Statement of Robert S. McIntyre, Director, Citizens for Tax Justice
To the President's Advisory Panel on Federal Tax Reform
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Summary of principal points:

1. Revenue sufficiency—and revenue neutrality. The most serious problem with our current tax system is that it does not come even close to raising sufficient funds to pay for public services. The Panel's pledge to make its recommendations "revenue neutral" does not address this pressing problem, but it at least seems to promise not to make things worse. Unfortunately, this "revenue neutral" pledge appears to be a hoax. Instead, the Panel says that it will propose upwards of $7 trillion in additional tax reductions over the next 20 years compared to current law. To call this "revenue neutral" is both preposterous and dishonest. We will strongly oppose any plan that further expands public debt compared to current law.

2. Fairness and economic efficiency. The primary cause of tax complexity, unfairness and insufficient revenues is the fact that there are far too many loopholes, tax breaks and shelters for wealthy people and corporations. Proposals to make this situation worse—whether through still more tax concessions for investment income or through replacement of the income tax with a consumption-based tax—should be rejected. Instead, the Panel should use as a template for reform the loophole-closing Tax Reform Act of 1986, with tax rates sufficient to fund public services. The central principle of the 1986 reforms, that people and companies should be taxed on what they really earn, at progressive rate, should guide this Panel, too.

3. Tax administration. Any real tax reform proposal must not only cut back on loopholes, shelters and the proliferation of tax-based spending programs, but also reverse the decline in resources for tax enforcement. Even the best reforms won't work if they are not policed.

Citizens for Tax Justice (CTJ) is a non-partisan tax policy research group that has worked on tax reform issues since 1979. We played a significant role in the major tax reform enacted in 1986 under President Reagan. We have written extensively on the topics before the Advisory Panel, and far more details and data than can be provided here are available on our web site at www.ctj.org. My brief testimony is broken down under three headings, which are interrelated.

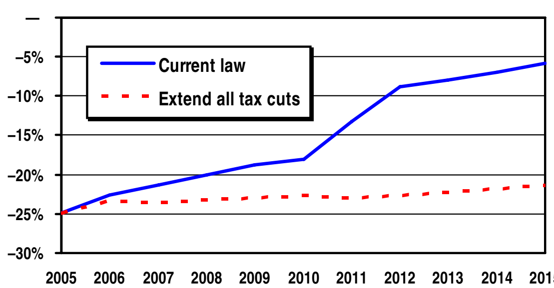
1. Revenue sufficiency—and revenue neutrality

The number-one purpose of the tax system is to raise sufficient funds to pay for public services. Our current tax code is woefully inadequate to this central task. In fact, we currently finance nearly a third of all federal outlays outside of Social Security with borrowing. To restore our nation's fiscal health, we desperately need a substantial and immediate increase in public revenues.

Unfortunately, we can't expect such responsible behavior from our current Congress and President. On the contrary, the best that we can faintly hope for is that our lawmakers will refrain from enacting even more tax cuts. In that regard, it was slightly heartening when the President promised that this Panel will be required to deliver a "revenue neutral" tax plan.

Given our current deficit mess, maintaining current revenue levels isn't anything to brag about. The latest revenue estimates from the Congressional Budget Office predict that as a share of the economy, this year's non-Social Security federal revenues (i.e., "on-budget" revenues) will be 25 percent less than in fiscal 2000 (when the budget was balanced). That shortfall, says CBO, will dwindle only slightly for the rest of the decade, with revenues as a share of the economy averaging a fifth below their fiscal 2000 level from fiscal 2006 through 2010.

% Shortfall in On-Budget Taxes as Shares of GDP in Fiscal 2005-15 — Compared to Fiscal 2000



Sources: Congressional Budget Office; CTJ. See attached tables for more detail.

Current law provides, however, that the large tax cuts enacted over the past four years—which are the primary cause of our revenue shortfall and skyrocketing debt—will expire after 2010. At that point, the revenue situation is scheduled to improve dramatically. Under current law, CBO predicts that on-budget revenues will be only 9 percent below their 2000 level as a share of the economy by fiscal 2012—and the gap falls to 6 percent by 2015.

