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TAX ANALYSTS

TAX REFORM 20 YEARS AFTER: TIME FOR ANOTHER ROUND?

Washington, D.C.

Monday, October 16, 2006

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Introduction

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JOSEPH THORNDIKE
CHARLES MCLURE
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PROCEEDINGS

(8:53 a.m.)

MR. BURMAN: Thank you all for coming to this conference, which I'm very much looking forward to. October 22nd, I think, 1986, Ronald Reagan signed the Tax Reform Act of 1986, I was actually at the event because I was the Treasury staff and they allowed us to stand way far back on the White House lawn.

And I remember when the president of the United States, who was probably the one person more responsible than anybody else for getting Tax Reform enacted, signed the

legislation. He laughed nervously and said, "Oh, I signed my name backwards."

(Laughter)

MR. BURMAN: So I found that really disconcerting.

(Laughter)

MR. BURMAN: And there were, you know, in Congress that — the two leaders of the tax reform effort were Dan Rostenkowski who ultimately went to jail for stealing postage stamps and Bob Packwood who left the Senate after it turned out he was a serial harasser. So in my view, the Tax Reform Act of 1986 was a huge miracle for many reasons. And one of the amazing things about the Tax Reform Act was that it closed a host of loopholes, and yet the law ultimately had overwhelming support in the Congress.

I think it's a real tribute to the fact that most voters don't know economics. They don't understand tax incidence; that the $100 billion in corporate tax increases were generally thought to be paid by corporations. And a lot of Blue Chip executives and corporate shareholders thought it was just a fine deal all around because they were going to get a big cut in their individual income tax rates.

Twenty years later I think it's clear that we need tax reform even more than ever, and its prospects seem even more remote than they did when Ronald Reagan floated the idea in 1984. Today's conference is not a nostalgia fest. We're going to talk first about what the 1986 Act meant, why tax reform is even more necessary now than it was in 1986, and what the next tax reform should be, and whether there is any way we could make it stick better than the last one.

I want to acknowledge the co-organizers of the conference here. The conference was organized by Tax Analysts, the American Tax Policy Institute, and the Tax Policy Center, which is a joint project of the Urban Institute and Brookings Institution. Larry Haas took care of all the logistics with help from Julianna Koch of the Tax Policy Center.

A number of people helped to organize the conference; Eric Toder and Gene Steuerle of the Urban Institute, Bill Gale of Brookings, Chris Bergin and Larry Haas of Tax Analysts, and Mike Murphy and Michael Schlear of the American Tax Policy Institute, and I think they did a great job.

Finally, I want to thank the exceptional panelists. Several of them changed their plans so that they could participate in this program, and I think we're really lucky to have all of them. Just one — a few technical notes — and one is if you have a cell phone, now will be a good time to either turn it off or turn it on to vibrate. That goes for BlackBerries, as well.

The conference is being recorded. There are handheld mics so before you speak you should identify — get a microphone and identify yourself. We do want audience participation. The conference is designed to include lots of time for that. We have an exceptional audience here.

If I started introducing the luminaries in the crowd I'd go on for another 15 minutes. And we want you to participate. And finally, just to make clear, the conference is on the record. So keep that in mind. Enjoy and thanks very much to the great panelists.

PANEL I

MR. BERGIN: Thanks, Len. My name is Chris Bergin. I'm with Tax Analysts. It's a pleasure to be here. We have an outstanding panel today. We're the first of three outstanding panels, and we're going to try to set the stage here for the first panel. So let me get started.

A few weeks ago I attended a lecture, and I mean that in the best possible way, from the current but soon-to-be-retired Chairman of the House Ways and Means Committee, Bill Thomas, known for his lectures.

His talk was about how we get lots of bad tax policy from our efforts to make good tax policy. Mr. Thomas noted that the basics of politics one-on-one in Washington are about who gets what, when and how. That's an excellent point and it's probably a key reason why our tax code may be on the verge of collapse.

Mr. Thomas went on to explain that some of our politicians are not exactly the cream of the crop of American society and probably don't put tax policy as one of their high ideals. "Don't think in this business that you're dealing with the best and the brightest," he said, "You're dealing with the available and the willing."

(Laughter)

MR. BERGIN: I'm just quoting him. Was it always this way? Some of my younger colleagues tell me I'm too nostalgic when it comes to the Tax Reform Act of 1986. I will admit that at the time I found the process including the politics thrilling, and I agree with Len, I thought it was a miracle. But if I'm nostalgic I'm not naove. I saw what the politicians did even then.

The Treasury I Study that the Reagan administration unveiled in 1984 was an outstanding piece of work. The legislation that eventually resulted, it became the Tax Reform Act of 1986, however, wasn't so outstanding.

Consider the so-called bubble. A key selling feature of the 1986 Tax Reform Act was that it supposedly provided only two low marginal income tax rates for individuals. Actually, as we all know, it provided three, the third and highest of which was hidden from view in a bubble. In fact, the 1986 Act was loaded with all sorts of gimmicks and gizmos to hold it all together, but the deal would not hold for long.

The politicians began dismantling tax reform the very next year with an Omnibus Budget Reconciliation Act. They continued the year after that what — with what's still my favorite name for a Federal tax bill, TAMRA, the Technical and Miscellaneous Revenue Act or problems with the 1986 Act that we had to fix combined with lots of other stuff that some of us wanted to put in the tax code. In other words, Politics 101 at work.

The dismantling of the 1986 Act continues to this day. Still what President Ronald Reagan signed into law at October 22, 1986, was, at least from my vantage point, much better than what we had before. It was true if not radical tax reform. It surely did lots to clean up the tax code and you don't see legislation like this come along everyday.

The Act may have mostly failed to achieve the stated goals of fairness, simplicity, and economic efficiency, but those high-minded goals were enthusiastically considered through two years of deliberation even if the realities of Politics 101 eventually put them beyond reach. And as many observers know, it's good to clean out your closet every 20

years or so.
So is it time again for a cleaning of our tax code closet? Personally, I don't think so. In fact, it may be time to knock the whole house down. For me, the 1986 Act offers at least two lessons for what to do as we move forward, neither of which suggest that a mere closet cleaning is enough.
First, we need to set the bar of ideals high as we did in the 1980s, and we need to try harder to meet them. We should never abandon the goal of a tax system that's fairer, simpler, and more economically efficient. Second, we have to recognize that the problem may be bigger than a cluttered closet.
Our tax system is so broken that the next reform of our tax code must be much more radical than the last one. And our budget is becoming so drenched in red ink that the next reform will probably have to raise revenue. Those realities, of course, make tax reform of the future tremendously hard to reach. To get there, the politicians will have to figure out not only who gets what, when, and how, but who loses what, when, and how much. And there will be a lot of losers the next time around.
As I said, this panel is designed to set the stage for the rest of our conference today, and we have excellent panel members to do just that. I will introduce them in the order in which they will speak.
Charles McLure is a senior fellow at the Hoover Institution at Stanford University. He is the author of numerous books and articles including works on federal tax reform. Before joining the Hoover Institution, he was vice president of the National Bureau of Economic Research and Cline Professor of Economics at Rice University. From 1983 to 1985 he served as Deputy Assistant Secretary of the Treasury for tax analysis. In that post, he was responsible for developing the Treasury proposals that became the basis for the Tax Reform Act of 1986.
Joe Thorndike is a contributing editor for *Tax Notes* magazine, and the director of the Tax History Project at Tax Analysts. He is the co-editor of *Tax Justice: The Ongoing Debate* and co-author of the forthcoming *Ask Not: America's Uncertain History of Wartime Fiscal Sacrifice.* He is currently writing a history of tax fairness and social justice during the great depression and World War II.
Chris Howard is a Professor of Government at the College of William and Mary. He is the author of *The Hidden Welfare State: Tax Expenditures and Social Policy in the United States*, and the forthcoming *The Welfare State Nobody Knows: Debunking Myths about U.S. Social Policy.*
I will now get out of the way. We will start with Mr. McLure.
MR. MCLURE: Well, thank you, Chris. It's good to see friends from 20 years ago, but when I went through the list of participants I didn't recognize most of the names so I guess sometime has passed during the last 20 years. While at the Treasury Department, I often described the objective of tax reform as taxing all uniform — all income uniformly and consistently without regard to its source or use.

This objective subsumes both economic neutrality and horizontal equity, eliminating gross differences in the amount of tax paid by those with similar incomes. Rather than questioning the vertical equity of the system, which inevitably leads to class warfare and makes the selling of the tax reform much more difficult, we propose that reform be distributionally neutral, that it not shift tax burdens among income classes except by eliminating taxes on those with lowest incomes.

Moreover, we attempted to be revenue neutral to neither raise or lose revenue, and of course, we wanted to simplify the system. Given what has transpired during the 20 years since passage of the '86 Act, the weight that can and should be placed on each of the objectives I have just mentioned, which will indicated in italics in *Tax Notes* has changed.

First: taxing income. Some economist probably viewed with consternation the proposal to tax income more uniformly rather than shifting to a consumption-based direct tax. After all, a consumption- based tax is arguably simpler than a conceptually pure income tax. It does not distort the decision of whether to consume now or later, and it is immune to inflation.

Of course, we had what we considered good reasons for this choice. Basically, we feared that late in the game we might encounter showstoppers — problems that we could not solve, that would preclude proposing a consumption-based tax — and be left without a set of well-considered income tax proposals to offer.

First was the question of whether gifts and bequests should be subject to tax. Some felt that — that the outcome would be unfair if they were not. Second, replacing the existing income tax with the consumption- based tax would entail daunting transition problems.

And finally, all of our tax treaties would need to be renegotiated, and methods of preventing double taxation would need to be rethought. It is hardly surprising that interest in taxing consumption has grown over the last two decades. The Tax Reform Act of '86 has shown some of the complexity that is inherent in the attempt to levy a conceptually sound tax on income.

Indeed, in an article I wrote in 1988, I asked whether the Act was tax reform's finest hour or the death throes of the income tax. During the last 20 years, there has been considerable research into the economic and other effects of a shift to a consumption-based tax, much albeit attempting to quantify the economic benefits of such a shift.

Unfortunately, the results depend crucially on the specific plan chosen and the transition provisions that are adopted as well as the exact specifications of the economic models used to simulate the effects of reform, and they range from substantial to hardly worth the trouble.

The potential effects on the distribution of tax burdens between generations has received lots of attention. Absent provisions reducing or eliminating tax on consumption financed by jotting down existing wealth, which will complicate compliance and reduce the purported economic benefits of shifting to a consumption-based tax, holders of such wealth, mostly the elderly, will experience substantial windfall losses.

Consumption tax advocates commonly say that changes in the distribution of the tax burden across income class is caused by shifting to a consumption-based tax. It could be offset by changing tax rates to maintain distributional neutrality, but those in the given income class who would pay higher rates would not necessarily benefit from the accompanying deduction for saving or exemption of capital income under a

consumption-based tax.

Transition and international issues, especially the international implications of the treatment of borrowing interest under a consumption tax, remain troublesome. Either borrowing would be included in the tax base, or interest would not be deductible. Of course, income taxes do not contain such provisions.

Thus the Bush panel states in a matter-of-fact manner, "Foreign governments could seek to renegotiate or terminate their tax treaty arrangements with the United States." A reform with those potential consequences is not to be undertaken lightly.

In the early 1980s, marginal effective tax rates, the percentage by which taxes reduce gross income, varied widely across all types of investments, methods of financing in industries, and were even negative for some debt-financed investments given the then prevailing levels of inflation.

In 1984, the Treasury Department proposed to reduce the variation in effective tax rates substantially by taxing income more uniformly. The primary exceptions aside from retention of provisions for retirement saving with the decisions not to eliminate the preferential tax treatment of owner-occupied housing, and not to treat all methods of financing the same especially by eliminating the double taxation of corporate source income.

The kind of gross differences and effective tax rates that characterize the tax system before the '86 Act have not crept back in. Moreover, the reduced taxation of dividends has eliminated some of the double taxation of corporate source income, but the preferential tax treatment of owner-occupied housing continues.

Besides distorting economic decisions, tax preferences create horizontal inequities. These contribute to the perception that the tax system is unfair and thus undermine the moral foundations of voluntary compliance.

At the time of the '86 Act, individual tax shelters were especially troublesome. These days far more sophisticated corporate shelters may be having a similar effect. But in the wake of Enron and other corporate scandals, the public may be so jaded they do not expect more and do not really care.

For distributional neutrality to make sense, the existing distribution of tax burdens across income brackets must be politically acceptable. It seems doubtful that a distributionally neutral tax reform as proposed by the Bush tax panel would be acceptable today. Of course, what is politically acceptable depends on who controls the Congress and who occupies the White House.

It seemed likely that those who have so vocally objected to the distributional consequences of the Bush tax cuts would — it seems unlikely they would acquiesce in a reform that does not reduce this - - would redress these perceived wrongs. But beneficiaries of the Bush tax cuts are not likely to relinquish their benefits without a fight.

In 1984, it did not seem unreasonable to propose a revenue neutral tax reform. Speculating on whether that is equally true today is beyond the area of my expertise. But if, as many think, the current fiscal deficit should be reduced — and deficit reduction would require a tax increase, the politics of the matter would be very different from those in the mid-1980s. Who should pay the increased taxes would come to the fore.

Simplification was one of our primary objectives in Treasury I. Indeed, we thought that we could eliminate both the individual and corporate alternative minimum taxes if our proposals were adopted. By comparison, the '86 Act needlessly made the income tax much more complicated for many taxpayers. And far from eliminating AMT, it set in motion the growth of this dreadful alternative tax.

Of all the objectives that Treasury I sought to advance, simplification may remain the most salient. As the Bush tax panel argued, the tax system has become even more complicated than it was in 1986. Well, tax preparation software has eased the burden of compliance for the computer literate if it's done so at great cost.

First, it turns the tax system into a black box; hardly a recipe for good government. Second, and much worse: some of the greatest complexity involves provisions addressed to low-income households. Those taxpayers are generally not computer literate, and thus need to pay professional tax preparers to assist them, file incorrect returns, or simply fail to file.

I conclude by asking how to create incentives for Congress to quit complicating the tax system and to simplify it. I have long thought that all members of tax-writing committees or perhaps the entire Congress and their staffs both — incumbents, and for a specific number of years thereafter, should be required to complete their own tax returns with nothing but a pad of paper, a pencil, and a calculator.

The proposal is of course impractical because some members of Congress would have complicated tax situations even under a simplified system. But if some bright young tax practitioner could figure out a workable variant that would accomplish the desired effect, I suspect that the public might be convinced to cram it down the representatives' collective throats. Thank you. MR. BERGIN:: Thank you Charles.

(Applause)

MR. BERGIN: Joe.
MR. THORNDIKE: Okay. I'm Joe Thorndike. And I'm usually brought into these events to provide a little historical perspective on things. And I'm struck at first by the fact that we're here for an anniversary, which is appropriate. It has been 20 years. And my only concern is that anniversaries tend to breed a little bit of nostalgia.

So I will talk some in my remarks about what the Tax Reform Act was all about and what it was supposed to be about, but I would like to start by talking about what it actually wasn't. As great as it was — and it was great — the '86 reform was not a watershed in

American tax history. It was certainly a landmark in fiscal policymaking, a milestone in modern politics, a key part of the congressional ascendancy of the 1980s. It was without question an important moment. I say this because there are going to be a lot of people irritated in this room if I don't give them all the credit that they deserve. But it was not a watershed.

According to the dictionary, a watershed is a critical point that marks a division or a change of course, a turning point. As important as it was, the '86 reform was not a turning point. It renewed, but did not transform, the American tax regime and in fact it's hard to transform a tax regime.

Historian Elliot Brownlee has identified just four watersheds, four true watersheds in the history of American taxation. The Civil War, World War I, the Great Depression and World War II — each of these crises ushered in a new fiscal regime, a new system of taxation, as he defines it, with its own characteristic tax-based rate structure, administrative apparatus, and social purpose.

I think it's fairly clear that the '86 reform was not that kind of reform, and was never really intended to be, but I think it serves as a useful reminder that what we are here to talk about today is important in any number of ways, but it is not necessarily something people are going to be talking about a hundred years from now, nobody talks about tax history anyway. So they won't be talking about any of this 100 years from now.

Generally speaking, tax regimes live and die by necessity, not design. Historically, old ones have disappeared when they failed to meet revenue needs, sometimes a tax base atrophies, such was the case with the tariff-based regime that arose in the wake of the Civil War and was done in by the trade disruptions of World War I.

Other regimes have succumbed to overwhelming revenue demands, demands that can't be met with existing tools. It was that sort of crisis that gave rise to our current regime in the months after Pearl Harbor.

The World War II tax regime marked by a broad-based progressive personal income tax, a moderate flat rate tax on corporate profits and a small but growing wage tax, really growing wage tax designed to fund social welfare programs has proven extremely durable in the many decades afterwards. Part of this durability has derived from tax preferences or loopholes as they are often called.

The wartime regime introduced millions of Americans to the income tax for the first time. And lawmakers used preferences to help ease the burden a bit, both for your average sort of plebeian taxpayer as well as for the rich ones who needed their own special preferences.

The mortgage interest deduction, a feature of the system since 1913, assumed new importance as home ownership saw it in a post-war era. And similarly the tax-free treatment of health benefits found a broad constituency once unions made employer-provided insurance a fixture of the modern labor market.

Tax preferences then became a functional necessity. They were the grease that made everything work in the new tax regime that gave millions of Americans a vested interest in the tax system, including its imperfections. But as the appetite for these preferences continued to grow, fueled in large part by inflation and the bracket creep that came with it, they started to assume dangerous proportions.

By 1967 the revenue loss from tax preferences equaled 21 percent of total direct expenditures, and by '84 the figure had risen to 35 percent. Preferences in other words were getting expensive, and they also contributed to a sense that the income tax was hopelessly complicated.

Although it's worth noting that the first complaints about complexity in the income tax could be found in the congressional record of 1916, three years after the tax was created. Congress was decrying it as a horrible monstrosity, impossible to administer, inquisitorial, blah, blah, blah.

Even more important, the accretion of incentives vitiated the apparent fairness of the income tax. Many Americans began to suspect that their neighbors were shirking their fair share of the fiscal burden, and by the mid '80s tales of widespread avoidance had combined with complexity worries to set the stage for reform.

The Tax Reform Act of '86 as others will talk about today and have talked about, made in that a real serious effort to deal with base erosion and fairness concerns, and made at least a feint towards simplification. But fundamentally, again it marked an effort to renew the existing regime, not replace it. And when it comes to tax regimes, renewals unlike replacements are not particularly durable.

The tax system had problems in the early 1980s, but even taken as a whole, these problems did not constitute a structural crisis. To be sure, if left unchecked they might have become that sort of crisis, the kind of crisis that has produced the other four watersheds in the American tax history. But the '86 reform had the surprising, and some might say perverse effect of making tax reform, more fundamental tax reform, substantially less pressing — at least over the near term.

Other, even more skeptical critics have suggested the tax reformer need not adjust the tax regime itself, but the seamy political dynamics that sustain it. As economist Milton Friedman has observed, the end result of base broadening and loophole closing is just a renewed opportunity for lawmakers to resell old tax preferences.

I mean that's a horribly cynical thought, and when I read it I thought he was just being horribly cynical on the pages of *The Wall Street Journal*, you know, where they are always horribly cynical about taxes. But I am beginning to think that there is something to that, that sort of Machiavellian thought does run through people's minds.

The '86 reform is history's best example of intentional as opposed to imperative tax reform, tax reform that people choose to undertake rather than those that they are forced to undertake by exogenous events. But it was certainly no mean feat. It was in fact the

apotheosis of a certain type of tax reform summed up by a mantra well known to every tax expert in this room, certainly, "broaden the base, lower the rates."

Income tax purists have been urging that program since at least the early 1920s when already they felt that the income tax had departed from that ideal. Thomas Adams, Robert Haig, Henry Simons more or less created the notion of our modern income tax, and this was their agenda. In the post-war era, this agenda found its most vigorous advocates in Stanley Surrey and Joe Pechman.

For decades these leading lights of the tax community led an effort to advance horizontal equity, and protect the income tax from the depredations of politicians and lobbyists. And 1986 represented the greatest achievement of this school of thought.

As important as it was, and I restate, what was very important, it was not durable. Perhaps it was never meant to be. Perhaps tax reform in the Surrey model is best regarded as a process, not an event.

If that's true, and I think it probably is, then I think the process has come to a grinding halt. I don't think the '86 reform is going to be a plausible model for future efforts. It's hard to believe that conservatives could once again be lured to the table by the promise of lower rates as Ronald Reagan and many others were.

