

Center for American Progress



SPECIAL CONFERENCE PRESENTATION:

“OPTIONS FOR TAX REFORM”

PANEL I: COMPREHENSIVE REFORM

SPEAKERS:

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SECOND CONGRESSIONAL DISTRICT, PENNSYLVANIA**

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MR. JOHN IRONS: – I would like to thank everyone for coming today. My name is John Irons, and I am the director of tax and budget policy here at the Center for American Progress. I think we have a very good lineup of policy experts to talk about tax reform today. Tax reform seems to be a perennial issue – leaping to life in the spring. Then going dormant, usually sometime in November, and then rising again the following year.

President Bush last year recognized the importance of tax reform when he established a presidential panel to develop options. And one of the panel members, Elizabeth Garrett, will be here later today. Many members of Congress, on both sides of the aisle, have offered reform options. And we are pleased to have Representative Fattah here with us as someone who clearly recognizes the need for tax reform.

The president's tax reform panel released their recommendations late last year, but the Bush administration appears now to have backed off of tax reform. And instead they are calling for extension of the tax changes set to expire in 2010. However, it is essential that the reform issue remain in the forefront of the policy debate. Policymakers of all stripes need to take up the call for reform and put forth positive ideas for change, and that is what this conference is all about. We have asked leading academic and policy experts to come here today to present concrete options for reform. We'll hear about proposals to scrap the current tax code and start anew. We'll hear about proposals to simplify the tax code. We'll hear about proposals to enhance work incentives and to strengthen supports for college education. We'll hear expert opinions and analysis of changes both major and minor. But overall you'll hear that the current tax code can be improved and that it needs to be improved.

But before we get into substantive issues, let me take care of a couple of pieces of business before we really start. First, the Center for American Progress is committed to providing an open, nonpartisan forum for ideas. And while you can never take politics fully out of policy, the conference today is firmly about policy options and not about political candidates. Second, many of the papers that will be discussed today are preliminary and are subject to revision. In fact, part of the goal of this conference is really to subject proposals to better scrutiny and really hope to strengthen the proposals going forward. Finally, the proposals presented today do not necessarily represent the position of the Center for American Progress.

Now, let me turn to our first panel. A bit of ground rules for the session and I think we're going to try to hold to this throughout the day. We've asked each panelist to be brief in their remarks. Since we have a good, crowded agenda throughout the day, we want to get as much good material in as we can. Obviously, the tax code is a very complicated beast and doing 10 minutes per person on reforming the entire tax code simply doesn't do it justice, so I refer everyone to a bluebook which is at the back of the room and you can hand out copies as well, which contains copies of all the papers that were presented during the course of the day today.

The speakers on the first panel have all been involved in developing far-reaching tax overhaul proposals. They include Representative Fattah of Pennsylvania; Maya MacGuineas, the director of the Fiscal Policy Program at The New America Foundation; Van Doorn Ooms, a senior fellow at the Committee for Economic Development; Paul Weinstein, the chief operating officer of the Progressive Policy Institute; and myself on behalf of the Center for American Progress. Full bios for all the participants can be found in the Bluebook as well towards the end; not just for this session, but for all the sessions that we have here today.

And after the congressman speaks, we'll proceed roughly in alphabetical order – exactly in alphabetical order. Bill Gale of the Brookings Institution will then comment before we open up to questions both from the experts on the panel as well as from you in the audience.

Leading off the panel is Representative Fattah. The Congressman has for the last 12 years represented Pennsylvania's Second District, which includes much of Philadelphia. He's been a strong leader on education issues and currently serves on the House Appropriations Committee. His legislative achievements include GEAR UP, the College Completion Grant program, Project GRAD and the Youth Opportunity Grants program. On the tax side, he's been promoting and will discuss today a broad tax reform plan called the Transform America Tax Fee – Transaction Fee. And let me say, I wish all members of Congress were as aggressive at promoting tax reform. The congressman has not only laid out his ideas conceptually, but he's submitted legislation, presented his reform to tax-writing committees, submitted his plan to the president's tax reform panel, requested several analyses from the Congressional Research Service, and has taken his campaign to the media and to the public. I sometimes feel bad for his tax staff, who must have to work on this issue 24/7. And you can see all the materials, I believe, in a packet of materials that he has left at the front of the room here. Frankly, I wished all of our elected officials were as committed to improving the tax code as the congressman.

Would you like to start us off?

REP. CHAKA FATTAH: Well, thank you very much. Let me thank everyone for being here bright and early in the morning to talk about a subject that has for far too long been neglected at least in terms of action here in Washington. There's really been – we've had the income tax for close to 100 years, and I think we know now that the country's progress is going to be dependent on us thinking anew about how we generate revenues. We have a national debt that we just raised the limit on to \$9 trillion, we have annual deficits of hundreds of billions of dollars, and we have unmet needs in the nation whether education or healthcare or in terms of homeland security that if we began to address would cost us additional hundreds of billions of dollars; and if we don't address them, they harm our nation and our opportunities to move forward. So the need to generate revenues is one that I think that is obvious for a variety of reasons.

We have a tax – a revenue generation system now that has significant problems with it. The GAO did a study not too long ago that showed that 62 percent of all businesses in our country paid no taxes over a five year period. We see through the report of the Joint Committee on Taxation that there are thousands of Americans who are earning a million or more who paid – had no tax liability under our present code. We have significant schemes that promote evasion of the present code.

So I have a – I put forth an idea that is not at its heart just a tax reform proposal. It really is a proposal to transform our country; that is, to take the opportunity to reform our revenue-generation mechanism and use it to deal with some of the longstanding problems that country faces, including the question of educational inequality in our states, by eliminating the income tax, the corporate profit taxes, the capital gains tax – eliminating all of the federal tax code as we know it now and replacing it with a transaction fee: a fee on transactions.

We have each year close to \$800 trillion of transactions that move through our federally regulated banking system. These transactions are protected through our court system and regulated through various mechanisms in our – and governmental apparatus. In fact, we have the most transparent transactions of any economy anywhere in the world and we could quite easily generate, based on the research of the Congressional Research Service at a revenue-neutrality number, you know, for less than half of a percent on each transaction; that is, eliminating some transactions that would be too sensitive for purposes of a fee where that will cause us challenges particularly in terms of the financial markets. But just looking at the transactions that take place in our economy, we could have a much simpler approach. We would not have the need to audit Americans – threaten them with all types of legal actions, provide a burden on them to divulge their most private financial details. We could just take dollars and transactions that move through our economy and exact a small fee.

Now, my suggestion is not one of revenue-neutrality. I suggest that we look first at what the fee would need to be for a revenue-neutral basis, but that the Congress be presented with a menu of escalating fees that could address some of the other problems that a country faces. And I lay out some of them, like paying off the national debt over a period of time so that we don't have our children and grandchildren saddled with debt. And most particularly that we don't continue to have to pay enormous interest fees or have foreign investors showing up at our Treasury auctions. And if they didn't show up, it would cause us even more problems than when they do show up.

So we have a host of needs for revenue that I think there's a better way to get at it than we're doing now under the present tax code. And I think that the realities of this as we go forward as a nation is as much as we have built a great country, relative and in comparison to others in the world, on the revenue-generation mechanisms we have in place now, it's clear, especially given the political rhetoric around taxation issues, that we're not going to be able to address this nation's needs in terms of education and healthcare, homeland security, and the like unless we create a different mechanism in

which we can have a more transparent, simpler tax system in which it was clear that people were paying their fair share.

And the easiest way I think to get at this is to look at where the opportunities are. And as I understand tax policy, it is without contradiction that the broader the base of taxes, the lower the rate. And if we can lower the rate, we can lower the political rhetoric. We can generate the revenues that we need so that we can move our nation forward.

So that's really my proposal. It's one of reforming the tax code, but using that opportunity to really transform our country in ways that would be meaningful and in which we can build a consensus around a system of generating revenues in which everyone would be clear by paying a very small fee on each transaction. And I think I use the word "fee," you can use the word "tax," they're exchangeable, but the reality of this is that for the most part if you look at just transactions a million and over each day in our and through our federally regulated banking system – and there're billions in transactions outside of the federal revenue – Federal Reserve banking system that could also be easily tapped. We could also address some of the problems of financial activity that's outside of the scope of our present ability to collect taxes on them, and you'll see a letter from Chairman Bill Thomas, who speaks on particular about the fact that we may be able to capture revenues through this mechanism that are now outside of our opportunity to collect revenues on them.

So there's a lot of money changing hands every day, every second, and for a small fee, we could run this country. In fact, we could improve it and have it move closer to its potential than it presently is.

So thank you for having me. I look forward to the question and answer session.

MR. IRONS: Thank you.

One of the advantages of having your last name begin in the first half of the alphabet is to get to go first on a lot of these panels. So I believe I'm next in line alphabetically and then we'll move along down the path here.

Last year, the Center for American Progress put out a tax reform proposal. I am rather proud that we came out before the president's panel was announced, so we jumped the gun a little bit in terms of proposing reform options. Let me run through a little bit of the details of what we proposed last year and talk a little about the current situation that led us to propose these changes. You'll see that there's a PowerPoint, which would be shown on these monitors as I go through some of my main points.