We cannot expect the Panel to go beyond its mandate and propose the immediate tax increases that are needed to bring revenues in line with outlays right away. Conversely, however, the Panel would betray its revenue-neutral mandate were it to propose additional tax reductions beyond those provided by current law. Unfortunately, such a betrayal seems to be exactly what the Panel has in mind.

To be sure, the Panel's April 13 statement explicitly pledges to "recommend options that are revenue neutral." But it bizarrely defines "revenue neutrality" as equal to "the baseline in the

President's Budget"—that is, to include tax cuts costing $1.5 trillion (including interest) over their first 10 years and $5.7 trillion more over the subsequent decade!

To call a tax plan that costs more than $7 trillion over the next 20 years "revenue neutral" is preposterous and dishonest. If the Panel is intent on proposing gigantic new tax cuts, it should drop its "revenue neutral" charade and admit the truth. If telling the truth is just too painful, then the Panel would be well-advised to disband.

For our part, we will strongly oppose whatever plan the Panel devises if it will push our country even further into debt than is already expected under current law.

2. Fairness and economic efficiency

If you asked most Americans what's wrong with the tax system, they'd say that it's unfair and complicated because it has too many loopholes for wealthy people and corporations. Most Americans are right. For example:

- A September 2004 CTJ study of the federal income taxes paid by 275 of America's largest and most profitable corporations found that 82 of these companies enjoyed at least one no-tax year from 2001 to 2003. Overall, the 275 companies told the IRS they earned only half the profits that they reported to their shareholders, and thus on average paid a tax rate of less than half what the law nominally requires.[1]
- Due to loopholes, shelters and evasion, federal corporate taxes fell to only 1.5 percent of GDP in fiscal 2003, their second lowest level since World War II. In fact, U.S. federal and state corporate taxes are now a lower share of GDP than in any of the other OECD countries, except Germany and Iceland.
- Personal taxes on investment income are now taxed at less than half the rate paid on wages and other earnings.[2] That means that types of income primarily enjoyed by the wealthy are taxed far less than the kinds of income that most Americans rely upon.

President Bush's tax policies have played a major role in this tax shift away from corporations and the wealthy. It would be wrong-headed to continue in the same direction. So we urge the Panel to reject out of hand any proposal that would add still more tax breaks for investment income or corporate profits. Such tax deforms include, by the way, proposals to replace most or all federal taxes with a flat-rate tax on retail sales, wages or value added. These plans would slash taxes on the well off and dramatically increase taxes on low- and middle-income Americans—something the designers of the so-called "Flat Tax" have cheerfully admitted and the proponents of a national sales tax falsely deny.[3]

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[1] CTJ & the Institute on Taxation and Economic Policy, *Corporate Income Taxes in the Bush Years* (2004).

[2] ITEP, *Federal Taxation of Earnings versus Investment Income in 2004* (2004).

[3] Promoters of a *national sales tax* (or its more administrable version, a value-added tax) believe that taxes should apply only to what people spend, not what they earn. One proposal, for example, sponsored by Rep. John Linder (R-Ga.) and others, would replace personal and corporate income taxes, payroll and self-employment taxes, and estate taxes with

Instead, it is in the interest of the vast majority of Americans that the revenues we need to pay for public services be raised in ways that are both fair and economically sound. While we will never perfectly achieve these goals, there is a template that we hope the Panel will follow in moving us closer to them: the Tax Reform Act of 1986.

The first principle underlying the 1986 tax act was that people and companies should be taxed, with a few exceptions, on what they really make. That approach serves both the equity goal of treating taxpayers with similar incomes similarly and the economic goal that the tax code should not distort economic behavior by favoring some kinds of activities and investments over others. The 1986 act's second principle was that tax rates should remain graduated, so that those who have gained the most from our society pay higher tax rates than those who are struggling to make ends meet.

In designing the 1986 act, President Reagan and Congress explicitly rejected fake tax-reform proposals to expand upper-income loopholes and abandon graduated rates (for example, a flat-rate wage tax or a value-added tax), as severely harmful to most taxpayers. Those lawmakers wisely centered their reform efforts on rationalizing and restoring the taxation of business and investment income, which were (and are) the source of most of the complexity and unfairness of the tax system.

