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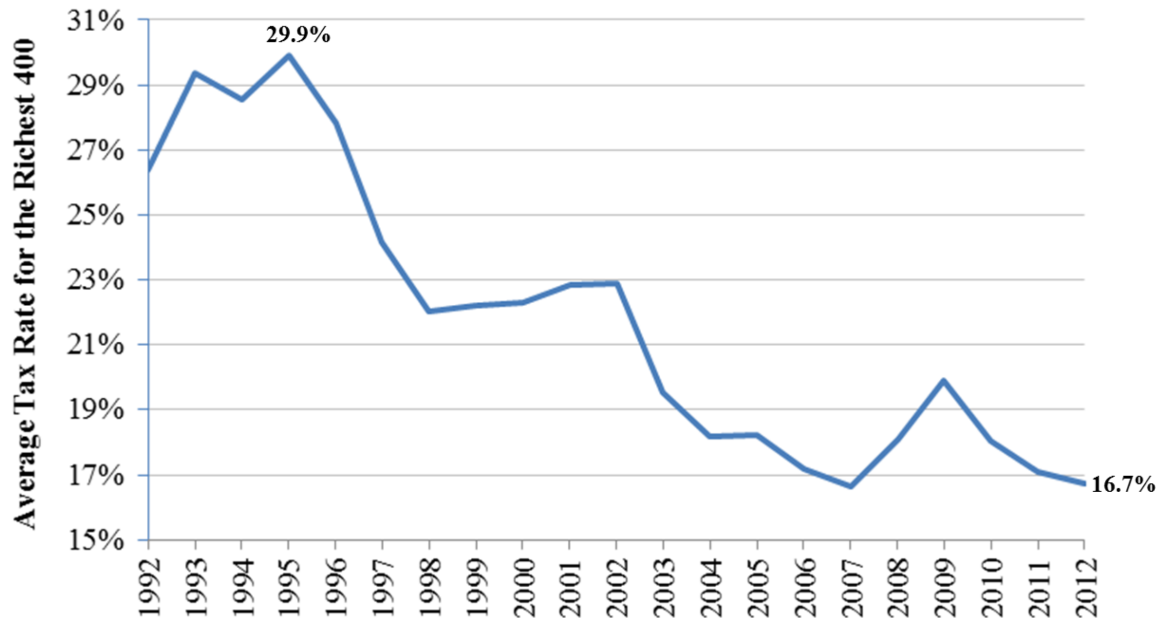
215 Dirksen

Next year will mark the 30th anniversary of the last major piece of tax reform legislation that has been passed by Congress and signed into law. While there have been many adjustments in the code since then, it has been far too long since a thorough overhaul was undertaken.

Ensuring a fair and effective tax code is a bit like maintaining a garden: Without constant watering and weeding, it will quickly deteriorate as lawyers and accountants find new ways to legally – but unfairly – ease their clients' tax burdens.

Consider, for example, the tax rates borne by the wealthiest Americans. In 1995, the 400 highest income Americans paid just under 30% of their adjusted gross incomes in taxes. By 2012, the most recent year available from the Internal Revenue Service, the tax rate for this same cohort had dropped to 17%.

