tax notes℠

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IS THERE PROGRESS IN TAX POLICY?

By Sheldon D. Pollack

Sheldon D. Pollack, Ph.D., J.D., is Associate Professor at the University of Delaware. He is the author of *Refinancing America: Republican Antitax Policy,* to be published in January 2003 by the State University of New York Press. In this article, Pollack reflects on the progress, if any, that has been achieved in federal tax policy over the last 30 years. He also considers past failures, as well as the future of federal tax policy.

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The 30th anniversary of *Tax Notes* is a fine occasion to celebrate the success and longevity of this esteemed publication, and at the same time, pause to contemplate the recent history, as well as the future of the American tax system — which often seems as if it has neither history nor future, only endless cycles of legislation, regulation, and litigation. *Tax Notes*, on the other hand, has a proud history and, we hope, a secure future. Aside from the excellent job that it does reporting on tax issues, *Tax Notes* serves as a forum for professionals and academics who would join the debate over federal tax policy in an effort to shape its course. Of course, few of us have had any such impact, although the editors and staff of *Tax Notes* most definitely have. Because of this, for those of us interested in American taxation and tax policy, it is hard to imagine a world without *Tax Notes* — the arrival of which every week brings with it keen insights into the workings of the tax code, as well as the most recent congressional proposals to abuse it. And where would we be without our weekly dose of Lee Sheppard skewering the New York tax bar or some Wall Street Investment bankers peddling a new and even more abusive tax shelter? Perish the thought.

Given the contribution of *Tax Notes* over the last 30 years in promoting a better understanding of the U.S. tax system, it seems appropriate to ask whether we have seen any commensurate improvements in federal tax policy over the same period. Certainly, there has been a whole lot of legislating since the founding of *Tax Notes.* But legislating is not synonymous with policymaking — which involves action guided by principle, rather than political trade-offs and bipartisan log-rolling. Based on our experience over the last three decades, we know that it is possible to enact massive omnibus tax legislation with barely a discernable trace of coherent policy or principle. One wonders whether it even makes sense to ask questions about "progress" in tax policy.

Most of the time, tax policymaking looks like all process and politics, with little purpose, let alone progress. Despite this, I would venture to say that over the last 30 years there have been some genuine advances in tax policy, even if these have been overshadowed by the more glaring and numerous failures. Like most cynical academics, I tend to harp upon the failures. It would be a mistake, however, to over look what we have learned to do right. Understanding what we have done right in the past can give us valuable insights for policymaking in the future. In this spirit, I shall take note of some of our most notable successes, and at the same time, remind us of the conspicuous deficiencies in our tax system, all in an effort to get a better sense of where we are and where we are headed.

That great philosopher Yogi Berra once remarked, "You have to be careful when you don't know where you're going because you might not get there." Yogi probably was referring to baseball, or perhaps finding a good pizza in Northern New Jersey, but much the same goes for tax policy. With tax policy, it seems as if we don't know where we're going and are moving full speed ahead to get there. There is a distinct disjuncture between what we say we want to do and what we are actually doing. For instance, everyone agrees that the tax system is much too complicated and that we should work for "simplification." Yet every day, everything we do (practitioners, academics, and government officials alike) makes the tax system more complex. Either we do not really know what we want, or else we are just fooling ourselves.

In assessing whether we have made any progress, we first need to understand what it is that we wish to achieve through our tax system — in other words, where we *really* want to go. Remarkably, after nearly 90 years living under the federal income tax (not counting the brief experiment with federal income taxation during the Civil War), and almost as much time spent with the federal estate tax, there is little consensus as to what we want from our tax system. Of course, that is the heart of the problem: Democrats, Republicans, and just about everyone else want different things from our tax system.

Ultimately, there can be no progress in U.S. tax policy, if by that we mean an inexorable movement toward perfection. We need to set our sights on more modest

goals. Experience and prudence suggest that the best we can achieve is basic competence in raising revenue and minor improvements in response to changing circumstances. Certainly, we never will achieve perfection, or anything close. It is self-delusional to believe that there is some ideal tax system out there waiting for us to adopt, if only we can overcome the politicians and ubiquitous "special interests" that stand in way. True, economists and tax law professors can design a tax system more perfect than our own — heaven knows, the law reviews and academic journals are full of intricate proposals offering the blueprints. Personally, I doubt that it is possible (or desirable) to cast aside a century of experience and deep-rooted practice under our present tax system in favor of *any* other system. I myself pray for modest improvements in what we have.

