

UNITED STATES OF AMERICA

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PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM

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FIRST MEETING

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WEDNESDAY,
FEBRUARY 16, 2005

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The Panel met in the Amphitheater in the Ronald Reagan International Trade Center, 1300 Pennsylvania Avenue, N.W., Washington, D.C., at 10:00 a.m., Connie Mack, Chairman, presiding.

PRESENT:

THE HON. CONNIE MACK	Chairman
THE HON. JOHN BREAU	Vice Chairman
THE HON. WILLIAM E. FRENZEL	Panel Member
ELIZABETH GARRETT	Panel Member
EDWARD LAZEAR	Panel Member
TIMOTHY J. MURIS	Panel Member
JAMES MICHAEL POTERBA	Panel Member
CHARLES O. ROSSOTTI	Panel Member
LIZ ANN SONNERS	Panel Member

WITNESSES:

STEPHEN J. ENTIN	Institute for Research on the Economics of Taxation
WILLIAM G. GALE	The Brookings Institution
FRED T. GOLDBERG, Jr.	Skadden, Arps, Slate, Meagher & Flom
LOUIS KAPLOW	Harvard Law School

PANEL STAFF AND DFO:

JONATHAN ACKERMAN, ROSANNE ALTSHULER, TRAVIS BURK
BENJAMIN GETTO, MARK KAIZEN, JEFFREY KUPFER

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I-N-D-E-X

SPEAKER	PAGE
SECRETARY SNOW	3
FRED T. GOLDBERG, JR.	26
LOUIS KAPLOW	68
WILLIAM G. GALE	80
STEPHEN J. ENTIN	94

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P-R-O-C-E-E-D-I-N-G-S

(10:02 a.m.)

CHAIRMAN MACK: Good morning, everyone.

First of all, I want to welcome everyone to the first meeting of the President's Tax Panel. I'm very pleased this morning that Secretary Snow could join us.

We're going to ask the Secretary to make his comments first. And because of his schedule, we want to give him that opportunity. And then we understand that he will have to leave us.

And then I will have an opening statement that will kind of run through mostly some organizational things, tell you a little bit about how we are going to proceed. And then other members of the panel will have some comments to make as well. And then we will get started.

With that, Mr. Secretary, again, welcome and we look forward to your comments.

SECRETARY SNOW: Thank you, Mr. Chairman, Mr. Vice Chairman, members of the panel. Thank all of you for being here today and the witnesses. You put together an extraordinarily talented group of witnesses today to launch the panel.

I think you know that this is a matter of

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1 extraordinary importance to the President and to the
2 country. The President is committed to major tax
3 reform, to real tax reform, to something more than
4 just moving the boxes around, to finding what the
5 opportunities are here to make the tax code fairer,
6 simpler, and more growth-oriented.

7 This panel has an opportunity to play an
8 extraordinary part, it seems to me, in what could well
9 be an historic effort to reform the code of the United
10 States, that code that touches every state, every
11 city, virtually every American, certainly every
12 American family. And if you can find a way to give us
13 options that will really put us on a path to
14 simplifying it, making it less complex, making it
15 fairer, making it more growth-oriented, you would have
16 done something of extraordinary importance, I think,
17 as public citizens to advance the interests of our
18 nation.

19 We have the most successful economy in the
20 world, the most dynamic economy in the world. I think
21 we continue to create the most opportunities for our
22 citizens of any country in the world. And, yet, we
23 have a tax code that in many ways doesn't help that,
24 that gets in the way of that, and that is a source of
25 enormous angst and anxiety and concern to the average

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1 American family, sort of mind-boggling when you think
2 of the path we're on with the code. Today, to say
3 it's murky, I think, would be an understatement.

4 Albert Einstein once observed that the
5 code was the only thing he had ever discovered in his
6 whole life that was totally impenetrable to the mind
7 of man. And that was a long time ago and has become
8 a lot murkier over the course of the last 50 years
9 since he said that. More than a million words, the
10 regulations have more than doubled in terms of page
11 length over the past 20 years.

12 Today's short form -- and this sort of
13 puts it in perspective. Today's so-called short form,
14 the short income tax form, as some of you fill out,
15 takes more than 11 hours to prepare. That's about the
16 same as the long form took just ten years ago.

17 It's pretty clear we're on the wrong path.
18 This commission has a chance to lay out options that
19 will get us back on the right path. I know it's not
20 easy. There are a few things more complex than trying
21 to figure out how to improve tax policy.

22 But I don't know any time in American
23 history where a more talented, distinguished, or
24 dedicated group of people from the private sector with
25 prior experience and many cases in the public sector

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1 have been brought together to focus on a major public
2 policy issue. And I don't know any time where there
3 is a combination of a President so dedicated to use
4 the results of a talented, distinguished private
5 citizen group to advance the public policy objective
6 of a code that is fairer, simpler, and more
7 growth-oriented.

8 It seems to me we owe it to America to
9 give this the best effort we can. And I know you will
10 do that. The President will give it the best effort
11 he can. I'm going to give it the best effort I can.
12 This is really in the forefront today of the public,
13 the domestic public, policy agenda of the President of
14 the United States.

15 When you think about the code, it would be
16 nice if somebody could say that it looked like it was
17 put together for a reason, rather than being the
18 accretions of a long series of individual ad hoc
19 actions and accommodations. And, yet, if you looked
20 at it, it really looks more like the latter than the
21 former.

22 I really think this is an historic
23 opportunity. I commend you. I really commend you
24 from the bottom of my heart for taking on this tough
25 assignment. And I pledge that we at Treasury will be

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1 at your service, be available with the Office of Tax
2 Analysis, Office of Economic Analysis, and the
3 resources of the IRS as well that you can draw on to
4 help you in your deliberations.

5 And so, with that, Mr. Chairman, I thank
6 you. I wish you well with today's proceedings and
7 with the proceedings as you take the panel and the
8 hearings out across America.

9 Thank you very much.

10 CHAIRMAN MACK: Mr. Secretary, thank you
11 very much for your comments, for the challenge that
12 you have given us. We take it very seriously. And we
13 hope that we will come back with something that will
14 be of great value to you and to the President and to
15 our country.

16 And we also appreciate your offer of
17 technical assistance. I'm sure we will be drawing on
18 that.

19 SECRETARY SNOW: Thank you very much

20 CHAIRMAN MACK: Thank you very much.

21 As I said, I'm going to make an opening
22 statement that will cover a lot of the direction in
23 which the panel will be heading. Today's meeting
24 marks the beginning of the panel's important work to
25 explore ways to reform the federal tax code.

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1 I believe that it is a good sign that we
2 are holding our first meeting to discuss reform in the
3 building that bears the name of Ronald Reagan, who
4 initiated the last bipartisan effort to reform the tax
5 code 20 years ago.

6 As we will hear today, a lot has changed
7 since then. This panel will take a fresh look at the
8 existing tax code and will formulate options for
9 making the tax system simple, fair, and productive.

10 I am privileged to serve as the panel's
11 chairman and would like to thank Vice Chairman Breaux
12 and the rest of the panel for agreeing to help tackle
13 this challenging task.

14 We have an ambitious agenda today. First,
15 I will provide some background about what the panel
16 hopes to accomplish and how we intend to accomplish
17 it. In addition, we will be hearing brief comments
18 from the other members of the panel as well.

19 I am very honored that the Treasury
20 Secretary was here to begin this important work. In
21 addition to the Secretary, we will hear from four
22 distinguished witnesses. Our first witness will help
23 us put our current tax system in context, provide us
24 a better understanding of how we got to where we are
25 today.

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1 Our second witness will provide needed
2 background about tax system design and valuable
3 insights into how to think about choosing a base for
4 taxation. He will explain the differences between a
5 tax on income and a tax on consumption.

6 Finally, our last two witnesses will
7 describe how the choice of an income tax base or a
8 consumption tax base impacts the overall function of
9 the tax system and the advantages and disadvantages of
10 each in terms of simplicity, fairness, and economic
11 growth.

12 The President has stated clearly that tax
13 reform is a key priority and formed this panel to
14 advise the Secretary of the Treasury on options to
15 reform the tax code.

16 We have been directed to provide the
17 Secretary our findings by July 31st. To accomplish
18 this task, we intend to do our work in two stages.
19 First, we will take a comprehensive look at the
20 existing tax system.

21 Our objective is to make sure that we have
22 a full understanding of the current problems in the
23 present tax code, specifically its complexity, its
24 impact on economic growth, and its perceived
25 unfairness.

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1 After we define the problems that need to
2 be addressed, we will turn to a consideration of
3 options for reform. These options may include making
4 modifications to improve current law, overhauling the
5 existing system, or replacing the current structure
6 and starting over. As part of our effort, we will
7 study the major reform proposals that have been
8 offered in the past as well as any new ideas.

9 As we move forward, we intend to hold a
10 number of public hearings like this one. We will
11 announce the dates and locations of those hearings
12 soon. We anticipate holding those meetings in
13 Washington, D.C. and in other parts of the country.

14 It is vitally important to all of us that
15 the public know what we are doing and have a chance to
16 provide input. We have established a Web site that
17 provides information about our activities. The Web
18 site is www.taxreformpanel.gov. We will also use the
19 Web site to receive and post public comments.

20 We welcome input throughout the process.
21 At the same time, we will also be requesting comments
22 on specific topics in connection with the first stage
23 of our work; that is, defining the problems in the tax
24 code. Today we're making our first request. We ask that
25 interested parties submit comments to the panel about

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1 headaches the taxpayers, both individuals and
2 businesses, face because of the existing system;
3 second, aspects of the tax system that you believe are
4 unfair; third, specific examples of how the tax code
5 distorts important business or personal decisions;
6 and, fourth, goals that the panel should try to
7 achieve as we evaluate the existing tax system and
8 recommend options for reform.

9 There will be additional requests for
10 comments. For example, when we move to the second
11 stage of the process and begin considering options, we
12 will make specific requests for suggestions,
13 alternatives, and proposals for improving the tax
14 system.

15 There is nearly universal agreement that
16 we must reform the code. The tax code is a complex
17 and cluttered mess that discourages economic growth.
18 Our tax laws penalize hard work, discourage savings
19 and investment, and hinder the competitiveness of
20 American business abroad.

21 Compliance with the tax code is
22 complicated and burdensome. It is also a waste of
23 resources. Nobody likes paying taxes. But, instead
24 of making it as easy as possible, the tax code is an
25 obstacle for those who pay their fair share.

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1 It is estimated that individuals and
2 businesses spend at least six billion hours each year
3 just to file their taxes. More than half of Americans
4 use a paid preparer to file their taxes. In fact,
5 costs incurred by individuals in connection with their
6 taxes exceed \$100 billion. These numbers are
7 staggering. Americans should not have to hire an
8 expert to help them calculate their taxes.

9 The problems of complexity are not limited
10 to individual taxpayers. In fact, the compliance
11 burden on business, both large and small, is enormous
12 and adds another 20 to 25 billion dollars to the total
13 cost of compliance.

14 I'm going to mention just one particular
15 area of the tax code. And that is the AMT. The AMT
16 imposes a second tax system that is separate but
17 parallel to the regular income tax system and requires
18 that taxpayers compute their taxes twice.

19 The AMT was enacted in 1960 to target a
20 small group of high-income taxpayers who were avoiding
21 paying all income taxes. Since then, changes to the
22 AMT and inflation have caused it to apply to large
23 numbers of middle-class taxpayers by denying families
24 benefits that are available under the regular tax
25 system.

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1 The number of Americans who will be
2 confronted by the AMT will grow from 3.8 million,
3 where it is today, to 51 million taxpayers just 10
4 years from now.

5 And, in conclusion, Americans are
6 demanding a better tax system. It should be simple,
7 transparent, and easy to understand. It should be
8 stable and predictable in order to permit informed
9 planning and decision-making. It should encourage
10 economic growth. And it should minimize the cost of
11 compliance and intrusion into the lives of taxpayers.

12 We look forward to completing this
13 important task and to presenting options that will
14 ensure a better tax system for ourselves and for
15 future generations.

16 And, with that, I will turn to the Vice
17 Chair for any comments you have.

18 VICE CHAIRMAN BREAUX: Thank you very
19 much, Mr. Chairman.

20 I would open by saying that I cannot think
21 of a finer colleague to serve with as the chairman of
22 this committee and participate and look forward to
23 working with than the former senator from Florida,
24 Connie Mack.

25 I think it is important that the committee

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1 have a working relationship that is able to work in a
2 bipartisan, nonpartisan fashion. This is the task of
3 this committee. And I look forward to working with
4 you in a cooperative fashion to meet the challenge
5 that this committee is facing.

6 We have an extraordinarily difficult task.
7 That is to make recommendations to the administration
8 to simplify and reform a very complicated tax system,
9 as you have outlined, and to do it in an appropriately
10 progressive way.

11 We have at the same time the challenge of
12 recognizing the importance of the home mortgage
13 deduction and charitable contributions. We also are
14 charged with making it revenue-neutral and also
15 assuming that the tax cuts of '01, '03, and '04 are to
16 be made permanent.

17 So it is an extraordinarily difficult task
18 that this panel faces, but we have an extraordinarily
19 talented group of individuals where who are on this
20 panel, both from the academic world, from the
21 professional world, people who have taught tax policy,
22 people who have run the Internal Revenue Service, and
23 people who have also served in the Congress. So while
24 the task is difficult, I think that the talent that
25 this panel brings to the table indeed is

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1 extraordinarily outstanding.

2 We have to do it in a fairly quick
3 fashion. Previous commissions that I have served on
4 as well as other members of this panel have had a year
5 or two years to tackle difficult tasks. We have to finish
6 our report by the end of July. So this is on fast track.

7 I think that is good because it will help
8 us make recommendations in a timely fashion so that
9 the administration and the Congress will have the
10 opportunity to take the recommendations. And then
11 they will be able to look at the political
12 possibilities and the political realities.

13 Our task, fortunately, now I would say to
14 the former senator and myself in that category we can
15 do this without the political concerns that will
16 dictate future decisions. We can make the best
17 possible recommendations as far as reforming this
18 system. And I am very optimistic we can do that.

19 Just one other point. I was visiting the
20 head of a law firm yesterday at a major tax firm.
21 And this was the senior partner, who told me -- he
22 says, "I don't even fill out my own tax return."

23 And here is a senior partner in a law firm
24 that specializes in tax work. So if they don't do
25 their own, how much more difficult is it for the

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1 average citizens to comply?

2 It has been said many times that taxes are
3 the price we pay for living in a civilized society.
4 That is true, of course, but taxes should not
5 intimidate people. It should not put the fear of God
6 in people. And it should not frighten or scare them.
7 And hopefully our product will be an effort to make
8 all of that possible with good recommendations.

9 And I look forward to working with you and
10 other colleagues on the panel.

11 CHAIRMAN MACK: Thank you very much, John.

12 I will go down this side of the table and
13 then come back to this side. I am going to use this term
14 that has been used a couple of times already,
15 "former." We probably won't use too many titles in
16 this group as time goes by but former Congressman Bill
17 Frenzel.

18 MEMBER FRENZEL: Thank you very much, Mr.
19 Chairman. I think the two of you have stated the
20 problem. And you two and the Secretary have dropped
21 the challenge on us. It is an interesting assignment,
22 I think, and we will all find ourselves wholly
23 occupied by it for the next months.

24 It is an important job. And we are all I
25 think glad to be here. I am pleased and flattered to

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1 be picked for this illustrious group. I don't think
2 any of us sought this chore, but it has come our way
3 and we'll do the very best we can with it.

4 With that, Mr. Chairman, I yield.

5 CHAIRMAN MACK: Mr. Rossotti?

6 MEMBER ROSSOTTI: Well, I welcome the
7 opportunity to participate in this panel because I
8 believe the objectives that the President and
9 Secretary Snow set out are eminently achievable,
10 notwithstanding the difficulties.

11 I spent most of my life in the business
12 world, but I did take an unexpected five-year detour
13 as IRS commissioner. In both of those capacities, I
14 certainly saw close up the costs imposed by
15 unnecessary complexity in a tax code that is ever
16 changing, never standing still.

17 Based on that experience, I firmly believe
18 we can collect the revenue the government needs in a
19 much simpler and fairer way if we just have the will
20 to do it. And so I am delighted that the President
21 has given us this task.

22 While there are many objectionable
23 features in the current tax system and the chairman
24 and vice chairman mentioned some of them, one of the
25 worst of them in my view is that honest and diligent

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1 taxpayers, who are, fortunately, the majority in this
2 country, pay a great deal extra to make up for the
3 minority who cut corners and don't pay what they owe.

4 And I think that part of the problem also
5 is a very solvable problem. And part of the solution
6 lies in developing a more straightforward tax code
7 that is less easily manipulated.

8 So I look forward to contributing to the
9 work of the panel and ultimately presenting to the
10 President realistic options to make the tax system
11 work better for the American people.

12 Thank you, Mr. Chairman.

13 CHAIRMAN MACK: Charles.

14 Liz Ann Sonders?

15 MEMBER SONDEERS: Thank you, Mr. Chairman,
16 Mr. Vice Chairman.

17 It is also my pleasure to be associated
18 with this. It is a pretty big task that we are
19 charged with but I think an extremely important one.

20 There are obviously a lot of routes you
21 can take to making tax code simpler, fairer, more pro
22 growth. And I think the simplicity is the most
23 obvious one and, arguably, the most simple one. For
24 lack of a better word, it's pro growth. And I am also
25 a big fan of having been a market participant and an

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1 observer of investors for a long time, I'm a believer
2 in the growth of this economy.

3 And I think that this has been one of the
4 issues -- our current code very much disincentivizes
5 the things that really get behind the growth in our
6 economy and will likely keep this economy, as
7 Secretary Snow said, the real engine of growth overall
8 globally.

9 The fairness issue is obviously the more
10 difficult one and I think the piece of this that is
11 going to be possibly the tougher task here. There is
12 no question that the current code, particularly in its
13 complexity, is a drag on the economy, both in terms of
14 what it does to incentives for savings and investment
15 but also just the behavioral side of this.

16 I am a student of and a keen observer of
17 the concept of behavioral finance. And I think the
18 same thing very much can be applied to the way we look
19 at the tax code and the impact it has on behavior.

20 So I also hope through this process that
21 we can make assessments of the likely benefit that
22 should accrue to overall economic growth by virtue of
23 the changes that we put forth.

24 And we are the engine of growth globally,
25 but we also have become very much a consumption

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1 economy versus the rest of the world that is more of
2 a savings economy. Hopefully this process will help
3 to ease some of those imbalances. And I am very much
4 looking forward to the next six months.

5 Thank you.

6 CHAIRMAN MACK: Thank you, Liz Ann.

7 Mr. Tim Muris?

8 MEMBER MURIS: Thank you very much, Mr.
9 Chairman.

10 Let me be very brief and say that I
11 associate myself with everything that has been said up
12 to date. The President's charge to us is simplicity
13 itself, but the task of making a tax code, making
14 recommendations for a tax code that will be simpler,
15 fairer, and more growth-oriented is monumental.

16 This is a great group. There are many of
17 my favorite people in government in the academy.
18 There are several academics like myself and several
19 people who have had government jobs, which I have had
20 as well.

21 We all know the current system is not
22 simple. It's often not fair. And it too often
23 discourages growth. So we have a lot to do. And I'm
24 anxious to get to work.

25 Thank you.

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1 CHAIRMAN MACK: Thank you.

2 It just so happens that we have Professor,
3 Professor, and Professor on my right. Jim, why don't
4 we go with you first.

5 MEMBER POTERBA: Thank you, Mr. Chairman.

6 As someone who has spent over 20 years
7 teaching and carrying out research on the economics of
8 taxation, it is a dream opportunity to be part of this
9 very distinguished panel and to have a chance to try
10 to put some of the lessons from the economics of
11 taxation into practice.

12 There are I think a well-documented raft
13 of behavioral effects of the tax system on the
14 decisions made by firms and by households. And I hope
15 that our panel as we think about changes to the tax
16 code will try to recognize both those intended and
17 those unintended consequences the tax system may have
18 and think about the impact on a variety of different
19 decisions that taxpayers make in their economic lives.

20 The task of looking for favorable options
21 going forward I think offers us different routes.
22 This panel is in the very unusual position relative to
23 other tax policy-makers of being able to look at the
24 entire tax code and not just at specific provisions
25 and to think about wholesale reform as well as

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1 incremental changes relative to our starting position.

2 I am confident that we can find
3 opportunities both by thinking about alternatives to
4 the current system and by thinking about modifications
5 within the structure of the current system, which
6 would lead us to be able to have a more efficient way
7 of raising revenue while also preserving revenue
8 neutrality and a fair tax code.

9 So I am very excited and looking forward
10 to the task ahead and appreciate all of your support.
11 Thank you.

12 CHAIRMAN MACK: Professor Garrett?

13 MEMBER GARRETT: Thank you, Mr. Chairman.

14 In his State of the Union address,
15 President Bush set out three objectives: pro growth,
16 easy to understand, and fair to all. I think that as
17 we go forward with those objectives, we need to keep
18 a few other things in mind.

19 I think, first, as others have emphasized,
20 we need to think about incentives. We have long used
21 the tax code to encourage people and businesses to
22 create value for our economy. And I am sure that any
23 reform proposal we bring forward will include some of
24 those. The executive order already instructed us to
25 take account of ownership and charitable deductions.

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1 But I think we have to keep in mind the
2 tax expenditures are justified only when they change
3 behavior in the way we intend it to change. It's not
4 worth the revenue loss if a tax expenditure subsidizes
5 behavior that would occur without the tax incentive.
6 All that happens is a windfall to some at the cost of
7 all taxpayers.

8 I think, secondly, we need to keep in mind
9 fiscal discipline as we go about our work. We need to
10 keep at the forefront of our minds that a tax code is
11 primarily designed to raise the revenue for what the
12 country wants to do at home and abroad.

13 Our proposal is supposed to be
14 revenue-neutral, which I understand to require a
15 proposal to raise the same amount of money as the
16 current tax system raises.

17 Some tax reform proposals we are likely to
18 consider may not result in immediate revenue loss but
19 will substantially reduce revenue that the federal
20 government collects in the long run.

21 I think we have to focus not only on the
22 next 5 or 10 years, but we have to focus on the long
23 run and the revenue implications of what we do over
24 the course of the next 10, 15, 20 years.

25 As a country, we face an enormous deficit

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1 of \$500 billion entitlement programs that are in
2 trouble. And I think as we go about our job, we have
3 to keep that in mind as we look at provisions.

4 And then, finally, I think we have to
5 remember that progressive rates are not the only
6 important feature of a tax system that is designed to
7 be fair to all.

8 We need to consider fairness across
9 differences in tax status, looking at whether some tax
10 credits should be refundable so that those without tax
11 liability can receive incentives. We need to think
12 about how to fairly balance taxes on income from
13 wages, which are already burdened by a payroll tax,
14 with taxes placed on income from savings and
15 investment.

16 I am very much looking forward to the next
17 few months of discussion and analysis and bringing
18 forward options for reform. And I would ask that my
19 comments be made a part of the record.

20 CHAIRMAN MACK: They will.

21 MEMBER GARRETT: Full comments. [attached]

22 CHAIRMAN MACK: Right. That they will be.
23 Professor Lazear?

24 MEMBER LAZEAR: Thank you, Mr. Chairman.

25 I have been a professional economist, like

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1 Jim Poterba, for over 30 years. And most of my work
2 has centered on incentives and productivity. There
3 are many explicit and some less apparent incentives
4 that are incorporated in any tax system. And I think
5 that we need to be cognizant of any incentives that,
6 both positive and negative, are implicit in any tax
7 program.

8 Like the chairman, I believe that we must
9 first identify the problem that we are trying to solve
10 and then select the strategy that best accomplishes
11 this goal. Specifically, I believe that we want a
12 system that encourages growth through the formation of
13 both physical and human capital, that is fair,
14 transparent, and that has staying power. There is
15 little value in recommending changes that will soon be
16 undone by the political process.

17 It is both an honor and responsibility to
18 be a member of this panel, which ultimately may guide
19 the parameters of tax reform. I look forward to
20 serving in this role.

21 CHAIRMAN MACK: Thank you, Ed.

22 And thank you for indulging us in our
23 opening comments. This may come as a surprise to you,
24 but this is really the first time that we as a group
25 have been together. And it's really the first time

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1 for many of us who have had the opportunity to hear
2 the points of view expressed by each of the panel
3 members this morning. So again I thank each of you
4 for your comments.

5 Our first panelist, if he will come
6 forward, is Mr. Fred T. Goldberg, Jr., partner of
7 Skadden Arps, former Commissioner and Chief Counsel,
8 Internal Revenue Service.

9 Fred, we look forward to your presentation
10 this morning.

11 MR. GOLDBERG: Mr. Chairman, it's a
12 pleasure to be here today. I want to thank you and
13 your colleagues for the opportunity. I spent last
14 week working with your staff. And I would just like
15 to note that, in addition to the quality that you all
16 bring to this effort, Jeff and Jon and Rosanne and
17 the others, are terrific and I think will add enormous
18 value to where you are trying to go.

19 They displayed that value first in giving
20 me my assignment. They wanted me to talk about the
21 history of the Internal Revenue Code, taking stock in
22 where we are, and explain why we are where we are. I
23 asked for three weeks. They gave me 20 minutes. So
24 if you read quickly and I talk quickly, we will meet
25 your time limit.

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1 I also want to apologize in advance for
2 the technology. Undoubtedly, my 14-year-old daughter
3 could make all of this work, but I am quite
4 intimidated by all of this. And at some point, I may
5 give up with the machines.

6 Where I would like to start is at the
7 beginning of 1913. The Sixteenth Amendment permitted
8 the Congress of the United States to enact an income
9 tax. In the beginning, it was tiny.

10 And we looked for analogies. And some of
11 your colleagues on the staff suggested that we might
12 think about a house. As you will see in the upper
13 right corner, indeed it was a tiny and tidy house.

14 The income tax at the beginning affected
15 less than one percent of the population. The maximum
16 rate was seven percent. And the reason that the
17 income tax affected so few people was an exclusion
18 amount or standard deduction amount. And that is how
19 people were kept off the tax rolls. If you made less
20 than 3,000 or 4,000 dollars, you didn't have to pay.

21 The death tax was added three years later.
22 And, again, you were talking about one percent on
23 estates above \$50,000 with a maximum rate of 10
24 percent on estates above \$5 million, which in today's
25 terms is about \$87 million. Again, in the beginning,

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1 essentially it was a tax focusing on issues of
2 dynastic wealth.

3 The first time the income tax had to stand
4 up and do something different was in World War I. In
5 World War I, there was a significant increase in
6 rates, from 15 percent up to 77 percent, which dropped
7 back down to 25 percent by 1925. The important lesson
8 there is that the income tax system was being used to
9 raise revenue, to pay, as Beth Garrett said, for what we
10 want the government to do.

11 There was also a sea change with the
12 commencement of World War I. International imports
13 obviously withered away. And what you will see is
14 that prior to World War I, excise taxes and tariffs
15 were about 80 percent of federal revenue.

16 Now, as some of the other panelists might
17 point out, excise taxes and tariffs are a form of
18 consumption tax. They are an ugly, inefficient form
19 of consumption tax, but that is how you can think
20 about them. That source of revenue had declined to 30
21 percent by 1924.

