

**HOW DID WE GET HERE? CHANGES IN
THE LAW AND TAX ENVIRONMENT SINCE
THE TAX REFORM ACT OF 1986**

HEARING

BEFORE THE

**COMMITTEE ON FINANCE
UNITED STATES SENATE**

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

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HOW DID WE GET HERE? CHANGES IN THE LAW AND TAX ENVIRONMENT SINCE THE TAX REFORM ACT OF 1986

TUESDAY, MARCH 1, 2011

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

The hearing was convened, pursuant to notice, at 10:02 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Bingaman, Wyden, Menendez, Carper, Cardin, Hatch, Grassley, Snowe, Enzi, and Thune.

Also present: Democratic Staff: Russ Sullivan, Staff Director; Lily Batchelder, Chief Tax Counsel; Tiffany Smith, Tax Counsel; and Andrew Fishburn, Detailee. Republican Staff: Chris Campbell, Staff Director and Chief Counsel; Mark Prater, Deputy Chief of Staff and Chief Tax Counsel; Kim Brandt, Chief Health Care Investigative Counsel; Theresa Pattara, Tax Counsel; and Jim Lyons, 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.

The author Thomas Friedman wrote, “The long-term opportunities and challenges that the flattening of the world puts before the United States are profound.” Indeed, increased globalization in the last several decades has spurred advancements in technology, business practices, and daily life.

Compared to life 30 years ago, the changes are profound. Back then, the Berlin Wall was still intact. More businesses did their business using snail mail, except we then called it regular mail. And the concept of derivatives was only familiar in a few, limited markets.

In the 1980s, most Americans had not heard of the Internet, cell phones were usually found only in high-end cars, and computers were hundreds of times slower than those we use today.

The global economy has indeed flattened. Business is usually done using e-mail, the Internet, and smart-phones. The use of interrelated financial products based on complex computer models nearly led to a global Great Depression. And today’s ubiquitous mobile phones have many times the computing power of the 1980s personal computer.

Today we will look at how the tax code has changed and whether it has adapted to these changes. We will look at how the tax environment is different since we last revamped the code in the 1986 Tax Reform Act. And we will consider how globalization affects the central issues we face in tax reform.

We have made 15,000 changes to the tax code since 1986, but many of these changes have stretched the code in different directions. Have these changes left us with a tax code that is more efficient, more competitive, more fair? How have these changes affected average Americans?

Today's panel of distinguished witnesses allows us to look back at the past 25 years of tax policy. We will hear more about the reasons behind many of those 15,000 changes. We will hear about what challenges they have faced and how things have changed.

The Assistant Secretary for Tax Policy sits at the intersection of tax policy and tax administration. In this position, our witnesses have been uniquely situated to see all sides of the tax policy debate. One major change we must consider is how doing business has evolved since 1986.

Changes in the foundation of conducting business have had a significant impact in how we collect revenue. Today, many U.S. businesses pass their income through to shareholders and pay the same tax rate as individuals. We call them pass-throughs. In 1986, about 40 percent of business income was earned by pass-throughs. Today, about 60 percent is earned through pass-throughs. Two-thirds of our large businesses are pass-throughs, which is more than twice the level of the next-highest developed country.

We receive more revenue from pass-through businesses every year than we do from businesses with traditional corporate structures, called C corps. We must consider how efficiently we tax business income, given that so much of it is taxed on an individual basis today. We must also consider how other countries' tax policies affect our system.

In 1986, we closed tax loopholes that allowed individuals to eliminate their tax liability by investing in tax shelters for a small fee. Today, complicated tax claim regimes are proliferating. They often involve cross-border transactions for individuals transferring funds offshore.

We made some progress in cracking down on offshore accounts recently. We enacted the Foreign Account Tax Compliance Act in 2010, and we have enacted other provisions that closed international tax loopholes in recent tax bills.

But have we kept up? In our global economy, intellectual property can be moved across borders quickly. Some companies use that advancement to drive their effective tax rates down to single digits, while other companies have payment rates closer to 20, or even 30 percent. This disparity can have a significant effect on our economy. It is a major driver of the need for tax reform.

We must also consider the gap between the taxes owed and taxes paid. The Treasury has estimated that gap as close to \$300 billion, and that estimate, I think, was in the year 2003. This tax gap is difficult to fill, but we need to find ways to improve compliance without excessive burdens on businesses or individuals. No one should be able to systematically avoid their tax obligations. Today

we will ask our panelists for their insights into this seemingly intractable problem. Perhaps information technology offers opportunities to reduce the tax gap, while reducing compliance burdens at the same time.

We will also consider changes to the tax law. In 1986, there was no concept of an annual tax extenders bill. Last year, there were 141 expiring provisions; the debate took 9 weeks of Senate floor time. We must look at why we have so many expiring provisions and how they affect our economy. So today we ask, how did we get here? I think more to the point, though, we should also ask, is here where we want to be?*

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

The CHAIRMAN. Senator Hatch, I am told, is on his way and will give his statement when he arrives.

So I would now like to introduce our panel. We have five former Assistant Secretaries for the Treasury for Tax Policy with us today. Thank you.

First is Fred Goldberg, who served as Assistant Secretary of the Treasury for Tax Policy in 1992. Thank you, Secretary Goldberg. Prior to that, Mr. Goldberg was the Commissioner of the Internal Revenue Service and the Chief Counsel for the Internal Revenue Service. We also have Jonathan Talisman, who served as Assistant Secretary for Tax Policy from 1999 to 2000. We have Mark Weinberger. Mr. Weinberger served as Assistant Secretary for Tax Policy from 2000 to 2002. Then we have Pamela Olson, who served as Assistant Secretary of the Treasury for Tax Policy from 2002 to 2004. Finally, Eric Solomon, who served as Assistant Secretary of the Treasury for Tax Policy from 2006 to 2009.

It is great to see all five of you. You have helped us over the years, and thank you all for coming again, same place, same time. We really appreciate it and hope to see a little synergy here. Thank you all for coming.

As is our regular practice, we will submit your statements for the record and ask you to summarize briefly.

Mr. Goldberg?

STATEMENT OF HON. FRED T. GOLDBERG, JR., FORMER ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY, 1992, WASHINGTON, DC

Mr. GOLDBERG. Mr. Chairman, members of the committee, in my case it has been quite a while, but it is a pleasure to be back. Thank you for the opportunity to testify today on the topic of tax reform.

In many respects, the emerging discussion is, in the immortal words of Yogi Berra, “Déjà vu all over again.” The Tax Reform Act, like the discussion today, focuses on the premise that lowering rates and broadening the base is the way to go.

As now, the stated goals back then were the timeless tax policy themes of simplification, fairness, efficiency, and competitiveness.

*For additional information on this subject, *see also*, “Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates,” Joint Committee on Taxation staff report, February 28, 2011 (JCX-15-11), <http://www.jct.gov/publications.html?func=startdown&id=3739>.

The Act did indeed broaden the base and lower rates and was an improvement in some respects.

But whatever those gains may have been, they were transitory. The tax system today is grotesquely complicated. It is perceived as unfair from every point on the political spectrum. It has caused gross distortions in the allocation of resources, and has played a significant role in eroding our competitive position.

My written statement addresses, briefly, two questions: despite the promise of the 1986 Act, why has the system ended up where it is today; and second, what are the lessons for reform this time around? In the interest of time, I will skip the former and focus only briefly on the latter.

The starting point is different circumstances from what they were 25 years ago. Among the most important are, the 1986 Act was grounded on the principle of revenue neutrality. I believe that will not be the case today. We have betrayed our children and grandchildren. A fundamental restructuring of entitlement programs, significant reductions in discretionary spending, and additional revenue are all required to right the wrongs we have committed. The only question is how to make these changes in ways that do the least damage to our future economic prosperity while honoring our commitment to the more vulnerable of our fellow citizens.

The second, as the chairman mentioned, is globalization and new technology, the rapid growth in the global markets for goods, services, and capital, the importance and mobility of human and intangible capital, and the emergence of formidable competitors on the global stage. These developments, in my view, are irreversible, but they need not be threatening. If the country responds properly, our Nation is uniquely well-positioned to take advantage of this change. Tax policy is a central player in whether we will succeed in this endeavor.

The third, and in some ways most troublesome, is the growing inequality in opportunity, income, and wealth among our citizens. In my view, the tax law is neither cause, nor cure, but tax reform can and should help address these circumstances by reducing distortions in economic activity and complexity that plague our current system. In my view, tax reform can accomplish these objectives while maintaining or enhancing our progressive individual income tax. So much for the circumstances.

My written statement sets forth what I believe to be seven lessons learned. While time is running short, I will touch on them only briefly. The first is a cautionary word. While we give lip service to the importance of taxes, I believe we understate their awesome and potentially destructive power.

In 1986, America was the undisputed center of the world's capital markets, and was home to most of the leading global financial institutions and pharmaceutical companies. Twenty-five years later, that is not the case.

There are many reasons for this shift, but the fact is that our tax system is increasingly hostile to capital in most of its forms, whether it is money, human capital, or intangible assets. These kinds of capital are mobile. They do not respect national borders, and they are extremely unforgiving. The 1986 Act and legislation that has

followed in its wake have ignored or sought to challenge these powerful forces. In doing so, we have acted at our peril, and I believe we are paying a very high price.

Second, businesses do not pay taxes—people do. Corporations may write the checks, but some combination of owners, workers, and customers pays the bill. This is, and has been, a truism. It is misleading and terribly counterproductive to suggest the contrary.

I urge you to think big. The time has come to pursue far more fundamental reform than was taken in 1986. I appreciate and applaud your effort to take on these issues. I wish you well, and I believe you can, and will, succeed.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you. When we get to the questions, I am going to follow up on how you think we should be more provocative.

Mr. GOLDBERG. Hopefully they are all forgotten by the time you get to them.

The CHAIRMAN. I am sure they will be. [Laughter.]

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

The CHAIRMAN. Mr. Talisman?

STATEMENT OF HON. JONATHAN TALISMAN, FORMER ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY, 2000–2001, WASHINGTON, DC

Mr. TALISMAN. Chairman Baucus and members of the committee, thank you for inviting me to share my recollections and some thoughts about tax reform. It is a privilege to appear before you once again, and I want to commend the committee for taking up the subject of tax reform.

We are facing a perfect storm of structural problems, including the growing reach of the AMT, numerous structural extenders that will expire soon, and competitiveness concerns raised by our corporate tax systems.

Unfortunately, our ability to address these problems is inhibited by the deficits we are facing and the growth in entitlement programs. Similar to the concerns of today, much of the focus of the parties in the 1990s while I was in service was on fiscal restraint and regaining control of the Federal budget.

In 1992, the budget deficit had grown to a then-record of \$290 billion and was projected to grow further. During his first term, President Clinton and the Congress took a number of actions to reverse this trend. The Omnibus Budget Reconciliation Act was enacted in August of 1993 to reduce deficits by nearly \$500 billion over 5 years, evenly divided between spending cuts and tax increases. As a point of pride, Senator Moynihan often subsequently referred to it, much to our consternation, as the largest tax increase in history.

In 1997, President Clinton began a second term, and I joined the Treasury Department. While economic conditions had improved, budget forecasts continued to project persistent deficits under current law. Eventually a budget framework was set, with spending cuts and net tax cuts up to \$250 billion over 10 years. The final tax package meeting that criteria created the Child Credit, the Hope Scholarship Credit, Roth IRAs, reduced capital gains rates,

raised the estate tax exemption, and included a number of simplification items.

Ahead of expectations, the budget registered a unified surplus of roughly \$70 billion in 1998, and increasing budget surpluses into the future. In his State of the Union address, the President called for saving Social Security first, suggesting that any surplus funds should not be used for spending or tax cuts until long-term entitlement reform was enacted. This set the tone for the next several years on tax policy, as efforts to pass significant tax cuts without offsets were defeated in Congress.

As today, there were numerous calls for tax reform while I was on the Hill. In fact, when I started with the Joint Tax Committee staff, Mark Weinberger and I helped draft one of the first VAT proposals for his boss, Senator Danforth, and Senator Boren. At the time, most reform proposals would have replaced all or part of the income tax with a consumption tax.

One of the first hearings I staffed for the Finance Committee was to examine the findings of a Tax Reform Commission, chaired by former Congressman Kemp. At the hearings, Senator Moynihan declared that a new set of simple rules was certainly appealing, given the volume and complexity of the tax law.

However, he admonished that we must proceed carefully. Any time a change of this magnitude is under consideration with huge potential risks to the economy and shifts of fortune in balance, we must approach proponents' claims with caution and healthy skepticism.

Senator Moynihan's statement raises several themes that are still important in considering tax reform today. First, it will be very important to agree on the goals and intended benefits of tax reform. The establishment and marketing of those goals will determine whether any significant tax reform is accomplished and how it is judged politically.

Second, revenue-neutral tax reform or corporate tax reform will, by definition, create winners and losers. We experienced this with the Foreign Sales Corporation and Extraterritorial Income Exclusion, or FSC/ETI, where the committee ultimately added a manufacturing deduction to address the concerns raised by domestic manufacturers and production companies who were significant losers in the bill sent over from the House.

Third, while simplification is desirable, some of the complexity of the code is unavoidable. We have a complex economy and society that require special rules to take into account different or unique circumstances in order to be fair or to prevent abuse. Also, in our political dynamic, there has been pressure not to increase spending, but the political desire for new programs has not disappeared.

Fourth, while an ideal tax system would not include many tax expenditures, we are not starting a tax system from scratch. Many of the largest tax expenditures are long-term features of our system, imbedded in the fabric of our economy. To avoid false expectations, we need to be careful in how we talk about base broadening and consider the practical, economic, and social effects of eliminating tax expenditures.

Stanley Surrey, who coined the term "tax expenditures," said that the classification of an item as a tax expenditure does not, in

and of itself, make that item either a desirable or undesirable provision, and concluded that most were assistance the legislators do want to provide. A good example of this is the research credit.

I would like to close by raising one final issue. During my tenure at Treasury, we were just beginning to see the challenges that globalization and information technology have posed for the tax system and for tax administration. To date, our tax system has not been adapted. Thus, as part of this reform process it will be important to reflect the dynamic challenges raised by the expanding global environment for business.

My comments are not intended to discourage this committee's efforts on tax reform; rather they are intended to make sure we do not lose sight of the reasons our tax system has developed as it has. Simplicity and efficiency are worthy goals, but so are fairness and ensuring we raise sufficient revenues to fund current priorities and to prepare for our long-term challenges.

Thank you once again for inviting me to share my observations. I would be happy to answer any questions you might have and to assist the committee as you move forward.

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

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

The CHAIRMAN. Mr. Weinberger, you are next.

STATEMENT OF HON. MARK WEINBERGER, FORMER ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY, 2001–2002, WASHINGTON, DC

Mr. WEINBERGER. Thank you, Chairman Baucus and members of the committee, for inviting me here today. In my written testimony we discuss five principal influences that have led to the need to re-examine and update the code. They include the evolving business and global landscape, increased global competitive pressures, the expanding use of the code, the cumulative effect of changing budget and legislative processes, and the worsening fiscal situation. I am just going to highlight a few.

The fundamental elements of our current tax system are the product of vigorous debate and have taken place over a long period of time. The code has been augmented, patched, clarified, and otherwise tweaked. As a result, the system has developed into an overly complicated set of rules that evolved largely without sufficient analysis or debate regarding the long-term competitive effect or alignment in the worldwide tax policy trends.

The observation is not meant to be a criticism of the process, it is merely a recognition of the practical and political realities. Through the evolution of our tax system, the way the world is doing business has been changing at an extraordinary pace. New industries have been created, new markets opened, the flow of capital has shifted, and new economic powers have arisen.

These developments are transforming the landscape for business in the United States and around the world. Businesses have completely changed their business models to adapt. If they did not change, they would not be successful. The same is true for the U.S. economy. We have to adapt our tax code to the same changing world if we want the U.S. economy to continue to excel.

Business tax reform needs to take account of the changing way American businesses operate and the impact that foreign competition increasingly plays in their success both here and abroad. As a result, the U.S. tax policy decisions which have been historically made without great concern about what is going on around the rest of the world can no longer be made in a vacuum.

I would like to read a quote: "Our tax system was once viewed as an asset, and it needs to be an asset again. The quality of tax policymaking and the frequency and predictability of change is a key concern of business and has the potential to undermine perceptions of stability which can make businesses less likely to invest here. Particular concerns have been made about a lack of clear direction, the frequency of change, and the lack of attention paid to the real impact on business." Was this written by the U.S. business community? No, it was not written by a business, and it was not written in the U.S. It was written by the U.K. government last year, which went on to say, "The government wants to send out a signal loud and clear that Britain is open for business."

The U.K., and many other jurisdictions around the world, have recognized the need to have a tax system that invites investment in labor and capital inside its borders, as the global ability of each has increased. The U.S. should consider the same.

The President, in his State of the Union address, called for revenue-neutral tax reform. He also called for reducing the high statutory rates. If Congress wants to meaningfully reduce statutory rates in a revenue-neutral manner, it will be hard work. The American people should be educated about the trade-offs, and the process should be outlined similarly to that in the United Kingdom.

Importantly, it cannot be achieved by merely closing loopholes, as some would believe. It would require finding a new source of revenue or curtailing longstanding preferences in the tax code. These preferences are some of the primary instruments that have been used to influence social and economic policy in this country, including for example encouraging education, increasing savings, providing for income redistribution, among others.

Where the code creates unintended consequences and where the rules can be tightened, tax reform should address those. But as a recent report of the President's Fiscal Responsibility Commission illustrates, the trade-offs go well beyond merely closing loopholes. Whether or not tax reform should be revenue-neutral is another question.

It is important to recognize that revenue-neutral tax reform can mean a lot of different things. Revenue-neutral does not mean neutral to all taxpayers. It will create winners and losers relative to the status quo, at least in the short term. Remember, every poker game is revenue-neutral. At the end of the day, the same amount of money leaves the table, but in very different pockets.

Regardless of whether Congress decides to proceed with revenue neutrality being a requirement of tax reform, we cannot ignore the unprecedented fiscal deficits and national debt we face that will require us to comprehensively reevaluate our spending and tax provisions. Since so many policy objectives are implemented through both spending and tax policies, each should be considered in conjunction with the other.

Finally, I would like to commend the chairman for the approach that you have laid out for addressing comprehensive tax reform in this committee. The thorough process you have laid out to assess the current state, consider changes, involve stakeholders, and then proceed with comprehensive reform is the appropriate approach to construct tax policy.

Over the years, the budget and legislative process have played very significant roles in how tax policy has evolved, not necessarily in the furtherance of tax policy. They undoubtedly will play a role here. The tax reform process is going to need to be navigated and well-orchestrated in order to ensure the end result is a stable, long-term reform that can respond to the changing environment and withstand the test of time.

Thank you, Mr. Chairman.

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

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

The CHAIRMAN. Ms. Olson?

STATEMENT OF HON. PAMELA F. OLSON, FORMER ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY, 2002-2004, WASHINGTON, DC

Ms. OLSON. Thank you, Chairman Baucus and members of the committee. I applaud your decision to commence a review of the tax system to consider serious reform of the country's tax system, because I think it is necessary.

Your efforts are timely, particularly in light of our country's pressing fiscal concerns and the changing global landscape. But you face a difficult challenge, and I will say some things that are easy for me to say because I am not running for election.

While the sources of our current tax system's shortcomings have been identified and can be addressed in any overhaul, doing so will require a greater measure of political courage and willingness to challenge the conventional wisdom than was evident in 1986.

The change that is required will require education and a willingness to look beyond the next election. Fortunately, this committee possesses leaders who have shown that it is possible to work on a bipartisan basis and to propose meaningful reform of the tax system.

In reforming the tax system, it is essential that Congress enact reform that rids the tax system of unnecessary complexity, reflects economic realities, not political rhetoric, lays a foundation for economic growth and job creation by fostering our Nation's global competitiveness, and allows us to pay our bills, not saddle our children and grandchildren with crippling levels of debt. We must be cognizant of the changes shaping other country's tax systems, because capital is mobile and those changes are affecting investment decisions and capital flows into, and out of, the United States.

Enactment of the 1986 Tax Reform Act represented a remarkable legislative achievement and addressed a number of serious flaws in the tax system. I share my colleagues' views that it had its own flaws, flaws that have grown more problematic over time for the economy, our national competitiveness, and tax administration.

The ideal system would raise the revenues to fund the operations of the government with the least adverse impact on the economy, but our current system fails that challenge. The flaws in the 1986 Act should serve as a warning in your tax reform effort today.

First, complexity. The Tax Reform Act carried the complexity of the tax law to new heights. There were many reasons for this, including the goal of revenue neutrality, one that, unlike my colleague, I would throw overboard, and political reluctance to address directly individual tax expenditures.

On the individual side, the Tax Reform Act included a beefed up Alternative Minimum Tax as a substitute for repealing or limiting a number of individual tax preferences. Though intended when originally enacted to ensure that wealthy individuals paid at least some amount of income tax, AMT's design never carried out that purpose. If reform is to succeed, individual tax expenditures must be tackled.

The exclusion for employer-provided health care should be on the top of the list. There is little to suggest that health care reform would bend the cost curve down, because the ultimate consumers of health care remain oblivious of its cost. Eliminating the health care exclusion would be a step towards disciplinizing health care costs. It would also eliminate a provision that is regressive and unfair.

Second, economics. Sound bites are not sound policy. The Tax Reform Act shifted the tax burden to corporations and perfected double taxation of corporate income, perhaps its most serious error. With a tax on corporate income over 20-percent higher than the tax on non-corporate income and a second tax on dividends and capital gains from the sale of corporate stock at ordinary rates, the act set off a furious effort on the part of every well-advised business to escape the corporate form of business via S election or converting to partnership form.

Master limited partnerships became so popular that Congress was compelled, just 1 year later, to enact a provision preventing the adoption of partnership form by publicly traded partnerships to protect the corporate tax base. The corporate double tax system encouraged the use of debt and discouraged the payment of dividends, contributing significantly to the corporate instability and governance issues that plagued us, particularly in the 1990s.

The Tax Reform Act also targeted the international operations of U.S.-headquartered companies. Many of the changes have no policy rationale other than that they raised revenue from an unpopular target—big businesses' foreign operations—and a complete failure to appreciate the important role of global engagement to the well-being of the U.S. economy.

Regardless of the merits of the policies that have been added to the code over the course of the last 25 years—policies that have put the IRS in charge of dispensing all manner of benefits—it is unreasonable to believe that the system can continue to operate on this basis. As a consequence, I strongly urge that the committee move in the direction of cleaning the tax code.

A couple of final points. It is important that you consider the budget holistically. Spending and taxes are inextricably linked and must be viewed together. It is critically important that you get the

economics right. Sound tax policy is based on sound economic policy, and sound economic policy dictates that rules should be neutral to avoid skewing business and investment decisions. Finally, it is important that you respond to global shifts that have taken place over time and have already been discussed by some of my colleagues at the table.

Thank you.

The CHAIRMAN. Thanks, Ms. Olson.

[The prepared statement of Ms. Olson appears in the appendix.]

The CHAIRMAN. Mr. Solomon?

STATEMENT OF HON. ERIC SOLOMON, FORMER ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY, 2006–2009, WASHINGTON, DC

Mr. SOLOMON. Mr. Chairman, Senator Hatch, and distinguished members of the committee, thank you for the opportunity to testify on how changes since the Tax Reform Act of 1986 have affected the tax code.

I agree with this committee that, in order to understand the options for reforming the system, it is important to start by understanding the changes in the past 25 years that have brought us to what we are today. The primary purpose of a Federal tax system is to collect the revenues needed to fund the programs of our government.

We would all agree that the goals of an optimal tax system would include promoting economic growth, minimizing distortions, and supporting U.S. competitiveness. An optimal tax system would also be as simple as possible, fair, stable, and administrable for taxpayers and for the Internal Revenue Service. There is a growing belief that our current tax system does not achieve these goals.

I would like to focus on the factors that have brought us to where we are today. First, our Nation is constantly changing, and our laws, including our tax laws, need to adapt.

Second, we are frequently adding to our tax laws, often on a temporary basis, and there is a periodic need to revisit the system and its components.

Third, our Nation is confronting enormous fiscal challenges requiring us to examine both spending and revenues. We live in a constantly changing world. Economic, social, and political developments, including accelerating advancements in technology, are changing our Nation and its role in global affairs and the global economy. As our world changes, we need to reevaluate our laws, including our tax laws, to ensure that they are responsive to, and appropriate for, current and anticipated conditions.

In December 2007, the Treasury Department issued a report, “Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century.” This report observes that globalization, the interconnectedness of countries and economies around the world, is increasing dramatically and profoundly affecting the U.S. economy. The United States needs to recognize and adapt to its changing role.

Scores of tax bills have been enacted in the last 25 years. The code grows by accretion. The code is a patchwork of provisions, serving a wide variety of purposes. The additions to the code are

designed with noteworthy non-tax objectives. In effect, however, some of these additions are the equivalent of spending programs administered through the code. As the code grows and the regulatory and administrative guidance interpreting and implementing the code also grows, our enormously complex system becomes even harder for taxpayers to understand and for the IRS to administer.

With the passage of time, various parts of the code should be revisited. Some policy decisions incorporated in the code should be reviewed, some tax incentives might not be effective, enacted provisions might overlap and potentially be duplicative, or a tax provision might not operate as originally envisioned. The various education incentives are an example of overlapping provisions. The individual Alternative Minimum Tax is an example of a provision that needs to be patched, or else it will operate in a manner contrary to its original intent.

In part because of budgetary rules, dozens of individual and business provisions are enacted on a temporary basis. Many of them are extended numerous times, some retroactively, which reduces desired incentive effects. Temporary provisions create unwelcome uncertainty, making it difficult for individuals and businesses to plan with confidence. The looming expiration of the 2001 and 2003 tax relief at the end of 2010 also creates this kind of uncertainty, which could occur again in 2012.

Everyone is aware of the fiscal challenges our Nation faces. To address our fiscal situation, policymakers are debating about how to manage discretionary and mandatory spending. At the same time, policymakers are considering the amount of revenues needed by our government and the features of the tax system itself. This attention to both the spending and revenue sides of the ledger has contributed to the increased focus on tax reform.

Finally, I would like to mention the tax gap, about which I have testified before this committee. An objective of tax reform should be to reduce the tax gap by increasing respect for the tax system, by including systems that strike an appropriate balance that maximizes compliance and minimizes burden, and by reducing complexity that results in taxpayer confusion and opportunities for avoidance.

Finally, in Greek mythology, the fifth labor of Hercules was to clean the Aegean stables, which had not been cleaned in 30 years. As Congress did in 1939, 1954, and 1986, once again we are considering cleaning up our code. Thank you for the opportunity to testify before the committee today.

The CHAIRMAN. Thank you, Mr. Solomon.

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

The CHAIRMAN. Who cleaned up the stables?

Mr. SOLOMON. Hercules.

The CHAIRMAN. Oh, Hercules did. We will have to look into that more. [Laughter.]

I would just generally like to begin by asking your thoughts about how we proceed and what you think the process should be. I intend to hold weekly hearings on tax reform. Clearly, they are more effective the more we have an organized agenda process on

how to proceed. I would be interested in your thoughts about that. I might just go down and ask each of the five of you.

The second question, obviously, is which of these so-called tax expenditures are more appropriate than others? More to the point, how do we determine, how do we measure the effectiveness, the appropriateness of the major provisions?

The third, we do not have time for, at least for me. You struck a real chord there, Mr. Solomon. You essentially mentioned that so many provisions are temporary. I have often said, I did not come here to be a maintenance Senator. I did not come here to be an extenders Senator. We spend way too much of our time on those extenders, reinventing the wheel over and over again.

Clearly, we know a principal reason is because of the budgetary constraints, which you mentioned. But just to describe it is not to answer it. It has to be solved. It is just no way to run a railroad. It may even get into a fourth area, which I will not ask about, and that is making a very fundamental change to our tax system, maybe other ways of collecting revenue which are potentially more stable than the ways we now utilize.

I will start out with the first. I would just be interested in any thoughts any of you might have as to how we proceed here. The goal here is to be, clearly, effective and not waste our time. Back in health care reform, this committee held at least 10 hearings, 12 hearings on health care reform in 2008 just to educate the committee, to educate the Senate, to educate us as to what our health system is and what it is not, how it works, how it does not work. No ideological bent at all.

Then we put together an options paper at the end of 2008, November of 2008, into 2009, and then we had many, many hearings and roundtables and so forth just to study the options. As it turned out, that legislation was not bipartisan. It was my hope at the time that it would be bipartisan. I spent innumerable days, hours, months with the members of this committee, both sides of the aisle, to come up with a comprehensive solution. So with all my talking, my time is all gone. I might start with anybody who might want to raise his or her hand and give us some thoughts on how we proceed here, how we make this thing work.

Mr. Talisman? Anybody?

Mr. TALISMAN. I believe the process you have laid out is actually a very appropriate process. As I said in my testimony, I think if in fact the tax reform is established on a revenue-neutral basis, then you are going to create winners and losers, and it is important for the public and for the members to be educated about where they are creating those pressures. I think it is also important that you educate the public as to the perceived benefits of tax reform over time.

If you look back to 1986 as a model, and I am not suggesting it is a perfect model, as some people have pointed out, but it was a model of broadening the base and lowering the rates. That process really took about 3 years. The Reagan Treasury put forward Treasury I in 1984, and then it took 2 more years for that process to congeal and for tax reform to move forward. It is a very difficult process, as I think we have all said. I think you are going at it at a constant but moderate pace, and that is perfectly appropriate.

The CHAIRMAN. Mr. Weinberger?

Mr. WEINBERGER. Thank you, Mr. Chairman. I would agree that it is a good idea to have weekly, sustained focus on tax policy. Tax policy, as we outlined in our testimony, has in large part been driven by other policies, and tax has been used as an instrument to execute those policies, whether it be housing or whether it be responding to various crises. To have a sustained effort, looking at just tax policy and the role it plays in our competitiveness, as Mr. Goldberg said, I think is incredibly important. So I think that sustained effort is important.

As far as a process that will work, I think that in the end it is going to take presidential leadership. We saw that in 1986. President Reagan, at the time, made it his number-one domestic policy initiative, and it still took over 2 years and failed 3 times before it was ultimately enacted into law. So it is a major commitment and has to be a high priority of those who are carrying it forward, I think, if we are going to get there.

I also think, however, the hearings are not the best place to make all the analyses and final decisions around how to proceed. Back in 1986, back actually in the 1960s when we did major reforms, a lot of discussion was done outside of the public cameras and hearings and people could feel free to fully exchange ideas without worrying about political ramifications, which is a very real, practical reality. That type of discussion, I think, is necessary. I know it is going on. I know that this committee does it. I know there are many Senators who are working together to try to come up with a sustained path. I think that is an important part of the process as well.

The last point I would make is, I do think it is important to consider spending and taxes together because we do entwine social policy so closely throughout them. But they are different purposes. When we look at spending policy, it is the appropriate amount of money we want to spend. When we look at tax policy, it is about, what is the best tax policy? Revenue neutrality, which is one of the things that has been proposed, is a very severe restraint that caused a lot of situations in the past to result in not great tax policy.

Over the long term, we need a sustainable source of revenue, obviously, but in the very short term, over a particular year or window, like the budget rules require, to require both at the same time is very difficult. It is kind of like eating your spinach and having dessert at the same time. It is not very desirous. It does not come up with a great result. You need to do both, but not necessarily over the very same time period.

The CHAIRMAN. All right. My time is up. What you are saying is a little bit different from what Mr. Goldberg said at the outset, and I think it is a good idea to—

Mr. GOLDBERG. Senator, I think all of us think inside the boxes where we live. I think one of the difficulties with the Tax Reform Act of 1986 was, it was driven far too much by those of us who practiced the craft as it exists today. My judgment is that, if tax reform is driven by the tax experts, it is going to end up back in the same ditch all over again. I think the challenge is to have those who have a—that is our job; there is nothing wrong with that.

But I think if tax reform is to succeed, the ownership of tax reform, certainly on the enterprise context, has to occur at the CEO level, it has to occur at the board level, because otherwise we are just going to replicate what we have done, because this is what we know how to do. I believe it needs to start over. It is important to ask fundamental questions. So I would encourage you, as part of the process, to obtain input from those who view themselves as stewards of more than just the tax law—they view themselves as stewards of the enterprise.

The CHAIRMAN. Yes. Excellent point. My time is way over. Senator Hatch?

Senator HATCH. Well, I think you have the right to go over. [Laughter.]

Those are interesting questions.

Well, as ranking member of this committee, Senator Grassley referred to an op-ed in the August 14, 2008 edition of the *Wall Street Journal*. Now, that op-ed was written by then-Senator Obama's senior economic advisors, Drs. Furman and Goolsby. They indicated that an Obama administration would seek to keep the revenue base at or close to historic averages of GDP. At that point CBO reported that, over the past 40 years, taxes as a percent of GDP averaged 18.3 percent.

The President's fiscal year 2012 budget stays very close to that average in the first 5 years, but trends about $\frac{1}{2}$ point above that average in the last 5 years, though it peaks at almost 21 percent in the last year. If we look at revenues as a percentage of GDP since the 1986 tax reform was enacted, we find that, for fiscal years 1987 through 2010, Federal receipts averaged, I think, 17.97 percent of GDP. So for the last 24 years, according to an examination of CBO data, the tax reform enacted in 1986 kept Federal revenues right around the historical average of 18 percent of GDP.

Is the only path to fiscal discipline to maintain record levels of Federal taxation as a percentage of the economy, going up to 21 percent of GDP or higher? Are there negative consequences to future economic growth if we return to record levels of Federal taxation? I think that would be the question I would ask. Any of you who would care to answer that, I would appreciate it.

Mr. GOLDBERG. Mr. Chairman, I think we all know the answer, and we are all afraid to answer it. [Laughter.]

Senator HATCH. That is why I asked the question. They are all pointing to you.

Ms. OLSON. Yes. Right. Senator Hatch, you ask a very important question. Obviously the more that we take out of the economy through taxes, the greater the depressing effect on economic growth. That said, we are in a hole, a fiscal hole. The first rule of holes is to stop digging. So, if we think about stopping digging, I think, to my mind at least, it is inevitable that we are going to have to look to raise some more revenue to start bringing the budget deficit back to a tolerable level.

Now, we obviously have to work on the spending side as well. We have let spending run wild for the last several years, and we have, in the longer term, entitlements staring us in the face. That is a far more serious problem. So we have to look at the spending side, and I think the two go hand-in-hand. We have to raise the revenue

that we have decided we want to spend. We have to cut the spending to fit the taxes we are willing to raise.

Senator HATCH. Does that mean you have to raise the marginal rates in order to pay for this?

Ms. OLSON. One of the things that I suggested to do in my written statement is look at some alternative tax basis. I do not think that raising rates is a good thing to do. I think we should look at base broadening, and that means taking a harder look at individual tax expenditures than we have done in the past. It means making sure that we have the policy right, because, any time you raise tax rates too high and narrow the rates too much, we end up with a system that is not the best system for fostering economic growth.

Senator HATCH. Yes, sir, Mr. Goldberg?

Mr. GOLDBERG. Senator Hatch, I believe additional revenue is both inevitable and appropriate. I think the challenging question is how to do it in a way that is least destructive and least intrusive as possible. All taxes are bad, but you have to do it. I think that Pam's notion about looking at the alternative tax base source of revenue is entirely appropriate. Marginal rates are a bad thing. I think that every effort should be made to reduce marginal rates as much as they can be reduced.

My personal view is that that inevitably leads to the notion of some other source of revenue, and whether you call it a value-added tax or a subtraction method VAT, whatever you want to call it, you can call it. But I believe that is where the movie has to end, and I think that movie has to end in the contexts of low marginal rates. I think some form of progressivity is important.

Prior to President Roosevelt, Americans paid taxes—all Americans paid taxes—but they paid sales taxes, consumption taxes, on the whiskey. What President Roosevelt did is, he moved the income tax from a class tax to a mass tax. That was part of his strategy on Social Security; it was a response to World War II. I personally believe the right answer is back to the future of a low marginal rate income tax at the high end and let everybody else pay the tax based on what they buy and what they spend. But I do not think we can avoid that, otherwise we are going to be where we are.

Senator HATCH. My time is up, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Bingaman, you are next.

Senator BINGAMAN. Thank you, Mr. Chairman.

I know all the discussion here is about how we reform the entire tax code, and I think that is a great goal. But my observation of this place is that we often define these issues so broadly, we cannot get anything done around here. Looking just at the corporate tax, everybody complains that the corporate tax is too high in this country. At the same time, OMB says that, between 2000 and 2009, 10.7 percent of Federal revenues came from the corporate tax.

That is down from 29.8 percent that came from corporate taxes back in the 1950s. Does it make sense for this committee or this Congress to pick a piece of this problem and work on it first rather than just focusing on the whole enchilada? I mean, what about looking at the corporate tax and trying to make appropriate

changes to that and then move on to the individual tax, or vice versa, do it the other direction. Do any of you have thoughts?

Mr. SOLOMON. I agree that our corporate tax needs to be reexamined, that the rates are high compared to other countries. Other countries are dropping their rates. The only observation I will make that makes it difficult to focus just on the corporate tax is the percentage of American business that is not done in corporate form. More and more in the United States, in large measure because of the double tax caused by our corporate tax system, many American businesses are done through pass-throughs, partnerships, LLCs, or S corporations, or done as sole proprietorships.

So, if you just examine corporate taxation by itself, you are leaving out a large portion of American business. So, when you are examining business taxation, I would think that it would be difficult just to focus on corporate taxation without looking at other ones that just—

Senator BINGAMAN. Yes. Maybe the focus should be on business taxation rather than on corporate taxation. But does it make sense to pursue a piece of this thing or does it make more sense to be pursuing the whole shooting match?

Ms. OLSON. Senator Bingaman, I would suggest that it does make sense for you to look at it on a piecemeal basis to the extent that you cannot do the whole thing. I think you need to do the whole thing, but I think the process of doing the whole thing may take a long period of time. I am concerned that on the corporate side in particular, our system is so out of line with other countries' systems, and change is happening so rapidly. If you look at the make-up of the Fortune 500 in 1999 and the Fortune 500 today, it is a significant difference in just a 12-year period of time.

So things are moving very rapidly on a global basis, and those changes mean that we should not take a long time to correct some of the problems with our corporate system. That includes, as Mr. Solomon indicated, the high rate of tax that we impose on corporate income, as well as our worldwide system and the discrepancy that that poses for U.S.-based companies doing business on a global basis.

Senator BINGAMAN. I think also one of the points you make is that we have a very great bias in our tax code right now in favor of debt rather than equity as a way to raise capital. Could that be addressed as part of a rewrite of business taxes? What are you recommending we do to fix that problem?

Ms. OLSON. If you eliminate the difference between debt and equity at the corporate level by eliminating the double tax on corporate income, you will go a long ways towards eliminating the current bias for indebtedness. At that point people will be making decisions on the basis of whether or not indebtedness is the best way for them to raise the capital to run their business or whether they ought to go the equity route. So I would go in the direction of looking to eliminate the disparity between debt and equity in the corporate sector.

Senator BINGAMAN. Do any of the rest of you have thoughts about whether that is an important change to make? Does that affect our ability to compete, our ability to raise capital, our ability to avoid excessive debt?

Mr. WEINBERGER. I would say I would agree, Senator, with Ms. Olson, that other countries have a more integrated tax system between the individual corporate side and the dividend to lower capital gains rates, and dividends rates that were enacted and extended do have a positive effect on that. Looking forward, trying to reduce the double taxation will have a very positive effect on capital formation, I believe, and will add to neutrality.

Senator BINGAMAN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Grassley?

Senator GRASSLEY. I want to continue in a little different vein, but with a subject that Senator Bingaman brought up. A common theme of tax reform discussion is, broaden the base and reduce the rates. In that context, I am interested in learning about whether existing tax provisions provide incentives in the corporate tax, provide incentives rather than rewards, and whether some should be eliminated or modified if—and the emphasis on “if”—rates are in fact reduced.

Two provisions that come to mind—and I only take these because R&D is the biggest one, and then there is one that is related to agriculture to some extent, indirectly—would be the R&D credit and the biodiesel credit. Since it is generally acknowledged that job growth is driven by small business, it makes sense to provide incentives to them to conduct R&D and grow their businesses. We know that the biodiesel tax credit created an incentive because, when it expired for all of last year, thousands of people were put out of jobs.

According to the Government Accountability Office report, the R&D credit is used mostly by large corporations. I would like your thoughts on whether the credit serves as a reward for these corporations. In other words, and this is the question: do you think that these corporations would cease or substantially reduce R&D activities if the credits were reduced or eliminated for them in conjunction with a lower marginal tax rate?

Mr. WEINBERGER. I will start, I guess, just with the R&D credit that you raise. There are important questions that you need to look at when you look at the entire code. I would acknowledge that, with the lower marginal rates that exist in all OECD countries and other countries around the world, they also have incentives for research and development as one example, because the return to society is greater than the benefit of the investment by the individual companies that invest.

So that has been the traditional reason for that type of incentive. When you talk about the energy incentives, what happens is, there are still very good reasons to jump-start different types of investments, but then once investments are started, when is the right time to stop incentivizing, and that beneficial return to society is diminished? That is why I think every single tax expenditure needs to be considered.

Mr. SOLOMON. I would just add, expiring provisions cause uncertainty. For example, the research credit is an example of the situation where it expired and it affects motivation. If it is supposed to have an incentive effect, retroactively continuing it certainly diminishes the incentive effect.

Senator GRASSLEY. I think you have told me—at least the two of you have told me—that even if you reduce the marginal tax rates, some of these credits would have to be kept, and specifically the R&D would have to be kept, right?

Mr. WEINBERGER. I think it is too early to say what definitely should or should not be in. I just think what we try to do in our testimony, Senator, is to really look around the world and make sure that, in this increasingly global economy, that we look at what other countries are doing. We cannot any longer just look where we are here. I think that should influence the discussion here, but it should not drive an ultimate conclusion of it.

Senator GRASSLEY. Let me go on to something a little bit different. Separately, the charitable sector is an area that is often neglected in the discussion of tax reform. I am talking about organizations, not the charitable deduction itself. It has been over 40 years since Congress has tackled major reform of the tax provisions governing charities. Since then, the sector has seen tremendous growth, particularly in fee-for-service charities. These include hospitals and universities, but now also we have software companies and consulting firms. I understand that the tax exemption granted to these entities is not currently considered a tax expenditure, so we do not know the revenue loss resulting from Federal tax exemption for these entities. So I would like your thoughts on whether we should try to get a handle on that figure and whether it makes sense to consider the impact of tax exemption on the revenue base when considering tax reform. Let me be clear, once again, I am not referring to those charities that are on the ground, feeding the hungry, sheltering the homeless. I am talking about those charities where there may be no discernible difference between commercial, for-profit entities. I mentioned a fee-for-service software company, fee-for-service consulting companies. I would appreciate hearing any of you who could answer that question.

Mr. TALISMAN. Senator Grassley, as I said in my testimony, I actually think the definition of tax expenditure in driving the tax policy and reform is a little bit of a problem. I think you should examine all these issues, but not necessarily because they are called a tax expenditure. So what we should be doing as we go through the hearings on tax reform and debating tax reform is looking to make sure our system is operating as intended.

If we think that we are getting benefits from providing tax-exempt status to these charities because they are providing social benefits, then that is something that should be all right, and whether it is labeled a tax expenditure or not ultimately should not matter. Now, I would expect, if you asked for a revenue estimate, you could get one on taking away the tax-exempt status, even if it was not labeled a tax expenditure.

One last point on tax expenditures. The numbers that are associated with tax expenditures in the budget and in the Joint Committee's estimates are not necessarily reflective of how much money you would actually raise if you were to eliminate that tax expenditure, because of interactive effects, and also transition rules, et cetera.

Senator GRASSLEY. I think you missed the point, though. I was asking the difference between those that are nonprofit that tend to

be commercial enterprises as opposed to charities that are recognized as charities. We do have fee-for-service software companies, we have fee-for-service consulting companies. Then I will stop, Mr. Chairman.

Mr. GOLDBERG. Senator, we do have a structure in the current law, the unrelated business income tax provisions, that are intended to get at that kind of question. I do have the pleasure of serving on a number of charitable boards, and every one of them loses their shirt every year. But for charitable contributions, they would all be completely out of business.

So, if that is an area of interest, I think that a more focused attention on the Unrelated Business Income Tax provisions might be a way to think about it. I mean, if I am a software company making a zillion dollars competing with for-profits, that would raise serious questions. If I am a software company that is doing software work with some fee-for-service to facilitate the public good, and I am doing it basically at a loss, I think that is a very different circumstance.

The CHAIRMAN. Thank you, Senator.

Senator Wyden, you are next.

Senator WYDEN. Thank you, Mr. Chairman.

This is a panel with great expertise and lots of history on this issue. You have given us a lot of suggestions. But the two words that I think are most important to the American people have not been mentioned this morning, and those two words are job creation. I am seeing everything right now through the prism of job creation.

When you look at the 1986 Act, in the 2 years after the Act was passed, according to the Bureau of Labor Statistics, we created 6.3 million new non-farm jobs. That was twice as many—twice as many—as we created through the whole period of 2001 to 2008. So we very much need your expertise on these issues, but I hope that in our future discussions we can really zero in on this question of job creation, because that is what is most important, in my view, in the minds of the public.

Now, I will start with you, Mr. Goldberg. You seem to come out strongly for a value-added tax. It is in your prepared testimony, and you have mentioned it to the chairman. Now, last spring, 85 U.S. Senators, in an overwhelming vote here, came out against the value-added tax. They saw it as a tax increase, they saw it as regressive. I think you are familiar with the kinds of complaints.

If you would, tell me, given that kind of showing of opposition, how the approach that you are talking about would somehow pick up the kind of bipartisan support we are going to want to have for tax reform.

Mr. GOLDBERG. Unlike my colleagues on the panel, Mr. Wyden, I spend no time up here in my day job, so I am free to just say what I think. But I believe the other way to talk about a value-added tax or a consumption tax, however you want to frame it, is everybody thinks of it as a new tax. I prefer to think about it as, what can you buy for the revenue? I believe what you can buy for the revenue from that kind of levy is overwhelmingly appealing to the business community and overwhelmingly appealing to individuals. So it is how you talk about it.

I believe that it is that levy, for example, as Professor Graetz has pointed out, that could take 100 million Americans off the tax rolls. I believe that kind of levy, in my judgment, is the only realistic way to reduce corporate rates and reform the corporate system to meet the kinds of objectives my colleagues are talking about.

So as long as the rhetoric is about the consumption taxes, it is just another levy and we are going to soak everybody, it is not going to work. I believe if you raise X dollars from the value-added tax and you spend that X dollars to appeal to all of the different constituencies, that is the only way to sell it. I think that happens to be the truth.

Senator WYDEN. Any proposals are certainly worth looking at. But put me down—given the fact that the people in my State, the people in a number of States, have come out against this again and again, we are going to need bipartisan support here in the Senate. When you have 85 Senators coming out against something, that is a pretty strong message.

My question for you, Mr. Solomon and Mr. Weinberger: you all make an important point that you are concerned that repealing tax breaks has, in the past, gone for spending programs. That is the concern I have as well. If people see that you are going out and repealing taxes to pay for spending, that will once again be seen as an opportunity to increase spending. My sense is that, if you are going to end substantial tax breaks, you ought to use the funds from that to enact comprehensive tax reform—again, the kind of tax reform that would help us create jobs.

For the two of you, because you seem to have shared the same concern I have about repealing tax breaks to promote spending, let us just get on the record, and I think you all suggest this, that you agree that revenue from ending substantial tax expenditures ought to be used for tax reform rather than for spending. Is that correct?

Mr. SOLOMON. Well, one of the essential questions at the very beginning, and you touched on it in your conversation with Fred, is both the spending side and the tax side. I just want to make a comment about what Fred said. I think it relates also to what you are asking now. In my personal view, you have to consider both sides, and so you should consider raising new taxes only in conjunction with controlling spending. I think that also goes to the point that you are raising here. Certainly if you are going to eliminate tax expenditures, the question is what it should be used for. I think it should be used to, overall, try to balance the budget.

Senator WYDEN. Anything?

Mr. WEINBERGER. Yes. I would just add similarly to the point I made before, Senator, which is that I do think tax reform is about our decision of how to have the most efficient tax system and what this committee is thinking about. As Senator Hatch pointed out, our taxation has remained relatively constant over time, about 18.3 percent of GDP, at the Federal level. What is happening is that spending has continued to rise due to commitments, so I do think it is important to look at the tax code and try and make it more fair and efficient, not just to pull out provisions to add more spending.

