News from Senator

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REMARKS OF SENATOR DOLE BEFORE

THE AMERICAN BAR ASSOCIATION SPRING MEETING

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It is a pleasure to be here this afternoon to talk about taxes. Not that taxes are the most pleasant thing to discuss these days--lately every time I mention taxes I have a lurking fear that the next day I will be accused of having destroyed another industry or driven some company into bankruptcy. It's always good to know people are listening, but some of the reactions I have seen convince me to weigh my words carefully.

Taxes are always a problem: this year is no exception. The very existence of the Tax Section is an acknowledgment of this fact. But the fact that tax problems do not go away should not be any reflection on the work of the Tax Section. You have done outstanding work over the years in trying to help rationalize the tax code and focus the attention of Congress on the practical problems that too often go unanticipated in the rush of legislation. The Tax Section has worked closely with the staffs of the Senate Finance Committee, the Ways and Means Committee, and the Joint Committee on Taxation on the ongoing tax simplification project and other matters--this has proved to be a valuable working relationship, and I am sure we all hope that it continues in the years ahead.

WHERE WE STAND

For students of tax policy, 1982 should prove to be a fascinating year. Some would say that we are at a crisis point when it comes to taxes; others that we are witnessing the customary congressional flip-flops when it comes to tax policy and economic policy in general. I would not subscribe to either .iew. Rather, I would say we are witnessing a necessary reckoning in tax policy that has been coming for some time. It should not surprise anyone who has been observing tax trends over the past decade or so.

After approving the largest tax cut in history last year, why are we obliged to raise revenues this year? On the face of it it seems as though we have been working at cross purposes. But the fact is, both last year's tax reduction and this year's revenue-raising proposals were needed.

Federal taxes grew steadily during the 1970's, despite periodic tax cuts. This was largely due to rampant inflation and bracket creep, and partly due to payroll tax increases approved in 1977. By 1981 Federal taxes reached a record high of 21% of GNP. Without the 1981 tax cut, that percentage would have climbed to 24% by 1987. The results of this high-tax policy were slow growth, high inflation, and declining productivity. Clearly a major correction was in order, and that is what we got in 1981. The same analysis applies with respect to business taxation. No one disputes that inflation had caused such a wide gap between depreciation writeoffs and actual recovery costs that we were actually imposing a tax burden on capital investment. In both cases, last year's tax cut may be seen as an attempt to overcome the distortions of inflation on tax policy and economic decision-making.

Now we are in recession--hopefully close to the end of the recession. The decline in growth, and the success of our anti-inflation policy, means that we now see record deficits projected for the years ahead: sustained, triple-digit deficits that are sure to undermine any chance for long-term recovery unless they are averted. Because we must cut those deficits, and because we can't do it all on the spending side, we need to raise taxes. This is not a consequence of last year's action: the tax cut did not cause the recession, nor did the budget cuts. As a matter of fact, I would submit to you that all the recession has done in terms of taxes is <u>accelerate</u> a trend that was already there. Even without a major deficit problem, I believe we would be considering things like a stronger minimum tax, modification or repeal of certain loopholes, and steps to close the compliance gap.

The reason is simple. Last year we reduced individual tax rates and indexed them against future inflation, so that Congress could no longer count on an automatic revenue windfall. In addition, the depreciation changes, carried out several years, left little room for further reduction on the corporate side. It has always been our experience that innovative Members of Congress--and of the bar, for that matter--each year come up with a wide array of new proposals for easing taxes here or there in order to stimulate this type of activity or that, or to relieve a perceived inequity. There are many examples of this in ERTA--the above-the-line charitable deduction, the incentive stock option, and the credit for adoption expenses. But let us be candid about it--these specialized tax provisions were much easier to enact when we had a windfall in inflation revenues to divvy up.

Once we committed ourselves to major, sustained tax rate relief--as we did last year--we changed the rules of the game a bit. From that point on, it was clear that further tax policy changes could come only at the expense of eliminating or modifying preferences already in the Code, or by raising new revenues elsewhere. We had already reduced taxes more than we had cut spending. Everyone understood last year that we would have to make significant additional spending cuts in order to bring the deficit under control. The recession has magnified that problem, as well, but it hasn't changed the nature of the problem. The fact is that we have put the squeeze on both the revenue and spending sides of the budget. On the revenue side, that means we are obliged to reexamine the tax base and consider whether it is being used in an effective way.

THE TAX BASE

I need not remind this audience that, as Chairman of the Finance Committee, I am not overly fond of the concept of 'tax expenditure'. There are those in Congress who would regard any diffferential in tax rates as a 'tax expenditure' if by so doing they could keep taxes high. In addition, there is something unappealing in a free society about the notion that taxes foregone by the Government for any reason are 'spent'--as though the Government had an automatic right to all our wealth.