Those who recommend that we scrap the current tax system in favor of some alternate scheme (be it a "flat tax," value added tax, national sales tax, or cash-flow consumption tax) should remember that policymakers do not have the luxury of writing on a blank slate, as do academics and ideologues. Policymakers face choices limited by our peculiar political history and constrained by the political institutions and offices within which they are located. At the same time, the accumulated weight of decades of past decisions limits the possibilities for today's decisionmakers. For better or worse, we adopted an income tax in 1913, and government dependent on its revenue (to say nothing of the countless economic groups with a vested interest in the current regime), Congress cannot simply vote to discard it. Nor is Congress free to abandon or radically alter our most popular and deeply rooted public policy program — Social Security. Similarly, past decades of deficit spending constrains the ability of today's policymakers to adopt new policies (things like adding prescription drug coverage under Medicare or repealing the Alternative Minimum Tax), just as the decision made 18 months ago by Republicans to enact a $1.25 trillion tax cut severely constrains options today.

The best we can hope for is something quite short of perfection — incremental tinkering that marginally improves what we have. And we should not discount the possibility that we will occasionally make things worse even while trying to make things better. Invariably, where there is *any* progress in tax policy, it is hard won.

What follows is a highly selective and cursory account of some of the modest improvements in federal tax policy achieved during the last 30 years. Of course, I would be remiss if I failed to remind of the grave problems that confront our tax system. Scattered throughout, the reader will find some tentative observations as to what trials and tribulations may lie ahead.

Thirty Years of Tax Policy

There are many benefits of a political system such as our own wherein tax policy is made by elected representatives, rather than experts and civil servants. Such tax policy is more likely to be responsive to public opinion and the electorate than policy made by bureaucrats. That usually is a good thing — but not always. There are drawbacks to a policymaking process that is overly sensitive and responsive to the electorate, as well as the electoral concerns of policymakers. Elections force policymakers to pay inordinate attention to their constituents (i.e., local and private interests), and accordingly, adopt policies aimed at local parochial interests, rather than broad national (public) interests. Consequentially, tax policymakers display a proclivity to use the tax laws to *distribute* federal revenue for political purposes, rather than as a neutral tool for raising revenue.

That politicians use the tax code for political purposes should come as no surprise. Still, the intense degree of partisanship in recent decades has been surprising, and the tax code has been the worse for it. A highly politicized tax policymaking process has become the norm. Over the course of the last 30 years, Democrats have enacted countless tax preferences benefiting their constituents (Big Labor and the education establishment, to name a few) and implementing their favored public policies (e.g., underwriting the cost of health care, education, alternative sources of

energy, etc.). Republicans have shown just as little restraint in rewarding constituents and the party faithful when they have controlled the reins of the tax policymaking process. On such occasions, significant amounts of federal revenue invariably have been sacrificed in favor of lower marginal tax rates for the wealthy and tax preferences for business.

These political instincts are deeply ingrained and hard to resist. In May 2001, Bush and congressional Republicans campaigned to "give back" to American taxpayers the projected 10-year surplus (once estimated by the CBO to be as high as $5.6 trillion) in the form of a tax cut. They succeeded in enacting a $1.25 trillion tax-reduction package, and soon after, a $60 billion economic stimulus. Today, with the projected surplus nearly vanished and budget deficits predicted for the immediate future, the Bush administration appears intent on initiating yet another round of tax-reduction legislation, including new preferences for capital gains and dividends. Republicans would also love to find a way to make the 2001 tax cut permanent — a very expensive proposition, indeed. To be fair, if Democrats had controlled the Congress and White House during the past two years, they too would have depleted the projected surpluses — no doubt in a new round of public spending on social welfare programs. The Republicans just beat them to the cookie jar by virtue of winning a few more elections in 2000.

Because of this entrenched political use of the tax code, the number of preferences written into the tax code has grown steadily over the last 30 years, regardless of which party controlled Congress or the White House. Similarly, the volume of tax expenditure "spending" has increased notwithstanding the efforts of reformers (most notably in 1986) to strip the tax code of the accumulated weight of decades of partisan abuse. In their seminal analysis, Stanley S. Surrey and Paul McDaniel calculated that government spending through tax expenditures had increased by 179 percent from fiscal year 1974 to fiscal year 1981.[1] Since then, the trend has continued unabated.