The starting point for, I think, any broad tax reform plan is to think about the broad principles. And the broad principles that we use are fairness, simplicity, and opportunity in economic growth. Now these are nothing new or nothing different. In fact, virtually every tax reform plan oftentimes starts with these three big basic principles.

I think most people on this panel will use these same three things. I believe the tax reform panel start with these same three principles. If you ask Dick Armev when he talked about his flat tax what does it main principles are, he'll say these same things. The key really is how you implement these ideas.

Let me first turn to the current situation and lay out a little bit of where we are now. First, on the current policy, it's seems to be the case that the system has become unfair, complex, and I'll call irresponsible. And let me explain what I mean by these three things.

Unfair: the tax system has shifted the burden of taxation away from the highest income earners. For example, those with the greatest income or people with incomes greater than \$1 million got more than \$100,000 in tax cuts in 2005. I think you can ask yourself whether or not you got a \$100,000 worth of tax cuts in 2005, and I think for the vast majority of people – we know for the vast majority of people, that's not true.

Second, the tax system has shifted away from the progressive federal income tax onto the regressive payroll tax and I'll elaborate that in a second. But in 2000 – this was several years ago – 70 percent of households paid more in payroll tax than on the income tax and the percent would likely be much greater today since the federal income tax has dropped significantly while payroll tax has not changed. Finally, the tax system has shifted away from wealth and onto work. You've seen decreases in the capital gains and dividends tax rates while we see other tax rates staying the same or – yeah, staying the same.

To put this into stark contrast, if you consider a millionaire, they currently pay 15 percent on the income earned from their capital gains and dividends, so the income earned from their previously accumulated wealth they taxed at 15 percent. If you consider that an average middle class worker and look at how much that they have to pay on the tax on their labor income. If you're in, say, the 15 percent tax bracket, you pay 15 percent, you then pay 6.2 percent payroll tax, your employer then pays 6.2 percent on your behalf and then there is another 2.9 percent combined payroll tax for Medicare. So if you add all these things up, you can easily be more than twice the 15 percent the millionaire pays on income from his previously accumulated wealth.

This illustrates the point, I think, a little bit more dramatically. This chart I realize is probably a bit hard to read. The top line represents the revenue generated from individual income tax as a share of gross domestic product. And if you look at over the last 50 years, that share has been roughly constant. The second line is the red line on the graph represents the payroll tax, primarily the payroll tax, social insurance and retirement taxes. And you can see how there's been this dramatic increase in revenue that is raised from this particular source. And you can see that if you look at the current period roughly the payroll tax and the individual income tax are of roughly the same magnitude in terms of how much revenue that is generated.

On the complexity side, there're several ways that the income tax have become more complicated. The first is the alternative minimum tax. The alternative minimum tax is something that most Americans don't really have any handle on what it is, it doesn't apply to them and it's simply no big deal. However, if you look at what things might be like in 10 years if you don't change the law, you'll see that well over 30 million people by 2010 will face this complicated tax. It's basically a second layer on the current tax system and makes the code much more complicated than it is already.

A second complexity is important because it can allow corporations and individuals to avoid tax. And even if it doesn't allow them to avoid tax, I think it's perception that someone else is taking these credits; someone else is taking advantage of these deductions. I'm not getting my fair share. And so complexity in the code can really add to the perceived unfairness of the system. So really the fairness and complexity points are two sides of the same coin.

Finally, the system of deductions and credits is unnecessarily complicated. I think we'll hear quite a bit from the other panelists today about how we can simplify the tax code in a number of these areas. Looking at the number of retirement saving plans, you got 401Ks, IRAs, Roth IRAs, simple plans, et cetera, et cetera. Same is true with supports for higher education. Susan Dynarski will talk about some of those plans later in the day. One of the most stark examples in my mind of the complexity of the tax code is when you look at the lower end. Look at the earned income tax credit. About 70 percent of earned income tax credit recipients filed taxes with a paid preparer. This is a group of people who could not afford to pay an extra \$100 or whatever it costs to file their taxes, yet the code is so complicated they feel the need to pay this extra or to bear this extra burden.

Finally, I think on responsibility side, I think the congressman was right: we see an enormous increase in the national debt. We're up to – the debt limit is up to \$9 trillion now and if you look over the next 10 years, there's no real sign that we're going to bring the deficit situation under control. If you look at longer than that, we can very much expect the deficit to explode as the baby-boomers retire, as medical costs really skyrocket when that happens.

So let me turn now quickly to the Center for American Progress plan and let me outline some of the major provisions. I'm only going to be able to touch on these right now, but, again, more on the details are included in the bluebook and some other publications that we have, and some of those are at the back of the room here. So first on the fairness front, and you can kind of guess where I'm headed with this. First, you want to remove extensive preferences for income from accumulated wealth and so for the very top end we would equalize the tax rates on capital income with the tax rates on ordinary labor income, so that means that the dividends and tax – the dividends tax rates and the capital gains tax rate would be set at the ordinary income tax rate.

Second, as you can guess, we would reduce the dependence on the regressive payroll tax. We do this by removing the employee's share of the Social Security payroll

tax, which is effectively cutting in half the payroll tax for most people. Now, as I mentioned before, since the payroll tax is the more important tax – the bigger tax on most people, this represents a significant tax cut for a large share of people. We would remove the cap on employer's side in order to make the payroll tax more progressive. And we'd also enhance the take-home pay of lower and middle-income tax payers by realigning the rate structure. Particularly, we would set the number of tax brackets to just three. We have a tax bracket of 15 percent, 25 percent and 39.6 percent. This might seem (suddenly?) high, but remember we're eliminating 6.2 percent on the payroll tax side which offsets any of these increases for most people. We'd close corporate and individual tax loopholes and we'll eliminate the alternative minimum tax. This is very expensive. If you look at the cost of eliminating alternative minimum tax, it's about \$1.2 trillion over the next 10 years. And to really – to do this right, to take the alternative minimum tax problem correctly, you really have to look at an overall restructuring of the tax code in order to raise enough revenue in order to ensure that there's fairness in the system.

Finally, we'd increased economic opportunity and growth. We take the first step toward restoring fiscal discipline by raising revenue by nearly \$500 billion over 10 years compared with Bush's policy if you assume that he extends tax changes. And we'd also increase the number of people who receive the child tax credit and allowing those with incomes as low as \$5,000 per year to receive the credit. This would mean that significantly more people would be able to receive the child tax credit.

In terms of the distributional implication – I'm sorry, it's probably nearly impossible for people to read this table on the chart, but again it's in the bluebook as well. The bottom line is that about 70 percent of the population would receive a tax cut under this plan, averaging about \$600 for people with incomes under \$200,000. If you are doing extremely well, you'll not like this plan most likely. We see that we will reverse most of – more than all of the Bush tax cuts for the top income groups. And so the revenue that is raised in the system primarily comes from those people who have benefited the most from the economy in recent years.

So let me sum up by saying that the tax code as it exists today is not working as it should. We're not funding our national priorities adequately. We're not raising revenue fairly. The American Progress plan reverses many of these harmful trends of the past several years and makes significant changes which will benefit the middle class. We clearly need a more modern, fair, and simple tax plan.

Maya?

MS. MAYA MACGUINEAS: Thank you. Is this on? Can you hear me? Okay. Thank you for holding this conference today.

The starting point where I'm going to begin is probably with the one that most people share, but it's that taxes will go up. And in recent months and years, much of the debate has been on whether taxes should go up or whether they should go down in fact.

And I think hopefully we'll quickly move past that discussion because no matter how we reform the nation's entitlement programs, which we will have to reform, there will still not be sufficient revenue in all likelihood to cover those costs. So it becomes increasingly important that your tax structure is one that is more efficient because the higher taxes are, the more inefficiencies are created. So you really want to get the right tax structure in place. We'll probably all agree that clearly we are not there right now.

So to that point, the New American Foundation has developed a five-part tax reform plan. Ideally, it would be taken comprehensively. I think comprehensive tax reform is what's in order given where we are right now. It's been a number of decades since we had fundamental tax reform and I think certainly thinking about what the ideal tax system would look like is the most useful exercise there is right now. That said, political realities are these things often get watered down and so this plan is also developed in a way that you could take any one of the five pieces and implement them incrementally and it would still hopefully be a dramatic improvement over what we have right now.

So to go over those five pieces, the first one would be to actually replace all of the payroll tax – the largest tax paid by most American taxpayers – and replace it with a progressive consumption tax. So the payroll tax suffers from multiple shortcomings: it's regressive, it punishes work, it's anti-business, it's anti-family, it's make no accommodations for different family sizes or situations. And while the payroll tax is bad now, it will get so much worse on the course we're on where it's the payroll tax that funds these entitlement programs that are going to be largest growing area of the budget.

So what we've recommended is that you eliminate the entire payroll tax and replace it with something called the progressive consumption tax which would be a tax on everything you spend in a year; not what you earn, but basically your consumed income – everything that is spent. But instead of flat tax rates, which is how most consumption taxes tend to work, it would have progressive tax rates. So just as an example, you might pay zero taxes on your first \$15,000 of spending and then 10 percent rate on everything you spend from \$15,000 to \$40,000 and increasing rates above that. You would set the rates and the amounts according to your distributional and revenue goals.

Just because I get this question a lot, you could do this change either as part of Social Security reform; you could reform the entire Social Security system at the same time, because we'll have to adjust benefits; or you could do it separately and still give people Social Security benefits based on their wages: what their contributions would have been under the current system, for instance.

