

**TAX REFORM: LESSONS FROM THE
TAX REFORM ACT OF 1986**

HEARING
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ONE HUNDRED ELEVENTH CONGRESS
SECOND SESSION

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SEPTEMBER 23, 2010
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TAX REFORM: LESSONS FROM THE TAX REFORM ACT OF 1986

THURSDAY, SEPTEMBER 23, 2010

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:12 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Wyden, Nelson, Carper, Grassley, Hatch, Snowe, and Bunning.

Also present: Democratic Staff: Holly Porter, Tax Counsel; Michael Grant, Detailee; and Lily Batchelder, Chief Tax Counsel. Republican Staff: Tony Coughlan, Tax Counsel.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order.

Jeffrey Birnbaum, who wrote the book on the 1986 tax reform, said this: “The tax code is like shrubbery—the more severely it’s pruned, the bigger and stronger it will grow back.”

In 1986, Congress pruned the tax code pretty severely, but it has grown back bigger and stronger and, once again, it needs to be pruned. The tax code is now about 70,000 pages long.

A recent article in *The Economist* reported that Americans collectively spend more than 7 billion hours filing returns. That is the equivalent of nearly 4 million workers toiling full-time, year-round, just to handle the paperwork.

The Tax Reform Act of 1986 was a landmark law. It affected every American family, every American business. It significantly reduced taxes for individuals. It eliminated many tax benefits for special interests.

The 1986 tax reform leveled the playing field. No longer could a wealthy individual escape taxes by buying into a shelter. No longer could a clever investment strategy get investors out of paying their fair share. No longer could businesses participate in notorious tax shelters. Similar taxpayers paid similar taxes.

But since 1986, Congress has made more than 15,000 changes to the code. Congress made these changes with the best intentions; some to collect revenue, some to stabilize the economy, others to further certain social objectives, all made for legitimate reasons.

But each change created additional complexity, and each change created the potential for exploitation.

Once again, just as in the 1980s, many can largely avoid paying taxes if they know how to manipulate the code. A long list of deductions, credits, and exclusions is available to help avoid taxation.

Those who do not have a savvy accountant and refuse to participate in tax games often end up paying more. Many honest taxpayers end up feeling like chumps.

During his effort to reform the tax code in 1985, President Reagan said this: "The American people are always willing, even eager, to do their duty, but you quite naturally resent it when you see others shirking theirs. It rankles to know that your taxes are so high because others who can afford high-priced lawyers and tax consultants are able to manipulate the system to avoid paying their fair share."

Millions of Americans dutifully and honestly file their tax returns. They just want a fair shake. They expect to pay the same tax as their neighbor who earns the same money. They expect not to feel like a sucker if they do the right thing, and that is not too much to ask.

Some may wonder why we are holding this hearing. They may assume that Congress, especially in these times, cannot tackle tax reform. They may think times have changed, Congress will not compromise or work together, and special interests are too strong.

That attitude is harmful to our country, it is harmful to the American people, and to our democracy. Tax reform is not just about the tax code. It is about one of the most direct relationships that citizens have with their government. It is important that we try to make that relationship as fair as possible.

Now is exactly the time to talk about tax reform. I am committed to tackling it. It is what our constituents sent us here to do. It is the right thing to do. They sent us here to meet challenges, not to shy away from them. They sent us here to make difficult decisions, not to ignore them.

Our continued prosperity, our international competitiveness, and many other factors rest on facing these challenges.

This is just the beginning. Today we ask, what lessons can we learn from the 1986 tax reform? Our witnesses today played a huge part in shaping that historic legislation.

We have a lot to learn from all of you. Thank you very much for taking the time to be here. This is an extremely important undertaking to begin, and thank you very much for coming to help us accomplish it.

We will follow up with other hearings, obviously, and we will dig into other areas of the code. This will be quite exhaustive over a significant period of time. Nothing will be off the table. But this is the beginning, and thank you all so very much.

So let us prune back the code. Let us restore fairness to this fundamental relationship with the government, and let us start today.

[The prepared statement of Chairman Baucus appears in the appendix.]

The CHAIRMAN. Senator Grassley?

**OPENING STATEMENT OF HON. CHUCK GRASSLEY,
A U.S. SENATOR FROM IOWA**

Senator GRASSLEY. Thank you, Mr. Chairman. This is a very important subject to be discussing, something we probably should have been discussing for a long period of time; not just under your chairmanship, but a lot of chairmanships.

Thanks to the panel for coming.

There is a consensus among the people of this country that the tax code is too complex and ought to be replaced. The problem comes with what to replace it with.

Senator Packwood was fond of saying, "Many taxpayers accept complexity that favors them." When we consider the complexity of the regular tax system and the creeping effects of the AMT, you have a recipe for disaster. Because of the way the AMT is structured, with no indexing, this AMT problem grows exponentially from year-to-year and more and more people are pulled into this, and that begs for a permanent solution.

So there is no question that we have a big problem. It is a problem the committee should focus on, and thank you, Mr. Chairman, for doing that.

While we all agree something should be done, the key premise that needs to be fleshed out is whether we assume current law levels of tax relief remain in effect, or whether we assume that the bipartisan tax relief plans of 2001 and 2003 have expired.

If we use the latter assumption, that the post-2010 record-level tax increases go into effect, then the tax reform reality becomes a historic tax increase.

President Obama campaigned on the, quote-unquote, "current policy" as opposed to a, quote-unquote, "current law" baseline. In an editorial appearing in *The Wall Street Journal* on August 14, 2008, Obama advisers Jason Furman and Austan Goolsbee wrote, "The Obama plan is a net tax cut—his middle-class tax cuts are larger than the rollbacks he has proposed for families making over \$250,000. Senator Obama would pay for this tax cut by cutting spending."

Whatever one's opinion of the specifics of this tax policy, I think most taxpayers and certainly this Senator support the idea of lowering the overall level of taxation and are certainly opposed to increasing the overall level of taxation beyond that 50-year average of 18.2 percent of gross national product coming into the Federal Government for 535 members of Congress to spend.

Since January 2009, Dr. Furman has been Deputy Director of the National Economic Council. Since last week, Austan Goolsbee has been Chairman of the Council of Economic Advisers.

As the Congressional Budget Office noted this past June in a publication titled "The Long-Term Budget Outlook," revenues or taxes collected by the Federal Government have averaged around 18.1 percent, compared to the 18.2 percent I just stated from my own memory, as a percent of gross national product over the past 40 years.

My reading of Dr. Furman's and Dr. Goolsbee's quote is that Candidate Obama was elected, in part, upon a promise to not increase the level of taxation.

An important question that must be answered before tax reform can be attempted is whether reformers are committed to holding taxes at or below the historical level of taxation of that roughly 18 percent of gross domestic product.

Given President Obama was elected, in part, upon a promise of a net tax cut, I do not see how any reform could contemplate increasing the historic levels of taxation.

As I have noted in the past, I believe that, for fundamental tax reform to truly succeed, it would require the full support of a White House in possession of an unambiguous mandate directly from the American people.

What this means is that a president must campaign and be elected, in part, on his vision for our tax system, as President Reagan was. Unfortunately, we are not able to speak with President Reagan anymore on his role in enacting the Tax Reform Act of 1986. But because of his absence, we should not take the importance and responsibility of the executive branch for granted in this process as we move forward.

Aside from creating the political clout necessary to get a complicated bill enacted into law, if a candidate sticks to the principles of tax policy he campaigned on and, of course, won on, it is more likely that the American taxpayer will see reform as beneficial and support it.

So, Mr. Chairman, I raise the point because, if we are to enter a tax reform playing field, we need to know the rules, including the size of the playing field and the revenue terms. Are we assuming tax reform is not possible without a record tax increase, is my basic question.

Thank you very much.

[The prepared statement of Senator Grassley appears in the appendix.]

The CHAIRMAN. Thank you, Senator.

I will begin with our witnesses; first, with Mr. Gephardt. Mr. Gephardt is recognized for many roles that he has played: Speaker, certainly, of the House of Representatives, but also as a primary co-author of Bradley-Gephardt, I think it was 1982, to kind of help really get the ball rolling here. Thank you very much, Dick, for taking the time and giving us your insights.

Next, Bill Archer. Bill Archer was the chairman of the House Ways and Means Committee. And when we passed the 1986 law, I think, Bill, you might have been the ranking member of the committee. I cannot recall exactly what your capacity was, you will tell us.

Buck Chapoton, Treasury Department. This committee has a very fond regard for you, Buck, and your advice over the years, and you have always been straight, just telling it like it is, never any political slant to it, just solid policy.

The same with you, Randy, obviously. Randy Weiss was Deputy Chief of Staff for the Joint Committee on Taxation. Randy brought a smile along with his expertise, with a sense of humor, as well.

So, we thank you all so very much.

So, Dick, why don't you begin? Obviously, we want to hear, from your perspective, how it was put together, some of the challenges

you faced, how you overcame them, and we will just take it from there.

**STATEMENT OF HON. RICHARD A. GEPHARDT, PRESIDENT
AND CEO, GEPHARDT GOVERNMENT AFFAIRS, WASHINGTON,
DC**

Mr. GEPHARDT. Thank you, Mr. Chairman, very much. I thank the ranking member, Senator Grassley, and other members of the committee who have been so effective and important on these tax questions. And I really want to first say that I admire you for taking on this important subject. It is important now, it always has been important, and it can be done, because we were able to do something in the late 1980s.

My name is Dick Gephardt, and I am honored here to testify about the 1986 landmark legislation. I represented Missouri's third congressional district for 28 years and served as Democratic Leader of the House for 14 years. On my first day in Congress, I was appointed to both the Ways and Means Committee and the Budget Committee. I was fortunate.

From my first day here until my last, I truly believed that a fair, simple, and transparent tax code was important for our country and our people. We advanced that goal in 1986, and I believe that today, tax reform can still play an important role in restoring public trust in our government and our country.

In 1982, Senator Bill Bradley and I introduced the Fair Tax Act. We proposed to simplify the code, making it easier to understand and clear that it was designed to benefit all Americans, not just one group or another.

We targeted shortsighted special interest loopholes. Let me give you a prime example—super dairy cows. There was a large tax break for investing in high yield dairy cows; yet, due to Federal dairy programs, there was already a glut of milk. There was so much milk, in fact, that cheese was spoiling in Federal warehouses. Yet, the code still pushed millions of dollars into this dairy tax shelter.

Once we put the bill in, we then reached across party lines. Congressman Jack Kemp and Senator Bill Roth were proposing an alternative, but important Republican tax reform proposal. We worked closely with them to promote reform and regularly debated each other to draw attention to the issue.

We also had leaders like President Reagan who were genuinely willing to negotiate with the other party. These were leaders who were true champions of conservatism and liberalism, but who were not hamstrung by partisan extremists who vilify compromise and promote obstruction.

On tax reform, President Reagan came to the same conclusion that we did—that the best approach was to reform the current income tax system and not abandon it or go to a completely new system, such as a consumption tax.

The House and Senate tax committees then held comprehensive hearings, like you are today, that built a solid understanding of the workings of the tax code. It was critical for Congress and the public to really understand what was happening and why it was happening.

Education of the members and the public was critical to reaching the bipartisan consensus we were finally able to reach.

I see many parallels today to what we faced in 1986. In 1986, memory of the deep recession of the early 1980s was fresh on everybody's mind, as well as the energy crisis of the 1970s, increased international competition, and the sharp rise in unemployment. All of these factors exist even more starkly in 2010. And just as in 1986, the public's faith in our government was at a low.

So it is time for us to look again at simplifying the tax code. We need to look at every provision and ask, "Is this really for the greater good? Is this the best way to grow the economy? Can we really afford provisions that only benefit one group or another?"

You now face an even greater fiscal challenge. Today's deficit is twice as large as a percentage of the gross domestic product. In 1986, the deficit was projected to stabilize and decline. Today, the best estimates have it growing substantially, particularly at the point when the vast pool of baby-boomers are retiring.

A responsible tax policy will contribute to solving the debt problem.

Not only must we keep the deficit in mind, we must also be aware that, by simplifying and closing loopholes, we are joining the larger debate about the distribution of tax benefits and burdens. If the effort to reform the code is undertaken, I would recommend these four quick lessons from 1986.

First, the process has to be transparent and open so that the public is aware step-by-step of what is happening.

Second, it needs to be a studied process. In 1986, the committees conducted hundreds of hours of hearings, not for grandstanding, but for learning and for getting information in front of everybody.

Third, it has to be bipartisan. We worked with the White House, even though we were Democrats and the President was Republican. We understood from the start that any final agreement was going to be a compromise and not a plank out of our party platforms.

Fourth and last, perhaps most important, nothing can be off limits. The tax code is a powerful tool for good policy, such as promoting job creation, or putting homeownership within the reach of American families.

Let us make certain, however, that every section is so justified. Remember, until 1986, super dairy cows were considered a sacred part of our tax code.

So we simplified the code. The widespread stories about wealthy people and big corporations gaming the system to pay no taxes disappeared. Today, special provisions are back, and the American people, conservatives and progressives, are more skeptical than ever that their government is working.

Real tax reform can send a powerful signal that we, the people, still own our government.

Thank you for letting me be here, and I look forward to the questions.

[The prepared statement of Mr. Gephardt appears in the appendix.]

The CHAIRMAN. Thank you very much, Mr. Gephardt, I appreciate it.

Mr. Archer?

STATEMENT OF HON. WILLIAM R. ARCHER, JR., SENIOR POLICY ADVISOR, PRICEWATERHOUSECOOPERS, WASHINGTON, DC

Mr. ARCHER. Mr. Chairman, I would start out by saying that I can associate myself with your statement and with that of Senator Grassley, and that would probably knock out a big part of my own statement.

The CHAIRMAN. Repetition usually works pretty well.

Mr. ARCHER. But I do appreciate your holding this hearing and your commitment to tax reform, which I think is essential to a better country, fairness, growth, jobs, and making us competitive in the global marketplace—and that is one thing that I would accentuate.

Today, we are in a very different environment globally than we were in 1986. And in my opinion, we need to be able to not only compete, but to win the battle of the global marketplace, and taxes are an extremely important part of that.

But as you requested, I am going to focus on the key factors that led to the Tax Reform Act in 1986 and the challenges that Congress faced.

Please note that, although I am now associated with PricewaterhouseCoopers, I do not speak for them. I speak on behalf of myself, and what I say is my own view and should not be attributed to PWC.

For 30 years, I represented the 7th district of Texas in Congress and was fortunate to be on the Ways and Means Committee for 28 years, and to be chairman of that committee for the last 6 years.

There were a lot of factors that led to the reform in 1985–1986. But I am convinced, as Dick Gephardt said, that President Ronald Reagan played the single most important role in bringing about the passage of the 1986 act. But I am not the first person to believe that.

Tax reform requires presidential leadership. It did then, and it is my opinion that it is true today.

Reagan was passionate about individual tax rates, and he often recounted that, in World War II, his income from acting was taxed as high as 91 percent, leaving him with only 9 cents of each additional dollar of work, and he understood from this experience that high rates discourage people from working harder and undercut economic opportunity.

He was discussing his situation with Chairman Rostenkowski about the 91-percent rate that he endured during World War II, and it is reported that Rostenkowski showed surprise and quickly replied that he did not think Reagan was a good enough actor to be in the highest tax rate, adding a bit of levity to the whole consideration. [Laughter.]

As Dick Gephardt said, bipartisanship is essential, and the bipartisanship of the congressional leadership at that time was critical to the ultimate passage of the bill.

Both Chairman Rostenkowski and Senate Finance Chairman Bob Packwood demonstrated strong leadership, as did other committee members, such as Dick Gephardt, who was then on the Ways and Means Committee, and Bill Bradley, who was on the Senate Finance Committee, which was really important to the ultimate success. And when tax reform seemed to stall, Chairman Rostenkowski initiated a dialogue with the American people that was entitled "Write Rosty" in a public outreach campaign.

Treasury officials were absolutely essential, and Secretary Baker worked tirelessly day after day with the members of the committee in working out compromises and seeing that there was ultimate success.

His presentation of Treasury II became the basis for all of the discussions for tax reform. So I think it is extremely important that Treasury be involved.

Other factors, of course, contributed. The public became very, very critical of what they perceived as an unfair tax code. And numerous press accounts revealed that some in society who paid low levels of tax compared to their income were selling losses to others and engaging in other schemes to avoid tax.

These concerns of fairness caused many Americans to support tax reform, and I think fairness is the most important issue to establish in order for any tax reform, even today.

The U.S. had come out of back-to-back recessions in the early 1980s, and tax reform provided an opportunity to promise long-term economic growth. So growth became the second major goal in 1986.

Mr. Chairman, as you mentioned, even then, the tax code had become too complicated, and it was such a complex document that simplicity became the third goal of tax reform then. It was interesting that, the day before the Ways and Means Committee was to hold a hearing on Treasury II, Secretary Baker appeared before our committee. And the day before, we had been delivered a 500-page summary of Treasury II. I did not have time to read it in detail, but I scanned through it and found that, in the chapter on taxation of foreign source income, international taxation, I could not believe my eyes, because it read, "The current law is complex and difficult to administer. Our proposal will make it more complicated and more difficult to administer."

So in the hearing, I asked Secretary Baker about this, and I read that statement in the summary to him, and I said, "How can you claim that this is simplicity?" And he said, "Well, Congressman Archer, that's why we put simplicity third in the order of things."

Later on, when I was talking to him privately, I got on him again a little bit about simplicity. He said, "Well, we knock 6 million people off the rolls, and that certainly is simpler for them." And I said, "Yes, for them; but for those of us who continue to do our tax return, it's a heck of a lot more complicated," and it was. And I was doing my own tax return, even when I became chairman of the Ways and Means Committee. I was very conscious of the complexities in the code.

But mindful of the budget deficits in 1982–1983, Reagan insisted that tax reform be revenue-neutral, and that became a rule that everyone operated under.

Unfortunately, revenue neutrality makes it very difficult to create sound tax policy, and you also create winners and losers, and losers inevitably are going to scream very, very loudly against what you are doing. So that is something that you are going to face in your current-day tax reforms.

In the end, I opposed the 1986 tax reform bill. Going in, I had really wanted to support lower rates, but I found that the offsets, to me, were creating a bigger problem than the benefits from the lower rates.

One thing I would encourage you to do is to be very careful about what the economic consequences will be of what you do and thoroughly consider that, because I was convinced that the retroactive changes in real estate taxes were going to undermine the value of real estate, which would, in turn, undermine the savings and loans; and, unfortunately, that happened at a cost of somewhere between \$100 billion to \$200 billion to the American taxpayer, which most of us remember with the Resolution Trust Corporation and the savings and loans. So that is very important to consider—what are the economic consequences of what we do—and to thoroughly understand that.

In addition, I think it is important to understand the cost of enforcement, the cost of compliance, both to the IRS and to the individual taxpayers, because that can be a drag on the economy. And unfortunately, compliance became much more costly after the 1986 act.

I have more in my statement, Mr. Chairman, but I am already over my time.

The CHAIRMAN. Mr. Chairman, go ahead. If you have some more to say, we want to hear it.

Mr. ARCHER. Even though the 1986 act was revenue-neutral overall, the corporate sector suffered a \$120-billion net tax increase, and those moneys were used to offset a reduction in individual rates. But in my view, this 25-percent increase in corporate tax payments was a deterrent to job creation and was not in the best interest of the country. And, Lord knows, today, jobs are a major item that have to be a concern in whatever you do.

I mentioned the real estate taxes were made retroactive, and would strongly urge you to not have any retroactivity in your final product. Retroactivity is a violation of promises to the American people and should be avoided at all cost. It was a major, major defect in the 1986 bill, not just on real estate, but the retroactive cancelation of the investment tax credit, which affected jobs.

I want to accentuate again that you should end up, in my opinion, with a tax code that permits us to be competitive in the global marketplace. I do not believe that we can remove ourselves from the global marketplace, and I think we will rise or fall in the future depending on how well we do competing. And we not only need to be competitive, we need to win, and our tax code is a major, major item in determining whether we win or lose in the global marketplace.

The ultimate international tax system, in my view, should be one that at least is on a level playing field, the way foreign countries tax their corporations; and, if it is not, we will lose the battle of the global marketplace, and we will watch the loss of high-paying

jobs, as our companies are bought out by foreigners who have a lower tax rate with their corporations.

Simplicity is an incredibly noble goal, but it fights equity, and it fights what is perceived as fairness by a lot of people, and I, like Dick Gephardt, encourage you to look at every one of the complexities in the code and find out whether they really are beneficial and not whether they help some special interest group.

When I was chairman of the Ways and Means Committee, I was so concerned about tax credits cluttering up the code that I just drew a line and said there will be no new tax credits while I am chairman, and there were not.

Since 1986, over 70 new tax credits have been added to the code. And, Mr. Chairman, I sympathize with you, because you are trying to extend expiring provisions. And I have looked at your proposal, your tax proposal, and, frankly, I did not realize all of the expiring tax credits and tax provisions that are in there to help out the most minute parts of our economy.

The Budget Act has contributed to that, too. The Budget Act basically has brought about a sunseting of provisions for revenue purposes, and then you have to come back and try to renew those instead of making them permanent in the code.

Another thing I would say that is important is to try to create certainty in whatever your ultimate product is.

So I thank you for taking this on—what I think is a very ambitious undertaking—and I wish you well. And I also will be happy to be available to you as the process unfolds in any way that I can be helpful.

[The prepared statement of Mr. Archer appears in the appendix.]

The CHAIRMAN. Well, thank you very much, Mr. Chairman. You have been very candid with your comments, and it is deeply appreciated.

Buck Chapoton?

**STATEMENT OF JOHN E. CHAPOTON, STRATEGIC ADVISOR,
BROWN ADVISORY, WASHINGTON, DC**

Mr. CHAPOTON. Thank you, Mr. Chairman. It is really my pleasure to appear before this committee again.

For the record, I am a tax lawyer. I was assistant secretary for tax policy in the first Reagan term. I am now with the investment firm of Brown Investment Advisory.

I should also state I am from Houston, TX, and Mr. Archer was my Congressman for many, many years, and I was well represented; and, of course, we worked closely together when I was at Treasury and he was on the committee.

So I am delighted to be here, delighted to be with this very distinguished panel, all of whom I have known quite well in the past and worked with. And I would really compliment the committee, the chairman and the ranking member, both of whom I have worked with extensively many years ago, for holding this hearing.

I want to join my comments with Mr. Gephardt and Mr. Archer in the importance of this entire undertaking and the importance of the tax code to America.

As I have stated many times, filing tax returns is the most important contact, in most cases, the only contact most Americans

have with their Federal Government. And so it is very, very important that we get it right and they feel like they are being dealt with fairly, and I suggest that is not the case today.

In my summary, I want to do four things. I want to describe briefly what I call the five stages of tax reform in the mid-1980s. Each had its own political and substantive impact. I want to list what I think were the two or three basic achievements in the final legislation.

I want to mention a couple of unusual factors that might have facilitated the development and enactment of this historic legislation. And then I want to describe some lessons that I think would be as important today as they were in the mid-1980s.

Now, the five stages of tax reform, I think it is sort of interesting—if you read “Showdown at Gucci Gulch,” you know them. But, first, you had, in December of 1984—and I will bypass the President’s very important statement in his January 1984 State of the Union Address that really got the ball rolling.

But then Treasury, in response to that direction, produced what we would commonly refer to as Treasury I in December of that year, which started the ball rolling. It was a comprehensive and theoretically pure, nonpolitical proposal. It redefined taxable income in terms of economic income. It focused on equal treatment for equals, a comment the chairman made a minute ago. It was massive elimination of tax expenditures. Capital gains were indexed, depreciation was indexed, and capital gains were taxed as ordinary income, by the way.

It was basically an economist’s dream and, some said, a politician’s nightmare. The White House was, I would say, startled and kept its distance.

The next phase was Treasury II in May of 1985. This was after the switch in jobs by Don Regan and Jim Baker. Treasury II toned down many aspects of Treasury I. It made political concessions at the front end, reflecting, I think, Secretary Baker’s pragmatic approach, but it was still a very historic, revolutionary—almost revolutionary, you might say—proposal in the tax world.

The third stage was a Ways and Means bill, December of 1985. It was a “soak the corporations” bill, almost no base-broadening for the individuals, and corporate incentives were greatly reduced. And it came out with lower tax rates. All these bills came out with lower tax rates. But it had a top tax rate for individuals of 38 percent and for corporations of 36 percent.