Is there any way to halt the growth of tax expenditures? Probably not. Tax reform in 1986 was a noble effort, but that legislation was the product of an unlikely and possibly one-time coalition between supply-side Republicans in the White House seeking lower marginal tax rates and liberal Democrats in Congress looking to strip pro-business tax expenditures from the tax code. Tax experts in the Treasury Department pushed their own historic tax reform agenda, which for a brief moment coincided with that of the politicians. Don't expect these planets to align again any time soon. On the other hand, several developments in the last 30 years have helped inject a measure of self-control into the budget process and tax policymaking. As meager as these improvements are, they offer our best hope for the future.

First, we now have a systematic method for keeping track of congressional abuses of the tax code. Thanks to efforts that began during Stanley Surrey's term as assistant secretary of the treasury for tax policy during the Kennedy administration, we now have a reasonably sophisticated system for tracking tax expenditures. Since 1968, the figures have been published by the Treasury Department right there in the federal budget for everyone to see. The original idea was to make policymakers aware of the hidden cost of enacting so many policies through the tax code, perhaps rendering them hesitant to add to the list. Sadly, self-awareness proved inadequate to the task. But if keeping track is not enough to halt the flow, publishing the annual tax expenditure budget (which *Tax Notes* reprints every spring as a public service) has contributed to improving the policymaking process.

Likewise, economic analysis has been fully integrated into the policymaking process, enhancing our ability to figure out where we are headed and how to get there. This may sound obvious, but before Congress enacts a new tax provision, it is nice to have some idea how the proposal will affect the economy, how much revenue it will raise (or lose), and how it might affect the rest of the budget. We take this for granted today, but it is a recent innovation. In the last three decades, economic forecasting has bolstered our ability to budget and tinker with the tax

code — for better or worse. Economists also have made great contributions to the public debate over tax policy. Once there was only Edwin Seligman and Henry Simons. Then came Joseph Pechman. Now there are dozens of talented professional economists standing in the wings, evaluating tax policy, writing in *Tax Notes*, and whispering in the ears of congressional policymakers. (Several of the best have contributed thoughtful and informative essays to this volume.) Whether the politicians are listening is another matter.

Some 50 professional economists in the Office of Tax Analysis, along with numerous economists serving on the staffs of the tax committees, the Joint Committee on Taxation, and the Congressional Research Service, provide an invaluable service in grounding the tax policymaking process in economic reality. Likewise, contributions from economists in academia and the venerable Washington think-tanks (the Brookings Institution, the Urban Institute, and the American Enterprise Institute) provide a wealth of insights into the workings of the tax system. Unfortunately, there are limits even to what practitioners of the dismal science can do. Economic analysis cannot cure all the deficiencies of the policymaking process because the problem is not always having the right numbers. Indeed, there are times when policymakers distinctly should *not* listen!

The danger is that policymakers will be overwhelmed by the data, or what is even worse, submit blindly and uncritically to the number crunchers. There is nothing more hazardous to the public health than policymakers who actually believe in their ability to fine-tune the economy and tax code. At its worst, policymaking becomes a game in which the advice of one group of economists is played off against that of another. Republicans have their economists and Democrats theirs. This is a pale substitute for genuine political debate.

In recent years, policymaking has been much too driven by the revenue estimates of the Congressional Budget Office (CBO) and Office of Management and Budget (OMB) — first with respect to deficits, and then projected surpluses. Policymaking requires more than just reacting to the economic forecasters. It takes good judgment, common sense, and the ability to evaluate the alternatives and see through the numbers. In other words, tax policy is an art, not a science. Obviously, it is vital to have an idea of how much revenue will be available and what a particular proposal may cost, but that alone is never enough. Economic analysis has improved budgeting and tax policy by giving policymakers a better sense of what they are doing and where we are headed, but we still must rely on the skills of our decisionmakers. We also need good rules and procedures for budgeting and making tax policy.

In the last 30 years, Congress has devised several institutional reforms that have been instrumental in improving the way Congress budgets and makes tax policy. First, Congress reorganized the budget process under the Congressional Budget and Impoundment Control Act of 1974. The new budgetary process directly involved Congress in what was once the exclusive domain of the executive — putting together the annual budget for the federal government. The legislation requires that Congress adopt a budget resolution establishing total spending authorizations, as well as the 13 individual functional allocations of appropriations that comprise the budget. In the annual budget resolution, Congress must approve total spending and revenue. The thought was that this would give Congress greater control over the end result, rather than just collating the separate and uncoordinated authorizations from the individual appropriations committees. The legislation also created CBO, which provides legislators with independent non-partisan economic forecasts and budget evaluation as a counterweight to OMB — the executive's budget agency.