Taxes for the Richest 400 Go Down

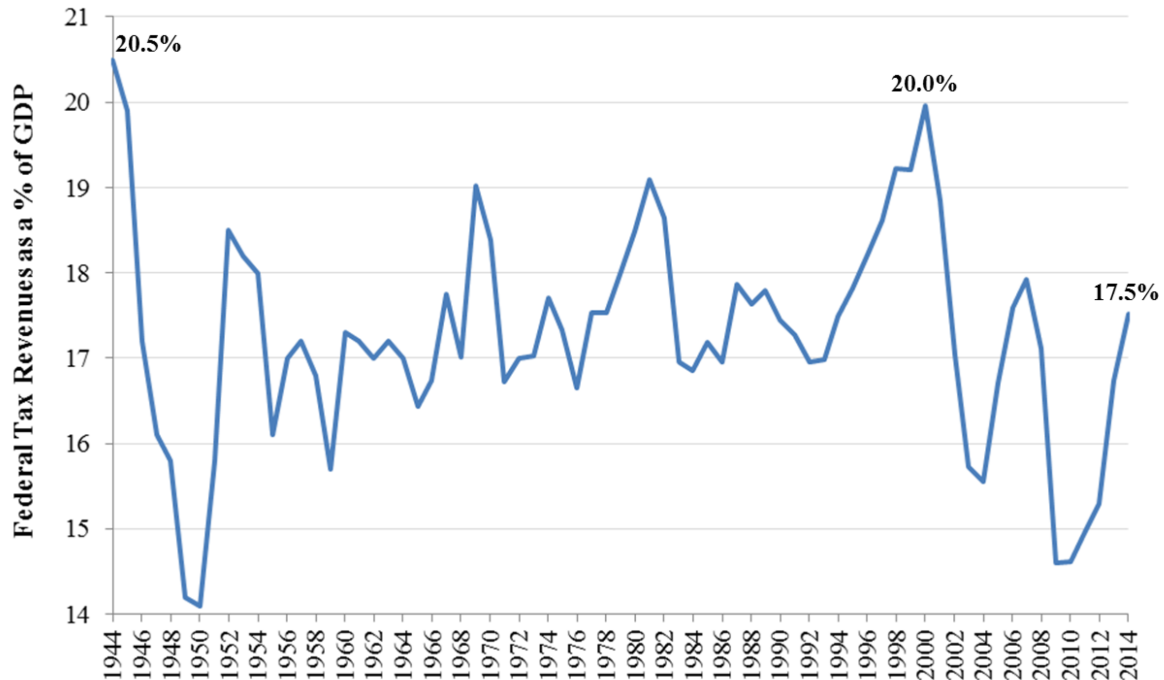


Source: IRS

Not all of that drop is due to clever tax manipulation; some resulted from lowering of rates on ordinary income, while most came from low rates on income from capital gains and dividends. (In fairness, the tax rate of this mega-rich cohort is likely to have gone up in recent years following the increase in the capital gains rate for the wealthy beginning in 2013.)

Meanwhile, after plunging to low levels during the financial crisis and recession, tax collections as a share of gross domestic product have recently risen to 17.5%, still at the low end of the historic band of 17% to 19%.

Fluctuating Tax Revenues



Source: CBO

To be fair, many of the most important changes made by the 1986 law have succeeded in reining in the most egregious tax avoidance schemes that operated prior to the law's passage.

But other abusive practices remain. We learned, for example, during the last Presidential campaign that one of the candidates was able to amass an Individual Retirement Account with a balance that he listed at $20.7 million to $101.6 million. That occurred in the context of maximum allowed total contributions during the relevant years on the order of $500,000.

Another well-publicized loophole is the ability for private equity and certain hedge fund operators to have their carried interest proceeds taxed as capital gains. At various points in my career (including at present), I have been a substantial beneficiary of these provisions and for the life of me, I can't understand why my tax rate on income from these activities was less than half of the tax rate paid by friends in other parts of the financial services industry.

Other provisions allow private equity professionals to convert ordinary income from management fees into lower taxed capital gains on their investments.

While the amounts of lost revenue to the Treasury from some of these mechanisms may not be huge, the significant attention around them contributes to resentment and a feeling on the part of average Americans that they are bearing an unfair burden.

It is true that by some measures, the progressivity of the tax code has increased in recent years, particularly because of tax reductions for those at the very bottom that have resulted in 41% of Americans paying no Federal income tax in 2014.

However, as we all know, pre-tax income inequality is currently at record levels. That disturbing trend should be considered by this Committee as it examines new tax proposals. Since the income tax was instituted in 1913, a bedrock principle has been that those Americans with higher incomes should pay higher rates.

There is no rulebook for what the appropriate amount of progressivity should be, and I accept the notion that at some high level, confiscatory taxes can discourage work. But in my 32 years on Wall Street, I have experienced top marginal Federal tax rates as high as 50% and as low as 28%, and I never detected any change in the motivation to work on the part of myself or any of my colleagues.

