ROUNDTABLE DISCUSSION ON
IDEAS FOR REFORMING
THE U.S. INTERNAL REVENUE CODE

A Public Hearing

by the

JOINT COMMITTEE ON TAXATION

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Joint Committee on Taxation Chairman Dave Camp and Vice Chairman Max Baucus announce a meeting of the Joint Committee for a roundtable discussion on ideas for reforming the U.S. Internal Revenue Code with The Honorable James A. Baker III and The Honorable Richard "Dick" Gephardt.

The meeting is scheduled for Wednesday, April 6, 2011 at 9:30 am in SVC 202-203 of the Capitol Visitor's Center.

The meeting will be open to the public.

JOINT COMMITTEE ON TAXATION
IDEAS FOR REFORMING THE U.S. INTERNAL REVENUE CODE
WEDNESDAY, APRIL 6, 2011
U.S. Senate/House of Representatives
Washington, DC

The roundtable was convened, pursuant to notice, at 9:34 a.m., in room SVC 202-203, the Capitol Visitor's Center, Hon. Dave Camp, (Chairman) presiding.

Also present: Senators Baucus and Hatch, Congressmen Herger, Johnson, Levin, and Rangel.

Also present: Hon. James A. Baker III; Hon. Richard "Dick" Gephardt.

OPENING STATEMENT OF HON. DAVE CAMP,
A U.S. REPRESENTATIVE FROM MICHIGAN

Chairman Camp. Welcome to everyone. The Joint Committee on Taxation will convene. I do want to say, for our guests and witnesses here, that the chairmanship of this committee alternates every year, and it just so happens this year the House Ways and Means chairman is the chairman of Joint Tax, but next year Senator Baucus will be chairman of the Joint Committee.

But I just want to begin by thanking our special guests for being with us today. It's an honor to have James Baker, who served as Chief of Staff to President Reagan, and went on to shepherd the 1986 tax reforms through the administration as Treasury Secretary, and by former Democratic Leader Dick Gephardt, who, along with Senator Bradley, helped kick-start the tax reform debate with their 1982 tax reform package.

As two of the key architects of the 1986 tax reform plan, you each bring a unique perspective to the debate that Congress has again embarked on: how to craft meaningful, comprehensive tax reform that strikes the necessary balance of ensuring the government has the resources it needs to provide for critical functions, while also allowing the private sector, employers, and families the freedom to grow and thrive.

The 1986 Act remains the basis of our system of taxation, but it is in some sense a shell of its former self. In the intervening years, members of Congress from both sides of the aisle have loaded the Tax Code with a dizzying array of credits, deductions, exclusions, and exemptions. While the merits of each of these changes can be debated, discussed and analyzed, the overall effect of those changes on the Code itself is beyond question.

With nearly 4,500 changes in the last decade alone--that is 4,500 changes in just 10 years--the Code is too complex. With Americans spending over 6 billion hours and over $160 billion annually to comply with the Code, it is too costly and too burdensome. Clearly, the time for comprehensive reform has come, and I am committed to finding a path forward.

I am under no illusion the task will be easy, nor can it be a partisan exercise. Instead, it will require the active participation of the American people, the administration, and all members of the House and Senate, beginning with the House Ways and Means and the Senate Finance Committees.

That is why we are here today. Senator Baucus and I wanted to host this roundtable in order to engage in a results-driven dialogue about tax reform. We hope that this roundtable format will allow for a more free-flowing conversation than the standard hearing, and today we will have brief remarks from me, from Senator Baucus, and from Ranking Members of both committees, and then we will go straight to the discussion.

I would ask that once we begin the question and answers, that members of the House side seek recognition from me, and Senator Baucus will keep track on the Senate side. There is not a five-minute rule today, but people are encouraged, obviously, to follow up on other questions, and certainly the answers Mr. Baker and Mr. Gephardt provide.

With that, let me turn this over to Senator Baucus for his opening comments.

OPENING STATEMENT OF HON. MAX BAUCUS,
A U.S. SENATOR FROM MONTANA

Senator Baucus. Thank you, Mr. Chairman. I believe, and I think everyone in this room believes, that the time has come for tax reform, individual as well as corporate tax reform, in America. This country advanced the ball in 1986. We are proud of our accomplishments in 1986. We modernized the American Tax Code by lowering the rates and broadening the base, and that did help our country move forward, there is no question about it.

We are now here in 2011, and the Code has gathered barnacles. The figure I saw is 15,000 changes to the Tax Code since 1986. One can question the merits of those changes, but they are there nevertheless. Our country also is in a different time compared to where it was in 1986.

The world is more complex, globalization is a greater challenge, American companies and American individuals face greater challenges today, not just within the United States, but worldwide. Other countries have different tax structures, which in many cases favor people in those other countries at our expense. We are also at a time when this country needs bipartisanship. It needs the Congress and the executive branch working together to forge solutions for our people, the people that we represent.

The current stalemate over the continuing resolution is just an example of the problems we face. Congressman Camp and I do not think we are going to solve all those problems, but we do have an obligation. We have an obligation to do the very best we can, working together. That is why we are holding this hearing together, to address the Code, individual and corporate, and try to get the changes we think make the most sense for America. We may reach our objective this year. It may take a couple of years. I remember, back in 1986, it took a little while. It was not something that happened overnight.

Our two friends here could explain in much greater detail what happened back then. But we are here. It is 2011. I am excited. It is a great opportunity. I see a good friend, Congressman Rangel. Man, oh man, Charlie Rangel has been talking about changing the Tax Code and about tax reform for a couple of years now. Charlie, here we are. With your help, and the help of everybody else here, we can hopefully make a lot of headway. We are certainly going to try. So, thank you very much.

Chairman Camp. Thank you.

Mr. Levin, my good friend from Michigan, the Ranking Member of the Ways and Means Committee.

OPENING STATEMENT OF HON. SANDER M. LEVIN,
A U.S. REPRESENTATIVE FROM MICHIGAN

Congressman Levin. Thank you. Mr. Secretary, you have so many illustrious parts of your career, I'm not sure what title to use: Mr. Secretary.

Secretary Baker. Jim.

[Laughter].

Secretary Baker. I'm a private citizen.

Congressman Levin. I don't know about that "private citizen". And Dick, it's nice to see both of you.

I'll have to leave for part of this because we're having a Democrat caucus in the House on the budget and on the CR, so I have to be there for part of it. So if I might, let me just give my opening statement and I'll leave, and then I'll come back as soon as I can.

House Republicans put out their budget yesterday and it highlights, I think, one of the major differences between now and 1986, the deep differences of opinion that exist between the two parties in Congress. We must address the deficit. We must not do so as a way to turn back the clock on more than a half a century of progress that helped foster the American middle class.

The Republican budget calls for unprecedented cuts that would lead to the unraveling of Medicare and Social Security. On tax policy, it embraces more tax cuts for the wealthiest and a higher burden for everyone else. If there is to be any chance of undertaking fundamental tax reform, we will have to find a way to bridge those basic differences in the Ways and Means and the Finance Committees to arrive at a bipartisan set of principles.

In 1986, those principles were simplicity, efficiency, and fairness. It is instructive to compare our situation today to the one that we faced in 1986. After the 1981 tax cuts, many felt that we had gone too far, just as many of us today feel that the 2001 and 2003 tax cuts went too far. But in the years between 1981 and 1986, Congress enacted three separate deficit reduction revenue measures so that we were on a far more sustainable fiscal path.

Today there is a broad agreement on the need to address our deficits, but very little common ground on how to most responsibly achieve that goal. Another major difference between 1986 and today is the dramatically increased income inequality in our country. In 1986, the average income of the bottom 90 percent of households was $31,282.

In 2008, the most recent year for which we have data, the bottom 90 percent averaged $31,244. In other words, the vast majority of Americans have seen essentially no gains since 1986 and are actually worse off in real terms. The top one percent, on the other hand, saw an average gain of almost $400,000; the top tenth of one percent saw an average gain of more than $2 million.

As I said before, one of the principles of the 1986 Act was fairness. A great deal of work went into ensuring that one segment of our society was not funding a tax cut for another segment. But when you look at the budget proposal that came out yesterday, that is exactly what some are proposing. By assuming that the 2001 and 2003 tax cuts are all made permanent, it locks in a policy skewed to the very highest earners. Nearly 80 percent of the benefit of extending the upper income tax cuts last year went to the wealthiest one-fifth of one percent of taxpayers, those with income over $1 million.

Mr. Camp, you and Mr. Ryan have also set a goal of the top individual tax rate of 25 percent. What is not laid out is what it would take to reach that goal or its consequences. It almost certainly would be necessary to eliminate major provisions that help build the broad middle class of this country, such as the mortgage interest deduction and the employer-provided health care exclusion.

One could eliminate other provisions that help the working poor, like the Child Credit and the EITC, which I don't agree with. Even if one eliminated the lower preferential rates for capital gains and dividends, the 25 percent top individual rate would still require choices that would increase the tax burden on working families and reduce the progressivity of our tax system.

In other words, the tax reform goals must not mean a tax cut for the wealthiest and a tax increase for working families whose incomes have been essentially stagnant in the years since the last tax reform. We need tax reform that directly encourages economic growth and creation of jobs here in the United States, helps working families, and does not add to our deficit. So I look forward to our guest's perspective on how we can get there. Thank you.

<u>Senator Baucus</u>. Senator Hatch?

OPENING STATEMENT OF HON. ORRIN G. HATCH,
A U.S. SENATOR FROM UTAH

Senator Hatch. Well, thank you, Mr. Chairman. I want to welcome these two great old friends here to Washington. Both have given sterling service to our country over the years and we're very appreciative that you'd take time to come and be with us.

We are in a real mess here. Our national debt is over $14 trillion, 90 percent of the GDP. We're headed towards 90 percent of GDP in spending if we don't watch out. A lot of us are very, very concerned. We're very concerned about what's going to happen at the end of these next two years, and what is going to happen to the tax rates and so forth?

We have seen more and more people being pushed into not paying any income taxes at all, and yet being dependent upon the Federal Government for even basic living. We know that the upper 50 percent of all wage earners are paying close to 97, 98 percent of all taxes. The administration is talking about doing away with deferral. Naturally they'd like to bring down corporate tax rates, and there may be some way that can happen. But that sure will make us very non-competitive if it's not done right.

