

TAX REFORM: PROSPECTS AND POSSIBILITIES

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C. Eugene Steuerle

C. Eugene Steuerle is Senior Fellow at the Urban Institute and codirector of the Tax Policy Center and columnist, Tax Notes Magazine. Any opinions expressed herein are solely the author's and should not be attributed to any of the organizations with which he is associated.

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Mr. Chairman and Members of the Committee:

Thank you for the opportunity to testify before the House Budget Committee—one of my favorite Congressional committees because of its continual efforts to examine issues in depth. Today the topic is tax reform, that ever-elusive elf that is beginning to tease us again with its potential charm. Because of my background as the original organizer and economic coordinator of the Treasury's tax reform effort that led to the Tax Reform Act of 1986, you have asked that I reflect on some of the lessons from that period and on what might make reform possible again.

As much as I believe in this elf and the possibilities it offers for improving economic and national well-being, I am also wary about thinking about it in mystical or magical terms. I have no doubt that we can create a better tax system that can improve equity, increase economic efficiency, and simplify our lives. Nonetheless, if I have any basic message, it is that systematic tax reform—if it is to achieve true economic gains—is hard work, very hard work, requiring substantial leadership and a well-thought out vision. Here are some further reflections on that theme:

Unlike simple tax cuts or expenditure increases, *systematic* reform creates identifiable losers. Systematic reform recognizes important societal trade-offs, and trade-offs mean that something must be given up to achieve something better. Simple increases in expenditures or reductions in tax only hide elsewhere—often in future changes--those who pay for the initial changes. *The only way to create no losers in tax and budget policy is to maintain current law.* It is a fundamental law of budget economics and accounting that almost any budget change has an impact on the other side of the ledger. Systematic reform usually makes those losers more identifiable up front.

- Example. My Urban Institute colleague, Adam Carasso, and I have suggested combining the child credit and the Earned Income Tax Credit, which are needlessly separated. However, they have different maximum ages for eligibility. Taking an average maximum age would reduce the availability of the EITC for some college kids, thereby creating some losers. Alternatively, extending upward the child credit to the maximum age of the EITC makes the costs skyrocket, and these must be covered somehow, perhaps by reducing subsidies in some other part of the reform package.
- Example: There are many interactions among the three higher education incentives in the tax laws, as well as with Pell grants and other direct expenditures. Simplifying the law by combining them into one program or even two is likely to simplify taxes, as well as lead to a more efficient

and productive use of educational incentives. But it is also likely to lead to some losers if no more revenue is made available since the combined program is likely to more rationally relate assistance to need (see Figure 1).

- Example: Saving incentives, if they are to work, must treat consistently both sides of the ledger: negative, as well as positive saving; interest payments as well as interest receipts. There are dozens of incentives today for making deposits that can be financed by borrowing, thus allowing taxpayers to arbitrage the tax system—to save taxes as if they had saved on net when they have not.

Reforming the tax system requires attention to an extraordinary range of policy issues. Being for tax reform is like being for expenditure reform, a level of generality that lacks enough specifics to give it any real meaning. There are literally hundreds of policies in play. When I set up the organization of the Treasury's 1984 tax reform study, I divided issues into roughly twenty different modules, each of which had to be examined by a team. Reforming taxes requires deciding upon policies for housing, pensions, healthcare (especially for the non-elderly), wage subsidies, charitable giving, fiscal federalism among national, state and local governments, and education, as well as tax policies for international transactions, depreciation, research and development, empowerment and enterprise zones, and local school construction—to mention only a few. One can't dodge these issues. Even when reform attempts to be more narrowly constructed so as to deal with only some of them, many stragglers force their way onto the agenda because they interact with the ones that are targeted.

- Example: The conversion of an income tax to a consumption tax must deal with the incentives for separately putting aside money for pensions and what retirement policy Congress wants to put into place.
- Example: Many programs, including tax subsidies and direct expenditures, use income accounting to determine eligibility for benefits. Therefore, elimination of income accounting for the direct income tax would not remove the requirements for income reporting and correct bookkeeping for many other purposes.
- Example: Congress has put in place a law that will soon provide an increase in tax subsidies of more than \$25 billion annually for the employee exclusion for employer-provided health care. Existing subsidies are sufficient to encourage insurance purchase; the additional subsidies (from the uncapped preference) encourage the purchase of higher cost insurance. The encouragement to purchase high cost insurance leads to higher costs, which, in turn, discourages some employees and employers from offering or buying insurance. The net result of these additional subsidies, therefore, is to *increase* the number of uninsured.

