SPECIAL CONFERENCE PRESENTATION:

"OPTIONS FOR TAX REFORM"

PANEL III: REWARDING AND ENCOURAGING WORK, SUPPORTING PARENTS, INTERNATIONAL TAXATION

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MR. JOHN IRONS: All right, if we can go ahead and get started. Do you mind taking your seats? Let's see. It looks like we have some drop-off from the rest of the day. I can't imagine why people wouldn't want to spend an entire Friday thinking about tax policy, but it's good to see a few faces that have been here since 9:00 this morning.

The final panel today will consist of three proposals, and we'll kind of go in alphabetical order here as well. The first paper will be presented by Anne Alstott, who is a professor of taxation at Yale Law School. She will examine the need to support our nation's families and proposes a caretaker credit.

The second paper is by Jason Furman, a visiting scholar at NYU's Wagner School. He will examine the relation between tax reform and poverty and emphasizes the need to expand and improve the Earned Income Tax Credit.

The final paper is by James Kvaal who is a former senior policy advisor to Senator John Edwards. He will take a look at the system of international taxation and will recommend a partial exemption system.

The three papers will be discussed by Robert Gordon, who is a senior vice president for economic policy here at the Center; John Gruber, a professor of economics at MIT; and Daniel Halperin, the Stanley S. Surrey Professor at the Harvard Law School.

Again, the full bios of all the participants, as well as the papers, are in the bluebook as well. So I guess we can go ahead and get started.

MS. ANNE ALSTOTT: Okay. My paper is very much in the policy wonk mode and indeed in the academic policy wonk mode, since I am an academic. I'm not going to say much about politics. I'll nod to it here and there, but I understand that Robert Gordon is going to remedy that gap when he comments on my paper and talk about the politics of some of these issues.

This paper interacts to some degree with – and I'll talk about this – circle back at the end with the variety of tax provisions that we now have that in some way seek to reduce the relative tax burden on or equivalently improve the relevant economic status of families with children or of parents who are caring for children: the child tax credit, the head of household filing status, the family size adjustment portion of the Earned Income Tax Credit at least arguably, the dependency exemption for children, the Dependent Care Tax Credit, the exclusion for employer-provided dependent care, and I've probably forgotten a few.

In contrast to the kind of thing that Beth was talking about in the prior panel, these are largely distributive provisions, right? They intend to redistribute resources. Now again, we can talk about the family size adjustment in the EITC and whether that

has an incentive component as well, but most of these largely are intended to better the relative situation of people caring for children or with children in their household.

Now, my paper is really an invitation to rethink why we have these, what purposes they serve, and whether there's a better way to think about doing this. My proposal really follows from two ideas, so I'm going to start with the ideas before I give you the actual proposal. And I want to note that the ideas are – you can buy one of them or both of them, but in principle they're separable. So and – but of course, I take them together to get to my proposal.

The first idea is that all parents should receive the same dollar amount, okay? In other words, the defining criterion here should be parenthood or technically slightly different but – for this purpose, probably the same child rearing should be the criterion, and not other kinds of criteria, like, are you in the positive tax-paying range or not? Implications include that the provisions should be fully refundable. If it's operated through the tax code, the provision should be fully refundable, and not take the form of a deduction and exclusion or a nonrefundable credit, so that my proposal comes squarely in the midst of the numerous proposals you've already heard today that would be fully refundable tax credits.

In contrast, the child or family – I think it was called the Family Tax Credit in the president's panel, would have – is not fully refundable, so that we're doing something different and rather more expensive. That's one principle: that all parents should remove the same dollar amount.

The second principle is that we ought to think why it is that we want to redistribute resources to parents. With what end, right? And my claim in the paper and in the larger book of which the paper sort of grows out of, my claim is that we ought to redistribute extra resources to parent because parenthood is especially – has distinctive economic burdens.

And in particular, I identify three economic burdens of parenthood. One is that parents, if they want to work, have to afford paid childcare. Paid childcare is expensive, particularly for women relative to their wages, right?

A second distinctive burden – economic burden of parenthood is that if you choose not to continue in the paid workforce in the same way that you otherwise would – and that's two of an enormous percentage of mothers, okay? There are – there's a high percentage of mothers who are in the paid labor force in some way, but a high – there's also a fairly high percentage of mothers not in the paid labor force and another large percentage who are working part-time so that there's a distinctive loss of human capital – loss of or failure to develop human capital when you take periods out of the labor force to rear your children or if you take a sort of mommy-track job path.

And then a third distinctive economic burden of parenthood is that you sacrifice many, though not all – parents sacrifice retirement security, right? And again, this is

disproportionately a characteristic of mothers who are very much the focus of my work. Again, if you take time out of the paid workforce or if you have an interrupted pattern of earnings, you are going to on average sacrifice private retirement provisions in the form of 401(k)s and the like. And while Social Security can make up for that in some instances, Social Security as we know has highly contingent requirements. I'm thinking in particular of the requirement that you be or have been married to collect the spousal benefit, which is one way that we attempt to redistribute to women that care for kids.

So what's the proposal falling out of these ideas? I call the proposal caretaker resource accounts. Now, why do I say caretaker? Well, this follows out of some theory stuff that's in my book that basically the focus is on people who take care of children, right? Because it's not all people who have children that bear these burdens, but it's people that take care of them, meaning, in our gendered society, mostly mothers, but not entirely mothers. So again, my focus is more on the dilemma of the person who either has to put in his or her time at home with the kids or has to at the margin purchase the child care to do this. And so the focus is on – you can – there are different names for these people, right? I could have called them secondary earners or I could have called them mothers, right? In general, I could have – but I called them caretakers because I wanted in part to be gender neutral in recognition of the growing number of men who are suffering these same burdens as well; my own husband being one.

So, what is a caretaker resource account? So a caretaker resource account is a – let me just say how it would work. Every year, the caretaker parent of a child, with child I offer different specifications for how we would define a child. You can – you know, depending on what you wanted to do, define it as under 18, under 13, or under six. Those are different specifications I'll get to later. Every parent of a child receives a dollar amount. And again, the dollar amount is variable, right? We could talk about a cheaper program in which the dollar amount is, say, $2,000. We could talk about a quite expensive program in which the dollar amount is, say, $10,000. This – you know, I – which one you picked depends on how much money you have, how much good you want to do, how important you think this is relative to other things. So I view this as not something that has to be nailed down, but there's a continuum.

But the – let's just – just to get a focal point, call it $5,000, right? So every year the caretaker parent of a child would receive $5,000. But the $5,000 wouldn't be simply a check from the government. Instead, it would be a deposit by the government into an account which could be either an actual account or a no-show account, and the parent could use the funds in any one of four ways, right?

One way the parent could use the money would be to pay for paid childcare. So in that sense it's like a voucher; a kind of voucher program for paid childcare. So you'd have up to $5,000 a year for that. But suppose that you're somebody who doesn't use that much paid childcare or indeed, maybe you're an at-home parent and you don't use any paid childcare at all or perhaps you're a person who has a relative who takes care of your kids or maybe your kids are old enough that you don't need paid childcare. What do you do then? How is the program valuable to you? Well, then the other uses come in.

The second possible use is that you can use the money in the caretaker resource account to pay for your own – which is to say, the parent's own education. Why is that useful? Well, it corresponds to the second economic burden of parenthood that I talked about: for parents who have taken time out, sacrificed their own education, want to retrain, want to retool, brush up their skills. Again, it's not a one to one – right – correspondence because what parents are losing is workforce experience, education can't – it's not like education is sort of workforce experience in a bottle and you just pour it back into them. But it does – it is responsive to some degree to that particular situation.

But maybe you don't want to do that; don't need it, don't want it, or it's not something that you could benefit from. You have another use. The money could be used to beef up the parent's retirement savings, okay? And again, this would be a kind of voucher that could be used to make a deposit into a 401(k) or whatever – it wouldn't have to be – kind of vehicle that would be.

And then the fourth use is that – is kind of a fourth use, but it's implicit in the account structure of the program, is you could choose to do none of those things and wait. In other words, hold the amount in the account until some future year and decide at that point which of the first three uses you want to do it. So the important takeaway here is you can never – until retirement, take it out and pay your grocery bill. You can never take it out and spend it on living expenses, and I'll get to that a little bit later. This is a program that is intended to support future-oriented economic planning by parents.

