

Center for American Progress



SPECIAL CONFERENCE PRESENTATION:

“OPTIONS FOR TAX REFORM”

***LUNCHEON PANEL: FUTURE OF TAX REFORM - OVERHAUL OR
INCREMENTAL CHANGE?***

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MR. JOHN PODESTA: As a couple of opening announcements, everyone should turn off their cell phone except Gene, who's wife is about to have a baby. He needs to keep his on. (Laughter.) And I would just note that the slow speed by which people went through the lunch line indicates there were a lot of people here who didn't grow up in large ethnic families. (Laughter.)

I'm John Podesta. I want to thank you all for coming again and I want to make a couple of special thanks first to the maestro here, John Irons, who helped pull this all together, to Robert Gordon, and to Kate Sabatini from the Center for putting together this terrific conference.

I think earlier today you have heard and you are likely to hear on this panel and in the panel to follow a common sentiment that the tax code needs major help. I think it's clear that America needs a tax code that's fair, that's easy to understand, that promotes economic growth, and that raises the revenue that's needed to fund our nation's priorities and make the appropriate investments in our future. And I think it is also fair to say that our tax code is far from that.

We have a great panel here to discuss these matters, but before turning over to them, I want to mention two disturbing aspects that I see in the approach that we see in the current administration's approach to tax policy. First, I think this administration has driven the tax code to benefit those who derive their income from wealth and investment, rather than from wages and work, and in doing so I think they've abandoned the middle class in this country. The tax rate on capital gains and dividends is 15 percent while the tax rate for average middle class Americans on their wage income once you add in particularly the payroll tax can easily be twice that much.

That bears repeating. As a result of the tax changes championed by President Bush, middle-income workers today can easily find themselves paying a functional tax rate on their wages that is double the rate that millionaires are paying on their investment income.

So if you add all that up, I think average workers today, middle-income workers can be paying as much as 30 percent on their wages. This trend is echoed, I think, in the efforts to repeal the estate tax. Maybe Gene will talk some about that. Heirs to vast fortunes can already inherit \$4 million tax free, yet our current leadership wants to give them yet another \$1 trillion worth of tax breaks by repealing the estate tax while we see the enormous deficits that this country faces.

A second, I think, and related point I'd like to make is that the tax code has becoming increasingly complicated and that complication can hardly be said to benefit middle-class Americans. It's no wonder that a recent Gallup Poll showed that 60 percent

of the American public think that the economy is getting worse, and only about a third of Americans rate the economy as excellent or good.

Over the last several years, wages and incomes have stagnated. The number of people without health insurance has increased by \$6 million since 2000 and costs for the basic middle-class expenses including fuel, homeownership, college education for the kids are all increasing faster than incomes for middle-class Americans.

One of the reasons that the middle class is being left behind is because the tax code's myriad deductions don't apply to them. Only a third of taxpayers with incomes less than \$100,000 in adjusted gross income itemize deductions. We need to reexamine the number of deductions in the code and for those that are kept, we need to ensure that the benefits are of equal value to everyone. I think Peter is going to talk about that. A number of presenters today have suggested that earlier. And again, I think this panel will take that issue up.

Finally, I think there's no excuse for a tax system that can only be fully understood by professional accountants; my apologies to those of you in the audience who are accountants, and a handful of lawyers. My apologies to you, John, for that. To take the most shameful examples of complexity, in 2003, 71 percent of Earned Income Tax Credit recipients filed their return through paid tax preparers. These are people who cannot afford the expense of paying extra just to compute their taxes. I think we need a different path. We need a tax code that rewards work, strengthens the middle class, and above all reinforces our country's fundamental belief in fairness. Comprehensive reform allows us to tackle these bigger issues and at the same time fundamentally alter how we raise revenue.

To tell you more about the tax code and the ideas for reform, it's my pleasure to introduce our panel. We're joined and honored to have Beth Garrett here with us today. Beth is the vice provost of academic affairs at the University of Southern California and the Sydney M. Irmas professor of public interest law, legal ethics, political science and policy planning and development. She's also the director of the USC Cal Tech Center for the Study of Law and Politics and served on the president's nine-member bipartisan tax reform panel that released its report in November of 2006 and languishes at the Department of Treasury.

After Beth, we're going to turn to Peter Orszag, who's the Joseph A. Pechman Senior Fellow in Economic Studies at the Brookings Institution, director of the Hamilton Project, director of the Retirement Security Project, co-director of the Policy Evaluation Project, and co-director of the Tax Policy Center. He also has time to run. And he's also a research professor at Georgetown University. He previously served as special assistant to the president for economic policy, and as senior economist and senior advisor on the Council of Economic Advisors during the Clinton administration.

We'll then hear from Gene Sperling, who's a senior fellow here at the Center focusing on economics, and he is the economic policy director of the Center on Universal

Education at the Council on Foreign Relations. I need to put a plug in for his book, *The Pro-Growth Progressive*. If you haven't gotten it, you should.

Previously, Gene served in the Clinton administration as the president's national economic advisor and director of the National Economic Council. He coordinated the president's Social Security and debt reduction efforts and played a key role in virtually every initiative of the administration, but including most particularly the 1993 Deficit Reduction Act and the expansion of the Earned Income Tax Credit and technology literacy initiative.

Finally, we're going to hear from Jon Talisman, who's the founding partner of Capitol Tax Partners and has extensive experience in tax and regulatory policy as well as in tax planning. Jon previously served as the assistant secretary for tax policy at the Treasury Department during the Clinton administration. In that capacity he had primary responsibility at Treasury for policy decisions relating to all federal tax matters, including all the president's budget proposals, regulatory guidance, and tax treaties. He was particularly fond of telling me that all of my ideas were crazy. He is currently chair of the formation of tax policy committee of the American Bar Association Tax Section.

I've asked each of our panelists to try to be as brief as possible. We're going to do preliminary statements, but we want to mix it up and get to your questions. I think that we'll start off with Beth and give us her views about what the most important results of the president's tax panel were and where things stand today.

PROFESSOR ELIZABETH GARRETT: Thank you. It's a great pleasure to be here to talk about our report, which apparently did not make it to the White House and may not have even made it to the Treasury Department, since we haven't heard much about it. (Laughter.)

But what I really want to do today is to highlight four elements of the report that I think are progressive elements of the recommendation, a recommendation that was a consensus recommendation from a bipartisan panel. And they're the kinds of things that I hope are taken up in fundamental tax reform; if not in this administration, then in others.

The first thing I think that is worth noting – and perhaps one of the most important things that this report can do – is that this report decisively kills the national retail sales tax as a serious policy option. I would not have thought it would have taken a national report to kill that as a serious policy option, but there is a group – the fair tax group – to their credit, for our hearings, they were largely our audience when we went out into the world. They feel very strongly about tax reform. I think they fundamentally misunderstand the proposal that their leaders put forward. I hope that one of the things that this report can do in the chapter on the national retail sales tax is to show what a nonstarter this is as policy.

As you know, to be revenue neutral even under the president's base line, which is not exactly revenue neutral, the rates had to be 34 to 49 percent, depending on what you

assume about evasion. I think evasion might even be higher than our assumptions, necessitating even higher rates. And even with the prebate that the fair tax folks support, the tax burden on the first through fourth quintiles would increase, while the tax burden on the fifth quintile of the richest Americans would decrease. So that's one progressive element of our report that has had some staying power.

The second thing I would underscore is that all the proposals brought forth by the panel were progressive. That's very important because when we began many people expected us to bring out a flat tax. I remember a *New York Times* magazine article where Grover Norquist told everyone that we were to be handed a script, and that script is what we would bring out. He didn't check that with us first. There was never any serious consideration, to be quite honest, of a flat tax. That was really never seriously on the table.

One of the most interesting parts of the testimony was when Professor Hall, the father of the Hall-Rabushka fat tax, testified before the panel. I asked him whether in light of growing inequality of wealth in this country he would still favor only one tax rate in addition to the zero percent bracket of the flat tax. As you know, the flat tax is not flat. It has a zero bracket and one rate. Professor Hall said that, given growing inequality of wealth, he would now favor two rates plus the zero bracket, so even the father of the flat tax believes it should now have three rates.

