

**REFORMING FEDERAL TAXES: SOME LESSONS FROM HISTORY**

Testimony

Before the

*Committee on the Budget*

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\*The views expressed are those of the author and should not be attributed to the Urban Institute, its trustees, or its funders.

**Mr. Chairman and Members of the Committee:**

Many tax and budget reforms know no ideological or party boundaries. While legitimate debates transpire on degrees of progressivity or 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 recession—threaten economic slowdown and place unfair burdens on our children.

You have asked that my testimony concentrate on what makes reform most likely, given the lessons of history. As Heraclitus noted, "You cannot step twice into the same river; for other waters are ever flowing on to you." Yet, as I will attempt to illustrate here, a little planning can still help one cross the stream. Let me engage in a bit of literary license and distinguish between serendipity and luck. Luck is random. Serendipity involves good things happening because one takes steps to increase the probability that they will, although almost never in the exact way one originally intended.

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 calling such reform "the impossible dream." Yet such reforms begin with a common consensus that something is broken and that, while we disagree on the perfect fix, 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. Such also was the consensus of close to two-thirds of the members of the President Obama's recent debt commission.

I also suggest (with admitted bias) that the advantages of nonpartisanship are displayed in the witnesses you have asked to testify today on the basis of their knowledge, not ideology. Three of us today are associated with the Urban-Brookings Tax Policy Center, where former deputy assistant secretaries of the Treasury under both Republicans and Democrats co-mingle with former heads or acting heads of the Congressional Budget Office appointed by members of both parties, as well as with the senior economist to the President's Advisory Panel on Federal Tax Reform in 2005, to mention only a few. Party lines and affiliations are neither issues nor criteria when we discuss which types of reforms we think might work.

The more general point is that most of us, elected officials and professionals alike, are about the same business: to try to find ways that government can best serve the public. And the 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 or 23 percent of GDP trumps bad government at both levels.

## Understanding How We Got Here

If reform always seems within reach, then 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 budgetary politics of "two Santa Clauses at the same time"; (3) misleading budget accounting; and (4) jurisdictional limitations within the executive branch and across congressional committees.

**Seeking Adulthood.** For most of U.S. history, the spending side of government was addressed to the items like 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 economists' viewpoint, transfers are merely negative taxes, taxes negative transfers. As these 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 phase-outs of both direct spending and tax subsidies. While we can explain this development as a consequence of government's movement through adolescence, we have yet to develop the processes and laws more applicable to adulthood.

**Two Santa Clauses at the Same Time.** Partly due to the large number of spending items in the tax code and effective taxes due to the phase-out of various benefits, I no longer divide the budget balance sheet into spending and taxes but, instead, as “giveaway” and “takeaway.” 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. Indeed, with perhaps one exception, most members in today’s Congress have never voted for any significant deficit reduction or for the systemic reform of any major spending or tax program. Both deficit reduction and systemic reform, you see, require identifying “losers”—those who must give up something to balance the sheets. Whatever one thinks of the exception—health reform—controversy over it tends to center less on whether it works than on who might be the losers. Accordingly, both political parties for a long time have only enacted tax cuts and spending increases while hoping that the other party will enact the tax increases and spending cuts that balance the government’s books.

Even when we know that the situation is no longer viable—as today, when we only collect \$2 for every \$3 we spend—the stalemate continues.



