

## SPECIAL SECTION

# 20 YEARS AFTER TAX REFORM

## Time for Another Round?

Last week, tax policy experts gathered in Washington to review the politics and economics that drove the Tax Reform Act of 1986 and to discuss the possibility of another round of tax reform. On the pages of this special section, we are pleased to present a selection of papers by panelists and moderators of the event, which was cosponsored by Tax Analysts (publisher of *Tax Notes*), the Urban-Brookings Tax Policy Center, and the American Tax Policy Institute.

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## The Tax Reform Act of 2010

By Leonard E. Burman

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Twenty years ago, President Reagan signed an amazing piece of legislation, the Tax Reform Act of 1986 (TRA 86). It rid the income tax of many loopholes, shut down (at least for a while) the flourishing tax shelter industry, and made taxes simpler and fairer for tens of millions of Americans.

While its scope was breathtaking, the true miracle was that it happened at all. Arguably, the most important player in the tax reform saga (brilliantly recounted in Jeff Birnbaum and Alan Murray's book, *Showdown at Gucci Gulch*) was President Reagan. The president, after he signed the bill, laughed nervously and said that he had signed his name backwards. Given that he had had lots of experience signing his name almost six years into his presidency, the admission was somewhat disturbing.

The congressional leaders, too, had issues. Ways and Means Committee Chair Dan Rostenkowski, D-Ill., the bill's main protagonist in the House, eventually ended up in jail for embezzling postage stamps. His counterpart in the Senate, Bob Packwood, R-Ore., slunk out of Congress after several female staffers recounted his improper advances.

And, of course, an army of lobbyists was lined up in opposition to the reform (the tasseled-loafer-wearing denizens of Gucci Gulch). Somehow, the public interest triumphed, even if briefly, over all the forces arrayed against it. A miracle.

Now we need another tax reform miracle — even more than we did in 1986.

In 1986 tax shelters were rampant. Rich people could engineer transactions to avoid all or most of their tax liability. Voters believed the tax system was unfair and cheating was thought to be on the rise.

Those problems exist to some extent today (although tax shelters seem to be more prevalent among corporations than individuals). But the real motivation for the Tax Reform Act of 2010 is a tax and budget tsunami about to hit our shores.

First, the tax system's ability to raise revenues is eroding because of both economic and political factors. The main economic factors are increased globalization, the growing sophistication of financial markets, and the genius of tax advisers in designing complicated financial transactions and corporate organizations (often spanning international borders) to hide income from tax collectors. Many observers think that those factors are undermining

the corporate income tax as a source of revenue and could eventually make it difficult to collect tax on capital income.

The main political factors are the individual alternative minimum tax and the expiration of the Bush tax cuts in 2010. In principle, the tax cuts can expire as scheduled at midnight, December 31, 2010, and revenues will jump up by over \$200 billion the following year — stanching the government's red ink, at least for a while. In practice, few expect it to play out that way. President Bush and congressional leaders would like to make the tax cuts permanent, and even most critics are reluctant to promise to roll back all of the tax cuts.

AMT revenues, another growing part of official projections, should also be recorded in invisible ink. If the tax cuts are extended, the AMT is *supposed* to bring in more than \$1 trillion over the next decade, but that assumes that over 50 million people, including virtually all middle-income families with children, will be subject to the tax by 2015. Nobody really expects that to happen either.

Bottom line: If the tax cuts don't expire and we can't subject most of the middle class to the AMT, about \$2 trillion in revenues counted upon by official scorers over the next decade will not materialize. Somehow we need to fill that hole.

At the same time, spending pressures will be unprecedented. The Congressional Budget Office projects that, if current trends continue, Social Security and medical care for the elderly (provided through Medicare and Medicaid) will cost 18 percent of GDP by 2050 — roughly the average of all federal expenditures over the past 50 years.

Put differently, unless baby boomers stop getting old and medical costs stop outstripping inflation, we're going to have to conjure up a lot more revenues than we ever have. The current unfair, complex, and dwindling tax base is clearly inadequate to the task.

We need a reformed tax system — one perceived as fair by most Americans and one that does not entail excessive burdens on honest taxpayers.

Is the 1986 reform a good model for the Tax Reform Act of 2010? No. TRA 86 was explicitly designed to be "revenue neutral," meaning that it did not increase or decrease revenue over the budget period, but that doesn't work this time around. A major impetus for tax reform is that the numbers don't add up. We need more revenue.

TRA 86 also relied on a sleight of hand to cobble together support. It increased corporate taxes by \$120 billion while cutting individual income taxes by the same amount. Economists know that individuals ultimately pay the corporate tax, but most corporate CEOs and wealthy shareholders were convinced that they would come out ahead because individual tax rates were cut almost in half.

Unfortunately, there does not appear to be a similar well of untapped corporate revenue to grease the skids for tax reform now. While attacking corporate tax shelters could raise billions, the gains are tiny compared with TRA 86's elimination of investment tax credits, accelerated depreciation, and a host of other corporate tax breaks. Corporate tax increases simply will not raise enough revenues to assuage grumpy individuals set to lose a raft of special tax breaks.

Voters will have to be convinced that the pain of individual tax increases — inevitable in any meaningful reform — is worth bearing because it serves a greater purpose. Recent history notwithstanding, that is possible politically. President Reagan himself made an impassioned speech in support of a significant tax increase after he was persuaded that the 1981 tax cuts had gone too far. He said:

The single most important question facing us tonight is: Do we reduce deficits and interest rates by raising revenue from those who are not now paying their fair share — or do we accept bigger budget deficits, higher interest rates, and higher unemployment simply because we disagree on certain features of a legislative package. . . . We're within sight of a safe port of economic recovery. Do we make port or go aground on the shoals of selfishness, partisanship and just plain bullheadedness? (Aug. 16, 1982)

With strong leadership, voters might be made to understand that (1) we need to raise more revenues to pay for the obligations that we have made to senior citizens, and (2) it would be better to do it with a simpler, fairer, broad-based tax system than by simply jacking up rates under the current, deeply flawed system.

How does it happen? Here's my fantasy scenario. A candidate runs for president in 2008 on a reform platform or possibly is maneuvered into embracing reform by a third-party candidate like Ross Perot who is willing to say that the current system is broken, this threatens our prosperity, and we can't just tinker around the edges. The new president instructs Treasury to produce a tax reform plan that is fair, simple, and adequate to financing the government. At the same time, the Office of Management and Budget develops a plan to cut both entitlement and discretionary spending. (While Treasury and OMB study, the president works on Congress to enact a few of the most popular campaign promises, bolstering poll numbers.)

In January 2010, the president delivers to Congress (at least one branch of which is controlled by the opposing party) a tax and spending reform package and makes clear that only a complete package will be signed. Republicans get the spending restraint they say they want and Democrats get a progressive and simple tax system adequate to fund essential public services for the foreseeable future. Congress wrestles with this plan as the clock ticks away toward the expiration of the Bush tax cuts in December. The president makes clear that anyone who undermines reform is voting for a continuation of a complex and unfair tax system and big tax increases in 2011 to boot. As in 1986, neither party wants to be tarred with killing tax reform. Somehow, against all odds, the president gets a bill to sign in October before Congress goes home to run for midterm elections.

Okay, it probably won't play out that way. But then again, nobody thought that a retired B-list actor, a corrupt Chicago pol, and a man who held weekly strategy breakfasts with rich campaign donors would produce the Tax Reform Act of 1986.

## Setting the Stage

By Christopher Bergin

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A few weeks ago, I attended a lecture — and I mean that in the best possible way — by the current, but soon-to-be retired, chair of the House Ways and Means Committee, William M. Thomas, R-Calif. His talk was about how we get lots of bad tax policy from our efforts to make good tax policy.

Thomas noted that the basics of politics 101 in Washington are about who gets what, when, and how. That's an excellent point, and it's an important reason why our tax code may be on the verge of collapse.

Thomas went on to explain that some of our politicians are not exactly the cream of the crop of American society. And that good tax policy rarely ranks high against what each politician wants for his or her special interests.

"Don't think in this business that you're dealing with the best and the brightest," he said. "You're dealing with the available and the willing."

Was it always this way? Some of my younger colleagues tell me I'm too nostalgic when it comes to the Tax Reform Act of 1986. I will admit that, at the time, I found the process — including the politics — thrilling. But if I am nostalgic, I am *not* naive; I saw what the politicians did even then.

The Treasury I study (formally known as *Tax Reform for Fairness, Simplicity, and Economic Growth*) that the Reagan administration released in 1984 was an outstanding piece of work. The legislation that eventually resulted and became the Tax Reform Act of 1986, however, wasn't so outstanding.

Consider the so-called bubble. A key selling feature of the act was that it supposedly provided only two low marginal income tax rates for individuals. Actually, it provided three — the third and highest of which was hidden from view in a "bubble." In fact, the 1986 act was loaded with all sorts of gimmicks and gizmos to hold it together.

But the deal would not hold for long. The politicians began dismantling tax reform the very next year with an Omnibus Budget Reconciliation Act. They continued the year after that with the Technical and Miscellaneous Revenue Act. That law, commonly known as TAMRA, is still my favorite name for a federal tax bill — but should probably be known as the "problems with the 1986 act that we had to fix plus lots of other stuff that some of us wanted to put in the tax code" act. In other words, politics 101 at work. The dismantling of the 1986 act continues to this day.

Still, what President Ronald Reagan signed into law on October 22, 1986, was, from my vantage point, much better than what we had before. It was true — if not

radical — reform. It surely did lots to clean up the tax code. You don't see legislation of that kind come along every day.

The act may have mostly failed to achieve the stated goals of fairness, simplicity, and economic efficiency. But those high-minded goals were enthusiastically considered through the two years of deliberation, even if the realities of politics 101 eventually put them beyond reach.

As many observers say, it's good to clean out your closet every 20 years or so. So is it time again for a cleaning of our tax code closet?

