UNITED STATES OF AMERICA

PRESIDENT'S ADVISORY PANEL ON
FEDERAL TAX REFORM

EIGHTH MEETING

WEDNESDAY
MAY 11, 2005

The Panel met in the National Transportation Safety Board Auditorium, 429 L'Enfant Plaza, S.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

RICHARD ARMEY	Co-Chairman, FreedomWorks
JIM BAKER	Chairman of Baker & Company, LLC
ROLAND BOUCHER	Chairman, United Californians For Tax Reform
DAVID R. BURTON	Partner, The Argus Group
ERNEST S. CHRISTIAN	Executive Director, Center for Strategic Tax Reform
CHRIS EDWARDS	Director of Tax Policy Studies, Cato Institute
EDGAR I. FEIGE	University of Wisconsin, Madison
STEVE FORBES	President and CEO of Forbes and Editor-in-Chief of Forbes Magazine
MICHAEL GRAETZ	Professor, Yale Law School
ROBERT HALL	Robert and Carole McNeil Senior Fellow, Hoover Institution, Stanford University
DAVID A. HARTMAN	Chairman, Lone Star Foundation
NORMAN G. KURLAND	President, Center for Economic and Social Justice
EDWARD J. McCAFFERY	Robert Packard Trustee of Law and Political Science at the University of Southern California, and the Visiting Professor of Law Economics at California Institute of Technology
CHARLES McLURE	Senior Fellow, Hoover Institution, Stanford University
DAVID S. MILLER	Partner, Cadwalader, Wickersham & Taft LLP
STEPHEN MOORE	President, Free Enterprise Fund
JOHN PODESTA	President & CEO, Center for American Progress
BARRY K. ROGSTAD	Former President, American Business Conference
PAUL WEINSTEIN, JR.	COO & Senior Fellow, Progressive Policy Institute
THOMAS A. WRIGHT	Executive Director, Americans for Fair Taxation

C-O-N-T-E-N-T-S

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

9:41 a.m.

CHAIRMAN MACK: Again, this may be very obvious. But for the last number of weeks, we have been spending our time trying to understand what people throughout the country have to say about the complexity of our present code, the problems with our present code.

Today we're going to start with a series of panels and hearings that are going to focus on alternatives to the present system. And as I said to some of the panel members, we've now concluded the easy part of our work. We're now going to get into the difficult part, making some meaningful decisions.

So anyway, that's just a kind of introduction. Also, we don't have the lights to be able to inform the panel that their time is running out, so I would ask each presenter to try to limit their remarks again to the ten minutes.

Our first panel will be on the value-added tax. And we will be hearing testimony from Charles McLure, senior fellow, Hoover Institution, Stanford University, and testimony of Michael Graetz, professor, Yale Law School.

I'm not sure which of you is going to go first? Charles, why don't you begin then.

And thank you both for your participation this morning.

DR. McLURE: Thank you, Senator Mack.

Senator Breaux, members of the panel, as you know, our tax system is a mess. You can perform a valuable service by helping us fix it.

I'll speak to you about the credit method value-added tax, which I think can be part of a sensible solution to our problems.

I have prepared a couple of slides to present an overview of things I am going to talk about and things in the appendix that I know I won't have a chance to talk about.

The credit method value-added tax is the most commonly used tax on consumption throughout the world. It is levied by approximately 150 countries worldwide, including all 25 members of the European Union. The credit method value-added tax has many political and administrative advantages over other indirect consumption taxes such as the subtraction method value-added tax, which is commonly known as the business transfer tax, and the retail sales tax.

Japan is the only country that I know of that uses the subtraction method value-added tax, and certainly the only one in the OECD.

Forty-six of the states, including the District of Columbia, and nine Canadian provinces, levy retail sales taxes. But this is a form of tax that is not used in any other evolved country.

What I have here is a slide that provides a simple example that I will use to illustrate the key features of the value-added tax. I'll call this the benchmark example. And the arrows here show what's going on.

In the top slide, they show that a farmer grows wheat and sells it to a miller for $300. The miller grinds the wheat into flour and sells it to a bakery for $700.

And then finally the baker bakes bread and sells it to the consumers for $1,000.

The value added, calculated in line three, is simply the difference between sales and purchases, $300, $400, and $300 in the three stages. And the total value added in the three stages is $1,000 in the value of sales to consumers.

Line four tells you how a business transfer tax would be calculated. It is just 10 percent of the number in line three, that is, 10 percent of value added as calculated by subtracting purchases from sales.

The value-added tax is sometimes described this way, but that's not the way it's actually done in the real world. The real world value-added tax is what's shown in lines five through seven.

This shows that if there is a 10 percent tax on sales at each stage, but the seller is allowed a credit which reduces his tax, the tax he has to remit, by a credit for the amount that he's paid on sales. So in other words the subtractions leaves you again with a net value-added tax liability of $30, $40 and $30, just as in line four, the total of 100 is in line four. The results are identical in this particular simple case, but is not the same in more complicated examples.

Now, finally, an idealized retail sales tax that applies only on sales to consumers would give you exactly the same result, which is $100 of tax.

So it is common to say that in their pure forms the three taxes would yield the same result, a taxation of consumption. But it's important to note that the value-added tax and retail sales tax are transactions-based taxes. They are levied on each sale. They are commonly stated separately.

The business transfer tax is an accounts based tax. It is not and cannot be levied on each sale. You could I supposed state it on each sale if you wanted but what you would be doing then is basically credit method by the back door.

In its pure form the business transfer tax taxes slices of value added, that is, sales minus purchases. This means that there's a tremendous incentive to try to get those slices exempt, and that I think makes it politically vulnerable.

Notice under a retail sales tax the tax collector gets only one bite at the apple. That is, if you don't get the money there, you don't get it.

By comparison, under the business transfer tax and value-added tax, much of the tax is already collected before the last stage, and that helps in case of evasion at that last stage.

And under the value-added taxes, invoices must be used to support input credits.

What I want to do now is to distinguish between zero rating and exemption, something that a lot of people probably don't understand exists. And this slide is going to be used to show the effect of the exemptions and zero rating at the last stage. That might be sales to consumers, or it might be exports.

And in both cases, both the exemption and zero rating, the baker's sales are not taxed - the baker being the last stage. But under exemption, the baker is not in the system. What that means is that the baker is not allowed credit for tax on purchases. And I use the arrow in my slide, the dashed arrow, red in this case, to show that the credit is missing.

And so what you see is that the last stage, the value added at the last stage is not taxed. But you still collect the tax on the first two stages under the exemption.

Now, by comparison, if you have zero rating of the last stage, that baker is in the system. The baker gets a credit for the tax that's been paid on sales. In this case gets a refund. This should say minus 70 in the bottom on the last column. And gets the money back. And when you add those lines up, you get zero.

In other words, the exemption or zero rating totally eliminates the tax on sales at the last stage. And this is the reason a zero rating and not exemption is used for exports, because you want to make sure that exports enter world markets free of tax.

Now, we want to move back one stage and

say, well, what if it's not the baker's sales but the miller's sales that are either exempt or zero-rated? Again, in either case, there's no tax on the sales, but if the miller's sales are exempt, the miller is out of the system and doesn't get credit for any tax paid on inputs.

And therefore, what you can see if you look at line six on the right-hand side, the total tax is $130, not $100 as in the benchmark example.

What this means, of course, is that the exemption of intermediate stages increases tax, it doesn't decrease it. Ordinarily we think exemptions save money. They don't in this case, because you have a break in the chain of input credits.

The key economic effect is what we call cascading. That is you have multiple taxation of value added, and that creates economic distortions including discrimination against the exempt sectors, and incentives for self supplies.

The key political effect is that intermediate producers are going to be very hard to exempt. They don't want to be exempt.

Now, by comparison, if you look at zero rating, the situation there is that the miller does get credit for the $30 of VAT paid on the wheat, and therefore, gets the money back, and that last line, what you see is that the result is $100, just as in the benchmark case.

What this means, one of the key conclusions for a value-added tax, is that only this tax at the last stage matters if you have zero rating or a difference of rates early on.

The key economic effect is that there is no cascading and no distortion of the type that you get with exemptions, and the key political effect is that intermediate producers are indifferent to zero rating. They may not mind it, but they're certainly not going to push very hard for it because it doesn't do them a lot of good.

The next slide simply summarizes what I said in the last two, so I'll move on and ask, well, how do you choose between exemption and zero rating?

Well, that depends on your objective. If what you want to do is to eliminate tax, as you would for export, you'd have to use zero rating. If you want to eliminate tax for example on the sales of necessities - not necessarily a good idea - you would need to have zero rating. Exemption would reduce the tax, but only on the last stage.

Similarly, if you wanted to take the tax off of purchases by non-profit organizations, you would need to allow them zero rating; that is, they would get refunds.

Now there is a question of, what about small businesses? Many countries exempt small businesses for administrative reasons. I doubt this will be necessary in the United States. After all the states do collect retail sales taxes from fairly small businesses.

But here you face a dilemma, because zero rating does not eliminate the administrative burden. They would still be in the system. Exemption eliminates the administrative burden, but it leaves a tax burden on them. Because as we just said, exemption increases taxation unless it occurs at the final stage.

So what you need to do there, if you're going to have the exemption for small business, you would certainly want to make registration and normal treatment optional.

A lot of people talk about international issues. It is easy to provide border type adjustments for value-added tax. This is done throughout the world. You simply zero rate exports, and you apply the tax to imports.

The destination basis of the value added would per se be neutral. It wouldn't make much difference. But if on the other hand you used the value-added tax to lower the income tax rates, you would have substantial international repercussions. You would have more excess foreign tax credits. U.S. income tax would look more like a territorial tax. Investment in the United States might be encouraged. And there would be pressure on foreign countries to lower income tax rates.

I think we'd all say that sounds pretty good. But I think we might want to worry about using revenues from all these taxes to totally replace the corporate income tax. Because that would have massive international disruptions, and I don't think it should be done except in the context of an international agreement to do that.

Now in concluding, I want to say a bit about --

CHAIRMAN MACK: Could I get you to say that again? Make your comment again.

DR. McLURE: I think that it would not be advisable to eliminate the U.S. income tax in the absence of international agreement - that is unless everybody would do this. Because it would have massive international repercussions, things that we could hardly even imagine, if we just eliminated our tax and left the rest of the world with theirs.

Now what I want to do in conclusion is to just talk briefly about the choice between direct and indirect forms of consumption taxes.

What do I mean by direct and indirect forms of consumption taxes? Well, an indirect tax doesn't allow - it can't be personalized. It does not allow for the circumstances of the consumer.

By comparison the direct tax, such as the flat tax or consumed income tax can be personalized to allow for the circumstances of the consumer.

