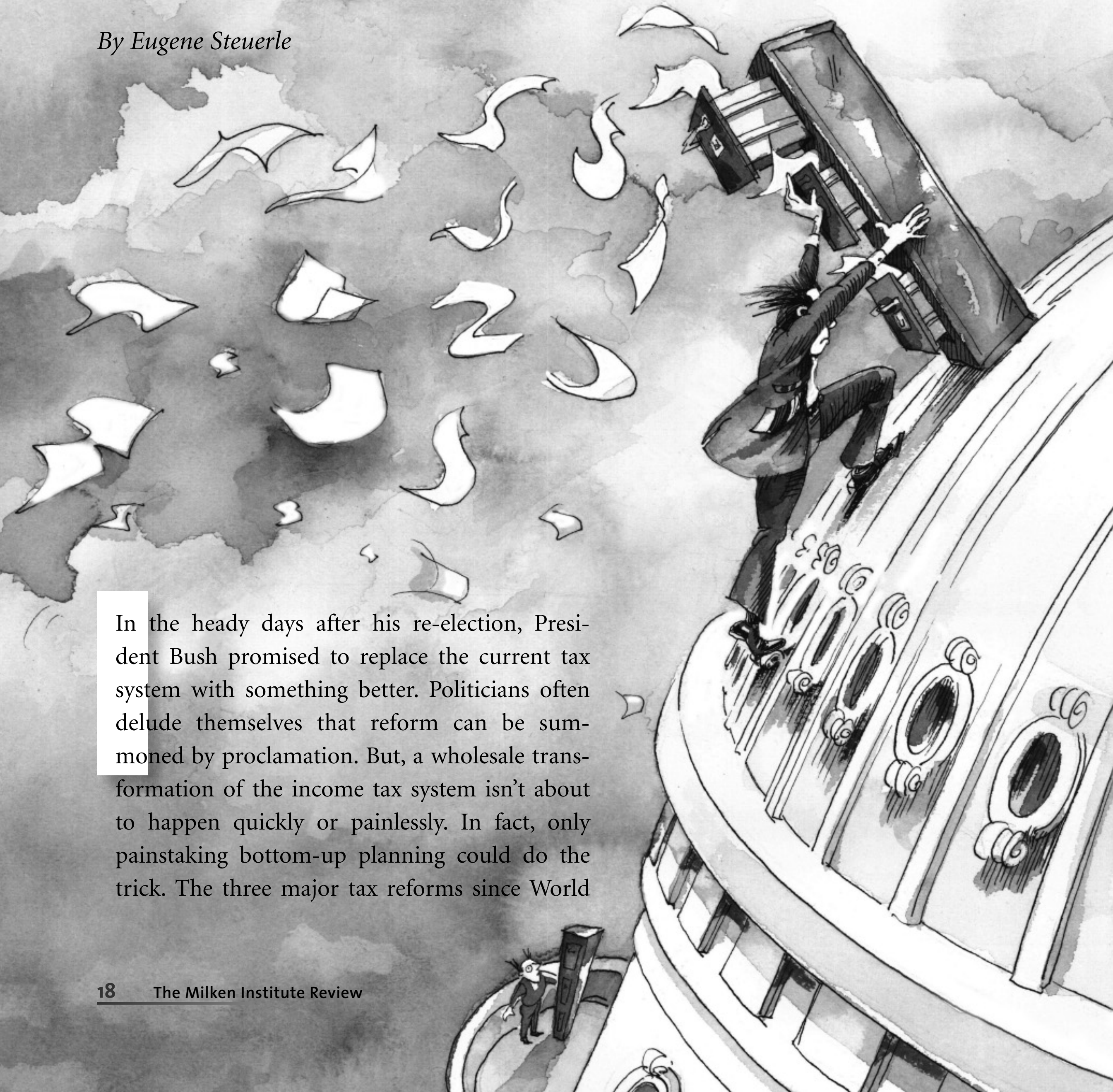
