UNITED STATES OF AMERICA

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PRESIDENT'S ADVISORY PANEL ON
FEDERAL TAX REFORM

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SECOND MEETING

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THURSDAY
MARCH 3, 2005

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The Panel met in the Jack Morton Auditorium, The George Washington University, 805 H Street, N.W., Washington, D.C., at 9:30 a.m., Connie Mack, Chairman, presiding.

PRESENT

THE HONORABLE CONNIE MACK, Chairman
THE HONORABLE JOHN BREAUX, Vice Chairman
THE HONORABLE WILLIAM ELDRIDGE 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 SONDERS, Panel Member

WITNESSES

THE HONORABLE ALAN GREENSPAN, Chairman, Board of Governors of the Federal Reserve System
THE HONORABLE JAMES A. BAKER, III, Former Secretary of State and the Treasury
THE HONORABLE MARK EVERSON, Commissioner, Internal Revenue Service
NINA E. OLSON, National Taxpayer Advocate
JOEL B. SLEMROD, University of Michigan Ross School of Business
LEONARD BURMAN, Urban Institute
CLAUDIA HILL, Tax Mam Inc.

I-N-D-E-X

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

9:34 a.m.

CHAIRMAN MACK: Good morning. I would like to welcome everyone to the second meeting of the President's Advisory Panel on Federal Tax Reform. At our first meeting - two weeks ago - I mentioned the importance that all of us on this panel have placed on making sure the public knows about our activities and has a chance to provide input to our process. I announced our website, www.taxreformpanel.gov, and also made a specific request for public comments on the problems with our current tax code and the goals that we should seek as we consider options for reform.

Since then, we have been contacted by hundreds of concerned Americans who have shared their own experiences with the tax code and expressed support and encouragement. For example, Mr. Shapiro from Florida wrote to the panel to express his concern that the tax system is a "great burden to individual entrepreneurs of our country" and that "the burdens of the complexities and potential consequences of errors dampen or destroy our creative impulses." We look forward to hearing from additional taxpayers like Mr. Shapiro who have an interest in helping us fulfill our mission to make recommendations for a tax system that is simpler, fairer and more growth-oriented.

I also promised that I would announce the dates and locations of our upcoming meetings. Next week, on March 8, we will be meeting in Tampa, Florida, the first of several meetings outside of Washington, D.C. In Tampa, we will examine the impact of the our tax system on business and entrepreneurship. The following week, we will travel to Chicago, where we will explore the influence of the tax system on important taxpayer decisions. We will be announcing additional meetings to be held during the last two weeks of March. At each of these meetings, we will hear from an array of tax experts and policy makers and from Americans who struggle with the code as they make decisions and business plans that affect how much they work and save, and how they organize their activities.

Before I describe today's meeting, I would like to acknowledge the recent death of David Bradford, one of the architects of the Tax Reform Act of 1986. Professor Bradford was an influential, insightful and intelligent voice for tax reform who participated in the policy debates as a scholar at Princeton University, a policy maker in the Ford Administration and an economic advisor to President

George H. W. Bush. We will sorely miss Professor Bradford's wisdom, but at the same time, I am sure that we will hear from many who have been influenced by David's creative ideas for tax reform.

Today we will build upon the excellent introduction to the current tax system we received at the first meeting and will put the problems of our tax code in sharper focus. We are honored to have with us Chairman Alan Greenspan who will explain how the tax system would benefit the economy. During the course of our work, we also plan to hear from a number of people who were involved in previous tax reform efforts. We are privileged to begin today with James Baker, who was Secretary of the Treasury during the last major successful reform, in 1986. Secretary Baker will join us from Houston.

Commissioner Mark Everson will help us examine our existing tax code from the viewpoint of the tax administrator. We will look at how the IRS copes with the tax code's immense complexity and the detrimental impact that complexity has on our system of voluntary compliance.

Our next two witnesses will help us understand the complexity from the taxpayer perspective. Nina Olson, the National Taxpayer

Advocate, will share with us her firsthand knowledge of the difficulties that taxpayers confront in understanding and applying the complicated rules found in our tax code. Professor Joel Slemrod will help us understand the magnitude of the compliance burden and the wasteful and inefficient nature of our tax system.

Our last panel will shine the spotlight on the Alternative Minimum Tax. Leonard Burman of the Urban Institute will explain how the AMT evolved from a targeted provision aimed at a handful of high-income taxpayers who were avoiding paying tax into a parallel system that imposes a significant hardship on millions of middle-class taxpayers. In addition, we will hear from Claudia Hill, a professional tax advisor who prepares hundreds of returns every year and whose clients, like many other Americans, have fallen into the AMT trap. Finally, we have a statement for the record submitted by Thomas Rinaldi, a small business owner and AMT taxpayer from Katonah, New York. Due to a medical emergency at his business, Mr. Rinaldi could not be with us. Mr. Rinaldi had never even heard of the AMT before his accountant told him that he would owe additional taxes. Mr. Rinaldi told us that his accountant has tried to explain the AMT to him several times, but that he still does not understand it. The

Rinaldis are just like millions of other American families who have been surprised to find themselves falling victim to the AMT.

Today's meeting, along with upcoming meetings across the country, will lay a solid foundation for a thorough understanding of the problems created by our tax code. We intend to build on this understanding in making recommendations for a tax system that will live up to the expectations of the American people. And Senator Breaux, did you say you had a comment to make?

VICE CHAIRMAN BREAUX: Yes, Mr. Chairman. Thank you very much. I just want to say to all of our members that after the first meeting as the members of this panel have gotten to know each other, both by reputations of outstanding panel members and also the personal interaction that the Committee has been able to engage in under your leadership, Mr. Chairman, I just want to say that I'm very optimistic about the potential for this panel to come up with a recommendation that is unanimous or as close to unanimous as it can possibly be.

Many of us have served on previous panels and commissions and many times you can sort of determine what the outcome of the panel or commission is going to be by the people who are on it because of the strong political positions that they have previously taken in which their biases were very evident and very well known. I think that this panel, the members, have, I think, the potential to work very well together. I think we come to this position all dedicated to meeting the charge of the President and just want to say that under your leadership, I'm very optimistic that we will be able to work very well together and reach a consensus agreement. Thank you.

CHAIRMAN MACK: Thank you and with that, Mr. Chairman, we'll look forward to your comments.

CHAIRMAN GREENSPAN: Thank you very much, Mr. Chairman and members of the Panel. The President has clearly assembled a very able panel to address an issue that is both important and exceptionally challenging.

The U.S. economy is the world's most dynamic and flexible, and the federal government's system for raising revenue must not hinder the processes generating that economic success. However, since the exemplary 1986 reform, the tax code has drifted back to be overly complicated and burdened by higher marginal rates and by many special provisions that have undesirably narrowed the tax base. Changes since the 1986 Act have been largely incremental without the appropriate all-encompassing context that broad reform brings to the table. It is perhaps inevitable that, every couple of decades, drift needs to be addressed and reversed.

I believe some useful lessons can be learned by examining earlier systematic reforms of the tax code, such as those of 1954, 1969, and 1986. Among those reforms, the 1986 effort is widely regarded as having been the most successful of the post-war era. This success was achieved, in large measure, I believe, because the reform hewed to an explicit set of principles. I am not suggesting that today's reform should follow the specifics of the 1986 reform. Both the economic and fiscal conditions, as well as the existing state of the tax system, have changed in important ways since that time, and some aspects of the framework that worked well in 1986 may be inappropriate today. Nevertheless, I believe that a number of the principles underlying that reform are still applicable.

A defining feature of the 1986 reform was the broadening of the tax base and the lowering of tax rates, and it is widely believed that these changes enhanced economic efficiency. High tax rates (whether the base is income or consumption) exacerbate the distortions that taxes invariably create. Moreover, distortions arise when similar activities are subject to different tax treatments. Such distortions reduce economic efficiency as households and businesses respond to the tax code rather than to underlyingeconomic fundamentals. Lowering tax rates by broadening the tax base generally will reduce the costs of such distortions, which are approximately proportional to the square of the tax rate. Over the years, economists have disagreed about the size of the efficiency gains that might be achieved from a broader base and lower rates, but there can be little doubt regarding their positive effect.

The 1986 reform also strove to achieve a measure of comity in the tax code, by treating taxpayers in similar circumstances in a roughly comparable manner and by maintaining progressivity in the tax system. In addition, the 1986 reform broadly applied the constraints of revenue and distributional neutrality, which appear to have facilitated bipartisan coalition building. Setting rough distributional neutrality as a rule of the game limited the number of losers created and likely made sacrifices in the name of efficiency easier for different groups of taxpayers who knew that losses would be relatively limited.

Of course, public views about the fairness of proposed changes to the tax code will surely play a significant role in the current debate, and these views will be driven by perceptions of the fairness of the current tax system. The standards by which the public judges fairness are deeply rooted in judgments of whether, and which, incomes are the consequence of individual effort. The contours of economic policy since the nation's founding have closely followed changing standards of fairness over time.

Simplification of an overly complex structure was another important accomplishment of the 1986 reform. Unfortunately, tax code drift since 1986 has evolved to a point where taxpayers are again confronted with great complexity. Indeed, an individual taxpayer may have difficulty even knowing his or her marginal tax rate because of the overlapping web of deductions and exemptions and the provisions that attempt to limit those deductions and exemptions. And many taxpayers are now required to compute their liability under two systems - the regular income tax and the alternative minimum tax. Such challenges also affect lower-income households, who face the complexities of the Earned Income Tax Credit. A simpler tax code would reduce the considerable resources devoted to complying with current tax laws, and the freed-up resources could be used for more productive purposes. Thus, greater simplicity would, in and of itself, engender a better use of resources.

A principle that I believe is important now but appears not to have weighed so heavily on those involved in the earlier reforms is predictability in the tax code. By this I mean creating a tax system in which households and businesses can look into the future and have some reasonable degree of certainty about the future tax implications of decisions made today. Just as price stability facilitates economic decision making by limiting the potential distortions from unanticipated changes in the price level, some semblance of predictability in the tax code also would facilitate better forward-looking economic decision making by households and businesses.

Given the expertise on this panel and the ultimate responsibility of the Congress and the President for the tax system, I would not presume to suggest the best specific path for reforming the tax system. However, past experience suggests that as the panel's work gets under way, one of the first decisions that you will confront is the choice of tax base; possibilities include a comprehensive income tax, a consumption tax, or some combination of the two, as is done in many other countries. As you know, many economists believe that a consumption tax would be best from the perspective of promoting economic growth - particularly if one were designing a tax system from scratch - because a consumption tax is likely to encourage saving and capital formation. However, getting from the current tax system to a consumption tax raises a challenging set of transition issues.

In 1986, tax reformers considered a consumption tax base and, despite the arguments in favor of such a system, they decided to enhance the comprehensiveness of the income tax system then in place. Circumstances are different today, and the right choice will require assessing anew the tradeoffs between complexity, fairness, and economic growth.

The choice of the tax base and other provisions of the code must also be taken in light of coming demographic changes. I believe that, as the baby boom generation begins to retire in a few years, it will become increasingly important for the nation to boost resources available in the future through greater national saving and enhanced incentives for participation in the labor force. The tax system has the potential to contribute importantly to those goals, and, at a minimum, tax reform should not hinder the achievement of those objectives.

Finally, fundamental, thoroughgoing tax reform will require tradeoffs among competing objectives and will create both winners and losers. In the past, these difficult choices were facilitated by bipartisan cooperation. In the 1954 reform, congressional support was bipartisan, and President Eisenhower signed the legislation. In the 1969 reform, efforts were started under President Johnson but were completed during the Nixon Administration. Similarly, in 1986, President Reagan worked with Democratic congressional leaders to see reform through.

I am confident that this panel can lay the groundwork for another historic reform and can get this process started off on the right foot. Thank you for the opportunity to share some thoughts with you today. I look forward to the results of your deliberations. Mr. Chairman, I look forward as well to your questions.

CHAIRMAN MACK: And thank you, Mr. Chairman. I appreciate your input. Let me just, for the benefit of the panel, I'm going to turn to Senator Breaux for the first question and then to Tim Muris and we'll work our way down the panel.

VICE CHAIRMAN BREAUX: Thank you, Mr. Chairman, and thank you, Mr. Chairman, for giving of your time to be with us this morning to talk about the task of this panel as we reach a recommendation to the President. On page four, you talked a little bit about options that are available to us. Looking at the concept of reforming the existing income tax system or looking at a consumption tax, you mentioned perhaps a combination of both, it seems that many other countries that are developed countries have sort of a combination of both, a consumption tax with a income tax.

Some would argue that the choice that we have to make is a recommendation for one or the other. Some argue on the other hand that you could do a combination of the two as many other countries have done. Do you have any thoughts about the viability of doing a combination, consumption tax/income tax, versus just one or the other?

CHAIRMAN GREENSPAN: Senator, we actually at the moment have a somewhat mixed system because remember, we do have a number of provisions in the tax code which lower the rate on savings and obviously, to the extent that you're lowering the rate on savings, you're essentially placing it on consumption. So in that regard, we do have a mixed system. I would suspect that probably that may be the best route to go.

In other words, don't try purity in either area because I would suspect that the opposition that would arise would probably make such a structure infeasible. So there's nothing inherent in the way one imposes taxes that you cannot use both. Any tax increase as you know inhibits economic activity in one way or another and we try to construct the tax system to raise the revenues we need in a manner in which the impact on economic activity is least. Having two types of fundamental systems from which to work to choose a menu, so to speak, of taxes strikes me as opening up a much broader way of solving this dilemma which cannot be pushed aside, namely, that whatever you tax you will get less of and if you're taxing the economy, regrettably that's what inevitably happens.

VICE CHAIRMAN BREAUX: A follow-up. Are

you confident that you can design a kind of consumption tax that would be fair to moderate to lower income people?

CHAIRMAN GREENSPAN: You can always construct a degree of progressivity into a tax system. Probably the simplest way is to exclude certain items from the tax which tend to be disproportionately consumed in the lower brackets. You obviously could also do it with brackets. The big problem you have with the consumption tax is what do you do about the consumption that is financed by old capital, capital that has previously been taxed and this is an issue which I think bedeviled the 1976 Commission and ultimately led to essentially an abandonment of trying to resolve that issue.

VICE CHAIRMAN BREAUX: Thank you, Mr. Chairman.

CHAIRMAN MACK: Tim.

MR. MURIS: Thank you very much, Mr. Chairman. I wanted to follow up on what you've been discussing by asking this question. In our last meeting, a panelist, I'm sorry, one of our witnesses suggested that one reason to create a separate consumption tax via something like a value-added tax was the need that he felt to raise additional revenues down the road and this would be an easy way to do that. Others have said that a problem with creating a separate consumption tax along with our current income tax would be that it would reduce pressure to make changes in some of the entitlement programs that ought to be made. Do you have a view on that debate?

CHAIRMAN GREENSPAN: I think you could find witnesses who will give you exactly the opposite answer on both those questions. The reason is that there are obviously those who believe that what's wrong with a value-added tax is that it's too easy to raise revenue and hence you will tend to raise more than you should in the context of the needs of the society and in the process, suppress economic growth.

I don't think any of these are easy and the mere facility of raising taxes shouldn't be a criterion and above all, we shouldn't try to hide what we're doing. All of these particular proposals somehow slip in an extra $20 billion and nobody will notice and that tax incidence somehow or another will elude people and if you bury it most deeply into the structure of the exchange rate system, rather into a system of exchange of goods and services, you will somehow make it invisible to all the people on whom the incidence ultimately falls. I don't doubt that

that happens and I don't doubt that we choose to do it. I just think that's not what an open, democratic system ought to endeavor to do.

MR. MURIS: Thank you.

CHAIRMAN MACK: Mr. Rossotti.

MR. ROSSOTTI: Yes. Thank you, Mr. Chairman. I wanted to follow up on one intriguing item in your testimony about predictability. This has been even in past forums given less emphasis than it should and I can see the importance of that. Could you give some ideas on how predictability might be achieved better than we have in the past?

CHAIRMAN GREENSPAN: Remember that the predictability that is most important is predictability of business investment. Clearly, all investment refers to expectations about the future and forecasting is tough enough without increasing uncertainties. To the extent that you have an uncertain tax structure, you increase the variants of the forecast and according, raise the real cost of capital and one would presume lower capital investment and lower growth and standards of living. You can raise similar issue in the household sector, but they're probably not as critical because households are not investing with the longer term with as much uncertainty as is the business community.

MR. ROSSOTTI: But what are some ideas on how more predictability might be achieved?

CHAIRMAN GREENSPAN: Predictability is largely achieved by trying to get the right tax structure in and then fending off all the endeavors on the part of others to chip away at it as the years go on. The obvious case is what's been happening since 1986. I thought that the Michelson-Morley experiment in the 19th century demonstrated what the speed of light was. I was mistaken. The speed of light is obviously even faster. It's not as fast as the response that occurred after the 1986 Act.

CHAIRMAN MACK: Bill.

CONGRESSMAN FRENZEL: Thank you very much, Mr. Chairman, for your testimony. Thanks also for your great service to this country over many years.

CHAIRMAN GREENSPAN: Thank you, Congressman.

MR. FRENZEL: My question was essentially the same as Commissioner Rossotti's. It related to predictability and you've already answered that. I guess we do the best we can here and pray that the future executives and congresses are slightly more resistant to change than they have been in the past.

CHAIRMAN GREENSPAN: I don't know. As a matter of fact if I had to find the answer to that, I probably would have called you because you've been around much longer than I in this particular area. It's a very interesting question. I don't perceive it, but I'm not sure that's a valid inference.

MR. FRENZEL: Thank you very much.

MR. POTERBA: Thank you for joining us today, Mr. Chairman. One of the issues that economists frequently wrestle with when trying to figure out how changes in the tax treatment of business investment or of interest deductibility or related issues would ultimately play out in what their final incidence would look like is how those changes might affect nominal interest rates in the economy. Given the size of the U.S. corporate sector, the size of the U.S. household sector and the global capital markets, how would you urge us to think through the possible equilibrium effects that we might see on interest rates from some of these changes?

CHAIRMAN GREENSPAN: You mean from the tax code?