Now the – why do I have this account structure, why am I allowing people to make choices and so on? Why does it have this slightly funny structure? Why not just say, let's make the Dependent Care Credit refundable, right? Why not restructure savings incentives in a progressive way, as some people have talked about.

Well, the answer is that again, you have to go back to the two principles I started with. The idea is to give every caretaker parent an equal dollar amount invariant to what they're going to do with it, okay? So the idea is not to give more to parents who paid more – paid childcare and less to parents who don't, more to parents who save for retirement and less to parents who don't, it's an equal dollar grant. And it's going to strike some of you as familiar. It had – it sounds a little bit like an Individual Development Account or something of that kind. But the principle behind it is, number one, to give parents an equal dollar amount, number two to underwrite – make it possible for more parents to engage in this kind of future economic planning.

And the account device also has some distinctive sort of policy wonk advantages, right? One advantage is that this kind of benefit if fully portable simply because it's not tied to employment, right? Unlike, say, the exclusion for employer-provided dependent care which is contingent on your having an employer and on the employer being large enough, well-funded enough, and sophisticated enough, to have one of these things; and on your being in a tax bracket so that you can take advantage of it. None of that matters here. It's an equal dollar refundable credit and you simply get it by virtue of your being a

parent. The vehicle is very flexible. It allows individuals to make tradeoffs across uses, right? It doesn't, again, make the centralized judgment that people who buy paid childcare get more than people who don't or that people who go back to college get more than people who don't. It's decentralized. It allows each parent to decide for himself or herself which use makes the most sense at any given time.

And the deferral feature, the feature that says I don't want to choose to use it all this year, maybe I'll save a little bit and see where I am next year, actually responds to a third – I don't know that I want to call it an economic burden, but let's call it a characteristic of parenthood, which is that each year is a new year, situations change. And we see this for example in the very interrupted and ever-changing labor force participation patterns of mothers, right? You may work the first year with your first kid, but a second kid is really going to change your life in ways and turn you into a stay-at-home parent for awhile. Maybe you go back when your kid is six, and then you have a sick child or something like that. And so you can – you don't have to decide once and for all I'm in the paid workforce and that's it.

And you also – I see. You also don't lose benefits, okay? You don't lose benefits. A lot of benefits have a – tax benefits now, including refundable credits, have a kind of use-it-or-lose-it structure, so that if we provided, say – well, say the Dependent Care Tax Credit, if you don't use your Dependent Care Tax Credit this year because this year you were a stay-at-home parent, too bad for you. You don't get it. You can't say, "I'm going to hold that money for some later time when I go back to work and then it will do me some good then."

One possible political advantage of all of this, although I think Robert is much more the political expert then I am, is that this kind of structure might help us sidestep some of the cultural wars that we are incessantly fighting about motherhood, right? The incessant cultural wars about working mothers versus nonworking mothers, you know, sort of red-state patterns and blue-state patterns, traditional values and sort of other folks. This is all about my view – the starting point for this project was this is all about people taking care of kids. They are all – at least if they have custody of their kids, they are all sort of – we ought to give them credit for all doing the best that they can in whatever cultural pattern they choose to use and their benefits shouldn't be dependent. So that may have some political advantages.

Now the final section of the paper, I'll just summarize it briefly since I got my three-minute warning, is how much would all of this cost and how would it interact with existing tax provisions? Pages 70 and 71 of the book give you some ideas. I give you a range of revenue specifications ranging from basically the fewer kids you cover, or the fewer parents you cover, and the less money you give them, obviously the less expensive the program. The more generous and the more kids you cover, the more expensive it is. And so I give you a range of revenue expenditures. Those, I have to say, are in no way sophisticated. I'm a lawyer, not an economist, and so I'm sure – you know, I just – I sort of estimated the simplest possible flat rate kind of proposal.

There's a question that I take up in the last section whether we should fund a program like this by cutting back on other kinds of benefits in the tax code, right? So for example, you could repeal – you know, the existing tax provisions that are the closest to what I'm talking about right now are probably the Dependent Care Tax Credit, the exclusion for employer-provided child care – both of which provide far less than I'm talking about, right – and the child tax credit itself. So you should repeal those and substitute this. Well, you can do that. And I think they're reasonably close in their aims.

But I have two caveats to that. One – and it's not caveats to what I've just said, I will defend that you could repeal the child tax credit and these two dependent care provisions, and I actually think it's a decent idea. But I have two caveats to the general thought that we ought to search hard for revenue offsets, and whenever we propose a new program, we ought to search really, really hard for – I mean, this is a theme of the last panel too, for revenue neutrality, right?

And the two caveats are, one specific to this proposal and one, more general. The one that's specific to this proposal is, I don't propose – I mean, I suppose I could have gone hog wild and said, let's repeal the EITC and let's repeal the 401(k) exclusion and all of this sort of thing. That would be crazy, right? Those programs do different things. In particular, one place I could have gone and didn't go in looking for revenue offsets here is I didn't want to fold the EITC into this, and I didn't want to fold – here's another possible revenue offset, welfare spending into this. Those are income-support programs. They offer day-to-day consumption subsidies for people that need day-to-day consumption subsidies.

My program, obviously enough, but it's worth saying, is not going to replace consumption subsidies, income support – whatever you like to call it – for people with children that can't pay their grocery bill, okay? I said before, this program doesn't let you pay your grocery bill. This is a program very much – it's for parents all up and down the income spectrum, but it has to coexist with income support because we're certainly not doing parents or children a favor if they can't also pay their grocery bill. My point is that we should think above and beyond the point where we're helping people pay their grocery bill, affording decent housing and so on. We ought to think about why, and if it all, we want to give additional sums to parents. And that's the – what this paper is about.

The more general caveat is, again, and it's obvious enough, but it seemed to me to be worth saying, that the search for revenue offsets feels politically safe, and it is politically safe, right? If you're going to realistically go up onto the Hill and propose something, they're going to say what are your offsets? And you're – they're going to try and whittle you down to a net number that's very, very small, simply because that's the political world they live in. Well, I'm an academic and I don't think that's the world that we necessarily have to live in, and I didn't see it as my mission necessarily to do it. So that the net revenue cost numbers in my paper are big. They're really big, but that's because I think that the net assistance we ought to be offering to parents is also big. And I don't think we should shy, as progressives, from saying that.

MR. IRONS: Thanks. Robert?

ROBERT GORDON: Oh, okay. Well, I want to start by saying how honored I am to be here and to speak about Anne Alstott's paper. She was a professor at Yale when I was in law school, and she was pretty much everyone's favorite professor. I think won a teaching award the year that I graduated, and I am reminded of why I made the mistake of taking tax before she arrived.

So, I think there are many terrific features of this proposal. The first I actually think is its breath and its boldness. I think we in Washington don't think this big often enough, and when we do think big, we tend to think big in the same ways. And this is a new way, and that's an admirable and important thing. I think taking the value of parenting seriously and its cost seriously is something that we don't do enough, and that is at the center of this plan. I agree with Anne that treating equally the decisions of parents whether to stay at home or go into the workforce is both a politically and substantively valuable feature and is an important thing for progressives who have gotten in trouble over these issues.

At the same time, I have a set of doubts, some of which I think of as political doubts, and some of which I think of as substantive doubts. And I will probably just run them together. I'll just start with a political story, which is that I – like James, I actually used to work for John Edwards. And he had a proposal in 2004 that actually was something that Gene Sperling if he didn't talk about here talks about in his book. And it was an idea that came from Gene to give a $1,500 tax credit in the first year to parents with a newborn child. So it's smaller, it has many different features: it's smaller, it's open ended how people can spend the money, and it was fully refundable also. And it was not a proposal that he – it was something he talked about – he gave a speech where he talked about it a little bit and it never really took off. It was an interesting thing. Most of his proposals he would talk about constantly. He didn't – it was one that didn't really work so well with audiences. And for whatever reason, I think it remained an official proposal, but it wasn't something that he continued to talk about.

And it's an interesting thing to think about why that it is and whether that that this proposal would have the same fate. I think other people who have tried to engage with the problems of struggling parents have had similar resistance met in the political sphere. I'm thinking of like, Karen Kornbluh who has done a lot of wonderful work on the situation of juggler families and their struggles of parents who are trying to balance. And again, I think she was frustrated in 2004 to see that ideas that have been very popular in a think-tank context had not really flown politically.

