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Before the Senate Committee on Finance

re:

"Lessons from the Tax Reform Act of 1986"
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Mr. Chairman and members of the Committee:

It is my great pleasure to appear before this Committee again. I congratulate the Chairman and the members for scheduling hearings on tax reform. Like many who follow the federal income tax issues closely, I have reached the conclusion that the current Internal Revenue Code is in desperate need of fundamental reform. It is far too complex, far too inefficient, and the levels of avoidance and even evasion appear to have reached unprecedented levels. For these and many other reasons, our tax system seems to have lost the respect and confidence of our citizens. Confidence that the tax system is basically fair is essential to the proper operation of the self-assessment tax system we have long considered a key ingredient of our free society.

I also applaud your decision to initiate this process with a review of the Tax Reform of 1986. As is often mentioned, any major change in the tax system will produce winners and losers, and the proponents of change will hear most vociferously and effectively from the losers. We know those are facts of life that have not changed since the 1980s. The fact that such sweeping tax reform was even proposed by President Reagan in 1984 was an act of political courage—some said it was an act of unnecessary political risk—and the ability of the Chairmen and members of the tax writing committees to see it through to completion in 1986 has been the subject admiration by most tax professionals, as well as study by political scientists. Your comparison of the tax system of twenty-five years ago, and the surrounding economic and political environment, with today's situation should be very enlightening. I hope my remarks will be of assistance.

I served as assistant secretary of the Treasury for tax policy from 1981, the first of the Reagan Administration, to August 1984. The office I headed was in charge of developing the Treasury tax reform proposals that resulted in the Tax Reform of 1986. The Treasury recommendations were presented to the President in the fall of 1984, and the President released them in December of that year. As the timeline shows, I resigned my position before our work on the tax reform proposals was completed so I did not witness the final developments from inside Treasury. (I should mention that I left this tour at Treasury after almost four years, and after overseeing three major administration-led tax bills. I decided if I did not leave before the tax reform proposals were presented to Congress it would be difficult to leave until completion of the legislative effort, which was obviously going to be a lengthy process.)

An individual who played a key role in developing the Treasury's tax reform proposals in 1984 and beyond was Eugene C. Steuerle, then a career economist at the Department. In this effort Mr. Steuerle was given the title Economic Coordinator of the Project for Fundamental Tax Reform. He later became Deputy Assistant Secretary for Tax Analysis and is now a well-respected analyst of taxes and economic policy with the Urban Institute. Perhaps most important for today's subject, Mr. Steuerle wrote a book entitled *The Tax Decade* (The Urban Institute Press 1991), which contains a very insightful discussion of the economic and political factors influencing the Reagan Administration's proposal of this monumental tax reform effort. This excellent book also discusses in some depth the significant achievements of the Tax Reform Act of 1986 and where he thinks the final legislation fell short. I have reread the book and consulted with Mr. Steuerle in preparing today's presentation. I highly recommend this publication to you.

Now let me turn to the substantive issues.

Tax Legislative Events Preceding the Inception of the 1984 Tax Reform Effort

Tax legislative activity was on the front burner throughout the first term of Ronald Regan's presidency. This legislative activity and the coalitions that grew up around it helped create the setting for fundamental tax reform. There were three significant tax bills during this four-year period.

ERTA *(Economic Recovery Tax Act of 1981)*

The President had run on a platform of lower tax rates (the top individual rate was 70% in 1980). He proposed a 30% cut in individual tax rates over three years for all rates—"across the board." Congress gave him a 25% cut but dropped the top rate to 50% in the first year.

In addition, the 1981 Act brought indexation of the individual tax brackets into the U.S. tax code for the first time, along with indexation of the personal exemption the standard deduction, all to take effect in 1985. Indexation was not part of the original Administration package—it was added by Senator Armstrong and others in this Committee—but it was supported strongly by the President and trumpeted as a major achievement by the Administration thereafter. It was a fundamental change in the tax system. It ended insidious "bracket creep"—moving all income of taxpayers below the top bracket into higher tax rate brackets—a feature of the old law that had provided a constant source of new tax revenues year after year without the political pain of raising taxes (indeed it allowed presidents and the tax writing committees to offer tax cuts every few years, always a welcome gesture to the electorate). Indexation also reduced, for future years, the erosion of the personal exemption which had occurred over many years increasing the income tax burden of families and the poor. The 1981 Act did not, however, raise the personal exemption.