High tax rates distort behavior, but they are hidden in many tax subsidies, alternative taxes, and direct expenditure programs. A few decades ago one could approximate the marginal tax rate for earning an additional dollar simply by looking at the statutory income tax rate structure. No longer. Economists now must look to the ways that alternative tax and subsidy schemes create their own implicit tax systems. Often these additional tax rates derive from the way that benefits are phased out as one's income rises.

- Example: The earned income tax credit phases out as income grows. So do many other tax subsidies, such as those for higher education. So do most transfer programs, such as food stamps. The total marginal tax rate (combining explicit and implicit taxes) for many households today, it often rises above 50 percent and frequently reaches 100 percent (see Figure 2).
- Example: Partly because of the very high tax rate on additional earnings from many tax subsidies and direct expenditure programs, most couples today face significant marriage penalties—often 10 to 20 percent, sometimes even 50 percent, of their combined income. Thus, a person making \$10,000 a year could, by marrying someone making \$30,000, potentially lose earned income tax credits, higher education subsidies, food stamps, housing vouchers, Medicaid, and child care allowances.

Systematic reform requires a truce from the fights over progressivity and higher statutory tax rates. Let me be clear: both progressivity and low tax rates or lean government are both worthy economic principles, even if emphasized differently on the two sides of the Congressional aisle. All families require more from their more affluent and able members, and high tax rates do distort behavior. Reform is very difficult to achieve when some advocates will fall on their swords over progressivity, and others do likewise over statutory tax rates. I am trying to make an economic, not political point: when one consideration alone is allowed to trump all others, and issues like simplicity or equal justice (equal treatment of equals) always get shoved to the side, there is a higher-than-necessary cost of taxation to the economy as a whole.

- Example: The alternative minimum tax (AMT) raises marginal and average tax rates, but few are willing to fold it into the regular rate schedule.
- Example: During the initial stages of 1984-86 tax reform process, progressivity was not an issue when deciding whether to remove, amend, or keep any particular item of tax preference. A bad preference didn't have to be kept because it was progressive, and a good preference didn't have to be removed because it was regressive. At the end of the process of

choosing the tax base, Treasury would determine overall proposed progressivity of the tax system (in that case, approximating current law) by adjusting the statutory rate schedule.

The Possibilities for Tax Reform: Some Lessons from History

While it is true that reform is hard work, and equally true that opportunity is important, it is mistaken to believe that many instances of failure were due solely to the absence of opportunity. Instead, the process itself was often ill-conceived and poorly carried out. Still, while history warns us that attempts at *systematic* reform often failed, there are notable exceptions. For modern examples of systematic reform, tax bills enacted in 1954, 1969, and 1986 stand out. (Interestingly, if we follow that trend for significant reform about every 15 to 17 years, then we are about due right now.) The difficulties of reform I noted above should not deter us. Right before the Tax Reform Act of 1986, attempts at major reform had failed so many times that some writers were beginning to call it the impossible dream.

All three cases of significant tax reform involved both a felt need to act and bipartisan cooperation and bipartisan agreement on the need to move forward and to work together. The 1954 reform centered around codifying and simplifying the much more complex system that had grown up in World War II and its aftermath. Wilbur Mills, as chair of Ways and Means, exercised substantial leadership, Congressional support was quite bipartisan, and President Dwight Eisenhower approved the legislation. The 1969 reform, interestingly enough, began to be developed in 1968 under President Johnson and arose partly because of Treasury reports on abuses by foundations and on ways that wealthy taxpayers avoided paying any tax. Hardly a beat was missed when Treasury moved to Republican hands in the Nixon Administration; the work continued, eventually leading to the Tax Reform Act of 1969. In the efforts leading to the Tax Reform Act of 1986, a Treasury study galvanized support by at least some conservatives and some liberals, in no small part because of the growing use of the tax shelters of the day and because the poor increasingly were being made subject to income taxation. President Reagan and Dan Rostenkowski, chair of the Ways and Means Committee, reached an agreement not to criticize each other as the Democratic House took up what had now become the Republican President's proposal.

I cannot speak to what will lead to bipartisan cooperation today. I will state that one trend over the last couple of decades is disturbing: the dearth of useful published studies from the Executive Branch—in particular, the Treasury Department and the Office of Management and Budget—about problems that need to be addressed. But they are still good departments, so the potential is there. However, I do believe that there is current opportunity—an opportunity, if one wants, that derives, as in the past, from growing problems that need to be addressed. In this case, the complexity of the system has become even more overwhelming, and few, if any, understand what the tax system means or how it works. The scheduled movement of tens of millions of taxpayers onto the Alternative Minimum Tax is more of a political than economic problem, but the need

to address it provides a catalyst for broader reform. Alternatively, the requirement to get the deficit under control also presents an opportunity to return toward base broadening (which in most cases is equivalent to a reduction in spending), as was done under President Reagan.

