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Concerning Fundamental Tax Reform
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Thank you for the opportunity to appear before the Committee today to discuss fundamental tax reform. This is an issue near and dear to my heart. Since 1976, I have devoted my career to promoting fairer taxes and to keeping the public informed about the meaning of various tax change proposals. That is also the mission of my group, Citizens for Tax Justice.

In my view, our nation's current tax policies are a disaster: morally, fiscally and economically. In my brief testimony today, I want to discuss what I think should be the principles of fundamental tax reform, illustrate how they have been applied in real life, and touch on what I see as false paths to reform.

I. Principles of Fundamental Tax Reform

Tax reform experts have traditionally pointed to three basic goals for a good tax system: fairness, simplicity and economic efficiency. I would add one more essential ingredient: revenue sufficiency. All four are interrelated.

Principle 1: Revenue sufficiency. The fundamental goal of any tax system is to raise the money needed to pay for public services. Our current tax system is failing miserably in this regard.

In the just-completed fiscal year, combined federal personal and corporate income taxes fell to only 8.3 percent of the economy, their lowest level since before World War II and a third lower than in fiscal 2000—with no relief in sight.

- Personal income taxes have fallen to their lowest level as a share of the economy in more than 50 years.
- Corporate taxes have plummeted even more than personal taxes. In fact, at only 1.2 percent of the economy over the past two fiscal years, corporate income taxes are at their lowest level since the 1930s, except for one year during Ronald Reagan's first term. The most recent OECD data show that U.S. corporate taxes as a share of the economy are now virtually the lowest in the industrialized world.

Some of the recent tax shortfall and the resulting huge budget deficits reflect the weak economy, but most of it is self-inflicted. President Bush's personal income tax cuts enacted in 2001 and 2003, for example, are expected to total $197 billion next year. The decline in corporate taxes mainly stems in about equal parts from President Bush's big corporate tax cuts enacted in 2002 and 2003 and the huge amount of offshore tax sheltering that corporations now engage in with congressional tolerance. Counting tax breaks that have been on the books for longer, corporate taxes are now almost 60 percent below the 3 percent of GDP they averaged from 1950 through 2000. To put that in perspective, if corporate taxes had equaled that 3 percent of GDP average last year, then revenues would have been $180 billion higher than they actually were.

For the foreseeable future under current policies, a third of the regular government will be financed with borrowed money. Obviously this can't be sustained for very long, either fiscally or economically. Such excessive borrowing endangers essential government programs and robs investment capital from our economy that we will need to sustain growth.

So a central goal of fundamental tax reform must be to address our huge revenue shortfall. Correspondingly, any "reform" proposal that purports to be "revenue-neutral" —let alone revenue-losing!—should be dismissed out of hand.

Principle 2: Fairness. Tax fairness is not only morally right, it's also essential to maintaining public support for the tax system. Traditionally, fairness has been divided into two important elements: horizontal equity and vertical equity.

First of all, taxpayers with similar incomes should pay similar taxes, no matter how they happen to earn their money. It's not fair to tax wage-earners more heavily than investors, and it's not fair to tax investors in, say, fake synthetic coal, less than investors in non-tax-sheltered activities.

Second, taxes ought to be based on people's ability to pay them. Those who have benefitted most from our society should pay the highest share of their income in taxes to support our country. Those who are struggling should pay the lowest rates.

Unfortunately, our current tax system violates both of these principles of fairness. An array of loopholes favors some taxpayers and some kinds of income over others. And the progressivity of our tax system has declined markedly over the last quarter century.

According to Congressional Budget Office data, the effective tax rate on the best-off one percent of Americans dropped by 16 percent from 1977 to 2000, despite rapidly rising incomes at the top end that normally would have produced higher effective tax rates. Since 2000, according to calculations by the Institute on Taxation and Economic Policy, President Bush's tax cuts have lowered the effective tax rate on the wealthiest by another 17 percent. In combination, that's a 30 percent drop.

This sharp decline in progressivity has a lot to do with our government's revenue shortfall, by the way. If the effective tax rate on the top one percent were as high today as it was in 1977, the government would collect more than $200 billion in additional revenue in 2004.

