

# Center for American Progress



**SPECIAL CONFERENCE PRESENTATION:**

**“OPTIONS FOR TAX REFORM”**

*PANEL II: EDUCATION AND MARRIAGE*

**SPEAKERS:**

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MR. JOHN IRONS: We're going to start in just a few minutes, if you guys could please take your seats. And please remember to turn off your cell phones, pagers, and anything that might make any noise. And also, towards the end of the panel discussion we're going to have a question and answer session. If you'd please remember to wait for the microphone and state your name and where you're from when you receive your microphone.

All right, I think we're ready for our second panel. Our second panel consists of two papers today. The first paper will be presented by Susan Dynarski, who's the associate professor of public policy at the Harvard Kennedy School of Government. She'll examine the complexity of the tax supports for higher education and will suggest ways to make the incentives more efficient and fair.

The second paper will be presented by Jeffrey Liebman, Professor of Public Policy at the Harvard Kennedy School also. The paper examines the implications of switching to a system of independent taxation which would make the tax code neutral with respect to marriage.

Our discussants will be Michael Dannenberg of the New America Foundation and Alan Auerbach who is a Robert D. Burch professor of economics and law at UC Berkeley.

You can find full bios of all the participants in the conference booklets; including Michael's who was a very last minute replacement. Austan Goolsbee was initially scheduled to be here; unfortunately had a last-minute illness in his family and so was unable to make it.

Let me just mention that Michael – since his bio is a little bit separate in the booklet, he was the lead staffer for Senator Kennedy on higher education issues, including student loans and education tax issues. So we're very, very happy to have him come and rearrange his schedule at the very last minute to take part in this.

So I think we're ready to go. Susan is going to kick us off.

MS. SUSAN M. DYNARSKI: Okay. My discussion falls on the incremental end of the continuum. I'm not going to be discussing conceptual overhaul of the tax system of the type that you saw earlier today, but rather changes to the current system that would enhance its equity as well as its efficiency. And that doesn't mean I wouldn't like to see a major overhaul of the tax system, but I think it's useful to think about incremental fixes as well as major overhauls. Though of course, that's not to say that the incremental fixes that I'm going to suggest would be politically simple to achieve either, but they would be incremental changes that would have good impacts.

All right, so first I want to make what I think is not a very difficult case that college is a good thing, that getting people to get more schooling is a good idea. College grads earn more, they live healthier lives, they're more likely to vote, so there are individual returns to college. There are also social returns to college, voting for example, but also maintaining a highly-skilled workforce contributes to economic growth.

And while we traditionally have been a leader internationally on the education front, we have been falling behind over time. So other nations are quite quickly catching up with us and even exceeding us in the share of young people earning a college degree. So if you go back 10 years or so, just a couple of countries were ahead of us in the college completion rate of young people; that was Canada and Finland. And since then, a good four or five countries have passed us; some of them passing us by, say, 10 percentage points, so we are no longer the leaders in terms of college completion internationally.

Now, there is evidence that if you subsidize the cost of college, you can increase college entry and completion, okay? So there's the theoretical basis and empirical basis for believing that subsidizing a college education will get you more education. There's a "can" there rather than a "does" because the design of the subsidies appears to matter. And so I will be focusing on a design of the subsidies quite a bit in this discussion.

Okay, so how does the tax code currently subsidize college? It falls into three categories. There are incentives that subsidize future education, and those are encouraging savings for college education. That's the Coverdell and the 529 education savings accounts. There are incentives that subsidize current education for people who are currently in college: the Hope and Lifetime Learning Credits; the college tuition deduction. There are others, by the way. I'm pointing to the major provisions, but there's even more than this – and incentives that subsidize completed education. People who have already completed a college degree, have already incurred their costs, and somehow the tax code is easing their financial burden: the student loan interest deduction falls into that category.

This is how the expenditures – the tax expenditures falls out for these categories, the Hope and Lifetime Learning Tax Credits being the largest component. If you add up all of the various incentives for higher education, including some that are not in this list, you are starting to approach the magnitude spent on the revenue side in terms of Pell Grant. So we spend about 13 billion dollars a year on the Pell Grant, which is the traditional form of subsidy for higher education. The tax incentives are starting to approach the revenue side at this point.

So let me describe quickly where we are to give some framework for where I think we should be. So first, the Coverdell and 529s are essentially Roth IRAs for education. You deposit after-tax dollars, the returns are not taxed – the withdrawals are not taxed if you spend them on education. The Coverdell is a federal program. It's got a \$2,000 annual contribution limit. The 529s are state programs and they allow you to shelter substantially more in the way of assets.

So the contributions of up to \$12,000 per year per parent, per child, are not subject to the gift tax. So in theory, a family with two kids could put \$48,000 a year into a 529 without triggering a gift tax. The overall account size is capped, and that cap varies by state. It's roughly supposed to represent the four-year cost of going to the most expensive institution. For some reason, South Dakota leads the pack in terms of what they perceive to be the cost for college. They've got a cap on the accounts of \$325,000. That's per kid. That's not per family, that's per kid, okay? So these allow people to shelter quite a bit of money.

The Hope and Lifetime Learning Credits – by the way, the provisions I just described don't have an income cap, okay? So there's no cap on participation in the 529. There is a cap on participation in the Coverdell.