The second recommendation which we have is looking at the corporate income tax and how most – how best to fully integrate it with individual income tax; something we've seen some progress on recently. But in return for integration between the corporate and individual income taxes, we believe you should tax all income at the same

rates. So wage income, capital income should all be under the same rates. There are a number of ways to do integration; all of them sort of suffer from their shortcomings.

Ideally in my mind, I would get rid of the corporate income tax based on that basic premise that corporations don't pay taxes, people do, and making the tax code as transparent as possible is good for both budgeting and in understanding of how much it costs to raise – how much money we raise and how much it costs to do the things you do in this country. There are real challenges in getting rid of the corporate income tax because it opens up a number of loopholes but there are sort of four different major ways you could look at integration. I think they should all be pursued or considered, but in return for that you need to tax capital income at the same level as other wage income.

Third, tax expenditures. The way that we do budgeting now is almost solely through the tax code. We don't really spend money in this country anymore. We do targeted tax cuts for just about anything. And I think we've really reached the limit of the use of targeted tax cuts. If you want to spend a dollar on child care or education or the environment, we should actually be willing to spend that dollar. There's nothing wrong with just spending it. As a result of what we've done, we have a tax base that's so complicated – and when people talk about complexity, they assume that has to do with having tax rates – a number of tax rates. It really doesn't matter if you have one tax rate or three tax rates or 20 tax rates in terms of complexity when you compare that to tax base that we currently have.

So our recommendation is to get rid of or alter as many of the tax expenditures that we currently have in the tax code both to simplify the system, but also because this is a highly, highly regressive way of delivering benefits in our society. So contrary to the popularity of things like the home mortgage interest deduction or the exemption for employer-based healthcare, I would say don't mend them, end them. I would like to scrap as many of the tax expenditures as we have and really broaden that base like we did in 1986.

Fourth, the estate tax. It looks as though the estate tax is going to continue to be debated, whether we should either alter it or repeal it completely. And what has been surprising to me through this entire discussion the past couple of years is how little resistance has been put up or how few arguments have been made in favor of the estate tax. I think the estate tax is one of the most sensible taxes we have and I would make it larger, but that's not going to happen given the way the discussion has been. So in exchange for that, I think we should have an inheritance tax where all inherited income would be treated as normal income. There's just no reason that I could think of why somebody who's working at a minimum wage job should be paying taxes on the first dollar earned while somebody else who inherits \$1 million should be paying no taxes on that. It's just – given the values of our society for work and saving, it makes very little sense. So I think all inheritances and a lot of people agree with inheritance taxes but think you should again exempt the first \$800,000 or \$1 million inheritances. I would tax all inheritances just like other forms of income.

Finally, in terms of a new revenue raiser, there are a lot of different ideas for how we should generate new revenues as, again, we're clearly going to have to do. The one that we support is an environmental/energy tax. Right now, we have a tax code that actually subsidizes our dangerous energy dependence in this country and the pollution that we're seeing. And there's a simple kind of truism in taxes that you should tax more of what you want less of. And in so many ways, we do the reverse. We tax savings; we tax earnings. We subsidize pollution. We subsidize energy dependence. I think the time to revisit the notion of energy taxes either in tradable carbon permits or BTU taxes make an awful lot of sense. And one of the heartening things I've noticed is that about a year ago if I would suggest this at a forum or with a member of Congress, I would pretty quickly get laughed out of the place, but things have shifted. I have noticed there's been a dramatic shift recently where there's far more interest in energy and environmental taxes than there were just a few months ago, so I actually think this is one policy that may get a lot of momentum in the next couple of years.

So just to end, I am continually frustrated by how the two sides of the tax debate are kind of stuck in their own camps where many people on the right are constantly focused on making the tax code more efficient and act as though the only way to do that is through a consumption base, which I think has merits, but with a flat rate, which isn't necessarily the only way you can have a consumption base. And then on the left, you have people who are more focused on the fairness of the tax code and sort of not nearly enough focus on the fact that taxes do create a drain in the economy and you want to make them as efficient as possible. Tax policy – good tax policy is about reconciling the tensions between efficiency and fairness, with the obvious principle of sufficiency: we really should be raising enough money to pay for what we spend. That's kind of – shouldn't even be a starting point, that should be a no-brainer. But reconciling those two tensions is one of the challenges of tax policy and I would like to see the two sides work together on that. Some of these proposals are meant to do that.

And then just finally I think three of the biggest challenges I see looking forward for our country and our economy are dangerously low levels of saving. Our saving rates in this country both because of government borrowing and personal saving rates create real economic challenges for us. Second, growing income inequality at a time when there're the winners and losers – it become scarier to become a winner and loser in this economy and I think plain old redistribution is a very valid focus of the tax code. You just want to do it in a way that's as efficient as possible.

And then finally, just a reflection of the new global competition in which we are working. So you want to create tax policies that help your economy, that help the business sector, that help workers realizing these kinds of changes that we have in this country. So those are kind of the founding – the principles and the objectives of the tax proposals that we put forth.

Thank you.

MR. IRONS: Thanks.

MR. VAN DOORN OOMS: Thanks very much, John, for holding the conference. My name is Van Ooms and I'm a senior fellow at the Committee for Economic Development. I need to say a word about the CED – the Committee for Economic Development – because the origins of the paper that's in the bluebook are a little different than that of many of these proposals, in that CED is a trustee-driven organization. The trustees are about 200 business and education leaders and the Research and Policy Committee, which is a subset of about 50 of those folks, is responsible for and the author of the full report, which is available on the web at www.ced.org or I'll be happy to send you a hardcopy if you want to give me a card afterwards. The paper in your volume is a very brief summary of what is in that policy report.

The CED trustees took about a year of discussion of a number of different options in coming up with the recommendations that we have. And those included fundamental tax reform to a pure consumption tax, scrapping the income tax, scrapping the income tax and replacing it with a value-added tax, simplifying the income tax radically and raising rates. Those discussions finally ended up with the bottom line here, which is a hybrid tax, a combination of a simplified and reformed income tax with a supplemental value-added tax.

The conclusion we finally came to was that we really need both taxes. We need a value-added tax in order to raise the revenues that will be needed in the future to pay for government, but we also need an income tax in order to make sure that the system remains equitable and progressive. The other thing I should say about this statement is that it takes a very long-run view compared with much of the tax reform discussion now. As you know from reading the paper, we're looking out a few decades, not just trying to look at the next five or 10 years. So admittedly that's unrealistic in a certain sense and yet we were driven to it by a very strong feeling that it is necessary to look at the fiscal problem and the tax problem together; that we're passed the place where we have the luxury of simply looking at revenue-neutral tax reforms and then saying "let's worry about the fiscal problem later." So we have tried in the policy statement and in this paper to integrate those two considerations.

I should say, following on what Maya said, that clearly any proposal for value-added tax now or even for new revenues is somewhat unrealistic in the anti-tax environment we've been facing. But like Maya, I think that there are two things we must remember in talking of "realism." First, eventually we will be overtaken by the realities of arithmetic. Much as we don't like it, the arithmetic will grab us and put us in the corner and make us do something. And second, I think I do hear some of the sounds of concrete cracking around the edges of the anti-tax environment we're in.

Let me go first of all to the fiscal outlook and what we consider the need for a new revenue source. We thought we really have two problems here, as I said, but they're very closely related. We have a long-term 7 to 10-percent-of-GDP fiscal gap and a dysfunctional tax system that is complex, economically inefficient, and in many respects inequitable. Our report goes into a good deal of detail about what's wrong with the

income tax, but I'm not going to go into a lot of that today; other speakers have covered that pretty well.

But these problems are closely related because a dysfunctional tax system cannot efficiently raise the revenues that are going to be required in the future when the fiscal problem becomes extremely severe, and that fiscal future is coming up on us reasonably rapidly. It's driven by demography and the aging of America, but especially by the extremely rapid growth in healthcare cost pressures. The standard charts show that Medicare and Medicaid will grow from about 4 percent of GDP to 9 to 12 percent in 2030 depending on the trajectory of those healthcare costs, and this then leads to a trajectory for total expenditure by mid-century of something in the order of 50 percent of GDP. Those numbers are not projections of what's going to happen, obviously, because that's not a sustainable situation. So what they mean is that current policy is unsustainable and we need to do something about it. And for reasons we argue in this report, the sooner the better.

There are two major implications from this. The first is that reform of the healthcare system, both the public aspects and the private aspects, is going to be not only necessary, but unavoidable in the future. We cannot simply decade after decade finance expenditures which are growing to 30, 40, 50, 60 percent of GDP. That trend cannot be tax financed and we're going to have to do something about it, so revenues are not a panacea.

Having said that, however, what we also came to believe very strongly is that fiscal restraint of the magnitude that we're likely to see and indeed the magnitude that is likely to be judicious is not going to be sufficient to finance government. More revenues will be needed, and we must have an efficient way of raising them.

We had a lot of discussion in our sessions about why we don't simply use the income tax to raise those revenues. There are two reasons why we didn't pursue that route. First of all, base broadening and the elimination of tax preferences, while commendable in many instances, and we support that and indeed have many recommendations for doing that in this report, is unlikely to give us the kind of revenue increases that we will need in the future. Let me note that in the 1986 tax act, which is widely regarded as the granddaddy of all base-broadening and tax preference reform, which it was, on a net basis raised only about 0.5 percent of GDP from base broadening. This is an environment where we're going to need several percentages of GDP in additional revenues.