And that's both the good news and the bad news. The good news is you can personalize it. It's bad news because that's what creates the complexity of our current income tax. And believe me, if you had more of those, they would be just as complex as the current tax.

Now what I've done here is to say, okay, we have different forms of consumption taxes, different forms of - there is direct taxes, and we have transaction-based indirect taxes, and the accounts-based business method value-added - business transfer tax.

And the question is, should we, could we, use either of these taxes as a total replacement for the federal income taxes? Could we, should we, use them as partial replacement for the federal income taxes to provide a different source of revenue? Not necessarily additional revenue, but additional source of revenue.

And my conclusion is that it might be possible to use one of the direct taxes as a total replacement. It wouldn't make sense to have that as a partial replacement, because then you'd have both that type and the existing income tax.

My real conclusion though - well, first let me say, I think it's not a good idea to use the business transfer tax for either of these purposes because it's simply inferior to the credit method value-added tax.

I think the retail sales tax probably can't be levied at the rate that would be necessary even for partial replacement.

This leads me with which I think is something that really should be considered carefully, and what Professor Graetz will talk about, and that is the possibility of using the credit method value-added tax as a partial replacement for the federal income tax.

Now that could take the form of an across-the-board reduction in the income taxes, but that would leave you with all the complexity you have now. You wouldn't gain much.

On the other hand if you adopt Professor Graetz' proposal, which basically would use the value-added tax to replace revenue from the income tax on the vast majority of American individual taxpayers, you would have very substantial simplification, and frankly, that's the way I think you should go.

Thank you.

MR. GRAETZ: Thank you, Senator Mack, and thank you, Senator Breaux, and members of the Panel, for inviting me to be here with you today. And let me begin by wishing you good luck on the task ahead of you. You've certainly got a challenging assignment.

I want to talk about a proposal. But I begin where you began, with the problems of the existing income tax. You've heard a lot about that, so I won't repeat them for you. But on the left-hand side of the slide we've got complexity, difficulties of administering the tax, the growth in the AMT, what I call chicken soup which is the Congress and the president have begun using the income tax the way my mother used chicken soup, which is as a solution for any problem that ails the country.

And I think as long as we have an income tax that applies to the masses, the temptation to use the income tax for education credits or long-term care or whatever happens to be the problem of the day will continue.

And in the last bullet there is that the American public has become cynical, particularly the youth, about complying with the income tax.

The summary of that slide for me is that I am very skeptical that you can fix the income tax. We tried that in '86, and I think we've gotten in a position we're in, and we would again.

The second slide is just my favorite slide. I just always use it. It's the number of words in the Internal Revenue Code and in the regulations. I won't linger over this one, but the Internal Revenue Code is now at least four times longer than "War and Peace" and considerably harder to read.

I want to now turn to a proposal that I have been advancing to fix the system. It has got four pieces, and the first piece is to pare back the income tax.

I am fond of describing it as, instead of repealing the Alternative Minimum Tax, let's repeal the regular income tax. You repeal the regular income tax. You then increase the AMT exemption to $100,000 for a married couple, $50,000 for singles, and you index that exemption so we never find ourselves back in the position we're in today.

You lower the AMT rate to a flat 25 percent rate. You permit appropriate deductions for income-producing activities. There need to be some changes there. And the payoff on this is that you eliminate 100 million income tax returns, about 150 million people will file no returns. For them April 15th will just be another day.

The marriage penalty will be eliminated. Deductions for home mortgage interest and charitable contributions, as the president has suggested, will be retained. And incentives - and I think this is very important - incentives for both retirement plans and health insurance provided by employers would be retained.

The second piece is to clean up the corporate income tax. I would lower that rate to 25 percent. The same rate that would apply to individuals. I would more closely align book and tax accounting, and allow Congress to make only the adjustments that it desires from book accounting.

I would consider replacing the foreign tax credit with a territorial system in order to eliminate the barrier of repatriation to the U.S. of foreign earnings.

I think that we should greatly simplify small business taxation by having a unified flow-through regime, and perhaps, more cash accounting.

And I think that book tax conformity is really the only way we can solve the tax shelter problem that has so plagued the corporate tax.

When these two changes are made - and this I think is a very important slide - what you see is, under the proposal, the U.S. would have income tax revenues as a percent of GDP of 4.1 percent, about a third of what we have had until just recently, and less than a third of the income taxes around the world.

We have not taken advantage of our status as a low tax nation. By keeping our income taxes high and our consumption taxes low, we have really frittered away that advantage. And the idea of this proposal is to make the U.S. income tax among the lowest in the world.

The next question, well, where do you get the revenues to do all this? And the answer is piece three, which is a credit method value-added tax of the sort that Charlie was just talking about.

By my calculations, you need a rate of about 10 to 14 percent -- I think the 13 to 14 percent is more realistic - to do what I've just suggested. So you would enact a 14 percent let us say value-added tax such as that that is used throughout the world.

I would insist that the VAT be visible, that it be shown on each sale by all consumers, so people know how much tax they're paying.

I would exempt small businesses, but as Charlie suggests, you let them come in if they want to opt in to the system.

And with the value-added tax, Joel Slemrod testified before this commission or this panel that compliance costs were about a third of what they were under the income tax.

I spoke to a fellow, international person at Ernst & Whinney. He tells me that five percent of their tax people work on the value-added tax in Europe, even though it collects more than half the revenues.

About 20 percent or so of the administrative costs are attributable to a value-added tax.

If you look at the next slide, you'll see that now as a percentage of GDP the U.S. is extremely low compared to the rest of the world on consumption taxes. So what we're doing is, we're having income taxes that are comparable to the rest of the world, and consumption taxes that are much lower.

The next slide shows that with the 14 percent rate, and the average sales tax rates in the states, we would be under this proposal comparable to the value-added taxes in the OECD and less, a little less, than they are in the EU.

And as I say, we would then be comparable in consumption taxes, and have a much lower income tax, than the rest of the world.

The fourth and final piece of this proposal is that you need to do something when you go to consumption taxes to both replace the earned income tax credit and to protect low and moderate income tax payers from a tax increase.

And any movement away from an income tax to a consumption tax will require an adjustment of this sort, although not all of the proposals have such adjustments.

What I would do is replace the earned income tax credit with a payroll tax offset for low wage workers, and allow employees to get back in the form of a payroll tax refund some of the taxes that they're paying in the form of value-added taxes.

I think this retains the EITC work incentives. It eliminates the marriage penalties of the EITC. It recognizes the contributions of non-custodial parents to their children's financing. And has other advantages. It doesn't affect their Social Security benefit.

Let me sum up by saying that this next chart will show you the number of returns, tax returns, under this plan as compared to current law. You'll see that we go from 133-1/2 million returns down to 35-1/2 million returns, eliminating about 100 million returns. The number of returns that would come into the IRS would be lower than the number that they received in 1946.

Now of course they would continue to get information returns, and those are not shown here.

Let me just summarize and conclude with the advantages of this plan. First, elimination of the 100 million tax returns will reduce compliance and administrative costs and eliminate the cynicism that has been generated by income tax complexity.

This system would lower taxes on saving and investment for everyone. Eliminate it for most people. And thereby stimulating economic growth and creating additional jobs for American workers.

Unlike the current tax, this system eliminates all marriage penalties, something Congress has tried but has been unable to do.

Fourth, and I think this is very important, by combining taxes used throughout the world, this system facilitates international coordination and fits well within existing international tax and trade agreements.

Many of the ideas that have been advanced are for taxes that are untested throughout the world, and I agree with Charlie's position. That is, if you're going to go to these radical changes, I would describe them, you really need to do that with international coordination.

Here, all I'm doing is picking up taxes that are common throughout the world. You can have confidence that a credit method value-added tax will produce the revenue that's estimated. I think it's very hard, for reasons that Charlie has gone through, to have that same confidence about a business transfer tax or a subtraction method value-added tax.

Fifth, this is an easy transition. Since I don't eliminate the income tax entirely, you avoid all the transition issues that have so plagued the Nunn-Domenici proposal and others.

You unburden the IRS. The IRS will be in a position to do its job and deal with the high income and corporate returns.

And I think this is a stable system. I think with fewer Americans filing tax returns there is less temptation for political tinkering, and the international capital mobility, and I suggest a supermajority voting requirement would keep this a stable system.

It's very hard for me to imagine someone standing up on the floor of Congress and saying, well, let's bring back those 150 million taxpayers into the income tax. Yet in fact this system resembles the system that we had prior to the Second World War, where you had a consumption tax on the masses. It was a bad consumption tax in the form of tariffs.

We now know throughout the world how to levy a good consumption tax, an effective consumption tax, in the form of a value-added tax. And you would have an income tax on only a relatively thin slice of Americans.

There is a revenue table in there which shows revenue effects. I won't go through that, but it's in the chart. It shows that this is a revenue-neutral proposal.

And let me conclude by just making one comment, and that is that this is a very flexible proposal. That is, I have described how I would deal with the income tax. But as I understand it, the president requested that this panel come up with an option that would reform the existing income tax.

Let me say this. Whatever option you come up with, if you add a value-added tax, you have the opportunity to take 150 million people out of the income tax, and to lower the income tax rates by about 10 percentage points.

So this is a system which is flexible and would go with any income tax reform that this panel would recommend.

Thank you, Mr. Chairman.

CHAIRMAN MACK: Thank you for the presentation. And I'm going to turn to Jim first.

MR. POTERBA: Thank you both very much. Let me raise an issue that both of you touched on which is the choice of various VAT options. I know you both favor a credit-invoice approach to both the tax rate and the VAT. I just want to explore that a little bit further. Is it your sense that the subtraction method is something which is essentially unworkable as a scheme we should think about for the United States in considering VATs or just further the credit-invoice to the subtraction method?

PROFESSOR GRAETZ: Well let me give an answer, and then I'll let Charlie answer it, because he's looked at these more than I have.

I think there are a couple of problems with the subtraction method VAT. I think it's subject to the difficulties that Charlie has pointed out; I'll let him expand on those, both exports and not collecting the tax at various stages.

I looked briefly at the Japanese statute, which is always cited as the only example of a subtraction method. It looks to me much more like a credit method. They use invoices and so forth. I think they've moved more toward a credit system.

The advantage that a lot of people seem to think the subtraction method VAT has is that because it's based on accounts, it looks like an income tax. And the main difference, or at least one of the main differences, is that capital purchases are immediately written off instead of depreciated under a subtraction method VAT.

So this is an idea that you can have something that looks like an income tax, but it's really a consumption tax.

For me the difficulty with that is, it's not stable. All it will take is to reintroduce depreciation, and you're right back into an income tax. And we saw in 1981, we were very close with the investment tax credit and the depreciation rules to something equivalent to expensing, and in 1982 and through 1986 you went back to deductions for depreciation.