The Hope and Lifetime Learning Credits phase out between about \$87,000 and \$100,000 for joint filers, and they're not refundable, which I'm going to touch on repeatedly. The Hope is worth up to about \$1,500. You can get a credit for 100 percent of the first \$1,000 dollars in your tuition and fees costs, 50 percent of the next thousand dollars. The Lifetime Learning Credit is worth up to \$2,000. It's 20 percent of your tuition and fees costs, up to \$10,000, okay? The tuition deduction phases out between \$130,000 and \$160,000. That lets you deduct up to \$4,000 in tuition and fees annually from your taxable income, okay? So that's – oh, one more: the student loan interest deduction. That phases out between 105 and 135, it lets you deduct up to \$2,500 in student loan interest annually. Okay, so that's where we are.

So they're regressive. Let me describe to you why they're regressive. They have the greatest value for high-income families. Now first, they're non-refundable, okay? If you don't have sufficient tax liability, you don't get a Hope or Lifetime Learning Credit. A family of four needs an income of at least \$30,000 if it's going to get the maximum credit. About half of families with college students don't get the full credit simply because their tax liability is too low. So that really is the key right there. The tuition deduction, of course, like all deductions, is more valuable in higher tax brackets. So deducting \$4,000 from taxable income is a lot more valuable to you if you're in the 28 percent bracket than if you're in the 15 percent bracket. And this is just the nature of a deduction versus a credit. As a result, over half of the benefits of this particular deduction accrue to households with incomes over \$100,000, okay?

The savings incentives are also more valuable in the higher tax brackets, and that's for several reasons. One is that upper-bracket households just save more, so they can benefit more from a savings incentive, from sheltering assets from taxation. But also, again, because of the structure of it, shielding asset income is more valuable in the upper brackets than the lower brackets. In the lower brackets if you invest in a 529 – when I say lower, that's below about \$50,000 a year in household income. If you invest in a 529, you're going to get an after-tax return that's about 25 to 40 percent above what you would get if you invested the same dollar in a non-tax advantaged account. But if you're in the top bracket and invest in a 529, you're going to get an after-tax return double that

you would get in a non-advantaged account, okay? And this obviously tilts the benefits towards the higher-income families.

Another reason why they're regressive is that the incentives have the greatest value for those who attend very expensive schools, okay? So the Lifetime Learning Credit, as I said, is 20 percent of tuition up to \$10,000 capped at \$2,000 credit. So it's got its maximum value in tuition and fees exceed \$10,000, which doesn't sound like much perhaps to many people in this room, but 90 percent of college students attend schools with tuition and fees below \$10,000, okay? So we have designed the credit for 10 percent of college students. Nobody believes this figure. It's true. (Laughter.) I can hear whispers of disbelief over here. But it's true. Basically no – half of kids go to two-year colleges and none of them cost anywhere near \$10,000. They're more like \$2,200 a year. And your typical public university – four-year university costs \$5,500 a year in tuition and fees, okay? Harvard is atypical. Yale is atypical. Bennington is atypical. Everywhere you went is atypical. (Laughter.) You are atypical.

Also, the living expenses of students do not count towards costs for the credits. So somebody who's going to that two-year public college might have very low tuition, say \$500 a year, but of course they still have to live. If they're going to go full-time to school, they're not going to be working, and they need to live. But the costs that they incur for living don't count towards the credits. So for those at public colleges, their schooling costs are just too low, statutorily, to qualify for credits. But living expenses do count as a cost for the savings incentives. So if you are a high-income family and you've got your kid at a Yale or a Harvard, and you're paying room or board, you can use those room or board expenses to tap your 529 or Coverdell. So the tax code is uneven in its definition of what a schooling cost is. And since the savings incentives are tilted towards people at the high end, again this is yielding to regressiveness in the current set of incentives, okay? So you can essentially shield the cost of your kids eating and living if they go to an expensive school, but not if they go to a cheaper one.

All right, I'd argue that regressivity actually reduces the incentive effects of these provisions. Our goal with these provisions is not just to redistribute income, but to encourage human capital investment – to get more people to go to school. So we need to think about their incentive impacts. We've got a goal with these incentives. The greatest potential for increasing college education is among low-income students, and here I'm focusing in these figures on kids who test in the top 25 percent of their class on an 8<sup>th</sup> grade math achievement test.

So I'm focusing here on the kids who have got good academic schools. If you look at the high SES kids, 99 percent of them go on to college. So the top test score quartile, high SES, 99 percent are going to college, 1 percent are never going to college. Low SES kids, 26 percent of those kids, even though they're in the top test score quartile, are not going to college, okay? So that is untapped human capital. Those kids have the skills – the academic skills that they've picked up in their K-8 education, but they're not going onto college later in life and that suggests that maybe costs are what's going on.

And if you look at the share who don't complete a BA, it's even more stark. So among the top 25 percent of test scores among the high SES, just 26 percent don't complete a BA, but 71 percent of a low SES kids don't complete a BA, okay? So if we want to increase college going and college completion, there isn't that much room among the high SES kids. They're already going. It's the low SES kids where we've got – did I say what SES is? Socioeconomic status, rich versus poor. But we've got much more potential to build our human capital with the low-income kids than the high-income kids.

So the education tax incentives are also complex. Complexity is not just a matter of aesthetics, okay? So I'm not going to argue for simplicity simply because it's nice and elegant to have a simple tax code, but because complexity actually imposes its own costs. So a complex tax code imposes cost in the form of compliance costs for the taxpayers. So for example, EITC receivers, 70 percent of them are going through H&R Block to get their EITCs – to get their tax credits. The money that they're paying for that is a compliance cost for them and it reduces the progressivity of the EITC, right? You've got to lop that right off of the amount of money that we're transferring to those families because it's not going to the family. It's going to H&R Block, and those were not the people we were trying to transfer money to when we designed the EITC.

