

**Statement of Jonathan Talisman
Before the Senate Finance Committee
“Comprehensive Tax Reform: Prospects and Challenges”
July 18, 2017**

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

It is a privilege to appear before you once again on a panel with my close friends and colleagues to discuss my thoughts regarding the important issue of tax reform. I want to commend the Committee for your continued examination and pursuit of tax reform, to ensure that our tax system is fair, competitive and efficient, while raising the revenues we need to fund our Government. I am appearing here on my own behalf and not on behalf of my firm or any client.

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.

Several of us appeared on a similar panel here over six years ago at a hearing entitled “How Did We Get Here?”¹ Given the general consensus among policymakers that tax reform has been needed, one might wonder why this hearing wasn’t called “Why Are We Still Here?”

But, in all seriousness, I believe significant progress has been made in the interim period.

First, a few critical issues we discussed that needed reforms in 2011 have already been addressed. Because of structural defects, the Alternative Minimum Tax (AMT) was exploding and threatened to reach deep into the middle class, absent annual patches by Congress. As one commentator put it, the AMT was morphing from a “class” tax to a “mass” tax. As part of the fiscal cliff negotiations at the end of 2012, Congress agreed to boost the AMT exemption retroactively for 2012 and to index future exemption levels to keep pace with inflation. While some still want to eliminate the AMT entirely, this step prevented the unintended creep of the AMT, eliminated the need for annual patches, and provided taxpayers with greater certainty.

Similarly, in 2011, we had well over 100 extenders that were scheduled to expire later that year or the following year, including the 2001 and 2003 tax cuts. I said at the previous hearing, “It is unsustainable for much of our tax code to exist on a temporary basis.” Fortunately, in the Protecting Americans From Tax Hikes (PATH) Act enacted in December 2015, Congress addressed a large part of the problem by

¹ Hearing on “How Did We Get Here? Changes in the Law and Tax Environment Since the Tax Reform Act of 1986,” Senate Finance Committee (March 1, 2011).

extending numerous items either permanently or for five years. This included important provisions like the research credit, expanded small business expensing under Sec. 179, bonus depreciation, and individual credits, such as the child tax credit, the earned income tax credit (EITC) and American opportunity tax credit. Unfortunately, a small number of expiring provisions were extended forward for only one year and thus expired at the end of last year. These need to be considered once again and include tax provisions for individuals and businesses, as well as several energy incentives.

Second, in both tax-writing committees, we have had a thorough examination of the principal options that exist to address the significant issues that remain (discussed below). Numerous hearings have been held (some have been repeated) and staff reports produced. Bipartisan working groups sought comments from outside sources and have made recommendations based on that input. Thoughtful discussion drafts and bills have been produced by Ranking Member Wyden, Senator Enzi, former Chairman Baucus, and former House Ways and Means Committee Chairman Camp that have allowed us to have an honest conversation about the tradeoffs likely in 1986-style reform that broadens the base to lower the rates. And the House Republican Blueprint, together with bills introduced by Senator Cardin, Rep. Renacci, and Rep. Nunes, have explored whether we should adopt a consumption (or quasi-consumption) tax to replace all or a portion of our income tax. All of these were important building blocks in the tax reform process.

I believe it is time for Congress to heed the instructions Yoda gave to Luke, "Do. Or do not. There is no try."

The prospect of tax reform has created uncertainty in planning, and crowded out work on other tax matters. So, in an effort to advance the cause of tax reform, let me briefly explore the principal remaining issues that should be addressed together with a few admonitions, and discuss some of the impediments to tax reform that remain.

Significant Issues Still Remain that Need to be Addressed

The major impetuses for tax reform are: competitiveness and growth; efficiency; fiscal responsibility and long-term deficits; a shrinking middle class and economic inequality; fairness; and removing unnecessary complexity and administrative burdens. The first two have received the most attention to date, but all are important. My views on each of these are briefly summarized below.