One Way of Viewing Tax Reform Issues

At the risk of oversimplification, tax reform issues can roughly be compartmentalized into those affecting three groups: moderate-, middle-, and higher-income taxpayers. Although there is much overlap, the issues affecting each group are often very different.

For moderate-income taxpayers, the most important tax rates derive from the phase-outs of benefit programs, including the EITC, and from the Social Security tax (which, for almost everyone for some time to come, is more than offset by the insurance value of Social Security and Medicare benefits). My work with Adam Carasso shows that many moderate- and middle-income taxpayers face combined tax rates from the phase out of EITC, Food Stamps, Medicaid and so forth of 100 percent or more for much of their earnings. Many also face enormous marriage penalties.

Some of these issues relate to provisions in the tax Code, such as the EITC and educational subsidies; some to other programs. To the extent that high tax rates distort economic behavior, it is now to the moderate-income taxpayer that we should devote our attention. Meanwhile, filing for the EITC has itself become complex, and most low-income taxpayers face more complex tax returns than many at higher income levels.

For middle-income taxpayers, combined tax rates continue to be high because of the phase-out of benefits, in this case stretching into such issues as the phase-out of educational benefits for post-secondary education programs. The middle-class gathers many benefits from dozens of exclusions, deductions, and credits in the tax system. Sometimes reformers look first to itemized deductions, but there are many other sources of preference. The number of saving incentives and retirement plan options not only adds complexity to that system; the cost of all the intermediaries—accountants, financial advisors, human resource personnel, insurance salespeople, lawyers—figuring out the tax law reduces the net return available from that saving.

For higher-income taxpayers, the issues often surround the taxation of capital income. In truth, the tax system at that income level has evolved in fitful stages, with any way to tax the rich often advocated on one side and any way to reduce their taxes advocated on the other. Much consolidation and integration could be considered, regardless of whether effective marginal tax rates are increased or reduced. An extremely important issue at higher income levels and for business is whether, for a given level of revenue collection, the tax system should favor existing wealth or new wealth. Under the Reagan tax reform, Treasury argued that lower rates were preferable to tax breaks because the latter tended to favor existing business over new business (which often couldn't generate enough taxable income to make use of special tax breaks). The

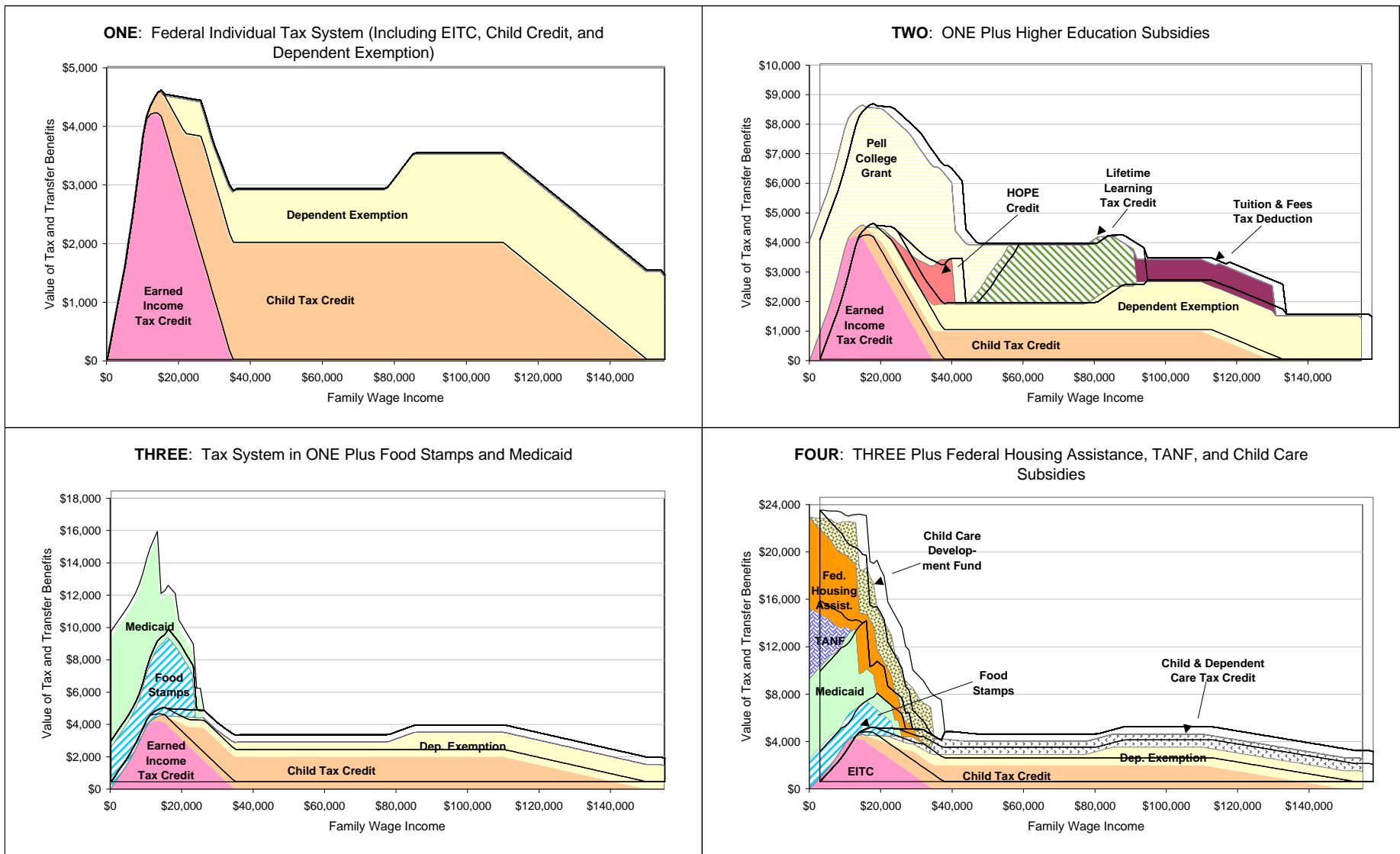
alternative minimum tax started out also as a high-income tax issue but has evolved quickly downward to the middle class.