Overall, the legislation achieved the desired goal of bringing Congress into the budget process and creating a new framework for congressional oversight. Nevertheless, these reforms produced little improvement with respect to the desired end result — controlling the budget. The system has never worked in a smooth or timely fashion, and it certainly has not been very successful in containing the significant deficits that started in the late 1970s and soared during the 1980s. Congress tried

even more dramatic measures to reverse the growth of budget deficits when it enacted the Balanced Budget and Emergency Deficit Control Act of 1985, commonly referred to as Gramm-Rudman-Hollings. This legislation provided for gradual reductions in the deficit from fiscal year 1986 through 1990 and required a balanced budget by 1990. It proved impossible, however, for Congress to reach balance by the target dates, so the targets were pushed back and then abandoned altogether. The right institutional mechanism for imposing discipline on the budget process remained elusive.

Congress tried again in 1990, and this time met with better results. A number of improvements were implemented under the Budget Enforcement Act of 1990, including spending caps on discretionary spending. True, these proved easy to evade. Nevertheless, the caps imposed *some* restraint on Congress. A more significant reform adopted in 1990 was the so-called PAYGO (pay-as-you-go) budget rule. PAYGO imposed "revenue neutral" budgeting on Congress and significantly altered long-standing patterns of tax policymaking. Under PAYGO, any tax reduction must be offset by a comparable revenue increase, reduction in a current tax expenditure, or cut to "direct" discretionary spending programs; annual net revenue losses from all new legislation must be offset by revenue enhancement or direct spending cuts. This requirement for revenue neutrality (which had guided negotiations over the 1986 tax reform act) created a new "zero-sum" environment for tax policymaking. Under the new system, the various interests competing for new tax subsidies were played off against each other. This forced a new discipline on Congress, imposing limits on enacting new tax expenditures while creating incentives to eliminate existing ones. The substantive policy goals furthered by PAYGO were deficit reduction and responsible budgeting.

The combination of PAYGO, spending caps, and the Senate's so-called Byrd rule,[2] has been relatively effective in blocking of new tax expenditures and pork-barrel spending. These budget rules also thwart those who would enact major new tax-reduction legislation. To avoid these restrictive rules, a number of leading Republicans campaigned in the 1990s to repeal the offending provisions. Former House Budget Committee Chairman John Kasich proposed repealing PAYGO outright so Congress could enact deeper tax cuts. A more moderate position was expressed by Bill Roth, former chairman of the Senate Finance Committee, and Pete Domenici (R-N.M.), then chairman of the Senate Budget Committee, both of whom expressed interest in relaxing the budgetary rules to allow for tax cuts funded by surpluses.

Republicans never succeeded in repealing or modifying PAYGO. But as the 1990 legislation was originally drafted, PAYGO was set to expire with the close of fiscal year 2002 — and expire it did, despite efforts to the contrary this summer by Senate Budget Committee Chairman Kent Conrad (D-N.D.) and Domenici, now ranking minority member. Conrad and Domenici met unexpectedly strong opposition from retiring Senator Phil Gramm of Texas. On the other side, Federal Reserve Board Chairman Alan Greenspan lent his support for to effort, testifying that it would be a "grave mistake" to abandon the budget rules at this time. A last-minute proposal (H.R. 5502) introduced by Rep. John Spratt (D-S.C.) of the House Budget Committee would have re-enacted PAYGO and the budget caps, but the House adjourned for the November 2002 elections before taking action. Luckily, the Senate acted on its own on October 16, approving a procedural resolution extending the supermajority rules in the Senate for six months. Thus, some time before April 15, 2003, Congress must revisit the entire issue or the budget rules will expire again. Even if Congress makes these budget rules permanent, we face years of recurring budget deficits. Without them, things will be a lot worse.

Indeed, with all the imperfections in our budgeting process, things would have been a lot worse over the last 30 years had it not been for the great success on the revenue side. We have been bailed out of fiscal disaster by the remarkable ability

of the federal tax system to raise vast sums of money to keep the government running. Unfortunately, the continued vitality of the tax system is in doubt.