They watched rates creep up quickly in the years after the '86 reform if not, you know, the way they had been. And I think they understand perhaps all too well the ephemeral nature of intentional as opposed to imperative tax reform.

And I am not sure Democrats can be talked into this either, they have developed a penchant which they share with almost all their GOP colleagues for using the tax system to serve every interest, meet every goal, and if they could, spend every dollar. Sure it was ever thus. Tax expenditures are our grand tradition and American public financing; to a great extent, they have made the tradition of American public finance possible.

I wrote a column earlier this year, called "Two Cheers for Loopholes," suggesting that we shouldn't hate them quite so much. They provide the political infrastructure for the kind of tax system we have wanted for many years.

But in fact it was not ever thus. It was once better; once upon a time Democrats at least could be counted on to defend a few spending priorities — you know, tuition grants for college, or some such thing.

Now, they catch every progressive goal in the neo-conservative rhetoric of growth and opportunity and they use tax incentives to offer symbolic if generally insubstantial support to fund these priorities. Democrats may consider this to be good politics, and maybe it is, it seemed to work for Bill Clinton, who was particularly fond of this sort of approach, but this sort of milk toast liberalism I don't think does anything good for the tax system over the long run.

Ultimately a durable tax reform happens when it must, not when it should. It happens when old taxes just can't keep up any more — not with fiscal demands, and not with changes in the economy. Sometimes even good taxes succumb to these changing realities. I am reminded of the waning years — now, you will forgive me, I am going to take you back, you know, 120 years or so, it's still relevant I promise, I am reminded of the waning years of the general property tax, a levy that states imposed through much of the 19th century.

Originally, it was the darling of liberal reformers, who believe that it would tax people according to their ability to pay. It was imposed on all personal property, not just real estate, that was the key. This seemed like a great idea, but it gradually became or really quickly became a sort of cruel joke.

Changes in the economy including the proliferation of financial instruments and other forms of intangible wealth after the Civil War particularly eviscerated the taxpayers, especially among the rich.

The only people who were actually paying tax on all their property were those who didn't have enough to keep much of it in intangible form. That perverse reality produced a backlash and fueled the popularity of nascent income taxes, which in turn opened the door to our modern fiscal state.

This one-time paragon of good, fair taxation that everyone thought was just going to save us all from, you know, excise taxes or head taxes or something else that no one wanted, proved to be a grand failure over time because it just got overtaken by events. We may be approaching that sort of regime changing transformative fiscal moment again, the moment when the tools start to fail.

The world is changing and the tax system may change with it soon. In theory I think, and I think the real problem comes from the question of capital income. In theory at least we still tax it. Many fans of consumption taxation however predicted in our ever more globalized world, global capital will ultimately become untaxable, leaving us with a de facto if not a de jure consumption tax.

Consumption taxes defended on their own merits may have a political future although the track record in the United States is not encouraging on that score. The consumption taxes that arise through erosion of the extensible tax base will almost certainly have problems. I think what history tells me is that the only thing Americans like less than taxes are Potemkin taxes, ones that claim to do one thing, while in fact doing nothing of that sort.

The resentment that flows from that sort of fiscal charade may well be a catalyst for lasting reform, and I think we may be approaching that sort of a moment.

MR. BERGIN: Thank you, Joe.

(Applause)

MR. BERGIN: Now, we are going to turn to Chris Howard for the political perspective.
MR. HOWARD: Surprisingly, few political scientists study tax policy, which probably explains how I managed to get invited to this conference.

(Laughter)

MR. HOWARD: You can think of me as one of the taller buildings in Arcachon. I live and work in Williamsburg, Virginia, which is two- and-a-half hours, and in some respects two-and-a-half centuries away from Washington, D.C.
News from inside the Beltway can take a while to reach Williamsburg, but I gather that a number of people are unhappy with the tax system and one comprehensive reform. There is a pervasive sense of loss. Policymakers worked so hard to improve the tax code in the mid 1980s and against long odds enacted the historic Tax Reform Act of 1986.
Sadly this achievement has been undermined by subsequent tax bills. The tax system has become less fair, less efficient, and more complicated in the last 20 years. Clearly, we need to find some way to recapture the magic of the 1980s, and reform the tax system once again.
Now, to be successful, I think those who favor major tax reform need to confront the Sam Girard problem. In the movie *The Fugitive*, Sam Girard is a federal marshal played by Tommy Lee Jones who won an Oscar for his role. For most of the movie, Girard is trying to capture Dr. Richard Kimble played by Harrison Ford.
Kimble has been convicted of murdering his wife, wrongfully, it turns out, and later escapes from custody in a spectacular train wreck. In one of the movie's best scenes, Girard is chasing Kimble through a series of large storm drains. When Girard finally catches up, Kimble points a gun at him and says, "I didn't kill my wife." Girard looks at him dolefully and replies, "I don't care."
Now, proponents of tax reform are like Dr. Kimble, accomplished professionals who have been treated badly by the powers that be, and yes, I am sure they get compared to Harrison Ford all the time.

(Laughter)

MR. HOWARD: Unfortunately, the American public may be playing the role of Sam Girard. According to recent polls, at least 75 percent of respondents feel that the federal tax system needs major changes or a complete overhaul. That sounds promising. But most people just don't care a lot about taxes these days.
The Gallop Organization routinely asks about the nation's most important problem. And in every poll since 2002, the answer "taxes" has been given by one to three percent of adults. Taxes currently rank well behind the war in Iraq, terrorism, fuel prices, and immigration in importance.
Although taxation was never the public's most important issue in the mid 1980s, it did rank in the top five or so, which made it more likely that elected officials would try to do something about tax reform.
There will come a time when foreign policy does not consume so much of the nation's agenda, giving tax reform new life. Nevertheless, I am not sure the odds will improve all

that much. In the mid 1980s, Americans felt that the federal income tax was the worst tax. Plans to reform the income tax therefore struck a responsive chord. Ever since then, however, the public's distaste for the income tax has diminished.

In the latest polls, only about 20 percent of Americans call the federal income tax the worst tax. Almost twice as many people single out local property taxes as the worst. So even if we assume that taxes will grow in importance as an issue, it is not clear that the public will be looking to Washington to do something about income taxes.

Alternatively, the two major parties may play the role of Sam Girard. Democrats have learned over the last 25 years that it is often easier to promote their policy objectives through the tax code than through traditional spending programs. In the wake of cuts to several anti-poverty programs in 1981, Democrats decided that expanding the earned income tax credit was the way to go.

The Tax Reform Act of 1986 marked the first major expansion, and others followed in 1990 and 1993. The EITC is now larger than food stamps or temporary assistance for needy families, what we normally call welfare. The demise of the Clinton Health Plan, passage of welfare reform, growing interest in privatizing Social Security, and the declining value of the minimum wage provide further evidence that the American welfare state had reached some sort of impasse.

Looking for a new way to address old problems, prominent Democrats have advocated tax deductions and tax credits for housing, education, long-term care for the elderly, retirement income, and families with children. This trend seems particularly true if your last name is "Clinton." This way Democrats can address pressing social needs without creating new bureaucracies, and without being labeled tax and spend liberals.

If an important objective of tax reform is closing loopholes as it was in 1986, then Democrats may not be nearly as supportive now as they were back then. While Democrats may go after various forms of corporate welfare that are buried in the tax code, the largest loopholes promote a variety of social welfare objectives that are near and dear to Democrats' hearts.

For their part, many Republicans view the tax code as a way to hold conventional social spending in check. The rapid growth of Social Security in the late 1960s and early 1970s prompted a number of Republicans to support an overhaul of the nation's private pension system, including a new tax break for individual retirement accounts. If private pensions were more available, they reasoned, pressure to expand Social Security would lessen.

Similarly, Republicans have long defended tax benefits from employer health insurance as a bastion against national health insurance. The child tax credit passed in 1997 was a part of the GOP contract with America. It was supposed to curb government spending on childcare by making it easier for families to keep one parent at home to raise children.

Republicans are not exactly dying to close major loopholes either.

Now, shortly after their exchange in the storm drain, Sam Girard pursues Richard Kimble only to see the good doctor jump out the end of the drain and plunge several hundred feet into the river below. The implication is that advocates of tax reform should take a flying leap.

(Laughter)

MR. HOWARD: And that's not quite right. I do believe that major tax reform modeled

after the 1986 Act is unlikely in the next few years, but I would never say impossible. One of the major presidential candidates could make tax reform a key part of their campaign, elevating the issue in Congress and the nation, win in 2008, and push legislation in 2009. Still that strikes me as a long shot. Perhaps then we should not look to 1986 for inspiration. In addition to all the problems described earlier, the U.S. tax system is not raising enough revenue to finance government spending.
Members of both parties have expressed dismay at how quickly large budget surpluses turned into large budget deficits under the current administration. Recent cuts to individual and corporate income taxes and to state taxes are certainly part of the story. The Tax Reform Act of 1986 was revenue neutral, and that might not be good enough today.
A different model for tax reform could be the Omnibus Budget Acts of 1990 and 1993, which combine spending cuts and tax increases to lower the deficit. Some officials from both parties might be willing to curb tax expenditures if the issue was framed as deficit reduction, and some conservatives might scale back the Bush tax cuts if offered some spending cuts in return.
Politically, this option is risky. The first President Bush broke his "no new taxes" pledge when he endorsed the 1990 Act, and he paid for it later when bidding for re-election. The 1993 Act in contrast is usually held as a high point of the Clinton years. Now, the chances of enacting this kind of tax reform are not great. After all, the American political system is designed to preserve the status quo and thwart major changes, but they may be greater than any sequel to the Tax Reform Act of 1986.

(Applause)

MR. BERGIN: As I said, excellent panel members, and we are on time, too. As Len pointed out this is designed for a lot of discussion. We've got a lot of time here to ask questions of the panel members. I just ask that you state your name, raise your hand, state your name, and I'll try to get as many people in as I can. Any questions? Professor.
MR. WOLFMAN: Bernie Wolfman, Harvard Law School.

MR. BERGIN: Bernie, there's a mic right here for you.

MR. WOLFMAN: Oh thank you. I am Bernie Wolfman, Harvard Law School. I just want to make a comment about the '86 Act. The comments that have been made so far, accurate as they are, come at them from an economist's perspective, a welfare perspective, but not from the lawyers' or legal perspective that was very important and effective with respect to the 1986 Act.

Prior to that Act, particularly in the world of closely-held corporations, the payment of the corporate tax was to a large extent elective. It could be avoided and avoided easily under the doctrine of the so-called *General Utilities* case.

It was a lawyer's heyday. When I was in practice before I went into teaching, spent a lot of my time performing what clients regarded as magic. We could do things that could avoid paying the corporate tax. That magic was taken away completely and effectively by the '86 Act, and that continues to today. Now, that may not be thought of as a good thing

in the sense that we do indeed have a double tax.

And when I say that, what I am saying and I'm saying it rather categorically is there is no way today since '86 of withdrawing appreciated assets from corporate solution without the payment of a corporate tax on the appreciation. No way. And prior to the '86 Act any lawyer who said that was confessing to incompetence.

Now, one person has written saying that the '86 Act was undesirable in perfecting the corporate tax, because it eliminated self-help integration. And he was an integrationist and he said if Congress won't integrate the two Acts, at least people could do it by maneuvering on their own beforehand. Well, I don't think that's a desirable thing.

I think if we're supposed to have a double tax system we should have it, and if we want integration we should enact it. And so in looking backward at the '86 Act we should take account of that the completeness of our double tax system is attributable to that Act, and it has been steadfast in its effect since then.

MR. BERGIN: Thanks, Bernie. Here first I'll get to you, Bill, is that okay?

MR. DOWNEY: I'm Tom Downey, I'm a recovering politician.

(Laughter)

MR. DOWNEY: I found the comments of the panel depressingly accurate from my own personal perspective having been there when we wrote the 1986 Act. But I'd like you to opine if you could a little bit on the thought that 2008 might be the sort of time where both parties and probably presidential candidates will have to address the fact that you can't have a 20 percent GDP government on a 16 percent GDP revenue base, and that with the expansion of Medicare and Medicaid that something's going to need to be done to increase revenue, and the only way to really do that is to basically try to hide it, and give some people some things and take away things from other people like we did in 1986.

MR. BERGIN: Joe, is 2008 the tipping point?

MR. THORNDIKE: I don't know. I think that the current budget situation and projections about where it's going might be the sort of crisis that prompts fundamental change. I suspect that those wheels may be turning. How long it takes for that to actually get to a critical point I don't know.

I mean — and when it gets to that critical point how much tax — what role tax plays in the answer is not clear to me either insomuch as the spending side of that equation is going to require at least as Herculean an effort and may even be more important in the long run to solving the problem.

But I do think looking forward that — you know, at this point people are unhappy about deficits and deficit projections and long- term budgetary gaps. It doesn't strike me that it's really got the resonance it needs at this point. I hope that — I hope that it does before too

long. I'm thinking 2008, that's pretty soon. Sometime in the next 10 years I think there's a decent chance of that.

And I also think continued — a continued sense that that system is not fair and that certain people are not paying as much they should is the kind of thing that builds the political will, and builds the political constituency to support that kind of a change.

So you have, you know, the imperative on the one side — you have to — really have to do something about this deficit at some point and bring that up to bear against a growing political unhappiness that basically people are cheating in some fashion, even if it's legal cheating. This has always been a really compelling force in American tax politics.

People have always — this whole loophole thing — I mean it's very easy to poke fun at it and then blame everybody for it because we all use them — truth is that campaigns to crackdown on tax avoidance are very popular, and have always been very popular and you can make good hay out of them. You can also turn them into something just as meaningless too as I think we've all seen a number of times.

But I think that too might become a fulcrum for real reform coupled with the sort of — the broader fiscal breakdown that seems to be at work.

MR. McLURE: In a book I published in 1987, I opined that we were only one president away from a value-added tax. No matter how you count presidents, I was clearly wrong.

(Laughter)

MR. McLURE: Are we likely to have one in 2008? I don't know. I don't see it as real groundswell for the VAT. But I think it may be worthwhile to mention an observation that Larry Summers made well before he was secretary of the Treasury. He noted that the common wisdom was we would never have a value-added tax because liberals wouldn't vote for it because it was regressive.
And conservatives wouldn't vote for it because it was a money machine. And he pointed out that we would have a value-added tax once conservatives realized it was regressive, and once liberals realized that it was a money machine. And I think if we look at the politics of today, we may be there. That is that the way things have gone, it may be that the Democrats really would like the money machine enough to vote for it, and the Republicans might accept it because at least it's regressive.
MR. BERGIN: Chris?

MR. HOWARD: I mentioned in my comments that I thought tax reform might have a better chance if it is not concerned so much with loopholes and horizontal equity, but with fighting the deficit. That said, one difference between the environment today and, say, in the early '80s when the deficit was large and growing, is that members of both parties seemed particularly concerned about the deficit in ways that I don't see quite so much today.

And there is a sense that the deficit doesn't matter either economically or politically. And as I sort of listen to the various campaigns now for Senate, listen to some of the presidential contenders I don't hear anybody really talking much about the deficit as a concern.

And I think in part because so many domestic issues have been put on the backburner in recent years, because of the various sorts of foreign policy concerns, the agenda is going to be very crowded in 2008. There are going to be a lot of people pushing a lot of different initiatives. And it's going to be hard for any form of tax reform to get much of a footing.

MR. BERGIN: Yeah, I think that's a good point. Bill?

MR. GALE: Bill Gale, Tax Policy Center. I was intrigued by the comments, by Bernie Wolfman's comments about the corporate tax which often gets left out of TR86 discussions and I want to preface my comment/question with the statement that I'm neither a corporate expert nor a tax lawyer. But when I look at the corporate tax now, I see two things.

One is declining corporate revenues over time as a share of GDP, and the other is a system that has enormous holes in it. About half of corporate income is not subject to corporate tax, because it's either sheltered or subsidized. About half of dividends where the double taxations first occur are not taxed at the individual level, because they go to pensions or nonprofit organizations.

And so I don't know what the corporate system was like before '86, but if this is a sort of airtight, you know, big advance it must have truly been awful before —

(Laughter)

MR. GALE: And I was just curious if there was more conversation about how much success we've had in getting forward the notion that every corporate — that every dollar of corporate-source income should be taxed at least once.

MR. BERGIN: If you're CFO of a major corporation you're paying 35 percent corporate taxes, I don't think you're the CFO for long, are you, in the current environment? Anybody?

MR. GOLDSTEIN: Benson Goldstein with the AICPA. I think I'm directing my question to Joseph Thorndike. I believe he said something to the effect that the — it's different today, the political cause or challenge for tax reform is different today than it was in the '80s.

And I guess I'm trying to understand what you meant by that, because I guess it's — anytime you're trying to challenge a constituency and that you're picking it up as a revenue raiser, I always think that that's very similar whether it's now or whether it's in the '80s. Did I interpret you earlier when you — I think you made that kind of statement?

MR. THORNDIKE: I'm not sure what I — this isn't my moment — I'm saying that it thus, it used to be better. I think that in the '80s, there was a more — and you tell me if I've gotten your question right or wrong here — that in the 80s there was a broader commitment.

I think it began within the tax policy community, people like Stanley Surrey and Joe Pechman, and the arguments that they've been marshalling for decades on the desirability of base broadening reform and that that had found real inroads among politicians who at least embraced in theory the desirability of that sort of reform.

And I don't think that you would find many today who think that's even interesting — and some would say not even desirable — for them to go down. The sort of hegemonic influence of that model of tax reform, which I think was extremely dominant for decades in the tax community is now I think confined almost exclusively to the tax community, and does not have any resonance among politicians.

They're just — and it — again it was always lust. Politicians always wanted to use the tax system for their own needs and purposes. I mean — you know, they were handing out tariff benefits before we had an income tax and using it the same way. But, I don't want to get silly and moralistic about this, but there was a sense that you could — some things might be embarrassing to try to do to the tax system. That I think has been lost.

(Laughter)

MR. THORNDIKE: I don't mean to pick on the Democrats so much either, but Bill Clinton spent a lot of the '90s proposing various education tax credits. And now they came out with a tax plan over it — I think Center for American Progress or somewhere, I'm not sure — and said, "You know, what we've got to do is we ought to get rid of these crazy — this proliferation of tax credits, what we need is another tax credit."
And obviously this is Hillary Clinton's plan. I thought this was her husband's proliferation of tax credits. They're just all wrapped up in that, and there's no sense that any kind of direct approach to priorities is worthwhile. It's a question of degree that was always there. I think it's much worse now for a variety of reasons.
Some of them are political, the dominance of this sort of growth in opportunity, rhetoric that I think has infused the entire political process, and some of it is that the budget picture is pretty tight right now, and there aren't many alternatives. I don't know if that answered the question or not.
MR. ENTIN: I am Steve Entin with the Institute for Research on the Economics of Taxation. I watched the situation unfold. I think there's been a concern in the room that somehow we're not getting back toward the ideal income tax and that things are slipping.

But I'd like to remind you that there are people who are still hoping we will move a little bit away from the broad-based income tax more toward the consumed income tax or saving consumption neutral tax. And if one keeps that perspective in mind, a lot of the things that are being complained about would be considered not good things if we had kept them, but good things to get rid of.

And we are in this — again battle is between what proper tax base is. If the deficit is of concern and if we do need to raise revenue in the future, I really think we need to address the base issue. The neutral tax base really does less economic damage per revenue dollar raised than the income base. And countries all over the world are taking that into account as they increase — government has a share of GDP.

It's not enough to say we need to broaden the base and lower the rates. If you don't know what base you're supposed to have, well the easiest way to broaden the base is put down your income on line 1, multiply it by 10 on line 2 and take 5 percent of it. That's not really what we want to do. If you want that, you can get the same base by having a consumed income tax and you can make it progressive.

The notion of the base really is not tied in specifically with the plan involved, but is a broader concept. And I think it needs to be addressed more than it has been. We talk about fairness and distribution in the distribution tables. They do drive the debate frequently. The burden tables we see today are not burden tables. They are incidence tables.

The burden of the tax depends on what happens when the tax works its way through the system, affects saving and investment, alters productivity, changes wages, and changes employment. None of the distribution tables really reflect the tax burden, only the initial incidence. It's becoming, I think, clear to the economic policy community that excessive taxes are in capital to press wages, and are largely shifted to the workforce.

