

**Statement of Pamela F. Olson
To the
Finance Committee
United States Senate
“How Did We Get Here? Changes in the Law and Tax Environment Since the Tax
Reform Act of 1986”**

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Chairman Baucus, Ranking Member Hatch, and distinguished members of the Committee, I appreciate the opportunity to appear this morning as the Committee commences serious consideration of reform of the country’s tax system. I am here today at the request of the Committee. I had the honor of serving as assistant Treasury secretary for tax policy from 2002 to 2004, and am currently a partner in the law firm, Skadden, Arps, Slate, Meagher & Flom, LLP. I am appearing on my own behalf and not on behalf of any client or other organization. The views I express are solely my own.

I. Introduction

The subject of this hearing is changes in the law and the tax environment since the Tax Reform Act of 1986. I commend the Committee’s efforts in exploring much-needed reforms to the U.S. tax system. These efforts are timely, particularly in light of our country’s pressing fiscal concerns and the changing global landscape. The velocity of change in the global economy makes swift action imperative. Our tax system and the manner in which it is interwoven with economic activity is complicated, however, and reforming the tax system is even more so. As a consequence, reforms must be carefully considered before they are enacted. The Committee has properly requested input on a number of issues that should be considered in any comprehensive tax reform effort. My written testimony addresses some of them; unfortunately, time did not permit me to address all of them. I would, however, be pleased to respond to any questions the Committee might have today or in further discussions.

The sources of our current tax system’s shortcomings have been identified and can be addressed in any overhaul. But doing so will require a greater measure of political courage and willingness to challenge the conventional wisdom than was evident in 1986. The change that is required will require education and a willingness to look beyond the next election. Our nation’s fiscal situation is such that partisan politics must be put aside for the sake of the greater good and future generations. Fortunately, there are leaders who have shown that it is possible to work on a bipartisan basis and propose meaningful reform of the tax system. They include former and current Senators and members of this Committee – Senators Breaux and Mack in their leadership of a tax reform study in 2005, Senators Wyden and Gregg in their comprehensive tax reform legislation in the last Congress, and Senator Simpson and Erskine Bowles in the Deficit Reduction Commission report issued late last year.

My testimony addresses some of the most significant shortcomings of the current system and the key areas for improvement in a comprehensive reform of the tax system. In particular, I believe it is essential that Congress enact reform that reflects economic realities, not political rhetoric, cleanses the tax system of unnecessary complexity, lays a foundation for economic growth and job creation by fostering our global competitiveness, and allows us to pay our bills, not saddle our children and grandchildren with crippling levels of debt. I also believe we must be cognizant of the changes that are shaping other countries' tax systems because those changes may affect investment decisions and capital flows into the United States if we do not respond to them.

II. Lessons from the Tax Reform Act of 1986

The Committee has chosen a good place to begin with the Tax Reform Act of 1986 ("Tax Reform Act" or "Act"). Enactment of the Tax Reform Act represented a remarkable legislative achievement, and it addressed a number of serious flaws in the tax system. That said, the Tax Reform Act itself had a number of serious flaws – flaws that have grown more problematic over time for the economy, our national competitiveness, and tax administration. The ideal tax system would raise the revenues to fund the operations of the government with the least adverse impact on the economy. Our current tax system, a natural development of the structure put in place with the Tax Reform Act, manifestly fails to meet that challenge. The flaws in the Act should serve as a guide to avoiding errors in this tax reform effort. A few of the more significant problems are described below.

Complexity. The Tax Reform Act carried the complexity of the tax law to new heights. There were many reasons for this, including the goal of revenue neutrality and political reluctance to address directly the provisions in the Internal Revenue Code ("Code") that reduced revenues on the individual side. Continuing legislative changes begun in 1984, Congress added many provisions that deviated explicitly from financial accounting principles in the belief that the provisions more clearly reflected income or curtailed some improper tax benefit. Invariably, such provisions were scored as raising the revenue necessary to meet a target. Whether the provisions increased revenue in the real world is open to question, but taken together, the apparent effect was a shift in the incidence of taxes from individuals to corporations.

On the individual side, the Tax Reform Act included a beefed up alternative minimum tax ("AMT") as a substitute for repealing or limiting a number of individual tax preferences. Though intended when originally enacted to ensure that wealthy individuals paid at least some amount of income tax, the AMT's design never carried out that purpose. As revised by the Act, the AMT is inordinately complicated and has the effect of reversing many of the benefits Congress determined to retain. Because it is unlike other provisions in the tax law that are indexed for inflation, it has the effect of ensnaring more taxpayers with each passing year. In the near future, the IRS is projected to collect more in revenue through the AMT than through the regular income tax.