Personally, I don't think so. In fact, it may be time to knock down the whole house.

For me, the 1986 act offers at least two lessons for what to do as we move forward, neither of which suggests that a mere closet cleaning is enough.

First, we should set high standards — as we did in the 1980s — and we should try harder to meet them. We should never abandon the goal of a tax system that's fairer, simpler, and economically more efficient.

Second, we have to recognize that the problem is bigger than a cluttered closet. Our tax system is so broken that the next reform of the tax code will have to be much more radical than the last one. And our budget is becoming so drenched in red ink that the next reform will have to raise revenue.

Those realities, of course, will make tax reform of the future tremendously hard to achieve. To do it, the politicians will have to figure out not only who *gets* what, when, and how, but who *loses* what, when, and how much. And there's going to be a lot of losers next time around.

## The Tax Reform Act of 1986: What It Wasn't

By Joseph J. Thorndike

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We're going to hear a lot today about what the Tax Reform Act of 1986 was all about — or at least what it was *supposed* to be about. In an effort to provide some historical context, I'll talk about that, too. But I'd like to start by saying something about what it *wasn't*.

The 1986 reform was *not* a watershed in American tax history.

It was certainly a landmark in fiscal policymaking; a milestone of modern politics. It was a key element of the Republican ascendancy of the 1980s. It was, without question, important.

But it was not a watershed. According to the *American Heritage* dictionary, a watershed is "a critical point that marks a division or a change of course; a turning point." As important as it was, the 1986 reform was not a turning point. It renewed, but did not transform, the American tax regime.

And that's not surprising: It's hard to transform a tax regime. Historian Elliot Brownlee has identified just four watersheds in the history of American taxation: the Civil War, World War I, the Great Depression, and World War II. Each of these crises ushered in a new fiscal regime, a new "system of taxation with its own characteristic tax base, rate structure, administrative apparatus, and social purpose." Tax regimes are durable, moreover, because they are *part* of their larger economic and political environment. They only change when that environment itself changes.

In other words, tax regimes live and die by necessity, not design. Historically, old ones have disappeared when they failed to meet revenue needs. Sometimes, the tax base has atrophied. Such was the case with the tariff-based regime that arose in the wake of the Civil War, done in by the trade disruptions of World War I.

Other regimes have succumbed to overwhelming revenue demands — ones that can't be met with existing fiscal tools. It was that sort of crisis that gave rise to our current regime in the months after Pearl Harbor. The World War II tax regime — marked by a broad-based, progressive personal income tax, a moderate flat-rate tax on corporate profits, and a small but growing wage tax designed to fund social welfare programs — has proven extremely durable. It has provided the fiscal foundation for a growing federal state for more than half a century.

Part of this durability has derived from tax preferences. Wartime legislation introduced millions of middle class Americans to the income tax; long exempt from this rich man's burden, they faced a new, and quite burdensome, fiscal responsibility.

Congress used preferences to help ease this burden a bit. Even before the war ended, a few lucky taxpayers, most of them businesses, managed to secure preferential

treatment. But after the war, such favors went retail. The mortgage interest deduction — a feature of the tax system since 1913 — assumed new importance as homeownership soared in the postwar era. Similarly, the tax-free treatment of health benefits found a broad constituency once unions made employer-provided insurance a fixture of the modern labor market.

Tax preferences soon became a functional necessity for the modern tax regime. They gave millions of Americans a vested interest in the tax system, including its imperfections. They also helped ease the bracket creep that marked this tax regime, especially in the late 1960s and early 1970s. Indeed, the appetite for preferences continued to grow. By 1967 the revenue loss from tax preferences equaled 21 percent of total direct expenditures, according to Brownlee; by 1984 the figure had risen to 35 percent.

Preferences, in other words, were getting increasingly expensive. They also contributed to a sense that the income tax was hopelessly complicated — although, it's worth noting that lawmakers were decrying tax complexity as early as 1916, just three years after the income tax hit the books.

Most important, however, the accretion of incentives vitiated the apparent fairness of the income tax. Many Americans began to suspect that their neighbors were shirking their fair share of the fiscal burden. By the mid-1980s, tales of widespread tax avoidance had combined with complexity worries to set the stage for sweeping reform.

The Tax Reform Act of 1986 made a serious and wholly commendable effort to deal with base erosion and fairness concerns — and it even made a feint toward simplification. But fundamentally, it marked an effort to renew the existing tax regime, not replace it. And when it comes to tax regimes, renewals — unlike replacements — are not particularly durable.

The tax system had problems in the early 1980s, but they did not rise to the level of a structural crisis. If left unchecked, those problems might have produced such a crisis, perhaps even triggering the arrival of a new tax regime. But the 1986 reform had the surprising — some might say, perverse — effect of making further tax reform substantially less pressing.

Indeed, some critics have even suggested that tax reform renewed not just the tax regime, but the seamy political dynamics that sustained it. As economist Milton Friedman has observed, the end result of base broadening reform is just a renewed opportunity for lawmakers to resell old tax preferences.

The 1986 reform is history's best example of intentional — as distinct from imperative — tax reform. That's not to diminish its achievements; intentional reform on a grand scale requires more effort and political skill than its imperative counterpart. The policymakers who actually pull it off have accomplished something truly extraordinary.

The 1986 act represents the apotheosis of a certain type of tax reform, summed up by a mantra well known to every tax expert: Broaden the base, lower the rates. Income tax purists had been urging that sort of program since at least the early 1920s, when Thomas Adams, Robert Haig, and Henry Simons more or less created the

notion of our modern income tax. But in the postwar era, this reform agenda found its most vigorous advocates in Stanley Surrey and Joe Pechman. For decades, these leading lights of the tax community led an effort to advance horizontal equity and protect the income tax from the depredations of politicians and lobbyists. In 1986 this effort had its greatest success.

But as important as this achievement was — and it was very important — it was not durable. Perhaps it was never meant to be. Perhaps tax reform in the Surrey-Pechman model is best regarded as a process, not an event.

But if so, then I think this process may be suspended indefinitely. I don't think the 1986 act is a plausible model for future tax reform. It's hard to believe that conservatives could be lured to the table again by the promise of lower rates. They watched rates creep up in the years after the 1986 legislation, and they understand, all too well, the ephemeral nature of intentional tax reform.

I'm not sure Democrats could be talked into it, either. They've developed a penchant, which they share with GOP colleagues, for using the tax system to serve every interest, meet every goal, and — if they could — spend every dollar.

Sure, it was ever thus: Tax expenditures are a grand tradition in American public finance, at least as old as the income tax. But in fact, it was *not* ever thus. It was once better. Once upon a time, Democrats, at least, could be counted on to defend a few spending priorities — tuition grants for college, for instance. Now, they couch every progressive goal in the neoconservative rhetoric of "growth" and "opportunity." They use tax incentives to offer symbolic, if often insubstantial, support for their priorities. Democrats may consider this to be good politics, and maybe it is. It seemed to work for Bill Clinton. But this sort of milquetoast liberalism won't do anything good for the tax system.

Ultimately, durable tax reform happens when it *must*, not when it *should*. It happens when old taxes just can't keep up anymore — not with fiscal demands, not with changes in the economy. Sometimes, even good taxes succumb to these changing realities.

Consider, for instance, the general property tax, a levy that states imposed through much of the 19th century. Originally, it was the darling of liberal reformers, who insisted that it would tax people according to their ability to pay. It was imposed on *all* personal property, not just real estate.

This seemed like a good idea, but it gradually became a sort of cruel joke. Changes in the economy, including the proliferation of financial instruments and other forms of intangible wealth after the Civil War, eviscerated the tax base, especially among the rich. The only people paying tax on *all* their property were those who didn't have enough to keep much of it in intangible form. That perverse reality produced a backlash, fueling the popularity of nascent income taxes, and opening the door to our modern fiscal state.

We may be approaching that sort of regime-changing, truly transformative fiscal moment — the moment when existing fiscal tools start to fail. The world is changing, and the tax system may have to change with it.

The most serious threat to the income tax, I suspect, will come from capital income. In theory, at least, we still tax it. But many fans of consumption taxation warn that globalization, and the increasing mobility of capital, will ultimately make capital income untaxable. We'll be left with a *de facto*, if not a *de jure*, consumption tax.

Broad-based consumption taxes, defended on their own merits, may have a political future — although their track record in American political history is not impressive. But consumption taxes that arise through erosion of the ostensible tax base will almost certainly have problems. The only thing Americans like less than taxes, it seems to me, are Potemkin taxes: taxes that claim to do one thing while in fact doing nothing of the sort. The resentment that flows from that sort of fiscal charade may well be a catalyst for lasting reform.

## Economics and Tax Reform: 1986 and Now

By Charles E. McLure Jr.

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While at the Treasury Department, I often described the objective of tax reform as "taxing all *income* uniformly and consistently, without regard to its source or use." (There were some important exceptions, which I will address momentarily.) This objective subsumed both *economic neutrality* and *horizontal equity* — eliminating gross differences in the amount of tax paid by those with similar incomes. Rather than questioning the vertical equity of the system, which inevitably leads to class warfare and would have made the political task of selling tax reform even more difficult, we proposed that reform be *distributionally neutral* — that it not shift tax burdens among income classes, except by eliminating taxes on those with the lowest incomes, which would cost only a small amount of revenue. Moreover, we attempted to be *revenue neutral* — to neither raise nor lose revenue. And, of course, we wanted to *simplify* the system.<sup>1</sup>

Given what has transpired during the 20 years since passage of the Tax Reform of 1986, the weight that can and should be placed on each of these objectives (indicated by italics) has changed.