22 The other noteworthy fact is that by 1924,
23 we had rules. They taxed single persons differently
24 from the way we taxed married couples. We had
25 deductions for the home mortgage and other interests.

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1 We had charitable contribution deductions. We had
2 state and local tax deductions. We had a capital
3 gains preference. And we had exemptions for children.

4 The income tax paid for war. The income
5 tax also fueled the Depression. From 1929 to 1936,
6 the Hoover administration and the Roosevelt
7 administration believed if you are in a Depression,
8 the best way out is to raise taxes. And that is what
9 they did. And, of course, the result was the
10 opposite.

11 Again, there is another point here. The
12 income tax system was viewed, incorrectly in this
13 case, but was viewed as a way to raise revenue.

14 Other highlights. In 1934, Social
15 Security. Now, I have listed on the chart here a
16 number of features of Social Security system then and
17 now to put that program in context, but the most
18 important point in the context of the income tax is
19 the last bullet: payroll tax withholding.

20 In order to fund Social Security,
21 President Roosevelt and the administration and
22 Congress enacted payroll tax withholding in 1934.
23 Well, if you were paranoid, you would think this was
24 all preplanned. But what that did is that laid the
25 foundation for probably the most important development

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1 in the income tax, which was from class tax to mass
2 tax.

3 During that period of time, the number of
4 taxpayers increased from 5 percent to almost 75
5 percent. The way that was accomplished was, again,
6 reducing the exclusion of mass, reducing the standard
7 deduction, if you will. You brought people into the
8 rolls by saying, "More of you have to pay tax on the
9 bottom because we are going to tax more of your
10 income." And all of that structure, as you will note,
11 was built on wage withholding that had been put in
12 place eight to ten years before.

13 So that by the end of World War II, that
14 itty bitty house has gotten quite large but, on the
15 other hand, a reasonably elegant design. You can find
16 the doors, the windows, the roofs, and the chimneys.
17 You can walk right from the kitchen to the dining
18 room.

19 Before moving on, a brief accident of
20 history. And I think this is illustrative of the
21 kinds of challenges you all will face in your work.

22 The IRS had said in the '20s that
23 employer-sponsored health insurance was not subject to
24 income tax, the contributions to employer-sponsored
25 retirement programs were taxed only when distributed.

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1 During World War II, the NLRB followed the
2 IRS lead and said, "Okay. If that's how the IRS sees
3 the world, that's how we are going to see the world
4 for wage and price control purposes." So the
5 employers could expand employer-provided health
6 insurance. Employers could expand contributions to
7 retirement programs without running afoul of
8 wage/price controls. You can see the result.

9 Between 1940 and 1950, the number of
10 workers covered by employer-provided health insurance
11 had increased from 9 percent to 50 percent. And
12 between 1940 and 1960, the number of
13 employer-sponsored pension plans, workers covered had
14 increased from 15 to 41 percent.

15 So an interaction of a view of the tax law
16 and a very practical NLRB that wanted to protect
17 workers and employers in the context of wage/price
18 controls has essentially put in place a system that
19 says we are going to do health insurance through
20 employer-sponsored plans. We are going to do
21 retirement through employer-sponsored plans.

22 And you can think that is good or bad tax
23 policy, good or bad health care policy, but what happens
24 in the tax system and what happens in the regulatory
25 context has very, very real real world effects.

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1 Where are we after the war? The
2 government and the tax system have been transformed.
3 Federal expenditures have grown from less than 5
4 percent to a stable 17 to 22 percent.

5 I include here a point again that I
6 believe Beth alluded to. By 2040, entitlements,
7 national defense, homeland security, and interest
8 alone will consume 28 percent of GDP. That means no
9 Justice Department, Treasury Department, IRS,
10 Agriculture Department, NEA, on and on and on.

11 Federal tax revenues as a share of GDP.
12 Again, we're less than five percent of GDP before
13 World War II. Since World War II, they have been a
14 relatively stable 17 to 21 percent. By 2040, who
15 knows?

16 We have also gone from a class tax to a
17 mass tax, from less than 6 percent of us paying income
18 tax to more than 70 percent of us paying income tax.

19 The next important event is the birth of
20 the modern era. And this is the Kennedy vision.
21 President Kennedy was the first in a very significant
22 and focused way to consider the tax laws' impact on
23 economic behavior as well as its role in funding the
24 government.

25 Under President Kennedy, individual rates

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1 were reduced from about 90 percent to 70 percent.
2 Corporate rates were reduced from 52 to 48 percent.
3 President Kennedy was the one who proposed and caused
4 to be enacted the investment tax credit. Depreciation
5 lives were reduced from about 19 years to 12 years.
6 Keogh retirement plans for the self-employed were
7 enacted.

8 This was also the first time that the tax
9 system began in a very awkward and sort of hesitant
10 way to deal with the fact that we are not alone, we
11 live in a world economy, and the result was a tax on
12 worldwide income currently. The vision is expanded.
13 We have added a gazebo to our house.

14 A mere seven years later, this was the
15 first run at tax reform. This was the first
16 legislation ever dubbed as "tax reform," as opposed to
17 a revenue act. It backed off some of President
18 Kennedy's focus on capital investment, as indicated.
19 It was the conception, if you will, in many respects
20 of the alternative minimum tax.

21 So you have President Kennedy in 1960 in
22 his first speech talking about we can use the tax code
23 to do good. We've got to get the system off the backs
24 of productive workers. We've got to use the tax
25 system to promote investment and economic growth. And

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1 in 1969, let's start thinking about reform.

2 Moving into the '70s, there are two
3 developments I want to mention. The first has to do
4 with the virtue of work. Milton Friedman had written
5 for many years about the impact of marginal tax rates
6 on low-income workers. The interaction of welfare and
7 the tax system was in some cases creating tax rates in
8 excess of 100 percent for folks on welfare who tried
9 to get a job.

10 And President Nixon proposed a guaranteed
11 income or negative income tax that ended up as the
12 earned income tax credit. The earned income tax
13 credit is now the largest federally funded means tested
14 cash assistance program in the country.

15 There is an important point here to note.
16 Remember we went from five percent of the taxpayers.
17 The 75 percent are paying taxes. Those in the early
18 1980s, 75 to 80 percent of us had positive income tax
19 liability. That percentage has now declined to about
20 60 percent.

21 About 40 percent of all potential
22 taxpayers with positive income in any given year pay
23 no income tax. But there is a difference here. They
24 don't pay income tax because the personal exemption or
25 standard deduction has gone up. They don't pay income

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1 tax because the earned income tax credit, the child
2 tax credit and other special provisions.

3 In order to get out of the tax system,
4 these folks have to walk in the front door, file their
5 return, pay nothing, or get a refund and walk back
6 out, as opposed to an early era, where their income
7 was less than that amount, they never bothered to
8 file. That is a big and important difference.

9 The second virtue, the virtue of thrift,
10 in 1974, we had ERISA, IRAs, 401(k) plans. Again, tax
11 policy matters. In 1975, 70 percent of active
12 retirement plan participants were in DB, or defined
13 benefit, plans. By 1998, those percentages had been
14 reversed. The house is getting larger.

15 CHAIRMAN MACK: I think I see where this
16 is going, Fred.

17 (Laughter.)

18 MR. GOLDBERG: Yes, Senator. We can just
19 skip to the end.

20 Language matters. We go from revenue acts
21 to tax reform acts to job creation acts. How we call
22 our tax bills tells us a lot. Tax expenditure, that
23 phrase is an illustration. The word is not invented
24 to do something. The word is invented to describe
25 something.

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1 And, as you can see, there is some data at
2 the bottom. Tax expenditures it's so called, between
3 1967 and 1982 increased from 38 percent to about 74
4 percent of tax receipts. Again, that word is not
5 invented to encourage us to do something. That word
6 is invented to describe what we are doing.

7 Another point. Inflation feedstock.
8 Between '61 and '70, the annual rate of inflation was
9 2.9 percent. Between '71 and '80, that same annual
10 rate of inflation was 8.2 percent. Between 1960 and
11 1981, the average income tax rate for a median family
12 of four increases by about 50 percent.

13 When you have brackets and you fix the
14 brackets and there is inflation -- in the '70s,
15 inflation was quite high. You have a built-in source
16 for generating additional revenue. And that
17 additional revenue funds government outlays.

18 And it also lets Congress says, "We have
19 cut your taxes. Of course, we may be putting you back
20 to where you were, but we can tell you we gave you a
21 tax cut."

22 The importance of inflation in driving the
23 revenue structure of the tax system cannot be
24 overstated. In 1972, Social Security benefits were
25 indexed. The house continues to grow. Oh, there

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1 appears to be a crack in the foundation, but we will
2 get back to that momentarily.

3 We move to the Reagan reforms. There are
4 several of these that are very important, but it is
5 useful to put it in historical context. It was
6 President Kennedy that went from 90 to 70 percent. It
7 was President Reagan that went from 70 to 50 percent.
8 It was President Kennedy that promoted the reduction
9 in depreciation periods from 19 years to 12 years. It
10 was President Reagan that promoted ACRS.

11 So you have President Kennedy staking out
12 a view. You have President Reagan staking out a view
13 that in many ways rhetorically if you look at the
14 State of the Union and everything else, rhetorically
15 builds on the Kennedy perspective.

16 In between, you have Richard Nixon, Milton
17 Friedman, a group of conservative Republicans who
18 don't focus on rate reduction, don't focus on
19 investment incentives but, again, instead come up with
20 an earned income tax credit refundable to the
21 low-income workers and indexing Social Security
22 benefits. As we look at our current political
23 environment, that may provide, if nothing else, an
24 interesting commentary on where we have come.

25 In many respects, the most important

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1 structural impact of the Reagan reforms was indexing
2 individual tax brackets, indexing the standard
3 deduction, and indexing the personal exemption.

4 President Reagan was absolutely out of the
5 closet, totally open, and those who supported his
6 proposals said, "We are taking away the feedstock."
7 And so once you back inflation out of the tax system,
8 over the long term, that has an enormous impact on the
9 structure of your tax system and your revenue base,
10 changes that were most warranted and clearly the right
11 call, but they do have an impact.

12 It's worth footnoting President Reagan at
13 the time was responsible for the largest tax cuts in
14 our nation's history. He was also responsible for the
15 largest tax increases in 1982 and 1984. But what is
16 important about those tax increases is protecting low
17 rates was what mattered.

18 Well, if you are not going to change the
19 rates, you have got to find some other place to get
20 the money. And the place they went to get the money
21 was what I refer to as the capillaries.

22 We're not going to expand the system
23 through rate increases. We're not going to expand
24 revenue through lowering personal exemptions or the
25 standard deduction. What we are going to do is we're

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1 going to find this little piece and go after it.
2 We're going to find that little piece and go after it.
3 We're going to find another little piece and go after
4 it.

5 The Tax Reform Act of 1986. It's sort of
6 interesting you had the Kennedy vision leading to the
7 Tax Reform Act of '69 less than ten years later. I
8 1986, tax expenditures were repealed. That was the total
9 amount of tax expenditures had been repealed in the prior
10 72 years. And they reduced benefits from 72 other
11 provisions.

12 The Tax Reform Act of 1986 also brought us
13 the current individual AMT. And it was not indexed.
14 Remember, this is a period from 1981 to 1985. We're
15 indexing rates. We're indexing brackets. We're
16 indexing standard deductions. But we're not indexing
17 the AMT.

18 The individual AMT reflects the data that
19 the Chairman described. It is a horrendous event
20 looming shortly. The corporate AMT has received less
21 attention. The corporate AMT simply exacerbates
22 business cycles. It is a silly, stupid tax. The
23 effect of the corporate AMT is the corporations pay
24 more tax when they are losing money and they pay less
25 tax when they are making money.

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1 Passive loss rules are worth noting. This
2 was the first comprehensive structural effort to deal
3 with the tax shelters that Commissioner Rossotti
4 alluded to. And it was effective. It created a
5 scheduler system that made it far more difficult for
6 individuals to shelter their income. But there is a
7 lesson there.

8 The 1986 Act is generally viewed as having
9 contributed to the sudden and significant declines in
10 real estate values. This is an important point
11 because as you look to tax reform, I believe one of
12 the most difficult challenges you will face is
13 transition.

14 The other piece of the '86 Act, phase-in
15 and phase-out provision, the so-called PEP and Pease.
16 IRA limits are worth noting because it was the
17 beginning of a trend. Now substantially all so-called
18 incentives for individuals are capped and phased out.

19 That is very important because it violates
20 notions of neutrality, especially in the context of
21 families with fluctuating incomes. If my incomes are
22 moving up and down, above and below the phase-out
23 level from year to year, I am treated very differently
24 from someone who has an average income below the
25 phase-out.

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1 So my family income may be the same as
2 your family income over five years, but if mine goes
3 up and down and yours stays the same, I lose the
4 benefit of those incentives. The same turns out to be
5 true at the bottom.

6 The other is cost of living. You don't
7 see a lot about this, but if the phase-out for a
8 particular provision, say, is \$60,000 of family
9 income, that may be fine for a small town in rural
10 Florida or rural Louisiana, but it ain't a great deal
11 in New Orleans or Miami.

12 This violates fundamental notions of
13 fairness. Once you go to phase-ins/phase-outs, that
14 is what happens. But the reason for it is not
15 irrational. It protects marginal rates, right? If
16 I'm not going to mess with marginal rates, I have got
17 to do something else. And it defends against charges
18 of unfairness.

19 It is worth noting that deductions are of
20 little or no benefit to the 40 percent of taxpayers
21 who don't owe taxes. A family of 4 with family income
22 of about \$40,000 gets no benefit from a charitable
23 contribution deduction, gets no benefit from a
24 mortgage deduction, gets no benefit from a deductible
25 contribution to an IRA. And one answer is, well, they

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1 don't pay taxes. That's the way it goes.

2 But another answer is, well, but if we are
3 trying to promote that kind of opportunity through the
4 tax code, we're doing a real poor job. And if you
5 think about a family whose income is \$30,000 one year
6 and \$50,000 another year, I've got \$50,000 income. My
7 spouse takes time off to care for a newborn kid. I
8 drop below. The distortive effect of these provisions
9 is really quite significant.

10 Anyway, here is the house. It's a little
11 bit smaller, as you can see. The '86 Act has done
12 something but not a whole lot.

13 CHAIRMAN MACK: Were you looking for a
14 response? [laughter]

15 MR. GOLDBERG: In less than ten years,
16 promises, promises. The top marginal rates ran from
17 28 percent to 39 percent. Capital gains were once
18 again taxed at preferential rates. Tax expenditures
19 had grown from about 45 percent of receipts
20 immediately after '86 to about 65 percent by 2003.
21 Between 1987 and 2004, more than 10,000 amendments were
22 made to the Internal Revenue Code.

23 Senator Moynihan wrote a great piece about
24 how we get inured of these things. It is hard. We
25 can't describe or capture what that 10,000 figure

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1 means. The notion that you are changing the tax
2 system 10,000 times since you did your '86 Act reform,
3 broadened the base, reduced rates, and kept it simple,
4 it just defies description.

5 Here we are between '86 and now. These
6 are the big picture policies we pursued in an income
7 tax designed to raise revenue. We want to reduce
8 rates on families and individuals. We want marriage
9 penalty relief. We want refundable child credits. We
10 want to expand the earned income tax credit, want to
11 promote savings and investment and education. So we
12 have this panoply of proposals.

13 We want to do death tax repeal. We want
14 to reduce the double tax on corporate income. We want
15 to reduce the rate on capital gains. We want to
16 provide expensing for small businesses. We want to
17 promote energy policy. We want to promote
18 international businesses. We want to close loopholes
19 and combat tax shelters.

20 So ever since '86, this is what we have
21 been about. And here we are.

22 Taking stock. Chairman, you described
23 most aptly we are living in a grotesquely complicated
24 system that distorts the allocation of resources and
25 violates common sense notions of fairness.

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1 There are two points I want to cover
2 quickly here. One is the perfect storm. The other is
3 the reasons why. Sunsets, provisions, the alternative
4 minimum tax, and deficits paint, if you will, a very
5 sad picture for us. And these are inexorable. Why?
6 What has been contributing to the difficulties we are
7 facing is entitlements. That also is inexorable.

8 So if you want to say it's sad, you can
9 blame it on the Marquis de Sade. But, in any event,
10 you all are working in a context of dealing with
11 sunsets, dealing with the AMT, dealing with deficits,
12 and dealing with entitlements. And I think it would
13 be only prudent to keep those externalities in mind.

14 A lot of it is competing virtues. It's
15 easy for all of us to criticize the complexity of the
16 tax system. But families matter. Home ownership
17 matters. Education matters. Work matters. Thrift
18 matters. Health care matters. Industrial policy
19 matters. Energy production matters. Savings matter.
20 Federalism matters.

21 And so it's easy to say we should do none
22 of this, but it's kind of hard to not do it because
23 this is not good versus bad. This is good versus
24 good. And I think it makes the task more difficult.

25 There is a distinction between promotion

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1 and removing barriers. We talk about incentives. I
2 think there are many instances in the tax law where
3 you are not providing an incentive. You are removing
4 a barrier to constructive economic activity.

5 If you are going to use the tax code this
6 way, you can do it well and you can do it poorly. The
7 mess we have in savings incentives is inexcusable. If
8 you are going to keep savings incentives, make it
9 simple.

10 The budget rules are another reason why we
11 are here. These are terrific in the sense that they may
12 be promoting fiscal restraint. But they have surely
13 promoted bad tax policy. Sunsets, gimmicks,
14 legislating in the capillaries are the inevitable
15 outcome of the budget rules we live under and the
16 primacy we place on maintaining low rates.

17 The '86 Act is exhibit A, PEP and Pease,
18 exempting AMT from indexing, and the corporate AMT.
19 These are the reasons we are in trouble. But there is
20 another reason. It is the world around us. Global
21 competition and global capital flows have changed
22 dramatically during the past 20 years. You can see
23 the data here.

24 The income tax has failed and in my view
25 is likely unable to adapt to the world around us in

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1 terms of global competition and capital flows, the
2 same with respect to financial derivatives. Financial
3 derivatives were nothing before 1990. Now they're \$200
4 trillion. Derivatives make a hash of the traditional
5 building blocks of an income tax system.

6 Value is moving from bricks and mortar to
7 intangibles. An income tax system has difficulty
8 coping with value embedded in intangibles. You can't
9 find it. You can't value it. That makes it harder to
10 do an income tax.

11 There has been a dramatic growth in tax
12 indifferent parties, parties who are not subject to the
13 U.S. income tax. Cross-border capital flows and capital
14 accumulated by pension plans and tax-exempt
15 organizations are enormous.

16 Imagine a world where corporations issue
17 tax-deductible debt held by people who don't pay tax.
18 That's not a bad thing. It's not an evil thing.
19 It's not a tax shelter. It's not anything. It is a
20 fact of the world we live in. And here is where we
21 are.

22 Now, there are several choices here. I
23 will just offer three observations. Everybody can
24 make what they want out of the history, but I think
25 that there are several lessons to be learned here.

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1 the phase-in/phase-out in concept that we ought to
2 focus on?

3 MR. GOLDBERG: I was instructed to recite
4 the history and express no views, but now that you
5 have given me the opportunity, I think that the issue
6 of where we are headed with entitlements is very
7 important. I mean, if we are locked into a commitment
8 to spend the kind of money, we are locked into a
9 commitment to spending, I think that in and of itself
10 should compel a rethinking of the tax system.

11 Second, I --

12 CHAIRMAN MACK: Do me a favor now. Relate
13 that, though. I mean, I think everybody agrees that
14 the entitlements are getting bigger, but how does it
15 relate, though, to reforming the tax code?

16 MR. GOLDBERG: Again, I am now in such
17 deep water Jeff is going to shoot me when I walk off.

18 For example, Mr. Chairman, the
19 entitlements are currently a pay as you go system
20 collected through a payroll tax. Payroll tax isn't
21 the only levy. You can imagine, for example, a
22 consumption tax that would fund some portion of
23 entitlements cost. That is a more progressive tax
24 than a payroll tax. So that is an alternative that
25 one can think about in terms of a funding source.

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1 MEMBER POTERBA: Yes. You alluded to the
2 difficulties of taxing capital income and changes in
3 the global marketplace, the rise of derivatives, the
4 rise of intangibles, and global competition as being
5 factors that are really very difficult here.

6 In your judgment, is it inherently
7 impossible to address those issues within the
8 framework of an income tax? And does that push you
9 toward thinking about alternatives or is this
10 something where we have just lagged in the way we have
11 designed the regulations and implemented the code
12 given that the economy has changed underneath us?

13 MR. GOLDBERG: I think it is impossible,
14 particularly if you're trying to keep up. You know,
15 you have some little code provision that gets at some
16 little piece of something somebody figured out. And
17 then you're never going to catch up. I think in that
18 sense, it's hopeless.

19 Now, that doesn't mean that you give up on
20 an income tax, but I think it means you think very
21 differently about an income tax. And it's going to
22 differ between whether you're talking about the
23 corporate sector, where there are shortcuts that you
24 take analogous to the passive loss rules, or whether
25 you're talking about individuals whose principal

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1 source of income is their own investments.

2 I don't think the current path is going to
3 work at all. I think it has failed. I think it is
4 going to keep failing.

5 MEMBER GARRETT: I want to continue to get
6 you in trouble if at all possible. One of the things
7 that struck me when I was looking at the budget and
8 when you sort of see where the sources of revenue are
9 coming now, as opposed to, say, 20 years ago, 30 years
10 ago, is there have been 2 big shifts.

11 One is that payroll taxes are increasingly
12 a source of revenue. If you look at '75 to 2005, in
13 1975 payroll taxes were 30.3 percent. In 2005,
14 they're 37.7 percent of all federal receipts.

15 The other shift that I think is
16 interesting is corporate income taxes. So that in
17 1945, they were 35 percent of receipts. In 1975, they
18 were 14.6. In 2005, we're only getting 11 percent of
19 our revenues from the corporate income tax, which
20 strikes me as the most complex, where a lot of the
21 dead weight loss is.

22 You focus mainly on individual taxes,
23 which is terrific, but I wondered if you could say
24 something about corporate income taxes and complexity.
25 In particular, is it worth all of our time that

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1 businesses and the IRS spend in compliance on
2 corporate income taxes when it is such a small part of
3 our income and when we could get those taxes from
4 individuals, who, after all, are people who get the
5 money from corporations.

6 MR. GOLDBERG: Boy, Beth, you did a U-turn
7 there in the middle. Two reactions. One, while
8 payroll taxes have obviously grown substantially as a
9 source of revenue, I believe that entitlement outlays
10 have grown faster. And so I don't think you can think
11 about payroll taxes independently of thinking about
12 how much we're spending. And, again, payroll taxes
13 only fund Medicare Part A. They don't fund Medicare
14 Part B. So you've got general revenue going there.

15 But my colleague Ty Greenberg who helped
16 put this thing together talks about the government, as
17 have others. You know, we're an army with an
18 insurance company. I mean, that is what we have
19 become as a government. And I think that you have got
20 to be careful about those numbers.

21 With respect to the corporate tax, a
22 couple of points. One, we cannot, absolutely cannot,
23 hope to compete in a global economy by setting
24 corporate taxes in a vacuum. We will get killed. And
25 I think that that is the reality, and we need to come

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1 to terms with that reality.

2 The truth is, at least in the current
3 structure, corporations don't pay taxes. Customers
4 pay taxes. Workers pay taxes. And shareholders pay
5 taxes.

6 And I think that one of the difficulties
7 we have is that the rhetoric around the corporate
8 income tax -- and it has certainly affected political
9 rhetoric -- is perhaps distracting us from the kind of
10 policy considerations that we need to make.

11 Now you need to be very careful. If you
12 say corporations don't have to pay tax at all. Well,
13 me and my buddies at Skadden Arps are going to
14 incorporate. We'll never pay tax again. So you've
15 got to watch out how you do it, but I think that that
16 is an area where the rhetorical efforts have sort of
17 gotten away from the real world policy issues.

18 You know, when you essentially control
19 world trade to the extent there is world trade in
20 1962, -- and, by the way, the appendix for this has a
21 lot of these charts in more detail -- you can pretty
22 much do what you want. But we don't. And so we can't
23 do it anymore.

24 MEMBER LAZEAR: You mentioned in your
25 comments when you were talking about the 1986 tax

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1 reform that the basic philosophy associated with this
2 was to broaden the base but to keep the rates low.
3 And in some sense, we seem to have failed on both
4 counts because the base is not clean, nor have we
5 succeeded in keeping the rates low over time.

6 I guess the question that I would like to
7 pose to you is, do you think there is something
8 inherent in the income tax structure per se that
9 causes these oscillating rates over time? Is that
10 just a natural feature? Does the historical record
11 back that up? And if so, what would you recommend to
12 us in terms of thinking about alternatives?

13 MR. GOLDBERG: I think it is a function of
14 human nature, not the tax system. I mean, how can you
15 sit there and say it's a bad idea to encourage
16 families to save for education? You can't say that's
17 a terrible idea. So let's change the tax law.

18 Well, you know, Bill Clinton wants his own
19 credit. And Senator Coverdale wants his Coverdale
20 thing. And Senator Roth wants his thing. Part of the
21 problem is if you want the tax system to accomplish
22 these objectives, that's okay. And some would believe
23 it is an efficient mechanism for doing so. But there
24 is a right way and a wrong way.

25 You look at the list of savings

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1 incentives. If I am a middle class family trying to
2 figure out, do I want my Hope Credit? Do I want to
3 deduct my interest on my student loans? Do I want to
4 do a 529 plan? Do I want to borrow money from my
5 Roth? What in the hell am I supposed to do?

6 Sometimes there are virtues in choices.
7 Sometimes there are virtues in not choices. There is
8 a very large virtue in my world of letting the person
9 decide.

10 Put the money away. If you want to use it
11 for education, good for you. If you want to use it to
12 buy a car to go to work, good for you. If you want to
13 save it for retirement, good for you.

14 And I think that there is a
15 micromanagement in the code right now of personal
16 behavior that is a big mistake. I think to the extent
17 you want to use the code in this particular fashion,
18 you ought to trust the people to get it right.

19 But, again, I think it is human nature,
20 sir. It's not the fault of the tax code, and it's not
21 the fault of people trying to do bad things. It's the
22 consequence of people trying to do good things.

23 VICE CHAIRMAN BREAUX: Thank you very
24 much, Fred, for an excellent presentation and really
25 putting it in an historical perspective as to where we

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1 have been and how we have gotten there.

2 The challenge of this commission is to,
3 number one, report a reform of a current structure.
4 One of the obligations we have is to make
5 recommendations based on the current income code
6 structure.

7 We also are going to have the opportunity
8 to look at other types of tax measures for collecting
9 revenues we need to run the government, including a
10 consumption tax, a VAT tax, sales tax.

11 I mean, can you just give a comment on the
12 difficulty of trying to move to a totally new
13 structure, as opposed to just doing the smaller
14 amendments to the current structure?

15 We have always sort of done little bits
16 and pieces and made incremental changes over the
17 years. One option that we could recommend is going to
18 a whole new system.

19 Can you comment just on the difficulties
20 that might be faced, I guess, either politically but
21 more probably structurally, I mean, how difficult it
22 is to go from an income tax based on wages and
23 earnings to something that would be based on
24 consumption?