Chairman Camp and I, we know that the States are 175 billion bucks in the hole. Chairman Camp and I put out a paper that adds another $118 billion that we know is there that they're also in the hole. It's almost mind-boggling, what's happening. I could go on, but I'm personally looking forward to hearing from both of you. I admire both of you, as you know. Both of you have given stellar service to this country over the years. I'm grateful to have you here and hope we can pick your brains and get a lot out of this meeting. Thank you for being here.

Thank you, Mr. Chairman.

Chairman Camp. Well, thank you. Again, thank you both for being here. I Just really wanted to kick it off by asking both of you: Were there any particular legislative strategies in the early days of tax reform, or tactics that really helped sort of jump-start the reform process in your minds that might be helpful to us now? And understanding it was a different time, as many people have mentioned, what were some of the early tactics or strategies that helped get reform started?

Secretary Baker. Well, the first thing, Mr. Chairman, let me say from my part, I'm delighted to be here this morning and I thank you for inviting me. Of course, we're looking back 25 years, and there will be a few things that Dick will remember that I won't remember.

Congressman Gephardt. No, that's not true.

Secretary Baker. But I do remember this. When we first started talking about tax reform in the counsels of the Reagan administration's first term, we saw it as a very difficult task. If you remember back to the President's State of the Union in January of 1985, he made that purposefully his number-one domestic priority. He said, America needs a better Tax Code. We need a more simplified Tax Code, or a Tax Code that broadens the base and reduces rates for all taxpayers-- not just corporations, but all taxpayers, individual and corporate.

I'm encouraged to hear what Chairman Baucus said when he said he thinks it is time for tax reform, because I think the stars are right for tax reform today, for a couple of reasons. If I might, I'll go ahead and throw those out there. Our country badly needs to see our government cooperate. Partisanship and adversarial combat is probably worse than it was 25 years ago, although it was pretty tough then.

Tax reform was an extraordinary difficult task to accomplish. But we had a President who made it his number-one priority, and we had a leadership in the House of Representatives, which at that time was Democratic, in Tip O'Neill and Dick Gephardt, who were pretty much, if not totally on board for it--I know Dick Gephardt was on board. Tip was a little bit like this, but willing to see it go forward. They put their shoulder to the wheel, but first and foremost, Chairman Rostenkowski, your predecessor, Chairman, as head of Ways and Means, was very solidly in the corner of trying to get tax reform done.

Charlie Rangel remembers it. It's extraordinary difficult because you are, in effect, goring everybody's ox when you decide you're going to broaden the base and eliminate loopholes and deductions. But the only way you can reduce marginal rates is to eliminate loopholes and deductions.

I never will forget one of the first things we did was to go on a retreat. We had a Ways and Means retreat that Danny held, and everybody got up and talked about the imperative of tax reform. I did, as Treasury Secretary, Danny did, others did. I never will forget Charlie standing up and saying, Danny, I want you to know that I'm 100 percent behind you for as long as I can be.

[Laughter].

Secretary Baker. You've probably forgotten that. But it was tough, really tough. We in the administration had to accept a bill from the House of Representatives that was a bill that we really probably would have never signed, and we had to do it over the objections of the Republicans in the House at that time.

But that's where the President wanted to go, and he used the stature and power of his office to push for tax reform. That is, I think, more than anything else the reason we got it. We had a committed chairman of Ways and Means, we had a committed chairman of Senate Finance on board for it, we had the leadership of the House on board for it. If you don't have that, I can't think of a legislative undertaking that's any tougher than tax reform.

But there is something in it for both parties. Republicans, of course--and I think quite properly because I'm a Republican--love lower marginal rates. We think that generates economic growth and creates jobs. Democrats like the idea of base broadening and eliminating deductions and loopholes for special interests, and there is nothing wrong with that.

But there is something in tax reform for everybody. To get there, you've got to have the leadership that I just mentioned, and you also have to be willing to undertake this on a revenue neutral basis. If you let your effort at tax reform get caught up in this debate that we're now having, and that we're going to continue to have at least through 2012, on how to deal with this terrible debt burden that the country is suffering from, if tax reform gets caught up in that you won't have tax reform.

So it has to be, if you expect to be successful, you'd better undertake it on the basis that it's revenue neutral and that it's distributionally neutral so that you don't have one set of taxpayers being gored at the expense of another. Those would just be some preliminary comments, Mr. Chairman. There are others I could make, but I don't want to monopolize the time because Dick will have a lot to say on that, too.

Congressman Gephardt. Thank you very much. I'm thrilled to be here. I thank you for inviting us, and I'm really happy to be with Jim Baker, who I have enormous admiration for all of his public service through many administrations.

I guess I'd start by saying that, to me, the most important thing -- I have a friend in Missouri who runs a bunch of very successful businesses and he has very good relations with labor. He has a saying for why he has that. His saying is, "You gotta wanna." They're the most important words in the English language. I think tax reform has to start there. You've got to have a critical mass, at least a core group of people--which may be in this room--that really want to do this for the right reasons.

In 1981, 1984, I think Bill Bradley and I put our bill out. We had a tremendously good reaction from the Reagan administration after that. So, I would support fully what Jim just said, and that is: you've got to be bipartisan, you've got to have a core group that really believes in this for the right reasons and wants to do the hard, heavy lifting to get it done, and I think it is important to try, if you can, to disassociate it from the budget issues.

You know, we did a big budget deficit reduction when George Bush 41 was president. Some of you may remember that. We took everybody out to Andrew's Air Force Base and worked all that out, and that's when George Bush, in my view, showed great leadership by saying taxes and everything else is on the table, which was a remarkable thing for him to do and showed real leadership, in my view. In that budget, we got about half the deficit reduction from spending cuts and half from revenue increases. I don't know whether that would be something that people would consider in a budget agreement now. I rather doubt it, but I don't know.

My point is: if you get this issue, hard enough on its own, ensnared into the whole question of how much money the government should take, it, I think, will defeat your purpose. I also want to add to what Jim said when he started, and that is that this may be, if you can do that, a way to show the country and the Congress that you can reach bipartisan agreements on very tough topics to deal with. So that may give you more fuel to really go through this process in the days ahead.

I totally agree with Jim that if you're doing that outside of the budget you really need to avoid, if you can--and I know it's hard--the questions of distribution and the question on how much money the government should take. You've got to be neutral on both of those topics, or in other words, leave it where it is. There may be a lot of members of Congress who don't want to leave those questions where they are, so that will be a major hurdle.

If you can't get agreement on that, an alternative B may be to try to get an agreement on a distribution chart that both sides could compromise on and live with. I think it's much harder to deal with how much money the government takes. I think that's really a budget question and almost has to be decided in that context.

The last thing I'd say is that this would not have happened in 1986 without the things that Jim mentioned. We had the leadership in the House and the Senate, we had, most importantly, the President committed to it, and we had Jim Baker, who was pivotal in holding it together and guiding it and keeping it on the track. It always will come off the tracks 10 or 12 times as you go down the road. So those elements were present. No time is ever like a past time, I understand that, but you've got to search for those elements if you hope to succeed. I wish you well. I admire the fact that you're here, that you're here together, that this is a bipartisan effort, and you're really seriously trying to figure this out and I wish you well.

Secretary Baker. Could I add one thing to what Dick said? The American people would like to have a different Tax Code. There will be a lot of support out there for tax reform generically, but when you start eliminating these deductions and preferences, the lobbyists are going to come at you with both barrels. There is a great work that a reporter at the time for the *Wall Street Journal* did. Alan Reynolds wrote a book called, *Shoot-Out at Gucci Gulch*, or that's basically the title.

Senator Baucus. *Show-Down at Gucci Gulch*.

Secretary Baker. Yes. If you haven't read that book, read it. It will give you a lot of insight into the kind of problems you will run into. But generally, the American people will support the idea of tax reform that lowers marginal rates and eliminates loopholes and deductions, broadens the base and simplifies the Code. We badly need it, and everybody really wants it.

The last thing I would say by way of an opening comment is that there is a policy institute at Rice University that is named after me: the James Baker Institute for Public Policy at Rice University. I've asked our people down there, our fellows, one of whom is here with me, John Diamond, who used to work for the Joint Committee, to come up with a study that compared tax reform in 1986 with the situation today. I did not do that in anticipation of this hearing because I didn't know I was going to be coming up here. We did it because I think the stars are right for consideration of fundamental, comprehensive tax reform.

I know the President has signed on to corporate tax reform and we do need to reform our corporate taxes. But I would argue strongly for trying to get to comprehensive tax reform where you reform the Code not just on the corporate side, but corporate and the individual side as well.

We brought 30 copies of this study with us and we'll leave them with you for whatever you should like to make of them.

Senator Baucus. Thank you.

Chairman Camp. Thank you.

Senator Baucus. I would just like to ask about beginning principles. I tend to think, you get a core group, as many as possible, agreeing to what the basic principles are going into it and sticking with it, that you're better off than not. You mentioned revenue neutrality as one. Get signed on for those pursuing this. Our goal is revenue neutrality. You also mentioned no change in distribution.

I know some think the Tax Code causes inequity in incomes in this country. I'm not going to get into whether it does or doesn't. There are a lot of explanations why there is a growing maldistribution of income in America. But if you could just talk a little bit about that, starting with the current distribution. It's kind of like the CBO baseline arguments always have: where do you start?

Third, are there any other sort of basic principles that you think we should all think about and potentially agree to? I'm going to bring up something that is probably a very bad analogy, but when I started working on health care reform I had several principles: 1) everything is on the table. Nothing is off the table; 2) we're all in this together. Everyone in the country is in this together, all the groups, whether it's pharmaceuticals, labor, consumer groups, we're all in this together. Everything is on the table; 3) if you don't like something, suspend judgment, if only for a nanosecond. Just don't immediately leap to "no," because it's so big, there are lots of ways to skin the cat here.

For a long time, that worked. I was on the phone a lot, just trying to keep people together, following those same principles. So if you could help me in any way, and I'm sure it would help others, if there are a couple, three other principles that you think we should focus on, and also a little bit more on distribution because that could be a bit difficult.

Congressman Gephardt. Well, I said a moment ago I think both neutrality on revenue and distribution are going to be really important to agree on ahead of time to the extent you can. I think if you can't, something hard gets harder. I would think that it would be easier to get revenue neutrality because you could put that off to whatever happens on the budget eventually. Distribution, I think, is harder. That's why I said alternative B, I would think, would be to try, if you can, to agree to a distribution chart - as hard as that would be - that both sides could grudgingly agree to.