Although congressional staff involved in the drafting of the Act have stated that the lack of indexing was intended to bring more taxpayers into the AMT and eventually replace the regular income tax base with the AMT base, neither Congress nor any President has embraced the AMT's stealth elimination of tax benefits. Nonetheless, the projected cost of repeal under the budget rules has prevented outright repeal or permanent indexing. Instead, Congress has enacted annual patches that increase its exemptions and limit its reach. The enactment of those patches, oftentimes late in the calendar year, has created problems for the Internal Revenue Service ("IRS") as it endeavors to program its computers and prepare instructions for the filing season.

AMT indexing is one of many features of the Code that operate on a more or less temporary basis because of budgetary constraints. For the individual taxpayers potentially subject to it, the result is instability and uncertainty. For the federal budget, the unwillingness either to embrace the AMT or permanently fix it yields a false source of revenue. The country's budget situation is actually worse than continuing temporary patches would lead one to believe.

Mistaken Economics. On the business side, the Tax Reform Act perfected the system of double taxation for corporate income. In this case, perfection is not a positive attribute. Indeed, perfecting a double tax system may have been the most serious error in the Tax Reform Act because it included a rate of tax on corporate income that was over 20 percent higher than the tax on noncorporate income and a second tax on dividends and capital gains from the sale of corporate stock at ordinary income tax rates. The Act set off a furious effort on the part of every well-advised business for which it was possible to escape the corporate form of business via S election or converting to partnership form. Master limited partnerships became so popular that Congress was compelled just one year later to enact a provision preventing the adoption of partnership form by publicly-traded partnerships to "protect" the corporate tax base. The corporate double tax system encouraged the use of debt and discouraged the payment of dividends. My personal view is that it contributed significantly to the corporate instability and governance issues that plagued us, particularly in the 1990s.

The double tax mistake was ameliorated somewhat by the enactment of a 15 percent rate on dividends and capital gains in 2003. I regard that change in 2003 as the most significant improvement to the structure of the Code in recent decades. Like so many other important features of the Code, however, it was enacted in temporary form and is now subject to the vagaries of the annual tax extender process.

The result is that non-corporate or passthrough entities continue to grow in popularity. That is reflected in the portion of business income – 75 percent in 2008 – that is earned by non-corporate entities and by the fact that even in the IRS's large business division, over half of the returns filed for 2009 were of pass-through entities.

Don't Tax Me. The Tax Reform Act also targeted the international operations of U.S.-headquartered companies with a number of complicated changes that tightened the rules for including foreign income and claiming foreign tax credits. Many of the changes

had no policy rationale other than that they raised revenue from an unpopular source – big businesses’ foreign operations. Although some of the most arbitrary changes have been reversed by subsequent legislation with a corresponding reduction in complexity and economic irrationality, a few of the legislative reversals had delayed effective dates – courtesy of budgetary rules – and have yet to take effect. The Tax Reform Act’s reduced rates – including on corporate income – minimized the adverse effect of some of the international changes for the first few years following its passage. As corporate tax rates have fallen around the world in the intervening years and our major trade partners have adopted territorial tax systems, the impact has been exacerbated. We find ourselves increasingly out of step with the policies adopted by other countries to the disadvantage of our economy and the jobs that might otherwise be created here.

III. Legislation in the Intervening Years

The Code has been amended thousands of times in the 25 years that have passed since the Tax Reform Act was enacted. That in itself is a problem because the pace of change far exceeds the capacity of the taxpaying public and the IRS to keep up with it. What should cause the greatest concern, however, is the tendency, particularly evident over the last 15 years, to use the Code to dispense all manner of benefits, many of them having no rational relationship to the collection of the revenue necessary to fund the operations of government. To my mind, this became a serious problem in the 1990s when both parties realized the goals of tax cuts and spending increases were mutually attainable if combined in targeted tax provisions. The continual enactment of targeted tax provisions leaves the IRS with responsibility for the administration of policies aimed at the environment, conservation, green energy, manufacturing, education, saving, retirement, health care, child care, welfare, corporate governance, export promotion, and economic development, among others. The array of targeted tax provisions also leaves taxpayers confused because the Code often contains multiple overlapping and mutually exclusive provisions aimed at many of these policies. A college degree may be necessary to determine which of the various education benefits is most advantageous.