The fourth stage was the Senate Finance Committee bill, May of 1986. You will remember this very well. It was the mirror image of the Ways and Means bill. It reduced or eliminated virtually all major deductions for individuals and repealed relatively few corporate incentives. But the effect was to enable the committee to produce a bill that reduced tax rates for individuals to 27 percent and corporations to 33 percent.

The Senate Finance Committee bill passed this committee unanimously, an incredible event, and I think most people think that was the turning point in the legislative effort on tax reform.

In the meantime, we had the conference agreement in August of 1986, where it, not surprisingly, followed the Senate bill more

closely on individuals, reduced those benefits, and it followed the House bill on corporations and reduced benefits for corporations.

As Mr. Archer has mentioned, it contained a dramatic shift, or it effected a dramatic shift, in the tax burden from individuals to corporations, and it came out with top tax rates of 28 percent for individuals and 34 percent for corporations.

When we look at what basically was accomplished by the final legislation, I just would summarize it in a few sentences. It reduced individual tax rates dramatically. The top rate, remember, was 50 percent in 1985. And by the way, remember, it was 70 percent in 1980, when the Reagan team came to town. So it was 50 percent in 1985. The tax bill, the Reform Act, dropped it to 28 percent, and that was paid for by base-broadening, eliminating individuals' deductions.

The three that were kept were charitable deductions, full charitable deductions, the state income taxes, and the home mortgage interest deduction. Virtually everything else was affected. And it reduced, as everyone said, it reduced tax expenditures quite significantly.

On the business side, it restored market incentives in business and investment decision-making and did remove most of the major tax incentives for investment, and that was the one of the primary goals of tax reform, to return business incentives, non-tax incentives in business and investment decisions. But, of course, in doing that, it eliminated the investment tax credit. It lowered marginal rates for corporations, as well as individuals, and tax shelters were very significantly curtailed.

At the same time, as Mr. Archer alluded to, the after-tax cost of capital was increased, to the consternation of many in the administration and many in the business community. And this was a dramatic reversal of the tax-based investment policy contained in President Reagan's inaugural tax bill in 1981, which had instituted the investment tax credit and the major investment incentives, particularly the investment tax credit, and greatly accelerated depreciation. You remember the 10-5-3 write-off proposal of 1981.

So that was a major change in policy, and, certainly, investment incentives will be a major consideration for this committee when it undertakes this task.

What permitted development of this historic legislation? You can read all the political scientists talking about it. It was a very interesting aspect of the legislation, and I would just say, who really knows? But I do point to—or I am impressed by the suggestion made by several people that a factor could have been the unusually tight control of the process at each stage.

The circumstances initiating the process, the presidential promise in the State of the Union in January, in an election year, permitted development and publication of the first draft to be handled—that is, Treasury I—to be handled by a relatively small group and all within the Treasury Department. The work was kept very much under wraps, and there were really no leaks in the process. Political considerations were basically ignored in that process.

Thereafter, relatively few people had a lot to say about how the legislation progressed. In the House Ways and Means Committee, Dan Rostenkowski and his staff, to a large extent, controlled

events. Excuse me. First of all, I should say Jim Baker and the Treasury Department controlled the development of Treasury II, the presentation, the position taken before the Ways and Means Committee. Then, as I said, Chairman Rostenkowski controlled events, to a large extent, in the House. When he got to the Senate, Chairman Packwood was in significant control and kept the process moving along.

As I describe in my written statement, each of these leaders seemed to take personal ownership of the legislation. They did not want it to fail on their watch.

I think the purity, if you will, of the initial product and its stated objectives allowed proponents to maintain the high ground throughout the process. Duplicating these conditions would be very difficult.

Finally, let me mention the lessons that we might take from the 1986 act that would be relevant today. First of all, to even consider undertaking fundamental tax reform, the proponents have to be certain of the public's overriding disgust with the current system. I think both Mr. Archer and Mr. Gephardt had mentioned that factor. I think we have reached that stage, but that is a very important factor.

Secondly, I would say establishing principal goals of a reform effort at the outset, and making sure they are contained in the initial product, is essential. It allows the proponents to receive the high ground and maintain it throughout the process, if they stick to those principals.

Taxpayers losing deductions need assurance that they are not being singled out and that a fair process is in effect, and I certainly associate myself with the prior remarks that it has to be open and very, very much above-board.

One of the clearly stated goals to me has to be revenue neutrality, which was constantly stated in the 1986 act process; not only revenue neutrality, but revenue neutrality within each economic segment of taxpayers.

The public cannot think that what is being foisted upon them is, in secret, a tax increase. If future tax increases are needed, a reformed code would be a vehicle that does much less damage to the economy in raising taxes than would be done if we had to use our present Internal Revenue Code to increase revenues.

Finally, let me mention the fact that has also been mentioned before. The Nation's chief executive is going to have to use all of the resources available to the President, both political and substantive, if this effort is going to be successful, and the President just has to be committed to the process.

So let me stop there. It is an interesting subject. We never get tired of thinking about it, and it is disturbing how far we have come since 1986. One of the things you asked us to address was what might have caused that, and, frankly, Mr. Chairman, it is hard to say. I think we all have our thoughts on it, but it is really hard to say. But it happens in a free society and with a Congress that is making the decisions, and it is going to happen in the future. But that does not mean we should not bring the system back now into a very fair system that we can be proud of and, frankly, that can lower rates and lower disincentives in our economy.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Chapoton appears in the appendix.]

The CHAIRMAN. Thank you, Buck, very, very much. I very much appreciate that.

Mr. Weiss?

STATEMENT OF RANDALL D. WEISS, Ph.D., MANAGING DIRECTOR, ECONOMIC RESEARCH, THE CONFERENCE BOARD, NEW YORK, NY

Mr. WEISS. Chairman Baucus and members of the committee, thanks very much for inviting me to testify at today's hearing. It is really a great honor to be sitting at this table, not as a staff person, but as someone whose experience you are looking to draw upon to help you in this very important effort.

As the committee did in 1986, it is really important for Congress to periodically review the income tax, which generates the major share of Federal tax revenue, in order to raise that revenue as fairly and efficiently as possible. And the big advantage of a comprehensive tax reform effort is that many tax provisions can be changed at the same time, so that you can shape a package that accomplishes these objectives and balances out many competing considerations. This is very difficult to do, as you know, if you are working with tax bills that only deal with a few provisions at a time.

What I would like to do in my remarks today is just to focus on a couple of aspects of the 1986 act that I think were responsible for generating the large appeal that it did. And when you look at the votes that occurred and realize that versions of the bill passed by 20-0 in the Finance Committee and in the full Senate by 97-3, you realize that there were aspects that made this very popular and cut across party lines.

I think that there are two features of the act that were critical; one, the substantial rate reduction that it achieved; and, two, the significant improvement in the public's perception of the fairness of the tax.

Also important were two other aspects of shaping the act—revenue neutrality and de-emphasis on adjusting taxes' distribution by income class. I believe all of these considerations would be important for and allow success of a tax reform effort in the current environment.

Now, let me elaborate a bit on these items. An important part of the Congress's ability to produce legislation that accomplished these objectives was the experience that it had had in tax legislation immediately before the 1986 act.

The popularity of low tax rates had been demonstrated during the elections and tax debates of the early and mid-1980s. Taxes are very complicated, but most people understand how important rates are in determining how much they pay to the government.

President Reagan had made tax rate cuts a focus of his 1980 election campaign, and the subsequent Economic Recovery Tax Act, ERTA, of 1981 featured large individual tax rate cuts and indexing of their brackets.

Congress learned that tax rate reductions were very popular. The public's perception that the income tax was unfair, driven by countless stories of high income individuals and large corporations that paid little or no tax, was pervasive during the 1980s.

The unfairness problem had become so serious and the act's attack on it sufficiently compelling that even members who were not enthusiastic about the substance of the act felt they had to avoid being blamed if it failed to become law.

During my work during the 1986 act, talking to many members, I had very similar conversations. They said, "This may be causing problems. I have constituents who may be harmed, but this is something that I can't be seen to be blocking, to seem to be an obstacle to the progress of this act."

Both of these key features of the act, low rates and perceived fairness, were accomplished by substantial broadening of the tax base, and that was really the key, the mechanism by which these objectives were accomplished.

So deductions, exclusions, and credits were scaled back so that tax liability more closely related to taxpayers' actual income.

Now, by the time the 1986 act was being debated, members of both political parties in both houses had already become familiar with and comfortable with enacting base-broadening provisions. Right after the 1981 passage of ERTA, substantial budget deficits were projected as far as the eye could see, which is an interesting parallel to the current situation, and both the administration and Congress embarked on a series of acts to reduce the deficit.

President Reagan insisted on low tax rates, but he did not object to raising revenue. Indeed, his administration proposed substantial base-broadening measures that were incorporated in the 1982 and 1984 tax legislation.

Although many of these provisions met with substantial opposition, this experience allowed Congress to understand that broadening a tax base would not lead to some of the dire consequences that some had predicted. I think this experience with base-broadening was really important in helping members feel comfortable with what was being done in the 1986 act.

Now, the question arises, of course, will these features of a new tax reform act generate substantial support today, and I believe the answer is yes. I think tax rate reduction is still critical and popular, and I think that that would be an important part of any future tax reform effort.

Fairness has become an issue again, and it is not so much that there are numerous stories of people avoiding all their tax, but that there are so many overlapping incentives in the code that, along with the alternative minimum tax and people's increasing delegation of their tax preparation to tax professionals and computers, it is very difficult for many people to understand how their tax liability is determined and to make decisions accordingly.

A perception of fairness requires that people see that their tax liability is determined according to some logical principals, and sometimes currently it is hard to do that.

Another issue that would be also addressed by tax reform is the extraordinary amount of uncertainty in today's tax rules and tax

environment. One way to measure this is to count the number of expiring provisions.

As of early 1989, just a few years after the act, there were 14 provisions that expired either that year or the previous one. In contrast, as of early this year, there were 141 provisions that expired last year or will expire this year, and these include some fundamental aspects of the tax system, such as the rate structure and the existence of the estate tax.

This uncertainty is causing grave concern among a wide variety of taxpayers and may be inhibiting economic growth. Tax reform would be an effective process for Congress to actually deal with these expiring provisions and make decisions about their long-term fate.

In conclusion, I would like to congratulate the chairman and members of the committee for beginning to consider how to make another round of tax reform happen in the near future.

I will be happy to answer any questions.

[The prepared statement of Mr. Weiss appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Weiss, very much.

A question I have is—it seems, in your testimony, that the perceived and actual unfairness in rate structure was a major driver back in that earlier era. But the individual rates are a lot lower now than they were then.

But I do think your last statement raised another prospect, which I think is stronger, maybe stronger now than it was back then, and that is uncertainty. I just sense that the public, whether individual side or business side, is uncertain about whether to hire new people, invest or purchase something or whatnot, not sure what the lay of the land is going to be 4, 5, 6 months or a couple years from now.

Some of that is implementation of health care reform, some of that is maybe implementation of financial regulatory reform, but I think some of it also is related to the tax code, especially the business side. Is this expiring provision going to be here next year or not?

I guess my first question is, do you agree that that is a greater driver today, this uncertainty, than it was back then, and is it strong enough to replace, if you will, a perceived unfairness?

I may be wrong, and this would mean that unfairness in rates anyway is less of an issue today than it was back then, but I just wonder if you could address how we take advantage of people's concern about complexity; that is, their tentativeness by not knowing how to predict the future.

To what degree is that a driver we can capitalize and take advantage of?

You, Randy, or anybody who wants to answer that.

Mr. WEISS. I will start off. Yes. As I mentioned, I certainly do think that the uncertainty of what the tax rules will be next year and in the future is really important.

People make commitments or decisions that really depend on knowing what the consequences will be in the future in terms of how they will be taxed. And so I think clearing up that uncertainty would be very helpful and would be appreciated by many.

The CHAIRMAN. It drives me nuts, frankly. [Laughter.]

We have all the expiring provisions and it just—we have become an extenders Congress, even a maintenance Congress, and we did not come here to do that—at least I did not.

So it is not only the public, which is far more important, I think, that is uncertain about the future. But I can just tell you that many of us in the Congress are very frustrated with trying to deal with all the expiring provisions, too. It is a big problem, greater problem than earlier.

Dick, were you going to say something?

Mr. GEPHARDT. I think part of the reason that we get into that is that it has to do with the deficit and the budget.

Congress does not want to make something permanent, because you get these 10-year, even beyond 10-year forecasts, and, if you leave things permanent, then you run into budget problems.

So I suppose that is the reason. It may be that tax reform gives you a counter-reason to clear that up and make your decisions on what you want to put in the code and keep in the code and what you are going to throw out.

I want to associate myself with the remarks that have been made here on certainty. Just take the R&D tax credit. I think companies are really not using it to the extent they should today, because it is uncertain, and you can go down the list. I think it is really an important factor.

So I think it is something to look at, and it may be something that you can do in tax reform as you go through this big change.

The CHAIRMAN. Another question. How critical is revenue neutrality in achieving success?

I mean, like you said, it is critical, and I think maybe you, Bill, I think you may have mentioned it, as well. We have these huge budget deficits. Yet, revenue neutrality is certainly something the public will see as, "Well, gee, maybe it is revenue-neutral, it is not a backdoor way to tax us more."

But yet, we have these big budget deficits, and maybe the answer partly is what you said, Buck. If you are going to have to raise revenue sometime, the predicate, the precondition of having already achieved tax reform might make it easier, if it is necessary to later raise revenue.

Mr. CHAPOTON. Mr. Chairman, I think that is a strong argument for tax reform. There is going to be a lot of pressure to raise revenue, and we just should not do it with what we have now.

The CHAIRMAN. Any other comments?

Mr. ARCHER. I agree with that, but I think, politically, it makes it a lot more difficult. If you could assume some loss of revenue, you can then bridge a lot of problems that are created, and those problems had to be bridged in 1986, and it was not easy to get over a lot of them.

As I mentioned, some of them were not bridged, and, if you do not take into account the economic consequences, you will live through some very, very bad situations. And I mentioned in my testimony—and I was very concerned then and I was going back over, interestingly enough, the comments that I had made on the floor and statements that I had made in the Congressional Record at the time.

To retroactively eliminate the passive loss rules under which people invested in real estate, assuming that they would get that, caused them to have to dump their real estate projects, and that dramatically undermined the value of real estate and thereby undermined the security of the savings and loans, creating a massive problem for this country.

So revenue neutrality, I think, is essential. I do not believe you can do it without revenue neutrality, but, boy, it is fraught with a lot of problems.

The CHAIRMAN. Thank you.

Senator Grassley?

Senator GRASSLEY. I am only going to have an opportunity to ask one question, because mine is as involved as the chairman's was involved.

I have a second question that I want to leave for answer in writing, and I hope that each of you will give it the same consideration.

Before I ask a question, I would continue where Representative Gephardt left off on the lack of certainty of the future and not using the R&D credit. I find that to also be true for a lot of the alternative energy tax incentives that we have, whether it be wind or biodiesel. There are currently 23,000 people unemployed in biodiesel, as just an example, and solar and other sources of renewable energy.

The extent to which we could give more certainty to them, I think we would get people employed tomorrow, the day after we pass the bill.

I would like to address this question to all members of the panel. One of the key preliminary questions regarding tax reform is whether it should be done on a revenue-neutral basis. Revenue neutrality is usually determined from current law.

The revenue baseline from current law includes a large spike in revenue from the expiration of tax relief in the bipartisan Tax Acts of 2001 and 2003. You can see the spike for projected revenue data.

CBO, for instance, shows individual income tax revenues shooting up by 10 percent and trending upward. You can see the spike by taking a quick look at how widespread the 2001 and 2003 tax rate relief plans are. Virtually every American income taxpayer would face a significant tax increase.

So, if we were to undertake individual income tax reform with the assumption that the reform plan would have to be revenue-neutral, it would mean a tax increase of at least 10 percent on individual income taxpayers in 2011.

All of you were involved in developing the tax relief policy during 1984–1986, as I was. I am pretty certain that some of you would agree that the revenue neutrality test ought to be employed assuming the bipartisan 2001/2003 tax relief plans were permanent.

So the question. Would you care to comment on whether and/or why revenue neutrality ought to be applied, assuming current law levels of taxation are in effect in 2011?

I will just go across, starting with you, Congressman Gephardt.

Mr. GEPHARDT. Thank you for the question. It is a really good question, and you have in front of you now issues on the tax code that we did not have in 1984 and 1986. You have this question of, should the 2001/2003 tax changes be made permanent or not?

I want to associate with all who have said that tax reform is really hard to do on its own. And, if you get into a quarrel also about distribution and deficit reduction in the midst of it, I think you cripple the effort. I just do not see how, politically, you can get through all of that.

So I would, I guess, think that maybe you have to decide this question of the 2001/2003 tax cuts, make a decision on that, if the Congress can and the President can, and then get into tax reform, because there is an old song, "Breaking Up Is Hard To Do." Tax reform is hard to do, and, if you complicate it further, it gets even harder.

Senator GRASSLEY. Chairman Archer?

Mr. ARCHER. I agree with that, but I would say that, in the practical sense, you are not going to be doing this, Senator Grassley, in the next year. It took 18 months from the time Reagan totally committed to tax reform and started the ball rolling before it actually happened.

By the time you have any reasonable expectations to reach a final product, you will have resolved the 2001/2003 tax situation, and you will know what your base is and you will know what your projections are.

But you are absolutely right that that needs to be the case. And, frankly, I am happy that I do not have to make those decisions.

Senator GRASSLEY. Secretary Chapoton?

Mr. CHAPOTON. I agree with both things that have been said. Keep in mind that, if you look at what happened in Treasury I, the rates were the last thing put on the table. In other words, you made the change, then you went to the computers and you saw what the rate structure would be based on the new tax base you created.

So you set those rates, I would say, to raise whatever revenue is then raised under the then-present tax law. If you can afford to—and I do not see how this would be possible—but, as Mr. Archer says, if you can afford to give away some revenue, it sure would solve a lot of problems in enacting tax reform, and I do think I would associate myself with him about the concern of the retroactivity on real estate, because of the demand that it not lose revenue. So, if you can lose some, it becomes easier.

Senator GRASSLEY. Mr. Weiss?

Mr. WEISS. I totally agree that bringing deficit reduction into a tax reform effort where you have significant changes in the distribution of tax liability by income class would cripple the effort. I totally agree with that.

I think, as a procedural matter and a process matter, I think the 1980s showed that Congress can do deficit reduction and tax reform at the same time, and that effort succeeded by separating these efforts.

Congress raised tax revenue in 1982 in a big way, 1983 in the Social Security amendments, 1984, and then turned around right after the 1986 act and had yet another revenue increase bill in 1987.

Deficit reduction was a big focus in the 1980s. The Gramm-Rudman bill, which had that deficit trigger, was enacted just in the

middle of the House Ways and Means markup on the Tax Reform Act of 1986.

So, again, I think as far as structuring a tax reform process, I think revenue neutrality is really an important discipline and will help promote the success of the effort.

Senator GRASSLEY. I thank all of you. Thank you.

The CHAIRMAN. Thank you.

Senator Carper?

Senator CARPER. Thanks, Mr. Chairman. Again, it is great to see all of you and thank you for your service to our country and thanks for your willingness to serve us again.

We have spent a lot of time in this room in the last year and a half, with folks sitting at this table talking to us about things that we might do, but the issue might be health care, and things that we might do to improve outcomes, to improve health care outcomes for Americans, but to do so for less money.

A number of the ideas that were suggested by witnesses at this table were ideas that later on we tried to get CBO to score. And some of the measures that we are convinced would save money, a lot of prevention stuff and wellness ideas, instead of it being scored to save money, they actually scored it to cost money.

It was just counterintuitive, but that is the way they did their scoring.

Mr. Chairman, I am trying to think of how we reconcile the advice that we are getting here for deficit neutrality, how do we somehow square that with the fact that we have huge deficits, and they are not getting any smaller; in fact, over time, depending on what we do with these expiring tax cuts, they could get even larger.

I am trying to figure out, how do we somehow be consistent with the advice that you are giving us, that is, deficit neutrality, and, at the same time, look at the size of these deficits that we face today and could face even more later.

I just want to throw this idea out here, and I just want to ask you fellows to respond to it. If we were to adopt ideas, tax ideas, that, in the end, are deficit-neutral, at least that is the way they are scored by CBO, but in our hearts and in our minds, we know they are going to generate more economic activity, stimulate the economy, and grow revenues, if that might be a way to thread the needle here.

I just send that generally as an idea. I just want to put it there on your tables and ask you to respond to that.

The CHAIRMAN. I want to add, first, it is Joint Tax that is going to be doing most of the estimating, not CBO.

Senator CARPER. I am sorry.

The CHAIRMAN. And all apologies to Randy. And not to take all your time, but I think we are going to have an easier time agreeing with the estimates of Joint Tax than we did with CBO, because of the nature of the beast. They are just very different.

Senator CARPER. Good. So I would like to ask each of you to respond. We face a conundrum here, I think.

Mr. GEPHARDT. Well, one of the things I think you can do is go back and look at the estimates that were made in 1985 and 1986 and then look and see what happened.

Let me take you over to health care in CBO for a minute. I am told, I did not investigate this, so I may be wrong, that some of the estimates that CBO gave us on some of the cuts in Medicare that were made in 1987 were too low, that the actual experience was much better than they said it was going to be.

So I encourage you to—I do not know what the facts are, but I really encourage you to look. I have always believed that tax reform would increase economic activity, more people would comply with the code than do today, et cetera, et cetera.

So you have a case model in front of you, and I urge you to look at the history of this and see what happened.

Mr. ARCHER. I think your point is very well taken, Senator Carper, and I struggled with this as both chairman of the Joint Committee on Taxation and chairman of the Ways and Means Committee, because I was not satisfied that we were getting accurate estimates.

To me, that is what ought to be talked about, not whether it is dynamic or anything, but is it accurate? And I think Congressman Gephardt's point is well-taken. We could never get them to go back and say this is what we estimated, now here is what actually happened. And, of course there are things other than taxes that determine how the economy is going to work. So that is difficult to do.

But I would suggest to you, Mr. Chairman, to the degree that you have the power to do so, that you reform the estimating process. And that is not easy, I know, because I struggled with it.

But at the time I was chairman, the CBO determined the baseline, and then the joint committee could only make its estimates on top of what that baseline was. And there was no consideration of what you said, Senator Carper, that what you are doing may increase growth and may increase revenue by having a better economy—no consideration of that.

I think you have to pull together the baseline and the independent tax revenue estimates so that, if you have a major change in the tax code, which you would in tax reform, that you force there being a change in the baseline at that time, too, to represent what is going to happen to the economy as a result of what you have done in the tax code.

Senator CARPER. Mr. Chairman, my time has expired. Could the other two witnesses respond to my question, please?

The CHAIRMAN. Yes.

Senator CARPER. Thanks. Please.

Mr. CHAPOTON. When I was at Treasury, we did spend some time, early on particularly, on sort of a look-back analysis, and I think Randy can go through this a lot more effectively. But the revenue estimators operate under constraints, as well, and Mr. Archer has referred to some of them. They cannot change the estimate of GDP, for example.

But I just sort of think back at Treasury. At Treasury, we had two staffs in my office. We had the staff lawyers and the staff economists, which included the revenue estimators.

I have to say the lawyers always thought they knew the revenue estimate better than the economists did, but the economists always won.

Senator CARPER. Mr. Weiss?

Mr. WEISS. I would just like to say that the revenue estimating process is very difficult. The estimators are faced with making projections about changes in the tax law for which often there is very little evidence.

Some are easy. So you can look at tax returns and say, "Well, if I change the rate, this rate is this much revenue." But items where there is not direct measurement of the tax provision and for which the behavioral response, which is taken into account in the revenue estimates, has not been the subject of detailed study, it is very difficult to do.

I believe, certainly, when I was on the joint committee, and I am sure that this is the case, the estimators take their best shot at giving an estimate that they believe is reasonable and realistic.

I actually wrote an article on trying to go back and look at revenue estimates and see how close the outcome had been to the estimate that was given. I guess the first thing you realize is that, in many cases, it is very difficult to answer that question, because the estimate assumed that the economy would behave in a certain way or there would be a certain amount of investment that was going on, and then for reasons totally different and totally extraneous to the tax process, those assumptions did not play out.

So to really know whether an estimate was accurate, you really would have to know what the economy would have been hypothetically if the tax provision had not taken place. So it is a very difficult exercise in many cases.

Senator CARPER. Thank you. Thank you all.