Principle 3: Simplicity. In a complicated world full of would-be tax avoiders and their highly paid advisors, no tax system can be completely simple. But a tax system that is generally understandable and that is devoted to raising revenue fairly would be much simpler than the one we have today. Unfortunately, the past decade or so has seen rapid growth in tax complexity, largely because lawmakers have chosen to use the tax code as a vehicle for numerous programs unrelated to fair tax collection. Some of these "tax expenditures" have noble goals; others would never be seriously considered if they were proposed as part of the regular budget process. But all these programs make tax filing and tax enforcement far more difficult than they need to be.

Principle 4: Economic efficiency. Most of us would be reluctant to endorse central planning as an ideal economic system. Instead, we'd probably insist that letting market forces drive consumer and business decisions is usually the best way to maximize our economic well-being. Virtually the entire economics profession agrees. But our tax code is increasingly becoming an *ad hoc* tool of central planning, as we lard the code with more and more "incentives" to shift economic activity into areas that have gained congressional favor. In contrast, an even-handed, level-playing-field tax code without favoritism for some business activities over others would improve the allocation of capital and enhance economic growth.

II. Tax Reform Principles in Action:

A fair, revenue-sufficient tax code is certainly difficult to achieve, but history shows us that it's not impossible. In fact, we came rather close to having such a tax code for a brief period a decade ago, due to the efforts of President Reagan, President Clinton, and to a lesser degree, the first President Bush.

After a dismal start with his loophole-laden, budget-busting 1981 tax act, President Reagan dramatically shifted gears. For the rest of his time in office, he devoted his tax policy primarily to closing unwarranted loopholes and boosting revenues. Reagan's tax reform drive began with the loophole-closing 1982 tax bill and reached its fulfilment in the 1986 Tax Reform Act.

To be sure, Reagan's post-1981 tax changes did not come close to bringing revenues in line with spending, nor did they fully restore the progressivity that the 1981 act had sharply eroded. But the tax code Reagan bequeathed to his successors was as close as our country may have ever come to a horizontally equitable, simple and economically efficient tax system. Its major flaw was that its upper-income tax rates were much too low.

Reagan's successors, the first President Bush and President Clinton, retained most of the Reagan reforms, at least initially, while addressing the continuing revenue problem. Bush I increased the top income tax rate in 1990, although he unfortunately resurrected the Reagan-repealed capital gains tax loophole at the same time. President Clinton further increased the tax rates on the highest earners in his 1993 legislation. When incomes boomed at the top of the income scale in the second half of the nineties, those higher tax rates helped give us our first balanced budgets since 1969.

I suggest that would-be tax reformers take the Reagan tax code of 1986, supplemented by the Clinton tax rate hikes of 1993, as an excellent paradigm for future fundamental tax reform. (Most of what's happened to the tax code since 1993, on the other hand, I suggest you spurn.)

III. False Paths to Reform:

On the other side of the tax reform issue are those who totally repudiate the Reagan-Clinton legacy. Specifically, they would scrap the progressive income tax in favor of a flat-rate consumption tax. One version of this approach calls for a high-rate national sales tax. Another is the flat-rate wage tax promoted by former president candidate and publisher Steve Forbes along with former House Majority Leader Dick Armey.

These and similar proposals are designed to drastically reduce taxes on the wealthiest people, both by lowering their tax rate and by exempting a large share of their income from tax. The plans would also increase taxes dramatically on middle- and low-income Americans, especially if they came even close to raising enough money to pay for the government.

Proponents of consumption taxes often argue that their plans would discourage consumer spending, promote savings and thereby increase long-term economic growth. But unbiased experts who have examined these claims generally find little if any economic improvement from switching to a regressive tax system. Indeed, since these consumption tax proposals would require tax rates that are implausibly high to avoid even bigger deficits, their net effect would probably be to reduce total national savings.

IV. Conclusion: Current Prospects for Reform

I wish I could reasonably hope that the current management in the White House and Congress will rush to repeal the Bush tax cuts, crack down on offshore corporate tax sheltering, reinstate the estate tax and otherwise take us back to the days when a fair, progressive tax system paid the government bills and even started to reduce the national debt. But despite my pessimism that you'll listen to my advice, I do recommend that you take all these steps.