This tri-level view of the system is quite simplified and leaves to the side many issues. My main purpose in presenting it is to recognize that fixing one part often tells us very little about what to do with the other parts. One might fix up the EITC and tax rates facing low-income taxpayers without doing much about all the deductions and exclusions affecting the middle class; likewise, one might tackle those middle-class issues without considering how capital and business income is taxed, especially among those at higher incomes.

Summary

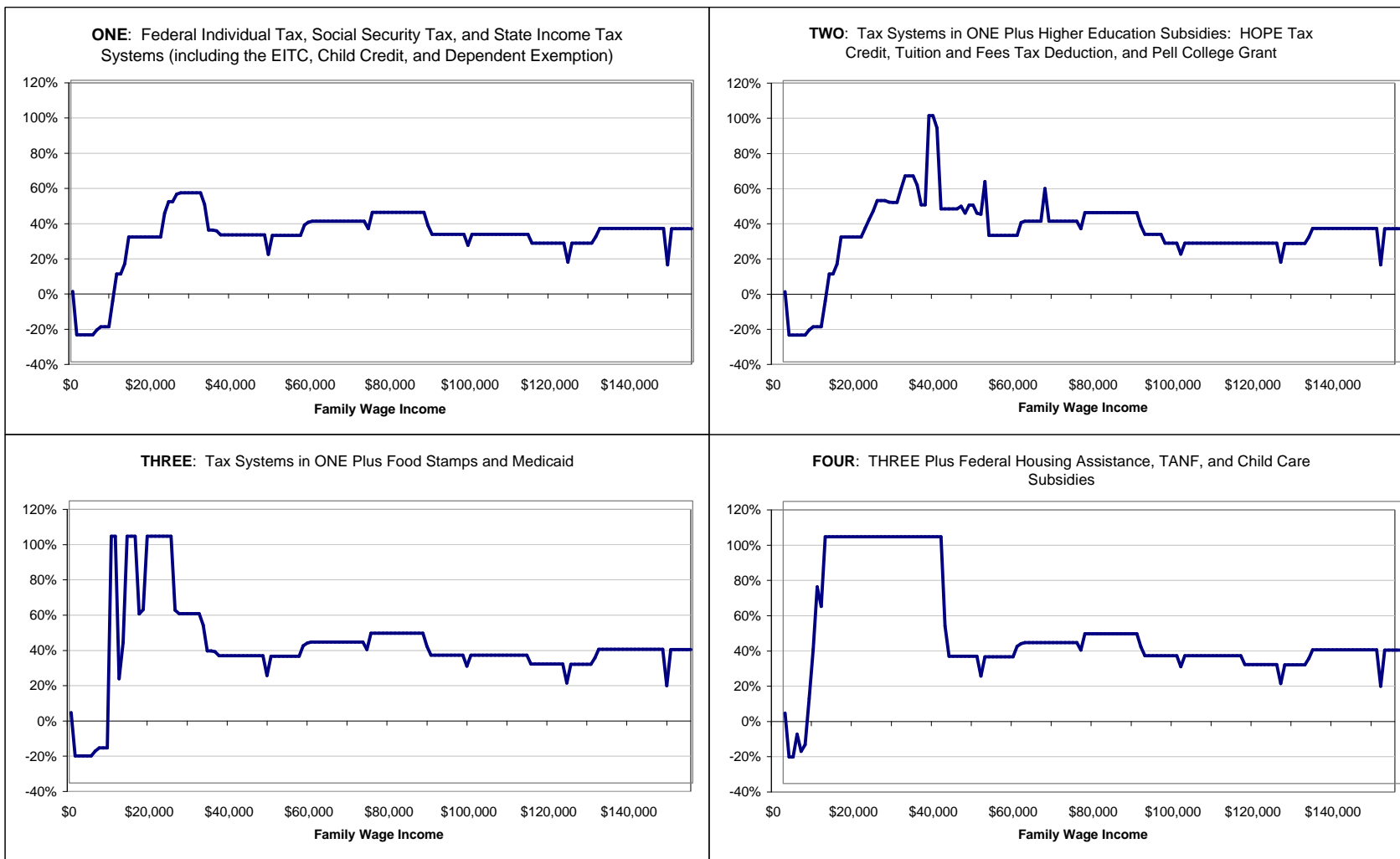
In summary, the gains in efficiency, equity, and simplicity from systematic tax reform could be substantial. However, to achieve those gains requires attention to many details. Tax reform efforts have failed often, but they have also succeeded, especially when rising problems created the opportunity and demand for reform, and tough issues were tackled in a spirit of bipartisan cooperation.