### Taxes & Spending per Household

(\$2011)

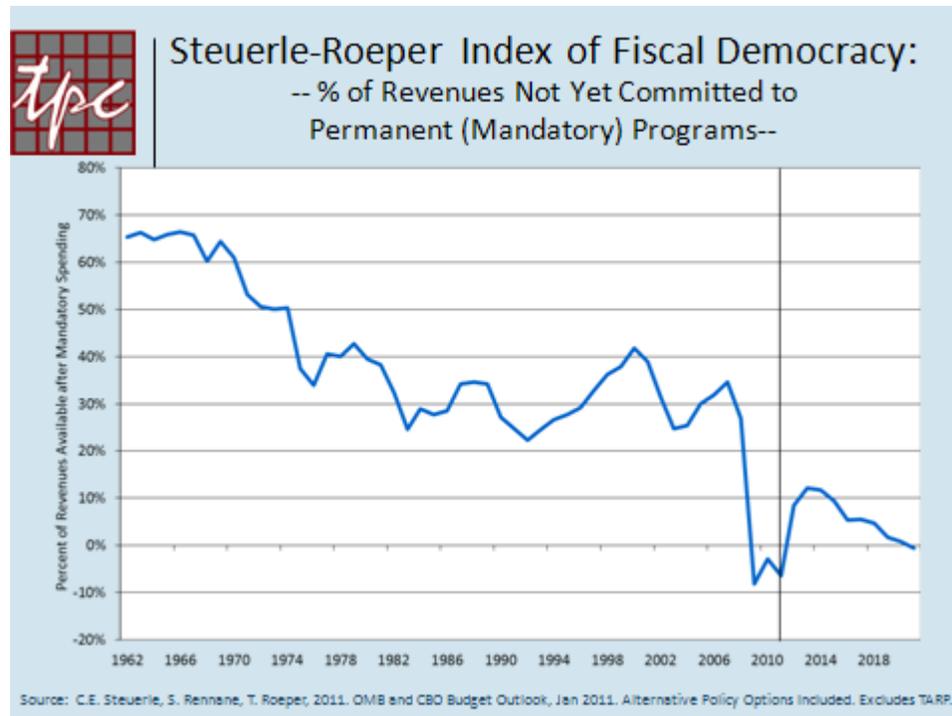
	<u>2011</u>	<u>2020</u>
<b>Taxes per household</b>	\$ 18,400	\$ 27,000
<b>Total Spending per household</b>	\$ 30,700	\$ 37,000
<b>Tax Expenditures per household</b>	\$ 9,600	\$ 12,400
<i>Interest Spending per Household</i>	\$ 2,000	\$ 6,200

Source: C. E. Steuerle and S. Rennene, Urban Institute, 2011. CBO Budget and Economic Outlook, Jan 2011. Alternative Policy Options Included.

To make matters worse, both parties think that the reward for such political suicide is only to strengthen the other party’s ability to control the future; that is, from one perspective, spending cuts will only lead to tax cuts, and from the other, tax increases will only lead to spending increases. Actually, I think there is some truth on both sides, and each is trapped in a

classic prisoners' dilemma—a complicated situation where it is always costly to lead and where 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.



Again, 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 some 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 one can't simply engage in the types of "giveaway" to which we became accustomed for decades in budget, tax, and spending bills.

**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 as to 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 really is 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.

**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 the Treasury's 1984–86 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 recommendations—had no authority over both direct spending and spending hidden in the tax code.

Another time came when testifying before the Ways and Means Committee on the possible superiority of direct housing vouchers to low-income housing tax credits. Representative Rangel 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.”

### **Lessons from 1986 (and 1969 and 1954)**

You have asked me to spend some time on lessons from the 1986 reform and why it was successful. While history never fully repeats itself, these lessons can still provide guidance.

**Seizing Today's “Opportunity.”** The opportunities of each age differ. In the mid-1980s, individual tax shelters were running amuck 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 these issues 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 I have already noted, 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 Social Security reform in 1983. This provided greater opportunity to propose a deficit-neutral tax reform.

**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, though both are done all the time. Some principles like progressivity must be balanced against concerns for efficiency, but, even here, 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, on the other hand, principles come much more into play since elected officials must justify to skeptical audiences why they made the choices they did. Principles not only guide initial decision-making, they can be used to control the process as it moves along.

**Comprehensiveness.** From a public policy perspective, we ought first to identify comprehensively what needs fixing before proceeding to the politics. This 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 what I label the “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, too, gear up to favor 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, irrespective of the amount at stake or even 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.