25 MR. GOLDBERG: The trouble is getting deep

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1 here, Senator. I think it's impossible. I think the
2 notion of we're going to get rid of everything we have
3 and start over is a waste of time. I don't think you
4 should bother thinking about it.

5 I think you can think about other revenue
6 sources in the form of certain types of consumption
7 taxes to permit you to do a great deal of good within
8 the context of the income taxes.

9 But once you talk about preserving
10 progressivity, which the President has said he is
11 committed to, and once you talk about preserving
12 incentives for charities and home ownership, you've
13 got income tax.

14 And I think that that is not bad because
15 I think that given -- you're just not going to throw
16 it away and start over, but I think that doesn't
17 preclude you from doing radical reform.

18 I mean, you can play a game. You can say,
19 "Well gee, if I raise \$600 billion from some kind of
20 consumption tax, how much good can I do in the income
21 tax and the payroll tax?" Well, it turns out you can
22 do a hell of a lot of good for \$600 billion.

23 VICE CHAIRMAN BREAUX: So the concept of
24 doing a combination income tax, VAT-type of tax from
25 a structural standpoint is more --

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1 MR. GOLDBERG: I think you have three
2 choices. I think one choice is to define a new
3 revenue source, like some form of consumption tax, and
4 buy all of the good things you can buy out of the
5 income tax.

6 Second, you can do base broadening and
7 say, "What am I going to do good with all of the base
8 broadening I have done?" Get rid of state and local
9 tax deductions or get rid of the rules on
10 employer-provided health care. And good luck. But
11 you can broaden your base and buy some good things or
12 you can think about the tax system in sort of discrete
13 sectors.

14 What can I do with respect to all of this
15 stuff out there on savings? What can I do out there
16 with all of this stuff relating to how we tax
17 corporations? What can I do about my international
18 tax piece? If you want to get into the estate and
19 gift tax, what -- and sort of think about them as
20 sectors.

21 And within each one of those groupings,
22 you can do very good things and you can do very good
23 things on a relatively tax-neutral basis. But, as
24 they say, there will by definition -- the only way to
25 avoid winners and losers is to do nothing. And I

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1 think that that is a challenge.

2 But there are three ways to approach it:
3 get some more money and do a lot of good, broaden the
4 base and do some good if you can broaden the base, or
5 think about different sectors of the tax system and
6 within each sector how can you make it work better on
7 a revenue-neutral basis. I think those are your three
8 choices.

9 CHAIRMAN MACK: Thank you very much.

10 MEMBER FRENZEL: Fred, thank you very
11 much. You have been at work in this play pen for a
12 long time and observed the gramatis personae at work.
13 If we were to scrub the system clean, irrespective of
14 whether it's consumption of income or whatever, how
15 long would it take before a hyperactive Congress would
16 redecorate it in such a way that we would be about
17 back where we started from?

18 MR. GOLDBERG: I would give you 10 to 15
19 years. I think it's about 10 to 15 years. But,
20 again, Congressman, it depends on what you do. And I
21 think, for example --

22 MEMBER FRENZEL: Well, we could make it
23 harder for them or easier.

24 MR. GOLDBERG: I urge you not to minimize
25 that. You could make it a lot harder depending upon

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1 how far you're willing to go. If you do it all within
2 the current context of the income tax, it's going to
3 be 10 to 15 years at the outside if you find some
4 other ways of restructuring the income tax, you may be
5 20 years, 20-30 years, which is a long time. I mean,
6 that's a good amount of time.

7 MEMBER FRENZEL: Thanks very much.

8 MEMBER ROSSOTTI: Fred, great
9 presentation.

10 With respect to the comments you made
11 about the hopelessness of what we are currently trying
12 to do with corporate income tax, what do you think are
13 the options for solving that broadly?

14 MR. GOLDBERG: Commissioner, let me be
15 clear. I think trying to figure out how to tax
16 capital is close to impossible. I don't think it's
17 impossible to figure out a way to tax enterprise
18 income, if you will. There are those, for example,
19 who have written about book tax conformity.

20 You pay income tax on what you tell your
21 shareholders you earn. Now, that creates lots of
22 transition issues, potentially a fair amount of
23 distortion. Obviously the accounting rules that we
24 have seen are potentially subject to manipulation, but
25 that would be radical simplification.

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1 I tell you how much I earned. I tell
2 Uncle the same thing.

3 MEMBER ROSSOTTI: I understand. Thank
4 you.

5 MEMBER SONNERS: Fred, terrific
6 presentation, very helpful. Thank you.

7 You know, you talked a lot about personal
8 behavior, as did I in my opening comments. And I am
9 a big believer that you have to pay attention to that.
10 I think it needs to be considered as well as maybe the
11 severity word but the scoring process.

12 We know that costs are pretty effectively
13 calculated when considering any kind of reform, be it
14 major or minor or wholesale. But the economic
15 benefits or disadvantages, to some degree, are not
16 considered as well.

17 Do you think there should be some sort of
18 unique scoring process adjustment or greater level of
19 formality in thinking about the scoring process when
20 approaching a wholesale reform, as opposed to just
21 some of these Band-Aid approaches?

22 MR. GOLDBERG: You looking for -- well,
23 no. I mean, I have been through these issues about
24 dynamic scoring and about -- there's a lot of
25 confusion about revenue estimates. Revenue estimates

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1 are dynamic today in the sense that they assume
2 changes in behavior.

3 For example, if you provide a \$5,000
4 first-time home buyer credit, the Joint Committee and
5 the Treasury Department will estimate a change in
6 behavior. They're going to say more people are going
7 to buy homes.

8 So in that sense, scoring is already
9 dynamic. Scoring is not dynamic in the sense that it
10 predicts sort of aggregate impact on gross domestic
11 product, for example.

12 You can do that. My answer to your
13 question no is in should you adopt a formal mechanical
14 rule. We get to revenue-neutral by getting to assume
15 this about impact on gross domestic product.

16 I think that formality runs a fair amount
17 of risk. On the other hand, I think it's essential
18 that you take into account the impact on the economic
19 activity that tax reform properly done will stimulate.

20 I think it is an absolute deadlock
21 certainty that properly done tax reform will increase
22 economic growth. That is a certainty. I think the
23 risk in trying to go beyond that obvious proposition,
24 which is true, to saying, "Well, gee, I am going to
25 give myself credit for an extra 50 basis points on GDP

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1 every year of growth," I think it runs some risks
2 because I'm not quite clear how sure anybody can be on
3 that number. And you move that number a little bit
4 and you move your revenue numbers enormously.

5 So it's not that you shouldn't consider
6 it. I think if you don't consider it, you're missing
7 the most obvious point. But I think if you try to
8 formalize it in "I'm going to get credit for economic
9 growth," I think you're going down a road that is
10 going to be very difficult and you are going to run a
11 credibility risk.

12 MEMBER MURIS: Thank you also for your
13 presentation. It was very helpful.

14 You present some interesting statistics
15 that just in the last 12 years, let alone over time,
16 the relatively well-to-do are paying a much, much
17 higher percentage of the income tax. And only 60
18 percent are now paying at all. Where are those
19 numbers headed? And what do you think the implication
20 is, page 60?

21 MR. GOLDBERG: Well, Page 60 shows a
22 traditional distribution table. Page 61 is some data
23 we pulled together showing the tax burden on folks
24 below the poverty level.

25 MEMBER MURIS: Right.

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1 MR. GOLDBERG: And all this does is what
2 this tells you is it's largely a function of the
3 earned income tax credit and the refundable child
4 credit is you're taking folks below the poverty line
5 off the tax rolls and giving them money. That by
6 definition means upper income folks are paying a
7 higher percentage of whatever is being collected.

8 I think that, again, fairness and
9 distribution are exceedingly important. I think those
10 who argue that the tax system has become more
11 aggressive are wrong. I think that the data suggests
12 it has become more progressive.

13 But, as one of the panelists said, that's
14 the hard one. What's fair? What's fair for people to
15 pay? But we have a tax system now where, in fact, the
16 top 5 percent of all income earners pay 53 percent of
17 the tax, and the top quarter pays 84 percent of the
18 tax. You have a situation where those below the
19 poverty level essentially have a tax burden of -23
20 percent.

21 Well, that's the world we have created.
22 That can be a good world. That can be a bad world.
23 I am a huge supporter of the earned income tax credit.
24 I think it's one of the best policies enacted in the
25 last 30 years because it does remove disincentives to

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1 work. I think it's a terrific policy.

2 This is what we are living with. Where is
3 it going to go? The answer is if you keep expanding
4 the earned income tax credit, more and more of the tax
5 burden is going to be borne by upper income earners.

6 There is another point here I would urge
7 you all to keep in mind. All of these tables are
8 static. I think that in thinking about these tax
9 policy questions, we sort of assume they are permanent
10 wealthy people, permanent poor people. And that is
11 not true.

12 The data suggests that there is a fair
13 amount of mobility. Bill Gale is going to pick on me
14 when he comes up here, but I think that there is a lot
15 of mobility. And I think that gets back to the point
16 about fluctuations in family income.

17 I think the system now has reached the
18 point where fluctuations in family income and
19 differences in cost-of-living are kind of undercutting
20 a lot of what we are trying to accomplish in the
21 income tax. So it's not always the same bottom 20
22 percent of the same top 20 percent.

23 So don't think of these as static numbers.
24 Think of these as moving numbers.

25 CHAIRMAN MACK: Again, unless someone has

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1 got a burning question that they have got to follow
2 up, because of time, I think we need to move on.

3 Fred, I want to thank you again for your
4 presentation. I think the material that you have
5 given us, I suspect that lots of people all over the
6 country are going to be using this background material
7 as this debate picks up. So thank you very much for
8 your input.

9 MR. GOLDBERG: I wish all of you the best
10 of luck. And just make it effective in about ten
11 years, when I retire, please. Thank you very much.

12 (Laughter.)

13 CHAIRMAN MACK: Thank you.

14 If I could ask the next panel to come on
15 forward, I would appreciate it. We are going to have
16 now again three panelists. The three panelists are a
17 professor of law and economics at Harvard Law School
18 is Louis Kaplow. From the Brookings Institute and
19 co-director of Urban Brookings Tax Policy Center is
20 William Gale, whose name we heard mentioned a couple
21 of times. And the third is Stephen Entin, who is
22 President and Executive Director, Institute for
23 Research on the Economics of Taxation.

24 And I think, Professor Kaplow, you were
25 going to go first.

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1 MR. KAPLOW: Yes, I am.

2 CHAIRMAN MACK: Okay. Great. And we are
3 going to then hear from all three of you before we get
4 into some questions.

5 MR. KAPLOW: Thank you, Mr. Chairman. It
6 is a pleasure to be here today before the President's
7 Advisory Panel on Federal Tax Reform.

8 I have been asked to step a good distance
9 back from the whirlwind tour of history that Fred just
10 presented and to address in a somewhat abstract
11 conceptual but really basic and fundamental level what
12 are the differences, the core differences, between an
13 income tax and a consumption tax system.

14 In order to do this, it is helpful to be
15 a little bit concrete and a little bit oversimplified
16 and to have a basic simple story in mind. So the
17 story I have is our taxpayer who lives in two periods.
18 In the first period, our taxpayer works, earns labor
19 income. And, of course, some of this will be
20 consumed. And the rest will be saved for retirement.

21 When our taxpayer arrives in the second
22 period, the retirement years, during the interim,
23 there will have been earnings on that savings, the
24 return, the interest, or whatever form it might take,
25 that will be received. And the taxpayer, being

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1 retired, all that remains is to consume. So the
2 taxpayer will consume both the principal of what was
3 saved along with the return or interest on that
4 savings.

5 And I am now going to use this basic story
6 to help explain a little more concretely what are the
7 differences between an income tax and a consumption
8 tax.

9 So what is an income tax? Well, the tax
10 base is all income. But then we have to ask, what is
11 income? The standard definition that is used, often
12 called the Haig-Simons definition of income, looks at
13 income not sort of by receipts but, rather, by uses
14 and sees income in an accounting sense as consumption
15 plus changes in wealth, that those together will equal
16 income in any given year.

17 Well, given the notion of an income tax,
18 what is actually taxed in the simple story that I
19 presented? Well, in the first period, when our
20 taxpayer was working, all of the labor income would be
21 taxed, both that which was consumed and that which was
22 saved because the savings would be a positive change
23 in wealth.

24 In the second period, when our taxpayer is
25 retired, all that would remain to be taxed would be

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1 the return on savings, which would be interest in a
2 simple example.

3 An important thing to observe at this
4 point since what I have described actually departs in
5 an important way from what we observe in practice is
6 that a pure income tax of this kind is one that taxes
7 income as it accrues. It differs from a standard
8 income tax primarily and taxes gains and losses as
9 they occur, rather than waiting for a realization
10 event.

11 In contrast, what is a consumption tax?
12 The tax base of consumption taxes all consumption.
13 And what I will be describing here is sometimes called
14 a personal or cash flow consumption tax. A bit later
15 I will contrast it with things like a national sales
16 tax or VAT.

17 What is taxed under a consumption tax?
18 Well, this is fairly straightforward in principle.
19 The first period's tax base would be whatever the
20 taxpayer in our story consumed in the first period.
21 The second period's tax base would be consumption in
22 the second period.

23 How might you implement this form of
24 consumption tax? In the old days, it was discussed,
25 well, trying to keep track of how much each person

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1 consumes at each point in time might be rather
2 difficult as an administrative matter, but it has been
3 observed that one way one could implement a
4 consumption tax -- and it's the way that has been most
5 talked about in recent decades -- is to define the
6 consumption tax base by starting with something like
7 the current income tax base or a theoretically pure
8 income tax base and simply subtracting the change in
9 wealth.

10 This is really, again, an accounting
11 identity. If you recall our original definition that
12 income is consumption plus change in wealth, if you
13 deduct the change in wealth from both sides, you then
14 get a definition of consumption.

15 Now, that is all a bit of abstraction in
16 accounting identity. What is this in the real world?
17 Well, you could envision, for example, a pure income
18 tax that provided a 401(k) or IRA-type vehicle that
19 simply had no cap. So individuals could put all of
20 their savings in something like an IRA or 401(k).

21 What would happen? Savings would be
22 untaxed when they were earned. Any accrual, as it
23 happens, would also be untaxed. However, when it was
24 withdrawn for consumption, every bit of it would be
25 taxed, in this case for the first time. So that's the

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1 basic operation of a personal cash flow consumption
2 tax.

3 While I have now given you definitions and
4 the definitions differ, the question is, what do we
5 make of that difference? What are different ways to
6 think about the difference?

7 What I would like to do is present two
8 different ways of thinking about the difference, which
9 will probably seem different. But both of them are
10 entirely correct and mathematically equivalent.

11 So you could say they really are two
12 different perspectives on the same thing. I am not
13 favoring one or another but just suggesting that both
14 will help our understanding of what is involved.

15 So the first equivalence relationship I'd
16 like to describe might be called an income tax
17 perspective on the consumption tax. This view would
18 state correctly that a consumption tax is equivalent
19 to a labor income tax. Put another way, a consumption
20 tax is like an income tax that exempts capital income.

21 How can we appreciate this intuition? It
22 follows from accounting identities, but to really
23 grasp it, consider a tax that is going to be at 25
24 percent. What if it were a 25 percent consumption
25 tax? Well, individuals obviously could consume 75

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1 percent as much as they could consume in each period
2 as in a world with no taxes. However, they chose to
3 allocate across periods.

4 What if, instead of a 25 percent
5 consumption tax, we had a 25 percent labor income tax?
6 Well, that would knock down their receipts to 75
7 percent of what they were before. And then with no
8 further tax, they would be free to allocate it as they
9 wished across periods, allowing them again to consume
10 75 percent as much as they could in a world without
11 taxes. So that is a way to see that a consumption tax
12 is indeed equivalent to a labor income tax.

13 Allow me now a second equivalence, which
14 really flips the perspective. This is a consumption
15 tax perspective on the income tax. So here the
16 statement is that an income tax is equivalent to a
17 consumption tax that applies a higher rate to later
18 consumption. The reason this equivalence is true is
19 because the income tax taxes savings on earnings that
20 were previously subject to tax.

21 Now, what is the intuition behind viewing
22 an income tax as just a consumption tax but that
23 applies differentially, heavier on future consumption
24 than present consumption?

25 Well, let's stick within period one for a

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1 minute and imagine our taxpayer is choosing between
2 apples and oranges. The income tax, whether you spend
3 it on apples or oranges, will be taxed in the same
4 way, obviously.

5 However, if you are considering oranges
6 today in this period versus oranges tomorrow in period
7 two, the money you put aside to spend on the oranges
8 in period two, the earnings on that savings will be
9 subject to tax.

10 So if you look at the relative effect of
11 tax, it will be heavier on period two oranges than on
12 period one oranges, which is just a simple, perhaps
13 artificial way of illustrating how an income tax bears
14 differently on consumption in different periods.

15 So those are some conceptual statements
16 about the mechanics. One question that is often
17 addressed is about the distributive difference between
18 an income tax and a consumption tax.

19 There is an apparent contrast, which has
20 an obvious dimension of reality to it, which is since
21 it is a fact high income taxpayers tend to save a
22 greater fraction of income than lower income
23 taxpayers, they will tend to fare worse under an
24 income tax or equivalently better under a consumption
25 tax.

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1 But one can ask whether inherently the two
2 tax bases really have different distributive
3 consequences. I would suggest as a first
4 approximation the answer to that is no. And the
5 reason is that you can play with the rate structure of
6 each.

7 So you could have a consumption tax that
8 by adjusting the rate structure ended up basically
9 having the same incidence as an income tax or starting
10 from a given consumption tax one liked, one could
11 adjust the rate structure of the income tax to have
12 the same incidence of where you started.

13 This is loosely analogous to the idea in
14 the 1986 Act that we can change an awful lot of
15 things, but if we are also allowed to adjust the rate
16 structure, we can essentially keep the distribution
17 the same.

18 What this point suggests -- and it is my
19 parting observation -- at the conceptual level is that
20 the really intrinsic difference between an income tax
21 and a consumption tax very much involves matters of
22 efficiency and administration. I'm not going to get
23 into those matters. And people disagree as to which
24 way they cut, but I think that is where much of the
25 focus appropriately should be, at least in principle.

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1 Before I mentioned that I was describing
2 a personal or cash flow consumption tax. How does
3 that relate to other consumption tax systems? Well,
4 a VAT or a national sales tax obviously are
5 consumption taxes. They are levied directly on
6 consumption.

7 Their primary difference is that without
8 a lot of administrative difficulty, one will tend to
9 apply them at a single rate. They are flat taxes of
10 a sort with no exemption.

11 Now, that, of course, has a different
12 distributive implication than the kind of consumption
13 tax I was describing before. However, I think most
14 envision that if one wanted to use a VAT or a national
15 sales tax, it would be a supplementary tax joined with
16 either a personal cash flow consumption tax so the
17 system would be all consumption tax with two
18 components or joined with an income tax.

19 And whichever one one joins it with, by
20 playing with the rate structure of the latter, one
21 could accomplish essentially any distributive
22 incidence that one thought was appropriate.

23 And it's just worth observing that most
24 other developed economies outside the U.S. use a VAT
25 with some sort of an income tax.

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1 My final set of remarks tries to relate
2 these somewhat abstract conceptual statements with the
3 system that we have. And given that I only have
4 another couple of minutes, I am going to do it briefly
5 and hitting sort of the main points, but I think it
6 will convey much of the important reality.

7 The question here is, what really is our
8 existing income tax? Ostensibly, our income tax is a
9 tax on income. But, in fact, I think most would agree
10 that substantial departures from an ideal income tax
11 make it a hybrid, somewhere between a pure accrual
12 income tax and a pure consumption tax.

13 What are some of the major categories of
14 departure? Well, departures from an income tax in the
15 direction of a consumption tax are many: consumer
16 durables, notably housing; many forms of retirement
17 savings, but only those in qualified plans or programs
18 of one sort or another.

19 There's preferential treatment of much
20 investment income outside of retirement savings,
21 deferral through the realization requirements, step-up
22 basis at death, preferential rates, accelerated
23 depreciation. Also, an under-explored area is the
24 human capital is essentially taxed on a realization
25 basis as well.

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1 If you add all of this together, a
2 tremendous portion of the entire capital stock is
3 taxed entirely or substantially as if we were under a
4 consumption tax, rather than under an income tax, just
5 an observation, not necessarily a criticism or a
6 compliment.

7 There are also departures from pure income
8 taxation in the opposite direction. That is, there
9 are certain respects in which the tax on the capital
10 stock is heavier under the current system than it
11 would be under an idealized income tax system. The
12 two major areas I would identify are inflationary
13 gains.

14 You are all aware that we index the rate
15 brackets and the like for inflation, but we do not
16 index the computation of interest for basis, which
17 means that much capital income, especially in high
18 inflationary periods, is taxed much more than a pure
19 income tax would tax it.

20 The other major departure is the corporate
21 income tax to the extent it's not fully integrated
22 with the individual income tax. And various proposals
23 have addressed how that might be done.

24 If you put these departures toward heavier
25 taxation of capital together with an earlier laundry

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1 list of departures toward consumption tax treatment of
2 capital, then that is probably that we are between an
3 income tax and a consumption tax, probably closer to
4 a consumption tax than a pure income tax, but that
5 varies over time as different tax reforms have been
6 enacted.

7 My final remark is just, well, what do we
8 make of the current hybrid system? One observation
9 follows almost by definition from what I have stated.

10 If you wanted to implement something
11 vaguely like a pure income tax or consumption tax, you
12 would be making quite a substantial reform, even aside
13 from myriad tax expenditures involving health care,
14 college, whatever it might be.

15 The second observation -- and this relates
16 to many of the comments that Fred made, especially the
17 more passionate ones -- is that when we look at the
18 cost of the hybrid system, the fact that we are in the
19 middle, often it's comfortable to be in a moderate
20 middle position taking the best of both. But in many
21 ways, we have the worst of both.

22 So there is economic distortion because we
23 don't uniformly treat everything in the middle. Some
24 things are treated at one extreme, some at another
25 extreme. And the wide variations create much economic

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1 distortion.

2 The second observation is that when you
3 think about the massive administrative compliance and
4 avoidance cost of the current system, many of them
5 actually involve gaming the system due to the fact
6 that we have all of these differences in the hybrid
7 system. So much of it involves boundary police and
8 keeping the various unsystematic, conflicting, and ad
9 hoc compromises we have made in line.

10 So the suggestion again is if one did make
11 the major reform moving toward either type of pure
12 system, there would probably be much gain to be had,
13 both on economic distortion and on complexity,
14 simplicity, and the like.

15 Thank you.

16 CHAIRMAN MACK: Our next presenter is Mr.
17 William Gale. Bill, go ahead.

18 MR. GALE: Mr. Chairman, Mr. Vice
19 Chairman, members of the panel, I would like to thank
20 you for inviting me to testify this morning. You have
21 an exciting and challenging task in front of you. And
22 I am happy to provide whatever help I can in that
23 regard.

24 In preparing comments about tax reform and
25 tax policy, I often feel like everything has been said

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1 and everyone has said it over the past 20 years. So
2 I wanted to start off with a little bit of a different
3 tack before I turn to my overheads. And that is I
4 want to quote from Yogi Berra and Winston Churchill,
5 two names that you don't often hear in the same
6 sentence, because I think that it provides the right
7 context for my comments.

8 Yogi Berra, the great social philosopher,
9 said that, "In theory, theory and practice are the
10 same. In practice, they're different."

11 To paraphrase Winston Churchill, my
12 comments are essentially in the real world, the income
13 tax is the worst tax except for all of the others.

14 And so the focus of my comments will be a
15 little different than Louis' in that Louis was at a
16 very high level of theory unsullied by the real world.
17 I want to get my hands dirty in the real world because
18 I think that is a first order consideration in talking
19 about tax policy.

20 So before we turn to the consumption
21 versus income tax issue, let me just note that that is
22 only one of five issues, really -- there are only four
23 issues listed here -- one of really five issues in tax
24 reform.

25 The most obvious issue is the tax base,

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1 what are you going to tax. And here the question is
2 income and consumption, but there are also
3 alternatives. There are wages. There are hybrids.
4 There are things that we can't even summarize because
5 they are so complicated.

6 The second issue is what kind of
7 exceptions to that tax base do you want to have?
8 Deductions, exemptions, education subsidies, child
9 subsidies, health subsidies, et cetera. And that is
10 in some sense a bigger issue than the tax base.

11 This is exactly what Louis was saying
12 before. The difference between a pure consumption tax
13 and a pure income tax is not that big. But if you
14 could get all the junk out of the code and get a broad
15 consistent base, that would be a big change relative
16 to the difference between a pure income tax and pure
17 consumption tax.

18 The third issue, of course, is tax rates,
19 whether they're flat or graduated.

20 A fourth issue is where you actually get
21 the money: individuals, businesses, automatic
22 withholding, third party withholding, et cetera.

23 And a fifth issue is actually the level of
24 revenue. I didn't put this on this overhead because
25 you have already been tasked to do a revenue-neutral

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1 reform, although I endorse all of Fred Goldberg's
2 comments in regard to the entitlement issue.

3 All right. Tax reform in theory and
4 practice. In theory, it is very easy to write down
5 much better tax systems than we have. Any of us could
6 list a half a dozen prototypes that work better.
7 They're simpler. They're more efficient, et cetera.

8 But in the real world, the changes that
9 you need to make to those idealized proposals to get
10 them through Congress, to get them past the efforts of
11 lobbyists, to get them beyond the ingenuity of the tax
12 shelter industry, to make them consistent with the
13 fickle and malleable nature of public opinion, all of
14 those changes make taxes more complicated, less
15 efficient, and less fair.

16 And if you don't believe me, I appeal to
17 every tax system in every country in the world. There
18 are no countries that have simple tax systems that
19 raise revenues on the order that we raise in this
20 country.

21 The implication of this is that comparing
22 the actual system to a system that only exists on
23 paper is fun but is not likely to be very informative
24 about what happened if you actually aimed to hit that
25 system. So we need to think about real world

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1 comparisons between the current system and
2 alternatives.

3 Then just before I turn to comparing
4 consumption and income taxes, let me note a couple of
5 issues here. As Louis mentioned, there are many ways
6 to design consumption and income taxes. And so what
7 I will be talking about is sort of central tendencies
8 for one tax versus the other.

9 I sent this around for comments yesterday.
10 And every comment was sort of "Yes, but," "Yes, but,"
11 "Yes, but." You can always find some exception, but
12 let me just acknowledge at the beginning I'm talking
13 about central tendencies.

14 So I will think of the income tax as the
15 current U.S. system, the consumption tax as either a
16 European value-added tax or the U.S. tax system with
17 expanded 401(k)'s, like Louis said, but also with no
18 interest deduction.

19 One of the huge unintended consequences in
20 the current system is we have tax-preferred asset
21 income but we give deductions for interest. And that
22 generates enormous tax sheltering activity.

23 So any proposal that wants to expand
24 tax-preferred saving has to do something to limit
25 interest deductions. Otherwise you generate an

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1 enormous tax shelter.

2 Okay. So let me start with progressivity.
3 Louis is right. In theory, there is no reason why a
4 consumption tax has to be less progressive than an
5 income tax. But in the real world, every consumption
6 tax ever designed has hit high income people less than
7 our current income tax system did.