Chapter 4 in the report has a section on progressivity that discusses the importance of progressivity and acknowledges growing inequality of wealth in this country over the past several decades. And I think that is a very important acknowledgement by a bipartisan panel formed by the Bush administration. Moreover, even the consumption tax is a progressive X-tax. It is not a flat tax.

Now, the consumption tax proposal in the report has been attacked – and as a tax policy scholar I think rightly so – as an uncomfortable hybrid between an income tax and a consumption tax because of the additional tax on capital that was included. I think that's partly because of the way the report was framed. I thought the report should be framed in the following way: that the country faces a fundamental decision about whether to go down the path of a pure consumption tax or whether to stay with the system we have which is generally an income tax, but has elements of consumption tax.

That is a fundamental value choice the political branches must make. I know my choice. My choice is not to adopt a consumption tax, a tax that falls on labor, but rather to work with the system that we have to make it fairer, simpler, more progressive. Nonetheless, that's a choice that has to be made by the political branches. What I saw this report as possibly doing is saying: if you go the consumption tax route, here in our view is the way to do a consumption tax: a progressive X-tax. If you do what we're doing now, but do it better, then choose the simplified income tax. And I would have felt comfortable signing on to that because, although I would make the decision to travel the simplified income tax route, if the country chooses a pure consumption tax, it must be a progressive X-tax of some sort.

Instead, the panel chose to put forward two proposals that we all thought were better than the current system. There were some of us who could not say that a pure consumption tax is better than the current system; rather, all citizens have to pay for government, including those whose income is purely from capital. And so that's why you get a very uncomfortable sort of X-tax with a bit of a taxation of capital. I agree with scholars who have written that that's an uncomfortable compromise. But the important thing is that even the consumption tax we brought forward is progressive and taxes capital.

The third element of progressivity I'd like to underscore are provisions in the simplified income tax. We organized, as many of you may know, into working groups, so this report was written in groups of four writing various parts of the proposal. That's done largely so that we can work without having everything disclosed immediately. Under the Federal Advisory Committee Act, everything that the full committee does has to occur completely in public, but you can work in working groups as long as their recommendations are then vetted through the full commission in a public hearing. So we worked in groups of four. I worked on two working groups: the one on the simplified income tax and the one on the add-on VAT, which I'll discuss in my fourth point. I think the simplified income tax proposal has many elements that I hope are noted and brought forward as discussions of progressive and fundamental tax reform continue.

First, I think that the shift from deductions to credits is a noteworthy and extremely positive move. In fact, I now wish we'd gone further. I wish that we would have brought out our health insurance incentive as a credit, not a deduction. I would be in favor of looking very seriously at changing the charitable deduction into a credit. I would like to see us go to a world where we use very few credits as our tax expenditures and get away from deductions to the extent we can. They're upside down. They don't make a lot of sense. They don't allow for refundability.

I think one of the important aspects of the simplified income tax is that we not only endorsed a credit like the Earned Income Tax Credit with a refundable aspect to it, but we also advocated a refundable savers credit. Again, if what you're trying to do through the tax code is to incentivize behavior, then you have to think about how you're going to incentivize the behavior of those who don't pay taxes. It seems to me that refundable tax credits are the way to do that. It's a very good way, I think, to send benefits from the government out to certain citizens and so I was very pleased that credits, not deductions, and refundable credits were provisions that we strongly supported.

The second progressive element of the simplified income tax is a very great skepticism about tax expenditures generally. Now, I know in the press this has been spun as "The panel had to do this in order to repeal the AMT because they were required to be revenue neutral according to the president's base line." On the contrary, I would have favored what we did with respect to tax expenditures even without the requirement for revenue neutrality. Tax expenditures in my view must be subject to a rigorous burden of

proof. There must be proof that they change behavior in the way that you say they're changing behavior, and there must be proof that they are the kind of government spending program that you would do as a spending program. It should not be the case that they're in the tax code because if you had to structure them as appropriations, everybody would be embarrassed.

What do I mean by that? Well, for example, take the current education tax incentives, none of which are in our proposal. I do not believe there is good evidence that they change the relevant behavior. As long as they don't change behavior, then in my view they are not justified as tax expenditures because tax expenditures have to be paid for by higher tax rates on the rest of us.

Take the home mortgage interest deduction. I know it received a lot of attention in the press. One thing I would note is that we didn't get rid of all incentives for home ownership. There's still no tax on imputed rental income. There's still a generous tax credit that can be enjoyed by all Americans who buy their homes. That tax credit is the kind of program that I think one can support as a housing subsidy. The current tax deduction is one that would be embarrassing if you enacted it as an appropriation. It is a tax subsidy that mainly benefits the well-to-do who would be buying homes no matter what the tax system did. It is mainly a subsidy to those who do not need it and whose behavior will not be changed in the desired way. Seventy percent of taxpayers receive no benefit from the current home mortgage interest deduction, and 55 percent of the tax subsidy goes to those with incomes of \$100,000 or more.

That's the kind of scrutiny that I think has to be leveled against every tax expenditure in the code. If expenditures can't meet this burden of proof, they should be eliminated. And that's what we tried to do in this report.

A third aspect of the simplified income tax that I just want to underscore is that we try to address the marriage penalty through the brackets – through doubling the brackets for joint taxpayers versus single. My own preference would have been mandating individual filing, but that's something that wasn't going to get consensus agreement. So what we tried to do instead was at least acknowledge the tax burden on second earners, largely women, and try to ameliorate that through some of the changes in the code.

Finally, I just want to discuss the savings incentives of the simplified income proposal because that's an element of our proposal I spent a lot of time on. I feel somewhat mixed about our recommendation, although I'm proud of some of the things that we did with respect to the savings package. It is very important to look at the savings recommendations of this panel as an integrated package. We made very clear in this proposal that we did not want items cherry picked by policymakers who then claim that their proposal got support from the panel. What was supported by this panel was the entire group of saving incentives.

The reason I say that is because I'm not keen on some of the parts of this package; I don't think they meet that burden of proof I mentioned. I think with respect to some of the individual savings accounts, essentially the Roth IRAs, the evidence that they change behavior is not substantial. I think they result in people substituting savings in one form for another, and I think that their out-year revenue losses make them extraordinarily problematic, particularly in times when we are running such tremendous deficits that our children are going to have to deal with.

However, this is a consensus document, and there are many on the panel who thought those are really good ideas. What I think are good ideas are: changing the default rules for employer provided plans, something that Peter Orszag and others have worked on; the refundable savers credit, which is targeted at low-income Americans; getting rid of the tax benefits for deferred compensation and for inside build-up on life insurance policies. So as you think about the savings package in this report, understand that it got through this panel because it was part of an integrated and comprehensive whole. Probably none of us would have written it this way had we been doing it solely, but I think all of us could sign onto this package as better than what we have now.

Let me just say one final thing about progressive elements of this proposal. You will notice that, while we try to kill the national retail sales tax, we are not as skeptical about an add-on VAT. There's a chapter about an add-on VAT where we discuss the optimal design of a VAT. There was not a consensus to bring that out as an alternative, and I think that was largely because our jurisdiction was just the income tax. I would have been an enthusiastic supporter of very serious consideration of using a value-added tax to replace the payroll tax. Payroll taxes were not on our agenda. Rather we had to consider whether you would use a VAT to replace part of the individual tax or the corporate tax, and that's a nonstarter for me. But I do think as a country we're going to have to grapple with Social Security and in particular Medicare. We're going to have to find other sources of revenue. And I think when we finally seriously do that, a value-added tax is something we have to have on the table as a replacement for the current payroll tax system.

MR. PODESTA: Thank you, Beth. That was a very compelling case on behalf of the entire commission, I think really, and maybe that's why it's locked in a vault in the Treasury Department. (Laughter.)

Peter, I think, can pick up on one of the things you mentioned, which is shifting from deductions to credits.

MR. PETER R. ORSZAG: Indeed. Thanks, John. Thanks, Beth.