So why is that? You know, I think there's a lot of possibilities. I wanted to, I guess, mention three sets of concerns. The first – and I want to credit Michael Lynde (sp) with this observation, which has been bouncing around in my head for a few days since he made it in another context, which is a totally unrelated context, but it applies here, which is that this is a paper that talks a lot about the values of choice and freedom, and those are obviously great American values. And then it attempts to say that we can use

government and tax credits as a way to help enhance people's freedom. And just – I want to raise the question, how far we can get in America talking about the idea of a government program and even a tax credit or a tax expenditure or a refundable tax credit as the way that we're going to enhance people's freedom. People on the right talk about tax cuts as a way to set people free. And that's – you keep your own money and you spend it however you want. We have tried to spin that around, talking in terms of refundable tax credits. But I'm – I guess I am really not sure how well we will – how far we can take this idea. And this is a proposal that takes it extremely far if we're talking about $5,000 per person credit or grant because I think that people think of an element as freedom as being freedom from government.

And if you think that about popular government programs, the contrast between those and this proposal – one is Social Security, but people think of Social Security as being their money; whether it is their money or not is a different question, but they think it's their money. And another is the EITC, which we have talked about a lot here. One difference between the EITC and this proposal, which is along a different axis of course, is that the EITC is a reward for work, which is resonant with a deep American value. This is a payment related of parenting, and I'll get to that in a second.

So one is that it's work related and the other is that we often like to talk about the EITC as an offset for payroll taxes, which is taxes that people are paid. So even though – even when it's fully refundable, it is an offset for taxes that people have actually paid. And I actually wanted to sort of close out on this thought about freedom whether it isn't worth progressives who are worried about the cost of childrearing – and this again would only address a piece of the concerns with Professor Alstott's proposal, thinking more seriously again about something like paid family leave because whatever the impacts on business, and I guess you can argue about that, the advantage of paid leave is it falls under tradition of mandates on business like the minimum wage that I think are very popular. And people, in part, because the costs are hidden and because they think of it as something that they are entitled to as an incident of their work. Obviously that only addresses a portion of the concerns here.

The second set of issues that I want to raise and I want to do it very quickly, are about the way that concerns – and these are both political concerns and policy concerns about the interaction – the way that this proposal seems to me at odds with other statements that we have about the interaction between family structure and poverty. Sorry.

The proposal is that you get a large grant for having – when you have a child and as you continue to have a child. And as I understand it, you would get it regardless of whether the age at which you have a child and regardless of whether you're married. And of course, you could say the same thing about the child tax credit that we have right now. But one, it's a lot smaller, and two as we all know, we've had a lot of fights about the refundability of the child tax credit. It seems to me it would be hard for – the premise of the paper is that – I think is that society should be neutral about these decisions, about when to have a child and whether to marry. That's not the assumption embodied, for

example, in the welfare reform legislation of a decade ago. And I think it's – to me, anyway, it's not necessarily an assumption that even progressives should embrace, given all that we know about the relationships between the age of which people are parents and opportunities for children and the relationships between marriage and poverty. And so I guess I question – I'm concerned both about the politics and about the substance in this aspect of the proposal.

Just one other thought. Yeah. My last thought, which is related to this about poverty, is about care giving and women and care giving and men. I was very struck by the *New York Times* article in the last week about the status of African-American men, and it had a number of quotes from people essentially saying that welfare reform had begun to bring about significant changes in poor communities in the lives of women, but that men were increasingly left out and that in some ways welfare reform had heightened gaps. The most striking quote in the article said that half of African-American men in their 20s were jobless in 2004. And I went back and found a quote from Jason Garparl's (ph) book, which talked about how women leaving welfare are constantly undermined by the men in their lives either deliberately because the man was under such stress or simply because the wives of poor men are so infectiously troubled themselves. And I was struck just by a question about whether a proposal like this, particularly with the amount of money that we're talking about, would have a tendency to exacerbate that problem at a time when we should be working to ameliorate it.

So I guess I'll leave it there. I think there's the notion of honoring parents and the work that parents and women in particular do is obviously enormously powerful. And I guess my concern is just that it seems to me that the proposal at least politically sort of inhabits – it inhabits a tough space because it does cost such enormous sums that it – in terms of its cost, brings it into competition with things like universal healthcare or universal pre-K, and I just – it's less than clear to me that the rationale for this kind of expenditure is as compelling as the rationale for those.

MR. IRONS: I'd like to move on a little bit, but I wanted to give Anne a chance – if you want to respond to any of Robert's comments? Or we could just respond later if you want.

MS. ALSTOTT: Yeah, why don't we – yeah. Why don't we go ahead? It's fine.

MR. IRONS: Okay. Jason?

MS. ALSTOTT: They were good comments.

JASON FURMAN: I attend every week a colloquium at NYU Law School and about half the people that present are lawyers talking about tax issues and half the people are economists talking about tax issues. And what I've learned is that lawyers are much, much better able to make their points without having to resort to crutches. As an economist though, I have a little short PowerPoint here to help make my points.

A little bit like Anne, and the paper's we're hearing today are coming from two different places, although you sort of end up – you know, you can end up in the same point. One set of concerns are a set of concerns about the tax code: it's too complicated, it's unfair, it's inefficient, you know, what have you. And we need to make the tax code better. And I think that's a perfectly valid and important motivation for reform. Another way of approaching it, though, is looking at social problems we have and asking how we want to solve them and whether changes in the tax code can play an important role in solving those social problems. And Anne's paper certainly took that perspective and that's – you know, for the most part where I'm coming from.

And the particular problem that I'm – I mean, sort of a lot of problems, but the particular one I'm concerned with in the context of this paper is the problem of – problems of poverty, inequality, and wage stagnation. Thirty-seven million Americans are in poverty, including 13 million children. The poverty rate among children is – you know, is substantially higher than for the population as a whole, which is 12.7 percent, part of what's driving this is a continued process of wage stagnation, and I noticed that I didn't actually label this graph.

So the bottom blue line shows wages for the bottom quintile of families with children – income – sorry, pretax income. And pretax income in 2003 was slightly lower than where it was 1979. For families in the middle, their income went up 15 percent. For families in the top 1 percent, it went up 136 percent. So we see this incredible wage stagnation at the bottom. Now, all these inflation measures might be a little off, unless you actually shift it all up, but the inequality story isn't going to change.

At the same time, we have since the early 1990s – or since 1990, witnessed two big expansions of the Earned Income Tax Credit and that what were in effect big expansions in the form of partially refundable child tax credit in 1997 and then EITC expansion, a minor one, and a more refundable child tax credit (after that?). As a result, the after-tax income of families with children in the bottom quintile has gone up 7 percent. That differential between the two is more than explained by the expansion of the EITC. I say more than explained because you have it at the same time that payroll taxes and some other taxes like that have gone up.

So you have this wage stagnation, continued inequality, and I think that pretax inequality is a persuasive argument for a more progressive tax system. And we don't – we can debate exactly what's causing this increase in inequality. One hypothesis someone tossed out this week is that CEOs are becoming increasingly skilled and increasingly better at doing their jobs. (Laughter.) You know, that's one possibility and there's some others. But regardless of what you think is driving it, it might be that the best answer to remedy it is going to be using the tax and transfer system.

The place of the – the part of the tax and transfer system that matters the most for low-income families is the Earned Income Tax Credit. For the most part, they're not paying positive income taxes. They are paying payroll taxes and then they're getting a bunch of money back from the EITC. And so the proposal I'm going to talk about

centers around – and sort of the opposite of Anne, a very unambitious, very low cost, but you know, from my perspective high bang for the buck – what the sort of best way in which you would expand the EITC is.

And I'm struck by how often you see – you know, David Brooks had a column a few weeks ago talking about inequality, and he's like, of course we need to expand the EITCs. It's something people say all the time. Less often do they know what they mean by it and how exactly they'd expand it, and that's what I want to explore a little bit more. And then after doing that because my motivation, as I said, is a little it more in solving a social problem and addressing a social issue, I think there's a persuasive argument for a broader tax reform, and there's an idea that – did you – was it you or Jeff Liebman and David Ellwood (sp) that came up with it first?

MR.   : (Off mike.)

MR. FURMAN: You? Max Sawicky and Robert Cherry came up with a brilliant idea that was ripped off by Jeff Liebman and David Ellwood (laughter) – subsequently ripped off by Wes Clark, among others. And then this, I'm going to get back to that and talk a little bit about how we'd think about a little bit differently now in light of the expansions of the child tax credit and the partially refundable child tax credit. But really argue that in thinking about a unified family credit, that one of the most important questions we have to ask is sort of what do we want to accomplish by it, how do we want to change the way in which the tax burdens and marginal rates are distributed? And you sort of need to ask that question first as a real motivation for the way in which you're going to devise these types of unified family credit proposals.