Competitiveness and Growth. The United States has the highest statutory corporate tax rate among our major trading partners. When we lowered corporate tax rates in 1986, our rates were well below the OECD average. The problem is that all of our trading partners soon followed suit and kept moving past us. According to a report issued by the President's Economic Recovery Advisory Board (PERAB) in 2010, a high corporate tax rate "causes or exacerbates many... significant economic

distortions."² The report called for broadening the tax base and lowering the corporate tax rate to "increase the stock of available capital - new businesses, factories, equipment, or research - improving productivity in the economy." The report also says that lowering the corporate rate would reduce the incentives of US companies to shift operations and employees abroad. It would also enhance the attractiveness of the United States as a location for foreign direct investment.

At the same time, our quasi-worldwide international tax system,³ adopted in 1918 and last structurally revised in 1962, has also become out-of-step with the rest of the world. Virtually all of our major competitors have adopted some form of territorial system, with the UK and Japan being the last major economies to switch away from a worldwide system in 2009. Among their stated reasons for changing their systems were to enhance their competitiveness as headquarter locations for multinational businesses and to spur repatriation of foreign income.

The combination of our worldwide tax base with the high U.S. tax rate often causes U.S. businesses to be at a competitive disadvantage in foreign markets relative to their competitors that are based in jurisdictions with lower tax rates or in countries that exempt foreign income. While deferral can mitigate competitiveness concerns, it does so only by creating a "lockout" problem -- discouraging redeployment of foreign earnings for domestic investment. Our worldwide international tax system can hinder U.S. companies in bidding for foreign acquisitions, while at the same time making them more susceptible to foreign takeovers or to seek inversions.

Yet, with all of this, our current international tax system fails to raise much additional revenue from U.S. multinational corporations and, unlike a pure worldwide system, it does not achieve equity or capital export neutrality.

Globalization and migration of capital have heightened concerns about the competitiveness of U.S. businesses and our tax system, and focused attention on the need for international tax reform. Other countries are taking significant steps to attract headquarters, IP ownership and other cross-border investment. At the same time, they are aggressively asserting additional rights to taxation at source – often times seeking to tax profits that have only a tenuous connection to their country. The United States must respond soon to these global tax developments to avoid a detrimental impact to our economy and U.S. tax receipts in general.

Efficiency. Expanding the corporate tax base by eliminating special deductions, credits, and other tax expenditures could improve the efficiency of our tax system. In many cases, a broader tax base would improve neutrality by removing distortions

² The President's Economic Recovery Advisory Board, "The Report On Tax Reform Options: Simplification, Compliance, And Corporate Taxation," (August 2010).

³ Our international system is actually a hybrid -- a worldwide tax system that permits deferral (i.e., effective territorial treatment) until earnings are repatriated and provides foreign tax credits to avoid double taxation. This may be the worst of all worlds. As one commentator has written, our international tax rules "are universally reviled as just a half step short of utter madness."

that favor or disfavor various investments and industry sectors. Other countries have taken a similar approach when they have reduced their corporate tax rates over the past decade.

However, there are a few important caveats and tradeoffs that should be considered. Many of the largest “tax expenditures” are long-time features of our system embedded in the fabric of our economy. Moreover, as Stanley Surrey, the father of tax expenditure analysis, 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.”⁴ These include items such as the research credit (passed 15 times and made permanent in the PATH Act), employer-provided health exclusion (which has survived two recent health care reform debates), deductibility of home mortgage interest, deductions for charitable contributions, incentives for retirement savings, reduced rates on capital gains and dividends, and exemptions for state and local bonds.

The primary consideration regarding whether to retain certain tax expenditures should be whether the intended result of the expenditure is still valid, whether the tax expenditure achieves its intended results in an efficient manner relative to the foregone revenue, whether these results are best achieved through the tax code (e.g., relative complexity and administration), and what the potential economic and social dislocations would be if they were eliminated.

I would like to make two additional points. First, 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. For example, the state and local income tax deduction is designed to mitigate double taxation, like the foreign tax credit. One is listed as a tax expenditure; the other is not.