So I think that if you want to go to a consumption tax, there is a tried and true way to do it. It's used in 150 countries throughout the world. We couldn't among us name 150 countries throughout the world. You can be sure that many of their administrative systems are quite rudimentary, once we get past the first 30 or 40. You're getting into some fairly basic administrative systems. And yet they're able to collect this tax.

And so for me it's take what works rather than something new.

Charlie.

DR. McLURE: Yeah, I think that's a very good question that the panel needs to pay a lot of attention to.

Back in 1987, when I wrote my book on the value added tax, I distinguished between a naïve and sophisticated versions of the subtraction method value-added tax. And what I thought of as the naïve version is simply one where you subtract purchase and sales, and pay taxes on the differences. In other words, your taxing slice is a value added.

I think it's pretty fair if you do that. That's kind of a godsend for lobbyists. They couldn't ask for anything better than something where we said we're going to tax slices of value added. Now you go up to the Hill and see if you can get your slice exempted.

And so I think that's a really bad idea. And also, if that ever happened, how would you know what the types of adjustment would be for international trade? How much should you collect on imports? How much should you rebate on exports?

If not everything was fully taxed at the same rate, then those rebates shouldn't be allowed, and those before-tax adjustments shouldn't be allowed at the full rate.

And believe me if you tried it our trading partners would go berserk, if, say, they thought that there was actually eight percent embodied in exports, and we were doing back end. They would not think that was a good idea.

And so one could try to avoid that problem using what I call the sophisticated value-added tax - subtraction method value-added tax. And basically what that would be would be to say, okay, okay, you can only subtract purchases on which you have paid the value-added tax. You can't subtract purchases on which you haven't paid the value-added tax.

Okay. So what that means is that basically you've recognized the problem with the subtraction method, and you're trying to mimic a credit method value-added tax.

In which case I would say, well, why don't you just do what everybody else does? What everybody else does is not necessarily always right, but in this case it is right. And I think to see the insanity of this approach, consider the situation if you have a foreign tourist that comes to the United States and buys something important enough that they'd like to get the tax back, as opposed to if you buy something say in Europe.

Okay, they go down and they say, well, we don't state the value-added tax separately on invoices, because after all, this is a subtraction method value-added tax. But if we stated it separately, this is how much it would be.

Now that sounds an awful lot to me like stating it separately. So why don't you just state it separately, get on with it and do what the rest of the world does.

PROFESSOR GRAETZ: Could I make one other observation? And that is, just to pick up on one thing Charlie said, we do not have a large country like the United States with the subtraction method VAT. It's clear that you cannot do border adjustments if you allow a deduction for wages, which is what the flat tax and what some CBIT related alternatives that have been bandied about would do. So which means that you are not exempting exports, and you are not taxing imports, which is, I think, one of the key advantages of a value-added tax. And I think American businesses are going to be very unhappy with a tax that is not on a destination basis - a consumption tax that is not on a destination basis like the rest of the world.

The interesting question is, and it's not answered, is whether under the GATT or WTO there would be a challenge to a subtraction method value-added tax even if you did not have a deduction for wages, and how that challenge would come out. And we don't know the answer to that question. They haven't challenged Japan, but as we know, the European Union has been more willing to bring challenges against the U.S. than they have against Japan.

CHAIRMAN MACK: Beth, we're going to go to you next. But let me just ask you if you could to try to keep the responses short, just because of time. We have lots of people who want to ask questions.

MS. GARRETT: Yes, thank you very much.

Michael, how much of your plan turns on the single rate? Although I guess there are really two rates, the zero bracket and then the 25. If a second rate was introduced what do you lose by that marriage penalty, really is one thing that comes to mind. And how important is having the payroll tax credit rather than just getting rid of the payroll tax and using the money for the entitlement programs directly?

PROFESSOR GRAETZ: Well, the flat rate does solve the marriage penalty problem, which I think is important but others may think it's less important.

Obviously you could have more than one rate with the AMT, and value-added taxes around the world have more than one rate.

I think one rate is better, and I think keeping that rate low is important. But there's nothing inherent in the plan that doesn't accommodate two rates.

I would not take on the payroll tax. I think that there are just too many issues that are raised when you take on the payroll tax directly, given the whole question of financing social insurance back here, and Social Security, and how you're going to do that and trust funds and the like.

So I'm doing something with the payroll tax, but I'm keeping it in place, and leaving this adjustment there really as a way of not adding to the difficulties.

I think I've set out a difficult enough task without adding the payroll taxes, but that's a judgment others might differ with.

MS. GARRETT: Thank you.

DR. McLURE: I would just say that it seems to me that it's quite ingenious to keep the payroll tax in place and allow an adjustment to the payroll tax for low income individuals, rather than keeping the earned income tax credit, and children credit, all that stuff in place.

I think there is a lot to be said for making this as neat and simple as possible.

MR. ROSSOTTI: Professor McLure, could you talk a little bit about how you would deal with financial services under the VAT, and in particular since in the U.S. we have a very heavy use of consumer credit in financing many things in the U.S., how you deal with issues where somebody buys a car on financing terms. And the ability for people who are selling the car to manipulate how much is shown as interest versus how much is shown as discount.

DR. McLURE: Well, the treatment of financial services is one of the most important issues. And this is one where I may not be able to be really brief, although there is this table here in the handout which does say what you'd really like to do is to treat financial services like everything else. That is, I'm not talking about lock boxes. I'm talking about financial services where the value of the service is not charged for separately; it's included in the spread say between interest rates.

The conceptual credit approach, of course, would be to not tax the business part, but to tax the part that accrues to individuals and the service they get. The trouble is, you can't do that because there are no transactions attached, and so the alternatives is either to exempt them, zero rate them, or what I describe as a hybrid.

And of course the exemption means, if you had an exemption it'd be a terrible idea. It would break the chain of credit in the way we described earlier with regard to the miller. And what that means is that U.S. financial institutions would have to bear that burden.

Now that is the way it's done in Europe. But it's interesting that the province of Quebec, when they put in their value-added tax, they broke from the federal value-added tax, and they said, we don't want these services, we don't want the folks in Montreal - or not Montreal, in Toronto - to be able to compete more favorably.

And so they actually zero rate financial services. Now the trouble with zero rating financial services is, it gets the business part right, but it undertaxes the services provided to individuals.

And so what the hybrid does, which I think could be administered, would be to use the conceptually right treatment, either tax them at a zero rate - I'm sorry, zero rate those sales to business, those services to business. It means there is no tax. But you exempt the transaction with households, again, no tax.

But what this would ultimately mean would be that you would not allow input credits for the part of the financial institutions' costs attributable to providing services to households, only the part attributable to providing services to businesses.

Obviously, that's a complication, but I think it would work.

VICE CHAIRMAN BREAUX: Thank you, Mr. Chairman, and thank the panelists. It was a very enlightening presentation, and a good explanation.

I guess the two questions that I would have, maybe in combination, would be the criticisms we've heard is that it's such an easy tax to increase.

And I wonder if you could maybe comment on the experiences of other countries that have the value-added tax. Is there a tendency to increase the rates easily or frequently?

And secondly, if you could comment just on another point, and that is the question of progressivity, I mean obviously many people would say lower income people have to spend a great deal more of what they earn on consumption, and therefore this is not going to be very progressive, as one of our charges happens to be for the president.

Could you comment on both of those?

PROFESSOR GRAETZ: Senator Breaux, if I could begin, both of these questions really get at the reason that I am arguing that you should use the value-added tax revenues to provide a very large exemption. I say 100,000, I'd be happy for it to go even higher, a $100,000 exemption from the income tax.

And I start with a level of value-added tax, if you remember that chart, that would put the U.S. right up immediately about where the rest of the world is today. I think we're really at the ceiling of where value-added taxes can reasonably go in this 18-19 percent range.

Obviously if you took a value-added tax as some had suggested of five percent and added it on for this or that in America, my view would be that you are going to have a value-added tax of 14 percent before long, and you won't have used it to pay to simplify the income tax or to get rid of income taxation.

So I think that if you're going to do this, you ought to do it large. Do it large at the beginning. Use the money to buy as much simplification and exemption of the income tax as you can. Get as many people out in the system, get the rates down as low as you can under the income tax, and then that would be a stable value-added tax rate.

With regard to the distributional question, I think you have to be very careful with any consumption tax proposal, not just a credit method VAT, but these other moving-toward-consumption tax proposals, to deal with the distributional issues on the middle class and low income people.

I've done that through a payroll tax investment. I thought about the elderly. I think that the elderly are greatly advantaged, again, under my proposal, because their pension income has not been taxed. And it would not ever be taxed once you have a $100,000 exemption for people with income in retirement up to $100,000 which is the vast majority of people.

So they're getting an income tax reduction, and they might get a Social Security benefit increase. And so I think with these two pieces of it, I've really taken care of the middle class.

But I think it's an issue you really have to be attentive to.

DR. McLURE: I would simply add to that that the way not to do it is to exempt necessities or zero-rate necessities, which is done in some countries.

You can see on the slide why you wouldn't want to do it. I won't take our time. But I think that you just don't need it as long as you have these other offsets.

On the money machine problem, that's one that I worried about for a long, long time. Because it's certainly true that European countries have higher government spending than we do.

But they had high government spending before they adopted the value-added tax. And let me say, what they did was basically replace really horrible forms of sales taxes, basically gross receipts taxes on everything, every time a transaction occurred, they taxed it. They replaced those with value-added tax, which gives you credit if you weren't paying tax. And so they improved their taxes, they didn't raise them.

And I don't think there has been a clear trend that shows that those tax burdens have gone up over time because of the value-added tax. I think it is a concern, but I think again that Michael dealt with the potential pretty well.

MR. FRENZEL: Thank you very much, gentlemen, for the splendid testimony.

Looking at Mike's graph on the top of page two showing the unseemly increase in the number of words and pages of the Internal Revenue code, I note that three members of the panel participated in what seemed to be the wildest period of growth.

So perhaps you are lecturing to the unwashed or the unwashable.

PROFESSOR GRAETZ: I won't take that as a question.

MR. FRENZEL: Take it as a comment. But I do want to follow up on John's comment and your reply about the distributional effects on various income levels.

From your reply I take it that you believe that your system has, as you presented it, is a shot at rough justice, but it actually has not been reduced to the usual Washington shorthand of burden per quintile of income.

DR. McLURE: That's correct, although I do believe it to be roughly distributionally neutral.

I think in order to be distributionally neutral at the top of the income scale, you have to retain an income tax. That is, these proposals for a flat rate of tax on either income or consumption, or to replace the income tax entirely with a sales tax or a value-added tax would clearly shift the burden down the income from the top end.

And so I think that - I mean my goal in designing the proposal was to be both revenue neutral and roughly distributionally neutral.