MR. POTERBA: Yes.

CHAIRMAN GREENSPAN: I'm not sure that we ought to be focusing on a number of elements such as interest rate structure in formulating the tax code. I think it's difficult as it is. There are obviously other much more profound forces involved in determining the real interest rate and inflation expectations and nominal rates and all that. While I'm not saying that the tax code obviously doesn't affect interest rates, clearly the structure of the degree of integration, if any, or elimination of the double taxation of dividends as an impact and clearly the extent to which the various structures of taxation have an impact on the leverage in the system, all have impacts.

I don't think, however, that in formulating the tax code it's wise to try to include measures which affect that. The basic reason is not that you can't improve, you cannot get a better system. I think you can. In other words, clearly, the whole issue of deductibility of interest and the non-deductibility, or at least now partial non-deductibility, of dividends clearly affects the leverage in the system and it will affect interest rates and one could argue that it's an important issue.

But aside from the very broad question which I've raised in our fora about the desirability of the elimination of the double taxation on dividends completely, I would be hesitant to use the tax code too generally for other than this general integration process. There are too many complexities in making judgments as far as I can see.

MR. POTERBA: Thank you.

CHAIRMAN MACK: Beth.

MS. GARRETT: Thank you, Mr. Chairman. As you know, we've had for some time in the tax code provisions to increase individual savings, employer-provided savings accounts, IRAs, back-load good IRAs. There are more proposals. It's part of the complexity analysis I think we have to engage in. It's made complicated by the fact that we're not very sure what effect those have on savings rate and we do know that some of the revenue loss may affect the deficit now and in the future. I wondered if you had a reaction to some of those savings incentives in the tax code and if you might provide us with some principles as we go forward to analyze those provisions.

CHAIRMAN GREENSPAN: This is a difficult issue because the critical facts are in dispute with respect to the impact. There are those who are demonstrably certain with fairly impressive sets of data that 401(k)s for example do add net to savings in the society and as I recall, the data are largely coming from various different types of panels and the like. There's another group who finds no such evidence and would argue that essentially what is happening with 401(k)s is merely a shuffling of savings from one part of one's asset system to another and there's no net increase in savings.

It is probably, however, indisputable that even if there is a shift and no new net savings you are indeed, by moving regular savings into 401(k)s, enhancing retirement accounts. That especially in the context of the discussions we've all been having in the last few weeks relevant to retirement funding and the like is clearly something which is desirable.

So I would say that, yes, we do lose revenue from 401(k)s and IRAs and obviously that's the general purpose of what we do, but I would suspect that it's probably a useful thing to do and at worst, it does very little harm and does cut the cost of taxation on capital which, in my judgment, is a positive for economic growth. All in all, I think that those particular vehicles even given the disputes about the actual impact are something which we should continue to pursue in my judgment.

MS. SONDERS: Thank you, Mr. Chairman, for spending some time with us this morning. I want to stay on this savings topic for a minute but take a different angle with my question. You've talked a lot about the need to have our tax code be more stimulative for savings and less stimulative for consumption and also obviously a lot lately, you've been talking about the need overall as it relates to global imbalances for our country to stimulate savings more. How far do you think a change in the tax code here that would stimulate savings more would take us on that path to easing some of these global imbalances?

CHAIRMAN GREENSPAN: I suspect very little. In other words, the forces which are driving global imbalances as a general proposition are far more deep seeded than structure issues with the economy than the elements of the tax code. I do not deny that you can find ways to alter the tax code to impact on the current account deficit or balance in general. My suspicion however is that the efficiency effect of doing that is probably a very bad trade-off in the sense it's far too costly in either complexity, loss of efficiency and potentially even revenue to get a meaningful impact on the overall current account balance.

CHAIRMAN MACK: Ed.

MR. LAZEAR: Thank you, Mr. Chairman. A primary rationale for increasing saving rate is that we expect that it will have impact on growth rates down the road. In order for that to happen, there has to be some link between domestic saving and investment. So what do you think we can infer about the effect of saving on investment given that we live in an international capital market?

CHAIRMAN GREENSPAN: Let's remember that the mere existence of savings doesn't create the investments and the issue is in order to have the investment you do need a form of financing. In this country what we have done to finance domestic investment is to have to stage almost six percent of our GDP in terms of foreign savings which we're borrowing to finance what we are doing. Clearly, anything which enhances domestic savings would give us greater flexibility in financing investment, but that still doesn't address the question of what are the incentives that are required in order to maintain capital investment.

In my judgment, the issue fundamentally is to have as low a tax as one can on capital investment and one of the reasons why we try to do that is it's fairly evident that capital investment is a critical part of the creation of gains and labor productivity. But let's remember that there are other elements in the tax system here which increase labor productivity which don't have anything to do with physical capital investment because as you're aware, approximately at this stage almost half of gains in labor productivity are created by what we call multi-factor productivity which is the amount of productivity gain which is attributable to all the technological and innovative activities other than those literally involved with the physical capital asset which we employ for productivity gains.

So anything that enhances investment or put it the other way around, any tax which reduces the incentives which are otherwise there in the most minimal way is the best tax. In other words, you will not create a tax which will enhance capital investment because in that regard zero tax is the best tax. So it's a question of what is the least that one can find in order to get the maximum investment. There are a lot of issues with respect to all sorts of elements within the tax code, the investment tax credit, forms of depreciation, charges, tax credits of all sorts. All of these alter the optimum path of capital investment and the less of those we have in my judgment the better off we are because what taxes do is either suppress investment or they shift it. In both instances unless you have monopolistic structures in the marketplace, you are creating a less than optimum capital structure.

CHAIRMAN MACK: Mr. Chairman, let me raise a question with respect to the consumption versus income tax in this context. One of the things that we will be thinking of as we go through these next several weeks and months is how much emphasis to place on consumption versus income and since consumption is such a driving force in our economy, do we need to be concerned about placing too much, if you will, tax on the consumption sector that we in essence drive down consumption and slow down the economy. I would assume that would be short term and if that's a reasonable premise to raise, is there a role for the Federal Reserve in that short term period?

CHAIRMAN GREENSPAN: There's always been disputes over the generations about the issue whether --

(Fire alarm.)

CHAIRMAN MACK: I think what I'll do, Mr. Chairman, is to -- You were at a point where you need to go and if you could provide me an answer with that question, I would love to have it.

CHAIRMAN GREENSPAN: I'll be delighted to.

CHAIRMAN MACK: Mr. Chairman, we're going to let you go at that point.

CHAIRMAN GREENSPAN: Thank you very much.

CHAIRMAN MACK: Off the record.

(Whereupon, the foregoing matter went off the record at 10:11 a.m. and went back on the record at 10:35 a.m.)

CHAIRMAN MACK: On the record. I believe any moment we will see Former Secretary Jim Baker on our television screens, I hope. This has been quite an interesting meeting, hasn't it? We're going to wait just a minute or two and if Secretary Baker is not ready, then we will go to our next panel. So just hold on a moment.

(Pause.)

CHAIRMAN MACK: We know he's there. Now it's just a question of getting us together. Jim, can you hear me? Okay. We don't hear you at this point.

SECRETARY BAKER: Okay. I'm talking to you.

CHAIRMAN MACK: We hear you now. Jim, thank you. We've had an interesting hearing already this morning as I think you probably know and we are delighted that you're able to be with us via television and look forward to your comments about the 1985/1986 tax reform. We are really interested in what you have to say. So again, thank you for taking the time to be with us this morning. Why don't you go ahead and proceed.

SECRETARY BAKER: Thank you very much, Senator, and thank you, Senator Breaux, and distinguished members of the panel. Ladies and gentlemen. Hang on just a minute. I'm getting a lot of feedback here, Connie.

(Pause.)

SECRETARY BAKER: I think it's quite appropriate that you start the hearing today with a fire, Connie. We had to put out a lot of fires in 1986 when we had the tax reform.

CHAIRMAN MACK: We're going to overcome this, folks. Believe me.

SECRETARY BAKER: Okay. Let's give it a try, Senator, and if it keeps up, I'll stop if I have to.

CHAIRMAN MACK: Okay. Fine.

SECRETARY BAKER: Let me begin by saying I'm honored to appear before you today and I'm grateful for the privilege of sharing my views on federal tax reform.

Thirty years ago, Presidential Candidate Jimmy Carter described the federal tax code as a disgrace to the human race. As President Ford's campaign chairman in 1976, I didn't often find myself in agreement with then-Governor Carter. But when it came to the tax code, he was absolutely right. And, sad to say, he would still be right today.

Our federal tax system is unnecessarily complicated, making much of it incomprehensible to anyone but specialized accountants and attorneys. It is financially burdensome to the millions of taxpayers who must comply with its Byzantine provisions. It fails to reflect adequately the increasingly integrated nature of the modern global marketplace. It is crippled by special-interest loopholes that both drain revenue and undermine public respect for the law. And, perhaps most importantly of all, it is too often counterproductive in terms of promoting our vital national goals of higher investment, employment, and overall growth.

In short, our current federal tax system is in acute and overdue need of a comprehensive overhaul. That's why I welcome this opportunity to speak to this panel.

If you permit me, I will focus on what I see as the broad objectives of tax reform. You will be speaking with experts better qualified than I am to discuss such complex and sometimes contentious matters as the Alternative Minimum Tax or eliminating or reducing the double taxation of corporate income. Instead, I will stress certain general principles that I hope will drive your deliberations. I will also touch on the successful efforts of the Reagan Administration to forge bipartisan support for major tax reform in 1986. I suspect our experience then may prove useful today as the panel goes about its work.

The Executive Order creating this panel summarizes the fundamental principles of any comprehensive tax reform. In it, President Bush calls for proposals that would simplify the federal tax code, promote fairness, and encourage economic growth. All of these objectives are critical.

This morning, however, I would like to stress the third objective: fostering broad-based economic growth. Indeed, I see tax reform as a vital complement to President Bush's efforts to lower marginal tax rates, reduce disincentives to savings and investment, and abolish the estate tax.

I supported the President's 2001 and 2003 tax cuts for a very simple reason. And that's because we have tried deep and broad-based tax cuts before under President Reagan and they worked. The tax cuts of 1981, I think, laid the groundwork for nearly two decades of economic expansion interrupted by only two quarters of negative growth at the time of the 1990-91 Gulf War. And I am convinced that President Bush's tax cuts, particularly if they are made permanent, will provide a similar foundation for the long-term growth of our economy.

Let me now say a word or two about the most sweeping overhaul of our federal tax system since the enactment of the modern income tax in 1913 and that was the Tax Reform Act of 1986. As you know, as President Reagan's Secretary of the Treasury at the time, I was deeply involved in this effort from inception to enactment.

As passed into law, the tax reform of 1986 lowered the top personal tax rate from 50 percent to 28 percent, reduced the number of brackets from 14 to two, curbed and eliminated deductions and loopholes, and completely removed six million low-income Americans from the tax rolls. But, regrettably, this sweeping reform proved transitory, as subsequent decades saw marginal rates raised and some deductions and loopholes restored. Nonetheless, the Act did represent genuine reform of a system that had seemed impervious to fundamental change.

So we might ask what are the lessons of our experience in 1986?

First, I think a most important lesson is probably that presidential leadership is critical. President Reagan made tax reform the centerpiece of his second-term agenda. He highlighted it in his 1984 State of the Union Address and he stressed it during his successful reelection campaign later that year. Throughout the long and difficult process leading to Congressional passage, those of us at Treasury could count on the President's commitment to reform and his willingness to expend political capital to advance it.

Let me add that presidential leadership also serves a broader purpose, one that I think this panel shares. That is educating the public on the issue of federal taxation, an issue that excites more emotion normally than sober consideration.

Second, that bipartisan support for tax reform can be decisive. The easy majorities by which tax reform eventually passed the Congress in 1986 bear witness, I think, to its broad appeal across the political spectrum. We in the Republican Administration looked to influential Democrats such as House Ways and Means Chairman Dan Rostenkowski and Senate Finance Committee member Bill Bradley as full partners in our effort to overhaul the tax system. By so doing, we managed to avoid politicizing the issue and instead fostered a spirit of cooperation that was instrumental to our ultimate success.

Bipartisan support would seem less important today than it did in 1985-86. Then, of course, the Congress was divided with a Democratic House and a Republican Senate. Today, of course, Republicans control both bodies. But, Mr. Chairman, I nonetheless believe that the broadest level of bipartisan support is still desirable if only to avoid plunging the debate over reform into partisan acrimony. And this panel with members from both major parties, I think, is an important first step in this direction.

The third principle, revenue neutrality is essential. By insisting on strict revenue neutrality in 1986, we imposed discipline on the reform process in two ways. First, we were able to remove contentious questions of overall revenue levels from the discussion. Second, we generally succeeded in limiting efforts to riddle the proposal with tax breaks for special interest groups since each and every loss in revenue would have to be offset.

I understand that revenue neutrality is a rather more complex issue today with such critical matters as Congressional extension of the 2001 and 2003 tax cuts still outstanding. As I have mentioned, I strongly support making the cuts permanent. Nevertheless, some form of revenue neutrality will be required if the process is to force the tough trade-offs necessary to achieve genuine reform.

Fourth and finally, I think a pragmatic assessment of political reality can give reform momentum. If you will remember, there was a November 1984 Treasury Department proposal for tax reform which limited the home mortgage deduction to principal residences and abolished itemized deductions for state taxes. That proposal went nowhere because it failed this test of political reality. Maintenance of the full deduction for home mortgage interest was one of foundations of our later successful efforts.

President Bush has made clear that he believes any reform should recognize the importance of home-ownership and the most of charitable giving. So

I urge you seriously to consider these suggestions. I realize that it is not exclusively the job of the panel to prejudge the political compromises necessary for final passage. But a basic recognition of political reality will help you shape recommendations that, I think, could survive the legislative process. This will still leave room for you to be bold and broad-ranging in your proposals.

Consider, for instance, a shift in the federal tax base from income to consumption, an approach put forward by many, but of course, which many also consider politically difficult. While I am no expert on the subject, Mr. Chairman, I believe that consumption-based taxation has very much to commend it and, if properly crafted, a consumption tax could certainly meet the fundamental criteria of being simple, of being fair and of being pro-growth.

In conclusion, let me again commend this panel for taking up the President's challenge to build a better federal tax system. I don't have to tell you that achieving significant reform is not going to be easy. Special interest groups and sheer institutional inertia are going to bedevil the process every step of the way. But, I think, our experience in 1986 demonstrates that comprehensive tax reform is indeed possible. I am convinced that the President of the United States is prepared to offer firm leadership. I also believe that the endorsement of such respected former Senators as the Chairman and Vice-Chairman of this panel will carry great weight with members of Congress on both sides of the aisle. So, of course, would a unanimous report by the panel.

You bring an impressive wealth of expertise and experience to these deliberations. And your willingness to serve as members of this panel is evidence of your deep commitment to good public policy. You will need all that experience and all of that expertise and all of that commitment in the weeks and months ahead. I would applaud you for taking up the task of tax reform because it is a daunting challenge and I wish you every success as you embark on your critical work.

Above all, I would urge that you keep your eyes on the prize: the prize being the creation of a simple, fair and pro-growth Federal tax system that, in the words of the President Ford's Treasury Secretary, Bill Simon, "looks like something designed on purpose." The American taxpayer, Mr. Chairman, demands and deserves no less. Thank you very much.

CHAIRMAN MACK: Thank you very much for your comments this morning. They will be very helpful and I'm sure that we will be thoughtful of those as we go forward. I am now going to look to the various panel members for their questions and we'll start with Ed Lazear.

MR. LAZEAR: Thank you, Mr. Secretary. I'd like to touch on two topics that you addressed. One was complexity and another was economic growth. I wonder if you could discuss the link between the two. We know that complexity is a very significant issue. Some estimates have the cost of complexity of the tax code being something like two percent of GDP and that's an enormous number. Do you believe that elimination of the complexity will have an effect on economic growth and, if so, through what mechanism?

SECRETARY BAKER: Well, I would think, sir, that simplicity or greater simplicity would enhance economic growth by simplifying or reducing compliance costs. The more complicated the tax code, the greater are the costs of compliance. The simpler it is, the less they are. The less those costs are, the greater is the potential for economic growth.

MS. SONDERS: Mr. Secretary, I want to talk about the notion of making this unravel-proof as I've heard the term used and it's hard not to think about this with an air of potential futility and the sense that 20 years from now, there will be another commission formed to go through this process again. So given your involvement in 1986, maybe you could share with us anything you look back on that you might have done differently to make this a little stickier, lessons that we can use as we develop our proposals.

SECRETARY BAKER: Ms. Garrett, I think it's Ms. Garrett asking the question.

CHAIRMAN MACK: It's Liz Ann Sonders.

SECRETARY BAKER: I don't have a solution to that. If we'd had a solution to that in 1986, we might not be having this hearing today because the `86 tax reform might not have come unraveled through the creation by Congress of new loopholes and deductions and the increase by Congress of the top marginal rates. I don't know how one Congress can bind another or better put, I suppose, I don't know how one Congress can bind a future Congress. So I don't know how you make it unravel-proof if that's the right word to use.

I think you're always going to be faced with the prospect that succeeding congresses will want to address the tax code. One of the most important things I think in promoting growth and simplifying is for the taxpayer to have some assurance that not every new congress is going to deal with the tax code, but the temptation of doing so are extraordinarily great. So I'm afraid I don't have a solution to that problem. I wish I did. If we had it in 1986, I think we would have tried to put it in place.

CHAIRMAN MACK: The next member of the panel is Elizabeth Garrett.

MS. GARRETT: Thank you, Mr. Secretary.

SECRETARY BAKER: Sorry. I missed. I thought Ms. Garrett was asking that question because I can't see you.

CHAIRMAN MACK: I'll try to identify for you each time. Sorry about that.

MS. GARRETT: You identified revenue neutrality as an important component of `86 and as part of this panel's charge. If we want to make changes to reform that lose revenue, that means we have to raise revenue in some way and one of the panelists from our last time suggested that one thing to consider is a VAT, in other words, to make our tax system more like the European tax system which has a couple of sources of revenue. I wondered what your views of that proposal might be. As you know, it's also been mentioned that that might be a source of revenue for entitlement reform as well. I wanted to know your reaction to that as a possible option for reform.

