



## **DEPARTMENT OF THE TREASURY**

### **OFFICE OF PUBLIC AFFAIRS**

**Embargoed Until 12:30 EST**  
**November 18, 2004**

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**Samuel W. Bodman, Deputy Secretary of the Treasury**  
**Remarks before the Tax Foundation Annual Conference**  
**November 18, 2004**

Thank you very much, Scott. I'd like to thank you and the Directors of the Tax Foundation for inviting me to be here today.

For nearly 70 years, the Tax Foundation has committed itself to independent research on tax policy and has developed a reputation for principled, high quality analysis. You deserve the thanks of every taxpayer, and Secretary Snow and I look forward to your continued good work.

As you are no doubt keenly aware, President Bush has made it clear that fundamental tax reform will be a key priority of his second term. During his nomination acceptance speech in New York and on several occasions since, the President has outlined his goals for tax reform, including simplifying the tax code, increasing long-run economic growth and job creation, and ensuring that taxes are applied fairly. He has also indicated that reform should be revenue neutral and, among other things, should recognize the importance of homeownership and charitable giving in our society.

The President will soon appoint a bipartisan panel to advise the Secretary of the Treasury on options to fundamentally reform the tax code to achieve these goals. While it is premature to speculate on who may serve on the panel or what their product might be, we at the Department are looking forward to the panel's deliberations and to receiving their guidance.

I will discuss the President's rationale for tax reform in more detail, but first let me say that we have a solid foundation on which to build this effort. Since coming into office in 2001, the President has proposed and signed into law a number of tax revisions that strengthened our economy in the short-term and will encourage more robust growth in the future.

The tax cut packages in 2001 and 2003 reduced marginal individual income tax rates by between 3 and 5 percentage points. Lower income tax rates advance one of the President's key reform

principles – increasing long-term economic growth – by increasing the after-tax rewards from work, saving, investment, and entrepreneurial activity. Lower rates also reduce the incentives to engage in sheltering or tax avoidance activities and increase compliance.

In addition, the 2003 tax cut also took a significant step toward eliminating the double tax on corporate income. This important tax change reduces a number of economic distortions that interfere with the productive use of our nation's resources.

As you will recall, the President proposed complete elimination of the double tax on corporate profits. While the legislation enacted in 2003 falls short of complete elimination, the maximum tax rate on dividends and capital gains was cut to 15 percent, which significantly reduces the double tax.

This tax cut reduced the tax bias against investment in the corporate sector of the economy, improved the neutrality of the system in its treatment of different forms of business organization and stimulated savings, investment and capital formation, which in turn will raise output and living standards in the long-term.

Importantly, the tax packages in 2002 and 2003 implemented partial expensing for business plant and equipment. They also increased the amount of investment small businesses are allowed to expense – from the previous limit of \$25,000 to \$100,000. These temporary provisions addressed a weak spot in the economic recovery – low corporate investment – at a key point in time, and helped keep the economy on the road to recovery.

Other important changes, enacted in 2001, included significantly expanding retirement saving incentives by raising contribution limits and indexing those limits for inflation. In addition, the 2001 tax cut also implemented a phase-out of the estate tax. The estate tax adds to the tax burden on investment returns accumulated over a lifetime, which reduces the incentive to save and invest, especially in closely held businesses.

The tax cuts adopted during this Administration have also made important improvements in fairness and simplification . . . by reducing the so-called “marriage penalty,” for example. Married couples have benefited from expansions of the standard deduction, the 15-percent tax rate bracket, and the Earned Income Tax Credit. Lowering tax rates also helped reduce marriage penalties. In 2004, the combined effects of the tax cuts have reduced marriage penalties by over \$15 billion. Marriage penalties have been eliminated for about 7 million couples.

Another significant step in tax simplification occurred this year when Congress passed an Administration proposal that affects over 50 million taxpayers with children. Taxpayers with children are eligible for five different tax benefits. And, though it may be hard to believe, each previously had a different definition of an eligible child. Taxpayers had to carefully check complicated rules for each of the separate benefits to determine if their child qualified. Not surprisingly, this resulted in taxpayer confusion and errors. In 2002, the Administration proposed replacing the diverse definitions of a child with a standard definition. This year, the proposal was enacted.