Obviously this proposal will benefit savers as compared with spenders. But in terms of income up and down the scale, I believe it to be roughly distributionally neutral, because the top end would pay both the income tax and the consumption tax, and the low end would be freed from the consumption tax through these offsets.

MR. FRENZEL: If it were shown that the top end seemed to be doing a little better, would you suggest an adjustment for it, Charlie, would you?

PROFESSOR GRAETZ: You could broaden the base of the income tax, if that were a problem. I don't know what you mean, a little better. When you're making this kind of change, my view is if they did a little better, they're going to do it largely because they're saving, that is, because they're not paying as much of a consumption tax.

And if they do a little better because their savings are higher, my instinct would be that the benefits of this kind of change so far outweigh that problem that I wouldn't worry about it very much.

But I would urge that if you're going to worry about it, solve it by broadening the base rather than raising the rates. I would try and keep these rates low.

MR. FRENZEL: Thank you. Are you inclined to agree?

DR. McLURE: Yeah, I think so. First, let me say that 25 percent rate may be misleading. Because remember that on the off chance that someone who has over $100,000 actually spends some of it, they are going to be paying that value-added tax too. So you take something right out of the first dollar over $100,000, they would be paying 25 percent plus if they spend all of that they're going to pay another 10 percent on say the 75 left over after tax.

So it's up about 32-1/2 or so. So it's not a low rate.

MR. FRENZEL: Thank you very much.

MS. SONDERS: You talked about the comparative tax rates here in this country relative to many others.

You talked about tax rates around the world, and compared ours under that proposal to add it on top of the corporate income tax to the rest of the OECD.

Instead of just looking at comparability from a tax rate perspective, talk a little bit if you could about impact on business behavior as well as economic growth in those countries that have adopted a value-added tax in top of an income tax.

And then the second part of that question would be using Italy as an example, the problems of noncompliance and how that is being attacked, and how we would want to consider that, to the extent we consider this as a proposal.

PROFESSOR GRAETZ: I really don't want to go back to my point, which is, what we would be doing in the U.S. is coming down to a low income tax as a percentage of GDP, and putting our consumption tax where other people's consumption tax is.

And by lowering the corporate rate, and lowering the tax on businesses, and I would go lower if I could with the rate, depending on how the numbers work out, I think the U.S. becomes a very attractive place for investment, compared to the way it is today.

So I think it actually advantages U.S.

businesses around the world. And if the corporate tax is simplified, which I think is important - that is, I did mention ways to simplify the corporate tax - I think it is simplified by, for example, starting with book income, and then allowing only those adjustments that Congress chooses, that you can get some of the compliance costs out of the income tax by having a lower rate, and having a closer connection between book and tax income, and eliminate the advantages of these tax shelters in the corporate form, which is where a lot of the action has been over the years.

As for compliance, I'll let Charlie say something about the Italian experience. I think these are taxes that you could collect.

DR. McLURE: Let me respond to the first one. You asked about business behavior.

I think one thing that is very important is, if we lowered our corporate income tax to 25 percent you would see a flood of taxable income coming into this country. If you have your choice whether you'd like to be taxed say at 35 percent somewhere else or 25 here, you would use all the usual techniques, all the transfer pricing, to shift income in and deductions out. You can bet that Canada would react almost immediately to lower their tax rate in order to prevent that from happening, because as you know, when we sneeze they catch cold.

As far as VAT and business behavior, I think it doesn't have much effect. When you think about it, nobody ever talks too much about the effect of the retail sales tax imposed by the states. To the extent that they do, they talk about the effects that occur because the retail sales taxes are so bad, that is, they don't allow exemptions for purchases by business, and they don't tax services.

Well, the value-added tax taxes services and allows a credit for all tax paid by business. Totally neutral, and therefore, you wouldn't have those problems. So I think --

CHAIRMAN MACK: But that's kind of a non-issue.

DR. McLURE: Oh, the noncompliance, I think actually the Italians are doing better. But since I didn't expect this question, I didn't prepare for it. But I think the IRS can handle a value-added tax. I mean if the Germans and the French and the British and the Malaysians and the Colombians and the Chileans do it, I think we can.

MR. LAZEAR: I have two quick questions for you.

First, all tax systems obviously create distortions. What are the largest distortions that you would see associated with an add-on VAT? And in particular, think about the income tax component of it. The VAT part is neutral with respect to present and future consumption, but the income tax part is not.

And if you had, say, a 25 percent tax on income, would that create a significant distortion on saving and investment?

Second, you talked about simplification. Although it's true in your plan that you would eliminate 80 percent of the tax filers, the complexity tends to be associated with the high income individuals.

Would there be an elimination of complexity there? And what about on the business side? Do you get simplification there? Because you still have the corporate income tax and some of the other aspects associated with that.

PROFESSOR GRAETZ: Well, remember, as part of this, I'm urging a great simplification of the business side, particularly for small businesses, but also for larger businesses. I think that needs to be a piece of what you're doing here, and I think it's an important piece of it.

I disagree, by the way, with the idea that the complexity resides for high income individuals. If you're talking about the 150 million people who are filing returns with incomes below $100,000, the majority of them are all using tax return preparers. That's where the free education credits are. That's where child credits and personal exemptions are, saving accounts for this or that.

And so there is a huge amount of complexity on the average American these days. And so I would urge simplification of any income tax that remains. But for me, the key is getting the rate down so that it produces fewer distortions.

I think that in terms of your economic question - what's the effect on the economy? - the chart that shows how low our income taxes would be compared to the rest of the world tells the tale.

That is, it is the income tax which is causing the distortion on the savings-consumption margin. Consumption taxes and payroll taxes both cause distortions on the work-leisure margin. And by getting the income tax down as low as this idea does, you greatly helped economic growth and eliminated or reduced greatly the distortions that now exist.

DR. McLURE: I think I would agree that obviously distortions occur in income tax, and they will be there unless you do something about it. But they will be a lot less important at the lower rate.

The big distortion probably is in the savings consumption choice, and it seems to me that for Michael's tax at the top of the income distribution, that could either be a pure income tax, a pure consumption tax, or something in between.

And given our history, I think it probably would be either something in between, or maybe one of the new proposals for a tax, a direct consumption tax. One needs to think about which of the two alternatives, consumed income tax, or the flat tax, would work better in that environment where only high income people were subject to it, and they may be in one year and out the next. I think those have crucial implications, and I think I know which one we'd want, although we haven't thought about it too much in advance.

I agree with Michael on the complexity. The earned income tax credit is extraordinarily complex. And if we eliminate that thing, it would be a great boon.

Also I think the nice thing about my

proposal of using the payroll tax offset is that you eliminate this phenomenon of the tax anticipation loans, where people who shouldn't be borrowing, and can't afford to pay the high interest rates are nonetheless doing it, in order to get that money from the federal government that the government should have had to start with.

I think this is a tremendous advantage if you can go that way.

CHAIRMAN MACK: Mike, I want to follow on with your comment about the importance of getting the rate down.

Twenty-five percent sounds appealing, but the reality is that individuals would not only be paying the 25 percent rate, I'm talking about the folks left on the income tax, but they'd also be paying some portion of the remaining income, the 15 or 14 or 13 percent VAT.

So where is the real advantage?

PROFESSOR GRAETZ: Well, let me just be clear about how the income tax works.

Everybody gets the $100,000 exemption. And people continue to get deductions for home mortgage interest and charitable deductions and so forth. So they're paying a very low average rate until you move fairly high up above that $100,000 number in terms of what their average rate of tax would be.

And I would keep retirement savings incentives in the tax. I'm a little concerned about moving beyond that so that retirement savings and all other savings are created the same, because I think you may create problems in terms of people not having enough at retirement if you move in that direction.

But so you have a lot of room in that income tax. We're paying low average rates, and then you're paying the value-added tax, until you get up to very high rates. To which my answer is, well, they're now paying 35, 36 percent rates, and it's a marginal rate on incomes taxes. It's causing distortions in the savings-consumption tradeoff, and it's better to have these two instruments with low rates, let the savers pay less, than it is to have one tax carry the whole freight.

And I also want to say that I think if you keep the individual tax rate at a 35 or 36, whatever, 37 percent number, whatever it needs to be in order to produce the revenue you want, and it then becomes very difficult to have a corporate rate that is significantly below that. Because the corporation then becomes a tax saving or tax sheltering device, and we had the accumulated earnings tax, and all sorts of other thins to guard against this in our history.

And the real pressure throughout the world is to lower corporate rates, because that's where the competition from capital is.

And so I think being able to get our corporate rate and our individual rate down, you know, as I say, I think if the numbers work out, you might be able to get a little lower. And if you get lower, I would be for it. But I think you can get to a 25 percent rate. I think it's a big advantage.

CHAIRMAN MACK: Thank you very much. That concludes the panel. Thank you very much for your participation.

We'll take just a minute or two to get set up for this next panel, so just bear with us.

(Whereupon, at 10:41 a.m. the aforementioned matter went off the record, the return on the record at 10:41 a.m.)

CHAIRMAN MACK: We will now start the next panel with Ernest S. Christian, executive director, Center for Strategic Tax Reform; Barry Rogstad, former president, American Business Conference; and Edward J. McCaffery, Robert Packard Trustee of law and political science at the University of Southern California.

Delighted that you all three are with us. I'd like to just make one comment again from a timing standpoint. Each panelist should not feel compelled to answer every question that is raised.

For example if I direct one towards Ernest, the other two don't necessarily have to respond as well.

So from a timing standpoint I would urge that.

Mr. Christian, we will go with you first.

MR. CHRISTIAN: Thank you, Mr. Chairman. I appreciate being here. It is always a pleasure to talk about tax reform.

It seems as though I've spent the last 25 or 30 years talking about tax reform.

Real tax reform is not about dramatic proposals, Mr. Chairman. Real tax reform is about dramatic accomplishments.

I think we've reached the point in the long road to tax reform where we are directing ourselves toward real accomplishment.

Therefore, step one on the road to tax reform should be, first year expensing for business capital equipment, immediate enactment of that.

Immediate enactment of universal savings and investment accounts that will permit all Americans to save and to become owners, the true American dream.

This relief from double taxation achieves 80 or 90 percent of the economic goals of even the most comprehensive tax reform proposal that you're likely to hear about today and tomorrow.

In addition these two simple changes to the current code, within its familiar framework, can readily be made revenue neutral, without even counting feedback revenues from growth, and certainly without doing anything radical that risks disrupting the economy during a transition, or risks tearing the social fabric.

I would emphasize that it is extraordinarily important to avoid changes which upset that fabric, such as excluding large numbers of voters from the tax rolls, such as creating two different classes of Americans, some who pay income taxes, and some who are referred to as the masses and who only pay some hidden form of sales tax - a dangerous idea.