So compliance costs for tax provision can fall on the very people that you're trying to target with your transfer. So I think we actually have to think of complexity as something that actually contributes to either regressivity or progressivity. It also has the classic efficiency costs, of course, in that if you have a complicated tax code, you've got varying tax rates; that gives people opportunities to shelter their income, to game their behavior, to induce the very inefficiencies that economists always focus on. And of course, there's the administrative cost of the government, so if you've got a very complicated tax code, the government is having to spend a lot of money tracking all these different sources of income. That money could be spent on something else, such as transferring it to the poor, okay? So complexity can contribute to both efficiency and equity, and I think it matters for that reason.

All right, so why are the education tax incentives complicated? There's lots of reasons. So say you're a typical taxpayer or an atypical taxpayer – you're a taxpayer and you're trying to decide which of the education tax incentives to use. To determine which one is optimal for you, you have to think about your income because they each phase out and phase in at different income levels.

You've got to think about your potential AMT status because the credit survived the AMT, but the tuition deduction does not, for example. You've got to think about your own marginal tax rate, which doesn't affect the value of the credits, but does affect the value of the deduction with the value increasing with the marginal tax rate.

You're not done. You also have to think about your enrollment status. So are you in the first two years of college or above? If you're in the first two years of college, you can get the Hope tax credit, but not the – but you cannot – if you're not in the second two years of college, you cannot get the Hope tax credit, but you can get the Lifetime

Learning Credit. If you're halftime, you can't get the Hope, but you can get the Lifetime Learning Credit. If this sounds confusing, it's because it is. I'm not trying to be clear. I'm trying to be as confusing as possible to express to you what it's like to people trying to get through the system.

You have to think about the number of students in your household. So you can have – there's a cap on the value of the Lifetime Learning Credit that applies to the household, but you can get one Hope Credit per student, so you can have multiple Hopes in a given household. The deduction cap is also for the household.

You've got to think about the type of your schooling costs, and as I pointed out, the Hope, the Lifetime Learning Credit, and the tuition deduction, only count tuition and fees towards cost, but the 529 and the Coverdell count all educational expenses, including room and board. You've got to think about the dollar amount of your schooling cost because they each cap the eligible amount for the subsidy differently.

And something I'm not even going to touch on, but is enormous in itself, interactions with financial aid. So all of these provisions interact in highly unpredictable ways with the financial aid system that's run through the Department of Education. So that system in itself is complicated, has its own implicit tax rates, and it combines with the tax code in all sorts of very entertaining ways.

Now, I would argue that the complexity of these provisions reduces their incentive impact. Simple and easily communicated subsidies for higher education have been show to have robust impact on college entry and completion, but there's little to no evidence that the tax provisions or even need-based aid such as the Pell or the subsidized loans have any such effect. The answer might be that students simply can't respond to a price incentive if they don't know what it is. So if you don't know what your price subsidy is through the tax code or the financial aid system, you can't respond to it. So you're going to act like college is expensive if you think college is expensive.

A very telling piece of data is that if you talk to high school students – low-income students, high-income students – they're all equally clueless about what the cost of college is. They all get it wrong. They tend to overestimate it. The high-income students, however, are quite confident that they'll be able to fund it. So they are certain that no matter what the cost of college is, they're going to be able to pay for it. The low-income students are not confident that they're going to be able to pay for college. And it serves to discourage them from going to college. So as is the case with the traditional needs-based financial aid, complexity blunts the incentive effect of the subsidies, and we've got extensive empirical evidence on this point.

If we make the education tax provisions more progressive, but we don't simplify them, I would predict that they're unlikely to actually affect the behavior on our target populations. So if they remain as complicated as they are, even if they become more progressive on paper, we're not going to have much impact on a behavior of first-generation college students, children of non-English speakers, low-income high school

students who have a lot of difficulty navigating through a complicated system like our tax code.

So what do I suggest? I suggest we simplify, refocus, and we coordinate the tax benefits for higher education. My main proposal is that we create a single refundable credit for tuition, fees, room and board. A single credit collapsing all of the different incentives we currently have would reduce complexity, obviously. The more simple it is, the more likely that families could actually estimate their credit in advance. So imagine if the parents of a high-school freshman could actually predict how much of a subsidy they were going to get for their children – they could actually use it to predict how much college was going to cost for their children. That might actually affect the children's academic effort in high school if they believe that college was affordable, okay?

So the simpler it is, the more likely you're actually to have an impact on academic preparation and on behavior. Telling somebody what their tax credit eligibility is – once they're in their freshmen year of college, is not real helpful in terms of encouraging people to go to college, but that's the way it's currently structured. You basically find out what your credit is a year after you've already incurred the educational costs.

Making the credit refundable would better target the subsidy towards those on the margins of college. As I showed you, it's low-income families that have more room to increase their college education levels, and if we make it refundable, we can actually get money to those populations who's behavior has room for improvement in terms of schooling investments. Counting room and board would extend the credit to those who are attending cheaper public schools, okay? And it would further reduce complexity by aligning definitions of costs across the different incentives.