8 So realistically a switch from an income
9 to a consumption tax that is revenue-neutral would
10 raise burdens on low and middle income households
11 relative to the current system, reduce burdens on high
12 income households relative to the current system.

13 Now, to be clear, this does not require
14 high tax rates. The 1986 example is a shining example
15 there. If you clean out the base, you have a lot of
16 revenues that you can use to reduce tax rates.

17 The second issue on the progressive income
18 tax is that it acts as a partial insurance mechanism.
19 If your income falls by a certain percentage, your
20 taxes fall by more than that. And, therefore, your
21 after-tax income falls by less than that.

22 So the progressive tax system acts as a
23 partial insurance mechanism. That is important in a
24 world where it is virtually impossible to ensure
25 against income fluctuations.

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1 In a consumption tax, it is possible to
2 have those things in there, but most of the
3 consumption tax proposals that are out there don't
4 have that feature.

5 All right. Another issue is which is the
6 better measure of ability to pay income or
7 consumption. Here I think there is a massive
8 difference between theory and the real world.

9 Every theoretical model will tell you that
10 consumption is the right measure of a household's
11 ability to pay. In the real world, I think that is
12 wrong. And I think that consumption can actually be
13 a really poor measure of ability to pay. Let me give
14 you some examples.

15 When people can borrow as much as they
16 want or lend as much as they want at a given interest
17 rate, then consumption is definitely a good measure of
18 ability to pay. But, in fact, people can't do that.
19 And that means that they don't have access to their
20 lifetime resources in every single year. And,
21 therefore, that raises the status of current income as
22 a better measure of ability to pay than consumption.

23 Another point that is widely known and
24 documented in the literature is that people have
25 different proclivities to save. Some save a lot.

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1 Some save a little.

2 What is not so well-known is that that
3 fact means that differences in consumption across
4 people are not good measures of differences in their
5 ability to pay. They're not good measures of their
6 lifetime resources because you might have a high
7 lifetime income person that saves a whole lot and,
8 therefore, only consumes a certain amount.

9 You might have a low income person that
10 doesn't save at all and consumes the same amount.
11 These people have the same consumption, but they have
12 very different ability to pay.

13 So the fact that people tend to have
14 different tendencies to save means that consumption is
15 not a good measure of ability to pay across people.

16 Finally, there are a number of situations
17 where I think it's just unambiguous that consumption
18 is a bad measure of ability to pay. I will just give
19 you two examples.

20 A family has a couple of kids. One spouse
21 stops working. Their income goes down. Their
22 consumption goes up. Under a consumption tax, their
23 taxes go up because their ability to pay appears to
24 have gone up if you use consumption as the measure.
25 Under income tax, their taxes go down because they're

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1 measured income has gone down.

2 Another example is somebody gets sick.
3 They lose their job. They have high health expenses.
4 Again, their income goes down. Their consumption goes
5 up. I would argue in that sense that income is a much
6 better measure of their ability to pay than their
7 consumption expenditures are.

8 So I would argue in the real world that
9 income is probably a better measure of ability to pay,
10 although I recognize the theoretical issues involved.

11 All right. Let's turn to complexity. I
12 am not about to defend the level of complexity in the
13 current income tax. I do believe Fred's comment
14 earlier about human nature being that tax systems are
15 going to be complicated. European value-added taxes
16 are enormously complicated. They are not the simple
17 four-line item that you see in textbooks.

18 Many of the reasons for taxes being
19 complicated would remain under a consumption tax.
20 That includes the desire to be fair, to administer
21 social policy, to reduce evasion, and to respond to
22 political issues.

23 There is one source of complexity in the
24 current code, which wouldn't have to be in a
25 consumption tax. And that is taxing capital income.

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1 Now, that doesn't mean it won't be in the
2 consumption tax. There were proposals in the mid-'90s
3 for something called the USA tax, which was a
4 consumption tax that floundered on how complicated it
5 was to tax capital income in that tax.

6 But that could be an area where the tax
7 system could be simpler. But, of course, it could be
8 simpler in the current tax system also. And if you
9 made all the simplifications in the current system
10 that you could, you would find that the difference for
11 going from there to a pure consumption tax would not
12 be that big a deal.

13 All right. Now, there are also two areas
14 where moving to a consumption tax would be more
15 complicated than the current tax code. And that is,
16 although a consumption tax gets rid of things like
17 debt versus equity, which makes for complicated taxes
18 now, it would inevitably introduce new distinctions
19 between taxable and nontaxable flows that I can go
20 into, but the point is unless you tax literally
21 everything, you have got something that is taxable and
22 something that is nontaxable, most consumption taxes
23 choose not to tax financial income and to tax
24 nonfinancial income. But if you do that, then you
25 create a big wedge between those two types of income.

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1 And you have people changing the nature of their
2 income from wages to capital to avoid the tax.

3 You will not have a system that can avoid
4 making distinctions that don't look like distinctions
5 in real life but do matter in the tax code.

6 The other place where a consumption tax
7 will be complicated is with all of the non-tax
8 features of society or the nonfederal income tax
9 features.

10 We have 40-some states that have state
11 income taxes. We have tax treaties with dozens of
12 countries. We have corporate accounting systems. We
13 have other income-reporting systems for stuff like
14 college financial aid and mortgage applications. We
15 have government benefit programs that depend on
16 income.

17 Anywhere where people have to hand in
18 their income tax form as evidence of their income is
19 a situation where the world is going to be more
20 complicated in a consumption tax because then they're
21 going to have to fill out their income tax form anyway
22 and turn it in. Okay? So it's not a slam dunk at all
23 that a consumption tax is going to be simpler.

24 All right. What about economic growth?
25 Well, again, in theory, there is no doubt that a

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1 consumption tax, a well-designed consumption tax, can
2 be more productive in terms of long-term growth than
3 the current income tax.

4 The key words there are not "consumption
5 tax." They are "well-designed." A well-designed
6 consumption tax should be revenue-neutral. It should
7 broaden the base. It needs to impose a tax on old
8 capital. And it needs to shut down the differential
9 distinction between the differential treatment of
10 interest income and interest expense.

11 If you can do that, you have the potential
12 to raise economic growth. But if you say go to the
13 flat tax and you put back in the health insurance
14 deduction and you let businesses deduct their state
15 and payroll taxes, which is what they asked for in the
16 '90s, and you put back the mortgage interest deduction
17 and you put back the charitable deduction, you will
18 not get an increase in economic growth out of that.

19 In addition, converting to a consumption
20 tax could actually blunt some of the savings
21 incentives that are in the current income tax. I'm
22 not a huge fan of all of them, I think
23 low and middle income households, they tend to work
24 fairly well. It would be a more promising way to
25 raise saving and growth by encouraging things like

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1 automatic escalation or contributions in automatic
2 enrollment than by trying to switch to a consumption
3 tax.

4 Let me just tick off three final points.
5 And I will stop. One is you will often hear people
6 say that a consumption tax taxes the underground
7 economy better than an income tax. That is not right.
8 It's based on a myth. There's this drug dealer
9 example that kind of floats around that is just wrong.
10 If you would like me to explain it, I will.

11 But the evidence is that European
12 countries, which have value-added taxes, have shadow
13 economies that are just as big as ours. So there's
14 nothing magical about a consumption tax in getting at
15 the underground economy.

16 One of the new things that came out of
17 recent consumption tax debates is dealing with
18 unstable tax systems. As you know, we have had a
19 dozen major changes in the last 25 years. It's
20 looking like we're to have more in the future.

21 One of the ways where consumption taxes
22 are decidedly inferior to income taxes is in dealing
23 with unstable tax systems. So if you are moving the
24 tax rate up and down over time, if you think of that
25 as a prototypical tax change going back and forth,

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1 that has a much bigger effect on the return to saving
2 investment in a consumption tax than it does in an
3 income tax.

4 That is something to think about in the
5 manner of what Fred discussed earlier, that if we make
6 a change but it's not stable, then it actually matters
7 whether it is a consumption or income tax change
8 because the damage that can be done in a consumption
9 tax can actually be bigger than in an income tax.

10 Last point, another difference between a
11 consumption tax and an income tax is if you move to a
12 consumption tax, you will have transition issues. I
13 won't talk about them here.

14 Let me conclude. The income tax might be
15 a big house, it might be a messy house, it might be a
16 jumbled community, but I don't think you should tear
17 it down. All right? I think you should try to
18 rebuild it.

19 It can be improved. Most of the changes
20 that we talk about making the system better involve
21 making the income tax simpler, more efficient, and
22 fairer.

23 If a consumption tax is added on in
24 addition to that, that is one thing. That is a way to
25 broaden the revenue base and look forward to paying

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1 for entitlements in the next 50 years, as has been
2 discussed. But if we eliminate the income tax and go
3 to a consumption tax, we're making a huge change in
4 the biggest tax system in the history of the world.

5 We're making a change that has never been
6 tried and a change that I believe will deliver much
7 less than hoped for as fraught with peril, both large
8 and small.

9 Thank you.

10 CHAIRMAN MACK: Bill, thank you very much
11 for those comments.

12 We now move to Stephen Entin. Steve?

13 MR. ENTIN: Mr. Chairman, members of the
14 commission, thank you very much for the opportunity to
15 be with you this morning. You have a great
16 opportunity to give us the best shot at fundamental
17 tax reform since 1986. And I certainly wish you well.
18 I will keep my comments short, perhaps submit a fuller
19 statement for the record.

20 We have heard a rather gloomy assessment
21 just now. I would like to point out that economics
22 really is not the dismal science if you have a morbid
23 sense of humor. And I would also like to counter the
24 notion that taxes are boring.

25 If you have ever been scrambling in terror

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1 to fill out your income tax at 11:00 P.M. on April
2 15th trying to get to the post office before it
3 closes, you know that taxes can be very stimulating
4 indeed.

5 We have been charged to produce a tax
6 system with more favorable treatment of activities
7 that promote growth. We would like more simplicity.
8 Fairness is a very important consideration. I would
9 like to add visibility and transparency, which the
10 chairman brought up, as an important point.

11 Taxes tell us what government is costing
12 us. And any consumer of anything ought to know what
13 he is paying for it so that he can decide how much of
14 it he wants to buy. It's really how we hold
15 government accountable.

16 Can we improve things? I think we will
17 have an easier time achieving these objectives if we
18 choose our tax base very carefully. And I would
19 suggest to you that a consumption base or moving
20 closer to a consumption base in our hybrid system
21 would be a good thing if we are going to satisfy both
22 basic objectives for the tax system.

23 I would like to toss out some ideas about
24 what income is and what isn't. These have
25 repercussions when you consider what is fair and how

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1 the economy works. I think we need to get them clear.

2 Income is not the ability to pay. Income
3 is the earned reward for providing labor and capital
4 to produce goods and services that other people value.
5 Income is produced. You have to work to do it. And
6 doing that means giving up leisure, and it means
7 giving up current consumption and doing saving
8 instead. It involves sacrifice.

9 Income is proportional to effort. The
10 output one produces depends on how much effort one has
11 made to acquire training, acquire capital, how long
12 one works. The goods and services we produce are
13 proportional to that effort.

14 And, therefore, I submit the fairest tax
15 is proportional to income once you have understood
16 that income is this net concept. It is revenue less
17 the cost of earning revenue. Deductions for costs are
18 necessary to measure income properly. Tax reform
19 isn't about getting rid of all deductions.

20 You don't ask the mom and pop grocery
21 store to ignore the cost of the soup that it puts on
22 the shelf and claim that the entire sale was profit.
23 And you should not expect individuals to be taxed on
24 their returns on saving without counting the saving in
25 the deferral of consumption as a cost.

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1 If you don't save, you don't get the
2 interest and you don't get the dividends. You can't
3 put a tax on the principal and then expect the person
4 to still have the interest and the dividends. He
5 can't give you the principal and still earn the
6 interest and the dividends to pay the taxes on them.
7 You can't have your principal and eat it, too.

8 Therefore, the best real measure of income
9 is consumption. And we should be taxing what we spend
10 when we spend.

11 The neutral taxes, the ones that treat the
12 orange today and the orange tomorrow evenly, are often
13 referred to as consumption taxes, but I think you
14 should think of them as taxes on income when all the
15 costs of earning income have been correctly measured
16 in time.

17 Neutral taxes do not fall more heavily on
18 saving and investment, then on consumption. They are
19 unbiased against growth activities. They are far
20 simpler than the income tax. They are fair, and they
21 are straightforward.

22 We have heard that the income tax does tax
23 people. The more that they work and produce, the more
24 that they save and earn because of the graduated
25 rates. And we have seen that the income tax hits

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1 saving and investment harder than consumption, which
2 simply encourages consumption by penalizing saving.

3 Take a quick review of the multiple stages
4 of taxation of saving. If you earn your money and you
5 pay your tax on it, you can buy a loaf of bread and
6 make a whole week's worth of sandwiches depending on
7 how large your family is. And you can eat those
8 sandwiches, and we don't bother you again. You can
9 buy a television set and sit there looking at the
10 stream of programming, and we don't bother you again.

11 If you buy a bond, we tax the stream of
12 interest. If you have a small business, we tax the
13 stream of profit as a second layer of tax on the money
14 we put into those activities.

15 If you buy corporate stock, we are going
16 to hit the corporation first and then hit you again on
17 your dividends or if the corporation retains the
18 earnings and gets bigger and stronger and the price
19 goes up and you sell the stock, we hit you on the
20 capital gain, which is another layer of tax on the
21 retained earning. And then if you still have too much
22 left over when you are elderly, we may hit you again
23 with the transfer tax, the estate and gift tax.

24 So we have four layers of potential tax on
25 saving versus one on consumption except for those

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1 bizarre few federal excise taxes that probably ought
2 to be canned.

3 Now, the taxes on the saving, on the
4 oranges tomorrow, are sometimes thought to be, in
5 fact, taxes on saving when they are really taxes on
6 future consumption.

7 We have heard the distinction between the
8 concept of the labor tax versus the income tax. In
9 fact, taxes don't stay where the tax writers say they
10 are putting them.

11 Taxes have economic consequences. Not
12 only is the worker or the person saving for retirement
13 so you're really taxing his earnings, which means
14 you're taxing his prior labor, but if I have someone
15 who hasn't saved yet and someone who has saved yet,
16 taxing the saver may very well hurt the current
17 worker.

18 Capital is very sensitive to tax. If you
19 put these added layers of tax on it, you get less
20 accumulated saving, less accumulation of plant and
21 equipment for the worker to work with. It depressed
22 productivity, and the wage goes down.

23 Economically most of the burden of the
24 taxes on corporations and businesses and savers
25 ultimately hit people in their role as workers because

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1 they are less efficient and they are paid less as a
2 result. Savers can always choose to switch to
3 consumption. Consumption is nice, too. But when they
4 do, workers lose their jobs.

5 We have made many steps in the income tax
6 structure to move in the direction of a consumption
7 tax. We have pensions and IRAs. And expanding those
8 would move us even further in that direction. A tax
9 that is neutral between saving and consumption, either
10 defer tax until saving is spent or tax the savings up
11 front and not tax the returns.

12 The difference to a saver over a lifetime
13 of putting money aside for retirement in an ordinary
14 income tax structure versus a tax-deferred consumption
15 style structure is enormous.

16 I have an example here of I think 7
17 percent, 7.2 percent, interest and the 20 percent tax
18 rate, \$1,000 a year from age 20 to 70. You end up
19 with \$400,000. In the neutral system, you end up with
20 under \$250,000 in the ordinary income taxes. It makes
21 an enormous difference. And that difference in saving
22 goes into capital formation.

23 A neutral tax would not tax corporate
24 income twice. It would be taxed at either the
25 corporate level or the shareholder level. And I agree

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1 it really should be passed through to the shareholder.

2 This is a situation where only people pay
3 taxes, businesses don't really. Businesses are
4 legally people. In the law, they can sign contracts
5 and be sued. But that is a legal fiction. And we
6 should not be trying to tax legal fictions.

7 And then there is that added layer of tax
8 that is the death tax that ought to be eliminated.
9 That is another tax on accumulated saving that either
10 has already been taxed or if they're in a pension plan
11 will be subject to the errors tax. It's always an
12 extra layer of tax.

13 There are many types of consumption-based
14 taxes. They look different, but they really are all
15 on the same tax base, which is either income less
16 savings or income less investment. And since saving
17 equals investment, they are all on the amount of
18 income that is used for consumption. They include the
19 cash flow tax, which is the saving-deferred tax; the
20 flat tax; the sales tax; the value-added tax; and all
21 of their permutations.

22 These things have a different point of
23 collection, but they really are on the same tax base.
24 They all treat saving neutrally versus consumption,
25 all employee expensing, instead of depreciation, and

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1 with appropriate adjustments for interest passthrough.
2 All are territorial. All have the same basic tax
3 base.

4 The objective is growth, one of the
5 objectives. And I would submit that as you do your
6 work, you ought to test and see what you are doing as
7 you proceed to the cost of capital. Is it raising the
8 tax on investment or lowering it?

9 In '86, no attention was paid. The cost
10 of capital was raised, not do good things for the rest
11 of the decade. You had a stock market crash the next
12 year as people realized what had happened to them.

13 If you want growth, you're going to have
14 to pay attention to that as you do your work. The
15 neutral taxes will give more saving investment and
16 growth. And I think potentially it would add several
17 trillion dollars to the capital stock.

18 It would add several million additional
19 jobs, and it would be at higher wages. It would
20 probably be thousands of dollars, maybe four to six
21 thousand dollars in the middle income range, in higher
22 family income pretax simply because the added growth
23 the system would generate. And the U.S. would become
24 a jobs and investment magnet.

25 If you are going to be constrained to a

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1 neutral, revenue-neutral, system, you really ought not
2 to ignore the growth. You will have to make sure that
3 the particular tax changes you have made actually do
4 contribute to growth. There are many tax changes that
5 will be proposed that make things look nice but don't
6 have any impact at the margin on activities that lead
7 to additional growth. And you would have to make sure
8 that as you assumed some growth or, in particular,
9 change, it was actually a change that was related to
10 growth.

11 But I think you would be very wise to do
12 that. Otherwise, you are going to be hard-pressed to
13 improve the economic climate.

14 The consumption taxes have varying degrees
15 of simplification, but they are all a good deal
16 simpler than the income tax. And the simplest tax of
17 all, of course, is simply collected at the cash
18 register. Individuals don't have to file. I don't
19 think that is a good idea. They tend to lose track of
20 how much has been taken from them over the course of
21 the year.

22 But even in the individual filing that
23 would be necessary under a cash flow or consumed
24 income tax, you get a great deal more simplification.

25 So even if they are collected on

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1 individual tax forms, you have no double taxation. It
2 would not be a filing at the corporate level. There
3 would be no limits on savings plans. You wouldn't
4 have to choose among them.

5 It wouldn't matter whether you put your
6 money into a derivative, such as Fred Goldberg said,
7 that is terribly hard to capture or an ordinary
8 savings account or a Treasury bond. As long as your
9 money was in the savings plan, it's deferred whenever
10 you took it out from whatever source you took it out.
11 It would be taxed.

12 There would be no separate calculation of
13 any taxes on capital gains. There would be no
14 depreciation scheduled for large and small businesses
15 to struggle through for each machine that they bought
16 or building that they put up. There would be no
17 foreign tax and tax credit problem to worry about,
18 although you would still have to define income at the
19 border. And there would be no phaseouts of dozens of
20 exemptions, credits, and deductions.

21 Fred mentioned that we have broadened the
22 base to preserve the rate structure. And so we have
23 gotten some revenue by phasing this and that out. But
24 when you phase out this or that, you change the effect
25 of marginal rate because earning an extra dollar means

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1 changing your taxable income by something more than an
2 extra dollar or losing part of a credit. Marginal
3 rate structures adjusted for phaseouts look like the
4 Manhattan skyline.

5 One of the worst offenders is the earned
6 income tax credit with a 21 percent phaseout, I think,
7 if you have two children. Put then on top of the 15
8 percent payroll tax and the 15 percent basic tax rate,
9 and you have someone paying almost 50 percent at the
10 margin. And so the earned income tax credit may
11 encourage people to take a low-paying job, but it
12 certainly is a deterrent to actually getting a
13 promotion.

14 Fairness gets back to the notion that
15 consumption is a fairer base of income. It reflects
16 what you have produced and worked to give to other
17 people. It respects the effort of people who work and
18 save.

19 Neutral taxes can be made progressive to
20 shelter the poor. There is no need to tax savings and
21 investment more harshly than consumption to achieve
22 progressivity. There have been a variety of ways of
23 handling progressivity already posed in various plans.

24 And the simple, clearer neutral tax would
25 be seen to be fair. Everyone would be filling out the

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1 same, fairly simple tax form. And there would be not
2 much on there that people could duck with. And people
3 would know that their neighbors were paying their fair
4 share, too.

5 This ability and transparency, Mr.
6 Chairman, I am glad you brought that up. Only people
7 pay taxes. Businesses and things don't pay taxes.
8 Taxes are best levied on individuals.

9 The voters need to see what government
10 costs. And I think everyone who can should pay
11 something toward the cost of government. That is
12 fair. And it is important that people see that
13 government is not a free good. In particular,
14 simplicity is no excuse for dropping tens of millions
15 of people entirely from the tax rolls.

16 In conclusion, tax reform is about getting
17 the tax base right. You had better decide that before
18 you choose whether something is to be in or out of a
19 deduction because unless you know whether you're
20 trying to tax consumption or income, many things will
21 simply appear to be arbitrary.

22 For example, in a consumption-based
23 system, pensions are not a tax expenditure. They're
24 the normal treatment. The current treatment of saving
25 would be the outlier. In the income tax, the pension

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1 is listed as a tax expenditure because you're
2 intending to tax saving and the returns immediately in
3 an income tax and putting in the bias. In the
4 unbiased system, it is the norm. It is not a tax
5 expenditure.

6 Once you have the tax base right and put
7 it in a visible form so the public knows what
8 government is doing to it, the people will tell you
9 how much government they want. And that will enable
10 you to set the rate at what they feel is appropriate.
11 Then they pick and choose how much government they
12 choose to pay for.

13 We would be raising revenue while doing
14 less damage to the economy. That is very important.
15 And if you make the tax system visible -- and some
16 consumption taxes are, and some are not -- you would
17 let the voting public realize what government is doing
18 so it can make informed decisions about how much
19 government activity to support. I think that is
20 important in a democracy.

21 Thank you very much.

22 CHAIRMAN MACK: Steve, thank you for your
23 presentation as well.

24 Now we'll go to some questions. I'm going
25 to start with Vice Chairman Breaux.

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1 VICE CHAIRMAN BREAUX: Thank you very
2 much, Mr. Chairman. Thank the three panel members for
3 their presentations. It's been a very interesting
4 dialogue to begin the discussions.

5 I would like to get some comments on the
6 question. We have asked you all to give us some
7 thoughts on a consumption tax and on the current
8 income tax. Give me your thoughts on not the
9 either/or situation but perhaps doing some type of a
10 combination recommendation, preserving the basic
11 structure of the income tax but adding to it some type
12 of a consumption tax.

13 What are the problems with that? How does
14 it work? Can you guarantee the progressivity of the
15 structure by doing an income tax with a consumption
16 tax?

17 I am not looking at it as an either/or.
18 I'm looking at it maybe as a combination. Can I get
19 some kind of comments on that thought? Louis?

20 MR. KAPLOW: Well, I will make a couple of
21 comments. I think the two main ways to move in a
22 consumption tax direction, in part, would be related
23 to things that were mentioned. One is to expand
24 ceilings on things like IRAs and 401(k)'s.

25 And, as Bill Gale pointed out correctly,

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1 negative assets, borrowing and interest, need to be
2 included and incorporated as one moves in these
3 directions, which we have not done consistently.

4 And, as one does that, it will certainly
5 be of more benefit to those taking more advantage,
6 which will tend to be at the middle and upper income
7 levels. And by adjusting rate structures somewhat at
8 the upper end, one could have the distribution be the
9 same if one wished.

10 Likewise, adding a VAT, a national sales
11 tax, at whatever level, at 5 percent, at 15 percent,
12 somewhat reducing the income tax is another way to go.
13 And, as I alluded to, if one wanted to preserve the
14 existing distribution, one would probably need to
15 somewhat raise rates at the top, lower them at the
16 bottom, make certain transfer programs or the EITC
17 more generous.

18 Just one other word about how it works out
19 in reality. I think of those on the podium, I am on
20 the bottom of the barrel of those who might predict
21 how it would work out politically in the United States
22 if we were to do these.

23 But I think it is interesting to observe
24 that in other countries in the world, where mixed
25 systems are the norm, typically a VAT and an income

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1 tax, many of them engage in more aggregate
2 redistribution leveling of income through the fiscal
3 system than we do. A few engage in less. And they
4 are at many different points along the spectrum.

5 So there's nothing inherent in the
6 schemes, I think, that affects distribution one way or
7 the other. But there probably are differences in
8 political systems. And how it would actually play out
9 is hard for me to say but perhaps easier for you.

10 CHAIRMAN MACK: Yes. Go ahead, Bill.

11 MR. GALE: I want to second everything
12 Louis just said but also just add. If you think about
13 the spending numbers that Fred put up earlier, unless
14 we are really serious about cutting Medicare and
15 Medicaid by enormous amounts, you know, half,
16 two-thirds over what they're projected to be, we are
17 going to need more revenue.

18 And then I say, "Well, can we get that
19 much revenue out of the existing tax instruments?"
20 And I think the answer is likely to be no. You can
21 broaden the base some. Maybe you can raise the rate
22 some.

23 But I understand this isn't your task
24 right now. Your task is do revenue-neutral reform.
25 But I think in doing revenue-neutral reform, you could

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1 do the nation a huge service by setting up a tax base
2 that then could be used to finance whatever
3 entitlements we eventually would like to have.

4 The obvious way to do that is to introduce
5 a value-added tax now and use some of the revenue to
6 get rid of the AMT, some of the revenue -- I don't
7 know -- for rate reduction or whatever. But
8 eventually that value-added tax base is a very
9 powerful money machine that can be used to finance
10 entitlements.

11 I would suggest that you might want to
12 even consider earmarking the value-added tax to health
13 spending as a way of making explicit how much health
14 spending is actually costing all the American people.

15 But I think on revenue grounds, I think on
16 progressivity grounds, you're on sound basis. And I
17 think with a consumption tax in there, there is a
18 stronger case to make than income tax itself, more of
19 a straight income tax with less of the loopholes. So
20 I think on that ground, it's a positive thing to do
21 also.

22 CHAIRMAN MACK: Mr. Entin?

23 MR. ENTIN: If you had two taxes, if there
24 was a prospect of a second tax, I think people would
25 be more afraid that you were going to have a net

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1 increase in taxes and that if it would bring on
2 substitution, that they would resist the opportunity
3 for Congress to have two taxes to raise, rather than
4 just one. I think it would be scary.

5 You could certainly have two neutral taxes
6 and split the neutral taxes in half. If you felt that
7 there was an administrative gain or a reduction in the
8 problems of evasion simply because the two rates would
9 be so low, then no one would probably be cheating on
10 either one. But a cleaner system, a more transparent
11 system would one neutral tax system.

12 We hear a lot about progressivity in
13 graduated rates. And they do contribute to
14 progressivity, but they don't necessarily contribute
15 to fairness when you realize that to earn more income
16 to get into the top brackets, you would have had to
17 produce more goods and services for others to use.