God Save the Income Tax

Since World War I, the income tax has been the principal source of federal revenue. Over the last 30 years, even more of the tax burden has shifted to the income tax — in particular, the *personal* income tax. So far, it has been up to the task. The income tax has bailed out politicians (Republicans and Democrats alike) who cannot get a handle on government spending. If that good fortune ends, policymakers will face even more severe choices. Budgeting has already become extraordinarily difficult in the last 30 years as the percentage of total revenue available for discretionary spending has declined appreciably. Compounding the problem, discretionary spending is up nearly 14 percent this year. These trends will likely continue, imposing even more severe constraints on policymakers. If the income tax falters, things will get much worse.

Several factors have contributed to the squeeze on budgeters. To begin with, the vast and growing revenue raised by the Social Security payroll tax ($694 billion in fiscal year 2001) is dedicated to that program and by law cannot be used to fund other public policy programs. Social Security is by far the largest and most important of the so-called entitlement programs — programs for which spending is mandated by law and determined by the number of persons who qualify for the program, rather than annual appropriations by Congress. This kind of expenditure is outside the annual budget/appropriations process, and hence, outside the control of budgeters. Spending on entitlement programs (which includes Medicare, Medicaid, food stamps, and military pensions) now totals over $1 trillion a year, accounting for some 10.5 percent of GDP and over half of all government spending. The OMB predicts that entitlement spending will account for 67 percent of federal outlays by 2010.[3] Spending for Social Security alone reached $433 billion in 2001 (23 percent of total outlays) and will continue to increase over time. Currently, 45.9 million people receive benefits under the program, and the number will rise dramatically as the Baby Boomer generation starts to retire. In other words, Social Security is squeezing out the rest of government.

This dramatic change in the composition of federal spending led economist Paul Krugman to quip that the federal government "has become a retirement program that does some military stuff and a bit of humanitarian stuff on the side."[4] Republicans are more inclined to do the "military stuff," and Democrats the "humanitarian stuff," but the reality is that there is precious little left over for either after the government pays retirees and services the national debt.

Because the revenue raised by the Social Security payroll tax is dedicated to that program, it falls largely to the income tax to fund virtually all the other activities of the federal government — which includes everything from the military to education, building highways and housing, foreign aid, and space exploration. The burden falls on the income tax because other sources of federal revenue are so insignificant. The federal estate and gift tax typically raises less than 1.5 percent of total federal receipts, while only slightly more than 3 percent comes from all federal excise taxes combined. While estimates are that revenue from the wealth transfer taxes will increase significantly in coming years (thereby thwarting Republican efforts to permanently repeal the tax), it still will remain a minor source of revenue compared to the income tax.

If the income tax is the workhorse of our system of public finance, it is the *personal* income tax that pulls most of the load. Over the last 30 years the corporate income tax has declined precipitously as a source of federal revenue. True, the corporate income tax raised over $151 billion in fiscal year 2001, but this amounted to less than 8 percent of total federal receipts. Back in the 1950s, the corporate income tax provided as much as a third of federal receipts — even more during the war years of the 1940s. As late as 1972, when Tax Analysts first began publishing *Tax Notes,*

the corporate income tax still raised about 15 percent of federal receipts. The 1981 tax act dramatically reduced the tax burden on corporations and hastened the decline of the tax.

Other factors hastened the decline of the corporate income tax, including the increased use of pass-through (i.e., non-taxable) entities such as subchapter S corporations and limited liability companies for conducting business, as well as the dramatic increase in corporate tax shelters in the 1990s. To be sure, in some quarters the demise of the corporate income tax is viewed with outright approval, as the double-taxation of corporate income is said to put our national business corporations at a competitive disadvantage in an increasingly global world market — another major change since *Tax Notes* first began publication. It may very well be that the corporate income tax is an economic drag on the economy, and the integration of the corporate and individual income taxes should be a high priority of policymakers. (To be sure, they better hurry before there is nothing left of the corporate income tax to integrate.) The problem is that there has been little conscious thought guiding this subtle restructuring of our tax system. We have been pushed and pulled by trends, rather than steering. Against Yogi's better advice, we have engaged in three decades of haphazard policymaking without knowing where we are going. The average individual taxpayer now pays more Social Security payroll tax than income tax, the estate tax is scheduled to disappear, the corporate income tax is in danger of becoming a quasi-voluntary tax, and it is left to the personal income tax to finance virtually everything in the federal budget other than Social Security. And pretty soon, we will need the income tax to keep Social Security afloat.