The CHAIRMAN. Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman. Mr. Chairman, let me also commend you for holding this hearing. And I also want you to know how much I appreciate your strong leadership in getting the committee into tax reform. I think this is absolutely key.

The CHAIRMAN. Thank you.

Senator WYDEN. Gentlemen, as you know, we are having a heated debate right now about the tax policies of former President Bush, George W. Bush, or passing the new proposals of President Obama.

I am of the view that this is the wrong debate to be having right now, because either of these approaches would, in effect, write this flawed, discredited tax system into stone. And, it seems to me, the more relevant debate is to look at how our economy grew when Democrats and Republicans worked together on tax reform in the 1980s to make the code fairer and more pro-growth and simpler, and how it grew much more slowly after the tax changes of the last decade.

My old leader, Dick Gephardt, I think talked about a case study. Bill Archer is absolutely right. These are relative, because you can never precisely determine what tax changes had to do with an economy.

But during the 1980s, when Democrats and Republicans worked together on taxes, 16 million new jobs were created, and there was a 17.6-percent expansion in payrolls. By comparison, from 2001 to 2008, 3 million jobs were created, and there was only a 2.3-percent expansion in payrolls.

So there are some numbers that ought to be looked at to show that making the code more pro-growth and fairer and simpler really does redound to this question of generating more employment.

So what I would like to do for my first question, for you, Leader Gephardt, is to talk about the area we have not gotten into today, and that is the international side of the debate.

The American people, as we know, are all completely disgusted with this idea that you get tax breaks for doing business overseas. The companies come back, on the other hand, and say, "We have to have those tax breaks because our rate is high relative to everybody else."

My question for you, Leader Gephardt, is, would it not make sense now, on a bipartisan basis, to talk about taking away those tax breaks when American companies do business overseas and use those very dollars to lower rates here in our country, to make American manufacturing more competitive in tough global markets?

Would that not conceptually be a good idea for Democrats and Republicans to look at now?

Mr. GEPHARDT. That is one of the real benefits of going through this process is that you—as I said in my statement—get to look at each provision that is in the code, really study its effectiveness, study whom it helps and whom it does not help, and then make a judgment on whether you want to leave it in or not.

I have not really fully analyzed it, obviously, but you could look at the whole array of things that help companies that are doing work abroad and see if you could get rid of some of those that do not make sense, and then use that revenue, as has been said by some of the speakers here, to lower the corporate tax rate for all corporations, including those that do business abroad and those that do not.

So that is the kind of tradeoff and balancing that you can do in this process. It is, obviously, a compromise, and there will always be some who are not happy with your outcome. But, if you can help the whole economy grow faster and help American businesses succeed better, then that is something you really have to look seriously at.

So I commend you for that kind of analysis.

Senator WYDEN. Let me ask our panel one other question that I have come to think is a serious matter, and particularly when you look back at the history of what happened in 1986.

In 1986, you passed this exciting transformational set of changes in tax law and, virtually, as soon as the ink was dry, all the special interest groups came back and started trying to jam in to the tax code various things to unravel the transformational reform you had made.

Now, no current Congress can ever bind a future Congress. It seems to me that, as part of this tax reform debate, at least there ought to be a discussion that, when we get real tax reform, under the leadership of Chairman Baucus and all Senators working together, are there ideas that might be considered to make it tougher to go back and unravel it this time when you actually get it done?

I think this issue has to get out on the table. Do any of you want to get into that?

Mr. ARCHER. I think that is an excellent point, but I do not know how you implement something like that, because, as you said, one Congress can say it is statutory, so it can be easily changed.

Gramm-Rudman was supposed to have great benefits to the deficits, and you know what happened there. It got waived every time it began to look like it was going to take effect.

So I am not sure you can do that. But I would like to just jump in on your first question, if I could, for a minute or two.

Senator WYDEN. With the chairman's leave.

The CHAIRMAN. Certainly.

Mr. ARCHER. I think you do have to go back to determine not just whether this sounds good—and the way you described it, it sounds good. The way you described it, I think the majority of the American people would likely say, "Okay, we agree."

But the real question is, what will that do in the long term to our corporations' ability to compete overseas with their foreign competitors? And one of the things that is so tough to do politically is to determine that your tax code on international income or foreign source income really needs to be in symmetry with the way our foreign competitors are taxed by their countries, not in symmetry to the way domestic corporations are taxed for activities in the U.S., because taxes have an enormous impact on ability to compete.

Taxes are a major cost of doing business. And it is why we have seen, in my opinion, many U.S. corporations having to be taken over by foreign corporations in order to compete in the world marketplace. And now we have an even greater complexity that has entered the arena, and that is country corporations, not just private corporations, that have the rules of taxation of their foreign country, but you have the Chinese who have their own corporations, government-owned corporations that are competing in the world marketplace.

So this is going to get more complex and more difficult. But, if you want to save the really high-paying jobs that are part of our multinational corporations' activities, you must let them compete on a level playing field with their foreign competitors.

Bankers Trust is now Deutsche Bank, because our tax code put extra costs in the way of Deutsche Bank becoming Bankers Trust. And I worry tremendously about the growth of this, which I think, in the long term, will not be in the best interest of this country.

I compliment you on your broad-based tax reform proposal that you and Senator Gregg put together on a bipartisan basis. It is a major move forward to address an awful lot of things.

But what you brought up on deferral is one of the things that I worry tremendously about and what its ultimate economic impact will be on our ability to compete in the world marketplace.

Senator WYDEN. Mr. Chairman, you have given me way too much time. Can I just make one other quick point?

Mr. ARCHER. That is my fault, not yours.

The CHAIRMAN. One point. Go ahead. I was going to follow up on deferral, so go ahead.

Senator WYDEN. And I think Chairman Archer makes an important point. The question, I think, for our policy consideration is asking companies, how low does the American rate have to go in

order to make you competitive so you can give up some of these considerations, and I think the only question I was raising with the chairman is how do we get into that debate.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you all.

Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman.

I want to welcome my two former colleagues from the House of Representatives, the distinguished majority leader and my chairman, when I was on the Ways and Means Committee for about 6 or 8 years, I think, who allowed me to head up a lowly subcommittee called the Social Security Subcommittee, and greatly helped me in getting passed my pet project of repealing the unfair Social Security tax on seniors, which is, I guess—the people who are 65 and older are thankful that you were chairman at the time.

You succeeded, also, Chairman Archer, in lowering the capital gains tax rate, providing death tax relief, and accomplished a whole lot of other goals that we worked with you on. And you always did it with grace and dignity, and I thank you for that.

Dick Gephardt, I want to thank you for all your years of service and your leadership in recognizing that tax rates should be lower to help boost economic growth, because you believed that very strongly when you were the leader in the House of Representatives.

The 1986 tax reform was passed the year before I came to Congress. So I cannot take any credit or blame for it. But I think we need to take an honest look at whether the 1986 act was really a success, as people seem to think it was.

For example, the real estate market, as has been said, had struggled for years after the law passed. For about 6 years, the commercial real estate market was in the tank because of the 1986 tax changes.

Hundreds of pages of special tax breaks have been added to the code since 1986, hundreds. God, I cannot believe the amount. Two-thirds of the taxpayers hire someone else to do their taxes, including me. And Chairman Archer was the only person on the Ways and Means Committee, when I served, who continued to try to do his own tax returns, and I guess he succeeded, because he is still here.

Mr. ARCHER. I guess so, because they have not—

Senator BUNNING. Come after you.

Mr. ARCHER. That is right.

Senator BUNNING. People still believe that the tax code is unfair. American people believe the tax code is unfair, no matter what bracket they are in. And individual tax rates are creeping up to near the levels they were in 1986.

Half of the American people pay no taxes, none, no income tax. They pay the payroll tax. And many of them actually get extra money from the Treasury that they never paid into the income tax system.

Every developed country except one has a corporate tax rate that is lower than ours. Only one country has a higher tax rate than ours.

The alternative minimum tax, AMT, God bless it, was not indexed for inflation in the 1986 act, and the AMT will soon be steal-

ing more money from taxpayers than the regular income tax that we have.

So my question to the panel is a very easy one. Is the 1986 act really a success?

Leader Gephardt, would you like to try it?

Mr. GEPHARDT. I think it was. Senator Baucus, in his opening statement, said that—he quoted someone who said the tax code is like shrubbery or a shrub that you whack it back and then it grows back even bigger and stronger.

The history of taxation among human beings is that, whenever a tax is imposed anywhere, immediately you have special pleaders come in and say, “It should not apply to me, because I do something that is really important for society,” and then we grant these special favors.

That is human nature, and I do not know that you can change that, to go back to Ron’s question. Maybe there is a way, once you get it in place, to say, “Okay, if you want to have that special pleading to be granted, then we have to raise the rates to accommodate that,” kind of a pay-as-you-go tax program that might be able to be constructed.

But my answer to your question, Senator, is I think it did succeed. I agree with the statement about the real estate industry. As I remember it, in the last stages of tax reform in 1986, some of the Senators wanted to get a top rate of 28 percent. That was really important to them. And they took that retroactive action in order to pay for that, because that is what you had to do to make it revenue-neutral, and we have talked about that. I think that was a mistake.

So it was not perfect. I have never seen a piece of legislation that was.

Senator BUNNING. Granted.

Mr. GEPHARDT. But it did accomplish its major goals. It did get rates down for almost everybody. It did create a perception and the reality of greater fairness. And it did create some simplicity. But as usual, the shrub grew back, and we started—it is easy to get up and say, “I think we need a tax break for X, because the country really needs that now,” and it is very easy to grow this thing back.

So, if I had one admonition here at the end, it would be to try to work out a procedure that would make that harder to do.

Senator BUNNING. Bill?

Mr. ARCHER. I do not disagree greatly with what Congressman Gephardt said, but I do not think it has been a massive success. I think the devastation to the S&L industry, single-handedly, was probably the biggest negative in the economy during the time I was in the Congress, if looked at just by itself.

In addition, President Reagan, and I have said this over the years, he was mesmerized by the rates. His goal was to get the rates down, and they got the rates down. But at what cost? At what cost to complexities?

I was talking to my childhood friend—Jimmy Baker and I grew up together in Houston, TX—and I said, “How can you claim simplicity in this?”, because I was still doing my income tax. And he said, “Well, we knocked 6 million people off the rolls, and that’s simpler.” And I said, “Yes, for people who don’t have to do an in-

come tax, I won't argue that it's simpler. But for those of us who have to keep doing it, it's a heck of a lot more complicated."

I can remember, for example, during the deliberations in the Ways and Means Committee, Andy Jacobs, Democratic Congressman from Indianapolis, just threw up his hands, and he said, "Well, I can see what's happening here. By the time you get through doing all the worksheets that you have to do before you can go to the income tax forms, it's Miller time." And I will never forget that.

So it did not simplify, and in the foreign area, it made it far more complex. Simplicity was not achieved, but people were knocked off the rolls, and that is one reason why, today, almost half the people pay no income tax, as you mentioned.

Mr. Chairman, one of the things that I think is going to create difficulty for you in this process is to mobilize enough individuals to feel like whatever you are going to come up with is better than what they have today.

Now, if they do not pay any income tax, and if a big percentage of them are actually getting a check back from the government, as Senator Bunning said, which is true, you are going to have a hard time selling them that any new program is really going to be better for them. And I have worried about that over the years.

We, as Republicans, were more responsible for knocking people off the rolls than the Democrats were, but that is what you have to deal with today, because you have to mobilize enough of the American voters to really believe in what you are doing to be successful, and that is going to be another part of your challenge.

The CHAIRMAN. Senator Hatch?

Senator HATCH. Well, it is great to see you folks back, I will tell you. Dick and Bill, you have been great people, as far as I am concerned, all the time I have known you. John Chapoton, it is so nice to see you again. We appreciate your service. Mr. Weiss, your Joint Tax service was very important up here. We appreciate all four of you. So this is interesting to me.

Chairman Archer, let me just start my questions with you. You emphasize in your testimony how critical to the success of tax reform was the role played by President Reagan. Now, you further asserted that successful tax reform today would also require presidential leadership.

To succeed, then, do you believe that tax reform would need to be the President's number-one domestic priority or just one on a list of things that we would like to see happen?

Mr. ARCHER. Well, that is a matter of opinion. I think it is going to be so difficult that it likely will have to be his number-one priority. It was for President Reagan, and I think that was extremely important in getting the job done, and I think all four of us agree on that.

But interestingly enough, too, Mr. Chairman, you are starting out with total bipartisan support here from all four of us. I hope you can keep that until the end.

Senator HATCH. Well, you and the other witnesses all mentioned that the centerpiece of the 1986 Tax Reform Act was a broadening of the tax base and a lowering of the rates. I agree that this rep-

resented significant and comprehensive tax reform. But my question is, was it fundamental tax reform?

I very clearly recall the persuasive arguments that you made, that you, in particular made, when you were chairman of the Ways and Means Committee, that we needed to tear the tax system out by its roots so it can never grow back to this new monstrosity, as it has since 1986.

Now, do we need a more fundamental reform, such as some sort of consumption tax or flat tax, or can we achieve that kind of tax system that literally would not allow the re-growth—the bush to grow even further?

Of course, America, in my opinion, needs—by broadening the base and the rate-lowering approach, would that be the way we should go once again?

Mr. ARCHER. Well, I think, if you are going to keep the income tax, you are going to have to broaden the base. And the only thing that—again, a caveat is that, as you broaden the base, you have to be very careful that you do not do it retroactively and that you know what the economic consequences are likely to be.

Frankly, I would hope, too, that there would be a thorough analysis of what the compliance costs are going to be, which are an unnecessary burden on the economy, in my view.

But unfortunately, and, again, these are my own opinions and I was not part of the majority, but I came away from 1986 very disillusioned as to whether you could ever fix an income tax.

I welcome the effort that you are undertaking, Mr. Chairman. I hope you can. I think it is desperately needed. But I came to the conclusion, as you mentioned, Senator Hatch, that we needed to tear it out by its roots and replace it with something that, number one, would not be a magnet to pull in all kinds of special interest provisions and all the things, Mr. Chairman, that you complained you have to deal with with the extenders.

The income tax is just a magnet to bring in those things from people who want to say, “Oh, yes, but my deal is important, so give me a special exception,” and it undermines ultimately the effort.

So my views were there in writing, and the dissenting views and the statements I made on the floor and everything else, but they were not sympathized with by the majority, and I lost.

However, it is very interesting to note that I was designing a motion to recommit with instructions that would have fixed some of the truly egregious things that I saw in the 1986 act, and I am convinced there were a majority of votes on the floor of the House that would have voted for that motion to recommit with instructions.

On the eve of that, I was called into Bob Michael’s office, and Bob Michael said, “Well, the White House is calling me, and they have to take away your motion to commit with instructions.” And he said, “I’m going to have to take it away from you and offer just a straight motion to recommit.”

In the end, rather than violating tradition and procedures, I agreed to go ahead and just offer a simple motion to recommit, without instructions. We still got 160 votes against the bill.

But I am convinced that, had we been able to send it back and make four or five changes, it would have been a success, Senator Bunning. So anyhow, that is just my opinion, Senator.

Senator HATCH. Thank you. Mr. Chairman, if I could ask one more question.

The CHAIRMAN. Yes, fine.

Senator HATCH. Mr. Chapoton, you played a major role at Treasury in developing the Treasury proposals now known as Treasury I and Treasury II. How important a role did these proposals play in the process of moving the Congress towards the 1986 Tax Reform Act, and can and must Treasury play a similar role in developing the underpinnings of a viable tax reform plan in the future?

Mr. CHAPOTON. Senator, I think, as I have said in my written statement, I think they played a pivotal role, because they—

Senator HATCH. Could you also cover—as I recall, you discussed the fact that a flat tax proposal was considered and rejected in the early 1980s because of the effect such a tax would have on redistributing tax burdens, if you could address that, as well.

Mr. CHAPOTON. Well, as I mentioned—well, first of all, to answer the first part of your question—I do think it was the work of the Treasury, and I think Randy hit on some points that—the whole process from 1981 to 1984 was instructive and helpful in the 1982 and 1984 acts that he mentioned. The fact that they did broaden the base, that they did raise revenues, certainly, without raising rates, was an important step in the overall consideration of the process in 1984.

In 1982, Treasury was asked to testify on flat taxes, and I testified, and I alluded to that in my written statement. And the problem that we were concerned about—we talked in the testimony about a lot of the efficiencies and the end simplicity if you go to a truly flat tax, but the overriding showstopper, if you will, was the redistribution effect of the tax burden from upper-income to lower-income. And we give some dramatic examples in the testimony.

But that was a serious concern, and I do not think the flat tax entered into the serious consideration in the tax reform effort in 1984.

Senator HATCH. Thank you, Mr. Chairman.

The CHAIRMAN. A question that comes to my mind is, how important is it or how much of a problem is it if individual income tax and capital gains—must they be the same as in 1986? Since then, capital gains has been a lower rate to spur growth in the country.

Must there be a differentiation between the capital gains rate and income rate or not? Anybody want to take that on?

Mr. GEPHARDT. Well, it has been a raging debate as long as I can remember, and we will all have different views according to how we come to this question. I think that, if you can get tax reform done and get income tax rates down, you kind of lessen the controversy.

I am not saying it will go away, but you make it a less controversial question. When the income tax rate is at 70 or 90 percent top rate, then there is real fire in the side that says there has to be a differential.

So we always thought in 1986, the lower we could get that top rate, then the less differential you would have to have, and you lessen the emotion and the difficulty of that debate.

The CHAIRMAN. Anyone else?

Mr. ARCHER. Yes. Mr. Chairman, in the late 1990s, the Joint Committee revised its computer revenue estimating process on capital gains and, for the first time, put in behavioral response. And, if you want more revenue from capital gains, you cannot have them above 20 or 25 percent.

If your individual rate is higher than that, and you put the capital gains rate up there, you are going to lose revenue on capital gains, and that—it is interesting to me that ABC, in one of the debates, asked Candidate Obama about that and even said, “Well, don’t you understand that, if you raise the rate, you are going to get less revenue?” The reporter asked him that. And he did not argue with that.

It was subsequent to that that he revised his proposals and said, “Well, the capital gains rate will only go back up to 20 percent.”

So I think, when you are concerned for revenue, and you will be in tax reform, that you need to take into account how you are going to get more revenue from the capital gains tax.

The CHAIRMAN. How important is it to pursue tax reform given our system, as we know it, or specifically pursue consumption tax, VAT tax, other systems?

Mr. GEPHARDT. I have always believed—we went through all that discussion in 1984 and 1986. We looked at VAT taxes, we looked at a totally consumption-based tax, a flat tax, a flatter tax, which is what we came up with, and my conclusion then, and it is probably still my conclusion, is that all of those other systems are a bridge too far.

It is almost like perfection in someone’s eyes meeting reality. This is a complicated country. It is a large country. It is a diverse country. You have many, many different views of what is fair and right.

I simply do not believe you can find a consensus that moves to a flat tax or a consumption tax. I understand the arguments that people make for that, and I tend to agree with those arguments.

But putting that aside, I just do not think you can find a consensus in anything other than amending or reforming the code that we have.

The CHAIRMAN. Anyone have a contrary view? Do you want to speak?

Mr. WEISS. I was just going to agree. I think one of the important aspects of the income tax is that it is progressive; that higher-income individuals pay a higher percentage of their income in tax than lower-income individuals. And I would be very surprised if the public were to accept a change that did away with that characteristic.

The CHAIRMAN. Mr. Chapoton?

Mr. CHAPOTON. As I have said, I think the basic flat tax or partially flat tax does not work; it is not going to fly. You are going to have a graduated, consumed income tax, but the problem is you have a smaller base, by definition, if you tax only consumption, and you have a much higher rate.

So I think that makes it—and when you get into perceptions of fairness, it does not look as good, frankly. And so I think I would encourage you not to—I do not think it would work.

The CHAIRMAN. Clearly, our goal is to make sure American companies can compete on a level playing field with other countries, companies, et cetera.

Chairman Archer, you talked a bit about this. I hear a lot about moving away from worldwide to territorial. I guess the U.K., and maybe another country, has recently moved to territorial, ostensibly for that reason. You hear from the business community in the U.S. that our corporate rates should be lower.

Your thoughts on what we need to do to maintain and enhance and, Chairman Archer's view, even out-compete other countries as we move to tax reform?

Mr. CHAPOTON. I would just say that is a real issue, a very complex issue because, as Mr. Archer said, the complexity of the international provisions is immense. And I think he really articulates quite well the conflicting views.

I do think—I have always thought that we should really look at a territorial tax. And I think politically, it would be tough to go there, but it might make a lot of sense, for the reasons he states. They are competing in another—our companies are competing in another market, and, if there is a different tax system in that other market, then they are competing with one arm tied behind their back.

The CHAIRMAN. Anybody else?

Mr. ARCHER. Yes. I would just revert back to what I said earlier, that a territorial system may be the way to get us competitive in the world marketplace. But we have to be very careful as to how it is contrived and how it is conceived and the details of it.

The important thing is to go back to what I said. We must have taxation of our foreign source income that is on a level playing field with our foreign competitors, and we will win if we are on a level playing field.

But when we are going into the arena with one hand tied behind our backs, we are not going to win ultimately, and we are going to lose our corporations, and they will become run by foreigners, and all the high-paying jobs will be in other parts of the world.

The CHAIRMAN. Randy?

Mr. WEISS. I think this is a difficult balancing act. I think it is really important to keep in mind that a big part of the international competitiveness of the U.S. is to make it very attractive for companies to do business in the U.S. And so that involves really, not the taxation of U.S. companies abroad, but rather the tax rates on income that is earned in the U.S., by both U.S. and foreign corporations.

So there is clearly a balance. On the one hand, it is definitely important that U.S. companies have the ability to expand their markets and drive innovation around the world. On the other hand, it is important to be able to attract and stimulate activity here at home and attract foreign investment, as well, which has been increasingly important.

The CHAIRMAN. As we proceed with our hearings, obviously, we are going to have to set up an agenda and schedule. Some subjects are going to have to come ahead of others. But one of the—Chairman Archer or somebody mentioned hours and hours, hundreds of hours of hearings to begin to get—to educate members of the com-

mittee and Congress and so forth. It is somewhat the same approach that we took in health care reform.

In 2008, this committee had many hearings on our health care system, to the degree we have a system; how does it fit together, how does—we had no ideological axe to grind, just the facts so we hopefully knew what we were talking about.

Would you give us some sense of what the order of subjects were that you addressed and any guidance you might have in what we might look at first, second, or third, anyone?

Mr. GEPHARDT. I think you have to start where you are, which is the concept, the overall tradeoff concepts that you are dealing with so that people can start to see what is involved here, that it is not a simple exercise, that there are lots of side roads you have to go down and things that have to be looked at, and then delve into each of these areas we have been talking about in greater detail, because they are the subparts that make it up.

Let me just mention the international business thing is one of the areas you really have to spend some time on. From this discussion, I think it is clear, part of the reason that we put things like deferral and other things in the code was because the corporate rate here, as Bill Archer said, got ahead of, or more than it was in many of our competitive countries.

So the international corporations came in here and asked for special treatment. They asked for a special way to deal with it.

If you could trade that off—and I do not know if you can, but that is what I think you have to look at—to get that rate down, is that a better overall outcome than what you have? And that just takes hard work, analysis, discussion, getting people to really look at the tradeoff and understand it, and see where you are.

The CHAIRMAN. Thank you. Anyone else?

Mr. CHAPOTON. That is a tough assignment, Mr. Chairman, but I certainly agree. Starting here is a starting point, and you might take a lesson from the organization at the Treasury Department when it had to undertake the same effort; where do you start and what do you look at first.

The CHAIRMAN. Well, basically, you—you have all been terrific in giving us lots of ideas, and I think the answer to my question is we just have to start somewhere. We just start, and then we will know what the next step is after that. This is not rocket science.

It will be difficult to find solutions, but I think it will not be too difficult to find the subjects to pursue.

Senator WYDEN?

Senator WYDEN. Thank you, Mr. Chairman.

I just had one other policy question, and it reflects the point you made at the beginning about how complicated this is and the thousands and thousands of pages, and that everybody has to get a preparer and buy software, and then you go through this April filing blues after you have done all of this.

What has left me confident that there still is a real opportunity for bipartisanship here is, when you look at some of the recent proposals for simplifying the code, there is a lot of common ground.

You all recall that the commission that George W. Bush put together that was chaired, I think, by Senator Breaux and Senator

Mack, they came in with a 1-page 1040 recommendation. I think it is like 33 lines long.