A simplified credit could have a real impact on schooling. It could be communicated easily and it could be communicated early, so families would know when their children were young that college was affordable. We could even send estimates of the future education credits to families. So right now we send estimates to workers of their future Social Security benefits. And we base it on their current earnings. It's a guesstimate. It might change depending on people's earnings trajectories, but based on current income and tax liability, we could estimate a family's current education tax credit eligibility and tell them, here's how much money you've got available for your kids to go to college once the time comes. And that could actually have a real incentive affect.

Ballpark costs – emphasis on the ballpark. Brookings/Urban simulated a roughly similar simplification to the one I just described, and the costs that they estimated were that to unify and simplify the credits would cost but \$1.4 billion. Making the credit refundable, more expensive at \$2.1 billion. The sum of those would be to propose what I've laid out, \$3.5 billion. If we eliminated the tuition deduction, that would save somewhere between \$1.4 and \$2.8 billion. The \$2.8 billion assumes that none of the people who were currently using the tuition deduction shift their costs into the new credit. The \$1.4 assumes that half of them do. They start taking up more in the way of credits. So that gives you a cost of about \$0.7 to \$2.1 billion, which shows, I think, that at

relatively low costs we could radically simplify the incentives for higher education, as well as make them more progressive.

MR. IRONS: Thanks. I think we'll go straight to the commenters – or straight to Michael, and then to the second paper after his comments. I think we'll hold comments from the other panelists and the audience until after we're done with both papers.

MR. MICHAEL DANNENBERG: Great. Thank you. Thank you, Susan. Every time I hear you speak or read one of your papers, I think to myself, that's the paper I wanted to write.

You asked a question in the midst of your presentation: why are the tax incentives for education so complicated and then you ran through the details of how they're so complicated, but I think the real answer of why they're so complicated is how they're made.

There was a time when Democrats used to give a little money to the middle class in order to give a lot of money to the poor. And I think in the 1990s that sort of changed, at least in higher education where we started giving a lot of money to the middle class in order to give a little money to the poor. And that's not a criticism. The alternative was, after a Republican takeover of Congress in 1995 with their proposed Contract of America, to dramatically slash capital gains, benefits, and so forth for the wealthy. So a lot of these tax credits and tax benefits were born of an environment where the political right was looking to slash taxes for the wealthy, and Democrats were sort of playing a defensive game. And so under a unique set of circumstances, Congress came up with many of today's higher education tax benefits on the fly.

But Susan is right, completely, in that these seven to 10 different higher education tax benefits are complicated. They're irrational in many circumstances given the different rules for who qualifies and what they qualify for and they're regressive. And they're numerous -- one of the benefits she mentioned, which I've never thought of before, is the parent exemption for dependent students in college. And Susan is right about the low take-up rate.

In the 2004 campaign, I got a call late one night from the Kerry campaign, I think it was the Kerry/Edward campaign at that point, because they hadn't – weren't able to get Brookings to score something for them, and they asked me to take a look at their College Opportunity Tax Credit and asked me to score it. And I – as I looked at it, I did it both inductively and deductively. And I took a look at the Hope and Lifetime Tax Credit take-up rate. It was up 50 to 60 percent in 2001 and 2000 for a Hope and Lifetime. I thought, well, geez, maybe that's because they're relatively new. They came online I think in 1997. But in fact, I suspect it's not much higher today for the very reasons that Susan's mentioned – that the system's just vastly too complicated. And so yes, I agree: consolidate, make higher education tax benefits consistent and refundable, and I would agree in terms of coordinating them with the traditional financial aid system.

But the truth is, if you just make these tax credits and benefits and so forth refundable, you're not going to be helping lower-income kids as much as you would think. And that's because of the coordination with the existing financial aid system. There are various rules in both the tax and traditional financial aid systems that have to be changed in order to help low-income kids, but you can do it. These are not undoable.

To different degrees, I think Susan is dealing with – her paper and her ideas are dealing with three main problems – technocratic problems when it comes to all financial aid, both the tax benefits as well as the traditional financial aid system: by traditional financial aid, I mean Pell Grants, and student loans and so forth. And broadly stated, those three technocratic problems are that the system is antiquated, it's opaque, and it's inadequate.

It's antiquated in that it's reliant on parent decisions. We have this sort of "Leave it to Beaver" notion that Wally is going to sit down with Ward and June and they're going to fill out their financial aid forms and their taxes, and gosh, when we get this benefit from the tax cut, we're going to give it to Wally to pay for school. Whatever gap there is in financial aid and tax benefits for Wally to go to school, Ward and June are going to pay the difference. Well, that doesn't always happen. So the current system is overly reliant on parent decisions, both in terms of federal financial aid, traditional financial aid as well as the non-traditional higher education tax benefits. Ward and June don't always help Wally, if they even exist as a family unit.

The system is opaque in that, as Susan says, there's this timing issue of benefits not being made available until a year after a student applies to college. And that holds with our traditional financial aid system as well. It's March right now. Kids are getting college acceptances. They applied for college in January. Some applied early in October. After applying for admission, they applied for financial aid. They get accepted to college in March, then they find out about their financial aid package – it may be in June. So when they're applying for college, they have no idea how much financial aid there is that is available to them, and that plays into the problem of students vastly overestimating how hard it will be to pay for college. Based on the gasp earlier at Susan's numbers with respect to tuition, even people interested in policy who make up this room's audience, vastly overestimate the cost of higher education.