I want to talk about an idea that I think would have substantial implications, but is actually at least conceivable to imagine that policymakers would take up, which is, indeed, to take a lot of the deductions that are currently in the code and transform them into uniform refundable credits, which has the advantage in my mind of being both more equitable and more efficient than the current system. So this is a situation in which the

traditional tension that is often hypothesized between equity and efficiency I don't think exists. I think both objectives are served by moving in this direction, and in fact I think in general the training that a lot of us have been given that those two objectives are inherently contradictory is often wrong and this is just one example in which that is the case.

In thinking about this sort of potential transformation, you need separate two types of deductions or exclusions. One is – one type is sort of measured – is intended to measure taxable income or ability to pay more accurately, and that's not what I'm talking about here. So there are a variety of provisions in the code that are supposed to just get at a better measure of income and that – I want to put those to the side.

But there is roughly \$500 billion in annual tax expenditures associated with deductions or exclusions or other tax incentives that are intended to promote socially beneficial behavior, like retirement savings, like home ownership, like education, like charitable giving. And that's what I'm talking about and I just want to pause. \$500 billion a year is a big amount of money that's for – north of 4 percent of GDP, so it's a very substantial investment that we are making, and we need to get it right in terms of how we make that investment.

Out of that \$500 billion there are two credits that are nontrivial that are currently, at least partially refundable, the Earned Income Tax Credit and the child tax credit. They amount to about \$70 billion a year, so out of the \$500 billion there's still well over \$400 billion of deduction-related things that could be transformed into refundable credits. And my thesis is that in the absence of any evidence to the contrary, that in the absence of any evidence that either behavior or elasticities varies significantly by income, everything that's done to promote socially-beneficial behavior should be – through the tax code should be delivered in the form of a uniform refundable credit; that is, the same credit amount regardless of income and you receive it regardless of whether you owe positive income tax liability or not. And again, I want to argue that that's both more fair and more efficient than the current system.

There are a whole variety of proposals I should note for expanding refundable credits. The president's commission had some. Glen Hubbard and his co-authors with regard to healthcare have proposed a new refundable credit. In a footnote in Anne's paper she notes that if her program were administered through the tax system it would also be a refundable credit, so there are a variety of proposals out there to expand refundable credits, but there is also a counterpressure: arguments like that we should not have refundable credits because people who don't pay income tax should not receive a tax incentive, that being one of the primary counterexamples.

In a paper that will be coming out – well, as soon as it's accepted somewhere – Lily Batchelder and Fred Goldberg – that I wrote with Lily Batchelder and Fred Goldberg, we present some evidence on precisely that question. And what's interesting is that people who receive a refundable credit, in particular, say, they Earned Income Tax

Credit, in one year – if you look over longer periods of time, are very likely to owe even just positive income tax liability and let alone positive income and payroll tax liability.

If you look over a 25-year period, over 80 percent of the people who receive a refundable credit in a year owe positive income tax liability over a longer period of time. And so refundable credits actually can be thought of as much more similar to carry-forwards and carry-backs that exist in the rest of the tax code that allow sort of smoothing of tax benefits across different years, and this argument that you don't owe income tax liability in a particular year misses sort of a more dynamic perspective.

Turning to the affirmative case from my perspective, the equity part of this I think is pretty simple, which is that transforming deductions which are – and exclusions, which are based on marginal tax rates and, therefore, accrue disproportionately to higher-income households who are in, say, the 35-percent bracket, transforming those deductions or exclusions into uniform refundable credit obviously moves tax benefits from high-income households to low and moderate-income households, which I think is particularly warranted given the dramatic shift in pretax income distribution that has occurred over the past few decades.

But that part seems to be somewhat controversial – the sort of equity argument – and is also kind of inherently subjective in terms of what one thinks, so I really want to focus instead on an efficiency argument that I would hope that both political parties could kind of agree on. And it's very simple, which is that if you're trying to encourage some behavior, say, homeownership or education, and you have absolutely no idea that on the margin some additional homeownership or education by a high-income household is more socially beneficial than additional education or homeownership by a low-income household, why would you want to exclude 35 percent of households from receiving any benefit whatsoever in delivering your incentive? And that's precisely what you do when you do not deliver things in the form of something that's refundable. Thirty-five percent of tax units in any given year, according to the Tax Policy Center numbers, do not owe positive income tax liability. Almost 50 percent of tax units with children do not owe positive income tax liability.

So if you're trying to do anything to alter the incentives for those households through the tax code, it is imperative, it's critical, it's necessary to deliver it in the form of refundability or you're going to be missing a very large chunk of the population, presumably part of what you're trying to do. Part of what you're trying to do is provide incentives, not ignore them.

Furthermore, though, there's sort of a deeper point which is that if we don't know anything about the – again, the behavior or the responsiveness of different households, the credit should be uniform. And we in the paper provide a little bit more sort of analytical meat to that. But basically, if you don't know anything and you don't know whether high-income households are more responsive than low-income households, the best thing you can do in that kind of ignorance is to provide the same credit to everyone.

And that's just from a simple efficiency point of view in terms of minimizing the squared error in your – in delivering your subsidy to different households.

And I'd sort of go beyond that, which is even if you, for example, thought that there was some differentiation in income and that therefore a uniform credit didn't make sense, it is entirely implausible to me that a nonrefundable approach makes sense because to have that be optimal you'd have to have some really sharp break in behavioral patterns right at the point of zero income tax liability, and that I just find completely implausible in practice. So as a default our argument is everything should be uniform refundable credits and those who want some other form of tax break should have the burden of proof that there is a strong behavioral pattern change across the income distribution. Changing north of \$400 billion in tax incentives from deductions and exclusions into these credits would not only be more fair, but in my opinion it would also be more efficient until we learn a lot more about how different households respond.

Thank you.

MR. PODESTA: Thank you, Peter.

Gene?

MR. GENE B. SPERLING: Thank you very much. Let me – I'm going to do a tiny bit at the beginning on just what I think some of the political dynamics are that affect the question of this panel, which is overhaul or incremental. And then I'd like to do a couple of caveats for us and then substantively I want to pick up on a piece of what Peter is talking about and what John talked about earlier about this as well on the particular issue of how we should be addressing the work versus wealth issue in taxation.

First of all, just on the history of tax reform, it is very interesting that the – people have often said, "Well, progressives, Democrats, they haven't come up with these big sweeping tax reforms. What's the matter?" And the interesting thing to remember is for the last 11 years other than for – how long was it? – maybe a brief year, the Republicans have controlled both houses of Congress and for the last five years or most of the last five years, they've controlled everything. So what's really actually kind of amazing is that they had the capacity for well over a decade straight to put forward a unified, sweeping tax reform plan and never have and that's really a striking issue. A candidate has here or there – Steve Forbes – but no – never the party, never seriously, even in this position of controlling in all of government.

Now, the question is, what are the political dynamics that tend to make tax reform more popular at these type of sessions and more popular in the abstract than in the reality of campaigns. And now, I think that progressives have – I think when we were – in the Clinton administration, we always used to say that income tax reform be judged by three principles: one, simplicity; two, fiscal discipline; and third, fairness or progressivity. And the difference that defines progressive versus conservative plans were they were for simplicity and some mix of going backwards on fiscal discipline or progressivity.

Now, even with us having the right three principles, why is it that none of these proposals have been able to launch as well? Well, I think that a lot of the proposals before really followed the same kind of political dynamic that the kind of sales tax/flat tax did. They were plans where people would limit or eliminate popular deductions and expenditures, and with the savings from there either flatten or make the tax code out and made it more progressive.

Now, what that meant is that if both sides were basically falling into pretty much an iron law of tax reform, which is that even if you have a reform in which you can show that 80 percent of the public will win and 20 percent will lose, here's the iron law: the 20 percent who lose are sure they will lose and the 80 percent who will win don't believe it. (Laughter.) A subsidiary of the iron law: the 20 percent who are sure they will lose will organize, advertise, and characterize and ultimately devastate the reform, and the winners will – potential winners will stay diffuse. And I think that really does explain the lack of progress even from the Republican side or both of us have been caught in this.