SECRETARY BAKER: I think it is a possible option. Again, I'm not an expert in how a value-added tax system works. We did not consider that in 1986 because we were purely and simply dealing with a reform of the income tax code. So we didn't get into that and yet I think given the mandate of this panel, it is something that you should look at. Just like I think as I said in my statement, I think you should carefully consider the possibility of moving the nation to a consumption tax of some type that would promote savings and investment.

CHAIRMAN MACK: Our next panelist is Jim Poterba.

MR. POTERBA: Thank you, Mr. Secretary. Looking back on the experience in 1986, are there particular pitfalls in trying to design a tax reform that you can alert this panel to that one is to avoid? You offered some broad principles that might guide our focus on the prize, but are there things, traps along the way, that we should try to stay out of?

SECRETARY BAKER: I think there are some traps and I mentioned a couple of them in my statement. If you're going to reform the income tax, I think above all else you must be conscious of political realities because you're going to have to do it through legislation and everybody wants a piece of the tax code for his or her own special interest.

I would recommend to you if you're interested in it a book that Alan Murray wrote at the time of the `86 tax reform effort called Showdown at Gucci Gulch. And that will give you a real vivid insight to what I'm talking about. I also mentioned the home mortgage interest deduction because if you're going to reform the current income tax code, you will not get there if you think that you're going to be able to eliminate that deduction in order to somehow permit you to get the top marginal rate lower. These are the kinds of things I think you need to be aware of.

We were disappointed in `86 that we could not eliminate all of state and local taxation deductions because it would have enabled us to again to reduce the top rate a bit further. We were able to get some of it. We got, I think, the sales tax deduction and the ad valorem tax deductions eliminated, but we were not able to get the state income tax deductions eliminated.

And to my way of thinking and maybe this is because I've had a fair amount of experience in politics, this is political exercise every bit as much as it is an economic exercise. I think it is important to set your economic goals and I've mentioned some with revenue neutrality and elimination of the poor as much as possible from the tax rolls, of maximum marginal rate, things like that and then proceed to put together a legislative group from both sides of the aisle that will support the prospect of reform. I think you have to be very attentive not to just the economic arguments, but also to the political ones as well.

CHAIRMAN MACK: Next, we'll go to Senator Breaux.

VICE CHAIRMAN BREAUX: Good morning, Mr. Secretary. Good to see you and good to be with you although I have to say that I prefer being with you down in South Texas hunting quail than where we are right now.

SECRETARY BAKER: I would enjoy that better, too, John. We ought to program that for this time next year.

VICE CHAIRMAN BREAUX: I'm for that. I'd just like to pick up on one of the points you made.

I mean what you all did in 1985 and `86 was a remarkable achievement in the sense that you all were able to bring Democrats and Republicans together in a panel that made the recommendations and really just stayed with it until they got a recommendation that they could all agree on. I think that was the key to the success.

Now one of the things you mentioned was the commitment of President Reagan at that time to make it the centerpiece of what he was advocating in his second term. Now it seems that the circumstances today is that the President has made Social Security reform the centerpiece of the second term at least so far. So the question I have given the parameters that we operate in, is there a way to make tax reform one of those centerpieces? I mean the question is can Congress do two things at once. I think that question is open for debate and for discussion. But I mean we are talking tax reform here and it seems like the Administration is talking Social Security reform.

SECRETARY BAKER: Like when they asked Yogi Berra, what do you think about up there at that plate and he said, "Who can bat and think at the same time?" But I certainly think they can do two things at the same time and you're quite right that the effort with respect to Social Security reform has already been launched and it's under way and it's either going to go or not to go it seems to me before your report comes in perhaps and before the Administration says, "All right. Here is the type of tax reform we're going to go with."

But again, it's a function of Presidential leadership and there's still plenty of time in the President's second term for him to grab hold of that at the time your report comes in, make his choice and lead the charge. So I don't think it's something that cannot be done at all. You start in a little bit better shape, Senator, because while you have, I've argued for putting as broad a bipartisan group together as you can. You do have a Congress today that is not a divided Congress which I think gives you more potential for pulling together majorities in both bodies.

VICE CHAIRMAN BREAUX: Thanks, Jim.

CHAIRMAN MACK: Congressman Frenzel.

MR. FRENZEL: Mr. Secretary, thank you for your wise counsel and with respect to Senator's comments, it is just always the greatest thing to have all your guys in -- as I recall in `86, we had a slight hiccup with the Republicans in the House when the rule was voted on and defeated from which difficulty you were in.

SECRETARY BAKER: I remember that very well, Congressman.

MR. FRENZEL: I was one of those fires you had to put out.

SECRETARY BAKER: That's right. In fact, there were a lot of people on our side of the aisle that fought us tooth and nail.

MR. FRENZEL: With respect to that, when this Commission reports to the President, the President will report something to Congress and obviously we have to be careful not to have our recommendation irritate any particular party of group in the Congress. But it seems to me we will be aided if we can go to statesmen like yourself in both parties as we develop our suggestions and perhaps if we will be lucky enough to gain support, that will be helpful and the Congress will have to work out its own arrangements as they did in your day. Is that a possibility?

SECRETARY BAKER: I think it is, Congressman. I think that fundamental tax reform is so important and it is also so difficult that you will get the support of people who have been in this arena before. I mean you'll certainly get mine. I know firsthand how tough it is to do this, how tough it is to come up with something that is pro growth and fair and simple.

As I mentioned in my opening remarks, I hope you'll take a look at this question of a consumption based tax. Now that's a very broad step to take. But in my opinion you can design something that would meet the tests of simplicity, of fairness and of pro growth.

MR. FRENZEL: Thank you very much, Mr. Secretary.

DR. NEWMAN: Mr. Rossotti.

MR. ROSSOTTI: Mr. Secretary, thank you for your comments. A lot of the complexity, probably the majority of it, actually is related to business taxpayers, both small and large business as opposed to individuals. Could you make a few comments about some of the particular problems you face and some of the options you say should be either considered or not considered with respect to simplifying the taxation of businesses of both types?

SECRETARY BAKER: Mr. Rossotti, I don't frankly recall too much in regard to that. Today you have increased tax avoidance, I think, at the corporate level. You're going to be hearing from your successor as a Commissioner of Internal Revenue as I understand it later on today and he could probably better answer that question for you.

But corporate taxation is it seems to me the most complicated area of the code and I found back in 1986 frankly that there was some elements of that even after they were explained to me that I had difficulty in understanding. So I'm not much help to you on that subject, but I'll bet you the Commissioner will be able to.

MR. ROSSOTTI: Thank you.

CHAIRMAN MACK: Tim Muris.

CHAIRMAN MACK: Thank you very much, Mr. Secretary, for appearing today and thank you for your service to America. Let me follow up on a question on the consumption tax. You mentioned that you didn't consider the VAT and let me just read you -- there are other ways to do consumption tax obviously within the context of an income tax by exempting savings.

Chairman Greenspan told us this morning that and I'm quoting the sentence here, "1986 tax reform was considered a consumption tax base and despite arguments in favor of such a system, they decided to enhance the comprehensiveness of the income tax system then in place." He goes on to say, "Circumstances are different today." I just wondered if you could comment on that choice that you made in 1986.

SECRETARY BAKER: We made that choice, I think, Tim, primarily because of our experience in 1981. We had, if you will remember, come into the office when the top marginal tax rate was 70 percent. Uncle Whiskers was taking 70 cents out of every top dollar that a lot of taxpayers earned and it was just not sustainable. It totally destroyed incentive. So we reduced in `81 the top marginal rate to 50 percent.

By the time I got over to Treasury in `85, we had discussed the possibility of further reductions in the top marginal rate because we had seen the generation of greater economic growth as a result of the tax reductions that we legislated in `81. I think that's primarily the reason we went with that approach as opposed to some consumption tax-based approach.

CHAIRMAN MACK: Jim, this is Connie. I think the question I want to go back to relates to the role of the panel and I'm trying to in my own mind address the issue, if you will, of the tension being sensitive to the political realities, but at the same time wanting to be bold in what we do. There's part of me that says that maybe we really shouldn't play much of political role. That we ought to focus on what we think is the best tax code that we come up with with respect to the goals of simplicity and fairness and growth. So try to help me think through about your recommendation, if you will, with respect to how we should act as a panel.

SECRETARY BAKER: Yes. Connie, if I'm correct, the executive order that sets up the panel asks you to come up with three potential methods and one of them has to be some sort of a reform of an income tax system. Now if that's correct, if I'm not mistaken in that assumption, then you have --

CHAIRMAN MACK: The only comment --

SECRETARY BAKER: Excuse me.

CHAIRMAN MACK: The only comment that I'd make is that there is no specific as to the number, but it is suggested that we come back with alternatives, one of which has to be as you explained it.

SECRETARY BAKER: One of which has to be. Okay. I don't know where I got the idea of three, but anyway, you can certainly come back with at least three and maybe more. I don't see anything wrong with laying out the pros and cons of each approach including in the pros and cons your assessment of the political difficulty or ease of a particular approach. I think that could be helpful to the Administration.

They will, of course, make their own political judgments as indeed they have to and again, you heard me say, and I believe this strongly, that this is not just an economic exercise. Like anything else when you're talking about legislation, you have to consider whether or not you think you can get it passed. It doesn't do any good to send something up and have it shot down. In fact, it sets you back and hurts the effort.

So it seems to me that you have plenty of room to say, "This system will do this, that and the other with respect to savings and investment. Unless it is crafted in a way that makes it simple and fair, it will be extraordinarily difficult to get through the Congress." I don't know why you can't send your recommendations over to the White House in that way.

CHAIRMAN MACK: Jim, thank you for those thoughts. As I indicated at least in my mind, I'm trying to find the right balance there. In this town, you can't be apolitical, but by the same token, I don't want to be so -- that we make conclusions about what the Congress is going to do.

SECRETARY BAKER: That's correct. And I totally agree with that, Connie. That's in effect what we had to do in 1986. There were things we wanted that we couldn't get, but we really didn't know that, didn't find out exactly what those crunch points were until we sat down with the tax-writing committees.

If you recall, we had retreats with Ways and Means and Senate Finance and we discussed this with representatives from both sides on the aisle in both bodies. At some point, it became quite clear mortgage interest was off the table, state and local taxes other than the sales taxes was off the table, but certain other things were in. That's the way we went about it.

CHAIRMAN MACK: Again, thank you very much, Jim, for your input. We really do appreciate your taking the time to be with us this morning.

SECRETARY BAKER: Thank you, Chairman.

CHAIRMAN MACK: We also appreciate your ability to adjust your time as we worked through our fire alarm here. Thank you very much.

SECRETARY BAKER: Thank you for having me, Senator. I appreciate it.

CHAIRMAN MACK: Thank you. All right, Mark. I would invite you up. As I indicated earlier, Mark Everson will describe the tax code from the view point of the tax administrator and will explain how the IRS copes with the tax code's immense complexity. So, again, we appreciate your being here this morning, Mark, and look forward to your comments.

COMMISSIONER EVERSON: Good morning, Chairman Mack, Vice Chairman Breaux and members of the President's Advisory Panel on Federal Tax Reform. My remarks this morning will cover three areas: a brief overview of our country's system of tax administration; observations about the way complexity in the code complicates tax administration; and a number of considerations which I believe you may wish to take into account as you develop policy options for Secretary Snow.

Before starting, however, I would like to commend the members of the panel for your willingness to take on this important task. The President has asked that we as a country step back, assess the existing tax code, and develop a simpler Internal Revenue Code that is both fair and promotes a healthy, sustainable economy. Your framing of the policy options is an important first step.

My job is to oversee the tax administration system and to make sure that the IRS brings in each year the $2 trillion that funds our Government, and that we do so in a fair and responsible manner without regard to political considerations. So I do have to be apolitical in this town. As this process unfolds, I don't expect to offer support for, or to oppose, any particular policy options. On the other hand, the IRS does want to help advance your work by providing information on how the existing system works, or doesn't as the case may be, as well as offering considerations pertaining to particular policy options based on our unique knowledge of the existing Federal system or other national systems.

Our nation's tax administration system is characterized by a number of factors: it is large and complex; its regulatory components extend beyond activities subject to taxation; and it includes not just the collection of taxes due but also important means-tested benefit programs where money is paid out. Furthermore, the functioning and integrity of the system is highly reliant on tax practitioners, and there are direct linkages to other important Governmental activities such as Social Security, Medicare and individual state revenue programs. I mention all these factors as relevant to your work because statutory changes in one area frequently impact another piece of the overall mosaic. At the IRS we administer this system by providing service to taxpayers, helping them understand their obligations and facilitating their participation in the system, and enforcing the laws so that Americans are confident that when they pay their fair share, their neighbors and

competitors are doing the same.

Concerning the size of our system, last year 183 million people filed individual tax returns. To put that number in perspective, it is fully half again the number of people who voted in the Presidential election. In that sense, paying taxes is a unifying experience fundamental to our democracy and respect for the rule of the law. Taxes are what President Kennedy called "the annual price of citizenship". The mechanics of our system are themselves complex: each year the IRS receives and processes vast amounts of information. For example, we receive over 220 million tax returns and over 1.3 billion information items, such as W-2s and 1099s, related to tax returns. Many of them shed light on different activities or functions of the same entity. A complete picture, for example, of a corporation's compliance with the tax code can require analysis of employment tax filings, pension plans, partnerships and joint venture interests, international transactions and affiliates, as well as associated charitable foundations and audits of its executive officers.

The regulatory responsibilities of the IRS extend beyond activities subject to taxation. Included are the nation's 1.7 million tax-exempt organizations, a role in the oversight of state and private retirement plans, and tax-exempt bonds, to mention several significant areas. In terms of monies paid out as opposed to collected, the IRS administers the Earned Income Tax Credit, which is the country's largest means-tested benefits program. Last year, the EITC paid out over $37 billion to 21 million taxpayers. The Heath Coverage Tax Credit is another example of a benefits program embedded in the tax code.

Linkage to other government activities is another dimension of Federal tax administration. Many states model their own tax systems on the Federal system. I would note that, on average, states collect almost $0.20 for every $1 the IRS brings in through examination activities. Social insurance and retirement receipts constitute 38% of the monies we expect to take in this year. The IRS is responsible for making sure that the nation's millions of employers properly withhold and remit both their own share of employment taxes as well as that of their employees.

What President Kennedy called our system of "individual self-assessment" relies heavily on tax practitioners to function smoothly and maintain its integrity. Altogether there are approximately 1.2 million tax practitioners, including attorneys, accountants, enrolled agents and other preparers. Beyond paid tax professionals there is an important element of volunteerism. Last year, the IRS worked with 80,000 volunteers at nearly 14,000 sites in cities and towns around the country helping people file their taxes.

As we approach our responsibilities, the IRS strives to do so with a balanced program providing both service to taxpayers and enforcement of the law. Our working equation at the IRS is Service plus Enforcement = Compliance. Not service or enforcement, we need to do both. And I would stress that when we enforce the law, it is imperative we do so with full respect for taxpayer rights.

Complexity in the tax code compromises both our service and enforcement missions. That is because complexity obscures understanding. Those who seek to comply but cannot understand their tax obligations may make inadvertent errors or ultimately throw up their hands and say, "Why bother?" In the enforcement context, complexity in the code facilitates behaviors at variance with those intended by Congress. A more complex and steadily more international business and financial environment further increases challenges to tax administration. Abusive shelters have been developed and promoted by a commercially reinforcing network of essentially stateless accounting firms, investment banks, and law firms.

Last October, the American Jobs Creation Act became law. There were 193 provisions in the law, 178 of which require IRS actions. Ninety-seven percent of the provisions were effective before, on, or within six months of the date of enactment.

The Jobs Act brings important benefits to the economy and does much to strengthen the Government's hand in combating abusive shelters. But it adds a lot of complexity to the code.

Let me take one of the provisions of the Jobs Act and give you a real life example of how complexity affects tax administration. The idea of this new provision is simple, an additional tax break to manufacturers by means of a special deduction. While simple in concept, the new provision requires companies to identify which activities are production activities and to make special calculations and allocations of income and expenses solely for the purpose of determining the amount of the new deduction.

To interpret the law, the IRS must issue guidance to help taxpayers understand the key concepts related to this provision of the Jobs Act. The guidance is not easy to craft. By distinguishing "production" from other activities, the provision places considerable tension on defining terms and designing anti-abuse rules. The first round of guidance the IRS issued was over 100 pages long. And I am told it covered only the most critical questions.

Aside from guidance, the IRS must take numerous other actions to implement the new deduction. To name just a few, changes need to be made to forms, schedules, instructions, and publications; training materials for our agents will need to be developed; and programming changes to IRS systems are also required to reflect the revisions to the forms. It will be necessary to devote significant audit resources to administering the new deduction.

Before closing I would like to suggest five factors which I would urge the panel to consider as you weigh policy options for changes to the tax code:

First, our economy is constantly evolving, with change seemingly ever accelerating. Examples of change include transformation of the workforce to more self-employed individuals; businesses contracting out activities they'd previously done themselves; the relatively greater portion of economic growth generated through smaller, non-manufacturing businesses; and increasing globalization. It is vital to construct a tax system that recognizes this dynamic and is built for the 21st Century, not the 1960s.

Second, policy options should be carefully assessed for their potential impact on attitudes towards compliance. Fairness and the perception of fairness are essential, as the President has recognized in his charge to you that your proposals be "appropriately progressive."

Third, administerability, my wife told me that wasn't a word but it's in here, is also an important consideration. Bolting on new programs to the tax code without significantly simplifying or eliminating existing elements may in fact make it more difficult to collect the $2 trillion we need to fund the Government.

Fourth, make an apples-to-apples comparison. Don't compare a sub-optimized existing system to a perfect, theoretical system. I can assure you from my conversations with counterpart tax administrators that there are administrative and compliance issues in all systems.

Finally, please recognize that transition issues associated with migration to a new system, or systems, merit close attention. If the transition is not properly planned and managed, the new system will get off to a rocky start. After such a start, it may take decades to recover.