18 Remembering that income is earned by
19 giving people services and products that they wish to
20 buy from you, that you're providing a service somehow
21 to your fellow creatures, you have to realize, then,
22 that perhaps graduation is not necessarily a fair
23 thing.

24 You have to weigh the fairness of
25 punishing people the more that they work and produce

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1 versus the kindness we would like to show to people
2 who are low-income. We would like to relieve them of
3 some of the cost of providing for defense and the
4 common good. But that is kindness, not fairness. And
5 fairness is a proportional tax.

6 The income tax is going to remain
7 distorting if you keep it. If you are talking about
8 incremental moves, you might consider that the
9 expansion of the IRAs to a more universal system,
10 shortening asset lives, moving toward expensing,
11 instead of depreciation, adjusting for interest
12 deductibility, these steps will clean up the tax
13 system without having to make a major break, such as
14 adding a whole new tax.

15 I even get 95 percent of the way toward a
16 consumption base by improving the movement away from
17 the income base toward the consumption base already
18 inherent in the system.

19 It was a mistake, for example, to let the
20 50 percent depreciation provision expire at the end of
21 last year. The last chart on my viewgraphs show that
22 it really did turn investment around and help get us
23 out of that recession. And we could see that
24 continued growth into the future.

25 So, rather than putting on a second layer

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1 of tax, I would suggest you simply move more toward
2 the consumption base than the existing structure.

3 VICE CHAIRMAN BREAUX: Thank you.

4 MEMBER FRENZEL: Thank you, Mr. Chairman.
5 Thank you, gentlemen, for your excellent
6 presentations.

7 I would appreciate it if you would amplify
8 a little bit on the subject of transition, not in the
9 sense of paying off losers but simply the sense of
10 converting if you go from something that we are all
11 used to into something that we don't.

12 For you, Bill, I assume that would be a
13 layover with huge taxes, which Steve has warned us
14 about. But still there are some rough spots. And
15 you've got cash flow, collection. How does that all
16 fit together?

17 And for you, Steve, presumably you would
18 prefer the full consumption. How long does it take us
19 to make the switch from the current system? And what
20 are the fish hooks and costs in there that aren't
21 apparent right now?

22 MR. GALE: I will start, although let me
23 mention the transition issue going from an income tax
24 to a consumption tax is you can think of it most
25 easily as someone who saved all their life under the

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1 income tax.

2 They paid money on their earnings. They
3 paid money on the interest, as Steve mentioned. And
4 then, boom, the minute they retire, we convert to a
5 consumption tax. And now they have to pay taxes when
6 they take the money out.

7 And they're not going to like that. And
8 they are, in fact, being double taxed. Okay? They're
9 getting the worst of both systems in that sense. So
10 the transition --

11 MEMBER FRENZEL: So we need a separate
12 system for current assets now?

13 MR. GALE: I am sorry?

14 MEMBER FRENZEL: Do you need a separate
15 tax system for --

16 MR. GALE: Well, the question is what to
17 do about that. Either you find some way if you want
18 to offer transition relief, you find some way of
19 exempting that tax burden, either directly or
20 indirectly. There are a number of ways to do that.

21 The issue, though, is that when we talk
22 about tax reform having positive effects on long-term
23 economic growth, the importance of actually double
24 taxing existing capital is key to that result.

25 If you give up that tax, remember, we have

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1 trillions of dollars of capital, if you give up all
2 that tax, then you have to have a higher tax rate on
3 everything else. And that dampens the effect on
4 economic growth.

5 The studies that are out there that
6 suggest that -- I don't know -- half, two-thirds,
7 maybe more, of the growth effect goes away if you
8 allow the transition relief. So it's a trade-off
9 between equity and efficiency.

10 I do want to mention, though, the
11 transition issues are much broader than just old
12 assets. Suppose we cleaned out every tax expenditure
13 in the code. That would be like a little tax hit on
14 every little sector.

15 Transition issues would come in there. As
16 well, there are income tax provisions or tax rules or
17 things related to the income tax are written into
18 contracts in society. And if you change that, then
19 you can change the whole kind of social fabric, the
20 whole network. Everything has to be relooked at and
21 updated.

22 But it's a potentially complicated issue
23 if you're going cold turkey from an income tax all the
24 way to a pure consumption tax. If you do something
25 more narrow, then it's in the range of a manageable

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1 issue. But it is an issue.

2 MR. KAPLOW: I will just add another word
3 or two on the pure income tax-consumption tax
4 transition. Taking the person who saves much of their
5 life, has already paid tax on that, and then under a
6 consumption tax is subject to another round of tax, I
7 guess I view it less as an equity/efficiency trade-off
8 and more as a pure efficiency question that reinforces
9 the view that one probably should be thinking about
10 giving substantial transition relief one way or
11 another.

12 And to the extent one imagined there was
13 this large growth benefit from this one-time tax on
14 capital, some estimates of benefits of consumption tax
15 to not assume that that is really obtainable.

16 Part of why I say this is if a consumption
17 tax in some significant way or some very large move
18 were going to happen, I very much doubt as a political
19 and realistic matter it would happen instantaneously
20 that there would be a report from a commission, there
21 would be movement, there would be debate, it would be
22 phased in and so forth.

23 There would be many intervening years
24 during which the prospect that any money you saved,
25 rather than consume now, you would be paying the tax

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1 on now. And you would be paying the tax on the day
2 the VAT went from zero to 15 percent or whatever it
3 might be would have a tremendous adverse incentive
4 effect, one that we would not want to contemplate or
5 to realize.

6 So I think that the right way to think
7 about doing a significant shift in the direction of
8 consumption tax is to have substantial relief for
9 existing capital.

10 I think there are fairly straightforward
11 ways to do it. "Fairly" is a relative term. I don't
12 mean to suggest that on the back of a postcard, but I
13 think it's not monumental and insurmountable. But I
14 think that's the right mindset to be in to think that
15 substantial relief will have to be provided to avoid
16 major dislocation.

17 And given that one is doing that and doing
18 both revenue estimates and effects on growth estimates
19 and so forth, one should be realistic about that, not
20 inconsistent about it.

21 MR. ENTIN: I think the fear of having to
22 provide enormous relief is overblown. Some might be
23 necessary. But when you start withdraw saving from a
24 retirement plan, part of what you are withdrawing is
25 principal, but a great deal of it is earnings.

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1 And those earnings are now going to be
2 taxed when you go to the store or on a personal tax
3 form as consumption, rather than as income, but it's
4 about the same amount of money. Much of what you take
5 out of your savings as you get older is, in fact,
6 taxable earnings under either system. So not the
7 whole thing is suddenly being double taxed. That is
8 absolutely not the case.

9 As you are putting money into your savings
10 through your lifetime, it is going to be taxed at a
11 lower level. There is no double tax on the build-up
12 on ordinary saving anymore. That gets a gain.

13 As you go to a consumption-based tax, at
14 least initially, on old assets, there is a great deal
15 more investment as a result of your enlightened tax
16 shift, old assets will be earning, at least
17 temporarily, a higher rate of return. You are going
18 to see the stock market rise and the gains go up.

19 So people are going to be compensated, in
20 part, by the rising stock market until at least they
21 respond by putting so much more capital in place that
22 the rates of return on capital are driven back down to
23 where they currently are on an after-tax basis.

24 So some of this is going to be handled by
25 itself by the market if you went to the pure saving

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1 deduction, tax it when you take it out kind of tax
2 system.

3 If you go to the sort of tax system that
4 Phil English is talking about where you have the sort
5 of Roth treatment for the saving, where you put it in
6 on an after-tax basis and then don't tax the returns,
7 of course, you don't have that situation at all. But
8 I would suggest that either way it is certainly
9 workable, particularly if you consider the market
10 responses.

11 MEMBER FRENZEL: Thank you.

12 MEMBER ROSSOTTI: One question for Mr.
13 Gale. You had mentioned, just without elaborating,
14 that you thought that on the consumption tax, the VAT
15 style, you had just as many problems with collections,
16 underground economy as you do with income tax. Just
17 could you elaborate just a little bit on that?

18 MR. GALE: Sure. The classic example is
19 that of a drug dealer who under the current income tax
20 doesn't pay taxes on his drug sales -- it's always a
21 him, by the way -- but then goes out and buys a
22 Mercedes and doesn't have to pay taxes on that. The
23 point that consumption tax advocates make is that
24 under a consumption tax, he would have to pay tax when
25 he went out and bought the Mercedes.

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1 And that's true, but it's only half of the
2 story. If there is an income tax in place, he doesn't
3 report his income and, therefore, doesn't pay income
4 taxes. If there is a sales tax in place, he won't
5 collect taxes from the people he sells the drugs to.
6 And that wedge is the same wedge that is present in
7 the income tax system currently.

8 So if you think of an economy where there
9 is no saving, where consumption is income, right, then
10 you see it has got to be true that one tax system is
11 not better or worse than the other.

12 And so it is one of these things that
13 sounds right and then you go home and think about it
14 and say, "Well, wait a second. That can't possibly
15 be."

16 There are second order issues. For
17 example, if the drugs are purchased with money that
18 was generated illegally, then that plays into it, but
19 I think that is distinctly a second order issue. The
20 first order issue is the drug dealer avoids taxes in
21 either case.

22 MR. KAPLOW: If I could add one further
23 comment to that? Bill's point about there being two
24 sides to every transaction has got to be true and is
25 worth keeping in mind.

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1 A significant part of the really
2 underground economy is the cash economy. Cash
3 business accounts for a significant portion of the tax
4 gap at various times that studies have been done. And
5 it's correct that if you're in a sector where there is
6 evasion, you will be losing on both ends.

7 There is a more modest administrative
8 benefit of a diversified system. This isn't so much
9 consumption tax, income tax. Within a consumption
10 tax, having it be half through personal cash flow,
11 kind of like the current income tax and
12 administration, and half through a VAT would have an
13 advantage.

14 A way of putting it is if you have one
15 system that taxes most, but not all, transactions at
16 30 percent and the rest at zero and you compare it to
17 a system where a lot of things that used to be zero
18 are now at 15 and a lot of other things that used to
19 be at 30 are now at 15, having a more common
20 intermediate rate, rather than some high, some low, is
21 a less distorting system in terms of economic
22 distortion. It's a bit more subtle, but I think given
23 the size of the cash economy and the cash gap, it's a
24 nontrivial issue.

25 MR. ENTIN: If you looked at what happened

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1 in Russia after they got rid of some really bizarre,
2 very high tax, narrowly based times and moved toward
3 a flatter rate tax, where it simply was not worth
4 trying to evade the system, their revenues did much
5 better. There is something to that.

6 If you do split it into that kind of a
7 choice, you may have less evasion because neither rate
8 would be high enough to warrant much effort given the
9 risks of being caught.

10 You do sacrifice some transparency if
11 people do not understand that they are paying the VAT
12 if it's not there on the sales slip and if they don't
13 take the trouble to add it up over the course of the
14 year.

15 One of the South American countries has
16 gotten around that and helped people enforce the VAT
17 by saying, "Collect your VAT slips, and we will give
18 you some discount on your income tax at the end of the
19 year." So you will always demand a receipt from the
20 company. And we can somehow make them more responsive
21 and more likely to be paying the VAT. So it reduces
22 evasion of that end.

23 There is a little bit of a trade-off
24 there. Otherwise I share your comment.

25 MEMBER SONNERS: We have talked a lot

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1 throughout the morning about the overall goal of the
2 recommendations of this panel, obviously being
3 simplicity, fairness, and pro growth. And we also
4 touched on throughout the morning a couple of the very
5 few restrictions that the President has placed on us:
6 number one, that we maintain the biases toward home
7 ownership and charitable giving, that we consider this
8 revenue-neutral, making the assumption that the tax
9 cuts from term one are made permanent.

10 But there is one other restriction. And
11 the question associated with that is I suppose to you,
12 Bill. And that is that at least one of our proposals
13 has to maintain the current federal income tax.

14 So, Bill, you specifically said that you
15 thought that there were some key improvements that
16 could be made to the current income tax structure.
17 And I was hoping you could expand on that a little
18 bit.

19 MR. GALE: Sure. Thank you.

20 Let me just mention first the revenue
21 neutrality issue is a little tricky because it's not
22 clear to me what time frame you all are supposed to
23 operate in. There are policies that are
24 revenue-neutral over five years and then fall off the
25 cliff after ten in terms of revenues. And I would

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1 urge you to be wary of them.

2 In terms of the income tax, I don't want
3 to list 87 particular proposals. Let me give three
4 principles to follow. One, the first one is do no
5 harm. And when I say that, I don't mean to any
6 individual taxpayer. You're going to have to gore
7 someone's ox, no question. But do no harm to the
8 system.

9 It really is a system or is supposed to be
10 a system. That is, the way capital income is treated
11 is related to the way capital expense is treated, you
12 know, and so on. So maintaining connections between
13 various parts of the system; in particular, in capital
14 income and interest expense, I think is really
15 important.

16 The second thing is in '86, this happened.
17 And maybe it can happen again. A wholesale attack on
18 tax expenditures I think is in order. And it's not an
19 issue of repeal the provision or not.

20 Tax expenditures tend to have this
21 upside-down structure that if you absolutely looked at
22 them as spending programs, they would look ridiculous
23 because they are giving the biggest benefits to
24 high-income households, the smallest benefits to
25 low-income households because you deduct the payment

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1 at your marginal tax rate.

2 So doing something like establishing a
3 uniform deduction rate, say 15 percent, for some of
4 these things would I think be equitable. It would
5 raise revenue that could be used to do things like get
6 rid of the AMT. And I think it would be a vast
7 improvement in the system.

8 The third thing I was going to say is
9 simplify. That's cheating because everybody wants a
10 simpler tax system, but every year the tax system gets
11 more complicated. And we have to kind of wonder what
12 is going on there.

13 What happens is that everyone makes
14 simplicity their second choice, like "I really want
15 this tax cut, and I want to make the system simpler,"
16 "I really want this adjustment, and I want to make the
17 system simpler." It's sort of ever the bridesmaid,
18 never the bride.

19 And one of the things the commission can
20 do is say, "Look, it's time to take stock and get away
21 from all of these different concerns. We have an
22 over-arching concern with simplicity. And that is
23 going to dominate these 900 judgments that we make.
24 And here they are." So I think that is a real
25 contribution that the commission could make.

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1 Again, if you simplify, you broaden the
2 base. You can use the revenues either to reduce
3 rates, to get rid of the AMT, for a lot of stuff. But
4 that puts you in a good situation in which to operate
5 because you have got revenues you can actually use for
6 some purpose.

7 MR. ENTIN: Could I add one thing to that?
8 You might consider something truly novel and take some
9 of these social engineering provisions out of the tax
10 code entirely and say that if you are going to
11 subsidize something like home ownership or health
12 insurance that it be done with a check voucher,
13 subsidy somewhere, elsewhere in the budget so that it
14 can compete for the federal revenues along with
15 everything else. And then you don't have to worry
16 about whether it is a tax expenditure or not.

17 Another point, though, is that this
18 business about broadening the base by getting rid of
19 tax expenditures, something is a tax expenditure in
20 one tax system, but it's normal in another.

21 Unless you have decided whether you are
22 viewing the tax base as something that looks more like
23 consumption or something that looks more like the
24 broad-based income tax definition, you will not know,
25 for example, whether a pension plan is a tax

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1 expenditure that ought to be eliminated or normal
2 treatment that ought to be expanded.

3 So just broadening the base by taking
4 current tax expenditures measured against the income
5 tax and getting rid of them is a decision you're going
6 to the income tax base. Decide first whether you're
7 going there or you're going in the other direction.

8 The real base broadening that will occur
9 if you make the tax system more pro growth is that the
10 economy will expand. Now, that is a kind of base
11 broadening that doesn't hurt anybody and helps
12 everyone. That's what you should be aiming at for
13 base broadening.

14 MEMBER MURIS: That is a perfect segue to
15 one I wanted to ask, which was about page 17 of Mr.
16 Entin's presentation. And I wanted to ask Mr. Gale to
17 comment on that.

18 The question is, I assume there is an
19 implied GDP growth in that. One, how big is it? Two,
20 how would it stack up? CBO for the first time put its
21 toe in the water on this sort of dynamic scoring. And
22 I'm assuming Mr. Gale will have a reaction. And I'd
23 like to hear how you respond.

24 MR. GALE: To tax reform and growth
25 generally or to dynamic scoring?

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1 MEMBER MURIS: No, no. To what he is
2 going to say about this kind of dynamic scoring and in
3 general about how big it is.

4 MR. GALE: Sure.

5 MEMBER MURIS: I would like to have Mr.
6 Entin respond first, though.

7 MR. ENTIN: It, in part, depends on what
8 you do. If you were to strip all of the excess tax
9 layers off of capital and get the cost of capital down
10 substantially, we currently have something like a 55
11 or 60 percent tax on capital commitment.

12 It means that capital has to earn roughly
13 twice what it would otherwise have to earn to satisfy
14 the savers. With buildings, it is even worse. If
15 inflation comes back, that number gets gigantic.

16 The tax rate given the fact that we don't
17 allow you the full write-off of your plant and
18 equipment and overstate the profit means the statutory
19 rates are even higher than I have just described.

20 We are not sure just how much saving and
21 investment have been harmed and capital formation has
22 been harmed by this. But given the several trillion
23 dollars that the capital stock is today and given the
24 size of the tax rate I have described to you, you
25 would expect several trillion dollars in additional

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1 plant and equipment structures to be built over
2 roughly a five to ten-year period. We get an
3 indication of that from previous times we have changed
4 depreciation schedules and capital gains rates and so
5 forth.

6 There is a problem in the modeling done on
7 the Hill and in the academic community in this area.
8 It's been hard to find marginal tax rate series, and
9 people have used average tax rates instead. Well,
10 they don't go in the same direction in some decades.
11 It's a very bad proxy.

12 Many of the studies in the old days that
13 got into this analysis used to assume, as we pointed
14 out or I think Fred pointed out, that we were back in
15 1962 and we were the king of the world and we had the
16 biggest, most powerful trading system. They treated
17 the United States as a closed economy.

18 The studies that use open economy models
19 and show that saving is highly elastic and investment
20 responds very quickly are showing these days a much
21 different answer than we would get from studies done
22 five and ten years ago. There are enormous benefits.

23 Now, since the capital stock is already
24 approaching eight to ten trillion, I think having
25 several trillion dollars more expected in investment

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1 over a decade is not at all unusual in an assumption.

2 I said several million jobs. I might save
3 five. Someone else might say two. Dale Jorgenson
4 told the Kemp Commission we would get a double-digit
5 increase in GDP. I've seen other models that go
6 higher that are open and use marginal tax rates as
7 their variables.

8 And that figure I suggested is only about
9 a ten percent increase in family income. I think that
10 is well within our grasp if you do your job correctly.

11 MR. GALE: Thank you.

12 Four comments, but let me preface this
13 first with the statement that Do Not Call rules are
14 one of the best things the government has ever done.
15 Thank you.

16 MR. ENTIN: Thank you.

17 MR. GALE: The first thing, I think
18 economic growth is a first order concern. It's not
19 that I don't think we should be growing a growing
20 economy, we should be expanding. I think we should.

21 Point two, however, is I think we should
22 be cautious about statements about how tax systems can
23 dramatically raise economic growth. Let me give you
24 an example.

25 Fred's history started at World War I,

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1 pre-World War I. I want to go back a little further,
2 to 1870, to World War I. We had what in some ways was
3 considered a very strong period of growth in U.S.
4 economic history. We had very low taxes, no income
5 taxes to speak of, no estate taxes, no corporate
6 taxes, no pay roll taxes, just these dinky tariffs and
7 customs. Real GDP growth was 2.2 percent per person
8 during that period. All right?

9 In the 50 years after World War II, we had
10 very high income tax rates, extremely high, extremely
11 high corporate income tax rates. We ratched up the
12 payroll tax numerous times. We had this estate tax,
13 which we all know about. Economic growth during that
14 period was exactly the same, 2.2 percent per person on
15 a real basis. Okay?

16 I don't want to argue that taxes have no
17 effect on economic growth, but I will say that if you
18 take those changes in tax policy, raising revenues by
19 15 percentage points of GDP, drastically raising
20 income tax and estate tax rates, and stick them in
21 Steve's model, it's going to say the economy doesn't
22 exist anymore. It's been taxed into nonexistence.

23 So we need to be very careful. If tax
24 changes of that magnitude don't show up in growth
25 trends, we need to be real careful about claiming

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1 about tinkering with this saving account or that
2 depreciation provision is going to create trillions of
3 dollars of growth.

4 All right. The third point, slightly the
5 other way, nonetheless, I believe that a very
6 well-designed, well-disciplined income tax would raise
7 growth and a well-designed, well-disciplined
8 consumption tax could go a little further.

9 But most of the benefit, the studies
10 suggest, comes from getting from a current system to
11 a well-designed discipline income tax. If we can do
12 that, we have basically won the game. And then if we
13 want to talk about income or consumption tax, that's
14 fine, but that is really gravy.

15 Last point on scoring, dynamic scoring.
16 This comes up in Social Security analysis, too. These
17 proposals are going to be so big that it is going to
18 be impossible to ignore the economic growth effects,
19 nor would we want to ignore the economic growth
20 effects.

21 I think I agree with Fred that for
22 purposes of the official revenue estimates, we need a
23 score that is done on a traditional basis. Otherwise,
24 you are going to create a bias or you could create a
25 bias in favor of, an inappropriate bias in favor of,

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1 big plants relative to small plants.

2 And the whole dynamic scoring issue is a
3 bigger issue. But basically everybody thinks their
4 proposal should be exempt from the standard scoring
5 procedures because their proposal is special.

6 Like I tell my children, yes, you are
7 unique and special, just like everyone else. And I
8 think that is the right answer here, too.

9 MR. KAPLOW: I will just offer one
10 academic side bar to some of these comments.
11 Economists often point out -- and I think we are
12 correct when we point this out -- that although growth
13 is the common coinage of good economic things in many
14 of these discussions, really, economic efficiency and
15 distortion are at the core.

16 And one very simple way of making the
17 point is you can go from a high level of distortion,
18 say, relating from present to future consumption to no
19 distortion to distortion in the other direction. And
20 there are scenarios in which that would have no effect
21 on savings, whatever. So you could have great
22 economic improvement but not necessarily more savings.

23 We also know from days of old, of
24 centrally planned economies that were wildly
25 inefficient but did have high growth rates. So it is

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1 worth keeping in mind that probably what we care about
2 is economic efficiency, how much the tax system is
3 contributing towards attracting from social
4 well-being.

5 It is often harder to get at and it
6 doesn't fit under the standard slogan, but there will
7 be important instances where it is quite different.
8 And the very fact that distortion over time in savings
9 are by no means one to one I think is the most
10 important.

11 MR. ENTIN: We may be in more agreement
12 than it sounds like. But we are talking about going
13 from an inefficient system to an efficient system. In
14 that adaptation, you are going to get about a decade
15 of faster than normal growth because we go from a low
16 capital stock to a high one.

17 Thereafter, once the adjustment is
18 complete, the growth rate will go back to more or less
19 normal. But you will be starting from a higher base.
20 And that is what we all mean by this.

21 I don't think anyone is talking about
22 raising the growth rate from four percent to eight
23 percent forever. That is certainly not what anybody
24 is talking about. I would rather start from a base
25 that is 30 percent large or 10 percent larger or even

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1 5 percent larger or grow to a normal rate from that.

2 MEMBER POTERBA: We have talked today
3 about the compliance and income definition problems
4 that arise under the income tax. As we think about
5 possible consumption tax alternatives, thinking of a
6 retail sales tax, a value-added tax, and then
7 something like a savings-exempt income tax, can you
8 give us any guidance on where the biggest difficulties
9 would arise in trying to measure the consumption side?

10 In particular, I am thinking if we were
11 working with, say, a case where capital income versus
12 wage income was very different, but, then, anything I
13 can do perhaps with the assistance of my tax lawyers
14 to make my wage income look as though it's capital
15 income, particularly in your self-employed ventures or
16 things like that, becomes a device to change what my
17 effective tax burden would be.

18 MR. KAPLOW: I will offer one fairly broad
19 comment on that. It really goes, Jim, to exactly what
20 you were pointing out about labor versus capital. One
21 of my early slides you may remember suggested that in
22 principle a labor income tax and a consumption tax
23 amounted to the same thing. In implementation, they
24 may differ greatly and for just the reason Jim was
25 describing.

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1 So if you are going to tax consumption at
2 the end of the day, wherever it may have come from,
3 you don't have to figure out. So to take a core
4 example, think of sole proprietors who invest capital
5 and invest their labor in a venture in which they play
6 a great role. And eventually they're spinning off
7 money that they are consuming, living on, retiring on,
8 passing on to their children and grandchildren.

9 If you had to figure out which of that
10 money came from capital and which of that money came
11 from labor, you would never emerge alive. You would
12 also have a great distortion in a system that by
13 people moving into forms of organization, such as
14 moving toward sole proprietorships, being
15 self-employed, if that was a huge tax shelter of the
16 next generation, the economic distortion, not to
17 mention the revenue loss would be great.

18 So it very much favors ex poste
19 approaches, ones that wait either as a cash flow
20 consumption tax or a VAT, rather than a labor income
21 tax approach, which does have one virtue, that by
22 withholding at the source, it's often easier to
23 monitor evasion.

24 But I think an economy like ours, for
25 those who are compliant with withhold at the source,

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1 we can probably also get them to send W-2's, 1099s,
2 and the like, and make sure it doesn't get lost in the
3 shuffle.

4 MR. ENTIN: I agree that the IRS has
5 always had a problem with the small business. How
6 much of the money taken out of the small business is
7 subject to the payroll tax and how much is returned to
8 capital? And, of course, they used to treat it mostly
9 as labor and, perhaps over tax, the farmer and the
10 small business first.

11 With the kind of system that we're talking
12 about, whatever you put into the business is deferred.
13 Whatever you take out of the business and draw from
14 the business is taxable. And we don't care whether it
15 was from capital or labor. It's a better situation
16 for the IRS.

17 MR. GALE: You asked about the consumption
18 tax? Okay. Let me just briefly run through a couple
19 of them. The national retail sales tax, retail sales
20 taxes, have not been tried at rates of about 12
21 percent anywhere in the world and have not really
22 survived, even at that rate, because of evasion
23 issues.

24 The evasion issue here is pretty
25 straightforward. The taxes collected at a single spot

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1 at the retail sale. And there is no third party
2 withholding. So nobody knows that the sale took place
3 unless the government is actually standing right
4 there.

5 Contrast that to how wages are attached
6 right now. Your taxes on your wages are withheld by
7 the firm. They're sent to the government that when
8 you file your tax return, you offer a second opinion,
9 if you will, on what that wage tax is. But you file
10 your wage tax because you know that the firm already
11 sent the money in and told the IRS what your wage is
12 or presumably that is not the only reason you file
13 your wage taxes. In the retail sales tax, there are
14 real evasion issues as the rate gets above 10 or 12
15 percent.

16 The value-added tax, we have a host of
17 experience in Europe. Value-added evasion rates vary
18 from like 2 percent in England to 40 percent in Italy.
19 I don't think that tells you about the value-added tax
20 so much as the different countries.