### Taxing Income

Some economists probably viewed with consternation the proposal to tax income more uniformly, rather than shifting to a consumption-based direct tax. After all, a consumption-based tax is arguably simpler than a conceptually pure income tax,<sup>2</sup> it does not distort the decision of whether to consume now or later as an income tax does, and it is immune to inflation — a consideration of no minor importance at that time. Of course, we had what we considered good reasons for this choice.<sup>3</sup> Basically, we feared that, late in the game, we might encounter "show-stoppers" — problems that we could not solve that would preclude proposing a consumption-based tax — and be left without a set of well-considered income tax proposals to offer.

First was the question of whether gifts and bequests should be subject to tax. Some felt that the outcome

<sup>1</sup>For further elaboration, see McLure and Zodrow (1987).

<sup>2</sup>Andrews (1974) had emphasized this.

<sup>3</sup>On this issue, see McLure and Zodrow (1987) and (2006).

would be unfair if, as seemed likely given the political environment of the time, they were not included in the tax base.<sup>4</sup> Second, replacing the existing income tax with a consumption-based tax would entail daunting transitional problems. Finally, we were concerned about international complications. In particular, all of our tax treaties would need to be renegotiated, and methods of preventing double taxation would need to be rethought. Moreover, inconsistencies in U.S. and foreign tax systems could create opportunities for tax evasion, tax avoidance, and long or indefinite deferral of tax.

It is hardly surprising that interest in taxing consumption has grown over the last two decades. The Tax Reform Act of 1986 has shown some of the complexity that is inherent in the attempt to levy a conceptually sound tax on income. (This is not to say that all the complexity we now experience is inherent in an income tax. It is not. But even after the 1986 act our tax system does not contain all the complex features that would be required to measure real income accurately.) Indeed, in 1988 I asked whether that act was tax reform's finest hour or the death throes of the income tax.<sup>5</sup>

During the last 20 years there has been considerable research into the economic and other effects of a shift to a consumption-based tax, much of it attempting to quantify the economic benefits of such a shift.<sup>6</sup> Unfortunately, the results depend crucially on the specific plan chosen and the transition provisions that are adopted, as well as the exact specifications of the economic models used to simulate the effects of reform, and range from substantial to hardly worth the trouble.

Taxation of gifts and bequests is hardly ever mentioned today, but the potential effects on the distribution of tax burdens between generations have received lots of attention. Absent provisions reducing or eliminating tax on consumption financed by drawing down existing wealth, which would complicate compliance and reduce the purported economic benefits of shifting to a consumption-based tax, holders of such wealth — mostly the elderly — would experience substantial windfall losses.

Consumption-tax advocates commonly say that the change in the distribution of tax burdens across income classes caused by shifting to a consumption-based tax could be offset by changing tax rates to maintain distributional neutrality. But those in a given income class who would pay higher tax rates would not necessarily benefit from the accompanying deduction for saving or exemption of capital income.

Transition and international issues, especially the international implications of the treatment of borrowing and interest under a consumption-based tax, remain troublesome. Either borrowing would be included in the tax base (and repayments of principal would be deductible) or interest would not be deductible (and would not

be taxable). Of course, income taxes do not contain such provisions. Thus the Bush tax panel states in a matter-of-fact manner, "foreign governments could seek to renegotiate or terminate their tax treaty arrangements with the United States."<sup>7</sup> A reform with those potential consequences is not to be undertaken lightly.

### Economic Neutrality

Presidents and members of Congress, while extolling the virtues of free markets and railing against central planning, commonly advocate tax breaks for various activities. Central planning via the tax system reached its zenith with the enactment of the Economic Recovery Tax Act (ERTA) of 1981. Marginal effective tax rates — the percentage by which taxes reduce gross income — varied widely across types of investments, methods of financing, and industries, and were even negative for some debt-financed investments, given then-prevailing levels of inflation.

In 1984 the Treasury Department proposed to reduce the variation in effective rates substantially, by taxing income more uniformly. The primary exceptions, aside from retention of provisions for retirement savings that are consistent with consumption-based taxation, but not an income tax, were the decisions not to eliminate the preferential tax treatment of owner-occupied housing and not to treat all methods of financing the same, especially by eliminating the double taxation of corporate-source income.

The kind of gross differences in effective tax rates that characterized the tax system before TRA '86 have not crept back in. Moreover, the reduced taxation of dividends has eliminated some of the double taxation of corporate-source income. But the preferential tax treatment of owner-occupied housing continues.

### Horizontal Equity

Besides distorting economic decisions, tax preferences create horizontal inequities. These contribute to the perception that the tax system is unfair and thus undermine the moral foundation of voluntary compliance. At the time of the 1986 act individual tax shelters were especially troublesome. Despite having been reduced by legislation enacted in 1982 and 1984, incentives for some types of investment were sufficiently generous that many high-income taxpayers invested in partnerships whose primary purpose was to generate losses for tax purposes that could be used to offset other income. In the mid-80s newspapers were full of stories that described these shenanigans and popular reaction thereto. One reaction was what I call the "cocktail party problem." Being told over cocktails that someone had used arguably legal means to avoid paying taxes, someone less sophisticated

<sup>7</sup>President's Advisory Panel on Federal Tax Reform (2005, p. 249); see also McLure and Zodrow (2006). Similarly understating the problem, the Treasury Department report on tax integration issued near the end of the first Bush administration acknowledged that the failure to allow interest deductions under the Comprehensive Business Income Tax would require "extensive international discussions with tax authorities and market participants." U.S. Department of the Treasury (1992, p. 48).

<sup>4</sup>See, for example, Aaron and Galper (1985).

<sup>5</sup>See McLure (1988).

<sup>6</sup>For recent collections of articles that reflect the current status of the debate on these issues, see Zodrow and Mieszkowski (2002b) and Aaron, Burman and Steuerle (forthcoming).

might reasonably feel foolish and justified in resorting to illegal means to evade taxes.

These days far more sophisticated corporate shelters may be having a similar effect. But, in the wake of Enron and other corporate scandals, the public may be so jaded that they do not expect more and do not really care.

### Distributional Neutrality

For distributional neutrality to make any sense, the existing distribution of tax burdens across income brackets must be politically acceptable. This condition seems to have held in 1986. While some argued that tax reform should make the system more progressive, that sentiment did not prevail.

It seems doubtful that a distributionally neutral tax reform, as proposed by the Bush tax panel, would be equally acceptable today. (Of course, what is politically acceptable depends on who controls Congress and who occupies the White House.) In particular, it seems unlikely that those who have so vocally objected to the distributional consequences of the Bush tax cuts would acquiesce in a reform that did not redress those perceived wrongs. But beneficiaries of the Bush cuts are not likely to relinquish their benefits without a fight.

### Revenue Neutrality

In 1984 it did not seem unreasonable to propose a revenue neutral tax reform. Speculating on whether that is equally true today would take me beyond my area of expertise. But if, as many think, the current fiscal deficit should be reduced and deficit reduction would require a tax increase, the politics of the matter would be very different from those in the mid-1980s. Who should pay the increased taxes would come to the fore and questions of distributional equity would be accentuated.

### Simplification

Simplification was one of our primary objectives in Treasury I. Indeed, we thought that we could eliminate both the individual and the corporate alternative minimum taxes (AMTs) if our proposals were adopted. Thus the title of Treasury I was *Tax Reform for Fairness, Simplicity, and Economic Growth*. By comparison, the president's tax proposals were for *Fairness, Growth, and Simplicity*. I never knew why simplicity and growth were transposed in those two titles, or by whom. Perhaps it was a desire to place greater emphasis on growth. Or perhaps it was simply an acknowledgment that it is difficult to achieve simplicity. In any event, the downgrading of simplicity in the president's proposals foreshadowed what would happen on Capitol Hill. The 1986 act needlessly made the income tax much more complicated for many taxpayers. And, far from eliminating the AMT, it set in motion the growth of this alternative tax. The Bush tax reform panel estimates that, if not "fixed," the AMT will affect 20.5 million taxpayers in 2006 and 52 million, or 45 percent of all taxpayers with income, in 2015.

Of all the objectives that Treasury I sought to advance, simplification may remain the most salient. As the Bush tax panel argued, the tax system has become even more complicated than it was in 1986. Indeed, the title of its report, *Simple, Fair, and Pro-Growth*, gives simplicity pride of place.

While tax preparation software has eased the burden of compliance for the computer literate, it has done so at great cost. First, it turns the tax system into a black box — hardly a recipe for good governance in a democracy.<sup>8</sup> Second, and much worse, some of the greatest complexity involves provisions addressed to low-income households. These taxpayers are generally not computer literate and thus either pay professional tax preparers to assist them, file incorrect returns, or do not file at all.<sup>9</sup>

Unless Congress has strong incentives to quit complicating the tax system and to simplify it, they will never do so. A key question is thus how to create such incentives. I have long thought that all members of the taxwriting committees of Congress (or perhaps the entire Congress) and their staffs, both while incumbents and for a specified number of years thereafter, should be required to complete their own tax returns with nothing but a pad of paper, a pencil, and a calculator. The proposal is, of course, impractical, because some members of Congress would have complicated tax situations, even under a simplified system. But if some bright tax practitioner could figure out a workable variant that would accomplish the desired effect, I suspect the public might be convinced to cram it down their representatives' collective throat.

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## Tax Reform: The Sam Gerard Problem

By Christopher Howard

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I live and work in Williamsburg, Virginia, which is 2½ hours and, in some respects, 2½ centuries away from Washington. News from inside the Beltway can take a while to reach Williamsburg, but I gather that a number of people are unhappy with the tax system and want comprehensive reform. There is a pervasive sense of loss: policy makers worked so hard to improve the U.S. tax code in the mid-1980s, and against long odds enacted the historic Tax Reform Act of 1986. Sadly, that achievement has been undermined by subsequent tax bills. The tax system has become less fair, less efficient, and more complicated in the last 20 years. Clearly, we need to find some way to recapture the magic of the 1980s and reform the tax system once again.