A few words about the American Jobs Creation Act, signed by the President last month, which included important reforms regarding the tax treatment of foreign earned income and tax administration relating to tax shelters. The Act made dramatic and much-needed changes that will help ensure that the foreign tax credit will operate as intended, so fewer U.S. businesses will be subject to double taxation on their income earned in foreign markets. Other changes better focus the U.S. rules regarding taxation of passive income earned abroad so those rules do not impose an inappropriate burden on U.S. businesses - a burden, I should add, that is not borne by their competitors from our trading partners. These international tax reforms will help U.S. businesses and American workers to compete on fair terms in the global marketplace.

The Act also included several provisions that will strengthen the IRS' enforcement capability with respect to potentially abusive transactions. It provides consistent, simplified rules for disclosure, registration and list-maintenance. For example, it requires that the same information about a questionable transaction be provided to the IRS both by the taxpayers participating in these transactions and by the promoters and their advisors, who also are required to maintain lists of investors. The law also imposes meaningful penalties on taxpayers and material advisors who fail to disclose transactions.

One of the primary goals of these rules is to provide certainty. Clearer disclosure rules, without exceptions and perceived loopholes, will be easier for taxpayers and their advisors to apply, harder for taxpayers and their advisors to manipulate, and easier for the IRS to administer and enforce.

While these tax law changes have made important improvements to our system, there is much more to be done. One top priority is making the President's tax cuts permanent. Under current law, the general tax rate cuts and the elimination of the estate tax expire at the end of 2010. The lower tax rates on dividends and capital gains expire at the end of 2008. The \$100,000 expensing limit for small businesses expires at the end of 2007. In order to provide a stable tax environment for American families and American businesses to plan for the future, these tax changes must be made permanent.

In addition, as I mentioned at the outset, the President has made clear the crucial need for fundamental reform of the tax system. Our system is widely perceived as complex, unfair, and easily manipulated. The resulting loss of faith in the code threatens voluntary compliance - a foundation of our system.

Complexity in the tax code results from the myriad incentives in the form of targeted deductions and credits, the tax treatment of capital income, the tax treatment of business income, and the Alternative Minimum Tax (AMT). The complexity is growing rapidly, not only because of new and frequent changes to complex provisions, but also because of the expanding reach of the individual AMT. By 2010, 34 million taxpayers will be affected by the AMT compared to 3.5 million today.

Both individual and business taxpayers spend enormous amounts of time and money filling out their tax returns. It is estimated that taxpayers spend 6 billion hours each year to decipher the tax rules, maintain records, and fill out returns. One reasonable estimate places the costs of

compliance at \$120 billion annually. This is nearly 13 percent of the amount of revenue collected by the tax, which is much too high. And this figure doesn't include any adjustment to reflect the frustration and annoyance experienced by taxpayers! Many turn to professionals for help – about 75 million individual taxpayers, including many with relatively simple tax returns, use paid preparers to fill out their returns.

The current tax system also imposes large costs on our economy by causing households and businesses to rearrange their affairs in ways that make poor use of economic resources, and ultimately lead to lower living standards. Taxpayers and businesses spend countless hours trying to figure out ways to minimize their taxes, with some going so far as to purchase tax shelters.

The tax system also influences important economic decisions. When people make decisions about whether and how much to work, save, or invest because of the tax system rather than economic fundamentals, resources are allocated inefficiently. By minimizing these economic inefficiencies, fundamental tax reform potentially could raise Gross Domestic Product and increase the capital stock substantially.

Understanding the short-comings of our current tax code helps set the stage for fundamental reform. As I mentioned earlier, the President has set out several objectives in this area. The first is that the tax system should be simpler. This means that it should be easier for taxpayers to understand. It means that complying with the tax system should be less onerous. Tax forms and instructions should be shorter and less complicated. It also means that the cost of administering the tax system should be reduced.