Senator WYDEN. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Enzi?

Senator ENZI. Mr. Chairman, I want to thank you for putting together this panel. It has been very educational. I appreciate all the effort that they put into their testimony, and I have looked at your full testimony as well. I have learned a lot, but I have a lot of questions, many of which kind of fall into the technical area. I am the accountant on this panel, and I will be submitting some questions in writing so that I will not bore everybody, but I do have a couple of questions.

[The questions appear in the appendix.]

Senator ENZI. Mr. Solomon, in your comments you were talking about some education incentives that create problems. Could you give me a little bit more information on that?

Mr. SOLOMON. Not necessarily that they create problems. The education incentives in the code are very valuable, and clearly Congress has considered them for good purposes. They do good purposes. My point was, there are 12 different incentives in the code for education. The question is whether they should be consolidated and be considered so they all act together, so the taxpayers, when they try to figure out what incentives apply to them, can understand what the rules are.

Senator ENZI. Thank you.

Mr. Talisman, you mentioned the warning on tax expenditures, and you pointed out the research credit. You had a little discussion on that. Do you think that it would be possible, if we phased in the elimination of the tax expenditures, that it would be more acceptable, be possible? I know it would have less impact.

Mr. TALISMAN. Well, again, I hesitate to answer your question completely, Senator Enzi. I think you have to look at what each tax expenditure is doing. As I said, I think the label is sometimes a misnomer. For example, Pam and I might disagree about whether lower capital gains rates is a tax expenditure, but it is in the tax expenditure budget. Stepped-up basis at death is a tax expenditure.

I think you have to look at the purpose for the tax expenditure, see whether it is serving that purpose, and then decide what to do about it. I am all in favor of broadening the base, but I think we have to do it methodically. I think we have to look at what these are doing, why they were put in the code in the first place, are they serving their purpose, what is the political—let us be realistic. We want to get broad-based tax reform done. How do we get it done in the most efficient way to make sure that we can do it both politically and practically to put forward the best system?

Senator ENZI. I noticed in the President's budget that he was going to phase out a number of the tax expenditures for the oil and gas industry. In the Deficit Commission, they suggested that those tax expenditures should go toward lowering all of the corporate tax rates.

I have had some of the companies mention that, if that were phased in, it might be possible to do it. It would cause a lot of upfront cash at the beginning and put a lot of them out of business, particularly small ones. So I appreciate the comments that virtually all of you made about needing to look at business taxes versus just corporate taxes as we make the changes.

Mr. Goldberg, you made a comment about thinking big. You had a whole paragraph in your testimony on it, but I know that you have more ideas than just that. Could you expand on that a little bit more for me, please?

Mr. GOLDBERG. Yes, sir. I do believe that we are talking, inside the concept of tax expenditures, let us phase out tax expenditures. Senator Wyden made the comment about the outgrowth, the employment growth. There were an awful lot of real estate companies that went completely bankrupt in 1986 because of the absence of the transition rules that you are alluding to. I believe the time has come to rethink the way we raise revenue.

I appreciate the Senator's point about the difficulty. Eighty-five votes is daunting, to say the least. But I certainly agree with you, it needs to be bipartisan. But I just do not think we have come to terms with what our tax system today is doing to our country and to our citizens. A couple of folks have talked about the exclusion for employer-provided health care. The conventional wisdom—and I believe the truth is that that exclusion is a major driver of out-of-control health care costs. No one on the panel has touched the notion of housing, and yet, if you listen to folks who actually understand the economics of all of this, there are those who believe that the subsidies for leveraged home-ownership have driven this country in the direction of over-investment in housing. If you change that cold-turkey, we are all toast.

But I think those are very important questions to think about. I believe, at the end of the day, it is really very simple. We will either choose to go to another revenue source, as painful, controversial as that other revenue source is, or I believe we will recreate in some form what we have today. I think that is a big mistake.

Senator ENZI. Ms. Olson, I want to thank you for your comments about the complexity, the AMT, the health care inclusion, the double taxation of corporations, and some other spending things that you mentioned. I will have some more questions on that.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Enzi, very much.

Senator Carper? Oh, he is not here. Senator Cardin, you are next.

Senator CARDIN. Thank you. Thank you very much, Mr. Chairman.

Mr. Goldberg, in your exchange with Senator Wyden, I think you missed a very good response for Senator Wyden. That is, if we had more consumption taxes and less corporate income taxes, they would be border-adjusted, therefore putting American companies in a stronger position in competition, creating more jobs here in America. I am not trying to make your arguments for you, but it seems to me jobs is what Senator Wyden was talking about, and I agree. I do think that it would make us more competitive and would create more jobs.

But let me tell you my concern and one that I am going to use to judge all the proposals that come in, and that is the progressivity. I do not want to see our code less progressive than it is today. I would like to see it more progressive. It is a challenge when you use consumption taxes to make it progressive, but it can

be done. There are things you can do for low income, and you can combine it with issues concerning higher income.

So, for those who favor trying to really change the structure of our tax code, I hope you will work on provisions that will satisfy concerns that I think many of us will have, that at the end of the day our tax code is as progressive or more progressive than the current way we raise revenue.

With that in mind, let me ask one specific question, and then I am more than happy to have a response on that. That is, under our existing tax code the Alternative Minimum Tax appears to create an unsolvable problem. But, if we wanted to eliminate the Alternative Minimum Tax, do it in a way that would be revenue-neutral and maintain the progressiveness of our tax code, is there a way to do it? Whoever wants to jump in. Ms. Olson?

Ms. OLSON. Yes. One of the things I spent quite a bit of time looking at while I was at the Treasury Department was how to get rid of the AMT, do it without busting the budget, and maintain progressivity. And it can be done, because the features of the AMT that particularly drive it are things like State and local tax deductions.

You can do things like put in a floor on State and local deductions and a ceiling that would maintain the low rate of tax at the bottom, but increase it at the top. So there are things that can be done. They would be politically unpopular, but there are things that can be done so that you can get rid of the AMT and maintain a progressive system, or make it even more progressive if you wanted.

Senator CARDIN. Why don't we go down the row? Certainly.

Mr. WEINBERGER. Thank you. I would want to help out my friend, Mr. Goldberg, on the end down there in response to his question.

Senator CARDIN. He needs some help.

Mr. GOLDBERG. Senator, that is why you are where you are and I am where I am. [Laughter.]

Mr. WEINBERGER. Any economist, I think, will tell you that the most efficient tax system is a consumption system because it does not distort capital and labor taxes, does not increase tax on capital labor. Almost every European country, and virtually every industrialized country in the world, collects a significant amount of tax through that system. So there is something we are missing, or they were able to somehow get it through their systems and we cannot.

The reason is—and this goes to Senator Wyden's point, and yours—I think that it is viewed as much more progressive. The distribution of our tax system and how corporate taxes are borne is really an important question. In other words, if you raise the corporate tax, it is not immediately understandable, that does flow through to an individual. Corporations do not eat sandwiches, they do not go on vacations. It will be borne in either higher prices, reduced ability to pay money for labor, or lower returns on capital.

In 1986 when the tax reform passed, it was celebrated as a tax cut across the board. There actually was a significant tax increase on business in 1986, but they did not distribute the corporate income tax to individuals at that time. There is an increasing body of knowledge working to do that. I think when you get into recogni-

tion that that level of tax is also borne by individuals, it becomes an easier discussion and more politically acceptable, but it is really hard to explain that to the American people when you are talking about a value-added tax they would pay on something they would buy in a store versus the higher prices they would pay because corporate income taxes are there.

Senator CARDIN. I am sorry you did not make that argument to the Supreme Court on *Citizens United* about corporations.

Mr. WEINBERGER. I am not going there.

Mr. GOLDBERG. Senator, I think the answer to both of your questions, as Pam said, is yes. We all sit here and talk about how hard all of this is to do. My personal judgment is, it really is not that hard to come up with the right ways to do it. You can argue about this, you can argue about that. I share your view that the system needs to be at least as progressive as it is, and my personal view is, more progressive at the end of the day. Having been appointed by President Reagan and President Bush, I can still say that. I believe that is right.

But I think the difficulty of Senator Wyden's point, and what every other panelist has said, is education of the American people. You can come up with lots of system that will get you where you want to go, and my guess is, this committee would agree. But how are you going to sell it to the American people? I think that is the big challenge.

Senator CARDIN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator SNOWE?

Senator SNOWE. Thank you, Mr. Chairman.

Returning to the question that was raised initially by Senator Bingaman about the corporate-only approach, Secretary Geithner testified before this committee on February 16 and indicated that corporate tax reform can be undertaken without addressing individual tax rates. Obviously that does represent, I think, tremendous consequences, in particular to small businesses as they were forced to form C corporations, which means a tax on essentially 27 million small businesses in America. He also indicated it would generate up to \$3 trillion in additional revenue as a result of that prerequisite on businesses that form as S corporations as opposed to C corporations.

That has tremendous implications at a time when we are trying to generate jobs, and obviously on small businesses. I mean, obviously, ignoring the individual tax rate, they will accelerate the high rate of 35 percent for individual rates post-2012, when the lower tax rates will expire.

So, Mr. Goldberg, what is your view on this question, particularly as it impacts 27 million, potentially, small businesses if they were forced to switch to C corporations and would have to pay a tax, and double taxes as it occurs under the C corporation?

Mr. GOLDBERG. Senator Snowe, I hear at least three of my colleagues—I am not sure about the fourth—say the tax system for years has worshipped at the altar of a double tax on corporate income. In my view, that is a false idol. That is a terrible mistake from a tax policy standpoint, and we should do everything conceivable to get rid of that double tax. I think getting rid of the double

tax allows you to deal with these arbitrary distinctions on debt/equity that are doing terrible damage to the system, and so that is how I would think we ought to approach it.

Now, I should say that, if you have a single-level tax on corporations and you have a corporate tax rate of, say, 20 percent and an individual rate of 35 percent, every one of us is going to be in a corporation. So you need to be careful about the spread in rates. I would just throw that out as a caution. Having said that, I would get rid of the double tax and drop the rates.

Mr. SOLOMON. Yes. Putting more entities into double taxation is probably going in the wrong direction. Having a double tax, as a number of us have pointed out, creates distortions. A perfect system would move towards integration, having a single level of tax.

Senator SNOWE. Mr. Talisman?

Mr. TALISMAN. And I agree with the statement by Mr. Goldberg. I think what you have to do here is be careful, though, because corporations should be paying one level of tax at least, and we need to make sure that that one level of tax is being collected. So it is a combination of both the corporate level tax and the capital gains dividend taxes—you want to make sure you are getting that one level of tax at least.

Also, I think what you have highlighted is that, ultimately, we are going to have to go through our priorities, because I have heard about four priorities already on the corporate side, and probably infinitely more on the individual side. We are not going to be able to fix all the world's problems, at least on a revenue-neutral basis, which may give rise to some of the discussions we have had about alternative taxes.

Senator SNOWE. Well, it is disconcerting at a time in which we are struggling to create jobs. We only created 36,000 last month. I mean, it is paltry. And 1.3 million during the course of the last 2 years. Yet, we have lost 7.3 million. Now to suggest to impose a tremendous tax on the one segment of our economy that is creating the jobs, it seems to me moving in the wrong direction and is in converse with the realities that exist on Main Street across America.

So I do not know that this is the time. It is going to cause further retrenchment among this sector of our economy if they think that the administration is contemplating choosing that requirement, particularly because it is part of the budget. It is predicated on that to generate the multi-trillions of dollars that the Secretary recommended. It clearly suggests to me the wrong direction.

In terms of presidential leadership, how essential is it for tax reform overall? I was one of the few who was around for the 1986 tax reform—so-called tax reform—and I well recall what you are describing about the prelude, the 3 years of preliminary effort before culminating in the 1986 tax reform effort. So realistically, what is your prognosis for the ability of Congress to undertake tax reform without concerted, aggressive presidential leadership?

Mr. TALISMAN. I think it is essential for presidential leadership ultimately on tax reform, because I think, as we have said on this panel, setting the goals for what tax reform is, having the bully pulpit to educate the public as to what those benefits and goals are, it is difficult, even among 100 Senators, to get consensus on that,

so I think you have to have someone speaking with one voice as to what the goals and purposes you are trying to accomplish are. I do think bipartisanship is also essential because I think, for it to be meaningful and for it to last, I think it needs to be done on a bipartisan basis, at least ideally.

Mr. WEINBERGER. I would agree, Senator. As I said before, I think presidential leadership is essential. I think committee focus and attention, sustained like Chairman Baucus has laid out, is essential. As you recall from 1986, Chairman Rostenkowski at the time, and President Reagan, worked hand in hand, and actually the President came to the House floor to save the bill several times. So the bipartisanship was a key element, and the trust that existed in the common goal of a simpler, better tax system was what I think really helped it to be sustainable.

Senator SNOWE. Thank you.

Mr. Goldberg, please.

Mr. GOLDBERG. Senator, I think having been in the administration from 1984 to 1986, I agree wholeheartedly. But the President was able to say it in a sentence. It was not complicated, it was not hard, and it was part of a broader message. So, yes, leadership is important, but it has to be understandable in a sentence: cut the rates, broaden the base, get the government off your backs. It is a different rhetoric now, but it was unbelievable.

Senator SNOWE. Thank you.

The CHAIRMAN. I think it is clear—obviously clear, as some have suggested—we are going to have to prioritize a little as we go down the road. It is a long road. As I mentioned, in some cases, at least if 1986 is the precedent, it was a couple, 3 years. A long road.

But let us take a crack here. If you could begin to prioritize, what are the one or two most disruptive provisions or parts of our tax system? You get up in the morning, you are shaving and thinking, you are driving to work, all that kind of thing. What is one that really leaps out? What is another one that kind of leaps out, like, holy mackerel, this is a problem! Something has to be done about this! What are a couple of them?

Mr. TALISMAN. Well I think, on the individual side, clearly the AMT is a problem. I think one of the problems you will have, as I said in my testimony, is that, because we have been patching the AMT, taxpayers do not know that they are going to be on the AMT. So you have been hiding the fact from the political constituency that is going to be benefitted that they will be benefitted.

Also, I think the temporary nature of multiple provisions is also highly problematic. Some of that is caused by our budget rules, et cetera, so we have to look at those to get meaningful, lasting, and stable tax reform. I think we have to look at the way our tax rules are written in conjunction with our budget rules.

I guess, thirdly, bringing down the corporate rate ultimately will solve a lot of the other ills that we have talked about. So, while there are other problems in the corporate system, certainly the one that I think stands out is, if you can bring down the corporate rate, it will diminish some of the other problems that the corporate code faces.

The CHAIRMAN. All right. Who else? Who else wants to take a stab? Pam?

Ms. OLSON. Two things. One, I do think that the corporate system is something that you need to look at quickly, and perhaps more quickly than being able to get to consensus on the others because of the change in the global economy and the rapidity of the change, which puts America as a competitive place to do business at risk.

The CHAIRMAN. What is the least competitive part of the American corporate code?

Ms. OLSON. The high corporate rate relative to the rate in other countries.

The CHAIRMAN. You always point out, well, gee, that may be the high statutory rate, but the effective rate is competitive.

Ms. OLSON. You say that like it is a good thing. It is not. That is actually one side of the problem with the system. The other problem is the worldwide nature of it relative to the system in other countries. The next thing I would put on the list on the individual side is the exclusion for health care, and the reason I put it on the list is because rising health care costs are what are driving a whole lot of the problems on the entitlement side. We have to do something to bend the cost curve down, and I think tackling the individual exclusion for health care might well go a long ways towards bending the cost curve down.

The CHAIRMAN. Who else?

Mr. WEINBERGER. I would just add, I agree with the corporate issue in particular, because it is not just about large corporations. Increasingly, they are intertwined with suppliers who are middle-market and smaller companies here. If we cannot win the 95 percent of the market that is overseas, then we cannot bring jobs back—to Senator Wyden's question—to the United States. If we cannot have a competitive business system here, then we cannot have jobs in the United States.

So I think that is a critical issue, both the base of taxation there, as well as the marginal rates. If you are an individual, of course, you are looking at complexity, but recall that 45 percent of individuals do not pay any income tax. They have other stresses with regard to trying to just comply with the rules, whether they are negative credits, or negative income credits like child credits and the like, or just complying with the AMT.

Mr. SOLOMON. I would say the individual AMT is the one that is most outstanding, and all the provisions that add to complexity and instability in our code.

The CHAIRMAN. Anybody else? Mr. Goldberg?

Mr. GOLDBERG. I would move from a hybrid system to a territorial system on the enterprise side. I would get rid of the double tax on enterprise income. I would reduce rates. I agree with Pam about the exclusion for health care, and I would add the subsidies we provide for leveraged home-ownership.

The CHAIRMAN. All right.

Senator Menendez, you are next.

Senator MENENDEZ. Thank you, Mr. Chairman. And thank you for the ambitious schedule you have here. I think it is a really important topic in trying to meet our shared goal of fundamental tax reform.

I have a couple of questions. Mr. Talisman, let me ask you, the current system includes at least 18 different provisions intended to help with cost and incentivize savings for higher education. Now, I think we could make significant progress in simplifying the code by uniting and consolidating the tax incentives into one universal credit and making the credit more fully refundable.

It seems to me that taking those basic steps would eliminate the complexities for middle-class families who have to fill out multiple formulas to figure out which incentive is best for them and which ones they may or may not be eligible for, and allow these families to have certainty into how much tuition tax relief they will get to put their kids through school.

Can you help the committee understand how we created a system that has 18 overlapping provisions meant to incentivize two behaviors, and do you believe it would be beneficial to consolidate and reform tuition tax incentives so that American families can have simple and predictable tuition tax relief that they can use in making their education spending decisions?

Mr. TALISMAN. Senator Menendez, I agree with you. I think this is an area where simplification is fairly easy to accomplish. I think we have incentives to borrow, incentives to save, and incentives to spend. I think you can pretty much, if you look at those three, combine them and come up with one incentive, or two incentives at least. I think you can also reconcile the way that educational expenses are calculated to make them easier to understand in a way that provides greater certainty for taxpayers and allows them to benefit from these incentives in the way that was intended.

Senator MENENDEZ. Well, I will look forward to working with the chair on some of those, because I think this is a great opportunity to really both help families and help us simplify the code, and do it in a way that probably would be a lot more productive.

Ms. Olson, I heard your response to the chairman. I agree with you that lowering corporate rates and having long-term predictability about those rates would help us in our competitive position in the world, but do you believe that you can do that and also maintain the corporate tax expenditures?

Ms. OLSON. Well, I think we need to take a hard look at all of the things that are classified as expenditures, not that, as Mr. Talisman has indicated earlier, all of the labels necessarily fit. There are some things that have been labeled as tax expenditures that are actually key parts of our income tax system and really do not belong in that category at all.

So we do need to look at it. I think it is absolutely critical, on the corporate side in particular, that we set policy on the basis of what the policy should be and not on the basis of trying to create something that is revenue-neutral. We have to get the policy right, and then we need to figure out where we need to go to collect additional revenue if additional revenue is necessary, and I think additional revenue will be necessary in any event in order to pay for the spending that we have agreed to do.

Senator MENENDEZ. So, if we framework the policy and, at the end of the day, we have come to the best conclusion as we ever can come to—unanimity is always a difficult goal—a pretty well-established consensus, and it creates a shortfall in revenue, then

your suggestion is that there be other tax provisions to increase revenue?

Ms. OLSON. That is right. Like Mr. Goldberg's testimony, I actually say we should consider an alternative tax base as well. I think eventually we are going to get there, and there are good reasons for doing so sooner rather than later.

Senator MENENDEZ. Then finally, Mr. Weinberger, let me ask you, in the 2001 Economic Growth and Tax Reconciliation Act it contained trillions of dollars worth of tax cuts, but it only exacerbated the problem of the Alternative Minimum Tax. So the bill lowered tax rates across the board, increased the child tax credit, created a multi-year estate tax cut, but did nothing about the AMT. Why would, at that time, Congress and the Bush administration move forward with such an ambitious tax plan, in your opinion, but have no level of AMT reform included?

Mr. WEINBERGER. Well, at the time, that was a serious, debated topic, as you would recall; this committee was actively involved. A lot of the decisions in the Bush tax plan were a result, frankly, of ultimately budget decisions, what could and could not get done. We made some decisions at the end of the day that were not what was in the original plan. For example, a 10-year cliff of all the tax cuts was not a tax policy decision. It was driven in large part by budget limitations, and some proposals that were ultimately enacted in the bill were phased in over time, which again was not a tax policy decision.

The AMT is something that should have been then, and should now be dealt with. It just did not rise at that point in time to the top of the list of all the other issues. We were in a relatively weak economy and a downturn, and there were other initiatives that were in the bill, but it does need to be addressed.

Senator MENENDEZ. Well, Mr. Chairman, I look forward to working on that. It is a pernicious complexity that actually claws back a lot of the benefits that middle-class families receive under the code.

So, for 1.5 million New Jerseyans, it is a big issue. Anyhow, thank you. Thank you all for your answers.

The CHAIRMAN. Thank you, Senator.

Senator Hatch, you are next.

Senator HATCH. Thank you, Mr. Chairman.

We appreciate this panel very much and appreciate the time you are spending with us here today. You are all experts, and we have had some excellent remarks here today.

The Federal spending averaged around 20 percent over the last 45 years or so, but it is up to, as of right now, 25.3 percent, according to what I have been reading, of GDP. Revenues, of course, have stood pat at pretty much 18.7 percent of GDP. Under current policy, to treat the two as similar drivers of the deficit is to ignore the ramp-up that has occurred on the spending side.

Now, even the Debt Commission report restrained spending to a historic average. Now, I agree with former House Democratic Leader Gephardt's statement to this committee that "if we combine revenue raising with reform, we make reform much more difficult." Now, I do not know if you agree with that or not, but I just wanted to make that comment.

Now, this is a follow-up question for all of you on the panel. As we all know, there is a structural problem with the individual Alternative Minimum Tax. It is driving us all nuts, and frankly we ought to get rid of it. Some of the key features of the regular income tax, like the standard deduction and personal exemption, are indexed for inflation. The AMT's basic features are not indexed for inflation.

Throughout the tax code, we do find features of the regular income tax that are sources of complexity because they are, like the AMT, not indexed for inflation. For lots of taxpayers, there is abundant confusion from the phase-outs. The confusion is compounded by the fact that, over time, inflationary gains remove taxpayers from eligibility for these benefits.

In the 25 years of tax reform, do you not think there is a lesson in steering away from phase-outs? Or, if they are necessary, should we not index phase-outs for inflation as well? Anybody could answer.

Mr. SOLOMON. I will just say, in the first place, perhaps we should not have phase-outs. We should have stable rules, and we should minimize complexity. Those would be two goals that I think all of us would find desirable.

Mr. WEINBERGER. And I would just add, I agree. I think this was stated earlier, Senator Hatch, that the AMT underscores the ambivalence of some of the policy decisions you made to provide those incentives in the first place by saying, once you take too many of them, we are going to take them all back. That, I think, is a very difficult dual objective to try to reach in the tax code. So I would agree that that ought to be looked at, but I also agree that phase-outs generally are complicated, and they create different effects on marginal tax rates that are not anticipated and should also not be used.

Senator HATCH. Would it be better for us to just knock out the AMT and take the hit as far as the budget is concerned and just get rid of it? Would that not be a smarter thing to do than just keep playing this game every year and having it go up every year until it is finally almost consuming everything?

Ms. OLSON. Well, I guess I would say that, if the AMT survives tax reform, you are going to need to go back and start over again. So, yes, I think you need to get rid of the AMT and not put yourself in a position of—

Senator HATCH. Would you be willing to do that even though we do not have an offset?

Mr. TALISMAN. Well, Senator Hatch, the AMT is a very expensive item, so I agree that it needs to be reformed and replaced. All I am saying is that, in the context of the budget deficits that we are running, we have to look at, as I think everybody on this panel knows and as you said, spending levels and tax revenues and try to get them in balance. If you want to get rid of the AMT, if the collective judgment of the Congress is to get rid of the AMT and spend that money on that, that is a fine determination. But I think we have to set our priorities.

I think one way to get rid of the AMT is to make it the regular tax. I mean, it is now less expensive to get rid of the regular tax than it is to get rid of the AMT. So this notion of broadening the

base and lowering the rates, one way to do that is actually to put the AMT as the regular tax. I am not suggesting you go there, I am just suggesting that it really is a very expensive item to get rid of without paying for it.

Senator HATCH. Yes. But would we not be better off if we did that?

Mr. TALISMAN. I think we are all in agreement on this panel that getting rid of the AMT—as I said, Senator, in response to Chairman Baucus's question, it is the most serious problem on the individual side. Yes.

Senator HATCH. All right. Well, thank you, Mr. Chairman. I think that is enough.

The CHAIRMAN. All right.

Well, thank you all very much. I appreciate it. Oh. Sorry.

Senator Wyden, you are next. Senator Thune, you never had a chance to ask questions.

Senator THUNE. No. Are we on a second round right now?

The CHAIRMAN. We are on the second, so why don't you go ahead with your first?

Senator THUNE. I know being at the children's table down here, you kind of get passed. [Laughter.]

But thank you, Mr. Chairman. Thank you all for your great insights. This is a subject that I think we all want to take on. I was actually a young staffer out here, 24 years old or thereabouts, in 1986 when the last big tax reform bill was done. It strikes me that every time Congress has touched it since, it has made it more complicated and made us less competitive. So I hope that we can take this very complicated subject on again. I do not think we have any choice, really, if we are going to be competitive.

Just a question, and whoever would care to answer this. But some have criticized moving to a territorial-based system of taxation because they claim it subsidizes outsourcing. I guess I would be interested, and maybe you could discuss why other countries have adopted a territorial-based system of taxation and what the effects on their economies and workers have been. Maybe Mr. Weinberger will take a shot at that.

Mr. WEINBERGER. Sure. Listen, territorial means a lot of different things to technical experts who sit around and draft these types of legislation. But generally across the world every country has moved to exempting overseas income from a double tax in a foreign jurisdiction, so either we are absolutely smarter than everyone else or we have it completely wrong.

Now, there is not 100-percent territoriality. There is often 95-percent exemptions. So I think when Congress is looking at whether or not and how to deal with territoriality, they ought to learn from the lessons overseas. But what we have seen is that there has not been a lot of the claimed jobs moving overseas as a result of other countries adopting territoriality systems.

In fact, we have seen the drumbeat continue just this past year. There were three major countries in the world economy, the United States, Japan, and the U.K., that had global, worldwide systems left. Last year, both the U.K. and Japan announced moving towards a territorial system. So the United States is the only country in the world that has a global, worldwide taxing of our corporate

income and a rate higher than 25 percent. So, when we talk about competitiveness and you tie it back to jobs, it is very difficult to say that that is the right answer.

Senator THUNE. Anybody else on that?

Ms. OLSON. I would just observe, I think that characterization turns reality upside down, because the reality is that it is our high rate that is the disadvantage to doing business here, and that is why we need to change it.

Senator THUNE. All right. I know you probably touched on this before, talking about the troubles of having a largely temporary tax code and how that impacts investment decisions and the effect that it has on the economy and jobs creation. Could you touch on that again, sort of this year-to-year-to-year extension that we currently operate with?

Mr. SOLOMON. Yes. Instability affects business planning and personal planning. If you do not know what the rules are going to be, you do not know how to plan. Certainly the energy incentives. I think there is evidence that shows that, with respect to the incentives, the uncertainty about the incentives has affected whether or not people undertake those investments. So stability. Just as stability is important in your political system and stability is important in the economy, so it is in the tax code.

Mr. WEINBERGER. I would just add one other fact. The individual side of the code and the temporary nature of that does not often get talked about as much as the business extenders, the expiring tax provisions. But there was a recent survey I read in a news article on the National Federation of Independent Business, where 75 percent of small businesses said that they are refraining from hiring because they would be the pass-through entity, as Senator Snowe referred to before, that would have the higher income or the instability of all the individual tax rates expiring. So I think that is a very big issue for pass-through entities, which again are 50 percent of our businesses.

Senator THUNE. All right. I think, Ms. Olson, Mr. Weinberger, and Mr. Solomon all mentioned that research has shown that higher corporate income taxes lead to lower wages. Could you elaborate or explain that, perhaps?

Mr. SOLOMON. Well, the basis for it is that the corporate income tax is ultimately paid by individuals. Corporations are not people. Individuals ultimately pay tax. A large portion of the corporate income tax is passed on to labor, thus resulting in lower wages. This has been put forth in various economic studies.

Senator THUNE. All right. What do you think are the best pro-growth type tax policies, if we were to move toward tax reforms that would get us into more of a growth-oriented tax code?

Ms. OLSON. I will go first, because nobody else wants to. I think it is important that we move in the direction of a lower corporate rate, a territorial system, because both of those changes will encourage more investment here in the United States, and more investment in the United States means more jobs. That has to be a key to what we do in the future.

I also think we need to take a hard look, despite the 85 votes in the Senate against a value-added tax, at a consumption tax like a value-added tax because that, likewise, is a tax that economists

have concluded is better for economic growth. Economic growth, again, leads to job creation.

Senator THUNE. All right. Great.

Thank you, Mr. Chairman. I thank the Senator from Oregon for yielding me time.

The CHAIRMAN. The Senator from Oregon?

Senator WYDEN. Thank you, Mr. Chairman. Thank you for your patience. I know you have a busy schedule.

A question for you, Mr. Goldberg, because I think you, of the panel, are perhaps the most skeptical of 1986. I want to just kind of walk you through a couple of the principles that have kind of guided my thinking. I think when you look at 1986, you had populist Democrats like Dick Gephardt and Ronald Reagan coming to some agreements on key kinds of principles. They said right away, we are going to have a progressive tax reform bill. Both sides agreed that was smart judgment.

Then they got into the two key questions that I think are just as valid today as they were when Ronald Reagan and Democrats got together in 1986. I want to get your thoughts on it. They made a judgment in 1986 that marginal tax rates are exceptionally important. They said the tax people pay on that last dollar they earn, that is a big deal. They also said that preferences, the idea of the special interests getting lots of money even when they were narrow, was not a good idea.

Are those three principles that were agreed on in 1986 not still valid today? Up front, they ought to have a progressive code. You ought to be sensitive on marginal rates because it goes to Senator Thune's point on growth, but the preferences are something that you ought to start pruning back. Are those principles not still valid today?

Mr. GOLDBERG. Yes, sir.

Senator WYDEN. All right. One last question for the panel on this territorial issue, because I have just studied and studied this issue. I think sometimes you feel, on territorial taxation, the more you learn the less you know, because it is so complicated. I am open to a variety of approaches.

One of the big issues that I was struck by is the Volcker Commission for the President said that a territorial system would lose a lot of money. They came in with a figure that it would lose about \$130 billion over 10 years compared to current law.

My question is, what happens to small businesses if you do not figure out how to do a territorial system in a way that is fair to them, because a lot of the small businesses do not have the foreign-source income. I am trying to stay open on this territorial question. I spent a ton of time talking to people about it.

But talk to me about what a territorial system would mean for small business, if you share my concern, if Paul Volcker is right that you lose a lot of money, it possibly gets passed on to small business. What do you do, for those of you who are interested in the territorial system, to design it in a way that would not end up boomeranging on the small business folks.

Ms. OLSON. Senator, I want to go back, first, to your first question and just tell you that, in your joint tax reform effort with Senator Gregg last year, you were far more courageous than the folks

back in 1986 in terms of the things that you put on the table. Yes, absolutely, we need to worry about the effect.

But I think that, first of all, I question a lot of the revenue estimates. You can find revenue estimates all over the place on what a territorial system would do. The Joint Committee put out a proposal a few years back that actually raised revenue by about \$50 billion over a 10-year period, so it depends on the details of it.

But the most important thing is to make sure that the companies that are globally engaged are competitive with the companies that they are competing with on the global stage, many of which come from countries that already have territorial systems.

So those companies are important to small businesses because they become the transit route by which those small businesses' goods and services, that become part of the big companies' goods and services that are being sold abroad, get into the global marketplace. So we need to make sure that the big businesses are healthy and competing in the global marketplace so that they carry the small- and medium-sized businesses along with them, and that is the best path for them to succeed in the global marketplace.

Mr. WEINBERGER. Yes. I would just like to add to that, I hope we do not ever get into the debate—and you were saying this—of large versus small business. I do not think we would want to reduce taxes on large businesses and increase them on small businesses in any way. In fact, I think their futures, like Pam said, are inextricably linked. If 95 percent of the market is outside the United States now, 75 percent of GDP growth over the next 5 years is going to come from emerging markets outside the U.S. borders. We have to win over there. It is not large versus small; we need to get that market share. If we have a system like the rest of the world that is competitive, I think it will help them. As Pam says, that means that they, as sellers to small businesses and purchasers of business from small businesses, will benefit small businesses as well.

Mr. SOLOMON. I would add, just very briefly, on the territorial systems, going to the point Pam made, there are many different issues in territoriality. Depending upon the design of it, it could raise revenue or lose revenue. It is very important that the debate move to the next level of discussing the details of what a territorial system might look like, because that is going to be very important, deciding whether it is advantageous.

Senator WYDEN. That is a good point to quit on. I think when you juxtapose—I am looking at what the Volcker Commission found. They say, "Adopting a territorial system could encourage movement of production, employment, and investment out of the U.S. to lower-tax jurisdictions." We have that, and we have the small business concerns.

I share your view, Ms. Olson, that we ought to significantly lower the corporate rate. I supported that, others have supported that. We ought to tie it to doing business in the United States, and I think that is the point of the chairman's hearings, to start working through these issues.

A very good hearing, Mr. Chairman. A great way to start.

The CHAIRMAN. Thank you, Senator.

I want to thank the panelists. It is a good beginning. I do not know where we are going, but it is a good beginning. Thank you very much for helping us start out.

The hearing is adjourned.

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

A P P E N D I X

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

**Hearing Statement of Senator Max Baucus (D-Mont.)
Regarding Changes in the Tax Code since the 1986 Tax Reform Act**
As prepared for delivery

Author Thomas Friedman wrote:

“The long-term opportunities and challenges that the flattening of the world puts before the United States are profound.”

Indeed, increased globalization in the last several decades has spurred advancements in technology, business practices and daily life.

And compared to life 30 years ago, the changes are profound. Back then, the Berlin wall was still intact, most business was done using snail mail – except then we just called it, “the mail,” and the concept of derivatives was only familiar in a few, limited markets.

In the 1980s, most Americans had not heard of the internet, cell phones were usually found only in high-end cars, and computers were hundreds of times slower than those we use today.

Today, the global economy has indeed flattened.

Business is usually done using e-mail, the internet, and smart-phones. The use of interrelated financial products based on complex computer models nearly led to a global Great Depression. And today’s ubiquitous mobile phones have many times the computing power of the 1980’s personal computer.

Today, we will look at how the tax code has changed, and whether it has adapted to these changes. We will look at how the tax environment is different since we last revamped the code in the 1986 Tax Reform Act. And we will consider how globalization affects the central issues we face in tax reform.

We have made 15,000 changes to the tax code since 1986, but many of these changes have stretched the code in different directions. Have these changes left us with a tax code that is more efficient, competitive and fair? How have these changes affected average Americans?

Today's panel of distinguished witnesses allows us to look back on the last 25 years of tax policy. We will hear more about the reasons behind many of those 15,000 changes. We will hear about what challenges they faced and how things have changed.

The Assistant Secretary for Tax Policy sits at the intersection of tax policy and tax administration. In this position, our witnesses have been uniquely situated to see all sides of the tax policy debate.

One major change we must consider is how doing business has evolved since 1986. Changes in the foundation of conducting business have had a significant impact on how we collect revenue.

Today, many U.S. businesses pass their income through to shareholders and pay the same tax rate as individuals. For that reason, this business structure is often called a "pass-through."

Since 1986, we've seen the number of pass-throughs double and today, over 94 percent of all businesses are now organized as pass-through entities. Additionally, two-thirds of our large businesses are pass-throughs, which is more than twice the level of the next-highest developed country.

We receive more revenue from pass-through businesses every year than we do from businesses with traditional corporate structures, called C-corporations.

We must consider how efficiently we tax business income, given that so much of it is taxed on an individual basis today.

Given our increasingly global economy, we must also consider how other countries' tax laws affect our system.

In 1986, we closed tax loopholes that allowed individuals to eliminate their tax liability by investing in tax shelters for a small fee.

Today, complicated tax planning regimes are proliferating. They often involve cross-border transactions, or individuals transferring funds offshore.

We have made real progress cracking down on offshore accounts recently. We enacted the Foreign Account Tax Compliance Act in 2010, among other provisions that close international tax loopholes. But have we kept up?

In our global economy, intellectual property can be moved across borders quickly. Some companies use that advancement to drive their effective tax rates down to single digits, while other companies are paying rates closer to 20 or even 30 percent.

This disparity can have a significant effect on our economy. It is a major driver of the need for tax reform.

We must also consider the gap between the taxes owed and the taxes paid. The Treasury has estimated that gap is close to 300 billion dollars.

This tax gap is difficult to fill, but we need to find ways to improve compliance without excessive burdens on businesses or individuals. No one should be able to systematically avoid their tax obligations.

Today we will ask our panelists for their insights into this seemingly intractable problem. Perhaps information technology offers opportunities to reduce the tax gap while reducing compliance burdens at the same time.

We will also consider changes in the tax law. In 1986, there was no concept of an annual tax extenders bill. Last year there were 141 expiring provisions vying to be extended. The debate took nine weeks of Senate floor time.

We must look at why we have so many expiring provisions and how they affect our economy.

So today we ask: How did we get here?

I think more to the point though, we should also ask: Is here where we want to be?

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Written Statement of
Fred T. Goldberg, Jr.
Before the Senate Finance Committee
March 1, 2011

“How Did We Get Here?
Changes in the Law and Tax Environment
Since the Tax Reform Act of 1986”

Mr. Chairman, Senator Hatch, and Members of the Committee, thank you for the opportunity to testify today on the topic of tax reform. My name is Fred Goldberg. I am currently a tax partner in the Washington, DC office of Skadden, Arps. I served as IRS Chief Counsel from 1984-1986, as IRS Commissioner from 1989-1991, and as Treasury Assistant Secretary for Tax Policy during 1992. I am appearing solely in my individual capacity and the views I express herein are my own. I am not appearing on behalf of Skadden, any Skadden client, or any other organization.

With tax reform very much on today’s agenda, it is an appropriate time to consider what lessons can and should be learned on the 25th Anniversary of the Tax Reform Act of 1986.

In many respects the emerging discussion of tax reform is, in the immortal words of Yogi Berra, déjà vu all over again. The Tax Reform Act of 1986 was premised on the notion of lowering rates and broadening the base. The stated goals were the timeless tax policy themes of simplification, fairness, efficiency and competitiveness.

The Act did indeed broaden the base and lower rates, and was an improvement over prior law in important respects. But whatever those gains may have been, they were transitory at best. The tax system today is grotesquely complicated. It is perceived as unfair from every point on the political spectrum – from the most liberal Democrat to the most conservative Republican. It has caused gross distortions in the allocation of resources and has played a significant role in eroding our competitive position in a global economy.¹

I would like to address, briefly, two questions: (1) despite the promise of the ’86 Act, why has the system ended up where it is today? (2) What are the key lessons for tax reform this time around?

¹ For those who believe that the singular accomplishment of the ’86 Act was to reduce the top marginal rate on individuals to 28%, and eliminate the differential rate on capital gains, it is worth noting that the top rate is now 35% and that the Administration and others support effective top marginal rates on earned income approaching 50% or more. Meanwhile, the differential rate on capital gains has (at least for the time being) been restored.

Mission Creep, Structural Flaws, and “The Great Tax Wars”

In hindsight, it is clear why the system has ended up far deeper in the ditch than it was before the '86 Act: (1) inevitable mission creep; (2) fundamental structural flaws in what was done in 1986; and (3) the inherent tension in our nation's core values as they play out through the tax law.

(1) *Mission Creep*. For two reasons, and for many decades, the tax system has been the tool of choice to pursue social and targeted economic policy.

- First, the tax system is an extraordinarily efficient delivery system. Whatever the objective, providing a tax incentive (*i.e.*, a subsidy by way of a deduction, exclusion or credit) does not require a programmatic bureaucracy. Enact it, and they will claim it.
- Second, programs funded through direct outlays require annual appropriations.² In contrast, programs funded through tax benefits are on automatic pilot unless Congress takes affirmative steps to shut them down.³

The '86 Act did nothing to change the easy-to-implement and automatic pilot features that are inherent in our broad-based income tax. In retrospect, it was as certain as the sun coming up that successive Administrations and Congresses of all political persuasions would take advantage of the irresistible opportunity. Hence, the endless stream of post-'86 Act, bi-partisan legislation to promote social and targeted economic policy objectives. Overall, there is little or no evidence that this avalanche of law making has accomplished its objectives. The only thing we know for sure is that the primary effects have been to add mind-numbing complexity and distort behavior in very destructive ways.

(2) *Structural Flaws*. While the '86 Act achieved the laudable goal of lower rates, its claims of base-broadening were sorely over-stated. It left in place – and in some cases exacerbated – fundamental structural flaws in the tax system that made our current mess inevitable. In brief:

- On the *individual side*, base-broadening efforts were modest and round-about. Repealing the deductions for state sales taxes and personal interest and capping the home mortgage interest deduction, were sensible and forthright efforts, but they ignored the heart of the matter. For the most part, individual base-broadening was accomplished through the alternative minimum tax and an endless array of phase-outs.

² Some express the view that direct expenditures are often renewed under the false pretense of baseline budgeting, and without serious scrutiny. But at least some form of Congressional action is required each year.

³ Efforts to deal with the automatic pilot feature of the tax law through sunsets have proved an abysmal failure. Their primary impact has been to compound uncertainty and facilitate budget-by-gimmick through artificially imposed “sunsets” that are highly unlikely to occur.

- The AMT was pernicious policy from the outset; it has now become a perennial budgetary and political nightmare.
- Phase-outs are frequently and fairly criticized on policy and administrative grounds. But I think they reflect a more fundamental problem. In a system that “does” social policy through the tax code, the political parties have reached an unprincipled accommodation. Here’s the trade: those who insist on phase-outs at the top are willing to live with deductions rather than flat rate refundable credits for everyone else. Setting aside the all-important question of whether the tax system should be used to “do” social policy, this arrangement strikes me as indefensible on tax policy grounds.⁴

The fact is that the primary contributors to erosion of the individual tax base reflect our core values as a country: hard work (the ETIC); families (*e.g.*, personal exemptions and the child care credit); thrift (myriad tax-favored savings vehicles); education (an impenetrable array of conflicting credits and deductions); home ownership (deductions for mortgage interest and property taxes); health care (the exclusion for employer-provided health care); and charity (the charitable contribution deduction). This is where the money is. This is where the ’86 Act refused to go. And this is where the Code has expanded with abandon during the past 25 years.

- On the other side of the coin – the taxation of *enterprise and capital income* – the fundamental flaws of the ’86 Act were of a very different nature.
 - Certainly in hindsight, the ’86 Act failed to reflect a coherent or workable theory of how our income tax system should tax enterprise and capital income. Some of the glaring errors were obvious at the time. Others failed to account for the inexorable development of the global economy, global capital markets and the increasing importance and mobility money, human capital and intangible assets. The result has been needless complexity, uncertainty and instability; counter-productive legislation in the capillaries; and a serious adverse impact on our country’s competitive position.
 - A fulsome discussion of this topic is far beyond the scope of my testimony today, but following are three fundamental errors that should have been obvious at the time: (i) repeal of the *General Utilities* doctrine imposed a huge and inappropriate toll charge on corporate restructurings, leading to a significant mis-allocation of capital, (ii) the corporate AMT and shortening loss carry back periods have exacerbated business cycles, primarily at the expense capital intensive manufacturing businesses and start-up enterprises; and (iii) limitations on net operating losses that reflected the ultimate triumph of abstract theory over sound tax policy and commercial reality.

⁴ See, Batchelder, Lily, Orszag, Peter; and Goldberg, Fred, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 Stan. L. Rev. 23 (2006).

- Less obvious, but more important, is that the '86 Act failed to reflect a coherent theory for taxing global business activity and cross-border capital flows.

(3) *The Great Tax Wars* is the title of a thoughtful and readable book that Steve Weisman wrote a number of years ago on the enduring conflict over tax policy.⁵ Pointing to de Tocqueville as an early authority, Mr. Weisman notes that Americans are an odd amalgam – on the one hand, we believe deeply in meritocracy and rugged individualism, and have an instinctive distrust of government. On the other hand, we are a generous and big-hearted people who believe in opportunity, fresh starts and a helping hand, and have an instinctive distrust of a monied aristocracy. Mr. Weisman's book does a terrific job of characterizing how these competing strains played out in "the great tax wars" from Lincoln to Wilson – a conflict that continues to play out today. Because there is no right answer to how the tax law reconciles these aspects of our national character, the tax law will inevitably change in response to the national mood and politics of the time.

The real question is whether tax reform, this time around, can create a durable structure that will accommodate these conflicting strains within a framework that does minimal violence to the country's prosperity and ability to compete in a global economy.

Different Circumstances and Lessons Learned

Different Circumstances. As a preliminary matter, it is important to note that circumstances today are very different from what they were 25 years ago. Among the most important are:

- The '86 Act was grounded on the principle of revenue neutrality. That will not be the case today. The fact is that our Nation is hopelessly bankrupt. We have betrayed our children and our grandchildren. A fundamental restructuring of entitlement programs, reductions in discretionary spending – and additional revenue – are all required to right the wrongs we have committed. Anyone who says that we can avoid or defer one or more of these steps is delusional (or worse).

It is clear that tax reform and our fiscal peril are inextricably linked. Raising taxes without confronting entitlements and discretionary spending is like asking the owners of a hopelessly bankrupt business to contribute capital to an enterprise that cannot and will not survive.

The only question is how to make these changes in ways that do the least damage to our future economic prosperity – and to the more vulnerable of our fellow citizens.

⁵ Weisman, Steven R., *The Great Tax Wars* (2004). I readily acknowledge Steve's book as an important source for my thinking on tax policy and tax reform. All errors and omissions are, of course, my own. More recently, Mr. Weisman has edited the letters of your former colleague, the late Senator Moynihan. It is a wonderful compilation and should be mandatory reading for anyone interested or involved in public policy. Weisman, Steven R., *Daniel Patrick Moynihan: A Portrait in Letters of an American Visionary* (2010).

I want to congratulate three members of this Committee for their courage, leadership and wisdom in confronting these issues through their support last December of proposals by the President's Fiscal Responsibility Commission. Senators Conrad, Coburn, and Crapo deserve our gratitude, as do others who have shown a willingness to confront these challenges head-on.

- The second change in circumstances is the accelerating pace of change over the past 25 years in five areas. Four of them directly affect the performance of our economy, our prosperity, and our prospects for the future: (i) global enterprise; (ii) global capital markets; (iii) the importance and mobility of human and intangible capital; and (iv) the emergence of formidable competitors on the global stage.

The last – and perhaps most troublesome – trend is growing inequality in opportunity, income and wealth among our citizens. In my view, the tax law is neither the root cause nor the cure. Tax reform can and should make a contribution by reducing the job-destroying distortions and complexity that plague our current system – while maintaining or enhancing our progressive individual income tax. But I believe that far more can be accomplished by reigning in out-of-control entitlements and wasteful spending to free up funds that can be profitably invested in our future.

Lessons Learned. A host of lessons can and should be learned from the aftermath of the '86 Act. Following, in no particular order, is a brief summary of my top 6.

1. *Businesses Don't Pay Taxes, People Do.* Corporations may write the checks, but some combination of owners, workers and customers pay *all* business taxes. This is, and always has been, a truism. And it is increasingly evident that the folks who bear most of the burden are rank-and-file workers (in the form of lower wages) and middle class investors through mutual funds, insurance policies and pension plans (through lower returns on their investments). Efforts to shift the tax burden to big business (as was done in the '86 Act) makes for easy and effective retail politics. But it is misleading and terribly counter-productive. A critical question is whether, this time around, those involved in the tax reform debate will do a better job of educating the public.

2. *Taxes Matter: The Individual Income Tax.* There is a widespread tendency to discount the extraordinary cumulative impact of individual income taxes on the behavior of individuals. We give lip service to the notion, but the evidence suggests we don't take it all that seriously. Two examples should suffice. As noted above, despite its base-broadening claims, the '86 Act did little to address housing subsidies and nothing to address health care subsidies provided through the tax law. It is now conventional wisdom that the former have prompted an over investment in leveraged home-ownership and that the latter is a primary contributing factor to escalating health care costs. Unfortunately, it took a housing bubble and devastating increases in the cost of health care to teach these lessons. The question is whether, this time around, policy makers will take them to heart.