To be successful, those who favor major tax reform need to confront the Sam Gerard problem. In the movie "The Fugitive" (1993), Sam Gerard is a federal marshal played by Tommy Lee Jones, who won an Oscar for this role. For most of the movie, Gerard is trying to capture Dr. Richard Kimble, played by Harrison Ford. Kimble has been convicted of murdering his wife — wrongfully, it turns out — and later escapes from custody after a spectacular train wreck. In one of the movie's best scenes, Gerard is chasing Kimble through a series of large storm drains. When Gerard finally catches up, Kimble points a gun at him and insists, "I didn't kill my wife!" Gerard looks at him dolefully and replies, "I don't care."

Proponents of tax reform are like Dr. Kimble, accomplished professionals who have been treated badly by the powers-that-be (and yes, I'm sure they get compared to Harrison Ford all the time). Unfortunately, the American public may be playing the role of Sam Gerard. According to recent polls, at least 75 percent of respondents feel that the federal tax system needs major changes or a complete overhaul. That sounds promising. But most people just don't care a lot about taxes these days. The Gallup organization routinely asks about the nation's most important problem, and in every poll since 2002 the answer "taxes" has been given by one to three percent of adults. Taxes currently rank well behind the war in Iraq, terrorism, fuel prices, and immigration in importance. Although taxation was never the public's most important issue in the mid-1980s, it did rank in the top five or so, which made it more likely that elected officials would try to do something about tax reform.

There will come a time when foreign policy does not consume so much of the nation's agenda, giving tax reform new life. Nevertheless, I'm not sure the odds will improve all that much. In the mid-1980s, Americans felt that the federal income tax was the worst tax. Plans to reform the income tax struck a responsive chord. Ever

since then, however, the public's distaste for the income tax has diminished. In the latest Gallup polls, only about 20 percent of Americans call the federal income tax the worst tax; almost twice as many people single out local property taxes as the worst. Even if we assume that taxes will grow in importance as an issue, it is not clear that the public will be looking to Washington to do something about income taxes.

Alternatively, the two major parties may play the role of Sam Gerard. Democrats have learned over the last 25 years that it is often easier to promote their policy objectives through the tax code than through traditional spending programs. In the wake of cuts to several antipoverty programs in 1981, Democrats decided that expanding the earned income tax credit (EITC) was the way to go. The Tax Reform Act of 1986 marked the first major expansion, and others followed in 1990 and 1993. The EITC is now larger than food stamps or "welfare" (i.e., temporary assistance for needy families). The demise of the Clinton health plan, passage of welfare reform, growing interest in privatizing Social Security, and declining value of the minimum wage provided further evidence that the American welfare state had reached some sort of impasse. Looking for a new way to address old problems, prominent Democrats have advocated tax deductions and tax credits for housing, education, long-term care for the elderly, retirement income, and families with children. This way, Democrats can address pressing social needs without creating new bureaucracies and without being labeled tax-and-spend liberals. If an important objective of tax reform is closing loopholes, as in 1986, then Democrats may not be nearly as supportive now as they were back then. While Democrats may go after various forms of "corporate welfare" that are buried in the tax code, the largest loopholes promote a variety of social welfare objectives that are near and dear to Democrats' hearts.

For their part, many Republicans view the tax code as a way to hold conventional social spending in check. The rapid growth of Social Security in the late 1960s and early 1970s prompted a number of Republicans to support an overhaul of the nation's private pension system, including a new tax break for individual retirement accounts. If private pensions were more available, they reasoned, pressure to expand Social Security would lessen. Similarly, Republicans have long defended tax benefits for employer health insurance as a bastion against national health insurance. The child tax credit, passed in 1997, was part of the GOP Contract With America; it was supposed to curb government spending on child care by making it easier for families to keep one parent at home to raise children. Republicans are not exactly dying to close major loopholes, either.

Shortly after their exchange in the storm drain, Sam Gerard pursues Richard Kimble, only to see the good doctor jump out the end of the drain and plunge several hundred feet into the river below. The implication is that advocates of tax reform should take a flying leap, and that's not quite right. I do believe that major tax reform, modeled after the 1986 act, is unlikely in the next few years — but I would never say impossible. One of the major presidential candidates could make tax reform a key part of their campaign, elevate the issue in Congress

and the nation, win in 2008, and push legislation in 2009. Still, that strikes me as a long shot.

Perhaps, then, we should not look to 1986 for inspiration. In addition to all the problems described above, the U.S. tax system is not raising enough revenue to finance government spending. Members of both parties have expressed dismay at how quickly large budget surpluses turned into large budget deficits under the current administration. Recent cuts to individual and corporate income taxes, and to estate taxes, are certainly part of the story. The Tax Reform Act of 1986 was revenue neutral, and that might not be good enough today. A different model for tax reform could be the omnibus budget acts of 1990 and 1993, which combined spending cuts and tax increases to lower the deficit. Some officials from both parties might be willing to curb tax expenditures if the issue was framed as deficit reduction, and some conservatives might scale back the Bush tax cuts if offered some spending cuts. Politically, this option is risky. The first President Bush broke his "no new taxes" pledge when he endorsed the 1990 act, and he paid for it later when bidding for re-election. The 1993 act, in contrast, is usually hailed as a high point of the Clinton years. The chances of enacting this kind of tax reform are not great — after all, the American political system is designed to preserve the status quo and thwart any major change — but they may be greater than any sequel to the Tax Reform Act of 1986.

## Tax Reform and Future Revenue Needs

By Joseph J. Minarik

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### Why Did It Happen?

Take yourself back to the early 1980s. After their triumph in the enactment of the 1981 tax cuts, supply-side advocates had continued, and even increased, enthusiasm for marginal tax rate reduction. Their vision included a “flat tax” — a vague notion, but generally inclusive of elimination of tax preferences along with further substantial tax-rate reduction.

Ostensibly on the other side of the issue was the traditional tax reform constituency — whose eternal, unanswered cry was “broaden the base and reduce the rates.” They had always espoused big reductions in marginal tax rates as the reward for the elimination of the income tax preferences that they abhorred. And they were beginning to have some resonance among the traditionally apathetic taxpaying public — who were hearing about non-tax-paying corporations from groups like Citizens for Tax Justice, and beginning to see — indeed, to see through — real-life tax shelters (the notorious see-through office buildings).

This interest from both ends of the intellectual spectrum in pursuing tax reform — enthusiasm for big cuts in marginal tax rates, and at least tolerance of elimination of long-standing tax preferences — meant, to steal a line from journalist and explicator of the making of the 1986 act, Alan Murray, that there was a deal to be cut. And there was a perceptible optimism in this entire movement, in the sense that both supply-siders and loophole-closers thought they could achieve something much better than the status quo.

Is this environment like what we perceive today? Did the Tax Reform Act of 1986 blaze a trail that can be followed again soon? To betray my conclusion, I am skeptical. We need tax reform even more now than we did in 1986. There are outward similarities between today and a fifth of a century ago. But deeper in the substance, I believe, are stronger and fatal differences.

### The Budgetary Environment

There was a big deficit problem in 1986, and there is a big deficit problem today. This is a distinct similarity, and some might argue that the deficit drove tax policy toward reform then, and will do so again now. I doubt it. The 1986 tax reform was explicitly deficit-neutral, and many economists at the time chided tax reformers for wasting energy that should have been devoted to deficit reduction.

Personally, I would challenge that allegation. As one of the players in the 1986 debate argued, “You can’t reduce the deficit by raising unfair taxes.” I would characterize the 1986 act as a sound, zero-coupon investment in deficit reduction. It allowed the later direct tax increases in 1990 and 1993, which actually did tame the deficit, and which might not have been possible had the higher-rate pre-1986 law remained in effect.

For perspective, however, I believe that the deficit problem today is immeasurably more serious than that of 1986, largely because the fiscal crunch time — the retirement of the baby-boom generation — was a remote threat then but is virtually upon us today.

Reviewing the numbers: By 1986, the debt held by the public had grown to \$1.7 trillion, or 39.4 percent of GDP. Now the debt is just under \$5 trillion, or a bit over 38 percent of GDP.

Current deficits are lower. In 1986, the nation had run a string of five annual unified deficits of at least 4 percent of GDP, and the deficit was still running at 5 percent of GDP. There followed a temporary four-year reduction, after which, pushed by a recession, deficits rose again. Now, after two years of deficits at about 3.5 percent of GDP, the deficit has declined for two years, with fiscal 2006 coming in at only \$248 billion, or 1.9 percent of GDP.

I am not the only economist to doubt that the two-year string of declining dollar deficits will continue for long. The budget improvement has come exclusively from increasing revenues, and the increasing revenues have come not from a stronger economy — the economy has proceeded right on the administration’s forecast track — but rather from “technical reestimates” — that is, more revenue than expected from the same amount of GDP. This is the same phenomenon as in the 1990s (although then, the economy was somewhat stronger than economists had anticipated), and we learned then that such revenue bubbles do not persist.

The policy lesson from the 1990s, of course, was that one should take the proceeds of the seven years of plenty and store them away, because there is no telling how long such a windfall shall last (failing a projection with a small standard error from an angel in a dream). In the 1990s, the nation paid down debt with its windfall. Now, to say that the nation has wasted the last six years would be far too kind. We wasted the time, but we made the underlying budget problem far worse. We are kicking not the can, but the hand grenade, down the road. We should be saving for our future — not mortgaging it.

With a debt-to-GDP ratio about the same as that in 1986, we now have interest costs at barely half the 1986 share of the budget — about 8 percent now, versus 13.7 percent in 1986. This will not last. Interest costs are now the fastest-growing part of the budget, and higher interest rates would drive debt service up rapidly. In fact, we may be in a catch-22 situation; longer-term interest rates have remained low in large part because many economic forecasters have predicted slower growth, or even a macroeconomic “hard landing.” If we have the good fortune that interest rates stay well behaved, it will be because the economy has slowed and thereby cut down the growth of tax receipts, burglarizing the budget through the front door rather than the back.