Second, in searching for additional sources of revenue to offset the cost of corporate tax reform, policymakers must be careful to avoid tax reform proposals that do more harm than good – that is, revenue proposals that limit ordinary and necessary business expenses. These proposals are counter-productive to the goals of tax reform. By overstating economic income, they arbitrarily raise certain businesses’ effective rates above statutory rates, reducing fairness and impeding investment and growth. Such proposals would act as negative tax expenditures.

As I have written in *Tax Notes*, a case in point is the suggestion by certain policymakers that limits be imposed on the deductibility of business interest. Proponents argue that the imposition of such limits will reduce economic distortions caused by the different tax treatment of corporate debt and equity. But recent research suggests that the so-called “debt bias” has not led to over-leveraging or distress in the non-financial sector. In fact, Duke University Finance

⁴ Surrey and McDaniel, *Tax Expenditures* (1985).

Professor John Graham has found that there is a significant degree of conservatism in corporate debt policy. Moreover, lowering the corporate tax rate will, by itself, reduce the value of the corporate interest deduction by 20 percent or more.⁵ It also significantly lowers the double-level tax on equity. Finally, as Chairman Hatch has suggested, a partial or full dividends paid deduction would address the real problem (i.e., the double level tax on corporations) and be a better solution. *Tax Notes* Chief Economist Marty Sullivan admits, “it would be far better to eliminate double taxation than to expand it through an elimination of interest deductions.”⁶

Fiscal Responsibility and Long-term Deficits. In a response to questions for the record, CBO Director Keith Hall explained in detail the fiscal situation facing policymakers:

If current laws generally remained the same, CBO projects, federal spending would grow from 20.7 percent of GDP this year to 23.4 percent in 2027; federal revenues would grow more slowly over that period—from 17.8 percent of GDP to 18.4 percent. About 70 percent of the growth in outlays over the next 10 years is attributable to just three sources: Social Security, Medicare, and net interest on federal debt. To avoid the negative consequences of high and rising federal debt and to put debt on a sustainable path, lawmakers would have to significantly change tax policies to increase revenues above what they are projected to be under current law, substantially amend spending policies to reduce outlays for large benefit programs below the projected amounts, or adopt some combination of those approaches.⁷

Obviously, it will be important for policymakers to keep our long-term fiscal situation and the impending demographic problems in mind in crafting tax reform to ensure we do not exacerbate our budget concerns.

Income Inequality and a Shrinking Middle Class. The issue of rising income inequality and the thinning of the middle class is a critical issue that should be addressed as part of tax reform.

According to my former Treasury colleague Len Burman, “the middle class has been in a 30-year recession.”⁸ Brookings Institution economist Adam Looney recently

⁵ See Carroll, R. & Neubig, T., “Business Tax Reform and the Tax Treatment of Debt: Revenue Neutral Rate Reduction Financed by an Across-the-Board Interest Deduction Limit Would Deter Investment,” (Ernst & Young, May, 2012), at 6.

⁶ See Sullivan, “Treat Corporate Interest Deductions Like Any Tax Expenditure,” *Tax Notes*, August 6, 2012, at 632.

⁷ Answers to Questions for the Record Following a Hearing on the Budget and Economic Outlook for 2017 to 2027 Conducted by the Senate Committee on the Budget, Congressional Budget Office (April 6, 2017).

⁸ Testimony of Leonard E. Burman, Hearing on “Tax Reform Options: marginal Rates on High-Income Taxpayers, Capital Gains, and Dividends, Senate Finance Committee (September 14, 2011).

testified that earnings have stagnated for middle- and lower-income households, while they have “risen dramatically at the top—by more than 250 percent over the past 30 years for households in the top one percent of the income distribution.”⁹

The progressive income tax has long served as an important bulwark against inequality: graduated tax rates require that high-income people pay a larger share of their income in taxes than lower-income people. According to Looney, “Changes in the tax system over the past 30 years have exacerbated these problems; the very people who have received the biggest income gains in the past three decades have also seen the largest tax cuts.”

This is not a partisan issue. President Obama called rising inequality “the defining challenge of our time.” Similarly, in the campaign, President Trump talked about a hollowed-out middle class and a system “rigged” against average Americans. Economists warn that it may be slowing overall economic growth. And the campaign demonstrated that a significant segment of the public feels left out, creating a “festering distrust of government and of corporate leaders whose promises of better times ahead never fully materialized.”¹⁰ One result has been a backlash against globalization and free trade that many Americans feel tilted the economy against them.