So very quickly, most people in this room know how the Earned Income Tax Credit works. For a family with two children, for every dollar you earn up to around $11,000, you get 40 cents back. That's refundable, so you get to keep that money. As a result, you can get a maximum amount of $4,500. As your earnings rise above $14,000, you lose 21 cents for every dollar you earn. It's smaller for families with one children, and then there's a miniscule tax credit if you can see it there at the bottom for families without any children at all.

The economic evidence on this is about as clear and consistent as I can think of. Unlike a lot of the other tax expenditures we talked about today for savings, it's very controversial and heated. I mean, I know what I think, but not everyone agrees with me. For some of the other tax expenditures we have, like mortgage and healthcare, I think there's also a certain amount of unanimity that the existing structure is a problem.

For the EITC, you don't have that. There's a lot of evidence that increases participation in the workforce for single mothers over the period of the expansion that participation rate increased by 9 percentage points, virtually no evidence that it reduces the number of hours that people worked, even though in theory you'd think it should. It seems like people may not actually have these trapezoids in their head and do all the computations to work the fewer hours that they should be working. Some evidence that

there's – that the marriage penalty and the high marginal rates this imposes on secondary earners may reduce their labor supply, but other than that on balance it's considered, as Ronald Reagan said, one of the best pro-work, pro-family taxes we have.

If you look at what the limitations in the existing EITC is, the first and most stunning one is the fact that EITC maxes out at families with two or more children. This is unlike the dependent exemption or child tax credit, both of which are based in the philosophy of if you have more children either it reduces your ability to pay for each additional child in the case of the dependent exemption or just society should give you some extra resources for each one of those additional children.

So if you make $50,000 a year, $100,000 a year, for each child you have, your taxes go down. If you're poor, for each extra child you have, your taxes don't go down or your transfers don't go up. They do a little bit starting around $14,000 because of the partially refundable child tax credit, but for most poor families having extra children doesn't entitle you to anything extra. This is part of what's driving the stunning disparity – the poverty rate pre-EITC for families with one or two children is 12 percent. For families with three or more children, it's 26 percent. More than half of all poor children are in families with three or more children. If you look at the effectiveness of the EITC – and it lowers poverty proportionately much more for families with one and two children than it does for three or more, so it actually increases this disparity between larger families and poorer families. So that's observation number one, and it's sort of a horizontal equity point, and then we'll get to in a moment sort of cost effectiveness for poverty reduction point.

Issue number two with the Earned Income Tax Credit goes back to this childless EITC. It's – as I said, it maxes out at $412.00. Prior to it, the tax burden for non-elderly childless households were actually rising, and we talked in the morning about how we shifted from taxing through corporate taxes to taxing through the payroll tax. If you look at the distribution of taxes, that hasn't actually cause a massive shift of the tax system towards being more regressive, but at the same time we did that, we expanded the Earned Income Tax Credit at the same time.

So income taxes – while payroll taxes matter a lot more than they used to, income taxes have also become a lot more progressive than they used to be, especially at the bottom. You see that particularly for households with children. Non-elderly childless households, though, have tax rates that are similar to slightly below where they were 25 years ago. This gets to some of the issues Robert was talking about with childless men and work incentives for childless men. An extra $400, which is if your income happens to be in that right narrow range, just can't be a whole lot of work incentive. I at least haven't seen any evidence. Maybe somebody's done something that it actually does do it. Enhancing this both can address some equity issues as well as really try to bring more childless workers, including men, into the workforce.

Issue number three, one that's been talked about a lot is the marriage penalty and the Earned Income Tax Credit, and this just gives you an example of a woman making

$15,000 with two children, marries a man making $25,000. As a result of him being married, they'll lose their Earned Income Tax Credit and their taxes will go up by $2,666. As a proportion of their after-tax income, this is a massive marriage penalty. It's much larger than the other marriage penalties we talk about in the tax code, and it's one that is – you know, it's probably more troubling. There's not a lot of evidence that it impacts marital decisions. There's some evidence, as I said before, that it impacts decisions about whether to work or not for the secondary earner.

And then finally, issue number three. Let me be the, I think, fourth person today to say that nearly 70 percent of EITC recipients use paid preparers – higher than the population as a whole. The IRS explanatory publication for the EITC is 56-pages long. Fourteen percent of eligible taxpayers with children do not participate. It's even higher for those without children. To put that participation rate in context, that's much better than food stamps or TANF for even means-tested programs. It's much worse than what you have in the tax code. No one talks about the participation rate for the dependent exemption. I mean, I'm sure there are some people who could take dependent exemptions and they sort of mess up and don't, but it's not going to be anywhere like this type of magnitude. And then finally, there's some concern – you know largely overblown, but not entirely illegitimate, over error rates and overpayments.

So proposal number one is first of all to add a third tier to the EITC. And the way I'd do it is you'd get – rather than 40 cents for every dollar, you get 50 cents for every dollar if you're a family of three or more children. For most families with three or more children, this would be an extra $1,134.

Second, I would triple the maximum childless EITC by doing two things, both doubling the phase-in rates that would replace all of your payroll taxes. Right now, it only replaces the employees' share of the payroll taxes. And second, have it continue to phase in for a slightly longer period of time. And I think when you're talking about a number like that, at least just psychologically, you're not talking about something that might be large enough to make the difference between somebody who's deciding whether to work or not work.

Third, I would address the marriage penalty by shifting the phase-out out another $3,000. We've done a little bit of that so far. And then finally, a number of things to simplify. All this would be very cost-effective. It would cost about $7.5 billion annually, and would sort of in a targeted way address and improve a lot of the shortfalls in the existing EITC.

This then could become a basis for – if you take our current system with this proposal number two, which as I said, is the Cherry/Sawicky/Liebman/Ellwood proposal of unified credits, and this is something that just got a big endorsement from the president's tax reform advisory panel. And what they did was they – the problem is the sort of simplest, easiest frameworks that we always wanted to do don't work anymore. And the reason is, for a low-income family with children, you can get up to $2,600 per child. If you just do something really simple, that everyone gets $2,600 per child, that

becomes pretty expensive. You're talking about $30 billion a year. So almost any one of these proposals at this point, if it's going to be cost effective and if it's going to give up some of the benefits that those original proposals had in terms of lower marginal rates for the phase-out and eliminating the marriage penalty, end up having sort of two moving pieces, and in this case a $1,500 partially-refundable child tax credit, just like the EITC.

And then a sort of wraparound to that of a work credit, which would bring in your childless EITC and bring in the sort of extra money that families making $10,000, $15,000, $20,000 a year get right now. The total cost of this proposal would be $10 billion annually. It would be a simplification and an improvement in a number of ways. And that is my time.

MR. JONATHAN GRUBER: Okay. Thanks, Jason. That was an excellent talk. I'm glad to be here to comment on it. I'm actually really happy to be here for three reasons today. The first is I'm just so delighted that the Center for American Progress exists and has been so successful. The highlight of my morning, as I'm sure for many of you, is that little ding dong at 11:00 when the Progress Report appears in my email and I can learn what the press isn't telling me about what's going on in the world. And so I'm delighted to be here.

I'm also delighted that John Irons, who I remember fondly as a long-haired graduate student, has now cleaned up and is putting on such an excellent performance. I'm glad to see an MIT Ph.D. education being used so fruitfully.

And then finally, I'm just thrilled that the real consensus towards sensible tax reform that we're hearing about today. And basically, I think for too long, progressives have focused solely on the tax rate and ignored the issue of the tax base. We've been beating up – we've been beaten up as the party just wants to tax the rich, while the other side has been very good at successfully hiding their tax cuts through manipulating the tax base. I'm glad to see that we're taking those issues seriously.

And particularly, there's two key themes I see today that I really like. One is following what economists have always said about broadening the tax base. And this is an idea that was almost achieved in 1986, but has been repeatedly bastardized since by both the Democrats and the Republicans. I don't think either party is particularly distinguished in this situation. But basically, the kind of reforms we've discussed today would move us back towards a very broad-based tax system.