As to the demographic threat to the budget, it is worth reviewing the numbers as well. The beginning of the adverse effects of population aging is far nearer than many would think. When Social Security was rescued from an imminent threat in 1983, before tax reform, the action taken had the effect of building annual trust-fund surpluses. Those surpluses were squandered until the late 1990s, of course, but they did have the effect of reducing the Treasury's need to borrow from the public. That wave will crest in just two years, and will begin to recede. That is to say, the Social Security operating surplus, not including interest income, will reach its highest dollar value in fiscal year 2009 (according to administration estimates), just two years from now, and then will begin to decline. Social Security will continue to reduce federal borrowing needs, but it will do so by declining amounts — meaning that from year to year it will drag the budget down. The effect will become negative in absolute level, of course, in the late 20-teens (by SSA estimates).

So the budgetary problems now are really far more urgent than those the nation confronted 20 years ago. The need for a change in the long-term fiscal trajectory of the country is far greater. In 1986 the nation could afford a zero-coupon investment in deficit reduction. Now, prudence suggests that we should not; the time is far too late. That will make any attempt at tax reform either far more difficult, if it does address the budgetary problem, or far less justifiable, if it does not.

### Tax Policy Issues and the Budget

The president in 1986, for all of his tax cutting conviction, was flexible and pragmatic enough to entertain significant deficit reduction through revenue increases, in 1982 and in 1984. President Reagan's flexibility on revenue increases immeasurably facilitated the achievement of tax reform, by allowing him to raise corporate taxes (by roughly \$25 billion per year, \$120 billion over a five-year estimating horizon) to finance individual income tax cuts. This was extraordinarily helpful, because, for the most part, what happens to *individual income taxes* drives the political verdict. It is *people* — to be crass, *voters* — who generally determine what their legislators are willing to accept. And President Reagan's transfer of tax obligations from individuals to corporations was, in the end, the grease that allowed the tax-reform machine to run.

To generate the corporate tax revenue kitty that helped to close the 1986 deal, there were convenient tools at hand for legislators — namely, the repeal of the biggest corporate tax preference, the investment tax credit (ITC), and a slowing of the highly accelerated depreciation allowances made possible by a moderation of inflation. These revenues financed a big cut in the statutory corporate tax rate, which made the overall package more salable.

Many corporations were brought on board, even with the elimination of the ITC and the corporate tax revenue increase, because they saw the long-run payoff to a lower statutory rate. Though opinion of corporate managers was by no means unanimous, there was enough satisfaction with tax reform that unified opposition was impossible.

The situation today is very different. In effect, there is a *negative* revenue kitty that will throw sand in the tax-reform gears, rather than lubricating them. That problem is the enormous scheduled baseline revenue increase from the individual alternative minimum tax (AMT). Every serious legislator will tell you off the record that the projected AMT revenue increase is unsustainable. This problem hasn't been fixed simply because policymakers have not wanted to pay the bill to repair this largely opaque problem; you get no credit for solving a problem that people do not yet know they have. (Of course, people are learning about the AMT problem, and very quickly.) Also, in negotiating sessions for the 1997 budget deal, neither side wanted to spend its revenue kitty on the AMT problem, knowing that they instead could use those same dollars for very visible tax cuts. And the two sides would not cut a deal to solve the problem jointly. Then, in the 2001 and 2003 tax cuts, supply-siders assumed that the AMT repair (and the defense buildup) could be paid for with the waves of new revenue that would pour in because of the tax cuts.

Just for perspective, the Congressional Budget Office (CBO) estimates a generic fix of the AMT problem, including interest, at over \$60 billion per year over a five-year budget horizon, rising to over \$70 billion per year by the end of those five years, and \$100 billion per year by the end of 10 years. For very rough perspective, tax reform efforts today will face a five-year revenue *hole* that will be roughly the same size, proportionate to total income tax revenue, as the corporate tax *bonus* that helped to sell the 1986 tax reform. And, of course, the ten-year horizon is even worse, because the AMT problem is growing rapidly.

I believe that the administration might well compound this problem. The stated goal of several past administration economic advisers, for what it is worth, is to eliminate the taxation of income from capital. Economists of a conservative bent have espoused this position for some time. In contrast, the 1986 reform made the taxation of all forms of income more uniform, which had the effect of *raising* the effective tax rate on income from capital. (Note the increase in the tax rate on capital gains; the elimination of the investment tax credit; and the slowing of depreciation deductions. I might add that I particularly enjoyed at the time explaining to non-economists how *reducing* the *statutory* tax rate on income from investments in commercial real estate would have the effect of *increasing* the *effective* tax rate on that income.)

Therefore, in comparison, what might be the administration's brand of tax reform today, by *narrowing* the tax base in this respect, would have a much harder time achieving revenue neutrality, let alone deficit reduction, than did the 1986 reform, which *broadened* the tax base. (I have heard an advocate of a national sales tax claim that his proposal is in fact a tax on capital. An economist would note that a sales tax or VAT is a *one-time-only* levy on *old* capital, and for that matter, one that the elderly would be highly unlikely to swallow in the political process.)

There is one more potential lurking revenue leakage for tax reform today. When this administration first raised the prospect of a tax reform effort, press reports

suggested that one tax preference on the hit list was the exclusion for employer-provided health insurance. We should keep in mind that healthcare experts have long counted the revenue gains from cutting back that preference as resources that they would use to improve the healthcare system (as, for example, covering the uninsured). It is by no means a sure thing, but we might keep in mind that those revenues might be encumbered, and thus might not be available to achieve rate reduction or revenue neutrality.

All of these revenue issues make the prospects for tax reform far more problematic. They make a deficit-reducing tax reform still more difficult.

### Why We Need Tax Reform Now

As difficult as it would be to achieve tax reform in the current political and policy environment, we need an improved tax system to meet the federal government's growing financing needs.

A quick look at the long-term budget picture indicates that the major problem is outlays. The villain appears to be mandatory outlays, particularly those related to the elderly. In an intermediate case in the CBO's most recent long-term budget projections (December 2005), total outlays are projected to reach 37.7 percent of GDP by 2050 — well above the projected 2010 level of 20.5 percent. Within that 2050 total, Social Security, Medicare and Medicaid will constitute 19 percent of GDP, up from a projected 9.2 percent in 2010.

Some might quickly conclude that the entitlements are the problem, and the entitlements must be the solution — all of the solution. However, that conclusion jumps too far and too fast, for two reasons.

First, with all of the will in the world, we should not overestimate how much can be saved from entitlements for the elderly. As is widely known, the ratio of the elderly to the working-age population will rise from about 1 to 3.5 today to about 1 to 2 by the middle of this century. With that monumental growth in the elderly population, it is most unlikely that the nation can achieve sufficient savings from the programs for the elderly, particularly for health care, to offset totally the sheer numbers of persons involved.

And second, we should not overestimate how quickly any savings can be achieved. President Bush readily accepted the notion that persons age 55 and over should be exempt from any change in Social Security. That principle postpones the first dollar of savings from a Social Security repair for about 10 years. Savings thereafter surely would be phased in gradually. Thus, significant savings would be long in coming. (In fact, if Social Security repair were centered on private retirement accounts, the net flows would be adverse for years, as payroll taxes were diverted from the Treasury to capitalize those accounts, while savings would come only when today's workers retired decades on.) Healthcare savings also would take years to build, because the structure of the industry and the practice of medicine will not change overnight.

There is a handle on outlay growth, however, and that comes from controlling interest spending — that is, from controlling the deficit itself in the near term. Of CBO's projected outlay growth from 20.5 percent of GDP in 2010

to 37.7 percent in 2050, 10.3 percentage points — more even than the entitlement share — comes from increased net interest cost. Thus, if deficits can be controlled in the early years, there can be significant savings in outlay growth, to "buy time" so that reforms in the major entitlement programs can build. Controlling the deficit now will come to only a very limited degree from squeezing defense and other discretionary spending, which are projected to grow very little anyway. The necessary leverage to achieve significant near-term deficit reduction can be found only on the revenue side of the ledger.

And that is where tax reform comes in. To raise additional revenue *and* minimize economic distortions and unfairness, we need at least an improved income tax. The Committee for Economic Development has proposed a restructured income tax, combined with an add-on VAT to increase revenue potential (see *A New Tax Framework: A Blueprint for Averting a Fiscal Crisis*, Committee for Economic Development, 2005). Increases in the low-income relief provisions under the income tax would offset the additional burden on those with modest incomes. This approach holds promise to meet the daunting fiscal challenge that looms on the horizon.

In 1986 the nation had the time to make a zero-coupon investment in deficit reduction. That investment paid substantial dividends, but those dividends have since been squandered. Now, the retirement of the baby-boom generation is upon us. We need a sound tax system more than ever. Perhaps the key lesson of 1986 for today is that it takes bipartisanship, and leadership, to meet the nation's needs.

## Tax Reform and Tax Administration

By Lawrence B. Gibbs

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Twenty years ago, after the Tax Reform Act of 1986 became law, tax administration was pretty much the same as it had been for the previous 20 years. On the front end of the tax administration process, the IRS provided taxpayer service to get returns filed. On the back end of the process, tax compliance depended largely upon IRS examinations, collection, and enforcement activities. Penalties were the principal sanction the IRS then used to deter tax noncompliance. With the help of Gene Steuerle's book, *Who Should Pay For Collecting Taxes? Financing the IRS*, Congress and the administration were persuaded to fund the IRS tax compliance activities to deal with the tax gap.

Today, 20 years later, tax administration at IRS is different and is continuing to change. The changes are in part the result of the increasing sophistication of our financial markets and the globalization of business activity. IRS workload, in terms of the number of returns filed, has grown every year for 20 years. IRS compliance resources have remained flat or decreased almost every year for 20 years. There is no foreseeable prospect for future decreases in annual IRS workloads. Prospects are not good for future increases in IRS compliance resources as annual federal budgets become even tighter, especially with the budget crunches that are likely to result from the coming demographic shift as the boomers retire. In the future, IRS protection of the integrity of the U.S. tax base will become increasingly important to help pay for the ever-increasing costs of federal health and retirement programs as well as our defense and homeland security costs. All these factors will require IRS to think even harder about its approach to tax administration, particularly its approach to tax compliance, in the future.

