

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

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

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

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

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

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

*How We Got Here—The Clinton Era*

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

### *Tax Reform Efforts and Themes*

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

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

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

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

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

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

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

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

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

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

Stanley Surrey, who introduced the notion of tax expenditure analysis in the late 1960s, wrote with Paul McDaniel that “the classification of an item as a tax expenditure does not in itself make that item either a desirable or undesirable provision,” and concluded that most were assistance “the legislators really do want to provide.”<sup>4</sup> A good example of this is the research credit. It has passed the Congress 14 times<sup>5</sup> and every President since Reagan has proposed to make it permanent. Clearly, this demonstrates a bipartisan belief that encouraging research and innovation is a desired feature of our tax system.

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

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

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

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

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<sup>4</sup> Surrey and McDaniel, *Tax Expenditures* (1985).

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

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

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