You know the definition of a compromise is that everybody is totally unhappy and angry when it's done, so you've got to use that as a test. But if you could do that, then you might be able to do an alternative B. I don't know how important it will be, but I would think some Democrats will not want to vote to lock in the distribution that is in the present Code and would be reluctant to do that, so you've got to work your way through that issue in some way.

I want to address what you're going to deal with. I think probably, in this day and age, we didn't deal with the business side in 1986 to any great extent at all. I think you probably want to do that now, or at least you want to consider doing that because of the world competition we're in and what that means for American businesses. So that's something that you probably need to try to agree on.

I think one of the things that we didn't do very well, and it's hard to do, is to try to really look at every tax break the same way we try to look at spending, direct spending, because when you really think about it, any tax break is really government spending. You're intervening in the market to get something to happen that you think government needs to intervene on to get to happen.

Probably when I was around, and now, we didn't do enough, really, oversight of our direct spending programs. I remember zero balanced budgets and all the ideas that came around that forced Congress to look at everything anew every few years. The same thing applies, in my view, to tax breaks. We all know that tax breaks are unequal. Some of them are huge revenue losers, some of them are tiny, some of them apply to the whole population, some of them only apply to a slice of the population. So trying to make sense out of that, I think.

The last thing I'd say is kind of a principle, is try to get an agreement that you're not going to let the perfect be the enemy of the good. When we finished in 1986, it was very different than a lot of the bills that had been presented. You can write a bill that is very elegant, has no imperfections from a theoretical standpoint. But when you get into the tough business of politics and listening to the American people, there are some things you're not going to be able to get the votes to do. We had the charitable deduction out of the Bradley-Gephardt bill. It came back in. We tried to take out mortgage interest in one of our versions. It came back in.

<u>Senator Baucus</u>. State and local was out.

<u>Congressman Gephardt</u>. State and local. Charlie Rangel wouldn't let us do it.

[Laughter].

<u>Secretary Baker</u>. State and local was out for a while. It's the one time Rostenkowski hung up on me.

[Laughter].

<u>Congressman Gephardt</u>. So I'd just end by saying, keep flexible, understand the toughness of reality, and don't let the perfect be the enemy of the good. We came a long way in 1986. We got rid of a lot of loophole stuff and we got the rates down. The top rate was 28 percent. Incidentally, and I will just tell one last anecdote, we were above 28 percent by a good deal. At the end--Orrin, maybe you'll remember this--Bob Packwood insisted that we get to 28 percent.

A big part of getting to 28 percent was taking away retroactively, for the first time in the history of the Code, some tax benefits for real estate investments. I am still to this day hearing from those constituents who were plenty angry that we did that on a retroactive basis. So, this is hard to do. This is really hard to do.

Secretary Baker. Hey, those real estate people were primarily Republican constituents, too.

Congressman Gephardt. Some of them were Democrats.

Secretary Baker. Don't think we didn't hear from them, either.

Congressman Gephardt. Well, that's it.

Secretary Baker. I agree 100 percent with what Dick said about, don't let the perfect be the enemy of the good. I'm not sure I understood what you said about, you didn't deal with the business side. We reduced the corporate tax rate from 48 percent to 34 percent.

Congressman Gephardt. We did.

Secretary Baker. And we eliminated one hell of a lot of preferences and deductions on the corporate side, and in fact we eliminated so many that it made it possible for us to sell tax reform as an overall 8 percent reduction in individual tax rates. So we dealt with it in a very substantial way. That may make it a little harder today to get where you want to go, except there have been, as you pointed out, Mr. Chairman, a proliferation of things that have come back in. Distributional neutrality.

I understand what Dick said about, some people don't think the current distribution is fair, others would like to see them go more in the direction that they've gone in recent years. I wouldn't get into that argument if you want to accomplish comprehensive tax reform. I think you have to take the situation that exists today, both on revenue and distribution, and say, okay, we're not going to tamper with that. Otherwise, you're going to make your job so damn difficult, in my view, that you're going to have a heck of a time getting there.

If you, on the other hand, can say, look, we're not messing with the overall revenues that are coming in and we're not going to screw around with what current law says the distribution is. We're not into that game. That's for the major league budget debate that is going to take place, in my view, probably after 2012, not before 2012. But it's facing us.

As one of you said, we have a debt-to-GDP that's totally unsustainable: 90 percent debt-to-GDP. I think it was Senator Hatch who said it. It is proposed to be 100 percent for the next 4 to 5 years. If we did not have the dollar as the de facto reserve currency of the world, we would be Greece. We're broke. We are in really bad shape. This is the number-one problem facing our country today and we're going to have to deal with it.

As someone who lived up here for 13 years or so, and worked in 3 administrations, I don't think it's going to be dealt with before 2012. Why do I say that? That's a cynical view, but that happens to be my view. Because we have a divided government. If we can fight like we're fighting over a continuing resolution and $7 billion, think about what the fight is going to be when we start talking about the big problem. So I think tax reform gives you an opportunity to do something that the American people would really relate to and applaud that would see their government working together to fix a Tax Code that is abhorrent, that is just terrible.

Senator Baucus. I don't mean to jump in. I apologize. Do you see any sequence between tax reform, on the one hand, and the budget deficit reduction on the other hand?

Secretary Baker. Yes. Yes. I think that you ought to go ahead and try and do tax reform. I really applaud the fact that both of you are suggesting that maybe you could take it on, recognizing, as Dick said, that it's going to be a long-term proposition. We started talking about it in 1984. We finally got it done in 1986. And we had two Treasury bills, if you'll remember. We had Treasury 1, and then we had Treasury 2 in addition to the bills that Dick and Bill Bradley came up with.

So it isn't going to be done in six months, but it is a particularly worthwhile effort and endeavor. This country should have a better Tax Code. It's a disgrace, what we've now got. The American people will really relate to the idea of simplifying it if we can and making it more understandable, and fairer.

Senator Baucus. I apologize to my colleagues for jumping in like that.

Chairman Camp. No, no problem.

Mr. Herger?

Congressman Herger. Well, thank you. This is very helpful. It's something we have to do. But I'm interested -- the world has changed so much since 1986. We look at how much more globalized it is, we look at how much China is involved, Russia, different ones, India. How do you see this changing the global economy as far as affecting what we're trying to do, compared to what it was back in 1986?

Secretary Baker. Well, I think for one thing--and you've already focused on this, as I understand it, or certainly the administration has--in their suggestion that you reform corporate taxes. We need to be more competitive. We do need to reform the corporate part of the Code. So it's very sad that we have the second-highest corporate tax rate among the industrialized countries, second only to Japan. So when people are talking about locating businesses and so forth, they don't want to come here. They put them elsewhere. That doesn't create jobs.

Congressman Gephardt. I have heard from labor unions recently, and companies, who want to try to bring some of the foreign-earned income back, as we did in 2004, to the United States. They believe from their study that there is probably almost $1.5 trillion sitting offshore that would, some of it--at least half of it--would probably come back if we could figure out how to do it. That's a lot of money to come back to the United States and would create jobs and replenish pension funds and all kinds of things that need to be done, and it would increase in revenue to the U.S. Government that could be used for competitiveness, reducing the deficit, or whatever you want to do.

So I second what Jim said. We're in a different world. It's much more a world economy today than it was in 1986, even. Almost all of our companies are engaged in world trade and world competition, so you've got to look at the Tax Code with that in mind so that we try to be as competitive with the rest of the world as we can be. It is what it is. So, I think that is an important thing to look at.

Finally, I may be wrong, but I think if you simplify the individual Tax Code you allow Americans to be more competitive individually. I don't want to overstate it, but I think it happens to have some truth in it. When people wind up spending so much time worrying how to avoid taxes and find their way into loopholes, paying lawyers and accountants huge amounts of money to find these loopholes that they can get in, it's not increasing our competitiveness. I would rather have people be trying to figure out how to compete, how to make a better product, how to make a better service that we could compete in the world with. We are in a world economy and we have to win in it, at least more of the time than we are now.

Senator Baucus. Orrin?

Senator Hatch. Well, thank you. I just want to tell you both how much I appreciate listening to you, and always have. Maybe a little less to you, Dick, than I did to --

[Laughter].

Senator Hatch. But I'm very grateful to both of you. But the U.S. is the last major economy operating on a worldwide tax system. In the 1980s, we had 37 of the top 50 multi-national corporations in the world right here, based in America. Today, we have 16, as I recall, because we currently tax the income of our companies wherever it is earned.

Currently, companies have the option of bringing the profits that they earn back to the United States, but then they face a tax of 35 percent. You talk about repatriation, where we brought it back at 5 percent. The problem with that is, they continue to hold it overseas after they get the 5 percent because they're afraid they'll get hit with the 35 percent later, and they want to wait until there's another 5 percent deal.

But these businesses would rather not pay this additional tax. They may keep their money abroad, as we know, deferring the additional tax. Now, current tax laws provide that they can defer these funds indefinitely. President Obama's proposal, at least in this year's budget, would substantially limit deferral. I think we ought to go to a territorial system where we can solve these problems, but I'd like to have your thoughts, both of you, with regard to the proposals laid out by the Obama administration relating to the international tax arena and what we should do in these areas.

Secretary Baker. Well, I'm not an expert on those specific proposals, Orrin. I haven't really looked at them in detail. Generally speaking, I think there is some that might make sense.

I do think that we need, when we start talking about foreign taxation, to look at it through the prism of American competitiveness. That would be the lode star as far as I'm concerned. But I don't think that you can take these issues in isolation if you're talking about comprehensive tax reform.

Senator Hatch. No, I agree with that.

Secretary Baker. Yes. If you're going to do it and you're going to do something like that, then you've got to figure out, particularly if you have the revenue neutrality principle enshrined in your effort, you're going to have to look at doing something like that from the view of, well, okay, how are we going to pay for it and how are we going to substitute for it, and that sort of thing. But I'm not an expert in the details of the administration's budget on repatriation of foreign corporate earnings.

Congressman Gephardt. I would agree that it probably best if it is done in the context of overall tax reform. It makes it, I think, easier to put the whole thing together. I do think that on this question of deferral we have got to confront the fact that a lot of our multi-national companies, which are growing by the day, if you don't do something on it, are simply going to keep the money indefinitely in other places.