The good news is that the personal income tax has proven to be an amazingly versatile and successful tool for raising vast quantities of revenue — notwithstanding efforts by Republicans to repeal the income tax and dismantle the IRS. The unprecedented and sustained economic growth of the mid-1990s produced record receipts under the personal income tax. After the 1993 Democratic tax increase, revenue literally poured into the U.S. Treasury faster than the government could spent it — at least, in the short-term. In 1996, adjusted gross income reported on individual tax returns rose 8.3 percent over the prior year, and total individual income taxes rose 12 percent. Most of this was attributable to a surge in realized net capital gains — up 48 percent over 1995. The trend picked up steam in 1997 and continued for the rest of the decade. In fiscal year 2000, for the first time ever, the personal income tax raised over $1 trillion in revenue for the federal government — nearly 50 percent of all federal receipts. Of course, this was all because of the booming economy and stock market. The numbers were slightly off for 2001 and 2002. Blame that on the recession and the bear on Wall Street. But projections are the personal income tax will again raise over $1 trillion in fiscal year 2003. Even in Washington, that ain't hay!

Notwithstanding the great success of the income tax in raising revenue, serious problems lie ahead. One is that the Alternative Minimum Tax (AMT) — one of the worst policy innovations in the last 30 years — threatens to swamp the "regular" tax system. Policymakers are just coming to grasp the political danger the AMT poses to the tax system. The revenue collected under this alternate tax system (originally designed for millionaire taxpayers who pay little or no tax, but now grabbing middleclass taxpayers) is projected to increase considerably over the next 10 years, and it is just too costly to repeal this Frankenstein tax. Replacement revenue must be found. The easiest and most intellectually honest thing to do would be to raise marginal rates under the regular income tax — something Republicans certainly will refuse to do. Without this, we will only get patchwork and temporary fixes. Republicans should bite the bullet and agree to raise income tax rates in exchange for the Democratic votes necessary to kill the AMT — both the corporate and individual. Don't expect this to happen anytime soon, but we can always hope for miracles.

The AMT is a quagmire, but an even more sinister problem threatens to undermine the tax system. Our largest and most prosperous corporations now routinely collude with Wall Street investment bankers and some of our most prestigious accounting and law firms to defraud the Treasury through massive tax evasion under the guise of tax shelter "investments." The integrity of the entire tax system is in jeopardy. What began in the late 1980s as limited marketing of some very sophisticated shelter deals to a select list of large corporate clients by a small group of aggressive promoters (e.g., Merrill Lynch and Price Waterhouse) has become an all-out war on the fisc. Promoting shelters is now widespread and common practice, the legal support for the deals is highly dubious, and the practice has spread from corporations to wealthy individuals. Abandoning even the pretense of legality and integrity, promoters market such gems as Guam trusts, "lease in, lease out" (LILO) transactions, the "Eliminator" (apparently some kind of shelter for individuals employing foreign tax straddles to defraud the Treasury), offshore credit cards and trusts, and tax-haven bank accounts. Promoters market these shelters as proven methods of reducing taxes. In a sense, they are right — it has been "proven" that the IRS cannot keep up with this kind of massive tax fraud.

A lead article in *Fortune* magazine recently asked, "Are You a Chump?" — meaning, are you (the honest taxpayer) a chump for paying your taxes? Sadly, this is a sign of the times, and if the IRS does not take strong action soon, it won't be long before a whole lot of "chumps" (fortunately, still a majority of taxpayers) take umbrage and stop voluntarily forking over a third of their income to the government. When that happens, the tax system will face a meltdown.

We must immediately address the problem of escalating tax shelters, fraud, and noncompliance before the foremost source of revenue of the federal government is exhausted. A good place to start is by dramatically increasing the budget for the IRS, which is chronically under-funded. The IRS must be given enough money to hire new staff specially trained to deal with sophisticated tax shelter promoters. Very few tax professionals that I know can follow the intricate details of the more sophisticated shelter deals, and the IRS (as well as the Tax Court) has its hands full just figuring out what is going on. Congress needs to give the IRS adequate resources to administer and police the tax system. Amnesty and settlement offers granting 80 percent of the tax benefits to those who buy into these bogus schemes will not do the trick!

