Trump’s Tax Reform Dilemma

By Eugene Steuerle *Thu, May 11, 2017*

Tax reform will require more than the mere elimination of waste, fraud and abuse in government, warns our guest columnist, a former Treasury official. Popular subsidies, like the tax deferral for retirement savings, will be scrutinized.

Q: Since the modern federal income tax was created in 1913, how often has Congress enacted a revenue-neutral income tax reform that significantly expanded the tax base and lowered rates?

A: Once. In 1986.

It is no wonder that the Trump administration—like others before it—is struggling with broad and systemic tax reform. To better understand why, think of tax legislation in three distinct flavors: Tax cuts, tax increases, and revenue-neutral changes.

Most income tax bills cut taxes. The reason is obvious. Elected officials like to give something to voters rather than take something away from them.

Since the large tax increases that financed World War II, most revenue bills reduced taxes, particularly in the period up through 1981. Significant reductions in defense spending as a share of the economy, along with inflationary increases in incomes that pushed people to pay higher individual income tax rates, made legislated tax cuts possible during what I call the “Era of Easy Finance.”

In a few cases, Congress did raise income taxes. Tax historians Joseph Thorndike and Elliott Brownlee have shown that almost all major income tax increases came about as a result of war. Others, generally raising annual revenues by well less than 1% of GDP, have been enacted, for instance, as part of several deficit reduction agreements between 1982 and 1997.

Broad-based and systemic income tax reform that keeps revenues roughly the same as current law requires a tremendous amount of work, largely because it means broadening the tax base by identifying which popular tax subsidies, now costing more than $1 trillion annually, should be targeted for elimination.

Less broad-based but still systemic reforms are also possible. Outstanding modern examples are the codification effort of 1954 and the 1969 reform best known for addressing tax issues surrounding foundations and charities.

As economic coordinator of the Treasury’s 1984 study that led to the Tax Reform Act of 1986, I remember how difficult it was for Treasury and Joint Committee on Taxation staffs to draft legislation and to estimate cost and distributional effects for those proposals.

Increasing taxes on some to pay for tax cuts for others requires tax writers to agree on principles to guide and justify their actions. The political aspects of tax reform—building a political coalition to push to see these principles enacted—are even more difficult than the technical concerns.

Tax reform of the revenue-neutral variety is much harder than merely cutting taxes. To cut taxes, lawmakers simply tally a set of wants, perhaps pare them down to fit within a specified amount, and leave the financing bill for current tax cuts to future generations of unidentified taxpayers.

Finally, the design of any systemic reform must acknowledge the economic and political environment of its time. The 1986 Act, for instance, took advantage of bipartisan concerns over tax shelters, President Reagan’s focus on high tax rates, Democrats’ objections to the rising income taxation of the poor, and social conservatives’ efforts to reverse the rising burden being placed on families with children.

Deficits were perceived to be a problem, though a smaller one than today in part because Congress had raised taxes and cut spending in the 1982 and 1984 budget agreements and in the Social Security Act of 1983.

President Trump and his team have promised to cut tax rates for all businesses and for the middle class, while not increasing the deficit. They can’t get there by taxing the poor. Even if they assume greater economic growth, it’s not going to be enough to pay for the historically large tax cut provisions. So what’s left?

Some seem to want simply to throw in the towel on revenue neutral tax reform and just cut taxes instead. But $1.3 trillion in additional spending is already built in for 2026 (largely due to rising interest costs and increased spending on Social Security, Medicare, and Medicaid). This is far more than the $850 billion in additional taxes projected to be collected for that year due to a growing economy. How will Congress and the president cover that existing shortfall, even before they think of more tax cuts?

That’s the box the Administration is in. And it is why tax reform is no easier than health care reform. Avoiding big new revenue losses requires systemic reform, such as increasing taxes on individuals to offset business tax cuts or engaging in true budget reform that scales back popular programs. Those are the requirements of our time, like them or not. While they might briefly be ignored politically, over the longer run they can’t be dodged as a matter of either economics or arithmetic.