That needs to be taken into account when you start talking about fairness. That is part of the debate that is usually omitted. Dr. McLure did bring up some of the concerns that were in effect in the mid 1980s and were prevalent in the economic community at that time. We still hear some of the echo today.

There are still people who are saying that if you switch to a consumption tax, you have to hit granny and her wealth one more time on the way out, or you won't raise national saving and get the benefits. This is based on the premise of a fixed saving quantity, not even a fixed saving rate, but fixed saving quantity, an elastic supply of saving, plus a closed economy.

It's not a valid claim. So I'm hoping that we will think as we talk about what isn't — it's not a tax expenditure, whether or not dividends had double taxed simply because people get consumption treatment of saving and pension plans and such things as we go on today, that we really have to think about the growth effects of the consumption base.

Or put it this way, a base in which the cost of saving is adequately reflected in that you are giving up current consumption and there should be a deduction for it versus the income base where we simply blindly accept all the multiple layers of tax on saving. If we're going to raise revenue, we better know which base we're going to pick.

MR. BERGIN: Anybody want to address? No? Other questions? Go ahead.

MR. GLECKMAN: I'm Howard Gleckman with *Business Week*. I'm curious whether the panelists think that public opinion, widespread public opinion in support of tax reform is really that important. My memory of '86 was it was really pretty much top down. It was driven from Washington when the Washington pols got on TV, Rostenkowski did his right [off mic] thing.

But that was not something that bubbled up from public demand. So I wonder — first of all if my memory is correct and if it is, is it really that important that the public hear about this? Or does it really just take a politician or two to galvanize the issue and drive it in the future?

MR. HOWARD: I think that public opinion won't tell policymakers exactly how to change the tax code. But I think it provides important cues to them of all the different issues they could be worrying about, what should they spend their time on. And I think that if you look at the priorities in the 1980s, taxes and tax reform were higher than they are today.

Now, that said, I think that public opinion can be affected and challenged by policymakers if they think there is some potential groundswell. And in the early '80s you had people who felt that federal income tax was the single worst tax. So when they thought of tax reform they thought of income taxes.

You had a number of vivid stories in the media about tax shelters, especially around real estate that seemed to sort of play up the muckraking angle and the need for reform. I don't see that happening either. I gave myself a little bit of an — my comments saying yes, I could imagine a politician trying to make this an issue and trying to convince the public that it was important.

I think that's a real uphill challenge right now given that people aren't focusing on income taxes as much as other kinds of taxes, and given all the other issues that are potentially on the agenda. But yes, it could happen. And I think if you wanted to look for a model, George Bush campaigning in the late '90s for tax cuts and tax reform would probably be the best analogy you could find.

MR. THORNDIKE: I don't think I share Chris's opinion here that public opinion was all that important in the '86 reform. It's always struck me that the people who made that reform happen are sitting in this room. And I mean that seriously, that experts play an important role in shaping of agenda in Washington.

And I think if we read these insiders' reports by — you know, the Gene Steuerles of the world that are there at the creation — what you really get a feel for is that this is something that was driven very much top down inside the administration, and that's where it really got its foothold. I think public opinion came along. And public opinion around property taxes I think actually turned out to be relevant.

It gave as Reagan as a great property tax hater, had real credibility among those who hate property taxes. And I think for voters that the — sort of "I-don't-like-taxes" thing

translates pretty well between property taxes and then federal tax reform if you have somebody like Reagan making the case. So I think that it can play a role there.

The other place that I think it might be playing a role right now is you look at poll data on what Americans think is bad about the tax system and they ask this question every year and it says, "Do you think the taxes that you pay are fair? Do you think that taxes are — or should we raise taxes on rich people? Should we raise them on poor people?"

You know, they got all these different things, and then they say, "Do you think that corporations are paying their fair share?" And they all say no. I mean — it's like 70 or 80 percent say no, and in all the other categories everybody is doing okay, even the rich people are doing much better. Americans are apparently pretty convinced that corporations are not paying their fair share.

You can understand where they might get that opinion from reading the paper. I think that's a potentially significant development that — and that somebody may take it and run with it. And I know some Democrats are trying to do that right now. I'm not sure that the way to do that is to say, "Yeah, we just need to ratchet it all down and make the tax we have exactly what it is and make it work for us."

But I think a debate over corporate tax reform is probably not out of the question, especially if coupled with one over taxes people actually pay. That to me seems like a hot button issue again because it gets at the "are-they-paying-their-fair-share" question, which is I think in tax politics the one that always moves the debate.

MR. BERGIN: You know, I saw a campaign advertisement for the Virginia Senate race, which I'm interested in. And I'm trying to figure out if "he's going to increase your taxes" is scarier than "he's going to break the bank." And I can't figure out which one's going to win, because I think it's being drowned out by the war on terror, the war in Iraq, and ethical problems.

So no, I can't figure out where people are on tax. I keep asking "do taxes matter" around my neighborhood and nobody cares.

MR. FARRELL: Jack Farrell from the *Denver Post*. Might the AMT, the growth of the AMT be something that convinces people that the tax system needs reform, or is that something that's hidden in the what somebody called the "black box"?

MR. BERGIN: Well, I predicted this one wrong. I thought the AMT would get attention eight years ago, and tried to sell it to a lot of editors and reporters, but so far not ....

MR. THORNDIKE: I think I've made the case that I don't think it's going to have that kind of an effect. I think that it's hidden by the almost universal use of tax preparation software or paid tax preparers. So any kind of administrative burden that falls to the taxpayer is I think negligible at this point.

The next question is how much more they're actually going to be paying, and is it going

to really be an irritant? And I think for some of them it will be, but for others it won't. I just don't think it's going to be the kind of explosive issue that I'd say some of us in this room have been hoping for as a catalyst for reform. It's just taxpayers are too far away from actually paying their taxes.

MR. DOWNEY: I just want to make one point about what motivated me during the '86 Act and it had much more to do with Ronald Reagan's skill in lowering rates in an animated Democrat [off mic] committee. Quite specifically ... that if we didn't do something, that rating would be the one that would capture a generation of voters for having lowered the rates so that really there was absolutely no interest on part of most Democrats at the time in helping him. It was much more a question of fear that if he was able to do this and we stood in the way, that we would pay a very heavy price.

MR. BERGIN: That's a great loss then. Len?

MR. BURMAN: Len Burman, Tax Policy Center. Charlie, I wonder if you'd just comment on how President Reagan actually became the leader of the previous tax reforms. My understanding is the whole thing was pretty much an accident; he thought that Mondale was going to propose tax reforms, so he said, okay, Treasury put together a plan; we'll release it after the election, and I think everybody expected it would just disappear at that point.

So what happened, and is it possible some other president could be sort of dragged into being a leader in tax reform, you know, even they don't start out that way.

MR. MCCLURE: I'm not sure I can answer the question, and I — I mean I was, close to the street as it were at the Treasury. But, no, it seemed to me that Reagan began with his interest in what we might call fundamental tax reform, and certainly lower rates. And you can only get to lower rates and the revenue to waive if you grow on the base. And clearly, you know, he made the announcement that we would produce what became Treasury I to be released in November of '84, and when he did that, there apparently was, that was done in a State of the Union message, and there was apparently laughter in the Congress because it was known that would be after the election, and who cared.

And unfortunately nobody told us that he wasn't interested, that he wasn't serious, and so we took it seriously, and then when Mondale said during the election that basically he said he would, what he said, he would raise your taxes, I guess it was ...

Well, so that meant that we were kind of home free in terms of not having to worry about some kind of Democratic thing preempting this somehow, and then as we developed the proposals, what was quite amazing was that they had given Washington, that almost never became public, not until maybe October or so, it was somebody leaking the stuff to the press, and so Don Regan felt that we had to do this as soon as possible.

And I remember this strange meeting and put, roughly right before Treasury I was ready to go, and as I recall he was kind of like "what are you going to do with it?" And somebody, I don't know if it was me or somebody else who said we've not thought of

what fields to run, and of course we released it, and the first thing, well, what happened was, he said two things; first, it was a wonderful proposal, and second, that he hadn't read it.

(Laughter)

MR. McCLURE: And that kind of makes your day, if you're coming home late at night and trying to figure out what's going on. Anyway, I can't really answer your question, but I do think it's true though that the — kind of — that there was a case of the lining up of the planets as it were, that you had Reagan, obviously the great communicator who detested high tax rates, and you had Senator Bradley in the House, and Jack — I mean, Bradley in the Senate, Jack Kemp in the House along with their cosponsors in the other Houses, and that created at least some political interest in it at least among some people. And of course the technicians liked it but that won't get you very far. And somehow, as the title of *Gucci Gulch* says, "How did the impossible become the inevitable?" that's one of the enduring questions. And the question is can it — could it ever happen again? I don't know.
MR. BERGIN: Considering where the last Treasury study's gone, doesn't look like it now. Sir?

MR. ALEXANDER: Don Alexander. Going back to the election in Virginia, which I hope will soon be over. I can see all the hands.

(Laughter)

MR. BERGIN: Ruined my football game yesterday.

MR. ALEXANDER: Yeah? If one candidate is accusing another candidate, "you're the one that's going to raise my taxes," and the other candidate says "you have already raised taxes." So I guess maybe it will be very difficult to raise taxes assuming that the expiration of the low rates on dividends, on capital gains is not an increase. I don't know, I'd like to get the view of the panel on that.

But there's something else that they hid in there, the difference between what we are spending including very heavy expenditures on the war in Iraq and what we're getting in tax revenues. And that's the tax gap. Now, is in the view of the panel, is it likely that the next Congress and the next administration will want to address the tax gap where you don't raise anyone's tax rates, where you don't raise anyone's tax base assuming that anyone is paying what he, she or it ought to be paying in the first place. But you are collecting more revenue.

MR. BERGIN: Anybody? You know, I think we're getting into the next session, but yeah, I'm dubious when you hire private debt collectors for the IRS. But I think you're making an excellent point. You know better than I as the former commissioner of the Internal Revenue Service.

MR. ALEXANDER: I wanted to comment on that. I'm sorry, I assumed that we're getting debts, but as to private debt collectors, that is of course scored. If IRS's budget could be viewed, not as an outlay, but as an offset to revenues then we might meet that wonderful sky where each taxpayer has his, her or its own revenue agent.

(Laughter)

MR. BERGIN: What happened to customer service?
MR. ALEXANDER: Customer service, oh yes, I call it taxpayer service, but there will be some of that too. But is there a way, and maybe you're getting ahead, I'm sorry, I've got to go to Tampa, so I can't enlist in the next group, of meeting part of the problem through increased information reporting, document matching and the like where we narrow the gap, increase revenues and don't raise anyone's taxes where we can have perhaps genuine reform.

MR. BERGIN: Well, I'll give you one opinion of mine. I think it would be helpful to know how well the IRS is currently doing, that information is sometimes hard to get, in order to help them do their job in the future, but I agree with you, I think it should be looked at as a profit center, and I think it will be, soon. Anybody? Mr. Sunley?

MR. SUNLEY: Emil Sunley. We've mentioned that part of the '86 Act was to increase corporate taxes relative to individuals, and Bernie mentioned *General Utilities*. I thought another defining feature of the '86 Act was the incredibly harsh transition rules, particularly on people who held tax shelters. Would anyone want to comment on sort of the transition rules that were necessary?

MR. BERGIN: Actually it's one for you.

MR. McCLURE: Well, to some extent we didn't pay enough attention to transition rules in Treasury I in a way that's almost inevitable, because you don't have enough time to pay attention to two things, because you also need to know what you're transitioning to.

But certainly, we, I think we would have proposed to do things in a much less draconian way. I mean, on the one hand I don't have all that much sympathy for people engaging in tax shelters that wouldn't pass the smell test. One the other hand, there was the law, I understand they were doing things that were illegal; it doesn't seem to me that you should say, okay, this is allowed today and tomorrow it's different and to heck with you. You should have foreseen it.

So I mean I don't know whether that — what that does for the prospects of future reform, maybe it does, maybe it doesn't do anything, but certainly I thought it was a tad unfair to just pull the rug out so quickly.

MR. BERGIN: Eric?

MR. TODER: Eric Toder. Tax reform is often equated with reducing tax expenditures as

part of lowering rates and Joe has made some comment on what happened in the Clinton administration, I think Chris has as well.

In '86, actually I believe that not a whole lot was done about tax expenditures except indirectly to the extent that lowering rates, reducing them, and the business tax expenditures were reduced a lot, but the things like the home mortgage deduction, the exclusion for healthcare and so forth, the big programs that affect individuals' pensions were largely untouched. Pensions were adjusted a little bit.

So I guess my question for the panel is whether they think that — what they think that the relationship is between controlling tax expenditures and tax reform is that if you're just eliminating tax expenditures to get the rates down, and then you're throwing it to the other side of the budget, and increasing the pressure on spending programs. Do they think they've accomplished anything, or to put it differently, is there any reason not to have these programs in the tax system as opposed to one in the expenditure side?

MR. BERGIN: Anybody?

MR. McCLURE: Well, I don't, I guess you're right, Eric, that we didn't, or they zigzagged, didn't do all that much on the big tax expenditures. I guess the — eliminating the deduction for state and local sales tax was probably one of the bigger money items. But other than that it was a lot of smaller things plus the draconian transition rules, the — I guess the money from tax shelters which opened up largely on the individual side.

And of course there was this big shift from higher corporate taxes, lower individual taxes. When we initially designed the program we — when we said revenue- neutral distribution, neutral, I'm sure you remember, we meant revenue neutral by pieces, that is corporate would be revenue-neutral, individually revenue-neutral, but when we took the rates to Secretary Regan, it was something like, I think 15, 28, 37 percent, and he said that that sounds like you're calling signals in a football game, like a quarterback's calling the step count, or something from under the center, let's have 15, 25, 35.

Some people once asked me "how did you come up with the rates," and I said, "we counted the number of fingers on one hand, and the one, two, and three, got 15, 25, 35." And so — but those rates, the 28 and the 37 raised money, and so we had to find some way to get some money well, the obvious source was the corporate side.

Regan, despite having been at Merrill Lynch, seemed to kind of like to poke his finger in the eye of the corporations, so he seemed to think that was dandy. And of course politically it helped us, it helped sell the package, I think, because people are not particularly astute when it comes to incidence analysis, and so they saw the reduction in their rates without paying attention, I guess, to whether or not they might actually be paying part of the corporate taxes too. I mean it's kind of the sleight of hand, combines the magic of numbers divisible by five.

MR. BERGIN: Okay. We've got three hands up here, so I'll go quickly. Professor?

MR. WOLFMAN: Bernard Wolfman. Just a word on tax shelters. The '86 Act, which as I said before, had the lasting effect of preventing the elimination of the double tax system, did not do anything as just has been pointed out about tax shelters as such.

But we have had legislation other than the '86 Act. In the area of individual tax shelters there are two major pieces of legislation, one eliminated the so-called or enacted the so-called "at-risk" rules which substantially reduced the number of tax shelters based on borrowings where there was nonrecourse that, and that was followed with legislation several years later that imposed the so-called "passive loss limitations" that supplemented the "at-risk" rules, and those two acts very much reduced to this day so-called individual tax shelters.

The result, however, was the increase in corporate tax shelters. People moved were mandated to have tax shelters, the people who promoted them, sold them to a large extent to the "big four" accounting firms, moved to the creation and marketing of corporate tax shelters. They can't be dealt with by legislation the way the individual ones were, but that takes a desire to do so, and so far that's been lacking, but it's an important thing to do, and it can be done. There are all these pieces of legislation that could do it. But they need to be enacted.

But that's how we got there in that route, and it's by focusing on it that if we want to, the corporate tax shelters can be substantially reduced, the number, the way the individual ones were.

MR. BERGIN: Gene.

MR. STEUERLE: Gene Steuerle, Tax Policy Center. Just a couple of facts to add to the discussions. I think one political scientist did a calculation set in '86. We removed 13 deductions of credits ... and we cut back on 65 directly; I think those were his numbers. Some of these were partial cutbacks, Eric's right. [Off mic] the main source of cutbacks then you take the revenues from that [off mic] you plan to lower rates, you get a further reduction of value of remaining deductions and exclusions which is valuable, but it was not trivial. It just shows that if you hit the ball rolling down the hill, what you can get in additional amounts.

A second point, Charlie, I think you'd agree with this, is when we went for the 35 percent rate that was in [off mic] Treasury I where we had more corporate integration, and we did these calculations on effective tax rates or on the cost of capital and came to the conclusion, at least under some calculations, that it was about the same.

In some calculations we used highly leveraged resources, and it didn't come up the same. One reason we ended up with a 35 percent rate in the corporate and the [off mic] sector was that this was the same top rate, so we were going for basically the same tax rate whether you were incorporated or in a partnership, and I think that was also a part of the discussion.

And finally just in terms of why there was a consensus for the format that was passed,

now it seemed to me that there were two major liberal-conservative compromises, and it really worked well for tax reform. One was with the application of tax shelters to the distribution tables, which hadn't been done before. It shows that we were able to keep the system as progressive as before, so Ronald Reagan got his lower rates and the Democrats got their progressivity and also [off mic] the tax shelters, so that was one major source, I think, of Democratic-Republican agreement.

The second one was, we at the time, because of bracketing things, we were moving more and more people into poverty. So then we pumped up the personal exemption as well as .... [off mic]. Democrats came onboard because we were moving people out of poverty, but some people may have mixed feelings about this, and this also became the point at which the social conservatives got into the tax code and decided this was a great, great issue for adjustments for family size because also we had to give a much larger dependent exemption to families with dependents, so that was another liberal-conservative compromise.

And those two men in both parties wanted to move along, and the final point I want to make is the one thing that was really crucial and maybe really was accidental is after Treasury I came out and got support from both the left and the right, there was sort of this leadership problem that Baker came to the Treasury and [off mic] Treasury II. All of a sudden he started to look bad and when Rostenkowski was starting to falter in Ways and Means, he started getting really bad publicity and the same thing happened for Packwood, who probably is the least likely of all persons ever to favor tax reform. He fought against base broadening all his life but he started getting really bad press.

So there was something to having one person responsible for getting through the next stage and then having to bear some onus if - - failure — if they didn't get to the next stage.

MR. BERGIN: We've got time for just one more question. Okay. Take it.

MR. COHEN: Sheldon Cohen, Washington, D.C., I come from where Don comes from.

(Laughter)

MR. COHEN: The issue just raised is it doesn't make any difference whether the IRS administers the farm subsidy or the Agriculture Administration. I venture to differ. The IRS is ill equipped and doesn't know a damn thing about soy beans or whatever the hell it is. And what you do is, figure that the cost of administration is free and therefore you don't take it into account.
And the reason of administration, most of these things are not administered, they just go fallow. So we crap up the taxes due with a lot of garbage that ought to be administered, if it belongs, it belongs in the Agriculture Department and the Interior Department, wherever it belongs, it does not belong in an IRS agent making an issue on an issue that he has nothing to add to.
MR. HOWARD: I want to add to that that I agree that one thing also that is lost is

transparency and that a number of programs embedded in the tax code have a distribution of benefits that if they were more visible, I'm not sure if people would agree to. The big three are for home mortgage interest, company health benefits, corporate retirement benefits. Those go overwhelmingly to middle and upper middle class individuals, and I think if you said "oh, by the way, we're going to be spending $200 billion to $300 billion this year largely in the middle and upper middle class, everyone agree?" I'm not sure the public would want the distribution to look quite that way and that if you had it on the spending side, that distribution is more visible.

MR. BERGIN: Alright, we're going to end with that. I want to thank the panel members, it was an excellent discussion. We're going to take about a 10-minute break.

(Applause)

MR. BERGIN: And thank you all. There's coffee in the back of the room and there's soda and juice outside the door.

(Recess)

PANEL II

MR. TODER: Hi, I'm Eric Toder, and the title of this session is "Action-Forcing Events." We have a really excellent panel. I'll just comment briefly on this session and then I'll turn it over to them. The theme of this session is that tax reform is not optional and that the current tax system is unsustainable in a way that was not true in 1986. At least that's my view — the panelists may or may not agree with me.

So while reform is needed, today, even more than then, the solutions will be different. This session will address four reasons why change may be needed. First is the question of revenue adequacy. CBO, GAO, and everyone else who does these projections are projecting massive increases in entitlement spending, in Social Security, Medicare, and Medicaid under the current law, in the next 20 or 30 years. Clearly action needs to be done to restrain the growth of these programs. But it's hard to imagine politically that all the adjustments for this long run fiscal problem will be on the spending side. So unlike 20 years ago, when we did revenue neutral tax reform, it's really hard to imagine that we won't have to look for increased revenues this time and it also is clear that the current tax system may not be up to the task of dealing with that. So that's the first reason.