The dramatic decline in audit rates also must be reversed. As it is, virtually everyone knows that no one is watching. Some of the "customers" of the IRS need to be reminded that paying taxes is not voluntary, notwithstanding what the kooks and charlatans tell them. Unless we beef up the enforcement capacity of the IRS, the revenue-raising capacity of the income tax will be severely diminished. That would be a tragedy. After all, we may wish to do a bit of "military" and "humanitarian" stuff in the future, and it would be nice to have *some* money to pay for it.

The Crisis of Social Security

If the spread of tax shelters and fraud threatens to erode the income tax base, an equally serious challenge to the tax system is posed by the impending insolvency of our most popular (and costly) domestic policy program — Social Security. If nothing is done, the fiscal foundation of Social Security will crumble in the next 30 years, threatening to bring down everything else with it. That we have had difficulty addressing this problem, let alone solving it, is disturbing.

The problem is that the Social Security and Medicare trust funds will soon be broke. The government's unfunded liability for future benefits threatens to swamp the entire ship of state. Estimates put this unfunded obligation in the range of $3 trillion to $11 trillion.[5] Whatever the precise number, this enormous liability is our most pressing domestic problem — one that will haunt policymakers for decades to come.

Why will things only get worse? Social Security is a fiscal time bomb waiting to explode. The modern social welfare state (in the United States, as well as Europe) has been largely financed through a vast Ponzi scheme that will eventually collapse under its own weight, absent a significant injection of cash. Social Security imposes an enormous intergenerational transfer of wealth, taxing current workers to pay future retirees.[6] The program imposes a massive tax on young workers lucky enough to have jobs to pay benefits to their parents and grandparents. The problem is that the ratio of retirees to workers has declined significantly since the program was created. In 1945, five years after benefits were first paid, there were only two retirees collecting benefits for every 100 workers contributing to the trust fund. Today that ratio is roughly 30 retirees for every 100 workers, and it is expected to increase to 500 retires for every 100 workers over the course of the next 30 years. This dramatic change in the retiree-to-worker ratio is attributable to favorable demographic changes in the population — workers are living longer and collecting benefits for longer. In 1940, the percentage of the male population that lived to 65 years of age was 54 percent, while 61 percent of females lived that long. In 2000, the percentages were 76 for males and 86 for females. In the next 50 years, these numbers will rise another five or six percentage points. To be sure, good health is good news for the nation. But with longer life comes increased benefits and hence, greater pressure on the Social Security system.

Measures taken in 1983 by Congress under the able leadership of New York Senator Daniel Patrick Moynihan enhanced the solvency of Social Security. This was perhaps the highlight of responsible tax policymaking during the last 30 years. Under the Social Security Amendments of 1983, the wage base was gradually expanded, the payroll tax was raised, and future benefits were indirectly reduced by postponing the retirement age for future generations of workers. Despite this effort to shore up the trust fund, along with minor reforms during the Clinton administration, the ultimate day of reckoning was merely postponed. The $250 billion annual surpluses now generated by the payroll tax will soon disappear. Then the trust fund will "go negative" — meaning more money will come out than goes in. The most recent estimates are that the combined Social Security trust funds will go negative by the year 2017 and be exhausted by the year 2041.[7] That's when the real crunch will come!

Compounding the problem, the surpluses produced by the trust fund since 1983 have been loaned to the federal government to finance other spending. Because of this, the positive cash-flow from Social Security has masked the true extent of government over-spending. Eventually, this piper must be paid — in this case, some $1.2 trillion (the assets of the combined Social Security trust funds as of January 1, 2002).

Why are we not taking immediate steps to correct the problem that lies directly ahead? Is there any way to "fix" Social Security? There is great political and institutional resistance to changing Social Security, and there really are few solutions — none of which is very attractive. In the past, Democrats have proposed raising the payroll tax. That may be necessary. Payroll taxes, however, are already at historic levels, and popular resistance to further increases seems likely. Of course, Democrats have also proposed adding prescription drugs to the list of entitlement programs, seemingly incapable of grasping that there are limits to what government can do. You simply cannot keep adding new programs and expect to raise taxes indefinitely.

On the other side of the aisle, Republicans have offered a wide array of plans, all of which in some way or another include the dreaded "P" word. These plans all rest on some form of privatization (whether complete or partial) and promises of greater returns on the investment assets in the Social Security trust fund. With the very significant decline in the equity markets over the past year or so, not much has been heard of late from proponents of such "solutions." But when the stock market picks up steam again, the issue will surely return. To be fair, we are so deep

in the hole for future Social Security benefits that it may be necessary to give this a try. There are few alternatives, other than the politically unacceptable option of cutting back benefits to future retirees. Believe me, no politician thinking of running again is going to propose that!