3. *Taxes Matter: Taxing Enterprise and Capital Income.* There is a similar failure to take account of how our taxation of enterprise and capital income drives economic efficiency, prosperity, competitiveness and – in the current environment – jobs. To illustrate the point, in 1986 America was the undisputed center of the world's capital markets and was home to most of the leading global financial institutions and pharmaceutical companies. Twenty-five years later, this is not the case. While there are many reasons for the shift, it is clear that our tax system is a primary cause. The fact is that our tax system is increasingly hostile to capital in most of its forms – money, human capital, and intangible assets. These kinds of capital are mobile, don't respect national borders, and are extremely unforgiving. The '86 Act, and legislation that has followed in its wake, have ignored or challenged these powerful forces. In doing so, we have acted at our peril – and we are paying a very high price. The question is whether, this time around, those responsible for tax reform will pay these forces their due, and enact legislation that turns them to our country's advantage.

4. *"Broaden the Base – Reduce the Rates" Has a Nice Ring, But* not at the expense of sound tax policy. As noted above, this was one of several fatal flaws in the '86 Act. Our economy has been paying the price ever since; the question is whether those responsible for tax reform will learn their lesson this time around.

5. *Tipping Point.* The tax system is reaching an interesting juncture. Currently, about 40% of all Americans owe no income tax. That percentage is increasing, and if the health care tax credit provisions go into effect, more than 50% of all Americans will owe no income tax. While the reach of the payroll tax is far greater, it is (in theory) a dedicated tax in the nature of premiums for a progressive system of social insurance. The fact that more than 50% of all Americans in any given year will pay *nothing* for the general operations of the Federal government is uncharted territory in our nation's history. Its implications for tax reform are uncertain, but there are many who find it a potentially troublesome development.

6. *Think Big.* While the '86 Act was major tax reform by any measure, it retained the fundamental structure of the existing system. For example: (1) an individual income tax system requiring participation by most Americans, with tax subsidies for home ownership and employer-provided health care; and (2) an enterprise income tax; a double tax (or more) on corporate earnings; the differential treatment of interest and dividends; and an international tax regime that taxed some non-US income currently and the rest on actual or deemed on repatriation.

The time has come to pursue far more fundamental reform than was undertaken in 1986. With respect to the *individual income tax*, a little-known fact is that prior to President Franklin Roosevelt, most Americans did not pay an income tax. Their contribution to the fisc came in the form of consumption taxes (sales taxes on certain items and tariffs) paid by all consumers. The income tax was limited to those with relatively high earnings. As part of his strategy for enacting Social Security, and in response to World War II, President Roosevelt reformed the income tax from a "class tax" to a "mass tax" and reduced the country's reliance on consumption taxes. That all happened more than 70 years ago, and worked reasonably well for much of its history. But times of changed. It may well be that our system should head back to the future –

some form of consumption tax that paid by everyone to fund a portion of the government's operations, and a high end income tax to maintain (or enhance) our progressive system.⁶

A number of interesting and well-developed ideas for changing how we tax enterprise and capital income have been around for a while. Some have suggested that the corporate income tax be replaced with a subtraction method value added tax or a progressive business activities tax. Others have suggested that the starting point for determining the corporate income of public companies should be the income they report to their shareholders. Short of these reforms, it is clear that a fundamental rethinking of our system for taxing enterprise and capital income is in order. Dramatically lower rates and a territorial system are, in my view, the fundamental pre-requisites.

I also take issue with those who maintain that corporate tax reform must be "revenue neutral" (or, worse yet, those who maintain that corporate tax reform should raise additional revenue). This is backwards. As noted above, corporations never have and never will pay taxes – people do. And the folks being taxed are workers and middle class savers. Tax policy in recent years has been characterized by a sentiment that we should increase the tax burden on companies, and a "better-not-leave-or-else" view of the world. These policies have been and will remain a dismal failure. Our country would be far better off if we took advantage of our unique strengths to become a 21st century tax haven – a country where stable tax policy, with relatively low marginal tax rates and tax burdens on enterprise and capital income, help induce businesses, mobile capital and highly productive individuals to locate their job-creating activities in the United States. This approach is doable – and can be accomplished within a framework that maintains or enhances the all-in progressivity of the tax system.

7. *Start at the Top.* To a large extent, the '86 Act was driven by tax "experts" in the public and private sector. This approach had its benefits, and succeeded in important respects. But it also had significant downsides. It meant that reforms would retain the basic structure of the current system. It also meant an unhealthy obsession with "closing loopholes" and adherence to tax theory that was wholly at odds with reality. This time around, tax reform should be driven by a broader community of public and private stakeholders with a clear perspective on what kind of corporate tax reform is best for the country.

⁶ Considerable thinking has gone in to this type of reform. I commend your attention to the work of Professor Michael Graetz, whose 2007 book, *100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States*, is the most thoughtful and comprehensive exposition of the concept. I readily acknowledge Professor Graetz as an important source for my thinking about tax policy and tax reform. All errors and misguided analysis are, of course, my own.

**STATEMENT OF HON. ORRIN G. HATCH, RANKING MEMBER
U.S. SENATE COMMITTEE ON FINANCE HEARING OF MARCH 1, 2011
HOW DID WE GET HERE? CHANGES IN THE LAW AND TAX ENVIRONMENT
SINCE THE TAX REFORM ACT OF 1986**

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, released his opening statement from a committee hearing today examining how changes to the Tax Reform Act of 1986 have affected the tax code. Today's hearing is the first in a series this Congress examining America's inefficient and burdensome tax code and ways to improve it to spur economic growth and job creation.

A full copy of Hatch's remarks, as prepared for delivery, follows:

Mr. Chairman, thank you for calling this hearing.

At the start, I want everyone to know how much I appreciate the bipartisan spirit with which you are starting the tax reform process. You and your staff have indicated a great willingness to put in the time and energy. You and your staff, along with those on this side, will ask the tough questions about our current tax system. The notion is that we're not going to simply be treating the tax system as a big ugly piñata.

We will methodically examine every feature of the tax system. I expect that we will conduct that examination with President Reagan's three criteria as our guide posts. We will be looking at the fairness of the system. We will be looking at the efficiency of the system, with a particular emphasis on the anti-growth features of the systems. We will be looking at the complexity of the current system. After that examination, I'm optimistic that we will be in a position to re-build the system in a way that meets President Reagan's three criteria.

Today, we will take a look back at the almost quarter century that has elapsed since tax reform. As the hearing title indicates, we will be asking how did we get to here, in 2011, from there, in 1986?

Tax Reform achieved the bipartisan goal of lower rates and a broader tax base. At that time, the tax system raised revenue roughly in line with the historical average of roughly 18% of the economy. That is what the Congressional Budget Office tells us would be raised if we define revenue neutrality by reference to current policy. It seems to me to be a good benchmark to use. I have a chart. The chart shows that, despite many movements up or down in the marginal rate structure, the American taxpayer tends to yield that much revenue.

The motivational speaker Harvey McKay once quipped:

Day in and day out, your tax accountant can make or lose you more money than any single person in your life, with the possible exception of your kids.

There's a lesson in there for all of us policymakers. No matter how much we may tinker with the law and squeeze revenue of one or more disfavored groups, they react.

Tax policy driven primarily by politics will have to meet that reality.

For instance, it is very easy politics to attack the top 5% of earners. Target them for a tax increase and everybody else is fine. As the chart shows, they are not automatons. They will employ talented tax people to minimize the effect. Often that advice channels productive resources into tax-favored activities.

Once you get past the politics, the reality is that one sector of society reacts and the other sector may not get the revenue they desire.

As we look back over the last 25 years, I'm sure some will say I'm wrong. They will point to the 1993 partisan tax hike where the grand bipartisan bargain of 1986 was dramatically undone. How was it undone? Here's how.

Two new marginal rates of 36% and 39.6% were added. Those rates were pushed up from the 31% rate that Congressional Democrats and Republican President George H.W. Bush agreed to in 1990. Under current policy those two marginal rates rest at 33% and 35%. That's two and four percentage points above where they were in 1990.

And to listen to some on the left in the punditry you'd think these two marginal rates are the cause of the decline of Western Civilization. Yet they are significantly higher marginal rates than either the grand bargain of 1986 or the 1990 deal between Congress and President George H.W. Bush.

Some on the left will say, wait a minute. The surpluses of the late Clinton Administration were entirely attributable to the partisan 1993 tax hike. Unfortunately for them, the Clinton Administration's Office of Management and Budget says differently. OMB concluded those tax increases were a minor factor in the surpluses that appeared at the end of the 1990's.

Here's a chart that demonstrates it. Only thirteen percent of the deficit reduction in the 1990's was attributable to the partisan tax hike.

Or we might hear some on the left say I'm wrong because all fiscal calamities of this decade were attributable to the 2001 and 2003 tax relief plans.

Again, fiscal facts suggest otherwise. According to the CBO, only 25% of the fiscal change in the last decade was attributable to the 2001 and 2003 tax relief plans.

While marginal rates have gone up significantly since tax reform, another big change has occurred. Tax expenditures have grown.

The pamphlet produced by the Joint Committee on Taxation catalogs the growth. As an aside, unlike spending, tax expenditures generally grow as tax rates grow. With rates rising considerably since 1986, there's growth attributable to that factor. On the other hand, lower marginal rates will reduce the tax expenditures related to those rates.

Tax expenditures do affect the tax base. Refundable credits have proliferated for low-income folks. Middle-income people have more benefits though they're subject to complicated phase-outs and the nightmare of the Alternative Minimum Tax ("AMT"). Higher income people are also using some tax expenditures, including many designed to ultimately benefit lower income people.

History also has not been kind to the simpler structure of the 1986 reform.

Mr. Chairman, I'm pleased to hear the testimony of these distinguished former Assistant Secretaries of Tax Policy. Hopefully, they can help us find a path back to President Reagan's criteria of fairness, growth, and simplicity.

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**Statement of Pamela F. Olson
To the
Finance Committee
United States Senate
“How Did We Get Here? Changes in the Law and Tax Environment Since the Tax
Reform Act of 1986”**

March 1, 2011

Chairman Baucus, Ranking Member Hatch, and distinguished members of the Committee, I appreciate the opportunity to appear this morning as the Committee commences serious consideration of reform of the country's tax system. I am here today at the request of the Committee. I had the honor of serving as assistant Treasury secretary for tax policy from 2002 to 2004, and am currently a partner in the law firm, Skadden, Arps, Slate, Meagher & Flom, LLP. I am appearing on my own behalf and not on behalf of any client or other organization. The views I express are solely my own.

I. Introduction

The subject of this hearing is changes in the law and the tax environment since the Tax Reform Act of 1986. I commend the Committee's efforts in exploring much-needed reforms to the U.S. tax system. These efforts are timely, particularly in light of our country's pressing fiscal concerns and the changing global landscape. The velocity of change in the global economy makes swift action imperative. Our tax system and the manner in which it is interwoven with economic activity is complicated, however, and reforming the tax system is even more so. As a consequence, reforms must be carefully considered before they are enacted. The Committee has properly requested input on a number of issues that should be considered in any comprehensive tax reform effort. My written testimony addresses some of them; unfortunately, time did not permit me to address all of them. I would, however, be pleased to respond to any questions the Committee might have today or in further discussions.

The sources of our current tax system's shortcomings have been identified and can be addressed in any overhaul. But doing so will require a greater measure of political courage and willingness to challenge the conventional wisdom than was evident in 1986. The change that is required will require education and a willingness to look beyond the next election. Our nation's fiscal situation is such that partisan politics must be put aside for the sake of the greater good and future generations. Fortunately, there are leaders who have shown that it is possible to work on a bipartisan basis and propose meaningful reform of the tax system. They include former and current Senators and members of this Committee – Senators Breaux and Mack in their leadership of a tax reform study in 2005, Senators Wyden and Gregg in their comprehensive tax reform legislation in the last Congress, and Senator Simpson and Erskine Bowles in the Deficit Reduction Commission report issued late last year.

My testimony addresses some of the most significant shortcomings of the current system and the key areas for improvement in a comprehensive reform of the tax system. In particular, I believe it is essential that Congress enact reform that reflects economic realities, not political rhetoric, cleanses the tax system of unnecessary complexity, lays a foundation for economic growth and job creation by fostering our global competitiveness, and allows us to pay our bills, not saddle our children and grandchildren with crippling levels of debt. I also believe we must be cognizant of the changes that are shaping other countries' tax systems because those changes may affect investment decisions and capital flows into the United States if we do not respond to them.

II. Lessons from the Tax Reform Act of 1986

The Committee has chosen a good place to begin with the Tax Reform Act of 1986 ("Tax Reform Act" or "Act"). Enactment of the Tax Reform Act represented a remarkable legislative achievement, and it addressed a number of serious flaws in the tax system. That said, the Tax Reform Act itself had a number of serious flaws – flaws that have grown more problematic over time for the economy, our national competitiveness, and tax administration. The ideal tax system would raise the revenues to fund the operations of the government with the least adverse impact on the economy. Our current tax system, a natural development of the structure put in place with the Tax Reform Act, manifestly fails to meet that challenge. The flaws in the Act should serve as a guide to avoiding errors in this tax reform effort. A few of the more significant problems are described below.

Complexity. The Tax Reform Act carried the complexity of the tax law to new heights. There were many reasons for this, including the goal of revenue neutrality and political reluctance to address directly the provisions in the Internal Revenue Code ("Code") that reduced revenues on the individual side. Continuing legislative changes begun in 1984, Congress added many provisions that deviated explicitly from financial accounting principles in the belief that the provisions more clearly reflected income or curtailed some improper tax benefit. Invariably, such provisions were scored as raising the revenue necessary to meet a target. Whether the provisions increased revenue in the real world is open to question, but taken together, the apparent effect was a shift in the incidence of taxes from individuals to corporations.

On the individual side, the Tax Reform Act included a beefed up alternative minimum tax ("AMT") as a substitute for repealing or limiting a number of individual tax preferences. Though intended when originally enacted to ensure that wealthy individuals paid at least some amount of income tax, the AMT's design never carried out that purpose. As revised by the Act, the AMT is inordinately complicated and has the effect of reversing many of the benefits Congress determined to retain. Because it is unlike other provisions in the tax law that are indexed for inflation, it has the effect of ensnaring more taxpayers with each passing year. In the near future, the IRS is projected to collect more in revenue through the AMT than through the regular income tax.

Although congressional staff involved in the drafting of the Act have stated that the lack of indexing was intended to bring more taxpayers into the AMT and eventually replace the regular income tax base with the AMT base, neither Congress nor any President has embraced the AMT's stealth elimination of tax benefits. Nonetheless, the projected cost of repeal under the budget rules has prevented outright repeal or permanent indexation. Instead, Congress has enacted annual patches that increase its exemptions and limit its reach. The enactment of those patches, oftentimes late in the calendar year, has created problems for the Internal Revenue Service ("IRS") as it endeavors to program its computers and prepare instructions for the filing season.

AMT indexation is one of many features of the Code that operate on a more or less temporary basis because of budgetary constraints. For the individual taxpayers potentially subject to it, the result is instability and uncertainty. For the federal budget, the unwillingness either to embrace the AMT or permanently fix it yields a false source of revenue. The country's budget situation is actually worse than continuing temporary patches would lead one to believe.

Mistaken Economics. On the business side, the Tax Reform Act perfected the system of double taxation for corporate income. In this case, perfection is not a positive attribute. Indeed, perfecting a double tax system may have been the most serious error in the Tax Reform Act because it included a rate of tax on corporate income that was over 20 percent higher than the tax on noncorporate income and a second tax on dividends and capital gains from the sale of corporate stock at ordinary income tax rates. The Act set off a furious effort on the part of every well-advised business for which it was possible to escape the corporate form of business via S election or converting to partnership form. Master limited partnerships became so popular that Congress was compelled just one year later to enact a provision preventing the adoption of partnership form by publicly-traded partnerships to "protect" the corporate tax base. The corporate double tax system encouraged the use of debt and discouraged the payment of dividends. My personal view is that it contributed significantly to the corporate instability and governance issues that plagued us, particularly in the 1990s.

The double tax mistake was ameliorated somewhat by the enactment of a 15 percent rate on dividends and capital gains in 2003. I regard that change in 2003 as the most significant improvement to the structure of the Code in recent decades. Like so many other important features of the Code, however, it was enacted in temporary form and is now subject to the vagaries of the annual tax extender process.

The result is that non-corporate or passthrough entities continue to grow in popularity. That is reflected in the portion of business income – 75 percent in 2008 – that is earned by non-corporate entities and by the fact that even in the IRS's large business division, over half of the returns filed for 2009 were of pass-through entities.

Don't Tax Me. The Tax Reform Act also targeted the international operations of U.S.-headquartered companies with a number of complicated changes that tightened the rules for including foreign income and claiming foreign tax credits. Many of the changes

had no policy rationale other than that they raised revenue from an unpopular source – big businesses’ foreign operations. Although some of the most arbitrary changes have been reversed by subsequent legislation with a corresponding reduction in complexity and economic irrationality, a few of the legislative reversals had delayed effective dates – courtesy of budgetary rules – and have yet to take effect. The Tax Reform Act’s reduced rates – including on corporate income – minimized the adverse effect of some of the international changes for the first few years following its passage. As corporate tax rates have fallen around the world in the intervening years and our major trade partners have adopted territorial tax systems, the impact has been exacerbated. We find ourselves increasingly out of step with the policies adopted by other countries to the disadvantage of our economy and the jobs that might otherwise be created here.

III. Legislation in the Intervening Years

The Code has been amended thousands of times in the 25 years that have passed since the Tax Reform Act was enacted. That in itself is a problem because the pace of change far exceeds the capacity of the taxpaying public and the IRS to keep up with it. What should cause the greatest concern, however, is the tendency, particularly evident over the last 15 years, to use the Code to dispense all manner of benefits, many of them having no rational relationship to the collection of the revenue necessary to fund the operations of government. To my mind, this became a serious problem in the 1990s when both parties realized the goals of tax cuts and spending increases were mutually attainable if combined in targeted tax provisions. The continual enactment of targeted tax provisions leaves the IRS with responsibility for the administration of policies aimed at the environment, conservation, green energy, manufacturing, education, saving, retirement, health care, child care, welfare, corporate governance, export promotion, and economic development, among others. The array of targeted tax provisions also leaves taxpayers confused because the Code often contains multiple overlapping and mutually exclusive provisions aimed at many of these policies. A college degree may be necessary to determine which of the various education benefits is most advantageous.

Regardless of the merits of the policies and whatever the IRS’s capabilities, it is unreasonable to believe the IRS has the capacity to oversee such a diverse range of activities. Moreover, the result of running such policies through the Code is spending that is largely uncapped, unverified, and unverifiable. In the best of circumstances, we have limited means of assessing the efficacy of many government programs. In this case, Congress has effectively signed a blank check. Because many of these provisions duplicate direct spending by other agencies of government, it is particularly difficult to assess whether a provision has been effective in attaining the intended objective.

There is another hazard of the targeted tax provisions and that is that the complexity they bring undermines respect for the tax law. There are too many restrictions, too many qualifications, too many exceptions, and too many phaseouts for the taxpaying public to comprehend. The result is a sense of unfairness stemming from a concern that the taxpayer has been arbitrarily cut out of an available benefit and a sense of uneasiness that available benefits have been missed. That said, many taxpayers prefer

the targeted tax provisions to other forms of government spending – probably because they are easier to access than other forms of government spending. That is not a reason for continuing them. It is a reason to evaluate the operations of other government departments and agencies to see how they might be improved so that they can assume responsibility for the spending programs logically within their purview.

IV. Tax Reform Considerations

Taxes and Spending Go Hand in Hand. As the Committee considers tax reform, it is imperative that the budget be considered holistically, as President Obama instructed the Deficit Reduction Commission. Spending and taxes are inextricably linked and must be viewed together. For that reason, Congress should set aside deliberations on the meaning of revenue neutral tax reform. In the final analysis, Congress must raise the revenue necessary to cover the spending it chooses to undertake and cut the spending to fit the revenue it determines to collect. Although information on the country's fiscal situation is available for those inclined to look for it, misinformation abounds with the result that many in the public do not understand that difficult decisions lie ahead. Eliminating waste, fraud, and abuse will not suffice on the spending side. Neither will a tax hike on the top two percent or the foreign operations of U.S. companies suffice on the tax side. It is hugely important that congressional leaders convey that reality. It is hugely important that the President do so as well, which is why it is so disappointing that the Administration has chosen to delay consideration of Social Security reform. The Social Security trust funds represent nothing more than a promise to raise taxes in the future to satisfy our obligations to Social Security recipients. In the very near future, we will have to raise those taxes because Social Security benefit payments will outstrip Social Security taxes.

Along those lines, last year's health care reform represents a significant missed opportunity to address rising entitlement costs and address the most significant individual income tax expenditure. Controlling rising health care costs requires consumers to have some skin in the game. The unlimited income tax exclusion for employer provided health care eliminates consumer cost sensitivity. To bend the health care cost curve down, we must consider eliminating or capping the exclusion for employer-provided health care.

Keep It Simple. Every tax system that uses income as a base features certain irreducible complexity because measuring income is difficult. This is the reason law students, in their first tax course, devote many hours to answering the question, "What is income?" A manageable question for an individual whose only source of income is his or her salary is far more vexing when posed in the context of a modern business, which may employ complicated financial instruments and arrangements. The difficulties multiply when the business owns multiple operations or operates in multiple jurisdictions.

Although some complexity in a tax system is unavoidable, other types of complexity are entirely optional. "Optional" complexity arises, for example, from attempts to accomplish a particular goal, other than raising revenue in the least harmful

way, through the tax system. A recently-enacted case in point is the deduction for domestic production activities, with its maze of rules for determining what activities, exactly, are blessed with a deduction. In the individual context, consider the array of overlapping deductions and credits available for children, child care, and education.

Setting aside the complexity that arises from policymakers enlisting the tax system for purposes other than raising revenue, complexity remains that serves no apparent purpose at all. Businesses must measure their income for financial accounting purposes, keeping books according to detailed rules prescribed by institutions such as the Financial Accounting Standards Board or the International Accounting Standards Board. For purposes of complying with the Code, however, a company must re-measure its income according to rules devised by Congress. Regardless of the wisdom of the legislators, assisted by tax lawyers, accountants, and economists, who devised the rules in the Code, the benefit of the multiple deviations from financial accounting are questionable. While it is undoubtedly true that the Code's measurement of income must differ in certain particulars from the rules of financial accounting because their purposes are not completely aligned, there is no compelling reason for the many disparities between the Code and the financial accounting rules. Greater conformity of book and tax accounting would have the added benefit of leveraging potentially competing interests against each other.

Complexity in the tax system breeds inefficiency and undermines our system of voluntary compliance. Where the rules of the tax system are unclear or difficult to comply with, compliance will lag. Compliance may suffer because taxpayers are unwilling to expend the effort necessary to unravel the complexity completely or because the complexity itself offers an opportunity for taking an aggressive reporting position. Both taxpayers and the IRS waste tremendous resources complying with and administering an unnecessarily complex tax system. Tax reform should have as a principal goal mitigating wasteful complexity wherever possible.

Get the Economics Right. Sound tax policy is based on sound economic policy. Sound economic policy dictates that the tax rules should be neutral to avoid skewing business and investment decisions. Provisions that skew decisions reduce national income, thereby reducing economic well-being and tax revenues. Tax provisions that correct for market externalities may be tolerable or even necessary, but the Code should otherwise avoid interference in the market because a tax system that is neutral maximizes national income.

Considering and understanding the economic impact of changes to the Code is crucial. Unfortunately, economic impacts are not always obvious with the result that tax law changes may produce unanticipated consequences. Individuals and businesses respond to incentives, regardless of whether intended, and the aggregate of their actions impacts the welfare of the entire country. The "perfect" double tax system of the Tax Reform Act illustrates this well. It should not have been a surprise that the higher corporate rate and double tax on dividends prompted an exodus from corporate form. And yet, the need for the laws passed the following year to clamp down on the use of

master limited partnerships to avoid the double taxation to which corporate earnings were subject clearly demonstrates that Congress did not anticipate the mass departure that occurred.

While some economic effects are predictable with careful consideration, other economic effects are difficult to foresee because they are not well understood. That is particularly the case where the incidence of a tax does not match the burden of the tax. Consider, for example, the employer's share of payroll (Social Security and Medicare) taxes. The tax is imposed on the employer, yet economists have concluded the burden of the tax falls on the employee whose cash wages are reduced to reflect the tax that is imposed on the employer's payment of wages. It is not uncommon, however, to hear the tax described as a tax burden borne by the employer rather than the employee because the incidence of the tax is on the employer. During the consideration of health care a year ago, a similar debate ensued over the excise tax on "Cadillac" health care plans. Some described it as a tax on the employer providing the "Cadillac" plans, consistent with the tax's incidence. Others correctly recognized that the burden of the tax would fall on the employees who enjoyed the "Cadillac" plans.

The placement of the burden of the corporate income tax has been the subject of considerable debate for a number of years. Given the incidence of the corporate income tax, many have assumed the burden of the tax fell on the owners of the corporation. Economic research over the last decade supports the conclusion that, conventional wisdom notwithstanding, the corporate income tax is regressive. Although the corporation makes payments of corporate income tax, some actual person or persons ultimately bears that tax, whether in the form of lower dividends, lower wages, or higher prices. Economists have concluded that, in fact, the employees of the corporation bear the bulk of the corporate income tax burden in the form of lower wages. Yet, in listening to most popular commentary, one could be forgiven for concluding that Paris Hilton is the primary payor of the corporate income tax. This illustrates why education about the tax system is so important. When debate is so unmoored from economic reality, there is a real danger that tax reform will both perpetuate existing harms and create new ones.

It is important not to overlook another key economic insight – that taxing an activity discourages it. The economic burden of a tax affects the amount of the activity on which the tax is imposed, a fact brought home by a recent article in the Wall Street Journal, in which the president of a small New Jersey company explained why he was not hiring new workers. He described how he paid \$74,000 in salary, taxes, and contributions to provide a worker with a nominal salary of \$59,000 – take-home pay of \$44,000 and \$12,000 in benefits. The employer's combined tax costs amount to a 33 percent surtax on the worker's net compensation. The result of the high tax cost of hiring is fewer workers with fewer jobs and lower wages. The same is true of the burden of the corporate income tax.

Responding to Global Shifts. For the U.S. to remain a global leader, we must be more effective in attracting new companies and new capital. The shift away from the United States as a base for globally-engaged companies began some time ago and has

accelerated as new companies and industries have come to the fore. To understand the dynamic nature of the world economy, consider the rate of turnover in the Fortune 500. Forty-eight percent of the companies on the Fortune 500 list in 1999 had disappeared from the list by 2009, and only 14 percent of the companies on the list in 1959 held on until 2009. On the Fortune Global 500 list, U.S. companies' representation is rapidly declining, falling from 179 companies in 1999 to 140 companies in 2009. Over the same time period, the number of Chinese companies on the list increased from 10 to 37. While it was once necessary for innovators to come to the United States to raise capital, recent years have seen a significant increase in the wealth concentrated in places like the Middle East, Russia, China, and India, reducing the need for foreign enterprises to tap the U.S. capital markets.

Foreign competition has increased. Institutions of higher learning produce highly skilled workers that form a growing middle class in the developing world. Governments vie for research and development investments.

A change in our global dominance will have knock-on effects throughout the economy. The foreign operations of U.S. multinationals are responsible for U.S.-based investment and jobs that support those foreign operations. Diminished opportunities for U.S.-based global companies means diminished opportunities for the smaller U.S. companies that are a part of their supply chain. It is also important to keep in mind that the presence or absence of a single company may have an incidental effect that extends beyond that single company. Researchers have documented a "cluster effect" whereby businesses within a geographic area spur productivity of other businesses in the area, meaning the whole is greater than the sum of the parts. In light of this pattern, particular care should be given to devising a tax system that encourages clustering – and the attendant productivity and employment gains – here in the United States.

The tax system is certainly not the only cost of doing business in the United States, but it may be the least defensible. We have burdensome corporate governance and securities regulatory regimes, broad environmental regulation, tort laws that impose a substantial "litigation premium," and generally high labor costs. For each of these costs, however, there is generally an attendant benefit. By contrast, there is no rationale for maintaining an outlier tax system that discourages companies from engaging in global business operations from a U.S. headquarters and from reinvesting foreign earnings in the United States.

Under our current tax system, U.S.-based global companies occupy a uniquely disadvantaged competitive position among their peers. With the recent adoption of territorial tax systems by Japan and the United Kingdom, the United States is the last of the G-7 to tax its residents on their worldwide income. Following the Tax Reform Act, the United States had the lowest corporate tax rate; beginning on April 1, when Japan is scheduled to reduce its corporate income tax rate by 5 percentage points, the United States will have the highest combined corporate income tax rate among OECD countries. Thus, while a foreign-based global company generally pays little or no home-country tax

on its income earned abroad, an identical U.S.-based company must pay the 35 percent U.S. corporate tax rate when it repatriates that income to the United States.

Our tax system is often described as rewarding U.S. companies' foreign operations because foreign earnings are not taxed until the earnings are repatriated. Such a characterization turns reality upside down. The problem is with the high tax rate the United States imposes on corporate income, not the fact that other countries impose much lower rates and grant incentives for research and development. We cannot make U.S. companies more competitive or the United States a more attractive location for investment by adopting a system that seeks to impose our higher corporate tax rate on U.S.-based companies' foreign income. Imposing a 35 percent rate on foreign earnings will only make U.S. companies' foreign operations more valuable in the hands of their foreign competitors. U.S. companies today face a definite disadvantage at home and abroad. The most effective means of rectifying the disadvantage is to bring our corporate tax rate into line with the corporate rates imposed by other countries and to eliminate the disincentive to U.S. companies reinvesting their foreign earnings in the United States.

Timing. It is important that major changes to the tax system receive careful consideration before they are enacted. That said, the rapidity of change in the global business environment suggests a need for speed with respect to reform of the corporate tax regime. It may well be necessary to consider business reform separately from broader reform of the tax system.

Get the Policy Right. Budgetary constraints have dictated many legislative decisions in recent years, often to the detriment of sound policy. In considering corporate tax reform in particular, I urge you to make sound policy your primary objective. Bearing in mind the fact that a substantial part of the corporate tax burden falls on workers and that corporate capital is particularly mobile, it is more important to get the policy for the corporate tax regime right than to ensure it raises a particular amount of revenue. The experience of the Tax Reform Act illustrates the risks inherent in designing to meet a revenue target rather than designing the soundest corporate tax system. On a static basis, the double tax system worked well. In the dynamic real economy, it failed to deliver. A redesigned system should attract, not repel, capital investment.

Alternative Tax Bases. There are limits to our ability to generate additional revenue through our existing tax bases. It seems unlikely that our primary tax bases – most notably, the corporate and individual income taxes and the Social Security and Medicare payroll taxes – can efficiently generate adequate revenue to meet future spending obligations even if those obligations are radically reduced. Economists have long observed that the economic burden of taxation increases with the square of the tax rate – that is, the cost of generating each dollar of tax revenue increases as the tax rate increases. Consequently, I strongly recommend that the Committee consider the addition of an alternative tax base, coupled with lower rates on existing tax bases, as part of tax reform. The alternative source could be a carbon tax or a consumption tax. Either would meet with resistance, but so will the elimination of the individual income tax expenditures necessary to broaden the base sufficiently. Importantly, the addition of a

consumption tax would align our tax system with the tax system of every other developed country.

* * * *

I applaud the Committee for taking a hard look at the tax system and steps toward reforming it and thank you for the opportunity to testify today. I would be pleased to respond to any questions you may have.

**Testimony before the
Committee on Finance**

United States Senate

Eric Solomon and Mark A. Weinberger¹

March 1, 2011

Chairman Baucus, Ranking Member Hatch, and distinguished Senators on the Committee, thank you for the opportunity to testify today regarding the factors that have brought us again to consider updating and reforming our Internal Revenue Code (the “Code”).

The thorough process you have laid out — to assess current state, consider changes and then proceed with comprehensive reform — is the correct approach to construct tax policy. Judging from our nation’s tax history, the undertaking you are beginning will not be easy and will not be without twists and turns. It most certainly will not be without controversy. However, the goal of a simpler, more efficient, competitive tax system is an imperative. We offer our assistance to you, and your staff, as you advance through this process.

This year will mark the 25th anniversary of the Tax Reform Act of 1986 (the “1986 Act”). The 1986 Act — building on reforms from the early 1980s — significantly lowered marginal tax rates while broadening the income tax base. It was the last comprehensive reform of the Code.

Since that time, we have witnessed numerous and material changes in our tax laws. The changes in our economy, demographics, business environment and global landscape over this period have been even more dramatic. In 1986, our nation’s principal political rival was the Soviet Union, there was no European Union or Euros, no concept of BRIC² countries, no smart phones, nor the wide use of cell phones.

Clearly, the world is very different than it was in 1986. As the world has changed, businesses and other governments have rethought their business models and revenue policies and adopted strategies in order to compete successfully. The United States too needs a tax code that reflects this changed landscape.

We have had the opportunity to view the tax system from different vantage points over many years, through experiences in the executive and legislative branches of government, as well as in the private sector. You have asked us to discuss in our written and oral testimony what we think are the most compelling factors that have brought us again to consider comprehensive tax

¹ Mark A. Weinberger was Assistant Secretary for Tax Policy from 2001 to 2002. Eric Solomon was Assistant Secretary for Tax Policy from 2006 to 2009. We have both been asked to testify in our individual capacities. Our written and oral remarks are our own and do not necessarily represent the views of Ernst & Young LLP.

² The BRIC countries are Brazil, Russia, India and China.

reform. What we have seen is that the interest in comprehensive tax reform has intensified principally because of the:

- (1) **Evolving business and global landscape.** Our nation and the world have changed dramatically. The business environment is more complex and globally connected. The world economy is now more integrated and nations are more interdependent, with fundamental changes having occurred in industry composition, use of technology, and the role of emerging markets. Our tax laws have not kept up.
- (2) **Increasing global competitive pressures.** Growth in foreign markets, increased global competition for jobs and capital, and the rapidly changing economic and tax policies of our major trading partners compel us to improve the competitiveness of our tax laws.
- (3) **Expanding use of the Code.** Our tax system has been asked to do more and more over the years. New provisions are constantly added to the Code to address social and other policy issues and respond to economic circumstances. Moreover, as political perspectives have changed, tax legislative priorities have shifted frequently. The Code has grown enormously. Once added, new provisions are difficult to remove and add to complexity, which results in increased economic burden.
- (4) **Cumulative effect of changing budget and legislative processes.** Federal budget rules and legislative process changes have played a significant role in how tax policy has evolved over the years. The result has been increased use of temporary tax provisions, the phasing in and phasing out of tax laws and the increased use of revenue offsets. While the budget rules serve an important purpose, they have had the effect of adding to the complexity and instability of the Code.
- (5) **Worsening fiscal situation.** Our unprecedented fiscal deficits and national debt require us to comprehensively re-evaluate our spending and tax priorities. Since so many policy objectives are implemented through both spending and tax provisions, it will be difficult to address spending without considering taxation. Moreover, the large fiscal imbalance increases the need for an efficient and pro-growth tax system.

In the following sections of this testimony, we provide further discussion of our observations and conclusions.

1. Evolving business and global landscape

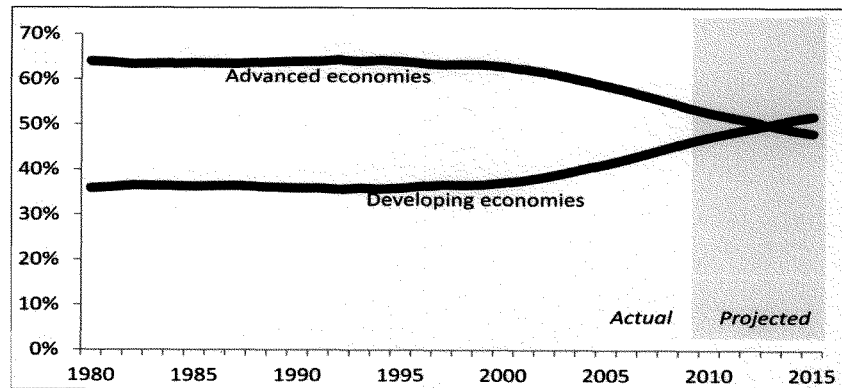
The world economy in 2011 is vastly different than it was several decades ago. The U.S. economy represents a smaller share of the world economy, in significant measure due to the rise of developing economies. In addition, the U.S. economy is increasingly integrated and interdependent with the economies of other nations. Both capital and labor have become increasingly mobile. The composition of the world economy has also changed. Traditional manufacturing has declined in relative size, while technology, services, financial innovation, and intangible assets have become more important. In light of all of these changes, it is necessary to re-examine the Code.

In the several decades following World War II, the United States was the largest exporter of capital. Now it is the largest importer of capital. These shifting capital flows have rebalanced

economic influence from West to East in a major way. Cross-border capital flows have also grown significantly, which has increased the interdependence of global capital markets.

The economic prominence of the United States has diminished in the past 50 years, with the U.S. share of world Gross Domestic Product ("GDP") falling from 38% in 1962 to 21% in 2007³. This reflects the more rapid growth in the developing world as compared to the more advanced economies (including the United States). As shown in Chart 1, the GDP of developing countries has grown from 37% of world GDP in 2000 to 47% in 2010 and is projected to be 52% of world GDP in 2015.

Chart 1. Shares of world GDP: advanced and developing economies, 1980-2015

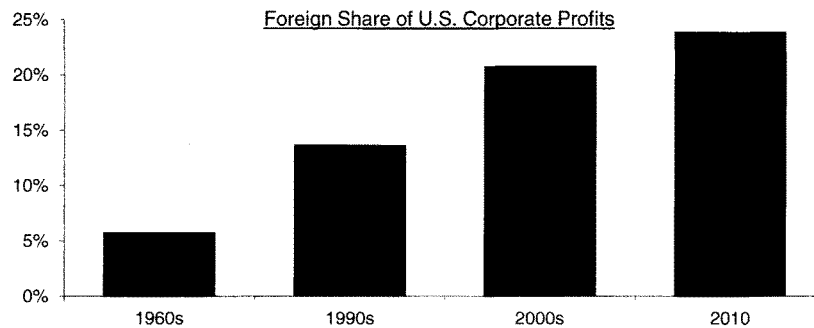


*Note: Projected estimates begin in 2009. GDP based on purchasing power parity (PPP).
Source: International Monetary Fund, World Economic Outlook, April 2010.*

³ The World Bank, *World Development Indicators*, December 15, 2010.

As shown in Chart 2 below, much of the potential for market growth now exists outside the United States, with foreign markets contributing to an increasing share of U.S. corporate profits. The foreign share of U.S. corporate profits has risen from just over 5% in the 1960s to nearly 25% in 2010.

Chart 2. Foreign markets are increasingly important to the growth and profits of U.S. companies



Sources: Bureau of Economic Analysis, *National Income and Products Account Table 6.16* (as of 2/23/2011); Ernst & Young LLP projection for 2010.

Companies from developing countries are also becoming more significant competitors for U.S.-based companies, with the number of Global Fortune 500 companies headquartered in BRIC countries increasing more than threefold in the past 10 years, from 16 in 2000 to 58 in 2009 (see Table 1).⁴

⁴ Barbara Angus, Tom Neubig, Eric Solomon and Mark Weinberger, "The U.S. International Tax System at a Crossroads," *Tax Notes*, April 5, 2010, p. 51.

Table 1. Shifting composition of the Fortune Global 500 companies

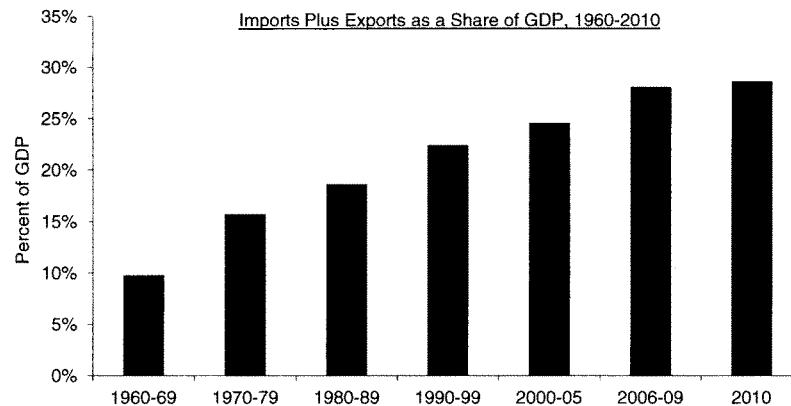
Country	Total Revenue (\$billions)	2000 Number of Companies	Percent of Companies	Total Revenue (\$billions)	2009 Number of Companies	Percent of Companies
United States	4,681	179	36%	7,544	140	28%
Japan	2,931	107	21%	2,980	68	14%
Germany	1,217	37	7%	2,259	39	8%
France	922	37	7%	2,166	40	8%
China	200	10	2%	1,661	37	7%
United Kingdom	765	38	8%	1,585	27	5%
Netherlands	391	10	2%	1,044	12	2%
Italy	264	10	2%	699	10	2%
Korea	242	12	2%	603	14	3%
Switzerland	293	11	2%	566	15	3%
Total Top 10	11,904	451	90%	21,106	402	80%
Other	792	49	10%	4,069	98	20%
Total Global 500	12,696	500	100%	25,175	500	100%
G-7 countries ¹	10,929	420	84%	17,613	338	68%
BRIC countries	291	16	3%	2,619	58	12%

Note: Totals may not add due to rounding.

¹The G-7 countries are Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

Sources: Fortune, Global 500; Ernst & Young LLP.

As a result of globalization, we have also seen an increasing interconnectedness of global economic fortunes. The success of U.S.-headquartered global companies abroad often depends on a local presence abroad. U.S. exports are often an important source of supply for U.S. companies operating abroad. As shown in Chart 3, the U.S. economy is increasingly globally integrated, with exports and imports now representing nearly 30% of total U.S. GDP. This reflects both the globalization of U.S. production (exports) and consumption (imports). New consumer markets are opening as a new economic middle class emerges in many countries, causing companies to adopt more complex and efficient supply chains.

Chart 3. The U.S. economy has become increasingly open over time

Source: U.S. Department of Commerce, Bureau of Economic Analysis, NIPA accounts.

Another change in the global economy over the past several decades is the type of economic activity taking place globally. Although manufacturing is still a vital part of the economy, an increasing share of world economic activity and growth is in services and intangible assets.

Technology has contributed to the significant growth of global markets and the higher productivity that underlies rising living standards around the world. The United States has traditionally led in the development of new technologies and the resulting new products and services. For example, U.S.-headquartered companies have led in the information technology ("IT") advances that have been critical to the development of businesses in all industry sectors around the world. Today, companies from emerging market countries such as India and China are beginning to play a growing role in the IT sector. The changes in technology pose substantial challenges for tax administration and enforcement in a world where products can be moved around the world with a mouse click and the migration of intangibles is becoming increasingly commonplace.

Likewise, research and development (R&D) has been critical to the success of U.S.-headquartered global companies. R&D will be even more critical in the future in the increasingly global marketplace. Patents, copyrights, brand names, new business processes, and other R&D expenditures are all growing in importance. The value of intangible assets was only 62% of the value of fixed assets (equipment and buildings) in the 1960s.

By 2003, that percentage had risen to 136%. Today, much of a company's value can come from its people, ideas, processes, and other intangible assets.

The development of intangible assets is more and more a global effort, with global companies having multiple research centers and a growing number of cross-border joint ventures. The rise

of services and technology has meant that the flow of capital has become more mobile as well. Capital is no longer just foreign direct investment in bricks and people. It increasingly consists of investment in intangible assets, including ideas in the form of patents, copyrights, trademarks, and R&D. These changes have put new and increasing pressures on our current tax system, which is largely unequipped to deal with these developments.

Finally, globalization also leads to more complex business structures. Companies commonly have dozens of affiliates or subsidiaries, as well as global supply chains. As business relationships and transactions have become more complex, governments around the world need to deal with similar complexities.

In sum, as a result of dynamic changes in the global economy and business structures, it is becoming harder to apply our existing tax laws in a way that can accurately identify and measure the source of profits, including income from intangibles. Moreover, while governments remain national, businesses are increasingly global. The interaction of all the tax laws and regulations, including their inconsistencies and complexities, has led to an increased amount of time spent by businesses on tax planning (to avoid double taxation and minimize liabilities) and compliance.

Moreover, globalization has integrated the world economy in fundamental ways. It is now important to assess economic and tax developments around the world, and to consider U.S. tax policy in light of those developments. While several decades ago the United States could be more inward-looking and focus on tax policy in isolation, the rise of developing economies and new growth markets now requires the United States to view tax policy in a more integrated manner.

We can no longer view U.S. tax policy in a vacuum. Our tax system needs to adapt to the changing role of the United States in the world economy.

2. Increasing global competitive pressures

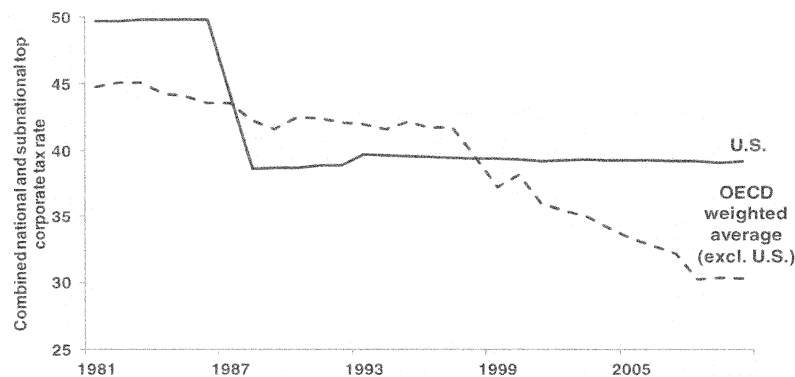
The U.S. business tax system has been slow to respond to this changing global landscape. While the Code has grown in size and complexity, structurally it has largely remained unchanged for the past several decades. In contrast, other nations have more readily adapted to the changing global economy. Other developed nations have lowered their corporate tax rates, sometimes dramatically, and have also shifted their systems for taxing foreign source income towards territorial tax systems. While the rest of the world seems to be moving in a generally consistent direction, the U.S. tax laws are increasingly out of step.

At the beginning of the 1980s, the United States had a statutory corporate income tax rate slightly above the OECD average (see Chart 4). When the U.S. federal statutory corporate income tax rate was reduced from 46% to 34% under the 1986 Act, the United States instantly became a low tax rate country relative to its major trading partners. Since 1986, however, our major trading partners have been reducing their statutory corporate income tax rates below that of the United States. Today, the United States has a 39.2% combined federal-state statutory corporate income tax rate, significantly above the average 25.2% rate within the OECD (or 31.1% when weighted by GDP).

Of the 34 OECD nations, 30 have lowered their statutory corporate income tax rates since 2000. China lowered its statutory corporate tax rate on foreign companies from 33% to 25% in 2008 to further encourage foreign investment, even though many companies were already increasing their investments in China to capitalize on its rapid economic growth.⁵

Moreover, countries continue to lower their corporate tax rates. The United Kingdom is expected to lower its corporate tax rate to 24% by 2015, and Japan is expected to lower its corporate tax rate effective this April. In 2011, Canada has also lowered its corporate tax rate.⁶ A critical aspect of these changes, and the lack of change in the United States, is their effect on U.S. jobs and the real wages of U.S. workers. There is an increasing amount of economic research that draws on the experience abroad, and at the state level within the United States, that finds that workers bear a substantial portion of corporate income taxes. That is, this research suggests that if corporate income taxes were lower, their wages would be higher.⁷

Chart 4. Average OECD member country corporate tax rate, 1981-2010



Note: Average weighted by exchange rate adjusted nominal GDP.
Source: Organization for Economic Co-operation and Development, 2010.

⁵ [Explanation of the Draft Enterprise Income Tax Law](http://www.npc.gov.cn/englishnpc/Speeches/2007-03/08/content_360344.htm), March 8, 2007. National People's Congress of the People's Republic of China. Accessed: Feb 23, 2011, <http://www.npc.gov.cn/englishnpc/Speeches/2007-03/08/content_360344.htm>.

⁶ Canada lowered its corporate tax rate from 30.5% to 28.5% effective January 1, 2011. This rate will be further lowered to 26.0% effective January 1, 2012.