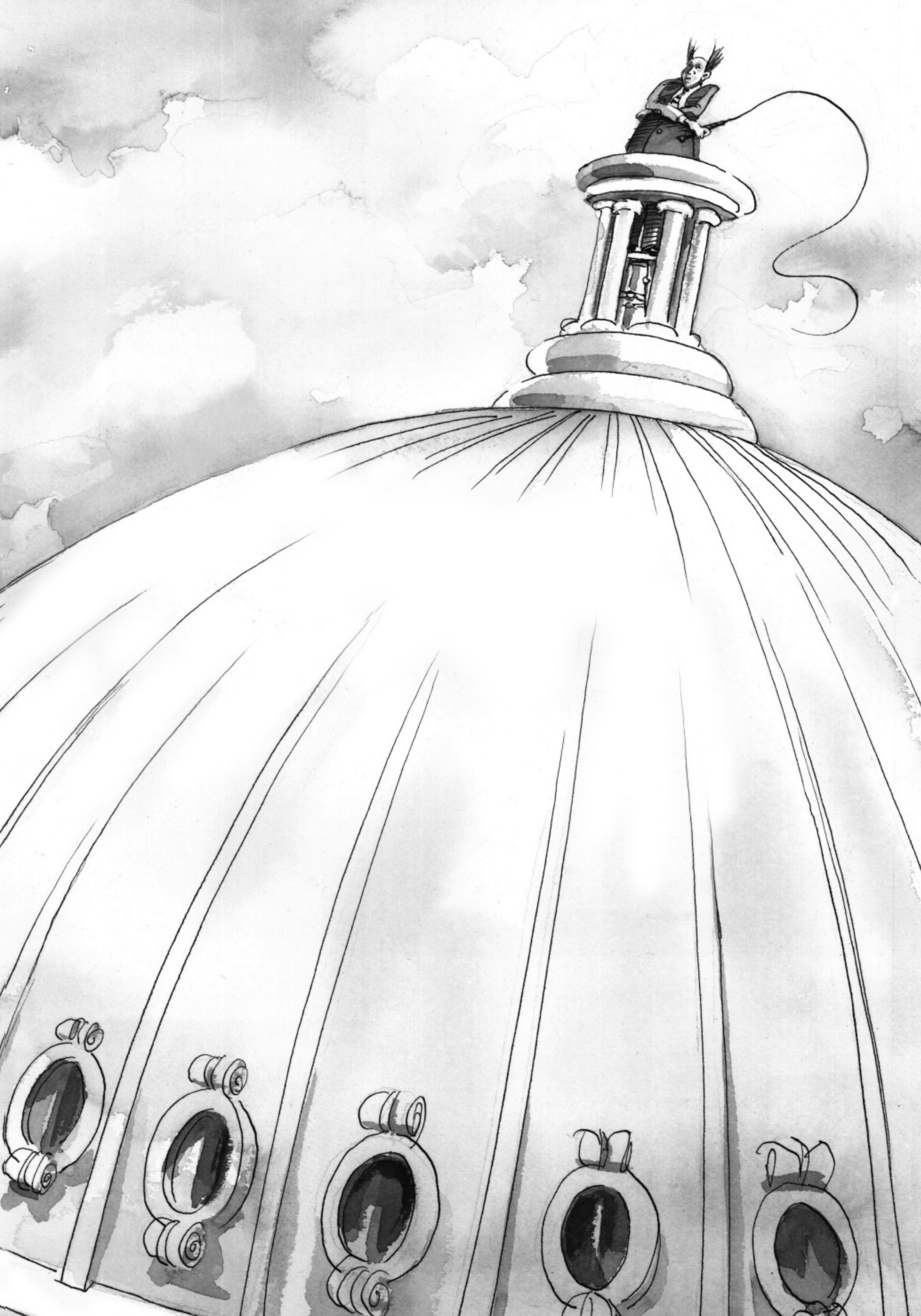
Sisyphus Had it Easy

