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**Before the**
**Senate Committee on Finance**

**Tax Reform: Lessons from the Tax Reform Act of 1986**

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

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

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

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

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

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

In 1981, early in his first term, President Reagan succeeded in reducing the top individual rate from 70 percent to 50 percent. He continued to press for lower rates in his campaign for reelection in 1984. After the election, President Reagan made tax reform a center piece of his 1985 State of the Union Address and second term agenda. Ultimately, with the 1986 Act, he achieved a historic reduction in tax rates to a top individual rate of 28 percent and a top corporate rate of 34 percent. At that time, these were among the lowest rates in the world.

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

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

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

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

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

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

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

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

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

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

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

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

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

I wish I could have voted for tax reform with a historically low rate structure.  I was excited about the prospects of tax reform but I grew increasingly concerned about the direction of the bill as the process unfolded. In the end, I felt the legislation on balance would do more harm than good. Let me briefly explain some of these concerns.

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

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

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

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

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

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

Generally, targeted incentives have detailed criteria and definitions that a taxpayer must decipher. With so many features in the tax code, taxpayers are confused and unable to figure out how to navigate through the maze of overlapping provisions, definitions, worksheets, and elections. As complexity has grown, individuals and businesses have seen their cost of tax compliance increase significantly. I hope that future tax reform efforts will make meaningful reductions in tax code complexity and the compliance burden.

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

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

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