Of course, the 1986 tax act was not flawless. Most important, its tax rates were both too low to cover the cost of public services and insufficiently graduated. But that problem was addressed in the early 1990s under the first President Bush and President Clinton. Specifically, Congress increased tax rates on the very best-off taxpayers, and within a few years, we entered a brief era of balanced budgets and robust economic growth.

More recently, however, the tax reforms of 1986, 1990 and 1993 have been undermined. An array of new spending programs has been embedded in the tax code. The corporate alternative minimum tax, designed mainly to curb excessive tax benefits for leveraged leasing, has been gutted, and the rules for determining domestic (versus foreign) corporate profits have been

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a retail sales tax on everything from food, to clothing, to shelter, to health care. To slightly mitigate the extreme regressivity of such a tax, the Linder bill would provide a direct government grant to every man, woman and child in the country, designed to rebate the sales tax on spending up to the poverty level.

Proponents of the Linder bill dishonestly claim that their plan would raise revenues equal to the taxes it replaced at a 23 percent tax rate. Analyses by us and others, however, show that the actual sales tax rate would have to be about 45 percent currently and close to 60 percent in later years. And these calculations assume that such high rates would not be evaded in many cases, which is, of course, very unlikely.

Whatever rate a replacement sales tax would take, there is no doubt that it would mean hugely higher taxes on the vast majority of Americans, coupled with very large tax reductions for those at the top of the income scale. A September 2004 microsimulation analysis of the Linder bill by the Institute on Taxation and Economic Policy found that it would increase taxes by an average of $3,200 a year for the bottom 80 percent of taxpayers nationwide. The next 15 percent of taxpayers would pay slightly less than they do now, the next 4 percent would pay about $14,000 a year less, and the top 1 percent would get a staggering average annual tax cut of $227,000 a year.

Promoters of the so-called *"Flat Tax"* also argue for a replacement tax system modeled after a value-added tax. The twist in the Flat Tax is that wages and other earned income would be excluded from the value-added tax base and instead taxed at the personal level. This approach allows exemptions (based on family size) from the tax on earnings, and would thus retain a very modest level of progressivity despite the flat tax rate. The designers of the Flat Tax have admitted that their plan would be "a tremendous boon to the economic elite" and that " it is an obvious mathematical law that lower taxes on the successful will have to be made up by higher taxes on average people."

severely weakened. Personal tax rates have been sharply reduced, especially on types of income that are mostly enjoyed by the wealthy, i.e., capital gains and dividends. Aggressive tax sheltering by both corporations and well-off people has proliferated, as lawmakers have added new loopholes and failed to maintain the tax laws to curb new sheltering schemes. All of these issues need to be addressed in a real tax reform plan. (See the attached tax reform checklist for more details.)

As the designers of the 1986 tax reforms understood, income and wealth are the best measures we have of people's ability to pay taxes. Returning to the principles of the 1986 Tax Reform Act, with tax rates sufficient to fund public services, is our best hope to restore the fair and comprehensible tax system that the American public deserves.

3. Tax administration

Over the past decade, our lawmakers in Washington have increasingly delegated the administration of tax-based spending programs to the Internal Revenue Service. And they have done so without any corresponding increase in the IRS's budget. Quite the opposite, in fact. From 1994 to 2005, the IRS's total resources have been cut by more than a fifth, both in terms of employees as a share of the U.S. population and in dollars as a share of the economy. Enforcement resources have been particularly hard hit, plummeting by 40 percent by the same measures. The result has been a bonanza for tax cheaters and avoiders, and a disaster for honest taxpayers.

We need to reverse this breakdown in the ability of our government to police our tax laws. Otherwise, even the best-designed tax system will be prone to evasion and a host of unintended shelters limited only by the creativity of tax lawyers and accountants. We strongly recommend that this Panel's recommendations include not only cutbacks in the proliferation of unwarranted tax-based spending programs, but also sharply increase funding for tax enforcement.