In particular, I'd really like to push more – you know, we talked about the idea for the tax panel of converting deductions to credits. Let's go further: let's talk about getting rid of some of these (unintelligible) talk about getting rid of some of these, like the mortgage credit. They do talk about getting rid of the state and local tax deduction, the mortgage deduction, the health insurance exclusion. These are enormously costly loopholes in our tax base that could be used to fund much higher priorities, and I think that discussion should go further.

So – but in any case, let me now turn to Jason's excellent paper here which is on a very important topic. Basically, Jason's paper starts by highlighting the success story of the EITC, which is a policy of course that everyone should love, although some seem to manage to find ways not to, but by and large it's pretty popular. And he's suggesting four reforms. The first is to expand the EITC for families with more children, the second is to expand the EITC for childless adults, the third is to reduce the marriage penalty in the EITC, and the fourth is to simplify the EITC.

Now the first and the last of his ideas I think are totally uncontroversial. I hadn't – I think it's striking the facts in the larger families that I think it's sort of a no-brainer to do that and to simplify, but I actually want to talk more about the second and third. In particular, I want to talk about the expanding for childless adults. And I really – I think is going to encounter more resistance than Jason's other ideas, but I think it's the best of the list. Look, I love kids. I've collected three of them myself. They're cute, they're cuddly, they're politically fun. But the truth is, we do way too little for childless adults in America. And it's not just here. In health insurance, a kid is covered in America to 200 percent of the poverty line until that horrible event known as their 19th birthday at which point they're not covered at all no matter what they're income is, unless they happen to be willing to get pregnant. Okay? This is really – we have a definite, enormous hole in our system. We've massively over-favored kids and parents (unintelligible) the childless adults and I think we need to start thinking about remedying this.

Now, even if all we care about children – let's (unintelligible) care about children – we still should care about childless adults because today's childless adults are tomorrow's parents. If we want children to be raised well, we need to set the predicate for an environment where they are raised well. We need to get childless parents the resources so they can be in position to support children, to have households which will be successful. And this is, once again, I want to come to this *New York Times* series that was mentioned by Robert about a striking lack of success among African-American males. Okay? We need to lay the predicates for good parenting by promoting success among all adults, not just ones who happen to have already had kids.

And I think the enormous disparities between the way the EITC treats families with children and families without children are very problematic and I think that's the most important part of what Jason's talking about. And I would really think we ought to – you know, despite the political difficulty, the lack of appeal of childless families, that's the place we ought to be focusing a lot more energy both in this arena and in the health arena as well, I would argue.

Now, if that isn't controversial enough, let me go further. The one part of Jason's plan I liked the least is the marriage tax discussion. I'm sick of the marriage tax. Okay? Let's be honest about (unintelligible). First of all, it doesn't affect anybody's decision to get married, ever. It might affect whether you get married on December 31st or January 1st, but no one – there's no evidence that it affects people's decision to be married. Okay? So first of all, there's no efficiency argument for getting rid of the marriage tax.

There may be sort of an equity argument that we kind of like married people more, and that's well and good, but I don't see that's what seems to be being made.

The other argument is the one Jason made about the problem with marriage tax is that they penalize secondary earners, and that is a problem. But once again, we don't have a lot of evidence that that actually matters much in the EITC. There's one study. It finds a little bit of an affect. But, look, the story of the EITC is based on this story incentivizing people to work, but not really affecting how hard you work once you work.

Now, we don't really understand why that it is. It could be for one of two reasons. First of all, it could be because people are more responsive in their decision to work then in how much to work. I think more likely it's just people are dumb and they say, gee, my friend got an extra three grand for working, I'm going to go to work. They don't realize that how hard they work is getting (clawed?) back. They don't understand the trapezoid.

But in any case, the bottom line is the EITC really has been successful in promoting people to go to work. It did not have that big of an effect on distorting people's hours choices. By that same margin, I don't see there being a huge problem with these higher second-earner taxes that result.

Now, in a perfect world of unlimited resources, absolutely – let's get rid of the marriage tax, although let's be clear about what that means. You cannot have a system that is – both has progressive marginal rates and has family-based taxation and doesn't have some marriage tax and subsidies. You've got to have all subsidies or all taxes or somewhere in between. But the important point to remember is once you have a family-based taxation situation and rising marginal rates, you can't get marriage neutrality. That's impossible. It's only what mix of marriage tax and subsidies you want. Okay?

So we could push towards – right now, Jason points out we have many more taxes and subsidies, we could push that up. My only point is let's contrast that with the other ways he wants to use the money. Let's imagine we didn't have $7.5 billion. Let's imagine only $5 billion. I would argue it's a much, much less important use of the money than expanding for bigger families or expanding for childless adults. I – this is – it's a great political sound bite that we're penalizing marriage, but I don't think it actually matters that much. And I think that we need to focus – that there are other priorities we can focus more on. If we have enough money to do all of it, great, but I think this is the lowest priority.

Now, at the end of his paper, Jason moves onto this bigger question of how the tax code should be designed to alleviate poverty. And let me raise one other sort of nitpicky – not nitpicky, but sort of negative point here, because I'm an academic and we're negative, okay? One more negative point, which is our love affair – let's not let our love affair with the EITC go too far. I mean, the EITC is just win/win. It's wonderful. It's wonderful to talk about expanding the EITC because you get to redistribute and you promote work. And who's not going to like that except for some

cranky Republicans? Okay? And who's going to like that? But there are people who really can't work. I mean, they're – they need our help, too. And we can't forget the other part of the tax system which redistributes to people who don't have earnings, to people who can't take advantage of the work incentives embodied in the EITC.

And there's actually some work – Jason mentions in the paper, I've done some work with Emanuel Saez out of Berkeley sort of doing some simulations of what the tax system ought to look like, given what we know about how people respond to taxes. And that evidence suggests that the right ideal system – Emanuel's really done the best work on this – would have a (big?) EITC, but also a big transfer component besides the EITC – just a flat transfer regardless of whether you work or not. And those would both be phased out very quickly, and then you'd actually have a relatively flat tax schedule. So what's interesting about this system is it's actually a system where marginal rates – marginal tax rates actually fall with income while average tax rates rise. It's an important distinction to remember.

We (came up with?) this article – the *Wall Street Journal* wrote – my only editorial in the *Wall Street Journal* ever, they wrote how wonderful this article was because we said there should be following tax rates, but the point was there should be falling marginal tax rates. And what I mean by this is the following: a system with a big transfer to poor people that's phased out very quickly because once again the evidence of the EITC in other places, this is just a phase-out won't distort people very much. But the more we can target the dollars, the more effectively we'll combat poverty. So a big transfer that's phased out fairly quickly, then with a relatively flat schedule – you could argue, well, (unintelligible) after – is one will actually feature higher marginal tax rates on the poor, because we'll phase it out fairly quickly, but lower average tax rates on the poor. The poor will on net benefit from the tax system; the rich will pay more taxes.

It's just – see, this is why back in 1999, 2000 when Larry Lindsey was talking about how we have to worry about these high marginal rates on the poor, that was just a veiled cover for cutting back transfers, because the only way to get rid of high marginal tax rates on the poor is to – the way he wanted to do it was to cut transfers. You could also do it by phasing it out more slowly, but that costs a ton of money. My point is we could have a system that's very well targeted, not too expensive, if we recognize that the – phasing out quickly doesn't have enormous costs; it has benefits in letting us target. So I think the bottom line is that we ought to think about doing even more redistributions through the tax system.

I think sort of the lesson of today, if you take sort of one meta-lesson of today, it's let's use the tax system less as a tool of social policy and more of as a tool of redistribution. Let's get rid of the little – the holes we keep punching in the tax code to serve this purpose and that purpose. Okay? Let's have a broad-based tax system, but let's make it more redistributive. And let's let the IRS, who's got good information on people's income and good information on the tax code – let's run our redistributive programs more through there and less through other mechanisms and let's stop using the tax code as much as a tool for other social policy goals.

So thanks.

MR. IRONS: Thanks. Jason, you want to spend two minutes or will you just –

MR. FURMAN: Yeah, just really one minute.

MR. IRONS: Okay.

MR. FURMAN: I mean, I think the most encouraging thing in what John had said – and it comes right out of his research, and I cite it there, is the worry about doing more redistribution unless it's very expensive in the way, as I said, some of the original family credit proposals were, is that you have very high marginal rates that phase out. Right now it's a 46 percent marginal rate for some low-income families. The lesson we have both from the experience with the EITC and from – you know, more theoretically calibrated research is, yeah, in an ideal world, we wouldn't have that. But if you have a choice between being able to transfer money to people and then take it away from them as their income goes up so that you have a high marginal rate or not transfer money to them in the first place and give them a lower marginal rate, that that former is almost always going to be preferable to the latter, and I think I was glad to hear John reinforcing that.