I wish to emphasize that these points are not offered to suggest inaction. That would be perhaps the worst option. I strongly support the President's call for simplification. But, of course, as you would expect anyone in my position to say, given the stakes, before moving forward we need to have a high confidence level that the path chosen will lead to success.

Before taking your questions, I would like to return to the manufacturing deduction provision of the Jobs Act and talk for a minute about doughnuts. The new provision contains an exception from the manufacturing deduction for receipts from the sale of food, this is Evelyn Petshek, she has some doughnuts, or beverages prepared by the taxpayer at a retail establishment. If I make a jelly doughnut at my retail establishment and sell it to Commissioner Rossotti, that does not qualify for this new manufacturing deduction.

On the other hand, if I sell to you, Mr. Chairman, a box of doughnuts baked in the same oven wholesale for you to resell to your fellow panel members including perhaps Charles if he wants a second doughnut, some of my colleagues told me he might want a second doughnut, that sale qualifies for the special deduction. So Charles has two doughnuts baked side by side but treated differently under the tax law. I hope this gives you some food for thought.

CHAIRMAN MACK: Well done and we're all a little hungry as a result.

COMMISSIONER EVERSON: Please.

CHAIRMAN MACK: Jim, go ahead.

MR. POTERBA: We've all heard about starve the beast, but feed the panel is great. Thank you very much for your comments. I wanted to kick off on an issue that you've raised about the interplay between the federal tax code and the states and localities and arises in part with the special compliance issues that you've alluded to and in fact a more general issue of what the consequences are of changing the federal code for the administration of the range of state income tax systems and a variety of other tax programs.

Can you just give us some guidance on how we'd like to think of these set of issues? We've looked back at past experience and states typically tend to come along when there are modifications in the federal law or do we need to be cognizant of a host of administrative complexities which arise if we try to think about moving the federal system in a dramatic direction while leaving the state codes where they are?

COMMISSIONER EVERSON: I'm not an expert on the state systems and there are organizations of the fifty states. I think really you ought to call as a later witness some of the folks from those organizations, but as you say, we do have very direct linkages. As I indicated, if something happens in our system, it's mimicked.

If you go back, all of us are probably filing different state returns. I live in Virginia. The Virginia return starts off the adjusted gross income. If you do something here, there are something like 43 states that have a income tax or some form of an income tax. That is going to implicate 43 states. So just recognize that. I think you do need to talk about the states. We work very closely with them on compliance issues. We have great relationships with them, but you need to think about it.

MS. GARRETT: Thank you. As we think about complexity and simplicity for individuals, one way to make things simpler is just to take people off the tax rolls and another way to make it simpler is for those remaining on the tax rolls, particularly in the lower and middle income, is to just make the whole process of filing easier. Now some of that requires legal changes to take people off the roles.

But in my home state of California, we're experimenting with something called the "Ready Return System" which means that the state actually fills out the returns when they are very simple for some of the taxpayers. The taxpayers see those returns. They can choose to go ahead to just sign them and file or they can choose to file them on their own. There have been lots of discussion about return-free filing. I wonder if you could give us some insight into how it would be possible for us to move to a system for many taxpayers of return free filing and simplicity in that aspect of the tax system.

COMMISSIONER EVERSON: I think that you'll see that they’ve also done something like that in the U.K. There are a big number of returns that are not filed. I think it depends on what system you construct largely. The U.K. doesn't have nearly as many deductions or as many options. So for a whole large percentage of the taxpayers, there aren't that many variants as to what's happening. You can't retain a lot of the options or a lot of the potential deductions here and be as successful in implementing that.

The other concern that I would go back to is and I think you need to consider, again I'm not taking a position on it, is what I started out with, the 183 billion returns that are filed. You need to be attentive that as the country changes. Chairman Greenspan was talking about the demographics. We have huge numbers of immigrants. We're working to try and make sure that everybody participates in the system and understands their obligation.

The degree to which people are working in cash economics and you have immigrant communities where people have come into this country because of their desire to be in a country with respect to the rule of law, they may be coming from other environments where taxes were not a centerpiece of how they lived. You want to make sure that people are learning their civic obligations as they go along here and that they understand that they are paying taxes if you move to a system such as you're espousing and not in some ways forgetting that fact because ultimately in all these systems you get to a certain income level and then you do have to file a return. We're not exempting everybody from doing that.

MS. SONDERS: Thanks, Commissioner. Assuming that one of the paths chosen is this total reform, you talked a lot about the regulatory burdens and the compliance burdens. A general question of how much you think those would ease given that you suggest to them that with any reform comes additional compliance regulatory burdens and then a more personal question of the future of your organization.

COMMISSIONER EVERSON: You cover a lot of ground. You can do something very different here but you will still have an IRS. You might call it something else, but there is Inland Revenue which they have a VAT in the U.K. I think it brings in something like 20 percent of the monies they get, but you don't get away from a taxing authority. What I was suggesting there is that you have a tax gap in VAT say in the U.K. that's about 12 percent right now. They're working to bring that down, but you do have to have an organization that is looking to make sure that it's administered correctly and that people understand it and are honestly complying.

There would be big ramifications and change of course. I guess a transition is used, but whatever you do here, you're still going to need a significant governmental entity. I'm not suggesting it would be exactly the same entity, but there would be a successor for the IRS for sure. And your other question was?

MS. SONDERS: A general question on the sense of the increased cost of compliance part.

COMMISSIONER EVERSON: I don't think that the difference in the cost -- The cost of the IRS is relatively modest. It's about $10 billion compared to the $2 trillion. That is according to the --

MS. SONDERS: I'm talking more in general about the overall compliance costs for our businesses.

COMMISSIONER EVERSON: So it's not in the government lane. It's not even in the piece that I talked about, the million practitioners. It's all in the burden, the billions of hours that people are spending filling out the forms, of keeping the records. That's where it is. That question is better when economists are here quite frankly.

MR. LAZEAR: Let me ask you a follow up to that question in terms of complexity. In general terms, which aspect of complexity would be most easily eliminated and which do you think would have the greatest social benefit for our nation? I don't want to talk about this in specifics obviously but more in general.

COMMISSIONER EVERSON: There is a lot of conversation on this. You're going to hear about the AMT and other things as you go forward. I would point you towards the Joint Committee on Taxation. They've done some good work on this.

But in terms of some of the things that I would mention, I think the AMT is of course a candidate here. People go through a calculation. They think they've gotten to the end and you sort of pull the rug out from under them and there they are saying, "Sorry. You really have to pay this." That would be one obvious candidate.

The Secretary talked in response to Charles's question. I think that there is a real dynamic in the corporate area that is quite damaging. There is a tension between the desire to increase earnings for book purposes and drive a share valuation on the one hand and then of course generate losses for tax purposes. This is not something that will respond to tinkering.

This inherent tension, I think, needs to be addressed at the root level. I know academics have written on this about are you going to generate a tax off of accounting income. But I don't think you're going to with the panel. It keeps coming back to congressional changes over time. This is one where for sure the unraveling will occur relatively rapidly if you just tinker around the edges I would suggest.

A couple of others, the Joint Committee mentions the various credits. If you go back to 20 years ago, 1984, Form 1040 had four personal tax credits. Now we have more than a dozen. This is something that I think merits very real discussion by the panel. There are at least seven different educational tax benefits. This is something that people don't understand. So they don't know where they are and what they should choose.

The other area that I would mention as a place of concern and gets a lot of discussion in the Finance Committee is we're seeing a migration, if you will, between the various components, between the taxed entities and the not-for-profit entities where you're seeing the abuse of charitable entities to get through complexity, through shelters, that are pedaled by the accounting firms and others to make use of these governmental or non-taxed entities essentially to benefit taxpayers in a way that nobody ever intended. I think getting some simplification of the rules there would be another area I would look at.

VICE CHAIRMAN BREAUX: Thank you, Mark. Thanks for the doughnuts. Appreciate it and your words of wisdom as well. What in your opinion is the biggest consistent complaint that the IRS gets and secondly, what's the most difficult part of the code to administer?

COMMISSIONER EVERSON: The complaint in terms of a citizen not understanding, I think there's just a general complaint about the complexity. Now over half of the people get their returns by paid professionals and that just reflects the fact that to a very real degree they no longer feel that they are competent. They don't even begin to try to understand the code anymore because they work into some preparer and they have to provide A, B and C documents. So I would say it's just a general feeling of being overwhelmed.

VICE CHAIRMAN BREAUX: That means that half of them just file the simple form.

COMMISSIONER EVERSON: No, not at all. They go into one of the firms and they're filing the 1040. They may have all these schedules with them but they're using paid preparers to help them do their filing. That extends to all income groups. There's over half of the people who file the EITC are using preparers as well. So it's not just middle or upper income folks.

VICE CHAIRMAN BREAUX: And the second part, what part of the code is the most difficult for the Internal Revenue to administer?

COMMISSIONER EVERSON: I think it clearly goes back to what Charles and the Secretary were saying.

It's the corporate area. I gave a talk about six weeks ago to the New York State Bar Association, a tax section. There were 98 tables of ten and they were not there to do work for EITC taxpayers. They were there to help figure out ways to get the best deal for companies.

VICE CHAIRMAN BREAUX: Thank you.

MR. FRENZEL: Thank you, Mr. Chairman. Mr. Commissioner. Secretary Baker mentioned, I think you did too, sometimes about taking people off the bottom end of the tax code as one of the glories of his `86 Act.

If this commission were to go to a consumption kind of tax presumably in the interest of fairness, we may have to whack some more off the bottom. I understand less people, less earners, file today than file ten years ago. I believe that was the testimony. Something like less than 70 percent of earners have some sort of tax bill today as compared to maybe 10 percent higher 20 years. Is that a good thing or a bad thing to take people off the bottom? Shouldn't most Americans have some interest in the tax system and shouldn't they be paying something?

COMMISSIONER EVERSON: I consider that a policy question. So I am going to be very ginger in my response. Most Americans are paying something. I talked about I view it as my job to take in the full $2 trillion and as I mentioned 38 percent of that are the employment taxes. So if you're working and even if you're getting a total break on the income tax, you're still paying in that FICA. The question is many people don't view it in some terms of the political discussion as paying a tax, but I think when they look at their pay stub, they get it.

MR. FRENZEL: I regret asking that question of the wrong person. Then I retract it and ask a second one.

COMMISSIONER EVERSON: That's all right.

MR. FRENZEL: There is a talk that the EITC which you mentioned is not subject to a lot of oversight and control. Can you give us an idea of what is the fraud potential or your estimate of it?

COMMISSIONER EVERSON: Sure. The way the study we have would indicate that the error rate in the EITC approaches 30 percent. We have to update those studies. It may have changed and declined a little bit.

This gets down to the point that I mentioned earlier in the statement about the fact that we have embedded in the tax code certain things that are really means-tested benefits program, but they are administered as though they are another element of the tax code. If you look at food stamps or rental subsidies, housing subsidies, they're large administrative structures that test people for qualification at the front end. That doesn't happen in the EITC.

Now we're doing some pilots in trying to figure out how to work this through in a way that gets rid of the error rate but doesn't dampen participation by those who qualify. That's the problem you get to. When Congress put things into the code that are beyond this traditional purpose, but then you don't build an administrative structure, you don't get an efficient system.

MR. FRENZEL: Thank you.

MR. ROSSOTTI: I tried for five years to try to figure out how to demonstrate the complexity of the tax code and this is a tour de force. This is the best.

COMMISSIONER EVERSON: Thank you.

MR. ROSSOTTI: I have to say if you had decided to provide one piece of nourishment for every one of the sections of the Jobs Creation Tax, how long a meal would that have been? You mentioned in one of the points about the ever changing economy and especially the globalization and the fact that there's a tremendous amount of income in the business area that now is across border and there's this whole array of investment bankers and other people. Could you just elaborate on that a little bit for the benefit of the panel and the audience on some of the things that happened in that particular arena?

COMMISSIONER EVERSON: Sure. I do wonder whether those 98 tables of ten wouldn't ultimately put themselves out of business because sooner or later no tax will be paid by this portion of the public and I think that's actually a consideration that you need to address and academics have addressed in terms of where you do the taxation. But they are relentless in their pursuit of reducing the tax.

We've looked at this and traditionally you know, Charles, we've been organized as a national tax administration. We've taken a step in the last year. We've formed something called the Joint International Tax Shelter Information Center in partnership with our colleagues from Great Britain, from Australia and Canada to, within existing treaty obligations, share information about the products that are developed and as appropriate to follow up and see what individual tax matters there are.

It's been very striking to me that what

we've seen is, I would tell you that in the past corporations were seeking to find where the low tax entity is and then structure their business accordingly. I think we're seeing some evidence that what they'd really like to do now is structure it so that there's no tax and that's a real challenge for administrators.

We're taking steps forward to make sure not that we do not cede any of the U.S. Government's authority to multi-lateral groups in any way, but that we

coordinate with others because this is about speed, Charles, as you know. We're not a speedy or agile organization, but the people who are working in the corporations and in the investment banks and in the accounting firms, they get out there in front of us. They develop a new product. We're on to these things a little bit better now because of the disclosure that Treasury has put in. But it's still a real challenge keeping up.

MR. MURIS: There are several of us on this panel who are academics and some are professional economists and others like myself are called teletravelers. There's a large academic literature about optimal detection, optimal penalties, about issues dealing with enforcement. I understand a lot of noncompliance stems from the complexity but a lot of it doesn't. Do you have opinion on the issues of compliance and not just in terms of the number of people you have, but also the size of the penalties that you have because they are both related obviously to enforcement and compliance.

COMMISSIONER EVERSON: I think that enforcement is very important again going back to the basic point that it erodes confidence in the overall system and the willingness of people to comply honestly. Now I would suggest to you that we don't have the best research on this. We're just now finishing an update to something called the National Research Program.

The last time we looked at noncompliance it was in 1988. We stopped doing that because Congress asked us not to with the view that the audits at that time were too intrusive. In another several months, we will give out the first results on what that tax gap is. The tax gap now runs to several hundred billion dollars a year.

As to a more broad question of what happens in here, I think that the components to this of the system, it's like the highway system. Tim, I would suggest to you that you need to have well designed roads in a highway system. You need to have good signage and then you need to have the state troupers under the bridge.

What happens is it's not only the touches on the individuals when the trooper pulls somebody over. It's the fact that everybody else sees it and knows it's out there. We collected $43 billion last year in direct enforcement revenues. That's mostly tax and interest. A small amount of penalties is in there, but the impact beyond that just from even if we audited and nothing happens to you, you still talk to Charles about the fact that you were audited. Even if you came out with no change, he hears that. He will actually be more careful. Well, maybe not Charles, because we know Charles is careful. So penalties, I think, have an impact but they are not as important as having an overall adequate enforcement presence.

One other thing I'd say on penalties is that in too many instances particularly in the corporate arena, we've developed a reputation for trading them away and it was always in the interest of the noncompliant taxpayer to take an aggressive position with the Service and then we go through this analysis, hazards of litigation and we would probably insist on less than 100 cents on a dollar, the tax, some interest and trade away the penalties.

We are changing our approach. We've gone through two big settlement initiatives to clean up a couple of these shelters, the Son of Boss one which will bring in billions of dollars. We're insisting on 100 cents on the dollar, applicable interest and a 10 or 20 percent penalty depending on the circumstances. So we are taking a look at penalties and we are not trading them away anymore in most circumstances. It will take a long time to know since they haven't been adequate where you need to draw the line though.

MR. MURIS: If you look accidents and cars, there are three things you can influence. You can influence the roads, the vehicle and the driver. For a long time, federal policy didn't pay enough attention to the driver. I think that's changed. Obviously, it's hard to influence but extremely important. Is there a similar kind of issue with what you do in reaching out to taxpayers?

COMMISSIONER EVERSON: Again, it goes back to that equation. I think we have to do both, provide the service. People have to understand what their obligation is and feel comfortable in the system, but there has to be a clear understanding that if they step over a line, that the law will be enforced. We've articulated four enforcement priorities. They'll go to these abuses by corporations and high-income individuals. They go to cleaning up where needed in the tax profession. There was clearly an erosion in the ethics of too many accountants and attorneys who pedaled these abusive products. They go to criminal tax work.

Then the fourth is again this issue on the charities because let me make one point here that I haven't said. The stakes on this charitable dimension are terribly important and they extend beyond the tax system. Look at credit counseling right now. It's a billion dollar industry. We have fully half of the credit counseling industry under audit and that's because what used to be entities that provided advice to a couple or a family that got into difficulty, sell your second car, cut back here, do this, they've become largely vehicles for inflated salaries for directors or packaging payment programs for profit-making related parties.

What's at stake here and in the other abuses that have been well documented is not just changes to the tax system but damage to another pillar of our society which is charitable giving and volunteerism.

If Americans no longer trust charities, they'll stop giving and then those in need will suffer. So again, that just goes back to all of the different relationships you have here.

CHAIRMAN MACK: Mark, let me get you to help us with an issue that would be related to the various large options that are on the table when people talk about a retail sales tax for example or a VAT tax or a flat tax. I assume each one of those has its own set of compliance issues. So help us think through that if you will and then you mentioned in your statement that you in essence have learned things from what other countries do.

COMMISSIONER EVERSON: Yes.

CHAIRMAN MACK: So give us some thoughts with respect to those.

COMMISSIONER EVERSON: As a question of process, I mentioned talking to the states before about the impact on the income tax. I certainly think that if you're seriously considering sales or back taxes that you need to extend your work beyond just academics to include discussions with people. Perhaps some of you should go to Europe or someplace. I know that Congressmen or Senators sometimes take these trips. Were you aware of that?

VICE CHAIRMAN BREAUX: Not former members.

COMMISSIONER EVERSON: I would encourage you to get a practical understanding of the different alternatives and you're not going to learn it at all from the IRS. I've asked Dave Robison. He was our head of Appeals to be a full-time liaison to this group. Charles knows him and he has a lot of international experience. So he'll provide Jeff Kupfer and his staff a lot of details, but again I would suggest you ought to try and see some of these options on the ground if you can.

CHAIRMAN MACK: Very good. Thank you so much. We appreciate it. Quite helpful.