Next slide we see that the elimination of double taxation is the core principle - double taxation on savings and investment is the core principle of nearly all tax reform proposals. Some are experimental, and some have uncertain side effects.

In contrast, first-year expensing has predictable results based on experience, some quite recent experience.

Universal savings accounts are patterned after the familiar Roth IRA, familiar to almost all Americans, and familiar to all members of Congress. After all, the name of the game is to get tax reform enacted into law.

Why go searching for some new magic elixir with unknown results? Universal savings accounts reward work and first year expensing get the job done.

Expensing allows deductions up front, and therefore decreases the cost of capital equipment. Depreciation in contrast postpones deductions, requires companies to prepay tax, and therefore increases the cost of capital equipment.

As we see from both the chart and the graph, the 10-year nominal revenue loss from expensing is roughly $750 billion.

We also see from the chart that the present value in year one is $603 billion. We should keep that in mind, that difference in mind.

Thus, a one-time offsetting revenue gain in year one of $603 billion would pay for expensing, the nominal cost of expensing over a 10-year period.

A universal saving account is like a Roth IRA, except that it is unlimited and not restricted to retirement savings. Deposits are made out of current year after-tax earnings.

A universal savings and investment account will function much like a brokerage account. People may withdraw or add money whenever they wish. Because these accounts are funded with after-tax savings, withdrawals are not taxed. For the same reason, interest, dividends and gains on investments inside the account are not taxed.

The pattern of revenue losses from universal savings accounts is the opposite of first-year expensing. Because no up front deduction is allowed for deposits into the account, the revenue loss is small in the beginning and builds up slowly over time.

The combined revenue cost for expensing and universal savings and investment accounts can and should be paid for in a familiar and non-radical way.

First, in order to do that, you will need to expand the universal savings and investment account concept to allow the owners of existing investment portfolios to transfer those stocks and bonds into a universal savings and investment account.

Second, you should require those people to pay a voluntary toll charge - and they will do it - to pay a voluntary toll charge for the privilege of transferring existing savings in the form of financial assets into those universal savings and investment accounts.

Many tax reform proposals that you have heard about or will hear about automatically and without charge exclude from additional tax all future dividends, interest gains, and so forth on existing savings, as well as new savings. After all, most existing savings has already been taxed, in most cases numerous times.

But then those proposals go on to make up the revenue loss elsewhere in the code, often in a radical manner.

I think it is better to pay for this transition cost on old savings, so to speak, in a traditional manner with a voluntary toll charge. In addition I suggest that everyone who has tax deferred savings today in a 401(k) plan or other similar arrangements be given the option of paying a toll charge, a realistic toll charge, for converting those tax-deferred plans to the yield exempt Roth IRA of retirement savings.

How much is available that might be transferred to universal savings accounts? We see from some Federal Reserve data that approximately $21.4 trillion of liquid financial assets, roughly speaking, are out there and eligible to be transferred or converted.

The theory of this toll charge is as important as its amount. Economists tell us that a share of stock is worth the discounted present value of the future stream of dividends and gains that the market predicts it will produce.

Under current law the owner of a stock is required to pay a 15 percent tax on those future dividends and gains, and because the value of a stock is equal to the present value of the future stream, current law in effect imposes a 15 percent tax on the value of stock, on capital.

If, however, the share of stock is put into a universal savings and investment account, the owner will not have to pay tax on the stream of dividends and gains in the future, and therefore, the implicit 15 percent tax on the value of the stock that would exist today is removed.

I suggest that in exchange for removing that 15 percent tax on the value of the stock a one-time voluntary toll charge of 10 percent of the value of the stock is appropriate.

Now in the next slide, we see a simple example. I'm not going to read that example. It is straightforward and quite understandable I believe.

The main point is that Mr. Jones in this example would be strongly motivated to pay a $10 toll charge for putting his stock in the universal savings and investment account.

The rule of thumb illustrated by the example is that one ought to be willing to pay $10 in exchange for $17. That seems to make sense.

Therefore, there should be quite a bit of transfer of existing savings into universal savings and investment accounts and payment of toll charge.

We have experience with toll charges. The American Jobs Creation Act of 2004 allows U.S. companies to repatriate accumulated foreign-source income upon payment of a 5.2 percent toll charge.

Indications at the present time, pending some clarifications under Treasury regulations indications are that about 50 percent of the eligible amount will pay the toll charge and be repatriated.

In those cases where the assets are liquid, and the repatriation is more clearly advantageous to the company, pending regulations, the rate of repatriation is likely to be close to 100 percent.

Since 1997 we've had experience with toll charges on people converting Roth IRAs. There's been quite a bit of conversion in spite of the fact that the toll charge is extraordinarily high, and the ability to convert a 401(k) to a Roth IRA is very restricted as to those who are eligible.

CHAIRMAN MACK: If I could get you to wrap up here if you could.

MR. CHRISTIAN: Yes.

Therefore, I think we have a reliable mechanism in terms of budget impact. The slide shows that we have a net present value, budget impact, with a 10 percent toll charge, would pay for expensing, pay for the universal investment account, and would leave $140 billion left over.

With a 12 percent toll charge and a 75 percent transfer rate, everything would be paid for, and there would be more than $800 billion left over.

I'm not giving you a precise revenue estimate, Mr. Chairman, but I am suggesting that this mechanism does work. I am suggesting that within this framework the Treasury's expertise, and the expertise of the financial community can come up with an optimum toll charge rate which will produce a substantial amount of conversion and transfer.

And I am suggesting that we have before us the option of a simple, effective, revenue neutral approach to tax reform that can be enacted and will work. And I hope you will include it in your recommendations.

Thank you very much.

CHAIRMAN MACK: Thank you.

And Barry, should we go on to you next?

DR. ROGSTAD: Thank you, Mr. Chairman. And good morning. I appreciate very, very much the opportunity to appear before this panel to discuss with you the simplified USA tax, SUSAT for short.

The generic SUSAT framework directly deals with a great concern that the panel has been discussing in the past about the role of the tax code in impeding the nation's economic growth. I won't go into those.

The SUSAT framework as it now is is developed and written into the code is a vast simplification of the code that reduces the size of the code to a small fraction of its present size, which is straightforward in its presentation, and I think most importantly in an issue that I want to underscore, it's the income tax system that's understandable to all users. Next slide.

SUSAT consists of two parts: a portion of the tax is collected at the business level, where income is produced; the remainder of the tax is collected when received at the household individual level.

Let me highlight a couple of points on the business side if I may.

The simplified USA tax treats all businesses alike. There is no distinction between the corporate and the non-corporate form.

It lowers tax rates dramatically. It provides for first-year expensing of business equipment; helps to level the playing field in that export income is excluded under the business tax base. And because of its territorial approach, foreign source income is excluded in the SUSAT business tax.

The provision of territory also allows for the option of an import tax to be imposed, and significantly in contrast with our current business tax system, there is a wholesale elimination of a host of special provisions.

On the individual side, first and foremost, SUSAT provides an unlimited ability of individuals to save at any level and for any purpose through the pattern now known, the familiar pattern known as the Roth IRA. It is in fact an unlimited Roth IRA.

No longer are taxes paid twice under this system. It has the capacity to maintain the current treatment of certain itemized deductions which this panel has called for in particular charitable giving and home mortgage interest.

It also, in its generic structure, has set up a deduction for human capital, in the form of a post-secondary education deduction allowed for each individual, and it lowers and flattens the tax rates, but at the same time preserves the progressivity of the current income tax system.

Let me turn to how it works. It involves only a few steps in the tax calculation. The basic corporate income is from revenues and domestic operations, from which is deducted export income. Also deducted are all purchases from other businesses, inventory, equipment, and services.

On that tax base is applied tax rates of eight and 12 percent. The eight percent rate applies to the first $150,000 of business income. That is simply the tax, together with the rates, the tax liability of the business.

Business also under this proposal receives a tax credit for the employer-paid payroll tax.

I want to note the distinction between the business tax under the simplified USA tax from current code. In particular there was no deduction for wages paid, and there is no deduction for interest paid. What this provides for, then, is that equity and debt financing are now treated equally under this system, and wages along with all other returns to capital are now taxed exactly alike.

Now, as I said, it's a two-tiered tax, with wages and interest and dividends partially taxed at the business level. Those factor payments now flow through to the individual household level where wages, interest, dividends, sale of stock, and also other assets, form the taxable income. The generic SUSAT applies rates of 15, 25, and 30 percent. Those are illustrative. We also incorporate the provisions of current code to have a 15 percent rate on dividends and gains.

Treatment of savings is important here.

That's the revolution on the household side. Under a universal Roth, which is the provision that satisfies the unlimited savings provision here, there is no deduction for the amount saved, but once deposited into a Roth account, returns on that saving in the forms of interests and dividends is forever outside the tax system.

SUSAT as it's presently formulated does allow for a continuing deduction of traditional IRAs, 401(k)s, et cetera. There are other deductions as well to the individual and the family living allowance we call it, which is an exempt amount. And there are in addition to those individual deductions there are allowances for home mortgage interest, charitable, and the secondary education deduction I mentioned.

If I may I'd just like to mention the origins of SUSAT for a minute, because I think it's important. SUSAT and the whole USA framework is a distillation of a bipartisan process that's gone on for almost 15 years. It was originally started by current Senator Pete Domenici, former Senator Sam Nunn. In 1991 they were chairs of something called the Strengthening of America Commission. And they worked over the next four years to develop their unlimited saving allowance USA tax proposal.

I think their guidelines were very meaningful. First and foremost they made the decision that we ought to do this within the current framework of the understandable income tax. They said we needed to follow a proven intellectual pedigree, and the core framework that we relied on all the way through was the well known ideas of David Bradford.

Mr. Chairman, I would respectfully suggest that we'd love to have him here with us today, all of us.

Thirdly, they wanted to ensure bipartisan support and involvement throughout the process. And from my standpoint what that really means is that they demonstrated a good tax policy, good tax principles lead to good politics.

And finally the framework was always one of revenue neutrality and progressivity. I should note that in fact Congressman English, who was part of this process, introduced what is known as the simplified - what I'm talking about today - the simplified USA tax into the House in 1998.

A word on why simplification, if I may. The original USA tax was in the genre of a consumed income framework. Within that approach you had a deductible unlimited. As Michael Graetz even pointed out earlier, it led to complications, and those complications were, how in fact do you deal with what's known as old savings.

And there were transition kinds of questions, and we developed all kinds of accounts for old, new savings, net, gross saving, et cetera, and it did get complex.

The introduction of a Roth IRA that we've been talking about here eliminates all of that complication, and I think is what really makes the USA tax framework now workable, understandable to the American people. And that is really the revolution, and why we're emphasizing similar simple USA tax.