Second, leading into that are the problems of the tax system itself. In 1986 although there were many bad features of the tax system, it was at least a stable system. Today, we're facing the fact that we have tax cuts that were enacted, all of which will expire at the end of 2010. We also have an alternative minimum tax which will snare almost 30 million taxpayers by 2010, under current law, unless something is done about it and so far Congress has done things one year at a time. So the possibility of doing nothing is really not there; some major changes will have to be made.

Third is the issue of tax shelters, always a perennial concern, and other forms of tax avoidance and the tax gap. In 1986, the shelter activity, as some have mentioned, was mostly on the individual side, and in large sense was driven — a large degree was driven

by inconsistencies between the existence of preferences for investment income, combined with interest adoptability.

So reforming those preferences went a long way to getting rid of that — and restricting passive losses, went a long way to getting rid of the problem. Today, the problems are mostly on the corporate side and they are much more subtle. They're also addressing inconsistencies, but ones that are a lot harder to fix. And so the changes are more processed changes than changes — changing specific provisions of the tax code, if those changes indeed are desirable.

Finally, the complexity of the law is challenging the administration of the tax system in ways that it hasn't been challenged before. Combined with likely, continued funding constraints on the IRS, the fact that we're auditing fewer — more people than a few years ago, but way fewer people than we were a decade ago, is another issue that has to be addressed.

This conference is organized on the past, the present, and the future. This session is about the present, and will be mostly, I think, at least doing some whining rather than offering anything constructive. However, I'm sure that our speakers in this session have constructive issues about solutions as well as understating the problems and they should not be restrained from offering them if they wish.

The panelists are, in the order in which they'll speak, Joe Minarik, who is the senior vice president and director of research at the Committee for Economic Development. Prior to joining CED, he held a number of high-level staff positions on budget policy making in the executive and legislative branch. He was chief economist for the House Budget Committee and I worked with him closely when he was associate director for economic policy at the Office of Management and Budget in the Clinton Administration. In the 1980s, Joe worked very closely with Senator Bill Bradley in developing his tax reform plan which eventually contained many of the ideas that were enacted in 1986.

Bill Gale is vice president and director of Economic Studies at the Brookings Institution, and a codirector and my colleague at the Urban-Brookings Tax Policy Center. Bill has published extensively on tax policy issues, including research on fundamental tax reform, macroeconomic effects of tax policy, and taxation of pensions and savings. He's the author of — co-author of — books on fiscal policy in the Bush administration, retirement security in America, estate and gift taxation, and fundamental tax reform. Bill also served in the government but it was a long time ago on the CEA, in the first Bush administration.

Lindy Paull is a comanaging partner of the Washington National Tax Services Office of PricewaterhouseCoopers, and also an adjunct professor of law at Georgetown University School of Law. Lindy served as chief of staff of the Joint Tax Committee between 1998 and 2003 and before that she was chief of staff and chief counsel of the Republican staff on the Senate Finance Committee.

And last but not least, Lawrence Gibbs of Miller and Chevalier has a general tax practice, in which he counsels business on how to solve their domestic and international tax problems. He frequently writes and speaks on subjects involving taxation and is active in numerous tax professional associations, too long for me to list. Most important, between 1986 and 1989, he served as commissioner of the Internal Revenue Service, and he will give us some ideas about how we can address our tax administration problems.

I'm going to ask the panelists to limit their remarks to 10 minutes so we have time for

discussion and Joe, you're on.
MR. MINARIK: I'm going to start with my own cinematic reference. Whenever I get together to talk with people about the tax reform act of 1986 these days, it always makes me think of the first scene in the movie Chariots of Fire. For those of you who are old enough to know that movie, you will probably 9 out of 10 think of the scene with the young guys running down the beach preparing for their bout in the Olympics. In fact, however, the first scene of that movie is the old guys sitting at one of their funerals and talking about those good old days, I'm not going to be nostalgic though. I'm going to read a little and riff a little.

There was a big deficit problem in 1986 and there is a big deficit problem today. There is a distinct similarity and some might argue that the deficit drove tax policy toward reform then and we'll do so again now. I'm a little skeptical. The 1986 tax reform was explicitly deficit neutral, and many economists at the time chided tax reformers for wasting energy that should have been devoted to deficit reduction.

Personally, I would challenge that allegation as one of the players in the 1986 debate argued, "You can't reduce the deficit by raising unfair taxes." I would characterize the 1986 Act as a sound zero-coupon investment in deficit reduction. It yielded — it allowed the later direct tax increases in 1990 and 1993, which actually did tame the deficit and which might not have been possible had the higher, pre-1986 law remained in effect.

For perspective however, I believe the deficit problem today is immeasurably more serious than that of 1986, largely because the fiscal crunch time, the retirement of the baby boom generation was a remote threat then, but is virtually upon us today. Reviewing the numbers in 1986, the debt held by the public had grown to $1.7 trillion or 39.4 percent of GDP. Now, the debt is just under $5 trillion or a bit over 38 percent of GDP. Current deficits are lower.

In 1986, the nation had run a string of five annual unified deficits of at least 4.0 percent of GDP, and the deficit was still running at 5.0 percent of GDP. There followed a temporary four-year slow down in deficits after which, pushed by a recession, deficits rose again. Now, the deficit is in such a slowdown with fiscal 2006 coming in at only $248 billion or 1.9 percent of GDP. But I am not the only economist to have doubts that the two-year string of declining dollar deficits is likely to continue for long.

The budget improvement has come exclusively from increasing revenues and the increasing revenues have come not from a stronger economy — the economy has proceeded right on the administration's forecast track for the last three years — but rather from "technical re-estimates." This is the same thing as what occurred in the 1990s, although then, the economy was somewhat stronger than economists had anticipated. And we've learned since, that such revenue bubbles do not persist.

The policy lesson from the 1990s of course was that one should take the proceeds of the seven years of plenty, and store them away, because there is no telling how long such a windfall shall last unless some angel tells you that's exactly seven years. In the 1990s the nation paid down debt with its windfall. Now, to say that the nation has wasted the last

six years would be far too kind. We wasted the time, but we made the underlying budget problem far worse. We are not kicking the can down the road, we are kicking the hand grenade down the road. We should be saving for our future, not mortgaging it.

With a debt to GDP ratio, now about the same as that in 1986, we now have interest costs a little more than half than — no, we have interest costs that are barely half of the 1986 share of the budget, that's about 13 percent of the budget in 1986, versus about 8 percent now. But that will not last. Interest costs are now the fastest growing part of the budget, and higher interest rates would drive debt service up sharply.

In fact, we may be in a catch-22 situation. Longer term interest rates have remained low in large part, because many economic forecasters have predicted slower growth or even a macro-economic hard landing. If we have the good fortune that interest rates stay well-behaved, it will be because the economy has slowed, and thereby cut down the growth of tax receipts, burglarizing the budget through the front door rather than the back door.

As to the demographic threat to the budget, it is worth reviewing the numbers as well. The beginning of the adverse effects of population aging is far nearer than many would think. When Social Security was rescued from an imminent threat in 1983, before tax reform, the action taken had the effect of building annual trust fund surpluses. Those surpluses were squandered until the late 1990s of course, but they did have the effect of reducing the Treasury's need to borrow from the public.

That wave will crest in just two years and will begin to recede. That is to say, the Social Security operating surplus, not including interest income, will reach its highest dollar value in fiscal year, 2009, according to administration estimates, just two years from now and then will begin to decline. Social Security will continue to reduce federal borrowing in absolute terms but it will do so by declining amounts, meaning that, from year to year, it will drag the budget downward. The effect will become negative in absolute level, of course, in the late 20-teens by SSA estimates.

So the budgetary problems now are really far more urgent than those the nation confronted 20 years ago. The need for a change in the longterm fiscal trajectory of the country is far greater. In 1986, the nation could afford a zero-coupon investment in deficit reduction. Now, prudence suggests that we should not, the time is much too late. That will make any attempt at tax reform either far more difficult, if it does address the budgetary problem or far less justifiable if it does not.

Getting into some of the interactions of budgetary issues and the tax reform issues, the president in 1986 — for all of his tax cutting conviction — was flexible and pragmatic enough to entertain significant deficit reduction through revenue increases in 1982 and 1984. This president has not yet shown that kind of pragmatism.

President Reagan's flexibility on revenue increases immeasurably facilitated the achievement of tax reform by allowing him to raise corporate taxes by approximately $25 billion per year, $120 billion over a five year estimating horizon, to finance individual income tax cuts in the 1986 Act. This was extraordinarily helpful because for the most

part what happens to individual income taxes drives the political verdict.

And President Reagan's transfer of tax obligations from individuals to corporations was in the end the grease that allowed the tax reform machine to run. In addition to the corporate tax revenue kitty that helped to close the 1986 deal, there were ready tools at hand for legislators to implement that, namely the repeal of the biggest corporate tax preference, the investment tax credit.

Revenue from the repeal of the ITC financed a big tax cut in the statutory corporate tax rate, which made the overall package more saleable. Many corporations were brought on board, even with the elimination of the ITC and the corporate tax revenue increased because they could be more knowledgeable and forward-looking and see that the long run pay off was there from a lower statutory rate. Though opinion of corporate managers was by no means unanimous, there was enough satisfaction with tax reform that unified opposition from the corporate front was impossible.

The situation today is very different, in effect there is a negative revenue kitty that will throw sand in the tax reform gears rather than lubricating them. That problem is the enormous scheduled baseline revenue increase from the individual alternative minimum tax. Looking at the numbers, relative to total, individual, and corporate income tax revenues, the AMT over the next five years will create a negative kitty that is approximately the same size in proportionate terms as the positive kitty was, looking at the corporate income tax shift back in 1986.

One final point, and that is that when we look at the possibilities for broadening the corporate tax base, the administration in its commission report raised the possibility of eliminating the exclusion for employer provided health insurance. We should keep in mind that healthcare experts have long counted the revenue gains from cutting back that preference as resources that they would use to improve the healthcare system, as for example, covering the uninsured.

It is by no means a sure thing, but we might keep in mind that those revenues might be encumbered and thus might not be available to achieve, either rate reduction or revenue neutrality. I have already run over my time, I have one or two more things to say. Why don't I stop and we'll leave it for questions.

MR. TODER: Okay, thank you, and I will turn to Bill Gale.

MR. GALE: Thanks Eric, it's always hard to go after Joe Minarik, because he usually says many of the things that I was going to say. It's particularly difficult this morning, because now I have the theme from Chariots of Fire bouncing around my head. So if I occasionally kind of look off to the heavens, you will know why. The title of my talk is, "Why the Current Tax Law Is Unsustainable," and I want to disavow my connection with that title. I didn't choose it; it was handed to me.

There is only one reason why current tax law is unsustainable, and that's a good one. And that is if future spending goes up the way it's supposed to, we're going to have to raise

revenues to pay for that spending. That's a matter of arithmetic and I guess I could contractually fulfill my obligations by stopping there, but I won't.

I will add a little bit on the comparison between '86 and now. Joe compared the economic situation between then and now, with the key element being that the baby boomers are retiring 20 years sooner now than they would have been 1986, that is, their retirement is right around the corner. Let me just add two elements though. One is, Joe mentioned the public saving situation now and then, but equally important is the national saving situation. Our national saving rate then was much higher than it is now, and the reason is that the saving done by individuals and corporations is much higher than it is now. So that's a source of concern because if you think of budget deficit that is reducing national saving, that's a bigger issue — the lower national saving is — to begin with.

And as exacerbated by the other key difference, which is the international status of the United States. And I don't know exactly where it was in 1980 — in 1986 — but in 1980 the U.S. investors held more assets overseas than foreign investors held here to the tune of 10 percent of annual output. Now, 25 years later, 26 years later, foreign investors hold more assets here than we hold overseas to the tune of about 30 percent of output.

So over the last 26 years, we've essentially borrowed from overseas 1 percent of output per year. And so we're now, of course, the world's biggest debtor nation and as we think about fiscal needs, we have to think about not just the government spending line, we have to think about raising the national saving enough to be able to pay back the debts that the country is accruing to other countries around the world.

Okay, so that's the reason the tax law cannot continue as it is, and of course that could be resolved by cutting spending, but as Eric said, it's unlikely we're going to cut spending that much. And that's a very important reason, but then it gets us into all these other potential driving forces for reform, which I'll mention. One is the complicated aspect of the tax code for individuals, in particular low income households.

The rise of the AMT, the fact that all the tax cuts expire in 2010, you could add growing income inequality to the list of potentially driving forces for reform. I think I'm in the Joe Thorndike school here; I don't think any of this is going to make a difference to whether we get reform or not. Not whether we should have reform, I think it makes a big difference to whether we should have reform, but I don't think it's going to make a big difference to whether we do have reform. Something has to happen to get reform to happen, and those things by themselves don't seem to be enough.

So let me turn to that question of, you know, "will we actually get there?" And I think it's important to know that while there are forces for reform, there are also, at the risk of sounding obvious, very important forces against reform. One is inertia, sheer political inertia. Second is lobbyists. Third is one-party rule, single-party rule at both houses and the White House.

And I want to be clear here, I'm not saying it's because the Republicans are in power that we can't get tax reform. If the Democrats held both houses and the White House, we'd be

in the same situation. The issue is as follows. To have reform, you need to hurt some people, especially if you're going to raise taxes. Even if it's a revenue neutral reform, somebody's taxes have to go up. If it's a revenue raising reform, a lot of people's taxes have to go up.

All right, well, parties aren't going to do that by themselves. They're going to say, well, we had to — the only way it would work was if both parties have some say, both parties at the table and then each group can go back to their constituents and say well, we like these aspects of the reform, we don't like these aspects but we had to agree to them, because these other guys, who are so unreasonable made us do it.

Right now, there's no other guys at the table. So there's no one you can blame the unpopular, but necessary, aspects of reform on. So split government, I think, will make it possible. But you know, this is raising the likelihood from near zero to noticeably higher than zero, but it will make it possible.

There is one other aspect I want to mention, which I always am amazed at how little attention this gets. And that's the commitment not to raise taxes, that more than 80 percent of Republicans in Congress have signed the no new taxes pledge. Almost every Republican member of the Ways and Means Committee has signed this, almost every Republican member of the Budget Committee has signed it, and comically or tragically, depending on your view, almost every Republican member of the Senate — of both appropriations committees have signed it, as spending continues to rise year after year.

We're in a situation where if Republicans who signed this are at the table, they either have to violate what they've signed, right, or they have to — or we can't raise revenues or they have to be out of office. And there's no easy — again, this is 80 percent and more of the members of the Congress, on the Republican side. So that is a huge tirade on what can be done, even going in to the possible negotiations, and I just think it deserves much more attention in talking about the politics of tax reform than it typically gets.

Let me close by talking about the tax reform panel that the White House convened last year. I think it's fair to say that among tax analysts there is general agreement on the way reforms should go. You want to broaden the base, reduce the use of social policy in the code, you want to use that money to simplify tax rules, reduce rates, etc. If you're going in that direction, then there is a further debate about do you want to go all the way to a consumption tax, or do you want to stay at an income tax. But that debate frankly is not very big compared with the debate of moving from the current system to a truly broad based income tax.

All right, and just to give you an example, the flat tax that gets talked about all the time allows firms to expense investment. If instead they had to depreciate their investments over time as they currently do, that would be an income tax, all right. The difference between that amended flat tax and the actual proposal that's out there would not convince anyone to change their vote on that proposal. And therefore, the difference between an ideal consumption tax and an ideal income tax is not very big.

The big difference is between the current mess that we have and moving toward either ideal system. So I think analysts agree generally on that. What they don't agree on is the level of revenues, and again, this came out in the tax reform panel report. The tax reform panel's proposals look good in particular because they cut the level of revenues — that's at the analyst level.

At the political level, you've seen what's happened to the tax panel's report — it's basically gone into the void. And I think that politically that speaks volumes about the likelihood of tax reform. Thanks.

MR. TODER: Thank you. Lindy.

(Applause)

MS. PAULL: Thank you, I appreciate the opportunity to be here today to share some of my perspectives. As somebody was — my very first bill working for the Congress was the 1986 Tax Reform Act. So I can't help but be a little bit nostalgic. It was a really rough ride, but it was an interesting ride for the first tax bill to ever work on. It was the first bill that was ever televised in the United States Senate. Some people may not know that, and it was kind of interesting to be on the Senate floor for three and a half weeks working on a bill that isn't protected by any procedures or anything like that.

It was not an easy process, and I think some people have summarized some of the things that helped move that bill along. But I think at any stage of the process, you would have thought the bill would die. So I think it's kind of interesting to think back on the '86 Act and think about some of the things that did drive the bill, and they are — there's nothing new in tax law, I don't think so.

You know, some of the things that drove that bill, like a strong leader in the White House, like a — whatever the dynamic was that Mr. Downey talked about in the House, and then in the Senate, once it came over there, you know, it was like the hot potato, you don't want the bill to die there either, but it certainly had a number of lives.

My topic was to try to dissect out of that bill one issue which is the whole issue of — the extent to which noncompliance issues and tax shelters drive a tax reform effort. And just thinking about the '86 Act, I was thinking some of the major features of that bill that drove the debate about trying to create a tax system that is more fair, really tried to target certain things, and I remember one of the things was the fact that the tax code was riddled with a lot of incentives and to the extent that they were going to remain in the tax code that taxpayers should, at a minimum, have paid some minimum level of tax.

Hence, a very strengthened AMT was developed in the '86 Act and as it turns out today, a lot of the other reforms that occurred in the '86 Act maybe made the strengthened AMT not as needed as it was thought. But the debate around it was of course the same kind of debate you hear today, and I've heard earlier today that corporations are reflecting on their income statements, their financial income statements, large profits for paying lower amounts of tax, that certain high net worth individuals, and I remember the legendary Ms. Dodge, I don't know if anybody remembers her, but she was probably not even around in the '86 Act, but she was still legendary for the fact that she received a lot of income. My recollection was a million dollars of income, none of which was taxable, because she

invested in municipal bonds. All of that debate drove towards a very strengthened AMT and also drove the debate into the passive loss rules, which were developed when the Senate actually was enabled to, I mean, remember our first mark up went on for about three weeks in the Finance Committee and ultimately failed, because the next deduction that was on the table, to be restored, I think it was the state and local income tax deduction.

And the chairman didn't have the votes and he said, "Well, we don't really have a bill anymore." So he pulled the bill and stepped back and tried to reshape a bill. So the passive loss rules are really the critical piece to that picture, when the bill came back. Because the bill would not have worked either from a distributional standpoint or from the standpoint of once again, fairness, the passive loss rules were directed at noneconomic investments that were producing losses for tax purposes.

So that's another area. Another thing that I would note about the '86 Act is in the corporate area. One of the other drivers behind the bill were these ads in the *Wall Street Journal* for trafficking and tax losses, that were — there were members who would come to the mark up with the papers saying, what is this? You know, how can somebody be selling their tax losses. So hence, strengthened net operating loss rules and tax attribute rules.

So that was a big part of the debate and it was a big factor in the '86 Act. It certainly wasn't the only factor, because you can't — I mean, in constructing a tax reform bill, you can't rely on only one thing. The president's drive towards the lower rates, he was a very persuasive president, and at the right moments he was there to persuade Congress.

Actually, another interesting thing that Sheldon Cohen reminded me of during the break, in the '86 Act was the Social Security numbers for dependents. That was an interesting compliance provision and it knocked the number of dependents way down right after the act. So anyway, there were a lot of pets, etc., that might have been cloned.

Anyway, I think that when you're thinking about tax reform, the whole area of noncompliance, tax gap, tax shelters, always is going to be a piece of the driving force behind it because they go to the heart of the perception that the tax system is unfair. And they go to the whole argument that some people say, "Why should I be so above board and honest with my tax return, when there are other people who are not doing the same thing or they're able to find some complicated scheme to lower their taxes."

So I think from that standpoint, it was a significant factor in the '86 Act. You can see that the issue is quite teed up on, at least in the Senate Finance Committee, with the leadership of that committee requesting from the administration a comprehensive strategy to address the tax gap.

One of the issues that Don Alexander raised earlier on the tax gap, was you know, what about additional reporting, presumably coupled with the ability to do some matching within the — by the Service — and certainly that's an area that I think Congress is looking at pretty carefully. It looks like there's some low-hanging fruit.