⁷ For example, one recent paper finds that labor bears between 45% and 75% of the corporate income tax. Mihir A. Desai, C. Fritz Foley, and James R. Hines, Jr., "Labor and Capital Shares of the Corporate Tax Burden: International Evidence," *International Tax Policy Forum*, December 2007. Other recent research finding a link between corporate income taxes and wages includes Arulampalam, Wiji, Michael P. Devereux, and Georgia Maffin, (2008). "The Direct Incidence of Corporate Income Taxes on Wages," Oxford University Centre for Business Taxation, WP, May 7, 2007; Robert Carroll and Gerald Prante, "Corporate Income Taxes and Wages: Evidence from the 50 States," Tax Foundation Working Paper No. 8, August 2009; Alison R. Felix, "Do State Corporate Income Taxes Reduce Wages," *Federal Reserve Bank of Kansas City Economic Review*, Second Quarter 2009; and Kevin Hassett and Aparna Mathur, "Spacial Tax Competition and Domestic Wages," American Enterprise Institute for Public Policy Research, December 2010.

The point is often made that the U.S. statutory corporate income tax rate is not the right measure for comparing the United States to other nations because it does not reflect differences in the tax base. The same trends, however, are reflected in other metrics for comparing corporate income taxes. In several recent studies the effective marginal tax rates on new investment are found to be higher in the United States than in the member nations of the OECD.⁸ In another study on effective tax rates based on financial statement data, the United States had an effective tax rate that was the second highest among the 15 countries analyzed, exceeded only by Japan.⁹

Moreover, the statutory corporate tax rate is the relevant tax rate for a number of important business decisions. High statutory tax rates encourage the location of income and investment in low tax rate locations and encourage the use of debt to finance business operations. Higher statutory tax rates encourage increased tax planning to lower the tax cost faced by businesses.¹⁰

Not only is the U.S. statutory corporate income tax rate relatively high, but the U.S. system of taxing international income still reflects the world as it existed in 1962, when many of the important U.S. international tax rules were enacted.¹¹ In contrast, most developed countries have moved, by varying degrees, away from worldwide taxation of active foreign income to territorial tax systems, whereby companies are not subject to domestic tax on their active foreign business income (see Table 2 below).¹² At the beginning of 2009, there were three major exceptions—the United States, the United Kingdom, and Japan. However, since then, both the United Kingdom and Japan have moved to a territorial tax system. With an increasing percentage of every global company's revenue coming from overseas markets, the taxation of their foreign earnings becomes more important. Now, the United States is the only OECD country with a corporate tax rate above 25% and a worldwide tax system.

⁸ Effective marginal tax rates measure the taxes paid on the last dollar of new investment and take into account statutory rates plus features of the tax code that affect the taxes paid on new investment such as depreciation deductions, inventory allowances, and interest deductions. See Duanjie Chen and Jack Mintz, "Taxing Business Investments: A New Ranking of Effective Tax Rates on Capital," World Bank, July 2008.

⁹ See Kevin S. Markle and Douglas A. Shackelford, "Cross-Country Comparisons of Corporate Income Taxes," University of North Carolina, Working Paper, February 2011.

¹⁰ Testimony by Rosanne Altshuler before the Senate Committee on the Budget, "Tax Reform: A Necessary Component for Restoring Fiscal Responsibility," February 2, 2011, p. 6.

¹¹ For further discussion of international tax reform, see Barbara Angus, Tom Neubig, Eric Solomon and Mark Weinberger, "The U.S. International Tax System at a Crossroads," *Tax Notes*, April 5, 2010.

¹² Most of the territorial tax systems of U.S. trading partners are dividend exemption systems under which dividends from foreign subsidiaries, and in some cases income from foreign branches, are completely or largely exempt from domestic tax. However, other categories of foreign source income, such as interest, royalties, and export sales income, may be subject to domestic tax.

Table 2. Comparing taxation of foreign source income

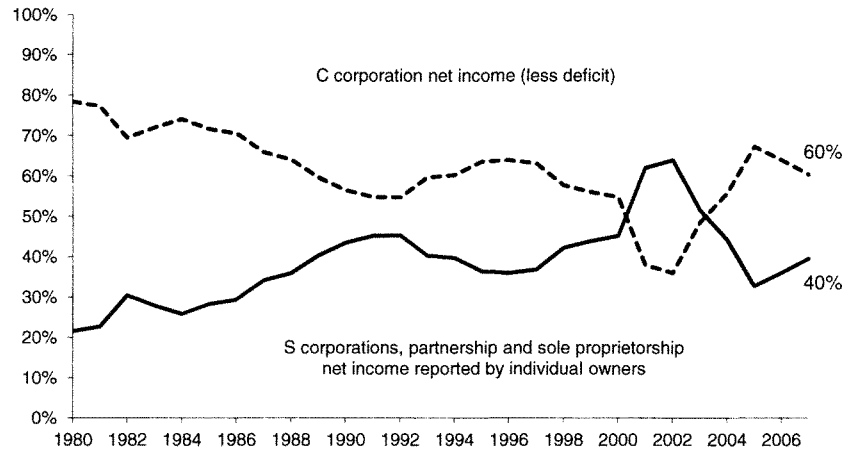
Top 10 countries with most <i>Fortune</i> global headquarters	2011 statutory corporate tax rate ^a	Taxation of foreign-source income
Countries with worldwide tax regimes		
United States	39.1%	Worldwide with deferral and foreign tax credit
China	25.0%	Worldwide with deferral and foreign tax credit
Korea	24.2%	Worldwide with deferral and foreign tax credit
Countries with exemption tax regimes		
Japan	35.7%	95% dividend exemption enacted in 2009
France	34.4%	95% dividend and branch exemption
Germany	33.0%	95% dividend exemption
Italy	31.4%	95% dividend exemption
United Kingdom	27.0%	100% dividend exemption enacted in 2009
Netherlands	25.5%	100% dividend and branch exemption
Switzerland	21.2%	100% dividend and branch exemption

a: Includes both national and sub-national statutory corporate tax rates. Japan's proposed change in tax rate from 40.7% to 35.7% would become effective April 2011.

Sources: Fortune Global 500; Ernst & Young LLP.

Another important development in business taxation is that an increasing percentage of U.S. business income is not taxed at the corporate level. A substantial portion of business activity in the United States is increasingly conducted by pass-through entities (e.g., S corporations, partnerships and limited liability companies) and sole proprietorships. As Chart 5 demonstrates, the share of business income earned by pass-through entities and sole proprietorships has increased substantially. In recent years, these businesses reported 60% of business net income and one-third of business receipts. The United States has the second largest non-corporate sector among the OECD countries, exceeded only by Mexico.

Pass-through entities earn a large percentage of the business income in the United States for many reasons, but tax policy is one of the most important. The double taxation of corporate earnings, once when earned by the corporation and then again when distributed to individual shareholders, is a principal consideration when individuals choose to establish a business. The elimination of a second level of taxation on business income reduces the taxation on capital and therefore leads to increased investment. As tax reform progresses, and the taxation of business income is analyzed, it will be important to recognize the large percentage of businesses that are pass-throughs and sole proprietorships and any potential consequences proposed reforms may have on them.

Chart 5. U.S. pass-through and C corporation shares of business income, 1980-2007

Sources: Internal Revenue Service, *Statistics of Income, Corporate Source Book and Individual Tax Returns* (publication 1304), various years.

In sum, the goal for U.S. policymakers should be to ensure that the tax laws contribute to the success of U.S. businesses operating in the global economy, which will contribute to the diversity and growth of the U.S. economy and the well-being of the American people.

The U.S. business tax system is not the only factor that influences the location of income and investment. Many other factors, such as an educated work force, regulatory oversight, infrastructure, secure property rights and a well functioning legal system are also important factors. However, as other nations become more developed, these other factors are becoming less of an advantage for the United States. This means that differences in business taxes are becoming even more important.

3. Expanding use of the Code

The primary purpose of a tax system is to raise adequate revenue to support the government's needs. In collecting that revenue, there are basic objectives that policymakers have identified that our tax system should achieve: fairness, pro-growth and simplicity. When there are political shifts in the country, the priorities in these objectives often shift as well. The budget proposals of various Administrations illustrate the differing priorities that have been proposed, considered and sometimes adopted. For example, there is a significant difference in priorities between the last Bush Administration budget proposal in 2008 and the first Obama Administration budget proposal in 2009 (see Appendix 1).

At the outset, we note that these objectives are sometimes inconsistent and not complementary. For example, although various individual preferences have a purpose to achieve fairness, they often complicate rather than simplify the Code. Examples that come to mind include the Earned Income Tax Credit, refundable credits, phasing out of tax benefits for upper income individuals and the individual alternative minimum tax (“AMT”).

A consistent theme has been the increasing use of the Code to address non-tax policy issues. For example, the Code is used to encourage certain activities that the Congress and the American people view as important — home ownership, charitable giving, savings, education, investment and innovation, green initiatives, and health care, to mention some of the more prominent areas. Once enacted, these provisions are difficult to narrow or remove from the Code. Industries develop and constituencies grow from the tax benefits provided, often seeking to modify or expand them.

The Code has also increasingly been used to address broader economic circumstances beyond social policies. For example, in 2002 and 2003 Congress enacted many provisions to stimulate economic activity because of the downturn, which was caused in part by the 9/11 tragedies. In addition, Congress enacted stimulus bills with tax provisions to assist in the recovery after the recent financial crisis.¹³ In order to respond to other circumstances, such as natural disasters, Congress has often turned to the Code to provide relief and assistance.¹⁴

Since 1986, numerous tax laws have been enacted in every session of Congress, adding hundreds of new provisions to the Code (see Appendix 2). According to figures cited by the National Taxpayer Advocate, there have been more than 4,400 changes to the tax code over the past 10 years — an average of more than one a day — and an estimated 579 changes in 2010 alone.¹⁵

Tax laws enacted since 1986 have served a variety of policy goals, including, for example:

Deficit reduction: Omnibus Budget Reconciliation Act of 1993; Balanced Budget Act of 1997; Deficit Reduction Act of 2005

Disaster relief: Victims of Terrorism Tax Relief Act of 2001; Katrina Emergency Tax Relief Act of 2005; Gulf Opportunity Zone Act of 2005; James Zadroga 9/11 Health and Compensation Act of 2010

Economic growth: Taxpayer Relief Act of 1997; Economic Growth and Tax Relief Reconciliation Act of 2001; Job Creation and Worker Assistance Act of 2002; Jobs and Growth Tax Relief Reconciliation Act of 2003; Working Families Tax Relief Act of 2004; Economic Stimulus Act of 2008; American Recovery and Reinvestment Act of 2009; Hiring Incentives to Restore Employment Act; Small Business Jobs Act of 2010

Energy incentives: Energy Policy Act of 1992; Energy Tax Incentives Act of 2005

¹³ Economic Stimulus Act of 2008 (Pub. Law 110-185); American Recovery and Reinvestment Tax Act of 2009 (Pub. Law 111-5); and Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (Pub. Law 111-312).

¹⁴ Disaster Relief and Emergency Assistance Amendments of 1988 (Pub. Law 100-707); Katrina Emergency Tax Relief Act of 2005 (Pub. Law 109-73); Haiti Economic Lift Program Act of 2010 (Pub. Law 111-171).

¹⁵ National Taxpayer Advocate's 2010 Annual Report to Congress, December 31, 2010.

Health: Health Insurance Portability and Accountability Act of 1996; Children's Health Insurance Program Reauthorization Act of 2009; Patient Protection and Affordable Care Act

Response to WTO trade challenge: American Jobs Creation Act of 2004

Retirement savings: Pension Protection Act of 2006

The accumulation of tax law changes over time has created a disjointed Code. Despite the good intentions underlying the provisions, they result in substantial complexity and are difficult for taxpayers to use and for the Internal Revenue Service (the "IRS") to administer. Some provisions are duplicative and have overlapping objectives. For example, there are a dozen different tax preferences for education, with different eligibility criteria and different benefits.¹⁶ In addition, the Code contains numerous tax-preferred savings vehicles.¹⁷ While the value of a good education and saving for retirement is well understood in this country, how to take advantage of the tax incentives is difficult for taxpayers because of the confusing array of provisions.

The Code also contains provisions that have operated in ways not originally envisioned. The AMT was first enacted in 1969 to ensure that a small group of high-income individuals would pay at least a minimum amount of tax. Because the AMT exemption is not indexed, and because certain itemized deductions are not allowed in computing the AMT, more and more middle-income Americans are potentially subject to this tax. Periodically, the Congress has to "patch" the AMT to keep the number of Americans subject to the AMT from rising dramatically.

The primary reason that the Code has become the vehicle of choice for social and economic policy changes is that, as our fiscal situation has worsened and pressure has been applied to limit new spending initiatives, the Code has become an alternative means to achieve those policy objectives. While there is significantly increased scrutiny placed on new spending programs, and they have come to represent "bigger government," tax incentives and preferences are somewhat less visible. A targeted tax reduction is, however, as much a decision by government to allocate resources to a specific priority or initiative as a direct spending measure. Either one will require less spending elsewhere in the federal budget, or higher taxes, to compensate for that decision. Politically, however, it has become much easier to provide that benefit through the Code than through direct spending.

Moreover, as previously mentioned, it is difficult to remove tax incentives from the Code. All changes to the tax system are compared with the status quo. If there is an identifiable benefit a particular constituency risks losing, the constituency will alert policymakers. Since the provision was put in the Code for persuasive reasons when enacted, the arguments to retain the provision will likely be successful. Furthermore, the benefits to the overall tax system of eliminating provisions are not easily quantifiable. The message of higher growth attributable to lower fiscal burdens and a more pro-growth tax system is much harder to quantify and explain than the detriment to a particular constituency of losing an existing tax preference.

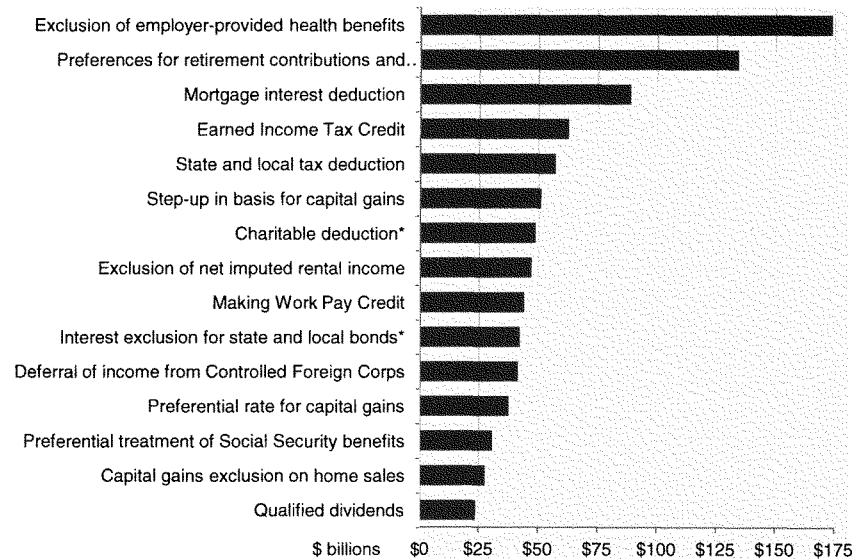
What is important to recognize, however, is that when considering comprehensive tax reform, such as broadening the tax base and lowering marginal tax rates, the type of tax provisions that will be under consideration are not "loopholes". The major tax expenditures are tax provisions

¹⁶ Congressional Research Service, *An Overview of Tax Benefits for Higher Education Expenses*, January 3, 2005.

¹⁷ National Taxpayer Advocate's 2008 Annual Report to Congress, December 31, 2008.

that for the most part have been in the Code a long time, and were carefully debated and added to the Code to achieve specific policy objectives, as discussed above (see Chart 6). When modifying or reducing either tax preferences or direct spending, lawmakers must consider the underlying social policy or economic policy the provision was meant to promote.

Chart 6. OMB Largest Tax Expenditures, Fiscal Year 2011



* Denotes that tax expenditure includes both corporate and individual tax expenditure components.
 Note: Estimates were based on current law prior to December 2010 tax act.
 Source: Estimates of Federal Tax Expenditures for Fiscal Years 2012-2016, Analytical Perspectives.

4. Cumulative effect of changing budget and legislative processes

Federal budget rules and procedures, as well as the tax legislative process, have played significant roles in the development of tax policy. The result has been the increased use of temporary tax provisions, the phasing in and phasing out of tax laws, enactment of tax laws with limited legislative history, and an increase in tax proposals being based more on the need for revenue “offsets,” rather than emanating from tax policy principles.

Influence of federal budget rules and procedures on tax policy

As the federal government has struggled to control public spending and budget deficits over the years, Congress has established restrictive budget rules and procedures. The budget rules are

derived from both statutory laws and procedural rules of Congress. They include the Congressional Budget and Impoundment Control Act of 1974 (the “Budget Act”),¹⁸ the Balanced Budget and Emergency Deficit Control Act of 1985 (Gramm-Rudman-Hollings)¹⁹ legislation, the Budget Enforcement Act of 1990,²⁰ the Statutory Pay-As-You-Go Act of 2010 (the “Statutory PAYGO Act”),²¹ the “Byrd rule” in the Senate, the budget resolution and budget reconciliation processes, and various forms of pay-as-you-go (“PAYGO”) procedural rules in the House and Senate.

Since the Budget Act, the federal budget rules have undergone a series of changes. A key element of this regime has been the establishment of a budget window, the time period over which estimated revenue effects of legislation are evaluated. Over the years, the length of the budget window has varied between five and ten years. A provision that expires before the end of such a multi-year window is said to sunset.

The Budget Act establishes a budget process with detailed instructions and timelines. It provides for the drafting of an annual budget resolution, which, if agreed to by the House and Senate, serves as the blueprint for fiscal policy and establishes a framework for consideration of spending and revenue bills for the year. Part of the budget resolution contains budget enforcement language. Because a budget resolution is basically an in-house document, it can include new rules for the House or Senate (or both) to follow in the budget process. A prime example of this is the PAYGO rule. PAYGO refers to the requirement that all increases in direct spending or tax cuts be fully offset with new tax increases or entitlement spending cuts. PAYGO was not part of the original Budget Act. It passed as part of a budget resolution in the early 1990s. It expired in 2002 and then was reinstated in 2007 by the 110th Congress. In February of 2010, President Obama signed the Statutory PAYGO Act, the purpose of which was to reestablish a statutory mechanism to require revenue and direct spending legislation considered during a Congressional session to be budget neutral.

While budget resolutions establish enforceable revenue targets and spending limits, they can also make allowances for the possible consideration of deficit neutral legislation on a certain subject without violating those budget limits.

The budget reconciliation process is a process where committees are directed in the budget resolution to make changes to laws to achieve spending and revenue targets provided for in the budget resolution. The reconciliation process provides for limitations on the time for consideration of reconciliation measures on the Senate floor.

Most important from a legislative strategy perspective is the fact that reconciliation bills require only a simple majority vote in the Senate for passage, where most other legislation can be subject to a 60-vote hurdle. Importantly, however, 60 votes are required to waive violations of the Byrd rule (named for the rule’s author, the late Senator Robert C. Byrd), which requires, among other things, that any spending or revenue bills not increase budget deficits for periods outside the budget window, which is usually a ten-year period. The Byrd rule also imposes a 60-vote hurdle on provisions that do not produce a change in outlays or revenues.

¹⁸ The Congressional Budget and Impoundment Control Act of 1974, Pub. Law 93-344.

¹⁹ The Balanced Budget and Emergency Deficit Control Act of 1985, Pub. Law 99-177.

²⁰ Pub. Law 101-508.

²¹ The Statutory Pay-As-You-Go Act of 2010, Pub. Law 111-139.

The budget reconciliation process was established to facilitate consideration of deficit reduction measures in Congress, and particularly in the Senate. As a result of a Senate parliamentary ruling in the mid-1990s, the process began to be used as a means to pass other legislation, including major tax cuts.

The federal budget rules, along with political compromise, played a major role in the development and ultimate enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). In the spring of 2001, President Bush released his tax proposals which called for reducing individual income tax rates, eliminating the estate tax, making the R&D credit permanent, doubling the child credit, reducing the marriage penalty, and making other significant changes to the Code. The tax provisions were proposed to be permanent.

Due in large part to the difficulty in navigating the tax proposals through a closely divided Senate, Congress considered the tax bill as part of the budget reconciliation process, discussed above. In the Senate, the tax bill had the support of most Republican Senators, as well as some Democratic Senators. However, the tax bill did not have the support of 60 Senators. This influenced the bill, since any Senator could raise a point of order under the Byrd rule that the bill had the effect of increasing the federal deficit beyond the ten-year budget window. If such a point of order was raised, and a motion to waive the point of order failed to get 60 votes, the entire bill would fail. Accordingly, in large part to avoid the point of order, all tax provisions in the bill were set to sunset at the end of the budget window. Moreover, many provisions were phased in or had delayed effective dates in order to prevent points of order from being raised.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRA) was also significantly affected by the federal budget rules. JGTRA was evaluated over the budget window 2003-2013. The bill included additional marriage penalty relief, increased Section 179 expensing, and reduced taxation of capital gains and dividends, all of which were scheduled to expire by design in later years. The scheduled expiration of these provisions was not a result of tax policy considerations, but rather resulted from the application of the budget rules. While sunsets may reflect rational behavior on the part of lawmakers seeking to work around the existing budget restrictions and procedures, they have contributed uncertainty that is difficult to reconcile with tax reform's usual objectives of raising revenue as simply and efficiently as possible.

Some tax bills have effective dates that exist only to meet revenue targets established by the budget rules. For instance, bills such as the Small Business and Work Opportunity Tax Act of 2007²² that contain provisions to increase or move estimated tax payment dates for corporations, or bills such as the Hiring Incentives to Restore Employment Act of 2010²³ that delay the effective date of provisions (e.g., the worldwide interest allocation rules), are enacted to meet revenue targets rather than to achieve a tax policy goal.

The Code also contains an ever-increasing number of provisions that are temporary, in part because of the significance of the estimated cost of making them permanent, or because it would be difficult for Congress to agree on politically viable offsets to meet the various PAYGO rules. These include many business and individual provisions such as the R&D tax credit, the state and local sales tax deduction, and the exception to the Code's Subpart F rules for active financing

²² Pub. Law 110-28.

²³ Pub. Law 111-147.

income. This results in significant uncertainty for those taxpayers who rely on these provisions, including uncertainty in financial reporting for businesses.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010²⁴ (signed into law in December 2010) retroactively extended a number of provisions as of January 1, 2010, resulting in businesses having in some cases to record the entire financial benefit of provisions in the quarter the law was enacted, as opposed to ratably throughout the year. The bill also included the extension of individual provisions, including the 2001/2003 tax relief through 2012, as well as an extension of the AMT patch through 2011, among its dozens of temporary provisions. The scores of business and individual tax provisions that are temporary in nature, with no guarantee of being extended, contribute to enormous uncertainty for businesses and individuals alike.

With these temporary provisions in the Code, there is no permanent set of rules governing the tax consequences associated with wages and salaries, capital gains, dividends, and payroll taxes, as well as numerous targeted tax provisions assisting families, workers, and businesses. Temporary provisions add complexity and uncertainty to the Code, requiring lawmakers to spend a significant amount of time annually or biannually in the process of considering legislation related to extending them. Moreover, individuals and businesses do not have stable tax rules that they can rely upon for future income tax and estate planning.

Finally, as a result of these budget rules and processes, many permanent tax increases have been enacted to pay for temporary tax provisions. For instance, in the Tax Relief Extension Act of 1999,²⁵ the repeal of the installment method for most accrual basis taxpayers and changes to the tax treatment of derivatives were used to pay for a temporary extension of certain expiring provisions, including the R&D credit.

Influence of tax legislative process on tax policy

The tax legislative process has also changed significantly since 1986. There have been changes in the number and depth of Committee and Subcommittee hearings, mark-ups and other deliberations on proposed tax legislation. There has also been a reduction in Senate Finance and House Ways and Means committee reports detailing the intent of policymakers with regard to tax legislation. The staff of the Joint Committee on Taxation and the staffs of the Senate Finance Committee and House Ways and Means Committee include technical experts who are well versed in tax policy and tax technical issues. The Committee Reports they write provide valuable insights into the thinking of policymakers in passing legislation and explain the issues surrounding the changes in law.

Because of the size and complexity of the Code and the number of legislative changes requiring significant administrative guidance, it is difficult for the Treasury Department to keep pace in issuing enough administrative guidance to interpret and help implement new provisions. Many provisions of the Code, therefore, currently lack guidance years after enactment. Moreover, the increasing burdens placed on the IRS to administer complicated provisions in non-tax areas, as well as administer other increasingly complicated rules, has placed a significant burden on IRS resources.

²⁴ Pub. Law 111-312.

²⁵ Pub. Law 106-170.

While citing these changes, we recognize the recent announcement by Chairman Baucus to return to Committee hearings and Committee mark-ups as a regular practice, as well as his notification to the Finance Committee that tax legislation will not proceed under Rule 14, which allows legislation to go directly to the Senate floor without going through the Committee.

Another recent tax legislative process phenomenon is the enactment of tax provisions as offsets to the cost of spending programs as those spending bills move through the Congress. Last year, for example, a set of international tax increases, including the “foreign tax splitter” provision, were enacted as part of a non-tax bill to fund education and Medicare items.²⁶ The fact that these tax provisions were used as part of a spending bill to fund Federal Medicare Assistance and other government spending (and not tax relief) was unexpected. Moreover, without opportunity for public comment on the statutory language, the foreign tax credit splitter provision was drafted in a way that left substantial uncertainty about the scope of the provision, with much being left to IRS interpretation. Although the IRS issued guidance that narrowed the scope for pre-2011 years, uncertainty still exists about its scope for 2011 and thereafter.

Another example is the expansion of the Form 1099 reporting requirement in last year’s health care legislation. Less than a year later, a proposal to repeal the requirement before it takes effect has bipartisan support. Policymakers desiring to address the tax gap may not have fully appreciated the burdens the provision would impose.

Taken together the federal budget rules and procedures, as well as the changed tax legislative process, have significantly influenced the Code over the years in a manner not always consistent with sound tax policy.

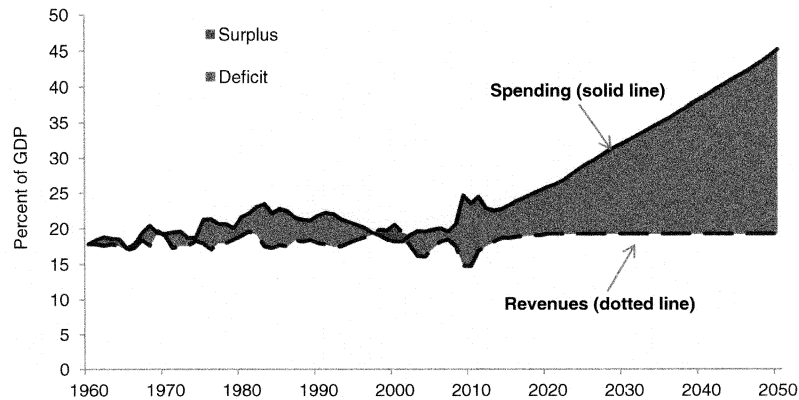
5. Worsening fiscal situation

We are all aware of the fiscal challenges our nation faces. In part as a result of the recent financial crisis, we have a large budget deficit in the near-term — 9% to 10% of GDP. With all of the recent attention on this topic in this body, the Congress at large and across the U.S., we don’t intend to cover this topic in depth here. That being said, there are important points worth noting.

Over the longer term, the fiscal condition will worsen due to the rise in entitlement spending, primarily Medicare, Medicaid and, to some extent, Social Security (see Chart 7). The longer-term problem is fundamentally caused by the aging of the U.S. population and the rapid growth in health care costs.

To address our fiscal situation, policymakers are debating about how to manage discretionary and mandatory spending. At the same time, policymakers are considering the amount of revenues needed by our government and the features of the tax system itself. This attention to both the spending and the revenue sides of the ledger has contributed to the increased focus on tax reform.

²⁶ Legislation commonly referred to as the Education Jobs and Medicaid Assistance Act (“EJMAA”), enacted on August 10, 2010 (Pub.Law 111-226).

Chart 7. Federal government spending and revenues as a percentage of GDP

Note: Projections are for the CBO's alternative fiscal scenario. Actual Treasury data are shown for FY2010.
 Sources: Congressional Budget Office, "The Long-Term Budget Outlook" (June 2010 – for projected data); Department of the Treasury, Monthly Treasury Statement (September 2010 – for FY2010 revenue and deficit only); Office of Management and Budget, Historical Tables of the "President's Proposed Budget for FY2012" (February 2011 – for historical data).

The President's Fiscal Responsibility Commission last year detailed the deteriorating fiscal situation and proposed an illustrative set of reforms.²⁷ Its proposal would "bend the cost curve" for the major entitlement programs in ways that would slow the growth in spending and put it on a more sustainable path. At the same time, its proposals would reform the Code and raise more revenue. While the historical relationship of revenues to the size of the economy has averaged roughly 18% over the post-World War II period, the proposal put forward by the Commission would increase federal revenues to 21% of GDP. At the same time, spending would be lowered to 23% of GDP. The Commission's plan is intended to put the nation back on a fiscally sustainable path. The plan is illustrative of the difficult choices that our country will need to make in trying to balance the need to both reform the Code and address the nation's long-term fiscal imbalance.

Another reason tax reform is being discussed in the context of deficit reduction is because a substantial amount of preferences are provided through the Code. Consideration of changes in federal government spending and changes to specific spending programs should take into account the more than \$1 trillion in preferences provided through the Code annually.

One aspect of tax reform to keep in mind is that although these special provisions may be well-intentioned, together they substantially reduce the size of the tax base, by roughly 50% in some estimates,²⁸ and require higher tax rates to raise a given amount of revenue. The tradeoff between

²⁷ National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, December 1, 2010.

²⁸ Report of the President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, November 2005, p. 23.

tax rates and the breadth of the tax base also affects the revenue efficiency of the tax system because higher tax rates can reduce the size of the tax base through the distorting effect they have on household and business decisions.²⁹ Lowering tax rates can reduce the distorting effects of the tax system.

Another feature of the Code that affects revenue efficiency is information reporting and other measures to address the tax gap. Generally, more information reporting translates into improved compliance. However, this can be a double-edged sword. More information reporting to increase the compliance rate can also mean larger compliance burdens for taxpayers. Thus, a delicate balance needs to be struck between the information gathered by the IRS for enforcement and compliance and the additional burden imposed on taxpayers by additional reporting requirements.

Conclusion

The fundamental elements of our current tax system are the product of events and vigorous debate that have taken place over a long period of time. The Code has been augmented, patched, clarified, and otherwise tweaked. It has been amended to provide additional incentives, to address inequities and unintended consequences, or simply to raise revenue. As a result, the system has developed into an overly complicated set of rules that has evolved largely without sufficient analysis or debate regarding the long-term competitive effect or alignment with worldwide tax policy trends. This observation is not intended as a criticism of the process, but merely a recognition of the practical and political realities.

Throughout the evolution of our tax system, the way the world does business has been changing at an extraordinary pace. New industries have been created. New markets have opened. The flow of capital has shifted. New economic powers have arisen. These developments are transforming the landscape for business in the United States and around the world. As a result, U.S. tax policy decisions which have historically been made without great concern about what has been happening beyond our borders, can no longer be made in a vacuum.

Recently, the principal discussion of tax reform has been about the corporate tax system. Corporate tax reform has significant ramifications for U.S. businesses, American workers and the U.S. economy that must be fully debated and understood. Increasingly it is being recognized that with such a large percentage of U.S. business income being earned by flow-through entities and sole proprietorships, that the tax reform debate cannot be limited to corporate taxes.

We believe that tax reform needs to take account of the changing way American businesses operate and the impact foreign competition increasingly plays in their success here and abroad. One thing taxpayers and policymakers of both political parties can agree on is that tax laws should not disadvantage American workers, businesses or consumers.

As we embark on the tax reform debate, it is important that the discussion not be overtaken by rhetoric. Some may suggest that the current preferences are "loopholes." They are by and large not loopholes. To meaningfully reduce statutory tax rates without significant budget consequences, it would require addressing preferences that have been included in the Code with

²⁹ For example, see Robert Carroll and Warren Hrgun, "What Does the Taxable Income Elasticity Say About Dynamic Responses to Tax Changes?" *American Economic Review*, 95(2), 2005, pp. 426–431.

deliberation and intention. They are some of the primary instruments we use to influence social and economic policy — including, for example, education, savings, income redistribution and investment in certain areas or industries.

Our unprecedented fiscal deficits and national debt require us to comprehensively re-evaluate our spending and tax priorities. We must not ignore that. Since so many policy objectives are implemented through both spending and tax policies, each should be considered in conjunction with each other. The imperative of attaining a more pro-growth and efficient tax system is even greater in the face of our long-term fiscal situation.

Finally, we would like to commend the Chairman for the approach he has laid out for addressing comprehensive tax reform in this Committee. The thorough process you have laid out — to assess current state, consider changes, involve stakeholders, and then proceed with comprehensive reform — is the appropriate approach to construct tax policy. Over the years, the budget and legislative processes have played significant roles in how tax policy has evolved. They undoubtedly will play a role here. The tax reform process will need to be navigated and well orchestrated in order to ensure that the end result is a stable, long-term reform that can respond to the changed environment and withstand the test of time.

Warren Buffett recently said in his annual shareholder letter, “The prophets of doom have overlooked the all important factor that is certain ... human potential is far from exhausted, and the American system for unleashing that potential — a system that has worked wonders for over two centuries ... remains alive and effective.” Our tax system has been with us since the early 1900s. It was reformed in the early 1900s, 1954, 1969, early 1980s, and most recently 1986 — 25 years ago. It is time to reexamine and update it again, with an eye to unleash the potential of American workers and businesses.

Appendix 1**Selected Comparison of Bush and Obama Administrations'
Budget Revenue Proposals****General Explanation of the Administration's FY 2009 Revenue Proposals (02/01/2008)**

In 2008, the tax provisions in the last budget proposal submitted by the Bush Administration contained the following proposals:

- make the 2001/2003 tax relief permanent
- simplify and encourage savings (e.g., expand tax-free savings opportunities, and consolidate employer-based savings accounts)
- encourage entrepreneurship and investment (e.g., increase expensing for small business)
- invest in health care (e.g., a new standard deduction for health insurance, expand and make health savings accounts (HSAs) more flexible)
- provide incentives for charitable giving (e.g., permanently extend tax-free withdrawals from IRAs for charitable contributions, permanently extend the enhanced deduction for corporate contributions of computer equipment)
- strengthen education (e.g., allow the Saver's Credit for contributions to qualified tuition programs)
- strengthen housing (e.g., allow tax-exempt bonds to refinance home mortgages to provide relief for subprime borrowers)
- protect the environment (e.g., eliminate the volume cap for private activity bonds for water infrastructure)
- restructure assistance to New York City
- simplify the tax laws for families (e.g., clarify the uniform definition of child, simplify the earned income tax credit)
- improve tax compliance
- expand information reporting
- strengthen tax administration

General Explanation of the Administration's FY 2010 Revenue Proposals (05/09/2009)

In the next year, with a dramatic shift in the political landscape, the first budget proposal submitted by the Obama Administration contained the following proposals:

- provide tax cuts for families and individuals (e.g., create a “making work pay” credit, expand the EITC, expand the refundability of the child tax credit, expand the Saver’s Credit, create the “American Opportunity Tax Credit”)
- provide tax cuts for business (e.g., eliminate capital gains taxation on investment in small business stock)
- increase tax on upper-income taxpayers and dedicate the revenue to deficit reduction (e.g., reinstate the 39.6% rate, reinstate the 36% rate for taxpayers with income over \$250,000, reinstate the limitation on itemized deductions and the personal exemption phase-out, impose a 20% rate on dividends and capital gains for taxpayers with income over \$250,000)
- make permanent the R&D tax credit
- expand the net operating loss carryback
- enact revenue changes and loophole closers (e.g., reinstate the Superfund excise tax, tax carried interest as ordinary income, repeal the Last-In, First-Out (LIFO) method of accounting, eliminate oil and gas company preferences)
- reform the U.S. international tax system (e.g., defer deduction on certain expenses, reform the foreign tax credit rules, limit shifting of income through intangible property transfers, limit earnings stripping by expatriated entities, repeal the 80/20 rules, and modify the tax rules for dual capacity)
- expand penalties and make reforms to close loopholes
- restructure assistance to New York City
- reduce the tax gap (e.g., expand information reporting)

Appendix 2

Tax Laws Enacted Since
Tax Reform Act of 1986

Public Law No.	Date	Statutes Enacted by the 99 th Congress – 2 nd Session
99-595	10-31-86	To extend the exclusion from Federal unemployment tax wages paid to certain alien farmworkers
99-640	11-10-86	Coast Guard Authorization Act of 1986
99-662	11-17-86	Water Resources Development Act of 1986
Statutes Enacted by the 100th Congress – 1st Session		
100-17	4-2-87	Surface Transportation and Uniform Relocation Assistance Act of 1987
100-202	12-22-87	To make further continuing appropriations for the '88 fiscal year, and for other purposes
100-203	12-22-87	Omnibus Budget Reconciliation Act of 1987
100-223	12-30-87	Airport and Airway Safety and Capacity Expansion Act of 1987
Statutes Enacted by the 100th Congress – 2nd Session		
100-360	7-1-88	Medicare Catastrophic Coverage Act of 1988
100-418	8-23-88	Omnibus Trade and Competitiveness Act of 1988
100-448	9-28-88	Coast Guard Authorization Act of 1988
100-485	10-13-88	Family Support Act of 1988
100-647	11-10-88	Technical and Miscellaneous Revenue Act of 1988 (TAMRA)
100-690	11-18-88	Anti-Drug Abuse Act of 1988
100-707	11-23-88	Disaster Relief and Emergency Assistance Amendments of 1988
Statutes Enacted by the 101st Congress – 1st Session		
101-73	8-9-89	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
101-140	11-8-89	Repeal of Code Sec. 89 Non-discrimination Rules
101-179	11-28-89	Support for East European Democracy (SEED) Act of 1989
101-194	11-30-89	Ethics Reform Act of 1989
101-221	12-12-89	Steel Trade Liberalization Program Implementation Act
101-234	12-13-89	Medicare Catastrophic Coverage Repeal Act of 1989
101-239	12-19-89	Omnibus Budget Reconciliation Act of 1989
Statutes Enacted by the 101st Congress – 2nd Session		
101-280	5-4-90	Technical Corrections to the Ethics Reform Act of 1989
101-380	8-18-90	Oil Pollution Act of 1990
101-382	8-20-90	Customs and Trade Act of 1990
101-508	11-5-90	Omnibus Budget Reconciliation Act of 1990
101-509	11-5-90	Treasury, Postal Service and General Government Appropriations Act of 1991
101-604	11-16-90	Aviation Security Improvement Act of 1990
101-624	11-28-90	Food, Agriculture, Conservation and Trade Act of 1990
101-647	11-29-90	Crime Control Act of 1990
101-649	11-29-90	Immigration Act of 1990

Public Law No.	Date	Statutes Enacted by the 102 nd Congress – 1 st Session
102-2	1-30-91	Armed Forces Taxes
102-40	5-7-91	Department of Veterans Affairs Health-Care Personnel Act of 1991
102-54	6-13-91	Veterans programs for housing and memorial affairs
102-90	8-14-91	Appropriations for the Legislative Branch for the fiscal year ending 9-30-92
102-107	8-17-91	Emergency Unemployment Compensation Act of 1991
102-164	11-15-91	Emergency Unemployment Compensation Act of 1991
102-227	12-11-91	Tax Extension Act of 1991
102-240	12-18-91	Surface Transportation Revenue Act of 1991
Statutes Enacted by the 102nd Congress – 2nd Session		
102-244	2-7-92	Extension of Unemployment Benefits
102-318	7-3-92	Unemployment Compensation Amendments of 1992
102-393	10-6-92	Appropriations for the Treasury Department, U.S. Postal Service, Executive Office of President, etc. for the fiscal year ending September 30, 1993
102-486	10-24-92	Energy Policy Act of 1992
102-568	10-29-92	Veterans' Benefits Act of 1992
102-581	10-31-92	Airport and Airway Safety, Capacity, Noise Improvement and Intermodal Transportation Act of 1992
Statutes Enacted by the 103rd Congress – 1st Session		
103-66	8-10-93	Omnibus Budget Reconciliation Act of 1993
103-149	11-23-93	South African Democratic Transition Support Act of 1993
103-178	12-3-93	Intelligence Authorization Act for Fiscal Year 1994
103-182	12-8-93	North American Free Trade Agreement Implementation Act
Statutes Enacted by the 103rd Congress – 2nd Session		
103-260	5-26-94	Airport Improvement Program Temporary Extension Act of 1994
103-272	7-5-94	Codification of Certain U.S. Transportation Laws as Title 49, United States Code
103-296	8-15-94	Social Security Independence and Program Improvements Act of 1994
103-305	8-23-94	Federal Aviation Administration Authorization Act of 1994
103-322	9-13-94	Violent Crime Control and Law Enforcement Act of 1994
103-337	10-5-94	National Defense Authorization Act for Fiscal Year 1995
103-387	10-22-94	Social Security Domestic Employment Reform Act of 1994
103-429	10-31-94	To codify without substantive change recent laws related to transportation and to improve the United States Code
103-465	12-8-94	Uruguay Round Agreements Act
Statutes Enacted by the 104th Congress – 1st Session		
104-7	4-11-95	Self-Employed Health Insurance Act
104-88	12-29-95	ICC Termination Act of 1995

Public Law No.	Date	Statutes Enacted by the 104 th Congress – 2 nd Session
104-117	3-20-96	To provide that members of the Armed Forces performing services for the peacekeeping efforts in Bosnia and Herzegovina, Croatia and Macedonia shall be entitled to tax benefits in the same manner as if such services were performed in a combat zone
104-134	4-26-96	Omnibus Consolidated Rescissions and Appropriations Act of 1996
104-168	7-30-96	Taxpayer Bill of Rights
104-188	8-20-96	Small Business Job Protection Act of 1996
104-191	8-21-96	Health Insurance Portability and Accountability Act of 1996
104-193	8-22-96	Personal Responsibility and Work Opportunity Reconciliation Act of 1996
104-201	9-23-96	National Defense Authorization Act for Fiscal Year 1997
104-264	10-9-96	Federal Aviation Reauthorization Act of 1996
104-316	10-19-96	General Accounting Office Act of 1996
Statutes Enacted by the 105th Congress – 1st Session		
105-2	2-28-97	Airport and Airway Trust Fund Tax Reinstatement Act of 1997
105-33	8-5-97	Balanced Budget Act of 1997
105-34	8-5-97	Taxpayer Relief Act of 1997
105-35	8-5-97	Taxpayer Browsing Protection Act
105-61	10-10-97	Appropriations for the Treasury Dept., the U.S. Postal Service, the Executive Office of the President, and certain Independent Agencies, for the fiscal year ending 9-30-98, and for other purposes
105-65	10-27-97	Departments of Veterans Affairs and Housing and Urban Development and Independent Agencies Appropriations Act, 1998
105-78	11-13-97	Appropriations for the Depts. of Labor, Health and Human Services, and Education, and related agencies for the fiscal year ending 9-30-98, and for other purposes
105-102	11-20-97	To codify without substantive change laws related to transportation and to improve the United States Code
105-115	11-21-97	Food and Drug Administration Modernization Act of 1997
105-130	12-1-97	Surface Transportation Extension Act of 1997
Statutes Enacted by the 105th Congress – 2nd Session		
105-178	6-9-98	Transportation and Equity Act for the 21 st Century
105-206	7-22-98	IRS Restructuring and Reform Act of 1998
105-277	10-21-98	Tax and Trade Relief Extension Act of 1998
105-306	10-28-98	Noncitizen Benefit Clarification and Other Technical Amendments Act of 1998
Statutes Enacted by the 106th Congress – 1st Session		
106-21	4-19-99	To extend the tax benefits available with respect to services performed in a combat zone to services performed in the Federal Republic of Yugoslavia (Serbia/Montenegro) and certain other areas
106-36	6-25-99	Miscellaneous Trade and Technical Corrections Act of 1999
106-78	10-22-99	Agriculture, Rural Development, Food and Drug Administration and Related Agencies Appropriations Act, 2000
106-170	12-17-99	Tax Relief Extension Act of 1999

Public Law No.	Date	Statutes Enacted by the 106 th Congress – 2 nd Session
106-81	4-5-00	Wendell H. Ford Aviation and Investment Reform Act for the 21 st Century
106-200	5-18-00	Trade and Development Act of 2000
106-230	7-1-00	To require Code Section 527 organizations to disclose their political activities
106-408	11-1-00	Fish and Wildlife Programs Improvement and National Wildlife Refuge System Centennial Act of 2000
106-476	11-9-00	Tariff Suspension and Trade Act of 2000
106-519	11-15-00	FSC Repeal and Extraterritorial Income Exclusion Act of 2000
106-554	12-21-00	Consolidated Appropriations Act 2001
106-573	12-28-00	Installment Tax Correction Act of 2000
Statutes Enacted by the 107th Congress – 1st Session		
107-15	6-5-01	Fallen Hero Survivor Benefit Fairness Act of 2001
107-16	6-7-01	Economic Growth and Tax Relief Reconciliation Act of 2001
107-22	7-26-01	To rename the education individual retirement accounts as the Coverdell education savings accounts
107-67	11-12-01	Treasury and General Government Appropriations Act, 2002
107-71	11-19-01	Aviation and Transportation Security Act
107-90	12-21-01	Railroad Retirement and Survivors' Improvement Act of 2001
107-110	1-8-02	No Child Left Behind Act of 2001
107-116	1-10-02	Departments of Labor, Health and Human Services, and Education and Related Agencies Appropriations Act, 2002
107-131	1-16-02	To simplify the reporting requirements relating to higher education tuition and related expenses
107-134	1-23-02	Victims of Terrorism Tax Relief Act of 2001
Statutes Enacted by the 107th Congress – 2nd Session		
107-147	3-9-02	Job Creation and Worker Assistance Act of 2002
107-181	5-20-02	Clergy Housing Allowance Clarification Act of 2002
107-210	8-6-02	Trade Act of 2002
107-217	8-21-02	To revise, codify, and enact without substantive change certain general and permanent laws, related to public buildings, property, and works, as Title 40, United States Code, "Public Buildings, Property, and Works"
107-276	11-2-02	To amend Section 527 of the Internal Revenue Code of 1986 to eliminate notification and return requirements for State and local party committees and candidate committees
107-296	11-25-02	Homeland Security Act of 2002
107-330	12-6-02	Veterans Benefits Act of 2002
107-358	12-17-02	Holocaust Restitution Tax Fairness Act of 2002

Public Law No.	Date	Statutes Enacted by the 108 th Congress – 1 st Session
108-27	5-28-03	Jobs and Growth Tax Relief Reconciliation Act of 2003
108-81	9-25-03	Museum and Library Services Act of 2003
108-88	9-30-03	Surface Transportation Extension Act of 2003
108-89	10-1-03	To extend the Temporary Assistance for Needy Families block grant program, and certain tax and trade programs, and for other purposes
108-121	11-11-03	Military Family Tax Relief Act of 2003
108-173	12-8-03	Medicare Prescription Drug, Improvement, and Modernization Act of 2003
108-176	12-12-03	Vision 100 – Century of Aviation Reauthorization Act
108-178	12-15-03	To improve the United States Code
108-189	12-19-03	Service Members Civil Relief Act
Statutes Enacted by the 108th Congress – 2nd Session		
108-202	2-29-04	Surface Transportation Extension Act of 2004
108-203	3-2-04	Social Security Protection Act of 2004
108-218	4-10-04	Pension Funding Equity Act of 2004
108-224	4-30-04	Surface Transportation Extension Act of 2004, Part II
108-263	6-30-04	Surface Transportation Extension Act of 2004, Part III
108-280	7-30-04	Surface Transportation Extension Act of 2004, Part IV
108-310	9-30-04	Surface Transportation Extension Act of 2004, Part V
108-311	10-4-04	Working Families Tax Relief Act of 2004
108-357	10-22-04	American Jobs Creation Act of 2004
108-375	10-28-04	Ronald W. Reagan Defense Authorization Act for Fiscal Year 2005
108-429	12-3-04	Miscellaneous Trade and Technical Corrections Act of 2004
108-476	12-21-04	To treat certain arrangements maintained by the YMCA Retirement Fund as church plans for the purposes of certain provisions of the Internal Revenue Code of 1986, and for other purposes
108-493	12-23-04	To amend the Internal Revenue Code of 1986 to modify the taxation of arrow components