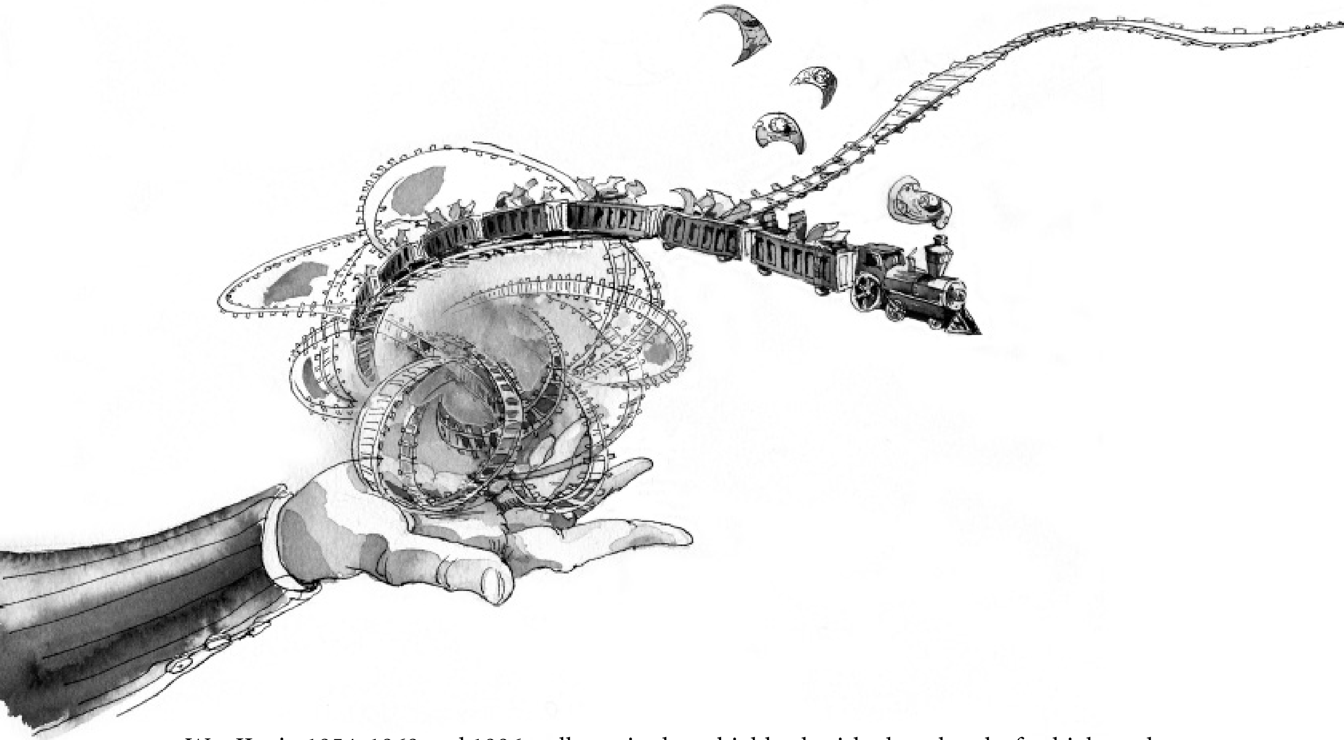
Reflections on Tax and Budget Reform

By Eugene Steuerle



In the heady days after his re-election, President Bush promised to replace the current tax system with something better. Politicians often delude themselves that reform can be summoned by proclamation. But, a wholesale transformation of the income tax system isn't about to happen quickly or painlessly. In fact, only painstaking bottom-up planning could do the trick. The three major tax reforms since World





War II – in 1954, 1969 and 1986 – all required an enormous amount of staff work and Congressional coalition building. And of the three, only the 1986 changes amounted to a true makeover.

Since the tax system now affects nearly every facet of American life, hardly anyone likely to pay more goes to the shearing without a bleat. Tax breaks provide indirect subsidies to homeowners that are greater than the entire budget of the Department of Housing and Urban Development. The Earned Income Tax Credit program is now larger than any other welfare program, including food stamps. The break for employer-provided health insurance, currently costing $150 billion per year, is the largest federal health subsidy for the non-elderly and is growing faster than almost all other domestic programs. And then, of course, there are more than half a dozen highly cherished tax breaks for higher education, not to mention preferential tax rates on income received as capital gains.

Meanwhile, the average citizen faces an array of tax-based retirement-plan provisions that makes the fabled Clinton health reform plan look simpler than a Starbucks menu. Check that: I meant Starbucks before the latest tax legislation, which grants a tax break to some integrated coffee chains on "the value of roasted coffee beans used to brew the coffee," provided the roasting is done off premises.