The President's initial 1981 tax package also proposed significant tax benefits for business. These were not in the form of rate cuts (the corporate tax rate was and remained at 46%). The business tax cuts were in the form of major new write-offs for business investments: very front-loaded depreciation deductions, plus a 10% investment tax credit, for new investment. Congress adopted these provisions substantially as proposed by the Administration. These changes significantly reduced taxes and the cost of capital to businesses, particularly large, well-established businesses that had income from earlier investments against which to use the new large tax benefits handed to them.

At the same time businesses that were not capital intensive—service companies, retailers, the high-tech sector, etc.—received little good news from the 1981 Act and were still left paying a full 46% tax rate. The same was basically true for new or small capital intensive businesses—since they did not have large tax liabilities from income produced by older assets they could not use the new tax deductions, at least not until years later, and thus the 1981 Act meant little to them. In spite of this clear dichotomy between winners and losers, there was strong support for the 1981 Act from the entire business community, even those sectors not directly benefitted. This was probably due in large part to the widespread belief in the business community, shared in Washington, that cost recovery deductions for new plant and equipment had been allowed to drop and America was in danger of losing its competitive edge. In spite of the surface tranquility in 1981, the disappointment of the high-tax companies didn't disappear; it smoldered and reappeared when the fundamental tax reform debated surfaced.

TEFRA *(Tax Equity & Fiscal Responsibility Act of 1982);* ***DEFRA*** *(Deficit Reduction Act of 1983)*

There were significant pieces of tax legislation in 1982 and 1984, although nothing on the order of the 1981 Act. These two bills were in effect spawned by the earlier big bill. First, anxiety about the revenue cost of the 1981 Act appeared immediately after the legislation was signed and was a continuing factor in the years following its enactment—OMB Director David Stockman reportedly told the President to expect budget deficits of $200 billion "as far as the eye can see." In addition there was concern on many fronts that the tax write-offs given business had simply been too large. Some studies showed that the new depreciation deductions, plus the large investment tax credit, produced a "negative tax rate" on some business investment—that is, the cost of the investment, after taking tax benefits into account, was lower than the cost would be if the owner were simply exempted from federal income tax. This was particularly true, it was argued, when coupled with large interest deductions if the equipment's cost were debt financed. It should be noted that the negative tax rate analysis is significantly impacted by the inflation rate, which was quite high in the early 1980s.

At the same time aggressive tax shelter schemes, which were already a huge problem, became even bigger when shelter promoters jumped at the chance to give high income individuals the depreciation write-offs and ITC offered by the new law. Obviously significant leverage (real and created by manipulation) made these transactions produce even larger tax deductions.

These factors and others resulted in Congress taking back part of the depreciation deduction benefits in 1982, the year after enactment. As I recall this action was not strongly resisted by the Business Round Table and similar groups. Also in these post-1981 Act years, "revenue enhancement" became the phrase of the day. Revenue enhancement was a buzzword for a tax increase that President Reagan, obviously an ardent tax cutter, could support. To qualify the provision had to have the clear marks of a loophole closing change, or tax avoidance preventer; a naked tax raiser would never win the Administration's support. A significant number of revenue raising provisions were enacted in the years following the 1981 act. They undoubtedly helped reduce the deficit and stopped, or at least reduced, some tax motivated transactions that should have been blocked. But these changes were not part of a larger tax policy design. Moreover, they made no significant dent in the large volume of tax shelter activity that had been growing dramatically over the preceding decade and was exacerbated by the huge tax benefits given for new investment by the 1981 act.

The Appearance of the Tax Reform Effort in 1984

It is argued that President Reagan's focus had shifted over the years of his presidency from simply focusing on tax rates (the 1981 Act) to consideration of the broader questions of base erosion, tax avoidance and unfairness in the law, as indicated by his support of the 1982 and 1984 Acts. Whether or not this is correct, it was clear to all that notwithstanding the significant amount of tax legislation passed in the first three years of his presidency, there was widespread dissatisfaction with the tax code. The following are some of the prominent sources of unhappiness that were often cited:

- In spite of the major reductions of individual tax rates, the rates were quite high in absolute terms for both individuals and corporations (top rates were 50% & 46% respectively). Rates at these levels cause significant distortions in the economy, particularly when accompanied by avoidance opportunities.
- The basic unfairness in tax burdens between the capital intensive industries and the service, high tech, retail and other companies receiving little benefit from the 1981 Act had become more open and contentious.
- The fact that taxes played a major role in virtually all business and investment decisions was lamented. Some said the economic viability of competing opportunities was often secondary to the tax benefits it presented.
- The Internal Revenue Code was thought to be far too complex; the public objection seemed directed principally at the difficulty of gathering the necessary information and completing the form rather than transaction complexity.
- The Code was regarded as basically unfair. Undoubtedly the growth of tax shelters and the publicity surrounding them made many taxpayers feel they were overpaying while others were not paying their fair share.
- More sophisticated tax schemes had begun to appear taking advantage of the failure of the Code to properly deal with issues such as the time value of money. The use of derivatives appeared in tax schemes, permitting hedging and straddle transactions to shift defer tax liability.
- The tax base for both individuals and corporations has been seriously eroded by the increase in tax expenditures over the preceding decade or more (some of which, for example the investment tax credit, had been enacted in part to offset the impact of high tax rates on businesses investment).

- In policy shops there was continuing unhappiness with the increased tax burden on the poor and families caused primarily by erosion of the personal exemption through inflation over the years with inadequate relief in the tax reduction bills that appeared periodically.

The Administration was keenly aware of this dissatisfaction but many of the President's advisors argued that taxes had dominated the agenda during the President's first three years and it would be a mistake to put tax reform on the table and let that dominate the final year of the first term. This was an election year of course, and there was keen awareness that tax reform proposals were already on the table—Republican proposals such as Kemp-Kasten and Roth-Moore, and more importantly the Democrat proposal by Senator Bill Bradley and Representative Dick Gephardt. While these proposals varied significantly they contained similar themes—the principal one being base-broadening primarily through reduction of tax expenditures, accompanied by significant reduction in tax rates. Generally speaking they also dealt with fairness issues that had been long neglected, principally the increased share of tax imposed on families and the poor over the years.

The Bradley-Gephardt bill was the focal point. It was a very comprehensive proposal. The sponsors each served on the tax writing committees of their respective houses of Congress and thus had access to the talents and resources of the staff of the Joint Committee on Taxation. A very important resource in such an undertaking is of course the ability to compute accurate revenue estimates. A proposed change in the tax law can take on an entirely different hue once the amount of revenue it will gain or lose versus current law is discovered.

Flat Taxes

Proposals for flat taxes were also very much in evidence at the time, but other than the seductive appeal of lower rates they offered, I do not think they were a major consideration in the policy discussions. The Treasury had been asked to testify on flat-tax approaches in 1982. The Tax Analysis staff in the Office of Tax Policy did its usual careful and balanced critique which I presented to the Committee as Assistant Secretary. The analysis discussed the benefits and simplicity that could theoretically be achieved by a flat, or almost flat, tax. It also presented clearly the redistribution effect, the major concern then (as it is now in my mind) with the flat tax idea. In the purest version of the flat tax Treasury concluded the highest taxpayers would receive a tax reduction of 61%, while taxes on those with incomes between $5,000 and $10,000 would be increased by 149%. Those extremes could be reduced, but by no means eradicated, through adjustments in the structure of the tax. It's my view the unavoidable redistribution effect made flat taxes a non-player in the tax reform debate of the mid 1980s.

President Reagan's 1984 State of the Union Address

The President announced in his1984 State of the Union speech that he had asked the Treasury Department to produce a proposal for tax reform, "to simplify the entire tax code, so all taxpayers, big and small, are treated more fairly." He also mentioned the desirability of a broader tax base with lower rates. At the end of these comments he said he had directed Secretary Don Regan to deliver the proposal to him in December—after the presidential elections in November. The audience laughed, and the President, seemingly genuinely surprised, said in effect, “Did I say something funny.” The only additional direction Treasury had in its charge to produce a tax reform proposal, as far as I know, was a statement the President made in a subsequent speech that the home mortgage deduction would not be touched by tax reform.