Public Law No.	Date	Statutes Enacted by the 109 th Congress – 1 st Session
109-1	1-7-05	To accelerate the income tax benefits for charitable cash contributions for the relief of victims of the Indian Ocean Tsunami
109-6	3-31-05	To amend the Internal Revenue Code of 1986 to extend the Leaking Underground Storage Tank Trust Fund financing rate
109-7	4-15-05	To amend the Internal Revenue Code of 1986 to provide for the proper tax treatment of certain disaster mitigation payments
109-14	5-31-05	Surface Transportation Extension Act of 2005
109-20	7-1-05	Surface Transportation Extension Act of 2005, Part II
109-35	7-20-05	Surface Transportation Extension Act of 2005, Part III
109-37	7-22-05	Surface Transportation Extension Act of 2005, Part IV
109-40	7-28-05	Surface Transportation Extension Act of 2005, Part V
109-42	7-30-05	Surface Transportation Extension Act of 2005, Part VI
109-58	8-8-05	Energy Tax Incentives Act of 2005 (title XIII of the Energy Policy Act of 2005)
109-59	8-10-05	Safe, Accountable, Flexible, Efficient Transportation Act: A Legacy for Users (Transportation Act of 2005)
109-73	9-23-05	Katrina Emergency Tax Relief Act of 2005
109-74	9-29-05	Sportfishing and Recreational Boating Safety Amendments Act of 2005
109-135	12-21-05	Gulf Opportunity Zone Act of 2005
109-151	12-30-05	To amend title 1 of ERISA, title XXVII of the Public Health Service Act, and the Internal Revenue Code to extend by one year provisions requiring parity in the application of certain limits to mental health benefits
Statutes Enacted by the 109th Congress – 2nd Session		
109-171	2-8-06	Deficit Reduction Act of 2005
109-222	5-17-06	Tax Increase Prevention and Reconciliation Act of 2005
109-227	5-29-06	Heroes Earned Retirement Opportunities Act
109-241	7-12-06	Coast Guard and Maritime Transportation Act of 2006
109-280	8-17-06	Pension Protection Act of 2006
109-432	12-20-06	Tax Relief and Health Care Act of 2006
Statutes Enacted by the 110th Congress – 1st Session		
110-28	5-25-07	Small Business and Work Opportunity Tax Act of 2007
110-42	6-30-07	Andean Trade Preference Act
110-52	8-1-07	Approving the renewal of import restrictions contained in the Burmese Freedom and Democracy Act of 2003
110-138	12-14-07	United States-Peru Trade Promotion Agreement Implementation Act
110-140	12-19-07	Energy Independence and Security Act of 2007
110-141	12-19-07	To exclude from gross income payments from the Hokie Spirit Memorial Fund to the victims of the tragic event, loss of life and limb, at Virginia Polytechnic Institute & State University
110-142	12-20-07	Mortgage Forgiveness Debt Relief Act of 2007
110-161	12-26-07	Consolidated Appropriations Act, 2008
110-166	12-26-07	Tax Increase Prevention Act of 2007
110-172	12-29-07	Tax Technical Corrections Act of 2007

Public Law No.	Date	Statutes Enacted by the 110 th Congress – 2 nd Session
110-185	2-13-08	Economic Stimulus Act of 2008
110-190	2-28-08	Airport and Airway Extension Act of 2008
110-233	5-21-08	Genetic Information Nondiscrimination Act of 2008
110-234	5-22-08	Food, Conservation, and Energy Act of 2008
110-244	6-6-08	SAFETEA-LU Technical Corrections Act of 2008
110-245	6-17-08	Heroes Earnings Assistance and Relief Tax Act of 2008
110-246	5-22-08	Food, Conservation, and Energy Act of 2008
110-253	6-30-08	Federal Aviation Administration Extension Act of 2008
110-289	7-30-08	Housing Assistance Tax Act of 2008
110-317	8-29-08	Hubbard Act
110-318	9-15-08	To amend the Internal Revenue Code of 1986 to restore the Highway Trust Fund balance
110-328	9-30-08	SSI Extension for Elderly and Disabled Refugees Act
110-330	9-30-08	Federal Aviation Administration Extension Act of 2008, Part II
110-343	10-3-08	Emergency Economic Stabilization Act of 2008
110-351	10-7-08	Fostering Connections to Success and Increasing Adoptions Act of 2008
110-381	10-9-08	Michelle's Law
110-428	10-15-08	Inmate Tax Fraud Prevention Act of 2008
110-458	12-23-08	Worker, Retiree, and Employer Recovery Act of 2008
Statutes Enacted by the 111th Congress – 1st Session		
111-3	2-4-09	Children's Health Insurance Program Reauthorization Act of 2009
111-5	2-17-09	American Recovery and Reinvestment Act of 2009
111-12	3-30-09	Federal Aviation Administration Extension Act of 2009
111-46	8-7-09	To restore sums to the Highway Trust Fund and for other purposes
111-69	10-1-09	Fiscal Year 2010 Federal Aviation Administration Extension Act
111-92	11-6-09	Worker, Homeownership, and Business Assistance Act of 2009
111-116	12-16-09	Fiscal Year 2010 Federal Aviation Administration Extension Act, Part II
111-118	12-19-09	Making appropriations for the Department of Defense for the fiscal year ending September 30, 2010, and for other purposes
111-124	12-28-09	To extend the Generalized System of Preferences and the Andean Trade Preferences Act, and for other purposes
Statutes Enacted by the 111th Congress – 2nd Session		
111-126	1-22-10	To accelerate the income tax benefits for charitable cash contributions for the relief of victims of the earthquake in Haiti
111-144	3-2-10	Temporary Extension Act of 2010
111-147	3-18-10	Hiring Incentives to Restore Employment Act
111-148	3-23-10	Patient Protection and Affordable Care Act
111-152	3-30-10	Health Care and Education Reconciliation Act of 2010
111-153	3-31-10	Federal Aviation Administration Extension Act of 2010
111-161	4-30-10	Airport and Airway Extension Act of 2010
111-171	5-23-10	Haiti Economic Lift Program Act of 2010
111-173	5-27-10	To clarify the health care provided by the Secretary of Veterans Affairs that constitutes minimum essential coverage
111-192	6-25-10	Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010
111-197	7-2-10	Airport and Airway Extension Act of 2010, Part II

Public Law No.	Date	Statutes Enacted by the 111 th Congress – 2 nd Session (continued)
111-198	7-2-10	Homebuyer Assistance and Improvement Act of 2010
111-203	7-21-10	Dodd-Frank Wall Street Reform and Consumer Protection Act
111-216	8-1-10	Airline Safety and Federal Aviation Administration Extension Act of 2010
111-226	8-10-10	FAA Air Transportation Modernization and Safety Improvement Act
111-237	8-16-10	Firearms Excise Tax Improvement Act of 2010
111-240	9-27-10	Small Business Jobs Act of 2010
111-249	9-30-10	Airport and Airway Extension Act of 2010, Part III
111-274	10-13-10	Plain Writing Act of 2010
111-291	12-8-10	Claims Resolution Act of 2010
111-309	12-15-10	Medicare and Medicaid Extenders Act of 2010
111-312	12-17-10	Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010
111-322	12-22-10	Continuing Appropriations and Surface Transportation Extensions Act, 2011
111-325	12-22-10	Regulated Investment Company Modernization Act of 2010
111-329	12-22-10	Airport and Airway Extension Act of 2010, Part IV
111-344	12-29-10	Omnibus Trade Act of 2010
111-347	1-2-11	James Zadroga 9/11 Health and Compensation Act of 2010

Senate Finance Committee Hearing
 “How Did We Get Here? Changes in the Law and Tax Environment Since the Tax Reform
 Act of 1986”
 March 1, 2011
 Responses to Questions for the Honorable Eric Solomon and the Honorable Mark
 Weinberger

Questions from Senator Kerry

Tax Reform Act of 1986

- 1) Several of you were involved in some capacity with 1986 Tax Reform Act and I was here at the time, but not a Member of the Finance Committee and I supported it. I think there are some similarities and some differences between now and 1986. The major similarity is we need to broaden the base and lower the rates. What do you think are the major differences between now and 1986 and will these differences affect how we should approach tax reform.

The world is a very different place today than it was in 1986. The marketplace is more global and business is conducted using technology that did not exist in 1986. The use of intangibles has also increased dramatically. As expanded on greatly in our testimony, the major differences include:

- a) **Evolving business and global landscape.** Our nation and the world have changed dramatically. The business environment is more complex and globally connected. The world economy is now more integrated and nations are more interdependent, with fundamental changes having occurred in industry composition, use of technology, and the role of emerging markets. Our tax laws have not kept up.
- b) **Increasing global competitive pressures.** Growth in foreign markets, increased global competition for jobs and capital, and the rapidly changing economic and tax policies of our major trading partners compel us to improve the competitiveness of our tax laws.
- c) **Expanding use of the Code.** Our tax system has been asked to do more and more over the years. New provisions are constantly added to the Code to address social and other policy issues and respond to economic circumstances. Moreover, as political perspectives have changed, tax legislative priorities have shifted frequently. The Code has grown enormously. Once added, new provisions are difficult to remove and add to complexity, which results in increased economic burden.
- d) **Cumulative effect of changing budget and legislative processes.** Federal budget rules and legislative process changes have played a significant role in how tax policy has evolved over the years. The result has been increased use of temporary tax provisions, the phasing in and phasing out of tax laws and the increased use of revenue offsets. While the budget rules serve an important purpose, they have had the effect of adding to the complexity and instability of the Code.

e) **Worsening fiscal situation.** Our unprecedented fiscal deficits and national debt require us to comprehensively re-evaluate our spending and tax priorities. Since so many policy objectives are implemented through both spending and tax provisions, it will be difficult to address spending without considering taxation. Moreover, the large fiscal imbalance increases the need for an efficient and pro-growth tax system.

- 2) One of the reasons that tax reform was revenue neutral in 1986 was there were some very abusive tax shelters and many of these were eliminated. In addition, we have taken steps to crack down on corporate shelters. In 1997, we required the registration of corporate tax shelters and we passed the codification of the economic substance doctrine in 2010. We also have eliminated some loopholes on a case by case basis. What loopholes on the individual and corporate side should be eliminated?

As expanded upon more fully in our testimony, when considering comprehensive tax reform, such as broadening the tax base and lowering marginal tax rates, tax expenditures will be under consideration. These are not “loopholes.” The major tax expenditures are tax provisions that for the most part have been in the Code a long time, and were carefully debated and added to the Code by Congress to achieve specific policy objectives. When modifying or reducing either tax preferences or direct spending, lawmakers must consider the underlying social policy or economic policy the provision was meant to promote.

- 3) I believe that the 1986 Tax Reform Act harmed the real estate industry. Changes were definitely needed, but I felt that it went too far and harmed the economy. Do you have any advice on how we can strike the right balance by eliminating tax preferences without having a negative impact on a particular sector which will result in job loss and impact economic growth? Would the real estate industry have not been harmed if there was transition relief?

You raise an important point. As the economy continues its uncertain recovery, the challenge of making appropriate tax law changes while minimizing harm to the economy will be even more relevant. No one will be able to anticipate all of the consequences of meaningful changes to the tax laws. In order to minimize unintended consequences, it is important to have appropriate dialogue with potentially affected industries as part of the evaluation to determine the potential negative impact of tax law changes that would affect job creation and economic growth. The process should be as transparent and deliberate as possible.

With regard to the impact of the 1986 Tax Reform Act on real estate, it is our view that the industry likely would have been affected even if there had been transition relief because of the significance of the change in the tax treatment of real estate. Dramatic and immediate changes to the tax code have the potential to cause substantial economic dislocation.

International Tax Reform

- 1) I am concerned that our current tax system provides incentives to keep revenues offshore and discourages investment in the United States. In the past, I have introduced legislation to eliminate deferral and the revenue raised would lower the corporate tax rate. My proposal eliminates deferral so companies will be taxed on their foreign subsidiary profits in the same way

they are taxed on their domestic profits. In order to ensure that American companies can compete in international markets, income companies earn when they locate production in a foreign country that serves that foreign country's home markets can still be deferred. I believe that we need to make changes to our current international tax system. Various approaches have been suggested and there is support among U.S. multinational corporations for moving away from a worldwide system towards more of a territorial system. I have some concerns that a territorial system could result in more investment moving offshore and favor some industries over others. Do you have suggestions on how we should reform our international tax system and can it be done in manner that encourages investment in the U.S. and helps us remain globally competitive? Are there parts of our international tax system that we should retain such as subpart F?

We can no longer view U.S. tax policy in a vacuum. Our tax system needs to adapt to the changing role of the United States in the world economy. As discussed more specifically in our article "The U.S. International Tax System at a Crossroads" (*Tax Notes, April 5, 2010, p. 51*), there are a number of considerations in designing an international tax system.

It is difficult to identify which provisions should be retained without knowing the structure of a reformed system. We do note, however, that issues such as transfer pricing, sourcing of income and deductions, and treatment of offshore passive income (subpart F) are likely to continue to exist under a reformed international tax system. It would be worthwhile to examine how most of our primary trading partners have transitioned to some form of exemption system (territorial) and how they have dealt with transfer pricing, sourcing, and offshore passive income (subpart F).

- 2) If we make changes to our current international tax system, I think it will be difficult to transition to a new system. Do you have suggestions on how to transition to a different system?

How to transition to a new system depends on the design of the new system. Transition rules should strike a balance between achieving the favorable effects of the reform and potential dislocations that could result from the reform.

Corporate Tax Reform

- 1) I have given some thought about how to lower our corporate tax rate and I think it will involve some difficult choices to lower the corporate tax rate from 35 percent to under 28 percent. In 2007, the Bush Administration released a report entitled "*Approaches to Improve Competitiveness of the U.S. Business Tax System for the 21st Century*" and it included suggestions about lowering the corporate tax to 28 percent by eliminating certain provisions, such as the research and development tax credit, deductions for U.S. production/manufacturing activities, low income housing tax credit, and the deductibility of charitable contributions. As you can see from this partial list, it will be difficult to repeal business tax incentives. Are there any specific incentives that you think should be eliminated in exchange for a lower rate? We have all read the stories about corporate effective tax rates and how they vary and some companies have relatively low effective tax rates far below what a new statutory rate would be. Do you think it is feasible to reform the corporate tax system in a revenue neutral manner and have the support of the business community? Won't changes result in winners and losers?

There will certainly be winners and losers in any reformed corporate income tax system. However, to the extent the overall economy grows, everybody should benefit. In the end, the support of the business community will depend on how a reformed system addresses the basic goals of simplicity, fairness, economic growth and competitiveness.

- 2) Do you think it is feasible to address corporate tax reform without doing individual tax reform? If only corporate tax reform is done and the corporate rate is substantially lower than the top income tax rate, what do you think the impact will be?

It would be difficult to address corporate tax reform without more broadly considering business tax reform. A substantial portion of business activity in the United States is increasingly conducted by pass-through entities (e.g., S corporations, partnerships and limited liability companies) and sole proprietorships. In recent years, these businesses reported 40% of business net income and one-third of business receipts. The United States has the second largest non-corporate sector among the OECD countries, exceeded only by Mexico. The large number of non-corporate business taxpayers is due in no small part to the double taxation of corporate earnings—once when earned by the corporation and again when distributed to individual shareholders.

Lowering the corporate tax rate and paying for this change by eliminating or limiting business tax expenditures—including provisions that are available to and widely used by both C corporations and flow-through businesses—would raise the taxes paid by owners of flow-through businesses, even though these businesses would receive no tax benefit from the lower corporate tax rate. More generally, any reform resulting in a significant disparity between the treatment of corporate taxpayers and those taxed at the individual level will have an impact on behavior, especially if the rates are different. However, it is important to note that there are other countries around the world in which corporate tax rates are lower than the rates for individuals. The interplay between individual and corporate rates is complicated and raises a number of issues, especially with the large number of flow-through businesses in the United States.

- 3) I have been a long-time supporter of the research and development tax credit. I believe that now more than ever it is important to encourage research and development. The President's budget for fiscal year 2011 proposes to make the credit permanent and increase the alternative simplified tax credit from 14 to 17 percent. Do you think this credit has been successful in incentivizing investments that would have not occurred without out? Should this credit be made permanent? Should changes be made to the credit? Should the credit remain the same percentage for all sectors or should we temporarily have a higher percentage for a certain industry which we are trying to incentivize such as clean energy?

The R&D credit is important to the growth of the economy. Other nations share the same view, and almost every country in the world has R&D incentives, many of which are more generous than those provided in the United States. R&D results in collateral benefits to the economy. The benefits of R&D to society are of higher value than the benefits enjoyed by the particular company that makes R&D expenditures.

With regard to permanency, temporary tax provisions in general are problematic and result in significant uncertainty for those taxpayers who rely on these provisions, including uncertainty in financial reporting for businesses. Temporary provisions add complexity and uncertainty to the Code, requiring lawmakers to spend a significant amount of time annually or every couple of years in the process of considering legislation related to extending them. Moreover, with such temporary provisions, individuals and businesses do not have stable tax rules that they can rely upon for future planning.

General Questions

- 1) Do you think the current tax system can be reformed by eliminating provisions and broadening the base or do you think we need to make more drastic changes?

In addition to considering the elimination of provisions and broadening the base, it would be wise to examine the entire system. For example, in evaluating any changes to the Code, it is important to consider what is occurring around the world and view the U.S. tax system in the context of the broader global economy.

- 2) If we are successful in reforming the tax code, how can we prevent it from becoming over burdensome and in need of another major overhaul within twenty to twenty-five years?

We need to constantly evaluate the Code and the effectiveness of specific provisions. The goal should be to create a Code that is as simple, fair, pro-growth and competitive as possible in the current and anticipated future environment, but that does not mean a Code that can never be changed. Change is inevitable as the world, the economy and our society change. Tax laws should be evaluated to determine whether or not they remain effective in light of those changes. Therefore, it is appropriate to periodically review tax laws just as it is appropriate to review other types of laws.

Questions from Senator Enzi

- 1) The number of businesses operating in non-corporate form has increased significantly over the past 25 years. In fact, seventy-five percent of businesses are organized as pass-through entities, meaning they pay taxes on their business income at the individual income tax rates. Currently, the Obama administration is calling for revenue-neutral corporate income tax reform, including lowering the corporate income tax rate. If certain tax expenditures are reduced or eliminated in exchange for a lower corporate income tax rate, there could be a significant tax increase on many non-corporate businesses since many also currently benefit from those same tax expenditures but wouldn't receive the benefit of a lower income tax rate.

In your view, to what extent is it possible to achieve revenue-neutral corporate tax reform without negatively impacting non-corporate businesses?

Potential reforms should be evaluated taking into consideration their effect on pass-through entities and sole proprietorships, which represent a large portion of the economy. Corporate tax reform would be helpful to lower the corporate tax rate and make taxation more efficient, but it is important to take into account the potential effects on pass-through entities and sole proprietorships given the large role they play in our economy.

- 2) The number of businesses operating in non-corporate form has increased significantly over the past 25 years. At the Finance committee hearing on the President's FY2012 budget proposal, Treasury Secretary Geithner commented that "Congress has to revisit this basic question about whether it makes sense for us as a country to allow certain businesses to choose whether they're treated as corporations for tax purposes or not. It's not a fundamentally sustainable balance now...."

Would you please give us your thoughts on the ability to elect how a business entity is treated for U.S. federal income tax purposes and whether it is a concern that should be addressed? In what ways might one perceive that abuses could arise by virtue of this election?

The corporate tax results in double taxation: a tax on corporate earnings and a second tax upon shareholders receiving dividends or recognizing capital gains on their stock. Consequently, corporate taxation creates distortions, such as encouraging corporations to use debt financing rather than equity financing. The corporate tax motivates many businesses to operate as pass-through entities. When the Code provides an election for choosing either corporate or pass-through taxation, making a choice that lessens the tax burden is not inappropriate. Changes to the Code should attempt to reduce or eliminate the distortive effects of our corporate tax system, and at a minimum should not increase distortions by adding additional layers of tax.

- 3) The Tax Reform Act of 1986 (1986 Act) significantly lowered individual and corporate income tax rates in an overall revenue-neutral context. It also created significant winners and losers, with business tax increases paying for individual tax reductions. An important issue for any corporate tax reform will be the tax treatment of pass-through business owners (partnerships, S corporations and sole proprietorships) because corporate base broadening affects non-corporate businesses. The 1986 Act not only increased total corporate income taxes by \$120 billion over five years, it also increased taxes on non-corporate business owners by \$60 billion over five years. More specifically, pass-through business owners had \$89 billion of gross tax increases, offset by \$29 billion of tax cuts, including an estimated \$25 billion from individual tax rate reduction, for a net tax increase of \$60 billion.

Would you please give us your thoughts on whether and to what extent the conditions are the same or different than 1986 (e.g., unemployment rate, nature of the economy, the number of businesses operating in corporate versus non-corporate forms, etc.) such that the tax reform approach taken then might or might not be an appropriate approach to tax reform now? For example, can the need to lower unemployment be met, in part, with a tax reform effort similar to the 1986 Act that raises taxes on corporate and non-corporate businesses?

As set forth more fully in our testimony, the global and economic conditions are different than they were 25 years ago. The U.S. economy represents a smaller share of the world

economy, in significant measure due to the rise of developing economies. In addition, the U.S. economy is increasingly integrated and interdependent with the economies of other nations. Both capital and labor have become increasingly mobile. The composition of the world economy has also changed. Traditional manufacturing has declined in relative size, while technology, services, financial innovation, and intangible assets have become more important. In addition, the number of businesses operating as pass-through entities or sole proprietorships—and the earnings of these businesses—has grown dramatically over the past 25 years.

It is important to be prudent in any reform effort, because increased taxes on businesses could hurt growth and job creation.

- 4) The Obama Administration has called for revenue-neutral corporate income tax reform, including lowering the corporate income tax rate. Based on your past experiences as government officials and current positions as tax practitioners and advisers to small and large companies across the United States and around the world, to what rate would the U.S. corporate income tax need to be lowered to enable these U.S. companies that you advise to compete more effectively and to encourage investment, R&D, and manufacturing in the United States by both domestic and foreign companies?

To enable U.S. companies to compete more effectively, Congress would need to consider lowering the corporate tax rate to a rate closer to or equal to the average of our global competitors – approximately 25%. The U.S. statutory corporate tax rate is now the second highest among the 50 countries that are largest by GDP. Ten years ago, 13 of the top 50 countries by GDP had statutory corporate tax rates above 35 percent. Today only Japan and the United States have statutory corporate tax rates that high. Today 37 of the top 50 countries by GDP have statutory corporate tax rates at 30 percent or below. Countries continue to lower their corporate tax rates. The United Kingdom is expected to lower its corporate tax rate to 24% by 2015.

- 5) A series of proposals and recommendations have recently been offered to restore the nation's fiscal balance, with tax reform being a significant contributor to such an effort. For example, the final report from the National Commission on Fiscal Responsibility and Reform recommends a move to a territorial tax system as part of reforming the corporate tax structure. As advisers to both large and small U.S. multinationals, I'm sure you are well aware that such a move could have a significant impact on the organizational structure and operations of these entities, as well as potentially significant financial statement impacts. Given this, it would be prudent to include appropriate transition rules in any tax reform effort.

To what extent should a transition plan be a part of a reform of the individual and corporate income tax systems? For example, if certain tax expenditures are repealed, over what period of time might they be phased out? What types of transition were built into the Tax Reform Act of 1986? What, if any, lessons were learned from that experience? Have there been other tax law changes that were phased in or out over the past 25 years, and what were the experiences of

taxpayers, tax practitioners, and the government as a result of those phased approaches to change?

It is important to consider transition issues in enacting a new tax system, but first it is necessary to determine the features of the proposed new system. Transition rules should strike a balance between achieving the favorable effects of the reform and potential dislocations that could result from the reform. In evaluating whether to enact transition rules and what kind to enact, it is important to have a dialogue with potentially affected industries to determine the potential negative impact of tax law changes that could affect job creation and economic growth. The process should be as transparent and deliberate as possible.

- 6) While the Deficit Commission did not include in its proposal a value-added tax (VAT) or consumption tax, such proposals did appear in the Domenici-Rivlin plan and Congressman Ryan's Road Map for America's Future. The Domenici-Rivlin plan called for a 6.5% Debt Reduction Sales Tax (which actually operates as a credit invoice method value added tax), and Congressman Ryan's plan called for an 8.5% subtraction method border adjustable value added tax. Of course, Congressman Ryan's plan also called for repealing the corporate income tax and significantly simplifying the individual income tax.

Based on your experiences as advisors to companies across the United States, to what extent has the business environment changed (or not changed) such that a VAT may or may not be palatable to the business community (potentially in place of the corporate income tax or in conjunction with a significantly reduced corporate income tax)? Given the proliferation of U.S. businesses that operate globally, are more companies gaining experience dealing with a VAT by virtue of operating (or transacting with customers) in foreign countries that have enacted some form of a VAT?

It is difficult to speak for the business community as a whole, and it is early in the tax reform process. That said, in evaluating whether a VAT might be palatable to the business community, it would be necessary to analyze a proposed VAT in conjunction with proposed changes in spending and other changes to the tax system. In addition, it would be necessary to understand the details of the proposed VAT, for example whether it is an add-on VAT or a VAT that replaces the corporate income tax. Because many other countries around the world have a VAT, more companies with international operations are gaining experience with a VAT.

- 7) At 35 percent, the U.S. statutory corporate income tax rate is the highest among all the countries in the Organization for Economic Cooperation and Development (OECD). Since the 1980s, other OECD economies have been steadily lowering their tax rates, but the United States has not cut its top statutory tax rate since 1993. In the OECD, the United States also has higher-than-average effective average and effective marginal tax rates, which are the best indicators for capital investors of their true tax liability.

What have other OECD countries been doing over the past 25 years to enable them to lower their corporate income tax rates? Was it through significant income tax base broadening? Have the

changes been revenue neutral, or have they replaced lost corporate income tax revenues with other sources of revenues, like a VAT or other consumption tax? Has there been any correlation over the past 25 years between an uptick in domestic reinvestment and foreign direct investment and changes in these OECD countries' tax systems, including lower corporate income tax rates?

Other OECD countries that have lowered their corporate tax rate have also generally included base-broadening or increased value-added taxes or other consumption taxes. While we are not aware of studies on the correlation of business investment with lower tax rates, there is an increasing amount of economic research that draws on the experience abroad, and at the state level within the United States, that finds that workers bear a substantial portion of corporate income taxes. That is, this research suggests that if corporate income taxes were lower, worker wages would be higher.

8) On Friday, February 25th, Bloomberg ran an article titled "Geithner Says Tax Overhaul Must Address Businesses Filing as Individuals." The article focused on Treasury Secretary Geithner's recent comments regarding revisiting long-standing rules that give businesses a choice of paying taxes as a corporation or through a structure as a partnership through which they can report business income on individual tax returns. In that article, one of the witnesses, Pam Olson, is quoted as follows: "Congress may be forced to choose between eliminating the double tax on corporate income or requiring all businesses to pay a corporate-level tax."

If corporate tax reform were to include a significant lowering of the corporate income tax rate as well as subjecting all business income to a corporate-level tax, what would be the tax impact to small businesses in Wyoming and across the United States that currently operate in pass-through form – would they pay more or less than under the current system? Depending on the corporate income tax rate and the applicable dividends tax rate, is it possible that they could be subject to the same tax burden as they currently face under the individual income tax system? Even so, would such a change lead to even more complexity for small business owners in terms of tax compliance and reporting?

The corporate tax results in double taxation: a tax on corporate earnings and a second tax upon shareholders receiving dividends or recognizing capital gains on their stock. Consequently, corporate taxation creates distortions, such as encouraging corporations to use debt financing rather than equity financing. The corporate tax motivates many businesses to operate as pass-through entities. Many of these businesses are small businesses. Changes to the Code should attempt to reduce or eliminate the distortive effects of our corporate tax system, and at a minimum should not introduce a new level of taxation to businesses. A change subjecting all business income to corporate tax would create burden by imposing a second level of taxation on all businesses and by requiring all business owners to deal with the complex corporate tax system.

Questions from Senator Schumer

- 1) In his testimony and in the Q&A period, Mr. Solomon referenced the need for consolidating the various tax benefits for higher education. For the past several Congresses, I have authored legislation that would have consolidated the tuition deduction, Lifetime Learning credit, and

HOPE credit into one program with one set of qualifications. Now, with the American Opportunity Tax Credit (which I authored) in place, I am developing legislation with some of my colleagues to make the AOTC permanent and consolidate it with the tuition deduction and Lifetime Learning credits.

First, I take it from all of your testimonies, either directly or implied, that you think such legislation would be a good idea, and would provide some simplification to middle-class taxpayers? What are some factors that we should be cautious about?

It may be helpful to consider each of the multiple tax incentives for higher education and determine if they are duplicative. Each of these incentives has different though possibly overlapping beneficiaries, and there would be a need to evaluate whether beneficiaries of any of the incentives would be harmed by consolidation or simplification of them. Furthermore, it would be necessary to consider whether there is a revenue cost resulting from a consolidation of the incentives that is designed in a way that avoids harming anyone who is a current beneficiary.

- 2) Second, Mr. Solomon referenced a number of different tax provisions for higher education, but my understanding is that these are the three most common ones that people claim on their personal tax returns. I was wondering which of the others any of you believe should, or could, be easily rolled into this consolidation effort, or whether these three should be the first ones we target.

As indicated above, it may be helpful to consider each of the multiple tax incentives for higher education and determine if they are duplicative. Each of these incentives has different though possibly overlapping beneficiaries, and there would be a need to evaluate whether beneficiaries of any of the incentives would be harmed by consolidation or simplification of them.

Moreover, all provisions for both individuals and businesses might be evaluated for potential opportunities for simplification and consolidation. The 2005 President's Advisory Panel on Federal Tax Reform recommended consolidating savings accounts into employee retirement savings accounts, retirement savings accounts, and lifetime savings accounts. Also, they proposed consolidating family provisions into a single family credit and replacing the earned income tax credit with a work credit. While the proposals were not enacted, they provide an example of possible methods to consolidate tax provisions as part of a comprehensive reform effort.

- 3) Setting aside for a moment that it would introduce some additional complexity, I wonder what each of you think of the idea of having the tax brackets be adjusted for the highest cost-of-living regions of the country? I don't mean having a sliding scale, which would be far too complicated. I mean, simply having one additional set of tax brackets that is slightly adjusted upwards for the 10 or 20 or 30 highest-cost counties. I ask this because, as all of you know, a \$50,000 income in Little Rock is fundamentally different than a \$50,000 income on Long Island. Do you think something like this could be implemented?

Adjusting tax brackets by region would help taxpayers in high-cost areas, but it would add more complexity to the system. It would also increase the tax burden on taxpayers in lower-cost areas, assuming the same amount of federal revenues is required. It would also be difficult to determine how those tax brackets would be adjusted in a way that is perceived to be fair and equitable to those who are not eligible. It may make sense to see how payments in direct expenditure programs are calculated for these high-cost areas. How payments in direct expenditure programs vary for high-cost areas, if at all, could affect one's view of adjusting tax brackets for high-cost areas. With regard to proposals such as this, it is important to balance the perceived benefits with the detriments, including additional complexity.

Questions from Senator Hatch

- 1) In Mr. Goldberg's written testimony before the committee, he said,

"The last – and perhaps most troublesome – trend is growing inequality in opportunity, income and wealth among our citizens. In my view, the tax law is neither the root cause nor the cure. Tax reform can and should make a contribution by reducing the job-destroying distortions and complexity that plague our current system – while maintaining or enhancing our progressive individual income tax. But I believe that far more can be accomplished by reigning in out-of-control entitlements and wasteful spending to free up funds that can be profitably invested in our future."

Since the United States, as shown by the chart prepared by the Finance Committee on the last page, already has the most progressive federal tax system of all OECD countries, what are your thoughts regarding the progressiveness of the tax system? Should a reformed system be more or less progressive?

Refer to chart titled *Progressivity of Taxes in OECD Countries by Share of Taxes Paid by Richest 10 Percent, 2005*

Progressivity of Taxes in OECD Countries by Share of Taxes Paid by Richest 10 Percent, 2005		
	Share of Taxes of Richest 10 Percent	Share of Market Income of Richest 10 Percent
1 United States	45.1	33.5
2 Ireland	39.7	25.6
3 Australia	38.8	25.1
4 United Kingdom	38.6	32.3
5 France	35.0	24.7
6 Netherlands	33.0	24.7
7 Canada	35.8	29.3
8 Belgium	31.1	23.2
9 Austria	30.3	24.4
10 Denmark	29.7	24.4
12 Germany	31.2	29.2
13 Luxembourg	30.9	20.4
14 Finland	29.0	24.5
15 Japan	28.3	24.2
16 Greece	27.0	24.9
17 France	28	25.5
18 Italy	26.9	23.9
19 Korea	26.1	24.8
20 Sweden	26.7	26.6
21 Norway	26.2	25.7
22 Portugal	25.7	23.7
23 Spain	25.2	23.7
24 Switzerland	20.9	23.5
OECD-24 Average	31.6	25.4

(Source: Organization for Economic Co-operation and Development (OECD), Growing Unequal? Income Distribution and Poverty in OECD Countries, <http://browse.oecdbookshop.org/oecd/pdfs/browseit/8108051E.PDF>)

As the above chart demonstrates, our system is quite progressive. Goals of an optimal tax system are that it be simple, fair, pro-growth and competitive. In considering our nation's fiscal challenges, including managing government spending and determining the level of revenues government should collect, the desired level of progressivity of the tax system is one issue among many that Congress must consider.

- 2) A fundamental question that all of us will have to answer as we think critically about tax reform is whether our final objective is to raise taxes in the misguided hope of increasing revenues coming in to the government, or whether our goal is to simplify the tax code and reduce the dead-weight loss it inflicts on the economy.

Under current law, the top statutory marginal income tax rate will increase from 35 percent to nearly 40 percent in 2013. In a July 14, 2009, National Journal article, Lawrence Lindsey, former head of the National Economic Council, is quoted as saying, "When marginal tax rates go over 40 percent, the evidence suggests that the excess burden of collecting additional revenue rises very sharply, making the cost to the private sector of moving additional funds from the private sector to the public sector several times the additional revenue raised."

Leonard Burman spoke in a similar vein when he testified before this Committee last summer. Dr. Burman is currently a professor at Syracuse University and is former co-director of the Urban-Brookings Tax Policy Center. In his written testimony, Dr. Burman wrote, "Tax rate increases harm the economy and cannot, by themselves, close the budget gap."

I would like the panel to respond to what I've just said and to discuss the implications of the statutory top marginal tax rate approaching 40 percent or of tax rates going even higher as part of tax reform.

High tax rates are a significant concern. The top federal tax rate was lowered to 28 percent under the Tax Reform Act of 1986. The top tax rate rose to 31 percent under the 1990 Act and to 39.6 percent under the 1993 Act, before being lowered to 35 percent under the 2001/2003 tax cuts. These tax rates are scheduled to rise to 39.6 percent again when the 2001/2003 tax cuts sunset at the end of 2012. When you factor in the increase in the Medicare tax to 3.8 percent in 2013 and state income tax rates, the top income tax rate could rise to near 50 percent for some taxpayers.

Economic research indicates that taxes affect a large number of household and business decisions. Taxes affect how much labor workers choose to supply, what types of jobs they pursue, and whether they choose self-employment over working for someone else. Taxes also affect how much taxpayers give to charity, how much they borrow when buying a home, how much they save, how they align their investment portfolios, and to what extent they comply or attempt to evade paying taxes.

Higher tax rates also affect the size of the tax base and revenue the federal government collects. Because households and businesses take taxation into account when making business and investment decisions, the federal government collects less revenue than it would otherwise because of the many ways taxpayers respond to higher tax rates. This is not to say that tax cuts pay for themselves, but it does mean that an increase in income tax rates can be expected to cause the income tax base to contract. Not only is the contraction in the tax base an indication of the economic harm of higher tax rates, but with a smaller tax base, the federal government can be expected to raise less revenue than it would otherwise.

- 3) Under current law the top statutory marginal tax rate will jump to 39.6% in 2013. Now the actual effective rate will actually be higher because of the reinstatement of PEP and Pease. On top of all of this, the increased Medicare tax bestowed upon the nation as part of Obamacare means that in 2013, the self-employed owner of a small business, the heart and soul of our economy, will face an increase in the marginal rate on flow-through business income and for labor income of 0.9 percent. This is on top of a return to the high Clinton tax rates.

Is the panel concerned with the implication that under current law, marginal tax rates in 2013 will be higher than they were during the Clinton administration?

High tax rates are a significant concern. Please see the answer to the previous question.

- 4) Once again, we find ourselves facing the individual alternative minimum tax ("AMT") problem. Thanks to a provision that was developed here in the Finance Committee in the 2001 tax relief bill, we've temporarily not made the problem worse. That provision runs out at the end of this

year. A renewal of the patch will result in a revenue loss of \$60-\$70 billion by Joint Tax's account.

According to Joint Tax, this tax, which was intended to hit only a thin slice of high-income taxpayers with tax preferences, will ensnare 23 million families next year if we don't act. According to the Congressional Budget Office, the AMT will balloon Federal revenue to record levels of gross domestic product ("GDP"), with or without an extension of the 2001 and 2003 bipartisan tax relief in the future.

Now, many on the other side insist that we cannot reform the AMT unless we offset the revenue loss from this unintended tax with tax increases on other taxpayers.

I'd like each of you to answer a basic question. Is it fair to condition AMT reform on substitution of revenue when we never intended the AMT to generate the projected revenue in the baseline? Why should AMT reform be secondary to maintaining an unintended stream of revenue?

The AMT was first enacted in 1969 to ensure that a small group of high-income individuals would pay at least a minimum amount of tax. Because the AMT exemption is not indexed, and because certain itemized deductions are not allowed in computing the AMT, more and more middle-income Americans are potentially subject to this tax. Periodically, Congress has to "patch" the AMT to keep the number of Americans subject to the AMT from rising dramatically. Certainly the AMT needs to be reformed or eliminated. In the deliberations about tax reform, the appropriate level of the tax revenues necessary to fund our government is one of the important issues Congress will need to consider.

Questions from Chairman Baucus

- 1) Some of you suggested that we should think "outside the box" and consider tax bases other than income. Professor Barker of the Dickinson School of Law advocates replacing the corporate income tax with a destination-type expenditure tax (see William B. Barker, "International Tax Reform Should Begin at Home: Replace the Corporate Income Tax with a Territorial Expenditure Tax," 30 Nw. J. Int'l L. & Bus. 647 (2010)). In his view, such a tax would be clearly superior to any of the income tax alternatives; he says it would "promote long-term revenue gains, protect the domestic tax base, and, at the same time, stimulate economic growth in U.S. jobs and business in a tax neutral fashion" and would be "an efficient, fair, largely unavoidable tax that would enhance U.S. welfare."

Do you have a view on this proposal? Were any proposals of this kind considered during your time at Treasury?

Treasury has considered consumption-type taxes, but not the specific proposal referenced. The 2007 Treasury competitiveness study, "Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century," examined a Business Activity Tax (BAT), a type of consumption tax that would replace the corporate income tax. Under a

BAT, the tax base for each firm would be the gross receipts from the sale of goods and services minus purchases of goods and services (including purchases of capital goods) from other businesses. Wages and other forms of employee compensation (such as fringe benefits) would not be deductible. Treasury found that, because a BAT does not tax the normal return to saving or investment, a BAT is likely to stimulate additional saving and investment.

- 2) The IRS launched e-file in 1986. Last year more than 70% of tax returns were filed electronically, a figure that has grown each year. Today roughly 60% of taxpayers utilize paid tax preparers. There has been an historical debate about whether the IRS should enter into the software business and provide a free electronic preparation portal for the easiest of tax forms. This would largely mirror the tele-file options that used to be available for 1040EZ filers.

What implications does this have for tax reform? Does it create opportunities? Challenges?

The need by taxpayers and the IRS to use technology demonstrates the complexity of our tax system. However, technology may allow the system to be implemented in a more efficient manner. To some extent, technology mitigates the complexity of the Code for taxpayers complying with it and the IRS administering it, but technology cannot be relied upon too heavily with the expectation that it will eliminate the compliance and administration burdens of the tax system.

- 3) Since 1986, the number of corporations has dropped 28% while the number of pass-throughs has grown 102%. In 1986, pass-throughs earned 40% of all business income. Today, they account for nearly 60% of the income earned by all businesses.
 - a) Do you think this trend is a problem?
 - b) How has the tax code kept up with this change in the form of American businesses?
 - c) What implications does the increasing proportion of business income that is being taxed as individual income have for tax reform?

The corporate tax results in double taxation: a tax on corporate earnings and a second tax upon shareholders receiving dividends or recognizing capital gains on their stock. Consequently, corporate taxation creates distortions, such as encouraging corporations to use debt financing rather than equity financing. The fact that entities are given the option not to be under the more distortive corporate system does not appear to us to be a problem. The corporate tax motivates many businesses to operate as pass-through entities. The trend has also resulted in more complex laws for partnerships and S corporations in order to address issues arising more frequently as a result of increased use of these forms of business organization.

When the Code provides an election for choosing either corporate or flow-through taxation, making a choice is not inappropriate. Changes to the Code should attempt to reduce or eliminate the distortive effects of our corporate tax system.

Potential reforms to the Code should be evaluated taking into consideration their effect on pass-through entities and sole proprietorships, which represent a large portion of the economy. Corporate tax reform would be helpful to lower the corporate tax rate and make taxation more efficient, but it is important to take into account the potential effects on pass-through entities and sole proprietorships given the large role they play in our economy.

Questions from Senator Grassley

- 1) I wanted to seek clarification regarding the question I raised to the panel during the hearing last week regarding tax expenditures. Mr. Talisman, in his written testimony, stated the following:

“Many of the largest “tax expenditures” are long-time features of our system embedded in the fabric of our economy. These include items such as the employer-provided health exclusion, deductibility of home mortgage interest, deductions for charitable contributions, incentives for retirement savings, the deduction for state and local income taxes, reduced rates on capital gains and dividends, the exclusion for capital gains on home sales, inside build-up on life insurance, the child credit, the earned income tax credit, and exemptions for state and local bonds. Collectively, these account for close to two-thirds of all tax expenditures in 2010 according to Treasury.”

It appears that the overwhelming majority of assets in 501(c)(3) organizations reside in fee-for-service charities such as hospitals and universities. The activities of these charities are generally no different than for-profit organizations. There are also now fee-for-service software and consulting companies that are also recognized as charities. The tax-exemption for such entities is currently not included as a tax expenditure in the Joint Tax Committee’s annual report on tax expenditures.

I understand that the definition of a tax expenditure is something to be debated when considering tax reform. However, I would like your thoughts on whether tax-exemption, particularly for fee-for-service charities, should be considered a tax expenditure.

To be clear, I understand that Congress has historically provided exemption to charities because of the societal benefit they provide. Given that fee-for-service charities are operating in the same space as taxable for-profit entities, it seems that Congress should have an idea of the value of the tax-exemption.

The process of identifying and quantifying tax expenditures became formalized in 1974 with the enactment of the Congressional Budget and Impoundment Control Act of 1974, which mandated the annual publication of tax expenditure estimates in the Budget of the United States Government. This Act defined tax expenditures as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.” It must be determined whether the tax exemption for fee-for-service charities is a special exemption that fits within that definition. In making this determination, it would be important to evaluate the benefits to society created by these charities and the amount of revenues forgone.

- 2) Both written and oral testimonies included the comment that tax reform will result in “winners and losers” and there seems to be agreement that the corporate rates must be reduced. One witness, Mr. Weinberger I believe, stated that we should not pit large businesses versus small businesses. A November, 2009, GAO report found that: “Large corporations have dominated the use of the research credit, with 549 corporations with receipts of \$1 billion or more claiming over half of the \$6 billion of net credit in 2005 (the latest year available). In 2005, the credit reduced the after-tax price of additional qualified research by an estimated 6.4 to 7.3 percent.”

So, if corporate rates are reduced, I would like your thoughts on whether some of the largest tax expenditures for businesses, such as the R&D credit, should be retained. If yes, since there is also general agreement that small businesses drive job growth, should such expenditures be reduced for large corporations? In other words, if corporate rates are reduced across the board and winners and losers will result, would it make sense for tax expenditures to favor small businesses?

As Congress considers tax reform, all aspects of the Code should be evaluated to determine whether they are consistent with a tax system that is simple, fair, pro-growth and competitive. In examining the R&D credit, Congress is likely to recognize that the benefits of R&D to society are of higher value than the benefits reaped by the particular company that makes R&D expenditures. It is true that tax reform inevitably will create winners and losers. However, one of the goals of tax reform should be to reduce distortions and create neutrality, which would suggest that it would not be desirable to provide tax benefits to businesses based on their size.

**Testimony of Jonathan Talisman
Before the Senate Finance Committee
Hearing on “How Did We Get Here? Changes in the Law and Tax
Environment Since the Tax Reform Act of 1986”
March 1, 2011**

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

Thank you for inviting me to share recollections about my experiences while in government service, and some thoughts about tax reform. It is a privilege to appear before you once again.

I served at the Treasury Department beginning in early 1997 through President Bill Clinton’s second term. Before that, I served on the Joint Tax Committee staff from 1992 to 1995, and then as Chief Democratic Tax Counsel to the Senate Finance Committee under Senator Daniel Patrick Moynihan.

Over the past several years, we have been facing a “perfect storm” that many policymakers believe compel the need for tax reform. Because of structural defects, the AMT (absent patches) is exploding and reaching deep into the middle class. We have well over 100 structural extenders that will expire later this year or next year, including the 2001 and 2003 tax cuts. It is unsustainable for much of our tax code to exist on a temporary basis. The U.S. will soon have the highest corporate tax rate and is one of a handful of remaining countries with a worldwide tax system. The combination is giving rise to competitiveness concerns. And, unfortunately, we’re facing all of this when we have record near-term deficits, and projected expanding long-term deficits from the impending demographic surge in entitlement programs.

I want to commend the Chairman, Ranking Member Hatch and the Committee Members for recognizing the seriousness of the issues we’re facing and scheduling these hearings on tax reform, in an effort to ensure that our tax system is fair and efficient, while raising the revenues we need to fund our Government.

How We Got Here—The Clinton Era

Similar to the concerns of today, much of the focus of both parties in the 1990s was on fiscal restraint and regaining control of the Federal budget. In 1992, the budget deficit had grown to a then-record of \$290 billion and was projected to reach half a trillion dollars by the end of the budget window. At the same time, family incomes were stagnating, unemployment was high, and welfare rolls were growing. There was a strong belief that increased Federal borrowing necessitated by these deficits was driving up interest rates and crowding out private investment.

To reverse this trend, Congress and the President enacted the Omnibus Budget Reconciliation Act of 1993. The President’s budget had called for a \$30 billion

stimulus package and significant long-term deficit reduction, including tax increases and spending cuts. However, the stimulus package was withdrawn when it was filibustered in the Senate, and Senate opposition also led to a proposed broad-based energy tax based on British Thermal Units (the so-called "BTU tax") being replaced with a 4.3 cent per gallon increase in the gas tax. The final bill passed the Congress in early August, 1993 and was estimated to reduce deficits by nearly \$500 billion over 5 years, with the burden roughly evenly divided between spending cuts and tax increases.

The tax increases included an upper bracket rate increase, removal of the wage cap for Medicare taxes, increased taxation of Social Security benefits, an increase in the top corporate income tax rate, and various loophole closers and other base broadeners. As a point of pride, Senator Moynihan often subsequently referred to it (much to his staff's consternation) as the largest tax increase in history.¹ The package also included a number of targeted tax incentives proposed in the President's budget, such as expansion of the EITC, a small business capital gains exclusion, extension of the research credit and the low-income housing credit, and creation of empowerment zones.

For the next two years, there was little movement on the tax legislative front for two reasons. First, in September 1993, President Clinton outlined his health care reform plan. As in the last Congress, the debate over health care reform was contentious and commanded significant attention, crowding out other activity. The most controversial element of the President's health care bill was an employer mandate to provide coverage to employees through competitive health care plans. Eventually, even a compromise bill introduced by Majority Leader Mitchell, which slowed down effective dates and exempted small businesses, failed to produce sufficient votes for passage. After over a year of work, health care reform was pronounced dead.

Second, after the Republican takeover of Congress in 1994 (and as I began my work on the Finance Committee staff), the Clinton Administration and Congress engaged in a fierce standoff over budget reconciliation and increasing the debt limit. This resulted in three Presidential vetoes, two government shutdowns, and an impasse over increasing the debt limit requiring Treasury Secretary Rubin to take special measures to avoid default on U.S. obligations. The gridlock eventually broke in the spring of 1996 with agreement on an increase in the debt limit from roughly \$5 trillion to \$5.5 trillion, and a modest budget and tax package, including permanent extension of the health care deduction for self-employed individuals and a few small revenue offsets.