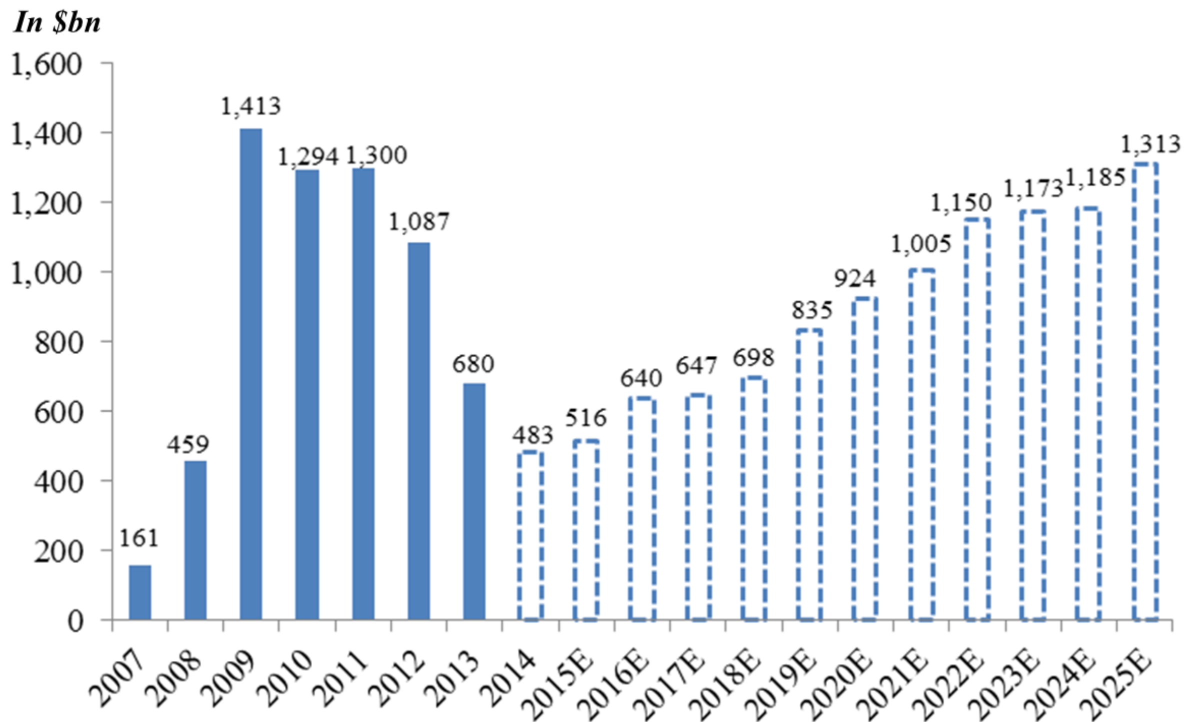
Similarly, the tax rate on long-term capital gains has ranged from 35% in the 1970s to 15%. A tax rate of at least 28% on this type of income would be appropriate.

In that regard, it is important to remember that the 1986 law provided that capital gains would be taxed at the same rate as ordinary income, a principle to which we should endeavor to return.

The cost of this tax expenditure is substantial – on the order of $120 billion per year. Only the exclusion from AGI of employer-provided health care costs the Treasury more.

In addition to achieving greater fairness, we need more revenue. While our budget deficit has come down rapidly, all reasonable forecasts show that at some point it will turn back up, particularly as the cost of retirement and health care costs for those of my baby boomer generation begin to mount.