Real tax reform can't begin until policymakers (or, at least, their staffs) understand the implications of change for everyone from caffeine empires like Starbucks to farmers who make a living selling their corn to make ethanol additives for gasoline. Saying that one is for tax reform is like saying that one is for eliminating wasteful government expenditures; it's just not very informative.

Throwing out the tax code may sound fine in a sound bite. But policymakers still have to decide what to do with federal programs for housing, work, education, retirement, charity, energy, environment, transportation and

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all the other policies now largely implemented through the tax code. By the same token, someone still has to decide whether the IRS is going to need employees to rate movies for arousal potential, because Congress has extended the new manufacturing tax break to that vital piece of the industrial heartland known as Hollywood – excluding, "certain sexually explicit productions."

Sometimes, reformers can't ignore the implications of tax change, even if they are determined to try. Converting the income tax to a consumption tax, for example, would eliminate special incentives for retirement saving at a time when such saving is one hope of making it through the baby boomers' golden years without bankrupting the Treasury.

However difficult and even quixotic, the quest for tax reform must be undertaken once in a while if for no other reason than to keep the arteries of the tax system from becoming hopelessly clogged with preferences. Trouble is, to keep budget deficits within bounds, the public would have to swallow the changes associated with base-broadening and simplification with an even bitterer swig of deficit reduction. Meanwhile, President Bush is attempting to make his previous tax cuts permanent, which implies that any deficit-cutting measures he proposes would suck more cash from fewer pockets. The same can be said of changes required if part of the Social Security tax is redirected into individual accounts, leaving Washington to cover the system's existing liabilities from other sources.

The backdrop for reform is even darker. The president and Congress have inherited health care and retirement policies that long ago put government spending on an unsustainable track. The problem is not just that spending on the elderly accelerates in 2008, when the boomers start turning 62; it's also that the growth rate of national income and government revenues can be expected to decline along with the drop in the fraction of adults working and paying taxes. When the boomers are all in their dotage, close to one adult in three will be collecting Social Security. The cost of Medicare, another wide open entitlement for seniors, will grow even faster than Social Security outlays; the new prescription drug program will only add to the budget problem.

Exacerbating the fiscal crunch, the last few Congresses went on a giveaway spree like none other in the nation's history. New tax cuts and entitlements, a defense buildup and more spending for farms, highways, workers, doctors, manufacturers and everyone's favorite uncle breezed through Capitol Hill. This rapid, unparalleled growth in commitments from a "conservative" Congress has been the major factor wrenching the federal budget from short-term surplus to yawning deficit – a turnaround of 7 percent of GDP.

In the current post-election budget milieu, the powerful push for tax reform that does not affect total revenues can mean much more than simplifying and rationalizing some of the provisions catalogued above. Some want a revenue-neutral reform to further lower tax rates (particularly on investment income) as a matter of economic policy, and competing consumption tax proposals abound. Every

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special break in the tax code has a private lobby to defend it, not to mention a cheering section within the government bureaucracy.

RETREAT FROM TAX PRINCIPLES

Tax breaks – "tax expenditures" in economic jargon – account for one-fourth to one-third of government benefits and subsidies. The tax code is riddled with preferences that undermine the goal of equal treatment under the law, distort investment and consumption choices, and boost administrative and enforcement costs.

Clearly, simplification is among the most slighted tax principles. Joel Slemrod of the University of Michigan estimates that the value of time spent on filing income tax returns alone is equal to about 10 percent of the total income from tax collections. This tax tithe is no argument for stripping every preference from the tax code – some do serve defensible social purposes. However, there is little excuse for the inequity, inefficiency and complexity associated with, say, the alternative minimum tax, or the layers upon layers of savings subsidies, child credits and allowances, capital gains tax rates and energy and environmental subsidies. This morass has formed because both major political parties have all but abandoned traditional tax reform principles.

Does anyone even remember what those principles are? Here's a quick reminder:

- Equal justice, or "horizontal equity," asserts that those with equal ability to pay should pay equal taxes.
- Progressivity, or "vertical equity," suggests that those with greater needs should receive more from government and that those with greater ability should pay more to government.
- "Individual equity" holds that individuals are entitled to the product of their own labor and to a fair return on their own saving.
- Efficiency requires that programs should operate with as little waste or distortion of behavior as possible.
- Simplicity and transparency complement the first four principles.