¹ We pointed out to Senator Moynihan on several occasions that the Tax Equity and Fiscal Responsibility Act of 1982 was actually a larger tax increase, indexed for inflation and as a share of GDP, but he chose to ignore us. See Jerry Tempalski, "Revenue Effects of Major Tax Bills " OTA Working Paper 81, Office of Tax Analysis, US Treasury Department, July, 2003.

The breaking of the impasse led to passage of several significant bills containing tax provisions before the 1996 elections. In July, the Taxpayer Bill of Rights 2 was enacted expanding the IRS's ability to abate interest, modifying installment agreement procedures, creating the Taxpayer Advocate position, and restricting use of retroactive regulations. In August, the Health Insurance Portability and Accountability Act of 1996 (HIPAA) increased the deductibility of health care for the self-employed, modified the tax treatment of long-term care, and created a 4-year demonstration project for medical savings accounts (which was a highly-negotiated compromise between Congressional leadership and the Administration). Around the same time, the Small Business Job Protection Act of 1996 was passed, including an increase in the minimum wage and a fully-offset \$20 billion package of tax relief for small businesses. Among the principal provisions were an increase in expensing for small businesses, an S corporation reform package, a retirement savings package (including new SIMPLE plans for small businesses, and allowing contributions to IRAs by non-working spouses), and an extenders package. The largest offset was the phase-out of the section 936 credit for Puerto Rico and other possessions.

In 1997, President Clinton began his second term and I joined the Treasury Department. While economic conditions had improved significantly, budget forecasts continued to project persistent deficits under current law. The President's budget set forth a plan to eliminate the deficit over 5 years, and called for tax simplification. The Treasury Department released a package of roughly 60 simplification proposals in April, 1997.

Negotiations over a budget framework stalled at first over the size of tax cuts in any final bill. To maintain fiscal discipline, Treasury Secretary Rubin argued that the size of tax cuts should be reasonably limited over a 10-year window. Ultimately, by May, a budget agreement was reached limiting the size of net tax cuts to \$85 billion over 5 years and \$250 billion over 10 years. The tax cuts were to include Administration priorities, such as education credits and the child credit, and Republican priorities, such as capital gains cuts and IRA expansions. The budget framework also called for significant cuts in Medicare and Medicaid, and additional limits on discretionary spending.

A tax package meeting that framework was developed and negotiated over the next two months. Sticking points were concerns raised by President Clinton and Secretary Rubin regarding "exploding" out-year costs caused by Republican savings initiatives and efforts to index capital gains, and concerns raised by Republican leaders over the structure and size of the Administration's education tax credits, efforts to make the child credit refundable, and proposed tobacco taxes. In late July, a compromise was reached to remove indexing, impose income limits on savings incentives, to allow partial refundability of the child credit while increasing income thresholds for eligibility, and to raise the cigarette tax by a smaller amount than initially proposed. The final deal created the \$500 child credit, the Hope Scholarship and lifetime learning credits, Roth IRAs, and education IRAs. In

addition, the bill reduced capital gains rates and raised the estate tax exemption to \$1 million. The bill also incorporated most of the simplification items that the Administration had proposed back in April, including a \$500,000 exclusion on home sales to replace a rollover provision.

Ahead of expectations, the budget registered a unified surplus of roughly \$70 billion in FY 1998, and increasing budget surpluses were projected into the future. In his State of the Union, the President called for “saving Social Security first,” suggesting that any surplus funds should not be used for spending or tax cuts until long-term entitlement reform was enacted. Instead, surpluses would be used to reduce debt held by the public. This set the tone for the next several years on tax policy, as efforts to pass significant tax cuts without offsets were defeated in Congress.

Other issues consumed much of our attention during this period. First, the IRS Restructuring and Reform Act was adopted in 1998. The bill restructured the IRS’s operations, strengthened the offices of the Commissioner and Taxpayer Advocate, and put in place an oversight board. In addition, the bill addressed customer service through greater accountability and contained over 70 provisions designed to strengthen taxpayer rights, including a shift in the burden of proof, innocent spouse relief, collection due process procedures, and reduced penalties on installment agreements. Obviously, the IRS and Treasury, led by Commissioner Charles Rossotti and Chief Counsel Stuart Brown, spent a great deal of time and effort implementing the provisions of the Act.

At the same time, we developed a comprehensive legislative and regulatory approach to address the growth of corporate tax shelters. Beginning in the President’s first term, Treasury had discovered and shut down several transactions sold as “products” off the rack to produce a substantial reduction in a corporation’s tax liability, including lease strips, fast-pay preferred stock, lease-in-lease-out transactions, and so-called “chutzpah trusts.” We determined that addressing these transactions on a piecemeal basis was inefficient, costly and added complexity to the Code. Beginning with our 1999 White Paper,² we developed a multi-pronged approach to deter tax shelter development and use: (1) new regulations requiring greater disclosure by taxpayers and promoters; (2) legislation to increase penalties for non-disclosure and to strengthen the substantial understatement penalties; and (3) codification of the economic substance doctrine. Most of these legislative proposals were enacted during subsequent Congresses.

Finally, we spent a great deal of time working collaboratively with the tax-writing committees developing a legislative response to the WTO’s ruling that the “foreign sales corporation” (FSC) provisions were an impermissible export subsidy under GATT. We were under a number of constraints in crafting the legislation: (i) to maintain fiscal discipline by keeping the response as close to revenue neutral as

² *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals* (July, 1999).

possible, (ii) to respond meaningfully to the WTO decision and address the issues raised in the case; (iii) to ensure that existing users of FSC benefits were not disadvantaged; and (iv) to avoid creating new opportunities for abuse. Eventually, to comply with the WTO decision, the FSC provisions were repealed and replaced with an extraterritorial income (ETI) exclusion. Among its features, the legislation was designed to eliminate the export subsidy, by allowing the benefits to certain non-exporters. Unfortunately, the WTO subsequently ruled the ETI regime was also an impermissible export subsidy. As a result, in the American Jobs Creation Act of 2004, the ETI regime was repealed and replaced with the section 199 manufacturing tax incentive, small business relief, and numerous international tax changes.

Tax Reform Efforts and Themes

As today, there were numerous calls for tax reform while I was on the Hill. In fact, when I started with the Joint Tax Committee staff, Mark Weinberger and I helped draft one of the first Value-Added Tax (VAT) proposals, introduced by his boss Senator John Danforth together with Senator David Boren. Most of the proposals, at the time, would have replaced all or part of the income tax with a consumption tax. This included flat tax proposals by Congressman Dick Armey and Senator Arlen Specter, and separate VAT proposals introduced by Congressman Sam Gibbons and Senators Sam Nunn and Pete Domenici.

One of the first hearings I staffed for the Finance Committee was to examine the findings of the National Commission on Economic Growth and Tax Reform, chaired by former Congressman Jack Kemp.³ Their principal recommendations were to replace the current tax code, to have a single low tax rate with a generous personal deduction, and to allow a deduction for payroll taxes. In his opening statement at the hearing, Senator Moynihan declared that a new set of simple rules was certainly “appealing” given the volume and complexity of the tax law. However, he admonished that we should proceed carefully:

Any time a change of this magnitude is under consideration, with huge potential risks to the economy and shifts of fortune in the balance, we must approach [proponents' claims] with caution and healthy skepticism...A high degree of confidence must exist that the change would bring significant benefits. For government to dramatically change the ground rules, instantly creating huge winners and losers, any less would be unconscionable.

Senator Moynihan's statement raises several themes that are still important in considering tax reform today.

³ The commission was appointed by Senate Majority Leader Bob Dole and House Speaker Newt Gingrich.

First, it will be important to agree on the goals and intended benefits of tax reform. The establishment and marketing of goals will determine whether any significant tax reform is accomplished, and how it is judged politically. For example, on the individual side, there appears to be broad policy support for reforming or repealing the AMT. At my confirmation hearing in 2000, I responded to Finance Committee Chairman William Roth that I thought the growth of the AMT was one of the most serious problems in the tax system. The problem grew as a result of the 2001 tax bill. However, because we have “patched” the AMT for years, most of the people who will benefit from such reform, don’t know it. Thus, proposed reform of the AMT, while necessary, is not as politically salient as the 1986 reduction in rates, making it likely that resistance to the provisions necessary to offset the significant cost of reform or repeal will be stronger.

Second, revenue-neutral tax reform will, by definition, create winners and losers. The FSC/ETI experience is emblematic of the political problems this can cause, as the losers are likely to complain loudly, while the winners will quietly pocket their gains. When we passed ETI in 2000 to replace FSC, it sailed through on a bipartisan basis because the legislation was specifically written in a manner to avoid creating losers. However, when ETI had to be repealed in 2003, House Ways and Means Committee Chairman Thomas initially tried to replace ETI with a number of international tax reforms. Many domestic manufacturers and production companies who had benefitted from the FSC/ETI provisions were significant losers under these proposals. They complained loudly, the business community was divided, and the process slowed down. Eventually, the section 199 manufacturing deduction was added to the package by this Committee to avoid creating many losers and the package sailed through.

Third, while simplification is desirable, some of the complexity of the code is unavoidable, and would be necessary in any tax system that is adopted. We have a complex economy and society that requires special rules to take into account different or unique circumstances in order to be fair or to prevent abuse. Another factor is our political dynamic. Since the early 1980s, there has been pressure not to increase spending; however, the political desire for new programs did not disappear. Accordingly, many new programs are being run through the tax code. Finally, much of the complexity and current instability in the code is caused by legislative efforts to meet our budget rules. Phase-ins, phase-outs, timing shifts, short-term extensions, and sunseting of provisions are generally included to satisfy revenue constraints or other budget rules. Until we reform these rules, the complexity is likely to continue.

Fourth, while an ideal tax system would not include many tax expenditures, we are not starting a tax system from scratch. Many of the largest “tax expenditures” are long-time features of our system embedded in the fabric of our economy. These include items such as the employer-provided health exclusion, deductibility of home mortgage interest, deductions for charitable contributions, incentives for retirement savings, the deduction for state and local income taxes, reduced rates on capital

gains and dividends, the exclusion for capital gains on home sales, inside build-up on life insurance, the child credit, the earned income tax credit, and exemptions for state and local bonds. Collectively, these account for close to two-thirds of all tax expenditures in 2010 according to Treasury. To avoid false expectations, we need to be careful in how we talk about base broadening, and consider the practical, economic and social effects of eliminating tax expenditures. For example, the largest tax expenditure – the exclusion for employer-provided health care – was reviewed during health care reform and survived virtually intact. Hackles were raised when, as an alternative, an excise tax was imposed on certain high-cost plans.

Stanley Surrey, who introduced the notion of tax expenditure analysis in the late 1960s, wrote with Paul McDaniel that “the classification of an item as a tax expenditure does not in itself make that item either a desirable or undesirable provision,” and concluded that most were assistance “the legislators really do want to provide.”⁴ A good example of this is the research credit. It has passed the Congress 14 times⁵ and every President since Reagan has proposed to make it permanent. Clearly, this demonstrates a bipartisan belief that encouraging research and innovation is a desired feature of our tax system.

If these tax expenditures were removed from the tax system, they likely would ultimately be reenacted as direct subsidies. And, at least in some cases, delivery of the subsidy directly could be less efficient than running it through the tax system.

Two additional caveats should be added regarding tax expenditures. The definition of a tax expenditure is very broad (i.e., any item that differs from the base of an idealized measurement of income) and subjective, and may include items that are really normative provisions of our tax law. For example, according to Treasury, deferral of foreign source income is considered a tax expenditure even though that is a normative feature of our tax system. If we moved to a territorial system, would the exemption of foreign source income be a tax expenditure? Another example is stepped-up basis for inheritances. Is carryover basis really the norm in a tax system with an estate tax? The state and local income tax deduction is designed to mitigate double tax, like the foreign tax credit. One is listed as a tax expenditure; the other is not.

In addition, the numbers in the tax expenditure budget do not reflect actual revenue estimates of the cost of repealing those expenditures. The revenue estimates are likely to be far lower in many cases because behavioral effects are not taken into account in determining the tax expenditure budget.

I would like to close by raising one final issue. During my tenure at Treasury, we were just beginning to see the challenges that globalization and information technologies posed for the tax system and for tax administration. Businesses were

⁴ Surrey and McDaniel, *Tax Expenditures* (1985).

⁵ See <http://www.treasury.gov/press-center/press-releases/Pages/tg1061.aspx>

becoming more global in scale and mobile with regard to their activities. Flows of capital, goods and services began moving across borders at the strike of a key. The global business environment was becoming more competitive every year. To date, our tax system has not been adapted to reflect the dynamic challenges raised by the expanding global environment for business. Thus, as part of this reform process, it will be important for Congress and the Administration to determine how activities of U.S. taxpayers should be taxed when those activities increasingly transcend our borders.

Thank you, once again, for inviting me to share my observations. I would be happy to answer any questions you might have and to assist the Committee in any way that I can as you move forward in your consideration of tax reform.

Senate Finance Committee Hearing
 “How Did We Get Here? Changes in the Law and Tax Environment
 Since the Tax Reform Act of 1986”
 March 1, 2011

Responses to Questions for the Honorable Jonathan Talisman

Questions from Senator Kerry

Tax Reform Act of 1986

- 1) **Several of you were involved in some capacity with 1986 Tax Reform Act and I was here at the time, but not a Member of the Finance Committee and I supported it. I think there are some similarities and some differences between now and 1986. The major similarity is we need to broaden the base and lower the rates. What do you think are the major differences between now and 1986 and will these differences affect how we should approach tax reform.**

I was not involved in the 1986 Tax Reform Act, but was practicing in Washington at the time and observed the process. There have been several significant changes since 1986 that will likely need to be considered in any tax reform effort now. These include: (i) globalization and the mobility of capital; (ii) changes in the corporate tax systems of our major international treaty partners, including lowering of corporate tax rates and movement to territorial regimes; (iii) financial instrument innovation; (iv) our budget situation and the impending growth in entitlement spending; and (v) growth in income disparity.

- 2) **One of the reasons that tax reform was revenue neutral in 1986 was there were some very abusive tax shelters and many of these were eliminated. In addition, we have taken steps to crack down on corporate shelters. In 1997, we required the registration of corporate tax shelters and we passed the codification of the economic substance doctrine in 2010. We also have eliminated some loopholes on a case-by-case basis. What loopholes on the individual and corporate side should be eliminated?**

A loophole is generally defined as an unintended feature of the law that allows taxpayers to defer or avoid tax. As you note in your question, when I was at Treasury in the late 1990s, we and other policymakers became concerned about the growing use of corporate tax shelters. Congress and we took multiple steps to combat these shelters, from shutting down specific shelters as they came to light, increasing disclosure of listed transactions, and working together to develop legislation to more comprehensively address the issue, so that we wouldn't have to continue addressing transactions in a piecemeal fashion. I believe these steps have reduced such tax shelter activity.

Treasury and the IRS typically are made aware of loopholes through their audits and their interactions with taxpayers and practitioners. They likely should be aware of current loopholes

that should be addressed. For example, the President's FY 2011 budget includes several items that are labeled as "loophole closers."

- 3) **I believe that the 1986 Tax Reform Act harmed the real estate industry. Changes were definitely needed, but I felt that it went too far and harmed the economy. Do you have any advice on how we can strike the right balance by eliminating tax preferences without having a negative impact on particular sector which will result in job loss and impact economic growth? Would the real estate industry have not been harmed if there was transition relief?**

Determining the right amount of transition relief is always a difficult question for policymakers as it involves significant trade-offs. Transition relief is typically provided for fairness reasons, to eliminate or ameliorate losses from unanticipated changes in policy after taxpayers have made decisions based on existing law. Also, generous transition relief is often helpful to eliminate political opposition to significant policy changes. One of my colleagues used to say: "If you want to make sure the policy change sticks, don't shortchange the transition relief."

On the other hand, providing transition relief likely will mitigate any efficiency or revenue gains from the change in policy, and will add complexity. Also, it is important to note that transition rules often are only provided in one direction – favorable changes are generally immediate or only phased-in for revenue scoring purposes. Thus, in determining the need for transition relief, policymakers should consider the effect of favorable changes, as well as unfavorable changes, on various sectors of the economy.

As described more fully below, the design and minimal amount of transition relief provided in 1986 were likely a contributing factor to the fall in commercial real estate values in the late 1980s. Better-designed and more generous transition relief could have softened the economic dislocations caused by the new rules. Admittedly, however, it is often easier to make these determinations in hindsight.

In 1981, Congress encouraged investment in real estate by lowering the recovery period of buildings and other improvements to 15 years. This precipitated a huge building boom, particularly in office space, as significant capital flowed into new construction to take advantage of the favorable rules. And much of this new capital was raised from "passive" investors who were attracted to these activities by the ability to generate non-economic losses to reduce their tax liability.

Congress became concerned that this growth in real estate investment was uneconomic and the ability of passive investors to "shelter" their other income was unfair to other taxpayers. As a result, in 1986, Congress made several changes to the Code affecting the real estate industry. First, Congress significantly increased the depreciable lives for commercial real estate. Second, Congress restricted the ability to use losses from certain "passive activities," including rental real estate, against income from other activities.

While Congress recognized the need for transition relief, only a limited phase-in of the passive loss rules was provided for investments made or committed to before the effective date and this benefit was restricted as losses allowable under the phase-in rules were treated as preference items for AMT purposes. Also, the transition rules did not apply to any subsequent purchaser of

the property. As a result, the resale value of much commercial real estate fell dramatically after the 1986 Act.

This may be an important lesson if Congress determines, as has been suggested, that tax expenditures should be eliminated or reduced in order to broaden the base and reduce rates. For example, if the home mortgage interest deduction is limited, housing prices could fall as they were purchased with an expectation of interest deductibility. Merely grandfathering existing owners would not eliminate this problem. If prospective owners lost the tax benefits of interest deductibility, market values would necessarily fall. It is unclear whether adequate transition relief can be provided that would prevent this loss in value. (Certain reform plans have ameliorated the problem by converting the home mortgage interest deduction to a credit and extending it to non-itemizers. This expands the pool of potential purchasers with a tax benefit, and may help to preserve home values.)

International Tax Reform

- 1) **I am concerned that our current tax system provides incentives to keep revenues offshore and discourages investment in the United States. In the past, I have introduced legislation to eliminate deferral and the revenue raised would lower the corporate tax rate. My proposal eliminates deferral so companies will be taxed on their foreign subsidiary profits in the same way they are taxed on their domestic profits. In order to ensure that American companies can compete in international markets, income companies earn when they locate production in a foreign country that serves that foreign country's home markets can still be deferred. I believe that we need to make changes to our current international tax system. Various approaches have been suggested and there is support among U.S. multinational corporations for moving away from a worldwide system towards more of a territorial system. I have some concerns that a territorial system could result in more investment moving offshore and favor some industries over others. Do you have suggestions on how we should reform our international tax system and can it be done in manner that encourages investment in the U.S. and helps us remain globally competitive?**

Our current international system is a hybrid, a worldwide tax system that permits territorial treatment (i.e., deferral) until earnings are repatriated and provides foreign tax credits to avoid double taxation. This may be the worst of all worlds. It discourages redeployment of foreign earnings for domestic investment, distorts other investment decisions to maximize credit use, encourages complex and wasteful tax planning, and treats multinationals very differently based on circumstances and planning. Yet it fails to raise much revenue from U.S. multinational corporations and, unlike a pure worldwide system, it does not achieve capital export neutrality. In fact, the complicated rules regarding foreign tax credits may allow some corporations to help themselves to results that are even more favorable than territorial taxation. In these cases, the United States government effectively subsidizes marginal investment abroad. As a result, our system is worldwide for some corporations, territorial for other corporations, and better than territorial for a third set of corporations.

At the same time, arranging affairs to avoid taxation of foreign earnings is costly for U.S. multinational corporations. The worldwide tax base (together with the high U.S. tax rate) raises concerns that U.S. businesses are at a competitive disadvantage in foreign markets relative to

competitors based in jurisdictions with lower tax rates or in countries that exempt foreign income.

Lowering the corporate tax rate, as most other OECD countries have done,¹ will mitigate the competitive imbalances and distortions created by the current system. It will encourage investment in the United States, and will help reduce current barriers to repatriating foreign earnings.

In addition to lowering corporate tax rates, many other countries have adopted some form of territorial system, which generally exempts active foreign income. Most recently, Japan and the United Kingdom have changed from a worldwide system to a territorial system. Among their stated reasons for changing their systems were to simplify the method of relieving double taxation of foreign earnings, to spur repatriation of foreign income, and to enhance their competitiveness as a headquarter location for multinational businesses. There are many different forms of territorial regimes and whether one should be adopted will depend largely on these details.

Are there parts of our international tax system that we should retain such as subpart F?

If the United States moves toward a territorial system, subpart F will probably need to be retained in some form for passive or mobile income (to prevent deflection of income to low-tax jurisdictions). While the current categories of subpart F are a logical starting point, they were developed in 1962 and should be reexamined in light of the global economy. For example, the subpart F study released while I was at Treasury suggested that the foreign-to-foreign related party rules are not working as intended and should be replaced with a more effective test, which would eliminate distortions. If subpart F is retained in some form, the current exception for active finance income will be important to retain as well and should be made permanent.

Obviously, if we move to a pure worldwide system, subpart F would be unnecessary and could be repealed, as foreign source income would be taxed currently.

2) If we make changes to our current international tax system, I think it will be difficult to transition to a new system. Do you have suggestions on how to transition to a different system?

If the United States fundamentally reforms its international tax regime, policymakers will need to address the treatment of pre-enactment untaxed foreign earnings. An approach that eliminates or minimizes any “lock-in” effect and the need to track pre-enactment versus post-enactment earnings on a going forward basis would be simpler to apply and easier to administer. Under a territorial system, one transition approach would be to impose a significantly reduced one-time U.S. tax on pre-enactment accumulated foreign earnings (regardless of actual repatriation). Alternatively, taxpayers could be given an election to repatriate pre-enactment accumulated earnings at a reduced tax rate, in a manner similar to section 965.

¹ Since 2000, 25 OECD countries have decreased their statutory corporate income tax rates.

Corporate Tax Reform

- 1) I have given some thought about how to lower our corporate tax rate and I think it will involve some difficult choices to lower the corporate tax rate from 35 percent to under 28 percent. In 2007, the Bush Administration release a report entitled “*Approaches to Improve Competitiveness of the U.S. Business Tax System for the 21st Century*” and it included suggestions about lowering the corporate tax to 28 percent by eliminating certain provisions, such as the research and development tax credit, deductions for U.S. production/manufacturing activities, low income housing tax credit, and the deductibility of charitable contributions. As you can see from this partial list, it will be difficult to repeal business tax incentives. Are there any specific incentives that you think should be eliminated in exchange for a lower rate? We have all read the stories about corporate effective tax rates and how they vary and some companies have relatively low effective tax rates far below what a new statutory rate would be. Do you think it is feasible to reform the corporate tax system in a revenue neutral manner and have the support of the business community? Won't changes result in winners and losers?

As I stated in my testimony, the creation of winners and losers is inevitable in revenue neutral tax reform. Moreover, broadening the base and lowering the rate may have a disproportionately large impact on certain sectors of the economy relative to others. For example, many of the largest business tax expenditures (e.g., the section 199 deduction, accelerated depreciation, inventory sales source rules and the research credit) currently benefit the manufacturing and technology sectors. Thus, eliminating or limiting these items in order to achieve revenue neutral tax reform will hit these sectors harder than others. It will be difficult for Congress to achieve relative balance between sectors. Thus, for tax reform to succeed, the President and Congress will need to make a compelling case that reform will increase economic growth, improve US business competitiveness, and eliminate inefficiencies and unnecessary complexity and administrative burdens.

- 2) Do you think it is feasible address corporate tax reform without doing individual tax reform? If only corporate tax reform is done and the corporate rate is substantially lower than the top income tax rate, what do you think the impact will be?

It will be difficult to broaden the base to achieve meaningful corporate tax reform without negatively impacting non-corporate businesses. Many of the base broadeners that have been suggested to date -- e.g., eliminating the manufacturing deduction, accelerated depreciation or the LIFO inventory method -- would affect non-corporate entities, as well as C corporations. Thus, while all businesses would apparently lose the benefit of these provisions, only C corporations would benefit from a corporate rate reduction. Of course, Congress could decide to apply the base broadeners only to C corporations. This will reduce the amount of rate reduction that is possible, and will ameliorate the simplification and efficiency benefits, if any, of eliminating these provisions. Also, it is possible that the reduced corporate rate could induce some pass-through entities to elect to become taxed as corporations.

Some commentators have suggested that an alternative means of reducing the corporate rate through base broadening would be to increase the capital gains and dividends tax rates on

individuals. According to Altshuler, Harris and Toder, this is the approach that several of our foreign competitors have taken to reduce their corporate tax rates. They also argue that it will reduce economic distortions in decision-making because individuals have less cross-border mobility than corporations. However, it will be difficult as a political matter to raise taxes on individuals in order to provide a corporate rate reduction. Moreover, it is not clear, as a scoring matter, that raising the rates on dividends and capital gains will offset the cost of corporate rate relief, because the dividend rate is scheduled to increase after 2012 (and thus the increased rate is already included in the revenue scoring baseline) and increases in capital gains rates may cause realizations to diminish. Finally, the reduction of the tax rate on dividends in 2003 was meant to provide some level of corporate integration and mitigate the double tax under our “classical” system of taxing corporate income. It will be important for policymakers to keep this in mind in considering these types of proposals.

As your question implies, there are significant planning opportunities that arise if the top corporate rate is significantly below the top individual rate. Service businesses, people holding investment portfolios and others would have incentives to incorporate to reduce their tax rate. This problem existed in our system previously as there used to be a significant rate advantage for corporations over individuals. As a result, mechanisms already exist in the tax code that would have to be rejuvenated to address these problems. These include the accumulated earnings tax, the personal holding company rules, and the personal service corporation rules.

- 3) I have been a long-time supporter of the research and development tax credit. I believe that now more than ever it is important to encourage research and development. The President's budget for fiscal year 2011 proposes to make the credit permanent and increase the alternative simplified tax credit from 14 to 17 percent. Do you think this credit has been successful in incentivizing investments that would have not occurred without out? Should this credit be made permanent? Should changes be made to the credit? Should the credit remain the same percentage for all sectors or should we temporarily have a higher percentage for a certain industry which we are trying to incentivize such as clean energy?**

I believe the research credit should be retained, made permanent, strengthened, and simplified to ease compliance and administration. Research has shown that investments in research and innovation help drive productivity growth, improve living standards and have important spillover benefits for other firms and sectors of the economy. It is important that the U.S. continue to incentivize innovation in a more competitive global marketplace. Numerous other countries offer generous incentives that aim to lure R&D investment and jobs out of the United States. Recent lapses in the credit have caused uncertainty for American businesses and impacted the credit's effectiveness. R&D projects often span multiple years. Making the credit permanent will help encourage long-term investment in innovative projects.

In addition, we should examine additional tools to encourage innovation and to maintain U.S. developed IP in the U.S. For example, certain countries permit a deduction or exclusion for some portion of royalty income earned from IP developed in that country by the taxpayer. Other countries have made their research credits refundable for certain small/start-up businesses. Finally, some countries condition availability of the credit to retaining the IP in that country.

*General Questions***1) Do you think the current tax system can be reformed by eliminating provisions and broadening the base or do you think we need to make more drastic changes?**

I believe it is important that policymakers establish clear goals for tax reform. This will largely determine what is accomplished, how best to accomplish it, and whether it is successful and has staying power.

I believe the tax code certainly can be improved by broadening the base and lowering rates. However, as I stated in my testimony, base broadening will not be easy. Unlike in 1986, there do not appear to be many “loopholes” ready to be closed. And many of the largest tax expenditures are long-time features of our system, which will be difficult to eliminate without significant economic dislocations and creating winners and losers. Important sectors of the economy may be disproportionately impacted relative to others. Policymakers must be realistic in how they address base broadening and consider carefully the effects of eliminating longstanding tax expenditures.

Several leading commentators (e.g., Michael Graetz and Alan Auerbach) have recently suggested use of a consumption tax as a partial replacement to features of our income tax system. While it may be necessary or wise as a policy matter to consider a VAT or other consumption tax, I do not believe the political groundwork has been laid for adopting a Federal consumption tax any time in the near future. Also, the purpose of imposing a consumption tax will matter to its political success. Because VATs are regressive taxes, adoption of one is likely to be more palatable if it is replacing another regressive tax or providing a progressive benefit. It is also important that, when policymakers examine the benefits of adopting a consumption tax, they don’t compare our current income tax to an idealized consumption tax, but rather look to what a consumption tax looks like after it has been subjected to a political process. Finally, there are significant transition issues that must be considered with respect to a VAT.

2) If we are successful in reforming the tax code, how can we prevent it from becoming over burdensome and in need of another major overhaul within twenty to twenty-five years?

With an evolving, complex society and an ever-changing political climate and leadership, I’m not sure it is possible to prevent. While the goal of simplification is always important for policymakers, at times other goals take precedence. For example, as I stated in my testimony, deficit reduction was the paramount consideration in the 1990s and this affected tax policymaking during this period.

Questions from Senator Enzi

- 1) **The number of businesses operating in non-corporate form has increased significantly over the past 25 years. In fact, seventy-five percent of businesses are organized as pass-through entities, meaning they pay taxes on their business income at the individual income tax rates. Currently, the Obama administration is calling for revenue-neutral corporate income tax reform, including lowering the corporate income tax rate. If certain tax expenditures are reduced or eliminated in exchange for a lower corporate income tax rate, there could be a significant tax increase on many non-corporate businesses since many also currently benefit from those same tax expenditures but wouldn't receive the benefit of a lower income tax rate.**

In your view, to what extent is it possible to achieve revenue-neutral corporate tax reform without negatively impacting non-corporate businesses?

It will be difficult to broaden the base to achieve meaningful corporate tax reform without negatively impacting non-corporate businesses. Many of the base broadeners that have been suggested to date – e.g., eliminating the manufacturing deduction, accelerated depreciation or the LIFO inventory method -- would affect non-corporate entities, as well as C corporations. Thus, while all businesses would apparently lose the benefit of these provisions, only C corporations would benefit from a corporate rate reduction. Of course, Congress could decide to apply the base broadeners only to C corporations. This will reduce the amount of rate reduction that is possible, and will ameliorate the simplification and efficiency benefits, if any, of eliminating these provisions. Also, it is possible that the reduced corporate rate could induce some pass-through entities to elect to become taxed as corporations.

Some commentators have suggested that an alternative means of reducing the corporate rate through base broadening would be to increase the capital gains and dividends tax rates on individuals. According to Altshuler, Harris and Toder, this is the approach that several of our foreign competitors have taken to reduce their corporate tax rates. They also argue that it will reduce economic distortions in decision-making because individuals have less cross-border mobility than corporations. However, it will be difficult as a political matter to raise taxes on individuals in order to provide a corporate rate reduction. Moreover, it is not clear, as a scoring matter, that raising the rates on dividends and capital gains will offset the cost of corporate rate relief, because the dividend rate is already scheduled to increase after 2012 and increases in capital gains rates may cause realizations to diminish. Finally, the reduction of the tax rate on dividends in 2003 was meant to provide some level of corporate integration and mitigate the double tax under our “classical” system of taxing corporate income. It will be important for policymakers to keep this in mind in considering these types of proposals.

- 2) **The number of businesses operating in non-corporate form has increased significantly over the past 25 years. At the Finance committee hearing on the President's FY2012 budget proposal, Treasury Secretary Geithner commented that “Congress has to revisit this basic question about whether it makes sense for us as a country to allow certain businesses to choose whether they're treated as corporations for tax purposes or not. It's not a fundamentally sustainable balance now....”**

Would you please give us your thoughts on the ability to elect how a business entity is treated for U.S. federal income tax purposes and whether it is a concern that should be addressed? In what ways might one perceive that abuses could arise by virtue of this election?

Businesses conducted as sole proprietorships, partnerships, limited liability companies, or “S corporations” generally are subject to only one level of federal income tax (i.e., income, deductions and other tax items pass through and are taxed to the owners of the entity), whereas income from businesses organized as C corporations is subject to two levels of tax – once at the entity level and once at the shareholder level. Classification as a C corporation generally depends on whether the entity is incorporated, or is publicly traded. If neither is true, entities generally can elect to be taxed as a pass-through entity under the check-the-box rules. If the entity is a corporation but not publicly-traded, it may be able to elect S corporation status, provided other conditions are met.

Assuming tax can be administered efficiently and promptly on a flow-through basis,² I believe that pass-through treatment (i.e., one-level of tax) is generally a better paradigm than the classical two-level tax system applied to C corporations. Economic efficiency could be enhanced by more closely conforming the tax treatment of corporations to the tax treatment of flow-through entities through some form of integration regime. However, it is important to note that a significant reduction in the corporate tax rate will ameliorate any current distortions, if top individual rates remain close to where they are today.

- 3) **The Tax Reform Act of 1986 (1986 Act) significantly lowered individual and corporate income tax rates in an overall revenue-neutral context. It also created significant winners and losers, with business tax increases paying for individual tax reductions. An important issue for any corporate tax reform will be the tax treatment of pass-through business owners (partnerships, S corporations and sole proprietorships) because corporate base broadening affects non-corporate businesses. The 1986 Act not only increased total corporate income taxes by \$120 billion over five years, it also increased taxes on non-corporate business owners by \$60 billion over five years. More specifically, pass-through business owners had \$89 billion of gross tax increases, offset by \$29 billion of tax cuts, including an estimated \$25 billion from individual tax rate reduction, for a net tax increase of \$60 billion.**

Would you please give us your thoughts on whether and to what extent the conditions are the same or different than 1986 (e.g., unemployment rate, nature of the economy, the number of businesses operating in corporate versus non-corporate forms, etc.) such that the tax reform approach taken then might or might not be an appropriate approach to tax reform now? For example, can the need to lower unemployment be met, in part, with a tax reform effort similar to the 1986 Act that raises taxes on corporate and non-corporate businesses?

² The principal rationales for imposing an entity-level tax on corporations are ease of administration and ensuring that tax is paid when the income is earned.

Changes since 1986 that will likely need to be accounted for in any tax reform effort include: (i) globalization and the mobility of capital; (ii) changes in the corporate tax systems of our major international treaty partners, including lowering of corporate tax rates and movement to territorial regimes; (iii) financial instrument innovation; (iv) our budget situation and the impending growth in entitlement spending; and (v) growth in income disparity. Congress had already taken steps to address deficit reduction before undertaking tax reform in 1986.

Also, as I stated in my testimony, base-broadening will not be easy. Unlike in 1986, there do not appear to be many “loopholes” ready to be closed. And many of the largest tax expenditures are long-time features of our system, which will be difficult to eliminate without significant economic dislocations and creating winners and losers. In fact, many of the largest tax expenditures existed prior to the 1986 Act and Congress decided to keep them as part of that effort.

Finally, as your question points out, the 1986 Act was revenue-neutral, but the business community was a significant net loser. To date, the President and other policymakers are calling for business tax reform to be (at worst) revenue neutral. However, even if it is revenue neutral, various sectors of the economy are likely to be winners or losers. Congress will have to take this into account and determine the effects and efficacy of this given the state of the economy.

- 4) The Obama Administration has called for revenue-neutral corporate income tax reform, including lowering the corporate income tax rate. Based on your past experiences as government officials and current positions as tax practitioners and advisers to small and large companies across the United States and around the world, to what rate would the U.S. corporate income tax need to be lowered to enable these U.S. companies that you advise to compete more effectively and to encourage investment, R&D, and manufacturing in the United States by both domestic and foreign companies?**

When the U.S. reduced our corporate tax rates from 46% to 34% in 1986,³ it gave us one of the lowest corporate tax rates among our competitors. But over the past decade, the corporate tax rates of most of our major trading partners have declined significantly to well below the U.S. rate. According to the OECD, the OECD average rate was over 33% in 2000 and has dropped to roughly to 27.6% in 2007. The U.S. top marginal corporate tax rate is the second highest among nations in the OECD, and may soon be the highest (if Japan lowers its statutory rate as scheduled). On the other hand, as a percentage of GDP, U.S. corporate income tax receipts are below the OECD average and many corporations have effective rates well below the statutory rates. Many have concluded from this that the U.S. rate is too high and the base is too narrow. There is a growing consensus among both business and political leaders that our corporate tax rates should be lowered significantly and more closely conform to the rates of our major trading partners.

This will have several benefits. It will make the U.S. more attractive for domestic investment and foreign inbound investment. Also, it should reduce concerns that U.S. multinationals are disadvantaged relative to foreign competitors in doing business and investing overseas. Finally,

³ The top corporate rate was raised one percent to 35% in 1993.

by limiting any residual US tax, it reduces barriers to repatriating foreign earnings for domestic investment.

There are a couple of important caveats. First, we need to be careful if there is a significant rate differential between the top corporate rate and the top individual rate. This will create incentives for service businesses, people holding investment portfolios and others to incorporate to reduce their tax rate. This problem existed in our system previously as there used to be a significant rate advantage for corporations over individuals. As a result, existing mechanisms in the tax code would have to be rejuvenated to address these problems. These include the accumulated earnings tax, the personal holding company rules, and the personal service corporation rules.

Second, broadening the base and lowering the rate may disproportionately impact certain sectors of the economy relative to others. Many of the largest business tax expenditures (e.g., the section 199 deduction, accelerated depreciation, inventory sales source rules and the research credit) currently benefit the manufacturing and technology sectors. Thus, eliminating or limiting these items in order to achieve revenue neutral tax reform will hit these sectors harder than others. It will be difficult for Congress to achieve relative balance between sectors and avoid creating winners and losers. Failure to achieve balance could reduce the political likelihood of reform.

- 5) **A series of proposals and recommendations have recently been offered to restore the nation's fiscal balance, with tax reform being a significant contributor to such an effort. For example, the final report from the National Commission on Fiscal Responsibility and Reform recommends a move to a territorial tax system as part of reforming the corporate tax structure. As advisers to both large and small U.S. multinationals, I'm sure you are well aware that such a move could have a significant impact on the organizational structure and operations of these entities, as well as potentially significant financial statement impacts. Given this, it would be prudent to include appropriate transition rules in any tax reform effort.**

To what extent should a transition plan be a part of a reform of the individual and corporate income tax systems? For example, if certain tax expenditures are repealed, over what period of time might they be phased out? What types of transition were built into the Tax Reform Act of 1986? What, if any, lessons were learned from that experience? Have there been other tax law changes that were phased in or out over the past 25 years, and what were the experiences of taxpayers, tax practitioners, and the government as a result of those phased approaches to change?

Determining the right amount of transition relief is always a difficult question for policymakers as it involves significant trade-offs. Transition relief is typically provided for fairness reasons, to eliminate or ameliorate losses from unanticipated changes in policy after taxpayers have made decisions based on existing law. Also, generous transition relief is often helpful to eliminate political opposition to significant policy changes. One of my colleagues used to say: "If you want to make sure the policy change sticks, don't shortchange the transition relief."

On the other hand, providing transition relief likely will mitigate any efficiency or revenue gains from the change in policy, and add some complexity. Also, it is important to note that transition rules often are only provided in one direction – favorable changes are generally immediate or

only phased-in for revenue scoring purposes. Thus, in determining the need for transition relief, policymakers should consider the effect of favorable changes, as well as unfavorable changes, on various sectors of the economy.

One potential lesson from the 1986 Act is that more generous transition relief can soften the economic dislocations caused by adopting new rules. The design and amount of transition relief provided in 1986 were likely a contributing factor to the fall in commercial real estate values in the late 1980s. (Admittedly, however, it is often easier to make these determinations in hindsight.) When Congress modified the treatment of commercial real estate by adopting the passive loss rules and lengthening depreciable lives, only modest transition relief was provided and this benefit was restricted as losses allowable under the phase-in rules were treated as preference items for AMT purposes. Also, the transition rules did not apply to any subsequent purchaser of the property. As a result, the resale value of much commercial real estate fell dramatically after the 1986 Act.

This may be an important lesson if Congress determines, as has been suggested, that tax expenditures should be eliminated or reduced in order to broaden the base and reduce rates. For example, if the home mortgage interest deduction is limited, housing prices could fall as they were purchased with an expectation of interest deductibility. Merely grandfathering existing owners would not eliminate this problem. If prospective owners lost the tax benefits of interest deductibility, market values would necessarily fall. It is unclear whether adequate transition relief can be provided that would prevent this loss in value. (Certain reform plans have ameliorated the problem by converting the home mortgage interest deduction to a credit and extending it to non-itemizers. This expands the pool of potential purchasers with a tax benefit, and may help to preserve home values.)

- 6) **While the Deficit Commission did not include in its proposal a value-added tax (VAT) or consumption tax, such proposals did appear in the Domenici-Rivlin plan and Congressman Ryan's Road Map for America's Future. The Domenici-Rivlin plan called for a 6.5% Debt Reduction Sales Tax (which actually operates as a credit invoice method value added tax), and Congressman Ryan's plan called for an 8.5% subtraction method border adjustable value added tax. Of course, Congressman Ryan's plan also called for repealing the corporate income tax and significantly simplifying the individual income tax.**

Based on your experiences as advisors to companies across the United States, to what extent has the business environment changed (or not changed) such that a VAT may or may not be palatable to the business community (potentially in place of the corporate income tax or in conjunction with a significantly reduced corporate income tax)? Given the proliferation of U.S. businesses that operate globally, are more companies gaining experience dealing with a VAT by virtue of operating (or transacting with customers) in foreign countries that have enacted some form of a VAT?

While it may be necessary or wise as a policy matter to consider a VAT or other consumption tax, I do not believe the political groundwork has been laid for adopting a Federal consumption tax any time in the near future. As you know, the Senate passed a non-binding resolution opposing adoption of a VAT last year by a vote of 85-13. Tax Notes editor Marty Sullivan explains the political antipathy to a VAT as follows:

For decades the conventional political wisdom has been that a VAT will never be enacted in the United States because liberals view it as a tax targeted on the poor and conservatives view it as a money machine. And in response to this observation pundits would quip: a VAT will be enacted when liberals view a VAT as a money machine and conservatives view it as a tax on the poor.

Ultimately, the purpose of imposing a consumption tax will matter to its political success. Because VATs are regressive taxes, adoption of one is likely to be more palatable if it is replacing another regressive tax or providing a progressive benefit. It is also important that, when policymakers examine the benefits of adopting a consumption tax, they don't compare our current income tax to an idealized consumption tax, but rather look to what a consumption tax looks like after it has been subjected to a political process.

Also, in your prior question, you asked about transition relief. Enactment of a VAT involves significant transition issues that will need to be considered. The imposition of a VAT could affect pricing of goods, asset values, and interest rates which could result in gains or losses for various taxpayers. As another example, adoption of a consumption tax may have a disproportionate impact on the elderly who have been saving for retirement while paying the income tax. Now as they begin to dis-save, a new tax is imposed on their consumption.

- 7) **At 35 percent, the U.S. statutory corporate income tax rate is the highest among all the countries in the Organization for Economic Cooperation and Development (OECD). Since the 1980s, other OECD economies have been steadily lowering their tax rates, but the United States has not cut its top statutory tax rate since 1993. In the OECD, the United States also has higher-than-average effective average and effective marginal tax rates, which are the best indicators for capital investors of their true tax liability.**

What have other OECD countries been doing over the past 25 years to enable them to lower their corporate income tax rates? Was it through significant income tax base broadening? Have the changes been revenue neutral, or have they replaced lost corporate income tax revenues with other sources of revenues, like a VAT or other consumption tax? Has there been any correlation over the past 25 years between an uptick in domestic reinvestment and foreign direct investment and changes in these OECD countries' tax systems, including lower corporate income tax rates?

My understanding is that recent rate reductions in the United Kingdom, Germany, and Japan have been accompanied by significant expansions of the corporate tax base. For example, in the United Kingdom, they recently reduced their corporate rate from 28% to 24% on a phased-in basis and offset the cost largely by reducing favorable capital allowances. At the same time, to lower budget deficits, the U.K. increased their VAT rates and increased capital gains rates.

Moreover, according to a recent paper by Altshuler, Harris and Toder, "other countries – perhaps more attuned to cross-border competitive effects – have lowered their corporate tax rates while removing provisions that allow shareholder relief from dividend taxes." See Altshuler, Harris & Toder, "Capital Income Taxation and Progressivity in a Global Economy," 30 Va. Tax Rev. 356, 358. The paper cites Finland, France, Germany, Italy, Norway, Sweden and Turkey as examples

of countries that have done this. Their paper argues that this type of change will encourage domestic investment, reduce the shifting of income overseas by U.S. and foreign-owned multinationals, and increase repatriations of profits. However, as noted above, it will be difficult to raise taxes on individuals to provide corporate rate relief. Also, it is not clear that raising the rates on dividends and capital gains will offset the cost of corporate rate relief, because the dividend rate is scheduled to increase after 2012 (and thus the increased rates are already included in the revenue scoring baseline) and increases in capital gains rates may cause realizations to diminish. Finally, the reduction of the tax rate on dividends in 2003 was meant to provide some level of corporate integration and mitigate the double tax under our “classical” system of taxing corporate income. It will be important for policymakers to keep this in mind in considering these types of proposals.

- 8) **On Friday, February 25th, Bloomberg ran an article titled “Geithner Says Tax Overhaul Must Address Businesses Filing as Individuals.”** The article focused on Treasury Secretary Geithner’s recent comments regarding revisiting long-standing rules that give businesses a choice of paying taxes as a corporation or through a structure as a partnership through which they can report business income on individual tax returns. In that article, one of the witnesses, Pam Olson, is quoted as follows: “Congress may be forced to choose between eliminating the double tax on corporate income or requiring all businesses to pay a corporate-level tax.”

If corporate tax reform were to include a significant lowering of the corporate income tax rate as well as subjecting all business income to a corporate-level tax, what would be the tax impact to small businesses in Wyoming and across the United States that currently operate in pass-through form – would they pay more or less than under the current system? Depending on the corporate income tax rate and the applicable dividends tax rate, is it possible that they could be subject to the same tax burden as they currently face under the individual income tax system? Even so, would such a change lead to even more complexity for small business owners in terms of tax compliance and reporting?

This depends somewhat on the personal circumstances of the small business owner. Take the following example. Assume A is an accountant operating as a sole proprietor in Sundance, Wyoming and he is in the 33% bracket currently. Assume further that the corporate tax rate is reduced to 25%.

Under current law, all of his income from the business currently flows through directly to his return. Thus, if he makes an additional net income of \$100, he will pay \$33 of tax on his personal return.

Now if he is required to file as a corporation, he would pay tax of \$25 on his corporate return, and when he distributes the remaining \$75 of profit to himself as a dividend, he will pay a second-level tax of \$11.25 ($\$75 \times 15\%$), for a total tax liability of \$36.25 (i.e., a 10% tax increase).

However, he has two alternative means of self-help to reduce the second-level tax. First, he can take the \$100 profit as compensation – the corporation would receive a deduction of \$100, would

report profit of \$0, and he would report the \$100 of compensation income on his individual return, achieving the same tax result (i.e., \$33) as current law (subject to reasonable compensation limits).

Second, if he can afford to wait, he can defer the payment of the dividend and reinvest the profit in the business. By doing this, he benefits from deferring the second-level tax, which reduces his effective tax rate.

I believe that for most small businesses current-law flow-through treatment is simpler and generally should be the proper paradigm. The two-level tax imposed on corporations will add some complexity, may create distortions, and could cause confusion. Also, if the rate differential between corporations and individuals is large, it may be necessary to revive dormant and complex mechanisms such as the accumulated earnings tax and the personal holding company rules.

Questions from Senator Schumer

- 1) **In his testimony and in the Q&A period, Mr. Solomon referenced the need for consolidating the various tax benefits for higher education. For the past several Congresses, I have authored legislation that would have consolidated the tuition deduction, Lifetime Learning credit, and HOPE credit into one program with one set of qualifications. Now, with the American Opportunity Tax Credit (which I authored) in place, I am developing legislation with some of my colleagues to make the AOTC permanent and consolidate it with the tuition deduction and Lifetime Learning credits.**

First, I take it from all of your testimonies, either directly or implied, that you think such legislation would be a good idea, and would provide some simplification to middle-class taxpayers? What are some factors that we should be cautious about?

As I testified at the hearing in response to Senator Menendez's question, I believe that simplification through consolidation of the various education incentives is a good idea, and something that can be realistically achieved. The myriad of currently available incentives with different requirements creates confusion and complexity.

