to many executive branch staff members working on health reform in 1993, they noted that the bearers of useful but uncomfortable information were often unwelcome. When I heard this news, I knew then that the reform effort was likely to fail.

(2) Know the Forces at Play

The true catalysts for reform are those economic or other forces that cannot be ignored. In the mid-1980s, the rapid growth of the leveraged tax shelter was one major force. Today, anyone trying to deal with tax reform must tackle the alternative minimum tax (AMT), which is rapidly becoming the hard-to-ignore 10,000-pound gorilla at the tax reform party.

Once we recognize the forces at play, other issues can be carried along. If reformers attack tax shelters, that might make more room for rate reduction. If simplification of the AMT is one requirement for future reform, then it becomes easier to make other improvements under the banner of simplification.

(3) Have an Overall Vision

A variety of tax reform goals can coexist. The tax system is so all-encompassing that reforming it is not much easier than trying to reform the entire spending side of the budget all at once. How *not* to get distracted by all sorts of issues? If reformers don't start out with some vision of what is achievable and what should be pursued, then the reform movement will lurch from one issue to the next and likely come unhinged by the end.

Vision does not mean having all the answers. But it does mean having a sense that one can get from here to there, even when the intermediate steps are obscure. A vision of making the tax code better is not a vision, nor is it a vision to complain about the tax code's many complexities, however legitimate. A vision involves a clear perception of what the better system will be and why it will garner support relative to the status quo.

The vision must be carried through the later process. In many bills, so much attention is paid to image and symbol that bills purporting to do one thing will by the end do the opposite. Consistent with the vision, certain demands must be made early on to define the bill and determine what amendments will be acceptable from Congress. Often the president can specify only two or three defining issues, leaving Congress enough flexibility to make other changes, as long as they are consistent with the overall vision. The limited control that belongs to the president, therefore, should be exercised carefully and wisely, with eyes always on the prize.

(4) Start With Principles

Beginning with principles may sound obvious, but very few reforms start out this way. Sometimes, they start out with top officials throwing out solutions based on newspaper columns or magazine stories. Politics often forms the beginning, middle, and end of the process. Yet only principles can provide a guiding beam, allowing people to judge whether they are on course or not.

Beginning with principles may sound obvious, but very few reforms start out this way.

Politics obviously has an important role to play, but that role changes over time. In reform's early stages, politics provides a simple reality check on what to tackle. Later, political bargaining and even logrolling may be required.

Starting with principles goes hand-in-hand with listening. If principles are stated broadly enough, then staff has a much greater chance to develop options. When a reform process starts choosing options without regard to the principles supposedly underlying them, viable alternatives never make it into the incubator in the first place.

As one example among many, reformers might try to maintain efficiency by lowering the cost of capital or minimizing any increase. However, that cost is determined by a variety of factors, such as depreciation allowances, investment credits, corporate tax rates, and individual tax rates. Specifying what is to be done with the cost of capital is much less constraining than deciding ahead of time what all the credits, depreciation rates, and statutory rates must be and then hoping the mix is affordable and administratively feasible.

(5) Balance Principles

A reform may emphasize one or many principles. Usually, the principles that get attention are those that elected officials think have been most thoroughly violated. The distortions caused by 90 percent tax rates bothered President Reagan all his political life. The inefficiencies and inequities caused by the proliferation of tax shelters in the late 1970s to mid-1980s helped drive reform in 1986. A current reform might place more emphasis on simplification given the increase in complexity and paperwork over the past 15 years or so. Certainly, the very large growth scheduled in the AMT will force simplification to get at least some attention this time around. In general, concern over the economy can often lead to reforms that would make the tax system more efficient.

In general, concern over the economy can often lead to reforms that would make the tax system more efficient.

Regardless of which principles are emphasized in a particular reform, legitimate principles compete with each other. The trick is establishing and maintaining some reasonable balance. Without this balance, reform will get shot down for its failure on one front even if it is successful on another.

Of all the principles that motivate individuals, none is more powerful than equal justice, equal treatment of equals, or horizontal equity. One can hardly think of any major issue that divides Americans more than the sense that this principle has been violated. Equal rights at the ballot box, equal punishment for the same crime, equal tax on those with equal ability to pay — these are only a few examples. Find a taxpayer who feels as if she is paying more tax than someone similarly situated, and you'll find an irate taxpayer. Find a business that pays higher taxes on the same income as a competitor, and you will not lack for protest.

One great advantage of the equal justice principle is that it conflicts least with other principles. For instance, progressivity and efficiency may at times be at odds, but no matter how progressive, flat, or regressive the tax system, it is usually more efficient if equals are treated equally. Thus, although elected officials ignore this equal justice principle with perilous consequences among voters, it is one of the easier ones to keep in balance no matter what the level of attention given to other principles.

(6) Seek Some Bipartisan Consensus

Even when a single political party holds a majority in the Congress and holds the presidency, major reform almost always requires some bipartisan consensus. Reform proposals need to be built with that in mind.