Now, as I look at the proposals out in the last few years, I actually feel a lot more optimistic about the progressive tax reforms because I think many of them are not falling into that trap. If you look at the type of family-first type of reform that Jason Furman worked on and with – for Wes Clark and Rahm Emanuel and many others have, it takes more of a particular area of the code and can pretty much explain to virtually everybody that – everybody why this would be better off. The proposal by the two Johns, Irons and Podesta, was not – was probably because it was broad may have been a little harder to explain each of the components in a quick political sense, but was able to fairly quickly identify who the losers were and really to try to show that the overwhelming majority of Americans far higher than 80 percent, more like 98 percent, would be winners.

I think there's a lot more proposals here – what Peter's talking about, the unified credit – where at least we are able to present and be very clear on who the losers are and feel we can take on that issue, because really all we're doing in the sense of – to (greater?) losers is making the tax code more progressive at a time that it has become more regressive.

But it is worth us thinking about how it is these things actually happen if you're going for a broader overhaul. One is, I think you need something we don't have right now, which is an actual commitment to bipartisan where you could actually allow powerful people from both sides to get together and to simultaneously present a plan where they could all show that 80 or 85 percent of people are winners, and I think – I'm not going to say that's exactly the way 86 was, but it was closer to that model – or to be able to explain, as I think some of these more recent progressive tax reforms have, to be able to explain very clearly who's going to benefit and feel that you can take that on politically, so I do feel more optimism there.

Second part of my talk here is I just wanted to say what I thought a couple of caveats were. When I was working for Mario Cuomo in 1989-1990, there was kind of

the sense that the holy grail for progressives was to somehow devise a progressive consumption tax; that if you could just have it so that you could take away the regressivity of the consumption tax, you'd have more savings, and this would be the holy grail. And I think that we should at this point in our economy, at this point in the state of inequality in our country bury that idea that that's the holy grail once and for all. There is really no format that does not tax capital income or wealth that is not going to lead to an exacerbation of wealth inequality in our country. And I'm glad to see that in a proposal like this virtually everybody has moved away from that. And even – and I'm not – I'm sorry, Maya, I can't necessarily endorse your plan, but I do think at least when people are thinking about these type of value-added consumption in terms of the payroll tax at least they're not falling into the trap of going to zero taxation on capital income.

Now, my other caveat is simply that the political realities of putting together these reforms is that people want to show not only that they're making things better, they tend to want to sweeten the deal and to show that you're going to be given even significant new and additional tax cuts, and this is where I think those of us who work on tax reform have to look at the whole agenda. I do think there are areas where it does make sense to go beyond and give additional tax relief, but for those of us who've had to put together entire budgets – there will be a session here on early childhood, there will be a session here on health care, and one has to not fall into the trap of spending every reasonable amount of savings you could get simply on tax reform when we have so many other pressing issues for progressives for addressing wealth inequality, for addressing our competitiveness with China and India.

Now, on work and wealth, a couple of points. One, I want to just add to something that Peter said, is there is always this theory you get too generous on the EITC and then you are actually providing subsidy that's greater than income taxes or greater than income taxes and even payroll taxes, and that at a certain point we have to back off. Now, Peter gave one justification for, well, that's not the case. One also remembers that poor people pay sales taxes, state, local taxes, but I also want to remember another thing, which is I thought what President Clinton's genius was was in realizing that Americans are generous when they think it is related to people going to work and working for their living.

And we should remember that the expenses associated with work are enormously regressive. Child care is a burden for most of us in the room. It's a devastating burden for working poor families. The transportation, your car, every single thing that allows you to go to work is essentially a regressive expense. For us to be for helping people go to work, to take away some of the regressivity tied to working is still, I believe, a value construct that we can talk to the American public about and get resonance with, even when we are talking about more generous refundable tax credits.

Now, on the issue – to zero in on Peter's issue, but in the area of savings, there's a tendency to try to look and say, yeah, deductions are better than credits, et cetera. We should recognize when it comes to savings incentives that it's not – that our progressive tax system that we're proud of to the degree it's progressive is not just off, it gets

completely turned on its head when we go into the savings structure. I mean, I think this is one of the things we never appreciated enough: that the more you made the tax code progressive, the more that if you were in a world where you've incented savings through deductibility, the more you were creating a completely upside down system. So therefore the more you make, the higher income you are, the less studies show you're more likely to be affected, the more savings we give you. If you're – the less you make, the more you're struggling, the more you need help, the less we give to you.

So you have the high-powered female superstar CEO and she's a triple winner in our system. She goes to work, 100 percent of people in that category have a very generous pension with a match at work. Secondly, there's a candy land of other savings accounts that you can put money into. I don't think I really quite discovered the SEP IRA until I left government. It's – I benefit from it, but I – it's hard to justify.

And then third, to the degree that that CEO saves a dollar, she gets a 35-percent deduction. Now, the person who comes in and cleans her office: she's a triple loser under our system. About 85 to 90 percent of people in that category do not have an employer-provided pension or match at work. Second, the other savings accounts, which are a candy land for people who are well off are irrelevant, and if that woman is lucky enough to save a dollar under our deductibility, if she's in the 10 percent bracket, she gets 10 percent – one-third – one-third of what the CEO whose office she cleans gets. I used to say if you put that system on an SAT logic exam and said, what's the logical principle behind it, you'd have to say that the principle is the easier it is for you to save, the more we want to help you; the harder it is for you to save, the less we want to help you.

Now, combining with this is the notion that we now have taken this system, this upside-down system and are taking steps that make it considerably worse. And I would argue make it considerably worse at exactly the wrong time in our economy because what we are seeing more and more as more economic data comes out is that globalization for all its positives and benefits does seem to be at this point creating more winner-take-all, loser-lose-all outcomes. The work of people like Farber and Hacker and some who have spoken here have talked about people who are taking falls in the economy, taking deeper falls.

On the other hand, the fortune – the 400 richest people are taking a higher and higher percent of our GDP. So now we have a more winner-take-all, loser-lose-all economy. Now – but then one thing we could be proud of at least is that we had a progressive tax system that at least moderates those outcomes. It can't maybe stop them, but it moderates them. It says, if you benefit, whether it's by luck or fortune or talent or a combination, you're going to reinvest more to give other people first and second chances.

Now let's look at what we're doing to the system as John described it. And I like to take the example of two twin brothers. It's the year 2000. One goes and works for Lucent; one goes and works for Google – equally good choices at that time. The twin brother who goes to Lucent finds himself –

MR. PODESTA: He's moving to France.

MR. SPERLING: Probably on the – probably been laid off and is getting retrained. The one who goes to Google – who chose Google has \$2 million in stock options. Well, that's life. We have a free economy. Some people get lucky. Some people don't. Some people choose right. They don't.

But now let's look at what our tax system does. The person making \$2 million – who has a \$2 million-a-year nest egg there can now at a 6 percent return save 6 percent in capital or dividends, make \$120,000 each and every year in perpetuity or more, and pay a 15 percent rate. His twin brother, who may have got a \$60,000 job and is working his way up, through payroll and income taxes is probably paying 25 percent – nearly double as much. Now, how does that fit our value construct? That is going into the world and saying, how do we exacerbate, not moderate, the winner-take-all outcomes?

Now, my final caveat before mentioning, which I always mention a couple different proposals I support, is while I think there is an enormous importance from a value construct for us to make this point over and over again that conservatives have gone off the deep end, they have gone to a point where they have lost touch with the value structure of the country that does believe that hard work by working families should be honored more than passive wealth. And that is a point that we can make and underlines much of the tax reform that's said here. But I have to make the following warning: if we start saying this is about wealth versus work, we're going to send a signal to most Americans that we don't care about them ever attaining wealth. I'm not for work over wealth. I'm for helping average people who work have the income to both support their families and save and create wealth.

We can't just have a work-versus-wealth message. We have to have a progressive wealth-creation message. We have to have a nest egg message. We have to be the champions when we're doing tax reform of helping people move up and have their own nest eggs. I support a universal 401(k), which is just an outgrowth of our USA accounts, so I hope 70 years from now I just don't have three new names in the same proposal. (Laughter.) But the notion that we can have – give to everybody the same benefits that that CEO gives, at least the opportunity to save and create wealth, that we can lead with why we want to help create a nest egg.