A recent op-ed by Glenn Hubbard, former chairman of the Council of Economic Advisors in the George W. Bush administration, suggests that the pro-growth agenda may not be sufficient to generate inclusion and mass prosperity.¹¹ I agree with him that policymakers “must confront the question of what happens when growth does not generate inclusion.” Social factors may be at play that need to be overcome to provide greater opportunity. For example, as Senator Moynihan predicted years ago, single-parent families are more likely to be poor than other families and less likely to ascend the income ladder. Hubbard suggests the tax code should provide greater encouragement of human capital formation, education, and skills development.

Another positive step would be adoption of legislation proposed by Senators Brown and Bennet to expand the EITC for childless workers and to strengthen the child credit for families with young children. Studies have shown that economic insecurity has detrimental effects on children’s long-term health, education, and employment outcomes, ultimately costing the U.S. economy hundreds of billions per year.

⁹ See Testimony of Adam Looney, Hearing on “Supporting Broad-Based Economic Growth and Fiscal Responsibility through Tax Reform,” Senate Budget Committee (May 22, 2013).

¹⁰ See, “Why It Matters: Income Inequality,” Associated Press (August 18, 2016).

¹¹ See Glenn Hubbard, “Tax Reform Is the Best Way to Tackle Income Inequality,” Washington Post (January 10, 2014).

Fairness. The fairness of the tax code is highly subjective, but it will be critical to the success of any tax reform effort that it be perceived by the general public as fair. Fairness is generally based on ability to pay and notions of horizontal and vertical equity. Horizontal equity is the concept that similarly situated taxpayers should be taxed similarly. Vertical equity compares the treatment of taxpayers at various income levels and is generally measured by the progressivity of the overall system.

Certain tax expenditures are meant to address fairness and should be judged on that basis. For example, allowing deductions for catastrophic health expenses addresses the fact that these taxpayers have less disposable income and ability to pay. Also, ensuring that taxpayers cannot evade or avoid taxes imposed on other similarly-situated taxpayers is important to perceptions of the tax system's fairness. The shutting of loopholes in the 1986 Tax Reform Act was a significant reason it was perceived to enhance fairness.

Simplification. The complexity of our tax rules is a significant concern. It affects economic growth by imposing substantial costs and administrative burdens on taxpayers. Complexity can also increase uncertainty as taxpayers struggle to ensure they are compliant in effecting their business decisions. In designing rules, we often should accept rough justice, rather than seeking to target the provision perfectly. For example, in response to a question from Senator Menendez, I testified at the last hearing that consolidation of the various education incentives is a good idea. The myriad of currently available incentives with different requirements creates confusion and complexity.

However, 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 but 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.

Overcoming Impediments to Tax Reform

So, given the strong consensus among policymakers that tax reform is needed, why hasn't it happened yet? Well, frankly, like health care reform, it's hard. Health care reform is visceral because it affects choices and our ability to care for our families and us. But it impacts only roughly 17 percent of GDP. Tax reform may be less visceral, but it impacts our everyday choices and our ability to provide for our families. And it impacts virtually 100 percent of GDP.

Also, while agreement exists that tax reform is needed (and despite all the work that has been done), there is still no clear consensus as to approach. Tax reform is defined in different ways. Important goals may conflict with each other. It will be important to agree on the goals and intended benefits of tax reform. Once these are established, it will be important for the President and other political leaders to market these goals and intended results to the American public.

The success of the 1986 Act was in no small part attributable to the initial sales job by President Reagan and Ways and Means Chairman Dan Rostenkowski. President Reagan delivered an Oval Office speech that called for revenue neutral tax reform to close loopholes and lower rates, saying “No other issue will have more lasting impact on the well-being of your families and your future.” Rostenkowski delivered the Democratic response, saying that they were committed to a tax system that was simple and fair and would support the President if “his plan is everything he says it is.” He then asked them to write Rosty: “Just address it to R-O-S-T-Y, Washington, D.C. ...And stand up for fairness and lower taxes.” He received more than 75,000 letters and one package with a wooden two-by-four with instructions to use it on any interfering lobbyists.

