The Tax Reform Act of 2010

By Leonard E. Burman

Leonard E. Burman is director of the Tax Policy Center and a senior fellow at the Urban Institute. Views expressed are those of the author and should not be attributed to the Urban Institute, its trustees, or its funders.

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.