COMMISSIONER EVERSON: Thank you.

CHAIRMAN MACK: Let me announce that we're going to take a half an hour for a break here for a quick lunch. So that means getting back here at 12:30 p.m. Off the record.

(Whereupon, at 11:58 a.m., the above-entitled matter recessed to reconvene at 12:37 p.m. the same day.)

A-F-T-E-R-N-O-O-N S-E-S-S-I-O-N

12:37 p.m.

CHAIRMAN MACK: On the record. Before I introduce the next panel, I wanted to make some comments with respect to the recent death of David Bradford, one of the architects of the Tax Reform Act of 1986. Professor Bradford was an influential, insightful and intelligent voice for tax reform who participated in the policy debates as a scholar at Princeton University, a policy maker in the Ford Administration and an economic advisor to President George H. W. Bush. We will sorely miss Professor Bradford's wisdom, but at the same time, I'm sure we will hear from many who have been influenced by David's creative ideas for tax reform. I intended to make that comment earlier this morning, but because of timing issues was unable to and wanted to make that comment at this point.

So we will move on. Our next two witnesses will help us understand the complexity of the tax code from the taxpayer perspective. Nina Olson who is the National Taxpayer Advocate and assists taxpayers in navigating our complex tax system will share with us her firsthand knowledge of the difficulties taxpayers confront in understanding and applying complicated rules now in our tax code.

And Professor Joel Slemrod from the University of Michigan has studies the complexity of our tax code for years. He will help us understand the magnitude of the compliance burden and the wasteful, inefficient nature of our tax system.

MS. OLSON: Thank you for having me here. In my 2004 Annual Report to Congress of which there are copies in the Green Room, all 620 pages, we're participating in the complexity of the code ourselves, I reported in my Annual Report the number one most serious problem facing taxpayers today is the confounding complexity of the tax code.

I'd like to illustrate this point by first presenting a taxpayer's centric viewpoint for showing some statistics that depict taxpayer characteristics. Each of these statistics represents the average value within its category or its median to try to identify that. What leaps out immediately is that the middle of the road taxpayers is not particularly affluent.

Now we also see that 80 percent of returns result in a refund. That 15 percent of returns with a balance due are paid at the time of filing and only five percent of returns are unpaid at time of filing. We are essentially talking here about a population that is largely compliant with this complex code.

These statistics are projections to Year 2010. These projections are important since they are related to the ability of taxpayers to understand the complex tax code and the ability of the tax code to reflect the life circumstances of its taxpayers.

Now keeping in mind the average taxpayer characteristics, family status, foreign born, age of workers, Internet usage or not, single or nontraditional households which would be almost 50 percent by 2010, median AGI, here are a few areas of the code that present complexity for these taxpayers. I've listed about ten of them.

I'm going to talk about some of them in a little more detail later, but regarding family status issues, I want to say a few words. We've achieved some simplification in the code recently by enacting the uniform definition of a qualifying child. We used to have six definitions of a child by my count. Now we have theoretically one.

But we need to think about the next step. Do we need all of these family status provisions? Must they be separate provisions? Do they reflect how taxpayers think about and how they live their lives? Are we focusing on characteristics that bear no relationship to taxpayers' lives? How do we define a family unit if by 2010 almost one half are single or nontraditional households?

The complexity of the earned income credit is obvious and this provision is for low income taxpayers. Thirteen subsections, that's ridiculous. This complexity leads to errors and makes it difficult for the IRS to administer. IRS processes lead to errors. In many EITC exams, the best you can say is that the taxpayer flunked the exam, not necessarily that the taxpayer didn't deserve the EITC.

No wonder taxpayers go to preparers in droves for the EITC and yet IRS studies show that preparers have similar error rates. Yet I believe that the EITC is an appropriate program to run through the code. It's just been added to, patched on to, avoid the perceived abuse de jour. Instead of asking about rough justice, do we need this requirement really? And that's a very strong message I want to bring home to you. It's to really think about whether you need certain requirements that add complexity to the code.

The AMT was originally designed to prevent wealthy taxpayers from escaping taxation through the use of tax-avoidance transactions has morphed into a second layer of taxation that affects middle income taxpayers. You have another panel later on today. So I'm not going to spend a lot of time on this particular slide except to say that we have recommended repeal of the AMT.

But I am going to give you an example. It's my favorite. It's Mr. and Mrs. Brady, the Brady Bunch. Now if they were alive today and living in California in a rented home with their six children and they claimed married filing joint status and took the standard deduction in 2004 and made the median income for an architect and Mrs. Brady just worked as a teacher part-time, they would basically end up paying $4,442 because of the AMT. One thousand forty-eight dollars is attributable to the AMT.

Now let me just point out to you that if Mr. and Mrs. Brady were not married, they lived together. They each claimed their three kids and filed as head of household each one of them, Ms. Brady would pay no taxes and get $4,100 back in refundable credit. Mr. Brady would pay about $6,000 in taxes. Their combined tax would be $1,800 or $2,500 less than if they were married and got hit by the AMT. Now the second scenario might make a better TV show, but it's really lousy tax policy.

One of the things that we tried to highlight in my annual report to Congress was the complexity of retirement plans and really the point that we're trying to make is that retirement plan incentives are numerous and complex. More than a dozen tax-advantaged retirement plan vehicles are available and are subject to different sets of rules, government eligibility, contribution limits, a tax treatment of contributions and distributions, withdrawals, the availability of loans and portability. I recommend you take a hard look at this confusing array of options and I suggest that you consider streamlining it.

I'm going to give you an example of some of the complexity. Last year, I was on CSPAN's Washington Journal. I do that every year. I received two callers who called in about the unemployed and taking early withdrawals from their retirement plans.

Because of the kind of plan that they had even though they had financial hardships, they were hit with the ten percent additional penalty, the additional tax, for early withdrawals.

But if they had had a 403(b) plan, if they worked for an exempt organization, if they had a Keogh plan instead of a simple IRA, they wouldn't have had to pay that additional ten percent. There is no policy

reason for having those differences between retirement plans from my point of view. From the taxpayer point of view, it's hard to explain.

Education credits, deductions, exemptions. There are at least nine different provisions. Now the point of a tax incentive almost by definition is to encourage certain types of economic behavior. But taxpayers will only respond to incentives if they know they exist and understand them. Few if any taxpayers are aware of all the education tax incentives and familiar with their particulars.

Now I can tell you and we covered this in the annual report, but two weeks ago, I prepared my son's taxes. He's going to school part-time. The software program spewed out for me what education provision we should use on his tax return because he's an independent taxpayer. But for me to determine why that was the right result, I had to read for two hours to feel confident that it was the right result and I'm still hard pressed to know what I should be doing next year, how I can plan.

Now these incentives had virtually no effect on my son. They are irrelevant to him why he went to school and I can tell you that I am personally disincentivized as a result of that experience.

All right. Now a few words about compliance. We talked about how complexity impacts taxpayers. Clearly, the tax code has to be simplified for many reasons including making it easier for taxpayers to comply with the law. Thus in reforming the code, you need to be aware of several compliance factors as well as taxpayers' attitudes toward compliance in order to ensure that simplification proposals have a positive impact on compliance.

With all this complexity, how and why do taxpayers comply? Obviously, withholding is a major driver of compliance. Someone else takes the taxes out of the taxpayer paychecks and pays it over to the government. Third-party reporting acts as an honesty factor. Taxpayers report their income when they know the IRS is going to find out anyway.

So where there isn't withholding or there isn't third party reporting, compliance plummets and we see this with Schedule C sole proprietors and self-employed taxpayers, particularly in what we call the cash economy, what makes taxpayers noncompliance? It's not just that it's the abstract complexity of the code, but also the way it's administered. I think a lot about taxpayer attitudes toward compliance. If they're in compliance, are they at least trying to comply? What kind of hurdles does the law or the tax administrator put up against a taxpayer who is trying to comply? Just how long will that taxpayer keep trying if we make it too hard? At what point, will the taxpayer stop trying and become a taxpayer who won't comply? We could do just the opposite and enact laws that help taxpayers comply. So those who are trying actually do become compliant.

This information was published in IRS Oversight Board study conducted by Roper. It basically shows that the report identified that many factors influence whether people report and pay their taxes honestly. The strongest factor influencing tax reporting is personal integrity, 88 percent with 73 of taxpayers saying it has a great deal of influence.

And other factors have much less influence. For example, fear of an audit is only 59 percent. I find that a very interesting thing.

Now building on the work of social scientists, some tax scholars have developed a topology of noncompliance. It is not just enough to know that a taxpayer is noncompliant. You must know why. Different tax law provisions will engender different types of noncompliance. Some can be avoided by better design and simplification, for example, procedural or unknown noncompliance.

Others may be unavoidable. For example, social noncompliance will generally have to always be addressed by traditional enforcement actions. Some respond to social norms engendering either compliance or noncompliance depending on what the norm is of the group within the network within that taxpayer operates.

Finally, we need to ask in any kind of reform in the system how the tax administrator or how taxpayers are going to be touched by that system. This isn't just in the post filing experience of examination or collection, but also how many hoops do we make the taxpayers jump through to simply file their returns correctly. Now again from the Roper study that I cited earlier, we know that the most heavily relied upon source of tax information and advice are IRS representatives closely followed by IRS publications and then the IRS website.

We also know from a recent study by the Pew Foundation that when it comes to matters that may involve the disclosure of personal information people feel comfortable with a firm or another means with the Internet not widely being preferred and this is especially true for personal tax issues. They want to talk to someone.

So when I think about simplification from a taxpayer-centric point of view, I ask myself why should taxpayers comply. We are asking taxpayers to come and report their income and pay their taxes. What is government's end of that bargain? What does government owe taxpayers in exchange for their compliance with the tax laws?

Here's my attempt at some basic principles. Government has the responsibility to design a tax system that:

(1) does not entrap the taxpayer. No arcane technical "gotchas" like the IRA distribution. For the majority of Americans, it can be complied with on a single form and also be document matched. We can

verify that third party reporting;

(2) allows most individuals and small business taxpayers to fill out their own returns. They don't need preparers. Tax administrators can explain it. That would be a nice aspect of it;

(3) anticipates that large areas of noncompliance and by that, I mean it really thinks about how to reduce opportunities for noncompliance. It does not create whole armies of industries like preparers and refund anticipation loans and all those things that feed off of a complex tax system; and

(4) provides choice but not too many options because it makes it too confusing.

Finally, refundable credits are not inherently problematic. We need to think through the elements, the opportunities for noncompliance and then administer the refundable credit programmatically. There is no inherent reason why refundable credits are undesirable. In fact, let me just point out they may be very desirable wherever income is the eligibility criteria. We're the people who have it. If you put it in another department, that department is going to have to get their verification from the Internal Revenue Service. That undermines the confidentiality of tax information and that, in turn, affects compliance.

And finally, we need to incorporate some kind of periodic review of the code, some kind of mechanism that checks complexity creep. We really need to ask ourselves when thinking about tax provisions "Why do we care about this provision. Do we really care about this provision and if we do care, what are we going to make taxpayers do to comply? Is it worth it?" Thank you.

CHAIRMAN MACK: Joel. Thank you, Nina, very much for those comments.

PROFESSOR SLEMROD: I want to thank you, members of the panel, for providing me the opportunity to address you today. Let me begin with my bottomline. For many families and businesses, the current income tax system is highly complex and that complexity is costing the U.S. economy about $135 billion per year.

In a comprehensive survey taken in 2002, 32 percent of Americans said that the complexity of the tax system bothered them more than any other aspect of the tax system. This is more than twice as many who said that the biggest thing that bothered them was the large amount of taxes they paid. Fifty percent of people rated the system as very complex and someone holding that belief was about ten percent more likely to favor scrapping the income tax for another system.

The questions before us today are whether the tax system is too complex, to what extent tax reform should focus on simplifying the process and what reforms would best accomplish this simplification. These are not easy questions because almost any simplification also has consequences for fairness and for growth and because the design of the tax system reflects fundamental choices about the relationship between government and citizens. Today I will do my best to provide you with some background information based on my own and others' research about how complex the tax system is, what the complexity is buying us and what trade-offs we face in simplifying the tax system.

There are many ways to measure tax system complexity. Some people count the number of pages or even words in the tax code. Others stress that tax practitioners rarely agree on the true tax liability or tax return of even moderate complexity. Many point out that it takes several years to finally resolve the tax liability of a big corporation.

I will focus today on one measure of

complexity, the resource cost of tax collection. This includes the IRS budget, the administrative costs and a value of the time and money spent by taxpayers and third parties such as employers as withholders in complying with the tax system which I will call the "compliance cost" of the tax system. The sum of the administrative and compliance of the collection costs is the dollar value of the savings that could be achieved if the tax revenues could be collected and enforced like magic with no cost at all.

But what are the collection costs? The administrative cost part is pretty straightforward. The IRS budget is about $10 billion per year, although some of that budget is directed to the administration of other than the income tax. Nailing down the compliance costs though is considerably more difficult.

The estimates I'll discuss today are based on surveys and analyses done by myself and others often under contract to the IRS. The answers depend on a number of assumptions particularly concerning how to place a dollar value on taxpayers' time dealing with tax matters, but these are my best educated guesses. How big are compliance costs? For individuals, about $85 billion a year. This includes the value of about 3.5 billion hours of taxpayer time per year which is the equivalent of nearly two million hidden IRS employees.

About one-quarter of that $85 billion is money expended on professional help, tax software, etc. and about three-quarters of the $85 billion is a valuation of the time that the taxpayers put into their tax affairs.

For businesses not including sole proprietorships which are included in my estimate for individuals, the cost is $40 billion a year. The average Fortune 500 firm spends about $5 million a year on tax matters. Many of the largest companies spend well over $10 million a year.

Total compliance costs then is $125 billion per year which comes to nearly 13 cents per dollar of income tax receipts and is more than 12 times higher than the IRS budget. Clearly, the compliance costs dominate the administrative cost of raising taxes. The cost ratio has probably, almost certainly, grown in the last two decades, but it's very, very difficult to get reliable quantitative estimates that one could compare from one year to the next.

Let me get behind the totals and say a few words about the nature of compliance costs. For individuals, about two-thirds of the cost is due to record keeping. The costs are highly concentrated both among individuals and among businesses. Forty million taxpayers spent five hours or less per year on their taxes. It's important to keep in mind. The system is not complicated for everyone.

Compliance costs rise with taxpayers income and tax liability, but less than proportionately. Compliance costs are regressive. This is true for individuals and it's true for businesses. Costs go up with income, but less than proportionately.

Costs are particularly high for self-employed taxpayers compared to other individuals. Tax software reduces the difficulty of filling out forms and doing calculations but does not reduce the burden of record keeping which remember is a very substantial part of the compliance costs.

Now I've stressed these numbers but I want to add some caveats to take these at their face value. First of all, it's hard to know what is really a marginal cost, what would not have to be incurred if it weren't for the income tax for all but the biggest businesses. You would really need to know whether states would continue to require income calculation for their own income tax.

If they do, the savings could be considerably less than these numbers suggest. Finally, would a calculation of income still be needed for, for example, college financial aid offers and mortgage applications. If many people are still going to have to calculate their income, these savings could be substantially less than what I've indicated here.

Now, I said the dollar measure of the resource cost is useful, but it's not the end of the story. There are other costs of tax complexity that are hard to measure in dollars. Complexity causes a capricious and often uncertain distribution of tax burdens. Even professionals often disagree about the true tax liability. In that way, complexity impacts fairness.

Complexity rewards those who have the means and inclination to find all the angles. Complexity undermines trust in the fairness of the tax system which may in turn undermine voluntary compliance. Many people with simple tax returns feel that others are taking advantage of the complexity leaving them holding the tax bag.

Complexity reduces the transparency of the tax system. It is not healthy in a democracy if the citizens do not understand why they owe what they owe. In this regard, tax preparation software may be part of the problem as it allows taxpayers to be disengaged from how the program inputs produce the program output, the tax liability.

So certainly, the tax system we have has costs, but why is it so complex? What, if anything, is it buying us? We know the simplest way to collect taxes is not the best. After all, we could take the trillion dollars or so of income tax revenue, divide that by 130,000 million taxpayers and get about $8,000 per return and everyone would owe that and that would be that. That would be simple for sure, but most of us, many all of us, would judge that very, very simple system to be very, very unfair.

Thus to some extent, the tax system reflects a belief that simpler or less conscientiously enforced systems cause an unfair distribution of the tax burden. We have chosen to fine-tune tax liability to personal characteristics and to require a progressive distribution of the tax burden. This requires reporting and monitoring a measure of well-being such as income with many adjustments.

Second, the tax system is now an awkward mixture of a revenue raising system plus scores of incentive and reward programs that have nothing to do with raising revenue.

Finally, income and especially capital and corporate income is often inherently difficult to measure. This leads to inconsistencies in the code that reward complicated transactions such as tax shelters and tax-oriented financial products. This is a structural problem related to our current income tax system.

Is the cost of collection higher in the U.S. than other countries? In many cases that operate very different systems that perhaps this panel will consider for the U.S., this is a difficult question to answer partly because the costs can vary for reasons unrelated to the complexity of the system, for example, the fraction of the people who are self-employed and how well enforced the tax system is and partly because no comparative across country study using the same methodology has ever been done.

Let me make just a few comments. Only six countries in history have operated retail sales tax at rates of ten percent or more. None do now. The cost revenue ratio for states that use a retail sales tax is in the order of 2.5 to five percent of revenue, but this is for rates of four to six percent rather than the 30 plus percent rate that would be necessary to replace income tax revenues. So the cost revenue ratios for existing retail sales tax operated by the states are not relevant.

The cost revenue ratio of European VATs ranges from three to five percent. The cost revenue ratio for European income taxes is apparently not much higher than for their value added taxes and is much lower than for the U.S. income tax. Evidence therefore suggests that cost can be significantly lower.

What are the keys to simplifying the tax system? What will we have to do to get these significant costs down? The keys to simplifying the tax system follow pretty directly from the causes of tax complexity. We need to resist fine-tuning the tax liability of individuals. We need to resist fine-tuning the economy through the tax system by subsidizing and rewarding activities deemed to be especially valuable.