Secondly, especially in a world of globalization, we felt that continually raising the income tax over the decades as we go out was likely to be a self-defeating strategy. It's probably politically infeasible, but more importantly given our skepticism about the amount of base broadening and simplification that you can get in the system, we're very likely to be raising rates on what remains a very dysfunctional system. And furthermore, with globalization and the increasing mobility of capital, increases in income tax rates, and in particular the corporate income tax rate, are likely to fall upon labor income rather

than upon capital income and for that reason there are distributional problems with that approach. So we came to then conclusion that we need a new revenue source, that the best revenue source for doing that – and we thought about energy taxes, and we'll talk about that later-- that we need a supplemental VAT as part of a hybrid system.

So the CED framework, just to outline the major points very briefly, is first of all to go as far as you can in eliminating and reducing tax preferences and simplifying, and we make some specific recommendations with respect to production subsidies, especially in housing, in saving, low income, health insurance, and higher education. But we also caution, as I've said, that shouldn't expect too much from this strategy because so many of these very large tax expenditures are firmly embedded in our society as the foundation for saving, as the foundation for our healthcare system, as the foundation for our low-income programs, and as the foundation of family wealth accumulation.

Second, we would phase in a broad based 10 percent VAT to supplement the income tax. We believe that would be the most efficient way to raise new revenues because, as is well known, a broad based VAT is likely to have much smaller deadweight cost for the economy than the current income tax. We would modify the income tax to protect low income households from the VAT and to support progressivity, and to do that we would need to have an expanded unified, refundable credit that would cover households both with and without children.

We would repeal the AMT, but retain the tax shelter provisions of the AMT within the regular income tax. We would rationalize capital income taxation by integrating the individual and corporate income taxes, but by narrowing substantially the differential between ordinary income and capital gains to remove the very strong incentives now for tax sheltering. And we would modify but not repeal the estate tax. We also have some recommendations for improving the processes for making tax and budget policies, and for increasing resources for the IRS, but those are somewhat tangential to this morning's discussion.

I'd like to close by pointing out the fiscal impact of a program of this kind as shown in your bluebooks. If you'll look at Figure 3 on page 35 and Table 1 on page 36 of the bluebook, it shows what happens if you try raise revenues relatively soon – sometime in the next few years – by phasing in a value-added tax and by implementing some of the other proposals that we've made. Those specific assumptions were laid out on page 32.

What the proposal would do would be to produce some years – a decade or two – of modest fiscal surplus before you run into a situation where again you will be overtaken, if you don't make the appropriate changes, by escalating healthcare costs. This period of fiscal balance or surplus would do three things. It would first of all avoid the dangers of a fiscal crisis, which we're coming closer to as we delay attention to the revenue side of the budget. And the fiscal crisis is likely to be driven by runaway interest costs and by a rapidly rising debt-to-GDP ratio, which historically has been the way in

which nations get in trouble. We've lived under the illusion that since we can print money, we don't have to worry about that. I think we're in a very different world now.

Second, it would increase national saving and growth by increasing public savings substantially in a society that seems to be incapable of raising private saving very much. And if we don't do that, we believe that national saving is likely to be dangerously low for an extended period of time with the obvious implications for growth.

And finally, it would allow us to buy some time to make some transformations of the healthcare and other entitlement programs. I don't think we have a clue at the moment as to what to do about the healthcare system in this country, despite extensive discussion. For Social Security, we have a political argument and we can lay out the options and address those fairly easily. On healthcare, it is much more difficult. It's going to take a lot of time. We should not be sitting still, watching debt accumulate, watching the deficits grow while we are trying to do that.

So in closing just let me say that we think that this hybrid system of a VAT and a reformed income tax would provide a fairer and more efficient tax system, but in particular one that would provide adequate revenues to forestall a fiscal crisis.

Thank you.

MR. IRONS: Thanks.

Paul?

MR. PAUL WEINSTEIN JR.: Thank you. Hi. I'm Paul Weinstein. I'm the chief operating officer at the Progressive Policy Institute and a professor at Johns Hopkins University. First of all, let me thank CAP for hosting this conference. It's a very important topic. I don't know; I feel I work on every issue that basically seems to go nowhere,. (Laughter.) You know, we actually need tax reform. We need budget reform and I actually also work on Amtrak issues and that's never going to happen either. (Laughter.) But anyway, we'll keep trying.

It's March madness and I think most people, when they think of March madness, they, of course, think of the NCAA tournament. And for you Duke fans, I guess that was a tough night last night, but for some people March madness could be used to describe the sensation that many tax filers are going through right now as April 15th comes charging towards them. They're feeling that they're basically – they look at their tax forms and try to figure out, , which college break should I take, what's the difference between a Roth IRA and a traditional IRA, wife is self-employed, did I pay enough – you know, pre-pay enough this year,? How do I handle this Social Security tax for, you know, my household employees, et cetera, so it's a very complicated system. I think we all know that. Everyone here does their taxes. At least looks at their taxes when they get them back from their accountant.

Actually, thinking of March madness, I guess I noticed that Mark Mazurr – I thought he was out there from the IRS. I was going to suggest – one idea we could do, of course, is to tax everybody's NCAA pool and I think that actually might help with our deficits. I'm not suggesting anyone actually participates in those because that would be wrong, right? (Laughter.)

Anyway, but clearly, you know, it's been 20 years since we've had major tax reform and it's really been 20 years too long, unfortunately. We've got – I mean, we all know the basic problem. I think some have talked about it here:, the code has become much more complicated. I was in the Clinton administration. I think Maya talked about targeted tax credits, I disagree with her a little bit. I actually am a fan of targeted tax credits, but will also admit that we created too many of them and too many of them that work at cross purposes, but I actually believe that they can be very useful because they also allow for some individual choice on some of the things we're doing. And as someone who's also had experience in terms of creating some programs such as the (empowerment zone program where we had a grant program on one side and a tax incentive program on the other. I will tell you that the tax incentives work much more effectively than the grant programs because what basically happened was the agencies that were handing out the grants simply don't understand what it is that a business does or how to make those grants or understand the risks involved. On the tax side, you let the individual do it and they take on the risk. But having said that, you know, we do have too many targeted tax credits.

We've got a code now that's 10,000 sections. Somebody told me the other day, it's 1.4 million words. People throw around tax compliance numbers. I know that one study Treasury did said it was about \$115 billion annually. I don't know if that's accurate. I mean, those numbers tend to be very, very broad ranges, but the general sense you could get is it's got to be pretty high. One study said it took the average taxpayer 31 hours to complete the tax filing process. More than half of filers now use paid tax preparers. Seventy percent of EITC filers use paid preparers now. Okay? That's how complicated the EITC's become.

We have an issue on, you know, Bill Gale's here; I know Peter Orszag here. They've done great studies in terms of the changes that we've seen in the last several years in the tax code and the fact that if you make certain assumptions about whether the the tax cuts the Bush administration put in will be permanent, that basically middle-class and low-income people are going to be much worse off over the long term. Clearly, the tax system, if we leave it as it is now, is going to be very harmful in terms of both fairness and equity towards most taxpayers. Because our code's complicated, we have a huge tax gap and \$311 billion according to one estimate on tax gap, so we have problems there left and right.

And as I said, it's been 20 years since we've done anything about it to reform. The code is also not exactly pro-growth, despite some of the proposals over the last several years about how cutting taxes would lead to more growth. I think basically you can make an argument that in the '90s we had much better returns on growth and we had

much more investment-led growth than we do right now and we certainly had a different tax rate structure there.

One of the things I wanted to talk about today is that Congressman Rahm Emanuel and Senator Ron Wyden are about to actually introduce a bill in a couple of weeks. Part of this is – or basically half the proposal's based on something we developed at PPI about a year ago called Family-friendly Tax Reform. It combines that with essentially Congressman Wyden's approach, which he calls fairer, flatter tax reform. Basically, what it does do is it basically tries to fix the current income tax system.

And let me just say that I think we're stuck with the income tax system, and I don't mean that as a negative thing. I think it's the best system that we have. It just needs to be regularly fixed. It's like government. You need government, but you constantly need to reform it, and those of us who believe in that need to emphasize a few things need to be reformed. That's not to say I don't disagree with Maya that we need some other sources of revenue. For example, I actually think the idea of tying some environmental taxes to help us pay for healthcare, where there is actually a nexus between some of the environmental damage that we're creating out here is also causing public health problems, and that you can actually make that kind of argument. And I think it makes some sense to look along those lines.

But I think in general, we've got to recognize the income tax code is here to stay and we need to make it better, to be more pro-growth, to be fairer, and to be simpler, and we constantly are going to have to strive to that.

I want to talk a little bit about the Wyden-Emanuel bill because I think it heads somewhat in the right directions along those lines. Essentially, the proposal – as I said, it combines the few approaches that Senator Wyden – he's already introduced his bill; Congressman Emanuel's based a lot on the PPI proposal with some changes. One of the most important things about it is it will actually reduce the deficit by \$100 billion over the next five years. It pays for all the new breaks it gives by closing a large number of loopholes and also basically raises additional revenues as well.