In summary I would advance to you that the USA tax as simplified is a technically correct and usable and understandable approach to tax restructuring. There is really nothing new about it. It works with all the pieces that we've been discussing in the tax code for years. And I would suggest to you, if you look at what people might interpret as progress in the income tax system over the last 10-15 years, we're moving it inexorably in this direction.

Again, I want to emphasize as others have that preserving the income tax structure eliminates the need for a whole new level of mechanisms and administrative bureaucracy. It does address all of the criticisms of the current code, and we think lends itself to drastically reduce taxpayer mistrust and greater understanding. And I think it has proven bipartisan appeal.

For all of those reasons, and some others I hope we can talk about in the Q&A, I would respectfully suggest that the simplified USA tax is worthy of the panel's full consideration.

I thank you for time to speak with you.

CHAIRMAN MACK: Thank you, Barry.

And Ed, we'll go to you next.

PROFESSOR McCAFFERY: Great. Thank you, Mr. Chairman and panel, for doing all the work you've been doing over these many months.

I'm a teacher. I'm a law professor out at USC and Cal Tech, and I'm going to teach in my 10 minutes here. I've written a book called Fair Not Flat, and that has more details.

To begin with last words, I think a lot of tax is about timing. And it's time to get the fair timing of tax done right. In America we tax people when they work, when they save, when they marry, when they give, and when they die. And I think these are wrong times to tax. I think we should tax people when they spend, and only when they spend.

That leads me to talk about a consumed income tax, and I'm really going to talk about a traditional David Bradford-style consumed income tax.

From where we are, we can get there very simply. We place all savings accounts on the traditional IRA models, the 401(k) model. We have an unlimited deduction for savings. We remove all limits on the contributions to and withdrawals from such accounts, and then very importantly, I think the fatal flaw, really in the Nunn-Domenici 1994-1995 proposal was the failure to include debt in the tax base. You have to include debt in the tax base, as you do under a sales or spending tax.

Those three steps: unlimited traditional IRA accounts, no limits on contributions to or withdrawals from, and the inclusion of debt - gets us to the promised land of a consumed income tax.

Once we do that, we can repeal capital gains preferences, repeal the gift and estate tax, and repeal the corporate income tax for the reason that a consumed income tax does tax the yield to capital for reasons I'm about to explain.

The next slide I want to back up and talk about some traditional tax policy, and where traditional tax policy has gone awry. There are three types of comprehensive individual tax: an income tax; a prepaid consumption tax; and a post-paid consumption tax. The post-paid consumption tax is also known as the consumed income tax.

The income tax is based on both consumption and savings, all sources equal uses, inflow equal outflows. That's the Haig Simons definition. Income equals consumption plus savings.

It is, as John Stuart Mill pointed out in 1848, a double tax on savings.

Now there are two forms of consumption tax. The prepaid consumption tax is a wage tax. It works like the Roth IRA, which my fellow panelists have been touting and I am not a fan of. Under this model we pay tax now, not later.

A post-paid consumption tax is a spending tax or a sales tax. It's equivalent to the value-added that Michael and Charlie McLure were talking about this morning.

It's also a consumed income tax, and it works on the traditional IRA model. We pay tax later, not now.

Such a tax can be predicated on annual

returns in the manner that first Nicholas Kaldor and later David Bradford pointed out so eloquently; Bill Andrews also at Harvard Law School.

Consumption equals income minus savings. If we add in all income, including now debt, and subtract savings, we're left with consumption as the ballast.

The prepaid and the post-paid consumption tax are equivalent under constant rates.

Next slide gives the key insight that the equivalence of the prepaid and post-paid consumption tax does not hold under progressive rates, and we've always had progressive rates in this country, and the charter to this panel includes our own president's commitment to continue progressivity.

Given progressive rates, the three taxes have very different effects.

An income tax double taxes all savings. A prepaid consumption or wage tax ignores all savings. But a consumed income tax, a progressive consumption, post-paid consumption tax, a progressive sales or spending tax, splits the difference in a principled way by design.

Now the next slide, and a lot of this I've worked out in much more academic detail, but I'll be brief and hopefully nonacademic here, we can think of two broad types of savings, or two broad uses of capital.

One use is to smooth out - what I call smoothing. This translates uneven earnings into smooth or even consumption. It moves individuals and taxpayers, households, earnings around in time to times of greater need, such as retirement, education or medical needs.

A second use of capital and its yield is to shift consumption patterns up or down.

The three taxes again: an income tax double taxes both uses, a prepaid consumption tax ignores both uses, but a consumed income tax favors or does not disfavor smoothing, but falls on shifting, it falls on enhancing.

Next slide, and here I have to thank your wonderful staff, particularly Itai, for keeping the number of graphics I put in the presentation to a minimum, this slide gives a very simple picture of smoothing transactions.

As all of us know, all of us who are parents know, and all of us who are people remember, we come into this world as consumers. But as all of us who are parents know, we don't come into this world as earners. We build up our human capital, and then for a short period of life, and increasingly shorter as a percentage of the period of life, we earn labor market earnings.

In order to balance our own books on an individual level we have to borrow, either from our parents or in a formal way, to spend in our youth, and we have to save in midlife to pay off the debts of our youth and to pay for our retirement.

So an income tax and a prepaid consumption tax tax you on that solid labor earnings life. The decision of progressivity falls on it.

A post-paid consumption, or spending tax, falls on that dotted line, the consumption line. So savings that bring down our bunched labor market earnings into that smooth line lower the burden of taxation under a post-paid consumption tax.

Now the next two slides, which on the plane I decided I'll write up as a Tax Notes piece, I started writing on hybrid income consumption taxes, my second academic piece, in 1992. And at the time I said tax policy was not to design ideal income or consumption taxes, but rather, ideal hybrids, because we have mixed thoughts about savings.

Fourteen years later, I'm embarrassed to say, I've somewhat rethought that position. And prompted by this panel's own reflections on hybrid income-consumption taxes, I now have thoughts about good and bad hybrids.

A bad hybrid is a cut-and-paste mix-and-match income and consumption model. If we take the current income tax, with its realization requirement, the non-taxation of debt, and we simply add on prepaid consumption taxes, the Roth style accounts, then savers can put old savings into Roth-style accounts. And here I am more skeptical of the toll charges that would minimize this problem.

There is no help for the middle class living paycheck to paycheck. These people don't save because they can't save, and yet a prepaid consumption tax gives no immediate deduction for savings. The result is no new savings.

If on the other hand we take an income tax and add on a post-paid consumption tax, the traditional IRA or 401(k) model, taxpayers can put money into a traditional IRA with one hand, and run up credit card debts with the other hand. The result is a tax deduction with, again, no new savings.

Based on his analytics, it should be no surprise that the Urban Institute recently found that we spent more money in foregone revenue with tax favored savings provisions than we generated in new savings last year.

The next slide gives a note on a good hybrid. A good hybrid would tax some but not all savings. What savings do we not want to tax, not want to double tax? Smoothing, or savings for ordinary uses, retirement, education, medical needs, and I believe intra- or intergenerationally.

What kind of savings do we want to tax? Shifting savings, savings that allow greater lifestyles, that allow people to live better than they would without that yield to capital.

A progressive consumed income tax does this by design, without the need for ad hoc exceptions. It moves when you move from high earnings periods to those of greater need, you lower taxes. When you live better off the yield to capital, you raise taxes.

Next, and penultimate slide, summarizes the consumed income tax, how it would work. A consistent consumed income tax encourages savings for ordinary purposes. It taxes capital when its yield is used to elevate or enhance lifestyles, but not otherwise.

It discourages consumptive debt, which is an important thing in a country. Alan Greenspan would like this presentation. It encourages real savings across generations, not the illusion of savings. And it's a mistake to think that a conversion to a consistent consumed income tax, it's a mistake to think it's radical, as hopefully the first slide indicated, and it's a mistake to think that it would need higher rates.

The standard result in the literature is that if we move from an income tax which includes savings to a consumption tax which does not, we need higher rates.

The problem with that is we're not taxing much savings today. Under a consistent consumed income tax we have no need for a capital gains preference, a base-broadening move. And under a consistent consumed income tax we pick up debt financed consumption, another base-broadening move.

Finally the last slide gives some take-home points. I think tax reform is needed. I've spent my life believing that tax reform is needed.

One thing to say, by the way, as Charlie McLure said at the end of the first panel, this proposal for a consumed income tax works perfectly with Michael Graetz' proposal. It doesn't make Michael Graetz perfectly happy, but it, a consumed income tax, is analytically equivalent to a sales tax, or a value-added tax. So the two lowest rate brackets can be met with a national sales tax or a value-added tax, credit invoice, or any other method, and a rebate to create a zero bracket.

So tax reform is needed. Point number two, we do not have, have never had, and will never have, an income tax. I'm sorry to say that to a panel on income tax reform. But because of the low, deferred, and avoidable taxes on capital, we have never had an income tax. When we add the tax we have with the payroll tax, weak corporate and gift and estate tax, we have a prepaid consumption tax, we have a wage tax.

Prepaid consumption taxes are wage taxes. They put no burden on the wealthy. They generate no marginal incentive to save. It is where we are, not just where we are headed.

Post-paid consumption taxes are consumed income taxes. They are spending taxes. They can be progressive, and they eliminate the need for separate capital taxation because they tax the yield to capital at the individual level when it's normatively appropriate to do so.

Therefore we can repeal capital gains, gift and estate, corporate income. We're basically getting rid of the tax concept of basis, and it is where I think we should be headed.

Many more details and additional slides in the appendix.

CHAIRMAN MACK: Thank you very much.

And Ed, we'll turn to you.

MR. LAZEAR: It's been argued by many that the USA tax or versions of it are an implementation nightmare in terms of trying to keep track of borrowing and flows from one kind of account into another kind of account.

Can you address that, and tell us why that is not a problem?

PROFESSOR McCAFFERY: I think, Senator, I think there are two problems. One Barry alluded to is the problem of pre-enactment basis. Two solutions to the problem of pre-enactment basis, one coming from my former teacher at Harvard, Louis Kaplow: ignore it. It's a sunk cost.

Something to be said for that in the sense that I'm not sure how much basis there is out there. These days there are a lot of ways to not have basis.

So one way is to ignore it. Another way is to amortize it, give some kind of credit over time.

The other problem which you alluded to is about picking up debt. That was in my estimation, not pre-enactment basis but the failure to pick up debt, was the fatal flaw in the USA tax. If you don't pick up debt, you get a deduction for savings on one hand, but non-inclusion for debt on the other hand. You've arbitraged tax out of existence.

But I'm sanguine that you can pick up. It's a cash flow tax. It's very easy to audit, because you have lifestyle audits. If people are spending, they should be paying tax. You could substitute a sales tax or a value-added tax, but basically we would have to rely on financial intermediaries, as we do today with the 1099 forms, to pick up debt.

MR. CHRISTIAN: May I, Mr. Chairman?