But since the '86 Act, since the passive loss rules, there was an intervening, I think, unfortunate episode — both for tax professionals and for the tax system, which I — you know, when I was still at the Joint Committee, I had an opportunity to at least look at in-depth in terms of some of the kinds of structured transactions and lack of a better word, aggressive tax planning and perhaps tax sheltering that was going on in the mid to late '90s.

That has been a very interesting process to see the response to that, and we don't have time to go through all the response, but the response has been multi-faceted, which I think you have to do when you're dealing with these kind of issues. You can plug the holes in the tax law itself, if you know about it, but a lot of this work has been done. And I have to give the Treasury Department and the IRS a lot of credit for doing a tremendous job of targeting the resources so that they could go about the business of detecting earlier these kinds of transactions, assembling the right team, and really trying to work their way through the system.
Also, I think that the tax shelter legislation that was just enacted in 2004, where there were much stronger, steeper penalties, realistic penalties, really changed the equation, the cost-benefit equation, going into a lot of these transactions that we haven't had before. But when you look at the list of transactions that were listed by the Internal Revenue Service and the Treasury Department, I've heard around here that you know, we've taken care of the individuals.
If you look at those lists of transactions during that period, about two-thirds of them were predominantly individual transactions, and about one-third were corporations or businesses. There were a lot of transactions oriented towards capital gains. Market was up, there were a lot of business transfer transactions in the mid to late '90s, huge gains, and trying to shelter those gains with some of these transactions.
So I think it's important to understand that you know, it's not just a corporate issue here. There does remain individual issues, and that is where the bulk of the income tax revenues come from. With that I just want to give my two cents on what drives tax reform, in my view. I do believe the budget has to be a significant factor in driving tax reform and there has been, over the last couple of years, continuing discussion that our long-term budget picture is unsustainable.
And so I do think that while today, you know, we have budget deficit that's 1.9 percent of GDP, the long term picture is not as rosy. It is discouraging and you know, obviously the ability to deal with those kinds of longer term issues today is better than waiting until you're really in the middle of the storm.
So I think the long-term budget picture is one of the drivers. I think another difference between now and 1986 is the fact that you have significant components of the tax code expiring in 2010, and also the AMT. And I do think also there is a radical change in the way businesses are operating today than they were in '86 — much more global operations — and I think that the tax code needs to be modernized for that as well. My time's up, thank you.

(Applause)

MR. TODER: Larry Gibbs.
MR. GIBBS: For my topic, tax reform and tax administration, I'm going to look back at tax administration, look at tax administration today and then if have time, take a look forward. As I prepared for today, I was struck by the fact that 20 years ago, after the tax reform of 1986 became law, tax administration was pretty much the same as it had been for the preceding 20 years.

On the front end of the process, the IRS provided taxpayer service to get the returns filed. On the back end of the process, tax compliance depended upon IRS examinations,

collections, and enforcement activities. Penalties were the principal sanction the IRS used to deter noncompliance 20 years ago. As a matter of fact, 20 years ago, with the help of Gene Steuerle's book, *Who Should Pay for Collecting Taxes? Financing the IRS*

The administration and the Congress were even persuaded to fund the IRS tax compliance activities to deal with the then tax gap. Today, 20 years later, I submit tax administration at the IRS is different and it is continuing to change. The changes, in part, are the result of the increasing sophistications of our financial markets and the globalization of our business activities.

IRS workload, in terms of the number of returns filed, has grown every single year in the last 20 years. IRS compliance resources on the other hand have remained flat or decreased almost every year for the last 20 years. There is no foreseeable prospect for future decreases in annual IRS workloads. Prospects are not good for future increases and IRS compliance resources, as the annual federal budget becomes even tighter especially with the demographic shift as the boomers retire, that Joe mentioned.

In the future, the IRS's protection of the integrity of the United States tax base will become increasingly important to pay for the ever increasing cost of federal health and retirement programs. All of these factors, I submit, will require the IRS to think even harder about its approach to tax administration, particularly its approach to tax compliance. So what has the IRS been doing over the last 20 years, and what is the IRS likely to do in the future to try to maintain tax compliance?

Well, increasingly, it seems to me that IRS has been dividing taxpayers into two groups, compliant and noncompliant taxpayers. And the IRS has been treating each group differently. For example, the IRS has provided incentives to compliant taxpayers to remain compliant, such as the pre-filing, limited issue focused examination and compliance, assurance process initiatives and other programs to help large and mid-sized businesses to keep their tax affairs current, and currency is important these days, particularly now that we have FIN 48. To deal with noncompliant taxpayers, the IRS has been shifting more of its compliance resources toward dealing with the noncompliant, and using more and larger penalties and other sanctions to penalize and deter noncompliance.

In the future, I believe the IRS is likely to shift the cost and the burden of tax compliance to the private sector. It has already happened. For example, the IRS relies on taxpayers to self police through initial disclosures by taxpayers to the IRS of potentially troublesome transactions — your tax shelter disclosure rules. Through the use of the M-3 on corporate returns to require more self disclosure by corporations, and through the use of monitors by noncompliant taxpayers such as the recent plea bargain requirement that KPMG bear the cost of employing Richard Breeden to monitor KPMG's future tax activity.

IRS is likely to continue its efforts to motivate professionals to assist IRS in maintaining taxpayers' compliance through increased disciplinary activity by the IRS Office of Professional Responsibility, and changes in the Circular 230 rules like the recent changes to encourage the use of higher standards when professionals advise taxpayers.

For those taxpayers who fail to comply in the future, I believe the IRS is likely to apply even tougher sanctions to those it catches, and to request privacy waivers from some noncompliant taxpayers to publicize and make examples of them to deter others. It has already happened. Finally, the IRS is likely to rely more on technology to enhance its compliance efforts, such as the use of the Office of Tax Shelter Analysis in the IRS tax shelter compliance program, which I think largely has been unsung. eginning to focus on the importance and utility of front end compliance. A provision in the recent Grassley bill, the "Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act," provides for the licensing and regulation of tax return preparers.

As Lindy indicated, there has been increased discussion about more information reporting requirements. Who knows? Perhaps old ideas like withholding on nondividends and interest and independent contractors will resurface. Interestingly, the tax sections of the ABA and the Federal Bar have scheduled upcoming programs to focus on the tax gap and ways to encourage tax compliance.

I submit that IRS might benefit in looking at what other federal regulatory agencies have done to maintain compliance with flatter diminishing resources. We have time; this is an interesting subject. We need to, in any event, I believe, rethink the role of penalties in tax administration. The 1987 IMPACT legislation, a prior American Tax Policy Institute article by Dick Stark, and a recent article in *Tax Notes* by Dennis Ventry are good places to start.

One cautionary note, some new compliance techniques may raise due process issues such as the waivers of the attorney-client privilege and the refusal to pay attorney's fees in the KPMG case. These and similar events have raised questions about the so-called Thompson memo requirement for corporations that wish to avoid prosecution.

My point is that 20 years after the 1986 Tax Reform Act, I believe it is time to rethink and reform the way we think about administering our tax system to obtain better tax compliance in order to protect our tax base as we head into that demographic shift when the boomers start to retire, and to ensure the effectiveness and fairness of our tax system. IRS audit and enforcement actions will continue to be important, but I believe we still rely too much on them to maintain tax compliance.

And IRS, in my opinion, is not likely to have the resources to be able to rely primarily on its examinations, collections, and enforcement actions in the future, particularly as its work load continues to grow. So we will need to do more to encourage and cause taxpayers to comply by expecting IRS to use its compliance resources including its technology as efficiently and effectively as possible.

By shifting the IRS focus away from post-return filing to pre- filing emphasis; by exploring more withholding information sharing in upfront taxpayer disclosures; by doing more to encourage tax professionals, including tax return preparers to assist in the process; by moving more of the cost and burden of compliance away from the IRS to the private sector, but in a manner that addresses the fairness and due process issues that are likely to arise. Will it be enough? Time will tell.

(Applause)

MR. TODER: Thank you all. I'd like to ask the members of the panel if first they would like to respond to what anyone else says, or have an opportunity to finish any comment that I cut off. Yeah, all right, well, Rudy, go ahead.
MR. PENNER: Rudy Penner, from the Urban Institute. I guess I'd characterize the problem a little differently from the way Joe did. I think we face a very serious problem today, because things are just too darn good. That's very hard to get excited about a deficit less than 2 percent of the GDP, that GDP ratio is going down. I think those good prospects that will continue to do so, interest rates, inflation rates, unemployment are all much better than they were in the 80s.

And despite what you said about Social Security, which is correct, the real acceleration and expanding doesn't occur until the first baby boomer applies for Medicare in 2011. And it won't be apparent we're falling off a fiscal cliff, I think, until about 2016. So the real problem, as I see it, is making all that vivid today, and some have suggested the present value accounting techniques, and make the debt trillions and trillions of dollars.

I'm a little skeptical of all of that. But I'd be interested, Joe, in what you think about these various changes in accounting that tried to bring the problem forward and make it look more serious.

MR. MINARIK: Well, I guess in terms of present value techniques to answer your last question first, one of my first — actually my first supervisor in a government position — told me his rule number one was when you speak to members of Congress, don't mention present values.

(Laughter)

MR. MINARIK: Simply because they're not transparent to people who are not economists, I guess. Whenever I want to convey the nature of the problem, I point people to the chapter in the analytical perspectives volume of the budget, because that's something that everybody reads, of course.

(Laughter)

MR. MINARIK: In the stewardship chapter, where the administration projects what the long range outlook for the budget is (they do that every year; CBO does it every other year). And we can talk about whether the inflection point on the cliff is in 2009, 2011, whatever. If we want to start a pool on when the problem is going to be addressed in the Congress that might be important.
It seems to me that one of the most important aspects here is simply to get action on this issue as soon as possible. I didn't know what to take from the first session with the conclusion that tax changes that are done on a, I guess the term is voluntary, I'm not sure, basis, are not enduring. Only tax changes that occur in crisis that are mandatory or necessary are going to last because if we wait until the next crisis, obviously we're going

to be very much too late on the budgetary problem.
And we just have to continue communicating the nature of these issues. What I learned from looking at the improvement in the budget in the 1990s is that you get revenue bubbles which show up in individual and corporate income tax receipts. But don't worry, a night's recession will take care of that, and we'll have one sooner or later.
MR. GALE: Yeah, I just want to follow up on Rudy's question about how does one convey the information, the longer term issue, and I agree with, I think, with what you're implicitly saying, which is that spouting numbers like 70 trillion just kind of makes people's eyes glaze over, and they say, "Oh well," and it doesn't translate into any specific focus.

So I just wanted to put forth one other approach; my colleague Diane Rogers has written about the birth tax as opposed to the death tax. And the notion is that people come in, people who are born, come into life, as American citizens, owe a certain amount of taxes that's written in present value form, but, you know, you don't have to say present value.

And it's a big number; it's like $200,000 or something like that over the course of a lifetime. So it's like we're making everybody buy an extra house to pay off our current fiscal burdens, every new person and/or in some parts of Northern Virginia, or in Maryland, you know, an extension on a house.

(Laughter)

MR. GALE: But it's a lot of money, and in a lot of other places in the country it's two houses, so it might be one way to personalize it and, you know, you almost want to walk around and put dollar signs on people's foreheads that, you know, because of what's going on, you are going to owe x hundred thousand dollars. So it's got to — I agree with you, we have to do something more than just do the calculation that say there is a $70 trillion shortfall.
MR. TODER: Okay, anyone else? Gene?

MR. STEUERLE: This is Gene Steuerle, the Tax Policy Center. I wonder if you could elaborate on professional responsibilities of particular lawyers and accountants. If you want to, you can add economists too, but there are a few of us. You know, sometimes I think of what happened, not just with respect to tax system, but with respect to the way we account for things in general.

It's almost as if — it seems to me many professionals are almost dodging their fiduciary responsibilities whether it's fiduciary responsibilities like we've seen with the stock options, which isn't a necessary tax issue although we can argue the taxes interact with that. And not reporting to shareholders what they deserve to know, or in charities not reporting to donors what they deserve to know.

And I just wonder if there is not almost like some higher level of shame or retribution, or denial of licensure, or something that the professional societies themselves really need to get into beyond what IRS might be able to enforce in the professions. Or is this just

something where we've sort of thrown in the towel that professionalism really means what it says it is.

MR. GIBBS: Gene, I think that's a tough question for me to deal with because I come off sounding like just an old — another old fogy. When I say that frankly, things really are very different, for me anyway, in my perspective than they were 43 years ago when I started to practice. Through a variety of different ways, you understood that you had an advocate's role, a representative's role, and then you took off your advocate's hat, and it was up to you to be interested in, and to do something about making the tax system work.

And they were two distinct roles, but if you wanted to be a tax professional you had to perform both roles. Some still perform both roles today. But frankly, I believe the second role is really not something that is understood, respected, or believed to be important. And I think that's part of the reason why the government has gone more to a regulatory type of approach.

If you had told me 20 years ago that the government would be relying on the Director of Practice Office — now the Office of Professional Responsibility — to try to do something about professionals, I think I probably would have laughed. Frankly, that function for 16 years got no respect. It was shown at the Treasury, it was in different places in IRS. And yeah, that's where we come to in terms of the IRS attempting to do something about bringing professional responsibility up close and personal to the practitioner. I can go on, but I'll stop and let others comment. That's my perception here.

MR. MURPHY: My name is Mike Murphy, and I had the good fortune of working with Mr. Gibbs at IRS, and many other commissioners. An earlier panel brought up a comment about this unheard of thing, Gene, of IRS going off budget, so that the Service would not have to compete with Homeland Security and others to get the resources they need to deal with the tax gap. But I think it's of — it makes sense to me, and I think it's a very fair question to both ends of this panel. Lindy, in her past life as chief of staff, and also Larry, as a former commissioner, so I'd like get your reactions to that.

MR. TODER: Lindy.

MS. PAULL: Well, Mike, there certainly is some precedent for that, for some other agencies that are off-budget. But I will tell you that it's a very hard sell to Congress because the appropriations process is a process that's considered to be partially an oversight process, and I think Congress would have some difficulty giving up that role.

So, you know, as desirable as it sounds to try to get more money into the Service, to take care of some of their needs, especially when it comes to the technological modernization that really is integral to being able to move into a more strategic role of compliance for the Service. I think that's a hard sell to Congress.

MR. MINARIK: And if I can just add one thought, I'm no longer an OMB appointee, but I still play one on TV.

(Laughter)

MR. MINARIK: And there is always the concern that you've got a large number of demands on the federal government's resources. They're all valid, you've got the national parks, you've got the Environmental Protection Agency, etc., etc. Giving different agencies different treatment does make life extremely difficult. It makes it harder to make choices as Lindy said very appropriately; it makes it harder to provide appropriate oversight. There'll be a lot of hesitation about doing that because the next thing you know, we'd be going hell for leather down that road and we'd have a lot of problems.
MS. PAULL: Also, just on Gene's comment before, I would just say the Joint Committee staff, when they prepared the Enron report, invited some of the professional responsibility agencies to look into some of the performance of professionals. And unfortunately, they did not take up the staff on that. So it is one of the, you know, which has led to changes in Circular 230, etc.

But one of the things you get into in this area is that, yeah, everybody's licensed in different jurisdictions and it's up to those jurisdictions to go and decide whether or not the professional is performing up to their standards. And it isn't — even though they're practicing before their Service, it's kind of up to those jurisdictions to do the right thing here. And unfortunately, I never saw anything come back after what happened, as a follow-up to what went on in the Enron report, sorry.

MR. GIBBS: Mike, my comment simply is this, looking at it, the last 20 years, just go back even further if you wish. It seems to me that I'm very skeptical. You could tell from my remarks that IRS is going to be given more funding certainly trying to do it in a fashion where it's not as visible. If it's visible, I think it's going to be very difficult. And if you'll think about it this way, what I've been trying to get my mind around is when that day comes, whatever the date is, when we start going through the crunch.

You think about the federal agencies that are going to line up with programs that people want, and they're not going to be able to get funding for them. Do you really believe politically you'll be able to vote for increases at the IRS and continue to serve in your position? Now somebody — we need to start dealing with this because my reaction is — put it this way — 1972, when I came on board, people were concerned about the disparity between public and private sector pay. We don't even mention it anymore, it's just there. I'll be really interested to see if 20 years from now anybody really talks about giving the IRS more money.

MR. TODER: Van.

MR. OOMS: I'm Van, I'm from the Committee for Economic Development. I wanted to ask Mr. Gibbs to elaborate a little more on what he was saying. I found the description of the shift in the approach of the IRS extremely interesting. What I'm wondering — I mean, to me, what that sounds like is a softer, sort of a softer approach.

You then described a culture, however, which is changing in a way that seems to suggest

that you may need a harder line approach. I'm just wondering how you reconcile those two, or is the softer approach really not so much a question of principle but of an acknowledgment of what you've just said that there may not be any resources there to do it anyway, so we'd need to do or work it around.

MR. GIBBS: I guess the way I would respond is — let's take the example that came up previously. This is an explosive issue folks. Hiring private debt collectors to go collect IRS debts; man, that's an explosive issue. I had six months where I was portrayed as a bounty hunter. As IRS commissioner, I didn't like it, it was really, really tough.

But I ask you, if you don't have the resources to collect what is admittedly owed and could be collected, and you can't get additional resources, what do you do? Do you tell the public, how ever many [off mic] there are, we just can't get to it? That doesn't seem to me — the point is we're going to have to think more creatively. That's moving part of the issue to the private sector.

It does have a soft and a hard piece, it's part of going back to the IRS dividing its resources — its activities. So if you fall on the compliance side, frankly, it is a softer type of approach. If you get over on the noncompliant side these days, it is much tougher.

SPEAKER: Yeah.

MR. GIBBS: Much tougher. And so you're going to hear both messages at the same time. But if you want to talk tough, look at what some of the other federal agencies are doing. When you look at how the Foreign Corrupt Practices Act is enforced by the Department of Justice in terms of what is required of companies, to basically comply with that, it makes IRS look soft.

All I'm saying is whether you like it or not, this is what's happening. When the money is not there, what the folks are — what the people and agencies are already doing, and what I predict will happen, is that you're going to have more and more of this pushed to the private sector. Monitors, how about the Bristol-Meyers article, CEO is gone with the monitor, think about it in terms of words known.

MR. TODER: Steve.

MR. ENTIN: Steve Entin, Institute of Research on the Economics of Taxation. Private sector [off mic] the tax collection and tax farming has been around for a long time, it was a factor toward the end of the reign of Louis XVI, and the career of the great chemist Lavoisier was cut short because of his involvement in it.

Bill mentioned the importance of ending disparities in tax treatment across assets, but suggested that there is not much difference between a consumption based on an ideal income tax. When you get the corporate double taxation, and the tax burden on saving calculated, get over the transition issue, you're talking about a roughly 10 percent difference in real output per year at a 3 percent real return that's 3 in the third year's output, which is, forgive me for taking a present value, something on the order of 43

trillion, about 8 trillion in federal revenue, about 4 trillion and 5 trillion same. Local government revenue with over 30 trillion left for the public. So let's not sneeze at it.

Joe raised a number of interesting points including some that I had to deal with back in the 80s. We had a higher burden of interest payments back then in the federal budget. Part of it was higher interest rates left over from the inflationary period against which we were not counting the reduction in the value in the federal debt outstanding because it was being eroded by inflation which inflated the apparent burden of the debt quite considerably.

Even today of our current deficit somewhere between 100 and 150 billion is probably due to these remaining inflation premiums, much lower than then in the interest rate structure. This might give some indication perhaps as to why now that the numbers are more real than they were back then, people aren't quite so fussy about the deficit. There had been considerable technical re-estimates, Joe suggests that the burst of revenues we're having now won't last. There's a good reason why they won't last. If we don't recognize that the technical re-estimates represent an error in the forecast of what revenues would come in if we had a more favorable tax climate toward capital, and think we can just repeal those incentives with no ill effect then indeed these higher capital gains payments, the higher dividend payments and the taxes on the dividends and the surging profits and profit taxes from business in the corporate, non-corporate sector may very well be eliminated because we didn't think they were going to continue. Well, that's unfortunate. We should be doing —

MR. TODER: Excuse me, Steve, do you have a question?

MR. ENTIN: To what extent does the tax community still rely on GDP static estimation, and to what extent are some of these conclusions still assuming in elasticity in the availability of saving? And I ask because if we raise the tax on capital to reduce government borrowing, it may reduce private saving by as much or more than we reduce the deficit and reduce national saving, which is again part of this transition question between the income and consumption based taxes. To what extent is research in this area helpful?