Senator Hatch. Or they're going to move overseas.

Secretary Baker. They've moved. They're already doing it. They're building plants and hiring workers over there because the money is there. If the money comes back here it will tend to do the same thing here.

Senator Hatch. Would you use the repatriation argument to maybe get us to get rid of deferral altogether? If we repatriate, shouldn't we go to a territorial system where we're like every other country in the world?

Secretary Baker. It probably would be a good idea.

Congressman Gephardt. It's my understanding that Europe has pretty much done that. I don't know that, but --

Senator Hatch. Almost everybody else has.

Congressman Gephardt. So it's something you really have to consider. I haven't thought it all through and I'm not an expert on it, but it's something you've got to look at. When I hear there's $1.5 trillion sitting offshore, half of which or more could come back, that excites me. I'm on the board of a number of companies and they face this problem, and right now they're keeping the money somewhere else. So, that's not a good thing.

Senator Hatch. Appreciate it.

Chairman Camp. Go ahead, Charlie.

Congressman Rangel. Well, let me thank you two for pumping some life back in this idea of tax reform. Of course, seeing you two reminds me of an old Army saying, that "the best camp that you ever was in was the one you just left."

[Laughter].

Congressman Rangel. And seeing you two, I'd have treated both of you a lot better if I had known what was coming.

[Laughter].

Congressman Rangel. But Secretary Baker, you said initially that the stars were aligned, that this is the time for us to consider it. Quite frankly, I have never seen, from a personal point of view, a worse time since -- you'd have to agree that trust is so important when so many people are going to be affected by these decisions, and there's going to be a lot of political pain involved in attempting to do the right thing.

Some people can afford to do the right thing and not pay for it politically, but generally at the time that we're in, could you please share with me anything that you -- why did you say, this is the time, the timing is so good, the stars are aligned for us to move on this issue politically?

Secretary Baker. I said that, Charlie, because I think the American people desperately want to see a decent Tax Code. They hate this Tax Code and, quite understandably. They'd like to see a new Tax Code. I think, as I've said earlier, that they would be behind the effort. Is today more partisan and adversarial than it was in 1986? Perhaps so. But don't forget how tough it was back then. We were going into another presidential election, sort of an open election if you will.

President Reagan, of course, won overwhelmingly in 1984, but 1986 was only two years away from 1988 and we didn't know what was going to happen. There was plenty of adversarial jockeying for position. You remember the discussions that we had, particularly with respect to the House bill and some of these issues we've touched on this morning, charitable, mortgage interest, State and local, a whole host of others. I said the stars are aligned if, first of all -- and also, the public wants to see our government work together to a good end, to something that would benefit the people.

Secondly, if you do it in the way we're suggesting, that is, you say, okay, we're going to do it revenue neutral and we're going to do it distributionally neutral so we don't get into a lot of those arguments and we don't hook this up to the big debt bomb problem we have in this country, this is a separate undertaking that has plenty of merit to stand on its own two feet. That's why I said what I said. It's been so long, it's been 25 years. During that 25 years we've loaded the Tax Code up with all these additional special interest exceptions, deductions, loopholes, and there's room to get something done the way we did it in 1986. That's why I said what I said.

Congressman Rangel. I remember in 1986 when the President, Ronald Reagan, brought this up. You are so right that Rosty really wanted to get something done and it really gave him a lot of latitude in terms of making the decisions for all of us. And if you recall, Rosty started something in saying, write Rosty if you think it's time for reform, that Democrats were prepared to meet the challenge and take advantage of the opportunity to reform the Tax Code. It really worked. I mean, people, like you said, wanted reform. But boy, when you got down and found out that it was their ox that was on the table! So at a time that we are now, this is great, notwithstanding the fact that newspapers may report that someone is trying to take away State and local or something like that.

[Laughter].

Congressman Rangel. But having said that, we need a method how we can move forward without endangering any parts of the changes we have to make, and with a small group I think we can get trust. But on the eve of a campaign where anything goes with certain groups of people, it seems to me that we have to plan very carefully because a derail at this time, it would be so difficult, with the dramatic changes that we've had, especially in the House, that it could take a long time to put this train back on the tracks.

Secretary Baker. It took us a long time, Charlie. You remember? It took a long time. And remember this: we were a Republican administration with a Democratic House, with a strong President. Today you have a Democratic President with a Republican House, and a President who has shown substantial strength in electoral ability. So I just think the situation is just very much like it was in 1986.

I grant you that the partisanship may be worse today, but if you do this on a basis where you separate it from the really partisan budget debt debates that we're going to have, I think you can get it done. But it will take the President and it will take the chairmen of both the tax-writing committees and the leadership in the House.

Congressman Rangel. Well, we don't want to waste your time on that issue, but I do hope that the two of you just have some small meetings as to how we can afford getting involved in a crucial setback because we want to do it before we even start the process. If we can just build up the right thing to do for America, is to reform the system without getting involved in the details, to get a head of steam behind us that we are forced to do something, then it would make it a hell of a lot easier. But boy, with the concurrent resolution, H.R. 1, the 2012 thing, and you tell me now the stars are aligned, I say, wow, what are you drinking?

[Laughter].

Congressman Rangel. But I think if we don't do anything, the quicker we get started in trying to wrestle with this thing, the better. Of course, it's easy for me to say because I'm in a position not to get hurt. But with all these new members, we're going to have to do a whole lot of studying about how we move on this.

Congressman Gephardt. Charlie, can I add to this dialogue? I think working together, or bipartisanship, is like baseball or playing the piano: you've got to practice it, you've got to do it, you've got to start. This may be a place to start. Let me embellish that with two things. One, and Jim mentioned it a minute ago, when we really got going, Ways and Means Committee and Senate Finance, I think, had retreats with the administration present.

Congressman Rangel. Sure.

Congressman Gephardt. Where we got everybody off-campus, away from all the distractions that go on here, and really got to talk in an informal, relaxed, unforced way about these tough issues. We also got to know one another better and began to trust one another better. In the end, bipartisanship is about human relationships more than any other thing. So that maybe is a way to go. The other thing I'd say to you is that if you look at history, look at what followed the 1986 Tax Reform bill.

You may not remember this, but in, I think, 1988, we had a bipartisan bill on trade that, for the first time, demanded fairness in trade from countries like Japan, and we had Ronald Reagan really demanding that that law be exercised. I would tell you that I think it's the main reason today that some of the big Japanese manufacturers of automobiles have as many plants in the United States as they have.

I do not think it would have happened but for that effort that Ronald Reagan and a Democratic Congress fashioned. So tax reform, in a way, yielded another bipartisan agreement in 1988. Then in 1990, with a new President, we did the first big deficit reduction step. We had everybody out at Andrew's Air Force Base for a week, getting to know one another better. We came up with this incredible budget plan that was bipartisan and was hated by everybody, so it was a great compromise, and we got it through. So you could be a precursor or a leader to get some other things to happen. I think that's what we're really trying to say.

Senator Baucus. I have a question. How important was it for Treasury to get the ball started here, back in 1986? Because there was Treasury 1, there was Treasury 2.

Secretary Baker. It was critical.

Senator Baucus. In reading that book --

Secretary Baker. Critical.

Senator Baucus. -- it was very clear.

Secretary Baker. It was critical.

Congressman Gephardt. If you don't have that, you're --

Secretary Baker. If you don't have Treasury, you don't have the President.

Senator Baucus. Right. But back then, who knows where anything starts. But a starting point was the Treasury putting together -- and you -- I remember, at least according to the book, if it's accurate, you made some dramatic concessions, Jim, with respect to some industries just as a show of good faith. But anyway, it was an effort contained, as I recall, that was secret. You kept close --

Secretary Baker. We did a lot of it. We did a lot of it confidentially, because once you get it out there, of course, in the public echo chamber, everybody can kick it and beat it up. We unveiled it when we had to, and there was plenty of debate about it. But you will recall, we had two Treasury bills. We had one Treasury bill that was economically and technologically superb on tax reform, but it was dead as a doornail politically. Then when I left the White House as Chief of Staff and became Treasury Secretary, we rewrote it and it became Treasury 2 as opposed to Treasury 1, which had been the bill crafted under Don Regan, my predecessor at Treasury and my successor at the White House. We changed that bill and we made it a bit more politically palatable.

But even then, I want to remind everybody that we had a President who accepted a bill from the House that we really disagreed with. I know he would never have signed the bill that came out of the House. We had a Republican revolt, Dave, where the Republican members of the House -- I never will forget Dick Cheney and Trent Lott and these guys coming down to see me, and saying, you know, you're taking these loopholes and deductions out, you're eviscerating our natural constituencies and we're not going to let it happen. I said, well, I guess we'll just see you on the Hill. We had the Gipper and they didn't, and we won. You've got to have the President.

Then when we got it over to the Senate, it became a much more bipartisan effort and exercise, and we finally came up with a bill out of conference that both Democrats and Republicans could support. And Senator Levin, it passed 97-3 in the Senate, something like that. Yes. So it can be done. It can be done. There will be blood on the floor before you get there, but it can be done. But you're not going to get there unless you pay strict attention to revenue and distribution neutrality, in my view. Otherwise you get caught up in all of these political debates that Charlie is talking about, and all the adversarial posturing and so forth.

Chairman Camp. Mr. Levin?

Congressman Levin. I'm sorry I missed your comments. I'm glad I picked up where you left off, where I came in. I wasn't on the committee in that year. I tried to be and I was still trying, so I remember I came to some of the meetings, and then came on the committee and saw its composition. Clearly we need to have an effort at reform. It's been 25 years. It's a long time. So, there's a need. I don't want to throw a complete wet blanket on it because of the need, but really the partisanship is much deeper and different today than it was then.

Secretary Baker. I agree with that, Senator.

Congressman Levin. Very much so. As a result, for example, the argument over the deficit, there's an understanding of the need to address it, but it's infused with different feelings and deep differences. I think we have to recognize that. Dick, you mentioned, in the House, we worked together on the 1988 Trade Act. But there was a different aura there in terms of partisanship and a different feeling between the White House and the Congress. So I think we need to be realistic. For example, Jim, you mentioned--if I might call you that--distribution neutrality. I'm not quite sure how you look at tax reform and not look at distribution issues. I don't quite know how you do that because, for example, the major tax provisions have issues of distribution in them.