And then finally the education tax benefit and traditional financial aid systems combined are inadequate. Financial aid is inadequate not just because, as Susan said, smart poor kids are going to college at the same rate as rich dumb kids – or I should say low achieving kids to be politically correct. It's a problem because of the explosion of student debt. That is what's really telling us that financial aid is inadequate in America. It's fast-growing student financial aid debt which on average for undergraduate students is about \$18,000 per now. But for some students, particularly graduate students in professional schools, reaches well into the six figures and loan payments reach over \$1,000 a month when they graduate.

So I think to different degrees, Susan's responding to the ways in which the system is broken. I'm going to throw out a bigger issue, which I think needs to be responded to as well, which Susan's paper doesn't respond to, nor does our current tax-based or traditional financial aid system respond, and that is the tricky issue in higher education finance of escalating college costs. As Susan said, yes, students vastly overestimate the cost of college. There's sticker shock. They think it costs \$40,000 a year when in fact, as Susan mentioned, 90 percent of students pay less than \$10,000 in tuition and fees. Seventy-seven percent of all students go to public two and four-year colleges.

The big unaddressed problem is that of rapid tuition increases. Under George Bush's presidency, we've seen tuition and fees at public four-year colleges and universities go up approximately 40 percent after adjusting for inflation. Why? Because public universities and colleges get their funding from state budgets as much as anything else, and as the state budget crisis has hit, the states have whacked higher education funding knowing the colleges can backfill the money by raising tuition. That is why you've been seeing these big tuition hikes – state budget cuts.

There are rapid tuition and fee increases because colleges, frankly, there's an incentive problem with colleges, sort of like with health care. You have a third-party payer situation. The producer doesn't really have any incentive to control costs, because the consumer wants the best education that they can get. Just like health care, the consumer wants the best health care they can get. And just like with health care, the consumer doesn't have the same price influence that regular consumers do, because there's a third-party payer in the form of the government through grants and tax benefits and even loans – subsidized loans and so forth. There's still an incentive for the consumer, but it's not as strong as when you go to buy a widget at Wal-Mart. I guess we don't go to Wal-Mart here at the Center for American Progress. (Laughter.)

So there's this escalating cost problem. It's got political bite. It really affects the middle class. It affects college aspirations. What to do about it? I'll suggest three brief things in addition to the things that Susan is talking about that I think make sense in terms of reforming and improving our higher education tax benefits.

One, truth in tuition. Yes, the sticker price is high. But net price is much lower, because most colleges and universities discount tuition and fees. Eighty percent – eight of 10 students attending a private college and university, receive a tuition discount averaging 40 percent. Two out of 10 students enter – enrolled in a public university receive a tuition discount averaging 14 percent. So kids are paying far less than the advertised price. Now, what I would do is, (a), require the colleges to report that in their pricing material, instead of hiding the ball and just making it available in financial aid; and (b), require colleges to state their costs for each cohort's class for four years. So when you are entering your freshman year you know what your college costs are going to be your freshmen, sophomore, junior, and senior year. Truth in tuition enables families to plan financially and I think would encourage colleges voluntarily to keep their price increases under control.

Second, states should have to maintain their fiscal effort on behalf of education so that colleges aren't able to backfill costs through higher tuition and fees. We have state matches for transportation, Medicaid, elementary and secondary education. We at least should have the state's maintain their fiscal effort for higher education as well. The states are actually in a good position now to do that, because state coffers are going to start filling up.

And then third and last, the incentive structure, I would argue, needs to change when it comes to higher education, both in terms of tax benefits as well as traditional aid. We need to provide more institutional aid to schools and in exchange require them to limit their tuition and fees— what I would I say is to have zero tuition and fees, at least in your first year. That was John Edwards' proposal in the 2004 Presidential campaign – a variation thereof – and it cost about three – he had it funded at about \$3 billion a year, which isn't far from Susan's cost.

So yes, good job, Susan, on responding to our antiquated, opaque, and inadequate financial aid system, and I urge us to think about the larger issues of college cost escalation as well.

MR. IRONS: Great. Thanks. I think we're going to turn now to Jeff.

MR. JEFFREY LIEBMAN: Okay, great. I hope that means they're going to hand me that computer in a second, but I can start for a minute without it. I want to say that the work I'm about to present is joint with Dan Ramsey, who's sitting somewhere back halfway in the audience here. And if any hard questions come up, Dan is going to have to answer them.

Thank you, John, for organizing this important conference. I think it's fair to say that what you think is a large fraction of the people, certainly around this table and probably in this room, is a desire to find a more productive way to channel the anti-tax sentiment in America than toward deficit-producing tax cuts. And which is where they – most of the anti-tax sentiment seems to be channeled today.

And in that vein, I've recently been thinking about a doctrine of tax policy which I call the "It's bad enough that you waste our – that you take our money, don't also waste our time" doctrine of tax policy. And policies that violate this doctrine include highway tolls that are used simply to raise revenue and not to alter commuting behavior, user fees that require when the rate's small \$7 quarterly checks to local governments which could be avoided if they would simply the raise the property tax rate or the state income tax rate by a few pennies, and state income tax income systems that don't piggyback on the federal taxable income definition.

When I first learned that more than 30 other countries; including the UK, Germany, and Japan, have tax systems where a sizeable number of taxpayers don't have to file tax returns because the government gets withholding exactly right throughout the

year, I started to think about whether the entire 1040 tax form fits into this doctrine of unnecessary time-wasting approaches to raising revenue. Research has shown, however, that countries with tax-free return systems – tax-return free systems tend to have much simpler tax systems than the U.S., and that absent tax simplification the benefits of a return-free system in the U.S. would be minimal.