The Treasury staff under the direction of Secretary Regan proceeded on its task in the greatest secrecy possible. The Secretary was determined that the decisions they made in the process would not make the papers, and in this they were quite successful. At an initial stage in the process Treasury adopted several principals and goals. Two often-repeated goals seem the most important to me. The first was to attempt to return the income tax to its primary purpose of raising revenue and away from the tasks that had been thrust upon it over the years of both shaping capital investment and supporting multiple social purposes unrelated to the need to produce revenue. The second basic goal was to make the new tax reform package revenue neutral with the existing tax law in terms of overall revenue and within each economic income grouping. Everyone involved in the process was aware, of course, that even if these goals could be achieved there would be big winners and big loser within each grouping. The attitudes and actions of the losers would present the major legislative hurdle.

Secretary Regan’s team produced its package—on time and “on budget”—shortly after the November 1984 presidential election.

The five Stages of the tax reform effort in brief

1. <u>Treasury I (December 1984)</u> —A very detailed document outlining fundamental reform in a very purse sense. Virtually all deductions were eliminated and every attempt was made to redefine taxable income in terms of true economic income; depreciation and capital gains were indexed for inflation, and capital gains were taxed at same rate as ordinary income. The White House was startled and basically kept its distance. Many economists loved it but businessmen and many others had serious reservations.
2. <u>Treasury II (May 1985)</u> —Sent to the Congress as the Reagan Administration’s tax reform proposal (this followed the job switch between Secretary Regan and White House Chief of State Jim Baker). Toned down many of the politically unacceptable aspects of Treasury I, making several political concessions at the beginning of the process. Reflected Secretary Baker’s more pragmatic approach, but it was still a proposal for fundamental reform of both the individual and corporate taxes.
3. <u>Ways & Means Bill (December 1985)</u> —A soak-the-corporations bill; almost no base- broadening changes for individuals (the major deductions—interest, charitable and state and local taxes—untouched) but corporate tax incentives were reduced significantly. Top tax rates: individuals—38%; corporations—36%.
4. <u>Senate Finance Committee Bill (May 1986)</u> —Mirror image of the W&Ms bill—reduced or eliminated virtually all major deductions of individuals, and changed relatively few of the corporate incentives in the Code. Top tax rates: individuals—27%; corporations—33%.
5. <u>Conference Agreement—Enacted Bill (August 2086)</u> —Followed Senate bill more closely on individuals and the House bill with respect to corporations. Dramatic shift of the tax burden

from individuals to corporations ($120 billion over five years, principally by repealing the ITC). Top tax rates: individuals—28%; corporations—34%.

The basic outcome, and how did it happen?

Many found it difficult to believe that a President who had sponsored ERTA in 1981 could push through and sign the Tax Reform Act of 1986. The first brought effective tax rates on capital investment to near zero; the second dramatically increase tax rates on capital. On the other hand, the 1986 act was certainly consistent with President Reagan's original and overriding goal in 1981, the reduction of marginal tax rates.

In my view the 1986 act largely accomplished its primary goals: For individuals it reduced rates dramatically by broadening the base primarily by reducing tax shelters through a broad, conceptual approach (the passive loss rules) rather than adopting specific responses to specific problem transactions. On the business and investment side it basically took tax considerations out of investment decisions, thus permitting markets to direct investment to the most productive assets (certainly a good solution for economic growth). If these conclusions are correct the act largely achieved President Reagan's State of the Union goal of treating all taxpayers big and small more fairly.

A more difficult topic is how such a hopeless legislative undertaking was ever accomplished successfully in our free-wheeling legislative process. The success was obviously a confluence of events, some planned and many fortuitous. One factor that probably played a major role has been suggested. The fact that a relatively small number of people were basically in control of the legislative effort at any given point in time, unusual for such a large legislative initiative, made it easier to control and correct mistakes in tactics and substance throughout the process. The people in charge of each group are easy to identify:

1. Treasury Secretary Don Regan
2. Treasury Secretary Jim Baker
3. Ways & Means Committee Chairman Dan Rostenkowski
4. Senate Finance Committee Chairman Bob Packwood

Secretary Regan took what could have been considered a request for politically and legislatively feasible tax recommendations and ran with it, maintaining a tightly controlled and managed team to develop a gigantic legislative project. One can argue that from that point the product was so "pure" and thus promising in a theoretical sense that each of the successive "owners" was highly motivated not to let it fail during his stewardship. It seems clear that at some point under the final three owners, tax reform became the status quo. After that those wishing to change it, even in a small detail, had the burden of showing how their problem was different enough from the complaints of others to risk disrupting the new structure. Those seeking change were also routinely asked to enumerate the significant benefits provided for them elsewhere in the legislation, usually in the overall rate cuts.