Then when you look at everybody else's ideas, they all go between like 29 and 35 lines long. And that's pretty good for government work. There are a lot of opportunities for compromise here.

There is one idea that has come to light I would be interested in your opinions on, because I think it could be a real boon for taxpayers if it was laid out as an option. And that is the idea of saying that, if Americans opted for this, nobody would be required to do it, it would be completely voluntary. Americans could, in effect, say to their government, the IRS, you have all of this information that is being reported anyway, about retirement, savings, and a variety of areas where information is collected, dividends and the like. If people chose it, they could have the government, in effect, take that information, do their taxes for them, and then mail it to them, and then an individual could revise it. So the people, if they chose it, could get out from under some of the hours and hours and hours that were devoted to it.

I think it is an attractive idea. I would be interested—do any of you have thoughts on this? And emphasize an option, a question of whether taxpayers, come April, could say, "You fill it out. Send me what amounts to a draft kind of code, I'll make some adjustments, and I'll mail it in."

Leader Gephardt, any thoughts, any of you, on this?

Mr. GEPHARDT. Obviously, anything you can do to make it easier for people is a good thing. I take it you are probably looking at people who would be in the most simple return, short form or whatever.

Senator WYDEN. Right.

Mr. GEPHARDT. And maybe it could work for them. I have doubts that it would work for people who have a little more complication. And as you heard, you do not have to get very high up to have a lot of complication with today's code.

But if you simplify it and you get more people onto a simpler form, maybe that is something that could be looked at.

Mr. ARCHER. Well, I compliment you on your creativity and your determination to do something about this, and I mean that very genuinely. But I tend to agree with Congressman Gephardt.

When I was doing my own return, it took me more time to get ready to go to the form than it did to complete the form. And so I do not think that having the IRS complete the form would have been of any benefit to me.

Senator WYDEN. I only bring it up because apparently there has been interest in this concept, as well, with the taxpayer advocates. So it seems to me that we will continue the discussion.

Chairman Baucus has been great to let this go so long.

The point, it seems to me, and Leader Gephardt makes the point, what we want to do for people is start with a 1-page 1040 form.

Every single objective analysis, whether it is President Bush's commission or the various proposals that are out there, they are all between 28, 29, and 35 lines long. We ought to, on a bipartisan basis, be able to do that.

Then, it seems to me, that some of the additional ideas—California has started this concept that I have described on a trial basis. It seems to be well-received.

Leader Gephardt has made the point that not everybody, obviously, is going to use it. We ought to be looking at trying to give people tools to get out from under this idea that they spend their entire spring, when they would rather be with their family, wading through all this stuff.

Mr. Chairman, again, thank you for all your leadership. It has been a great way to start.

The CHAIRMAN. Thank you, Senator. You have lots of energy and imagination, as Chairman Archer has said.

I just want to thank you all very, very much, on behalf of the whole committee and, frankly, the country. As Senator Carper said, you are all great public servants, and you still are serving. We are deeply indebted to you. Thank you so very much. I have a hunch we are going to be talking to you several times more on this very subject.

The hearing is concluded.

[Whereupon, at 12:15 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Statement of Bill Archer
Senior Policy Advisor, PricewaterhouseCoopers

Before the
Senate Committee on Finance

Tax Reform: Lessons from the Tax Reform Act of 1986

September 23, 2010

Chairman Baucus, Ranking Member Grassley, and Members of the Committee:
Thank you for holding this hearing on tax reform and for inviting me to testify today on "Lessons from the Tax Reform Act of 1986." Our tax laws play a critical role in our Nation's ability to grow, create jobs, and be competitive in the global economy, and I appreciate the opportunity to discuss this important subject with you today.

As requested, my testimony will focus on the key factors that led to the Tax Reform Act of 1986 and the challenges that Congress faced in considering such a significant tax reform proposal.

Let me start by noting that I am speaking on my own behalf. While I currently serve as senior policy advisor to PricewaterhouseCoopers, my views are my own and should not be attributed to PwC.

For 30 years, I had the great honor of representing the 7th Congressional District of Texas in the House of Representatives. The Ways and Means Committee was my primary committee for 28 of those years, and I was fortunate to serve as Chairman from 1995 to 2001.

There were many factors that led to tax reform in 1985 and 1986, but I am convinced that President Ronald Reagan played the single most critical role in passage of the 1986 Act. I am not the first person to note that major tax reform requires presidential leadership. That was true in 1986 and it is true today.

President Reagan was passionate about individual tax rates. He often recounted that during World War II his income from acting was taxed as high as 91 percent, leaving him with only 9 cents of each additional dollar of work. He understood from this experience that high tax rates discourage people from working harder and undercut economic opportunity.

In 1981, early in his first term, President Reagan succeeded in reducing the top individual rate from 70 percent to 50 percent. He continued to press for lower rates in his campaign for reelection in 1984. After the election, President Reagan made tax reform a center piece of his 1985 State of the Union Address and second term agenda. Ultimately, with the 1986 Act, he achieved a historic reduction in tax rates to a top individual rate of 28

percent and a top corporate rate of 34 percent. At that time, these were among the lowest rates in the world.

As an aside, in a lighter moment during the work on tax reform, I have been told that President Reagan spoke with Ways and Means Chairman Dan Rostenkowski about the President's personal experience with tax rates as high as 91 percent during his career as an actor. Reportedly, Chairman Rostenkowski showed surprise and quickly replied that he did not think President Reagan had been a good enough actor to be in the highest tax bracket.

Without doubt, President Reagan's personal commitment to lowering individual tax rates was a key factor that helped keep tax reform on track.

The Ways and Means Committee and the Senate Finance Committee also were critical players in the 1985-1986 tax reform legislation. The two committees held extensive hearings and worked closely with the administration in crafting the legislation that became the 1986 Act. From start to finish, the process lasted approximately 18 months and went through several reincarnations.

Ways and Means Chairman Dan Rostenkowski and Senate Finance Chairman Bob Packwood demonstrated strong leadership in the day-to-day process of developing and debating specific proposals. Other tax committee members, such as Dick Gephardt and Bill Bradley, had long supported lower tax rates and were committed to this effort. When tax reform seemed to stall, Ways and Means Chairman Rostenkowski initiated a tax reform dialogue with the American people with his "Write Rosty" public outreach campaign.

Treasury officials performed an essential role in the tax reform process and devoted significant resources to this effort. Treasury Secretary Don Regan oversaw the development of the Treasury I proposals. White House chief of staff James Baker and Secretary Regan switched jobs, and then Secretary Baker put forth the Treasury II blueprint for tax reform and helped the President and Congress to deliver the final legislation.

In sum, the commitment of the President, the Treasury Department, and Congressional leaders was an essential ingredient to the enactment of the Tax Reform Act of 1986.

Other factors contributed to an environment fostering support for a serious tax reform effort. There was a general public sentiment that the tax code was unfair. Numerous press accounts revealed that some in our society were paying low levels of tax compared to their income, selling tax losses to others, and engaging in other schemes to avoid tax. These concerns about fairness provided a general receptiveness among many Americans to support tax reform as a means of restoring tax fairness. Maintaining distributional neutrality among different levels of individual taxpayers was part of the fairness equation. The number one goal of tax reform became to restore fairness to our tax laws.

The United States had come out of two back-to-back recessions in the early 1980s, and tax reform provided an opportunity to promote long-term economic growth through a reformed tax system. President Reagan often spoke of the economic growth benefits of lower tax rates and the potential impact on individual entrepreneurs. Many economists testified in favor of a low rate tax system with a broad tax base as an efficient means of funding government and promoting economic growth. Economic growth became the second major goal of tax reform.

There was a widespread belief that our tax laws had become too complicated. Excessive compliance burdens were being imposed on individual and business taxpayers. With this in mind, simplicity became a third goal of tax reform. But simplifying the tax code is a very difficult task. I recall asking Treasury Secretary Baker how anyone could claim that the tax reform proposal would advance simplicity. I recounted my surprise to find that the 500 page description of the Treasury II proposals said the proposed change to foreign source income would add significant new compliance burdens on taxpayers and the IRS. Secretary Baker responded that the three goals of tax reform were fairness, growth, and simplicity, and there was a reason why simplicity was listed last.

Raising revenue to reduce the budget deficit was not an objective of the tax reform effort. Major efforts previously had been undertaken to reduce budget deficits, and new rules to restrict government spending had been put in place (e.g., Gramm-Rudman-Hollings). I was a member of the 1982-1983 Greenspan Commission that was credited with restoring the immediate solvency of the Social Security program. Concern about the potential growth in entitlement spending was not as pressing as it is today.

Nevertheless, mindful of large budget deficits from the 1982-1983 recession, President Reagan proposed that tax reform would have to be achieved on a revenue-neutral basis. It was not an option for tax reform to increase the deficit, and I am convinced that President Reagan would not have signed a bill that resulted in a net tax increase.

This Committee is well aware of the strain that revenue neutrality places on sound tax policy and stakeholders. A revenue-neutral tax reform bill makes it difficult to consider some worthy ideas and inevitably produces "winners" and "losers."

Achieving revenue neutrality was not easy in 1986 and is not easy today. Tax reform was at risk of coming apart throughout the entire process because of concerns about the impact of the base broadening features of the bill. There are many examples, but I remember well the concerns raised by some in the business community about the impact of repeal of the investment credit and accelerated depreciation on business investment, and about the overall impact of the legislation on the ability of our businesses to compete in the global marketplace. President Reagan even had to travel to Capitol Hill at a key point in the process to secure passage of a House rule so that the bill could move to the Senate.

I wish I could have voted for tax reform with a historically low rate structure. I was excited about the prospects of tax reform but I grew increasingly concerned about the

direction of the bill as the process unfolded. In the end, I felt the legislation on balance would do more harm than good. Let me briefly explain some of these concerns.

The economic impact of many of the base-broadening proposals was uncertain at best. Industries were raising legitimate concerns about the adverse impact of the changes on capital formation and global operations, among other things.

While the 1986 Act was revenue neutral overall, the corporate sector suffered a \$120 billion net tax increase to offset individual rate reductions between 1987 and 1991. This was roughly a 25-percent increase in corporate tax payments at the time. Such a significant tax increase on business makes it harder for businesses to grow and create jobs.

The 1986 Act made a significant change to real estate investments on a retroactive basis, causing serious adverse consequences. I am referring to the passive loss rules that imposed restrictions on the deduction of losses from existing real estate investments. A number of economists and the Federal Reserve have cited this change as adversely impacting real estate values, which in turn contributed to the U.S. savings and loan crisis during the late 1980's and early 1990's.

I hope that future tax reform efforts will learn from this experience and give more consideration to the economic consequences of proposed changes. Today -- in a more internationally competitive business environment than in 1986 -- the economic consequences of reform are even more important.

As I noted at the beginning of my testimony, it is critical that our tax system promote growth, job creation, and global competitiveness. While the 1986 Act put in place some of the lowest rates in the world, this is no longer true. The U.S. corporate rate of 35 percent today is the second highest rate among our OECD trading partners (the U.S. rate inclusive of state taxes is 39.2 percent) and well above the 25.5 percent OECD average rate. In addition, many OECD countries have adopted tax systems that generally do not tax active business income earned abroad and have significantly strengthened their incentives to encourage domestic research and other innovation activities. These developments have caused American businesses to face a significant competitive disadvantage in global markets today. We urgently need to catch up with our trading partners on this front.

Tax code complexity continues to grow dramatically, and simplicity remains an elusive goal. In 2005, President Bush's tax reform panel reported that Congress had made more than 14,000 changes to the U.S. tax code since 1986. Facing a growing trend to use tax credits to address all sorts of problems and the resulting additional complexity, I put an informal moratorium on new tax credits during my tenure as Ways and Means Chairman. I was recently told that the tax code now has almost 100 separate business and individual tax credits, with over 70 new credits added since 1986.

Generally, targeted incentives have detailed criteria and definitions that a taxpayer must decipher. With so many features in the tax code, taxpayers are confused and unable to

figure out how to navigate through the maze of overlapping provisions, definitions, worksheets, and elections. As complexity has grown, individuals and businesses have seen their cost of tax compliance increase significantly. I hope that future tax reform efforts will make meaningful reductions in tax code complexity and the compliance burden.

Uncertainty also has become a significant challenge to the tax code since 1986. The 1986 Act made a large number of permanent tax law changes. In fact, so many changes were made that the tax code was renamed the Internal Revenue Code of 1986. Since then, there has been increasing reliance on temporary individual and business tax provisions. The most recent Joint Committee on Taxation report on expiring tax provisions lists more than 170 temporary provisions in the tax code. Over 70 of these provisions expired nearly nine months ago, and this Committee is currently working on their renewal. The 2001 and 2003 individual tax cuts affecting over 160 million tax return filers are scheduled to expire in December. The resulting uncertainty of these temporary provisions is disruptive to the economy and serves to undercut the desired incentive effects of the provisions.

In closing, the 1986 Act experience demonstrates that tax reform can be accomplished, but it is a difficult road fraught with peril. Achieving tax reform demands presidential leadership working together with the Congress for the good of the American people and businesses. The stakes are high because our economy, jobs, and the ability to be competitive globally rely on a well-designed tax system.

Thank you for the opportunity to visit with you today. I would be happy to answer any questions you may have.

Senate Committee on Finance Hearing
“Tax Reform: Lessons from the Tax Reform Act of 1986”
September 23, 2010
Responses to Questions for The Honorable William R. Archer, Jr.

Questions from Senator Grassley

- 1) As I mentioned in my opening statement, under current law, any discussion of tax reform must contemplate the spike in tax burdens in the individual income tax system that will kick in 2011. The rate system will dramatically change and affect virtually every American taxpayer, especially married couples. In 2001, when the bipartisan 2001 tax relief legislation was considered, the committee heard testimony on marginal rates. Some witnesses indicated that the rate structure then in effect was bringing back a form of bracket creep. If we return to that rate structure in 2011, with respect to any group of taxpayers, would you have the same concerns?

Bill Archer: I strongly support lower tax rates and believe they are the foundation for economic growth in this country. Bracket creep -- both due to inflation and real income growth -- can expose taxpayers to higher marginal tax rates over time and undercut economic growth benefits. Other tax code provisions that are not adjusted for inflation under current law also can have similar effects. It is important to periodically review tax rate structures and these other provisions to determine the impact of inflation and income growth and take steps necessary to mitigate these effects. A return to the pre-2001 tax rate structure could impose a risk of bracket creep for many taxpayers. The individual alternative minimum tax is a well-known source of inflationary bracket creep that Congress must address on a periodic basis. I also am concerned about the risk of bracket creep in new tax provisions; for example, the new health insurance tax on investment income since the threshold for this new tax is not indexed for inflation.

- 2) The landmark 1986 Tax Reform Act contained scores of transition rules. The Philadelphia Inquirer published a Pulitzer Prize winning series on the legislation. Much of that material focused on the transition rules. As a result of that controversy, Finance Committee Chairmen, from Senator Bentsen forward, on a bipartisan basis, implemented a practice prohibiting “rifle shots.” Many practical observers of the process for the 1986 legislation would contend that the transition rules were necessary to secure political support for passage. The political imperative of transition relief is an issue we cannot ignore. Setting aside revenue neutrality for an instant, how do all of you recommend treating transitional items such as credit carryforwards and the loss of depreciation deductions, interest deductions, and deductions for the recovery of inventory?

Bill Archer: Fairness and equity dictate that taxpayers must be able to rely on existing tax law when they make investment decisions. Tax law changes should be made prospectively, with fair and equitable transition relief for similarly situated taxpayers. Retroactive changes to tax laws should be avoided. As my testimony made clear, my opposition to the retroactive effects of specific base-broadening measures was one reason I voted against the Tax Reform Act of 1986.

Questions from Senator Hatch

- 1) Chairman Archer, you said that Secretary Baker told you that the Administration believed the three goals of tax reform in 1986 were fairness, growth, and simplicity, in that order. Do you think that these three goals should be the same for tax reform today, and if so, should the order of importance be changed?

Bill Archer: I do believe that fairness, economic growth and simplicity were the right goals for the Tax Reform Act of 1986. Achieving fairness in our tax laws and driving economic growth are worthy goals for any new tax reform effort. Simplicity often can be difficult to achieve, but it is an important goal seeking to reduce the compliance burdens of taxpayers filing annual income tax returns. One of the problems with the 1986 tax reform effort was that simplicity was defined by some as simply removing people from the tax rolls, but the goal of simplicity got left behind for many of those who still were required to file tax returns.

- 2) You mentioned that you did not support the 1986 Tax Reform Act because of several serious concerns you had with its effect on the economy, including the now widely-held belief that it contributed significantly to the savings and loan crisis. I, too, voted against the final version of the 1986 Act for similar reasons. Is it possible for us to enact beneficial tax reform that does not leave the economy reeling?

Bill Archer: It is critical that any future tax reform be carefully designed to promote economic growth. I do have serious reservations about excessively constraining the design of reform efforts by a requirement of revenue neutrality for two reasons -- the risk of unintended consequences it poses and the sacrifice of more beneficial pro-growth changes for the economy that could be made absent such a requirement.

- 3) In your testimony, you discussed the great need to make our tax system more able to promote growth, job creation, and global competitiveness for the United States. I could not agree more. Did the international tax changes made with the 1986 Act harm or help the U.S. in these areas? Given how much more disadvantaged U.S. firms are now in the global marketplace, compared with 1986, do you believe we should move international competitiveness higher on the list of goals for tax reform?

Bill Archer: During the deliberations on the tax reform bill, I was very concerned about the possible adverse impact of the international tax changes being made in the bill, and this was an important factor in my decision to oppose the Tax Reform Act of 1986. Today, more than ever, global competitiveness is an integral component of the ability of the United States to increase and sustain economic growth. As summarized in my testimony, most of our trading partners have drastically lowered their corporate tax rates, eliminated tax on active business income earned abroad, and strengthened research and innovation incentives. A key goal of future tax reform efforts, at a minimum, should be to put our tax system on a level playing field with the systems of these countries.

- 4) Do you think partisanship was as big a problem with the 1986 Act as it seems to be in the Congress today? Would today's Congress be able to make the necessary compromises to accomplish major tax reform?

Bill Archer: There is no denying that achieving bipartisan legislation that provides real reform is difficult. Bipartisanship requires responsible compromises to find common ground. I am encouraged that today there is a recognition by members of both parties that tax reform is needed, particularly to improve the competitiveness of our companies at home and abroad.

Questions from Senator Bunning

- 1) I am convinced that it will be nearly impossible to do major tax reform again, if the goal is to make the tax code more simple. There is only one interest group who wants simplicity, and that group probably includes almost all American taxpayers. But regular taxpayers aren't as vocal or organized as the special interest groups that are out to protect their special tax break. And in this information age, groups can easily stir up their members to flood Congress with messages against repealing their special tax provision. There is also the challenge of the political parties not cooperating with each other on any major issues. Many of you pointed out the importance of Ronald Reagan starting the tax reform movement from the top. Would Presidential leadership be enough to spur tax reform in our current environment?

Bill Archer: Strong Presidential leadership is essential but is not sufficient in itself. You need bipartisan leadership in Congress as well.

- 2) What should be the correct order of priorities in an ideal tax system? For example, how would each of you prioritize raising revenue, maximizing economic performance, simplicity, and making social policy? And how does our current tax code stack up in that priority list?

Bill Archer: The priorities should include fairness, economic growth, and simplicity, generally in that order. When I was chairman of the House Ways and Means Committee I wanted to tear the tax code out by its roots because of the failings I saw in an income-based tax system. Many economists believe that a consumption tax system would be a more pro-growth way of raising funds needed to run the government. I was disappointed that I could not achieve consensus even within my own party to move our country away from the current tax code, but your question highlights the fact that the tax code does serve overlapping priorities. During the decade since I left Congress, tax complexity, compliance burdens, and uncertainty continued to present formidable challenges to taxpayers and tax administrators.

- 3) Some people used to think that the expiration of the 2001 and 2003 tax cuts this year, combined with the exploding alternative minimum tax, would force Congress to reform the tax code. Did the decision of Congress to exempt 80% of those tax cuts along with several years of the AMT patch from the pay-as-you-go-rules -- known as PAYGO -- prevent Congress from making the tough decisions we should about tax reform?

Bill Archer: The recent historic high levels of federal budget deficits are a serious concern and threaten our Nation's economic health. If left unchecked, these deficits and corresponding debt can be expected to pose a significant challenge to tax reform and other tax legislation. An important step would be to stem the large growth in federal spending as a means of reducing deficits. This could pave the way for a meaningful tax reform discussion.

- 4) Chairman Archer, you mentioned that the fact that half of Americans are not paying any income taxes is a huge barrier to tax reform. Are there other dangers of having more people "riding in the cart" and fewer people "pulling the cart." For example, I am concerned that many people will not realize the true cost of government unless they have to pay something for it. Do you think that more Americans should have to pay at least a token amount, so people understand that government programs are not "free"?

Bill Archer: Simply removing people from the tax rolls is not the same as simplifying the tax code. At the same time, I think most Americans believe they have an interest in how taxes are raised and spent because nearly everyone pays at least some form of tax at the federal, State, and local level, whether it be an income tax, a payroll tax, or a sales tax.

Questions from Senator Bill Nelson

- 1) If you could repeal one tax expenditure and use the revenue to provide broad-based tax relief, what tax expenditure would you repeal and why?

Bill Archer: The large growth in the number of tax credits and other tax expenditures clearly is a concern. As I noted in my testimony, I attempted to hold the line on the creation of any new tax credits during my time as chairman of the House Ways and Means Committee. I am told that now there are almost 100 separate business and individual tax credits, with over 70 new credits since 1986. I think a first step should be to refrain from adding new tax credits while a comprehensive review of existing credits to evaluate their relative merit is conducted.

- 2) While the United States has relatively high marginal income tax rates, it remains a low-tax nation, overall, relative to most of the developed world. What other countries lack in income tax revenue, they more than make up through other types of taxes. In your view, is it possible to keep the United States income tax competitive with other countries' income tax regimes when our income tax bears such a disproportionate share of the revenue burden?

Bill Archer: Again, when I was chairman of the House Ways and Means Committee, I wanted to tear the tax code out by its roots because of the failings I saw in an income-based tax system. Many economists believe that a consumption tax system would be more pro-growth and promote investment in new jobs and business expansion. Consumption taxes can be designed to be border-adjustable, which serves to enhance competitiveness. According to OECD data, shown below, the United States relies on income taxes for 49 percent of total federal, State and local revenues, compared to an average of 36 percent for other OECD countries. Consumption taxes contribute just 16.6 percent of total U.S. revenues at all levels of government, compared to 31.4 percent in other OECD countries. The overall mix of revenue sources should be considered by Congress as part of a pro-growth tax reform effort if we want to ensure that the United States is competitive around the world.

Tax Revenues (All Levels of Government) as a Percent of Total Taxation, OECD, 2007

Country	Income & profits	Social security & payroll	Property	Goods & services	Other*
United States	49.0%	23.4%	11.0%	16.6%	0.0%
OECD (excl. U.S.)**	36.0%	26.2%	5.4%	31.4%	1.0%
Difference	13.0%	-2.8%	5.6%	-14.8%	-1.0%

*Including rounding error

**Unweighted average

Source: OECD, Revenue Statistics, 1965-2008



**Hearing Statement of Senator Max Baucus (D-Mont.) Regarding
Tax Reform: Lessons from the Tax Reform Act of 1986**

Jeffrey Birnbaum, who wrote the book on the 1986 tax reform, said:

"The Tax Code is like shrubbery — the more severely it's pruned, the bigger and stronger it will grow back."

In 1986, Congress pruned the tax code, pretty severely. But it's grown back, bigger and stronger. Once again, it needs to be pruned.

The tax code is now about 70,000 pages long. A recent article in *The Economist* reported that Americans collectively spend more than seven billion hours filing our returns. That's the equivalent of nearly four million workers toiling full-time, year-round, just to handle the paperwork.

The Tax Reform Act of 1986 was a landmark law. It affected every American family and every American business. It significantly reduced taxes for individuals. And it eliminated many tax benefits for special interests.

The 1986 tax reform leveled the playing field.

No longer could a wealthy individual escape taxes by buying into a tax shelter. No longer could a clever investment strategy get investors out of paying their fair share. No longer could businesses participate in notorious tax shelters.

Similar taxpayers paid similar taxes.

But since the 1986 tax reform, Congress has made more than 15,000 changes to the tax code. Congress made these changes with the best intentions. Some to collect revenue, some to stabilize the economy, others to further other social objectives.