These principles sometimes clash. A common place of conflict is the nexus between progressivity and individual equity, since taking from A, a person with means, to give to B, a person with needs, typically also denies A some of the rewards of his or her own work. But such conflicts don't explain how far we've strayed from the righteous path. The tax system is rife with examples in which one principle is violated without furthering another.

RETREAT FROM BUDGET PRINCIPLES

Improving tax policy requires at least some modicum of budget discipline. Unfortunately, that's pretty much disappeared, too. Perhaps the most troublesome transgression is the way Washington is effectively restricting future budget choices.

The name of the game in Washington and

most state capitals these days is to spend the money before somebody else does. And that means spending not just today's revenues, but tomorrow's as well.

Throughout most of the nation's history, Congress avoided budget decisions that dug an enduring hole. Indeed, except in wartime, economic growth prompted sufficient growth in revenue to cover temporary deficits created by higher discretionary spending. Thus, even careless spending, or tax-cutting, did not perpetuate future deficits. But over the past quarter-century, the dividends of economic growth have come to be fair game. Even if the Bush tax cuts had not been made, retirement and health programs alone would have absorbed all revenue growth in coming decades.

Spending ahead in this way has become a glaring economic problem. Nobody knows tomorrow's needs well enough to be signing such binding contracts today. But you wouldn't know it if you watched lawmakers at work.

For example, advocates of maintaining built-in growth in Social Security benefits (through ever-higher annual benefits keyed to wages and through more years of retirement support as we live longer) contend that we can always change the law later. Elected officials pushing tax cuts even further into the future play the same game: they cut back on future taxes that would help finance government, meanwhile spending all the revenue that would normally accompany economic growth. The bottom line is that such prespending and scheduling of future tax cuts treats future voters as if they were unreliable adolescents who need to be controlled and ensures that government is designed around yesterday's needs.

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LESSONS FROM THE 1986 TAX REFORM ACT

Judging by tax and budget history, Washington won't quickly dig us out of this quagmire. Tax reform might not materialize for a few years; changes in Social Security – which is not nearly as complicated to reform as taxes – may come first. President Reagan called for tax simplification in January 1984 but didn't sign the bill into law until October 1986.

Moreover, Reagan was riding the momentum of two major deficit-reduction packages and a Social Security reform that took place during his first term. In short, by 1986 there was room for systemic tax reform on the policy agenda because Congress had already engaged in deficit-cutting and other systemic reform.

Still, tax reform meant tough choices. Building a viable majority for reform in 1986 required policymakers to abandon some changes proposed initially. When estimates revealed significant revenue losses as a result of these political compromises, new "losers" had to be identified. In short, anyone exercising leadership in this give and take had to have political backbone.

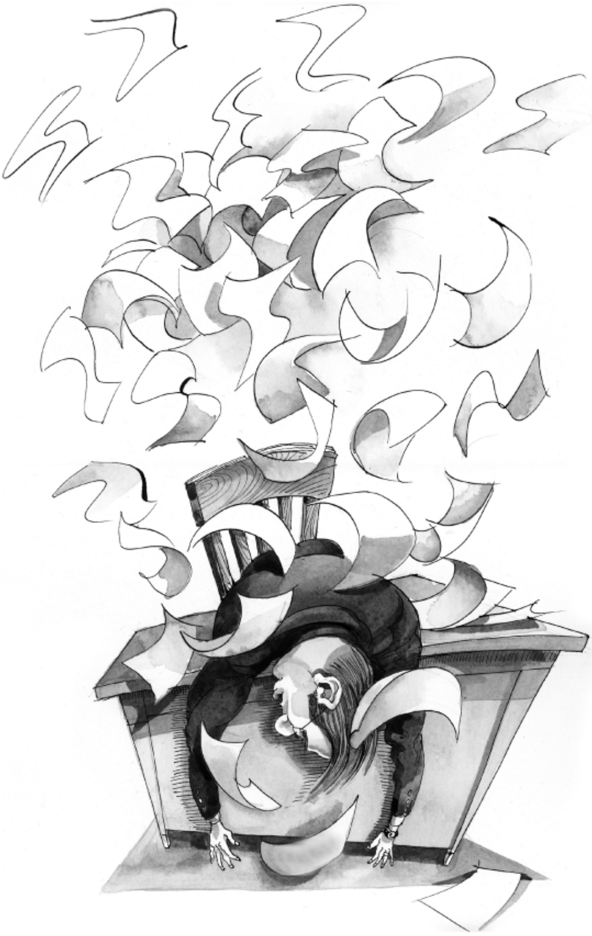
I had just returned to the Treasury Department from a sabbatical year in 1984 when the role of economic coordinator of the tax reform work fell into my lap. The charge to study reform came, almost like it does today, with little instruction on what reform was to entail. Also, like others do now, we flirted with consumption-tax and flat-tax proposals but ultimately adopted the more conventional rate-lowering, base-broadening theme.