It's simplification in the sense that a large number of taxpayers will basically only have to do a one-page 1040. It does reduce the number of brackets. It creates three brackets and 80 percent of the people would get a tax cut under the proposal. It fixes the AMT. It would triple the standard deduction, taking it from 5,000 to 15,000 for an individual and 10,000 to 30,000 for married couples. It would leave the 35 percent corporate flat tax in place, but would also close a lot of business tax breaks right now. So effectively actually increasing the amount of revenue that we're raising from the business side of the ledger.

It also creates four new super incentives, and this is sort of the PPI piece of this proposal. Again, going back to the issue of targeted tax incentives, we've created a lot of these incentives and I think again for – and I've had my hand in a number of them from helping to clean up brown fields to helping support community development banks and

there some other people around the table who have also helped contribute to a number of things and I think we're actually quite proud of them, including, for example, the expansion of EITC, which I would argue as probably one of the most effective anti-poverty programs that's ever been created and in the '90s was strengthened due to the fact that made it even much more effective.

But recognizing that there's a lot of complication with regards to these things – you know, we've all heard the stories about the 1,000 definitions of what a “child” is in a federal government and so forth – we decided to take a different approach. We tried to create four super incentives that are sort of focused around things that most families have to address and are important to most families. So, for example, the first thing we did was – and will be included in this bill – is to create a single college tax credit, which takes the five existing breaks for helping students and families pay for college, you know, now; that is, we don't touch the savings accounts, of course. We're not looking at the 529 plans or the education IRAs, although you can make an argument you need to fix some of those as well. We're looking primarily at the HOPE lifetime learning, the deductions, and so forth – took those, combined it, and then actually made it more generous. Made it \$3,000 a year and made it refundable. Okay? Why \$3,000 a year? Well, there's cost issues involved, obviously, but we wanted to make it as generous as possible and get it as close to what the typical cost of tuition at a public university. Okay? That's number one.

Number two, we took the home mortgage deduction and I know there are a number of proposals out here to try to either eliminate for second homes or cap the home mortgage deduction. I would have no problems looking at some of those things. I think there's a definite fairness argument there. But what we mainly focused on here was actually trying to take the home mortgage deduction and making it available to non-itemizers. Why? Well, primarily we did this because there are a lot of low-income, a lot of elderly folks who are unable to take this – the existing home mortgage deduction – and who would now be able to do so if you move it above the line. So that was the second piece that we wanted to look at.

A third piece, you know, there are 16 some different types of IRA accounts. I'm not talking about the 401Ks. I'm talking on the individual retirement side – 16 different types of these different accounts. Some have been created and applied to – for small businesses, for self-employed. Obviously, we have now the Roth IRA, which is a whole different way of offering a tax incentive. And now, of course, the Bush administration has pushed forward on the 401(k) Roth, which actually is going to make things even more complicated.

We need a lot of work, obviously, on our retirement pension security areas, but one thing we need very much to do is make it very easy for people to start saving money. We have a savings rate that's zero. We have a huge retirement crisis facing us. We have issues on Social Security. The complications involved with IRAs are in many ways a deterrent for people to participate. Number two, we have a situation where people go from their 401(k)s and they're constantly pulling out their money. Fifty percent of people withdraw money out of the 401(k) instead of rolling it over into an IRA. Why?

Well, in part because they handed a check and they're said, "Here." Okay? And many people want to take that check even though it's a 10 percent penalty and they also got to start paying taxes on top of what they would actually have to pay in terms of income taxes on that amount – over 50 percent. Now, that's primarily among younger people, but that's who we need to keep their money in their retirement accounts.

Universal pension would take all 16 IRA accounts and merge it into one. Give everyone a \$500 stake to open an account. Would work with a – would take the idea that others have put forward about a refundable, low-income savings account tax credit – making that truly refundable – and basically would create a system where essentially you could take your 401(k) and immediately just roll it over. You would hand your number – your account number to your employer just like you do when you hand him your Social Security number and your money will just roll over into your IRA.

The final piece which others have talked about is really an idea that's come from a number of others. I think I saw Max Sawicky walk in here. He was one of the original developers of this idea of a simplified family credit or single family credit which takes EITC, takes the Child Credit and so forth, and merges it together. Basically, as we've said, EITC has become very complicated. We need to provide some simplification here. I'm a big supporter of it, but I think we need to bring these together and make it more universally available to everybody.

With that, I'll close because my time is up and I'm done.

MR. IRONS: Okay. I think we're going to turn now to Bill Gale of the Brookings Institution. Before I give him the go-ahead, though, I think both Bill who's here and Peter Orszag who are here are both co-directors of the Tax Policy Center. I think the Tax Policy Center deserves an enormous credit for really generating a huge number of statistics and data and estimates and all kinds of tax reform and options. I know I rely on them for all kinds of numbers on a daily basis, as does I think a lot of other policy analysts here in D.C., but I think he's going to try to comment on some of these papers now.

MR. WILLIAM GALE: Thanks. Actually, I was going to go through all of the statistics on the Tax Policy Center website. (Laughter.)

I want to focus on three broad issues: one is revenue levels, the second is particular reform ideas, and the third are the political economy aspects of this. But let me start at the revenue level. Maya mentioned that it should be a no-brainer that this is the first issue: that taxes should cover spending. And I agree with that completely, but I would put the emphasis on the word "should," whereas I think Maya was putting the emphasis on the word – the expression "no-brainer." We are not in a situation where taxes are covering projected spending now or any plausible time in the future. I disagree with people who say that we've ignored fundamental tax reform the last several years. Every time we've made a tax cut, we have made a choice. We have made perhaps the most fundamental choice about taxes, which is how high they should be. For the

administration to say, “Okay. Now we’ve done all this other stuff; now let’s talk about tax reform,” it’s kind of five years too late. We’ve been talking about tax reform, just not calling it that, since 2001.

The level-of-revenue issue kicks in particularly strongly with the rise of entitlements as a number of people have mentioned, and also as a number of people mentioned, if the level of revenue has to go up, that doesn’t mean that the equity-efficiency tradeoff is less important; it means that it’s more important. If you need to the car to drive fast, the engine really has to work well. So if you need a revenue system to raise a lot of revenues, it needs to be really efficient or it’s going to really mess up the economy. To put it differently, an inefficient tax that raises 1 percent of revenues is not a big deal for the economy. It doesn’t have to be. And inefficient tax that raises 20 percent of revenues is in everybody’s way and creating hassles everywhere. It’s very, very important that the major pieces of the tax system be made more efficient in order for them to be made more equitable.

The AMT fits into this issue of revenue levels, too. Everyone would like to get rid of it. There’s just sort of a trillion-dollar issue there over the next 10 years of how to pay for it, but it fits squarely into this issue that we need to think first and foremost about what the revenue level is.

And the last issue here, of course, is the expiring tax cuts. If you want to think about how much spending we would need to cut to make the tax cuts permanent and pay for it on an annual basis, I’ll offer you the following calculation. If you exempt Social Security, Medicare, and Medicaid from this calculation on the grounds that you’re going to have to cut them or fix them anyway, and you exempt defense and homeland security because, (a), we’re in the worldwide war against terrorists and, (b), India now has nuclear capabilities, and you exempt net interest because if you didn’t that would be called default, and you just look at the rest of government: The rest of government would have to be cut by half to pay for making the tax cuts permanent; that is a permanent cut in the rest of government by half – all other spending.

So it’s not just a matter of giving the people their money or letting them keep their money. It’s a first-order issue: do we want the government to do these things, or half of these things that they’re doing, or do we not want them to do it? So I think the main reasons the focus should be on revenue levels as the fundamental issue in tax reform are (a) it’s not being focused on; (b) it is the fundamental issue; and, (c) it links up to the whole question of why we have taxes to begin with. If we didn’t want to have government spending, we wouldn’t need taxes at all. So I think the tax reform debate should start there and I’m not saying anyone disagrees with this. This is just a point of emphasis given the discussion that we’ve had so far.

All right, point two: particular reform ideas. I am not going to list my particular 117-point reform. I do want to say a couple of things. I don’t think we will ever get a simple tax system as long as we have individual people literally filling our forms and sending them in. I could see that if we go to a no-return system where people don’t

actually see the return, it just gets taken care of offline somewhere, that there might not be the push for all of these subsidies. But as long as people are filling out a form, I think there's going to be massive political pressure to have subsidies that operate through the tax system.

I like the relatively new discussion that Maya and John and others have about changing the payroll tax to either a progressive consumption tax or folding it into the income tax. I think that's a really important new direction in thinking about policy. Payroll tax raises a lot of money. It raises it in a very regressive manner and so some fresh thinking about that is much more useful than saying, "Can we tweak the EITC up by another 2 percentage points or child credit up by another 2 percentage points?" If you look at where the money is, a lot of it is in the payroll tax, especially for low income households.

I very much like the new emphasis on doing something about the mortgage interest deduction. I'm not saying it's likely, but the deduction is a messed up policy in all sorts of ways. It doesn't appear to encourage first-time home-buyership, which seems to be the only plausible justification for it. At the same time, it costs an enormous amount of money; it inflates housing prices. It probably makes those who don't itemize worse off because it inflates the value of land and so on. So I have some ideas about that. Other people do, too. But I think that's another big area of tax policy where the chinks in the armor are finally beginning to appear.