But each change created additional complexity. And each change created the potential for exploitation.

Once again today, just as in the 1980s, many can largely avoid paying taxes, if they know how to manipulate the tax code. A long list of deductions, credits, and exclusions are available to help avoid taxation.

Those who don't have a savvy accountant or who refuse to participate in tax games often end up paying more. Many honest taxpayers end up feeling like chumps.

During his effort to reform the tax code in 1985, President Reagan said:

"The American people are always willing, even eager, to do their duty, but you quite naturally resent it when you see others shirking theirs. It rankles to know that your tax rates are so high because others who can afford high-priced lawyers and tax consultants are able to manipulate the system to avoid paying their fair share."

Millions of Americans dutifully and honestly file their tax returns. They just want a fair shake.

They expect to pay the same tax as their neighbor who earns the same money. They expect not to feel like a sucker if they do the right thing. And that's not too much to ask.

Some may wonder why we're holding this hearing. They may assume that Congress cannot tackle tax reform. They may think: Times have changed, Congress won't compromise, and special interests are too strong.

That attitude is harmful to the American people and American democracy. Tax reform is not just about the tax code. It's about one of the most direct relationships that citizens have with their government. It's important that we try to make that relationship as fair as possible.

Now is exactly the time to talk about tax reform.

I am committed to tackling it. That's what our constituents sent us here to do.

They sent us here to meet challenges, not to shy away from them. They sent us here to make difficult decisions, not to ignore them.

Our continued prosperity and international competitiveness rest on our facing these challenges.

Today, we ask: What lessons can we learn from the 1986 tax reform?

The 1986 reform was the largest tax reform of a generation. It's important to learn from that history. And that's what this hearing is about.

We'll follow up with other hearings. We'll dig into areas of the tax code ripe for reform. Nothing will be off the table.

And so, let us prune back the tax code. Let us restore fairness to this fundamental relationship with government. And let us start today.

Statement of John E. Chapoton
Before the Senate Committee on Finance

re:

“Lessons from the Tax Reform Act of 1986”

September 24, 2010

Mr. Chairman and members of the Committee:

It is my great pleasure to appear before this Committee again. I congratulate the Chairman and the members for scheduling hearings on tax reform. Like many who follow the federal income tax issues closely, I have reached the conclusion that the current Internal Revenue Code is in desperate need of fundamental reform. It is far too complex, far too inefficient, and the levels of avoidance and even evasion appear to have reached unprecedented levels. For these and many other reasons, our tax system seems to have lost the respect and confidence of our citizens. Confidence that the tax system is basically fair is essential to the proper operation of the self-assessment tax system we have long considered a key ingredient of our free society.

I also applaud your decision to initiate this process with a review of the Tax Reform of 1986. As is often mentioned, any major change in the tax system will produce winners and losers, and the proponents of change will hear most vociferously and effectively from the losers. We know those are facts of life that have not changed since the 1980s. The fact that such sweeping tax reform was even proposed by President Reagan in 1984 was an act of political courage—some said it was an act of unnecessary political risk—and the ability of the Chairmen and members of the tax writing committees to see it through to completion in 1986 has been the subject admiration by most tax professionals, as well as study by political scientists. Your comparison of the tax system of twenty-five years ago, and the surrounding economic and political environment, with today's situation should be very enlightening. I hope my remarks will be of assistance.

I served as assistant secretary of the Treasury for tax policy from 1981, the first of the Reagan Administration, to August 1984. The office I headed was in charge of developing the Treasury tax reform proposals that resulted in the Tax Reform of 1986. The Treasury recommendations were presented to the President in the fall of 1984, and the President released them in December of that year. As the timeline shows, I resigned my position before our work on the tax reform proposals was completed so I did not witness the final developments from inside Treasury. (I should mention that I left this tour at Treasury after almost four years, and after overseeing three major administration-led tax

bills. I decided if I did not leave before the tax reform proposals were presented to Congress it would be difficult to leave until completion of the legislative effort, which was obviously going to be a lengthy process.)

An individual who played a key role in developing the Treasury's tax reform proposals in 1984 and beyond was Eugene C. Steuerle, then a career economist at the Department. In this effort Mr. Steuerle was given the title Economic Coordinator of the Project for Fundamental Tax Reform. He later became Deputy Assistant Secretary for Tax Analysis and is now a well-respected analyst of taxes and economic policy with the Urban Institute. Perhaps most important for today's subject, Mr. Steuerle wrote a book entitled *The Tax Decade* (The Urban Institute Press 1991), which contains a very insightful discussion of the economic and political factors influencing the Reagan Administration's proposal of this monumental tax reform effort. This excellent book also discusses in some depth the significant achievements of the Tax Reform Act of 1986 and where he thinks the final legislation fell short. I have reread the book and consulted with Mr. Steuerle in preparing today's presentation. I highly recommend this publication to you.

Now let me turn to the substantive issues.

Tax Legislative Events Preceding the Inception of the 1984 Tax Reform Effort

Tax legislative activity was on the front burner throughout the first term of Ronald Regan's presidency. This legislative activity and the coalitions that grew up around it helped create the setting for fundamental tax reform. There were three significant tax bills during this four-year period.

ERTA (Economic Recovery Tax Act of 1981)

The President had run on a platform of lower tax rates (the top individual rate was 70% in 1980). He proposed a 30% cut in individual tax rates over three years for all rates—"across the board." Congress gave him a 25% cut but dropped the top rate to 50% in the first year.

In addition, the 1981 Act brought indexation of the individual tax brackets into the U.S. tax code for the first time, along with indexation of the personal exemption the standard deduction, all to take effect in 1985. Indexation was not part of the original Administration package—it was added by Senator Armstrong and others in this Committee—but it was supported strongly by the President and trumpeted as a major achievement by the Administration thereafter. It was a fundamental change in the tax system. It ended insidious "bracket creep"—moving all income of taxpayers below the top bracket into higher tax rate brackets—a feature of the old law that had provided a constant source of new tax revenues year after year without the political pain of raising taxes (indeed it allowed presidents and the tax writing committees to offer tax cuts every few years, always a welcome gesture to the electorate). Indexation also reduced, for future years, the erosion of the personal exemption which had occurred over many years increasing the income tax burden of families and the poor. The 1981 Act did not, however, raise the personal exemption.

The President's initial 1981 tax package also proposed significant tax benefits for business. These were not in the form of rate cuts (the corporate tax rate was and remained at 46%). The business tax cuts were in the form of major new write-offs for business investments: very front-loaded depreciation deductions, plus a 10% investment tax credit, for new investment. Congress adopted these provisions substantially as proposed by the Administration. These changes significantly reduced taxes and the cost of capital to businesses, particularly large, well-established businesses that had income from earlier investments against which to use the new large tax benefits handed to them.

At the same time businesses that were not capital intensive—service companies, retailers, the high-tech sector, etc.—received little good news from the 1981 Act and were still left paying a full 46% tax rate. The same was basically true for new or small capital intensive businesses—since they did not have large tax liabilities from income produced by older assets they could not use the new tax deductions, at least not until years later, and thus the 1981 Act meant little to them. In spite of this clear dichotomy between winners and losers, there was strong support for the 1981 Act from the entire business community, even those sectors not directly benefitted. This was probably due in large part to the widespread belief in the business community, shared in Washington, that cost recovery deductions for new plant and equipment had been allowed to drop and America was in danger of losing its competitive edge. In spite of the surface tranquility in 1981, the disappointment of the high-tax companies didn't disappear; it smoldered and reappeared when the fundamental tax reform debated surfaced.

TEFRA (Tax Equity & Fiscal Responsibility Act of 1982); DEFRA (Deficit Reduction Act of 1983)

There were significant pieces of tax legislation in 1982 and 1984, although nothing on the order of the 1981 Act. These two bills were in effect spawned by the earlier big bill. First, anxiety about the revenue cost of the 1981 Act appeared immediately after the legislation was signed and was a continuing factor in the years following its enactment—OMB Director David Stockman reportedly told the President to expect budget deficits of \$200 billion “as far as the eye can see.” In addition there was concern on many fronts that the tax write-offs given business had simply been too large. Some studies showed that the new depreciation deductions, plus the large investment tax credit, produced a “negative tax rate” on some business investment—that is, the cost of the investment, after taking tax benefits into account, was lower than the cost would be if the owner were simply exempted from federal income tax. This was particularly true, it was argued, when coupled with large interest deductions if the equipment's cost were debt financed. It should be noted that the negative tax rate analysis is significantly impacted by the inflation rate, which was quite high in the early 1980s.

At the same time aggressive tax shelter schemes, which were already a huge problem, became even bigger when shelter promoters jumped at the chance to give high income individuals the depreciation write-offs and ITC offered by the new law. Obviously significant leverage (real and created by manipulation) made these transactions produce even larger tax deductions.

These factors and others resulted in Congress taking back part of the depreciation deduction benefits in 1982, the year after enactment. As I recall this action was not strongly resisted by the Business Round Table and similar groups. Also in these post-1981 Act years, “revenue enhancement” became the

phrase of the day. Revenue enhancement was a buzzword for a tax increase that President Reagan, obviously an ardent tax cutter, could support. To qualify the provision had to have the clear marks of a loophole closing change, or tax avoidance preventer; a naked tax raiser would never win the Administration's support. A significant number of revenue raising provisions were enacted in the years following the 1981 act. They undoubtedly helped reduce the deficit and stopped, or at least reduced, some tax motivated transactions that should have been blocked. But these changes were not part of a larger tax policy design. Moreover, they made no significant dent in the large volume of tax shelter activity that had been growing dramatically over the preceding decade and was exacerbated by the huge tax benefits given for new investment by the 1981 act.

The Appearance of the Tax Reform Effort in 1984

It is argued that President Reagan's focus had shifted over the years of his presidency from simply focusing on tax rates (the 1981 Act) to consideration of the broader questions of base erosion, tax avoidance and unfairness in the law, as indicated by his support of the 1982 and 1984 Acts. Whether or not this is correct, it was clear to all that notwithstanding the significant amount of tax legislation passed in the first three years of his presidency, there was widespread dissatisfaction with the tax code. The following are some of the prominent sources of unhappiness that were often cited:

- In spite of the major reductions of individual tax rates, the rates were quite high in absolute terms for both individuals and corporations (top rates were 50% & 46% respectively). Rates at these levels cause significant distortions in the economy, particularly when accompanied by avoidance opportunities.
- The basic unfairness in tax burdens between the capital intensive industries and the service, high tech, retail and other companies receiving little benefit from the 1981 Act had become more open and contentious.
- The fact that taxes played a major role in virtually all business and investment decisions was lamented. Some said the economic viability of competing opportunities was often secondary to the tax benefits it presented.
- The Internal Revenue Code was thought to be far too complex; the public objection seemed directed principally at the difficulty of gathering the necessary information and completing the form rather than transaction complexity.
- The Code was regarded as basically unfair. Undoubtedly the growth of tax shelters and the publicity surrounding them made many taxpayers feel they were overpaying while others were not paying their fair share.
- More sophisticated tax schemes had begun to appear taking advantage of the failure of the Code to properly deal with issues such as the time value of money. The use of derivatives appeared in tax schemes, permitting hedging and straddle transactions to shift defer tax liability.
- The tax base for both individuals and corporations has been seriously eroded by the increase in tax expenditures over the preceding decade or more (some of which, for example the investment tax credit, had been enacted in part to offset the impact of high tax rates on businesses investment).

- In policy shops there was continuing unhappiness with the increased tax burden on the poor and families caused primarily by erosion of the personal exemption through inflation over the years with inadequate relief in the tax reduction bills that appeared periodically.

The Administration was keenly aware of this dissatisfaction but many of the President's advisors argued that taxes had dominated the agenda during the President's first three years and it would be a mistake to put tax reform on the table and let that dominate the final year of the first term. This was an election year of course, and there was keen awareness that tax reform proposals were already on the table—Republican proposals such as Kemp-Kasten and Roth-Moore, and more importantly the Democrat proposal by Senator Bill Bradley and Representative Dick Gephardt. While these proposals varied significantly they contained similar themes—the principal one being base-broadening primarily through reduction of tax expenditures, accompanied by significant reduction in tax rates. Generally speaking they also dealt with fairness issues that had been long neglected, principally the increased share of tax imposed on families and the poor over the years.

The Bradley-Gephardt bill was the focal point. It was a very comprehensive proposal. The sponsors each served on the tax writing committees of their respective houses of Congress and thus had access to the talents and resources of the staff of the Joint Committee on Taxation. A very important resource in such an undertaking is of course the ability to compute accurate revenue estimates. A proposed change in the tax law can take on an entirely different hue once the amount of revenue it will gain or lose versus current law is discovered.

Flat Taxes

Proposals for flat taxes were also very much in evidence at the time, but other than the seductive appeal of lower rates they offered, I do not think they were a major consideration in the policy discussions. The Treasury had been asked to testify on flat-tax approaches in 1982. The Tax Analysis staff in the Office of Tax Policy did its usual careful and balanced critique which I presented to the Committee as Assistant Secretary. The analysis discussed the benefits and simplicity that could theoretically be achieved by a flat, or almost flat, tax. It also presented clearly the redistribution effect, the major concern then (as it is now in my mind) with the flat tax idea. In the purest version of the flat tax Treasury concluded the highest taxpayers would receive a tax reduction of 61%, while taxes on those with incomes between \$5,000 and \$10,000 would be increased by 149%. Those extremes could be reduced, but by no means eradicated, through adjustments in the structure of the tax. It's my view the unavoidable redistribution effect made flat taxes a non-player in the tax reform debate of the mid 1980s.

President Reagan's 1984 State of the Union Address

The President announced in his 1984 State of the Union speech that he had asked the Treasury Department to produce a proposal for tax reform, "to simplify the entire tax code, so all taxpayers, big and small, are treated more fairly." He also mentioned the desirability of a broader tax base with lower rates. At the end of these comments he said he had directed Secretary Don Regan to deliver the proposal to him in December—after the presidential elections in November. The audience laughed, and

the President, seemingly genuinely surprised, said in effect, "Did I say something funny." The only additional direction Treasury had in its charge to produce a tax reform proposal, as far as I know, was a statement the President made in a subsequent speech that the home mortgage deduction would not be touched by tax reform.

The Treasury staff under the direction of Secretary Regan proceeded on its task in the greatest secrecy possible. The Secretary was determined that the decisions they made in the process would not make the papers, and in this they were quite successful. At an initial stage in the process Treasury adopted several principals and goals. Two often-repeated goals seem the most important to me. The first was to attempt to return the income tax to its primary purpose of raising revenue and away from the tasks that had been thrust upon it over the years of both shaping capital investment and supporting multiple social purposes unrelated to the need to produce revenue. The second basic goal was to make the new tax reform package revenue neutral with the existing tax law in terms of overall revenue and within each economic income grouping. Everyone involved in the process was aware, of course, that even if these goals could be achieved there would be big winners and big loser within each grouping. The attitudes and actions of the losers would present the major legislative hurdle.

Secretary Regan's team produced its package—on time on "on budget"—shortly after the November 1984 presidential election.

The Five Stages of the Tax Reform Effort in Brief

1. Treasury I (December 2004)—A very detailed document outlining fundamental reform in a very purse sense. Virtually all deductions were eliminated and every attempt was made to redefine taxable income in terms of true economic income; depreciation and capital gains were indexed for inflation, and capital gains were taxed at same rate as ordinary income. The White House was startled and basically kept its distance. Many economists loved it but businessmen and many others had serious reservations.
2. Treasury II (May 1985)—Sent to the Congress as the Reagan Administration's tax reform proposal (this followed the job switch between Secretary Regan and White House Chief of State Jim Baker). Toned down many of the politically unacceptable aspects of Treasury I, making several political concessions at the beginning of the process. Reflected Secretary Baker's more pragmatic approach, but it was still a proposal for fundamental reform of both the individual and corporate taxes.
3. Ways & Means Bill (December 1985)—A soak-the-corporations bill; almost no base- broadening changes for individuals (the major deductions—interest, charitable and state and local taxes—untouched) but corporate tax incentives were reduced significantly. Top tax rates: individuals—38%; corporations—36%.
4. Senate Finance Committee Bill (May 1986)—Mirror image of the W&Ms bill—reduced or eliminated virtually all major deductions of individuals, and changed relatively few of the corporate incentives in the Code. Top tax rates: individuals—27%; corporations—33%.
5. Conference Agreement—Enacted Bill (August 2086)—Followed Senate bill more closely on individuals and the House bill with respect to corporations. Dramatic shift of the tax burden

from individuals to corporations (\$120 billion over five years, principally by repealing the ITC).
Top tax rates: individuals—28%; corporations—34%.

The basic outcome, and how did it happen?

Many found it difficult to believe that a President who had sponsored ERTA in 1981 could push through and sign the Tax Reform Act of 1986. The first brought effective tax rates on capital investment to near zero; the second dramatically increase tax rates on capital. On the other hand, the 1986 act was certainly consistent with President Reagan's original and overriding goal in 1981, the reduction of marginal tax rates.

In my view the 1986 act largely accomplished its primary goals: For individuals it reduced rates dramatically by broadening the base primarily by reducing tax shelters through a broad, conceptual approach (the passive loss rules) rather than adopting specific responses to specific problem transactions. On the business and investment side it basically took tax considerations out of investment decisions, thus permitting markets to direct investment to the most productive assets (certainly a good solution for economic growth). If these conclusions are correct the act largely achieved President Reagan's State of the Union goal of treating all taxpayers big and small more fairly.

A more difficult topic is how such a hopeless legislative undertaking was ever accomplished successfully in our free-wheeling legislative process. The success was obviously a confluence of events, some planned and many fortuitous. One factor that probably played a major role has been suggested. The fact that a relatively small number of people were basically in control of the legislative effort at any given point in time, unusual for such a large legislative initiative, made it easier to control and correct mistakes in tactics and substance throughout the process. The people in charge of each group are easy to identify:

1. Treasury Secretary Don Regan
2. Treasury Secretary Jim Baker
3. Ways & Means Committee Chairman Dan Rostenkowski
4. Senate Finance Committee Chairman Bob Packwood

Secretary Regan took what could have been considered a request for politically and legislatively feasible tax recommendations and ran with it, maintaining a tightly controlled and managed team to develop a gigantic legislative project. One can argue that from that point the product was so "pure" and thus promising in a theoretical sense that each of the successive "owners" was highly motivated not to let it fail during his stewardship. It seems clear that at some point under the final three owners, tax reform became the status quo. After that those wishing to change it, even in a small detail, had the burden of showing how their problem was different enough from the complaints of others to risk disrupting the new structure. Those seeking change were also routinely asked to enumerate the significant benefits provided for them elsewhere in the legislation, usually in the overall rate cuts.

Are these lessons helpful today?

A generation has passed since the events of the mid-1980s occurred. There is no hope of duplicating that process, and I doubt anyone would suggest that be attempted. But certainly there are some important lessons from that experience.

Perhaps the most important takeaway is that when the public is totally dissatisfied with the tax structure, as it was in 1984, the political system and the government it controls should respond and do so in a serious, responsible manner. I think the public is equally dissatisfied with today's tax laws, and with good reason. The political system responded in 1986 and certainly it can do so again today. It is worth the effort; when the public at large does not have confidence in the tax laws of a country over a long period of time, it is worrisome indeed. Other than voting, paying federal taxes is the only direct contact most Americans have with their federal government. Their government should not ignore their concerns.

A decided strength in the 1984 undertaking by the Regan Administration was the principled approach initiated by the Treasury Department and for the most part emulated by the leadership and staffs of the tax writing committees. Even those who would be disadvantaged had to concede that in concept the approach made sense "in a perfect world." They were relegated to arguing that the world is not perfect and cannot be made perfect. If the proponents maintain the high road, that objection begins to look empty. That is what happened in 1985 and 1986; even though all could see some political concessions being made, they could also see the overriding effort was staying with the basic principles adopted at the outset. At the individual level, everyone had to give up serious benefits in order for their tax rates to be significantly lowered; at the business level there was no waiver from the goal of taking tax considerations out of investment and business decisions to every extent practicable.

Of course one of the key principles in 1986 was revenue neutrality – tax reform was not to be a hidden tax increase. Many may disagree, but I think that same principle would be essential in a tax reform effort today. The public and many members of Congress would be very suspicious of a proposal designed to both make your taxes fairer, and to increase the government's take. If revenues must be raised, it should follow the tax reform effort as a separate, independent legislative undertaking.

Another obvious lesson to me is that a legislative effort of this magnitude must have the committed involvement of the president and all the resources he can bring to bear on the topic. An administration has the substantive assets and the bully pulpit. It is hard to imagine how tax reform could move without a clearly committed chief executive supporting the effort in every way. It would obviously be helpful if the personal commitment of the Congressional leadership that occurred in the 1986 effort could repeat itself but that cannot be made to happen.

Who are the culprits today—tax expenditures?

A disadvantage today may be that there are not the broad, high-profile tax culprits like the tax shelter industry in the 1980s. There is a feeling that many are not paying their fair share but the reasons may not be as apparent, and indeed the reasons may be more imbedded in the system and thus more

difficult to observe. Moreover, tax rates are considerably lower than they were a generation ago so there is not as much to trade for giving up miscellaneous tax benefits. But the unnecessary complexity, inefficiency and unfairness are there and need to be corrected. The tax expenditure list has grown exponentially. One analysis indicates – as a dramatic example -- that if all tax expenditures were suddenly removed from the law there could be a 34% reduction in tax rates across the board.

It is important to realize, however, that tax expenditures do far more harm than simply reduce revenues. They make the tax system much more complex and less efficient, and they do damage unrelated to our revenue raising apparatus. For example, the full exclusion of employer-provided health care from the compensation base not only makes tax rates significantly higher than they need to be, tax-free health insurance has a decidedly counterproductive impact on the demand for health care services and thus increase their cost. The deduction for home mortgage interest (to pick another noncontroversial tax expenditure) diverts capital away from more productive uses in the economy and was clearly a factor in the housing crisis we are dealing with today.

In addition, there are numerous examples of the complexities and inefficiencies we have created when we use the tax system to provide benefits unrelated to the production of revenues and don't do it carefully enough. A prominent example is the multitude of rules that apply to refundable tax credits for the poor, with different income rules and different and overlapping phase-out schemes. Not only are these provisions mind-numbing in their complexity, they add tremendous inefficiency and cost to the entire effort. There are similar examples throughout the Code.

Our Internal Revenue Code is, in a word, in terrible shape.

Conclusion

It is my pleasure to share these thoughts with you today. I have had the highest respect for the Finance Committee for many years and I have always enjoyed working with the members and your excellent staffs. I hope my thoughts may be of some help as you consider the important subject of fundamental reform of our tax system.

**STATEMENT OF
DICK GEPHARDT
PRESIDENT & CEO, GEPHARDT GOVERNMENT AFFAIRS
FORMER HOUSE DEMOCRATIC LEADER
BEFORE THE
SENATE FINANCE COMMITTEE**

Tax Reform: Lessons from the Tax Reform Act of 1986

September 23, 2010, 10:00 am

Chairman Baucus, Ranking Member Grassley, and Members of the Committee:

Thank you for inviting me here today. My name is Dick Gephardt and I am honored to appear before you to talk about the landmark Tax Reform Act of 1986 and the lessons it continues to offer.

I represented Missouri's 3rd Congressional district from 1976 to 2004. I also served as Democratic Leader of the House of Representatives for 14 years, from 1989 to 2003. On my first day in Congress, I was appointed to both the House Ways & Means and Budget Committees. From that first day until my last here – 28 years I was privileged to serve – I worked for a fair, simple and transparent tax code. I strongly believe that we advanced those goals in 1986, and I also believe that today, more than ever, tax reform can play an important role in restoring public confidence in the American Government.

BRIEF HISTORY OF THE 1986 TAX REFORM

In the early 1980's, the tax code had become so complex that over 80,000 people in the Country made their livings preparing other peoples' taxes. This was coupled with the perception and, too often the reality, that the code had unintended consequences on our economy. As a result, the vast majority of taxpayers came to believe that the tax code was not created with their needs in mind.

The one place that the public comes into contact with their Government on an annual basis – in fact every time they see their paystubs – is the tax code. Simply filing out the 1040 EZ had become an exercise in futility, sending millions of Americans to tax consultants to help them fill out a tax form. Roughly 60 percent of Americans felt the need to pay to get their taxes prepared.