When one looks at the simplifications that would be necessary for the U.S. to get most of the benefits that could accrue from a return-free system, three of the four simplifications are appealing even in the current filing system. The first is to replace the complicated child-related tax provisions with a simple per child payment. David Ellwood and I wrote a paper a few years ago about this topic, but the proposal we came up with still had the phasing in of child benefits with income analogous to the current phasing in of the Earned Income Tax Credit. What I currently favor, and frankly what I favored back then but couldn't get David to go along with, is something even simpler: a per child benefit that is not dependent on income at all and that could therefore replace not only all of the child-related tax provisions in the tax code, but also a substantial share of food stamps and TANF for families with children as well.

The second desirable simplification would be to tax all capital income at a single rate and to withhold the tax on its income at its source so that most individuals would not have to report and pay tax on their capital income. This could ease integration of the personal and corporate income taxes and then the double taxation of earnings from corporate equity.

The third needed simplification is to reduce deductions, as experts ranging from Dick Gephardt to the members of President Bush's advisory panel have recommended. One doesn't have to eliminate all of the deductions to have a return-free system. For example, the UK maintains a deduction for charitable giving through a very clever mechanism. Taxpayers make a payment to the charity that is 80 percent of their intended gift, and then the charity files with the government to get the remaining 20 percent.

So, so far, so good. The simplifications that would be needed to go aggressively toward a return-free system are all things we should want to do anyway. But the fourth simplification is more problematic. And the fourth simplification would be to tax married spouses independently. In a tax system with multiple brackets, independent taxation greatly facilitates the exact withholding required a return-free system because it means that information about one spouse's income does not need to be communicated to the other spouse's employers.

Independent taxation also would reduce marginal tax rates on secondary earners, eliminate marriage penalties and bonuses, and eliminate the inequities associated with treating cohabitation differently for marriage. But there is a potential drawback to independent taxation: since household members share economic resources, a strong argument can be made on the ability-to-pay grounds that total household resources should be taken into account in determining tax liability. And the purpose of this paper is to determine how significant this potential drawback is. In addition, we explore whether

there are any adverse distributional consequences of a move to a stylized system of independent taxation.

It turns out to be the case – it turns out that the case for joint taxation as a way to more accurately assess ability to pay is not all that strong. And let me explain why, with two examples.

The first example compares two couples, each with \$100,000 in total earnings, but with the earnings split differently between the two spouses. In this example, we assume that both spouses work full time. So in this example, the two-households work the same total number of hours and then the same income. Under joint taxation, the two couples would pay the same tax. Under independent taxation, the couple with more unequal earnings would pay more tax because more of the earnings would be taxed in the high bracket. And this is the kind of example that makes people argue for joint taxation since it is hard to see why these two households should be taxed differently.

Now let me show you a second example. Again, the two households – the two couples have the same total earnings, but now the annual hours are different. In this case, couple A not only has a \$100,000 of earnings, but it has a lot more untaxed leisure or non-market work done by the wife. So couple A is almost certainly better off than couple B, where only by – where for couple B only by having both people work full time can they get up to \$100,000 worth of earnings. So in this case, joint taxation again makes the two couples pay the same amount, but in this example that's not a good thing; rather, independent taxation, which makes couple A pay more in taxes, gets it right.

The most straightforward analytical approach to adjusting for different family labor supply and determining ability to pay is to rank households based on their potential income rather than their actual income, where potential income is the income the household would have if each spouse worked 2,000 hours per year. And that's basically the approach we take in this paper to analyzing the equity implications of moving from our current tax system to one of independent taxation.

So what we do is we study an illustrative independent taxation system in which we have to make several choices about how it's going to be designed. We decide that the tax system for each spouse is going to be the current tax brackets for single taxpayers. We replace the child tax provisions with a payment for each child that does not depend on income, although it increase – the payment for the earlier child – children is larger than for later children to try to mimic the value of the Earned Income Tax Credit under the current tax code. We tax all capital income at 15 percent under the assumption that it would be withheld at the source. And we replace deductions with a 15 percent tax credit. This is really a placeholder for whatever elimination of specific deductions might come out of a reform like this.

And – oh, what happened when we put this plan together, we actually didn't spend a lot of time iterating through versions of this. We were just trying to come up with an illustration, but what we came up with was pretty close to distributionally neutral

and revenue neutral overall. And the first main result that came out of this is that it's pretty simple. You have enough free parameters in a system like this to match the income distribution, the average amount of tax paid at each level of income of the current system. So there's no reason why a transformation to an independent tax system would have an – has to have any particular adverse distributional consequences.

The second and I think main result of this paper can be shown in the last two slides that I want to put up which show the distribution of average tax rates at different income levels under the current tax system in the top panel, and under this reform system in the bottom panel. And you might want to look at this in your book rather than the screen given that there are lots of little dots on the diagram.

And so I'm going to show you this figure presented two ways. In the first slide, the income measure that's going to be used is taxable income; in other words, the current definition of income under the tax code. And of course, under the current tax system, families with the same taxable income pay the same tax with the exception of families that claim tax credits or have capital income taxed at a preferable rate. And so what you can see is that under the current tax system in the top panel, most of the taxpayers face average tax rates that are very tightly clumped along the dark line at the top of that diagram; whereas if you look at the independent taxation system, you'd end up with a much wider spread of average tax rates at any level of income.