In the end, we must decide whether we can afford to pay benefits to future generations of retired workers and senior citizens at current levels. If we decide in favor of preserving present benefits, then we must recognize that it is necessary either to raise taxes or accept some greater risks to attain higher rates of return on the investment of Social Security assets. No matter what, we will need to supplement the Social Security and Medicare trust funds with general revenue from the income tax. This will be an easier pill to swallow if there are on-budget surpluses which allow us to pay down the national debt today, reducing the government's future obligation to make interest payments and thereby freeing up additional revenue for Social Security and Medicare. But realizing on-budget surpluses is no easy matter, as the 107th Congress and the Bush administration know so well. If we decide that tax rates are already too high and transfers from general revenue are unacceptable, as most Republicans believe, then we *must* reduce benefits to future retirees. There are no other options.

Whither the U.S. Tax System?

Back in 1959, Charles Lindblom of Yale University wrote a classic piece on policymaking entitled "The Science of 'Muddling Through.'"[8] In his essay, Lindblom obliquely made the case for incremental decisionmaking (what often looks like "muddling through"). Incremental decisionmaking makes sense in a world of limited human intellectual capabilities, complex problems, and fundamental disagreement over objectives. That pretty much describes what we now have, and likely will see in the future from U.S. tax policy — muddling through. Rational comprehensive problem-solving lies beyond our abilities, with tax policy and just about everything else.

Grieve not! Muddling through is not so bad, although granted, it is not very satisfying either. Somehow, we will find a way to cope with our many crises, including budget deficits, the AMT, the impending insolvency of Social Security system, and unscrupulous tax shelters promoters. Undoubtedly, other new crises will surface along the way, and we will deal with those as well. Mind you, do not expect solutions! We lack the mental power and cash to actually solve all these problems. We can, however, make marginal adjustments to keep the tax system afloat. If the income tax base is eroded, it will not disappear. Nor will it be junked by Congress, although it may be *supplemented* by a VAT or some other form of consumption tax. That even makes sense. The same goes for the federal estate tax, which should, and likely will be preserved for the long-term as an impost on the super-rich with very generous exemptions that exclude everyone else.

Finally, let's forget about definitive and comprehensive "reform" of the tax code. The best we can hope for is occasional bursts of enthusiasm that clean up some of the mess. Of course, after that inevitably we will revert to our old ways, cluttering up the tax code once again. Our political system simply does not lend itself to radical changes or final solutions. In tax policy, we will have to settle for muddling through.

[1]Stanley S. Surrey and Paul McDaniel, *Tax Expenditures* (Cambridge: Harvard University Press, 1985), 6.

[2]This parliamentary rule, devised by West Virginia Senator Robert Byrd, requires that any "extraneous" provision in a budget bill (*i.e.,* one not having significant revenue or spending impact) be stricken unless 60 senators vote on the floor of the Senate in favor of retaining such provision.

[3]Office of Management and Budget, *The Budget for Fiscal Year 2002,* Table S-17 ("Baseline Category Totals").

[4]Paul Krugman, *Fuzzy Math: The Essential Guide to the Bush Tax Plan* (New York: W.W. Norton & Company, 2001), 49.

[5]The GAO put the number at $3 trillion. United States General Accounting Office, "Social Security: Different Approaches for Addressing Program Solvency," (GAO/HEHS-98-33) Washington: U.S. General Accounting Office, July 1998. A more recent estimate is that there is a $11.7 trillion unfunded liability for Social Security benefits that have already accrued. *See* Jonathan Barry Forman, "Thoughts on Saving Social Security," *Tax Notes,* Sept. 3, 2001, 1357.

[6]The best account of the Social Security "tax" imposed on younger workers to pay the benefits of current retired workers is Laurence J. Kotlikoff, *Generational Accounting* (New York: Free Press, 1992).

[7]Social Security and Medicare Board of Trustees, *Status of the Social Security and Medicare Programs: A Summary of the 2002 Annual Reports* (Mar. 26, 2002).

[8]Charles E. Lindblom, "The Science of 'Muddling Through,'" 19 *Pub. Admin. Rev*. 79 (1959).