The public's confidence was at a historic low and, the code, as it existed, was distorting investment decisions. During the 1980's, there was a dramatic rise in tax avoidance plans – shelters, loopholes that had riddled the code and were easily accessible to taxpayers with the means to hunt down arcane provisions that could be used as an excuse to hide income.

In 1982, Senator Bill Bradley (D-NJ) and I introduced the Fair Tax Act which reflected our view that the tax code needed to be dramatically simplified to restore public faith, and trust that the

code's intentions were to promote sound economic growth for all, and not just narrow, shortsighted and often counter-productive benefits for a few.

Super Dairy Cows were a prime example of that. There were substantial benefits to taxpayers to invest in dairy cows that could produce higher quantities of milk. Yet, due to dairy programs in the Farm Bill, there was already a glut of milk on the market. There was so much milk in fact, that cheese was literally spoiling in federal warehouses, with no appropriate consumer for the product. Schools, nutrition programs and other users already had their fill. Yet, millions and millions of dollars were invested in these tax shelters – with the federal taxpayer underwriting the benefits – because of some talented lawyers who helped arrange the tax dodge.

We began an aggressive effort to promote our tax reform plan. Similarly, Congressman Jack Kemp (R, NY-13) and Senator Bill Roth (R-DE), came up with an alternative approach from the Republican side of the aisle. We worked closely with them and their offices to help promote the need for action, and regularly publicly debated each other on our plans.

But, it wasn't until President Reagan embraced the idea of tax reform that real action started. The President had commissioned a number of extensive studies by the Treasury Department to look at various options – such as sales taxes and the VAT. After full analysis, President Reagan came to the same conclusion that I did – that the best approach was to reform the current income tax system rather than abandon it.

House Ways & Means Chairman Dan Rostenkowski (D, IL-5) began comprehensive hearings that helped establish a thorough and fair understanding of the provisions in the tax code at that time, how the code might be altered and what the implications of each change would be. It was critical for members of Congress to come to a complete understanding of the interaction of the thousands of individual tax provisions. Without this level of understanding of the complex issues involved we could never have reached the bipartisan consensus that in the end passed the bill.

FACTORS KEY TO 1986 REFORM

I see many parallels between then and now. And in many ways, the need for action is more pressing in 2010 than it was in 1986. In 1986, memories of the deep recession of the early 1980's were fresh, as well as of the energy crisis of the 1970's, increased international competition and the sharp rise in unemployment across the Country. All of these factors exist even more starkly today.

And just as in 1986, in 2010 the public's faith in their Government is waning. Taxes remain the principal point of contact between the average citizen and the Federal Government, and during tight budget times, the American people want to make certain that their tax dollars are not only fairly spent, but also fairly collected.

And, we all know, with each passing year, the tax code has become once again more riddled with preferences and provisions that alter investment decisions, encourage bad policies, unnecessarily reduce revenue and favor a privileged few. Why, for example, do we continue to provide tax

benefits for companies that move jobs offshore, when we are in such dire need of enhanced investment and job creation here at home?

It is time for us to look again at whether we can dramatically simplify the tax code so that it is broadly understood and – while perhaps not loved, at least respected. We need to look over every provision in the code and ask: does this really serve the greater good, is this the best way to help grow the economy, can we really afford the myriad of provisions that only benefit the privileged? And finally, we have to make certain that the tax code itself is not the driver of everyday investment decisions, leaving those to the free market and the great commonsense of the American people.

In 1986, we had the benefit of a strong desire for change in Washington and across America. We had leaders in both parties, like President Reagan, who were willing to negotiate in good faith, and debate when needed, and not just block anything and everything from getting done. These were leaders who were true champions of their respective philosophies as conservatives and progressives, but who were not hamstrung by partisan extremists who question every opponent's patriotism, vilify compromise, and who have more in common with the Know-Nothings than with our Founding Fathers.

CHALLENGES TO THE 1986 TAX REFORM

By 1986, the tax code had become riddled with preferences, many perhaps with a fair reason to explain their existence, but nearly all of them with a class of beneficiaries determined to protect their privileges.

Additionally, the public was wary of the process. They were anxious for change, but skeptical of our ability to deliver. We did substantial polling and focus groups at the time, to understand how the public viewed taxes and the political system. People supported the goal, but wanted to retain the tax provisions they used. Not a surprise.

I went into the process with a determination that, at the end of the day, we need to simplify dramatically the tax code - in a way that would maintain its progressivity and would not lead to higher budget deficits. We were not trying to raise taxes on the rich, nor cut them either. And, we didn't want to add to the budget deficit that was already careening out of control.

You now face an even greater fiscal challenge. Today's deficit is nearly twice as large as a percentage of the Gross Domestic Product as it was in 1986. Then, the debt was projected to stabilize and eventually decline. Today, the best estimates have it growing substantially, particularly in the out-years at just the point when the vast pool of baby-boomers is retiring.

If the effort to reform the tax code is undertaken, I would recommend these five lessons that I learned in 1986. First, it is vital that the legislative process reflect the openness and transparency that existed 24 years ago. With the vast expansion in media and the rich resources of the internet, you must ensure that the public is aware, step-by-step, of what is going on.

Second, it needs to be a studied process. In 1986, prior to the first markup, the Committees,

aided by the Joint Committee on Taxation, evaluated and discussed every major tax area. The Committees conducted hundreds of hours of hearings – not for grandstanding, but for learning. The Administration was also involved with the analysis of the tax code and options within tax policy.

Third, it needs to be as bipartisan as it was then. Tax reform need not be a partisan issue and, indeed, if it is, it would be doomed to failure. We openly worked with the White House, even though we were Democrats and the President was a Republican. We understood from the start that any final agreement was inherently going to be a compromise and not a plank out of either of our party platforms.

Fourth, you need to go deeper into some of the areas that the 1986 effort skirted – most important being the international aspects of the tax code. Today, the impact of globalization is felt in all sectors of our society, far more than at that time. Our tax code needs to reflect this fact.

And fifth, and perhaps most important, nothing should be off-limits in terms of discussion about the design of the code. Remember, until 1986, Super Dairy Cows were also considered sacred.

CONCLUSION

The 1986 Tax Reform Act was not perfect, but it did dramatically simplify the code. The widespread stories about extremely wealthy individuals and prosperous corporations gaming the tax code to pay no taxes largely disappeared from the newspapers at the time. Today, the erosion that has occurred has allowed a myriad of provisions to be restored and new provisions to be added – many with appropriate policy goals when viewed in isolation – but that together create an economic labyrinth and often is at odds with itself, confuses nearly us all, and undermines public trust.

Thank you again for the opportunity to appear today. I am happy to answer any questions you may have.

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**Statement of Senator Chuck Grassley
Senate Finance Committee Hearing
“Tax Reform: Lessons from the Tax Reform Act of 1986”
Thursday, September 23, 2010**

Just about everybody agrees that our tax code is too complex. The tax form instruction book is probably the most unwelcome piece of mail many taxpayers get. The complexity means taxpayers can't be confident that they've received all the breaks coming to them, or that they haven't paid more than they owe. As we note the complexity, we should note a point one of the key 1986 Tax Reform Act architects has made many times. Former Senator Packwood was fond of saying, “Many taxpayers accept complexity that favors them.”

When we consider the complexity of the regular tax system and the creeping effects of the alternative minimum tax (“AMT”), you have a recipe for disaster. As an example of the problems from the AMT side, if we do not extend the hold-harmless or “patch” for 2010, about 26 million tax filers, mostly families, will be affected by the AMT. That would be an increase of around 22 million families and individuals over 2009. Because of the way the AMT is structured, with no indexing, this AMT problem grows exponentially from year-to-year, and more and more people are pulled in every year we do not enact a permanent solution.

So, there's no question that we have a big problem. It is a problem that the committee should focus on. Let me say that I have no pre-conceived notion of which direction we should go, whether we're talking about a flat tax, national retail sales tax, value-added tax (“VAT”) or substantial modification of the current system.

While we all agree something should be done and we should be open-minded about what reform would look like, I'd like to remind folks that there is a key premise to tax reform that needs to be fleshed out. The premise I refer to is whether we assume current law levels of tax relief remain in effect or whether we assume that the bipartisan tax relief plans of 2001 and 2003 have expired. If we use the latter assumption, i.e., that the post-2010 record level tax increase goes into effect, then tax reform really becomes an historic tax increase.

President Obama campaigned on a “current policy” as opposed to a “current law” baseline. In an editorial appearing in “The Wall Street Journal” on August 14, 2008, Obama advisors Jason Furman and Austan Goolsbee wrote “the Obama plan is a net tax cut – his middle-class tax cuts are larger than the rollbacks he has proposed for families making over \$250,000. Senator Obama would pay for this tax cut by cutting spending. . . .” Whatever one's opinion of the specifics of this tax policy, I think most taxpayers, and certainly myself, support the idea of lowering the overall level of taxation, and are certainly opposed to increasing the overall level of taxation. Since January of 2009, Dr. Furman has been Deputy Director of the National Economic Council. Since last week, Austan Goolsbee has been Chairman of the Council of Economic Advisors.

I ask unanimous consent that their editorial be printed in the record of this hearing.

As the Congressional Budget Office noted this past June in a publication titled “The Long-Term Budget Outlook,” revenues, or taxes collected by the Federal government, have averaged around 18.1 percent of GDP over the past 40 years. My reading of the Furman/Goolsbee quote is that candidate Obama was elected in part upon a promise to not increase the level of taxation. An important question that must be answered before tax reform can be attempted, is whether reformers are committed to holding taxes at or below the historical level of taxation of 18.1 percent of GDP. Given President Obama was elected in part upon a promise of a net tax cut, I

don't see how any reform could contemplate increasing the historic level of taxation. As I've noted in the past, I believe for fundamental tax reform to truly succeed, it would require the full support of a White House in possession of an unambiguous mandate directly from the American people.

What this means is that a President must campaign and be elected in part on his vision for our tax system, as President Reagan was. Unfortunately we are not able to speak with President Reagan anymore on his role in enacting the "Tax Reform Act of 1986," but because of his absence we should not take the importance and responsibility of the Executive branch for granted in this process moving forward. Aside from creating the political clout necessary to get a complicated bill enacted into law, if a candidate sticks to the principles of tax policy he campaigned on and won on, it is more likely that the American taxpayer will see reform as beneficial and be supportive of it.

Mr. Chairman, I raise this point because, if we are to enter the tax reform playing field, we need to know the rules, including the size of the playing field in revenue terms. Are we assuming tax reform is not possible without a record tax increase?

This is a question that all policymakers should have to answer and we must acknowledge today.

THE WALL STREET JOURNAL.

The Obama Tax Plan

By JASON FURMAN and AUSTAN GOOLSBEE

August 14, 2008; Page A13

Even as Barack Obama proposes fiscally responsible tax reform to strengthen our economy and restore the balance that has been lost in recent years, we hear the familiar protests and distortions from the guardians of the broken status quo.

Many of these very same critics made many of these same overheated predictions in previous elections. They said President Clinton's 1993 deficit-reduction plan would wreck the economy. Eight years and 23 million new jobs later, the economy proved them wrong. Now they are making the same claims about Sen. Obama's tax plan, which has even lower taxes than prevailed in the 1990s -- including lower taxes on middle-class families, lower taxes for capital gains, and lower taxes for dividends.

Overall, Sen. Obama's middle-class tax cuts are larger than his partial rollbacks for families earning over \$250,000, making the proposal as a whole a net tax cut and reducing revenues to less than 18.2% of GDP -- the level of taxes that prevailed under President Reagan.

Both candidates for president have proposed tax plans. But they are starkly different in their approaches and their economic impact. Sen. Obama is focused on cutting taxes for middle-class families and small businesses, and investing in key areas like health, innovation and education. He would do this while cutting unnecessary spending, paying for his proposals and bringing down the budget deficit.

In contrast, John McCain offers what would essentially be a third Bush term, with his economic speeches outlining \$3.4 trillion of tax cuts over 10 years beyond what President Bush has already proposed and geared even more to high-income earners. The McCain plan would lead to deficits the likes of which we have never seen in this country. It would take money from the middle class and from future generations so that the wealthy can live better today.

Sen. Obama believes a focus on the middle class is appropriate in the wake of the first economic expansion on record where the typical family's income fell by almost \$1,000. The Obama plan would cut taxes for 95% of workers and their families with a tax cut of \$500 for workers or \$1,000 for working couples. In addition, Sen. Obama is proposing tax cuts for low- and middle-income seniors, homeowners, the uninsured, and families sending a child to college or looking to save and accumulate wealth.

The Obama plan would dramatically simplify taxes by consolidating existing tax credits, eliminating the need for millions of senior citizens to file tax forms, and enabling as many as 40 million middle-class filers to do their own taxes in less than five minutes and not have to hire an accountant.

Sen. Obama also recognizes that small businesses are the engine of job growth in the economy. That is why he is proposing additional tax cuts, including a tax credit for small businesses that provide health care, and the elimination of capital gains taxes for small businesses and start-ups. The vast majority of small businesses would face lower taxes under the Obama plan than under the McCain plan. In addition, Sen. Obama supports reforming corporate taxes in a

manner that would help create jobs in America and simplify the tax code by eliminating distortions and special preferences.

Sen. Obama believes that responsible candidates must put forward specific ideas of how they would pay for their proposals. That is why he would repeal a portion of the tax cuts passed in the last eight years for families making over \$250,000. But to be clear: He would leave their tax rates at or below where they were in the 1990s.

- The top two income-tax brackets would return to their 1990s levels of 36% and 39.6% (including the exemption and deduction phase-outs). All other brackets would remain as they are today.

- The top capital-gains rate for families making more than \$250,000 would return to 20% -- the lowest rate that existed in the 1990s and the rate President Bush proposed in his 2001 tax cut. A 20% rate is almost a third lower than the rate President Reagan set in 1986.

- The tax rate on dividends would also be 20% for families making more than \$250,000, rather than returning to the ordinary income rate. This rate would be 39% lower than the rate President Bush proposed in his 2001 tax cut and would be lower than all but five of the last 92 years we have been taxing dividends.

- The estate tax would be effectively repealed for 99.7% of estates, and retained at a 45% rate for estates valued at over \$7 million per couple. This would cut the number of estates covered by the tax by 84% relative to 2000.

Overall, in an Obama administration, the top 1% of households -- people with an average income of \$1.6 million per year -- would see their average federal income and payroll tax rate increase from 21% today to 24%, less than the 25% these households would have paid under the tax laws of the late 1990s.

Sen. Obama believes that one of the principal problems facing the economy today is the lack of discretionary income for middle-class wage earners. That's why his plan would not raise any taxes on couples making less than \$250,000 a year, nor on any single person with income under \$200,000 -- not income taxes, capital gains taxes, dividend or payroll taxes.

In contrast, Sen. McCain's tax plan largely leaves the middle class behind. His one and only middle-class tax cut -- a slow phase-in of a bigger dependent exemption -- would provide no benefit whatsoever to 101 million families who do not have children or other dependents, or who have a low income.

But Sen. McCain's plan does include one new proposal that would result in higher taxes on the middle class. As even Sen. McCain's advisers have acknowledged, his health-care plan would impose a \$3.6 trillion tax increase over 10 years on workers. Sen. McCain's plan will count the health care you get from your employer as if it were taxable cash income. Even after accounting for Sen. McCain's proposed health-care tax credits, this plan would eventually leave tens of millions of middle-class families paying higher taxes. In addition, as the Congressional Budget Office has shown, this kind of plan would push people into higher tax brackets and increase the taxes people pay as their compensation rises, raising marginal tax rates by even more than if we let the entire Bush tax-cut plan expire tomorrow.

The McCain plan represents Bush economics on steroids. It has \$3.4 trillion more in tax cuts than President Bush is proposing, largely directed at corporations and the most affluent. Sen. McCain would implement these cuts without proposing any meaningful steps to simplify taxes or eliminate distortions and loopholes. In addition, Sen. McCain has floated over \$1 trillion in new spending increases but barely any specific spending cuts.

As previously mentioned, the Obama plan is a net tax cut -- his middle-class tax cuts are larger than the rollbacks he has proposed for families making over \$250,000. Sen. Obama would pay for this tax cut by cutting spending -- including responsibly ending the war in Iraq, reducing excessive payments to private plans in Medicare, limiting payments for high-income farmers, reducing subsidies for banks that make student loans, reforming earmarks, ending no-bid contracts, and eliminating other wasteful and unnecessary programs.

While Sen. Obama would shrink the deficit from its current record levels, he recognizes that it is even more important to confront our long-term fiscal challenges, including the growth of health costs in the public and private sector. He also believes it is critical to work with members of Congress from both parties to strengthen Social Security while protecting middle-class families from tax increases or benefit cuts. He has done what few presidential candidates have been willing to do by making a politically risky proposal to strengthen solvency by asking those making over \$250,000 to contribute a bit more to Social Security to keep it sound.

Sen. Obama does not support uncapping the full payroll tax of 12.4% rate. Instead, he is considering plans that would ask those making over \$250,000 to pay in the range of 2% to 4% more in total (combined employer and employee). This change to Social Security would start a decade or more from now and is similar to the rate increases floated by Sen. McCain's close adviser Lindsey Graham, and that Sen. McCain has previously said he "could" support.

In contrast, Sen. McCain has put forward the most fiscally reckless presidential platform in modern memory. The likely results of his Bush-plus policies are clear. As Berkeley economist Brad DeLong has estimated, the McCain plan, as compared to the Obama plan, would lower annual incomes by \$300 billion or more in real terms by 2017, costing the typical worker \$1,800 or more due to the effect of large deficits on national savings and thus capital formation. Sen. McCain's neglect of critical public investments would further impede economic growth for decades to come.

Do not take the critics' word for it. Go look at the plans for yourself at www.barackobama.com/taxes. Get the facts and you will see the real priorities at stake in this election. America cannot afford another eight years like these.

Messrs. Furman and Goolsbee are, respectively, economic policy director and senior economic adviser at Obama for America.

How Did the 1986 Tax Reform Act Attract So Much Support?
Randall D. Weiss
The Conference Board
Testimony before the Senate Committee on Finance
September 23, 2010

Chairman Baucus, Senator Grassley, and members of the Committee, my name is Randall Weiss. I am the Managing Director of Economic Research at The Conference Board in New York City. The views I express in this testimony are my own, and should not be construed to reflect any position of the Trustees or staff of The Conference Board.

It's a great honor to be speaking to you today on the lessons of the 1986 Tax Reform Act. Many members of Congress, their staffs, and executive branch personnel worked very hard to make it happen. They knew that the income tax generated the major share of Federal tax revenue and that the income tax carried the burden of raising this substantial revenue in a way that the public would believe was fair. This is still true today. It is important for Congress to periodically review the income tax in order to raise the necessary revenue as fairly and efficiently as possible. The advantage of a comprehensive tax reform initiative is that many tax provisions can be changed at the same time, thus allowing a package to be shaped that accomplishes these objectives. This is much more difficult to do in piecemeal tax bills that deal with only a few provisions at a time.

What made it possible to enact this legislation, versions of which passed the Senate Finance Committee by a 20 to 0 vote and the full Senate by a 97 to 3 vote, with such overwhelming bipartisan support? I believe that two features of the Act were critical—(1) substantial rate reduction and (2) significant improvement in the public's perception of the fairness of the tax. Also important were two other aspects of the shaping of the Act—revenue neutrality and de-emphasis on adjusting the tax's distribution by income class. I believe that all of these considerations would be important for, and allow the success of, a tax reform effort in the current environment. Not only would a new tax reform initiative deal with the fairness issue and the economic distortion that result from excessive tax expenditures, but it also could help to resolve the extraordinary degree of uncertainty about what the tax law will be in the very near future.

In my testimony today, I will further describe these major features of the Act and explain why they made it so popular in the economic and political environment of the mid-1980s. I will then discuss why those features match the tax policy environment in which we find ourselves today. Of course, my views reflect the experiences I had as the Deputy Chief of Staff of the Joint Committee on Taxation during the legislative battles that shaped the Act. I had the privilege of participating in virtually every meeting that the Senate Finance Committee, the House Ways and Means Committee, and the Conference Committee conducted, as well as many smaller meetings with members. I was able to witness firsthand the issues, conflicts, and compromises that members had to wrestle with in order to put the legislation together. A few years before, I had become familiar with tax reform issues when I was part of the core group of staff that worked with Senator Bradley and Congressman

Gephardt to develop their tax reform proposal, which was a precursor of the Act in many respects.

Rate Reduction and Fairness

Achieving rate reduction and improving the perception of fairness were key accomplishments of the '86 Act. The popularity of low tax rates had been demonstrated during the elections and tax debates that took place in the early and mid-1980s. Taxes are very complicated, but most people understand how important tax rates are in determining how much they pay to the government. President Reagan had made tax rate cuts a focus of his 1980 election campaign, and the subsequent Economic Recovery Tax Act (ERTA) of 1981 featured large individual tax rate cuts and indexing of brackets. The tax rate issue arose again during the 1984 presidential election. Rate increases were avoided in fashioning the substantial revenue increases that Congress legislated in 1982, 1983, and 1984. Instead, the income tax base was broadened by scaling back deductions, exclusions, and credits.

The public's perception that the income tax was unfair—driven by countless stories of high-income individuals and large corporations that paid little or no tax—was pervasive during the early 1980s. It is hard to overemphasize how important this perception was in driving the progress of the Act. Congress had begun to demonstrate concern about this in 1982, when it repealed safe-harbor leasing, a provision of ERTA that allowed companies to sell their newly expanded investment tax benefits for investment to other companies that could use them. The unfairness problem had become so serious, and the Act's attack on it sufficiently compelling, that even members who were not enthusiastic about the substance of the Act felt that they had to avoid being blamed if it failed to become law.

Base broadening

Both of these key features of the Act—low rates and perceived fairness—were accomplished by substantial broadening of the tax base, that is, scaling back deductions, exclusions and credits so that the computation of tax liability more closely matched the taxpayer's actual income. Base broadening allowed Congress to lower the rates. At the same time, by reducing the large variation among taxpayers in their tax liability's relationship to their actual income, base broadening was the key to dealing with the perception of unfairness. The Act implemented numerous cutbacks on tax benefits and on tax benefit transfers (such as the passive loss rules). Although many of these cutbacks were challenged by influential constituents, members felt that the vast popularity of low rates and the improved perception of fairness outweighed the potential tax increases that these taxpayers would experience.

By the time the 1986 Act was being debated, members of both political parties and both Houses had already become comfortable with enacting base broadening provisions. After the 1981 passage of ERTA, substantial budget deficits were projected "as far as the eye could see," and both the Administration and Congress embarked on a series of Acts that reduced the deficit. President Reagan insisted on low tax rates, but he did not object to raising revenue; indeed, his Administration proposed substantial base-broadening measures that were incorporated in the 1982 and 1984 tax legislation. Although many of these provisions met

with substantial opposition, this experience allowed Congress to understand that broadening the base would not lead to the dire consequences that some had predicted.

Revenue Neutrality and Distribution by Income Class

Two other features of the Act were important during its consideration—revenue neutrality and roughly maintaining the distribution of taxes by income class. The Bradley-Gephardt bill had strictly adopted these goals, and they were an important part of the framework on which the '86 Act was fashioned. The revenue neutrality constraint was particularly controversial because, as noted above, Congress also was focusing on budget deficit reduction, and some of tax reform's opponents believed that any major tax bill should reduce the deficit. But the major tax reform proponents, both on Capitol Hill and in the Administration, believed that revenue neutrality was an important part of achieving tax reform. That way, all the revenue of base-broadening could be ploughed into the tangible benefit of rate reduction.

The distributional neutrality of the Bradley-Gephardt bill was ultimately not fully embraced in the '86 Act; lower-income taxpayers received slightly larger tax reductions than higher-income taxpayers. However, this outcome was not the result of a broad debate about whether the degree of progressivity in the existing tax system was optimal public policy. Rather, the small scale of the distributional changes reflected a political decision that a large change in distribution would add an additional layer of controversy that could derail bipartisan support for the reform.

To sum up, I believe that four aspects of the 1986 Tax Reform Act were key to its support:

1. Substantial reduction in tax rates
2. Moving the tax base closer to actual income
3. Revenue neutrality
4. De-emphasis on distribution by income class

Tax Reform in the Current Environment

Would these features of a new tax reform act generate substantial support today, and would recent Congressional experience help facilitate the process of enacting it? My general answer is—yes.