Tax reform in 1986 achieved bipartisan consensus mainly by emphasizing two opportunities for compromise. First, an attack on tax shelters was offset by lowering tax rates, thus appealing to principles of both fairness and efficiency. Second, an increase in the personal exemption was successful both in exempting the poor from taxation and in making sure that families with children no longer faced the highest increases in tax rates as income grew. These anti-tax-shelter/lower rate and anti-poverty/pro-family issues formed the core of the liberal/conservative compromises that eventually drove the reform process.

Bipartisan consensus is built not only through the design of proposals but also in the execution of political action to get a plan enacted. In the period leading to the 1986 tax reform, some bills had already been promoted by both Democrats and Republicans as ways to expand the tax base and lower rates. This opened an avenue for compromise. In addition, Ways and Means Committee Chair Dan Rostenkowski and President Reagan got together and bargained over the extent to which they could avoid criticism of each other's efforts and how much partisanship they could reasonably constrain.

(7) Plan Your Snapshots

Often a few pictures or symbols in the public's mind will sell or kill reform. During the early preparation for the 1984-1986 reform effort, it became clear that there could be a serious problem if the traditional distributional tables were developed with people ranked by their adjusted gross income. It turned out that most tax shelters of the day generated substantial negative declarations of partnership income even when the sheltering taxpayers might have substantial income from other sources. Accordingly, the AGI of the rich would sometimes make them look poor. If reform removed some of the tax shelter options then prevalent, it would look like a tax increase on the poor. Tax reform would then be condemned as regressive.

Every reform has presentational issues that need to be anticipated well in advance. Often it will take weeks or months to perform the necessary analysis and to develop models that will tell a more complete or accurate story of what is going on. For instance, since most systematic tax reforms cut back on the tax shelters of the day — every era has its own crop — it is vital to think ahead to how those changes are going to be represented in various distributional and revenue tables.

(8) Acknowledge That Reform Involves Losers

Some reforms are easy. Lower tax rates. Provide some extra deduction or subsidy. Reforms like that appear to create only winners. Politicians love them. Systematic reform, on the other hand, can't dodge the government's balance sheet: If somebody's taxes go down, then either somebody else's go up or somebody's expenditures go down.

One of the ways that systematic reform gets killed is the unwillingness to acknowledge this unpleasant fact of economic calculus. But it can't be kept hidden for long. Soon, some bright young political appointee will note at a meeting that there are some politically important groups that will become losers on the country's way toward a more efficient or equitable tax code. These quick remarks can surprise unsuspecting decisionmakers and induce them to retreat to the least politically difficult proposals.

The only way to avoid this downward spiral is to beat the naysayers to the punch. Just admit up front that the inevitable result of following principles is to create losers among those unduly favored by current provisions. This does not mean that it is politically savvy to use this information indiscriminately or to toss the media tidbits that will excite some people and make them feel threatened. It does mean that the consequences of action need to be anticipated and well-understood in advance.

(9) Work Bottom Up and Top Down

Although a vision is important for reform, it is also vital to go through all the nooks and crannies of the code to discover what else must be done. Complication arises from detail, and the detail must be conquered. Sorting through detail is a tedious task that seldom yields major political dividends. But it is vital. For instance, if pension reform is driven by some vision of how coverage might be expanded, it is still necessary to go through the dozens of plan types and multiple rules covering deposits, taxation, withdrawals, allowances for borrowing, spousal rights, and so forth. These multiple rules then must be melded together better to fit the reform objective.

Although a vision is important for reform, it is also vital to go through all the nooks and crannies of the code to discover what else must be done.

When I served as economic coordinator of the 1984 tax reform effort, I divided code provisions into about 20 modules, e.g., itemized deductions, international taxation, pensions, etc. Each of these modules was then divided into multiple issues. That's how we conquered the details. Bottom-up planning helped the proposal to be more comprehensive, and it also revealed a number of interactions and implications that might otherwise have been missed.

(10) When Stuck Between Camps, Work on Common Concerns

In 1984, tax reform debates in the Treasury often got stuck, especially in the quagmire of complex issues surrounding the taxation of capital income. At one point, the whole process came to a halt for lack of direction. We then regrouped, and some of us pushed up front those modules that had to be solved independently of this stalled debate, such as the treatment of health care expenses or charitable contributions or earned income credits. In doing so, we kept momentum. Another advantage was that we eventually revealed just how much rate reduction would be possible with and without different changes in the treatment of capital income.

In most successful reform efforts, there is a lot of common ground between camps. That ground has to be found and claimed.

II. Conclusion

Systematic reform efforts have failed far more often than they have succeeded. Knowing that something is wrong and needs to be fixed is only a first step. The guidelines above won't by themselves guarantee the enactment of reform, but ignoring them can certainly put any reform effort in jeopardy.