But if we're going to do that, arguably it should be done through the tax system rather than by creating a separate bureaucracy having one financial account between government and the citizens. Finally, we should simplify the tax system sufficiently to take advantage of large scale, final withholding at business level either radically as in a value added tax which requires no income tax returns at all or through a return free income tax system for many, if not most, of our citizens.

You've been given in your mandate several objectives including simplification. There are trade-offs alas in designing a tax system and I want to close by talking about the trade-offs that need to be faced in simplifying the tax system.

Simpler business-based taxes like that value added tax involve a massive redistribution of tax burden away from high income to low income families. Simplifying the tax base restricts activist government and requires settling for rough justice. Nothing simplifies the tax system without also affecting equity and efficiency. Finally, as has been mentioned already today, transition to an even simpler new system will entail one-time costs as new rules are assimilated.

In conclusion, it costs us about $135 billion a year to collect $1 trillion or so of income tax revenue. Not all of this cost is gratuitous. Some of it occurs because we have high standards for the fairness of our tax system. Some of it occurs because we use the tax system for many things other than raising revenue and some of it occurs because of structural problems in the income tax system.

I hope I've convinced you that dealing with tax complexity requires addressing the most fundamental questions about the relationship between citizens and their government, how activist should the government be, how intrusive should it be, when should it settle for rough justice. I wish you good luck and thank you for the opportunity to address you today.

CHAIRMAN MACK: Joel, thank you for your comments. You point out once again how difficult our task is. John.

VICE CHAIRMAN BREAUX: Thank you, Mr. Chairman and thank you both panel members for an excellent presentation. Ms. Olson, congratulations for what your department does over at the Internal Revenue Service and the representation that you give to millions of those people who don't know where to go. I know you've done a terrific job and I congratulate you for that.

You gave us some specific recommendations and we thank you for that. We all want to simplify the tax code. The question is where do you begin. You really spelled out some specific areas that could be simplified. It seems to me that many of the tax provisions that are designed to help lower income people who cannot afford to hire tax attorneys are some of the most complicated.

The earned income tax credit, for example, is one of those examples. The people who are entitled to that cannot afford to hire tax attorneys. Yet the way it is implemented is indeed extremely complicated. So can you just elaborate on just that one item that you mentioned, the EITC? How can we ensure that it continues to work as it was intended and yet make it simpler?

MS. OLSON: The earned income credit was put in the code because of the dissatisfaction with the delivery of a traditional welfare system. At least, that was one of the reasons, the thinking being that if taxpayers, individuals, who were working were of low income and needed assistance, they had to file their income tax returns anyway, that they could apply for it without the stigma of having an interview with a case worker. We would get higher participation rates which is the point of the program and we would be then able to deliver it seamlessly.

What has happened with the earned income credit, and I think Commissioner Everson discussed this briefly earlier, is that the administration of it through the Internal Revenue Code is very difficult if you do it within the traditional design of the Internal Revenue Code where you don't really have face-to-face interaction with the Internal Revenue Service.

We don't have face-to-face interaction with the taxpayers. We are in an enforcement mindset rather than a case worker/social worker mindset.

I have maintained for a long time that a program like the earned income credit, it is a appropriate to deliver through the Internal Revenue Code but that you need that administrator to understand from the beginning that it is a separate program and you take a programmatic approach to it. You have a dedicated group of workers who take the taxpayer and that program from start to finish whether it's education or examination activities or collection or even reporting to Congress that it goes from cradle to grave. That goes back to what I've talked about about understanding the characteristics of the taxpayer population.

VICE CHAIRMAN BREAUX: What you seem to be talking about is EITC and how it's being implemented.

MS. OLSON: And implement change and then I think to go to that phrase "rough justice." I think you can look at the earned income credit to decide what of those 13 subsections do you truly need. What happened to the EITC over years is every time they saw an abuse, we added another section to stamp out that abuse and each time you do that, you create a tax trap inadvertent for somebody else.

I think you can look at that credit and decide what do you care about. What are the things that the taxpayers that you're pulling into this program get chewed up about and can't comply? Can you eliminate some of those things and live with the possibility that you may be delivering the credit to the wrong people a little bit, but the trade-off is that you would get so much more simplification.

VICE CHAIRMAN BREAUX: We don't have time to go into it today, but I would very much appreciate it if your operational restrictions would allow you to give a paper which would address specifically the EITC changes that you think could keep the program intact, but simplify it.

MS. OLSON: Certainly. Thank you, sir.

VICE CHAIRMAN BREAUX: Thanks.

MS. OLSON: That would be a pleasure.

MR. FRENZEL: Thanks to both of you for splendid testimony. Ms. Olson, you were talking about at one point in your presentation the various retirement plans. I'm happily still contributing to retirement although I long since steamed through the biblical three score and ten limitation principally because it's wonderful for my tax return. But how do we preserve past equities if we amalgamate all of those into one ugly lump?

MS. OLSON: Yes. We had proposed perhaps not amalgamating them all to one lump, but again looking at the tax characteristics and maybe instead of 11 or 12, coming up with three, you know, a plan that was specifically for small business, a plan that might be for individuals and then a plan that was really for larger businesses. And there are political issues there. You have to tell the teachers they can't have their plan. You have to tell the government and other state employees you can't have your special plan.

But I think if you look in those buckets, you would be able to take at least the predominant characteristics of those plans and carry them over into some more streamlined choices. That goes back to my last point. Choice is good, but too many choices, you'll again get into these traps. You get into complexity and that leads to noncompliance.

MR. FRENZEL: Thank you. Dr. Slemrod, you gave us an intriguing comparison of what it costs the Europeans to collect taxes compared to ours, but then you give us the caveat that it's hard to compare. Are those comparisons reliable? How do you feel about them? Are we spending a good deal more money to collect taxes than the Europeans are?

PROFESSOR SLEMROD: I feel fairly confident in saying we spend more. Our compliance costs are higher and on average, we have a more complex tax system. I feel less confident in trying to put the numbers on it and saying as the slide suggests that our costs are, say, two and a half times more than a typical European income tax. I think we don't know that, but I think we might have the crown of the most complex tax system in the world.

MR. FRENZEL: Thank you.

MR. ROSSOTTI: Joel, you made the point that the tax burden is not evenly distributed for some and naturally the self-employed and the business income is more. Can you just elaborate a little more with a little bit more depth? For example, the $85 billion number compliance cost for individuals, one question is how much of that is for people with business income versus how much for people that don't have business income. And for the people within business income, what are the drivers of that complexity?

PROFESSOR SLEMROD: Sure. The estimates that I provided in my slide of the $85 billion compliance cost for individuals and $40 billion for businesses, included in the $85 billion for individuals were the self-employed, sole proprietorships. Based on the estimates I had done at the time, I would have said about $10 billion of the $85 billion was just due to the self-employed business part.

But since the analysis underlies this was done, the fraction of people who are self employed has gone up. So I would not be surprised if that number isn't quite a bit higher now. We know that on average self employed individuals report spending 60 more hours a year on tax matters than non-self-employed individuals.

Probably all of this in back of the taxicab when we reveal we study taxes, I've heard taxi drivers tell us that they have to spend a half hour every night doing paperwork that they wouldn't otherwise do if it wasn't for the income tax. And of course, those are only the ones that comply.

MR. ROSSOTTI: I don't want to pursue it too long here, but if you had that data available, could you maybe submit it to the staff? I would be interested in knowing those taxpayers that have businesses, breaking down the $85 million, just between two groups. Those that have no business income at all, how much do they spend and how many people there are versus those that have business income of whatever type? I remember studies that did show that it's even more concentrated perhaps than you said, a very large percentage for those with business income.

Nina, I have one question for you. Again, it's a little bit far enough just on the EITC. You know you have to have all these different requirements and I don't want to put you on the spot here, but you said we don't need all those requirements. What would you say basically would be the bare minimum requirements that you would really have to have? You have to have some requirements besides income in order to qualify for earned income credit. So if you really just wanted to boil it down and get rid anything you didn't need, what would be the bare minimum?

MS. OLSON: Obviously, you're looking at income level.

MR. ROSSOTTI: Besides income.

MS. OLSON: And then you have to decide whether you want to give it based on family or children and what you're going to do with that and what is the stiffest requirement and I keep trying to think "how can you make this simpler" is if you are basing it on family size that there is to be an existence of a child somewhere, how do you go about proving that child and do you use residency? Do you use relationship? What do you do?

I don't know that I can come up with an answer right now except that's really what I'm focusing on. If you just have that, pretty much everything else falls away. You have little things around the edges. Do you give it to people who aren't documented and on and on and on? But if you're just thinking about family and then the income eligibility, we can test income eligibility easily.

MR. ROSSOTTI: Income I know. It's other things besides income.

MS. OLSON: And it's the family, if a child exists with you and where does the child exist. We were talking about United Kingdom. I had been visiting with some of the folks from Inland Revenue. They've just instituted several credits, three different credits, one of which is the earned income credit. The other is a working credit and the third has more to do with dependent care.

When I was trying to explain to them our earned income credit and I said, "We have this whole new part of it about the child has to live with the taxpayer for more than half a year," the administrator just looked at me and said, "Why do you care?" I didn't have an answer to that. But it's that sort of thing that you fundamentally have to ask those questions. Why do you care? Now maybe the answer is "I care because..." But if I don't ask that question, I may be putting a burden on somebody I don't need to.

MR. ROSSOTTI: Perhaps when you're sending an answer to the other question, you could put in some discussion about that. What do you really have to hear about? I mean maybe you could put one or two, but if you just boiled it down that the income is one thing and there's something about the family. What does it have to be? If you just start with a blank sheet of paper and design it the way it's supposed to be rather than the way it's evolved over the years.

MR. MURIS: Let me stick with the EITC which seems to be a favorite topic and ask a question of both of you on that related to this estimate, this upwards of 30 percent of the payments are wrong. I don't know anything about that study and this is what I'm asking you if you know inside of it either one or both of you. If we have a system where it's so complex nobody understands what's going on, then you would expect the errors to be randomly distributed minuses and pluses. Even if that's not true, and it wouldn't surprise me if it wasn't true, the complexity would contribute to lots of small errors. Do you know anything about the distribution of these errors, either of you?

MS. OLSON: First, I have to make a full disclosure. I started practice the year that the EITC was enacted and represented thousands of taxpayers in the courts and before the IRS on EITC returns. I prepared thousands of them. The inadvertent errors are very serious. That is my determination that most of the error is inadvertent.

The EITC compliance study, these cites are based on the 1999 compliance study which should a range of 27 percent to about 32.5 percent over claims. The reason why you got the range was there were so many no responses to the IRS's attempts to reach out to taxpayers that in the higher range, they said let's assume that all the no responses mean that they're not eligible and in the lower range, we took the no responses as if they were in the same results as the audits actually were.

My office just completed a study this year that showed depending on how you contact taxpayers you will get a different result in your audit. We showed that phone contact and face-to-face contact rather than correspondence contact, just sending a letter to people who may not even be literate or speak our language, not surprisingly resulted in taxpayers getting more or less. And we particularly looked at the no response rate and we found in the population that we looked at that 43 percent of the taxpayers who had been determined to not be eligible for the EITC received a 96 percent of the EITC when we went back in and looked at it and engaged them with phone calls and actual contacts.

So I question the compliance study rates. I do think that it is high error rate. I personally think that if you back out the no responders, you give people representation, you change the way the IRS is administering the program, you may still have a noncompliance rate of 15 percent. That's just a guess from me.

MR. MURIS: And let me let Professor Slemrod answer, but again the inadvertence at the limit implies that there are lots of people who are getting less than they should.

MS. OLSON: Yes.

MR. MURIS: And that's your experience.

MS. OLSON: We think that there's about 25 percent of the population that's eligible that's not receiving the credit or a health credit.

MR. MURIS: That's a different point. I understand that's an important point, but it's a different point than saying people are making mistakes who are applying for the credit. If it's inadvertent and complex, there should be a lot of minuses as well as pluses. I'm just wondering if that's what your experience is.

MS. OLSON: They have not measured that.

MR. MURIS: Okay.

MS. OLSON: But I've seen that, yes, where taxpayers have come in and you can say, "Look, you're eligible for more. You didn't claim this. You didn't do that." One thing that happens is that taxpayers are only supposed to put two children on the form. If we disallow one children, but they have a third child in their household, nobody asks, "Do you have another child?" So then they're disallowed the credit for the second child where they could actually be entitled to it for the third child.

MR. MURIS: Professor Slemrod.

PROFESSOR SLEMROD: I don't have anything to add to what Nina has said.

MR. MURIS: Do you agree with her or it's not something you studied?

PROFESSOR SLEMROD: It's not something that I studied.

MR. MURIS: Okay. Thank you.

CHAIRMAN MACK: Jim.

MR. POTERBA: Thank you both very much. This has been an extremely informative round of presentations. Joel, let me ask a question that leans to various consumption tax alternatives that tries to address compliance issues there. One thinks of the various options that might emerge that were outside the income tax structure, so either a value added tax, subtraction based VAT or an income credit VAT or a retail sales tax option. Could you say a bit about the compliance issues that arise in those alternatives and if possible, rank them in terms of where you would see compliance problems one way or the other?

PROFESSOR SLEMROD: Okay. It just so happens that I had prepared a slide for that, Jim. Can you reactivate the laptop so that we can see that slide? Funny you should ask.

MR. POTERBA: Although we see each other a lot, this was not a set-up.

PROFESSOR SLEMROD: I'll answer your question and then maybe the slide that I can see everyone will be able to see. At least of three consumption tax alternatives, we might want to talk about retail sales tax, value added tax or a true so-called Hall Rabushka flat tax. I could also say a few things about a personal consumption tax although that didn't make it up to my slide.

First the retail sales tax, on the face of it, the retail sales tax seems simpler. For sure, individuals won't have to file any tax returns and most businesses if they're not retailers won't have to file. My own view is that the compliance costs and the compliance problems that we see in state retail sales taxes don't provide any meaningful information about what would occur if the rate were 30 percent plus that we need to have to replace income tax revenues compared to the four to six percent range we see in most states.

My conclusion is that at that rate it would not be administrable. It would simply not be administrable at our usual standards of equity and intrusiveness. I can't say that for sure because no country has ever tried it and I think that's telling in itself. In history, as I said earlier, only six countries have tried retail sales taxes at a rate of 10 percent or more and as far as I can tell, none still do that.

Now value added tax is very similar to a retail sales tax except in how it is administered and it's certainly administratively more robust. I think it could cut compliance costs significantly if it replaced the income tax, half or more. But a lesson in all these alternative taxes is the devil is in the details. As we all heard already today, if you go and talk to European tax administrators about the value added tax, they won't say this is simple; it administers itself, it enforces itself. They will tell you about the incredible complexities it engenders.

A true flat tax could cut compliance costs in half I believe. The problem is that compared to a value added tax the flat has individual returns which is a good thing because it facilitates introducing progressivity, but it's a bad thing in that it also facilitates the reintroduction of complicating incentive and reward programs. It's hard to have tuition credits or child care credits in a value added tax because individuals don't file tax returns.

The fourth kind of consumption tax which isn't mentioned on the slide, but let me say a few words about is a personal consumption tax in which individuals basically compute their income as they do now but would then be able to deduct their savings to get to consumption. That's sort of like having unlimited IRAs. My view on that is that also that would raise very, very difficult compliance enforcement questions because it would make transactions such as depositing money into an account or withdrawing money from an account have tax implications that have no tax implications now. I think for tens and tens of millions of people this would not just be an acceptable extension of what has tax implications.

MS. GARRETT: I have a question that I want both of you to address. I think one of the difficulties in thinking about tax complexity simplification is because some simplification is often in tension with the other goals that we're being asked to pursue. So that take for example fairness. Some simplification can be in tension with fairness as we try to pursue that.

So we might want to have a greater use of refundable credits, but on the other hand, that's more complicated to the extent that we want to take people off the tax rolls. That does not take people off the tax rolls because they have to file to get their credits. So we have this tension. That's just one example, but I think it's throughout the tax code and I wonder if you could address maybe specifically with respect to refundable credits versus deductions or just more in general.

MS. OLSON: When you were talking, an example came to mind and it really is a perfect example of how taxpayers think about things and I'm talking about my little average people who came to me to get their returns done. As recently as 2001, I had clients who came in and brought their medical expenses and their miscellaneous itemized employee/business expenses, their little tax return preparation piece from the year before and all these other little things that every single year since 1986 they weren't able to claim because of the percentage writeoff. But they still brought it in because to them, this nurse paid for her uniform and it went to her income. It was her way of thinking about it.

Now I could say to her, "Well, this was a simplification change" but to her, it wasn't a simplification. It didn't represent what her income was and what I'm trying to tell with that story is that taxpayers have a really strong sense of what's fair and what fairly represents what it takes for them to work for her income or make income. They're often able to do some tradeoffs about simplification, but you have to really understand what matters to them.

I think that with credits you can use credits through the code but you have to make sure that they align with, what I said before, the taxpayer population and that they are able to avail themselves of those credits. I think that is a design issue, but you can do it. You really can do it. Not for everything, but you can do it.

PROFESSOR SLEMROD: I want to thank you for raising the issue of tensions, what Congress would call tradeoffs because this panel in the country is going to have to make tradeoffs in thinking about tax reform. I would urge the panel in its report to be explicit about the tradeoffs that have to be faced up to in designing a tax system.

I certainly agree with you that in many cases achieving simplicity is at tension or must be traded off for other goals particularly fairness can be settled for rough justice. Just achieving appropriate progressivity, the term used in the charge to this panel, requires a certain amount of complexity right there.

Credits versus deductions issues certainly raises the issue and let me also say deductions with a standard deduction versus deductions for everyone raises the same issue. After all, the reason we have a standard deduction predominantly is so that the IRS won't have to monitor and the taxpayers won't have to keep records on all the itemizable deductions and about 70 percent of taxpayers don't do that, don't itemize. What that means is that they don't get the subsidies that are implicit in the deductions. There is no incentive to give charity for somebody if they're unitemized.