You know, everything being equal, he'd rather have lower marginal rates and that's why I'd want to broaden the tax base, but in terms of this one particular tradeoff between giving people and then having to worry about the cost effectiveness or phasing it out, the evidence and the theory seems pretty clear.

A second point related to that is there's another argument for doing a certain amount of your – these things through the tax code rather than through transfer programs, is at least with the tax code you can understand what that marginal rate is and think about it in an integrated way, so if you take our tax and transfer system as a whole, for people that fully participate you can have marginal rates in excess of 100 percent when you take into account food stamps, housing, taxes, et cetera. By putting more of those things into the tax code, especially where they're contingent on your income, it actually makes it a little bit easier to monitor some of those phase-out, coordinate them, and, you know, I'm not concerned about marginal rates at 46 percent if it's the price you have to pay for larger transfers. You know, I probably am concerned about marginal rates of like, 120 percent. And doing more of certain types of things that are related to income and distribution in the tax code can actually help you get that done a little bit better.

MR. : (Off mike.)

MR. IRONS: Well, I think we're going to put off questions until the end, if that's okay. Just a quick timing note: I think we're scheduled on the program to leave at 3:15. I'm more than happy to stay here as long as we need it. I suspect my panelists aren't

willing to stay as long, but if I can ask them to stay for another 15 minutes or so, then we can get to more questions at the end. But let's turn to James.

MR. JAMES KVAAL: Thank you. I really appreciate the opportunity to be here today to talk about some of the international aspects of our tax system, and I have my own professor story. I'm actually taking a class right now from Professor Halperin. So I'm really grateful to him for being here to comment on my paper. (Laughter.) And I had –

MR. : (Off mike.)

MR. KVAAL: Yeah, well, I had to skip the class last night, so I hope you're not mad. (Laughter.) But this is an important issue, I think. And it's one that maybe doesn't get enough attention in my opinion. When we are moving toward a globalized world, the costs of trade and the costs of moving locations and of locating production anywhere in the world are going down, and that is magnifying the impact of the remaining costs. And one of those costs is tax differentials.

So under the current tax code, there certainly are opportunities for U.S. multinational corporations to get substantial tax savings, depending on where they locate their investment activities, and I think that's troubling. Just as we don't want countries to get ahead by taking a low road on labor policies and environmental policies, it's also troubling that countries could affect foreign investment by undercutting their neighbor's tax base. So that's something I think that deserves a lot of attention, and while it's not a problem that the U.S. can solve alone, a good place to start, I think, is looking at some of the features in our own tax code that have the effect of exacerbating these problems.

So I wanted to talk today about how the U.S. tax code subsidizes foreign investment. And when I say subsidizes, I mean that in a couple different senses. Sometimes the U.S. government does not tax foreign profits at as high a rate as it taxes domestic profits. It's also possible for multinational corporations to avoid tax on foreign profits at all. And most troublingly, in some cases there are negative tax rates, so multinational corporations can claim deductions or credits associated with foreign income without paying any U.S. tax on that income. The result is they are paying lower U.S. taxes then they would be if there had been no foreign investment at all.

The results of these subsidies – well, ideally from an economic sense you would not – you would want to minimize the impact of tax subsidies on where corporations are locating their investments, because if corporations are locating their investments based upon tax incentives, then they're not doing it where the economic returns are highest, so you're sacrificing some economic efficiency.

Secondly, if U.S. multinational corporations are investing overseas instead of investing in the United States, there is a possibility that that would reduce the capital available here in the United States, and that could have an impact on the U.S. economy and workers' wages.

Third is, even if there's no impact from tax disparities on actual substantive economic activity – so even if corporations don't move their investment overseas in terms of actual plants or equipment or research and development – these tax disparities still give them an opportunity to engage in tax planning in ways that erode their U.S. tax bill. So I'm going to talk about that and I'm going to talk about one possible solution, which is a partial exemption system, which would ensure that worldwide business is taxed once at a reasonable rate, whether by a foreign government or by the U.S. government.

These are I think some troubling statistics about the state of tax competition today. Tax havens have only 1 percent of the world's population, but they have 8 percent of U.S. multinational foreign investment in property, plants and equipment, and half of U.S. companies' foreign profits. Moreover, between 1998 and 2000, which is the most recent data we have, corporate profits were shrinking in the United States, but they grew by 45 percent in two years in low-tax countries. I think this is evidence that both of these things are happening, both that corporations are responding to incentives to move actual economic activity to low-tax countries, and that they are also shifting profits in a way that reduces their taxes without affecting actual business investment.

So how does the U.S. tax system work? In principle, we tax U.S. multinationals on all of their worldwide profits, which you might think we'd solve this problem, but there are two major exceptions in our tax code. The first is that we reimburse corporations for foreign taxes with the foreign tax credit, so if a company invests in a country with high foreign taxes, those taxes are – they get foreign tax credits for those taxes which they can apply against their U.S. taxes on that income, and the U.S. ends up collecting very little income tax from investments in high-tax countries.

The second is deferral. U.S. multinationals investing overseas don't have to pay income tax right away. It's kind of like an IRA for foreign investment. They can keep their profits in their foreign subsidiaries and don't pay taxes until that money is redistributed to the United States as a dividend. So that can substantially reduce their U.S. taxes.

Now I want to talk about three ways in which this system creates incentives to move overseas. The first is that it allows corporations to enjoy lower tax rates that are available abroad. Many countries have tax systems that are fairly comparable to our own. The other members of the G-7 and most OECD countries have fairly substantial corporate taxes, but there are countries that do have very low tax rates; for example, Bermuda, the Cayman Islands, Switzerland, Ireland, Singapore. These countries can have an effective tax rate of below 10 percent, so that would create very substantial tax savings for a corporation that was interested in moving there. And because the U.S. tax code collects little tax in general on foreign income, it fails to close those disparities.

The second problem is deferral and the lockout effect. Now, if you don't have to pay U.S. taxes as long as you leave income overseas, then there's a big incentive for

companies to leave income overseas as long as possible. And as a result, they do. They often choose not to pay the voluntary U.S. taxes. And as you can see, there's a great deal from these statistics, only 7 percent of foreign profits from low-tax countries are repatriated, and well over $600 billion in profits were held overseas in 2002. Now, that number is probably somewhat smaller today. In the fall of 2004, Congress passed a tax holiday on the repatriation of foreign profits, so that was a temporary one-year tax cut reducing the tax rate by 85 percent. And that was successful in getting corporations to bring some of their profits back, but it did so by further rewarding corporations with still lower taxes on foreign profits; and moreover, it's likely to be self-defeating in the long run because when the tax holiday is over, corporations are likely not only to resume keeping profits overseas but they may do so even more aggressively in the hopes that another tax holiday will come.

Third, and I think the strangest problem with our tax code, is the negative tax rates. Here's a quote from the Treasury, so you don't have to take it from me, you can take it from the Treasury, indicating that the effective tax rate on foreign profits is often negative. One analysis by Altshuler and Grubert found that a typical investment in a low-tax country pays a foreign tax of 7 percent, a U.S. tax of minus 2 percent, and a total tax of 5 percent. So that indicates that our tax system is exacerbating these problems of low-tax countries.

Well, why? There are three reasons I want to talk about today. And I think I should start with a caveat, which is these are very complicated, and I think I would lose you all, even if weren't a Friday afternoon, if I tried to trace all of the exceptions and limitations and conditions placed on multinationals' ability to exploit these. So there's more detail in my paper, and suffice it to say that these are real problems. They're not universally available to every multinational in every situation, but they are common enough that they are real problems for our tax code.

The first is that multinationals can deduct the cost of foreign investment against their U.S. taxes even if they aren't paying taxes on their foreign income. So for example, a multinational corporation could borrow money in the United States, invest it overseas; they could then claim interest deductions in the United States and they would never pay income tax on the resulting foreign profit.

