

As Prepared for Delivery

Testimony Of
The Honorable James A. Baker, III
Before
The President's Advisory Panel on Federal Tax Reform
March 3, 2005
Via Satellite from Houston, Texas

I am honored to appear before you today and grateful for the privilege of sharing my views on federal tax reform.

Thirty years ago, presidential candidate Jimmy Carter described the federal tax code as “a disgrace to the human race.” Well, as President Ford’s campaign chairman in 1976, I didn’t often find myself in agreement with then-Governor Carter. But when it came to the tax code, he was right. And, sad to say, he would still be right today.

Our federal tax system is unnecessarily complicated, making much of it incomprehensible to anyone but specialized accountants and attorneys. It is financially burdensome to the millions of tax payers who must comply with its Byzantine provisions. It fails to reflect adequately the increasingly integrated nature of the modern global marketplace. It is crippled by special-interest loopholes that both drain revenue and undermine public respect for the law. And, perhaps most importantly of all, it is too often counterproductive in terms of promoting our vital national goals of higher investment, employment, and overall growth.

In short, our current federal tax system is in acute and overdue need of a comprehensive overhaul.

This is why I welcome this opportunity to speak to you.

If you permit me, I will focus on what I see as the broad objectives of tax reform. You will be speaking with experts better qualified than I to discuss such complex and sometimes contentious matters as the Alternative Minimum Tax or eliminating or reducing the double taxation of corporate income. Instead, I will stress certain general principles that I hope will drive your deliberations. I will also touch on the successful efforts of the Reagan Administration to forge bipartisan support for major tax reform in 1986. I suspect our experience then may prove useful today as the panel goes about its work.

The Executive Order creating this panel summarizes the fundamental principles of any comprehensive tax reform. In it, President Bush calls for proposals that would simplify the federal tax code, promote fairness, and encourage economic growth. All of these objectives are critical.

This morning, however, I would like to stress the third objective: fostering broad-based economic growth. Indeed, I see tax reform as a vital compliment to President Bush's efforts to lower marginal tax rates, reduce disincentives to savings and investment, and abolish the estate tax.

I supported the President's 2001 and 2003 tax cuts for a very simple reason. And that's because we have tried deep and broad-based tax cuts before – under President Reagan – and they *worked*. The tax cuts of 1981, I believe, laid the groundwork for nearly two decades of economic expansion interrupted by only two quarters of negative growth at the time of the 1990-91 Gulf War. And I am convinced that President Bush's tax cuts – particularly if they are made permanent – will provide a similar foundation for the long-term growth of our economy.

Let me now say a word or two about the most sweeping overhaul of our federal tax system since the enactment of the modern income tax in 1913: The Tax Reform Act of 1986. As President Reagan's Secretary of the Treasury at the time, I was deeply involved in this effort from inception to enactment.

As passed into law, the tax reform of 1986 lowered the top personal tax rate from 50 percent to 28 percent, reduced the number of brackets from 14 to two, curbed and eliminated deductions and loopholes, and completely removed six million low-income Americans from the tax rolls. But, regrettably, this sweeping reform proved transitory, as subsequent decades saw marginal rates raised and some deductions and loopholes restored. Nonetheless, the Act *did* represent genuine reform of a system that had seemed impervious to fundamental change.

What are the lessons of our experience in 1986?

First: that presidential leadership is critical. President Reagan made tax reform a centerpiece of his second-term agenda. He highlighted it in his 1984 State of the Union Address and stressed it during his successful reelection campaign later that year. Throughout the long and difficult process leading to Congressional passage, we at Treasury could count on the President's commitment to reform and his willingness to expend political capital to advance it.

Let me add that presidential leadership also serves a broader purpose, one that this panel shares. That is educating the public on the issue of federal taxation – an issue that excites more emotion than sober consideration.

Second: that bipartisan support can be decisive. The easy majorities by which tax reform eventually passed the Congress in 1986 bear witness to its broad appeal across the political spectrum. We in the Administration looked to influential Democrats such as House Ways and Means Chairman Dan Rostenkowski and Senate Finance Committee member Bill Bradley as full partners in our effort to overhaul the tax system. By so doing, we managed to avoid politicizing the issue and instead fostered a spirit of cooperation that was instrumental to our ultimate success.

Bipartisan support would seem less important today than it did in 1985-86. Then, the Congress was divided, with a Democratic House and a Republican Senate. Today, of course, Republicans are in control of both bodies. I nonetheless believe that the broadest level of bipartisan support is still desirable if only to avoid plunging the debate over reform into partisan acrimony. And the panel – with members from both major parties – is an important first step in this direction.

Third: that revenue neutrality is essential. By insisting on strict revenue neutrality in 1986 we imposed discipline on the reform process in two ways. First, we were able to remove contentious questions of overall revenue levels from the discussion. Second, we generally succeeded in limiting efforts to riddle the proposal with tax breaks for special interest groups since each loss in revenue would have to be offset.

I understand that revenue neutrality is a rather more complex issue today, with such critical matters as Congressional extension of the 2001 and 2003 tax cuts still outstanding. As I have mentioned, I strongly support making the cuts permanent. But some form of revenue neutrality will be required if the process is to force the tough trade-offs necessary to achieve genuine reform.

Fourth and finally: that a pragmatic assessment of political reality can give reform momentum. A November 1984 Treasury proposal, for instance, which limited the home mortgage deduction to principal residences and abolished itemized deductions for state taxes, went nowhere because it failed this test. Maintenance of the full deduction for home mortgage interest was one of foundations of our later successful efforts.

President Bush has made clear that he believes any reform should recognize the importance of home-owning and charitable giving. I urge you seriously to consider the President's suggestion. I realize that it is not exclusively the job of the panel to prejudge the political compromises necessary for final passage. But a basic recognition of political reality will help you shape recommendations that can survive the legislative process. This will still leave room for you to be bold and broad-ranging in your proposals.

Consider, for instance, a shift in the federal tax base from income to consumption, an approach put forward by many, but which many consider politically difficult. While I am no expert on the subject, I believe that consumption-based taxation has much to commend it and if properly crafted, a consumption tax could certainly meet the fundamental criteria of being simple, fair, and pro-growth.

In conclusion, let me again commend this panel for taking up the President's challenge to build a better federal tax system. I don't have to tell you that achieving significant reform will not be easy. Special interest groups and sheer institutional inertia will bedevil the process every step of the way. But, as our experience in 1986 demonstrates, comprehensive tax reform *is* indeed possible. I am convinced that the President is prepared to offer firm leadership. I also believe that the endorsement of such respected former Senators as the Chairman and Vice-Chairman will carry great weight with members of Congress on both sides of the aisle. So would a unanimous report by the panel.

You bring an impressive wealth of expertise and experience to these deliberations. And your willingness to serve as members of this panel is evidence of your deep commitment to good public policy. You will need all that expertise, experience, and commitment in the weeks and months ahead. I would like to thank you for taking up the daunting challenge of tax reform. And I wish you every success as you embark on your critical work.

Above all, I would urge you to keep your eyes on the prize: the creation of a simple, fair, and pro-growth Federal tax system that, in the words of the President Ford's Treasury Secretary, Bill Simon, "looks like something designed on purpose." The American taxpayer demands and deserves no less.

Thank you.

###