Deficits Projected to Rise



Note: Figures are adjusted for war spending drawdown
Source: CBO Alternative Fiscal Scenario, CRFB

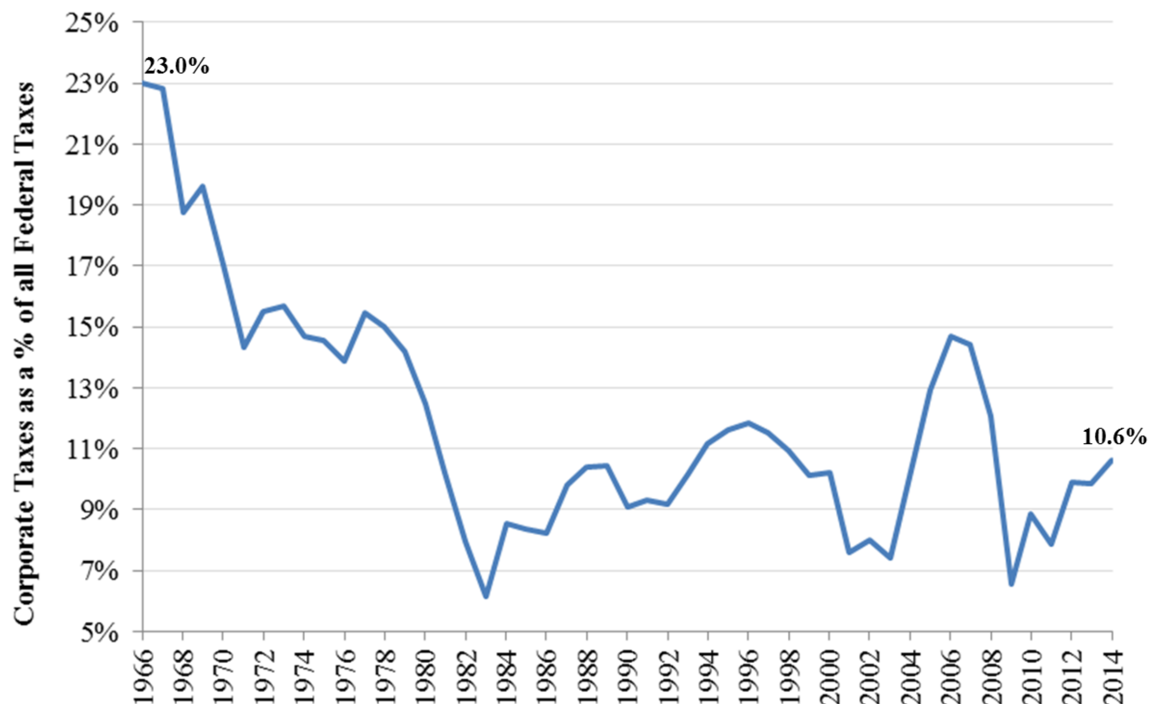
I do not believe that society will accept the reduction in these benefits necessary to maintain fiscal prudence nor do I believe that further cuts in real discretionary spending would be appropriate – indeed, outlays on many of these items should be increased.

While I was asked to focus my remarks on tax code fairness as it relates to individuals, no discussion of taxes and fairness would be complete without at least mentioning the sorry state of our corporate tax provisions.

Few policy issues engender such unanimity as the consensus that the tax code as it relates to business is riddled with loopholes, drives business out of the United States instead of encouraging it to locate here and creates such divergent outcomes as to make the individual provisions look like a paragon of equity.

In particular, the rampant use of inversions and earnings stripping and the even more rampant abuse of transfer pricing have contributed to a massive decline in the contribution of business tax revenues to the overall Federal tax revenues of the United States. In 1966, corporate taxes accounted for 23% of all Federal tax revenue; by 2014, just 10.6%.

Declining Share of Corporate Tax Revenues



Source: CBO

A good starting off point for the committee would be the exhaustive work of the Simpson-Bowles Commission, which much like the 1986 law, proposed reducing the number of tax rates to three, erasing the special treatment of capital gains and dividends, and eliminating most other tax deductions.

Many other meritorious plans have been put forth, such as the proposal made by Senators Wyden and Coats in 2011.

In his recent budget, President Obama proposed a few smaller changes that are worthy of the Committee's consideration, including a modest increase in the tax rate on capital gains and dividends and eliminating the step up in basis on assets held at death.

The President also proposed a variety of measures to provide tax relief for the middle and working class Americans, importantly including expansion of the Earned Income Tax Credit. As the Committee considers both tax fairness and adequate revenues, its review should encompass changes that would benefit Americans whose incomes have not been raised by the economic recovery.