Conclusion

In conclusion, let us emphasize that we believe restoring fairness and revenue adequacy to our tax system is essential to our nation's future. We hope this Panel decides to do a better job in helping to achieve these goals than it currently seems to have in mind.

A Tax Reform 1040 Checklist

Item	Recommendation
Income	
Capital gains	Repeal special low rate, require 1099 reporting by brokers
Dividends	Repeal special low rate
Business income (sole proprietors, partnerships, Subchapter S, rental, etc.)	Eliminate loopholes and increase enforcement (this area should be a central focus)
Roth IRAs	Repeal
Tax-exempt interest	Limit further or replace with direct subsidies
Employer-paid health insurance	Strengthen anti-discrimination rules; or replace with national health insurance
Employer pension contributions & inside build-up	This isn't going to be changed fundamentally, but anti-discrimination rules should be strengthened
Foreign earned income exclusion	Repeal; retain cost-of-living adjustments
Other income	Generally ok
Adjustments	
Half of self-employment tax	Keep for consistency with FICA taxes
Self-employed health insurance	Keep for consistency with worker plans
Keoghs & IRAs	Keep for consistency with pensions
Alimony	Keep for consistency with alimony income
Tuition deduction	Already sunsetted
Other adjustments	Mixed bag; some should be reconsidered
Itemized deductions:	
State & local income & property taxes	Keep, to better measure ability to pay taxes
Mortgage interest	Transitional issues make change difficult or impossible
Charitable donations	Keep for cash deductions; limit or eliminate double (or fake) deductions for appreciation, either directly or through AMT
Credits	If plausible, assign to more appropriate agency if still desirable as spending programs
Alternative minimum tax (individual)	Restore to original purpose by expanding the list of business and investment tax breaks covered; eliminating add-back for state & local tax deductions; and increasing and indexing exemptions and bracket points. Adjust regular tax rates to cover revenue losses and maintain progressivity
Self-employment tax	Eliminate Subchapter S loophole

A Corporate Tax Reform Overview

Item	Recommendation
Income	
Foreign vs domestic profits	Major reforms needed here (including crackdown on tax havens)
Exclusions	Repeal
Deductions, shelters, etc.	
Depreciation	Scale back; scale back further for leveraged investments through AMT
Tax shelters	Clarify law; step up enforcement
Other business tax breaks	Repeal
Alternative minimum tax (corporate)	Restore to original purpose by expanding the list of business tax breaks covered; sharply limit depreciation write-offs to deal with leveraged leasing

CBO On-Budget Revenue Projections under Current Law

Net of Refundable Credits ($-billions)

Fiscal years	Personal income tax	Corporate income tax	Estate & gift	Other revenues	Total
2005	$ 851	$ 216	$ 24	$ 345	**$ 1,436**
2006	938	226	27	368	**1,559**
2007	1,034	226	25	386	**1,671**
2008	1,124	237	26	401	**1,788**
2009	1,217	246	27	418	**1,908**
2010	1,314	249	21	434	**2,018**
2011	1,513	254	19	454	**2,240**
2012	1,685	261	43	472	**2,461**
2013	1,789	270	46	491	**2,596**
2014	1,898	281	52	510	**2,741**
2015	2,014	292	58	530	**2,894**

Shares of GDP

Fiscal years	Personal income tax	Corporate income tax	Estate & gift	Other revenues	Total
2000 actual	10.1%	2.1%	0.3%	3.1%	**15.6%**
2005	7.0%	1.8%	0.2%	2.8%	**11.7%**
2006	7.3%	1.8%	0.2%	2.9%	**12.1%**
2007	7.6%	1.7%	0.2%	2.8%	**12.3%**
2008	7.9%	1.7%	0.2%	2.8%	**12.5%**
2009	8.1%	1.6%	0.2%	2.8%	**12.7%**
2010	8.3%	1.6%	0.1%	2.8%	**12.8%**
2011	9.2%	1.5%	0.1%	2.8%	**13.6%**
2012	9.8%	1.5%	0.2%	2.7%	**14.3%**
2013	9.9%	1.5%	0.3%	2.7%	**14.4%**
2014	10.1%	1.5%	0.3%	2.7%	**14.6%**
2015	10.2%	1.5%	0.3%	2.7%	**14.7%**