Still, even if we can't agree on what a tax expenditure is, we can observe what the growth of special tax preferences tells us about our tax base. According to the Congressional Budget Office, in 1967 there were 67 tax expenditure items with an associated revenue loss totalling $36.6 billion. That amounted to 4.4% of GNP. By 1981, this list had grown to nearly a hundred items, totalling $228.6 billion, or 8.0% of GNP.

One should be cautious in generalizing here, but the near-doubling of this list of tax preference items over a 15-year period does, I think, tell us something. It shows we have a 'swiss cheese' tax base: broad and solid, but full of holes. By allowing taxpayers to be inflated into higher marginal rate brackets, we not only raised taxes generally, we also facilitated their reduction in specific ways, for specific purposes, many of which have little to do with tax or economic policy per se. We consistently chose special, narrowly targeted tax breaks at the expense of general tax relief.

THE RESULT

The consequences of this policy, whether it was conscious or unconscious, have been mixed. Some would say that many special tax credits and deductions fulfill a valuable purpose, and do it well--if not always fairly. The investment tax credit and the mortgage interest deduction are often cited as examples, but even in these very basic provisions of our tax code there are clearly distortions, inefficiencies, and excesses. Other tax preferences are obviously not so good--safe harbor leasing is a prime example. In addition, good or bad, we cannot forget that the special relief must come at the expense of the general.

This has led, I believe, to much of the taxpayer resentment and frustration over the perceived unfairness of our income tax system. People do not want to soak the rich--but they are concerned to see that the wealthy pay a fair share of tax. That is why working men and women increasingly see an inequity in the availability of sophisticated tax shelters to the wealthy which enable them to drastically reduce their tax burden. Whether the existence of these shelters makes sense from the standpoint of some other congressional purpose is beside the point: when the proliferation of special tax privileges undermines confidence in the system, it is time for a change.

The system has become too complicated, too vulnerable to the charge of inequity. I do not think it is a coincidence that 9 to 16% of interest and dividend income goes unreported, or that 44% of capital gains go unreported, or that private barter transactions in the so-called underground economy are on the rise. We have a lot of explaining to do for the inconsistencies in our tax system.

HOW TO PROCEED

As the budgetary situation increases the pressure for a thorough reexamination of the tax base, we need a few guiding principles. I would suggest three: equity, balance, and simplicity. Equity, because it is important in a system of voluntary compliance to ensure that everyone pays a fair share of tax, and for taxpayers to perceive that the system is fair.

Balance, because we do not want to veer to one extreme or the other. There will still be many occasions where we will want to use tax incentives to advance a legitimate public policy goal. But we do not want to allow such devices to get out of hand, so that general tax relief is slighted and the average taxpayer foots the bill. What we need is a balance between the general and the specific, so that narrower policy goals do not undermine tax policy in general and the revenue-raising function in particular. Finally, we need simplicity because it aids our other goals--it reduces the burden of compliance, it is more efficient for purposes of raising revenue, and it enhances public acceptance and understanding of what our tax system is all about.

These three general principles lead us right into a few specifics. To increase equity and the perception of equity, we can improve our compliance record. It is difficult to explain to taxpayers why they should be asked to pay more in taxes when we are doing less than the maximum in collecting taxes already due. That is why Senator Grassley and I have proposed a package including better information reporting, a revised system of penalties, and voluntary withholding on benefit payments from qualified plans. This Taxpayer Compliance Improvement Act is far from a radical measure, but it provides enough new and improved tools for the Internal Revenue Service to help narrow the compliance gap and better ensure that the tax burden is fairly shared.

Another step we can take, in the interest of both equity and balance, is to greatly strengthen and revise the present minimum taxes. The present alternative and add-on minimum taxes simply are not effective. If we are to have a minimum tax in the interest of fairness, then it has to be effective. On both the individual and the corporate side, we need a minimum tax that ensures that every taxpayer pays a reasonable percentage of real income in taxes, regardless of other tax preferences and incentives we have provided by law. This is fair because it prevents taxpayers from avoiding tax altogether: it helps restore a balance in the tax code by ensuring that the revenue-raising function is not undermined by the proliferation of special tax incentives.

Finally, we come to the matter of specific loopholes. I believe we can greatly improve the simplicity of the tax code over time, as well as encourage the public to perceive the system as fair, by proceeding to reexamine the economic effectiveness of many tax incentives. I am not proposing a systematic or radical overhaul--I suspect that events, as I have indicated, will force us to review tax incentives in any event. The heat is already on, and we have to set priorities and stick to them from now on in the tax area as much as in the spending area. It simply will not do to shift our resources from direct spending programs to targeted tax breaks as a means of implementing national policy. There will always be room for both of those approaches, but the danger with tax incentives is that relying too heavily on them dangerously undermines the broader goals of tax policy, and frustrates our efforts to manage fiscal policy as well. We have to make choices, and we have to start making them right now.