A second problem is cross-crediting of foreign tax credits. I mentioned before that foreign tax credits are limited to the amount of U.S. tax that would otherwise apply. This means that companies investing in high-tax foreign countries get excess foreign tax credits. Now, in theory, that limit would be applied on each item of income. So if you have a company that earned $200 – $100 in the United States and $100 in a country with a 40 percent tax rate – that country would pay $35 in U.S. taxes, $40 in foreign taxes, and it would have $5 of foreign tax credits that it can't use. And that's the way we need it to work in order to keep foreign investments from overriding the tax base, because if we let them use that $5 credit, then we'd only collect $30 in U.S. taxes even though they had $100 in U.S. profits, and we'd be giving away a piece of the U.S. tax base.

Unfortunately, the rules limiting the use of these credits are not fully effective and corporations are able to use these credits against essentially domestic economic activity. So, for example, they can shift intellectual property to foreign subsidiaries, making the royalty payments foreign income, and that makes them eligible for the application of excess foreign tax credits. Another problematic rule is the sales source rule, which deems some export income for goods produced in the United States to be partially foreign income and therefore also eligible for excess foreign tax credits.

The third problem is that just having foreign subsidiaries allows U.S. corporations to shift profits there, so income-shifting I think is a fairly straightforward concept. If you had a U.S. corporation and a foreign subsidiary in a low-tax country, you would want to increase the amount of income that was earned in the low-tax country. So, for example, if you were selling goods and services from the American parent to the foreign subsidiary, you could set prices artificially low and that would reduce your U.S. income and increase your foreign tax income.

Now, under the transfer pricing rules that police this, corporations are supposed to set these transfer prices based upon fair market values, but in reality these judgments are very contextual. They're subjective. They yield more than one acceptable result, and they're very difficult for the IRS to enforce, and so it is a big problem. Marty Sullivan, of Tax Analysts, recently looked at the profits that U.S. corporations earned in Ireland and found that based upon the return of assets of those corporate subsidiaries, probably three-quarters of that income was not actually earned in Ireland, but was shifted from other parts of the world.

So here's my proposal to fix these problems or get us a good chunk of the way anyway. I think we want to start with a goal that income everywhere in the world will be taxed at a reasonable rate, whether it's by the U.S. or by a foreign government. And that's because if a foreign government is taxing at a reasonable rate, the truth is we don't collect very much tax right now anyway. Most of that income is shielded by foreign tax credits. And it doesn't pose a real threat to U.S. economic interests. There's no big incentive to locate a plant in Germany instead of locating it in the United States, or at least no tax incentive. Other income, though, that is earned in tax havens or in other low-tax countries would be subject to immediate taxation. We'd repeal deferral for these countries, although they could still claim a foreign tax credit.

I think the most obvious question for a system like this is how do you define what a comparable country is, so who is eligible for the exemption? And I think it's actually not that hard when you start looking at these countries. It's not as hard as you might think it would be. So this is – this shows the tax rates of OECD countries, ranging from Japan all the way down to Ireland. And the bar across this – the horizontal bar is a 28 percent tax rate. So I think you can see that almost every country has a marginal tax rate of 28 percent or higher on corporate income. That's about the point where it starts to decline very rapidly.

I'm not saying that we would want to distinguish among countries solely based

upon the statutory tax rate. We'd also want to look at things like depreciation deductions and deductions for interest expenses, how effective tax collection is. But I think this is a good place to start. The fact that these distinctions could be drawn in other countries also has similar facets to their tax system. So, for example, France is often mentioned as a country which doesn't tax foreign income at all, but it often does tax foreign business income if it's taxed at a rate less than half of the French rate. Likewise, Japan runs a deferral system kind of like our own, but you generally cannot defer income that's taxed at less than 25 percent by a foreign government. So our allies do have similar systems.

The advantages of such a system: it limits tax disparities to a narrow range, so a company wouldn't be able to get the Irish rate of 12.5 percent or the Bermuda rate of zero percent. There would still be some slippage. They might be able to pay the English rate of 30 percent instead of the American rate of 35 percent, but by narrowing the range of these disparities you would reduce the impact on investment decisions and you would also take the juice out of tax planning efforts to shift income from one country to another. It ends the lockout caused by deferral without further tax cuts on foreign income, like the recent tax holiday.

It rewards countries that adopt responsible tax systems. If you're a tax haven now and you want to attract U.S. investment, you'd be better off adopting some sort of responsible tax system and qualifying for the exemption, maybe setting your rate a little bit below the U.S. rate, because that would allow U.S. companies to move there and not pay any U.S. taxes. It reduces some of the cross-crediting problems simply reducing the credits earned in high-tax countries.

As a result, it would substantially cut tax subsidies for foreign investment. I didn't hear too many proposals here today that would actually raise revenue.

MR. FURMAN: You can pay for my proposal.

MR. KVAAL: I can pay for Jason's – yeah. So I was a little surprised. I thought we were here about progressive ideas and everyone wants to cut taxes. (Laughter.) [I'm not sure anyone actually laughed, but I'm worried you can't tell that I was joking – so can I get a laugh trak?) But these resources I think could be better spent in other efforts to improve productivity, whether other corporate tax cuts that are more broadly available or investments in research and education.

The main concern I think you would hear with this proposal is one of competitiveness. U.S. multinational corporations say that if their tax rates are higher in low-tax countries than their foreign competitors that they wouldn't be able to compete in low-tax countries, and they may even reincorporate as foreign corporations. Really what they're arguing for here is a special subsidy. I think we need to keep in mind that in general the principle is that we should not distort economic – we should not distort the allocation of capital. And so if you have large tax subsidies targeted for one particular type of investment, such as foreign investment, generally you're going to reduce overall economic welfare. And if we're going to subsidize one area of investment, I just don't

that think that there is convincing evidence that we'd better off subsidizing foreign investment instead of subsidizing domestic investment.

I'd also note that this competition argument, I think, even if you believed it, it wouldn't necessarily justify the current system. I mean, if the idea is that you should be able to go to Ireland and compete on a level playing field with an Irish corporation, that doesn't mean you should be getting negative tax rates or additional tax benefits from the U.S. government. So even under this logic, I think some reform is needed.

One possible compromise, if you took these concerns seriously and did want to address them, you could exempt income from local sales in low-tax countries. So if you set up plant – sorry to pick on Ireland – but if you set up a plant in Ireland serving the Irish market, then your income would be exempt, but you wouldn't be able to use Ireland as a base to export all of the world. And that's similar – a similar exception was in Senator Kerry's campaign proposal, which Jason could tell you all about.

These are some contrasts with other proposals. I think because we're short on time I might skip this, but I hope we could get to some questions about it if people are interested.

And I wanted to close with a poem. I don't know how many of you are familiar with this work of Russell Long: "Don't tax you, don't tax me, tax that fellow behind the tree." But there was also a second verse written later by Chairman Rostenkowski: "Don't tax you, don't tax me, tax the companies across the sea." And I want to suggest that he maybe wasn't the greatest poet, but I think he was on to something in terms of economics. Thanks.

MR. DANIEL HALPERIN: Thank you. It's a real pleasure to be here. As others have mentioned, I think this organization is doing great things, and I'm glad to do whatever I can to help. It's also great to see your students participating in the tax policy debate, even though you had nothing to do with it, but you like to think so. And not only was James my student, but I taught tax to Anne a few years ago. So it's great to be here.

I'm not a foreign tax expert. James is not taking foreign tax from me, he would have had to take it in 1981, which was the last time I taught it. Most of you don't remember back that far. So I want to just talk a little bit about trying to put this proposal somewhat in perspective and talk about what would be necessary in order to get something like this enacted, because I generally agree it's a good idea.

You can think of the U.S. tax system as essentially saying that if you earn your income in the United States, we want to tax it immediately and in full. If you earn your income abroad, we want to tax in the United States the excess of the U.S. taxes over the tax that you paid to the foreign country. Now, we don't achieve this, as James indicated, with respect to the latter – the excess tax on foreign income. You can defer that indefinitely by operating abroad through a foreign subsidiary and never bringing the money back into the United States or only bringing it back after a long period of time.

Secondly, and more importantly, again as James said, in the slide on negative tax rates because of the reasons indicated there, we, in fact, in the case of multinational corporations don't fully tax the money they earn in the United States, which is something that presumably would be the first order of business. And in addition to all that, we have a system which is extraordinarily complex. So people obviously I think would agree that this is a problem we should do something about.

And one proposal that you do see around – it was in the president's commission report and also proposed by the Joint Tax Committee – is we go to something called a territorial system in which U.S. would give up on trying to tax foreign income, but presumably would try to do a better job in taxing U.S. source income. We would try to plug those loopholes so at least he U.S. source income would be taxed. But if we went that direction, of course we would be giving up totally taxing foreign source income at the excess U.S. tax rate, presumably the tradeoff is the system would be simpler, and also, we would eliminate the disincentive to bring money back into the United States.