And when I wrote my book, I had the estate tax savings pay for this, and this was because I wanted to send a message. We're not about just being against wealth. We want to have more families have a chance to have an estate – have wealth someday. And then finally, a proposal both Peter and Jason, many of us support, and Jon as well, is have a flat tax credit. And this really is essentially what Peter was saying. But the idea – I would be a little more generous and make it a 30-percent flat tax credit. The flatness that Republicans have always used for simplicity is ours in the area Peter talked about, and so I talk about the 30-percent credit as being a flat tax incentive for savings. For people in the 15 percent bracket, it's a doubling of their savings incentives, so I – for me, this is where I would put my greatest focus in more of the incremental tax reform is in having –

turning our upside system on savings right side up and having not just a negative message, but positive, affirmative proposals for helping more Americans create wealth and savings.

MR. PODESTA: Thank you, Gene. That's terrific.

Jon actually lives in the belly of the beast up there most days, so I hope you – in your comments, Jon, you'll give us a little bit of perspective of how you see things potentially working out and which of these strategies you think are viable.

MR. JON TALISMAN: And I am the technician, I guess, on this panel, so I may get into the weeds a little bit, but I note that the first tax incentive that Gene talked about keeping, given that he's expecting, is a child care credit. (Laughter.) That's very interesting to me how things change over time.

But I feel somewhat on this panel, and I've said this before, that we're stuck in the movie *Groundhog Day*. We talked about tax reform a lot. In fact, I actually staffed Senator Moynihan when the Kemp Commission came out with their report and actually when I was a young associate in a law firm, I actually attended a hearing on (unintelligible) gets flat tax in the early 1980s, so we've been talking about tax reform I think on and off over the many years that I've been practicing tax law.

And the complaints really are the same over the decades: it's too complex, discourages hard work and saving and risk taking, it's not fair, and it's difficult to comply with and administer. In my opinion, we're facing a period where we actually – a perfect storm almost, so to speak, where we really need to get ourselves to be able to turn off the alarm clock and change the music.

There are structural extenders that are coming into play in 2010. There's the AMT problem, which frankly I've probably bent John and Gene's ear incessantly when we were in the Clinton administration that this was a pending storm and we actually came up with at least a partial solution. I think there was a huge opportunity missed and lost in 2001 when there were actually budget surpluses, that the AMT problem could have been addressed. I think – as Gene talked about with winners and losers, I think we could have done structural reforms in a way that frankly he would not have necessarily had to create as many losers in 2001 and now that we're in budget deficits, obviously tax reform is far more difficult. If I'd had a \$1 trillion to spend on tax reform in 2000, I probably could have done some good.

So I think it's important also, though, to set forth a principle from Senator Moynihan that's do no harm. And I quote this only because he wrote it in my working papers that I had to quote him every time possible, so it's: the thought of a new set of simple rules is always appealing. However, any time a change of this magnitude is under consideration with huge potential risks to the economy and shifts of fortune in the balance, we must approach proponents' claims with caution and healthy skepticism. And what I'd like to do a little bit today is talk about switch to a value added tax as a

replacement, and I'm not necessarily throwing dirt on the issue of an add-on value added tax, but I think that the proponents' claims that a value-added tax is both simpler and will increase savings and is fair, I think we need to at least approach with some notion of healthy skepticism.

Much of the complexity in the income tax, I think, other than the fact that obviously you're not taxing savings, would be true in a value-added tax. In fact, quoting – again, I'm quoting, “We have been concerned for some time about the seemingly inexorable and exponential increase in the complexity of the tax system, especially insofar as it affects ordinary people and small businesses.” That seems like it's a quote about our income tax. Unfortunately, it's actually about the English value-added tax.

“The majority of people who do not deal with a VAT on a day-to-day basis seem to find the tax almost unintelligible,” also a quote about the value-added tax. There's a 16-percent evasion rate in the English value-added tax. That's approximately the same evasion rate we have in the U.S. on our income tax. So, again, I'm not sure that the value-added tax is the be-all and end-all as far as complexity. I'd like to cite the following examples about tax expenditures also with respect to a value-added tax. Are we really going to eliminate all sorts of complexity in choosing value – in choosing what to tax and what's not to tax? Children's clothing in England is zero rated, but fur clothing is (excepted?). Is a roller coaster public transport? There was a huge case because public transport is zero rated. Is Jaffa cake, which I don't even know what a Jaffa cake is, but is Jaffa cake a biscuit or a cake, because they're treated differently.

So again, I think the question of a value-added tax there are difficult questions in designing the base, which are the issues that a technician like me deals with, and I don't think that necessarily the VAT is less complex, other than the fact that you're not taxing capital, which gets to equity issues, than an income tax.

I think it's also important in talking about reforming our current system to talk about the fact that we not only tax at the federal level, we also tax at the state level, and state taxes are very generally regressive in nature. In fact, we raise \$2.9 trillion in total taxes in 2002 and \$1 trillion of those dollars were raised at the state level, so again, that all needs to be built into any analysis of tax reform. And when you compare (us to?) sort of foreign systems, the U.S. has a lower tax burden than virtually all of our trading partners. Our income taxes and social insurance taxes are close to the OECD averages. The big difference is consumption taxes. We have a 4.2 percent of GDP consumption tax, and that's obviously at the state level primarily. And the OECD average is about 11.1 percent of GDP. Of course, they use VATs rather than sales taxes, and we don't know of any major industrialized nation that uses only a consumption tax to raise revenue.

In fact, my understanding is both Pakistan and India had only a consumption tax, but deemed them actually not sophisticated enough to deal with their complex economies, so you can only imagine what it would be in our economy. (Laughter.)

Finally, I think it's important to know when talking about ability to pay, and again, I'm not a pollster, but the polling does indicate that much support for a consumption tax comes from the misinformed belief that it will be more progressive, rather than regressive, than the current system. And I think if you try and make a consumption tax more progressive, you also will undermine many of the purported efficiencies in moving to a consumption tax, so we also have to keep that in mind. And I'll throw it over to John.

MR. PODESTA: I think those English tax collectors will be surprised to learn that a Java cake is actually a software program from Sun Microsystems, not something you serve at a coffee klatch.

MR. TALISMAN: Anybody who knows John Podesta knows where he would come down on the roller coaster tax. That's inside.

MR. PODESTA: I'm going to kind of throw it out to the audience here in a second, but I'm going to let our panelists make brief comments and ask questions if you want to.

Jason, you want to go first?

MR. JASON FURMAN: Sure. It was great, Peter, to hear you make such a forceful case for converting deductions into credits, and that's an element of a lot of the proposals that people have made here today. And I think if anything it's one of the most coherent, consistent themes in at least Democratic tax-wonk proposals is to say, we're going to be doing social policy through the tax code – might as well get that social policy right.

I just wanted to add two points, and then you're welcome to comment on them or not, to what you said in terms of the efficiency arguments. First, a lot of what we try to encourage through the tax code we are more interested in – like if you take housing, we're more interested to the degree we want to encourage housing in getting someone to have a house than in getting someone to go from a medium to a large house. With education, we are more interested in somebody going to college and we'd like them to go to a better and more expensive college, but again we care less about – care less in proportion to that. Healthcare similarly: we care more that somebody has health insurance and if we have limited resources, less about subsidizing and a more generous policy.

All of that says in terms of efficiency that having a credit that gives you \$2,000 if you buy a house, you could make limit it in some way proportionately rather than a 25 percent of your mortgage interest or 3 percent of the value of your house up to a \$10 million house that you can be more efficient in terms of credits at putting more money at getting people to make that initial binary choice and less money at making them go from

a medium to a large house. So that would be point number one. I'm not sure how you have in mind structuring credits.

Number two, I would think in most of these things, the degree we have evidence on elasticities – our intuitions on elasticity is the exact opposite of our current system: that low-income people are going to be a lot more responsive to incentives to own houses, to go to college, certainly child care to go to work. So I would think that there would be a very compelling efficiency case for having most of these credits be larger for low-income families and probably phase out for higher-income families, and then if you don't like what that does to vertical equity you can raise tax rates on people at the bottom and lower them on people – I don't think you should do that, but it's a separable question of vertical equity from efficiency and I would think efficiency would be the opposite.