So what that shows in this pair of figures is the classic argument against independent taxation, if taxable income were a good measure of the ability to pay, if the deductions and exemptions in a just total income and produced taxable income do what they're intended to do, then there would be a strong case for joint taxation. But as I illustrated a few slides ago, judging ability to pay from taxable income ignores the fact that families can have wide variation in labor hours, so potential income is a much more appealing basis for ranking families on ability to pay.

And so that's what I do in this next slide. And what you see here is that when you rank families by the more appropriate potential income concept of ability to pay, we see that the spread in average tax reaches quite similar with the two approaches. We basically have two offsetting effects. Independent taxation is more equitable in the treatment of households with different amount of labor effort, while joint taxation is more equitable in the treatment of households with the same labor effort, and the same total earnings, but different spouse wage levels.

So the conclusion that comes out of this analysis is that when properly measured, independent taxation and joint taxation are similar on horizontal equity. And given that independent taxation is preferable in other grounds, given that it produces lower marginal tax rates on secondary earners and has some of the other equity advantages I discussed, it doesn't seem to me that this should be the obstacle to a return-free system. Indeed, I would put independent taxation alongside the other simplifications I mentioned as things that are desirable whether or not we go to a return-free system.

Thank you.

MR. IRONS: All right, let me jump in real quick here. Obviously, we're running a little bit behind schedule. I think we're going to try and take another 10, 15 minutes for the session, let Alan comment, ask if you have a couple of questions, and then we will jump to lunch which I see has arrived. So that will keep us – give us incentives to be brief. Alan?

MR. ALAN J. AUERBACH: I guess that's meant for me. (Laughter.) Can I have the computer? Okay, so, where do you want – how do I –

MR. LIEBMAN: Is your presentation on here somewhere?

MR. AUERBACH: Is mine here somewhere?

MS. : Yeah, go back to the slide show.

MR. AUERBACH: Go back to the slide show.

MS. : Yeah.

MR. AUERBACH: Okay.

MS. : And keep flipping through.

MR. AUERBACH: Oh, I see.

MR. LIEBMAN: I had two things I didn't – two slides I didn't use.

MS. : There you go.

MR. AUERBACH: Okay, thank you. Okay. Well, I quite enjoyed this paper. It's provocative and certainly it's a question worth asking. The title of the paper is a question worth asking. It's actually – there are actually three questions that the paper addresses. First, do we want return-free filing? Second, if so, can we design a workable system of independent taxation, which is really going to be needed for return-free filing. And third, if independent taxation is feasible – if we can figure out how to do it – is it a good idea? And all three questions are addressed. I think the third is certainly the main focus in the paper.

But just to go through all three questions, do we want return-free filing? Well, there are pros and cons. I think Jeff assumed it was a good idea because it would sort of reduce transaction costs, and obviously there would be substantially reduced compliance costs. And some would also see it – as Jeff said, the systems are simpler because it reduces the scope for complicated tax expenditures. It's – you just can't put those into a system with return-free filing.

Now, there are cons. One con is it reduces the awareness of tax burdens which is a criticism that some people have leveled against return-free filing. And then of course, some people like complicated tax expenditures. After all, that's the only explanation for why we have them, isn't it? And, you know, they would be upset at being constrained by not being able to put these messy education provisions into the tax code. But I think on balance I'd certainly vote with the pros on this. I think that – I think return-free filing is a very attractive alternative to our current approach.

Now as the – as to the second question, is independent taxation feasible? Well, yes, and Jeff goes through some of the changes that would necessary to introduce a system of independent taxation. A few to just highlight, credits and deductions are generally not based on filing status. If you're having – if the system is based on individual, then by definition you can't bring in a lot of the things that have to do with the family structure.

Second, capital income. Jeff said you'd need to go to a flat-rate tax held at source. Well, what's the reason for that? Well, if we try to keep progressive capital income tax rates – first of all, that makes it very hard to coordinate with the withholding at source of wage and salary income because then you're trying to figure out what – you need to have information – different payers have to be able to coordinate information on what the individual's tax bracket is.

And second, there's a very major problem which is the possibility of a shifting of income within families. And of course, that's one of the reasons why we don't have independent filing now. And if you want to eliminate that incentive, then the only way to do it is to not have different marginal tax rates for different members of the family and that means having a schedule or system of capital income taxation not based on individual circumstances. And that's what the simulations in the paper assume.

And finally, something that isn't mentioned in the paper is the treatment of small business. And I – small business means a lot of operations, not just the classic grocery store or something like that, but also all the people who file schedule C and some of the other schedules and that represent partnerships and other kinds of small businesses. Of course, we know that these businesses – the income in these businesses are part capital income and part labor income, but if we – and it's a problem now, but it would be a lot bigger problem if we try to have a progressive labor income tax and a schedule or a, say, 15 percent capital income tax unless we just punt and decide to treat all small businesses as capital and just tax them at 15 percent. Otherwise, they're going to be real problems in trying to figure out how to deal with small businesses. But in – on balance, I guess I would say an independent taxation is certainly feasible. We can figure out a way to do it. Other countries have done so already.

And finally, the last question, is independent taxation a good idea? Well, it's – think about some of the issues that might come up. First of all, you might look at the necessary change in capital income taxation and be concerned at the reduced

progressivity of tax rates. I have two responses to that. First of all, we're there already. I mean, 15 percent isn't just a number Jeff picked out of a hat, I assume, and so it's not exactly clear what we'd be giving up from our – certainly from current system. And also, keep in mind that system progressivity is what matters, not the progressivity of capital income taxation, per se. And there are ways of dealing with it in the context of an overall tax and transfer system, and I don't think we have to be that concerned about having a 15 percent capital income tax.