FIGURE 1: Select Tax and Transfer Benefits for a Married Couple with Two Children in Tax Year 2003



Source: Adam Carasso and C. Eugene Steuerle, The Urban Institute, 2004. Notes: Child ages are assumed to be 4 and 13, except in graph TWO where child ages are 12 and 18. Tax calculations include the alternative minimum tax and assumptions on itemized deductions. Welfare programs apply rules for Pennsylvania, which is the median TANF benefit state. We assume \$6,000 maximum annual child care costs and \$10,000 annual tuition costs.

FIGURE 2: Effective Marginal Tax Rates from Select Tax and Transfer Programs in Tax Year 2003 for a Married Couple with Two Children



Source: Adam Carasso and C. Eugene Steuerle, The Urban Institute, 2004. Notes: Child ages are assumed to be 4 and 13, except in graph TWO where child ages are 12 and 18. Tax calculations include the alternative minimum tax and assumptions on itemized deductions. Welfare programs apply rules for Pennsylvania, which is the median TANF benefit state. We assume \$6,000 maximum annual child care costs and \$10,000 annual tuition costs.



TEN GUIDELINES FOR SYSTEMATIC REFORM

By C. Eugene Steuerle

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

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

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

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

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

I. The Guidelines: A Summary

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

(1) Listen

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

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

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

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

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

(2) Know the Forces at Play

The true catalysts for reform are those economic or other forces that cannot be ignored. In the mid-1980s, the rapid growth of the leveraged tax shelter was one major force. Today, anyone trying to deal with tax reform must tackle the alternative

minimum tax (AMT), which is rapidly becoming the hard-to-ignore 10,000-pound gorilla at the tax reform party.

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

(3) Have an Overall Vision

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

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

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

(4) Start With Principles

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

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

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

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

(5) Balance Principles

A reform may emphasize one or many principles. Usually, the principles that get attention are those that elected officials think have been most thoroughly violated. The distortions caused by 90 percent tax rates bothered President Reagan all his political life. The inefficiencies and inequities caused by the proliferation of tax shelters in the late 1970s to mid-1980s helped drive reform in 1986. A current reform

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might place more emphasis on simplification given the increase in complexity and paperwork over the past 15 years or so. Certainly, the very large growth scheduled in the AMT will force simplification to get at least some attention this time around. In general, concern over the economy can often lead to reforms that would make the tax system more efficient.

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

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

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

(6) Seek Some Bipartisan Consensus

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

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

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

(7) Plan Your Snapshots

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

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

(8) Acknowledge That Reform Involves Losers

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

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

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

(9) Work Bottom Up and Top Down

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

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

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

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

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

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

II. Conclusion

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