21 So one advantage of the value-added tax
22 that was you can exempt small business and not lose
23 much money because they're exempted both on their
24 purchases and their sales. So it's sort of a net
25 wash.

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1 The USA tax that was proposed several
2 years ago had all sorts of compliance issues that
3 Louis could probably explain better than I could. Let
4 me talk about the flat tax for a second because this
5 is sometimes considered the classic airtight system.
6 I don't think it is.

7 In the flat tax, firms pay taxes on their
8 receipts minus their outlays. Their receipts are all
9 their nonfinancial inflows, and their outlays are all
10 their nonfinancial payments.

11 So any money that is coming in to the
12 firm, the firm is going to want to call a financial
13 payment and, therefore, it not be taxed on it and any
14 money that is going out it is going to want to call a
15 nonfinancial payment and, therefore, get a deduction
16 for it.

17 Now, in firm to firm relations or
18 transactions, that is not going to be a big deal.
19 But, remember, Fred has shown us that there is a large
20 variety of what you can call tax-indifferent
21 enterprises out there: pensions, nonprofits, in this
22 case foreign firms, governments, et cetera. They will
23 be indifferent to the form of the payment.

24 So it will be possible. I don't know if
25 you can write regs to close this, but let me come back

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1 to that. You will have massive avoidance or /evasion
2 because it's not clear whether it's legal or not by
3 having all inflows characterized as finance and all
4 outflows characterized as non-finance.

5 This is a point that was raised by Charlie
6 McClure and George Zodrow, who are two consumption tax
7 advocates who have worked extensively on building
8 consumption taxes around the world.

9 If it were just something they thought of
10 on paper, I would discount it. But it's something
11 that they say is important given the operation of real
12 tax systems. So I think it is a real potential
13 concern.

14 MEMBER GARRETT: There is always part of
15 this exercise that is a bit artificial when we compare
16 income tax to consumption tax because even though we
17 say we're doing it theoretically, we all have in mind
18 the current income tax system which is terrible,
19 complex, we all dislike, everyone dislikes. And we're
20 kind of comparing it to a theoretical consumption tax
21 that seems great in theory and we don't really have
22 any practice.

23 I think some of these questions have
24 highlighted some of the possible difficulties with
25 that pure consumption tax when we bring it into the

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1 real world. There are political difficulties, which
2 we don't have to worry about because we're not a
3 political group.

4 There is the problem of definition of
5 base, which Jim brings up. And then my question kind
6 of follows on to Bill's last comment, which is there
7 are also sectors that are very difficult to tax. I
8 once had something to do with drafting a subtraction
9 method consumption tax.

10 We found it very difficult to deal with
11 financial services generally, that entire sector.
12 There are questions about homes, right? What do you
13 do with the sale of homes, particularly given our
14 mandate?

15 I wondered if you could identify for us
16 other sectors, other activities that will be
17 particularly troublesome if one attempts to deal with
18 consumption, to move entirely to a consumption tax.

19 MR. KAPLOW: It partly relates to Jim's
20 question. I mean, there are some sectors. So going
21 back to an earlier discussion about avoidance and
22 evasion, if we think of the cash economy, the cash
23 economy is a disaster under all systems. And that's
24 the same entities that aren't reporting the income are
25 also probably not paying payroll taxes, are also not

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1 reporting on the sales because if they reported one,
2 they may well be caught on all. And although there
3 are ways one can get at that better and worse, that
4 basically is not an area one can make much progress
5 on.

6 Another thing that I think is helpful to
7 think about that was suggested by a number of your
8 specific points is that certain areas, like certain
9 clusters of tax expenditures that have nothing
10 particularly to do with whether you have an income tax
11 or a consumption tax, which is a lot of them, many of
12 them are not greatly affected, for better or worse, in
13 any respect, by which system you're under and whether
14 one is going to attack them, whether one politically
15 can attack them, whether one should attack this one or
16 that one. Those debates I think are largely held.

17 So I think it's important to keep focus on
18 it really has to do primarily with taxing capital
19 income and different ways of taxing capital income.
20 It is certainly the case that if you are -- I mean,
21 certain kinds of systems, so a certain personal cash
22 flow consumption tax, where everything is fully
23 integrated. If unlike in certain other systems, which
24 have simplicity benefits, you are funneling it all to
25 whether individuals make final consumption decisions,

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1 certain categories become less important.

2 But, like with the wages, it would have
3 been nice to tax the wages at the source because you
4 wouldn't have to follow it later. So I think that's
5 a common sort of trade-off.

6 MR. GALE: One of the nice things about a
7 consumption tax is that it takes areas of the income
8 tax that are considered shelter and makes it the
9 normal treatment. It is like reducing crime by
10 saying, "We're not going to define this activity as a
11 crime anymore." Okay?

12 I think in terms of difficult --

13 CHAIRMAN MACK: It has been suggested that
14 that might be a bad analogy, but that's okay.

15 (Laughter.)

16 MR. GALE: It never seems to go over very
17 well. The difficult areas in the existing system, the
18 really good, I think are the financial sector, which
19 you mentioned, and then two sectors that really
20 haven't come up yet today in this panel, which is
21 international foreign income flows, and corporate
22 shelters.

23 And I, frankly, don't know enough about
24 either of them to opine confidently except that they
25 strike me that they are really important tails that

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1 could well wag the tax reform dog here. I would
2 encourage you to pay attention to them, either in the
3 income tax or in a consumption tax system.

4 MR. ENTIN: There was an effort a few
5 years ago in one of the flat tax submissions to simply
6 get rid of the international section. It's a
7 territorial tax. And they deleted that section of the
8 code that dealt with international.

9 Unfortunately, they also deleted the
10 definitions of what was domestic and what was
11 international in the process and had to be reminded by
12 the tax counsel to put it back in. These problems
13 arise in all kinds of systems. And you do have to pay
14 attention to them.

15 They do arise more perhaps when the tax is
16 attempted to be collected at the business sector. And
17 if you can pass it through to the individual, some of
18 it does go away. So I would urge you to look at that
19 very closely.

20 In the flat tax submission, as it was
21 originally planned, they did not know what to do with
22 the banks, the insurance companies, and so on. And
23 the Europeans leave them out of the VATs for that
24 reason.

25 It is perfectly all right if you are going

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1 to keep a business sector tax to have a VAT type for
2 most industries and then leave the financial sector
3 the way it is and just keep your boundary conditions
4 clean because you can have a neutral tax under either
5 type of situation and you can have two neutral taxes
6 side by side, one for one sector and one for the
7 other, again as long as you are careful, and still
8 handle the financial sector. But it has to look very
9 much like the current tax system.

10 MEMBER LAZEAR: All of you mentioned
11 stability in your discussions. And Mr. Gale talked
12 specifically about it by saying that there were larger
13 effects of instability on savings and investment in a
14 consumption-based tax than an income tax.

15 I wonder if you would comment a little bit
16 on the differences in the stability of the two
17 different systems. So if we thought about, say, a VAT
18 and looked at how that was likely to be changed over
19 time versus income taxes and how that would likely be
20 changed over time?

21 Are there different incentives, both
22 political and incentives in the private sector, that
23 might be involved in thinking about the different
24 kinds of taxes that you have talked about today?

25 MR. GALE: It is a really good question.

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1 We can look I think to Europe for some guidance on
2 what happens to value-added taxes. And there seem to
3 be two things. One is they go up. And two is they
4 get more product exemptions.

5 I guess three is there are two ways to run
6 a value-added tax, a credit invoice, which is where
7 you get a credit for taxes paid on earlier purchases,
8 or a subtraction method, where you deduct the actual
9 purchase.

10 I think most American economists like the
11 subtraction method because it is simpler, but every
12 European country has a credit invoice method. And the
13 reason is that you can do special preferred treatment
14 of different goods and services that way. Politically
15 that is an advantage. Economically it is probably
16 not.

17 So I think that is the way the VAT would
18 go. The income tax, we have seen how it goes, up and
19 down and with increasing tax expenditures over time.
20 So I don't see why that would change.

21 MR. ENTIN: Who are we trying to help:
22 people or federal budget writers and the members of
23 Congress?

24 MR. KAPLOW: They are people, too.

25 MR. ENTIN: They are people. They have a

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1 peculiar outlook on the world, however. Consumption
2 is less likely to fluctuate, even in a down turn, that
3 would investment spending. Investment spending goes
4 through the big cycles. So in a sense, the
5 consumption base is a stabler base given whatever
6 happens in the economy than is an income tax base.

7 Congress has, of course, reacted to that
8 through the corporate AMT, which says that, even in a
9 recession, you have to pretend your income is higher
10 than it really is and continue paying. And we'll give
11 it back to you later on when your income goes back up
12 and you have gone back into the ordinary tax system.

13 So Congress does take measures to protect
14 itself from fluctuations in revenue when, in fact, the
15 government with its perfect credit rating should be
16 the one to take the hit when there is a down turn,
17 sometimes caused by federal policy.

18 So I would suggest to you that the tax
19 system, either over business cycles or between
20 products, should remain a steady and unbiased, no
21 exemptions from the VAT if you have one, no peculiar
22 rules that kick in during recessions to change the tax
23 treatment of businesses that tend to worsen
24 recessions, by the way, none of that.

25 Let the government go through the roller

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1 coaster. Let the government borrow when it has to and
2 pay down debt when it can. But don't keep changing
3 the rules on the private sector. It is not a good
4 idea.

5 MR. KAPLOW: It is not clear to me how
6 much difference there is under the two systems with
7 the political forces. I mean, I think Bill's
8 observation about European VAT is certainly correct.
9 You go for product areas of expenditure. But you can
10 just see how seamlessly one can move between one and
11 another.

12 So under an income tax, if we want to help
13 people who are sending their kids into higher
14 education, we enact a savings goodie. If we had a
15 consumption tax, well, since we're giving that savings
16 treatment to everything now, that would not be the
17 natural way to go.

18 But just on the direct outlay, we could
19 provide a preference of similar magnitude. It might
20 be simpler, which might be good. It might be simpler,
21 which might be bad, because more of it would creep in,
22 even when it doesn't necessarily make sense.

23 I think there is a sense in which many of
24 the forces in a fairly one to one way would migrate
25 from one to the other and, for better or worse, play

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1 themselves out in a similar fashion.

2 MR. ENTIN: These reforms are all better
3 if Congress, either on the outlay side or in the tax
4 side, would meddle less in people's decisions and just
5 get out of the way and let people order their lives
6 the way they see fit. Then many of these
7 complications in either system would simply go away.

8 CHAIRMAN MACK: Many businesses believe
9 that the U.S. tax system makes them less competitive
10 at home and abroad against foreign-based
11 multinationals. How would a tax on consumption affect
12 the competitiveness of U.S. companies?

13 I think I'll keep it at that. I mean,
14 there is this whole issue, I guess, of border
15 adjustments and so forth. So whoever wants or all
16 three can respond to that. Anybody want to take it?
17 After you.

18 MR. ENTIN: I hope none of my donors are
19 listening. Economists generally believe that the
20 advantages of the consumption-based taxes are that you
21 have stripped away the excess layers of tax on capital
22 formation. You have gone to expensing. You don't
23 double tax the corporate income. And there is no bias
24 against saving. This lowers the cost of capital.

25 You would have a lot more investment in

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1 the United States. The capital stock would be much
2 higher. Workers would be more productive. And they
3 would be paid their productivity increase. Everyone
4 would be better off.

5 Whether this would change the competitive
6 picture of American businesses vis-a-vis some other
7 country is not something an economist cares about
8 because if we are bigger, then we are fine, whether
9 there is the rest of the world out there or it doesn't
10 even exist. We're better off not discriminating
11 against domestic growth.

12 The question then arises with some of
13 these taxes, does border adjustability add anything
14 over and above the fact that you have gone to
15 expensing and stripped off the double taxation of
16 capital? Economists would generally say no. The
17 benefit of going to the consumption base is that you
18 have lowered the cost of capital.

19 The border adjustment runs into many
20 descriptions that say it is going to be better for
21 you, but it really can't work. And the reason
22 economists say it can't work is as follows. You often
23 hear, well, it's because exchange rates adjust. Well,
24 yes, they do, but that is just the transmission
25 mechanism.

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1 What is really happening is this. Suppose
2 I suddenly go to a tax system where I am not taxing
3 exports and I am taxing imports and I try to produce
4 more for exporting and supposedly I am not going to be
5 buying the imports. My population is being paid,
6 nonetheless. They're producing something, and they're
7 selling it. They're going to get the same income.

8 If now we take a chunk of our output that
9 we were producing for domestic use and send it
10 overseas but we still have the same income, I am still
11 going to want to buy that stuff I was previously
12 buying that we have now shipped to Europe. It's gone.
13 What am I going to buy instead? I'm going to be
14 buying European products that they had to sell to us
15 to earn the dollars to buy what we just sent to them.

16 You may get more exports, but if you do,
17 you're going to get more imports or the exchange rate
18 may adjust and you don't get more exports and you
19 don't get more imports. Theoretically there is no
20 distinction in terms of total economic activity,
21 whether the thing is border-adjustable or it isn't.

22 If you have different situations in
23 particular industries, where elasticities of this and
24 that may vary, you may get some situation. In the
25 VAT, for example, if the financial sector is exempt,

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1 you may get a distinctive twist in the relative
2 competitiveness of the manufacturing sector versus the
3 financial sector. And there may be some shuffling of
4 resources.

5 In the large, it shouldn't have a major
6 effect. If you're already at full employment, how are
7 you going to get more employment, for example? I
8 mean, there is another question to ask. Why would it
9 make a difference?

10 In the several kinds of consumption-based
11 taxes, two of them are explicitly border-adjustable.
12 The retail sales tax obviously is on whatever you buy
13 at the store: The import and the domestic product.
14 And the export doesn't go through retail. So it's
15 gone, not taxed.

16 VAT does the same thing. It's adjustable
17 at the border. But think of the VAT tax, if you will,
18 or think of the consumed income tax, which is your
19 revenue minus your saving. Revenue minus saving is
20 what you take to the store.

21 Now, I'm already going to pay tax on it
22 before I leave the house because it's collected at my
23 household level. But now that I have taken my
24 after-tax income to the store, whether I buy an import
25 or I buy a domestic product, I have already been taxed

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1 on my income. So in a sense, it's implicitly but not
2 explicitly border-adjustable.

3 So I wouldn't worry about which of those
4 varieties of consumption tax that you pick vis-a-vis
5 its effect at the border. If the businesses'
6 community is correct that it somehow is going to boost
7 exports, well, it will under either system, either
8 topic that's on the base tax. If it's not going to
9 boost exports, while it won't under either type of
10 consumption-based tax.

11 And basically just remember no one is
12 going to give us something for nothing. If we're
13 going to sell more to them, they're going to have to
14 sell more to us.

15 What I do hear often is that somehow we're
16 going to solve our balance of payments problem by
17 going to a border-adjustable tax. If you go to any
18 tax which increases investment in the United States,
19 which a neutral tax would do, it's a race. Will
20 domestic saving go up to cover it or not quite go up
21 to cover it?

22 Because if investment rises by more than
23 saving, we're going to attract more capital. And if
24 the saving rises by more than investment, we're going
25 to need less foreign capital.

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1 The movement and the balance of payments
2 on goods and services will be in the opposite
3 direction and of equal size to the movement and the
4 capital flow.

5 If you make the United States the better
6 place in which to invest and attract more foreign
7 capital, we're going to have a worst trade deficit.
8 But we're going to be growing faster. And everything
9 we produce is going to be bigger until the adjustment
10 takes effect and we go back to normal.

11 I think the long-term problem we need to
12 look more at is that the fuss is over manufacturing.
13 We are becoming more of a service economy, less of a
14 manufacturing economy. People are upset.

15 There is a bias in the income tax against
16 manufacturing, which tends to be capital-intensive
17 relative to the financial sector and the service
18 sector. And that is because we don't allow a full
19 present value right off of the cost of plant and
20 equipment because we do depreciation, instead of
21 expensing, because we have a higher cost of capital
22 due to the structure of the income tax.

23 If you went to a neutral tax system, you
24 would probably see a little bit of a bump up in
25 manufacturing, a little bit of reduction in the

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1 service sector until that adjustment was completed and
2 then trend growth and both.

3 That is not because of border adjustment.
4 That is because of the nature of the income. And that
5 would be benefitted by moving towards these neutral
6 systems, even if there were nobody else in the world.

7 So listen to the arguments. Bear in mind
8 they probably don't matter. And then do what you
9 think best as long as it's neutral somehow.

10 CHAIRMAN MACK: That was quite an ending
11 to that, John.

12 Bill, do you want to?

13 MR. GALE: Sure. Just real quickly, I
14 talked to someone in the White House, asking them
15 advice about what I should say to the Tax Reform
16 Panel. And they only had one thing to say, which is
17 don't mention border adjustability. So I'm not going
18 to go there.

19 But I do think that to the extent that
20 competitiveness is a goal, there are lots of other
21 tools besides tax policy. Fiscal policy and its
22 impact on the dollar, R&D policy, education policy,
23 you know, infrastructure can all make a difference.

24 And I'm a card-carrying economist.
25 Therefore, I agree with Steve that border

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1 adjustability is not an issue. But I understand that
2 is not a compelling argument to the millions of people
3 that think it is. And I would encourage you to
4 actually have a session that goes through this and
5 tries to nail it down.

6 MR. KAPLOW: I have very little to add to
7 that because there are some things economists agree
8 on, at least a few. And this is certainly one of
9 them.

10 But an aspect of something that Steve
11 mentioned, just to embellish it a little bit, at the
12 end of the day, if our nation is able to enact a tax
13 reform that eliminates economic distortions in the use
14 of capital in the organization of firms, which is part
15 of how the distortions are manifested, that will
16 enhance productivity. That is a gain.

17 Now, a question we can ask, you know,
18 "Will those in Europe, Japan, or China mimic us to the
19 extent they are not already ahead of us?"
20 Fortunately, in many respects, they're not. They may
21 or may not.

22 We can also ask, since we're talking about
23 an integrated system, how does the taxation of
24 corporations relate to that of individuals and so
25 forth, when you then get corporations that are

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1 foreign-owned but located here, the question of how we
2 are going to take any reform that we apply within our
3 borders and apply either to foreign corporations
4 operating here or to U.S. investment abroad, which is
5 the international dimension of the system, those are
6 things we want to worry about getting right that can
7 have effects.

8 If we extend a more efficient system to
9 foreign capital operating here, that will help the
10 owners of that capital, which are people in other
11 countries, but will also enhance that productivity of
12 their capital in the U.S., which we might think is a
13 good thing and we might not want to cut off our nose
14 to spite our face in a situation like that.

15 So on the international sides in both
16 directions, there are pieces that have to be brought in,
17 for whatever one will do, but I don't think any of
18 this is tipping against. It's really operating on a
19 different dimension from the overall statements about
20 how capital and trade flows in and out, how prices,
21 exchange rates adjust, and whether this is something
22 really to worry about or not.

23 MR. ENTIN: I do apologize. None of us
24 answered the other half of your question, which was,
25 what happens to American firms working abroad

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1 vis-a-vis other firms abroad and they are trying to
2 impose our tax rate structure on them when their
3 competitors abroad don't face our tax rate structure?

4 That can indeed mean that our companies
5 have a harder time in a third country than other
6 countries' home-based countries. And that I think is
7 why you have deferral and why you have firms treated
8 the way they are overseas.

9 In a territorial system, you would simply
10 clean that all up. And we wouldn't be imposing our
11 tax structure on the firm for an affiliate abroad.
12 And they could compete in Ireland. They could compete
13 in France with French and Irish and German and British
14 firms on a level playing field.

15 When they can, they tend to use more
16 services from the home company here. They tend to buy
17 more from the home company here. It's probably a gain
18 to us. And it's also fairer treatment.

19 CHAIRMAN MACK: Good. Well, several of us
20 have over the years participated in lots of hearings,
21 but I want to suggest that the four of you have been
22 outstanding today. I think that the dialogue that has
23 developed, as opposed to just kind of engaged in sharp
24 questioning, has really again provided us with lots of
25 very useful information.

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1 So I do appreciate the time and the effort
2 that you all have put into both preparing your
3 thoughts for today and for your open dialogue with us
4 about the issues that we have raised. So thank you
5 very much for that.

6 I would also just say that we are going to
7 have another hearing on Thursday, March the 3rd at
8 9:30 a.m. It will be held here in Washington at
9 George Washington University. The topic will be
10 perspectives on tax reform and continued explanation
11 of the problems in our current tax system. And we'll
12 release the names of those who will be participating
13 in the panels a little bit later.

14 With that, I also want to thank the panel
15 for your time and your effort this morning. At this
16 point, this hearing is adjourned. Thank you all very
17 much.

18 (Whereupon, at 1:09 p.m., the foregoing
19 matter was adjourned.)
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University of Southern California
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Opening Statement

Federal Tax Reform Panel

*Elizabeth Garrett**

February 16, 2005

In his State of the Union address, President Bush set out three objectives for tax reform: “pro-growth, easy to understand, and fair to all.” Since the enactment of the Tax Reform Act of 1986, we have been moving farther away from its goals of fairness and simplicity with each succeeding tax bill. I am looking forward to working with my colleagues on the Tax Reform Panel to find our way back to a fairer, less complex system of raising revenue, one that also ensures strong economic growth and international competitiveness for our country. As we examine how to assemble changes to the tax system that promote growth, fairness and simplicity, we need to keep several goals in mind.

First, we need to think about incentives. We have long used the tax code as a way to encourage people and businesses to create value for our economy

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and society. I am sure that any reform proposal we bring forward will include some such provisions; indeed, the Executive Order that established our Panel directed us to recognize "the importance of homeownership and charity in American society." As we consider which tax expenditures should be retained, which should be expanded, and which should be eliminated, we must keep in mind that tax expenditures are only justified when they actually change behavior in the way we intend it to change. It is not worth the revenue loss if a tax expenditure subsidizes behavior that would occur even without the tax incentive; all that happens is that we create a windfall for a few at the expense of all taxpayers. Fortunately, we have data about the effect of tax expenditures that have been in the code for years, and I look forward to carefully scrutinizing that data so that we are certain every tax subsidy we support is likely to produce its intended effects.

Second, we need to remember fiscal discipline. As we go about our work, we must keep in the forefront of our minds that the tax system is primarily designed to raise revenue to support the activities that the federal government engages in – both at home and abroad. Our proposal is supposed to be revenue neutral, that is, to raise the same amount of money as the current tax system raises. Some tax reform proposals that we are likely to consider may not result in immediate revenue loss, but over time they will substantially reduce the revenue that the federal government collects. We cannot focus only on the short-run and leave the next generation to face dire fiscal realities. Given the current federal fiscal situation, with a deficit estimated at around \$500 billion in fiscal year 2005, as well as with looming shortfalls in the entitlement programs – Medicare and Social Security – we have a profound obligation to recommend changes that are fiscally prudent not just in the next five or ten years, but also in the long term. We must be aware that the fiscal health of the country is much more dramatically affected by revenue decisions and decisions about entitlement programs than it is by spending through the annual appropriations process.

Third, we must remember that progressive rates are not the only important feature of a tax system that is designed to be “fair to all.” The goal of fairness is concerned with how the tax system treats people in different circumstances. We need to recognize that in our complex society, taxes can be unfair not only when they fail to take into account differences in income levels. We need to consider fairness across differences in tax status, looking at whether some tax credits should be refundable to provide incentives to those without tax liability as well as to those who owe taxes. We must consider what is fair across differences in marital status, determining the right structure to tax married couples when both work and earn income. We need to think about how to fairly balance the tax burden on income from wages – already burdened by payroll taxes – with the tax burden placed on income from savings and investment.

Fairness also implicates issues of transparency. Citizens must understand, in at least a general way, how they will be taxed. It is not fair, for example, to surprise them with an alternative minimum tax that was designed only to apply to the very wealthy in our country, but which is now projected to apply by 2010 to more than 34 million Americans, many of them families with relatively modest incomes.

These are some of the issues, among many, that I hope we will address in our work. I am looking forward to the next few months of discussion and analysis and to bringing forward options for reform that are consistent with the President's goals, and with the goals we all share for a better, fairer tax system.

**REFORMING TAXATION:
ADVANTAGES OF A SAVING-CONSUMPTION NEUTRAL
TAX BASE, AND PRINCIPLES TO GUIDE REFORM**

**Statement to
The President's Advisory Panel on Federal Tax Reform
by Stephen J. Entin
President and Executive Director
Institute for Research on the Economics of Taxation
February 16, 2005**

President Bush has called for wide-ranging tax reform and simplification. He is asking for a tax system that is more pro-growth, that is simpler, and that is fairer than the current system. The possibility of real tax reform is higher now than at any time since 1986. Consequently, it is an honor and a privilege to be asked to testify before the Commission, and I thank you for the opportunity.

I have been asked to discuss the advantages of a tax system that is neutral in its treatment of income used for saving and for consumption, sometimes referred to as a consumption-based tax. A neutral tax treats all economic activity alike, and avoids the anti-saving biases in the broad-based income tax. A neutral tax would be simpler, more pro-growth, and, in my view, more uniform and fairer than the current tax system.

IRET <www.iret.org> has published several papers on the advantages of neutral tax systems and their economic impact which would be useful for the Commission to review.

- ***The Inflow-Outflow Tax***¹ <<ftp://ftp.iret.org/pub/InflowOutflowSum.PDF>>, which we view as the optimal neutral tax system.
- ***The Economics of Taxation and the Issue of Tax Reform***² <<ftp://ftp.iret.org/pub/EntinNewOrl-2003.PDF>>, a handbook on the way in which taxes affect the economy, the concept of marginal tax rates and a non-distorting tax base, the anti-saving, anti-investment features of the current income tax, and the advantages of neutral taxation.
- ***Reforming Taxation: Attributes of a Good Tax System and Principles to Guide Reform***³ <<ftp://ftp.iret.org/pub/ADVS-183.PDF>>, some basic facts on the purposes of taxation, and the nature of income, fairness, and efficiency that should be understood in order to develop a good tax system.

- ***Renew Bonus Expensing To Keep Recovery Strong***⁴ <<ftp://ftp.iret.org/pub/ADVS-173.PDF>>, showing the sensitivity of investment to tax treatment.
- ***The End of Tax Expenditures As We Know Them?***⁵ <<ftp://ftp.iret.org/pub/BLTN-84.PDF>>, which warns that what is an anomaly under the income tax, and may have been branded a tax expenditure, may be the highly desirable norm under a consumed-income or consumption tax (example, all pension and retirement plans).
- ***Tax Incidence, Tax Burden, and Tax Shifting: Who Really Pays the Tax?***⁶ <<ftp://ftp.iret.org/pub/BLTN-88.PDF>> which demonstrates that all taxes are paid by individuals, that taxes on corporations and capital income in general are largely shifted to labor by depressing saving, investment, productivity, and wages, and that graduated tax rates on the upper income result in lower incomes across the board.
- ***Phase-outs Increase Tax Rates and Tax Complexity***⁷ <<ftp://ftp.iret.org/pub/BLTN-71.PDF>> which calculates the adverse impact on marginal tax rates of many tax provisions that means test deductions, credits, and exclusions.
- ***Taxes and the Good Society***⁸ <<ftp://ftp.iret.org/pub/TaxesGoodSoc.PDF>>, which is a discussion by the late Dr. Norman B. Ture, one of the country's leading tax experts, on the basic concepts of tax fairness, neutrality, and the purpose of taxation in a democratic society.