Secretary Baker. That's right.

Congressman Levin. For example, in mortgage interest, the charitable, they all have distribution issues in them. The EITC, et cetera.

Secretary Baker. Can I try to answer your question by saying, look at that in the context of the overall budget and debt debate that's going to take place separately from your effort on tax reform. There are plenty of good reasons to reform the Tax Code other than trying to use it to solve this big fight that we've got that's going to continue, in my view, until 2012 or after. Do that separately.

There are a lot of good things you can do with tax reform. Yes, the climate is not good, but wouldn't you agree with me that the new Republican leadership in the House would be receptive to the idea of lowering marginal tax rates? And don't you think that the Democrats in the House and Senate would be receptive to the idea of getting rid of special interest deductions, loopholes, and credits?

Congressman Levin. I think so. I think it would depend on what you call "special interests." I mean, for example, the mortgage interest deduction is sometimes called a special interest. The same is true of the health care deduction. But they've been the basis, the foundation, of the health care system in the case of the deduction and the building of the middle class. I come from Michigan. Without the mortgage interest deduction, I don't think Michigan could have been among the leaders in creating a middle class.

Secretary Baker. That would be the debate you would have as you try to reform the Tax Code. You will have that debate as you try to reform the tax system if you undertake it.

Congressman Levin. Let me just say a word, just a quick word, on repatriation, just one minute's worth.

Chairman Camp. Mr. Johnson is also seeking recognition.

Congressman Levin. Okay. The last one was supposed to be something related to job growth and it did not really work out that way, unless you assume, if money comes back, that automatically it will be used to assist job growth. And you know, as you look at all the money over there, if most of the money was earned in jurisdictions with a substantial tax burden, the foreign tax credit would allow people to bring it back here without much taxation. So we don't know the details, but it would appear that a substantial portion of it was earned in places with a very, very low tax burden and essentially that was an inducement for companies to essentially produce in these tax havens instead of the United States.

So it's not such a simple issue. You have to really look at what's behind those earnings, and if they were brought back, would they be used the way they were used last time when all the reports indicate they did not in any direct way promote economic growth. I think that's why it has to be part of a discussion of overall tax reform, of corporate tax reform. It can't be done separately.

Congressman Gephardt. We both said we thought it should be in the context of overall tax reform, and all of that has to be considered that you mentioned. The one thing I'd say about what you said is that I think, unfortunately, today we're in competition with a lot of places that aren't just tax havens because they have low taxes, they also have good workers who are very efficient, and you can drop technology anywhere in the world today and we lose those jobs. So if we can figure out how to get less of that to happen and a little more of the money be invested here, that would be a really good thing.

Congressman Levin. I agree.

Congressman Gephardt. I urge you to look at all that as you go through tax reform.

Congressman Levin. Thank you, Mr. Chairman.

Secretary Baker. Another reason, of course, to lower the corporate rate is to prevent corporations from shifting income to low-tax countries. I'm not sure we mentioned that specifically. But another thing that the 1986 Tax Reform Act did, Senator Levin, was to take the $6 million low-income Americans totally off the tax rolls by increasing the personal exemption and the standard deduction. We eliminated $6 million taxpayers, low-income taxpayers, from the tax rolls. So a lot of things that I suspect you would think are good can be accomplished under a revenue-neutral approach to tax reform.

Congressman Levin. As Mr. Hatch said in his opening statement, I don't think, Orrin, you were so sure about that portion of the 1986 tax reform. But it shows, kind of, how controversial it can be. Also, it does relate to issues of distribution.

Congressman Gephardt. Yes. Right.

Chairman Camp. American hero, Mr. Johnson.

Congressman Johnson. Thank you, Mr. Chairman. You alluded to it, and he just now brought it up and so did you. As you know, today roughly half of all households don't pay income tax today. It's my viewpoint everybody ought to pay at least a dollar. Let's say everybody needs to participate in this government. So I want to know if you think that's fair. You just mentioned that you've got a lot of low-income people off the income tax. Second, do you recall what the figure was during the last reform effort of number of households? And lastly, how do we go about getting buy-in from the American public for reform if half of all households don't pay tax, income tax?

Secretary Baker. Well, a lot of households do. More than half do pay, and they're going to buy in to reform that is simple, fair, and effective, I think. They did in 1986, Congressman, and I think they will again today. Now, do I think it's fair for everybody to have a stake in their government? Of course I do. Do I think they necessarily have to pay a dollar in taxes? I don't know about that. I'm not sure the future of the Republic depends on that.

Congressman Gephardt. I think everybody should do something. I think a lot of people that don't pay the income tax pay the Social Security tax or the Medicare tax, so they are making a contribution to a common social effort that's very important.

On saying this, I want to spend a second on that. When we put the bill in, Bill Bradley and I went out in the country and went to every gathering we could find to talk about tax reform. We talked about it with Republican groups, Democratic groups, liberal groups, and conservative groups. I think that's a really important part of this, is explaining it and engaging the people of the country in a dialogue about it. Then of course when the President got involved, that raised its visibility tremendously. Then Dan Rostenkowski did his Write Rosty campaign and he got people engaged in the debate as well, so it's a very, very important part of this.

One other thing that Sandy mentioned that I want to briefly comment on. He was saying that it's so partisan today, unlike 1986. And I would agree with Jim, we had our fights then as well. But I tend to think Sandy's right, and I'll go back to what I said. Bipartisanship has to be started somewhere. You have to infuse the habits of bipartisanship. You've got a lot of new members here, especially in the House. They've never been here. They haven't been through any of this. They come with strong feelings, I understand that. That's one of the benefits of having new people come here. But this is a huge organization. This is 535 people. I thought about it every day when I was Leader, and there were days when I didn't think we could ever get anything done.

I mean, somebody on the TV this morning was saying, on one of the shows, do you think any business would run like Congress does? I thought, well, of course not! This is Congress. We've got all the people at the table. We do this better than anybody in the world. We've done it longer than anybody in the world. But it takes human relationships to make it work as well as it can. All of you are leaders. You are the leaders of this Congress, and I believe you can start a tax reform effort that can be the model that can be applied to all these other issues if you can get those relationships to be formed.

Chairman Camp. All right. Well, I want to thank both of you for being here, and I want to thank the members for participating as well, and Senator Baucus for arranging that we could be on the Senate side for this. You've given us a lot of good ideas, a lot of good goalposts to look at as we go forward. I just really appreciate the benefit of your expertise, your experience, your advice. I think this is the start that will help us as we try to move forward on this issue. I very much would like to see us try to move forward on it. I want to give you both an opportunity to say anything to sum up, but also want to give Senator Baucus an opportunity to make any comments he'd like to make.

Senator Baucus. Oh, I think this is great.

Chairman Camp. But just to say thank you very much.

Senator Baucus. Yes. No, I think it's great. Everyone in the room clearly believes we should reform our Tax Code. It needs to be reformed. There's no disagreement there. In fact, there is sort of a lot of energy to get started. I just want to thank all of you for that. I think we'll have later conversations on next steps. Thank you very much.

Chairman Camp. I didn't know if there were any closing comments you wanted to make. You've both been very generous with your time, very enlightening, and we want to thank you very much.

Secretary Baker. No. I just would applaud you for being willing to undertake it, because it's not easy, but it's something the country badly needs.

Chairman Camp. Thank you.

Congressman Gephardt. I salute your effort and we're thrilled to be here. Anything else you ever want, we'll try to do. Thank you.

Chairman Camp. Thank you both very much.

Senator Baucus. Thank you.

[Whereupon, at 10:50 a.m. the roundtable was concluded.

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Contact: Julia Lawless, Antonia Ferrier, 202.224.4515

Hatch Statement at Joint Committee on Taxation Roundtable Discussion on Tax Reform

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, today delivered the following remarks during a Joint Committee on Taxation Comprehensive Roundtable Discussion on tax reform:

I commend the Joint Committee on Taxation along with Chairman Camp and Chairman Baucus for convening this meeting. If there's one thing I've learned from the hearings we've held in the Finance Committee and will continue to hold, it's that tax reform is very, very complicated. At times it seems impossible that we could come to any sort of agreement within the Committee, much less in both Houses of Congress.

However, whenever we are sifting through the minutia of tax reform, of which there is plenty, it is reassuring to know that it has been done before. That is why it is so valuable to hear from two of the victors of the 1986 tax reform. Secretary Baker and Leader Gephardt have helped to accomplish what we are now trying to do.

The Finance Committee has already held tax reform hearings on efficiency, complexity and other topics. We've held hearings on the tax reform done in 1986. However, tax reform will not magically happen as the result of a certain number of hearings. We can't simply mix various random ideas and suggestions together in a cake, bake it, and expect to feast on economic prosperity. What I'm saying is, it isn't enough to assemble lists of good ideas; we have to put together a coherent and workable proposal that has a chance of enjoying broad support. Though I can't think of a better way to spend a morning than talking about tax policy, I think everyone here would agree that our goal is to eventually get a bill passed and signed by the President.

Some essential ingredients to our tax reform cake that we haven't spent a lot of time discussing are the fundamental values that will underlie the specific reforms we hope to implement. In putting together various reforms and rates, what do we want our package to accomplish? To answer this question we need to think about how American citizens should interact with their government. One primary value that we need to consider is increasing individual liberty. It sounds simplistic to say, and I'm sure no one would say, or at least admit, they want to diminish liberty, but we can't take it for granted that whatever we do will make Americans more free from our current tax code.

But what exactly do I mean when I say we should promote individual liberty? I have three criteria that I think will, in part, help us do that.

The three criteria that we must not forget, though not necessarily the only criteria we need to evaluate, are fairness, growth, and simplicity. We could probably spend days or weeks talking about what these words mean, but I will briefly describe what I think about when I hear the words, fairness, growth, and simplicity. Also, the Finance Committee has spent some time looking at these criteria, and we will spend more time doing so.

Regarding fairness, does the tax code make taxpayers feel like they are being taken advantage of? Do they see some shirking their obligations and being rewarded, while others are punished for the same or lesser offenses. Do the rules apply differently to the powerful and well-connected? Are those that derive power from their positions of responsibility over the tax code able to abide by it?

