Written Statement of
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"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.

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[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 form 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. *<u>Taxes Matter: Taxing Enterprise and Capital Income</u>*. 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. *<u>"Broaden the Base – Reduce the Rates" Has a Nice Ring, But . . . . .</u>* 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. *<u>Tipping Point</u>*. 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. It's implications for tax reform are uncertain, but there are many who find it a potentially troublesome development.

6. *<u>Think Big</u>*. 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 or 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 progessivity 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.