Let me respond if I may. This is a very fundamental point. And I respond from the standpoint of, I drafted the original USA tax, every jot and tittle. I drafted the simplified USA tax that we are talking about today.

No one except in an academic sense is any longer concerned about the so-called complexities that were associated with the original USA tax. What we demonstrated to ourselves at that time, hand and glove with two major Senators of the United States, is that it is impossible to implement the classic in real time, real life legislation, this classic idea of a consumed income tax where you deduct the amount saved and tax dis-savings.

No one that I know of thinks that will work. And as far as debt being taken into income is concerned, I recall a conversation with Senator Sam Nunn when I raised this with him. He said, Ernie, you explain to the American people about why they have to pay tax on debt as income. I said, yes, sir, we'll do it another way.

And that complicated it greatly. But we solved all those complications. The simplified USA tax has none of these problems about accounting for basis, old savings, new savings, net savings or gross savings, or all the other complex mechanisms that I created for the two senators in the original USA tax.

And I will tell you, it is an extraordinary job to try to draft one of these consumed income taxes. It's a nice idea in theory. I've spent 25 or 30 years playing around with the concept. Finally we've managed to translate the good results into a workable system that the American people can live with.

MS. SONDERS: Thanks, gentlemen.

Staying on the SUSAT for a minute, you all talked about your various proposals and the effect on distribution tables. And I won't ask you to go into detail on those. We're assuming some relatively similar level of progressivity if not better.

But there is another way to look at fairness besides just deciles or quintiles on distribution tables. But also based on filing status.

Have you found that there is any significant camp of folks, whether it's by filing status or otherwise, that gets hurt under a structure like this? Head of households as an example, perhaps.

DR. ROGSTAD: I don't think so. I don't think so. I think that one of the issues that Ed talked about was the smoothing question. You could put a lifecycle income in - how you allow an unlimited savings allowance to run across somebody's total income or total consumption patterns over their lifetime could make a difference. I think that's an issue.

It's one of the reasons why we still have a traditional IRA in SUSAT so that in fact somebody could use that mechanism for that smoothing. I think in sort of an ad hoc sense that could be a form of discrimination that you're alluding to, and I think having both provisions in there takes care of that.

MR. FRENZEL: Thank you very much, gentlemen. I'd like to ask Ernie and Barry, we've had a bit of trouble recently with the late departed DISC-FISC, and currently ETI, or maybe it's something else now.

Is SUSAT in your opinion compatible with the accepted rules of the WTO?

MR. CHRISTIAN: Mr. Frenzel, yes, it is comparable with the WTO rules. It does permit exports to be excluded. There is no complication about excluding exports. Just exclude export income.

You don't have to have all these tracking mechanisms that Charlie McLure, and my friend Mike Graetz talked about. All these European-type French mechanisms that lawyers and accountants and other people like to play with.

I was once fascinated with those things myself. But they're unnecessary.

The key to what the business tax is under the Simplified USA Tax, just to show you that I've read a few books myself, is Dave Bradford's X-tax.

The leading thinker in this whole area is Mr. Bradford, as you know, Mr. Freznel. David Bradford's X-tax is the corporate income tax we have today, stripped of all the nonsense that's been put on it all over the years with no deduction for labor, no deduction for interest, no deduction for dividends.

Therefore, both factors of production, labor and capital are taxed. A tax is collected at the business level, where income is produced. That's the X-tax.

Some people like to refer to it as a subtraction method value-added tax. Well, that's really a misnomer, because the value-added tax is a gross receipts tax or a disguised sales tax.

If you want to have a sales tax, have one. But this is a corporate tax that David talked about, and that's the corporate tax that we have under SUSAT. It differs from the current corporate income tax in two respects: it doesn't allow a deduction for interest, and it doesn't allow a deduction for wages paid.

But it does allow companies a credit for the employer payroll tax on those same wages, which are not deductible. Once you get the corporate rate down low enough, you see that there is an equivalency between the payroll tax and deducting or not deducting wages against a 10 or 12 percent rate for example.

The answer to your question is, exports can be excluded.

MR. FRENZEL: Mr. Rogstad, that's your experience as well?

DR. ROGSTAD: Yes, sir. I think that the change in the current corporate tax that Ernie talked about in terms of eliminating those two deductions, the deduction for wages and the deduction for interest, makes that system compatible with international tax treaties.

VICE CHAIRMAN BREAUX: It seems to me gentlemen that your ideas - I appreciate your presenting them - I was just wondering, the ideas that we've discussed generally have been tried in other countries and other jurisdictions around the world.

Any of your ideas been tried by any other countries anywhere with any degree of success?

PROFESSOR McCAFFERY: Probably I speak for all the panelists to some extent. These are based on things we're already doing.

So we have a 401(k) plan. We have IRAs. And simply repealing it, the picking up of debt is an important point.

One thing about the picking up of debt, though, is you do pay tax on debt under a sales tax, under a value-added tax. If you buy goods on a credit card, nobody asks you where the money is coming from. You pay tax then.

So the only new element of my proposal would be having to pick up debt. Otherwise this is an adjustment to the income tax that is already in place.

One other thing I'll give a little shout out for, the thing I said at the beginning, that we should tax people when and only when they spend, I've long been a liberal fan of getting rid of the estate tax for the simple reason that dead men don't spend. And in terms of just abolishing the gift and estate tax, that's becoming a bit of a worldwide trend with Australia, Israel, Canada which has a stepped up taxation on gains.

VICE CHAIRMAN BREAUX: Mr. Rogstad.

DR. ROGSTAD: I agree with that.

I think, Senator, that one of the interesting issues here is, it's the experience of the U.S. that I think is important. I'm not one that just internalizes to say, let's tear out the current income tax system.

I think if you could make it transparent and understandable to people, and perceive that everybody is playing by the same rules, which I think this provision makes possible, our experience with the income tax system provides the best foundation for the panel to move forward on.

VICE CHAIRMAN BREAUX: Anybody else tried yours?

MR. CHRISTIAN: We've tried it here in various forms, as Mr. McCaffery said.

To the best of my knowledge no one has ever, around the world maybe I'm incorrect in this -- has ever enacted and implemented a classic consumed income tax. In terms of my proposal, in terms of Simplified USA Tax, all the elements here are American elements. They are elements that are drawn from our current income tax but they're done correctly.

The only thing that has not been tried here before is the foreign side, and that is the export exclusion and there is in the Simplified USA Tax a territorial rule. Almost all other countries tax territorially. We traditionally have taxed on a worldwide basis.

Almost all other countries exclude exports. We traditionally have taxed exports. So those are the new items.

I will say that the European credit invoice VAT that was talked about in the first panel is the only real exotic import that I think we've talked about today, and it is an exotic import that is contrary, in my view, to American experience and the American ethic in the politics of taxation.

CHAIRMAN MACK: Do Ed or Ernie, either of you, have you calculated the distributional consequences of your proposals?

PROFESSOR McCAFFERY: Can I take the academic Fifth? So I'm just an academic. I've sketched out things. I believe -- one point I've made is, I think it's a mistake to think it's a radical shift in distribution because we're radically shifting from the income to a consumption tax.

We already have a hybrid. This is being more systematic, and what we're going to be losing in terms of the unlimited deduction for savings we can make up with the repeal of capital gains preference. You don't need a capital gains preference inside a traditional IRA, and the inclusion of debt financed consumption. But I need people inside the beltway to help me out on the scoring front.

CHAIRMAN MACK: But your instincts are that it's not a major shift?

PROFESSOR McCAFFERY: Yes, exactly right, Senator, those are my instincts.

CHAIRMAN MACK: Ernie?

MR. CHRISTIAN: The Simplified USA Tax does not bring about any major shift in distribution effects. That's what I can say that with great certainty.

I would point out that the rates of tax that Mr. Rogstad talks about could be much, much, much lower, down in the teens, and still be revenue neutral, if you utilize the toll charge that I talked about in my testimony, which not only pays for expensing, which is an element of the Simplified USA Tax, but pays for the savings treatment, and has money left over.

You are looking at the possibility of combining expensing, simplified USA, the toll charge, and the savings element together, and having an extraordinarily low set of rates, would then have a distributional pattern that I think would be to everyone's liking.

MR. POTERBA: Mr. Christian, let me pick up on the toll charges. I'm curious about whether you're worried about potential abuse in the valuation of assets that might be moved through the toll gate in this setting. We're moving publicly traded securities from an existing owner into these accounts. It seems relatively straightforward to monitor the valuations. But for anything non-traded - a part interest in a business, a rental property, something like that - it seems to me there is tremendous opportunity for calling the value at the time of transfer something below the current market value, and then basically capturing all of the incremental return when it is ultimately into the tax deferred and tax exempt state.

MR. CHRISTIAN: Good question. I'm not concerned about it because in the contemplation of the toll charge, remember we are working off the concept that is in present law of the Roth IRA, except we're just not limiting it to retirement.

Therefore we are talking about essentially financial assets, the kinds of things that a Roth IRA today can invest in. A Roth IRA today basically invests in market securities, things that are valued by the market. And that's the reason on the Federal Reserve flow of funds table that I had on one of the slides, the only parts that I was taking into account was what seemed to be the liquid market determinable, almost cash equivalent, kinds of assets that we think about in these terms.

Therefore, I do not believe that there is a valuation problem. It does, as you point out, leave a certain very large amount of capital outside.

CHAIRMAN MACK: Because of time, let us move right along.

MS. GARRETT: Sure. Ed, I want to ask you about your bad hybrid slide, which was similar actually to Michael Graetz' last side on the five easy pieces, and the difficulties with that sort of an approach.

You both identified the problem of interest and tax sheltering. You also identified the problem of windfalls to old savings.

Is there anyway short of your proposal that is more incremental where you could retain the sort of hybrid that we have now, but ameliorate some of those concerns? Or is the only solution to do something along the lines that you propose?

PROFESSOR McCAFFERY: I'm skeptical. I think the current income tax, we've had a lot of experience with the current income tax. We've had the income tax since 1913, and we've had the United States Supreme Court opinion in Eisner v. Macomber in 1920, that killed the income tax.

So the entire time we've had an income tax we've had a realization requirement. One of the things I say in my additional slides and in my work, and anybody listening if you want some personal tax advice, I say my tax planning 101 three words: buy, borrow, die. So if you buy assets that appreciate without spitting out cash, you borrow against them to finance your lifestyle, you die and you get your stepped up basis, and then you pay off your debt, you pay no tax. No payroll tax, no income tax, no gift and estate tax.

So I think the way that the system we have now is a very, very leaky vessel for trying to promote savings. And I think it's no - I realize it's very difficult to have a conversation with the American people about debt levels. I think it's no surprise that we wake up 100 years after the income tax was invented with a country with laughably low savings rate, high consumptive debt. We've got trouble.