What has IRS been doing over the last twenty years and what is IRS likely to do in the future to maintain tax compliance? Increasingly IRS has been dividing taxpayers into two groups, compliant and noncompliant taxpayers, and IRS has been treating each group differently. IRS has provided incentives for compliant taxpayers to remain compliant, such as the prefiling agreement, LIFE, and CAP initiatives and other programs to help large and midsize businesses keep their tax affairs current, which is important in the post-Sarbanes-Oxley world, particularly for companies coping with the demands of the new FIN 48 requirements. To deal with noncompliant taxpayers, IRS has been shifting more of its compliance resources toward dealing with the non-compliant, and it has been using more and larger penalties and other sanctions to penalize and deter non-compliance. In the future, IRS is likely to increasingly

shift the cost and burden of tax compliance to the private sector. The recent use by the IRS of private sector debt collectors is an example. IRS already relies on taxpayers to self-police through initial disclosures by taxpayers to IRS of potentially troublesome transactions in the tax shelter area, and IRS is using Schedules M-3 on corporate returns to require more self-disclosure. Finally, the IRS has made limited use of monitors by noncompliant taxpayers, such as the recent KPMG plea bargain's requirement that KPMG bear the cost of employing Richard Breedan to monitor KPMG's future tax activity. The IRS is likely to continue its efforts to motivate tax professionals to assist the IRS in maintaining taxpayer compliance through increased disciplinary activity by the IRS Office of Professional Responsibility and changes to the Circular 230 rules, like the recent changes to encourage the use of higher standards when professionals advise clients about the clients' tax affairs. For those taxpayers who fail to comply in the future, the IRS is likely to apply even tougher sanctions to those it catches and to request privacy waivers from some noncompliant taxpayers to publicize and make examples of them to deter others. Finally, the IRS is likely to rely more on technology to enhance its compliance efforts, such as its use of the Office of Tax Shelter Analysis in the IRS tax shelter compliance program.

Congress is beginning to focus more on the importance and utility of front-end compliance. Provisions in the recent Grassley bill, the "Telephone Excise Tax Repeal & Taxpayer Protection and Assistance Act," provide for the licensing and regulation of tax return preparers. There also has been increased discussion about more information reporting requirements. Perhaps old ideas, like withholding on dividends and interest and independent contractors, may again resurface. The tax sections of the ABA and the Federal Bar have scheduled upcoming programs to discuss the tax gap and to focus on ways to encourage tax compliance. The IRS might benefit by looking at what other federal regulatory agencies, such as Customs, with its program to fast-track goods, and the Department of Justice in enforcing the Foreign Corrupt Practices Act, have done to maintain compliance with flat or diminished resources. In any event, we need to rethink the role of penalties in tax administration, and the 1987 IMPACT legislation, the prior American Tax Policy Institute penalties article by Dick Stark, and the recent *Tax Notes* article by Dennis Ventry are good places to start. One cautionary note: Some new compliance techniques may raise due process issues, such as waivers of the attorney-client privilege and the refusal to pay attorney fees in the KPMG case. These and similar events have raised questions about the fairness of the so-called Thompson memorandum's requirements for corporations to avoid prosecution.

My point is that 20 years after the 1986 Tax Reform Act, I believe it is time to rethink and reform the way we think about administering the tax system to obtain better tax compliance in order to protect our tax base as we head into the demographic shift caused by the boomers retirements in order to ensure the continued effectiveness and fairness of our tax system. IRS audit, collection, and enforcement actions will continue to be important, but I believe we still rely too much on them to maintain

compliance. In any event, the IRS is not likely to have or be able to obtain the needed resources to rely primarily on these back-end programs in the future. We will need to do more to encourage and cause taxpayers to comply. We should expect the IRS to use its compliance resources, including its technology, as efficiently and effectively as possible to do so. The IRS should continue to shift its focus away from post-return-filing activities to prefiling techniques to find more ways to encourage greater compliance. Treasury and Congress need to explore more opportunities for greater withholding, information sharing, and up-front taxpayer disclosures. More needs to be done to encourage tax professionals, including tax return preparers, to become part of the compliance process in the way they advise their clients. Finally, we need to consider moving more of the cost and burden of tax compliance away from the IRS to the private sector but in a manner that addresses the fairness and due process issues that are likely to arise.

Will the foregoing be enough? Time will tell.

## A Consensus Base for Tax Reform

By Gene Steuerle

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The biggest mistake in tax reform is the label itself. Saying that one is in favor of tax reform is about as informative as saying that one is in favor of expenditure reform. Everyone has items on both sides of the budget they would like to change. They just don't always agree on what those items are. Despite this murk, I suggest that there is a consensus base on which fundamental reform can and should rest — the type of foundational base on which any tax system itself should rest and, by the way, the base on which reform in 1986 reform proceeded. That base is nothing more or less than developing, first, reform options that adhere to basic principles of taxation and, second, a legislative process that gives them heed.

What are these basic principles? They start with the queen of principles: equal justice or equal treatment of equals. What that means in practical terms is that any form of discrimination must be assumed to be wrong except where there is a solid, very solid, basis for such discrimination. The burden of proof, in effect, always remains with the advocates for discrimination. Taxation according to ability to pay is a principle that does allow some discrimination: just as in a family, children are not expected to contribute equally to the household's fortune, so in a tax system, those with no ability to pay taxes cannot be expected to pay net taxes. But it must be balanced against the individual equity principle that emphasizes the right of individuals to the returns from their own work. Another principle is efficiency, which has several branches. One branch leads to conclusions similar to those that derive from equal justice: forms of discrimination among different items of income or consumption are often inefficient, not just unfair. A tax system further should be simple, avoid waste, and be enforceable. Still another principle receiving more attention in the modern period is that a tax system should be non-corruptible. A tax system and the tax legislative process should not invite abuse, whether legal or illegal, whether in encouraging cheating or simply the buying of officials.

Now it is true that balance must be obtained among the principles. But many, many proposals and laws represent no balance at all among principles. So we must be careful to distinguish between reasonable and unreasonable compromises. The most contentious debates relate closely to issues of degree, either of size of government or progressivity. Thus, efficiency considerations (which can include concerns over growth) might lead some to favor supply side or Keynesian stimulus to boost the economy, while others might conclude that deficits unfairly and inefficiently shift revenue costs onto future

generations. Ability to pay considerations lead some to favor more progressivity, while individual liberty considerations make others want to limit the tax rates that can be assessed. Only the political process can ultimately decide such issues when there is a range of “reasonable” compromises, as when basic principles by themselves do not really tell us how stimulative, progressive, or revenue-raising a tax system should be. Still, none of these debates represents an excuse for abandoning other principles. All other things being equal — for instance, given a government of any size and progressivity, efficiency, simplicity, and non-corruptibility are still of value in and of themselves.

Because they are so contentious, once on the agenda, debates over degree or size of stimulus, progressivity, or revenues tend to dominate so much that other principles can be needlessly and carelessly neglected. A number of inefficient and complex giveaways, for instance, are often included in tax cuts, regardless of whether the cutting might be justified by macro-economic or budgetary considerations. One of the reasons the 1986 reform was able to succeed, at least to the extent that it did, was that it did not disdain those contentious and dominating issues of degree and size, it just put them to the side for awhile as a way to try to force focus on other core principles.

My suggestion is simple. Core principles that are of value in and of themselves must be given their due. Sometimes they can be addressed without major debates over degree and size, as was the model in 1986. At other points, these vital issues of adequacy of revenues, size of government, degree of progressivity cannot be ignored either for economic or political reasons and must also be tackled. But whatever the public’s choices on those fronts, the tax laws that result still should be developed in a way that is as efficient, simple, and noncorrupting as possible.

If we adhered to core principles in designing a reform, it would entail — just as was done in 1986 — going through almost every item in the tax code to determine its merit according to basic principles. It would require examining the worth of hundreds of tax programs, putting into practice recent budgetary efforts (and congressional mandates) to assess the effectiveness and outcomes of all programs on the tax or expenditure side of the budget. It would require discarding many items of insufficiently proven merit. It would require a different type of IRS, one that provided data on each of the programs under its control, even when it did not perform the final assessment.

Finally, it would require fundamental reform of the tax legislative process — not only restoring but enhancing the power of those whose job it is to provide the architectural and building system advice, whether in the Treasury or in congressional agencies like the Joint Committee on Taxation. To some extent it would require budgetary and procedural rules that insured support for nonpartisan and bipartisan staffs, and much greater time devoted to true nonpartisan examination of issues. And it would find ways to hold elected officials accountable as individuals, not just as a group. For instance, those elected officials who advocate special interest provisions need to be clearly identified, while the chairs of the tax-writing committees and the Treasury secretary need

to be held responsible for the tax legislative process and for protecting their turfs against the onslaught of special interests both from outside and inside of government.

The opponents of this approach to reform are many. Primarily, however, the opponents are those with specific agenda items for which they are willing to sacrifice core principles. Since there is, never will, and never should be complete agreement on what government should do on so many issues, the attack on core principles and the willingness to sacrifice them can never be assumed to go away.

Another attack is more subtle. Some claim that tax reform in 1986 was just too hard. They seem to advocate keeping all the junk in the tax code, no matter how inefficient, complex, inequitable, and corrupting — and overlay another tax on top of that system, while exempting most taxpayers from the first system. A related group seems to assert that the alternative minimum tax will somehow displace the current system, as if adding provisions like taxing dependents as tax shelters somehow removes all the other problems.