Probably, the biggest factor you need to take into account is that the lifetime learning credit was meant to be available for any courses taken to acquire skills during one's lifetime (even if not enrolled in a degree program), whereas AOTC and Hope are geared to students actively enrolled in a post-secondary degree program. Thus, the lifetime learning credit is not limited to a number of years and is determined on a per return basis, rather than a per student basis.

- 2) **Second, Mr. Solomon referenced a number of different tax provisions for higher education, but my understanding is that these are the three most common ones that people claim on their personal tax returns. I was wondering which of the others any of you believe should,**

or could, be easily rolled into this consolidation effort, or whether these three should be the first ones we target.

I believe the student loan interest deduction could be eliminated, at least for new loans, and any savings could be applied to increase the amount of the consolidated credit. Lowering the cost of college will reduce the need for loans and thereby reduce interest costs. Moreover, this treats taxpayers who choose to pay out of savings similar to taxpayers who choose to borrow.

I also believe the various education savings incentives should be examined for possible consolidation as well. The differing requirements and accounts can be confusing and cause taxpayers not to take advantage of these incentives.

Finally, one additional means of simplification and reform is to conform qualification requirements, to the extent possible. For example, the definition of qualified educational expenses should be similar for the various tax incentives.

- 3) Setting aside for a moment that it would introduce some additional complexity, I wonder what each of you think of the idea of having the tax brackets be adjusted for the highest cost-of-living regions of the country? I don't mean having a sliding scale, which would be far too complicated. I mean, simply having one additional set of tax brackets that is slightly adjusted upwards for the 10 or 20 or 30 highest-cost counties. I ask this because, as all of you know, a \$50,000 income in Little Rock is fundamentally different than a \$50,000 income on Long Island. Do you think something like this could be implemented?**

This is a very complicated question. You rightly note that a dollar earned generally is worth more in Little Rock than on Long Island. Thus, it seems unfair to tax a taxpayer earning \$50,000 in Long Island the same as a taxpayer earning \$50,000 in Little Rock. This problem is exacerbated by our progressive rate structure and income caps imposed on various tax programs (e.g., the education incentives described above).

On the other hand, the higher cost of living in a region generally reflects greater access to opportunities and amenities. For example, a teacher in Little Rock may earn only \$30,000 a year, while a similar teacher working similar hours on Long Island may earn substantially more. Thus, for a comparison to be fair, it may need to reflect relative salaries for similar occupations, as well as relative cost of living. Moreover, a higher cost of living in an area often reflects access to better schools and recreational opportunities. Should the tax code be adjusted if the high cost of living reflects a taxpayer's choice to live in Malibu overlooking the ocean? Finally, given the failure to adjust for cost of living is a longstanding feature of our tax system, adjustments may have already been made in the economy to account for this treatment.

The suggested solution may create its own sense of unfairness and misallocation of resources. For example, assume that Nassau County is in the top 30 but Suffolk County is just outside the list. A taxpayer who lives just across the border in Suffolk County will likely have a similar cost of living to one who lives near him in Nassau County, but they will be taxed differently. The Suffolk County taxpayer may choose to move to Nassau County to gain the benefit of this disparate treatment.

- 4) **Mr. Talisman, as you know, last year I worked closely with Senator Kyl and others to introduce the “Ponzi Scheme Victims’ Tax Bill of Rights,” which was designed to offer targeted tax relief to those who fell victim to Bernie Madoff and Allen Stanford’s elaborate schemes, among others. One of the most important provisions of that bill provided some relief to those who lost their money with retirement accounts such as an IRA or 401(k). I believed it was unfair that someone who lost their money in a taxable account received up to five years of loss carry back, but that those with retirement assets – even if they had just moved the assets into the account – received nothing. This seemed unfair to me.**

We did not have a chance to push that legislation last year, and I hope to work in a bipartisan way to push pieces of that bill in the new Congress. But I know there are those who believe that providing a theft loss deduction for those with assets in a nontaxable vehicle would set a poor precedent. I know that you have worked closely with some of the victims’ groups, and I’d like for you to explain to the Committee why you believe that providing such relief is indeed appropriate from a tax perspective.

As you state in your question, I have been actively involved in the effort to obtain tax relief for victims of financial fraud, such as the schemes perpetrated by Bernie Madoff and Allen Stanford.

Your legislation provides fair and essential relief to victims who were defrauded in several recent financial scandals. As a result of these scandals, these victims find themselves with little or no retirement nest egg despite a lifetime of working hard, saving wisely and investing conservatively. Those that have retired have lost a principal source of income and face an uncertain future. They are being forced to liquidate other assets, sell real estate, move in with their children, and even return to the workforce in the midst of an economic recession.

The proposed legislation provides some modest degree of relief to harmed investors, allowing them to recoup a small portion of their retirement assets. Special tax relief for these victims is warranted because the SEC should have discovered these theft years ago but failed to do so. Had they done so, the investors (who thought they were investing conservatively) would have invested for their retirement in other vehicles and their losses would have been significantly mitigated. With respect to the extended NOL carryback provision, many of the victims have been paying taxes on fictitious income for many years, and because they are elderly, they will have little or no streams of income against which to use existing tax law mechanisms to help recoup losses.

Questions from Senator Hatch

- 1) **In Mr. Goldberg’s written testimony before the committee, he said,**

“The last – and perhaps most troublesome – trend is growing inequality in opportunity, income and wealth among our citizens. In my view, the tax law is neither the root cause nor the cure. Tax reform can and should make a contribution by reducing the job-destroying distortions and complexity that plague our current system – while maintaining or enhancing our progressive individual income tax. But I believe that far more can be

accomplished by reigning in out-of-control entitlements and wasteful spending to free up funds that can be profitably invested in our future.”

Since the United States, as shown by the chart prepared by the Finance Committee on the last page, already has the most progressive federal tax system of all OECD countries, what are your thoughts regarding the progressiveness of the tax system? Should a reformed system be more or less progressive?

Refer to chart titled *Progressivity of Taxes in OECD Countries by Share of Taxes Paid by Richest 10 Percent, 2005*

Progressivity of Taxes in OECD Countries by Share of Taxes Paid by Richest 10 Percent, 2005		
	Share of Taxes of Richest 10 Percent	Share of Market Income of Richest 10 Percent
1 United States	45.1	33.5
2 Ireland	42.2	32.3
3 Australia	39.1	32.4
4 United Kingdom	38.6	32.3
5 Austria	36.9	31.4
6 Netherlands	36.7	30.9
7 Canada	35.8	29.3
8 Luxembourg	35.2	30.1
9 United Kingdom	34.2	30.4
10 Belgium	33.9	30.1
11 Netherlands	33.1	30.1
12 Germany	31.2	29.2
13 Luxembourg	30.7	28.4
14 Portugal	29.7	28.1
15 Japan	29.1	28.1
16 Ireland	28.3	28.8
17 France	28	25.5
18 Austria	27.2	27.4
19 France	26.7	26.5
20 Sweden	26.7	26.6
21 Germany	26.2	26.7
22 Belgium	25.2	27.2
23 Switzerland	24.9	27.2
24 Switzerland	20.9	23.5
OECD-24 Average	31.6	28.4

(Source: Organization for Economic Co-operation and Development (OECD), *Growing Unequal? Income Distribution and Poverty in OECD Countries*, <http://browse.oecdbookshop.org/oecd/pdfs/browseit/8108051E.PDF>).

The question of the right amount of progressivity is a subjective one and involves a balance or tradeoff between (i) fairness, the ability to pay, and maximizing social welfare, versus (ii) the economic inefficiency of higher taxes discouraging work effort. The political system is best able to decide the question of the right amount of progressivity.

However, I would like to make a few points about relying on the chart above to demonstrate the U.S. tax system's progressivity:

First, the chart only includes Federal income taxes and the employee's share of payroll taxes. It does not include the employer's share of payroll taxes. Because these taxes are regressive, the overall progressivity of the U.S. system reflected in the chart would likely diminish, but would likely still be more progressive than the other countries.

Second, the chart does not include state taxes, which tend to be more regressive overall. If these taxes were added to the table, the progressivity of our system would likely diminish.

Third, the table does not include certain types of income (e.g., unrealized capital gains and accrued pension benefits) in the share of market income. Thus, the richest 10 percent's share of market income may be understated, thereby making any system appear more progressive in the table than it actually is.

Fourth, according to the author of the OECD report on progressivity, you also have to take into account "what taxes get spent on." According to him, our system of social security and cash benefits "reduces inequality by less than any other OECD country except Korea," because the overall level of spending is low relative to other countries.

- 2) **A fundamental question that all of us will have to answer as we think critically about tax reform is whether our final objective is to raise taxes in the misguided hope of increasing revenues coming in to the government, or whether our goal is to simplify the tax code and reduce the dead-weight loss it inflicts on the economy.**

Under current law, the top statutory marginal income tax rate will increase from 35 percent to nearly 40 percent in 2013. In a July 14, 2009, National Journal article, Lawrence Lindsey, former head of the National Economic Council, is quoted as saying, "When marginal tax rates go over 40 percent, the evidence suggests that the excess burden of collecting additional revenue rises very sharply, making the cost to the private sector of moving additional funds from the private sector to the public sector several times the additional revenue raised."

Leonard Burman spoke in a similar vein when he testified before this Committee last summer. Dr. Burman is currently a professor at Syracuse University and is former co-director of the Urban-Brookings Tax Policy Center. In his written testimony, Dr. Burman wrote, "Tax rate increases harm the economy and cannot, by themselves, close the budget gap."

I would like the panel to respond to what I've just said and to discuss the implications of the statutory top marginal tax rate approaching 40 percent or of tax rates going even higher as part of tax reform.

In general, I believe this question is better handled by professional economists, which I am not. I would make two broad points. First, the economic effects of raising marginal rates on work and saving, if any, must be weighed against the benefits/reasons that Congress is raising the rates. For example, in the 1990s, President Clinton and the Congress raised marginal rates in order to reduce the deficit. They believed that reducing government borrowing needs would increase investment, lower interest rates, grow the economy, and reduce the need for future taxes. Despite some dire predictions to the contrary, the economy grew substantially after the 1993 Act and the income of high-income earners grew most rapidly.

Second, there is an administrative concern that marginal rate increases expand incentives for high-income, savvy taxpayers to seek to use tax shelters and other avoidance techniques to escape or defer the higher taxes.

- 3) **Under current law the top statutory marginal tax rate will jump to 39.6% in 2013. Now the actual effective rate will actually be higher because of the reinstatement of PEP and Pease. On top of all of this, the increased Medicare tax bestowed upon the nation as part of Obamacare means that in 2013, the self-employed owner of a small business, the heart and soul of our economy, will face an increase in the marginal rate on flow-through business income and for labor income of 0.9 percent. This is on top of a return to the high Clinton tax rates.**

Is the panel concerned with the implication that under current law, marginal tax rates in 2013 will be higher than they were during the Clinton administration?

See response to #2 above.

- 4) **Once again, we find ourselves facing the individual alternative minimum tax ("AMT") problem. Thanks to a provision that was developed here in the Finance Committee in the 2001 tax relief bill, we've temporarily not made the problem worse. That provision runs out at the end of this year. A renewal of the patch will result in a revenue loss of \$60-\$70 billion by Joint Tax's account.**

According to Joint Tax, this tax, which was intended to hit only a thin slice of high-income taxpayers with tax preferences, will ensnare 23 million families next year if we don't act. According to the Congressional Budget Office, the AMT will balloon Federal revenue to record levels of gross domestic product ("GDP"), with or without an extension of the 2001 and 2003 bipartisan tax relief in the future.

Now, many on the other side insist that we cannot reform the AMT unless we offset the revenue loss from this unintended tax with tax increases on other taxpayers.

I'd like each of you to answer a basic question. Is it fair to condition AMT reform on substitution of revenue when we never intended the AMT to generate the projected revenue in the baseline? Why should AMT reform be secondary to maintaining an unintended stream of revenue?

I agree that the AMT is having significant and unintended effects on taxpayers. As I stated in my testimony before the Committee, I have long felt that the unintended and expanding reach of the AMT is one of the most serious structural problems in the tax code. While we have "patched" the AMT annually to prevent it from harming middle-income taxpayers, we have not yet addressed its known structural problems.

As suggested by your question, the failure to address the AMT problem to date is largely attributable to the fact that the estimated cost of reform or repeal is very expensive, because of its projected expansion into the middle class. Another factor is that most of those potentially

adversely affected by the structural problems don't realize it yet, because we have temporarily hidden the problems with the annual patches. And thus they are not yet clamoring for a fix.

Unfortunately, the failure to offset the estimated cost of AMT reform or repeal has ramifications. The projected revenue growth from the unintended reach of the AMT is limiting the size of projected future deficits. Thus, eliminating the AMT without offsetting the cost will exacerbate the size of projected deficits, which are already at record levels. It seems highly unlikely and unwise for Congress to add nearly two trillion dollars to our projected deficits over 10 years at a time when most policymakers agree that our deficits should be reduced significantly and are considering major cuts in popular social programs.

Questions from Chairman Baucus

- 1) Some of you suggested that we should think “outside the box” and consider tax bases other than income. Professor Barker of the Dickinson School of Law advocates replacing the corporate income tax with a destination-type expenditure tax (see William B. Barker, “International Tax Reform Should Begin at Home: Replace the Corporate Income Tax with a Territorial Expenditure Tax,” 30 Nw. J. Int'l L. & Bus. 647 (2010)). In his view, such a tax would be clearly superior to any of the income tax alternatives; he says it would “promote long-term revenue gains, protect the domestic tax base, and, at the same time, stimulate economic growth in U.S. jobs and business in a tax neutral fashion” and would be “an efficient, fair, largely unavoidable tax that would enhance U.S. welfare.”

Do you have a view on this proposal? Were any proposals of this kind considered during your time at Treasury?

Professor Barker's proposal to replace the corporate income tax with a destination-based “expenditure” tax is similar to several other proposals. For example, Professor Alan Auerbach, former Deputy Chief of Staff at the Joint Tax Committee, recently wrote a paper for the Hamilton Project with a similar proposal to replace the corporate tax with a destination-based “cash-flow” tax. And in the early 1990s, Senators Boren and Danforth proposed to replace the corporate tax with a “business activity tax.” (I worked on this proposal when I was on the Joint Tax Committee staff.) Despite the labels, in each case, the replacement for the corporate tax is some variant of a “subtraction method” consumption tax.

Among the principal items that should be considered in analyzing Professor Barker's proposal or similar proposals are:

- (i) What is the treatment of non-corporate entities – are they subject to the new expenditure tax, as well as the income tax? Can they elect to be treated as C corporations? If not, is it fair to subject them to a new tax, when they get no benefit from repeal of the corporate tax?

- (ii) What is the treatment of passive income held by C corporations – will there be mechanisms to prevent individuals from stuffing their passive investments into corporate solution in order to avoid income tax?
- (iii) What is the incidence of the new tax – who will bear the burden of the new tax? Because it is a variant of a consumption tax, will price levels increase, or wage levels decrease? If so, it will likely be viewed as a regressive tax replacing a more progressive tax and this may need to be mitigated in some form (e.g., refundable tax credits). Or will it be viewed as a new accounts-based corporate tax with a narrower base, with the incidence falling on labor and the owners of corporate capital?
- (iv) Will any current tax incentive provisions for businesses be preserved (e.g., renewable energy incentives)?
- (v) Will such a destination-based tax be treated as GATT legal? While credit-invoice VATs are GATT legal, does the fact that Professor Barker's proposal is accounts-based (rather than transaction-based) or that he would allow a deduction for wages (which VATs do not) convert it to a direct tax that could be challenged in the WTO?
- (vi) Will other countries still view this as a corporate tax and extend exemption or credit benefits under tax treaties or domestic law?
- (vii) What transition rules are needed, if any, to protect owners of old capital?
- (viii) What is the proposed tax rate necessary to replace the revenue lost from the corporate tax?

Only after these questions are answered can an evaluation be made of the equity, efficiency and simplification benefits of these proposals.

- 2) **The IRS launched e-file in 1986. Last year more than 70% of tax returns were filed electronically, a figure that has grown each year. Today roughly 60% of taxpayers utilize paid tax preparers. There has been an historical debate about whether the IRS should enter into the software business and provide a free electronic preparation portal for the easiest of tax forms. This would largely mirror the tele-file options that used to be available for 1040EZ filers.**

What implications does this have for tax reform? Does it create opportunities? Challenges?

The IRS already has an agreement with the Free File Alliance, a coalition of several tax preparation software firms, to provide free online access to tax preparation software to taxpayers with AGIs below \$58,000. This agreement covers roughly 70% of all taxpayers. (We represent one of the coalition's largest member companies).

Having the IRS provide its own software does not appear to have many implications for tax reform. One potential significant concern would be the additional cost and resource burdens

imposed on the IRS at a time when it is dealing with the additional responsibilities required by health care reform, and potential new burdens imposed by implementing changes brought about by tax reform.

- 3) **Since 1986, the number of corporations has dropped 28% while the number of pass-throughs has grown 102%. In 1986, pass-throughs earned 40% of all business income. Today, they account for nearly 60% of the income earned by all businesses.**
- a) **Do you think this trend is a problem?**
 - b) **How has the tax code kept up with this change in the form of American businesses?**
 - c) **What implications does the increasing proportion of business income that is being taxed as individual income have for tax reform?**

I do not believe this trend, in general, is a problem. Because of changes in the tax law, most of the growth was either intentional or predictable. Among the tax law changes that have caused a growth in the number of pass-through entities and the proportion of business income earned by such entities are: (i) permitting pass-through owners in the early 1980s to qualify for favorable pensions previously available only to owners of corporations; (ii) flipping of corporate and individual top marginal rates; (iii) liberalized pass-through treatment (i.e., the advent of real estate investment trusts, treatment of limited liability companies as partnerships, S corporation reforms, and check-the-box regulations); and (iv) repeal of the *General Utilities* rule in the 1986 Act, resulting in a two-level tax on liquidation of corporations. I believe the adoption of the passive loss rules in 1986 also partially explains the growth in the share of pass-through net income as the incentives to generate losses in investment partnerships have diminished. Finally, although I am not aware of any research in this area, I believe the growth of the services sector of the economy may be another factor contributing to this trend, as service entities are more likely to use pass-through vehicles.

Also, as stated above and assuming the tax can be administered efficiently and promptly on a flow-through basis, I believe that pass-through treatment (i.e., one-level of tax) is generally a better paradigm than the classical two-level tax system applied to C corporations. (The principal rationales for imposing an entity-level tax on corporations are ease of administration and ensuring that tax is paid when the income is earned.)

It will be difficult to broaden the base to achieve meaningful corporate tax reform without negatively impacting non-corporate businesses. Many of the base broadeners that have been suggested to date – e.g., eliminating the manufacturing deduction, accelerated depreciation or the LIFO inventory method -- would affect non-corporate entities, as well as C corporations. Thus, while all businesses would apparently lose the benefit of these provisions, only C corporations would benefit from a corporate rate reduction. Of course, Congress could decide to apply the base broadeners only to C corporations. This will reduce the amount of rate reduction that is possible, and will ameliorate the simplification and efficiency benefits, if any, of eliminating these provisions. Also, it is possible that the reduced corporate rate could induce some pass-through entities to elect to become taxed as corporations.

Questions from Senator Grassley

- 1) I wanted to seek clarification regarding the question I raised to the panel during the hearing last week regarding tax expenditures. Mr. Talisman, in his written testimony, stated the following:

“Many of the largest “tax expenditures” are long--time features of our system embedded in the fabric of our economy. These include items such as the employer--provided health exclusion, deductibility of home mortgage interest, deductions for charitable contributions, incentives for retirement savings, the deduction for state and local income taxes, reduced rates on capital gains and dividends, the exclusion for capital gains on home sales, inside build--up on life insurance, the child credit, the earned income tax credit, and exemptions for state and local bonds. Collectively, these account for close to two--thirds of all tax expenditures in 2010 according to Treasury.”

It appears that the overwhelming majority of assets in 501(c)(3) organizations reside in fee-for-service charities such as hospitals and universities. The activities of these charities are generally no different than for-profit organizations. There are also now fee-for-service software and consulting companies that are also recognized as charities. The tax-exemption for such entities is currently not included as tax expenditure in the Joint Tax Committee's annual report on tax expenditures.

I understand that the definition of a tax-expenditure is something to be debated when considering tax reform. However, I would like your thoughts on whether tax-exemption, particularly for fee-for-service charities, should be considered a tax-expenditure.

To be clear, I understand that Congress has historically provided exemption to charities because of the societal benefit they provide. Given that fee-for-service charities are operating in the same space as taxable for-profit entities, it seems that Congress should have an idea of the value of the tax-exemption.

As I stated at the hearing, I do not believe the label should matter to the analysis and that a debate over whether tax exemption should be considered a “tax expenditure” may be controversial. For example, is the tax system’s failure to tax churches a tax expenditure or is it part of our normative tax system? I believe most people believe it is the latter.

That being said, I agree with the notion underlying your question. I believe it is appropriate for Congress to determine whether certain “fee-for-service” organizations are serving an exempt purpose, to determine whether the benefits to the public outweigh the “cost” of the tax exemption, and whether they are unfairly competing against taxable entities (without providing an adequate public benefit).

- 2) Both written and oral testimonies included the comment that tax reform will result in “winners and losers” and there seems to be agreement that the corporate rates must be reduced. One witness, Mr. Weinberger I believe, stated that we should not pit large businesses versus small businesses. A November, 2009, GAO report found that: “Large

corporations have dominated the use of the research credit, with 549 corporations with receipts of \$1 billion or more claiming over half of the \$6 billion of net credit in 2005 (the latest year available). In 2005, the credit reduced the after-tax price of additional qualified research by an estimated 6.4 to 7.3 percent.”

So, if corporate rates are reduced, I would like your thoughts on whether some of the largest tax expenditures for businesses, such as the R&D credit should be retained. If yes, since there is also general agreement that small businesses drive job growth, should such expenditures be reduced for large corporations? In other words, if corporate rates are reduced across the board and winners and losers will result, would it make sense for tax expenditures to favor small businesses?

In general, I don’t believe that tax expenditures should be geared toward small businesses unless that is consistent with the underlying purpose. Also, the primary consideration regarding whether to retain certain tax expenditures should not be whether their elimination would create winners and losers, but rather whether the intended result of the expenditure is still valid, whether the tax expenditure achieves its intended results in an efficient manner relative to the foregone revenue, whether these results are best achieved through the tax code (e.g., relative complexity and administration), and what the effects of eliminating the tax expenditure are on the economy.

For example, it will be important for the tax code to continue broadly to encourage innovation in a more competitive global marketplace. Research has shown that investments in research and innovation help drive productivity growth, improve living standards and have important spillover benefits for other firms and sectors of the economy. Numerous other countries offer generous incentives that aim to lure R&D investment and jobs out of the United States. Recent lapses in the credit have caused uncertainty for American businesses and impacted the credit’s effectiveness. Consequently, the research credit should be retained, made permanent, strengthened, and simplified to ease compliance and administration. Also, mechanisms should be examined to ensure that small/start-up firms can benefit from the credit. Other countries have made their research credits refundable for small/start-up businesses.

One area where attention should be given to tax provisions that favor small businesses are provisions that ease their tax administrative burden, relative to larger businesses. For example, the use of the cash method of accounting and the expensing of capital investment generally are reserved for small businesses to reduce both their tax and administrative burdens.

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The personal income tax portion of our plan rests on a little known economic reality. We believe that now and in the future, given the now global nature of our economy, Democrats will need to fully take advantage of this reality in order to be successful regarding tax policy. The little known economic reality is this: Within all the income that is earned by the top 5% of income earners in the US, only about 18% of all that income is the profits of any business that is not a C Corporation that has any employees in the US⁽¹⁾. For the top 1% of US income earners this number is about 21%, and for the top 10% it is about 12%⁽¹⁾. The top 5% of earners is roughly all households that make more than \$220,000 a year, or about where today's 33% personal income tax bracket starts. President Obama has pledged to have the Bush tax cuts expire on today's 33% and 35% brackets, and have them go to 36% and 39.6% respectively, beginning at \$250,000 of income a year where about the top 2% of income earners begins.

Republicans with often quote figures as high as 70% for the number of "business owners" in the top 1% or 2% of US income earners. Yet that number can only be derived at by counting all those who own any kind of stock as business owners. Republicans will also say that if we raise taxes on the top 2% we will be raising taxes on 50% of the income of small business owners. If we define small business income as all business income that is taxed through the personal income tax, then it is true that 50% of small business income would have its taxes go up.

One option within the personal income tax portion of our plan would increase tax rates on the top two brackets by the same amounts and at the same income levels as President Obama's plan. However, our plan would award US Employee Tax Credits for all W2'd employee wages and salaries below \$106,800 a year (or that years FICA cap) that are spent

in the US. These tax credits would enable a private businesses to lower their effective tax rate from the amount as though the bracket rates were 39.6%, 36%, 28%, 25%, 15%, and 10% to no lower than if the bracket rates were 35%, 33%, 28%, 20%, 10% and 5%. With the second set of numbers, given that the bottom four rates are below where they are today, and that the top two rates are not changed, the effective tax rate for about 98% of private businesses that hire in the US would go below where they are today under the current Bush plan. Effective tax rates for nearly all private businesses entering the 39.6% bracket would be cut by 2.25%. The 36% bracket would be cut 6.8%, the 28% bracket by 34%, the 25% bracket by 33%, the 15% bracket by 50%, and the 10% bracket by 50%.

These tax credits would create an effective tax cut for the employers of 98% of Americans that are hired by private businesses, and only about 1% of such Americans would have their employer's tax rate go up. These tax cuts, along with the fact that they are tax cuts for employee expenses spent in the US, would completely reverse the argument by Republicans that Democrats will be raising taxes on job creators during a recession!

Our US Employee Tax Credits are calculated by adding \$.15 for every dollar spent for the first \$106,800 in one tax year of W2 based wages and/or salaries that are paid for work done in the US. By only rewarding tax credits for wages and/or salaries paid below \$106,800, where social security payroll taxes are paid, the calculating of the tax credits for businesses, and the policing of the policy for the IRS, will be made much earlier. Also, the \$106,800 cap, which will increase as the social security tax cap increases, will insure that not much of the tax credits will be rewarded for the payment of very high salaries. Further, and very importantly, our US Employee Tax Credits would create an incentive for businesses to claim their employee expenses on their books and not pay employees under the table. Given that FICA taxes have been raised recently due to the healthcare bill, and may need to be raised in the future given increasing healthcare and social security costs, the underground economy in labor is going to become an increasing problem.

Employee wages and salaries that qualify for the tax credit must not go to any "owner of a business" nor any dependant of any owner of a business, be it a C Corporation or otherwise. Nor can they go to any immediate family member, including by marriage, who reside in any home owned by any owner of the business. An owner of a business is anyone who owns 10% or more of a business, C Corporation or otherwise. Further, qualifying wages and salaries cannot be any of the portions above 33% of any single employee's wages and/or salary who works more than 33% of the year outside of the US.

A private business's tax bill would be arrived at by first going through all existing steps in the tax code. Then, if a business owner, it would be calculated by using new tax tables at the end of each applicable schedule. These tables would give two numbers for each income grid square, one number as though the bracket rates were 39.6%, 36%, 28%, 25%, 15% and

10%, and the second as though the rates were 35%, 33%, 28%, 20%, 10%, and 5%. The business could then deduct \$.15 for every dollar of qualifying US Employee wages and/or salaries spent, from the dollar amount of the first number in the grid, to no lower than the second number in the grid.

These tax credits in the personal income tax portion of our plan would only cost about \$97 billion over 10 years, or conservatively about 20% of the \$488 billion over 10 years in new federal revenues that President Obama's planned personal income tax increase would raise. However, there are several possible pay-fors that would lower, eliminate the cost, or even raise more federal revenues than President Obama's personal income tax plan, while accomplishing one of our plans primary goals of increasing private sector job creation. For one, a 7th bracket could be created for all incomes above \$500,000 a year for both singles and joint filers with a rate of 41%. Such a 7th bracket would generate about \$91 billion over 10 years, or about 94% of the cost of our US Employee Tax Credits. If this 41% bracket were to start at \$349,700, and therefore become the rate for the top and 6th bracket, \$106 billion over ten years would be generated, \$11 billion more than President Obama's plan. Also, if the second to top rate were taken to 37% instead of 36%, another \$17 over 10 years would be generated. Therefore, our personal income tax plan could generate about \$28 billion over 10 years more than Obama's personal income tax plan while creating an effective tax cut for 98% of private businesses that hire in the US! Further, these revenue numbers assume that all private businesses in these top two or three brackets will exercise our US Employee Tax Credits to the fullest extent. Also, NOT ONE NUMBER is being dynamically scored in the above calculations. The reality is, growth should become much higher.

These rate increases to 41% and 37% would keep personal income tax rates on the top 5% of income earners, and the top 1% of earners which is about where today's top bracket begins, to BELOW the US historic averages since 1947. Married couples filing jointly, who are right at the income point where the top 5% starts, would pay a top rate of 28%, while single filers would pay a top rate of 39.6%. The US average since 1947 for the point where the top 5% starts is 32.8% for joint filers and 40.2% for single filers. The average from 1947-1986, a period ending with the Reagan tax cuts being fully implemented, was 34.6% and 43.5% respectively. All of the averages for the top 1% are far above 41%.

While implementing our US Employee Tax Credits without the pay-fors would cost some revenue, this option for our plan, regarding both personal income and capital gains taxes, would raise conservatively about 2% more federal revenues than President Obama's plans, \$702 billion over 10 years versus \$688 billion. Our plans would raise 15% more revenues, \$793 billion over 10 years, if a top bracket of 41% were created at \$500,000 of income. If the 41% bracket were taken down to \$349,700, 17% more federal revenues would be raised, \$808 billion over 10 years versus \$688 billion. If on top of that, the 2nd to top rate

were taken to 37% instead of 36%, 20% more revenue would be raised, \$825 billion over 10 years. Also, our FICA tax plan as explained below would raise another about \$336 billion over 10 years on top of the above numbers. That means as much as \$1.161 trillion over 10 years versus \$688 billion, or 69% more federal revenues.

ALL OF THE ABOVE NUMBERS do not account for any positive dynamic effect to tax revenue that would take place through our plan incentivizing private sector job growth and capital formation. Very importantly, our plan would take away the argument from Republicans that Democrats are raising taxes on job creators during a recession. In fact, our plan would create a continuous, built in, incentive to hire in the US. Moreover, the fact that it is a, continuous and built in, incentive would create more jobs than if the incentive were temporary!

Our capital gains plan would raise about 63% more revenues than President Obama's capital gains plan, not counting the new healthcare increases. This would be \$311 billion over 10 years versus \$200 billion. Our capital gains plan would create three rates for long term gains, 10% for where today's 10% and 15% personal income tax rates are, 20% for where today's 25% and 28% rates are, and 25% for where today's top two personal income tax rates are. But very importantly, our plan would lower to 15% the rate on the top bracket, it would lower to 10% the rate for the middle bracket, and drop to 0% the rate for the bottom bracket, on all long term gains derived from four investment types. These four are: One, all venture capital funds and projects. Two, all stocks bought at IPO or secondary offering. Three, all bonds bought at first issue. Four, the direct underwriting of any of the above three investments that would be taxed under today's Carried Interest rule.

These four investment areas represent anywhere from 3% to 20% of all capital gains in the financial markets, but most of the time they are only 5% to 12% of all financial market gains. Therefore, the tax on the 95% to 88% of capital gains that are speculative paper trades can be raised, and gains from the four investment areas can be lowered. This policy would increase government revenues, while steering capital to U.S. job creators, while also curtailing destructive speculative investment bubbles. Plus, it would reward those financial investments that require the most research and risk for the investor, and it rewards those investments that generate the most return to society.

Very importantly, the above four investments cannot qualify for a lowered capital gains rate if the business floating the stock or bond does not have at least 5% of its US expenses, or the venture capital project does not have at least 5% of its investment, being employee costs that would qualify for our US Employee Tax Credits as explained in the personal income tax section of our plan. In this way, our plan would insure increased job growth in the US, and not just an increase in the underwriting of financial instruments.

In order to achieve access by ordinary investors to the purchasing of IPO's and bonds at first issue, stocks should still be considered to be bought at IPO and bonds at first issue until the moment either is sold for the third time by an institutional trader or five working days after the first purchase, or until the moment either is sold for the first time by a non-institutional trader.

Under our plan, all tax brackets and rates for ordinary dividends and qualified dividends would go to the numbers that President Obama has proposed for 2011 and beyond.

Our corporate tax plan would employ nearly the same tax credits as our personal income tax plan. However, this portion of our plan we try to keep revenue neutral. Our plan would eliminate the top four brackets, while taking the fourth, 39% bracket, to 39.6%, and the third, 34% bracket, to 38%. Yet C Corporations, both foreign and domestic, could use our US Employee Tax Credits to lower their effective tax rate to no lower than if the bracket rates were 15%, 25%, 30%, and 30%. However, by making the US Employee Tax Credits for C Corporations worth only \$.04 on the dollar, about half of all US corporations would have their effective tax rate go down while about half would go up. This would keep this portion of our plan revenue neutral while creating a continuous, built in, incentive to hire in the US versus overseas.

It would also be possible to make the \$.04 tax credit worth more for those C Corporations that have a median wage and salary that is above the US corporate norm or greater, or greater than that areas prevailing wage. This would incentivize American corporations to treat their US employees better.

All existing foreign C Corporations that presently hire employees in the US would be taxed as though their US employee expenses that would qualify for US Employee Tax Credits, when compared to their global expenses, was at the same ratio as is the average for all US C Corporations. Then, once our C Corporation tax plan was instituted, these foreign C Corporations would have their effective tax rate go down or up depending upon if they increased or decreased their ratio of US Employee Tax Credits to global expenses. Also, once the plan is instituted, any foreign C Corporation that latter begins for the first time to hire in the US would be compared in their first year to the US C Corporation average ratio. Their tax rate would then go down or up depending upon if they increased or decreased this ratio. Foreign C Corporations could also have their effective tax rate go down if their median wage or salary was above the US average or the prevailing wage of a particular area.

Our FICA tax plan would accomplish the four primary goals of our revolutionary tax policy. These four goals are: one, stimulating private sector jobs and income growth, two, increasing government revenues, three, separating wealthy income that is more likely to create domestic jobs from wealthy income that is more likely to only purchase consumer goods or speculative financial investments, four, create a significant tax rate difference between those who hire employees in the US and those who do not, thus incentivizing entrepreneurship and the demand for labor domestically.

Our FICA tax plan would cut FICA tax rates for one year to 0, both on the employee and employer side, for the first 20 “net” new employees that are added to a business or the first 20 employees of a new business. These tax cuts would cost the federal government about \$14 billion a year. However, our FICA tax plan would more than pay for these cuts in a way that would further stimulate American job and economic growth.

Our plan would more than pay for these tax cuts by raising the FICA tax cap from \$106,800 of income a year where it is today to \$120,000 for non-business owners. Such a plan would raise about \$30 billion in the first year in new federal revenues above the \$14 billion cost of the tax cuts. This would mean a gain of about \$336 billion over 10 years in new federal revenues! Moreover, this \$336 billion gain includes the cost of allowing “business owners” to use US Employee Tax Credits, as both are defined under our personal income tax plan, to lower their tax burden to no lower than as if their FICA tax cap stayed at \$106,800. Very importantly, the fact that these business owners could lower their personal income and FICA tax rates by employing people in the US would greater incentivize job creation in the US by creating a greater difference in tax burden between those who hire in the US and those who do not!

Our plan would also make it easier for new entrepreneurs to start new businesses that hire in the US in that it would free them to focus on making a profit and growing their business as opposed to focusing on the bureaucracy of tax law. It would also make it easier for them, and potential employees, by making their first 20 employees cheaper to hire.

A FICA tax cap at \$120,000 would also keep the FICA tax cap BELOW the point where the top 10% of US income earners begins. The original intent of social security was to only have the top 10% of US income earners have their remaining income exempt from payroll taxes.

A business would be considered to have “a net new employee” with their first hire that takes the dollar amount of their total US payroll above what it was the prior year, not counting any salaries that might go to any “business owners.”

The plan would be phased in by allowing all existing businesses to eliminate FICA taxes on the employee and employer side for their first 20 net new hires for up to five years. Such a

rule would insure fairness among businesses with different size payrolls and when compared to brand new businesses. This rule would also create a greater incentive for all businesses to hire in the US. The above revenue numbers fully account for this phase in rule.

The final component of our tax policy deals with the environment. Under our environmental plan all private and public businesses, both foreign and domestic, would be allowed to lower their top tax rate on personal and corporate income by as much as 35 percentage points but to no lower than 0. Congress would be empowered to dictate to the EPA which manufacturing sectors and goods, and what types of production techniques that the EPA can then proclaim to be using "best practices" and/or "standard practices" in. Congress could dictate what is pollution regarding what is generated during the production of a product, and/or while a product is in use, and/or when a product is discarded.

It would be up to the EPA to propose "best practices" and "standard practices". Yet it would be up to Congress and the President to make law regarding what products and techniques these best and standard practices can lower a tax rate through the use of and by how much these tax rates can be lowered by. Our philosophy regarding environmental taxes is that they are most efficiently and effectively structured when they use primarily a reward approach as opposed to a reward and punishment approach or just a punishment approach.

Our plan is important to implement at this time for two primary and related reasons. These reasons are our federal deficit and debt, and the current fragility of our economy. Our federal deficit in 2010 is projected to be about \$1.38 trillion. Given that the total Obama tax increases regarding individual income, corporate, and capital gains taxes (outside of the healthcare bill tax increases that were created to pay for healthcare) are projected to raise only about \$688 billion over 10 years, in order to eliminate the \$1.31 trillion deficit that would be left, our economy would have to grow at an unrealistically fast rate above what it is now growing, or government spending would have to be cut by \$1.31 trillion below today's GDP growth rate. The problem with either of these scenarios is that the Obama tax increases, alone, will create some kind of drag on economic growth, and the decreases in government spending will likely drive GDP growth down even more so. This might not be a problem if growth in the private sector were robust. But growth there is not, so the tax increases and government spending cuts could force our economy into a double dip recession. This scenario will be even more likely given that Japan and Europe will be engaged in similar levels of tax increases and spending cuts at the same time we are.

However, our overall plan would reverse these two primary problems. Few policies would do more to stimulate private sector economic growth than our plan, and our plan would

more than pay for the tax cuts that would create this stimulus. Our capital gains and personal income tax plans raise 20% more federal revenues than President Obama's like plans, and our FICA tax plan would raise another \$336 billion over 10 years, all while giving a tax cut to capital formation and to the employers of 98% of Americans who work for private businesses in the US and a tax incentive for C Corporations to hire in the US.

To explain the US's current situation regarding economic growth we must understand our current political/economic position and how unique it is. Our current recession is taking longer to get out of because banks and other lenders see an economic environment where governments in the US, Europe, and Japan have such high debts that they are now, or soon will be, forced to reduce their spending levels. This will create a damper on economic growth. This reduction in spending would not be so bad except for another phenomenon that has never occurred simultaneously with such high levels of government debts. That phenomenon is the fact that the fed rates are now essentially at 0% and that most experts expect that any added quantitative easing would have little effect at lowering interest rates for borrowers. In a normal recession lenders could lend knowing that if the recession became stubborn or a double dip occurred the fed could always cut interest rates further and/or the government could spend more to stimulate the economy. This is the first recession in our history where this is not true, and this is why this recession has been so stubborn. Our tax plan would be the best prescription for allowing the government to continue its higher spending levels, while increasing private sector growth, and creating stability and confidence in the economy!

Right now Democrats could push for immediate passage of the tax cuts in the personal income, capital gains, and FICA tax parts of our plan. However, they should only pass these cuts with the legal agreement with Republicans that, in 2013 with a new Congress and possibly a new president, there would be an up or down vote regarding the tax increases in the plan that by law could not be filibustered. Separate bills in 2013 would address the C Corporation part of our plan, along with general C Corp tax reform, and perhaps the environmental component of our plan.

Republican would have to go along with these tax cuts, because, they are very simple tax cuts and Americans are desperate for private sector jobs. Whereas, with the small business bill that just passed, Republicans were able to argue that the bill mostly consisted of the government buying equity stakes in small banks. Also, the Republicans would appear very cowardly and undemocratic if they did not take the challenge to have the vote in 2013 after the 2012 election. A large majority of Americans are weary of the filibuster, so this would also work in our favor.

For several reasons our tax policy over time can raise much more federal revenues than any other current tax proposal. For one, because our policy lowers taxes on most businesses, our proposal would eliminate the fear among voters that raising taxes on the wealthy would slow job and economic growth. With the elimination of this fear, the top tax rate on the wealthy could be raised far above 39.6% or 41%, and that tax base, those who we consider “the wealthy”, could be broadened far beyond what it has in recent decades.

Beyond political reasons, our policy is simply much more efficient from a purely economic stand point. Under our plan the demand for labor will be increased in the US, and the cost of capital for businesses will be lowered because businesses will have more money in hand due to their lowered tax rate and because our capital gains policy would lower business borrowing costs in the financial markets. A lowering in the cost of capital for businesses will then raise productivity because businesses would then have more money on hand to invest in R&D, capital improvements, employee training, and new employees. It is only an increased demand for labor, along with an increase in productivity, which raises real wages for workers.

Our new philosophical perspective would desire the biggest differential possible between the tax rates of those who employ people and those who do not. Such a tax model would be the most efficient tax regime possible, as long as R&D was continued to be rewarded and the differential was not so large that all other capital investments were given a tax disadvantage that had a negative effect on economic growth. The increased economic efficiency of our tax plan can be most specifically measured by quantifying the amount of money that growing businesses would no longer have to pay in interest costs for moneys they had to borrow to make up for the capital they lost due to increased quarterly taxes.

But more importantly, in relation to job creation, economic growth, and overall prosperity, our tax policy acknowledges a social reality that our current tax model does not. That reality is: All things being equal, a person who employs people is more important to society than a person who does not; therefore we need to create more who do.

Our tax policy is a different way of viewing the economy. An old liberal view of the economy pushes a dichotomy between labor and employers. We look at business, particularly small business, as being on the side of labor. The most important dichotomy in the economy is between those who have capital to lend and those who do not! Our policy will also bring Democrats a new group of supporters in the form of the many business owners who would benefit from our policy.

Our policy continues the predictable cycle of having the definition of “liberal” substantially change every four, 25 year, generations, dating back to the 1500’s. Between 1905-15,

France, Britain, Spain, Germany, the US, and several other countries all passed a progressive income tax for the first time. Prior to this time progressive income taxes had only existed for short periods and in a few countries, and most often just to pay for war. Very importantly, it was during this period of time that the Labor Party in Britain that championed the progressive income tax became the dominant political party along with the conservative Tories, while the then dominant Liberal Party that was not as passionate in championing the progressive income tax began to slip into political obscurity.

This rapid move to a progressive income tax in the developed world, and then later for nearly the entire world, was done to compensate for the fact that economies had just moved from primarily agricultural to primarily industrial. This economic shift necessitated the need to compensate for the reality of Surplus Value. Surplus Value refers to the fact that, in an industrial economy, in order for businesses to make a profit, they must charge more for their products than what they pay their employees. For this reason, and therefore the need to redistribute income to the poor and middle class, the progressive income tax was created.

Today, we still need to compensate for Surplus Value with a progressive income tax. However, we now need to contour our progressive tax policy to the reality of the six fold increase in global trade that has come with the weakening and fall of the Soviet Union. The fall of the Soviet Union opened up a new cheap labor market of about 4 billion people to the multinational businesses of the developed world. This change is here to stay, regardless if some people want that or not. Nonetheless, due to the natural and accompanying desire to attract business investments, this globalization has created a race to the bottom, in tax policy. 30 years of this, race to the bottom, policy has created unsustainable government debts throughout the developed world, and our plan is the only responsible way to get out from under of this debt while prospering.

Redefinitions of "liberal" also came during the Second Great Awakening of the early 1800's with the advent of all the first modern socialist writers, during the Great Awakening of the early 1700's with the popularization of democracy, and during the Puritan Awakening of the early 1600's and the Protestant Reformation of the early 1500's regarding increasing degrees of religious freedom.

(1) Emmanuel Saez and Thomas Piketty, "The Evolution of the Top Incomes: A Historical and International Perspective," National Bureau of Economic Research, working paper no. 11955, January 2006.

The Only Tax Reform Plan that Will Increase Private Sector Jobs and Tax Revenues

For much more info see, ThirdWayProgressives.org, or contact Tom Pallow at 202.903.1133

Our overall tax reform plan raises more federal revenues than President Obama's and the Deficit Commission's tax plan, \$1.25 trillion over 10 years versus \$700 billion and \$925 billion. If these three tax plans were dynamically scored the gap would be much, much larger!

Our personal income and C Corporation tax plans award US Employee Tax Credits, dropping effective tax rates for the employers of 98% of Americans who work for a business that is taxed as personal income. For C Corporations our plan, in a revenue neutral way, lowers effective tax rates for all C Corps that hire more often in the US and in more socially responsible ways.

Our personal income tax plan raises rates where President Obama wants them. However, through our US Employee Tax Credits, our plan lowers taxes on the ONLY 19% of all income above \$250,000 that comes from a non-C Corp business that employs one or more Americans.

Our Capital Gains tax plan would raise 63% more revenues than President Obama's Capital Gains tax plan. Our plan raises the top rate on long term gains from 15% to 25%. However, rates would drop for gains from investments in venture capital funds and projects, from stocks bought at IPO and secondary offering, from bonds bought at first issue, and from the underwriting of the above three investments. Companies invested in would need at least 5% of their total expenses being labor expenses that would qualify for our US Employee Tax Credits.

Our capital gains plan would raise much federal revenues because the four investments receiving the tax cuts generally account for only 3% to 12% of all gains in the financial markets.

Our personal income and capital gains tax plan would create or save 7,471,000 jobs between 2012 and 2020!

Our FICA tax plan would raise \$336 billion over 10 years by increasing the FICA tax cap up to 90% of income. However, it would eliminate FICA taxes on the employer and employees side for the first 20 employees of any business and the first 20 net new employees hired in one year.

Our FICA tax plan would create 4,082,000 jobs between 2012 and 2020. Our overall tax plan, excluding our C Corporation plan that would certainly create many jobs in the US, would create or save 11,553,000 jobs between 2012 and 2020!

Studies propose that President Obama's tax plan would cause the loss of about 6,243,000 jobs between 2013 and 2020. The Deficit Commission's tax plan would cause even more job loss!

Keynes, Today, Obama, the VAT, and the Future of Prosperity

By Tom Pallow of Third Way Progressives, 2/24/11, contact: 202-903-1133

For almost a century now the US and the rest of the developed capitalist world has relied on Keynesian economics as a way of increasing consumer demand and job growth in the economy. The understanding of the need for something like a Keynesian stimulus in order to increase consumer demand dates back to the writings of Karl Marx in 1864 with *Das Kapital*. Marx did not invent the concept of Surplus Value, but he did popularize the concept. Surplus Value points to the fact that, in aggregate in an industrial economy, in order for businesses to make a profit, they must charge more for their products than what they pay their employees. Marx's fix to the problem of Surplus Value was so absurd that only the least literate, least democratic, and lacking of a fourth estate, countries of the world accepted his fix. Yet the problem of Surplus Value is why, once the most developed economies of the world became primarily industrial by the early 1900's due to the mechanization of farm equipment and railroad expansion, that these economies all enacted progressive income taxes between 1910 and 1915. The progressive income tax was needed to redistribute income from the wealthy to the poor and middle class in order to compensate for Surplus Value and keep consumer demand up.

Economists around the turn of the century popularized the idea of the progressive income tax. In America it was enacted into law in 1913, yet with a modest rate of 7%. It was up to John Maynard Keynes with his *General Theory of Employment, Interest, and Money* in 1935 that brought forward the intellectual framework that allowed the top progressive income tax rate to stay so high until the 1980's.

The primary dynamic leap in understanding that Keynes genius brought to the world of economics and policymakers was his description of his, Greater Propensity to Save. This, Greater Propensity to Save is simply a more detailed description of Surplus Value. It points to the fact that very wealthy people have a propensity to save a much higher percentage of their income than do the poor and middle class, and that through this Greater Propensity to Save consumer demand is slowly pulled out of the economy. As consumer demand is pulled out of the economy businesses will lay employees off. This will further depress consumer demand, and the cycle will continue. An example of the Greater Propensity to Save to save is the fact that, in the US today the top 5% of income earners save on average about 30% of their income, while the bottom 95% of earners save about 3% of their income on average. The top 1% of US income earners most often saves about 50% to 60% of their income on average.