- Tax rate reduction is still critical and popular. Rates are perhaps the most salient aspect of the income tax, and I believe there would be substantial attractiveness to a tax package which reduces existing rates.
- In the fairness arena, the biggest problem today appears to be not so much a systematic ability of high-income people and companies to avoid paying tax, but rather a kind of randomness in the computation of tax liability. There are so many overlapping incentives that, along with the alternative minimum tax and people's increasing delegation of tax preparation to tax professionals and computers, it is very difficult for many people to understand how their tax liability is determined and to make decisions accordingly. A perception of fairness requires that people

see that their tax liability is determined according to some logical principles. A tax reform package that responded to this concern would be popular.

- Revenue neutrality and approximate distributional neutrality would still be useful disciplines to impose on a tax reform process, since they put aside potentially thorny policy issues that could make the process even more difficult than otherwise.
- Concern about the budget deficit has increased, and Congress has begun to examine and adopt base broadening provisions to offset revenue losses from other provisions. This experience has begun to parallel the experience of the early 1980s.

The benefits of tax reform would still be large. As before, minimizing the economic inefficiency that results from high rates (think how high the rates would have gone in the 1990s to meet the revenue requirements of deficit reduction if the 1986 Act hadn't happened) and dealing with the need to maintain the perception of fairness would again be important benefits.

Another issue has emerged that also would be addressed by tax reform—the extraordinary amount of uncertainty in today's tax rules. One way to measure this development is to count the number of expiring provisions. At the beginning of 1985, 25 provisions were scheduled to expire in the next two years. As of early 1989, after the Act and other legislation resolved some of these issues, there were 14 provisions that expired either that year or the previous one. In contrast, as of early 2010, there were 141 provisions that expired in that year or the previous one. Among the 14 in the earlier period, the largest was the R&D credit, but in the later period, fundamental aspects of the tax system, such as the rate structure and the existence of the estate tax, are in play. This uncertainty is causing great concern among a wide variety of taxpayers, and may be inhibiting the growth of the economy. Tax reform would be an effective process for Congress to make decisions about the long-term fate of these provisions.

In conclusion, I would like to congratulate the Chairman and members of the committee for beginning to consider how to make another round of tax reform happen in the near future. I would be happy to answer any questions.

Senate Finance Committee Hearing
“Tax Reform: Lessons from the Tax Reform Act of 1986”
September 23, 2010
Responses to Questions for Mr. Randall D. Weiss, Ph.D.

Questions from Senator Grassley

- 1) Q: As I mentioned in my opening statement, under current law, any discussion of tax reform must contemplate the spike in tax burdens in the individual income tax system that will kick in 2011. The rate system will dramatically change and affect virtually every American taxpayer, especially married couples. In 2001, when the bipartisan 2001 tax relief legislation was considered, the committee heard testimony on marginal rates. Some witnesses indicated that the rate structure then in effect was bringing back a form of bracket creep. If we return to that rate structure in 2011, with respect to any group of taxpayers, would you have the same concerns?

A: Given that the rate structure, personal exemption, and standard deduction of the regular tax are indexed for inflation, bracket creep would be predicted only under the assumptions of a steady increase in real incomes for all income classes of taxpayers and for all types of taxable and nontaxable income. In reality, however, the income distribution varies over time and different types of income grow at different rates. If bracket creep actually occurred over a long period of time, Congress could adjust the rates at that point.

- 2) Q: The landmark 1986 Tax Reform Act contained scores of transition rules. The Philadelphia Inquirer published a Pulitzer Prize winning series on the legislation. Much of that material focused on the transition rules. As a result of that controversy, Finance Committee Chairmen, from Senator Bentsen forward, on a bipartisan basis, implemented a practice prohibiting “rifle shots.” Many practical observers of the process for the 1986 legislation would contend that the transition rules were necessary to secure political support for passage. The political imperative of transition relief is an issue we cannot ignore. Setting aside revenue neutrality for an instant, how do all of you recommend treating transitional items such as credit carryforwards and the loss of depreciation deductions, interest deductions, and deductions for the recovery of inventory?

A: Lowering tax rates does reduce the value of deductions arising from past transactions. However, this is roughly offset by the fact that future income associated with these transactions will be taxed at a lower-than-expected rate. And, of course, this lower tax rate also applies to the income of taxpayers who already benefited fully from these deductions at the higher rate. The debate about Treasury’s 1985 proposal for a windfall recapture tax illuminated the complexity of attempting to deal with the impact of rate changes on deductions and income arising from transactions prior to the rate change. Credits should be treated the same as deductions, though, which is why the 1986 Act reduced the value of credit carryforwards.

Questions from Senator Hatch

- 1) Q: Dr. Weiss, you mentioned the very real problem of uncertainty about the tax system and how it impedes economic growth. Hasn't this problem become much worse in recent years, and what can we do as we move toward tax reform to address it? In other words, how do we prevent the need for another major tax reform just a few years after the last one because of the constant tax changes proposed and enacted by Congress and the President?

A: Other than through a constitutional amendment, one Congress cannot prevent a future Congress from revising its work. However, as I pointed out in my testimony, a through and wide-ranging tax reform effort in which decisions are made about a large number of issues and in which all of these decisions can be used to balance their impact on various taxpayer groups may be the best way to achieve increased stability in the tax system.

- 2) Q: You said in your testimony that the public in the early 1980s had a perception that the income tax system was unfair and that this might have been driven by countless stories that high income individuals and large corporations were paying no tax. How accurate were such reports then, and has this situation changed today? Doesn't the public still have a perception of unfairness of the tax system? Is such a perception justified?

A: The public expects that, under a fair income tax system, a taxpayer's tax liability should be generally related to the taxpayer's ability to pay. The early and mid-1980s saw many documented examples where this was not the case. For example, corporations that reported significant profits were shown to have paid little or no tax, and high-income individuals often easily reduced their tax liability with tax shelters. So the perception of unfairness was justified. Today's situation is perhaps not as flagrant, but because of complexity, overlapping incentives, and the minimum tax, people have a hard time believing that the tax liability of their fellow citizens and themselves is reasonably related to ability to pay. A perception of fairness requires an understanding of the rules that determine tax liability, and the complexity of the current income tax interferes with that understanding.

Questions from Senator Bunning

- 1) Q: I am convinced that it will be nearly impossible to do major tax reform again, if the goal is to make the tax code more simple. There is only one interest group who wants simplicity, and that group probably includes almost all American taxpayers. But regular taxpayers aren't as vocal or organized as the special interest groups that are out to protect their special tax break. And in this information age, groups can easily stir up their members to flood Congress with messages against repealing their special tax provision. There is also the challenge of the political parties not cooperating with each other on any major issues. Many of you pointed out the importance of Ronald Reagan starting the tax reform movement from the top. Would Presidential leadership be enough to spur tax reform in our current environment?

A: Presidential leadership would be essential for a successful tax reform effort. Also necessary, however, would be a bipartisan willingness in Congress to reduce tax expenditures

and take other measures to broaden the income tax base. Such willingness had been demonstrated for several years before Congress began work on the 1986 Act.

- 2) Q: What should be the correct order of priorities in an ideal tax system? For example, how would each of you prioritize raising revenue, maximizing economic performance, simplicity, and making social policy? And how does our current tax code stack up in that priority list?

A: All of these goals are important, but they are somewhat different in nature. Raising revenue is required only to the extent necessary to pay for current spending and/or avoid deficits that cause significant intergenerational redistribution or cause the national debt to spin out of control. In contrast, the tax system's complexity and its interference with the economy should be as low as possible, but there may be a conflict between these goals. Fairness is another important, but competing, objective of the tax system. Clearly, the current tax system falls short on all of these fronts.

- 3) Q: Some people used to think that the expiration of the 2001 and 2003 tax cuts this year, combined with the exploding alternative minimum tax, would force Congress to reform the tax code. Did the decision of Congress to exempt 80% of those tax cuts along with several years of the AMT patch from the pay-as-you-go-rules -- known as PAYGO -- prevent Congress from making the tough decisions we should about tax reform?

A: PAYGO prevents certain tax changes from adding to the deficit projected under current law. Whether or not some changes are exempt from its reach, it does not directly promote tax reform. However, it may indirectly promote tax reform by making Congress more comfortable with revenue offsets that broaden the income tax base. As I argue in my testimony, such experience made it easier for Congress to tackle the entire income tax in formulating the 1986 Act.

Questions from Senator Bill Nelson

- 1) Q: If you could repeal one tax expenditure and use the revenue to provide broad-based tax relief, what tax expenditure would you repeal and why?

A: The desirability of repealing specific tax expenditures depends on what other changes in tax, spending, and regulatory policy are made at the same time. For example, whether the exclusion for employer health plan contributions should be repealed would depend on what other mechanisms are put in place to encourage employees to obtain health insurance. So singling out specific tax expenditures for elimination does not allow for a full assessment of overall impact.

- 2) Q: While the United States has relatively high marginal income tax rates, it remains a low-tax nation, overall, relative to most of the developed world. What other countries lack in income tax revenue, they more than make up through other types of taxes. In your view, is it possible to keep the United States income tax competitive with other countries' income tax regimes when our income tax bears such a disproportionate share of the revenue burden?

A: Actually, in comparison to GDP (which roughly corresponds to the base of the income tax), the reliance of the U.S. on the income tax is in line with international norms and thus does not pose competitive issues. In 2007, income taxes in the U.S, the EU15, and the OECD were 13.9, 14.0, and 13.2 percent of GDP, respectively (OECD statistics). What is different about the fiscal structure of many other countries is that their government spending is higher, especially because the government budget includes a larger portion of total national health expenditures. Compared to the U.S., this additional spending is largely financed through additional social security and consumption taxes.

- 3) Q: Do you agree with Congressman Archer's testimony that the Tax Reform Act of 1986 was the primary cause of the savings and loan crisis?

A: Real estate market cycles are often associated with financial services industry crises because of the latter industry's importance in enabling transactions in the former. It is clear from both historical and current evidence that the U.S. real estate industry has had many large cycles having nothing to do with changes in the tax system. Although the 1986 Act may have affected the real estate industry in the late 1980s, it was not the primary cause of the savings and loan crisis.

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**Statement of the
AMERICAN PUBLIC POWER ASSOCIATION (APPA)**

**For the
SENATE COMMITTEE ON FINANCE**

Hearing on Tax Reform: Lessons from the Tax Reform Act of 1986

September 30, 2010

The American Public Power Association (APPA) appreciates the opportunity to provide the following statement for the record for the Senate Finance Committee's hearing on "Lessons Learned from the Tax Reform Act of 1986."

APPA represents the interests of more than 2,000 not-for-profit, publicly-owned electric utility systems across the country, serving approximately 45 million Americans. APPA member utilities include not-for-profit state public power agencies and municipal electric utilities that serve some of the nation's largest cities. However, the vast majority of these publicly-owned electric utilities serve small- and medium-sized communities in 49 states, all but Hawaii. In fact, 70 percent of our member systems serve communities with populations of 10,000 people or less.

Overall, public power systems' primary purpose is to provide reliable, efficient service to their local customers at the lowest possible cost, consistent with good environmental stewardship. Like hospitals, public schools, police and fire departments, and publicly-owned water and wastewater utilities, public power systems are locally-created governmental institutions that address a basic community need: they operate on a not-for-profit basis to provide an essential public service, reliably and efficiently, at a reasonable price.

Many of the rules regulating tax-exempt financing have not been modified since the Tax Reform Act of 1986 imposed significant limitations on state and local government financing. Modifying some of these outdated rules in the tax code could provide much needed flexibility to public power utilities to build new transmission and new generation, and to have the ability to comply with future climate change legislation or renewable portfolio standards put in place at the state and/or federal levels.

Private Use

Private use restrictions on tax-exempt financing were put in place to insure that public financing is used for the public good. However the practical application of current rules, as modified by the 1986 Tax Act, can severely limit the ability of public power systems to build necessary generation and transmission facilities.

Current law generally permits up to 10 percent of the output of an electric facility to be used for private use. This 10 percent limitation, while burdensome, does provide flexibility for a public power system to sell off a portion of the output of a nuclear facility, for example, particularly while its load is growing into the facility. Public power systems may not, however, take advantage of this flexibility because they are limited to \$15 million of private use per “project” and an additional rule requiring that state private activity bond volume cap is needed for private use in excess of \$15 million. Given the size of the borrowings expected for nuclear facilities, a \$15 million limit permits almost no private use (for example, for a \$3 billion public power nuclear project it permits only 0.5 percent of the output to be used for a private use).

Although public power can use taxable bonds or equity to provide for additional private use, those sources of financing are much more expensive (and unlike investor-owned utilities (IOUs) public power cannot offset those costs with accelerated depreciation, interest deductions, etc.), putting public power customers at a disadvantage. These restrictions make financing of many projects unattainable at times -- meaning that public power utilities must decide either to raise rates considerably, or forgo building the project. Accordingly, we suggest the following changes.

Ten Percent Rule

Current law generally permits up to 10 percent of the output of an electric facility to be used for private use. Although the 10 percent limitation provides some flexibility, the 10 percent limit can also hamper the ability of a public power system to sell off a portion of the output of a facility. Moreover it restricts municipal governments from building various types of public purpose infrastructure that have some level of private use. APPA supports raising the 10 percent rule to 25 percent, the permissible level of private use prior to the Tax Reform Act of 1986.

\$15 Million per Project Rule

Public power systems are limited to \$15 million of private use “per project” and, like all municipal entities, are also limited to \$15 million per bond issue. Should more than one bond issue be issued for a “project,” (which is very common) the project would be subject to an overall \$15 million private use limitation. The 10 percent rule (or higher should it be raised) should be sufficient to address private use policy concerns. Therefore, APPA supports eliminating the \$15 million “per project” rule for public power entities.

\$15 Million per Issue Rule

Even if the \$15 million private use “per-project” limit on output facilities were repealed, public power providers would still be required to obtain “volume cap” for any bond issue in which the amount of private use is in excess of \$15 million. Volume cap is a scarce and valuable commodity which is often oversubscribed within states for pending qualified private activity bonds issues. APPA supports eliminating the \$15 million “per issue” rule for municipal electric utilities only.

Rostenkowski Rule

In order to provide for future load growth, public power utilities may seek to purchase assets from investor-owned utilities. However, a rule enacted by Congress in 1987 known as the “Rostenkowski Rule” prevents the issuance of tax-exempt bonds to purchase privately-owned

electric facilities. This rule prevents public power entities from purchasing facilities developed by IOUs when the entity has determined that they have planned or built a facility larger than they need for their own customers. From both a tax and energy policy perspective, it makes little sense to permit public power providers to build new generation, transmission and distribution assets while at the same time prohibiting the purchase of mothballed or underutilized output assets from an IOU. While this rule came after 1986, we feel it should be revisited and repealed.

In conclusion, repealing or modifying some specific private use measures from the 1986 Tax Act and years immediately following the Act, will make a significant difference to public power utilities financing new, needed generation while still preserving the spirit of the law.

Fifty Ways to Raise a Trillion

**Statement on the Shelf Project.
Senate Hearings on Lessons From the Tax Reform Act of 1986
United States Senate Committee on Finance
Thursday, September 23, 2010**

Calvin H. Johnson*

The inspirational lesson of the Tax Reform Act of 1986 is that this Nation and this Congress can join together to create a tax system that is fairer and more efficient. The best tax systems have a tax base that describes moneys available for standard of living, that is neutral among competing investments, that creates tax that is not avoidable, and that has rates that are as low as possible. Proposals to expand the tax base to reach a fairer and more efficient system can be adopted, the Tax Reform Act tells us, even by people who are adverse in the competition for political election. The impending revenue crises does not allow Congress to cut tax rates, as was possible in 1986, but expansion of the tax base, as was accomplished in 1986, can prevent income tax rates that might otherwise go to 85% and foreclose a VAT or federal sales tax with rates that might go to 61%. In the impending revenue crisis, provisions that politically impossible in ordinary times will become political necessities.

The Shelf Project is a collaboration by tax professionals to develop and perfect proposals to raise revenue by defending the tax base.¹ The Shelf Project develops proposals that can be pulled off the shelf when Congress is ready to raise revenue. This statement incorporates many of the proposals of the Shelf Project, but it has not been approved by participants and it does not bind any participants to conclusions with which they do not agree.

We should be doing the staff planning now for how to raise taxes with the least harm. We have contingency plans for unthinkable things like total thermonuclear war, Ebola aerosols in the DC Metro, and Russian tanks across the German plains, but we have no staff plans for the unthinkable thing in American politics, which is also not a contingency: How to raise revenue. It will take a great deal of staff work to make a fairer and more efficient tax system, and work should be done now, even if the Congress and the Nation are not yet ready to raise revenue.

We should be able to raise at least a trillion dollars a year more revenue within the current income tax system, without a rate hike or a VAT, largely by making our tax accounting better reflect economic income. Our current system has too many tax pits, which absorb revenue and distort investment decisions. We allow deductions for fictitious losses. "Taxable income" under our tax accounting does not reach and describe high-class consumption as well as it needs

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This memorandum draws heavily on Calvin H. Johnson, *How to Raise \$1 Trillion Without a VAT or a Rate Hike*, 128 TAX NOTES 101 (July 5, 2010)

http://www.utexas.edu/law/faculty/calvinjohnson/How_to_Raise_1_Trillion.pdf with some updating.

¹ *The Shelf Project: Revenue Raising Projects that Defend the Tax Base*, 117 TAX NOTES 1077 (2007) [<http://www.utexas.edu/law/faculty/calvinjohnson/shelf-project.pdf>].

to. Moving toward a more comprehensive income tax base to make it less easily avoided would improve both the fairness and efficiency of the income tax. Table 1, below, is a list of ways to raise \$1 trillion dollars. The list, however, cannot be adopted without a crisis.

It is said that a democracy can handle bad news only in a crisis. The impending revenue needs are going to be very bad news. The Congressional Budget Office estimates the federal deficit at \$1.3 trillion a year,² which is consistent with the current estimates of the permanent fiscal gap.³ Federal spending over the coming decade is projected to be 150% of revenue⁴ Those deficits cannot be sustained. Borrowing for the deficits will make us poorer. Delay in acting will increase the ultimate pain.⁵ We may in fact wake up one morning to find that the foreign powers so far willing to fund our \$1.3 trillion deficit are no longer willing.⁶ We will have our crisis.

The additional \$1 trillion revenue listed in Table 1 might not be enough. A contingency plan for tax must assume some reasonable projections of spending over the next decade, and here I assume the current OMB projections, requiring \$1.3 trillion more revenue per year. It is also reasonable to assume some cuts in spending, and the list in Table 1 is not exhaustive. If less than \$1 trillion is needed, then the list can be a menu to choose from. Still, if \$1 trillion can be raised within the current system and without raising tax rates, largely by defending the tax base and doing things we should probably already be doing anyway, then it looks like the impending crisis, although severe, will not require a VAT.

In addition to the suggestions in Table 1, the Treasury Department needs to be given a budget of \$4 million to hire 20 professionals to work for a year finding more ideas to close loopholes and defend the tax base. Creating a tax accounting system that is administrable reflection of real income is hard, professional work. Even finding the schemes and fixing the glitches may be hard to impossible. An investment of \$4 million in the design of the tax system, however, will return its cost many times over.

Raising tax rates would do more harm than adopting all the proposals on Table 1, especially if rates are raised using our current tax base. Taxable income in the American system has become a rotten measure of the economic resources of the nation. Years of brilliant taxpayer planning, myopic tax doctrine, accounting blindness, and constituent requests have left the tax base looking like a sponge with large holes and very little cellulose left.⁷ If rates are raised on the current tax base, tax planners will just flee to lower tax alternatives. The wisdom of a good tax system is to tax the alternatives as well. The Tax Foundation has projected that the current

² Congressional Budget Office, "The Budget and Economic Outlook: An Update" Summary Table 1 (Jan. 2010), <http://www.cbo.gov/ftpdocs/108xx/doc10871/Summary.shtml>. (\$1.3 trillion current deficit),

³ Alan J. Auerbach & William G. Gale, *The Economic Crisis and the Fiscal Crises: 2009 and Beyond*, 125 Tax Notes 101 (Oct. 5, 2009) (estimating a permanent fiscal gap of \$1.3 trillion).

⁴ We are taking in 15% of GDP in revenue. (CBO, *supra* note 2) and spending over the next decade is projected to be 22.5% of GDP (Office of Management and Budget, U.S. Budget for Fiscal Year 2010, Updated Summary Table, Table S-1. Budget Totals, available at <http://www.whitehouse.gov/omb/budget/fy2010/assets/summary.pdf>) implying a need to increase revenue by 150%

⁵ Alan J. Auerbach and William G. Gale, "Déjà Vu All Over Again: On the Dismal Prospects for the Federal Budget" (Tax Policy Center, April 2010)

⁶ Bruce Bartlett, "When Will America Face Its Fiscal Crisis? It's up to the Credit Rating Agencies to Decide" FORBES (May 21, 2010) argues that credit rating drop will trigger the crisis by making interest on federal debt much more expensive.

⁷ See, e.g., Calvin H. Johnson, *A Thermometer for the Tax System: The Overall Health of the Tax System as Measured by Implicit Tax*, 56 S.M.U. L. REV. 13 (2003) (using discount on municipal bonds as measure of competing tax rates and finding effective tax rates well under 10%).

deficit will require maximum tax rates of 85%, assuming no base expansion takes place,⁸ and tax rates at the 85% level would be a disaster to the economy. Increase in tax rates create deadweight losses, above the revenue collected, by the square of the rate increase.⁹ The tax system should be repaired to be more impervious to planning before tax rates are raised by one-sixteenth of a percent.

The core premise of Table 1 is that a tax does the least damage if it is as broad as possible, neutral, and unavoidable. A broader tax base means the lowest feasible tax rates, at whatever the level of revenue. Tax should be neutral across all investments, so that it is the pretax demand, and not the tax loopholes, that determine the allocation of capital. Tax accounting, to be neutral across investments, should identify the pretax internal rate of return from an investment and subject it to tax at statutory tax rates. To identify internal rate of return, and to be consistent with our given tax treatment of debt, the tax accounting must keep adjusted basis equal to the net present value of the investment.¹⁰ A fair tax system would also not allow negative tax, from the mismatch of debt and under-taxation of investment revenue. A fair tax system would not allow deductions for fictitious costs, as in percentage depletion or step up in basis at death, and would not allow deductions for amounts not lost, as in home mortgage deductions and “donations” given for services. The proposed list rejects the arguments that the tax expenditures and incentives improve the fairness or the efficiency of the tax system. Congress, in any event, has no control over the incentive system. For example, perhaps the most heavily subsidized activity is the development of quite awful computer games like *Doom III* and *Grand Theft Auto IV*.¹¹ If some activity is going to be subsidized, then it should be subsidized only within a skeptical budget process, with annual review, that takes the costs seriously and tries to minimize costs and the ratio of costs to benefits.

The proposals assume the distributional values reflected in the current statutory tax brackets. Under current law, income supporting the highest standards of living is taxed at 35%, half of taxpayers pay tax at 15%, and the income supporting the lowest standards of living at the subsistence or modest level is exempt from income tax. The state of the deficit implies that neither high- nor low-income taxpayers should expect a tax cut right now. Expanding the tax base will obviously have more impact within the 35% tax base than on taxpayers exempt from tax even after the reforms. Taking the current statutory decisions as the standard does not mean that the perpetual struggle to shift the tax burden to the other side will end or that the current brackets are uniquely correct. It is just that the status quo distributional decision represents a plausible peace treaty on the issue of distribution, so that repair of the tax base to serve efficiency can go on. Whatever the distribution of tax, the tax base needs to be fair among equals and unavoidable to be efficient.

⁸ William Ahern, *Can Income Tax Hikes Close the Deficit?* (Tax Foundation March 12, 2010), <http://www.taxfoundation.org/publications/show/25984>

⁹ See, e.g., JOSEPH STIGLITZ, *ECONOMICS OF THE PUBLIC SECTOR* 376 (1986).

¹⁰ The underlying logic of identifying internal rate of return is Samuelson depreciation, applied uniformly. Paul Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 J. POL. ECON. 604 (1964). See, e.g., Calvin H. Johnson, *The Effective Tax Ratio and the Undertaxation of Intangibles*, 121 Tax Notes 1289 (2008) [<http://www.utexas.edu/law/faculty/calvinjohnson/effective-tax-ratio.pdf>] for an identification of wide variations in the tax base.

¹¹ Calvin H. Johnson, *Capitalize Costs of Software Development*, 124 TAX NOTES 603 (August 10, 2009) [<http://www.utexas.edu/law/faculty/calvinjohnson/CapitalizeCostsOfSoftwareDevelopment.pdf>]. (arguing that expensing, tax credits, and domestic production exclusion turn a 10% pretax return into a 21% after tax return).