Regarding growth, does the tax code make it harder for someone to start a business, or expand a business, or otherwise take the risk in trying to present something of value to their fellow citizens? The tax code shouldn't be an argument against working more, or harder, or smarter, as it currently seems to be.

Finally, how much time and money should families and individuals spend complying with their tax obligations? Do we think people should be able to fill out their own tax return, or do we want most Americans to be required to pay someone else simply to obey the law? How much money do we want to tear out of the economy to be spent on tax preparation and reporting?

The three principles I've just laid out, fairness, growth, and simplicity, can help us to maximize individual liberty, as we contemplate tax reform. We need to remember that we are not working on Mount Olympus and deciding how best to manipulate the mortals below into living the way we think they should live. As their representatives, we have been tasked on their behalf to study the issues, in this case tax reform, and to recommend to them a voluntary tax code that will sustain their government with their consent.

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Fundamental Tax Reform: Then and Now

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Fundamental Tax Reform: Then and Now

John W. Diamond and George R. Zodrow[1]

I. Introduction

Recent months have seen renewed interest in fundamental reform of our nation's corporate and personal income tax system. This interest has been prompted by a variety of factors. There is, of course, widespread recognition that the U.S. income tax is a complex, highly inefficient, and costly way of raising revenues to finance government expenditures. Beyond this familiar concern, the reports of several recent commissions focusing on deficit and debt reduction, including the report of the National Commission on Fiscal Responsibility and Reform and the alternative proposed by the Bipartisan Policy Center's Debt Reduction Task Force (the Rivlin-Domenici plan), have highlighted the need to reform the income tax system. In particular, these reports recognize that additional income tax revenues are almost assuredly going to have to play some role in solving our nation's looming fiscal problems—even if this role is secondary to spending reductions and the cost-saving reforms of the Social Security, Medicare, and Medicaid programs. President Obama stressed the need for fundamental tax reform in his January 25, 2011, State of the Union address, the House and Ways and Means Committee is holding hearings on the topic, and several comprehensive blueprints for income tax reform were described in the 2005 report of the President's Advisory Panel on Federal Tax Reform.

Discussions of fundamental tax reform inevitably hearken back to the passage of the Tax Reform Act of 1986 (TRA86), the last sweeping overhaul of the income tax system in the United States. That reform, while certainly far from perfect, is widely heralded as the best example in recent memory of a bipartisan tax reform. Moreover, although prior to its enactment, passage of such a sweeping reform was widely viewed as politically impossible and the debate leading up to its enactment was vigorous and often highly contentious, the final passage of the act was marked by an incredible degree of consensus—including a final Senate vote in favor by a margin of 97-3. TRA86 was a landmark law that

1 The authors would like to thank James A. Baker, III, honorary chairman of the Baker Institute and former U.S. Secretary of State and of the Treasury, for his helpful consultation during the preparation of this report.

significantly broadened the bases of both individual and corporate income taxes by eliminating a wide variety of tax preferences. This allowed dramatic reductions in the top rates applied to individual and corporate income, as the top individual rate was reduced from 50 to 28 percent and the top corporate tax rate declined from 48 to 34 percent.

In our view, the conditions are right for another sweeping reform of the tax system and, indeed, the case for reform may be even stronger than it was prior to the passage of TRA86. Moreover, there are numerous similarities between current conditions and those that led to the passage of TRA86. At the same time, however, we recognize that several factors potentially make the enactment of a sweeping reform package more difficult in the current environment than in 1986, suggesting that the final package needs to be extremely attractive from both political and economic perspectives, and that considerable political skill, presidential leadership, and a spirit of bipartisanship—indeed statesmanship—will be required if fundamental tax reform is to be achieved.

Our discussion proceeds in three steps. First, we discuss the similarities and differences between the current situation and the environment that led to passage of TRA86. Second, we identify some general principles that should guide the process of achieving reform. Finally, although the specification of a complete reform package is far beyond the scope of this report, we identify the general outlines of what we believe fundamental tax reform of both the individual and corporate income tax systems should entail.

II. The Current Environment—Similarities and Differences Relative to 1986

The conditions that existed prior to the passage of TRA86 were similar in many ways to the current environment. Most importantly, the political atmosphere was highly partisan, especially with the houses of Congress split between the Democratic and Republican parties, each of which was positioning itself to try to capture both houses and the presidency in the upcoming election. Many pundits predicted political gridlock in Washington, with little hope of passage of major legislation. At the same time, however, there was widespread disgust with the income tax system, especially (1) the prevalence of tax shelters that enabled wealthy taxpayers to escape much of their tax liability; (2) high tax rates that hampered economic growth by discouraging labor supply, saving and investment; (3) distortions of consumption, saving and investment decisions caused by differential tax treatment of similar economic activities; and (4) a tax code that was hopelessly complex, resulting in high compliance and administrative costs and a pervasive sense that the tax system was fundamentally unfair as only those knowledgeable enough and willing to "game" the tax system were able to significantly reduce their tax burdens. The road to tax reform in 1986 was tortuous, and on several occasions it appeared that the process had been permanently derailed. However, the combination of persistent and effective leadership from the Reagan administration, as well as from both sides of the aisle in the House and the Senate, coupled with a reform proposal that significantly improved the tax system from an economic perspective while still maintaining political feasibility, was ultimately wildly successful. Indeed, as noted above, the proposal achieved nearly unanimous passage in the Senate,

and addressed, to at least some extent, virtually all of the problems of the pre-reform tax system.
In our view, the prospects for a similarly sweeping tax reform in the current environment are improving. Although the political environment is highly partisan, the need for tax reform is widely recognized and has been highlighted by recent discussions of the need for drastic fiscal reform as well as by the 2005 Tax Panel report. As President Obama searches for legislative proposals that can gain traction in a divided Congress, tax reform could become a high priority item, as it would address issues related to fiscal and labor market imbalances that are at the forefront of public attention. A well-designed tax reform package could have features that are economically sound as well as attractive to both parties. In particular, the standard base-broadening, rate-reducing approach implemented in 1986 and advocated in many current proposals could have considerable appeal to Democrats to the extent that it reduces tax preferences that primarily benefit the wealthy, and to Republicans as it lowers marginal tax rates and reduces implicit government intervention in the economy through the tax system. Moreover, there are numerous leaders on both sides of the aisle that might take on the cause of tax reform—provided that an attractive package can be devised that generates overall economic and political gains sufficiently large to outweigh the narrow losses that will be highlighted by those who gain disproportionately from current preferential tax treatment.

At the same time, however, it must be noted that tax reform may be more difficult to implement than it was 1986. In particular, the political climate seems more polarized than in the earlier era, so that a higher level of leadership, statesmanship and bipartisanship will be required to achieve reform. In addition, despite a dramatic reduction in corporate rates in 1986, corporate base broadening was sufficiently great that the total corporate tax burden increased significantly. As a result, the wheels of reform in 1986 were greased by a reduction in individual tax burdens of roughly 8 percent for all taxpayers—which meant that tax reform could be sold as a universal individual-level tax cut, even in the context of a tax reform that overall was revenue neutral. The current environment, however, is characterized by statutory tax rates on U.S. corporations that are the second highest in the world, as well as relatively high marginal effective tax rates on investment. This situation precludes a large tax increase on the corporate sector if U.S. firms are to remain competitive in today's highly globalized economy.

Tax reform may also be more difficult due to the temporary nature of several key provisions in the tax code that significantly raise current official projections of future revenues, and greatly complicate any proposal for fundamental tax reform if it is required to replace all of these revenues (as was made clear in the report of the 2005 Tax Panel). Most important is the alternative minimum tax (AMT) which, despite annual congressional "patches" that limit its reach, is assumed in future years to raise significant revenues from a large fraction of middle income taxpayers. Similarly, official projections assume that all of the Bush tax cuts are allowed to expire, which also results in significantly larger future revenues.

All of these factors may make tax reform more difficult than in 1986. At the same time, however, they highlight the scope of the fiscal problems that our nation currently faces and, most importantly, make the need for fundamental reform even more pressing.

III. Criteria for Evaluating Fundamental Tax Reform Packages

Numerous criteria might be utilized to evaluate proposals for fundamental tax reform. However, we would argue that any viable reform proposal must satisfy at least the following five criteria.

A. Revenue Neutrality

We believe that fundamental reform of the income tax structure is sufficiently difficult that the process of reform should not be encumbered by a requirement to raise additional revenues, which would ensure that many, if not most, taxpayers would end up being "losers" from reform, making the passage of reform virtually impossible from a political perspective. Although we understand that additional revenues will be needed in the future to address our nation's deficit and debt problems as well as to eliminate the AMT, we believe that raising rates within a reformed tax structure to obtain additional revenues, in conjunction with spending cuts as part of a sweeping fiscal reform package, must be treated as a separate issue if fundamental tax reform is to be politically feasible. Moreover, we believe that such treatment should be extended to the AMT and the Bush tax cuts; that is, we propose that the revenue (and distributional) baselines for fundamental tax reform assume that the AMT patches and the Bush tax cuts will be permanently extended. Thus, we propose a two-stage approach to reform—a revenue-neutral fundamental tax reform under the assumptions outlined above, followed by fiscal reform that reduces future budget deficits while reaching a compromise on distributional issues.

We would also like to emphasize that fundamental tax reform should not be held hostage to those who argue that the implementation of a more efficient and simplified broad-based income tax system is undesirable because it might facilitate greater growth in the size of government. Decisions regarding the size and scope of government must be left to the political process, and a host of instruments, including the use of budget rules to limit expansions of the size of government, are available to reduce current deficits. But perpetuating a highly inefficient and complex tax system in the hopes that it might limit the growth of government strikes us as an extremely costly and highly inappropriate way of achieving that goal.

Note also that revenue neutrality must be defined broadly to include long-run neutrality. This ensures that the long-run implications of provisions that accelerate revenues (e.g., conversion of retirement savings from traditional IRAs and similar accounts to Roth IRAs) are fully taken into account. At the same time, we believe that the definition of revenue neutrality, especially in the long run, should be broad enough to take into account conservative estimates of the dynamic revenue effects of reform-induced increases (or decreases) in economic growth.

B. Equity: Distributional Neutrality and Horizontal Equity

Again following the approach that was successful in the passage of TRA86, we also believe that tax reform should be approximately distributionally neutral (using the revenue baseline described above). As in the case of revenue neutrality, fundamental tax reform is difficult enough from a political perspective without complicating matters further by attempting to redistribute the tax burden across income classes.