Another principle specified by the President is that tax reform should foster economic growth and job creation. Economic decisions need to be based on economics rather than the tax code. This also means that the tax system should be structured to maintain and enhance the international competitiveness of U.S. businesses in a rapidly-changing, highly competitive global economy.

The President also has stated that the tax system should be fair. Progressivity is one attribute that is fundamental to fairness in taxation. As you know, our current tax system is highly progressive. The top 50 percent of taxpayers (ranked by income) pay 96 percent of all individual income taxes. I should note that the President's tax cuts have actually increased the share of income taxes paid by higher income Americans. The top 1 percent of Americans would have paid 30.5 percent of all individual income taxes without the tax cuts, but now pay over 32 percent. The bottom 50 percent of taxpayers now pays a smaller share – 3.6 percent of all individual income taxes with the tax cuts, instead of 4.1 percent without the tax cuts.

Fairness also means that the tax system should be transparent. Too many people perceive the tax system as unfair – believing that their neighbors are able to reduce their taxes through a maze of loopholes and clever tax planning. The smooth and efficient functioning of our tax system depends on a high level of voluntary compliance. But, voluntary compliance erodes if taxpayers come to believe that others are getting away with something that they are not.

The President also has said that any reform needs to get the incentives right, recognizing, for example, the importance of homeownership and charitable giving in our American society, which receive favorable treatment in our current tax system.

We believe that by reforming our tax code along these lines, we will create a better, fairer, simpler system that will diminish the appetite for future frequent change. As we all know, frequent changes to multiple provisions make the code even more difficult to administer and even more confusing for taxpayers to deal with. I suppose one might imagine (or dream of!) a tax system that is so obviously perfect and enjoys such widespread support that Congress could not possibly consider changing a single provision! We are not so confident as to believe that we will achieve such a state of flawlessness, but, we are certainly looking at ways to improve the stability of the system.

One of the key challenges in approaching tax reform is confronting the misperceptions that surround our system. A big part of the tax reform discussion in our country for the past several years has been around whether we should have an income tax or a consumption tax. Many people approach that issue believing that we now have an income tax. That may be partly because we call our tax an income tax. But, in reality, we have a hybrid tax system with some elements of an income tax, some elements of a consumption tax, and some elements that are neither.

The fundamental difference between an income tax and a consumption tax is that an income tax taxes the return to saving whereas a consumption tax does not. Our current so-called income tax includes several vehicles that effectively allow savings to escape taxation, primarily pensions, 401(k) accounts, and individual retirement accounts, or IRAs. Thirty five percent of household financial assets are held in these tax-favored vehicles, receiving tax treatment consistent with a consumption tax, not an income tax.

A related point: Some people also believe that our major trading partners depend substantially on consumption taxes – their value added taxes – and we do not. While we do not have a value added tax or significant consumption taxes at the federal level, our states rely heavily on sales taxes. In total, over 12 percent of tax revenue in the U.S. is derived from consumption taxes. This is lower than our trading partners – most of which rely on consumption taxes for between 20 to 30 percent of total revenue – but still significant.

One thing we do know is that achieving fundamental reform of the tax system will not be quick or easy. Nonetheless, this is extremely important work . . . and President Bush is committed to taking it on. The improvements that can be achieved through tax reform – simplification, reduced compliance burdens and costs, increased economic growth and output, and increased confidence in the system – make it well worth the effort and difficulty.

To be sure, there will be many obstacles to overcome. Almost every element of the current tax system is supported by some influential interest group that will argue calamity from its elimination or revision. There is an old saying that “an old tax system is a good tax system.” The people who know the current tax system and have figured out how to cope with it, fear the changes that might come in a new system. But another statement from a wise tax legislator says:

“we ought to have a tax system that looks like someone might have adopted it on purpose.” Our tax system currently does not come close to passing that test. We can and should do better.

As we go through this process, I am hopeful that groups like the Tax Foundation will contribute to and support our efforts. By working together, I believe that we can improve our tax system in ways that will make our lives easier, make our businesses more productive, and allow our economy to flourish.

Thank you.