MR. GALE: Sure. My discussion of the difference between a pure income tax and a pure consumption tax on the one hand and the difference between both of those in the current system had to do with the structure of those taxes and with the legislative likelihood. To me the big issue in tax reform, in terms of getting from here to there in political sense, is not whether we have a pure income tax or a pure consumption tax, it's getting from the current system to anywhere near a pure income tax or a pure consumption tax.

Having said that I'll address the economics of this. I don't know of any study that shows that the difference between a pure income tax and a pure consumption tax is 10 percent per year in output. I know of some studies that say that the difference between the current system and a pure flat rate consumption tax is 10 percent after about 150 years. But also remember that's comparing a system that exists in the real world to a system that only exists on paper. I've never seen a study that looks at a realistic consumption tax versus a

realistic income tax because I think it's — the latter's probably too hard to model.

So there's potential to improve the tax system along a number of dimensions and growth is certainly one of them. But I don't think we should overstate either the potential economic gains or the potential political likelihood.

MR. TODER: Joe, you can comment briefly.

MR. MINARIK: Okay. People often talk about the difference between a consumption tax and an income tax as a difference between on and off, as in a light switch. I think it is possibly more instructive to think about the differences between the effective tax rates on capital and overtime, and looking at what has happened as the tax law has changed. If you go back to the period pre-1964, when the U.S. tax system had statutory tax rates on individual income as much as 92 percent, corporate tax rate of about 50 percent, you look at what has happened since then. Keeping in mind that the distortions that are caused by taxation generally rise exponentially with the tax rates, you will find that there has been such a significant reduction in tax rates at the margin that if there were a remarkable benefit to be received from reductions in taxes on capital, I think we should have accrued a fair amount of it by now.

If there were going to be a miracle from improvements in reductions in the tax rate on capital, we should have seen it in the 1960s, 1970s, 1980s, 1990s. It's interesting to me that the strongest period in recent years in terms of economic performance including investment, came in the 1990s after tax increases. It's interesting that CBO recently reported that there has been an unanticipated reduction in labor force participation since the 2001 tax cuts were enacted over the last five years. It seems to me that history would suggest to us that we have a tax — levels of taxation — now that are low enough that the additional benefit from reducing taxes on capital or labor is probably limited.

MR. TODER: As a head of this session I'm going to insert my prerogative to say two things. One, remind you that we will be discussing the consumption income tax issue again at the last session. It is now 11:55, it is time for lunch, so I would like you all to — lunch is next door, but before that I would like you all to give a round of applause to the panel and —

(Applause)

(Whereupon, at 11:55 a.m., a luncheon recess was taken.)

AFTERNOON SESSION

(1:35 p.m.)

PANEL III

MS. OLSON: I'm going to be moderating the last panel of the day, which is going to take a look at where we're going in the future. I unfortunately wasn't able to catch the

morning sessions, I did catch much of the lunch speech, and I gather it has been a very interesting conference so far. And I think that with the three gentlemen to my left, we're going to have a very interesting end of the conference.
Each of these gentlemen are going to speak for about 12 minutes, and they're going to speak in the order in which they're listed on the program. So, starting to my far left, the introduction, Gene Steuerle. Gene is a former deputy assistant secretary for tax analysis at the Treasury Department, survived the 1986 Act at the Treasury Department, and played a key role in moving the Treasury Department study of tax reform through in the 1980s. Gene is now with the Urban Institute and the Tax Policy Center.
To Gene's right is Doug Holtz-Eakin. Doug is currently with the Council on Foreign Relations, he's served as a professor, an economics professor, as the chief economist at the Council of Economic Advisors, and most recently as the chief of the Congressional Budget Office.
To Doug's right and my immediate left is Rudy Penner, also with the Urban Institute and the Tax Policy Center. Rudy also is a former chief of the Congressional Budget Office, and is a renowned economic scholar. All three of these gentlemen are renowned economics scholars and have spent a lot of time in the public policy tax arenas. I'm looking forward very much to their remarks. So we're going to start with Gene.
MR. STEUERLE: Thank you, Pam. You forgot to mention one of my chief claims to fame was working with you at the American Tax Policy Institute for years. You know, at this point of the day we all know the old song about everything's been said better, everybody said it, but in this case everybody has said it, but I'll remind you of Samuel Johnson's dictum that "it's insufficiently considered that people need more often to be reminded than informed," so I'll proceed from that base.

The biggest mistake in tax reform, I believe, is the label itself, saying that one is in favor of tax reform is about as informative as saying one is in favor of expenditure reform. Everyone has items on both sides of the budget they would like to change, they just don't always agree on what those items are. Despite this murk, I suggest that there is a consensus base on which fundamental reform can and should rest. The type of foundational base on which any tax system should rest. And by the way, the base on which reform, at least early reform in '86 proceeded. That base is nothing more or less than developing both reform options that adhere to basic principles of taxation. And equally important basing the legislative process as well on a means or mechanisms that adhere more strictly to those reform principles.

Now what are these basic principles? Well, we all know them in various guises. They start with the queen of principles. I think Joe Thorndike mentioned that fairness is the issue upon which most taxpayers are driven. I think it's the queen of principles because it really reflects more the notion of equal justice or equal treatment of equals. And it's hard to deny that principle no matter what other principle you may go to.

What this means in practical terms — that any form of discrimination must be assumed to be wrong unless and where there is solid, very solid bases for such discrimination. The burden of proof in effect should always rest with advocates for discrimination, and it's a burden of proof that should be re-taken or re-engaged year after year.

Taxation according to ability to pay is also a principle and it does allow for some discrimination, just as in a family children are not expected to contribute equally to the household's fortune, so the tax system knows those of no ability to pay taxes cannot be expected to pay tax. But that principle must be balanced against the individual equity principle that emphasizes the right of individuals to the returns from their own work.

Another principle's efficiency, which has several branches. One branch leads to conclusions very similar to those that derive from equal justice. Forms of discrimination among different items of income or consumption are often inefficient, not just unfair. It's these two considerations of horizontal equity or equal justice and efficiency along this one particular branch that lead largely to the claim that a larger base and lower rates is efficient and fair.

A tax system should also be simple, avoid waste, and be enforceable. Still another principle receiving much more attention in the modern period at least as told by Emil Sunley, I don't know if he's still here, at the National Monetary Fund, is that a tax system should be non-corruptible. I think it's a principle to which we've paid far too little attention in past decades.

A tax system and the tax legislative process should not invite abuse whether legal or illegal, whether encouraging cheating or simply the buying of officials. Now it's true that balance must be obtained among the principles. But many, many proposals and laws represent no balance at all among principles. In that sense we have to be careful to distinguish between the reasonable and the unreasonable debates over a policy and policy process.

Now two of the most contentious debates, which are reasonable, relate closely to issues of degree, and those are largely issues related to size of government and progressivity. Thus sufficiency considerations which can include concerns over growth, might lead some to favor supply side or Keynesian stimulus to boost the economy while others might conclude that deficits unfairly and inefficiently shift revenue cost on to future generations. Ability to pay considerations also lead some to favor more progressivity while individual liberty considerations favor some to limit the tax rates that can be accessed.

Only the political process, I believe, can ultimately decide those issues — that is those issues of degree. Since the basic principles by themselves really do not tell us how stimulative, how progressive or how revenue raising a tax system should be. Still, despite the fact that there is conflict among principles, some of these debates really do not grant or give an excuse for abandoning the other principles. All other things being equal, for instance, given a government of any size and any progressivity, efficiency, simplicity and non-corruptibility are basically values in and of themselves.

Because they are so contentious, once on the agenda, debates over degree or size or stimulus progressivity revenues tend to dominate so much that often these other principle are simply, needlessly, and carelessly abandoned or neglected. A number of inefficient and complex giveaways, for instance, are almost always included within tax cuts

regardless of whether the cutting might otherwise be justified by macroeconomic or budgetary considerations.

One of the reasons that '86 reform was able to succeed, at least to the extent that it did, was that it did not disdain these other contentious and dominating principles related to degree and size. It simply put them to the side for a while as a way to focus on these other core principles.

So my suggestion is in one point simple, if we dodge the politics of course. Core principles that are of value in and of themselves must be constantly given attention. They must be constantly given vigilance. And our electoral process must be designed to let the public debate and decide how it wants to move on various fronts but without abandoning these principles. In particular, it must always try to achieve whatever goal it is, whether it's progressivity, whether it's revenue raising, whether it's revenue cutting, it still should do it in as efficient, simple and non-corrupting a way as possible.

If we adhere to core principles in design and reform, it would entail, just as it did in 1986, going through almost every item of the code to determine its merit according to basic principles. It would require examining the worth of hundreds of tax programs, putting into practice recent budgetary efforts, or at least theory in point of fact, a Congressional mandate that all programs should be assessed on the tax or the expenditure side of the budgets according to their efficacy.

It will require starting many items of insufficiently proven merit and it would require a different type of IRS, one that provided data on each of the programs under its control even if the IRS was not the agency that performed the final assessment.

Finally, it would require fundamental reform of the tax legislative process, not only restoring but enhancing the power of those whose job it is to provide the architectural in building system advice, whether it is in the Treasury or the Congressional agencies like the Joint Committee on Taxation or the Congressional Budget Office. To some extent it would require budgetary and procedural rules that ensured that adequate power and support was given to this nonpartisan and bipartisan staff in the analysis that they would provide.

Now the opponents to reform are many. Primarily however, the opponents are those with specific agenda items for which they are willing to abandon this attention to core principles. Since there is, never will, and never should be complete agreement on what government should do on so many of these agenda items, the attack on core principles and the willingness to sacrifice them along the way can never be assumed to be something that does not require constant vigilance.

Another attack is little more subtle. Friends like Michael Graetz claimed that the reform in 1986 was just too darn hard. At some points, people like Michael would claim that we really just need to keep all the junk in the tax code or maybe somewhere, somebody, someplace needs to deal with them. No matter how inefficient, complex, and inequitable they are in corrupting, and just simply overlay another tax on top of that system while

exempting most taxpayers from the first system.

Now that might be a partial solution in a sense of exempting some taxpayers from these provisions. But I think it's sort of throwing in the towel. It seems to me that if you've got hundreds of programs in the tax system just like you've got hundreds of programs in the expenditure system, you just have to deal with them, and let's just be honest about it. We can't say we don't have to deal with them because they're not in our academic models or because they're too much trouble not to deal with it.

Another group of reformers seeming too willing to attack the mess in the tax code but they condition that attack with movement on a much more contentious spread, such as converting the tax system into one with a flat rate or consumption base or both. Again, I don't want to discount the importance of that debate, but again at times it holds these basic principles hostage to a particular agenda item. Now I don't want to claim any of this is easy politically.

Government today is extremely messy and I would argue corrupted, in no small part, I would claim, because liberals and conservatives have largely been willing to abandon core principles in their continual battle over how to tax or not tax the rich or how to add or to subtract from existing systems of redistribution rather than reform them to actually work.

Not to mention how much the access given to those with money has tended to reduce the access of the non-partisan staff whose mission it is to design provisions well. Of course if you examine the core principles closely they apply equally well to the expenditure side of the budget.

What has essentially happened to tax policy in recent decades is that — or the process in recent decades — is that it has adopted many of the bad habits of the expenditure policy process. I'm not convinced any longer that one can be solved without the other. And therefore when I talk about tax policy process reform, I think it's got to extend to all the budget and not just the tax system.

As a practical matter then, what needs to be done at this point in time? I don't think that there is any doubt that the budget is so out of balance for so long — for so much in the long run that it will drive much of policy for a long time to come. Never before have so many promises been made for the future before that future has arrived, which means by their very nature they will violate the rules of efficiency and equity, not to mention taking democratic decision making out of the hands of the people. This is not a plea for revenue raising or for expenditure cutting, but for ensuring that when we go into this process, this process that I think several people here have already predicted, that the core principle get the attention that they deserve.

As for the tax system thought of by itself, reform means studying, identifying and providing data on all the mini programs in the system, with pressure to abandon programs that are unproved, that wouldn't make much difference, and with special pressure to remove those that are both unproven and violate norms of equal justice.

In terms of coming to grips with some issues, I think the president could base at least one reform effort. And I don't say it's all reform, but he could base one reform effort on the grounds of simplification with items identified by the ability of IRS to administer and enforce them.

Any principle-based reform, I believe, would mean tackling issues ranging from housing to pensions to charity to work subsidies to health and education to business subsidies, especially those that discriminate among business groups. And I don't think there's any way out of examining those issues, whether you are in favor of a consumption tax reform, whether you are in favor of a larger tax or a smaller tax system, you simply have to recognize that housing and pensions, education and charity — all of these things are in the tax code and they can't just simply be neglected along the way. Thank you.

MS. OLSON: Twelve minutes on the nose. Thank you very much, Gene. Doug.

MR. HOLTZ-EAKIN: Well, thank you for the chance to be here. Thank you for the invitation. And my invitation was to come and make the case that tax reform should take the form of a consumption-based tax, it's a task that I'm happy to take on. In doing it, I want to stick to my 12 minutes, and in doing that, I'll have to throw some very important issues overboard. And so I want to be clear about that at the beginning.

First, there is a presumption that there has to be tax reform in the future because of the large and growing discrepancy between the commitments that Gene just described and the revenue base just thwarts them. And so I think we're on track for something major in the way of reform.

Secondly, the politics of reform would be very difficult — and I don't want to minimize the importance of that. But I want to sidestep it for the moment because many of the political issues that will be involved in tax reform are the same regardless of whether you're favoring an income-based as your target or a consumption- based. We can come back to them in the Q-and-A if you would like, but I'm not going to dwell on that. And I also want to put aside any notion that I'm arguing for perfection. I'm arguing for a tax code that is better than the one we have today, and that's not an argument in favor of perfection. That's just towards sensibility.

So, what do I favor? Well, I would like to make the case that something that looks like the X-tax invented by the late great tax economist David Bradford, is something that the United States should take very seriously.

And I won't go through a long exposition, but suffice to say the X-tax is a two-part tax, much like our current income tax system. There is a business entity level tax that looks like a value-added tax. In fact, it differs from a value-added tax only in that you subtract off not just purchases from other businesses but also employee compensation.

And then at the individual level or the household level, there's a second part to the tax system that collects a tax based on employee compensation. It has a large exemption and a set of progressive rates. And the top rate would match the business level tax rate. That

system is the X-tax system. And it is the right way for the United States to go in the future for a whole variety of reasons.

Now, in doing the tax reform, it is also important to recognize that there will have to be a decision made about whether the tax reform is revenue-neutral with respect to simply the current income taxes, individual and corporate, or whether it might also involve the payroll tax, I think that's a very important design issue.

To my eye, it would be much better if we could somehow solve the problem and take the payroll tax on at the same time. Now, that inter-mixes tax reform with social security reform and that's probably politically unfeasible. But from the point of view of thinking about raising revenue, the United States finds itself in a very unfortunate situation in my view.

It's relying on an income tax that's increasingly only paid by a small fraction of Americans, and instead the tax that most Americans are familiar with is the payroll tax. And that's one of the least desirable taxes that one would want to rely on heavily. So it would be nice to solve both of those problems simultaneously. I don't know if that's going to be possible.

Now, one of the things I wanted to do when I took this job was to give a list of reasons why I'm not favoring a consumption tax. I mean there's a whole bunch of things that gets tossed around out there in terms of reasons why we might want to have a consumption tax, restrict the national sales tax version, which I'm not a fan of. And those typically come in about four areas. Number one, somehow it's just going to be simpler. We're going to have this nice simple tax — it won't be simple.

And one of the things that income tax advocates often complain about is that they — we are comparing the current messy system to this ideal consumption tax, that won't be the way it turns out. There will have to be some very difficult administrative and implementation calls made, and enforcement of the tax code is inevitably something that produces some very messy rulemaking. I think that's part and parcel of the future. So I'm not arguing that somehow this is going to be radically simpler.

I think it will be a better tax system. The second argument that's often made is we have to have this consumption tax, where everyone can see on their — on the sticker, the price of government. And every time you go to the store, you're reminded of just what's going on in Washington. I think we've proven pretty decisively in recent years that you can spend the money, which is the real commitment of the resources without revealing the price to the government in the tax code. And so I don't think this is going to radically change that.

It's the level of spending that matters, and that has to be controlled. Visibility can be achieved in a lot of different ways. I also want to put aside the notion that somehow this is going to raise the personal saving rate, that somehow we just, you know, tax consumption people will save and that's not what this is about.

It would be nice if Americans saved more. It's absolutely essential that the national

savings rate rise in the years to come. But I'm not advocating on those grounds.

And finally, I think it came up at lunch, where I came in at the end — I'm not arguing this on the grounds that somehow we will have a tax which is now border adjustable and will match the rest of the trading regime of other countries and thereby solve our trade imbalance.

Our current account balance is the difference between our saving and our investment. The tax code is not going to be the one that solves that problem. And I want to take that aside as yet another red herring that often comes up in this debate. So why should we have a consumption tax and why should it take that form?

Well, where I come, from the purpose of the tax code is to raise money, which is to say, it is supposed to make people poor. And the goal is to make people poorer in the most desirable fashion possible, and this one I think has exactly the right attributes.

First of all, I agree with what Gene said. The tax code should mean something. It should be founded on some underlying set of principles that are defensible, and it should not just be an arbitrary set of rules that collects revenue from those who are unable to defend themselves.

So I think it's appropriate in a modern economy to configure your tax code on the basis of how much people take out of the economy. One of the undesirable features of an income tax is the taxes; they are returned to labor and they are returned to saving. So if you contribute to the economy, if you go to work and actually help out or if you supply capital and thereby encourage physical capital formation on new technologies, and income tax penalizes you for that effort.

A consumption tax is fundamentally oriented on levying the tax on those things that are withdrawn from society and thereby diminishes the capacity to get larger in the future. And I think that's the issue of the day, and we should have a tax code that squarely takes on the issue of the day and tax people on the basis of how much they consume.

If you have two rich people, one of them is Sam Walton and one of which is Paris Hilton, I don't think you want to tax them the same. I think you want to recognize that if Sam's still driving a pickup truck, he's contributing a lot to the society, and configure the tax system to match that. That's step number one in having a tax code that means something.

Step number two, is to make sure that that tax code is fair. And one of the uncomfortable moments in the debate over consumption taxation is somehow this perception it that will be a tax code that's somehow radically unfair and regressive. And it's important to recognize that that is not the case. And that in fact a consumption tax can figure the way this one is configured, as a tax code that is going to look an awful lot like the income tax in an ideal sense.

So why do I say that? Well, the key is the difference between the treatment of savings and investment. Under an income tax we are going to tax that, under a consumption tax

we are going to exempt it. And mechanically, the way it's exempted under the X-tax is that at the business level you subtract off all purchases from other businesses, including your capital purchases. So you, in effect, expense all investment under the X-tax.

Well, under an income tax, you wouldn't expense things. You don't deduct upfront, you depreciate it. And so instead of getting all your depreciation allowances upfront, they're spread out over time. And so the only difference in this tax basis from that point of view is the timing of when you get the money into the Treasury, a lot less upfront for consumption tax and as a result, more down the line when there is no future depreciation.

Well, that's a difference that just most money through time at the Treasury borrowing rate, because under the consumption tax, you're not going to get that upfront tax revenue. Well, if two tax systems differ only by the Treasury rate of return and that's all they differ by, they can't produce a radically different income distribution. I mean, the millionaire next door notwithstanding, very few people get really, really, really rich by holding on to Treasury bills over their lifetime.

The key to the way this works is that the system essentially acts like one large unlimited traditional IRA. You get the deduction upfront, but you tax everything when you withdraw the principal plus the earnings. That means you tax any luck you might have, any market power you might have, any ability to lobby better than comparable firms in your industry, all returns above the Treasury rate return get taxed.

So this doesn't look like a radically different base. And in fact it's a tax system that will fairly tax people and can be tailored to the progressivity desires in the society.

Well, if it's not that much different than an income tax, why do it? Well, it has I think big efficiency advantages. Among the most important, right now, is that it would equalize the tax treatment of all investments, not just across physical assets, but it would equalize the treatment across physical and intangible assets, everything gets expensed, physical, and tangible, and human capital assets.

It's important in the economy as it evolves to recognize that enormous amount of value out there is not being derived from the physical assets, the tables, the buildings and all the things that are most easy to measure; it's the harder things. And by doing it upfront, we take the measurement issue off the table and make the investment allocation much more efficient. I think that's important for America in the years to come.

Certainly, you're going to tax the return to labor, because in the end you will work, you want to consume at some point, and that distortion will remain. So you don't want to overstate the case and pretend there are no distortions, but this will be a more efficient tax system. And one of the things that it will do is it will be more feasible and it will be a tax system that will actually stand up to time.