MR. PODESTA: (Off mike.)

MR. ORSZAG: Sure. On the first two points and then I'm going to add two others quickly. I agree that in many cases this sort of extensive version – well, getting people into an activity can be more important than how intensively they undertake that activity and, therefore, in many of these settings it would make sense. In others, it's not so clear, like with regard to the retirement savings.

MR. FURMAN: Yeah, it didn't.

MR. ORSZAG: It varies, so obviously we need some differentiation by type of activity.

On elasticities, I also agree and actually with regard to retirement savings, if anything, the elasticity of net saving with regard to an incentive is presumably higher at the bottom of the income distribution than at the top just because of asset shifting. You may have – even if the same contribution – you get the same dollar contribution in response to an incentive, it's more likely to represent net new saving at the bottom of the income distribution than at the top, so that also flips that way.

There is, though, some – there are some areas where the evidence could go the other way. The limited evidence on charitable giving, for example, arguably suggests that elasticities are higher at the top than at the bottom, but it's – in the absence of conclusive evidence, even if I like it one way or the other from my sort of equity perspective, I would say we should have a uniform credit. And if it's fairly convincing evidence one way or the other including, perhaps, towards lower-income households, then it should be tilted that way.

Just two other things quickly that I didn't mention that just reinforce the efficiency argument, though, taking the deductions and transferring them into uniform credits helps on the family level on income smoothing because you deliver more tax benefits during lean years – during low-income years, and then sort of effectively take them away a little bit during high-income years, and that's a good thing, especially for

low and moderate income households who can have trouble weathering shocks that happen. This sort of helps them to smooth their income across years.

And similarly from a macroeconomic perspective, although the effect is modest given the current size of refundable credits, refundable credits do help to make the tax system more of an automatic stabilizer than it would otherwise be. And both of those are further efficiency arguments in favor of this kind of transformation.

MR. PODESTA: Okay. (Dan?)?

MR. DANIEL HALPERIN: Peter, I think if you're doing a credit just to incentivize (ph) a particular behavior, I'm not sure why it should matter at all whether people pay taxes. I can see if you're saying – you're doing something with child tax credit where you're arguing that it's the way of adjusting the tax burden for people who can't afford to pay taxes at low incomes. Then you get into an argument about whether they're actually paying taxes. But if you can focus the discussion on whether you're trying to encourage people to buy a home or to give to charity or buy a health insurance policy, why should taxes be relevant? I mean, we don't care about whether people pay taxes if we give direct subsidies to people. Nobody's asked the farmers in the farm subsidy program whether they pay taxes.

MR. ORSZAG: Oh, I – you may have misunderstood. I was taking the opponents' argument and accepting it for a second.

MR. HALPERIN: I know, but –

MR. ORSZAG: I agree with you that it doesn't make sense, but my point is, even if you do accept that argument from a variety of other perspectives, it's also not accurate; in other words, over a longer period of time the picture changes. But I agree with you that the sort of first layer of importance is that it's not a particularly relevant consideration if we want to deliver incentives through the tax code, and we've made a social decision, obviously, that we are going to do some of that – or \$500 billion worth of it.

MR. PODESTA: I'm going to look for hands here in one second. Anne, did you want to say something? Go ahead. Please identify yourself, talk in the mike.

Q: My name is Jim Frech. I'm with the National Academy of Public Administration. We recently sponsored an intergovernmental forum where we asked the levels of government to talk about the design to the revenue systems, but from an intergovernmental or all-governments' perspective. So I was hoping that some of the panel members could comment about the role of state and local governments in the economy, their economic role, and the interaction effects of a lot of proposals that have been talked about today.

MR. PODESTA: Beth, you want to –

MS. GARRETT: Well, certainly the tax panel did try to keep in mind the burden of taxes at the state and local levels. That was an important consideration as we thought about the overall tax burden. I suppose the recommendation that we made that has the most significant effect on state and local governments is that we recommended eliminating the deduction for state taxes, which again I supported and would support even if we hadn't needed the revenue. It doesn't seem to me that somebody who chooses to live in a low-tax state should subsidize me in California, because I choose to live in a high-tax state.

Q: (Off mike.)

MS. GARRETT: Again, you should understand my approach to taxes is we should do as little incentivizing as possible through tax expenditures in the tax code. So there has to be a burden of proof that all tax expenditures must pass before they should be in the code; any of them undermine simplicity. They make paying taxes more difficult. You also have the problem of upside down quality of them. Once they get in the code, they're there forever, unless they're sunsetted. It used to be, when I worked in the Senate, that we didn't sunset that many. Now we sunset the entire tax code, so perhaps this is less of a concern!

I think the political dynamics of eliminating this deduction are going to be interesting. As you know, in 1986 that was a political battle to eliminate the deduction that could not be won. They decided there was no way they could repeal the state and local tax deduction. What's interesting now is that those paying the AMT aren't enjoying that deduction anymore. So if the trade is getting rid of AMT and no deduction, these taxpayers aren't in a very different situation. Again, I live in California, so we have a situation I think most of the country is going to have soon, but we in New York and California have it now.

But, of course, the irony of that reality, too, is if you're looking for revenue, the interaction of the deduction and AMT also reduces the amount of revenue that eliminating the state and local tax deduction can give you, because fewer taxpayers claim it now. There's less revenue gained when you repeal it, so I think the political dynamics will be interesting. The last thing I'll tell you about political dynamics is it did give me a sense that there are still strong supporters of the state and local tax deduction when Mr. Rangel attacked our report as a tool of the Republican Party and cited the elimination of the deduction as part of the reason that the panel's report was so conservative and unacceptable.

I think there can be bipartisan support for getting rid of that deduction. More than that, I think his view of this proposal blinded him to the progressive elements of this recommendation that I would have hoped people like Mr. Rangel and other Democrats would have embraced, even if they didn't like some parts of it.

MR. : Okay. Let me just add three things really quickly. One is some of the things that we're talking about, for example, the municipal bond interest, provide a good example of problems with the current structure. To the extent that the marginal investor in those types of bonds is not in the 35-percent tax bracket, there's a clientele effect so that the government is giving away a tax expenditure, and it's not actually flowing through to the benefit of the intended target. Instead, it's being captured by high-income tax filing units. Moving to a credit, again, I think is beneficial in that kind of setting.

Second point is that obviously there are a lot of interactions between the state tax codes and the federal tax code and often in simplification discussions people ignore the fact that you've got this other system tacked on and you're not really accomplishing very much if you dramatically simplify the federal system and then leave a lot of the state systems in place that then require many of the same pieces of information that had been required under the federal system.

And then the final point, because it came up this morning, I think one of the major things is more on the expenditure side of the state and local system, but with regard to higher education, which was the topic of some discussion this morning, I think it is dangerous for us to think that there's a full offset in terms of lower state and local government – state government subsidies for higher education being offset by higher tuition. Some work got done with Tom Cain (sp) suggesting that's not the case and it frankly would be surprising if it were. Instead, I think it shows up in terms of the quality of higher education delivered through the public system. And I think there are big questions about whether the historic system – the state government support for public higher education is sustainable. And if it's not, whether we need to be moving more towards the type – an expanded version of the type of approach that Susan Dynarski highlighted that is more student related rather than institutionally related in terms of support for higher education writ large at both the federal and state levels.

MR. TALISMAN: John?

MR. PODESTA: Go ahead, Jon.

MR. TALISMAN: Real quickly. I mean, and Peter alluded to it, a lot of the state income tax systems also piggyback on the federal system, and so when you start running tax expenditures through the federal system, you get into the question whether the state should follow, and oftentimes they do just naturally. They just sort of adopt it. But there are questions as to whether the state – the federal incentive makes sense for the states. That can create budgetary problems, et cetera. And to the extent they don't follow along, obviously that creates complexity, which is what Peter was talking about, because then you have to determine – and a lot of times that's confusing to people why I'm getting the benefit at one place, but not the other place.