Keynes argued that it is up to the government to help increase consumer demand, via the government borrowing, then spending, then paying for that borrowing via a progressive income tax. This was a strong enough argument during the economic chaos of the Great Depression,

which had just followed the roaring 20's, to greatly increase the height and base of the progressive income tax. Keynes had the right tax solution for his time only to the extent that his sole intellectual rival on the political/economic right were the followers of the 120 year old Say's Law and conclusions typically derived from that law. These conclusions in simplest form stated that the natural and quickest way for a recession to end is to have an economies workers except less pay. This idea had always been painful to except, but in the economic chaos of the 1930's, with no farms for workers to go back to and live off of, this solution was unacceptable.

So Keynes eliminated in the developed world the ability of a government to rely on followers of Say's Law as the only way to get out of a recession. However, it now can be said that, with the current British government and the Republicans here, such ideas are coming back. They now only beginning to look like an alternative because the Keynesian, New Deal coalition that has guided the left since the New Deal appears to be falling apart. Further, due to our new, highly competitive, high tech, global economy, there exists no traditional Keynesian method of stopping this deterioration. Therefore, President Obama is now trying to transform and add to our Democratic coalition.

This transformation is needed for the survival of our party, but most importantly, for the prosperity of our people! In order to understand how best to achieve this transformation, it is very helpful to see the shortcomings of Keynes's analysis, but most importantly we must understand how Keynes's solutions are no longer applicable given our highly competitive, high tech, global economy that has seen about a 10 fold increase in global trade since Keynes's day.

One of two primary shortcomings of Keynes's work as it relates to today is that, in his zealotry lobbying for government stimulus spending, he advocated for absolutely any type of government spending as a way to increase consumer demand. Keynes used to make the somewhat humorous argument that, during a recession, it would be better for a government to bury money in the ground and have unemployed people dig it up so that they could spend that money to stimulate the economy, than it would be for the government to do nothing. Such thinking has influenced Keynesianism over the last almost 80 years. Yet today, in our highly competitive, high tech, global economy, we can no longer afford the degree of economic inefficiency that comes with that thinking.

The other shortcoming of Keynes's work has also become even more problematic with the increasing competitive nature of our global economy. This shortcoming deals with Keynes analysis of the wealth's savings that is not detailed enough to have use within the realities of our global economy. This shortcoming exists because Keynes did not distinguish between wealthy income that was produced by individuals through employing fellow citizens, so that their income is more likely to be invested in ways that employ more fellow citizens, and wealthy income that is not generated via employment, and is therefore more likely to be saved in ways

that do not increase employment and/or only go into purchasing luxury goods for wealthy individuals.

In regards to a deeper analysis of the savings of the wealthy, for example, only about 19% of all of the income that is made by the top 2% of income earners in the US is the profits of any private business that is taxed as personal income that has even one or more employees in the US. This means that today, we can lower taxes on American hiring, private businesses through our US Employee Tax Credits, while we raise personal income tax rates on the wealthy who do not employ Americans. Since 19% is so much smaller than the remaining 81%, taxes can be raised on this 81% of the top 2% of US income earners and much new federal revenues can be raised. Meanwhile, effective personal income tax rates on the 19% of the top 2% that hires Americans can have go down. Very importantly to remember, the greater the differential in effective tax rates between those who hire fellow citizens, and those who do not, all else being equal, the greater there will be an incentive to hire in that economy and the more tax revenue will be raised! It is only increases in the demand for labor in the private sector, along with increases in productivity or quality of production that raises real incomes for the poor and middle class. The specifics of this personal income tax plan can be found at our website, ThirdWayProgressives.org.

In regards to wealthy savings that effects a capital gains tax, Keynes did not distinguish between savings that go into the four primary investments that create jobs, and all other investments that are simply speculative paper trades. These four primary investments are: One, venture capital funds and projects. Two, stocks bought at IPO or secondary offering. Three, bonds bought at first issue. Four, the underwriting of any of the above three investments.

Once again, like with the personal income tax data, the math works for us. Generally, only about 3% to 12% of all financial gains within our financial markets are generated from these four investments. Very importantly, with our capital gains tax plan, that can also be found at ThirdWayProgressives.org, the businesses invested in as part of these financial investments would have at least 5% of their total global expenditures consisting of US employee expenses that would qualify for our US Employee Tax Credits. Also, just like with our personal income tax, the greater the effective tax rate differential that exists between those engaged in simple speculative savings, and our four financial investments that drive job growth in the US, the more jobs that will be created in the US. The higher the capital gains tax rate is on gains from speculative, paper investments, and the lower is the tax rate on gains from the four primary investments, with our minimum employment qualifications, the more the government will raise in tax revenue, and the faster the economy will grow and the more jobs in the US will be created. This added economic growth, along with an increase in financial stability that our capital gains tax plan will also bring, will add even more to government tax coffers.

Our FICA tax plan would also increase government revenues throughout the US while greatly increasing American jobs and economic growth. We also have a C Corporation tax plan that would do the same. Both plans can also be found at ThirdWayProgressives.org. The reality is that today, in our new, global economy, we still have to compensate for Surplus Value and the Greater Propensity to Save, and the most efficient way to do this is through the progressive income tax because all other forms of taxation are much more regressive. However, in today's highly competitive global economy the progressive income tax must be contoured to the realities of this type of economy.

For many of the reasons stated above, the VAT tax is a very bad idea. A VAT raises the cost of doing business and the cost of capital for businesses. Very importantly, it does not take long for businesses to pass the cost of the VAT onto consumers, which makes the VAT very regressive and pulls consumer demand out of the economy. Then, if many VAT exceptions are made to try to make the VAT less regressive, the tax raises much less revenue, and an already bureaucratic and hard to enforce tax becomes even more bureaucratic and hard to enforce.

Yet, even though our overall tax plan is much more efficient than a VAT, and even though it raises more government revenues than President Obama's or the Deficit Commission's tax plans, \$1.25 trillion over 10 years versus \$700 billion and \$9.25 billion over 10 years respectively, our federal, state, and local governments cannot be as inefficient with future Keynesian stimulus's as has been too often the case over the past 80 years. In several ways President Obama appears now to be trying to make our government spending more effective and efficient while trying to build a broader Democratic Party coalition. Given these new efforts, we must encourage him, support him, and guide him to those extra steps that will ensure that his entire program will be successful.

The Obama budget does begin to move in this correct direction of directing government spending towards those investments that greatly increase private sector jobs growth and productivity. His idea to greatly increase to \$148 billion in 2012 the government's R&D assistance to among other things, "create transformative technologies", is a very positive move, as is his proposed "Manhattan Project" for critical clean energy research.

However, given that the administration has said that their budget plan is a starting point for negotiations, given that the President's 2012 budget will be 9.5% more than the Democrats proposed 2011 budget, and given that the Republicans now control the House, the final 2012 budget will need to have much less spending than what the President has offered. Therefore, the future cuts in the President's budget should not come from areas that either most adversely affect the poor and middle class, or are those areas that most increase private sector job growth and productivity. Things like the Home Heating Oil Assistance Program should not

be cut. Such a cut will create actual pain for many poor, and/or it would lower demand in the economy because many poor would have to restrain current spending to purchase oil.

Therefore, what is left to be cut are those investments that do not hurt the poor or economic mobility and that are not yet proven to add to the nation's productivity. More accurately, we should first cut those investments that have not been proven to pay for themselves over time above the rate of inflation and are not sustainable without future federal moneys. Such an expenditure would be the President's high speed rail proposal that has a price of \$56 billion over six years. In this time of austerity, much unbiased research would have to be made that showed that the high speed rail system would pay for itself once it was built in order for such an expenditure to be justified. After all, if the middle class and wealthy are not willing to pay high enough fares to pay for a high speed rail system, and meanwhile the poor will still opt for much less expensive bus rides, then why should a new rail system be built? At this time it would be much more efficient to increase the amount that is put into the new, Infrastructure Bank. The Infrastructure Bank would be more likely to fund projects that wind up paying for themselves. Putting off high speed rail might depress and anger some of the special interest groups that support us, but favoring them over the supporters of cheaper home heating oil or public/private R&D collaborations that will bring high paying private sector jobs to the US will only mean many Democratic Party losses in 2012.

President Obama has a long way to move regarding several aspects of the 2012 budget. How he handles these questions this year will greatly determine if he has a second term. That is, how President Obama adjusts Keynesian economics to the realities of the global economy will determine, in regards to domestic policy, whether he is considered a transformative and successful president, or a failure. Our version of Keynesianism for a global economy has long been called Qualityism.

Global Keynesianism or Qualityism can be explained in a simple way by differentiating between how traditional Keynesianism taxes and spends, versus how Qualityism taxes and spends. Old Keynesianism uses a blunt ax to tax all of the wealthy equally. It spends in ways that do increase consumer demand, but not optimally. It does not spend optimally because it does not demand that its investments pay for themselves and too often it makes the decision on how moneys are spent when that is not desired. Too often over the past almost 80 years Keynesian spending has created government projects that have to be perpetually funded with little return, and too often the government chooses how to spend stimulus moneys when the poor and middle class would rather make these spending decisions on their own via a tax cut or an increase in the Earned Income Tax Credit.

Qualityism believes that the wealthy should be taxed using the precision of a scalpel. Wealthy income that is hiring employees in the US and investing in ways that hire in the US should

receive a lower tax rate. All other wealthy income should have its tax rate go up. Regarding spending, Qualityism suggests that, unless government spending generates an overall financial return above inflation, the stimulus spending should be left to the poor and middle class via lower taxes and/or the EITC. Government stimulus should be left for investments that produce a return and create real technological advancements for the economy, or education expenses that empower people to generate more revenue than the cost of the education. For example, many of our federal expenditures in the area of basic medical research have been shown to reproduce three dollars in the economy for every dollar spent. History is full of, and developed economies have always relied upon, government assisted technologies that have greatly added to the prosperity of the private economy. Most often war was the motivator for these achievements. We cannot afford to, nor should we have to or want to, rely on war for this motivation in the future!

Qualityism is different in many ways from Capitalism. For one, Qualityism acknowledges that wealth needs to be redistributed to the poor and middle class, both for the economy to be more prosperous and to make incomes more egalitarian. Qualityism believes that the best and most efficient way to do this is through the progressive income tax, but a progressive income tax that is contoured to a global economy. Using tax incentives through the progressive income, capital gains, and C Corporation tax, businesses will be incentivized to create more and higher paying jobs. The higher the demand for labor in the private sector and increases in productivity will, for all classes in the economy, bring a higher quality of life and the freedom to have more time off with friends and family. Unlike laissez faire capitalism, Qualityism believes that government spending can add to the economic prosperity of a nation, and that this is best done through the advancement of new technologies. The government can do this best through fully financing basic research and coordinating with the private sector in applied R&D. Along with our environmental tax plan that can also be found at ThirdWayProgressives.org, this government R&D assistance will make the economy more environmentally sustainable and sound. The economy and society will be of higher quality!

When the economy first moved from primarily agricultural to primarily industrial, new social and economic thinkers had to arise to solve new problems. Today, we live in an entirely different economy compared to what existed just 40 years ago. With the fall of the Soviet Union and communism, the developed world has been opened to a new cheap labor market of 4 billion people. Add in new technologies that make outsourcing as fast as the speed of light, and we have experienced a six fold increase in global trade in the US and for the rest of the developed world. This has been every bit the change that occurred when the developed world moved from primarily agricultural to primarily industrial. With this change, new social and economic thinkers must arise to solve new and unique problems. Consider Qualityism the first attempt at doing so.

Why the Deficit Commission and Senator Warner are Wrong on Tax Policy and Our Tax Plan is Right

By Tom Pallow of ThirdWayProgressives.org; contact: 202-902-1133

It is time that we, in regards to tax and fiscal policy, rid ourselves of our ridiculous catch 22.

What is this catch 22? If we raise personal income taxes on the wealthy in order to acquire the federal tax revenue we need, we will be taking money away from private sector job creators at a time when private sector jobs are what we most need. But, if we don't raise taxes on the wealthy, we will go further in debt which could raise interest rates, and we will not have the federal revenue we need to keep consumer demand up either through the tax code or government spending just at a time when a lack of consumer demand is the biggest factor that is keeping our economy weak.

Of course, if there were any Fed funds rate left to lower, the Fed could lower rates to stimulate the economy, and we would not have to worry about this catch 22. But the Fed rate is essentially 0, and even if the rate were quite high, breaking our catch 22 would create a much more economically efficient way to tax.

So how is this catch 22 broken? Raise personal income tax rates on the wealthiest 2% of income earners up to where President Obama wants to raise them or above that. Then, award a tax credit worth \$.15 on the dollar for all W2'd US employee expenses up to the payroll tax cap. Also, set a floor cap on how low a private business can exercise these credits to the point as though the personal income tax bracket rates were 5%, 10%, 20%, 28%, 33%, and 35%. Remember, only 19% of all the income that is generated by the top 2% of US income earners is the profits of any business that is taxed as personal income that has even one employee in the US.

Such a tax plan would raise more federal revenues than President Obama's personal income tax plan while cutting the effective tax rates to below where they are today for the employers of 98% of Americans who work for a private business. You can look on the website, ThirdWayProgressives.org, for details on how this is done, along with a C Corporation, Capital Gains, and FICA tax plan. Each plan achieves the same basic goal of raising more federal revenues while incentivizing and creating more private sector jobs in the US.

But this paper is about why the Deficit Commission and Senator Mark Warner are wrong on tax policy, and why our policy would work much better. So why is this so?

The primary feature of successful tax policy that the Deficit Commission's tax reform plan leaves out is the promotion of economic growth. That is, successful tax policy needs to achieve three primary goals. Firstly, of course it needs to raise needed government revenues. But secondly and thirdly, it should increase consumer demand, and it should lower the cost of capital for employers in the US. Achieving goals two and three will increase economic growth. The higher the economic growth of the country, the more government revenues will be raised without having to raise tax rates.

Further, even though government tax revenues can be used to increase consumer demand by increasing government spending and/or lowering tax rates for the poor and middle class, it is only profits and increases in wages in the private sector that can provide growth to the economy as a whole over the long run. Increases in wages and salaries will increase government revenues, and private sector profits can be reinvested in the economy. These are the only ways to grow the economy over the long run.

If a government is very inefficient and small relative to GDP, an economy will increase its growth rate over the long run due to increases in efficient government spending. However, our advanced nation economy now has total government spending, federal, state and local, at about 44% of GDP. Today in the US, increases in government spending would not be likely to increase overall economic efficiency, productivity, long term employment careers, or long term economic growth. We need the private sector to do that now.

So how do the Deficit Commission's tax proposals stack up when compared to our plan in regards to raising new federal revenues, increase consumer demand, and lower the cost of capital for US businesses?

The truth is that their plan compares very poorly. Their plan appears to raise about \$925 billion over 10 years, while our plan would raise about \$1.25 trillion over 10 years. However, their plan compares most poorly when it comes to promoting economic growth. It compares poorly when it comes to increasing consumer demand and lowering the cost of capital for businesses in the US.

For example, the commission's first and most favored option is to lower all personal income tax rates in exchange for all tax deductions being eliminated. Today's 33% and 35% rates or next year's 36% and 39.6% rates would go to 23%. Today's 25% and 28% rates would go to 14%, and today's 10% and 15% rates would go to 8%. However, in order to get to these lower rates everyone would have to get rid of all current deductions: the Child Tax Credit, the Earned Income Tax Credit, the Home Mortgage Interest Deduction, and all deductions for retirement savings, among other deductions.

The problem here is that this type of trade off would greatly decrease consumer demand, and therefore slow economic growth. It would decrease consumer demand because those in the top 5% of US income earners would be getting a much better deal as a percentage of their total income than would the bottom 95%. That is, the top 5% of income earners pay about 60% of all federal personal income taxes, however, they are only responsible for about 22% of all tax deductions, and this number is much lower when including the EITC. So this would create a direct shift in income to the top 5% from the bottom 95%. Moreover, since the top 5% has an average savings rate of about 30%, while the bottom 95% only saves about an average of 3% of their income, this would mean that the overall economy would suddenly have a large chunk of consumer demand pulled from it, as well as a shift in income from the poor and middle class to the rich.

As for the ability of the Deficit Commission's tax plan to lower the cost of capital for businesses, it would do the opposite of that. Keep in mind that the Deficit Commission's tax plan would raise about \$80 billion a year in 2015 and about \$925 billion over 10 years, so it is also a net increase in taxes on the top 5% of income earners as well as all others. Most importantly, it is a tax increase in a way that would slow economic growth. This is, unlike our tax plan, it would increase taxes equally on those who run businesses that hire employees in the US with those who do not. Therefore, the Deficit Commission's plan would raise the cost of capital for American businesses that hire in the US, and thus slows down the economy. Our plan of course would do the opposite of both these things.

As for the Senator Mark Warner tax plan, it is a great pleasure to see that the Democratic Party is finally moving tax policy closer towards where it needs to be in the global economy of the 21st century. However, there are several ways in which the Warner plan needs to move closer to our plan and in one important way the plan fails miserably.

First of all, the tax cuts in Warner's plan lay primarily in "targeted" capital expenses, and in our plan they rest primarily in W2'd US employee expenses. If, outside of raising government revenues, the primary goal of American tax policy is to help create American private sector jobs, especially good paying US private sector jobs, than nothing does this more directly and efficiently than a tax credit for US employee expenses. Whereas Capital Expenses for a tax credit for creating jobs in the US is a much more amorphous concept to nail down from a tax avoidance perspective. Capital expenses are much more difficult to be traced as to where they are actually being used, whether they are being used in the US or in a foreign country. Yet W2'd US employee expenses are about as definable and enforceable a tax concept as could exist when it comes to determining whether a business expense is being spent in the US or not. This is not to say that tax cuts or credits for "targeted" capital expenses would be a bad thing. They

are great, especially for a few years during a recession, and especially when needing to rebuild an industrial base.

Secondly, our tax credits for US employee expenses would only cost about 22% of the federal revenue that would be raised under President Obama's personal income tax plan. The Warner plan proposes using 100% of these possible new federal revenues towards tax credits for US capital expenses, R&D expenses, and payroll tax cuts. It is unclear what the percentage brake down for these tax credits and cuts would be. Yet it is easy to argue that US Employee Tax Credits as explained in our personal income and C Corporation portions of our plan would be a great addition to the three Warner tax cuts. In fact, because of the reasons mentioned above, that they are more direct and enforceable, it is easy to argue that they should be the largest single component. It would also be best to increase the payroll or FICA tax cut contribution to the Warner plan, but our plan would create more jobs given that it is larger in size and structure. Also, the best way to merge the Warner plan with the C Corporation portion of our plan would be to install the tax cuts in our C Corporation plan for three years before instituting the tax increases in that portion of our plan.

This brings us to perhaps the important component of our plan and the Warner plan, and that is, how are these plans going to raise any new federal tax revenues? Obviously, neither our plan nor Senator Warner's plan would raise any new federal revenues until 2013. Warner's plan would raise taxes immediately to the personal income tax levels that Obama has proposed, but it would spend 100% of these revenues on tax credits for capital, R&D, and payroll expenses, most of which look to be permanent tax credits. Therefore, Warner's plan would raise little if any new federal revenues. However, our plan features immediate tax cuts for businesses, with increasing tax rates in 2013 that would more than pay for our tax cuts. Our plan would collect in 2013 as much as 80% more federal revenues than President Obama's plans, 35% more than the Deficit Commission's plan, and apparently about \$1.25 trillion over 10 years more than Senator Warner's plan!

Moreover, in order to improve our economy it is important not to raise taxes on anyone while our economy is still weak. The Warner plan would raise taxes on the top 2% of income earners immediately. While the top 2% of US income earners save about 35% of their income on average, this still means that they spend 65% of it. Such an immediate tax increase would pull consumer spending out of the economy, and therefore slow down the economy. However, our plan would work best in that it would not increase any taxes until three years out. It would give the economy three years to grow, and therefore three years to shift the spending in the economy from the top 2% to the poor, middle class, and businesses that are hiring in the US.

Also, because our plan would raise 80% more federal revenues than President Obama's plan, 35% more than the Deficit Commission's plan, and apparently about \$1.25 trillion over 10 years

more than Senator Warner's plan, our plan would immediately signal to the bond market that we are serious about our national debt. This alone would probably be enough to keep interest rates low enough to no longer need any more QE2, and certainly in three years there would be no need.

So how do our, the Deficit Commission's, and Senator Warner's tax plans grade when it comes to the three primary goals of tax policy, raising government revenues, increasing consumer demand, and lowering the cost of capital for businesses in America?

The Deficit Commission's tax plan does raise revenue, but it fails by lowering consumer demand and raising the cost of capital for American businesses. Warner's plan certainly lowers the cost of capital for businesses in the US. But it is a mixed picture on increasing consumer demand, and it fails miserably when it comes to raising government revenues. Only our plan accomplishes all three primary goals, and it surpasses the other two plans in all three areas!

How Our Tax Reform and Budget Plan Would Help Obama, Democrats, and Americans Win in 2012, and How All Other Plans Would Not

By Tom Pallow of Third Way Progressives, 1/17/11, tompallow@msn.com & 202-903-1133

Our tax reform plan is the only plan that would simultaneously increase private sector job growth and government revenues. To read specifically why this is so go to ThirdWayProgressives.org, and read the Weekly Blog post entitled, "Why the Deficit Commission and Senator Warner are Wrong on Tax Policy and Our Tax Plan is Right." This paper also addresses President Obama's tax proposals, and on the website you can read about our entire tax reform plan in great detail.

The most important thing to keep in mind is that our tax plan does by far the best job of addressing America's two most prominent needs. Every poll on the subject shows, and by large margins, that Americans are most concerned about lowering our unemployment rate and lowering our federal deficit. Given this desire to reduce our deficit, axiomatically it follows that most of the jobs that we create must come from the private sector.

Our overall tax plan would raise \$1.25 trillion over 10 years versus \$925 billion over 10 years for the Deficit Commission's tax plan and \$700 billion over 10 years for President Obama's tax plan. Further, if these tax plans were dynamically scored, our plan would greatly increase its revenue generation when compared to the other two plans. This is because our plan would also create through tax credits for US employee expenses an effective tax cut for the employers of 98% of Americans who work for a business that has its profits taxed as personal income. Our C Corporation tax plan would, in a revenue neutral way, also greatly incentivize US private sector job creation, and our FICA tax plan would raise \$336 billion over 10 years while doing the same. Our capital gains tax plan would raise 63% more federal revenues than President Obama's capital gains plan while lowering the capital gains tax rates on venture capital investments, stocks bought at IPO or secondary offering, bonds bought at first issue, and the underwriting of the above investments. These investments are the four primary investments that drive private sector job growth through the financial markets. Plus, within our capital gains plan, in order to receive a lower tax rate, these four investments would have to have at least 5% of their current business, or future investment, being US employee expenses that would qualify for our US Employee Tax Credits under our personal income tax plan. Therefore this policy too would go a long way in creating private sector jobs in the US, and it would be a great basis for reforming the Carried Interest tax rule. Again, for more on these tax plans visit ThirdWayProgressives.org.

So if you visit ThirdWayProgressives.org it will become obvious to you that our tax plan would do the best job, and by far, of both increasing private sector jobs and lowering our federal deficit. The ability to quickly achieve these two goals will set Democrats up for victory in 2012. However, sticking with President Obama's current tax plan (FICA tax cuts for one year, followed by personal income tax increases on all of the top 2% of income earners in 2013) will not bring Democrats or Americans success in 2012, nor will the Deficit Commission's tax plan, nor will the Wyden-Gregg Tax Bill. Let us walk through why all this is so.

Let us suppose that our government passed the tax cuts in our tax plan immediately, at least the US Employee Tax Credits in the personal income tax portion of our plan and the tax cuts in our capital gains tax plan. These tax cuts in our plan would stay indefinitely, and we would work to bring them even lower over time. Therefore, both political parties in the US would stand for lower tax rates for American job creators. These cuts would go a long way in creating private sector jobs in the US. One of the reasons this is so is because these tax cuts would create absolute certainty for US employers that their income tax rates and tax rates for capital formation in the US would never go up. Added economic confidence would arise with this absolute certainty. These tax cuts would only cost about \$122 billion over 10 years. However, in 2013 our plan would push personal income tax rates on the top 2% of income earners up to 39.6% and 36% at the same income levels that President Obama has proposed, and the top long term capital gains rate would go up to 25% in 2013 under our plan.

Further, and very importantly, because our tax cuts for job and capital formation in the US are set in stone, the vast majority of American voters will have no fear in 2012 of voting for Democrats who will raise taxes on the top 2% of income earners in 2013. That is, Americans will no longer fear that raising taxes on the top 2% will slow job growth and the economy by raising taxes on the 50% of business income that is taxed as personal income that exist within that top 2%. In fact, the opposite would happen! Voters will understand that the higher the tax rates that exist on those who do not hire in the US, and the lower the tax rates that exist for those who do, the more hiring that will take place in the US! Most importantly, the math always works in our favor in these areas. If one were to collect all of the income that is produced by the top 2% of income earners in the US, only about 19% of all of that income would be the profits of any business that is taxed as personal income that has one or more employees in the US. Regarding capital gains, only 3% to 12% of financial market capital gains come from the four investments that would receive a tax cut under our plan.

Therefore come 2012, our Democratic Party base, the vast majority of independents, and even some Republicans will vote for Democrats to raise personal income taxes on the top 2% of income earners and on the top capital gains tax bracket in 2013. This policy would energize our

base, but more importantly it would put the credit markets at ease both now and in the future that we are doing the right thing regarding our deficit and debt. This is because, not only would our economy be growing faster, but our tax plan raises more federal revenues than President Obama's and the Deficit Commission's tax plans. Also, the above scenario could occur without ever having to change the filibuster rule.

There are several problems with President Obama's current tax plan. Firstly, the FICA and business tax cuts in the President's plan will only be in place for 2011, so while the unemployment rate should be going down in 2011, it might be going back up and it will still likely to be very high in the election year of 2012. Our plan would not have this problem, especially if our FICA tax plan were passed into law. Secondly, most economists predict that in 2012, 2013, and 2014 the unemployment rate will still be quite high (above 8%), and there is a worrisome probability that it will be raising in 2012. This will mean that most voters outside of our base will be fearful in 2012 of increasing taxes on the top 2%, and therefore on 50% of business income that is taxed as personal income. Of course, our plan would not present this problem. Thirdly, because tax rates on 50% of non-C Corporation business income is set to go up in just two years, keeping the tax rates low on businesses over the next two years will not have the same tax certainty, confidence induced, bang for the buck, regarding job growth that the tax cuts in our plan would have. This is because businesses try to make most decisions looking more than two years into the future. Fourthly, because most economists predict that the unemployment rate will still be high in 2012, and therefore Americans will be hesitant to raise taxes on the top 2% in 2012, the credit markets over the next two years will find it hard to believe that we will actually reduce our deficit in the future. Hence, in order to achieve the same degree of credit market confidence that would occur under our tax plan, total federal government spending would have to be cut much deeper than it would under our tax plan. Also, our overall tax plan raises 80% more federal revenues than the President's tax plan.

The main problem with the Deficit Commission's tax plan is that it would create a net shift in income and consumer spending from the poor and middle class to the wealthy. That is, the Deficit Commission's tax plan regarding the personal income tax is to create a direct exchange for tax payers by eliminating all tax deductions in exchange for lowering all tax rates. The problem with this exchange is that the top 5% of income earners in the US pay about 60% of all federal personal income taxes, however, the top 5% is only responsible for about 22% of all federal tax deductions. So this exchange would create a direct shift in income to the top 5% of income earners from the bottom 95%. Since the top 5% of earners has an average savings rate of about 30%, while the bottom 95% only saves an average of about 3% of their income, this

would mean that the overall economy would suddenly have a chunk of consumer demand pulled from it. Therefore, with a large slice of consumer spending pulled from it, the Deficit Commission's tax plan would slow the economy and job growth. With a slower economy, less tax revenue as anticipated would be collected by governments in the US. Also, the Deficit Commission's tax plan would alienate and depress our Democratic Party voting base because it would create a shift in income from the poor and middle class to the wealthy.

As for the Wyden-Gregg Tax Reform Bill, this is a tax plan that only applies to the C Corporation tax code and it is assumed to be revenue neutral. The plan would create an exchange for C Corporations in the US of eliminating existing tax loopholes and deductions for lowering the statutory C Corporation tax rates. On face value this plan looks marginally helpful for the economy, but on closer examination looming danger can be seen. This danger existed because of the bills misunderstanding of some of the "averages" in this area of tax data. Their primary misunderstanding of the tax data is this: The "average" effective tax rate that American C Corporations pay is about 17% in the US, even though the top statutory rate is 35%. The problem with this particular "average" is that a very large C Corporation with many employees and a profit of \$1 billion a year is counted equally in this average with a small C Corp with few employees and a profit of \$100,000 a year. The problem with using such an average with this tax plan is that the majority of the tax deductions and loopholes that will be eliminated for C Corporations are made available only to America's largest C Corporations and not its smallest. Therefore, with this tax trade off, many of America's largest and best employee paying businesses will suddenly have their effective tax rates go substantially up, and only smaller C Corps with fewer employees will tend to have their effective tax rates go down. Hence, the cost of capital would go up for the employers of the vast majority of Americans who work for a C Corporation, which is about 50% of our private sector economy. This tax plan might actually raise more revenues to the federal government, but it would also have the effect of slowing the economy. Further, some of these tax deductions and loopholes exist for justifiable reasons that create economic efficiencies.

The best way to address our C Corporation tax code would be to get rid of all the most egregious and economically inefficient tax deductions and loopholes and replace them with a somewhat lowered statutory rate. But, so that effective tax rates do not go up on many of Americans best paying businesses, institute a US Employee Tax Credit like that in our C Corporation tax plan that can be found at ThirdWayProgressives.org. Such a policy would be revenue neutral when statically scored, but when dynamically measured it would raise more federal tax revenues than the Wyden-Gregg Bill. But most importantly, it would create an incentive for all C Corporations both foreign and domestic to hire in the US. It would most

reward those US and foreign C Corporations that pay their US employees in the most generous ways, and it would lower tax rates on those who pay above average in the US. Remember, there is no expenditure that has a greater multiplier effect in the economy than a high paying, steady, private sector job! Of course the worst paying US and foreign C Corporations would have their effective tax rates go up. Our C Corporation tax plan would also create much tax parity with our personal income tax plan which raises much new federal tax revenues. The Wyden-Gregg Bill is not intended to raise tax revenues, but neither is it intended to raise taxes on so much of the American economy and slow it down.

Again, because our overall tax reform plan raises more federal revenues than the Deficit Commission's or President Obama's tax plan, \$1.25 trillion over 10 years versus \$925 billion and \$700 billion over 10 years respectively (and again, remember, these numbers are not dynamically scored), less will be needed to be cut from the federal budget in order to balance our federal budget. Nonetheless, our federal spending will need to be reduced and some spending will need to be shifted to other areas.

However, letting the Republicans cut federal spending to a growth rate below the rate of inflation would be a mistake. Cutting spending to this level would pull demand out of the economy and therefore slow the economy. In regards to reducing our federal deficit it is just as important that we grow the private sector by sifting government spending into more productive uses. One thing our federal government needs to do to achieve high paying private sector growth is begin a public/private R&D matching program like what was done in California in the 1990's with regard to hybrid and electric cars, with an agreement that production will be done in the US. This program could be done along with matching funds from the states. This program would help build our manufacturing infrastructure. This program, along with our environmental tax plan that would reward manufacturers for using "best practices" (This plan can also be found at ThirdWayProgressives.org), would bend over time our applied science in manufacturing towards more environmentally sustainable production, and it would greatly increase high paying jobs and our manufacturing base in the US! Under the new House rules the moneys for such a program would need to come from existing programs, but such a shift would be well worth it.

Another part of our economy that still needs assistance is the residential real-estate market. Most economists covering this area predict that 2011 will be the worst foreclosure year in American history. There are millions of Americans who are upside-down on their homes. Many of them have mortgages that have arms that are about to expire or they are making less than

they once were. Given that interest rates are at record lows, there are millions of more Americans that are barely upside-down or have high loan to values that could save large amounts of money that would then increase consumer demand in the economy if they could only refinance.

Our federal government could fix this problem at NO COST with the following program that could also double as a way of reforming Fannie Mae and Freddie Mac: The federal government could underwrite second position mortgage loans for the portion of total loans made over 80% loan to value for each property. This can be done through Fannie and Freddie, and perhaps other lenders. The government would only guarantee the portion of Fannie's and Freddie's portfolio that consisted of these second position loans. These second position loans would be amortized over 40 and even 50 years, and the program should encourage lenders to sell each attached first position loan as 40 year amortized loans. With the government borrowing from the Fed at very low interest rates, and with these loans being amortized over 40 years and more, millions of Americans could have their mortgage payments drop and many would avoid foreclosure. Through this program, all existing loans will be completely paid off and consumer demand in our economy would rise. Both factors would add great confidence to our economy.

The mandate of this program could be that it be run in a revenue neutral or non-profit manor. There would only exist risk to the federal government if the lending guidelines were extremely lacked, even beyond what took place throughout the 2000's, or if the price of residential real estate in the US 40 or 50 years from now was somehow only worth a little more than what it is today or less. Given the average increase in residential real estate of 8% in the US over the last 100 years, we should not be fearful of the second risk. If we cannot manage the first risk, we should all turn in our democracy cards and ask to be British colonies again. Therefore, this is a program that we can be extended after this real estate crisis as one of our most important tools for creating affordable housing. Further, by the federal government only insuring that part of the portfolios of Fannie and Freddie that are these second position loans, we would be going a long way to reforming Fannie and Freddie, while maintaining in a sound and responsible way the government's ability to increase low income housing.

Another shift in federal spending that would be beneficial would be to actually cut the salaries of non-military federal workers, but then take that savings and hire more federal workers and replenish our infrastructure. The hiring of new federal and infrastructure workers would have the effect of lowering the unemployment rate and thereby saving money on the cost of unemployment insurance. Economic efficiencies would also be developed with the new infrastructure. This is also a practice the states could engage in. As for direct federal spending cuts, the easiest and most efficient way to "cut" federal spending while we are still essentially

in a recession would be to extend the age at which those under age 55 can start to receive social security.

However, the hardest issue for us to address over time regarding federal spending will be healthcare. This problem can best be understood by exposing a fundamental misunderstanding that nearly all policy makers in the US hold regarding healthcare's role in our society today. Policy makers tend to mistakenly believe that the high rates of inflation in recent decades in the healthcare field in the US has caused the healthcare portion of our overall GDP to become much larger than it was only decades ago. However, this relationship is backwards. In reality it is the expansion of healthcare as a portion of our overall GDP that is causing inflation in healthcare to be high. Remember, areas of the economy that are growing faster than the rest of the economy as a whole will nearly always have inflation rates that are above the national average.

All of this is because we live in a nation where less than 2% of our GDP can produce enough food that we throw away almost a third of it, we are the world's largest agricultural exporter, and obesity is a major problem. We also live in a nation where, because of high tech mechanization and cheap labor in the underdeveloped world, we can produce physical goods so cheaply that the addition of self storage units in order to hold people's extra things has been one of the fastest growing sectors of the US economy over the last two business cycles. Therefore, if you live in a very advanced society, like we do, where food and physical goods can be produced so cheaply that there exists almost too much of both for most people, that society's GDP will naturally shift to the areas of that economy that everyone never has enough of. One of those areas is how long we live. So it is the natural progression of a society as it gets more advanced to have a larger and larger portion of its GDP move to healthcare, along with other things like recreation and tourism. Hence, we cannot reject this inevitable increase in the healthcare economy. We must embrace and facilitate its technological advancements, and become its world's largest exporter. This would also be a good area to institute our R&D matching program through hospitals and universities.

That said, we must make certain that healthcare costs do not bankrupt our federal government and make our most important industries uncompetitive. To this end, Democrats must insist on keeping our new healthcare law that provides all Americans with preventative medicine and some level of health insurance. In order to keep the cost of Medicare, Medicaid, and the new healthcare plan down, Democrats should have a policy of, "Mend it, don't end it," for the new healthcare law. Democrats should allow Republicans to end the 1099 rule (Our tax plan can best help pay for this), allow them to greatly increase tort reform throughout the plan, and to force uniformity throughout the states that would eliminate the inefficiency of

consumers not being able to purchase health insurance across state lines. These changes should be allowed with Republicans than allowing the bill to be funded. More reforms can come if needed with future funding. Through the same type of efforts healthcare costs can be moved away from businesses and more on to consumers and the government. But no matter what, Democrats should always insist that all Americans have some level of health insurance.

Education reform is also a very important ingredient for our economic renaissance. Recent efforts should continue in this area along with developing more coordination with America's colleges and universities regarding our R&D matching and profit sharing program.

Yet the most important thing for Democrats and Americans to remember during this period of deficit reduction is that we cannot cut the growth in federal spending below the rate of inflation. Any larger amount of reduction would pull demand out of our economy and therefore slow our economy. The key to deficit reduction for our country is to find new ways to increase federal revenues that actually incentivize and grow our private sector. If you read the paper, "Why the Deficit Commission and Senator Warner are Wrong on Tax Policy and Our Tax Plan is Right" which can be found on the Weekly Blog section of ThirdWayProgressives.org, you will learn how the Deficit Commission's and President Obama's tax plans will have the effect of depressing our private sector and our overall economy, while our tax plan is the only plan that would actually stimulate private sector growth. At the same time our plan would raise more federal revenues than the Deficit Commission's and President Obama's tax plans, \$1.25 trillion over 10 years versus \$925 billion and \$700 billion over 10 years respectively, and again, these numbers are not dynamically scored.

Because our tax reform plan can raise more federal revenues than any other tax plan, and because our tax plan and budget priorities would increase economic growth so much, our nation will be in the strong position we need to achieve in order to acquire a successful trade and foreign policy. For example, from our new found position of economic and fiscal strength, where we did not need to borrow so much from nations like China, China would soon learn that they need a relationship with us more than we need one with them. It is this position of strength that will insure a positive and just result for us and the rest of the world regarding trade and currency issues with China. This economic and fiscal strength will also give us the ability and time to win our wars in the Middle East, as well as depress all other despotic dictators throughout the world who oppose economic freedom and democracy.

A Compromise Where America Wins

By Tom Pallow of Third Way Progressives, 3/14/11

It is obvious that we cannot continue to extend the debt limit every two weeks from now until October 1. Therefore, we need to create a compromise extension of the debt limit with the Republicans in a way that most benefits the American people and therefore our party. The key to developing such a beneficial compromise is to have policies to offer the Republicans that the American people will want and that Republicans cannot refuse in exchange for commitments we want, and very importantly, offering them so that they occur in the proper sequence.

For example and to start with in this sequence, it is clear that the Republicans are going to be extremely persistent when it comes to demanding that the federal government cut \$61 billion out of this year's budget. This is especially true given the American people's concern about our deficit, and the fact that \$61 billion is only about 3% of our projected 2011 deficit. However, the American people will also be nervous about the projected 400,000 or more jobs that will be lost due to the \$61 billion cut. Our best policy would be to offer, in exchange for cutting the \$61 billion, the tax cuts in our FICA tax plan. These tax cuts would only cost about \$14 billion in the first year, but they would also generate more than 400,000 jobs in the first year. Therefore, we would be increasing the amount of jobs in the US while cutting \$47 billion in federal spending. At the same time we would also be able to argue that we are shrinking the size of the federal government while we are increasing the size of the private sector. Given that the size of the federal government in relation to our overall GDP is now the highest it has been since WWII, this would be a good thing. It would bring confidence to the private credit markets, and therefore bring even more economic growth. Very importantly, as part of this compromise sequence, we would require that a vote be taken in 2013 regarding the tax increases in our FICA tax plan. This would entail taking the FICA tax cap up to 90% of American incomes or about \$180,000. This tax increase would generate about \$336 billion over 10 years. Plus we would propose that non-C Corporation business owners with US employees would be able to exercise US Employee Tax Credits in a way that would allow them to drop their overall tax bill to as if the FICA tax cap had not been raised. This would create an even greater incentive for wealthy individuals to hire in the US. Details of our FICA tax plan can be found at our website, ThirdWayProgressives.org.

This brings us to the second major step in our road to American recovery. This step would be to immediately enact the tax cuts in the personal income and capital gains portion of our tax plan. By enacting these tax cuts now we would be creating absolute certainty within the private sector that neither Democrats nor Republicans would be working to raise taxes on American job creators. In fact, American job creators would be certain from that moment on that

Democratic Party tax policy would be to lower their effective tax rate, especially those who hire in the most responsible ways. Such certainty, along with our FICA tax cuts, would create an environment that would be very conducive to private sector job growth in the US. The tax cuts in the personal income and capital gains portion of our plan would only cost about \$10 billion in the first year and \$105 billion over 10 years. So this year we would still be cutting over \$37 billion in federal spending.

However, in exchange for all the above tax cuts we would push for all of the tax increases in our overall tax plan. We could achieve this one of two ways. Our first effort should be to, in exchange for all of the above tax cuts, enacting some or all of the tax increases in our plan this year, with the tax increases scheduled to go up in 2013. Of course the Republicans would probably not agree to these tax increases, but we would embarrass them for stopping the future tax increases as part of a tax package that would grow the economy now. Nonetheless, the Republicans may not agree to any tax increase, even if they are scheduled to increase in 2013. Therefore, we should enact all the tax cuts in our plan this year, and have all the Democrats and President Obama run in 2012 on enacting all of the tax increases in our plan in 2013.

It might appear absurd that we would run on tax increases in 2012, but there are three factors that would make this a winning issue for us. One, the American people are very concerned about the federal deficit and debt, and they know that tax increases will have to be part of closing the fiscal gap. Two, after one year of federal budget cuts many more Americans will be fine with raising taxes on the wealthy if it means less government cuts. But thirdly, and by far most persuasive, Democrats will be able to make the argument that the higher the tax rates are raised on the wealthy who do not employ Americans, while the lower is the tax rate on those who do, the more private sector jobs and federal tax revenues will be created! This is because, for example within all of the income that is produced by the top 2% of US income earners, only about 19% of all that income is the profits of any business that is taxed as personal income that has one or more employees in the US. And remember, within our FICA tax plan we also let employers lower their overall tax bill through exercising our US Employee Tax Credits. For more information on all of our tax plans visit ThirdWayProgressives.org.

Our overall tax plan will raise more federal revenues than any other tax plan, \$1.25 trillion over 10 years versus \$925 billion and \$700 billion over 10 years for the Deficit Commission's plan and President Obama's plan respectively. The difference would be much greater if these plans were dynamically scored! As importantly, our plan would create or save many, many more jobs than any other proposed tax plan, over 11,553,000 between 2013 and 2020. Studies show that the Obama tax plan would cause the loss of as much as 6,243,000 jobs between 2013 and 2020. While it would be very surprising if studies showed that the Deficit Commission's tax

plan did not lose even more jobs. The private sector jobs that would be created in our plan would stimulate the economy even more and generate even more tax revenues. The Obama and Deficit Commission's plan would do the opposite! If all three tax plans were dynamically scored our tax plan could easily raise up to 4 to 5 times as much federal revenues as the other two plans!

Yet, even given the fact that our tax plan would raise about 50% of our deficit gap, we will still need to do other things to completely control our deficit gap. Therefore, the rest of the fiscal gap will need to be closed by other means but tax increases. The key here for Democrats is to emphasize moving government resources into more efficient activities that help to grow the private sector. Many of these ideas can be found on the "Weekly Blog" section of our website, ThirdWayProgressives.org. Remember, the variables to keep track of when it comes to our budget deficit are our federal revenue and spending in relation to overall GDP. Therefore, the more we can grow the private sector, the better will our federal revenue and spending to GDP numbers be.

Yet even with this, at least in the short run, some cuts will have to be made and they are best made in those areas that cost us the most, that being Medicare, Medicaid, and Social Security. They are also best made in a sequence that least adversely affects the economy but best puts the credit markets at ease. Such a policy would be to raise the retirement age for all those 55 or younger to age 67. This policy would send the message to the credit markets and the rest of the world that we are getting serious about our debt. At the same time this policy would not pull any consumer demand out of the economy.

Progressive activist will complain that the government is breaking a promise to the American people, but when Social Security was first enacted in 1935 the average American man lived to be 60 years old and the average American woman lived to be 64. Today these numbers are 76 and 81 respectively. Also, in 1950 there were 50 workers for every Social Security recipient, today there are only 3. The numbers for Social Security just aren't sustainable, even with raising the FICA tax cap up to \$180,000, and even with indexing that to inflation. So this is the fairest and most logical way to save money and make the system solvent. The quicker we make the system solvent, the more confidence there will exist in the credit markets and the private economy. The quicker we make this change the better, so it would be best to make this change this year. The vast majority of the American people will see this as real leadership and reward Democrats for it. Plus, the American people will vote for US in 2012 to raise the FICA tax cap.

The most complicated issue for us to settle optimally is healthcare. 2012, both the election and congressional hearings, should feature healthcare as the main issue. President Obama pulled an ingenious move by challenging the governors to come up with a healthcare plan that would insure as many people as his healthcare bill. By doing this, President Obama has opened

up the ability for states to experiment in ways that both progressives and conservatives only dreamed of doing during the healthcare debate of the last two years.

For example, more progressive states will now be able to create a public insurance option. These states could then create an association, and along with Medicare and Medicaid, use their bulk purchasing power to lower their overall healthcare costs.

Along with such innovations as above, it is just as important that the federal government make it as easy as possible for people to be able to buy health insurance across state lines. Given past interpretations of the commerce clause, there is no way that the states should be able to make their healthcare regulations so idiosyncratic that states have so few health insurers. These states are infringing on the personal freedoms of their own citizens. In fact, it should be the federal government's role to make the private health insurance industry as competitive as possible in each state with as many private options as possible in each state. Further, private insurance companies with a very large national presence would then be able to team up with Medicare and Medicaid in order to use their bulk purchasing power to lower their overall costs of healthcare.

Tort reform should also be a major component for the future of healthcare reform when it comes to healthcare for the poor. This would be true for both the private and public options. Healthcare is an art. Doctors and health providers should not have to make amends for educated, but still artistic decisions that go bad. They should only have to pay for decisions that even a lay person would know to be incompetent.

Along with the above changes to healthcare, the most important change that could be made to lower the cost of healthcare is to have a complete vertical integration of the healthcare system, where health providers are paid per client and not per procedure. Federal law can help here. We will know that our healthcare system is working optimally when a person's private or public option health provider employs virtually all employees in a hospital or a wing of a hospital. State and federal law can help there. The system will also be working optimally when, private and public option health insurers can collaborate with Medicare and Medicaid to bid down the cost of their healthcare. Federal and state governments must help here.

America has to except right now that many of its states are not going to except a "big government solution" to any problem at all, while others will demand it. A key to good government in the future is to provide both options where they are wanted so that much more competition exists.

The sequence for how we reform the just passed healthcare law is of great consequence. Democrats should spend 2011 passing the above proposed tax and Social Security reforms. Yet the primary issue in 2012 should be about saving and optimizing Medicare and Medicaid, and

about reforming the newly passed healthcare bill. There should be congressional hearings on these issues in late 2011 and early 2012. By the summer of 2012 President Obama and the Republican presidential candidate should be competing to sell voters on competing proposals to reform the new healthcare bill and Medicare and Medicaid. It would be unfortunate, and politically to their disadvantage, if the Republicans, unlike we Democrats, proposed insuring less Americans than would the Affordable Care Act. If we can come up with a reform of the Affordable Care Act that is acceptable to our base and independents, Democrats will win in 2012 if they run on this reform. Then in 2013, the party that wins the presidency, along with those in Congress should structure into law the healthcare plan of the winning party. Whatever law, or amendments to existing law that are drafted in 2013 should not go into law until 2015. In this way the American people would have one final vote in the election of 2014 as to what they thought of the legislation that was written in 2013.

Given that our nation now faces major problems that need to be solved, the best way to solve our biggest social and economic problems is to allow the American people to have elections that best determine the solutions that are enacted. The timeline and sequence of the proposed legislation in this paper achieve that.

Also, it is evident that we are now in a period of American history where Americans want many of our lingering and difficult problems to be solved, like healthcare, a lack of increase in real incomes for our poor and middle class, and our federal debt. Therefore, the American people are going to reward the politicians and party that run on very specific and workable solutions to these problems, and not political dogma! The American people will reward the party that pushes a positive agenda and not just fear of what the other party will bring. President Obama would greatly benefit by running on the above policies and the above sequence of enacting them into law. Wouldn't that be great if we lead, and ran on, and forced the other party to run on, proactive agendas rather than just fear of the other party? Now that would really be progress. That would be progressive.