We also stress that another dimension of equity—the equal treatment of households with similar taxpaying capacity, or horizontal equity—should guide all proposals for fundamental tax reform, as it did in TRA86 and as recommended by virtually all public finance specialists. Note that the implications of adopting horizontal equity as a prime criterion for evaluating reform proposals are far-reaching. In particular, as discussed further below, it implies that all forms of compensation, including currently untaxed fringe benefits, should be included in the tax base to the extent administratively feasible.

C. Simplicity

Tax simplicity is often emphasized in early discussions of fundamental tax reform, but is usually largely ignored as the process of tax reform unfolds. We believe that simplification should be advanced as an essential criterion for any current reform of the tax system. While we recognize that some tax complexity is unavoidable in measuring income accurately in today's complex economy, we nevertheless believe that there are many areas in which the tax code could be simplified significantly without seriously compromising accurate income measurement. For example, in the taxation of capital income, we are comfortable with ad hoc adjustments for inflation that assume the Federal Reserve Board is successful in achieving its goal of maintaining inflation at around a 2 percent rate, rather than an elaborate system of comprehensive inflation indexing. More generally, we support the simplification measures recommended in the 2005 Tax Panel report, including simplifying and coordinating various individual income tax credits including the standard deduction, personal exemptions, and the earned income tax credit; collapsing the current wide array of saving and investment incentives into a very small number of simplified plans; simplifying business accounting rules, especially for small businesses and in the area of depreciation allowances; and eventually eliminating the alternative minimum tax.

D. Economic Efficiency and Tax Neutrality

An essential element of any successful tax reform proposal is the elimination of tax-induced distortions of economic decision-making (other than in a few very narrowly defined activities with widespread economic effects, such as investment in research and development and the emission of pollutants). As stressed in the debate surrounding TRA86, the government should in general not be engaged in an implicit industrial policy by distorting investment decisions through differential tax treatment of various investment activities and business sectors, and similarly should avoid distorting individual consumption decisions. We recognize that, from a theoretical perspective, economic efficiency can require differential tax rates. However, we believe that, in practice, when one tempers efficiency considerations with equity concerns and takes into account the economic difficulties in determining an optimally differentiated tax structure and the political and administrative problems of implementing it successfully, simple economic neutrality—uniform tax rates on similar activities in the context of broad-based low-rate taxes—is a reasonable approximation to an efficient tax structure. Accordingly, we believe that economic neutrality should be a key guiding principle in the formulation of any fundamental tax reform proposal. This, in turn, has several implications.

Most fundamentally, the general approach to reform should follow the traditional path used in TRA86 of eliminating as many tax preferences as is politically feasible and using the resulting revenues to drastically lower marginal tax rates. In our view, this implies that the elimination of many preferences that have long been considered sacrosanct, even those not touched in TRA86, should be considered seriously. Note that such reforms are desirable on efficiency, equity, and simplicity grounds, and also to limit government expenditures that occur through the tax system and are thus subject to less scrutiny than direct expenditures. Moreover, many tax preferences are poorly designed in any case. The home mortgage interest deduction, discussed further below, is an excellent example. Although its primary purpose is to encourage home ownership over renting, it is very poorly designed to achieve this goal, as it offers little or nothing to low- and middle-income individuals who do not itemize, have total deductions that are less than or roughly equal to the standard deduction, or are subject to relatively low marginal tax rates. Instead, the vast majority of the benefits of the home mortgage interest deduction accrue to high-income taxpayers, encouraging overconsumption of housing at the expense of less investment in the rest of the economy.

In addition, neutral tax treatment should also be applied to saving decisions, that is, current consumption should not be favored over future consumption. In principle, this implies the tax base should be consumption rather than income. Although we believe that replacement of the income tax with a full-fledged consumption-based tax is not feasible at the current time, current personal income tax provisions that encourage saving should be maintained (although they should be simplified, along the lines described previously), and serious consideration should be given to reducing the burden of the corporate income tax on investment income.

E. Favorable Environment for Foreign Investment

Finally, we believe that in today's globalized economy, the income tax system in the United States should not put our multinational companies at a disadvantage relative to competing firms based in other countries, while at the same time discouraging tax evasion and tax avoidance, especially in the form of income shifting to low-tax countries. In particular, the tax system should not discourage foreign investment by U.S. multinationals, and should not discourage investment in the U.S. by foreign multinationals. Although a full discussion of the intricacies of the tax treatment of foreign investment is far beyond the scope of this article, we note that: (1) in order to make investing in the United States attractive to foreign multinationals, the taxation of capital income in the United States should be concentrated at the individual level; (2) the "territorial" system advocated in the "Simplified Income Tax" proposed by the 2005 Tax Panel has the advantage of putting U.S. multinationals on an equal footing with most of their competitors, but exacerbates incentives for shifting income abroad and requires complex allocations of U.S. costs across domestic and foreign activities; (3) any approach that instead increases the inclusion of foreign income in the tax base of U.S. firms (e.g., the elimination of deferral) should be accompanied by corporate income tax rate reductions that would leave effective tax rates approximately constant; and (4) another advantage of low statutory rates under the corporate income tax is that they reduce incentives for income shifting to other countries with relatively low tax rates.

IV. Outlines of Fundamental Tax Reform

A. Base-Broadening, Rate-Reducing Individual Tax Reforms

We propose an individual tax reform that would substantially reduce or eliminate many tax credits, deductions, and exemptions while consolidating and simplifying other tax preferences—that is, a base-broadening, rate-reducing (BBRR) reform similar to TRA86. TRA86 broadened the tax base by eliminating the exclusion for long-term capital gains, the investment tax credit, the deduction for two-earner families, income averaging, the deduction for state and local sales taxes, and the deduction for interest on consumer loans, including credit card interest. It also limited deductions for depreciation, passive activity losses, business meals and entertainment, medical expenses, and expanded the AMT to include deductions utilized by most households. Much of the resulting revenues were used to reduce rates, although standard deductions and personal exemptions were also increased significantly. However, TRA86 did not limit or eliminate the home mortgage interest deduction, the deduction for employer-provided health insurance, the deductions for state and local income and property taxes, the deduction for charitable contributions, or the exemption of interest on public purpose state and local bonds.

Under current law, home mortgage interest deductions are allowed for interest payments on up to $1.1 million in mortgage principal on first and second mortgages on residences, including home equity loans. While completely eliminating the mortgage interest deduction is often deemed politically infeasible, there are several options for reducing its magnitude. We propose a combination of reducing the cap on the amount of mortgage principal on which interest receives a tax preference, coupled with either (1) deductibility of only a fraction of home mortgage interest, or (2) a fixed-rate non-refundable tax credit for home mortgage interest. If deemed necessary to allow time for further recovery of the housing market, these provisions could be enacted with a delayed effective date.

Ending the deduction for employer-provided health insurance has been widely discussed. In 1986, this idea was rejected at least in part because it would reduce reliance on employer- provided health benefits and thus increase the pressure to implement government-funded health insurance. Although the health care reform bill was recently passed, this issue will likely continue to be a point of contention in the debate about the tax treatment of employer-provided health insurance. We propose to cap the deduction for employer-provided health insurance, and then to index the cap to general inflation only, rather than to the inflation in health care costs. This would gradually shrink the deduction and would raise revenues over time, allowing for a longer and smoother transition from current policy.

The deduction for state and local taxes reduces the effective price for state and local services for individuals who itemize. Many observers, including the 2005 Tax Panel, have argued that state and local taxes approximate payments for public services received and thus reflect consumption expenditures that should not be deductible. Moreover, to the extent such services do not provide significant national spillovers, deductibility encourages over-provision of state and local public services. In addition, the deduction is regressive because it increases in value with the tax rate and is thus positively related to income, and is available only to itemizers. We propose full repeal of the deduction for state and local taxes under the personal income tax on the grounds that most state and local expenditures approximate consumption expenditures and do not have significant national spillovers. Similarly, the tax exemption for interest on public purpose state and local bonds encourages over-consumption of state and local services to the extent that they do not generate national externalities and create a tax bias favoring debt finance. We propose that this exemption be eliminated for new state and local bonds (existing bonds would be grandfathered). We recognize that direct federal expenditures would have to increase to provide subsidies to those state and local activities that generate significant national externalities.

The deduction for charitable contributions is often justified on the grounds that the organizations that receive charitable donations produce national external benefits that should be subsidized, and that the deduction allows individual choice of the activities supported. We propose to transform the deduction into a non-refundable fixed-rate credit that can be claimed by all taxpayers that give more than 2 percent of adjusted gross income.

Individual reform should also limit and restructure the number of benefit provisions for low-income taxpayers and families with children. These provisions include the child tax credit, the earned-income tax credit, the child and dependent care credit, head of household filer status for unmarried taxpayers with dependents, and personal exemptions. We propose consolidating and reducing the various provisions and simplifying the structure of the provisions, along the lines recommended by the 2005 Tax Panel.

Reform should also reduce the number of provisions related to retirement savings and expand the programs to encourage low-income families to save. We propose to simplify the current system by reducing the number of programs to no more than two or three options, again following the lead of the 2005 Tax Panel, and to expand the low-income savers credit to allow low-income savers to better plan for retirement.

A BBRR individual tax reform that eliminates most tax expenditures and uses that revenue to reduce tax rates, expands incentives to save, and simplifies the tax code would be a critical first step toward fiscal responsibility, balancing the need for revenue, minimizing the efficiency costs of taxation, and achieving an equitable tax system.

B. Business Tax Reforms

We also propose a traditional BBRR reform of the corporate income tax that would eliminate as many tax preferences as politically feasible and use the resulting revenues to lower the corporate tax rate, along the lines of the reforms accomplished in TRA86. As stressed above, a BBRR reform of the corporate income tax would in general be highly desirable. In particular, such a reform would reduce costly distortions of economic decisions and thus promote economic growth and economic efficiency in resource allocation, simplify tax administration and compliance, reduce incentives for tax evasion and tax avoidance including incentives for income shifting abroad by U.S. multinationals, and create a fairer tax system.