**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 generally fought to restore a provision against a standard of equal justice and a comprehensive tax base, with few exceptions. 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.

As some of you know, this last reason compelled me early on in the debt commission's proceeding to push through the staff for a "chairmen's mark" that solved such problems as long-term debt and Social Security imbalances, so that those favoring current practices would have to be put on the defensive. Had the 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.

**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. These didn't just appear *deus ex machina*. Prior to 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 felt the family was under attack, and the second especially by liberals concerned about the poor. Meanwhile, lower rates were always foremost in President 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.

**Presentation.** So many reform efforts fail because no plan is in place to gather together the information that can present the problem in the most forthright manner. The 1984–86 reform effort worked 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 doctors and lawyers with +\$300,000 in professional income and −\$290,000 in fake partnership losses would have shown up 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 this issue, we had to adopt a better measure by which to classify taxpayers. We also worked closely with IRS to reveal much more data on the uses of partnerships as tax shelters.

**Empowering Nonpartisan Staffs at Treasury and Elsewhere.** Over the past three decades, a belief has arisen within both the White House and Congress that information needs to be centralized and controlled. 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? In addition, why not place more and more political staff over nonpartisan staff and civil servants so as to please more constituencies and restrict any news that might offend them? With a few major exceptions, such as the Congressional Budget Office, one consequence has been the multidecade downgrading of nonpartisan staff to the point that they are less able to serve the public with the information and knowledge that they have.

There is no doubt that the Tax Reform Act of 1986, as well as the Tax Reform Act of 1969, came out of studies that the Treasury Department 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 (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, many issues—ranging from tunnel bores to depreciation rates—in ways that haven’t been repeated since. Since then, the plumbers have not really been allowed to do their work; as one piece of evidence, the Treasury and the IRS for decades have failed to fulfill the requirement for performance review of the hundreds of programs under their purview.

**Leadership.** With the gift of hindsight, many people claim leadership, as in making the 1986 reform happen. In truth, when President Reagan first asked for a study in his 1984 State of the Union address, Congress immediately burst out in laughter. Internally to Treasury, some people thought we would treat this like a lot of other studies that never quite got done. And it was quite clear that the White House initially had little more in mind than to put this 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 we were debating internally because they didn’t want to have to defend it. Even after the Treasury’s study was

released, Secretary Regan started to back off, indicating that it had been written on a word processor and could be changed.

Still, after release, the study itself began to receive praise from many Democrats and Republicans. Momentum started to build. People like James Baker and Richard Darman saw both opportunity to lead and a way to establish an agenda for the president's second term. At a crucial moment, President Reagan and Representative Dan Rostenkowski came to an agreement that each would not criticize the other in advancing this ball to the next stage. Also, President 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. And clearly some members of Congress, led by Senator Bill Bradley, had already helped create momentum through bills such as Bradley-Gephardt, Kemp-Kasten, and many others.

**Accountability.** Interestingly, tax reform in those days was declared dead at least three times after Treasury's original report gave it some life. But as the effort moved from a Treasury proposal 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 James Baker, then Ways and Means Chair Dan Rostenkowski, then Senate Finance Chair Bob Packwood) ended up responsible for getting it to the next stage. When the press started reporting at each stage that reform was dead, the onus of failure became greater than onus of success. This 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 any reform.

**Empowering Someone to Be in Charge.** 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. But in a political system, someone then needs to be empowered to get reform through the political system without losing its core objectives. With respect to this stage of reform, I here paraphrase comments made by Richard 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 Secretary Baker took overall charge, mapped out a strategic plan, relied upon 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).

## 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 health 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 these 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 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 where 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 the right way. 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 at the analytic level 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;
- empowering nonpartisan staff with detailed knowledge of the subject matter to lay out a principled plan for reform before laying 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.