One group of reformers seems to be willing to attack the mess that is the tax code, but they condition that attack with movement along one very contentious line, such as converting the tax system into one with flat rate or consumption base or both. Again, I don’t want to discount the importance of this debate. But reform according to basic or core principles cannot be held hostage to one particular item of this type.

None of this is easy. Government today is extremely messy and corrupted — in no small part, because liberals and conservatives have largely been willing to abandon core principles in their continual battle over how to tax or not tax the rich or how to add to or subtract from existing systems of redistribution rather than reform them to do better. Not to mention how much the access given those with money has tended to reduce the access of those nonpartisan staff whose mission is to design provisions well.

Yet another issue of process must be addressed. If you examine the core principles closely, they apply equally well to the expenditure side of the budget. What has essentially happened to the tax policy process in recent decades is that it has increasingly adopted many of the bad habits of the expenditure policy process. I am not convinced any longer than one can be solved without the other, and, therefore, process reform must extend to all the budget, not just the tax system.

As a practical matter, then, what needs to be done at this point in time? I don’t think that there is any doubt that the budget is so out of balance for the long run that it will drive much of policy for a long time to come. Never before have so many promises been made for the future before that future has arrived — which means by their very nature they will violate rules of efficiency and equity, not to mention taking democratic decision-making out of the hands of the people. This is not a plea for any particular balance between the revenue raising and expenditure cutting that will take place, but for insuring that the core principles I have noted here get the attention they deserve when those tax or expenditure changes are made.

As for the tax system by itself, reform requires studying, identifying, and providing data on all the many programs in the tax system — with special pressure to remove those that are both unproven and violate norms of equal justice. In terms of coming to grips with some issues, I think a President could base one tax reform effort simply on grounds of simplification, with items identified by the ability of the IRS to administer and enforce them. Any principles-based approach, whether emphasizing simplification or not, still requires tackling issues ranging from housing to pensions to charity to work subsidies to health to education to business subsidies. Reform, therefore, requires very hard work if it is to be based on solid principles and a legislative process that gives those principles their due attention.

## The Case for a Consumption Tax

By Douglas Holtz-Eakin

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The broad outlines of the future of the federal budget tell a simple story: policymakers must rein in the growth of large mandatory spending programs, accommodate a rising tax burden, or both. The latter two possibilities are especially troubling. Given the widespread dissatisfaction with the current U.S. tax system, it is difficult to imagine that voters would accept a more aggressive dose of its medicine, and research suggests that this strategy would have detrimental consequences for overall economic growth.

These realities are the foundation of the most recent push for fundamental tax reform. The United States *should* undertake fundamental reform, and this reform should take the form of a progressive, comprehensive consumption tax. Appropriately structured, a consumption tax will be fair, efficient, and administratively effective.

### What Is a Consumption Tax?

A consumption tax is just what it sounds like: a tax applied to consumption spending. However, under that deceptively simple umbrella resides a vast array of potential variants. Consumption taxes can be flat or contain multiple rates; can be applied to households, firms, or both; and can be viewed as “direct” or “indirect” taxes.<sup>1</sup>

For the purposes of my remarks today, let me focus on a few identities that give the flavor of the issues. For a household — or the country as a whole — all income ( $Y$ ) is either consumed ( $C$ ) or saved ( $S$ ):  $Y = C + S$ . This suggests two broad strategies for taxing consumption. One is to tax consumption ( $C$ ) directly, as in a national sales tax. The alternative is to tax it “indirectly” by levying the tax on “consumed income” — income after deducting saving or investment:  $(Y - S)$ . This is the strategy taken by a value-added tax (VAT), the Hall-Rabushka flat tax, or the “X-tax,” a more progressive variant of the Hall-Rabushka tax developed by the late David Bradford.

To see the latter approach, begin with a VAT that consists of a single tax rate applied to a base equal to revenues less purchases from other businesses. A key feature of this base is that business investment — purchases of capital goods — is immediately deducted, or

<sup>1</sup>For a good review, see the collection of papers published in the *National Tax Journal*, September 1993.

“expensed,” prior to tax. When viewed from the perspective of the economy as a whole, this treats national investment (and the saving that finances it) like an unlimited, traditional individual retirement account (IRA). Saving and investment are deducted up front but the principle and earnings are taxed when “withdrawn”; *i.e.*, when they are returned in the form of business revenues.

The drawback to a consumption-style VAT is that it taxes all consumption by all households identically. The insight of the Hall-Rabushka flat tax was to collect the VAT in two pieces by allowing business to deduct purchases *and* employee compensation, but to tax households on the basis of their total compensation. If the same single rate is applied, this yields the same tax base but two sources of tax collections. The flat tax, however, is made more progressive by permitting a household exemption for a basic level of consumption.

The best system for the United States in the future is to build on David Bradford’s X-tax. The base is the same as the flat tax, but households are taxed using graduated tax brackets in which the top rate matches the single business tax rate. This permits greater flexibility and progressivity of the tax system.

### What the Case Is *Not* About

Interest in a U.S. consumption tax is not new. Advocates have touted the potential benefits from moving to a consumption tax for many years. However, I wish to separate my support from some of the more overreaching arguments. In particular, my support for a consumption-based tax reform is *not* about:

1. Simplicity. Some consumption taxes — notably the original Hall-Rabushka flat tax — have been publicized on the basis of their “simplicity.” Who can forget (admittedly tax economists have a limited reservoir of thrills) the first time they saw the Hall-Rabushka postcard tax return? Similar simplicity arguments have been made about a national retail sales tax, where advocates tend to argue that there is little to do except piggyback on existing state efforts.

But this really misses the point for three reasons. First, *no tax system will be that simple*. For any household, a goal is to legally minimize its tax liability. The innate craftiness of the American populace will dictate that any tax system will acquire a growth of rulemaking that delimits the boundaries of acceptable behavior. When a small business owner purchases a laptop computer, is it a business investment (which should not be taxed) or personal consumption (that is, employee compensation that should be taxed)? Inevitably a certain amount of complex rule-making will be necessary.

A common complaint of income tax defenders is that consumption tax advocates compare *ideal* consumption taxes with the *actual* income tax. This is truly unfair and no way to decide between the two.

Second, for many there is nothing simpler than the current income tax — they don’t pay it. As is becoming more widely appreciated, the current income tax is not your father’s income tax.<sup>2</sup> In the United States, the bottom one-half of the income distribution does not pay the income tax — on balance they *receive* net refunds. This is mute tribute to our attempt to turn every program in the Federal government into a welfare program — including the one that is supposed to pay the bills. In contrast, the top 50 percent pay all the tax and the top 5 percent pay 50 percent. Complexity of the income tax is the curse of those who pay it.<sup>3</sup>

Third, postcards are obsolete. For most with complex returns, taxes are “done” — that is computed — by tax-preparation software and filed on-line. Even if No Child Left Behind fails, the United States will be able to file taxes in a simple fashion.

2. Making taxes more or less visible. A common argument supporting a national sales tax is that it would make more visible the cost of government. Perhaps, but the ultimate measure of the size of government is its spending. Once the dollars have been committed, the taxpayer will pay one way or the other. Either taxes will be levied to match the spending, or there will be borrowing to cover the federal deficit. It may be important to raise the visibility of congressional decisions, but putting taxes on your register receipt does not display *spending*. Indeed, if a national sales tax did produce pressure to keep taxes low, it may do nothing to address the tsunami of future Medicare spending and lead to larger deficits.
3. Raising the national saving rate. A consumption tax *would* remove the tax bias in favor of current consumption, and many believe that this would raise the private saving rate. If so, then good. The main idea is to eliminate tax-based financial decisions and have households choose what is best for them on the basis of economic fundamentals. However, I suspect that the scope for dramatic change is somewhat limited — saving is concentrated in the upper part of the income distribution and many of these individuals have arranged their financial affairs to avoid income taxes on their investments. Instead, the most rapid improvement in the national saving rate will come from reducing government borrowing.
4. Eliminating the trade deficit. Some consumption taxes (notably the VAT) are border adjustable —

<sup>2</sup>It may be approaching your (great-) grandfather’s. The original income tax affected only a small fraction of U.S. households.

<sup>3</sup>An exception is the earned income tax credit, which is complex for those who are *not* paying taxes.

the tax is removed from exports and imposed on imports. This possibility has spawned tremendous confusion, with some advocates arguing that border adjustability will improve export-competitiveness and the balance of trade. In response, others have noted that *any* tax policy that affects all exports and imports identically will induce an equal and opposite movement in the dollar exchange rate that offsets the consumption tax.

Reality lies in between. Moving to a consumption tax *would* affect the cost structures of various industries — traded and nontraded alike. As these cost structures shift, the composition of manufacturing, services, exports, and imports would similarly shift. Put differently, a uniform consumption tax would not change the trade deficit, but it would affect everything that went into it — the tax would definitely matter. At the same time, a border adjustable consumption tax would not necessarily have uniform impacts. For example, some purchases of dollars are for capital transactions that a consumption tax would exempt.

### What the Case Is About

1. The philosophical foundation of the tax code. Public policies should mean something. The tax code exists for a single purpose: it exists to extract the funds necessary to cover the costs of (hopefully worthwhile) public programs. The powerful behavioral effects of taxation (more a tribute to the power of markets because all taxes do is change prices) have seduced politicians into thinking the tax code is an omnibus instrument for social good. It is not.

Since the purpose of the tax code is to raise revenue, it has as its core mission the objective of making people poorer. The central question is: who? In choosing between the traditional favorite tax — an income tax — and a consumption tax, it is essential that one be able to defend making consumers poorer as superior to making poorer those who earn incomes.

Of course, for those far-too-common Americans who spend their every penny there is no difference: consumption is by definition income minus net saving. If there is no saving, there is no difference. But there *could be*, even for those not currently saving.