One strategy that paid off was to make a comprehensive study that pooled every possible observation on how income was excluded from the tax base (or unnecessarily counted twice) and every conceivable remedy. Comprehensiveness, of course, meant attacking even the small, often overlooked, problems. This had two advantages. The first comes under what I coined the "hopper" theory of reform: if more good things went into the hopper, the more good and the fewer bad things likely would emerge in the legislation if Congress finally acted. Second, although this all-points approach took more special benefits away from more people, its evenhandedness convinced at least some taxpayers that the reform effort was a sincere attack on unfair preferences – not on particular groups or individuals. Many taxpayers were willing to pay the price of tax reform because they believed that they were not being singled out to pay its cost.

One key to success in reform is assigning personal responsibility for failure. After Treasury Secretary Donald Regan put forward the Treasury's tax reform study in late 1984, conservatives and liberals generally agreed that what was proposed was better than what we had. Those who successively shouldered primary responsibility – Treasury Secretary James Baker, House Ways and Means Committee Chairman Dan Rostenkowski, and Senate Finance Committee Chairman Robert Packwood – understood that they couldn't deviate far from the ground rules set when reform began. Once it became clear that a system could be designed to lower rates, eliminate shelters, remove the poor from the tax rolls, help to equalize treatment of individuals with equal income and even to make conservative and liberal support coalesce, none of them wanted to go on record as blocking reform. As a result, the Tax Reform Act of 1986 managed the largest restructuring of incentives and priorities ever achieved in a roughly revenue-neutral act.

PROGNOSIS FOR A BUSH TAX REFORM

More than the moon and stars must align to once again enact significant changes to such an all-encompassing system as the federal tax code. Sure, the Republicans or Democrats can avoid coalition-building when giving away more money to their favored constituencies in the name of reform, but that's not the game at hand. Inevitably, revenue-neutral reform will increase taxes for some as it lowers taxes for others. For true reform, Repub-



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licans must make common cause with some Democrats, and the White House must make common cause with Congress. Most important, elected officials must see more political risk in inaction than in action.

At this point, neither President Bush nor Congressional proponents of tax overhaul have put forward reform concepts with enough oomph to prompt these alignments. True, there have been some statements about moving toward a consumption tax, preserving mortgage interest deductions, taming the alternative minimum tax, and retaining progressivity. But those statements merely identify who might win or hold ground, not who is going to pay. And reconfiguring taxes according to basic principles is much tougher now than it was in the mid-1980s, because the long-term deficit outlook is much more problematic. Indeed, the broader battle between deficit reduction and what-me-worry politics has become the gorilla around which the other legislative monkeys must play.

Still, just as in the mid-1980s, there would be grave political consequences for doing nothing to reform taxes. This time around, the alternative minimum tax is on track to ensnare 29 million households in an expanded paperwork nightmare by 2010. Most of these will be families with children, since the alternative minimum tax treats the dependent exemption like a tax shelter. Meanwhile, real tax shelters – especially those created by shuffling financial assets and liabilities among countries – have become quite elaborate, and difficult to control.

LAYING THE GROUNDWORK FOR REFORM

Neither principled tax policy development nor forthright budget containment is going to happen without dedicated champions. Some of that leadership must come from the president and the heads of the House Ways and Means and Senate Finance committees. But passing the buck to the leadership isn't enough to get the job done. The route to tax reform in 1986 was paved by an agreement between major figures in both parties that something had to be done, and the starting point for action would be studies or analyses prepared by Treasury Department and Joint Committee on Taxation staff members based upon principles of taxation.