I want to say one more thing that I think is very relevant to the questions you're going to face. When we run subsidy programs through the tax system, one of the problems is they end up being of a form that I think would never pass Congress if they were standalone programs.

Our subsidies and charities that run through tax system is a subsidy given to only 30 percent of taxpayers to itemize. They tend to be the highest income people in the country and of the people who get the subsidy, the rate of subsidy is higher the higher your income because the rate of subsidy is essentially your original tax rate. My guess is if somebody came to Congress and said, "We want to subsidize charity. Here's how we want to do it," forget the tax system. It would never adhere. This is the way we do because we do it through the tax system.

MS. SONDERS: Thank you both for your expertise. Ultimately, we'll be out there to do our responsibility for the public itself. Now we used the term "centerpiece" earlier before when we were talking about tax reform and hopefully becoming the centerpiece for President Bush so he can use his political capital.

Right now however, Social Security has been more the centerpiece and we've gotten a sense now of public opinion on Social Security. We haven't gotten yet much of a sense on public opinion on these various full reports. I would ask you maybe to divide the public taxpayers into individuals and businesses because in the position you're both in, have you gotten any sense of traction of biases so that we understand what we might be facing in terms of any strong opinions that the public has toward what makes sense whether there's education behind that or they're just going on their gut instinct?

MS. OLSON: That's a really interesting question. I spend a lot of time talking to small business, representatives of small business, and I think that Joel's points about just the complexity that the compliance burden, that we think of burden, is enormous and I think that's what they think about when they think about taxes.

First, they're paying more than they should and that really impacts self employed. They see that they're calculating their self employment tax at the same time as their income tax and it's a killer. At the same time, they're having to do more work to pay more. I don't know what we do about that. There may be some very sweeping changes that might need to be made there.

For individuals, I think your fundamental issue is do you want individuals in the system. For a lot of taxpayers, they're being withheld from it and it's not really a chore to file their tax returns. But if you have a tiny -- like if you get an IRA distribution, if you have something that's in education that falls under one of the education plans, all of these things out there that make them think that they are missing something. Somebody else is getting a break and I am not. I can't tell you how many times taxpayers would come when I would do returns saying "Well, there surely has to be something I can do because everybody else is doing something," and you just say, "Look on your facts and circumstances you are paying only this much" and there's nothing. I have nothing to work with.

I think that engaging in a dialogue with taxpayers along those lines would be really helpful, having them think about what is it that they think others are getting away with and to really articulate that and what do they really want for their tax system. This is not necessarily in response to your question but I do want to make this point, too.

I think the third point that we actually have to do, and I think you're in a great position to do this, is to talk about what taxes themselves actually do. Why do we have a tax system? Why does government need taxes? One of the great judges once said, "Taxes are the life blood of government" and that's really true when you think about that. There ain't no government if it can't spend money. It just can't. You can't do anything and taxes bring that in. Well, why should taxpayers feel good about that and how simple do we make it for them to be able to participate in that government in that way? Engaging in that dialogue you get really interesting answers back from people.

MS. SONDERS: But you haven't see a consensus develop yet with your clients or these people that you talk to that have more a bias towards flat versus retail sales for that. Because I spend a lot of time with the investing public and I'm getting because of the position a lot more opinions given to me and I wouldn't say I've yet seen a bias. But you talk to a lot more folks than I do.

MS. OLSON: Well, it's interesting. Last week when I was on CSPAN Washington Journal, I had a gentleman call in and say, "How do you know that the Internal Revenue Code is constitutional and Russia's just enacted a flat rate. They are collecting so much more money. What do you think about that? And (3) what about a value-added tax?" I said, (1) "It's constitutional." Of course, I said that. I'm not going to get into that argument and (2) "I don't know anything about Russia's rule yet, but think about the rate and to your point. What's the rate going to have to be if we do a flat rate?" and (3) "Nothing's simple. It's all in the details." So you hear that kind of stuff. They're looking for a nirvana somewhere. The answer really is there isn't yet. That's really sad.

PROFESSOR SLEMROD: On public opinion about taxes, I'd like to bring to your attention a wonderful survey that was done in 2002 by Kaiser and the Kennedy School at Harvard and NPR which it's a couple years out of date, but I doubt attitudes have changed much. But it has just a wide range of questions and gives some wonderful insight into people's perceptions and misperceptions about the taxes.

Let me just spend a minute to answer your question. My own sense is that for individuals there is a reluctance to give up the special breaks they get through the tax system and certainly it's true for these interests that represent those special breaks. But I was also very surprised and impressed during the last serious debate we had about the flat tax, now nine years ago, that many people with relatively simple tax affairs who the numbers said would actually end up paying more under a flat tax actually told me they thought it was a good idea and I would say, "Do you realize, it couldn't be much simpler than it is now for you, you'll probably going to end up paying more?" And they say, "Yes, but I think other people are taking advantage of the taxes. I want a system where I can see where the money goes." Though I can see attitudes that go both ways for individuals.

For business, I see more of the reluctance to give up on special breaks. I talked about compliance cost for business which for a Fortune 500 firm averages $5 million and to some, it's $10 million or more. That adds up to serious money but it's actually a drop in the bucket compared to what they're gaining from some of the loopholes in the tax code that the Commissioner discussed earlier today. So that could be a harder road to travel.

I remember in the 1986 tax reform although there was a wide consensus in favor of the reform, the business community was actually quite split. There was a group of businesses that were quite for it possibly because they had done the numbers and understood the impact on your bottomline and another group of businesses that were quite opposed.

MR. LAZEAR: Joel, you just touched on a

question I wanted to ask you about. You mentioned reforms earlier. Now most of those because they are fined tuned simply by design affect a relatively small number of individuals and are relatively small in terms of the social cost and the revenue basis as well. Could you talk about some of those with those aspects of fine tuning you think aren't so small, maybe some of the larger ones that you think we would ought to be concerned about?

PROFESSOR SLEMROD: Sure. In order to get a tax system where tax liability depends on a family or household's ability to pay, we need to get some measure of that. We start right now with income, but we have enumerable adjustments to our measure of income, some of which are adjustments that because income by itself isn't a good measure of one's ability to pay.

The best example is involuntary medical expenses. I don't think that two households with $50,000 of income have the same ability to pay if one family has $10,000 per year of involuntary medical expenses. It needs to be deducted in order to get what economists call "horizontal equity" across these families.

I don't think there's any one such

adjustment I can point to that is making for a large portion of the compliance costs. What I know is there are scores of it and I think what this panel has to do and what the Congress will ultimately have to do is just consider whether in each case the extra cost of getting that fine tuning justifies all the cost of complexity that we've talked about today. I don't think there's one smoking gun. I think unfortunately you're going to have to look at a lot of things each of which when put together adds up to a significant amount of complexity.

CHAIRMAN MACK: Once again, I would echo the comments that have been made by a number of panelists that we really appreciate the input that you all provided here today and, Nina, I think that this has probably been posed, but I go back to your page six where you talk of areas of significant complexity and you run through the EITC and the alternative minimum tax for retirement provisions, education, so forth.

Again, it would be helpful if you have thought through each of these areas, in essence kind of how you would redefine some of these. If you could touch on all of these areas, I'd love to see how you would go about that. I think it would be very helpful information. I guess the reason that we have focused on what you all have said here this afternoon is because it's really the first time we've really had something specific in the area of simplicity.

I will give you my reaction to what I hear the most from people. It is clearly simplicity. We're willing to address the issue of simplicity and I'm thinking of it more at least in the area that you have presented today that we're missing an opportunity. Without simplicity being achieved, I don't know that there really will be public support.

I think that the issue of economic growth is the most important issue from my perspective, but what I'm saying is if we're ever going to get to a point of really being able to address tax reform that being about economic growth we have to significantly address the question of simplicity. So we appreciate both of you this afternoon.

Joel, I just wanted to touch on what you went through, I guess it's your appendix, where you say are there similar alternatives and you added a fourth. You talked about personal --

PROFESSOR SLEMROD: Personal consumption.

CHAIRMAN MACK: Personal consumption which would be different than a flat tax.

PROFESSOR SLEMROD: Yes.

CHAIRMAN MACK: And I really didn't absorb what you had to say, but it sounded to me like the compliance costs would be greatest in that area, I mean, that one as opposed to the other three.

PROFESSOR SLEMROD: I think a consumption tax base is neither necessary nor sufficient for simplification. I can think of consumption taxes that are more complicated than what we have now and I can think of ways to stay within the income tax regime and make things a lot simpler. The personal consumption tax can retain much of the complexity of our current system because we're still going to need to calculate much of income.

Although remember this is like an unlimited IRA. So it could be a step that people could put all their capital assets into these accounts. A lot of the complexities of measuring capital income will go away. But I think the tough nut to crack is the fact that like an IRA your deposits to the account become deducted and your withdrawals are taxed like a traditional IRA. That's how this would probably work.

But unlike an IRA which is limited and voluntary, this would presumably apply to everyone. So suddenly savings and withdrawals have tax implications for everyone and that is a whole new layer of complexity and enforcement and monitoring that, if the Commissioner were still here, I imagine he might be rolling his eyes. No country has done that. So we would have to think about the administrative and enforcement issues that that raises.

CHAIRMAN MACK: Very good. Again, thank you both for your presentations today. Appreciate it.

And now we would like to invite the final panel to come forward. Our last panel will shine the spotlight on the Alternative Minimum Tax. Len Burman of the Urban Institute will explain how the AMT evolves from targeted provision aimed at a handful of high income taxpayers who were avoiding paying tax into a parallel system that imposes a significant hardship to millions of middle-class families.

We will hear also from Claudia Hill, a professional tax advisor who prepares hundreds of returns every year. Again, we are looking forward to testimony from both of you. I guess I'll just add one additional comment with respect. I mentioned simplicity a moment ago.

The other thing that I suspect that we'll hear about is the AMT and what's interesting about that is that the AMT today only affects only about 3,4 million. I don't know whether that's families or taxpayers or whatever, but about 3.4 million. I think the interest that's already developed in this. I think a year from now they may only one or two million. This is an area that a lot are concerned about.

MR. BURMAN: Thank you, Mr. Chairman. I want to thank all of you for your work in this area. It's tremendously important. I came to Washington actually to work for Secretary Baker on the Tax Reform Act of `86. It was a terrible way to start a tax policy career because it's been downhill ever since.

The AMT was actually a singular failure of the `86 reform. They didn't have the billion dollars worth to cost index back then and it really embodies all that's wrong with the income tax system. The AMT is unfair. It's inefficient. Pointlessly complex and almost nobody supports it, but it's very hard to fix because it brings in a lot of revenue and its victims can't see it coming.

I just want to start with some background on how we got here. In 1969, the Treasury did a study of 1966 tax returns and Secretary Joseph Barr reported to

Congress there were 155 high income taxpayers who had paid no income tax in 1966. This actually caused a fire storm of protest. Apparently, there were more letters to Congress about this 155 high income nontaxpayers than there were about the Vietnam War which was amazing.

Congress could have done three things. They could have explained to the American people that the reason these people weren't paying taxes is because we have incentives, they were taking advantage of the incentives and doing things that we intended them to do. So they could have said, "Well, these incentives are unwarranted. So we'll get rid of them." They took a third course which was to put a Band-aid on the tax system so that people would pay a little bit of tax. That was the genesis of the current Alternative Minimum Tax.

Right now because of temporary patches that have been put in place, there are only about three million in the AMT. By the end of the decade, there will be 30 million taxpayers including virtually all upper middle class, families with children of two or more kids, will be subject to the AMT unless there's a change in policy.

I think Claudia is going to go into details of how AMT works. This slide is the Cliff Notes version of how you calculate AMT. You basically think you get done with your tax preparation and then you have to add a bunch of things back to your taxable income, subtract an AMT exemption. Then you calculate your tax using a separate AMT rate schedule and the rules that apply and if that's more than the regular tax, you pay the difference, the AMT. And it's a lot more complicated than that.

Then some details. The AMT exemption is currently at $58,000 for couples, $40,250 for singles. That's a temporary provision. It's been extended for the last few years but then next in theory, the exemption levels drops to $45,000 for couples and that's why 17 to 20 million taxpayers will be subject to the AMT next year if there's not a change in law.

The exemption phases out at a higher income level and the consequences of that is that it actually creates high implicit tax rates because of that phase out. The statutory rates are 26 and 28 percent but because the AMT exemption phases out at 25 percent rate, it creates theses phantom tax rates of 32.5 and 35 percent. Sometimes people say the AMT is a more or less flat tax, but it's really not. It's a goofy tax because there's 26 percent, 32.5 percent and

35 percent and then back down to 28 percent. And it's not indexed for inflation. That's in red and underlined because that's a serious issue.

These are actually data from the Treasury Department showing what the biggest AMT preference items are and the notable thing is that most of these things are not associated with tax shelters. People pay state and local taxes because they live in states and localities that levy taxes, not because it's some tax shelter activity. That's 51 percent of all AMT preferences.

Personal exemptions. I have four children so that basically puts me on the AMT by default. The more children you have the more exemptions. That's another one-fifth of the overall.

Miscellaneous deductions above the two-percent floor. Those aren't really tax shelter items. A lot of them are just the cost of varying income and so on.

So why is the AMT growing like this? This chart illustrates the factors that are built into the AMT growth over time. The little red line on the bottom which you can hardly see shows where we would be were it not for the 2001 tax cuts and if the AMT had been indexed for inflation back since 1993. The consequence is that the AMT would hit about 300,000 people a year forever. It doesn't increase. Just the failure.

The regular tax system is indexed for inflation which means that every year there's an adjustment so that your average tax rate doesn't go up simply because prices go up. This was the old bracket creep. It happened in the fairly early in 1980s. Your tax would go up just because of inflation. That's fixed in the regular tax but it's not fixed in the AMT. So if you're subject to the AMT, you're in a nasty bracket creep. Every year more and more of your income goes on the AMT even if it's not growing at all in real terms. Just because of that, there would be some like 15 million returns on the AMT by the year 2010.

The 2001/2003 legislation cut income tax rates, but on a permanent basis, they only cut the regular income tax. Since you pay whichever one's higher, there are bunch of people for whom the AMT was lower than the regular income tax. They cut regular income taxes. The consequence is just a matter of simple algebra. It put more people on the AMT.

That could have been fixed by cutting AMT at the same time but it wasn't. The consequence is you have twice as many people who will be on the AMT simply because it goes with the income tax codes. Another consequence is that a lot of people think they're getting income tax cuts because of the 2001/2003 legislation who are not getting any cut or they are getting much less than they expected because a significant portion of it is taken back by the AMT.

I'll just say one common misperception. Some people say, "Well, that means that the 2001 legislation actually is raising people's taxes." That's not true. Nobody is taking more tax. It's just more people are being thrown on to the AMT.

Here's just some projections of where we're going to end up over the next ten years if there's not a change in policy. I think one of the big problems with the AMT as I mentioned before is that it raises a lot of revenue. If that President's tax cuts are extended, this is baseline scenario, the AMT between 2005 and 2015 will be raising about $1.2 trillion of revenue. If we're not willing to increase the deficit, that means if we got rid of the AMT, you'd have to raise taxes somewhere else by that much to offset the revenue loss. Even if the tax cuts aren't extended, it's almost $700 billion that the AMT is raising over the next ten years.

In terms of the number of taxpayers, in 2005 it's about four percent of taxpayers that are on the AMT and about three percent of all tax returns. Some don't actually pay tax. By 2006, it will be 20 percent of taxpayers. By 2010, 30 percent. By comparison, that's about the same percentage of people who take the mortgage interest deduction.

The AMT has some real flaws as a tax policy. It inflicts very large marriage penalties and child penalties. The exemption for a couple is now twice what it is for singles and the rates are exactly the same regardless of your marital status. The consequence is by the year 2010 it's like 15 times as likely you'd be in the AMT if you're a married couple as if you're single. The other factor of course is that if you have children you get to take those exemptions against the regular tax, but not against the AMT. So the more kids you have, the more likely you are to be on the AMT.

Ninety-four percent of married couples with two or more kids with an AGI between $75,000 and $100,000 will be subject to the AMT by the end of the decade. It's an odd characteristic for a tax that was supposed to be hitting high income people. Because state and local taxes are not allowed, people in high-tax states are much more likely to be on the AMT than people in low tax states. By the end of the decade if you're in the high tax state, you would be about five percentage points more likely to be on the AMT than if you're in the low tax state.

As noted, this tax is supposed to make high income people pay tax, but by the end of the decade, most of the tax is going to be paid by people upper middle income or just middle income people. Eighty percent of AMT taxpayers will have income below $200,000 in 2010 and more than one-third will have incomes below $100,000.

Families earning $75,000 to $100,000 will be 18 percent more likely to be on the AMT than those earning over $1 million. That may seem counterintuitive but the fact is that remember you pay whichever one is higher, the regular tax or the AMT. Millionaires have most of their income tax at the top rate which is above the top AMT rates. The income tax rate is 35 percent. At that level of income, the AMT is 28 percent. So they're much less likely to be on the AMT than somebody earning $100,000 or $200,000.

It's a matter of tax policy and the AMT is just an all-around failure. Good tax policy is simple, efficient and fair. And the AMT doesn't meet any of those criteria.

Pointless complexity. Last night, I decided to look at the instructions for who must file the AMT and in theory, everyone who files an income tax return has to parse this out. "Attach Form 6251 to your return if any of the following statements is true: Form 6251 line 31 is greater than the line 34." That means you have to fill out the whole form even if you don't file the return. "You claim any general business credit, qualify to...blah, blah." The last one

is my favorite. "Total of Form 6251 lines 8 through 27 is negative and line 31 would be greater than line 34 if you did not take into account lines 8 through 27." I have no idea what that means. That's why I use Turbo Tax.

So a lot of middle class taxpayers have to file the form even though they don't owe any tax. Millions must go through the calculations and lots of people were surprised when the IRS tells them owe money because they didn't go through the calculations.

The rules regarding credits, capital gains, dividends, deferral preferences which I think Claudia is going to talk about, they are very complex. The deferral preferences don't even generate much revenue. They just change the timing of revenue and vastly complicates tax planning. You don't know. People can go on and off the AMT from one year to the next. You don't know what your marginal tax rate is until you get to the end of the year and figure out whether you're in that funny AMT schedule or on the regular tax schedule.