On the debate about tax credits that Maya and Paul are having, I think the real issue is they're just not imaginative enough. Joel Slemrod once proposed that we have a credit for anyone who doesn't qualify for any of the other credits. (Laughter.) And that's creative thinking. That, you know, or a TV tax credit for people that tune out FOX or something like that. (Laughter.) So there's hope there, but I agree that it's a mess and ideally we would run these things as spending policies, so you could see what the distribution will look like. Of course, if we were in an ideal world, we wouldn't be having this discussion to begin with.

the last point has to do with politics. I'm amazed at how long people can talk about taxes and tax reform and not mention the "No New Taxes" pledge. Eighty percent of Republicans in Congress have signed it. The president and the vice president have signed it. If you look at the Budget Appropriations and Ways and Means Committee in the House and the same, too, in the Finance Committee in the Senate, virtually every Republican on those committees has signed it. The one notable exception that I'm aware of is Bill Thomas, who'll tell you that signing it is stupid and he won't be any subtler than that. (Laughter.) And I think he's absolutely right, he doesn't like the idea. But everyone else has signed it. And it actually does constrain what people can do. And so realize also the same people that have signed this voted overwhelmingly in favor of the Medicare prescription drug benefit and have voted to raise other spending as well. So the issue about aligning taxing and spending really is a first-order issue. That's just being missed in the political debate right now.

So where does this all take us? I don't see us doing anything the next couple of years on comprehensive reform. I don't see us doing anything, frankly, until we have Democratic control of one of the houses or the White House. And let me be clear about this. The reason is not because the Democrats have such fabulous ideas about tax reform. Although I like many of the ideas up here, that's not why you need the Democrats in power. Why you need the Democrats in power is so that the Republicans have someone that they can compromise with. A party is not going to compromise with itself and so they would have to be able to compromise with someone else who's holding up their legislation, who they can blame the bad parts of the legislation on, et cetera. That's exactly what happened in '86. That's a very creative, thoughtful use of the political process and your opponents. Both sides can go back and say, "Yes. Yes. We got what we wanted and yes, there are these bad features, but we had to give them up. There was no hope."

So what I see come 2008 is some configuration where there's Democratic control of either house or the White House, and if that happens then you could imagine sort of a summit meeting after 2008 where they sit down and deal with the level of revenues, the structure of revenues, the Social Security issue, budget rules, and budget procedures basically all at once. Now, that's a huge task, I agree, but they're not going to do these things one at a time and they're certainly not going to do it when one party controls all Houses. It would be the same if the Democrats controlled all houses. So I think we need to get on our knees and hope for divided government. And I could see a situation that works out where the Republicans agree to tax increases and the Democrats agree to individual accounts in Social Security. I don't think it's fundamentally opposed to the mission of either party and they both back themselves into ridiculous positions and they could give a little – they could both give a little and get a lot.

Thank you.

MR. IRONS: Thanks, Bill.

I think we're going to open up to questions. I'd like to see if there's any question amongst the conference participants first, and then we can open up more broadly.

Jeff?

MR. JEFFREY LIEBMAN: I want to ask a question to both Maya and Van. Your proposals both came out of processes that are closer to what would happen in a bipartisan type of deal than I think the other proposals did, and they also have the commendable feature of dealing with not just the current revenue needs, but with a long term revenue needs, so I'm very intrigued about where you ended up. And the feature of both of your plans that I'm puzzled about is that they each seem to add a whole new complicated tax system to the existing personal income tax. In Maya's case, you add a personal consumption tax which is going to – maybe you keep the definition of "income" the same as the income tax, but then you at least have to keep track of everything you put

into savings vehicles along the way, and in the CED plan you add a whole value-added tax and that whole mechanism on top of the existing personal income tax.

And so I'm wondering as you moved in both cases in the direction of the consumption tax, why the processes you're involved didn't end up with something like David Bradford's X tax or something that would end up being some kind of progressive approach to consumption taxation that could completely replace the personal income tax and not leave us with these two parallel systems on top of each other?

MS. MACGUINEAS: I think it's a good question and an important point because I think one of the debates we're going to see in the coming years is there's going to be a lot of focus on consumption taxes and the question is will it replace the income tax or will it augment the income tax?

In developing our proposal, we came up with keeping the two taxes – two parallel tax systems for couple of different reasons. If we were to prioritize those different tax principles which we all start with – fairness, efficiency – simplicity is probably the bottom of my list. I think efficiency and fairness and sufficiency trump simplicity. So the complexities are problematic in that figuring out how those two taxes would work together presents real challenges, but making the tax code easy for taxpayers, while a goal of mine, is not the highest goal of mine. So the reason we came up with maintaining the income tax is, one, even though I think you can do a whole lot with the consumption tax to achieve your distributional goals, it becomes a lot more difficult if you have only a consumption tax base to have the level of progressivity that I think we were hoping for.

And the second reason is if you use the consumption tax to replace what we're looking to replace then, which would be a payroll tax and also both individual and the corporate income tax, the sticker shock of the necessary rates was just seen to be a non-starter. Now, it's interesting: a consumption tax – I think you can actually have a tax rate that is above 100 percent. You can spend \$1 and tax somebody \$2. There's not very many taxes where you can have a tax rate above 100 percent. I found that fascinating but not a really compelling idea. (Laughter.) So it was to maintain – the best way to keep the tax code as progressive as we wanted it to be, which is more progressive than it currently is while also keeping rates at a level that hopefully wouldn't make it impossible to implement such a proposal.

MR. OOMS: Jeff, really good question. Hours spent wrestling with it for the reasons that are implied by your question. There was a lot of concern about having another tax with the compliance and the administrative burdens that that would create. And there was a lot of temptation to go to wholesale tax reform and, in fact, in the form of the X tax, which has a lot of very attractive features, as we all know. The CED trustees resisted that finally, in the end because they felt it was a bridge too far, that ditching the income tax entirely and jumping to a progressive consumption tax was something that was just not politically saleable, that would be too unfamiliar, and that there would be a lot of resistance. And there were also a lot of specific transition problems in moving from one to another.

The attraction of the hybrid system and a supplemental VAT was in good part that we're more familiar with it. There are over 100 countries in the world that have a VAT. Many of them, and virtually all the industrial countries, have it in combination with an income tax, and that's not entirely an accident because they do serve different purposes. The VAT is a very powerful revenue raiser. People often object to it for exactly that reason; that it's a so-called money machine. I find that a little odd since if you look at the projections, what we obviously need or are going to need in the future is a money machine. But the VAT also poses large distributional problems and problems of equity, which is why the CED trustees felt very strongly that we needed to retain an income tax as well. So it's an unholy compromise, with a firm recognition that there are significant costs involved, but with an alternative that seemed to be less realistic.

MS. MACGUINEAS: One more quick point on that. I just thought that it was interesting that the president's tax advisory panel, which we expected to focus a lot on consumption taxes – that their proposal for consumption tax actually kept a small income tax as well, so I do think that this will be one of the interesting topics. Do we move wholeheartedly to a consumption tax or do we have both, or do we go nowhere with consumption taxes?

MR. GALE: John, can I just add very briefly.

MR. IRONS: Yeah.

MR. GALE: One of the most misleading parts of the current tax debate is to call our current system a hybrid. I would put forth to you, there's no such thing as a hybrid income-consumption tax. There is having a separate income tax and there's separate consumption tax. That's a combination. And then there is an income tax that has consumption tax features in it. That's a tax shelter. (Laughter.) That is not a hybrid. The way shelters work is you combine principles and ideas from one system, like a consumption tax, with those of another system, like an income tax, so the tax deductibility of interest earnings versus the deductibility of interest payments are treated differently in the two systems. If you can combine them in the right way in our current system, you can get a nice shelter. That is not a hybrid. That doesn't get you half way between an income and a consumption tax. It gets you somewhere else and it's somewhere else where you don't want to be. I think most tax reform experts agree that a pure income tax or a pure consumption tax would be better than the *mélange* that we currently have because if nothing else you would get rid of the uneven treatment of various types of taxation of capital income.

MR. IRONS: Jason, your question?

JASON FURMAN: This is really following up on Jeff's and raising some issues again, sort of, taking another run at that. Maya, when you mentioned the tax reform panel in the second plan, which has some problems – I mean, it does form more of – can I call it a hybrid, Bill, or – (laughter) –

MR. GALE: No. (Laughter.)

MR. FURMAN: If you think a Bradford X tax can't get you the current distribution of tax revenue and you don't like it for some other reason, you can append something on it that's taxing something like the normal returns on capital and maybe that's the way to do it or maybe some other is the way to do it. But that's in a sort of integrated (inaudible) where there is a form that you're basically filling out rather than two forms and keeping track of two. You also – just a separate thing on a cash flow tax, you don't you keep track of all the complications of measuring income and all the complications of measuring savings. And your plan sort of have all the complications you have with an income tax plus then you have a whole new set of complications with measuring savings rather than going the Bradford route of the cash flow tax.

So just taking sort of another run at that, it seems like there are other ways to combine the two other than having – and David Bradford also wrote about a number of other ideas that aren't pure consumption taxes – and sort of going back at Van Ooms, sort of the same two questions there. One is, again, why wouldn't we raise all the income tax rates by 8 percentage points and then if we think there's something a little bit more inefficient about that and the VAT, you know, tweak capital gains or dividends or what-have-you and get something basically as efficient as what you have even more recognizable to people today? So possibly, you know, a little bit politically easier.