Why choose consumption? Consumption is the spending that extracts resources from the economy. In contrast, saving is economic activity necessary to contribute to a growing economy. Recall the identity:  $Y = C + S$ . An income tax treats identically those high-income individuals who live frugally and plow their resources back into the economy and those that spend every night drinking champagne in a limousine while

hopping from club to club. Taxing consumption reduces the burden on the former, while focusing it on the latter.

2. Economic efficiency. A consumption tax would reduce the extent to which economic activity is dictated strictly by reducing taxes (an unproductive use of time and money). First, it broadens the tax base to include all consumption. To be fair, this would also be part of an income-based reform — the essential recipe in any tax reform is to broaden the tax base and lower tax rates. Specifically, the base would include the consumption of employer-provided health insurance (currently entirely untaxed) thereby correcting a major inefficiency that feeds health spending pressures. In addition, it would eliminate the current deduction for state and local taxes, thereby including consumption provided by sub-federal governments. Thus, it would improve the allocation of consumption spending across sectors.

A consumption tax would not distort household choices in saving — with a consumption tax you would either pay the tax now or save and pay it later. In contrast, under an income tax households pay at *both* times.<sup>4</sup>

A consumption tax would equalize the tax treatment of investments in physical capital, human capital, and intangible capital. At present, the firm purchases of the latter two types of investment are “expensed” (immediately deducted), while physical capital expenditures are depreciated. Moreover, by eliminating the deduction for mortgage interest, the allocation of physical capital would be improved as business investments would compete on a level playing field with the construction of housing.<sup>5</sup>

A desirable feature that is difficult to quantify is the impact on entrepreneurs. Entrepreneurial forces are widely acknowledged to be important to the success of the United States, but tax policy is rarely formulated with an eye to their incentives. For example, entrepreneurial ventures develop a scale and financial structure dictated by market conditions. In contrast, the tax code interferes with these incentives — extracting a double tax on equity in “C corporations,” subsidizing leverage, and thus distorting the choices of business form and financing. The flat business-level tax does not depend on financial structure — it is focused on “real” business transactions — and yields the same liability regardless of legal organization.

<sup>4</sup>Of course, the distortion in labor supply remains and will contribute to the overall efficiency cost.

<sup>5</sup>Again, to be fair, an ideal income tax would also equalize the tax treatment of all types of capital investment. It is impossible, however, to imagine correctly depreciating all the forms of physical, human, and intangible capital.

3. Acknowledgment of reality. Our current income tax is an exercise in fantasy. An important part of its administration is the taxation of the return to capital. To be successful, this requires that capital income — interest, dividends, capital gains, rents, royalties — be comprehensively measured and adjusted for depreciation and inflation. There is no reason to believe that the U.S. is even moderately successful in this effort, or that the continuing maturation of global financial markets will make it anything but less successful in the future.

A consumption tax focuses the tax base on *real* economic activity — not financial transactions.<sup>6</sup> This is an important difference in a world in which global financial markets have made it virtually impossible to tax capital income, and an excessive regulatory and enforcement regime has grown up around attempts to do so. Instead, the consumption tax focuses on “taxing at the source” before business income enters into financial markets and ultimately is paid to investors.

Specifically, the X-tax (along with the VAT or flat tax) would impose a single-rate business-level tax on a base that consisted of total receipts minus the sum of purchases from other firms and employee compensation. Households invest in those firms in order to reap the benefits of higher business revenues, but those returns are taxed prior to distributions in the form of dividends or interest.

The final reality is that in 1986 the United States tried a tax reform based on comprehensive income and it did not work. In only a few short years, the tax reform unraveled and the code became littered with special provisions and differential taxation. There is nothing that suggests another round of trying to tax comprehensive income would be more successful.

4. Fairness. Consumption taxes may be designed to achieve conventional distributional goals. To begin, under the X-tax, households are taxed on the basis of comprehensive employee compensation. However, such a system would include a generous exemption for a basic standard of consumption and a progressive rate structure, thereby taxing at the highest rates headline-grabbing compensation packages.

One concern is that taxing compensation permits high-income individuals to “avoid” tax on their capital income. However, an appropriately-designed consumption tax includes the vast majority of such earnings in its base. In the X-tax, saving and investment is immediately tax-

deductible or expensed, but all principle and interest is taxed in the form of revenues at the entity level. Mechanically, this differs from an income tax only by the fact that under an income tax the saving and investment would be depreciated and not expensed. That is, the two approaches differ only by the timing of tax receipts to the U.S. Treasury — less up front for the consumption tax because of expensing, but more in later years because there is no ongoing stream of depreciation. Accordingly, the two tax bases differ only by the return to Treasury securities — the least risky and lowest rate of return. All additional returns — accruing from risk, monopoly power, luck, and other sources — are included in the tax base of both tax systems. Since these types of capital returns are responsible for the largest differences in incomes and consumption tax would capture these in the base, the distributional consequences of such a consumption tax would be in accord with U.S. tradition.

Finally, a consumption tax is neutral regarding the timing of consumption over the life cycle and does not impose a penalty on households that save their income. Two households with the same lifetime incomes will pay the same lifetime taxes.<sup>7</sup>

5. Wasted minds. At present, a troubling fraction of the finest minds graduating each year devote their talents to financial engineering that changes the timing or characterization of business transaction for tax purposes. What a waste. Let’s move to a tax based on real economic activity and channel these minds to a greater social purpose.

## Conclusion

It seems fairly obvious that the United States will benefit from fundamental tax reform, and I have made the case that a comprehensive and progressive consumption tax would be the preferable (albeit not perfect) path forward. Making that case was what the organizers asked that I do. I have been silent on the obvious political pitfalls — the desire to exclude particular forms of consumption like housing or health care, the political optics of relying on a business level tax instead of having capital owners sending checks to the U.S. Treasury, and so forth — in achieving this objective. These obstacles are real, but may be surmounted with sufficient education about the strong case for consumption tax reform.

<sup>7</sup>If they leave different bequests, the equality will depend upon the treatment of cross-generational transfers.

<sup>6</sup>The consumption tax is not a panacea, as a difficult issue is the taxation of financial institutions and financial services.

## Can Congress Use Budget Rules To Improve Tax Policy?

By Rudolph G. Penner

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Ovid said that “Gods have their own rules.” So does Congress — a vast multitude of rules. The history of the Budget and Impoundment Control Act of 1974 and the Budget Enforcement Act of 1990 is one in which rules have been promulgated; Congress has found loopholes in those rules; more rules have been designed to plug the loopholes; and then the process starts over again. The end result is a set of budget rules that is so complicated that no single human understands them all. I have heard budget committee staffs admit that they sometimes make mistakes in knowing what actions are permitted and what actions are not.

This is extremely important, because Congress is the true 500-pound gorilla that can do whatever it wants. It can follow the rules, or it can break them, if it finds them inconvenient. The only restraint is public opinion as shaped by the media. If the rules are so complex that no one understands them, it is impossible for the public and the media to know whether Congress is behaving responsibly or irresponsibly.

That is not to say that rules are totally useless. There are limited circumstances in which they can nudge Congress into behaving better than they would otherwise. The pay-as-you-go rule (PAYGO) established in 1990 was one that worked extremely well for a time. It required that all tax cuts or entitlements be paid for, both in the first year and over whatever time horizon was being used by Congress for its budget resolution. Another successful rule helped shape the Tax Reform Act of 1986. It required that the act be revenue neutral and that all amendments be revenue neutral while the act was being written.

What made these rules successful when so many others failed or have been easily circumvented? First, these rules were backed by a broad bipartisan consensus. Second, while they helped encourage responsible actions, neither rule imposed significant political pain.

To understand the success of PAYGO, it is vitally important to understand its history. It was preceded by the bipartisan budget agreement of 1990, which was the biggest deficit reduction package in history. Both political parties shed much blood in negotiating the package’s

large spending cuts and tax increases. The first attempt at a package failed to pass and negotiators had to try a second time. Having endured so much pain in getting the package, members of both parties were concerned that it would quickly erode. To protect the budget agreement, they invented PAYGO along with caps on discretionary appropriations and outlays.

But it is very important to note that the only purpose of PAYGO was to prevent Congress from increasing the deficit. *It did not force Congress to reduce the deficit.* Thus, it was relatively painless compared to the negotiated budget agreement that preceded it.

PAYGO continued to be successful in enforcing the budget agreement of 1993, which was almost as large as that of 1990. That is a bit harder to explain, because the 1993 agreement was not bipartisan. To pass, it had to rely entirely on Democratic votes. Although the agreement may not have been bipartisan, I would argue that the goal of deficit reduction still was.

PAYGO continued to work well until a budget surplus emerged by surprise in 1998. After that, it totally broke down, even though it did not legally expire until the end of fiscal 2002. The rule had little political support after the deficit problem seemed to disappear. But rather than repeal the rule, Congress circumvented it.

Some, mainly Democrats, would like to reinstitute a traditional PAYGO. I think that there is essentially no chance that it would work under current circumstances. A new PAYGO, based on current law, would force Congress to pay for any relief that it provides for the alternative minimum tax and for any extension of the Bush tax cuts. Thus, unlike the original PAYGO, it would require a major cut in the deficit through either a major tax increase above current levels or a significant cut in entitlements. That is too much pain to ask any rule to impose. PAYGO could impose some discipline if it were redefined to start with current tax burdens or based on a new bipartisan budget deal, but the latter is hard to imagine given the current poisonous atmosphere on Capitol Hill.

The whole panoply of rules associated with the congressional budget process needs a critical reexamination. Indeed, it may be time to admit that the budget process is broken beyond repair. It is hard to seriously discuss redesigning the rules for enforcing congressional budgets when Congress has not even passed a budget for fiscal 2007.

Anyone trying to reformulate the rules should be guided by one admonition. Keep it simple. Yes, simple rules will often be circumvented, but so are complicated rules. The main point is that everyone must be able to understand when the rules are broken. Then, there is some chance that Congress can be embarrassed into behaving better.