Are these lessons helpful today?

A generation has passed since the events of the mid-1980s occurred. There is no hope of duplicating that process, and I doubt anyone would suggest that be attempted. But certainly there are some important lessons from that experience.

Perhaps the most important takeaway is that when the public is totally dissatisfied with the tax structure, as it was in 1984, the political system and the government it controls should respond and do so in a serious, responsible manner. I think the public is equally dissatisfied with today's tax laws, and with good reason. The political system responded in 1986 and certainly it can do so again today. It is worth the effort; when the public at large does not have confidence in the tax laws of a country over a long period of time, it is worrisome indeed. Other than voting, paying federal taxes is the only direct contact most Americans have with their federal government. Their government should not ignore their concerns.

A decided strength in the 1984 undertaking by the Regan Administration was the principled approach initiated by the Treasury Department and for the most part emulated by the leadership and staffs of the tax writing committees. Even those who would be disadvantaged had to concede that in concept the approach made sense "in a perfect world." They were relegated to arguing that the world is not perfect and cannot be made perfect. If the proponents maintain the high road, that objection begins to look empty. That is what happened in 1985 and 1986; even though all could see some political concessions being made, they could also see the overriding effort was staying with the basic principles adopted at the outset. At the individual level, everyone had to give up serious benefits in order for their tax rates to be significantly lowered; at the business level there was no waiver from the goal of taking tax considerations out of investment and business decisions to every extent practicable.

Of course one of the key principles in 1986 was revenue neutrality – tax reform was not to be a hidden tax increase. Many may disagree, but I think that same principle would be essential in a tax reform effort today. The public and many members of Congress would be very suspicious of a proposal designed to both make your taxes fairer, and to increase the government's take. If revenues must be raised, it should follow the tax reform effort as a separate, independent legislative undertaking.

Another obvious lesson to me is that a legislative effort of this magnitude must have the committed involvement of the president and all the resources he can bring to bear on the topic. An administration has the substantive assets and the bully pulpit. It is hard to imagine how tax reform could move without a clearly committed chief executive supporting the effort in every way. It would obviously be helpful if the personal commitment of the Congressional leadership that occurred in the 1986 effort could repeat itself but that cannot be made to happen.

Who are the culprits today—tax expenditures?

A disadvantage today may be that there are not the broad, high-profile tax culprits like the tax shelter industry in the 1980s. There is a feeling that many are not paying their fair share but the reasons may not be as apparent, and indeed the reasons may be more imbedded in the system and thus more difficult to observe. Moreover, tax rates are considerably lower than they were a generation ago so there is not as much to trade for giving up miscellaneous tax benefits. But the unnecessary complexity, inefficiency and unfairness are there and need to be corrected. The tax expenditure list has grown exponentially. One analysis indicates – as a dramatic example -- that if all tax expenditures were suddenly removed from the law there could be a 34% reduction in tax rates across the board.

It is important to realize, however, that tax expenditures do far more harm than simply reduce revenues. They make the tax system much more complex and less efficient, and they do damage unrelated to our revenue raising apparatus. For example, the full exclusion of employer-provided health care from the compensation base not only makes tax rates significantly higher than they need to be, tax-free health insurance has a decidedly counterproductive impact on the demand for health care services and thus increase their cost. The deduction for home mortgage interest (to pick another noncontroversial tax expenditure) diverts capital away from more productive uses in the economy and was clearly a factor in the housing crisis we are dealing with today.

In addition, there are numerous examples of the complexities and inefficiencies we have created when we use the tax system to provide benefits unrelated to the production of revenues and don't do it carefully enough. A prominent example is the multitude of rules that apply to refundable tax credits for the poor, with different income rules and different and overlapping phase-out schemes. Not only are these provisions mind-numbing in their complexity, they add tremendous inefficiency and cost to the entire effort. There are similar examples throughout the Code.

Our Internal Revenue Code is, in a word, in terrible shape.

Conclusion

It is my pleasure to share these thoughts with you today. I have had the highest respect for the Finance Committee for many years and I have always enjoyed working with the members and your excellent staffs. I hope my thoughts may be of some help as you consider the important subject of fundamental reform of our tax system.