Safe harbor leasing is not the only example of an unwarranted deviation from general tax policy, but it will serve as a good example of the problem that concerns me. When Congress approved safe harbor leasing it did so largely on the understanding that the provision was needed to balance out the capital cost recovery system, make it 'neutral' among various types of industries. But this was an illusion: extending tax benefits to loss firms is not neutralilty, it is a form of subsidy. We agreed to a provision that makes some firms better off than if there were no corporate income tax at all: and we provided windfalls for some highly profitable firms in the process, as well. The highly publicized abuses of the leasing provision have undermined public confidence in tax fairness. But they also represent a policy that was not adequately thought through from the standpoint of overall tax policy.

Besides it is not clear that leasing is even in the long-term interest of a company. I have been told that some corporate managers have been under pressure to enter into leasing arrangements just to improve short-term profit-and-loss statements. Some of us thought we were trying to get away from tax-motivated decisions and encourage business to make decisions that make long-term economic sense. Leasing appears to cut the other way.

Perhaps leasing is not the best example: we may never come to a complete agreement on the question of extending tax benefits to firms (or individuals for that matter) that are not making a profit. Some of us would urge extreme caution in this area, on the theory that tax incentives are by their nature designed for affecting the decisions of profit-making enterprises or individuals with real income. If we want to assist companies in a loss position or individuals in poverty, the tax code may not be the best place to turn. But the safe harbor leasing problem does tie together the principles I suggested--equity, balance, and simplicity--and it is the kind of tax policy decision that we ought to be more cautious about in the future.

Another example of the kinds of inequity we need to address is the tax break we allow for contributions to private pension plans. To allow over $45,000 to be set aside tax-free each year may be hard to justify in a time of fiscal austerity. That kind of over-generosity just undermines confidence in our tax system.

Fortunately, the President appears to agree with this view of the general direction we have to take. Now that it is conceded that we need to raise revenues, the administration has endorsed steps to narrow the compliance gap. It has proposed a number of loophole-closings of its own, including restrictions on use of industrial development bonds, cutting back on use of the completed contract method of accounting, and revising the taxation of the insurance industry. The administration also endorses a much stronger corporate minimum tax, and has conceded the need for at least some equitable adjustments in safe harbor leasing. All of this means that we are likely to make progress this year in the areas I have outlined.

The Bar Can Help

I am sure that the sweeping tax changes of last year, followed by a wholly new set of signals this year, has been somewhat bewildering to members of the bar as it has been to the entire tax community and the public at large. But I think you will agree that many of the changes made last year were long overdue. I think you will also agree that the fresh scrutiny of existing tax provisions is needed, and is likely to lead in the long run to a better and fairer tax system.

You have an important role to play. It is in your interest, and in the interest of your clients, to have some confidence of what the rules are, and to have them fairly and consistently enforced. It is also in the interest of the bar to maintain strong public support for our system of voluntary compliance.

I have already mentioned that the Tax Section performs a valuable role in working with the Congress and the Executive to help fashion tax legislation that will be clear, fair, and comprehensible. The simplification project is a perfect example. But you also have an important function in educating the public. You keep abreast of legislative and other developments within your profession--but you also provide an important line of communication to the public through your daily contacts with clients, through your conferences, seminars, and publications. You are in a position to gauge the public's attitudes towards taxes, and to help them understand better what the thinking is in Congress.

These lines of communication are more important now than ever. I sense both in the Congress and the public a growing sense of frustration over our tax system, and a growing desire to make radical changes. The concept of a flat-rate tax, of a gross income tax, or of shifting to a consumption or other tax base, all are being seriously discussed as never before. In fact, I have indicated that the Finance Committee may review the flat-tax idea--our tax system demands a fresh   There is a universal perception that our tax code has gotten too complex, too diverted to peripheral matters, and that fairness has suffered as a result. People are less confident that a progressive tax system really is progressive.

Unless we, the Congress, the bar, and the tax community in general deal with this problem, we risk forfeiting control over tax policy. I do not fear that will happen: Congress has already reasserted control over tax policy by the simple act of removing the 'automatic pilot' of inflation that distorted things for too many years. But it will take a concerted effort to restore public confidence in the tax code as a fair and straightforward device for raising revenue to meet the needs of our people. We hope to begin the effort to restore that confidence in the tax legislation we put forth this year. We need your help, and we look forward to working with you to achieve the goals I know we share.

Thank you.