And then if we didn't go that route and we went the VAT route, why didn't you think about having like a 15 or 20 percent VAT and combine that with raising the standard deduction to, you know, 25, 50,000 – you know, I don't have the numbers or how that would work out. Something like a mini (grafts?) plan where you actually would get a big chunk of simplification on the income tax side in exchange for this extra complication you're introducing, especially since a VAT – you know, in terms of complication there's no difference between a 5 percent VAT and a 25 percent VAT, but there is on the income tax side. You can buy less complication with a 25 percent VAT than a 5 percent VAT.

MR. OOMS: I'll go to the second question first. There was a great reluctance to put on a very large VAT along with the income tax partly because of the additional difficulties it raised in terms of resolving the distributional problems and the regressivity problems that were involved. With a VAT at 10 percent, the CED program in total would raise net revenues by a little less than 4 percent of GDP. That's probably not enough over the very long term, but one of the great advantages of the VAT is that it gives you a lot of flexibility so that you can make changes of that kind fairly simply. So the 10 percent is a starting point, but with a recognition – and we talked about this to some degree in the report – that there's a lot of flexibility involved.

With respect to why don't we simply raise the income tax, we felt that putting 8 or 10 points on the income tax, if you don't think you're going to get a more efficient income tax, would increase greatly the distortions that we currently have. This would

produce a very inefficient tax, much more costly to the economy than a broad-based VAT.

MR. FURMAN: Other than (inter-temporal?) distortion that you might think you get with an income tax that you don't get with a VAT that you could try to fix in other ways, I mean, what's the difference? If you have a 10 percent VAT and you work, your marginal rate is your income tax rate plus in effect that VAT rate, you know, minus what you're saving. So it's not – I don't see why there's a first-order difference and why you think there is (inefficiency?).

MR. OOMS: Because the tax preferences in the current income tax system generate very large distortions and the deadweight loss tends to rise exponentially with the rate, if you raise income tax rates by a very large amount, you're going to exponentially raise the efficiency costs of the income tax.

REP. FATTAH: The other issue – real quick – is whether you politically think there's going to be a VAT in this country. I mean, the VAT is not a new idea. It's been around for a long time. We don't have one. And I don't know that at the end of the day, there's anybody who believes we're going to create one as a way to generate revenues. I don't know whether – you know, I understand the back and forth of this but the politics of where we are seem to be the voice from this discussion which is how to get to, you know, something other than the status quo politically, which means you have to create the currency among the American public for an idea that has the ability to capture political support. It's not a pure economic discussion about, you know, the purity of tax policy.

MR. GALE: John, can I just –

MR. IRONS: Let me – Maya, real quick. You wanted to respond.

MS. MACGUINEAS: Yeah. And just because I appreciate the questions that both Jeff and Jason have put forth because in many ways I pushed for these kinds of arguments amongst my colleagues. I probably more than some of the other people who I've worked with would be interested in a full-fledged, developed, progressive consumption tax which would be as progressive as possible, but I think there are a number of reasons that this was the right decision. One, I said we are putting forth our ideal proposal, but we did think about political realities and I think there are too many people who are wed to an income tax, whether that is the right tax policy or not, but because as I talked about for the two different camps – progressive income tax and flat consumption taxes – I think there are people who would not let go of an income tax. And maybe showing what a full-fledged reform proposal could achieve would shift some people's minds, but I think that's unlikely.

Secondly, I really do think that the rates one would have to impose could be just too frightened to get over. The hurdle could be too difficult. And finally, there are a lot of people – and I'm not one of them – but who believe having a separate tax for entitlement programs is a good thing and that having dedicated taxes for Social Security

and Medicare is an important thing and so rather than fighting that battle here, since we've tried to put forth some plans how to reform entitlements, we figured keeping a separate dedicated tax for Social Security and Medicare was a better approach than the comprehensive getting rid of an entitlement tax and moving to a consumption tax all at one time.

MR. IRONS: I think, Bill, you have one quick comment.

MR. GALE: Yeah. The question about why not raise the income tax versus have a VAT relates directly to a comment that Maya and I were making at the beginning that when you raise more revenues, it's really important to have an efficient system in place to begin with. If you're talking about a perfect income tax, the perfect consumption tax, it wouldn't make much difference which one you raised. But when you're talking about an incredibly messy income tax with all sorts of distortions that go in all sorts of different directions, if you raise income tax up 8 percentage points, you're really creating deadweight loss. You raise a VAT from zero to 8 or zero to whatever, you're not creating as much deadweight loss.

MR. IRONS: Just to be clear. Maybe I was talking about a fantasy land, but I was talking about raising it by 8 percentage points and then making a few other changes and you could just as efficiently raise the revenue.

REP. FATTAH: Bill, let me ask you a quick question. What do you see as the differential between the base on a consumption tax and an income tax and what I'm suggesting as a transaction fee?

MR. GALE: Pure consumption tax will be slightly less than a pure income tax. A realistically broad consumption tax will be slightly bigger than a realistic income tax. Your base, I think, would be a lot – a lot bigger than either because transactions – you know, there are several transactions that happen before you get to GDP. So if you're looking at gross transactions – basically, value-added is the net transaction amount because everyone subtracts out the amount that they paid and that leads to total consumption. A gross consumption – a gross transaction tax would be – you know, would generate a much larger base.

REP. FATTAH: So if you got a larger base, you could have a lower rate?

MR. GALE: You could have a lower statutory rate. That doesn't mean you'd have a lower effective rate.

REP. FATTAH: Because there'd be some cascading?

MR. GALE: Yeah. Right.

REP. FATTAH: Right. And there'd be cascading under these other systems, too?

MR. GALE: Not in a pure consumption tax, but definitely in an income tax, and certainly in a realistic income tax.

MR. IRONS: Let me get to Anne for a quick question. Then we'll open it up to the audience.

MS. ANNE ALSTOTT: John, I was just interested that a couple of different people – either two or three; I had lost count – sort of suggested that an interesting thing to do in tax reform would be to get relatively narrow tax expenditures or even somewhat broad tax expenditures out of the code and into direct expenditures. And I just thought that was sort of interesting and sort of Paul was the exception, and I find myself a bit closer – just it seems to me when people talking about moving narrow tax expenditures or whatever you want to call them out of the code and into the expenditure side, they're really making very different kinds of claims that are worth spotting, right?

So one claim is the program is a bad program, right? So we could debate whether or not we will be subsidizing owner-occupied housing. Somebody made the case that we shouldn't be, but in that case you don't want to shove it onto the expenditure side. You don't want to do it, right? Because economically the distortions and other things from shoving it onto the expenditure side are the same. So one argument is don't do it and that's sort of case by case. Should we have higher education subsidies or not?

There's a second question about how if you're going to have a thing – so maybe higher education subsidies, as Susan is going to argue, are a good thing. Then there's the question about how you structure them. Are they well structured or not? Are they regressive? Right? Usually, it's pretty hard to argue that such things ought to be regressive, but then the answer to that is not to shove it on the expenditure side necessarily, but to restructure it, right? Are there too many overlapping things, right? The 17 different kinds of interest in the tax code or the numerous definitions of children or something. The answer to that is sort of institutional reform, not necessarily shoving it onto the expenditures side and letting them define interest 17 different ways.

And then there is this quite separate question of when you use the tax system and when you don't? And I myself don't have an overarching bias for using tax system or against using it, but I do think it's worth noting that in the last generation the structural capabilities of the federal tax system have changed. Right? So that when Stanley Surrey sort of said, "Oh. Never do these things through the tax system and always do them on the expenditures side because otherwise they get hidden or otherwise the IRS has no idea how to administer these things." I just think that kind of claim – not that anybody here was necessarily making it – but that's the kind of claim that would lead you to the old Surrey position of always shove them outside the tax code. It's just not true anymore, right? So that the EITC experience has led to enormous capability – maybe not enough – in the IRS, but think of the EITC participation campaign. You know, think also of the political structures that we now have in terms of the tax expenditure budget, the enormous professional staff of the tax writing committees, the Joint Tax Committee and

so on. I mean, there are a lot of institutions that have actually – good institutions that have been created around doing these things with the tax code.

MR. IRONS: Yeah. I think that's right. Let me make one quick comment and turn to Paul real quick. I think, you know, a lot of the tax expenditures you see come about from the purely political process. People who want to cut taxes see this as a way to cut taxes to generate tax credits, tax deductions for all kind of things. And that's combined with people who want to achieve a particular spending goal or other social or non-social goal. And so you have this alliance with people who can get something done and so I think that's where a lot of these expenditures come from.

Let me turn to Paul real quickly.

MR. WEINSTEIN: Yeah. I mean, again I just want to – I like Anne's comment so I just want to reiterate. I think everyone here is legitimately right in the sense that there are – there may be many of these targeted tax credits and deductions and special expensing rules and so forth and so on that are inappropriate and we might just want to end them, and some that we clearly need to consolidate. But there are instances where these things are effective, and as a public purpose we see them as being effective. I mean, again I will point to in the late '90s when we developed the brown-fields expensing rules, which basically led to a considerable increase in the redevelopment of these sites.