The primary objection to such a reform, which was also voiced during the debate surrounding TRA86, is that a BBRR reform is not well targeted toward new investment, and instead confers much of its benefit to existing capital and to investments that earn above-normal economic profits. Critics of the BBRR approach argue that maintaining a high statutory tax rate on all investments, including existing investments and those that are highly profitable, coupled with the introduction of investment incentives such as an investment tax credit or more accelerated depreciation allowances (including partial expensing) that apply only to new investment, is a less costly, better targeted, and thus preferable approach.

Although this argument has some merit, it must be qualified in several ways. Most importantly, a lower statutory rate under the BBRR approach reduces incentives for income shifting by U.S. multinationals (e.g., through the use of transfer pricing, debt reallocation, the relocation of patents and other intangible assets, and similar activities), which is a significant factor, given the accumulating empirical evidence that suggests this is currently a serious problem. In addition, rate reduction will attract investments by both U.S. and foreign multinationals that generate above-normal profits, which in turn will contribute to revenues. In our view, these arguments, when coupled with the traditional case for BBRR reforms, make a compelling case for following this traditional approach to fundamental tax reform.

With respect to identifying potential base broadeners or tax preferences that should be eliminated and used to finance rate reduction, a comprehensive list is provided in the U.S. Treasury's 2007 report on improving the competitiveness of the business income tax system. The most important items are accelerated depreciation allowances, the special deduction for U.S. manufacturing activities, and the research and experimentation credit (which arguably should be maintained for the reasons discussed above); in addition, the report lists many other tax preferences that are potential base broadeners. Note, however, that these should not include eliminating deductibility of state and local taxes paid by businesses, even though this was recommended by the 2005 Tax Panel report; such taxes represent a cost of doing business (even if they are direct payments for public services received) and should be deductible.

We close by mentioning a more ambitious—and economically sound but politically more difficult—potential additional element of fundamental tax reform. Although the BBRR approach outlined above has many advantages, our proposed reform—like TRA86—would neither eliminate the tax bias favoring debt finance under the current income tax (which arises because interest on debt is deductible but dividends paid to shareholders are not), nor would it reduce the overall level of investment disincentives under the current corporate tax. Accordingly, we believe that as part of the process of fundamental tax reform, serious consideration should be given to the implementation of an "allowance for corporate equity" or "ACE" that would result in roughly uniform treatment of debt and equity finance and lower the taxation of investment income at the business level to that associated with a consumption-based tax. This approach, which was recommended recently by the tax reform commission headed by Nobel Prize-winning economist James Mirrlees in the United Kingdom and has been implemented successfully in a small number of countries, allows firms an extra deduction equal to the product of the book value of equity capital and a risk-free nominal interest rate. The economic effect of the ACE is to put debt and equity finance on an equal footing at the business level, as the ACE deduction for equity-financed investment is comparable to the deduction of interest expense for debt-financed investment. Moreover, the ACE approach can be applied to all businesses, perhaps with an exception for small firms, and thus would eliminate the current income tax bias against corporate entities.

Relative to the much more commonly discussed option of expensing, the ACE has many advantages as a means of implementing a consumption-based business tax. Most importantly, firms continue to deduct depreciation and interest expense as under the current income tax system; by comparison, with expensing, interest deductions must be disallowed to avoid negative effective tax rates (the Flat Tax provides for such treatment). The ACE plan, thus, looks much like the current system, which implies it raises relatively minor transitional issues. Moreover, the ACE deduction can be limited to new investment to reduce the revenue losses associated with its implementation. In addition, (1) the short-run revenue loss under the ACE is considerably smaller than with expensing; (2) fewer firms are in a loss position under the ACE than with expensing, avoiding the problematic issues that arise with negative tax bases; (3) financial institutions are taxed like all other firms (they are exempt under the Flat Tax); (4) because depreciation deductions, interest deductions, and the allowance for corporate equity are taken each year (in contrast to expensing, which occurs only in the year of investment), changes in future tax rates do not affect investment decisions as they do with expensing; and (5) the ACE system results in relatively accurate income measurement, as any error in depreciation accounting or in the implicit inflation adjustment for a capital asset due to accelerated depreciation is offset by an equal and opposite error in the calculation of the allowance for corporate equity.

The ACE would, of course, cost revenue. Since we believe that taxes at the corporate level should be kept low to make investment in the United States attractive for foreign investors, we believe that this revenue should be recovered with higher individual-level taxes on dividends and capital gains. Although politically difficult, this would also facilitate meeting our goal of maintaining distributional neutrality. The goal should be a tax system that provides roughly uniform treatment of all forms of investment, taking into account both the corporate and individual tax burdens.

Finally, if a move to a full-scale ACE is too costly or too difficult from a political perspective, a partial ACE—that is, a partial deduction of the type described above—could be utilized. Indeed, if deemed desirable, the fraction deductible could even be varied depending on macroeconomic conditions, with the fraction of the ACE deduction permitted increasing during cyclical downturns. (We resist the temptation to refer to this plan as the "ACE in the hole.") Such an approach would be far preferable to the current practice, which uses partial or full expensing as a counter-cyclical instrument to stimulate investment, since expensing applies equally to both debt- and equity-financed investments, resulting in subsidies to the former while leaving the tax bias favoring debt intact. By comparison, a partial ACE would lower the tax burden only on equity-financed investment, narrowing the differential between the tax treatment of debt- and equity-financed investment while providing an overall stimulus to investment.

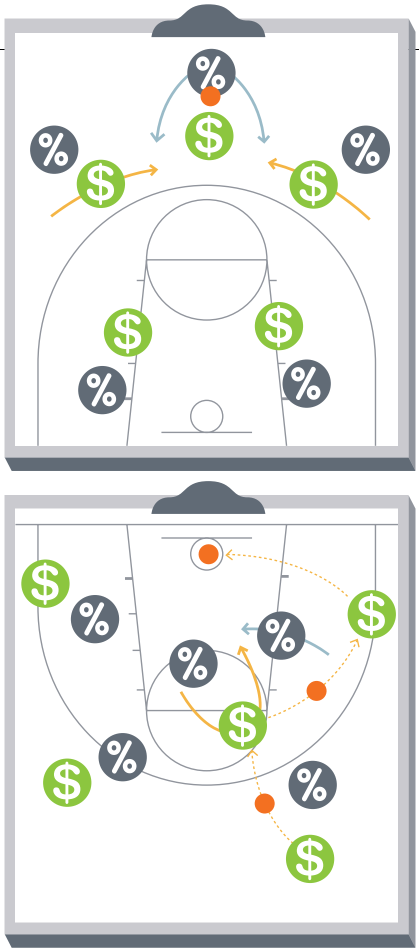
V. Conclusion

Several recent reports on fixing our nation's fiscal tax crisis have focused attention on the need for fundamental reform of the corporate and personal income tax systems. In this paper, we argue that the conditions are right for a sweeping reform of the tax system similar to that accomplished with the landmark Tax Reform Act of 1986, although several factors may make the enactment of such a reform somewhat more difficult than in 1986. Drawing on the TRA86 experience, we focus on delineating the general principles that should guide any effort at fundamental tax reform. However, we also identify the general outlines of what we believe fundamental reform of both the individual and corporate income tax systems should entail.

Point of View

Tax Reform Is A Team Sport

The lesson from 1986 is that you need an all-star squad to win at this game, says former New Jersey Senator **Bill Bradley**



In 1986, Congress passed an income tax reform that reduced the top personal income tax rate from 50 percent to 28 percent and created a 15 percent rate for everyone else. It was paid for by closing billions in loopholes, those arcane provisions in the code that reduce taxes for their lucky beneficiaries but leave the rest of us paying more. The '86 reform was revenue neutral, neither raising overall taxes nor increasing the deficit. It was guided by three principles: equity–equal incomes should pay equal taxes; efficiency–the market is a better allocator of resources than members of Congress; and fairness–those Americans who have more should pay more.

In the beginning the pundits said tax reform had as much chance of passing as an elephant has of flying to the moon. The tax code was seen as a playground for Washington's special interests–an unfair burden the rest of America would just have to bear. Yet reform passed. Average taxpayers got to keep more of each additional dollar they earned, all corporations were treated more equally, and the wealthy ended up paying a higher percentage of total income tax revenue.

As President Obama talks of reforming the tax code again, the experience of 1986 taught me that there are six things necessary to achieve the goal, no matter how he chooses to define reform:

1. A President who is fully committed. Ronald Reagan, a Hollywood actor when marginal rates exceeded 90 percent, cared passionately about lowering them. Giving up loopholes to get lower rates was not a hard decision for him.

2. A Treasury Secretary who will get deeply involved and at crucial moments has enough command of the subject to negotiate a resolution. Jim Baker and his admirable assistant, Dick Darman, drove the process for President Reagan. At the end, Baker himself was negotiating specific detailed provisions.

3. A chairman of the House Ways and Means Committee who will use all available chits to bring recalcitrant congressional members to support the cause. The chairman must be self-interested in reform's success. For example, in 1986, Dan Rostenkowski embraced reform because it was big enough for his ambition. He had been lambasted for cutting special-interest deals to pass Reagan's 1981 tax cut. By 1986 he could cut loopholes and gain a good government imprimatur. "Rosty" also wanted to do reform because others said it could not be done. Success would mark him as the most effective chairman of the era.

4. A chairman of the Senate Finance Committee whose interests are also served by overseeing passage. Bob Packwood played that role in 1986. He was a late convert to the cause, but once there, he persuaded, cajoled, threatened, and outsmarted the opponents. In the process, Packwood found his liberal Republican legs and defended the bill in the best progressive tradition of Teddy Roosevelt. His achievement offered a contrast to the previous Democratic chairman, Russell Long, who had fought the very idea of tax reform for decades.

5. Followers who know the subject, enjoy dueling substantively with opponents, and pursue the goal single-mindedly. These members can create the energy for passage. In 1986, I played that role for Packwood and Rostenkowski. For four years I talked about practically nothing but tax reform.

6. Finally, a tireless staff, smart enough to master the arcane details of tax legislation and savvy enough to be able to advise their principals about how to deal with other lawmakers and the media. In 1986, Rostenkowski, Packwood, and Baker had such staff–and so did I.

President Obama has a full plate, and the world's unpredictable economic events dominate Treasury Secretary Timothy Geithner's days. If the President does not have all six of these elements in place, he shouldn't waste his time. Yet if he does want to change the way Washington works–as he promised to do in 2008–there is no better place to start than with the shameful folly we call the 2011 income tax code. B

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