Regardless of the merits of the policies and whatever the IRS’s capabilities, it is unreasonable to believe the IRS has the capacity to oversee such a diverse range of activities. Moreover, the result of running such policies through the Code is spending that is largely uncapped, unverified, and unverifiable. In the best of circumstances, we have limited means of assessing the efficacy of many government programs. In this case, Congress has effectively signed a blank check. Because many of these provisions duplicate direct spending by other agencies of government, it is particularly difficult to assess whether a provision has been effective in attaining the intended objective.

There is another hazard of the targeted tax provisions and that is that the complexity they bring undermines respect for the tax law. There are too many restrictions, too many qualifications, too many exceptions, and too many phaseouts for the taxpaying public to comprehend. The result is a sense of unfairness stemming from a concern that the taxpayer has been arbitrarily cut out of an available benefit and a sense of uneasiness that available benefits have been missed. That said, many taxpayers prefer

the targeted tax provisions to other forms of government spending – probably because they are easier to access than other forms of government spending. That is not a reason for continuing them. It is a reason to evaluate the operations of other government departments and agencies to see how they might be improved so that they can assume responsibility for the spending programs logically within their purview.

IV. Tax Reform Considerations

Taxes and Spending Go Hand in Hand. As the Committee considers tax reform, it is imperative that the budget be considered holistically, as President Obama instructed the Deficit Reduction Commission. Spending and taxes are inextricably linked and must be viewed together. For that reason, Congress should set aside deliberations on the meaning of revenue neutral tax reform. In the final analysis, Congress must raise the revenue necessary to cover the spending it chooses to undertake and cut the spending to fit the revenue it determines to collect. Although information on the country's fiscal situation is available for those inclined to look for it, misinformation abounds with the result that many in the public do not understand that difficult decisions lie ahead. Eliminating waste, fraud, and abuse will not suffice on the spending side. Neither will a tax hike on the top two percent or the foreign operations of U.S. companies suffice on the tax side. It is hugely important that congressional leaders convey that reality. It is hugely important that the President do so as well, which is why it is so disappointing that the Administration has chosen to delay consideration of Social Security reform. The Social Security trust funds represent nothing more than a promise to raise taxes in the future to satisfy our obligations to Social Security recipients. In the very near future, we will have to raise those taxes because Social Security benefit payments will outstrip Social Security taxes.

Along those lines, last year's health care reform represents a significant missed opportunity to address rising entitlement costs and address the most significant individual income tax expenditure. Controlling rising health care costs requires consumers to have some skin in the game. The unlimited income tax exclusion for employer provided health care eliminates consumer cost sensitivity. To bend the health care cost curve down, we must consider eliminating or capping the exclusion for employer-provided health care.

Keep It Simple. Every tax system that uses income as a base features certain irreducible complexity because measuring income is difficult. This is the reason law students, in their first tax course, devote many hours to answering the question, "What is income?" A manageable question for an individual whose only source of income is his or her salary is far more vexing when posed in the context of a modern business, which may employ complicated financial instruments and arrangements. The difficulties multiply when the business owns multiple operations or operates in multiple jurisdictions.

Although some complexity in a tax system is unavoidable, other types of complexity are entirely optional. "Optional" complexity arises, for example, from attempts to accomplish a particular goal, other than raising revenue in the least harmful

way, through the tax system. A recently-enacted case in point is the deduction for domestic production activities, with its maze of rules for determining what activities, exactly, are blessed with a deduction. In the individual context, consider the array of overlapping deductions and credits available for children, child care, and education.

Setting aside the complexity that arises from policymakers enlisting the tax system for purposes other than raising revenue, complexity remains that serves no apparent purpose at all. Businesses must measure their income for financial accounting purposes, keeping books according to detailed rules prescribed by institutions such as the Financial Accounting Standards Board or the International Accounting Standards Board. For purposes of complying with the Code, however, a company must re-measure its income according to rules devised by Congress. Regardless of the wisdom of the legislators, assisted by tax lawyers, accountants, and economists, who devised the rules in the Code, the benefit of the multiple deviations from financial accounting are questionable. While it is undoubtedly true that the Code's measurement of income must differ in certain particulars from the rules of financial accounting because their purposes are not completely aligned, there is no compelling reason for the many disparities between the Code and the financial accounting rules. Greater conformity of book and tax accounting would have the added benefit of leveraging potentially competing interests against each other.

Complexity in the tax system breeds inefficiency and undermines our system of voluntary compliance. Where the rules of the tax system are unclear or difficult to comply with, compliance will lag. Compliance may suffer because taxpayers are unwilling to expend the effort necessary to unravel the complexity completely or because the complexity itself offers an opportunity for taking an aggressive reporting position. Both taxpayers and the IRS waste tremendous resources complying with and administering an unnecessarily complex tax system. Tax reform should have as a principal goal mitigating wasteful complexity wherever possible.