And one of the lessons of 1986, I think, is that we put in place the perfect tax code for the 1950s. We put in place something that looked just as close to a Haig-Simon's income tax, as the political system could muster at a time when it was no longer possible to run a

Haig-Simon's income tax. Why? That tax relies on the taxation of financial transactions. One of the features of the X-tax that is most striking is that it's all based on real economic activity.

The business level tax is based on all your revenues coming in, subtract off purchases from other businesses, tax it, get it right at the source before any dividends are paid, before any interest is paid, before any financial transaction begins to take place. And by focusing it on real economic activity, we're much more likely to be successful in capturing those tax dollars.

Once the money gets out into modern financial markets, we don't know where the capital income is on the globe, what year in which it was earned ,and how to correctly adjust for depreciation or inflation or anything. It's just not feasible to try to tax capital income anymore. We should stop and instead go to a tax system that won't unravel, but instead will stand the test of time and has the other features that we want — the progressivity and the efficiency in the allocation of assets.

Now, the flip side to being feasible is that instead of sending their finest young minds off to MBA and then finance schools so that they can, for tax purposes, transform one transaction into another to realize income in one form versus another, and basically waste the finest young minds of each generation, we should send those people off to do something good like finding a cure for Alzheimer's, and that would be the great game for moving away from a tax based on financial transactions to something that's based on just real economic activity and had the other virtues that we would like.

So I think the way to go is to move toward a consumption tax. We're halfway there; we've got a tax system that's neither income nor consumption tax. It's a hybrid, is a highly inefficient hybrid. We can make it a much better tax system by moving toward the X-tax. We've already got the machinery in place in the way of entity level taxes and individual and household level collection.

We should take what we have in place and finish the job in a way that we didn't finish in 1986 because we went the wrong direction.

MS. OLSON: Thank you, Doug. So we have the X-tax in 12 minutes. Now, Rudy.

MR. PENNER: Thank you, ma'am. Well, I was asked to discuss what role budget rules might play in the formulation of a better budget — better tax policy. And indeed they play a very important role. Ovid said, "The gods have their own rules," well, so does the Congress. But I'm being redundant.

(Laughter)

MR. PENNER: The Congress, in fact, has a vast multitude of rules, and I don't think I'm exaggerating much to say that the history of the Budget and Impoundment Control Act of '74 and the Budget Enforcement Act of 1990 is one in which rules have been promulgated.

Congress has found loopholes in those rules. More rules have been promulgated to close the loopholes, they find loopholes — and on we go. So the end result is a set of budget rules that is so complicated that no single human understands them all with the possible exception of Doug, of course.

(Laughter)

MR. PENNER: But I have heard Budget Committee staffs admit that sometimes they make mistakes in knowing what budget actions are permitted and what are not. This is — complexity is extremely important because the Congress really is a true 500-pound gorilla that can do whatever it wants. It can follow the rules or it can break them if it finds them inconvenient, and the only real restraint on them is public opinion as shaped by the media.

If the rules are so complex that no one understands them, it's impossible for the public and the media to know whether the Congress is behaving responsibly or irresponsibly.

Now, I don't want to say that rules are totally useless. There are limited circumstances in which they can nudge the Congress into behaving better than they would otherwise. The pay-as-you-go rule established in 1990 was one that worked extremely well for a time. It required that all tax cuts or entitlements be paid for, both in the first year and over whatever time horizon the Congress was using for the budget resolution.

And another successful rule that helped shape the Tax Reform of '86 was the one that required that the Act be revenue-neutral and that all amendments, while it was written, be revenue neutral.

Well, what made these rules successful when so many others have failed or have been easily circumvented? I would argue that there were two conditions that were important. First, the rules were bent back by a broad bipartisan consensus. Second, and this is really important, while they helped encourage responsible actions, neither rule imposed significant political pain.

To understand the success of pay-go, I think it's vitally important to understand its history. It was preceded by the bipartisan budget agreement of 1990, which was the biggest deficit reduction package in history. Both political parties shed much blood in negotiating the package that involved large spending cuts and major tax increases.

The first attempt at a package in fact failed to pass. And having endured so much time — so much pain in getting the package finally passed, members of both parties were concerned that it would quickly erode. So to protect that budget agreement, they invented pay-go, along with caps on discretionary appropriations and outlays.

But it's very important to know that the only purpose of pay-go was to prevent Congress from increasing the deficit. It did not require that they reduce the deficit. Thus it was relatively painless compared to the budget agreement that preceded it. Well, pay-go continued to be successful enforcing the Budget Agreement of 1993 which was almost as large as 1990.

And that's a bit hard to explain, because the '93 agreement, of course, was not bipartisan, the pass that relied entirely on Democratic votes. But although the agreement may not have been bipartisan, I would argue that the goal of deficit-reduction still was.

Well, pay-go continued to work well until a budget surplus emerged by surprise in 1998, and after that it totally broke down, even though it didn't legally expire until the end of

fiscal 2002. And the rule had little political support really after the deficit seemed to go away, but rather than repeal the rule, the Congress waived it routinely.
Now, some, mainly Democrats, would like to reconstitute the traditional pay-go. But I think there is essentially no chance that it would work under current circumstances. A new pay-go based on current law would force the Congress to pay for any relief that it gave for the alternative minimum tax that would force it to pay for any extension of the Bush tax cuts. Thus, very much unlike the original pay-go, it would require a major deficit-reduction through either a major increase in tax burdens above current levels or a significant cut in entitlements. And I think that is just too much pain to ask any rule to impose. Now, pay-go might impose some discipline if it was redefined to start with current tax burdens or based on a new bipartisan budget deal. Now, Chris Howard offered some very dim hope for such a thing this morning.
I find it unfortunately very hard to imagine such a deal given the current poisonous partisanship on Capitol Hill. Well, although pay-go worked well for a time, it was not without its flaws. There was a little gaming, but only a very little, given that there were in fact large loopholes that could've been exploited.
Perhaps more seriously, while the policies that were encouraged were fiscally responsible, I think it's very important to differentiate fiscal responsibility from good tax policy.
Those who watch the process carefully said that often if somebody wanted to create, say, a $50 million-tax expenditure, they would just look down the list of existing tax expenditures, find something that was worth $50 million and use it to pay for their favorite expenditure whether it was good policy or not. There was a sort of tyranny of numbers that really drove actions.
I find it actually hard to say anything bad about the revenue neutrality rule that shaped tax reform. I think it was a widely received notion before 1986 that you couldn't possibly get tax reform unless there was, in that, a tax cut that would reduce the number of losers. But revenue neutrality became an important disciplining goal for the '86 process. I don't think that if you had some rule that said, "Keep it neutral minus $50 billion," it would've had nearly the moral authority. I remember watching the markup in Senate Finance when someone offered the amendment to restore the 100 percent deduction for meals and entertainment. And I remember Senator Durenberger saying that he withdrew from the debate. He had a conflict of interest; his son was a bartender.

(Laughter)

MR. PENNER: But anyway the staff went away and they calculated what increase in the marginal rate would be necessary to finance this amendment. And there was only a few tenths of a percent, as I remember, but the debate ended immediately. It was quite remarkable how much force this revenue neutrality rule had. Well, another important rule that shapes tax policy is a part of the Byrd Rule that prevents reconciliation bills from increasing the deficit beyond the Congressional budget's time horizon.
That certainly seems reasonable enough if you believe that 60 percent of votes should be required to increase the deficit in the longer run. But it has an important downside that has caused a proliferation of temporary tax measures. So the tax policy becomes very uncertain and that has a significant cost, especially when you're talking about something

like the estate tax or the R&D tax credit where their provisions, theoretically at least, require a lot of long run planning.
In general, because budgeting is done in the Congress with a truncated time horizon, the budget process has a lot of trouble with tax changes whose long run and short run revenue implications differ significantly. Most of these problems arise in tax changes that affect saving and investment. The problem can go both ways. The Roth IRA costs much more in the long run than in the short run. The accelerated depreciation costs much more in the short run than in the long run.
There was a time when I thought we should try and solve such problems by making a lot more use of present value concepts as we discussed this morning. That's a real problem because much of the Congress and certainly the public doesn't understand what present values are.
And if you think about it a little bit, present value accounting would open the door to gaming that would make past cheating look relatively minor. So my bottom line is that too much intellectual effort goes into trying to develop and interpret rules designed to bring about sensible tax policy.
The debate should be much more focused on the substance of tax policy themselves, not on the rules governing them. I'm not arguing that debates over substance will often lead to the broad-based low tax rate systems favored by economists, but extremely complicated rules are unlikely to accomplish that either.
The whole panoply of rules associated with the Congressional budget process needs a critical reexamination. Indeed it may be time to admit that the budget process is broken beyond repair.
It's hard to seriously discuss redesigning the rules for enforcing Congressional budgets when the Congress has not even passed the budget for fiscal 2007. But to the extent that we try to reformulate the rules, we should be guided by one admonition, "Keep it simple."
Simple rules will often be circumvented, no doubt about that, but so are complicated rules. The main point is that everybody should be able to understand when the rules are broken. Then I think there is some chance that Congress can be embarrassed into behaving better. Thank you.

(Applause)

MS. OLSON: Thank you, Rudy. I think — I'm not sure who decided the schedules for the day that tax returns have to be filed for those of us who are late filers. But having spent several hours last night pouring over a very fixed set of returns, I can tell you that I really appreciate the suggestion that we keep it simple, at least as it applies to taxes if not budget rules.
I'm going to throw out a couple of questions here to get things started, and we do hope to have lots of interactions with the audience.
Gene and Rudy, you two in particular talked about partisanship, talked about principles and the importance of principles. And without meaning to criticize any current members of Congress, I must admit that my years at the Treasury Department suggested to me that principles are paid little attention to today when it comes to actually legislating.
You hear a lot about it in committee hearings, in markups, but by the time we get to

passing legislation, the principles seem to have been cast over the shoulder in the favor of the best sound bite rather than the soundest policy. And I wonder whether or how we get back to the kind of process, principled process that drove the debate in 1986.
MR. STEUERLE: Well, obviously, there are a lot of steps along the way and I can't speak to all of them really how we get there. I mean, among them is leadership. And I do think there was a time in the mid-80s when we had leadership on both sides of the aisle on the Hill. From Dan Rostenkowski to Bob Dole to Durenberger when he was there, to several other members, Howard Baker, who I think really did take on a leadership role.

And I am not saying that they didn't play a lot of politics in the end, but I think they really did exercise leadership that at times did go to principles. The other thing that I alluded to in my talk is I think that the power of the nonpartisan and the bipartisan staffs largely has to do with their ability to come up with sort of the first draft. And it's not that we didn't often lose the debates in the 60s and the 70s and even the 80s over the first draft we had proposed.

And certainly I think between Treasury I and tax reform in '86, there was a lot of bad things, political compromises, that were made along the way. But we got to do the first draft. And the first draft often does at the baseline for what's being done. You know, Rudy talked about rules, sort of, in the formal sense, but there are all sorts of informal rules. The very fact that you take up tax reform and you don't do something else, the very fact you take up a particular bill or you do a budget agreement, you're going to go for $500 billion in deficit reduction.

All these things are rules. So, you know, if you think about it, any time Congress acts in some way, there's something that holds in what they're doing and doesn't hold it in. And so the power of the first draft to start to set some guidelines, and hope to keep that within those guidelines is very important. And it's not so much that the nonpartisan staffs I think are weaker in the sense of the quality of the staff. It's just they have less access.

The lobbyists, who was it earlier mentioned, the lobbyists designed the bills today. I mean, you know, Treasury doesn't actually design the bills anymore. There used to be a time — you remember the '69 Act, we are talking about the '86 Act, the '69 Act was designed in the administration of Lyndon B. Johnson and without barely skipping a breath it was taken up by the administration of Richard Nixon.

Almost the same Treasury staff goes up and advocates for the same things that they were worried about in '68, they got in '69, and it gets passed under the Nixon presidency. So there was a time when that controlled that — that first draft became more powerful. How to re-jigger the balance so the nonpartisan — the bipartisan — staffs can reset the original agenda even if they lose later and the lobbyists have less control, goes all the way from the issue.

What process you should set up, to what leadership you have, to probably to the issues of lobbying reforms, which I know sort of less about. But the power of the lobbyists to take all the time of the legislatures and not have them even listen to, sort of, some of the other issues, I consider it to be a major problem when we have to deal with it.

MR. PENNER: Well, I think another really major problem involves — I call it — the intense partisanship. But that goes beyond that. It's not only Republicans versus Democrats, but House Republicans don't think much as Senate Republicans and vice versa. And there just seems to be an incredible amount of fractious debate these days. That's much worse than I think when I worked in the Congress.

And I think that means to get almost anything through, you can't depend very much on goodwill; you just got to buy people. And we've seen that in numerous recent tax bills where all sorts of people are being bought out. Now, I'm not sure what you do with that. We're going to come from an election campaign in which Democrats are going to be accused of being pro-terrorists and Republicans are going to accused of cuddling pedophiles. And they're not going to come back to Washington in a very good mood after this campaign.

(Laughter)

MR. PENNER: But somehow I think we have to go back to — yeah, I'm old enough to refer to the good old days where you could have the kind of leadership that Gene described, which is so crucial in developing the tax reform of 1986. Maybe it will help. Certainly, the Congress, in my view, on fiscal policy matters worked extremely well in the early '80s when we had the Senate controlled by Republicans and the House controlled by Democrats, and a number of people have made the points. And maybe that's a big hope, that we will get some sort of bipartisan government in the near future.
MS. OLSON: Doug, any comments on that?

(No response)

MS. OLSON: Okay. So leadership from both of you is key. One of the things I'm wondering is whether there is an action forcing event. The budget rules I gather aren't going to bring us there, Rudy, because you think the budget rules are broken. And if Congress can't fix the budget rules, maybe it can't fix the tax rules either.
But we've got some impending fiscal crisis not too far down the road with Social Security and Medicare and Medicaid costs rapidly rising. And one or maybe more than one of you have said that it would be difficult to take on entitlement reform and tax reform. But query, might that be the action-forcing event? And can we take on tax reform without looking at entitlement reform?
MR. HOLTZ-EAKIN: I, at least, think the answer to the last question is easily, no. I mean there is no way we will tax our way out of the potential growth in the entitlement program. So it's imperative that something be done on the spending side of the budget, and sooner would be better quite frankly. So that then raises the question, you know, what are the action-forcing events.

And I think the most powerful force in favor of big reform is arithmetic because as you go forward on the spending side, you'll have defense costs rising. I don't see anyway that they're going to go down. We're not going to get a pieced event of the type we got, that helped us in the 90s. They're going to go up. Both the base defense budget, and whatever is going to happen for operations abroad.

Holding non-defense discretion spending flat for the next millennium is going to be hard, I think. So that's a pressure upward. Social Security, Medicare and Medicaid, they get bigger and bigger and bigger. So how do you do that? And take out $50 billion and then $60 billion, then $70 billion for the AMT, and make it all add up. You can't. So that looks bad. I mean, that's why you want to put option on the presidency in 2008. I mean it's just —

(Laughter)

MR. HOLTZ-EAKIN: You know — and so, you know, if in fact we don't come to terms with that, financial markets will force the action. It will be better for there to be a leadership of the type that my colleagues had described to proactively take on this issue. And that would be the best action-forcing event.
MR. PENNER: I think the lessons from other western democracies are not real reassuring in this regard in that if you look at the various Social Security reforms that have been undertaken in Europe and in Japan, and they have been massive, they have been pressured either by severe budget crises or budget crises accompanied by economic crises.

I think the real trick in all of this, and I'm not sure how to do it, is to create artificial crises because in Europe some of the crises were artificial, caused by the Maastricht Agreement, the Maastricht targets, and deficits which pushed action. And when those actions occurred they were very often bipartisan actions. The countries had no choice but to reform.

So Graham-Rudman caused such a crisis, which led to the Budget Act of 1990. I thought there were a lot of things wrong with Graham- Rudman, but some more sensible version of that may be the way to go in all of this.

MR. STEUERLE: You know, psychologists often argue that people are very reluctant to do things that involve pain to themselves. They'll put it off and put it off and procrastinate. That's what we're talking about with politicians is they don't want to undertake the pain of reform. But the same psychologists often comment that when the pain of inaction becomes greater than the pain of action, we move.

So when the tooth is really hurting, that's when we go to the dentist even though we may dread sitting in that chair. I think it's possible to find — I mean, I think with leadership you can define pain in a way that is not just some point in the future but it is more today. I mean this has to do with I think — they're always I think of doing budget accounting.

They would recognize more of the taxes we're imposing on the future. And not that vague, inter-generational accounting, but to list the tax levels, the expenditure levels which is actually what they really are because we've got to pay for them. I think the president, whether they're talking tax reforms, or Social Security reform, can define things like alternative minimum taxes as raising burdens on people in an unfair way.

That makes it harder for somebody in Congress to dodge the issue. This certainly

happened in the '86 reform. Certain things got redefined in ways that it became very hard for Rostenkowski or Packwood not to act. We talked about this in a couple of panels. The pain of inaction all of a sudden became greater than the pain of action. I think you can also put responsibility. I think it's important on particular individuals.

Like you're the Treasury secretary, I'm going to hold you responsible for whether we get this done or not done. Or you're the head of the Ways and Means Committee, and we haven't had a president that has done that in a while.

But you put the onus on individuals and all of a sudden it's harder for them to back off from that responsibility, as "I couldn't do anything because it's the other party." So I think there are ways of playing this game if we really want to undertake reform.

MS. OLSON: Okay. Observation about the AMT and I'm going to take this first question here from the audience. I guess I've a reflection on the AMT that's not unlike Len Burman's comment at lunch about "What's wrong with taxing seniors?" What's wrong with the AMT overtaking our tax system? Isn't it backdoor tax reform, and isn't it an improvement over what we have?

MR. STEUERLE: Well, the AMT does two things. It gradually takes away the state and local tax deduction which we could debate one way or the other, whether you like that or not. And it taxes dependents as tax shelters. It's the sort of the two major revenue ways of the AMT, the notion that it is really broadening the base in this other sense is — this is just foolish. It's just got all these other problems remaining.

I mean, there's this notion that it's a flat rate. It's just not. It's not a flat rate system and people phase in and out of it, by the way raising marginal tax rates and the phase-in rates. It's a myth that the AMT is somewhat of a base-broadener that — that gets this reformed.

It's just another, you know, add-on to the system; confusing. And, you know, yeah, we can handle with our triple-taxes and everything these days, but it's — but it hardly affects along the lines of tax reform.

I mentioned earlier — I mean, we got all these in the tax code, and it is interesting with no sense of — what do we really want to do about housing policy? You know, what do we want to do about pension policy? Even under Doug's consumption tax, you have still got to figure out what you want to do as a pension policy. You're not done by saying, "Well, yeah, substance tax has certain implications."

I mean, we have — it's just hard work to deal with all these issues. And I — my fear lies when we talk about tax reforms so broadly is just, sort of, like we want to wash all these issues to the side. We've got hundreds of programs in the tax system. And we've got no less excuse for dealing with the tax system than we do in the expenditure system.

MR. HOLTZ-EAKIN: But I would say that's part of the problem. The tax code is supposed to raise revenue. It's not supposed to be a pension policy; it's not supposed to be a health policy, it's not supposed to be a poverty program. It's a tax code. And we've lost

sight of the primary job of the tax code, which is to raise revenue in a sensible fashion. That's what I think we need to do.

MS. OLSON: Okay, question.

MR. OOMS: Van Ooms from CED. There seems to be an underlying assumption here that when things get bad enough and the crunch comes, that the solution is then reform of some kind. Taking a very long historical perspective I think one could argue that when the crunch comes, the solution may be to inflate our way out of it rather than reform.

And that reform may just be for all the reasons we've heard much too difficult. And inflation may be the easier option. And it might take a very, very, very brave Federal Reserve to stand up against the kinds of pressures that might develop in those circumstances. I wonder if there's any comment.

MR. PENNER: Well, having worked a lot in countries that tried to inflate their way out of it, I was in — working in Georgia just after they had 10,000 percent a year inflation. The one thing you learned from those episodes is that, "Hey, the government can raise a remarkable amount of resources using hyper inflation and the tax on monetary instruments, the senior, and so forth."

However, they can only do it one year because at a certain point people just stop using money. So while a lot of these countries tried to inflate their way out of it, they ultimately had to engage in real fundamental reform.