What is the current system?

The current federal income tax system is a hybrid. It begins as a broad-based income tax, which is a type of tax that falls more heavily on income used for saving and investment than on income used for consumption, chiefly by subjecting saving and investment to multiple layers of tax. However, the current system contains provisions that treat a portion of saving and investment as they would be treated under a saving-consumption neutral system (or consumption-based system), in order to moderate the damage that would otherwise be done.

The current system taxes the world-wide income of U.S. residents (a global system), requiring offsetting credits for foreign taxes paid to avoid double taxation. The simpler alternative would focus on activity within the United States (a territorial system). These fumbblings and compromises have added greatly to the complexity of the tax system. A clean and simple neutral territorial tax system would achieve these objectives much more easily.

Why tax reform? Income, growth, and jobs.

The current tax system distorts economic activity and reduces income and employment. It does so to the degree that it is closer to a broad-based income tax than to a neutral or consumed-income tax. It hides much of the cost of government from the taxpayer-voters. It is complex, making it expensive and confusing to comply with, and hard to enforce. It is subject to abuse by taxpayers and the IRS. It breeds suspicion, because people do not see clearly who is paying the tax, and is widely viewed as unfair, although definitions of fairness vary.

We could end most of these distortions, complications, and suspicions by moving to a saving-consumption neutral tax. Such a move would improve the economy, raise incomes, and promote employment. The shift would have the added benefits of simplifying compliance and enforcement, enhancing transparency and confidence in the system, and reassuring people as to the fairness of the tax system.

Any of the several types of neutral tax system would be more conducive to capital formation than current law. They would all allow the economy to operate more efficiently and to gain, over about a decade, the investment that the current biased tax system has suppressed. I estimate that they would add about 10 percent to the GDP, or about \$4,000 to \$6,000 to average family income. The various neutral taxes take different approaches to eliminating the biases in current law, and provide differing degrees of simplification and transparency. They may differ in transition issues. But all would raise incomes and employment.

Other things equal, each time in the past that the United State has moved its tax system away from the income base toward the consumption base, it has seen, as of the dates when the changes became effective, improved levels of saving and investment, productivity, and wages. Each time that tax policy has shifted back toward the income base, with higher taxes on capital and steeper tax rates on those who produce the most, economic performance has deteriorated. The Tax Acts of 2001, 2002, and 2003, which reduced marginal tax rates and reduced the double taxation of corporate income, moved the United States toward a consumption base, and have greatly strengthened the recovery from the last recession. The Tax Reform Act of 1986 was a shift toward the income tax. It raised taxes on capital and was followed by a major stock market and real estate collapse. That "reform", plus two subsequent payroll tax increases, paved the way for the subsequent recession.⁹ The same phenomena have been observed internationally. Japan mimicked the 1986 U.S. reform in 1988, curtailing tax-neutral saving plans, instituting a capital gains tax, and raising property taxes soon after. As a result, Japan has been in a virtually non-stop recession for over 15 years. By contrast, lower corporate tax rates in Ireland and Eastern Europe, and flatter individual tax rates in Eastern Europe and Russia, have greatly improved economic performance.

Correcting flaws and avoiding errors.

Understanding the advantages of a neutral tax may require people to learn some new terminology, and to rethink some ideas about taxes that have been taken for granted over the past 80 years. We are used to thinking in terms of the current tax system. Its definitions of income and its structure of taxes seem normal, even though they are often at odds with reality, logic, and sound economics.

The Commission would perform a real public service by using its position to improve the public's understanding of the nature of income, what constitutes a sound tax system in a democratic society, and the advantages of making significant changes.

The Commission should start by taking stock of the purposes and attributes of a good tax system, to give itself a standard against which to judge the many proposals it will consider.

The Commission should consider how a revised tax system could promote good government by making the tax system more transparent to the voters and less susceptible to manipulation by special interests, either commercial or political.

The Commission must make an explicit choice early on about what it considers to be the right type of tax base. Until the appropriate concept of a tax base is selected, no decision about specific deductions, credits, exclusions, inclusions, or points of collection can be made in any sensible, consistent manner. A deduction or exclusion that may be natural under one tax base may be incorrect or distorting under another. If someone tells you that something is a "tax expenditure", ask him, "In which tax system?"¹⁰

The Commission should make sure that the steps it recommends would improve the functioning of the economy and raise the level of employment, output, and income. Otherwise, there is not much point.

In particular, the Commission must be aware of whether or not the reforms that it is considering would move in the direction of a more neutral tax base and lower the "hurdle rate" or cost of capital compared to current law. A neutral tax with a lower cost of capital would increase capital formation, productivity, and per capita output and income. If it does not take this precaution, it may stumble into recommendations that would reduce growth and job creation.¹¹

The Commission must consider how the tax is to be collected and administered. There are trade-offs between a tax that is highly visible and transparent to the voters, and one that is simpler to comply with but less informative of the cost of government.

The Commission should also review the basic concepts of fairness and efficiency in taxation, to ensure that they reflect the nature of production and income. The Commission should think through these fundamental issues before making decisions on the details and minutia of the new tax code.

Toward that end, I offer the following framework to guide the development of alternatives to the current tax system.¹²

Framework for thinking about tax reform.

What are the two main purposes of a sound tax system?

1. Raising revenue to pay for government goods, services and activities; and
2. "Pricing" government to let people know how much they are being charged for government goods and services so that, as taxpayers and voters, they may decide in an informed manner how much government activity they wish to support with their votes.

The current federal tax code fails to accomplish these purposes in an effective and efficient manner.

What Is Income? Income is earned. Income is the reward for supplying labor and capital services to the market to create goods and services of value to others. Except in rare instances, income closely matches the value of the effort and services provided by individuals to produce additional output. Supplying labor and capital means giving up leisure and deferring consumption. These sacrifices are the cost of earning income. These attributes of income have important implications for the concept of fairness and the design of the tax system.

Income is a net concept: revenues less the cost of generating those revenues. Just as a business cannot reasonably be said to have a profit until its revenues exceed its costs of production, neither can a worker or saver be said to have income until his revenues exceed the amounts spent on acquiring the skills (through education) or purchasing the assets (through saving and investing) that generate the revenues. To obtain a realistic measure of a person's income, the full value of all costs of earning revenues (including education expenses, saving, and investment outlays) should be subtracted from revenues. All returns from such efforts that exceed these costs (including withdrawals of deferred principal and its earnings) should be added to revenues.

Who Pays Taxes, and With What? In reality, only people pay taxes, and all taxes are paid out of income. Goods and services do not pay taxes; businesses do not pay taxes. Taxes collected by businesses fall in reality on the income of the businesses' shareholders or other owners, lenders, workers, or customers in the form of lower returns, lower wages and/or higher prices. This insight has implications for the design of the tax system, and who is responsible for collecting and sending taxes to the Government.

Four key criteria for tax reform.

Tax reform should be approached with four criteria in mind: neutrality, visibility, fairness, and simplicity. Fortunately, to a great extent, simplicity, neutrality, and fairness (properly defined) can all be achieved at once by means of saving-consumption neutral tax systems.

Neutrality. Neutrality is essential if the economy is to operate at peak efficiency, and if incomes are to be as high as possible. Strict neutrality requires that income be calculated correctly and then taxed at a uniform rate.

The tax system should be even-handed or neutral across various types of saving and investment, and between saving and investment and consumption. That can be achieved by treating saving and investment as costs of earning income. All saving must receive the sort of tax treatment currently afforded pensions, various types of IRAs, 401(k), Keough, SEPs, and other saving-deferred plans currently in the tax code. Investment outlays, research and development expenses, and purchases of inventories must be deducted in the year the outlay is made (expensed), rather than depreciated over time. Failure to do so, as in the income tax, raises the cost of saving more than it raises the cost of consumption.¹³

Neutrality also means that multiple layers of tax on capital must be avoided. In particular, the dual taxation of Schedule C corporate income at the corporate and individual level must be eliminated. The transfer tax on estates and gifts must also be removed, because an estate is saving that has already been taxed or will be subjected to the heirs' income tax.

Visibility. Visibility means a tax system is transparent to the taxpayers so it is clear how much government costs and who is paying for it. Visibility is necessary for voters to determine when the benefits of government spending are sufficient to match its costs. Visibility is a key element in holding government accountable to voter-taxpayers.

Visibility is best achieved by a tax levied as openly as possible with some form of annual accounting that confronts individuals with the full amount of taxes they have paid over the course of the year. Visibility suggests that revenues not be collected from taxes buried in businesses transactions.

Visibility also requires that as many people as possible be subject to tax, excepting only the very poor, so that they can see that government is not a free good. It should not be possible for a majority of voters to shift a disproportionate share of the tax burden onto a minority of taxpayers.

Visibility can reassure people about the fairness of the tax system. If everyone were filling out the same simple tax forms, and people could understand what was on them, then people would be far more certain that they and their neighbors were paying their fair share of taxes. The mystery and the suspicion would be gone.

Fairness. Fairness means equal treatment under the law, and respect for the people who produce goods and services. Income is the earned reward for contributing to the production of goods and services. This fact, combined with the principle of equal treatment under the law, strongly urges that a proportional (single-rate) tax on income is the fairest.

Compassion requires that the very poor be relieved of the burden of paying for the protections afforded by government and for the public goods and services provided by government that they and their families consume. But insofar as possible, it is fair that everyone should contribute something toward these communal efforts.

Allowing all individuals, regardless of income, an equal personal exemption is consistent with this concept of fairness. It would provide that persons of higher income pay a higher fraction of their income in tax than persons of lower income, but not in a greatly disproportionate manner.

Simplicity. The complexity of the current tax system imposes enormous compliance costs on taxpayers and enforcement costs on the government. Most of the complexity in the current tax code stems from its arbitrary definition of taxable income,

its effort to impose non-neutral taxation of income from capital, and its taxation of income from foreign sources offset by a tax credit for foreign taxes paid.

There is no conflict between simplicity and neutrality. Neutral tax systems that are not biased against saving and investment are inherently simpler and fairer than non-neutral ones. Systems that restrict taxation to income earned domestically are likewise simpler than systems that tax global income with a credit against foreign taxes paid. For simplicity, the tax system should be territorial, levied on income earned within the country.

However, the very simplest tax systems, those that would have businesses collect all taxes without income earners or consumers seeing what is taken or having to do any work would be a violation of visibility.

Simplicity should not be an excuse to remove large numbers of people from the tax rolls or to eliminate periodic tax filing. Some small amount of effort by the citizens in paying tax is a fundamental requirement of a tax system that informs the citizen-voters about what government is doing, enabling them to fulfill their civic responsibility in a democratic society.

The current tax code fails all four tests.

The current tax code violates neutrality by taxing some income at higher rates than other income, in particular by falling more heavily on income used for saving and investment than on income used for consumption. It hides significant revenues from the voters in business taxes, and it exempts tens of millions of people from the income tax rolls. It masks the cost of government. It encourages people to attempt to shift the cost of government goods and services to others. It is enormously complicated. It punishes real economic effort and treats many taxpayers very badly.

Let me take a moment to make clear what the income tax biases against saving and investment consist of. At the federal level, there is usually one layer of tax on income that is used for consumption, but there are at least four layers of possible tax on income that is saved (Chart 1).

1) Income is taxed when first earned (the initial layer of tax). If one uses the after-tax income to buy food, clothing, or a television, one can generally eat, stay warm, and enjoy the entertainment with no additional federal tax (except for a few federal excise taxes).

2) But if one buys a bond or stock or invest in a small business with that after-tax income there is another layer of personal income tax on the stream of interest, dividends, profits or capital gains received on the saving (which is a tax on the "enjoyment" that one "buys" when one saves). The added layer of tax on these purchased income streams is the *basic income tax bias against saving*.

Chart 1 Multiple Taxation of Saving One Tax on Consumption, Four Taxes on Saving

Layer 1– Tax on Earnings

Income is taxed when earned. If it is used for consumption, there is usually no further federal tax.

Layer 2 – Personal Income Tax on Returns

If the income is saved, the returns are taxed as interest, dividends, capital gains, or non-corporate business profits.

Layer 3 – Corporate Income Tax

If the saving is in corporate stock, the corporate tax hits the income before it is either paid out to shareholders or reinvested to boost future earnings.

Layer 4 – Transfer (Estate and Gift) Tax

Another tax on already taxed assets.

(Similar taxes at the state and local levels increase the multiple taxation.)

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Chart 2 Multiple Taxation of Corporate Income

	(a) Retained Earnings, Pre 2003 Act	(b) Dividend Payout, Pre 2001 Act	(c) Retained Earnings and Dividends, 2003 Act
1) Corporate Income	\$1.00	\$1.00	\$1.00
2) Corporate tax at top rate	\$0.35	\$0.35	\$0.35
3) After-tax corporate income: Either retained, raising stock price (columns (a), (c)), or paid as dividend (col. (b), (c))	\$0.65	\$0.65	\$0.65
4) Individual income tax at top rate (dividends as ordinary income, retained earnings as capital gain)*	\$0.13 (tax rate 20%)	\$0.2574 (tax rate 39.6%)	\$0.0975 (tax rate 15%)
5) Total tax	\$0.48	\$0.6074	\$0.4475
6) Total tax rate	48%	60.74%	44.75%
7) Income left to shareholder	\$0.52	\$0.3926	\$0.5525

* Top corporate rate excludes corporate surtaxes, and top individual rate ignores phase-outs of exemptions and deductions and taxation of Social Security, which may push effective top tax rates higher than statutory rates. Retained earnings are assumed to trigger a long-term capital gain with a maximum rate of 20% or 15%. Short-term gains are taxed at ordinary tax rates.

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3) If the saving is in corporate stock, there is also the corporate tax to be paid before any distribution to the shareholder, or any reinvestment of retained after-tax earnings to increase the value of the business. Whether the after-tax corporate income is paid as a dividend, or reinvested to raise the value of the business and create a capital gain, corporate income is taxed twice — *the double taxation of corporate income*.

4) If a modest amount is left at death (beyond an exempt amount that is barely enough to keep a couple in an assisted living facility for a decade), it is taxed again by *the estate and gift tax (the "death tax")*.

State taxes compound these biases.

The anti-saving and anti-investment biases in the income tax retard growth. The maximum combined federal corporate and individual income tax rates on dividends could exceed 60 percent before the 2003 tax reductions, and they are still nearly 45 percent today (Chart 2). That is before state and local taxes, and is on top of the tax on the income that was used for the saving. Estate taxes and the generation skipping tax can still raise the total tax burden on income going into a taxable estate to between 80 and 85 percent. The tax disincentives to save and invest, and to work, train, and take risks, lead people to under-save and over-consume, and to work less and play more.

It has long been assumed that high graduated tax rates and added layers of tax on income used for capital formation would do little economic damage, would harm only the wealthy, and would provide significant income redistribution. In fact, income redistribution was the main justification for the "Haig-Simons" definition of income that inspired the concept of taxable income in the current income tax. Professor Simons, at least, admitted that the tax was not economically optimal, and that it would damage saving and reduce output. His disciples seem to have forgotten that consequence, and are living in a state of denial.¹⁴

It has become apparent, however, that most of the taxes that seem to fall on those who supply physical capital, intellectual capital, or special talents to the production process may actually be shifted to ordinary workers and lower income retirees in the form of reduced pre-tax and after-tax incomes. Even for labor, the optimal (additional) tax on the normal returns to capital is zero.¹⁵

Capital is far more sensitive to taxation than is labor (Charts 3 and 4). Savers can easily switch to consumption, a satisfying alternative, or send capital abroad. Many workers, by contrast, have to work to make ends meet, or work hours that are set by their employers. (The self-employed or the upper income, who can afford to retire or take time off, have somewhat more flexibility as to hours worked.) Therefore, a given tax rate imposed on labor and capital has a far greater impact on the quantity of capital than the quantity of labor offered to the market. The relatively large reduction in the in the stock of capital depresses productivity and demand for labor, which lowers wages and employment. The work force bears the economic burden of taxes on capital (Chart 5).

Chart 3 Effect of Tax On Desired Capital Stock

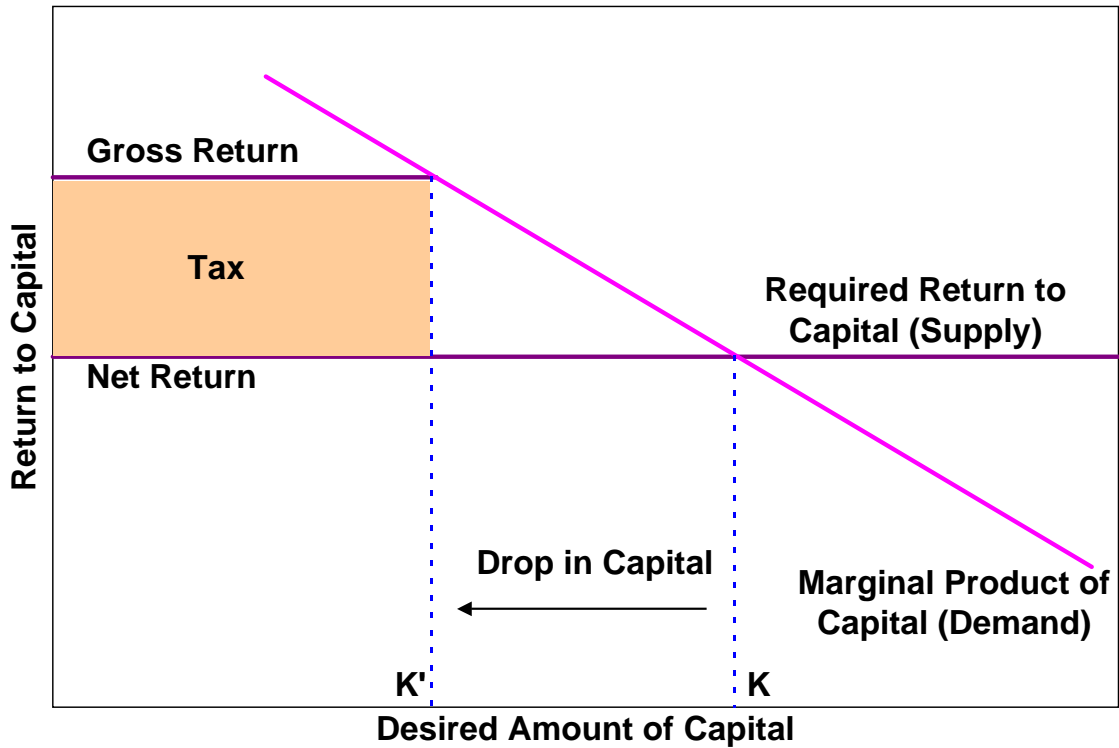


Chart 4 Effect of Tax On Labor

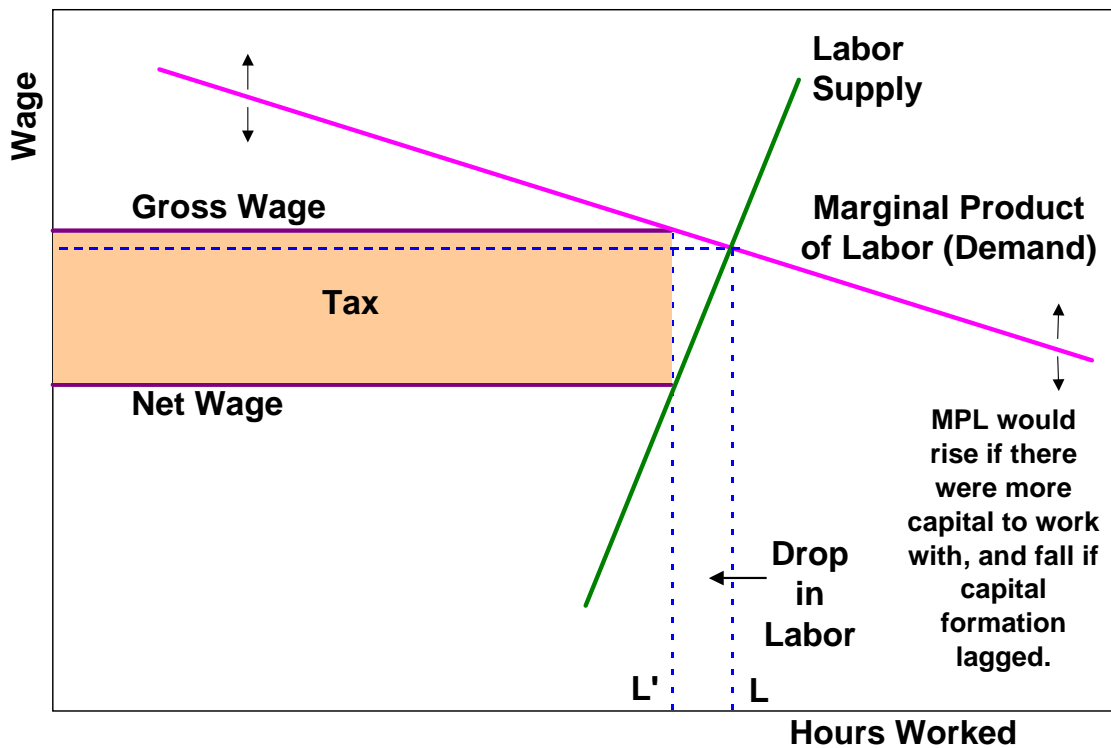
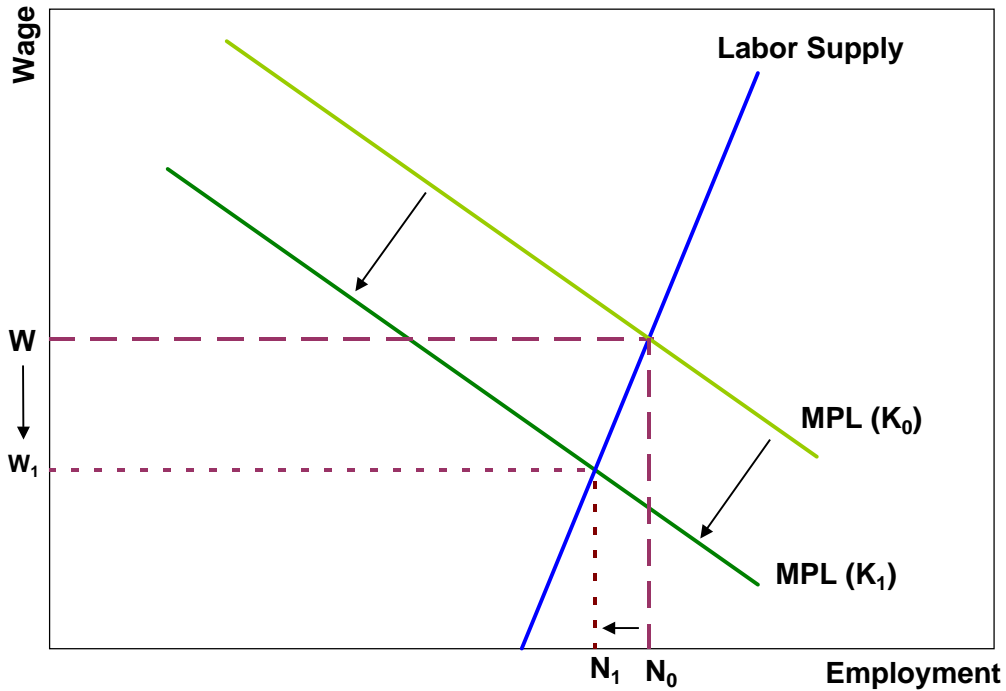


Chart 5 A Smaller Stock Of Capital Reduces Wages



Consider a small trucking company with five vehicles. Suppose that the rules for depreciating trucks for tax purposes change, with the government demanding that the trucks be written off over five years instead of three. The owner has had enough business to run four trucks flat out, and a fifth part time. He is barely breaking even on the fifth truck under old law. It is now time to replace one of the trucks. Under the new tax regime, it does not quite pay to maintain the fifth truck. The owner decides not to replace it, and his income is only slightly affected. But what happens to the wages of the fifth truck driver? If he is laid off, who bears the burden of the tax increase on the capital?

Consider another example, involving human capital, specifically, medical training. Suppose the imposition of a progressive income tax were to discourage the supply of physicians by inducing some doctors to retire, by causing others to work fewer weeks per year, and by dissuading people from applying to medical school. One result would be fewer jobs available and lower levels of productivity and incomes for nurses and support staff in medical offices and hospitals. Another would be a rise in the price of health care for consumers (including the government).

Neutral taxes can be best at satisfying the four key criteria for a good tax system.

Neutrality and Growth. Neutral taxes are, by their nature, more favorable toward growth than income taxes. Neutral taxes eliminate the income tax biases against saving and investment, and have flatter tax rates to avoid punishing people who work, save, and produce more output and income. Eliminating the estate and gift tax removes one layer

of tax bias. Another layer is removed by taxing corporate income either at the corporate level or at the shareholder level, but not both.¹⁶ For full neutrality, the basic income tax bias against saving and investment must be corrected by granting all saving the same treatment as is given to pensions or IRAs, either by deferring tax on saving until the money is withdrawn for consumption (as in a regular IRA), or by taxing income before it is saved and not taxing the subsequent returns (as in a Roth IRA). The two methods are equivalent if the tax rate is the same over time (Chart 6). Either method is a boon to savers. Putting away \$1,000 a year from age 20 to 70 at historical stock market yields is a saving deferred account yields \$400,000, but less than \$250,000 under ordinary income tax treatment (Chart 7).

President Bush's 2001 and 2003 tax reforms have gone a long way toward achieving the goal of tax neutrality. They provide for elimination of the estate and gift tax in 2010. They reduce the double taxation of corporate income by taxing dividends and capital gains at a reduced rate of 15 percent. However, the death tax returns in 2011, and the tax relief for dividends and capital gains expires at the end of 2008. At the very least, these steps should be made permanent.

The President's proposed expansion of the neutral treatment of saving in his lifetime saving accounts and pension reforms is a step in the right direction. The analogous treatment of investment is to allow immediate expensing of investment instead of lengthy depreciation. Depreciation understates business costs, overstates income, and overtaxes investment. Chart 8 shows, for example, that the value of the depreciation allowance on a seven year asset at three percent inflation is only 85 cents. The allowed tax cost of a building that must be written off over 39 years is only 37 cents. The erosion of the value of the allowed claims for cost by time and inflation greatly understates business costs, and the damage is worse the higher the rate of inflation. Assets have to be able to earn more to cover the added tax. Those that cannot never get built. Workers never get to work with these assets, and their wages suffer.¹⁷ It was a mistake to allow the 50 percent expensing provision in the 2003 Tax Act to expire at the end of 2004. The next chart shows the effect of the 30 percent and 50 percent expensing provisions in the 2002 and 2003 tax cuts. They were the major reason why equipment spending and economic output bottomed out and then took off in 2003 and 2004 (Chart 9).¹⁸

There are several types of neutral tax systems. They include a cash flow or saving deferred income tax¹⁹, a national retail sales tax, a value added tax (VAT)²⁰, a returns exempt Flat Tax²¹, or some combination. They all either defer taxes on saving or exempt the returns to arrive at a saving-consumption neutral tax base. They all eliminate multiple taxation of corporate and individual income and of estates.