Now, as to labor supply, well, there's a big payoff, and Jeff mentioned that, which is we've – we have the problem, we've been struggling with a second-earner deduction in 1981, getting rid of that. We know that there's a big problem with the disincentive facing secondary earners, and this gets rid of that.

The critical question which Jeff ended with and which I'll end with in just a couple of slides, is horizontal equity, which is – we're changing the treatment of families and there are going to be some winners and some losers. Now, as the paper indicates, there are two offsetting effects. On the one hand, you don't treat one spouse's decision not to work as a reduction in the family's ability to pay, and that's good and that's just putting a different spin on the fact that you're getting rid of the marriage penalty on secondary earners. You're not saying the family has higher ability because a secondary earner goes to work. On the other hand, it fails to recognize that circumstances depend on the family's ability to earn and not an individual's ability to earn, and that's a problem.

Now the simulation showed these really offset. I think, in terms of presentation the scatter plots are useful. It would have been helpful to present some sort of a summary index to indicate where the system does better – where in the income distribution the system does better, where it does worse.

Now there's a further horizontal equity issue that isn't considered in the paper, which is singles versus couples. So the entire focus is on the treatment of different kinds of married couples, but we should – should we ignore marital status? Well, it isn't obvious if you think about the economics, not worrying about the administrability (ph) of a system. After all, when we – traditionally when we thought about treatment of married couples versus single individuals, we thought about economies of scale, how the ability to pay changes when people live together as opposed to separately. Of course, it's not marital status per se; it's the family structure that we care about, and family structure is very hard to monitor and verify and probably getting increasingly so. So I don't think that there's much we can necessarily do other than what Jeff is assuming, but I think the simulation should consider the dimension of horizontal equity, however they want to consider it, between singles and married couples in similar situations.

So in summary, I think return-free filing is something well worth consideration, and I also agree with the authors that independent taxation isn't a barrier to adopting return-free filing. But I think that more thought is needed about provisions needed to implement independent taxation; for example, the treatment of small business. And I

think also more thought is needed about who the winners and losers are not only among married couples at different incomes, but also bringing single individuals into the comparison with married couples.

MR. IRONS: Great, thanks. I think we'll go ahead and take a couple questions now. If the authors want to respond to the commenters as well, we'll let you do that in the context of answering questions. But let me see if there's any questions. Raise your hand. Right here first.

MR. HALPERIN: Jeff, I'd like – I believe in independent filing. I tell my class that when I teach this stuff. But I don't think it's going to happen. I think it's not realistic. So it seems to me that if you want to have return-free filing, you've got to think about whether you can do it even though we're going to continue to have joint returns. I would assume it's not impossible. I mean, people have two jobs. I assume that that has to be coordinated in some way. I think Alan' is right: you're going to have to think about how to handle the small businesses. So it seems to me that it's not impossible to have some sort of reconciliation at the IRS level.

MR. LIEBMAN: Let me just say that if you went back in 1970 and looked at Europe, they all have joint issues and half to two-thirds of the country have switched –

(Cross talk.)

Q: And did they have income splitting? A lot of them did not, right?

MR. LIEBMAN: The politics were a little different, as I talk about in this paper a little bit, and that there was this weird confluence of the (Hope?) family organizations and the women's liberation movement in Europe that doesn't – isn't exactly the same as our politics, but it – the world's been moving this direction. Really no one's been going back, except maybe the UK, which is starting to put more – do more social policy in its tax code through reforms that require putting household income together. So I don't know. I agree it's politically hard.

MR. IRONS: Let's see if we can take one question on education, if anyone has an education question? Okay, we'll take one more question then –

MR. : All right.

MR. IRONS: – and go to lunch. All right, is there one in – let's go to the one in back here, on the left. Sorry. My left, your right.

Q: Heidi Hartmann, Institute for Women's Policy Research. I wanted to say I think independent taxation is a great way to go. And I think the women's movement in this country would also support it because it's – there's a tremendous movement of women into the labor force, but – and also, just one – another argument for it is that family structures do change and the general movement of women in and out of marriage

over a lifetime and very often winding up single in retirement means that they're – they don't really have the access to the marital benefits, and so anything that encourages them to work and reduces their taxes while they're earning also increases their security in retirement. So in general, I think it's a great idea, but I've always heard that because we have these community property states, we wouldn't be able to do it here, and I wondered if you had looked into that.

MR. LIEBMAN: You should turn that over to one of the lawyers here and not me. (Laughter.)

MR. AUERBACH: We've overwritten community property for IRAs. I don't see why we can't do it for this.

MR. DANNENBERG: But it wouldn't really be an issue with a 15 percent tax. That's – one of the problems with community property states is the allocation of capital income within the family –

(Cross talk.)

MR. DANNENBERG: (Of?) labor income.

MR. : Well, I think we can. I mean, you just pass the federal statute (saying?) community property doesn't count for labor income.

Q: (Off mike.)

MR. : You certainly could pass in the Internal Revenue Code that it's – community property does not count for purposes of determining who earned the income. As I've said, we've done it for IRAs, and I don't see why we couldn't do it generally.

MR. IRONS: Thank you. We'll want to wrap it up there. We have lunch outside. If you could get your lunch, if you'd like to eat it very quickly, we have a noon – or now a 12:15 panel which I think will be very interesting. Thanks. I'd like to thank our panelists as well, especially Michael for the last minute show.

(Applause.)

(END)