A federal VAT or other sales tax would shift the tax burden dramatically downward to people less able to pay. By my best estimates, for the people of Arkansas, excluding the richest 10%, adoption of a VAT to replace all their federal taxes and solve the revenue needs would increase their taxes by five times. The people of Arkansas, excluding the top 10%, now pay total federal tax, including corporate and individual income taxes and the social security and medicare employment taxes, of just under 12% of their income.¹² The Bush Administration Advisory Panel on Tax Reform projected that a FAIR tax or a VAT that replaced federal individual and corporate income taxes (but not employment taxes) would require a 38% tax rate when the tax itself is included in the tax base.¹³ The employment taxes would add another 7.65% tax¹⁴ for a total of 45% of income. The Bush estimates, however assumed a reimbursement of the VAT at the poverty level, and with the reimbursement, the total tax paid by 90% of Arkansas would be 40.5% or three and half times more tax than what they now pay. The 40.5% tax rate, however, is just an estimate of that needed to match current revenue yields from the income and employment taxes, and the deficit implies that we need to increase revenue yields by 150%.¹⁵ By that logic, the deficit would require revenue of $40.5\% \times 150\%$ or 61%, which is a quintupling of the tax paid by 90% of Arkansas.

One could refund a portion of a FAIR tax, VAT or sales not just to those below the poverty line, but also to the rest of the 90% of Arkansas taxpayers who are above the poverty line. The refunds would prevent their taxes from going up by three and half times or five times. Still, it is a Rube Goldberg machine to collect five times more tax from that group, and then try to refund it, and the refunding would of course require a higher tax to those remaining. A VAT or sales tax without a refund feature, increasing the tax paid by the lowest 90% of the people of Arkansas by five times would make this country a very different, and much nastier, place.

The list includes both \$100 billion from a tax on carbon and also \$71 billion from a 24-26 cent increase in federal tax per gallon of petroleum. We consume 300 billion gallons of petroleum per year, so that a tax on petroleum is revenue productive with increased tax of pennies per gallon.¹⁶ We should be suppressing our consumption of gasoline to encourage the least painful economizing and the conversion to renewable sources of energy. Neither tax is an income tax, however, and neither is consistent with neutral taxation of all internal rates of returns, nor with making the income tax more comprehensive. I think of the tax per gallon as the final reserves in the battle, adjustable with just a few cents per gallon to whatever we need. If there are faults in the revenue estimates, the tax on petroleum can go up or down to fit the needs.

¹² The 12% conclusion computes income tax and employment tax for the average 2.5 person Arkansas household, relying on Jonathan Forman, *2009 Poverty Levels and Federal Tax Thresholds*, 124 TAX NOTES 171 (July 13, 2009) to specify tax treatment of the near poor. Corporate tax is apportioned to dividends received. The spreadsheet, which consumes most of an area of 8x92 cells, is available upon request from the author.

¹³ THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR & PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 216 (2005) (giving 59% rate when tax itself is excluded from the base) Translating a tax excluded rate of 59% into a rate on a base that includes tax means $\$59/(\$100+\$59)$ or 37%. The logic of the translation is that \$100 represents the after tax income, so that pretax income is the 100% plus the tax itself.

¹⁴ IRS §3111(a)&(b).

¹⁵ See, *supra*, note 2 & 3.

¹⁶ According to the U.S. Energy Information Administration, <http://www.eia.doe.gov/basics/quickoil.html>, the U.S. consumes 19.5 mil barrels per day, and 19.5 mil barrels per day*42 gallons per barrel* 365 days per year = 300 billion gals per year.

Table 1. How to Raise \$1 Trillion (dollar figures in billions, 2010 FY)				
	<i>Revenue #s are especially soft)</i>	<i>Cum'ive Revenue</i>	Description	<i>Revenue estimate source note</i>
1. CO ₂ Tax	\$100	\$100	\$20 per ton tax on carbon, reimbursed to those who extract carbon from the air	shelf project ¹⁷
2. Mortgage interest	\$94	\$194	Current tax expenditure less 10% for symbolic and small allowance.	JCT ¹⁸
3. Transfer pricing	\$83	\$277	Limitations on shift on corporate income to foreign sources	¹⁹
4. Gas tax	\$71	\$348	24-26 cent tax per gal on petroleum, times 300 billion gallons annual consumption. ²⁰	
5. Tax Gap	\$70	\$418	20% of the tax gap by raising reporting standard to more likely than not, requiring taxpayer correction of errors on amended returns, web based tax liens, withholding on interest and sales, expanded employee classification, and hidden offshore accounts.	20% of Tax Gap ²¹
6. Repeal lower rate for capital gain, except for stock	\$51	\$469	Repeal lower rate for capital gain, except for sale of C corporation shares, because capital gain now supports standard of living and can be accessed by living beneficiaries. ²²	²³
7. Capitalize intangibles	\$50	\$519	Capitalize prepayments, investigation costs, product design, patent costs, software development, and film. ²⁴	

¹⁷ Ian Parry, *Raise \$100 Billion from a \$20 CO₂ Tax*, 123 TAX NOTES 243 (2009)

¹⁸ STAFF OF THE JOINT COMMITTEE ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2009-2013, JCS 1-10 (Jan. 11, 2010) (hereinafter "JCT"). All figures use 2010 year.

¹⁹ Kimberly Clausing, "Multinational Firm Tax Avoidance and U.S. Government Revenue" (April 2008)(estimating \$83 billion revenue from transfer pricing reform)

²⁰ If there is zero behavioral response a 24 cent tax would raise \$71 billion: 300 billion gal. (see *supra* note 16) times 24 cents = \$71 billion. A 10% drop in consumption of gasoline would require a 26.4 cent tax per gal. to raise \$71 billion.

²¹ IRS' most recent estimate of the tax gap is \$345 billion for 2001. IR-2006-28, Feb. 14, 2006.

²² Calvin H. Johnson, *Corporate Distributions from Earnings and Beyond*, 127 TAX NOTES 813 (May 17, 2010) <http://www.utexas.edu/law/faculty/calvinjohnson/corporate-distributions-from-earnings-beyond-05-17-2010-tax-notes.pdf>. The proposal here reflects a change in conclusion on the ground that it is too complicated to try to enforce reinvestment and inappropriate to give special treatment for old capital. Other shelf projects within the series on capital gains and cited (*id.*) would take away capital gain on intangibles, compensation, and funds not reinvested, and repeal the asymmetrical treatment in IRC §1231.

²³ JCT for lower rate on capital gain, taking out dividends (SOI Individual Returns) and stock as percentage of taxable estate (IRS Statistics of Income, Estate Returns Filed in 2007 (hereinafter "SOI Estates")."

8. Mark to Market	\$50	\$569	Mark to market for all derivatives and financial instruments for which there is an established market. ²⁵	
9. Tax planning and controversy	\$43	\$612	Disallow costs of tax planning, tax determination and controversy to match tax free revenue in reduction in reduction of tax. ²⁶	Volker Commission as to costs ²⁷
10. Fringe benefits	\$42	\$654	Meals always taxed, excise tax on costs of hard to value employee fringe benefits including gyms and cafeterias. ²⁸	JCT for differing fringes
11. Repeal artificial basis for heirs.	\$37	\$691	Step up in basis at death is fake cost, inconsistent with "profit," and which allows wastrel heir to consume without tax. ²⁹	OMB ln 72 with adjustments ³⁰
12. Deferrable foreign subs	\$35	\$726	Current tax of active controlled foreign income of subsidiaries	OMB line 6
13. Local taxes	\$34	\$760	End deduction of local Tiebout taxes that have presumptive quid-pro-quo. ³¹	JCT
14. Insurance build up	\$31	\$791	Tax investment return on insurance policies, but exclude actuarial gain. ³²	JCT

²⁴ The rationales for capitalization are in Calvin H. Johnson *Omnibus Capitalization Proposals*, 124 TAX NOTES 1121 (Sept 14, 2009) [<http://www.utexas.edu/law/faculty/calvinjohnson/Omnibus-Capitalization.pdf>]; Calvin H. Johnson, *Simplification by Repeal of the One-Year Rule for Prepayments*, 124 TAX NOTES 809 (August 24, 2009); Calvin H. Johnson, *Capitalize Costs of Software Development*, 124 TAX NOTES 603 (August 10, 2009), Calvin H. Johnson, *The Effective Tax Ratio and the Undertaxation of Intangibles*, 121 TAX NOTES 1289 (2008) [<http://www.utexas.edu/law/faculty/calvinjohnson/effective-tax-ratior.pdf>] criticized continued reliance on accounting income given the treatment of intangibles.

²⁵ David S. Miller, *A Progressive System of Mark-to-Market Taxation*, 121 Tax Notes 213 (Oct. 13, 2008) would mark financial instruments to market. Yarom Keinan, *Mark to Market for Derivatives*, 128 TAX NOTES 1269 (Sept. 20, 2010). Lower capital gains rates are primarily an incentive for realization, so that the case for capital gain within mark to market is weaker.

²⁶ Calvin H. Johnson, *No Deductions for Tax Planning and Controversy Costs*, TAX NOTES (forthcoming October 2010).

²⁷ The President's Economic Recovery Advisory Board: The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation 42, 46, 65 (Aug. 27, 2010), http://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report_for_final_vote.pdf

²⁸ Calvin H. Johnson, *An Employer-level Proxy Tax on Fringe Benefits*, 123 Tax Notes 483 (April 27, 2009) [<http://www.utexas.edu/law/faculty/calvinjohnson/employer-level-proxy-tax.pdf>]; Richard Schmalbeck & Jay A. Soled, *Elimination of the Deduction for Business Entertainment Expenses*, 123 TAX NOTES 757 (May 11, 2009).

²⁹ Calvin H. Johnson, *Elephant in the Parlor: Repeal of Step-up in Basis at Death*, 121 TAX NOTES 1181 (2008) [<http://www.utexas.edu/law/faculty/calvinjohnson/elephant-in-the-parlor.pdf>]

³⁰ OMB, US Budget FY 2011, Analytical Perspectives 299, Table 19-1. Estimates of Total Income Tax Expenditures for Fiscal Years 2009-2015, at 209, line 72 (hereinafter "OMB"). All figures use 2010 figures and combine individual and corporate amounts. The revenue estimate takes the line 72 figure for repeal of section 1014, and enhances it by 10% to reflect a proposal made here that heirs bear a higher tax on sale than founders. Tax on heirs has less effect on Founders' incentives, but gives the same money to the government. The revenue estimate is then reduced by 25%, to reflect that 25% of assets of estates are publicly traded stock and another proposal on the list would mark publically traded stock to market. SOI Estates

³¹ In theory, redistributional taxes in which the benefit goes to other taxpayers should be deductible, but benefits taxes in which the taxpayer gets benefits from the taxes should not. There is no shelf project pending on disallow local taxes.

³² Calvin H. Johnson, Andrew Pike and Eric Lustig, *Tax on Insurance Buildup*, 122 TAX NOTES 665 (February 2, 2009), [<http://www.utexas.edu/law/faculty/calvinjohnson/tax-on-insurance-buildup.pdf>].

15. Estate tax	\$25	\$816	Estate tax collection in 2007 plus 10% valuation reform	SOI Estates
16. Rental value >\$1 mil	\$24	\$840	Tax value of non-income use of real property worth in excess of \$1 million ³³	³⁴
17. Repeal house gain exclusion	\$24	\$864	End exclusion of cash gain from sale of house	
18. Ain't charity	\$20	\$884	Limit charitable deduction to basis, \$1000/year threshold when taxpayer attends the services or performances. ³⁵	³⁶
19. Municipal bond exclusion	\$16	\$900	Repeal exemption for municipal bonds but buy out issuers.	³⁷
20. Conform depreciation to debt.	\$15	\$915	Economic depreciation, including no negative capital accounts (e.g. basis lower than debt outstanding) ³⁸	³⁹
21. Domestic production	\$12	\$927	Repeal exclusion of 9% with minimal connection to domestic production.	JCT
22. Repeal energy credits	\$11	\$938	Repeal ethanol and other tax credits	JCT
23. Replace corporate income tax.	\$10	\$948	Replace §11 tax on accounting income with 8/10ths percent annual tax on market capitalization Revenue estimate is twice as high but overlaps with other reforms. ⁴⁰	
24. Contributions to capital from nonowner	\$10	\$958	Public funding of sports stadiums, factories, and location incentives are now treated as exempt capital, but they are "income" in ordinary sense because they improve net worth. ⁴¹	

³³ Calvin H. Johnson, *Taxation of the Really Big House*, 122 TAX NOTES 915 (February 16, 2009) [<http://www.utexas.edu/law/faculty/calvinjohnson/taxation-of-the-really-big-house.pdf>].

³⁴ Real property held by estates >\$2 mil (SOI Estates) grossed up by mortality (Statistical Abstracts of US Table 105), imputed return at long term applicable federal rate, and tax at 35%.

³⁵ Calvin H. Johnson, *Ain't Charity: Disallowing Deductions for Kept Resources*, 128 TAX NOTES 545 (Aug. 2, 2010) [http://www.utexas.edu/law/faculty/calvinjohnson/aint_charity.pdf].

³⁶ JCT figures total \$44.8 for all charity

³⁷ Calvin H. Johnson, *Repeal Tax Exemption for Municipal Bonds*, 117 TAX NOTES 1259 (2007), [<http://www.utexas.edu/law/faculty/calvinjohnson/repeal-exempt-muni-bonds.pdf>]

³⁸ Calvin H. Johnson, *Don't Let Capital Accounts Go Negative*, TAX NOTES (forthcoming October 2010)

³⁹ JCT on restricting to alternate depreciation is \$13.6 billion. Limitations on "negative capital accounts" are stricter than alternative depreciation and have broader scope.

⁴⁰ Calvin H. Johnson, *Replace the Corporate Tax with a Market Capitalization Tax*, 117 TAX NOTES 1082 (2007) [<http://www.utexas.edu/law/faculty/calvinjohnson/replace-corporate-tax.pdf>].

⁴¹ Calvin H. Johnson, *'Contributions to Capital' from Nonowners*, 126 TAX NOTES 1127 (2010) [<http://www.utexas.edu/law/faculty/calvinjohnson/contributions-to-capital-from-nonowners-03-01-2010-tax-notes.pdf>].

25. TARP tax	\$9	\$967	15/100 th tax on bank liabilities to cover government losses from TARP ⁴²	
26. Limit qualified plans	\$8	\$975	Limit qualified plan contributions to actuarial amount needed for \$50,000 in retirement	10% of JCT on qualified plans
27. Public stock in merger	\$5	\$980	Treat publicly traded stock as cash equivalent when received in merger ⁴³	⁴⁴
28. Repeal LIFO	\$4	\$984	LIFO inventory excludes real gains	JCT
29. Repeal Roths	\$4	\$988	Roths are not equivalent to consumption tax in rising revenue or known premium returns. ⁴⁵	JCT
30. No second set of low brackets	\$4	\$992	Section 11 gives second set of low rate brackets by merely incorporating.	JCT
31. Deferred sales	\$2	\$994	Treat first cash as boot, no capital gain after first year. ⁴⁶	Half of JCT
32. Like kind exchanges	\$2	\$996	Tax off-stage cash ⁴⁷	JCT
33. Oil and gas	\$2	\$998	End expensing of intangible drilling, percentage depletion, pool of capital, fast geological exploration write offs. ⁴⁸	JCT
34. Repeal ESOPS	\$2	\$1000	Undiversified pension investments undercut retirement security and do harm. ⁴⁹	OMB line 154
35. Small business stock	\$1	\$1001	Small business corporation stock benefits lead to abuses of funding of losing projects.	JCT

Smaller Revenue Items.

A revenue crisis is an opportunity for Treasury to do the right thing on 200 projects. Table 2, below, presents a list of projects with a revenue estimate of under \$1 billion per project.

⁴² White House explanation of Financial Crisis Responsibility Fee .

http://www.whitehouse.gov/sites/default/files/financial_responsibility_fee_fact_sheet.pdf

⁴³ Calvin H. Johnson, *Taxing the Publicly Traded Stock in a Corporate Acquisition*, 124 TAX NOTES 1363

(Sept. 28, 2009) [<http://www.utexas.edu/law/faculty/calvinjohnson/taxing-the-publicly-traded-stock-09.28.09.pdf>].

⁴⁴ \$1 trillion stock-only mergers over 24 years 1977-2000 (Matthew Rhodes-Kropf et al., 'Valuation Waves and Merger Activity: The Empirical Evidence,' 77 J. of Fin. Econ. 561), then of the 1/14th for one, it is assumed that half is gain taxed at 15%.

⁴⁵ Calvin H. Johnson, *Repeal Roth Retirement Plans To Increase National Savings*, 128 TAX NOTES 773 (August 16, 2010) [<http://www.utexas.edu/law/faculty/calvinjohnson/repeal-roth.pdf>].

⁴⁶ Calvin H. Johnson, *Deferred Payment Sales*, 120 TAX NOTES 157 (2008)

[<http://www.utexas.edu/law/faculty/calvinjohnson/deferred-payment-sales.pdf>].

⁴⁷ Calvin H. Johnson, *Impose Capital Gains Tax on Like-Kind Exchanges*, 121 TAX NOTES 475 (2008)

[<http://www.utexas.edu/law/faculty/calvinjohnson/like-kind-exchanges.pdf>].

⁴⁸ Calvin H. Johnson, *Accurate and Honest Tax Accounting for Oil and Gas*, 125 TAX NOTES 575 (Nov. 2, 2009)

<http://www.utexas.edu/law/faculty/calvinjohnson/accurate-and-honest-tax-acct-for-oil-and-gas-11-02-2009-tax-notes.pdf>].

⁴⁹ Andrew Stumpff and Norman Stein, *Repeal Tax Incentives for ESOPS*, 125 TAX NOTES 337 (Oct. 19, 2009).

The projects, in some cases, might be worth over a \$1 billion, but I am unable to do a responsible revenue estimate that high. The smaller revenue projection projects should still be done. The tax system needs hundreds of repairs to support a fairer and more efficient tax base, but the smaller repairs will not get done unless the staff work is done now in preparation. If a project raises *only* 250,000,00.00, for instance, a deficit of \$1.3 trillion can be met only with 5200 such projects, which a project completed every other week for 200 years. Only once in a generation or in a crisis does the government get a fair chance to make necessary repairs to the tax system. If the tax base is not repaired in the coming crisis, it will be a long time before the chance comes again.

Item	Description
1. "Green Stamps" reserves	Payments for future customer incentives are deducted years before payment in violation of time value of money.
2. Capital Construction funds	World War II-era incentives for investment in domestic ship building remain intact long after the rationale for adoption has disappeared.
3. Repeal Recurring costs exemption from economic performance accrual	Section 461(h)(3) of the Code allows current deduction of next year's expenses if the payments are "recurring." "Recurring" is part of "steady state fallacy" and does not justify deduction of next year's expenses not yet expired. Probably > \$1 billion.
4. Repeal common trust funds	Banks got passthrough system adopted before partnership tax was adopted to include anti-abuse provisions. The system is now a "living fossil." Banks need to use the partnership tax system instead. ⁵⁰
5. No lower capital gains rates	IRC §1(h)(1)(B) give 0% rates for dividends and capital gain received by taxpayers otherwise in lower tax brackets. Capital gain is now freely available for standard of living. Given that people truly in low brackets have no significant income from capital, rates lower than 15% are misdirection. Probably > \$1 billion.
6. Closing deferred revenue accounts	A set of multi-million dollar shelters sold in late 1990s and early 2000's worked only because cash received was not taxed because it was deferred income and then the deferred income was never brought as gain or deduction of basis. This violates fundamental accounting balancing. ⁵¹
7. End transfer of basis in wash sales	Wash sale rules are supposed to be a remedy to prevent abuse, but the rules are exploited as a way to transfer basis from one related entity to another. The suspended loss needs to stay with the same taxpayer. ⁵² Probably > \$1 billion
8. Preserving basis	Basis should not be deducted if the property retained has a value in excess of basis. ⁵³ This is part of the fundamental norm that if the tax accounting reflects economic income, then basis would not drop below net present value of the investment. Probably > \$1 billion.

⁵⁰ Calvin H. Johnson, *Common Trust Funds: The Living Fossil of Passthroughs*, 128 TAX NOTES 103 (2010) [<http://www.utexas.edu/law/faculty/calvinjohnson/common-trust-funds-living-fossil-of-passthroughs-04-05-2010-tax-notes.pdf>].

⁵¹ Calvin H. Johnson, *Closing Deferred Revenue*, 121 TAX NOTES 965 (2008)

[<http://www.utexas.edu/law/faculty/calvinjohnson/closing-deferred-revenue.pdf>].

⁵² Cf. Calvin H. Johnson, *Wash Sales with Replacement by Related Parties*, 120 TAX NOTES 1325 (2008) [<http://www.utexas.edu/law/faculty/calvinjohnson/wash-sales-with-replacement.pdf>] covers part of the problem, but not all of the transference-of-basis cases

⁵³ Calvin H. Johnson, *Casualty and Business Losses When Basis Has Not Been Lost*, 120 TAX NOTES 357 (2008), [<http://www.utexas.edu/law/faculty/calvinjohnson/casualty-and-bus-losses-when-basis.pdf>].

9. Taxpayer identification of basis.	When stock is sold, but fungible stock is retained, the gain should be calculated to maximize gain to bring basis up to value. ⁵⁴ Allowing taxpayer to identify certificates sold is meaningless except to understate taxable gain. Probably > \$1 billion
10. Cashing out on gain.	Short sales and issuance of option should be boot – gain first - if the taxpayers hold underlying property. ⁵⁵ Probably >\$1 billion
11. Retiring Partners	Create basis not deductions for buyouts of retiring partners. ⁵⁶ Probably > \$1 billion.
12. Third party compensation.	Tax Court decision allows plaintiff's lawyers to receive compensation backed by insurance company, although cash method taxpayers usually pay tax on funded promises to pay. ⁵⁷ Probably > \$1 billion.
13. Goodwill as ordinary asset.	The combination of ordinary deduction for input and capital gains rates for sales gives strong negative tax to goodwill and other intangibles. ⁵⁸ Probably >\$1 billion
14. Partnership capital gain	Distributions from expanded- definition collapsible partnerships need to be ordinary income. ⁵⁹
15. Extension of UBIT	Unrelated trade or business income tax needs to be extended to ESOPs and government affiliated entities to prevent shift of taxable income to exempt status and prevent use of tax exempt entities as tax sink to absorb income in a transaction. ⁶⁰

Conclusion

The impending revenue crisis is a big one. Some have projected individual tax rates of 85%, and some have advocated a federal sales tax of some kind, with rates that will need to be 61%. A \$1 trillion can be raised without a VAT or raising individual tax rates, mostly just by making tax accounting better reflect real economic income. Making tax more comprehensive and neutral will improve both the fairness and efficiency of the tax system.

⁵⁴ Calvin H. Johnson, *End Identification of Stock Certificates*, 119 TAX NOTES 1171 (2008)

[<http://www.utexas.edu/law/faculty/calvinjohnson/end-identification-of-stock-certificates.pdf>].

⁵⁵ Calvin H. Johnson, *End Tax-Free Monetization of Wealth*, 119 TAX NOTES 1361 (2008)

[<http://www.utexas.edu/law/faculty/calvinjohnson/end-tax-free-monetization.pdf>].

⁵⁶ Philip Postlewaite and Adam Rosenzweig, *Anachronisms in Subchapter K of the Internal Revenue Code – Is it Time to Part With Section 736*, 100 NORTHWESTERN L. REV. 379 (2006).

⁵⁷ Gregg D. Polsky, Brant J. Hellwig, *Close the Yield Exemption Loophole Created by Childs*, 123 TAX NOTES 1141 (May 18, 2009)

⁵⁸ Calvin H. Johnson, *Sale of Goodwill and Other Intangibles as Ordinary Income*, 118 TAX NOTES 321 (2008)

[<http://www.utexas.edu/law/faculty/calvinjohnson/sale-goodwill-other-intangibles-as-income.pdf>].

⁵⁹ Karen C. Burke, *Collapsible Real Estate Partnership*, 120 TAX NOTES 593 (July 21, 2008)

⁶⁰ Calvin H. Johnson and Ellen Aprill, *UBIT to the Defense! ESOPs and Government Entities*, 128 TAX NOTES 316 (July 19, 2010) [<http://www.utexas.edu/law/faculty/calvinjohnson/UBIT-to-the-defense.pdf>]