Get the Economics Right. Sound tax policy is based on sound economic policy. Sound economic policy dictates that the tax rules should be neutral to avoid skewing business and investment decisions. Provisions that skew decisions reduce national income, thereby reducing economic well-being and tax revenues. Tax provisions that correct for market externalities may be tolerable or even necessary, but the Code should otherwise avoid interference in the market because a tax system that is neutral maximizes national income.

Considering and understanding the economic impact of changes to the Code is crucial. Unfortunately, economic impacts are not always obvious with the result that tax law changes may produce unanticipated consequences. Individuals and businesses respond to incentives, regardless of whether intended, and the aggregate of their actions impacts the welfare of the entire country. The "perfect" double tax system of the Tax Reform Act illustrates this well. It should not have been a surprise that the higher corporate rate and double tax on dividends prompted an exodus from corporate form. And yet, the need for the laws passed the following year to clamp down on the use of

master limited partnerships to avoid the double taxation to which corporate earnings were subject clearly demonstrates that Congress did not anticipate the mass departure that occurred.

While some economic effects are predictable with careful consideration, other economic effects are difficult to foresee because they are not well understood. That is particularly the case where the incidence of a tax does not match the burden of the tax. Consider, for example, the employer's share of payroll (Social Security and Medicare) taxes. The tax is imposed on the employer, yet economists have concluded the burden of the tax falls on the employee whose cash wages are reduced to reflect the tax that is imposed on the employer's payment of wages. It is not uncommon, however, to hear the tax described as a tax burden borne by the employer rather than the employee because the incidence of the tax is on the employer. During the consideration of health care a year ago, a similar debate ensued over the excise tax on "Cadillac" health care plans. Some described it as a tax on the employer providing the "Cadillac" plans, consistent with the tax's incidence. Others correctly recognized that the burden of the tax would fall on the employees who enjoyed the "Cadillac" plans.

The placement of the burden of the corporate income tax has been the subject of considerable debate for a number of years. Given the incidence of the corporate income tax, many have assumed the burden of the tax fell on the owners of the corporation. Economic research over the last decade supports the conclusion that, conventional wisdom notwithstanding, the corporate income tax is regressive. Although the corporation makes payments of corporate income tax, some actual person or persons ultimately bears that tax, whether in the form of lower dividends, lower wages, or higher prices. Economists have concluded that, in fact, the employees of the corporation bear the bulk of the corporate income tax burden in the form of lower wages. Yet, in listening to most popular commentary, one could be forgiven for concluding that Paris Hilton is the primary payor of the corporate income tax. This illustrates why education about the tax system is so important. When debate is so unmoored from economic reality, there is a real danger that tax reform will both perpetuate existing harms and create new ones.

It is important not to overlook another key economic insight – that taxing an activity discourages it. The economic burden of a tax affects the amount of the activity on which the tax is imposed, a fact brought home by a recent article in the Wall Street Journal, in which the president of a small New Jersey company explained why he was not hiring new workers. He described how he paid \$74,000 in salary, taxes, and contributions to provide a worker with a nominal salary of \$59,000 – take-home pay of \$44,000 and \$12,000 in benefits. The employer's combined tax costs amount to a 33 percent surtax on the worker's net compensation. The result of the high tax cost of hiring is fewer workers with fewer jobs and lower wages. The same is true of the burden of the corporate income tax.

Responding to Global Shifts. For the U.S. to remain a global leader, we must be more effective in attracting new companies and new capital. The shift away from the United States as a base for globally-engaged companies began some time ago and has

accelerated as new companies and industries have come to the fore. To understand the dynamic nature of the world economy, consider the rate of turnover in the Fortune 500. Forty-eight percent of the companies on the Fortune 500 list in 1999 had disappeared from the list by 2009, and only 14 percent of the companies on the list in 1959 held on until 2009. On the Fortune Global 500 list, U.S. companies' representation is rapidly declining, falling from 179 companies in 1999 to 140 companies in 2009. Over the same time period, the number of Chinese companies on the list increased from 10 to 37. While it was once necessary for innovators to come to the United States to raise capital, recent years have seen a significant increase in the wealth concentrated in places like the Middle East, Russia, China, and India, reducing the need for foreign enterprises to tap the U.S. capital markets.

Foreign competition has increased. Institutions of higher learning produce highly skilled workers that form a growing middle class in the developing world. Governments vie for research and development investments.