Now, the alternative approach which – first proposed 45 years ago by Stanley Surrey when he was assistant secretary for tax policy, was to basically tax all foreign income to the U.S. parent corporation, even if it's earned through a foreign subsidiary. That would, as James said, remove the incentive to invest abroad, and presumably would increase the revenue to the United States.

James' proposal comes in between. He's essentially proposing a territorial system for business income earned in high-tax countries (in other words, whatever you pay there is all you ever pay and the U.S. doesn't try to tax any more of it), and we would have current inclusion for I guess passive income and for income earned in low-tax countries. And I think the benefit of this proposal – it seeks the advantage of the immediate inclusion without impacting on operations all over the world. It essentially says if you're engaged in business in high-tax countries we leave you alone, and in fact we sort of take a nod and say we think the territorial system is a good idea. So I think the proposal makes sense.

So I think we really need to talk about whether it's possible to get Congress to take this seriously or what you would have to do to get Congress to take it seriously. And you have to recognize that as an initial matter there would be very little congressional support for this proposal. There would be more support for shifting to a territorial system. And I think some experts would say that will make things better, or at least it conceivably could make things better in terms of taxing U.S. source income in full. So if that's a feasible proposal which might have some improvement, we have to be careful that in order to shoot for something even better, we pass up something that might be desirable in itself. But I think to think about the possibility of getting something like what James proposed enacted, you have to think about what the arguments for and the arguments against might be.

Now, I think the first case that has to be made is that this would be substantially simpler

than a full-exemption system, and I think that case can be made and I think anybody pushing this has to do that kind of analysis. Secondly, I think the arguments that I've heard from people in the past was, if we have a system in which the United States tries to tax all the income of foreign subsidiaries, regardless of where they operate in the world, there may not be any more U.S. corporations anymore. We may be able to prevent people from moving from the United States to elsewhere in the world by certain kinds of restrictions, but what about all new corporations. So there has to be consideration of how we are going to preserve the tax base; in other words, how are we going to make it desirable for companies to continue to incorporate in the United States. We use the place of incorporation. U.K. uses something like the seat of management. Certainly the place of incorporation is easily moveable. The seat of management may not be too hard to move, though that makes it a little bit more difficult. It gets you in the way of the way you want to operate. Looking at shareholders is hard to do given the ownership of multinational corporations. So I think that's an issue that strikes me as one that needs to be thought about.

The other point which James mentioned is this argument about competitiveness. And opponents of a proposal like this would say it's going to make it impossible for U.S. corporations to compete with other companies in low-tax countries. And the question of whether that is true or not has been debated back and forth by the few hundred people who think about foreign taxes all the time. But we've got to figure out a way to bring that debate more into the mainstream, and see if the arguments can be made in a way in which they would become more persuasive.

I think that one can question whether it is harmful for the United States if our corporations are unable to compete in low-tax countries. If they're going overseas and the only reason that it makes sense for them to invest overseas is because taxes are lower there than they are here, is that something that in the end is in the best interests of the U.S. and its population. If we have foreign policy reasons for trying to encourage investment in certain countries, we can do it certainly in a more targeted way through tax treaties and other ways rather than giving it to everybody regardless of the concerns that we might otherwise have.

So I think it's the competitive argument and the fact that we're going to lose our revenue base argument is what you'll hear against proposals like this. And it's up to people who are pushing it to try to develop the case for it as best we can. So I want to just stop right there.

MR. IRONS: Great. Thank you. I guess we can open it up for questions now either from the panel or from the audience. I think the audience has been sitting here nice and patiently for the past six hours now or something, so let me open it up to any questions here first. We want to know where you're from, please.

Q: Max Sawicky from the third floor. (Laughter.) I'd like to ask Professor Alstott to react to the following three points. One, under her proposal a credit is available to somebody that pays for daycare, which to me sounds like not a caregiver credit but a

custodial credit. Point two, you don't want somebody to use the proceeds to buy groceries, but if they let the accounts roll forward when they retire then they can use them to buy groceries. And point three, with your stakeholder society proposal, you propose to give people a lump sum at a young age which they could use to buy groceries, among other things. So it seems like there's some conflict between the principle of a credit focused on caregiving, per se, to do whatever you want with, and this other idea about somehow compensating for some extraneous targeted human capital consideration.

MS. ALSTOTT: Yes. Max, well, whenever you ask the author of a book a question the answer is always "It's in the book." But let me give you – so there's probably more answer to all of that than you want in my book, but let me give you quick answers here. First, maybe my nomenclature is confusing, but the idea of caretaking is that people who are parents of children have – in other words, if you have a kid living with you let's say, and you have primary responsibility for that kid, I think anybody who has done that will understand that even if you farm out care of that child for a few hours a day you have significant residual responsibility. And I want to say in all seriousness, the "No Exit" of my title is about the quality of that relationship between parent and child. Whether I put my child in daycare a few hours a day or whether I stay at home and take care of that child, my life is changed forever by virtue of this no exit relationship that I have, and that's explained in the book. So if my nomenclature of care-taking suggested to you sort of a cultural vision that this was about stay-at-home parents, then that nomenclature is maybe not right. This is about parenthood and having responsibility for children that people can, I think, legitimately discharge in different ways.

Second point, what about future groceries. Well, the quick answer to that is part of the goal of the proposal. Let me actually answer your second and your third point together because you raise the idea of the stakeholder society, which gave an unrestricted grant, and you're basically asking the very good question, why not just let people do. Well, Max, the answer is in this academic world that I'm constructing sort of for myself and Bruce and three other people, you would have two cuts at sort of the social resource – or two bites at the social resource apple. One by virtue of your status as simply a human being – that's stakeholder society, right. For those of you who don't know, the stakeholder society would spend even more money than this to give a social inheritance to people at the age of 21, but you get that simply by virtue of existing. That's by virtue of your dignity as a human being you get that.

So the question that preoccupied me in my next book, which is *No Exit*, was if I choose then to become a parent – if I choose one way of life, do I then get more, or should society say to me, hey, you got your stakeholder grant, shut up and go away, right. And so the argument of the *No Exit* book is that there is something distinctive about the status of being a parent, a parent who has responsibility for a child that does justify a second bite at the apple. But it doesn't justify a second unrestricted bite to do whatever the heck – in other words, if person A is a parent and person B is not, my argument is not that person A therefore should have just all kinds of better opportunities than parent B. My argument is that the person A – I should say parent A and person B – parent A has taken on a social obligation in the form of this childrearing obligation, and that that's an

extraordinarily costly obligation under present institutions. This proposal is an effort to remedy in effect some of the extra costs of that social responsibility and not simply to make the lives of parents better than the lives of non-parents. So that's a beginning of a response to you, but there is more in the book.

MR. IRONS: Other questions? All right.

MR. HALPERIN: I'll ask one question.

MR. GORDON: One question.

MR. HALPERIN: I wanted to ask John a question about the marriage penalty, too. It strikes me that the earned income credit case is different at least as a matter of equity, if it isn't as a matter of efficiency, because when we start taking it away, we're not recognizing the existence of another person in the home which would put that family at a lower economic level at the point that we start taking the earned income tax credit away from the married couples compared to the single person. And so it strikes me that whatever the case is on efficiency, you could certainly make the case that as a matter of equity this is different.

MR. GRUBER(?): I agree with that, Dan. I think that's a good point. And I was sort of trying to be a bit vitriolic to make the point that I think that this is I think a lower priority than other things. I agree. The problem with this is, if your (age per child with?) adults, that to me is just good thing. If you try to get rid of the marriage penalty, that means just increasing marriage subsidies for some people. And the point with the marriage thing is you're not moving towards marriage neutrality, you're just changing the shift of penalties and subsidies, and that that's I think something we have to recognize in this debate.

MR. : Right. I'd say the only thing I'd say about that is that balance between penalties and subsidies in the EITC seems to be much more tilted than the rest of the –

MR. : Right.

MR. : – tax code. I mean, it was five years ago, and it's even more tilted now.

MR. IRONS: Okay. Well, I think we can wrap it up. I'd like to thank all of our panelists for taking time out for this very interesting discussion. And I think that's it for the day. Thanks to everyone for coming and again to the panelists.

(Applause.)

(END)