An individual cash-flow tax is collected from individuals based on their earnings less their saving, which equals their spending on consumption goods and services. The Flat Tax uses the Roth IRA method to achieve the same end result. A retail sales tax is collected by retailers based on the consumption spending of individuals, which is that part of their earnings not devoted to saving. Value added taxes are collected in increments throughout the production process by businesses based on sales less investment expenses;

**Chart 6 Equivalence Of Saving Deferred And Returns Exempt
Exempt Tax On Saving; Contrast With Ordinary Income Tax**

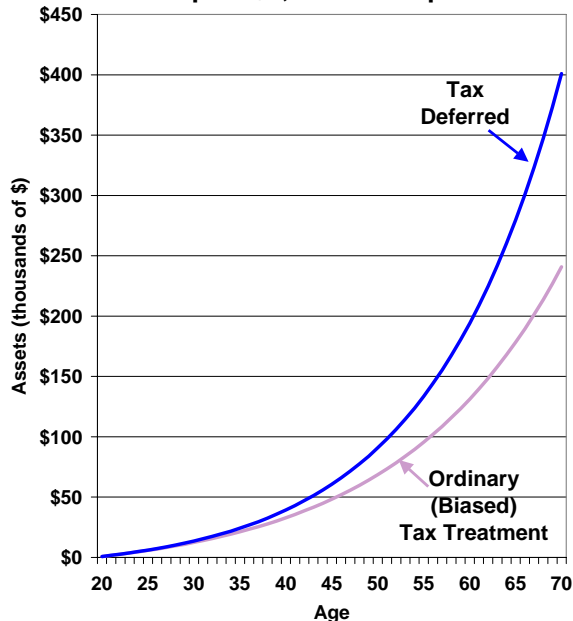
Tax Treatment	Saving Deferred	Returns Exempt	Ordinary Income Tax
Pretax earnings to be saved	\$100	\$100	\$100
Tax on saving	0	20	20
Amount saved	100	80	80
Is interest on inside build-up taxed?	No, 7.2% reinvested	No, 7.2% reinvested	Yes, 5.76% reinvested
Account after 10 years	200	160	140
Tax due on withdrawal	40	0	0
After-tax spendable balance	160	160	140
Cost to saver of ordinary tax treatment			20 (= 160 - 140) (a third of the interest)

Illustration assumes 7.2% pre-tax interest rate, 20% tax rate, and 10-year investment.

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**Chart 7
Advantage Of
Tax Deferred
Saving Over
Ordinary
(Biased) Tax
Treatment;
Build-up Of
\$1,000 Saved
per Year**

**Advantage Of Tax Deferred Saving
Over Ordinary (Biased) Tax Treatment:
Build-up Of \$1,000 Saved per Year**



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Saving from age 20 onward, under tax-deferred system and ordinary "double taxation" (assume 7.2% interest rate, 20% tax rate).

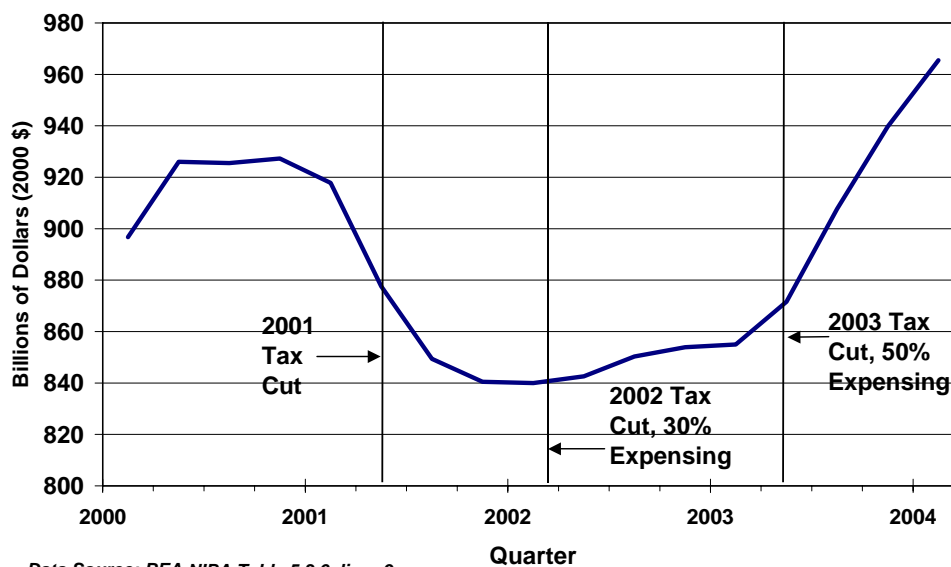
Chart 8 Present Value of Current Law Capital Consumption Allowances per Dollar of Investment Compared to Expensing (First-Year Write-Off)

Asset lives:		3 Yrs	5 yrs	7 yrs	10 yrs	15 yrs	20 yrs	27.5 yrs	39 yrs
Present value of first-year write-off of \$1 of investment:		\$1.00	\$1.00	\$1.00	\$1.00	\$1.00	\$1.00	\$1.00	\$1.00
Present value of current law write-off of \$1 if inflation rate is:	0%	\$0.96	\$0.94	\$0.91	\$0.88	\$0.80	\$0.74	\$0.65	\$0.55
	3%	\$0.94	\$0.89	\$0.85	\$0.79	\$0.67	\$0.59	\$0.47	\$0.37
	5%	\$0.92	\$0.86	\$0.81	\$0.74	\$0.60	\$0.52	\$0.39	\$0.30

Assumes a 3.5 percent real discount rate, 3-20 year assets placed in service in first quarter of the year, 27.5 - 39 year assets placed in service in January.

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Chart 9 Real Private Investment - Equipment And Software And 2001, 2002, and 2003 Tax Cuts



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sales less investment equals national income less saving, which again equals the amount spent on consumption of final goods and services. (The Flat Tax may also be thought of as taxing capital income at the business level with expensing, like the VAT.) In other words, these taxes all have the same fundamental tax base.

Some writers make artificial distinctions among saving-consumption neutral taxes, referring to them as consumption taxes if they are of the sales tax or VAT variety, and as saving-deferred or saving-exempt income taxes if they are of the cash flow type or Flat Tax, as if to imply that they generate different incentives to save or consume. In fact, the point of collection of the taxes does not change their common nature; they are all saving-consumption neutral taxes on people's incomes (properly defined).

Each of the types of neutral taxes has the potential to accommodate a single low tax rate on income, and to eliminate the alternative minimum tax and the estate tax. The systems all have expensing instead of depreciation (or equivalent non-taxation of investment outlays), and no separate taxation of capital gains. Each is territorial, and can substantially reduce the confusing treatment of foreign source income that cripples American businesses operating abroad.²² Many of the major sources of complexity in the current tax code would be gone.

Under all of the neutral tax systems, the costs of buying and operating equipment, factories, commercial buildings, and residential real estate, would all be lower. With a lower tax hurdle, several trillion dollars of capital investment that is just not sustainable under current tax law would become possible. Investment would boom for a decade or more, productivity would rise at a rapid clip, and wages would match the gains.

If the GDP were to be ten percent higher under the new tax regime, it would raise incomes for middle income families by about \$4,000 to \$6,000 a year. Everyone would gain. Labor would gain most of all. Capital formation boosts productivity and wages. Every dollar of additional GDP made possible by additional capital formation yields about 50 cents in higher after-tax wages, about 30 cents in higher federal, state, or local tax revenue, requires about 15 cents to replace the capital as it wears out, and returns about a nickel to the savers and investors.

The United States would be a magnet for capital intensive industries furnishing higher paying jobs. Starting a new business would be far easier, because one could concentrate on running the business instead of figuring out tax forms. One could put one's money to work expanding a business instead of paying insurance premiums to keep the business in the family in the event of one's death.

Neutral taxes and visibility. Visibility means that the voting public is well aware of how much the government is costing them. Among the various neutral taxes, those collected from individuals are more visible, and those collected by businesses are less visible. Some neutral tax plans have recommended very large exempt amounts. Visibility requires that, excepting the very poor, as many people as possible pay tax so that, as voters and consumers of government services, they will be aware of what government

costs, and realize that government is not a free good. Neither simplicity nor fairness should be used as an excuse for exempting tens of millions of people from tax.

Neutral taxes and simplicity. Neutral taxes are inherently simpler than income taxes. Picture the current stacks and stacks of tax forms that a parent, a small business owner, a saver, a retiree, or a low income worker receiving the EITC must fill out. Think of the worksheets that govern the taxation of Social Security benefits and the phase-outs of deductions, exemptions, and credits. Think of Schedule D, and of having to list dozens or hundreds of stock trades. Think of the dozens of depreciation schedules and the complexity of recapture on Schedule C.

Think about the rules relating to how much you can put into what kind of pension plan or IRA or education account, when and how much you have to start withdrawing, and what happens to you if you miscalculate. Try to figure out the foreign tax credit form without computer assistance. Picture doing it all over again if you run afoul of the alternative minimum tax (either the individual AMT, or, if you are a corporate tax officer, the corporate AMT, which taxes corporations more heavily when they are suffering reduced earnings in a recession, or trying to grow rapidly and increase employment). Try to plan sensibly for the estate and gift taxes without a tax attorney on your payroll and an insurance broker on call.

Now picture throwing that all into the waste basket. Under neutral taxes, even those that are collected from individuals, the filing would be a relative snap. There would be no vast array of credits and exemptions phased in or phased out. There would be no list of stock trades, no Schedule D, no separate calculation or peculiar taxation of capital gains. There would not be dozens of different pension arrangements; all saving would either be tax deferred without rules and limits, or would have been done after-tax with no taxation of the subsequent earnings.

There would be no depreciation schedules and no keeping track of different rules for different machines and buildings over many years; investment in machinery, buildings, land, resources and research would be deducted dollar for dollar in the year it was made. There would be no foreign income and foreign tax credit offset to compute, and less need for the IRS to rely on information from foreign banks or businesses to enforce U.S. tax law. Tax treaties would relate only to the accurate allocation of costs between parts of a multinational business.

Picture a tax system in which the individual tax forms fit on two sides of a sheet of paper, nearly all the numbers were provided by one's employer, bank, broker, or credit card company, and it only took a day to do.²³ Alternatively, picture a Fortune 500 business sending in a tax form that weighed one pound instead of one hundred. Picture fifty thousand tax accountants and IRS agents lining up to teach math in grade schools across the country.

Neutral taxes and fairness. It is clear that neutral taxes are fairer than income taxes, if one understands the nature of income. Income is the payments that people

receive for contributing to the production of goods and services by working or making capital available. Except in rare cases, people are paid in proportion to how much they add to the value of output. If income is proportional to effort and one's contribution to the economy, then a flat rate proportional tax, with no tripling up of taxes on saving and investment, is arguably the fairest tax.

Kindness and charity urge that the poorest citizens be relieved of the requirement to share in the cost of government. Neutral taxes can be made progressive via rebates (if the tax is levied on businesses) or by a personal exempt amount or even multiple tax rates (if levied on individuals), but that should not be carried to excess. Income support programs are best handled outside the tax system as explicit payments by federal and state agencies other than the Treasury.

Nonetheless, neutral or "consumption-based" taxes can be made progressive to the degree that is deemed desirable. It is not necessary to double or triple tax saving and investment to have a progressive tax. That was the main rationale for the income tax in the 1930s, but we know better today. We can have a fair and charitable neutral tax and still enjoy the added growth of jobs and income that the correct treatment of saving and investment creates.

Neutral taxes encourage investment in education, and encourage highly skilled people to keep working and to keep employing others. Spending a hundred thousand dollars on schooling, and losing four to eight years of paychecks, is a major sacrifice. The reward is a higher level of skill and income, compressed into a shorter working life. Graduated tax rates and the lack of a deduction for investment in education penalize such people. A flat or flatter rate neutral tax system would end that discrimination.

Bear in mind that growth generates a higher level of income across the board, and is a good thing for everyone. It is hardly fair if a misguided effort to redistribute the pie causes the pie to shrink, and it is worse than a crime, it is a blunder if such efforts hurt the poor the most.

Budget and distributional concerns.

Count the gains from growth in determining the budget impact of tax reform. The potential for faster growth of jobs and incomes should allay concerns that tax reform might force a choice between higher short-term budget deficits and tax increases for some taxpayers.

As saving and investment increase, productivity and the taxpayer's income will grow faster for a decade or more and be higher by increasing amounts over time. When we look at how tax reform affects a family or individual worker or taxpayer, it is not enough to apply the new tax code to last year's income because neither the economy nor the taxpayer will behave the same way after tax reform as before.

The taxpayer will enjoy lower interest rates on mortgages and student loans as the tax burden on saving is reduced. Although reduced taxes on saving may not instantly lower the tax of a twenty-year-old who has not yet begun to save, it will lower taxes on that worker as he or she accumulates assets over a working lifetime, and leave that worker many tens of thousands or even hundreds of thousands of dollars better off by age 65, and far more secure in retirement. Whatever happens the first year, people will enjoy a lifetime of benefits from a pro-grow tax reform, and it is the lifetime benefits that matter.

As for the federal budget, there are many benefits, short term and long term. People would immediately have less incentive to shelter their existing income from tax, and the Treasury would see some revenue offset to any net tax reduction even before any rise in economic activity and income. In addition, of course, national income would grow faster, right from the start. An extra point on the growth rate would add a cumulative extra half trillion dollars to federal revenues over seven years.

There would also be gains on the spending side of the budget. More people working, and working at higher paying jobs, would mean a natural reduction in claims for income support payments. In light of the great benefits of reform to the economy, the population, and the budget, it would be wise to forge ahead, regardless of the transitory budget consequences. If the transitory costs to the Treasury are of real concern to lawmakers, they can best be addressed by restraining the growth of federal spending to accommodate the tax reform.

Conclusion

Tax reform is not about shifting the tax burden to someone else, eliminating individual tax filing or making it painless, eliminating millions from the tax rolls, eliminating all deductions, eliminating the IRS, or eliminating competition from foreign companies or countries.

Tax reform is not just an indiscriminate "broadening the base and lowering the rate."²⁴ It is about getting the tax base right and setting rates that cover the amount of government that people want to have.

Tax reform is about raising revenue in a manner that does less damage to the economy than current law, and that better informs the public what it is paying for government so that voters can make informed decisions about how much government activity they wish to support. Get tax reform right, and we will have a better economy and a better government.

Endnotes

1. Stephen J. Entin and Norman B. Ture, "The Inflow Outflow Tax: A Savings Deferred Neutral Tax System," 1998, <<ftp://ftp.iret.org/pub/InflowOutflowSum.PDF>>.
2. Stephen J. Entin, "The Economics of Taxation and The Issue of Tax Reform," IRET Paper, April 24-27, 2003, <<ftp://ftp.iret.org/pub/EntinNewOrl-2003.PDF>>.
3. Stephen J. Entin and Lawrence A. Hunter, "Reforming Taxation: Attributes Of A Good Tax System And Principles To Guide Reform," *IRET Congressional Advisory*, No. 183, January 19, 2005, <<ftp://ftp.iret.org/pub/ADVS-183.PDF>>.
4. Stephen J. Entin, "Renew Bonus Expensing To Keep Recovery Strong," *IRET Congressional Advisory*, No. 173, May 6, 2004, <<ftp://ftp.iret.org/pub/ADVS-173.PDF>>.
5. Bruce Bartlett, "The End of Tax Expenditures As We Know Them?" *IRET Policy Bulletin*, No. 84, June 13, 2001, <<ftp://ftp.iret.org/pub/BLTN-84.PDF>>.
6. Stephen J. Entin, "Tax Incidence, Tax Burden, And Tax Shifting: Who Really Pays The Tax?" *IRET Policy Bulletin*, No 88, September 10, 2004, <<ftp://ftp.iret.org/pub/BLTN-88.PDF>>.
7. Michael Schuyler, "Phase-Outs Are Bad Tax Policy," *IRET Policy Bulletin*, No. 71, January 16, 1998, <<ftp://ftp.iret.org/pub/BLTN-71.PDF>>.
8. Norman B. Ture, "Taxes and the Good Society," Lecture by Norman B. Ture, Delivered at Center for Economic and Policy Education, Saint Vincent College, September 13, 1995, <<ftp://ftp.iret.org/pub/TaxesGoodSoc.PDF>>.
9. See note 11.
10. Bruce Bartlett, *The End of Tax Expenditures As We Know Them?*, *op. cit.*
11. Such issues were not considered in 1986, and the results were not good. The Tax Reform Act of 1986 was often described as "broadening the base and lowering the rates." Although this is sometimes offered as a definition of a sound tax reform, it misses many basic points. In fact, the 1986 Act was a major disappointment. It lowered personal tax rates at the margin, which was a good step toward economic efficiency. However, it sharply raised tax rates, at the margin, on new saving and investment, which increased the income tax bias against those activities. It did so, in the guise of base broadening, by removing provisions that mitigated the multiple layers of tax imposed on income from saving and investment. The Act eliminated the investment tax credit, lengthened asset lives for cost recovery purposes, ended the capital gains differential, imposed or tightened income and contribution limits on tax deferred retirement savings plans, and introduced passive loss rules on real estate that depressed returns in that sector for investors who were not active managers of their properties. The minor efficiency gains that came from canceling a few peculiar tax breaks for certain other activities in no way made up for these across-the-board increases in the taxation of capital.

In effect, the Tax Reform Act of 1986 moved the hybrid tax system in the direction of a purer broad-based income tax. The Act paved the way for the stock market crash of October 1987, and led to weakness in investment in plant, equipment, and real estate that, along with two payroll tax increases in 1988 and 1990, set the stage for the recession of 1991-92. The 1986 Act also removed several million

people from the income tax rolls, making them less concerned about the cost of government and less interested in controlling federal spending and tax rates in the future.

12. This framework owes much to the work of IRET's founder, the late Norman B. Ture. See his papers: "Taxes and the Good Society," *op. cit.*; "Restructuring The Federal Tax System" *IRET Policy Bulletin*, No. 65, December 15, 1995, <<ftp://ftp.iret.org/pub/BLTN-65.PDF>>; and "Federal Tax Policy and the U.S. Economy: Policy Options for Improving Both," March 13, 1997, <<ftp://ftp.iret.org/pub/FedTaxPol-Improv.PDF>>. For an overview of a model tax system that Dr. Ture proposed based on these principles, see Stephen J. Entin and Norman B. Ture, "The Inflow Outflow Tax — A Saving-Deferred Neutral Tax System," *op. cit.*.

13. For more on the biases against saving in the current income tax, see Stephen J. Entin, "The Economics of Taxation and the Issue of Tax Reform," <<ftp://ftp.iret.org/pub/EntinNewOrl-2003.PDF>>; Stephen J. Entin, "Fixing The Saving Problem: How The Tax System Depresses Saving, And What To Do About It," *IRET Policy Bulletin*, No. 85, August 6, 2001, p. 15 ff, <<ftp://ftp.iret.org/pub/BLTN-85.PDF>>. Also see David F. Bradford and the U.S. Treasury Tax Policy Staff, *Blueprints for Basic Tax Reform*, 2nd ed., revised (Arlington, VA: Tax Analysts, 1985).

14. Any justification of the comprehensive or broad-based income tax and the additional corporate and death duties must rely on significant non-economic social benefits, because these taxes impose high economic costs, including reduced incomes across the board. The usual social benefit assumed for the income tax is that it may be used to reduce income inequality. However, redistribution lowers total income, especially labor income, and the process can hurt those it is designed to help. Early advocates of using the broad-based income tax for redistribution, such as Professor Henry C. Simons, acknowledged some of the costs.

Simons admitted that the income tax is not economically ideal. He reasoned that, since the rich save more than the poor, taxing saving more heavily than consumption would be "progressive". Simons also favored making the marginal tax rate structure graduated (higher tax rates imposed on incremental taxable income as it exceeds specified levels) to further increase the progressivity of the system. The pure Simons definition of income did not allow for a corporate tax in addition to the individual income tax, however, because that would have been an additional layer of double taxation.

Professor Simons was well aware that the twin distortions of the tax base and the rate structure inherent in the income tax could lead to a drop in saving, investment, and national income. In his magnum opus, *Personal Income Taxation*, (Chicago, IL: University of Chicago Press, 1938), Simons wrote:

The case for drastic progression in taxation must be rested on the case against inequality — on the ethical or aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly evil or unlovely...

The degree of progression in a tax system may also affect production and the size of the national income available for distribution. In fact, it is reasonable to expect that every gain, through taxation, in better distribution will be accompanied by some loss in production...

[I]f reduction in the degree of inequality is a good, then the optimum degree of progression must involve a distinctly adverse effect upon the size of the national income... (Simons, pp. 18-20.)

Simons took seriously the possibility that saving and investment would suffer from his policy prescription:

With respect to capital accumulation, ...the consequences are certain to be significantly adverse... [I]t is hardly questionable that increasing progression is inimical to saving and accumulation... That the net effect will be increased consumption ... hardly admits of doubt." (Simons, pp. 21-23.)

Simons's remedy was not to do away with progressivity, but to offset its effect on saving by running federal budget surpluses. The assumption that the government virtuously would run large budget surpluses to make up for the anti-growth consequences of a biased and progressive tax system has proven to be utterly naive. Furthermore, a budget surplus cannot make up for the adverse effects that high corporate or individual tax rates and unfriendly capital cost recovery allowances have on the present value of after-tax cash flow from an investment, a calculation that any business school graduate will undertake in deciding on the feasibility of an investment project. Thus, even an offsetting budget surplus would not prevent a reduction in the equilibrium capital stock from a reduction in the marginal return on investment.

Professor Alfred Marshall, who bowed to the general acceptance of progressivity, nonetheless favored a more neutral graduated tax on consumption over a graduated tax on income: "[T]here is a general agreement that a system of taxation should be adjusted, in more or less steep graduation, to people's incomes: or better still to their expenditures. For that part of a man's income, which he saves, contributes again to the Exchequer until it is consumed by expenditure." (Alfred Marshall, *Principles of Economics*, Eighth Edition (1920), Philadelphia, PA, Porcupine Press, reprinted 1982, p. 661.)

As Marshall pointed out, one does not need to adopt a non-neutral income tax to achieve progressivity. Saving-consumption neutral taxes can be made progressive as well. In fact, it is not necessary to have graduated tax rates to achieve progressivity. A tax which exempts some amount of income at the bottom, and imposes a flat marginal tax rate on income above that amount, is progressive, because the average tax rate will rise with income. A graduated consumption-based tax is not as economically efficient as a flat rate consumption-based tax, because it increases the tax penalty at the margin the more productive an individual becomes and the more effort he or she makes. Nonetheless, it is far more efficient than a graduated income tax.

15. Several studies in the economic literature illustrate that neutral treatment of capital income would raise the after-tax income of labor, in present value terms, even if labor must pick up the tab for the lost tax revenue. That is, a tax on capital is effectively shifted to labor. For a further discussion of tax shifting and the literature on optimal taxation of capital, see Stephen J. Entin, *Tax Incidence, Tax Burden, And Tax Shifting: Who Really Pays The Tax?*, *op. cit.*

16. The Treasury issued a report on corporate individual tax integration in 1991, and there is a long literature on these mechanisms. Most other developed countries use one approach or another to mitigate double taxation of corporate income, and have lower corporate tax rates as well.

17. For a further discussion of the merits of expensing, see Entin, *The Economics of Taxation and the Issue of Tax Reform*, *op. cit.*, <<ftp://ftp.iret.org/pub/EntinNewOrl-2003.PDF>>. Also David Bradford, *Blueprints for Basic Tax Reform*, *op. cit.*

18. See Stephen J. Entin, "Renew Bonus Expensing To Keep Recovery Strong," *IRET Congressional Advisory*, No.173, May 6, 2004, <<ftp://ftp.iret.org/pub/ADVS-173.PDF>>.

19. A tax on income less net saving, in which all saving is tax deferred in the manner that current law allows for limited amounts of saving in an ordinary IRA, 401(k), or pension. This type of tax is also called an inflow-outflow tax, a consumed income tax, an individual cash flow tax, or an expenditure tax.

For a full description, see *The Inflow-Outflow Tax, op. cit.*, <<ftp://ftp.iret.org/pub/InflowOutflowSum.PDF>>.

20. Value added taxes include European style credit invoice method VATs, goods and services taxes or GSTs (as in Canada and Australia), subtraction method VATs, and business transfer taxes.

21. A returns exempt tax does not allow a deduction for or deferral of current saving, which must be done on an after-tax basis, but it does not subsequently tax the returns on that after-tax saving. It is the method used for Roth IRAs.

22. All the major saving-consumption neutral taxes would lead to international tax simplification because all are territorial. That is, they are imposed on economic activity within the United States, and not on economic activity conducted by U.S. residents elsewhere in the world. The present global income tax requires U.S. residents to report income from around the world, and then to file for a foreign tax credit to avoid double taxation. Moving to a territorial system, not only for businesses but for individuals as well, would provide great simplification for taxpayers and would reduce administrative and enforcement costs for the IRS with little revenue consequence. It would also greatly enhance the competitiveness of U.S.-based multinational firms that must compete with foreign firms whose home countries have territorial regimes and lower corporate tax rates than the United States. It would be expected to raise exports of intermediate goods and services of multinational businesses to their affiliates abroad, and lead to more demand for the research and management functions of the U.S. parents.

Sales taxes and VATs are generally imposed on imports and remitted or not levied on exports. This feature is called border adjustability. The border-adjustable form is natural because sales taxes (and the final layer of the VAT) are collected at the point of final sale to consumers. With border adjustment, any purchase, whether domestic or foreign in origin, triggers the same tax at the cash register. Consumed-income taxes and the Flat Tax are not explicitly border adjustable, because they are collected from individuals as they earn. However, these taxes fall on income before it is used for consumption, and so the tax falls on income used to buy a domestic good or an import. The tax is not levied on foreigners buying U.S. exports. These taxes may be thought of as implicitly border adjustable. Border adjustment and territoriality are different concepts.

23. A simple neutral individual cash flow tax might arguably be considered the optimal tax system. An example is the Inflow-Outflow Tax expounded by the late Norman B. Ture at the Institute for Research on the Economics of Taxation. It is levied only on individuals, and is therefore the most visible tax system. In it, people would defer tax on saving and investment (including tuition invested in human capital), and deduct any income they transfer to others (as gifts or as taxes). Thus, charitable gifts, payroll taxes, and taxes paid to state and local governments would be deductible (and recipients of transfers would report the receipts as taxable income if it exceeded exempt amounts).

Saving would be deducted from taxable income. Withdrawals from saving would be added to income. One's bank or broker would give one the required amount to enter on the tax form. There would be an exempt amount to protect the poor, and, ideally, a single (flat) marginal tax rate on all other income, which would minimize all other distortions of economic activity. Investment in inventories, equipment, and buildings for one's business would simply be expensed. The I-O tax would fall on virtually the same tax base as a national retail sales tax, but would be more visible to the taxpayer/voter, and would do a better job of "costing out" government. See *The Inflow-Outflow Tax, op. cit.*, <<ftp://ftp.iret.org/pub/InflowOutflowSum.PDF>>.

24. We do not want another Tax Reform Act of 1986. See note 11 and *Reforming Taxation: Attributes of a Good Tax System and Principles to Guide Reform* op. cit., <<ftp://ftp.iret.org/pub/ADVS-183.PDF>>.