The other thing I guess responding to Beth, and I'm not advocating whether the state and local tax deduction is the right or the wrong thing, but it is interesting that we wholeheartedly accept in our tax system getting a foreign tax credit for taxes paid – if you

live in a province of Canada for taxes paid to that province, but then we don't think we should give you state and local tax deduction.

I think that there're questions, obviously, and frankly I know the next panel is going to talk about international tax reform. The foreign tax credit system creates anomalies and incentives to invest abroad that also need to be examined and addressed. And I'm not advocating eliminating the foreign tax credit; I'm just suggesting that I think that we have to sort of being consistent in our thinking through why we give a foreign tax credit and maybe don't give a state and local tax deduction.

With respect to the add-on VAT, I think it's – obviously, everybody in the room knows this, but there's a lot of consternation among state tax officials about the interference with their – either their sales taxes, and it's also I guess ironic at a time when we're trying to get the state systems conforming under the streamlined sales tax that we'd be talking about putting a federal system that has different definitions that people have to deal with at the consumption tax level.

Q: Gilbert Brown, retired from the World Bank and now spend my time working on tax policy issues for the Women's National Democratic Fund. I recall in 1958 John Kenneth Galbraith published a book. The title escapes me, but his main – one of the main points was that we need to worry less about the regressivity of the tax system, or the progressivity, because – well, we want to make sure that those funds are spent in a progressive way in social programs. And I wondered if anybody wanted to react to that.

MR. PODESTA: Gene?

MR. SPERLING: Well, here's what I would agree with and my guess is others would too, which is that I do think one has to look at the whole package when you're doing a particular element. So, for example, Social Security would be the ultimate example of a tax that if you looked simply at the payroll tax it's quite regressive. If you look at the entire package of benefits that go with it, it's overall a progressive – it's overall still a very progressive program. So I think when you're looking at initial benefits – so if you're trying to make Social Security more progressive, you wouldn't necessarily just look on the tax or the benefit side. You would look at those together.

I imagine that this issue could raise its head someday in some of the proposals to finance universal healthcare. You can imagine a healthcare tax that would be – that may not be as progressive, but the benefits may be, so I do think it is important to look at the whole plan.

What I don't agree with is that you wouldn't want to look – when you have the income tax, which is your overall structure, there I believe, as I said before, the progressive tax system is inherent to, I think, our social contract that most people believe in this country that if you are benefiting most in this country – and nobody's more eloquent on the defense of this than William – than Bill Gates's father on the sense that you're paying a return – you've benefited the most from the opportunity in this country

and that you are essentially paying forward much of the benefits that were paid to you in creating the type of system that allows you to create the wealth or have the fortune that you did here.

MS. GARRETT: Well, I would agree that I can't imagine a tax system being acceptable without it also being progressive. It does seem to me, however, that you can't make the decision about the level of progressivity without thinking about how the government spends its money and without thinking about the background economic conditions. So while I might agree with Gene that the income tax system necessarily needs to be progressive, the question of how progressive is a question you can only answer if you also look at the spending patterns of the government, and the background economic conditions of the country.

And one reason I argued in my separate statement that we need a more progressive tax system than we have now is my view is that the spending side of government has become increasingly less progressive over the past few years, and background economic conditions have also worsened as growing inequality of wealth increasingly characterizes the country.

MR. PODESTA: Bernard?

Q: Bernard Wasow, the Century Foundation. A couple of years ago, the Century Foundation had a task force on tax breaks, and while the conclusions were very much like the panel that they wanted to do away with most tax breaks, the panel which consisted in part of people who had worked in the IRS were very leery of refundable credits, something I personally favor very much. But they felt that the administrative burden on the IRS would be extremely great, and that this was an institution that had no expertise in determining whether those now cash expenditures were warranted or not. And I'd like the response of the panel.

MR. PODESTA: Jon, that sounds like it's a –

MR. ORSZAG: Jon, you can step up if you want.

MR. TALISMAN: Go ahead.

MR. ORSZAG: I guess a couple comments. One is that the – that criticism applies not just to refundable credits, but obviously to a lot of the tax expenditures that are delivered through the tax code and it's sort of a purist tax-wonk type of argument with which I have some – for which I have some sympathy, but the fact of the matter is we're doing this stuff and we're doing it for a variety of reasons, some of which have to do with the optics of "tax cut" versus a spending program. And my view is, given that we're doing it, we should do it the right way.

And then we have to focus in on what is the differential administrative burden of a refundable credit versus some other socially-motivated tax expenditure. And

admittedly, there is some. I mean, for example, one of the effects that might occur – I think if Alan Auerbach is still in the room, he emphasized that in a discussion this morning, is that you get – you'd induce more tax filing units to actually file taxes. Those who are not currently filing would be – would have a strong incentive to do so.

That arguably could raise administrative costs. My view is that's a pretty small cost to pay to deliver incentives to households that we're trying to reach. And beyond that, I don't see any particular – it's sort of like somehow – and this comes up with regard to the savers credit, too – somehow a cash payment is seen as being more prone to fraud than reduction in taxes, and I just sort of don't get that. So when someone can make a rigorous case about why that's true, I might assign more weight to it, but in the absence of that I don't find it particularly compelling.

MR. PODESTA: A question in the back? Oh, I'm sorry, Jon.

MR. TALISMAN: That's all right. I was just going to say I agree with most of what Peter said. I think that going to Beth's comments, though, I think you have to analyze the tax expenditure first, determine whether it's a reasonable tax expenditure, and then if you're going to put that tax expenditure in place, I think the refundable credits make the most sense. And you may find a system where if we get the system right, you may have less tax expenditures, but in one pot so that, in fact, enforcement and administration may become easier.

If you can come up with a system that sort of gets these things dialed right, you can possibly make it easier and less – I mean, we have, what, about 12 tax incentives for education right now? I mean, you can combine those and put those all in one pot. It becomes easier to administer, so I agree. We also have to ask ourselves why are we running this tax expenditure through the tax code. I mean, a lot of times the reason we run things through the tax code is because Congress is against a spending cut – I mean, spending. And the real reason why we should be running things through the tax code is because it's easier for the IRS to administer than some other government agency. And we don't always look at them that way, so –

MR. PODESTA: Anne?

MS. ANNE ALSTOTT: I'm very much a subscriber to Peter's thought that in general the problem of evasion or difficulty in administering is the same when it saves \$100 in taxes as when you get a \$100 check, but I think what might have been coming out on your panel is that the EITC actually does make the refundable portion of the credit. It actually is structured different from anything else in the code in a couple of ways that actually facilitate evasion.

So to the extent that IRS folks and tax policy wonks have been schooled in the EITC experience, there are at least two features that make it atypical of the kind of thing that Peter is talking about, right? So Peter is – I think the poster child for what Peter is talking about would be like an education credit or something. It's no harder to verify that

a poor person has gone to a college than that a rich person has gone to a college. But what the EITC does is – for example, there are ranges in the EITC where if you overstate your income you get more money. The taxes – this is weird, right? For normal taxpayers if you overstate your income, you pay more money. And so the traditional tax system has been trying to get understaters of income, not overstaters of income, which meant that there were gaps in what the EITC is doing.

Similarly, in the EITC you can make up wages that don't exist. We don't normally have taxpayers making up income, but this is a funny sort of reverse hole in the 1099 system, the W-2 system, right? Anyway, so there's a kind of EITC exceptionalism that I don't want to have carry over to refundable tax credits generally, and that's the bigger take-away.

MR. PODESTA: In the back.

Q: Thanks. I'm Diane Lim Rogers and I'm from Brookings, but formerly from – recently formerly from Ways and Means Democrats and Charlie Rangel. So I just wanted to make a comment in defense of our not recognizing progressivity – progressive elements in the tax reform panel's recommendations. And I think that's because we really didn't view the tax reform panel recommendations as being a progressive change in large part because the baseline that the panel was forced to adopt was very – was quite regressive compared to current law. I think you assumed that the tax cuts were made permanent and I think you assumed that the savings – tax preferred savings accounts were also in place, which are not – have not yet been passed.

And so the problem is that we're talking about fundamental tax reform. And even if we don't move all the way to a pure consumption tax, moving part of the way toward a more of a consumption base is inherently a regressive change, and so I just – just in defense, I think you would – I think it's hard to argue that those recommendations compared to current law are progressive tax changes compared.