Compared to fiscal 2000 GDP shares

Fiscal years	Personal income tax	Corporate income tax	Estate & gift	Other revenues	Total
2005	–31%	–17%	–34%	–10%	**–25%**
2006	–28%	–18%	–30%	–9%	**–23%**
2007	–24%	–22%	–38%	–9%	**–21%**
2008	–22%	–22%	–39%	–10%	**–20%**
2009	–20%	–23%	–40%	–11%	**–19%**
2010	–17%	–26%	–55%	–12%	**–18%**
2011	–9%	–28%	–61%	–12%	**–13%**
2012	–3%	–29%	–17%	–13%	**–9%**
2013	–2%	–30%	–15%	–13%	**–8%**
2014	+0%	–30%	–8%	–13%	**–7%**
2015	+2%	–30%	–1%	–14%	**–6%**

Note: Other revenues include on-budget social insurance taxes, excise taxes, customs duties and miscellaneous receipts (mostly Federal Reserve).

Compare: If all expiring tax provisions are extended

Fiscal years	Personal income tax	Corporate income tax	Estate & gift	Other revenues	Total	vs. current law
2005	$ 851	$ 216	$ 24	$ 345	**$ 1,436**	$ –0
2006	925	224	25	368	**1,542**	–17
2007	998	215	24	386	**1,622**	–49
2008	1,071	218	24	402	**1,715**	–73
2009	1,140	224	25	419	**1,809**	–99
2010	1,228	221	19	436	**1,903**	–115
2011	1,319	220	–10	456	**1,984**	–256
2012	1,395	222	–8	474	**2,083**	–378
2013	1,478	227	–9	493	**2,188**	–408
2014	1,563	235	–9	512	**2,301**	–440
2015	1,649	242	–7	532	**2,416**	–478

Shares of GDP

Fiscal years	Personal income tax	Corporate income tax	Estate & gift	Other revenues	Total	vs. current law
2005	7.0%	1.8%	0.2%	2.8%	**11.7%**	–0.0%
2006	7.2%	1.7%	0.2%	2.9%	**12.0%**	–0.1%
2007	7.3%	1.6%	0.2%	2.8%	**11.9%**	–0.4%
2008	7.5%	1.5%	0.2%	2.8%	**12.0%**	–0.5%
2009	7.6%	1.5%	0.2%	2.8%	**12.0%**	–0.7%
2010	7.8%	1.4%	0.1%	2.8%	**12.1%**	–0.7%
2011	8.0%	1.3%	–0.1%	2.8%	**12.0%**	–1.6%
2012	8.1%	1.3%	–0.0%	2.7%	**12.1%**	–2.2%
2013	8.2%	1.3%	–0.1%	2.7%	**12.1%**	–2.3%
2014	8.3%	1.2%	–0.0%	2.7%	**12.2%**	–2.3%
2015	8.4%	1.2%	–0.0%	2.7%	**12.3%**	–2.4%

Compared to fiscal 2000 GDP shares

Fiscal years	Personal income tax	Corporate income tax	Estate & gift	Other revenues	Total
2005	–31%	–17%	–34%	–10%	**–25%**
2006	–29%	–19%	–35%	–9%	**–23%**
2007	–27%	–26%	–42%	–9%	**–24%**
2008	–26%	–29%	–44%	–10%	**–23%**
2009	–25%	–30%	–44%	–11%	**–23%**
2010	–23%	–34%	–60%	–12%	**–23%**
2011	–21%	–38%	–120%	–12%	**–23%**
2012	–20%	–40%	–116%	–12%	**–23%**
2013	–19%	–41%	–117%	–13%	**–22%**
2014	–18%	–42%	–116%	–13%	**–22%**
2015	–17%	–42%	–112%	–14%	**–21%**

Note: net estate & gift taxes are negative after fiscal 2010 in CBO's figures if repeal is extended past 2010, perhaps due to interactions with income taxes.

Source: Congressional Budget Office with CTJ calculations.