A change in our global dominance will have knock-on effects throughout the economy. The foreign operations of U.S. multinationals are responsible for U.S.-based investment and jobs that support those foreign operations. Diminished opportunities for U.S.-based global companies means diminished opportunities for the smaller U.S. companies that are a part of their supply chain. It is also important to keep in mind that the presence or absence of a single company may have an incidental effect that extends beyond that single company. Researchers have documented a "cluster effect" whereby businesses within a geographic area spur productivity of other businesses in the area, meaning the whole is greater than the sum of the parts. In light of this pattern, particular care should be given to devising a tax system that encourages clustering – and the attendant productivity and employment gains – here in the United States.

The tax system is certainly not the only cost of doing business in the United States, but it may be the least defensible. We have burdensome corporate governance and securities regulatory regimes, broad environmental regulation, tort laws that impose a substantial "litigation premium," and generally high labor costs. For each of these costs, however, there is generally an attendant benefit. By contrast, there is no rationale for maintaining an outlier tax system that discourages companies from engaging in global business operations from a U.S. headquarters and from reinvesting foreign earnings in the United States.

Under our current tax system, U.S.-based global companies occupy a uniquely disadvantaged competitive position among their peers. With the recent adoption of territorial tax systems by Japan and the United Kingdom, the United States is the last of the G-7 to tax its residents on their worldwide income. Following the Tax Reform Act, the United States had the lowest corporate tax rate; beginning on April 1, when Japan is scheduled to reduce its corporate income tax rate by 5 percentage points, the United States will have the highest combined corporate income tax rate among OECD countries. Thus, while a foreign-based global company generally pays little or no home-country tax

on its income earned abroad, an identical U.S.-based company must pay the 35 percent U.S. corporate tax rate when it repatriates that income to the United States.

Our tax system is often described as rewarding U.S. companies' foreign operations because foreign earnings are not taxed until the earnings are repatriated. Such a characterization turns reality upside down. The problem is with the high tax rate the United States imposes on corporate income, not the fact that other countries impose much lower rates and grant incentives for research and development. We cannot make U.S. companies more competitive or the United States a more attractive location for investment by adopting a system that seeks to impose our higher corporate tax rate on U.S.-based companies' foreign income. Imposing a 35 percent rate on foreign earnings will only make U.S. companies' foreign operations more valuable in the hands of their foreign competitors. U.S. companies today face a definite disadvantage at home and abroad. The most effective means of rectifying the disadvantage is to bring our corporate tax rate into line with the corporate rates imposed by other countries and to eliminate the disincentive to U.S. companies reinvesting their foreign earnings in the United States.

Timing. It is important that major changes to the tax system receive careful consideration before they are enacted. That said, the rapidity of change in the global business environment suggests a need for speed with respect to reform of the corporate tax regime. It may well be necessary to consider business reform separately from broader reform of the tax system.

Get the Policy Right. Budgetary constraints have dictated many legislative decisions in recent years, often to the detriment of sound policy. In considering corporate tax reform in particular, I urge you to make sound policy your primary objective. Bearing in mind the fact that a substantial part of the corporate tax burden falls on workers and that corporate capital is particularly mobile, it is more important to get the policy for the corporate tax regime right than to ensure it raises a particular amount of revenue. The experience of the Tax Reform Act illustrates the risks inherent in designing to meet a revenue target rather than designing the soundest corporate tax system. On a static basis, the double tax system worked well. In the dynamic real economy, it failed to deliver. A redesigned system should attract, not repel, capital investment.

Alternative Tax Bases. There are limits to our ability to generate additional revenue through our existing tax bases. It seems unlikely that our primary tax bases – most notably, the corporate and individual income taxes and the Social Security and Medicare payroll taxes – can efficiently generate adequate revenue to meet future spending obligations even if those obligations are radically reduced. Economists have long observed that the economic burden of taxation increases with the square of the tax rate – that is, the cost of generating each dollar of tax revenue increases as the tax rate increases. Consequently, I strongly recommend that the Committee consider the addition of an alternative tax base, coupled with lower rates on existing tax bases, as part of tax reform. The alternative source could be a carbon tax or a consumption tax. Either would meet with resistance, but so will the elimination of the individual income tax expenditures necessary to broaden the base sufficiently. Importantly, the addition of a

consumption tax would align our tax system with the tax system of every other developed country.

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I applaud the Committee for taking a hard look at the tax system and steps toward reforming it and thank you for the opportunity to testify today. I would be pleased to respond to any questions you may have.