We also had a grant program at EPA as well, but we found we've made these companies that this was actually a more effective incentive for them. Now, at the time, Treasury, you know, correctly raised with us some very important points. Like, for example, Treasury did not have experience or knowledge of environmental remediation and what those costs were and how to certify this and so forth. And, you know, no one really wanted the IRS to be involved with that and so forth, so we actually did something shocking which was actually bring EPA and Treasury and IRS together to actually develop a system where EPA would certify these remediation projects in advance and therefore give Treasury the okay to go. I mean, God forbid we'd have government agencies actually cooperating on some of this stuff. So there are cases where it can work.

Low-income housing tax credit was heavily criticized. That actually came out of the '86 reform effort – shocking – and there was a lot leakage in the program at the beginning – a lot of leakage and a lot of people complained about the intermediaries and there's definitely some efficiency arguments there. On the other hand, ask anyone in the housing industry and in particular the low-income housing industry, it's becoming increasingly efficient as the markets have adjusted and it's arguably more effective than a number of other discretionary housing programs. So again, I mean, I take other's points that the home mortgage deduction – you know, there's a lot of issues there and a number of these other things that we might want to consider getting rid of, but I wouldn't want to abandon as a policymaker a whole set of tools just because there are a large number of bad apples and we've abused it.

REP. FATTAH: Most people would want to argue for these tax deductions point to low income tax credits, earned income tax – most of the deductions in this code are not there to help poor people or to do good things. There are there to help people who make a lot of money and companies that make a lot of money avoid paying their fair share. So, you know, you can't – you got to get to the heart of what is going on with the code and we can't defend a whole host of these deductions on the basis of a few very good programs that are doing good. I mean, we've got to get to the heart of – the problem with the code and the problem with the way we generate revenues is that most of the people who should be paying are not paying at the end of the day and are using deductions in the code as to avoid paying.

MR. IRONS: I think we should go to the audience now and take a couple of questions. We have about five or 10 minutes left in this session and then we'll take a short break. But let's – please wait for the microphone to come to you.

Over here.

Q: I'm Carl Leubsdorf from the *Dallas Morning News*. In following up on Mr. Gale's and the congressman's efforts to bring a little political reality to the discussion, do any of you see any alternative scenario to the one that Mr. Gale mentioned? Specifically, does it require, (a), a sympathetic voice or a more sympathetic voice in the White House of either party, and, (b), will the mere fact of the possible – the expiration of the current tax cuts in '09 precipitate a debate – a more wide-ranging debate on this issue?

REP. FATTAH: Well, let me just say that I think that the reality – first of all, what we have to do is put this in some context. Twenty years ago, we had the discussion about the flat tax and the national sales tax proposals from the other party. The Reagan Treasury Department did a study and said they were not going anywhere. Twenty years later, the other party is still really at the same position. They kind of showcase these two proposals. But the Bush Treasury Department did the same study and they said neither one of those proposals is going anywhere. And you may have noticed that the Republicans have had the majority for the last 12 years and they have not offered for a vote on the floor either of those proposals. So what we have is kind of a status quo and Democrats get blamed for supporting the status quo. Republicans get political credit for pushing the flat tax and the sales tax even though they had no real effort behind either of those efforts to have the Congress actually consider them. And the policy wonks kind of sit back and talk about what could be a perfect world. That's about where we are.

Bush wants to make – get out of town with his tax cuts as part of his legacy, even if it runs up the deficits and the national debt limit, as O'Neill said in his farewell novel about his time in the White House in the Treasury.

So I think what we really need is an idea that the American public can get behind that is which offer a fair, transparent system in which they understood that they're paying their fair share and that everyone else is, too, and that could get us to a position where the country could meet its financial burdens. And I think that we don't have in the proposals;

that is, either the flat tax or the sales tax or in the status quo, a system that the public is willing to rally behind. If people are going to rally around the flat tax or sales tax, they've had 20 years to do it.

So I think it is a time for new ideas and that's why I think it's great that this forum is being held today to talk about options. And I think we need to talk about options that have some ability to attract the public support, which is that they don't like the tax code. They don't see it as being fair. Look at every poll and look at the actual reality and I think that you might even agree with them.

MR. IRONS: We'll go to Bernard.

Q: Thank you. Bernard Wasow, the Century Foundation. Now, this is an excellent panel, but five minutes out of an hour and 45 minutes I think is not enough for audience participation. My question deals with household saving. Mr. Gale has – Professor Gale has already pointed out that there are many measures, many tax rates – I think 16 were mentioned; I counted 20 in a paper from the Urban Institute. The consumption tax is aimed at household saving. My question is, is there any evidence – solid evidence that we need to tweak the tax system to increase household saving?

I know Bill Gale, (John Karl Scholz) have done work to suggest that people are saving rationally as it is. Given the floor provided by Social Security, it's reasonable for about a third of households not to save. Now, we have a macroeconomic saving problem. I don't deny that. We are – our current account deficit is much too big, but should we be using the tax code at all to solve what seems to me is a very – a problem that may not exist at all? Why not just get rid of all of the tax rates for saving – not replace them with one or two; get rid of all of them. Why do we need a consumption tax, which is a big change, which is more regressive and which has as its only goal as far as I can see to increase household saving when I'm not convinced we need to do that?

MR. IRONS: Let me partially respond. First, let me say that we have a full day's worth of conference, so I hope people will be able to stick around and have plenty of opportunities to engage us in discussion.

Let me also emphasize that the savings problem, as you said, is a national savings problem, and there is public savings and private savings. And so the federal deficit is obviously one component of that and so simply allocating a dollar to public – to private savings which is offset by a dollar in deficit does no good for national savings combined.

But let me turn and see if anyone here would like to say anything about individual savings.

MR. GALE: Yeah. After hearing that very good question, John, I want to thank you for only devoting five minutes of the hour and 45 minutes to questions from the floor. (Laughter.)

I wouldn't characterize my work quite the way you did, Bernard. I think the work shows that there are holes in the saving arena— in particular, we found a third of the households were not saving adequately. Scholz finds a much smaller number and much more overall saving. But I think you have to square those notions with the widespread, casual observation that people don't know what they're doing when it comes to saving. I mean, people don't know how to fix their cars and they can still drive around. We have a system right now, though, where if you don't know exactly what you're doing with saving and investment and financial choice and all that, you will get completely messed up in the IRA/401(k) system.

So I think that we do need public intervention here, but it doesn't have to be the old hammer of bigger tax cuts, you know, bigger contribution limits, et cetera. And in the work that Peter and I have done, we pushed things like automatic enrollment in 401(k)s, automatic enrollment in IRAs, a restructuring of the saver's credit to make it more manageable and understandable to people, because our work suggests – actually work with Jeff as well this year – suggests that people don't understand the saver's credit, the way it works. So I think we need to broaden the range – we need to broaden the question from do they actually have enough right now to do they know what they're doing? And we need to broaden the range of public policies that we think about to encourage saving to include not just how big the subsidy is, but how it's delivered, how it's framed, how it's advertised. And I think that's a really important new direction both for research and for policy. But I completely agree with you that just mindlessly raising the contribution limits is a waste of time and a waste of money.

MR. IRONS: Okay. I think we're going to take one more very quick question and then we'll wrap it up and take a break. In the back on the left.

Q: Yeah. Elliot Dubin, Multistate Tax Commission, and this has nothing to do with state taxes. One of the reasons possibly that there's very little demand on the part of public for major tax reform is the widespread use of computers and commercially prepared tax return software. All that – a lot of that pain has been taken out of paying tax, and that's the most people think. It's not such a terrible thing to pay taxes.

REP. FATTAH: I don't think it's a terrible thing for you to pay taxes, but I think you – but there's a lot of public support for simplifying the tax code and for tax reform, I believe. And that's why you saw in the winning presidential candidate in the last election in every stump speech he listed as one of his top priorities that he was going to work to simplify the tax code. It was polled. It was focus-grouped. It was well stated. Now, obviously the president's advisory panel in this report seems to dead on arrival apparently at the White House, but he had a lot of political utility. In fact, you may note that the Republican's since Reagan have all run on reforming the tax code and making it simpler, and it's just that nothing has actually happened to make it simple. In fact, they've made it more complex and added more deductions and so forth to it.

I think there's a lot of political utility and I hope that my party will learn that we should be not stuck in defending the status quo and that we should be articulating a

different viewpoint about tax policy in the country. My proposal is one that goes at the heart of this question. It's at the broadest possible base, which is transactions. In fact, it's so broad, it dwarfs the other bases of either income or consumption. And two, it has features at the state level to deal with education spending and to move away from property-tax financed education so that we can provide a more equitable education to our children.

I think Democrats should be talking about different approaches to revenue generation. I think our nation should be thinking about how we're going to pay our bills and not leave to our children and grandchildren now what is approaching double digits – we have \$9 trillion and growing in terms of our national debt, so we really do need to think anew about how we generate revenues and I don't think that tweaking in any incremental way the present system is the way to go. I think we need to be thinking about a better way to do this and so that we can be a much better country at the end of the day.

MR. IRONS: I think that's a great last word. We're going to take a five minute break and then we will reconvene to talk about education and marriage. So I'd like to thank all our panelists for coming as well, those who have to leave, especially the congressman.

(Applause.)

(END)