MR. GARRETT: Well, there you and I will have to disagree. Let me first say – and Peter knows this because he and I talked a lot about this when I was on the panel – I was not a fan of the baseline that we were asked to use. I think that when you are analyzing tax policy and budget policy, the baseline you should use is current law. And current law includes the fact that many of the tax cuts of the Bush administration are going to sunset. That should have been the baseline.

That was not an argument that I won. What we used instead was the president's baseline. The president's baseline assumes that virtually all tax cuts are permanent except for the AMT patch. This meant that repealing the AMT, which was something that we all agreed to do early on, was going to cost us a lot more under the president's baseline, because all of a sudden if you repeal the AMT and you assume the tax cuts are permanent, people start enjoying the tax cuts.

Remember, the way that the Bush administration has kept the tax cuts from really breaking the budget is to sunset them and also use the AMT to keep people from fully getting them. So if you keep them forever and you get rid of AMT, suddenly that is a very costly fix, and it made it much more difficult for us to be revenue neutral. So there's a kind of catch-22 to using the President's baseline.

Well, that summarizes my dissatisfaction with the baseline we used. However, I reject the notion that that makes our proposal regressive or somehow flawed, because what we did was put forward a structure that can accommodate any tax rate structure. I argued in my separate statement we should have a more progressive rate structure with this form of taxation.

I also argued that we should raise more revenue with the income tax than we do currently, actually over Congressional baseline. I think we're looking at serious revenue problems down the line because of the entitlement programs, and that we ought to as a country be talking about how to raise revenue, not how to continue to cut it.

Those who dismissed this report because of the baseline or because it had a provision that they didn't like overlooked what is a fundamental change in the income tax system: the move from deductions to credits, and acceptance by a bipartisan panel of refundable tax credits, and acknowledgement of the marriage penalty. There is a lot in this that people like Mr. Rangel and other Democrats on the Hill should have been open to. Instead, we got a lot of gobbledy-gook about the baseline, which in the end is a factor that does not in any way undermine the fundamental change represented by this proposal. We heard attacks on provisions that hurt some of their constituents, rather than statements that looked at the greater importance of the reform of the overall structure.

MR. : Beth, at least they read it, right? (Laughter.)

MS. GARRETT: That's right. And in academics, that's all you can hope for.

MR. PODESTA: We're not going to have a debate on this. I'm going to use the prerogative of the chair to ask the final question, which is previewed by what the title of this panel was, which was, could we get very far down the field through incremental reform if we really care about a progressive tax code or do progressives really need to kind of embrace much more fundamental reform if you want to see the sort of damage that's been done over the last several years righted, and maybe I'd just let each panelist speak to that for a second and the politics of that. But, Jon, do you want to start?

MR. TALISMAN: Well, I mean, actually it's interesting. I actually served as the moderator of a panel with Chairman Packwood and David Brockway and Ron Perlman (sp), who were intimately involved in the '86 tax reform process. And the one thing they all said is, as far as if you're talking about the reality of tax reform, it probably has to be a bipartisan effort that people have to go marching arm in arm in order to get it done ultimately. And so you're going to have to have, I think, both things that are attractive to both sides in order to get tax reform to move.

I do think that the better approach, and one of the reasons why I guess I talked about the problems with the consumption tax is I believe the better approach is to focus on the problems that we have with the current income tax system. I still think the current income tax system is fixable. I do think that it's going to take serious effort by serious people, but I do think that there are things in our system that we should be proud of as well.

We still raise revenue relatively painlessly in an efficient manner relative to other countries in that we need to find ways of improving our current system because I think its fairness, its progressivity – although I think it's less progressive than it was than it has been – I think that those elements of progressivity need to be retained and focused upon.

MS. GARRETT: I agree with what Jon says, and I would only advocate for a fundamental reform in two ways. I think we need to fundamentally change the way we look at tax expenditures. We really must rigorously subject tax expenditures to a burden of proof. If they do not change behavior, if they do not have their intended effect, if they are not the kind of program that we could do as a spending program and be proud of them, we need to take them out of the tax code. And I think to the extent we talk about fundamental change, we ought to be focusing on the entitlement programs. We have got to provide those a more steady source of income. We have to look hard at the payroll tax, which is the main tax burden for middle-income Americans, and we have to think about what is sustainable in the future, not just for us, but for the next generations.

MR. PODESTA: Gene?

MR. SPERLING: I think it makes sense for people to be working and thinking on both levels. In other words, if you had the capacity for larger reform, what would that be? I mean, I guess I feel the same as with healthcare perhaps as well that you should be developing, thinking through the details of what a broad reform would be like, but at the same time when you can move the ball forward, when you can make things more progressive, when you can help several million people – you know, I always used to tell people in the White House to imagine a basketball stadium with 20,000 people in it and imagine how 100,000 people you're – think of filling up that basketball stadium five times, so I don't think one should downplay the significance of when you do something that does help millions of people.

I think what's interesting and what's good about this whole process that John Irons and everybody's pulled together today is to make you think, though, a little bit about as you're doing your incremental reform whether it's consistent with the larger reform you're doing. I think often when you're in government you are looking for the opportunities in a particular area to make progress. So, you know, again, one could look at the unified – you know, Peter's vision as kind of the big picture in terms of deductions versus credits. One could look at some of the things on the family tax credit or what I would try to push on savings as consistent. They may be incremental, but they're consistent with what you think is a broader reform.

I think the third thing is the really tough, painful things, and I think the really tough, painful things can be doable in a different context, and I think we just – it's hard for us to remember that the last three presidents of the United States – two Republicans and one Democrat – at some point in their administration, at least once or twice, reached over to their nemesis in the other party and did something that they never could have done alone. No way Bill Clinton or Newt Gingrich clearly could have got the Medicare savings alone that they did in '97. No way Tip O'Neill or Ronald Reagan could have got the Social Security solvency they did in '83 together.

So I think if one's going to do something very big, painful – if one's going to use an energy tax to replace another part of our tax system, et cetera, there are things out there that a lot of people might think are positive that no one's going to want to step out on along. And there, I think, we're really – I hate to say I don't see much hope in this particular administration, but I do actually see hope regardless of who wins in the future that we could return to the norm where you have a president who wants to do something huge, major – have a legacy item in which he's willing to reach over. And that's why I do think thinking through these tradeoffs, even when they seem unfeasible now, are important, because when the moment comes that that happens, you want to have this stuff thought out.

MR. ORSZAG: Just briefly, I agree with the sort of incremental to a larger reform approach because I think that is feasible in the short run and beneficial in the long run. In terms of the sort of big bang, heavy lift kind of reforms, I guess I'm very reluctant to see anyone even try to do that on a revenue neutral basis because I don't really see the point. If we're going to do really heavy lifting on the revenue side, we should start to address the long term fiscal imbalance at the same time and perhaps wrap in reform and revenue increases.

And then finally since there's been so much discussion of the value added tax, I at various different points during the discussion was reminded of Larry Summers' line, which is I guess too cute by half but I still like it, which is that we don't have a VAT because Democrats think it's regressive and Republicans think it's a money machine. And we'll have a VAT as soon as Democrats realize that it's a money machine and Republicans realize that it's regressive. (Laughter.)

MR. PODESTA: Well, I should end with that, but I haven't gotten my full quota of knocks on the Bush administration in today, so I would think that the one thing that we haven't talked about today, but I think it will be a significant factor in the next couple of years, is that the public has reform fatigue, I think, after the Medicare prescription drug and particularly on Social Security. And I think that has to – I think perhaps, Beth, that's one of the reasons that tax reform report – not just the substance, but the inability of the political system to kind of digest and process another major reform was low at the time that the report was delivered. So that will hopefully wear off in the next couple of years, but it seems to me that it's an important factor now that we haven't really talked about.

With that, I want to thank the panelists for a really terrific set of presentations and commentary. Thank you.

(Applause.)

MR. ORSZAG: Thanks, John.

MR. TALISMAN: Thank you.

MS. GARRETT: Thank you.

(END)