By definition, revenue-neutral tax reform will create winners and losers and cause disruptions. As Columbia Law Professor Mike Graetz has written:

Since responsible tax reform in the current context cannot cut taxes overall, it inevitably will produce both winners and losers. Simplifying the tax code requires cutting back on someone’s deductions or credits, eliminating someone’s special tax breaks, and closing someone’s loopholes. In exchange, everyone can have lower tax rates. So there should be more winners than losers. But the losers may lose a lot, while the more numerous winners will gain only a little. If so, the losers will scream loudly enough to drown out the winners’ quiet applause.¹²

Engaging and educating the public is essential to build support and minimize blowback. While Chairman Baucus and Chairman Camp were on the right track with their road show, the electorate (and even rank-and-file members) has not truly been engaged yet in my opinion. Health care reform has predominated the public’s attention. How the goals for tax reform are established and marketed will determine whether any significant tax reform is accomplished, and how it is judged politically.

Another important lesson of the 1986 Act, as evidenced by the recent health care debate, is that bipartisanship is important to develop major legislation that does not divide the American public and is lasting. As President Clinton recently said in a panel appearance with President Bush, “The truth is in an interdependent complex world, diverse groups make better decisions than homogeneous ones...”

¹² Michael Graetz, *100 Million Unnecessary Returns* (Yale Press 2008), p. 47.

Consequently, like Chairman Hatch said in his recent speech to Bloomberg, “I am still hoping that tax reform can be bipartisan.”

While a partisan approach to tax reform seems easier to accomplish, the truth is it creates numerous impediments that will be difficult to overcome. To provide reconciliation protection in the Senate, a budget resolution will need to be passed by both Houses, which will not be easy. Even if this can be accomplished, the margin for error in both bodies will be extremely slim, again as evidenced by the current problems facing the health care bill. Finally, use of budget reconciliation can be a “Faustian bargain,” as one of my Republican friends has termed it, invoking the Byrd rule and other procedural protections. This can inhibit what is ultimately accomplished, and may require that all or part of tax reform sunset outside the budget window a la the 2001 and 2003 tax cuts (or that artificial devices be adopted to avoid sunseting).

Most business leaders are anxious for tax reform, but they are not yet unified in their vision for business tax reform. For example, a dispute still exists regarding the form of base erosion in a shift to a territorial system. The business community must find a way to come together and collectively help policymakers find solutions to reform the tax code in a manner that collectively benefits all, makes our system more competitive, and encourages domestic investment and job growth.

The recent focus on health care reform and the novel issues raised by the border tax adjustments in the House Republican Blueprint has crowded out focus on other important, and potentially controversial, tax issues. These issues are just beginning to surface and may take time for members and staff to fully consider. For example, not much attention to date has been spent on proposed changes to individual taxation to double the standard deduction and eliminate the state and local tax deduction. This combined change will not only affect state and local governments, but also the charitable community and the housing sector. When Chairman Camp made a similar proposal in his tax reform bill, the number of itemizers eligible to take the charitable deduction and the home mortgage interest deduction was estimated to fall to 5 percent of all taxpayers, down from over 30 percent.

Another important but difficult issue that has not yet been vetted is the special tax rate for pass-throughs included in the Administration’s tax reform proposal, as well as the House Republican Blueprint. A detailed proposal for the design of a special pass-through rate has not been released. How it is perceived will depend in part on how it is designed.

I would like to close with a few final thoughts. First, do not worry about solving all perceived problems at once. Incremental progress will be a significant accomplishment. In particular, debates over more fundamental tax reforms should not delay or preclude meaningful reforms to improve the current code that will provide relief to individuals and help stabilize the global tax environment and improve competitiveness for businesses operating in the U.S. Second, be careful not

to worsen or inhibit our ability to address our impending long-term fiscal problems. It will be more difficult politically to reverse course and unwind changes later.

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