MR. TITTLE: Martin Tittle. I'm wondering if there are transition issues involved in the changing to a Bradford X-tax, and if so what they are.

MR. HOLTZ-EAKIN: Yes, tons.

MR. TITTLE: Thorniest one then, if there are too many to discuss.

MR. HOLTZ-EAKIN: Oh, I — they really come in two bundles. The first of the bundles that are shared with the income tax. So like an income tax, you know, a consumption tax, an income tax is taxing consumption plus a little more. So you have to get all the consumption to begin with. And so that's housing, health, employer- sponsored health insurance, all of the things that would be involved in the politics of that.

The state and local tax deduction, whether you view that as consumption provided through those governments and how you think about those conceptually. So there's a lot of issues there. Then there's the additional issue of the existing depreciation that firms have outstanding, and how you want to honor, dishonor or otherwise treat that in a transition. Those are the big ones.

MR. STEUERLE: But — can I?

MR. HOLTZ-EAKIN: Yeah.

MR. STEUERLE: I was just going to add. For those of you who are interested, I guess it's — the same group here has sponsored a conference on taxation of capital income recently.

MR. HOLTZ-EAKIN: Right.

MR. STEUERLE: We have a book coming out hopefully near the end of the year. It covers a lot of these issues. I invite you to, if you're interested, give us your name or e-mail or anything, and we'll get in touch with you when that's published.

Among the best articles there are some by a couple of lawyers on both sides of this issue identifying all the shelter opportunities available in both the consumption and in income tax.

MR. PENNER: When long ago I was involved with Senators Domenici and Nunn in an attempt to develop a progressive consumption tax. And we ran into a transition issue that I've never seen in any textbooks. It was related to the depreciation issue. But there are all sorts of other instances in which corporations have essentially, I say, prepaid income taxes. I have all these net operating loses they haven't used.

They got foreign tax credits. They got alternative minimum tax credits. And even in that day, they still had investment tax credits so they had, you know, just left over. And these things are worth many, many billions of dollars, and we just couldn't contend with it. And believe me, we — I think we heard from every corporation that had some of these things.

And they are embedded in the balance sheets as everyone here well knows. And there's some corporations that will have negative equity, if — negative book value, if you remove these things. So I see that as enormously thorny political issue in terms of getting the business community onboard for any kind of X-tax approach.

MR. HOLTZ-EAKIN: I think Rudy's got the politics right. But you want to remember that if you only have positive balance sheet because of tax provisions you are not much of an economic entity – those are the guys I want to get.

MS. OLSON: Accelerate or demise. Question right here.

SPEAKER: Hi, I am Aviva Aron-Dine from the Center on Budget and Policy Priorities. Another question about capital income taxation. I was just wondering, given that under an X-tax you allow expensing but then you have to stilt tax business earnings, will that necessarily address some of these international capital mobility issues that you were raising?

MR. HOLTZ-EAKIN: It will address some, but it's not a panacea for things like putting the revenues in the United States or outside the United States based on transfer pricing and things like that. But it does attempt as its primary objective, I mean the big picture, to tax based on real economic activity and not the financial structure of the business entity. And that I think is the virtue.

Again, one of the things I want to take off the table at the offset is this naove optimism that there would be no shelter opportunities, you know, the original Hall-Rabushka flat tax printed on a postcard and wasn't that neat? But, you know, we do have Turbo Tax, we'll get over it. These are real issues, but base the tax system on something meaningful like how much comes out of society which is consumption and real economic activity, not your ability to undertake tax based financial engineering, I think should be a central goal of tax reform.

MR. STEUERLE: Can I just mention — just back to the transition, are other issues. I remember when in charge [off mic] were looking at Hall-Rabushka back in the late '80s, one of the issues that came up was interest payments out of the firm. If you tax interest payments out of a firm automatically it's being light consumption, which is sort of the way some of these flat taxes work. You've got to deal with the issue that if you tax them domestically in the United States, you pay them to a foreigner that has an income tax, that interest payment could be taxed twice. So there are a lot of very difficult international issues. The only thing I would say — actually I have to say in Doug's defense is — I don't know, not many, any of the international issues are easy and any of these tax systems —

MR. HOLTZ-EAKIN: No, because some tax will make any of them worse, they are just awful.

MS. OLSON: For those of you who are interested in more about transition, the tax reform advisory panel in its book last year, which I think is a very worthwhile reading if you haven't picked up a copy, but it's about 272 pages, does a very good job of walking through some of the transition issues because one of the plans they put forward was something called the growth and investment tax, and that is essentially the Bradford X-tax.

Note that at least in gauging the reaction of the business community to an X-tax, particularly the growth and investment tax plan that was put forward by the tax reform advisory panel last year, that there is a — even moving past the transition issues, when companies try to assess what the tax system did to them relative to current law, there was a remarkable lack of enthusiasm for the plan because the tax rate still stays fairly high, because the base does not expand enough to do much to bring rates down. I think that at least from my perspective of what I see going on in the business community, the thing that's driving investment decisions most today is the sticker price, if you will, the sticker price being what is the percentage rate that's applied to business income.

And so long as that rate stays fairly high you still have to the extent thattax [off mic] the balance of where to locate your investment, you still have that lower rate as a big attraction. So that's not going to go away regardless of the system that you operate under.

MR. HOLTZ-EAKIN: No, I feel that's the biggest tension in this - - you know, the X-tax had this business rate and the top individual rate matched up for purposes of avoiding incentives to turn something into a new business or vice versa, and unfortunately that business rate is the key international issue now. The base is less important than the rate at

which we tax corporations and so you like that thing to be very low for international tax purposes. But that's at odds with having a set of progressive rates at the individual level that matches the business rate. And that is absolutely an example of how you can't get everything with any single tax system.

MR. STEUERLE: Can I just add here, another issue on subject tax that is quite perplexing is if you actually just go to an X-tax and that's how you do it and the rest of the expenditure and other system stays the same, you've got this sort of crazy system where the poor middle class are basically in income tax systems because once you phase out educational credits and earned income credits, and food stamps, and TANF and everything else, basically you have all these benefit systems with income taxes. I mean let's face it, you know, we talk about tax expenditures, but there are expenditure taxes. The expenditure taxes, all these tax systems that back up all these expenditure systems, they all are based on income taxes.

So you're setting it up in this strange world where the push is to have consumption taxes on the rich and income taxes effectively on the poor and middle class. So it is often wondered if we really believe in the principles of consumption taxation. We're concerned about the incentives to save. I don't know why we don't focus more on — I say Mike Graetz does [off mic] proposal, that's why we don't focus more on why don't we move towards the consumption tax world for the poor and the middle class if that's what we're really after. I worry about their savings centers, why does the consumption tax debate always start at the top and never sort of work its way down through the income distribution.

MS. OLSON: We've got a couple of hands up here, and I think the microphones are up somewhere.

MR. GRAETZ: I have the microphone.

MS. OLSON: Michael with the microphone.

MR. GRAETZ: Michael Graetz from the Yale Law School. A couple of things I want to say. One is, the reason that I ended up going to a credit method value-added tax in my suggestion about tax reform rather than the X-tax, is that I don't believe the X-tax will work. I don't believe it will work because I believe that while you can sit there and say that you're going to distinguish between real and financial transactions, that the lawyers will take all your money away if you think you can do that first.

Secondly, that the international problems are huge, which led the president's panel to conclude that for implementation reasons, not for trade balance reasons, that they needed to have a border- adjustable X-tax essentially, which violates the WTO and therefore in addition to getting our Congress to pass it, you have to get the WTO to agree to it.

And then third, the transition problems that have been discussed and I think you have identified the right ones. We are so serious that David Bradford himself ultimately suggested running the income tax and the X-tax side by side for 10 years in order to get a

transition, which is not — a concession of that sort from David is not one that would give you a lot of confidence that you can transition easily.

And so I think you actually need to keep an income tax in order to avoid these transition problems for corporations and for individuals. But what you really need to do is get the rate down. And so, you know, what I do essentially is substitute 14 or 15 — I don't know how many of you know it does, but it substitutes to 14 or 15 percent value- added tax.

For much of the income tax it eliminates from the tax roles — from the income tax rolls, anybody with income — any married couple with income of less than $100,000. It reduces the income tax rate down to 20 to 25 percent on individuals and to 15 to 20 percent on corporations, which I think is crucial in the current world because of the transfer of pricing and other problems. And it gets the 100 million of the 135 million which turns out of the system.

And Gene says, well I don't deal with reforming the income tax at the same time. And I just want to respond to that by saying that I believe the reform does deal with the income tax in the sense that it's a major structural reform that eliminates for Congress the benefit of passing things like education credits and so forth, because most of the social and economic policy that we see through the tax curve is not special interest provisions. The big items are general interest provisions that are designed to reduce taxes on the wide middle class group of taxpayers.

And I think the only way to get Congress out of the habit of doing that is to eliminate people from the income tax and to realize 150 other countries around the world do rely on a credit-method value-added tax, which one need not argue is simple or slight spread, but it works.

We know it works, it has some leakage and it has some problems, but we know it works. And then I see Charlie McLure in the back, which reminds me that when we testified together before the president's panel Charlie made the important point that if you start putting exemptions into a subtraction-method value-added tax of the X-tax sort, you'll create another huge set of problems because you don't pick it up later in the system.

And then finally, since the X-tax looks a lot like an income tax, it's very easy to change it back into an income tax by changing your expensing, your money — well let's not have full expensing, let's have half expensing or let's have depreciation. And then you've got an income tax which includes interest income at the business level, and you become the only country in the world that taxes interest on a source basis, which was a big problem with the CBIT proposal — and again with all these proposals — but it was a big problem with the CBIT proposal that the Treasury came out with in 1992, which has also great advantages but has some serious drawbacks.

MR. STEUERLE: Can I ask a question?

MR. GRAETZ: I guess I could say, and Gene, what do you think of that?

MR. STEUERLE: Well, as you know, Mike, I've —

MS. OLSON: Gene, I think you should start by noting that Michael also had a hand in designing the '92 CBIT proposal.

MR. STEUERLE: Yes, that's right. Well, and in fact Michael knows that I am a fan of his, partly because he and I have this contest of who can tackle new issues first and always are at least jealous of each other whenever the other one gets to it before the other one does. Michael, my criticism of your plan is actually more for its incompleteness than for thinking about trying to use VAT as a base. And I think you would agree with that because you would even come back and try to work with us, for instance fixing up the income credit, which in your initial plan you didn't pay a lot of attention to.

And my point is at the top you got these things like health policy and pension policy and housing policy, and nobody is going to tolerate that. You say, well, politically they're all getting around doing it, but no one's going to tolerate housing tax breaks and pension tax — well, I don't want pension policies at that point — but pension tax breaks and health tax breaks for the rich and not for the middle class. At some point, these are problems you are going to deal with. You might say just throw them on the expenditure side and reform them, but I am saying that those agenda items will remain, and I am not sure you will disagree with that point.

MS. OLSON: We've got some other questions, we didn't get some mics here — this lady right here has had her hand up for a while.

MS. GREZLER: Rachael Grezler, the Joint Economic Committee. I am just wondering if the only way to achieve a consumption tax politically is to provide a very generous compensation in the transition. Is it so worth it to do that?

MR. HOLTZ-EAKIN: Depends on what you mean by worth it. I mean that's usually posed in computational models of tax reform, as in, are the efficiency gains large enough? And most of the models suggest that you lose a lot of the efficiency gains once you start providing transition relief for the generous type. So, I think that's out there. But I don't think that's really the big gain here. I think we need to find a tax system we believe in that will raise revenues, perhaps more than we are now, to fund the government in the decades to come. And as a result it has sufficient principles that people will believe in it and not unwind it.

I mean, I — Mike addressed a point about being nervous about going to this kind of a tax system because it might turn into something else, reveals all our problems in tax policy. We don't have a debate about what we want our tax system to be. We are all least worried about having a tax system that someone else might turn into something they want it to be. And we need to actually go back to some core principles and thrash this thing out and have a tax to raise the money.

That I think is still worth it, even if computational models don't give you big efficiency gains.

MS. OLSON: We have a question back here and then Steve, please, yes.

MR. GALPER: Hi, Harvey Galper. I think I have the missing piece, Gene and Mike, and that is what Mike is suggesting as currently a zero income tax for zero to 100,000 and a positive income tax above that, and the only piece that you are missing is a negative income tax. So what you need to do is have a negative income tax to the bottom, zero for much of the rest of the range and then an income tax at the top combined with the value added tax. So then you've got the complete part dealing with the lower income side, as well as dealing with most of the problems with the playing and mucking around with the credits and the deductions for the broad middle class.

I do also think though, if you are going to move to a consumption tax, although I used to be a big fan of a real consumption tax, either of the X type of even adding financial transactions to it, I really think that the combination of the complexity of that plus the transition rules are just absolute killers. I really think they are absolute killers.

I mean, on paper it's so elegant, but I really think it's going to be very hard to get there from here. So, I think that the consumption tax that you can get there from here is a VAT. And surprisingly, while the transition rules should and also exist for VAT, I mean you still are imposing the same burden on actually using after-tax income and not getting taxed again when you consume it.

They are not going to come up in the same context as in a VAT as they will come up with when you try to put in a consumed income tax. So I think that — I think that the Graetz way makes a lot of sense as long as you can find this other way of dealing with the issues on the bottom and so to deal with the same fashion as Mike's question, what do you think of that?

MR. HOLTZ-EAKIN: So well, on the first point, I thought in the break points, what you discover is a current income tax system — which is a negative income tax at the bottom and an earned income tax credit, nobody pays for a long period. Then a couple of people pay at the top. So I don't really think that's all that desirable.

I am confused by why it would be such a great thing from a policy and political point of view to get rid of part of the income tax, and with no transition replace it with a VAT when it would be an awful thing to do the same thing with other kinds of consumption taxes. So that strikes me as magic.

MS. OLSON: Steve Entin.

MR. ENTIN: Steve Entin, all right. Now, I am — you will find that our shop was very keen on basing a tax system on principles. And your emphasis on this today I think has been very important. I think tax reform would go better if people were more familiar with the principles, and better educated on them.

Some of the things that have been going on in economic theory in recent decades point to the fact that we are kind of in a transition in a number of ways. And again, that leads me

to that question, is it time for another round?

If by that, you mean, do we need a repeat of '86 based on what we knew back then, and what we thought back then, I would say no. If it means getting to know what we've learned since then and applying it properly, I would say, yes.

And so I have one comment, and two-and-a-half questions. '86 raised taxes on capital. It eliminated the ITC, gave us longer asset life and to the capital gains, differential restricted access to IRAs, gave us the passive loss stuff that will hit the savings of known people, did lot of things.

It was supposed to be compensated by cutting personal rates, and indexing depreciation. When the bill went to the Hill, the Senate pulled the indexing of depreciation to preserve some loopholes for some friends.

And it turned the "Cost Of Capital Reducing Bill" into the "Cost Of Capital Increasing Bill," which hurt us the rest of the decade, and with the payroll taxes paved the way for the '90-'91 recession.

I don't think that we want to do that again. Greg Mankiw and others have been saying that taxing capital now hurts labor, because it reduces productivity and wages. So that's part of my question, who bears the tax on capital. We used to think it was just the shareholders or the owners of businesses, now we are suggesting it's passed on to labor.

And in particular who bears the corporate tax? Economists have always been uncertain. Harberger taught us it wasn't just corporations, it was other businesses. Then he came back and said, you know, it's also labor. So we have been changing our view over the time. We need to know that and the public needs to know that if they are going to judge a tax reform plan wisely.

They have to know that they are paying some of these taxes on capital. The other thing that was brought up this morning, those are my two questions on capital: who bears the corporate tax, and who bears the l? Just one final question.

A lot of people today have been saying that tax reform is going to be driven by the pending ts over the entitlements. And do we need to also address entitlements? Well, of course we do. But I have a question there. Are we better off trimming entitlement growth a lot and avoiding major tax hikes? Our future generation is better off. Or are we better off, politically saying, well, we are going to do some — let's take half taxes and half benefit trimming.

Doesn't that depend on what these programs are worth, and what the relative pain of these tax hikes and benefit trimmings are going to be? And don't we need to know what the tax changes are going to do to income and wages before we plow forward on that? And has there been enough research on that?

MR. PENNER: Now, let me comment on the last point. I mean, I think Doug and others

have already made the point, health costs are growing faster than the GDP, and there is no sign under the current regime they are going to stop doing that. So very obviously, you can't finance very large portion of them out to infinity with tax increases. I mean, it is a simple, simple matter of arithmetic.

So what we need, a necessary condition is what I would call an extremely radical reform of the health system. And I hope you don't ask me what that is.

(Laughter)

MR. HOLTZ-EAKIN: A couple of thoughts, I mean, the first is that, you know one of the things that just generically has to be recognized when we talk about doing reform or not, internal events is that tax reforms is about raising people's taxes. The fundamental element of all good tax reforms is base broadening, which means you put things in that are not taxed.
And then lower rates, that's the goal. And so you have to develop a situation in which that tax increase becomes a good idea. And that's why this is such a hard topic to get into. When we did the '86 reform, one of the ways that this was successfully negotiated, and I think, Rudy made this point most clear is it was revenue neutral. So to the extent that there were going to be reductions one place, they were offset by tax increases elsewhere. And we counted on actual getting more money out of that corporate income tax in order to get the individual level of reduction.
My reading of the history, and people disagree on this is, that's what never showed up, that was the problem. We envision this as an ability to raise these taxes by taxing capital more heavily through the corporate tax. And one of the reasons I'm nervous about aiming back toward income tax is we never got to that capital income. It went somewhere, and I don't think we can get it.
And so I think that's one of the lessons of the '86 reform. And so in terms of who actually pays capital income taxes, I don't think we know the answer to that.
I think we have model specific answers that don't really inform the actual question who pays a capital tax. My point is simply that there is very little difference between the income tax and the consumption tax as the X-tax envisioned implementing it in terms of who pays it. Because it only exempts a tiny piece of the capital income in effect from tax. That's not universally true of consumption taxes. There are other designs, you think of a Roth-style IRA where, you know, once you pay the tax, fine, you get whatever comes out including all the windfalls. That could look very different. And so if you want to go to that style of a consumption tax, I think you have to answer your question. My advocacy for the X- Tax version is the fact that we can't.

MR. STEUERLE: Rudy and I have written quite a bit on budgetary reforms, trying to get it expenditures. My principle concern with building growth into systems or making promises for the future is, none of us know the future.

So no matter how brave we are at designing what we think is the right tax system and the right expenditure system, I don't think we have the right to put that system on to future taxpayers and beneficiaries, 30, 40, 50 years from now.

Even though I recognize to some extent you make obligations, so that people retire they have to have some expectation of what they are going to get. That being said I think basically there isn't sort of a right tax system, or a right expenditure system for all points in time.

And I believe that what we really have to do in the budget context is restore enough slack to the budget so that every generation is really given more power over what they ought to do. If they want to raise taxes and spending at the same time, then they have the right to do it. If they want to lower it at the same time they have the right to do it.

And the debate, the budgetary debate in Congress now is on both sides of the aisle, both sides have figured out that if they can get what they want in now, and promise it for 10, 20, 30, 50 years from now, there is no cost to the budget process, because it doesn't — might not show up in the five-year window or the one-year window, or the ten-year window.

And they can make all sorts of promises, and they lock government in. They don't lock government in, in a way that it can't get around it, but they lock government in that the future policymakers, if they want to do anything new, they want to respond to anything, whether it's a terrorist threat, or some demand for health reform, or actually even fixing up the older systems, so you favor the old old over the young old. You are — the only way you can get there is to renege on a past promise that somebody else made, so you can actually move forward to the future.

So on the spending side, and I think this is more dominated by spending. But it is in the tax system too, with a lot of tax provisions including those on capital income like Roth IRAs, which you can invest and then borrow on the same time without saving a single dollar.

So I think what we've got out in all these systems is a fundamental budget process reform is we've got to stop both sides from being able to make a lot of promises well into the future, and throw it back every year to the taxpayers. And then we can debate the efficiency issues you've raised.

MS. OLSON: All right. Thank you very much. I think our crystal ball says there are problems growing and reform lies ahead, but complete uncertainty as to what shape that will take. Please join me in thanking our panelists.

(Applause)

MS. OLSON: And then I want to thank the sponsors of the event today, Tax Analysts, the American Tax Policy Institute, and the Urban-Brookings Tax Policy Center. Thank you very much.

(Applause)

(Whereupon, at 2:57 p.m., the PROCEEDINGS were adjourned)