It will be tempting to turn to a blue ribbon commission to pave the way for reform, but a commission's limits should be understood up front. A commission by itself simply can't supply the leadership needed, while much of the detail work requires hands-on assistance from Treasury and Congressional staff members. Moreover, the record of past commissions suggests that success is hardly a sure thing. The best have appointees who are willing to make hard choices and to entertain political compromise. But even then, there must be some consensus on which tax problems are going to be addressed, along with a willingness on the part of elected officials to take some political chances.

While there is no surefire means to create a climate that will support traditional tax and budget principles, there are ways to strengthen the governmental institutions and processes so opportunities for reform can be seized when they come.

The IRS, which has done a very poor job of examining the effectiveness of the programs and policies it administers, needs to strengthen its tracking and accountability procedures. It should assemble data and perform studies on compliance; the distribution of program benefits and at least minimal measures of effectiveness like who gets what. Unfortunately, even after its touted modernization that began in 1996, the IRS still does not profile the beneficiaries of a multitude of key tax breaks, ranging from charitable contributions of appreciated property to enterprise and empowerment zones.

The Treasury Department, in turn, has an obligation to furnish the public with information on the successes and failures of various tax policy programs. When I came to Washington in the mid-1970s, the Treasury had a reputation for forthrightly articulating the problems with any proposal backed by members of Congress, even at the risk of offending them. Since then, the Department has grown increasingly afraid to take stands. Who, if not the Treasury, will represent the public, especially since most other executive-branch departments – like Commerce and Defense – are organized to carry water for specific constituencies?

The Office of Management and Budget must be restored to pre-eminent status within the Executive Branch, with the capability to deal with budget issues that straddle agency turf. Its too-small economic staff must be built up to resemble those of the Congressional Budget Office and the Office of Tax Analysis in the Treasury Department, equipped to examine the innards of programs ranging from health care to pensions, and directed to look at both direct expenditures and tax expenditures. Like the Treasury, OMB should be known for issuing studies on which programs work and which don't. Those studies should supplement ones put forward to support the presidential agenda.

The House Ways and Means and Senate Finance committees must restore the tradition of bipartisan internal meetings and retreats on key issues of concern. They need to make sure that disinterested researchers and staff members, including their own Joint Committee on Taxation staff, are able to testify and get more face time with members. The committees must also give greater weight to internal rules that require analysis of the complexity of bills before they come to a vote. Almost everyone who had a hand in creating the business tax bill enacted in late 2004 admits that the nation's legislative machinery must be fixed. Lobbyists in Washington joked

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that "if you didn't get anything in that bill, you really weren't much of a lobbyist." Not only must more-objective experts have a seat at the table, they must once again provide the first drafts.

Finally, Congressional budget committees should be empowered to develop and enforce rules that limit the long-term budgetary impact of initiatives. Sunset clauses, which require a program to end unless lawmakers later decide otherwise, should be used to force Congress periodically to reconsider programs, but not to hide the price tag of permanent programs by keeping all but the cost of the first few years off the books. The 1990 budget rules worked fairly well for almost a decade and helped balance the budget temporarily, so there is a recent precedent that augurs success. But since these rules covered only growth through new legislation and not the built-in growth of old legislation, and since entitlements impose even larger relative burdens today, the old rules simply don't cover enough of the budget. New budget rules need to apply also to both automatic growth in entitlements and tax subsidies.

ARIADNE'S THREAD

I still think we can get out of this maze. At some point, reform will become more viable than the alternatives. What will force budget action is the popularity of programs affecting education, jobs, community development, the environment and other areas, which are slated to all but disappear if current trends continue. On the tax front, the best hope for reform is probably the bad will created by the complexity and increasing bite of the alternate minimum tax. Indeed, that tax could be the horse on which the broader package rides.

Most of all, elected officials are going to have to gear their processes to make very different types of choices than they have made lately. The legislative ledger is quickly filling with requirements for both systemic reform and deficit cutting, and both demand leadership in identifying who is going to pay the price for civilized society. M