Jim Poterba has written about this issue with economic efficiency. The AMT raises marginal tax rates for most taxpayers. Two-thirds of AMT taxpayers face higher marginal tax rates under the AMT than under the regular tax. By the year 2010, there will be 92 percent. Now people creep in the higher brackets over time because unlike the regular income tax, the AMT isn't indexed. Now the AMT might enhance efficiency if it shut down tax shelters but 90 percent of AMT preferences have nothing to do with tax shelters.

Equity and fairness. The AMT has nasty marriage and child penalties. Some legitimate adjustments to the ability to pay are disallowed under the AMT. If you're a victim of a sexual harassment at work and you file a lawsuit, it takes a long time to contingent legal fees. The legal fees aren't deductible if you're on the AMT. And if your court award is very large, you will be on the AMT because that alters the lines.

So you're paying tax on your gross income when your actual income is the net when you have to pay the lawyer. David Cay Johnson had a story where somebody was actually worst off after the AMT than they would have been had they lost the lawsuit. It doesn't do much for progressivity and it doesn't collect much tax from rich people. Over time, it's basically doing nothing. Actually, my time has expired so I'm going to stop.

MS. HILL: I am pleased to be here today to share insight into how the individual alternative minimum tax affects individual taxpayers. It's been a favorite subject of mine for many years. In fact, I've been preparing taxes long enough to actually return when AMT had a rational focus and did apply to people who tax sheltered their investments through their targeted tax preferences.

Just this last week, I worked with a couple who were experiencing AMT for the first time. He had retired last year and the shock to have to pay high medical insurance and even worse, to pay high medical expenses. Their total income was under $100,000 composed of interest, dividends and withdrawal of IRA funds. They were surprised that AMT applied to them. I reviewed the Form 6251, discussing the components of the calculation. They had trouble with the name "alternative minimum," suggesting they didn't want that alternative. The regular tax was plenty.

Then the wife spoke up. "Are you saying that we're being punished because we had high medical expenses and paid our property taxes and pay taxes to the State of California." This couple are typical of those taxpayers who discover they're subject to AMT for the first time. It's the new "mandatory maximum tax."

It's neither an alternative nor minimum. It's a "gotcha." Many, if not, most taxpayers who owe AMT do not realize it until the tax returns are prepared and they see it added to their regular tax. AMT sends many wrong messages to compliant taxpayers. One of the first wrong messages comes with this surprise factor. Taxpayers discovering they are affected by AMT usually react in disbelief. They consider it unfair as if they'd been trapped.

What the public hears about how our tax system is supposed to be fair and transparent is inconsistent with the stealth nature of the AMT.

Taxpayers ask, "Didn't Congress lower my tax rates?" "Yes, but not yours." The alternative minimum tax rates have not changed.

Who is subject to the AMT? You've seen the numbers, but I'm going to give you examples of clients from my practice. Increasing numbers of lower and middle income families with children, those who invest in low income housing, small businesses who place expensive equipment into service, people who invest in rental properties, taxpayers who sell their personal residence and either don't qualify or exceed the 121 exclusion limit, taxpayers who buy a first home and discover that their property taxes are significant and normally deductible expenses, taxpayers who receive wrongful termination or legal settlements, farmers attempting to income average, nonresident citizens who might benefit from foreign tax credits and the last three that I mention are examples that were remedied as part of the Band-Aids that came into law this last October. However, the issue of legal settlement and unlawful discrimination has been addressed, the inequity remains for those cases that don't involve discrimination.

Note also that none of these examples illustrate taxpayers for whom the AMT was originally created. In fact, prior to 2002, it was even possible to lose part of your earned income tax credit to the AMT. To me, the juxtaposition of those two concepts speaks volumes about the inequity of this tax. To consider the EITC and the AMT, the two of the most complicated things that I see affecting individual taxpayers and they're supposed to apply to people at opposite ends of the economic spectrum, fortunately Congress did address that problem by now permitting the EITC to be used against the AMT.

The AMT sends the wrong message to taxpayers. It sends the message that it's wrong to have children, that incurring deductible medical expenses is not good for tax purpose, that paying their state and local taxes, property taxes, sales taxes is not good for tax purposes. Yes, now even my clients in Texas, Nevada, Washington and Florida will discover their new deduction for sales tax can be lost to the AMT.

It's a wrong message also that it's okay to receive and pay taxes on your interest, dividends, capital gains and seek assistance to comply with the law, but you can't deduct the tax advisory fees or portfolio management expenses you pay to help earn those incomes. It sends the wrong message that it's okay to earn wages, but it's not okay to incur necessary out-of-pocket expenses in order to earn them in the first place.

And if you've been unfortunate enough to benefit in a legal settlement, you'll pay taxes on the total, but don't expect except for the certain civil discrimination suits to get to deduct the legal expenses you incurred to receive it. This same message applies to those who seek and obtain alimony or spousal support. I'm not sure what the message is there. Is that we don't hire attorneys or that we don't seek justice for the wrongful actions?

Business taxpayers are sent the wrong message too. Generally, accounting best practices suggest that we discourage clients from keeping a second set of records. However, duplicate record keeping is required for AMT. Not only must you calculate depreciation and tangible drilling costs and several other deferral preferences using two methods, you need to keep track over the entire term that you hold the assets of the basis adjustments because of this so that when the asset is disposed of, you can then calculate your gain or loss for regular and AMT purposes.

Another wrong message, expecting to benefit by directing business investments in a way that is rewarded with business credits may sound good, but don't expect to use those credits against AMT. These wrong messages add both complexity and uncertainty to business and investment decisions.

The AMT is wretchedly complex. The nature of complexity is exhibited in a number of ways. The added complexity exhibits itself in ways such as the difficulty in anticipating that you'll be subject to it, the difficulty of correctly calculating it and the difficulty of IRS to administer it. Thinking of the AMT simply as a separate tax system parallel to the regular tax while useful for a general grasp of what is involved can mislead tax practitioners factoring the AMT element into their planning projections.

The nature of the complexity is also exhibited in the additional compliance burden associated with the duplicate computations because even though you may not have AMT in a specific year you need to keep track of the things related to AMT from year to year because it has a different basis, it has a different foreign tax credit allowance, a different net operating loss and the current calculation of one year can affect the calculations in later years. The nature of this complexity is exacerbated by the irrational and nonintuitive mechanics of the AMT calculation.

I've worked with taxpayers and AMT planning for many years and I don't even try to estimate whether it's going to apply to a taxpayer. I don't respond to the taxpayer without building a model and using that software to do it. I've been asked by my clients often, "What can I do to get out of AMT" and I've not found a rule of thumb that's easy to anticipate that I can help them with.

We all read and heard why AMT was created and for whom it was directed. Unfortunately, it's drifted so far off its mark, it rarely hits that target. The fastest growing category in the AMT payers I see are young couples with children after they buy that first home. These taxpayers have no taxable avoidance motives. They are subject to the AMT because they have children, because they pay property taxes and they live in a high tax state. What does it say about our system of tax when we let millions of families become collateral damage in a quest to achieve tax equity?

AMT is wretchedly complex because it creates anomalies in IRS compliance efforts and taxpayer contacts. The IRS struggles in its efforts to understand and detect at the front end processing with AMT returns as well as identify and pursuing violations at the back end. Last filing season, IRS sent letters to a surprising number of taxpayers who were not subject to AMT suggesting they had failed to include the AMT form in their returns. Now many of those taxpayers had filed electronically making it highly improbable that they had forgotten to put the piece of paper with the return. But the problem was an IRS calculating error.

Many taxpayers are even unaware that the AMT applies to them until they receive a notice from the IRS. Some discover that they have AMT liabilities that they did not anticipate and cannot pay.

The AMT cannot always be calculated with only information on the tax returns. Yet unless the AMT components are included in the return, the IRS has no way to calculate the AMT for those who overlook including it. This leads to another inequity in IRS compliance efforts and that is that they are directed toward those taxpayers whose only AMT adjustments are those from Schedule A, medical expenses, state and local taxes and miscellaneous deductions.

There are other reasons AMT cannot be calculated correctly using the information on the return. For most of them, it's the duplicate record keeping, but another issue is that third parties are not required to report to IRS certain items of income that must be included in the AMT. That example is that ISOs, the virtual income from those, as well as the private activity bond characterization, municipal bond interest.

The complexity the AMT creates computational errors. Although some of these errors understate the liability, I see an equal number that overstate it. Recently, I worked with a taxpayer who prepared his own tax return and I ended up amending that tax return because he had included his state tax refund as income. There's a line on the form for it. Unfortunately, this man had paid AMT the year before and received no tax benefit. He got a $7,000 refund. Now I noticed that no one has mentioned AMT credit, but it needs to be addressed and with just a few more moments on this.

CHAIRMAN MACK: We're close on time. So if you could wrap up your portion so we could ask questions.

MS. HILL: Would you like me to hold the credit for questions then hopefully? Or do you want me to comment?

CHAIRMAN MACK: Finish the comment and then end there.

MS. HILL: Okay. Theoretically, the AMT credit is an advanced payment of tax on the select list of deferral preferences. Theoretically, the credit is the mechanism to equalize the advanced payment when the preference is later reversed and acknowledged in income. In reality, it does not work that way. Even when the taxpayer meets all the requirements of acknowledging the income at the later time, there is no guarantee that they will be allowed to use those credits at that time. If the AMT still applies, they are not allowed to use the credits.

Currently, I have many clients who are waiting for the opportunity to use their accumulated AMT credits. Some of them struggled with the AMT on phantom income from the stock options during the 1999 through 2001 tax stock bubble. Five years later even if the stock has been sold, they are still waiting to use that credit. So as a matter of fairness, any substantial restructuring or repeal of the AMT would need to address the treatment of unused prior AMT credits.

Now in some circles we might call this -- Okay. That's fine.

CHAIRMAN MACK: We're going to have to stop you at that point and have a couple of questions. We are again under a time restriction. So, Ed, if you could start.

MR. LAZEAR: Quickly. This is for Leonard Burman. You mentioned that in 2006 the number of people who go on to the AMT will be a large percent of taxpayers. Do you have estimates since revenue neutrality is -- of the amount of additional revenue that would be collected by that change?

MR. BURMAN: In 2006?

MR. LAZEAR: Yes. If not, you can send it to us later. I don't mean to put you on the spot.

MR. BURMAN: I could submit that to you later.

MR. LAZEAR: That would be great.

MS. SONDERS: You have talked about the revenue generating power by virtue of the absence of index into inflation. Given that one of our proposals has to essentially be a mini-reform where we maintain the structure of federal income tax and assuming that maintains the AMT and we don't get rid of it all together, how much help would just index into inflation as sort of the one tack-on to the AMT provided?

MR. BURMAN: It would help a lot in terms of reducing the amount of people in the AMT but it would be tremendously expensive, on the order of $800 billion dollars over the decade. I mean if you're guessing the President's baseline, it's $800 billion over the decade. That's a lot of money.

MS. GARRETT: Thank you both and thanks to the panel for putting this terrific presentation today. My question is for Len and you may not be able to answer it now, but if you could send it to us. One of the problems that makes this not a simple tax is that it's not transparent. It's hidden and in addition to the AMT, we have a lot of taxes through phase-outs and other kinds of hidden taxes that aren't in the marginal rate structure. I would like to get a sense of if we get rid of the AMT, if we make these taxes explicit and part of the actual marginal rate structure, what does that rate structure look like to raise the same amount of money?

MR. BURMAN: If you're trying to raise the same revenue at each rate, the rate structure is really goofy. The highest rate actually applies at the second to top bracket. The top rates are at 40 to 45 percent. Then the rate goes way down at very top. The reason is that very high income people are much less on the AMT than people with moderate and moderate high incomes. I can send you an exact estimate. We looked at that data in the update we did last summer.

MR. POTERBA: This was extremely helpful. Thank you both. Do we have much information, either Claudia from your practice in compliance or Len from your analysis of data about the tax policies, on whether people are moving on or off the AMT or is this in some sense an absorbing state where once you fall into it you're likely to be on the AMT for the duration and therefore people basically should be planning as if they're AMT payers?

MR. BURMAN: That's an interesting question. As far as I know, nobody has looked at that data, what you need to do. It's actually something I'd like to do in the future. The Treasury Department could do that for you if you want because they have access to the taxpayers. To my knowledge, there aren't that many people on it about three million returns.

MS. HILL: When I work with clients that have the AMT and would plan around it, if there's something that creates a specific preference which is a one year thing as an ISO might or a specific type of balance in their income, we can work a little bit around. But I would say the majority of clients once they hit it if they're hitting it because of families, children, the rate, permutations, they're kind of stuck.

VICE CHAIRMAN BREAUX: I think you both. Thank you very much. You've made a very good point that the AMT has gone far beyond what Congress was trying to accomplish with it which was to say very well-to-do should pay something. That was the whole concept. Now it's gone far beyond that. So all agree with that. The question is how do we fix it. If we eliminate it, there's $1.2 trillion over ten years. Do you have any suggestions of where we could pick that up?

MR. BURMAN: Outside of political context, it's simple.

VICE CHAIRMAN BREAUX: Would you target the rates to the higher income to say, "All right. You have to be incur two or three percentage points because that's what we want to make sure you're paying."

MR. BURMAN: Prior to 1987, the biggest AMT preferences were capital gains. You can make an argument that the difference between capital gains, tax rates and other income is a major factor in the proliferation of tax shelters. So it actually was related to the original intent to legislation. If you made the capital gains differential a preference item under the ATM and you adjust at the rate, it would still have to go up a little bit, you could index the threshold for inflation and you could even increase the threshold someway. You could totally target the tax so that the prime targets would become the high income people. They are the ones that most likely to have a lot of capital gains income and the higher rate would affect everyone.

You could do things like incorporate some of the AMT preference items into the regular tax. Secretary Baker said one of his disappointments was that he couldn't tax state and local. He couldn't affect the nondeductibility of the state and local taxes. If you did that, that would cut significantly the number of people on the AMT and you would still have to raise rates a little bit to make it revenue neutral over ten years. That would go a long way to closing the gap.

You could just adjust ■- The thing about the AMT is that effectively we have a tax schedule that looks a lot different from the statutory schedule because people get into this AMT range and then there in this 26, 28, 32, 35 percent thresholds for the rates and then their rates go back down and then go back up again when their incomes get very high. It's just a matter of policy and it would make a lot more sense to just build into the rate schedule the rates that are adequate to raise your revenue and get rid of the AMT or really limit it to things that are actually related to tax shelters which is a very tiny part of the whole.

MR. FRENZEL: Thank you very much, Len. As you were talking to Senator Breaux, I sort of had the same thought. According to your presentation if you eliminate state and local tax deductions, you take more than half the people out of the AMT. Do I interpret you correctly?

MR. BURMAN: That's right.

MR. FRENZEL: That's an interesting incentive we might not want to have.

MR. BURMAN: Actually it would be a little bit higher now because it didn't include the sales tax deduction.

MR. FRENZEL: I'd like to ask Ms. Hill. How do we lose our AMT credit?

MS. HILL: I have the specific code section that does that. It's a weird calculation and it means each year when you calculate whether or not you can use, In a year that you aren't able to use it, you still have to make a calculation. It's called net revised version. I can get someone that piece of paper on it. It's too complex for me to describe. It has to do with the wording in the law on the calculation.

MR. ROSSOTTI: Claudia and Len, thanks for your testimony. Claudia, I see you're still laboring to help people in the IRS and elsewhere to understand how this stuff really works for people. We talked a little bit about why so many people are getting into it in the middle range. Could either one of you help explain why it is that the upper bracket people, the over million dollar people, are really not affected by this anymore?

MS. HILL: Because my over million dollar people are paying at a rate of 35 percent and there's a seven point spread on a large block of dollars. When you have AMT tapping out going through, it's 32 whatever and then back to 28, it stays flat and if you get enough income being taxed at rates above that, then you won't see it on the higher income people. Now if the components of it is capital gains, you're going to see it. But if it's ordinary income and the tax is 35 percent, you won't see AMT.

MR. POTERBA: If we had indexed the AMT originally, and this whole thing makes me think we need a different way to describe it, if we had indexed it
originally and repeated the 1966 study, what would it have looked like in terms of high income taxpayers?

MR. BURMAN: There aren't that many high income people who actually owe taxes because of the AMT. It's a matter of a few thousand. We looked at it last year. It's very little about the AMT. Actually, the Tax Reform of `86 got rid of a lot of the tax shelter provisions and allowed high income people to totally avoid tax.

MR. POTERBA: That's what I thought. So the original problem is difference.

MR. BURMAN: What we don't know and I think it's impossible to measure is how many people are dissuaded from engaging in tax shelter behavior because they know the AMT would make them pay some tax. My guess is that's not a huge number. But in terms of the actual preferences without the AMT there would be a few thousand millionaires who would not pay taxes and this is relative to several million of federal returns. It's not a very cost effective way to raise taxes from high income people.

CHAIRMAN MACK: Len, are there any wealthy persons that today are not paying taxes?

MR. BURMAN: There are a few.

CHAIRMAN MACK: So this whole thing that we started out years ago to ■-

MS. HILL: One hundred and fifty-five, Len.

MR. BURMAN: Actually, I have to say that this would be a question to ask the Treasury Department. We use public data and the high income returns are actually altered so we couldn't identify people. So our estimates are somewhat imprecise but our estimates are that there are hundreds of high income people, maybe 1,000 or so, who are not paying tax because they have all of their income probably is from tax exempt bonds. Most tax exempt bonds are outside the AMT.

CHAIRMAN MACK: And I'll just close. Claudia, you reminded me with your comment earlier about the conversation with my wife as I was trying to explain the two tax codes, the regular tax code and the alternative minimum tax, and when I got through with it and I said, "Then you have to pay the higher of the two," she said to me, "Why do they call it the alternative minimum tax code?"

Thank you very much for your presentations. We appreciate them. That concludes our panel of hearings for today. Thank you all for coming. Off the record.

(Whereupon, at 2:27 p.m., the above-entitled matter concluded.)