So I don't think mixing and matching, cutting and pasting, trying to get a tax that is theoretically committed to double taxing savings, which we don't really want to do, and adding in pro-savings provisions I think you end up in a place, as the Urban Institute told us, where we're spending more money to incentivize savings than we've getting savings.

And I think we have to do - there's a line, just one final thing, the line is from Thoreau, I think it's Thoreau or Emerson, what everybody always forgets is the first word, which is "foolish." "A foolish consistency is the hobgoblin of little minds adored by statesmen, religion and divines." A principled consistency is what I think we need. And if we just have - we're part income, and part consumption, and we don't have principled consistency, I'm skeptical we'll get the goal we want - more savings, less consumptive debt.

CHAIRMAN MACK: Charles?

MR. ROSSOTTI: I'm just interested, Professor McCaffery, how you would implement this concept of taxing debt.

PROFESSOR McCAFFERY: Well, thank you, Commissioner. And that gets back to Professor Lasear's opening question. I think basically in terms of the accounts, the unlimited savings accounts, that's relatively easy. We track contributions to and withdrawals from, and we do that today.

In terms of picking up debt, I think we need the help of financial intermediaries, much as we got that help with the 1099s.

MR. ROSSOTTI: But what help do we need from them? Just mechanically, what do you envision?

PROFESSOR McCAFFERY: Informational returns, miscellaneous returns.

MR. ROSSOTTI: Reporting what?

PROFESSOR McCAFFERY: The total, the amount of debt, the amount of credit card, the balances at the end of the year minus the balances at the beginning of the year. You know, Bill Andrews in his 1974 piece talked about this. It's been discussed in the literature. There are mechanisms for doing it.

The other thing that I alluded to in the face of Professor Lasear's question was, in terms of enforcement we at least do have a straight on shot for lifestyle audits, because we don't have to make any indirect argument. If someone is spending $100,000, $500,000, a million dollars a year, it ought to be on their tax returns.

So I think the combination of third party financial intermediaries reporting on account balances and credit card receipts and other lenders reporting that, and backed up. And we can also at the lower levels put in place a sales tax or a value-added tax which automatically includes debt without any complexity.

MR. ROSSOTTI: I understand how you could go that way.

CHAIRMAN MACK: Thank you, all three of you, for your presentations and participation. And we'll move on to the next panel.

CHAIRMAN MACK: Thank you, gentlemen.

And Tom, it's nice to see you at the microphone.

MR. WRIGHT: Well, thank you, sir. Am I on?

CHAIRMAN MACK: About to be. We have two individuals on our panel, next panel on the retail sales tax. Thomas A. Wright, Americans for Fair Taxation; and David R. Burton, partner at the Argus Group.

Again, welcome both of you, and whoever is going to go first.

MR. WRIGHT: I'll take it. And the magic of this button is, I'll push - there we are.

Senators and panel, thank you very much for having me here today, and again, I express the regrets of our chairman, Mr. Leo Linbeck, who could not be here due to some health problems.

I'm reminded of a quote from Thomas Jefferson when he was asked if he was there in Paris to replace Benjamin Franklin, to which he said, and I'll paraphrase, no one can replace Mr. Linbeck, but I am his substitute for the day.

By way of introduction to myself, I am an entrepreneur. The average size of the companies I've worked in in my life are about 20 employees. I fit in with the people who spoke to you in Tampa.

And while I have not suggested how tax law should be written, nor have I passed it, nor have I interpreted it, but I have enforced it on my employees, and lived it out there in the real world. So I bring that perspective to you today.

I am sure each one of you have seen the enthusiasm of our grassroots as you have read what you have done, as you've run into them on airplanes, as you've run into them in airports and in the hallways.

We are an enthusiastic group with the political will to replace the current system as we know it. To quote my friend, Jack Valenti, "it is time to stop tinkering in the margins; it is time to replace."

And our grassroots does have the political will to do that.

We intend to replace the federal income, the state and payroll taxes. We intend to do that with a simple, something my 15-year-old daughter buying her I-Pod Mini can understand. A tax system that's simple, that's transparent, it's at the bottom of every retail sales tax receipt.

And it is applied to the existing successful efficient and well known state sales tax bureaucracies. It does generate sufficient revenue to replace, dollar for dollar, all of the taxes that we're talking about replacing.

It prebates every family so that no family in America pays any tax up to the poverty level.

It taxes all new goods and services without exception one time at 23 cents out of every dollar spent. I emphasize one time, because many of the hybrids that have been discussed here, you get some of each to begin with, but inevitably, that becomes too much of all. This is one tax.

It does eliminate all other taxes that are embedded, ingrained, cascading throughout the entire supply chain of American manufacturing or service delivery.

It does end any chance of a hybrid system, because we also have in our plan the repeal of the Sixteenth Amendment. I believe we are the sole proposal which can survive without the Sixteenth

Amendment in place.

And we do this, we bring you this proposal, after thorough polling of the American public. We did not name this the Fair Tax; the American public did. In the polling that we did with them, in the focus groups that we did with them, in the test markets that we did with them, to develop this, along with thorough academic research over the last eight years to ensure that this is truly a workable system, a nonpartisan and apolitical system bent on simply, efficiently funding our government, and no other means.

These are the criteria that you've discussed earlier, that you asked us to address. I'm going to go straight to number nine and discuss fairness.

I want to discuss two aspects of fairness. One is our polling. We went out to the American public and asked them, how do they want to be taxed. How are they willing to be taxed? What are they willing to tolerate?

They named this the Fair Tax; we did not. But that's what came back from them.

The second thing I want to discuss on fairness is, we have built an income tax system, we have built a tax system, with an army of some 18 million non-filers. Those non-filers are people who are burdening, particularly low income people, with the taxes that they are not paying.

So a tax that does indeed bring those non-filers back into the system is a tax that is certainly more fair to all Americans, but certainly most fair to those at the low income scales who cannot afford the kind of burden that these no participants put on them.

We believe we will make America a competitive juggernaut. None of the alternatives that you have heard about, or will hear about in the next day, combines all of the following.

Most importantly, we tax all imports sold in America in exactly the same manner that we tax all goods and services manufactured or delivered in America. We even the playing field.

We bring the most fertile possible investment tax environment to the United States, with a zero rate on corporate taxes.

You have heard Greenspan say it, you have heard Feldstein say it - Friedman say it, sorry. People don't pay taxes. Sorry, corporations don't pay taxes, people pay taxes. Only people pay taxes. The Fair Tax acknowledges that.

It will make us a magnet as you heard earlier, with lower corporate tax rates, for capital and corporate profits, and of course it encourages savings, investment and growth.

We are progressing. It is hard to see the chart behind us due to the lights, but I have one later. It shows on the left a deeply progressive tax rate under the Fair Tax, in the blue, where the red is the current progressive tax rate system. If you want to see a better one of this, I have it in the back.

We end all taxes on the poor. We completely untax them, removing that impediment to upward mobility. Gross pay equals net pay. As I worked the floor of the Texas Democratic convention, and I tell union members, they're with me that their gross pay equals their net pay under their Fair Tax, they are galvanized in support of this proposal.

The working poor enjoy earned income tax credit like benefits, but nothing is taken out of their paychecks. They have no filing. They have no preparation costs. They are not taken advantage of by those preparers, and they are not audited by the IRS.

We lower effective tax rate on fixed-income Americans as well as middle income Americans. Wealthy consumers pay the highest taxes. And accumulated wealth over the lifetime of the estate is successfully taxed.

I've heard some criticism of the president for requiring you in the mandate to ensure the continuation of a bias towards homes and charitable giving. We compliment him for putting that in there, because the Fair Tax not only protects these, it improves upon the current tax system.

Simply put, under the Fair Tax, Americans will pay their entire house payment with untaxed dollars. A bit of a simplification, but nonetheless, that's the bottom line. They pay their entire house payment with untaxed dollars.

And do they have to itemize to do this? Do they have to choose to itemize to do this? No. Itemization is gone. Every American homeowner pays their entire house payment with untaxed dollars.

It also of course allows the faster accumulation of the down payment because we're not taxing savings or investment.

What do we do for charitable giving? The best correlation for charitable giving is the health of the economy, is personal income. The Fair Tax many economists have rated as a huge boost to the American economy. At the same time you could look at marginal tax rates, which have fluctuated from 70 to 28 percent, yet charitable giving remains at two percent of GDP.

The best corollary for charitable giving is a booming economy, which of course the Fair Tax delivers. And of course these are done without itemization again.

What will the Fair Tax impact be on retailers? I believe you've heard something along these lines. Right now they collect taxes like ours in 45 states and the District of Columbia. In every single jurisdiction they deal with corporate taxes, they deal with their employees' Social Security matching.

We of course get rid of all of those taxes that deal with anything other than sales taxes, which overnight, terminates all of the costs in those retailers having to do with income and payroll. Compliance costs drop as well. Those will taper with time.

Their domestic suppliers experience similar reductions in their cost of doing business. At the same time American consumers suddenly have a raise.

Now we can all hope in this room that

those American consumers will become disciples of Mr. Greenspan and save all that extra money that they will have in their paychecks. I don't think it's practical to think they'll do that. I think we all know what Americans will do in the early stages, and they'll go spend that money at retail.

The most important thing, the biggest help to retailers will be strong economic growth, the high employment that leads to higher investment and much higher consumption.

How might the states benefit from the Fair Tax? Of course they'll benefit hugely from the economic growth that comes from the Fair Tax. They'll also get a national template that addresses the goal of the streamlined sales tax project that they're all working on right now.

Should they choose to conform to the Fair Tax base, they would see a significant reduction in their tax rates, if they choose to do that. But most importantly, they'll see an end to revenue growth that lags their economies, due to taxing only products. It makes it much easier for them to do their job.

In conclusion, a Fair Tax sweeps away the obfuscation that comes from taxing anything other than consumers, anything other than people. It demonstrates to the American public the value they get for the government, and shows them exactly what they're paying for it.

It also returns to the constitutional concept of uniformity: every taxpayer is taxed the same way.

And last but not least, I'd like to read something from our chairman, Mr. Linbeck. "The passage of the Fair Tax as a replacement for the current system will be a principal factor in reestablishing the civil liberties, the personal liberties, that this country holds so dear, and the hope among our citizens that the American dream remains within the grasp of every American."

Thank you for your time.

CHAIRMAN MACK: Thank you.

(Applause)

David?

MR. BURTON: Thank you, Mr. Chairman. It's a pleasure to be here and contribute in some small way to the important work of this panel.

I am here today to present on the proposal called the BEST tax, which is likely to be introduced in the Senate towards the end of the month, and soon thereafter in the House.

The BEST tax would repeal the individual income tax , the corporate income tax, and the estate and gift tax. It would replace those taxes on a revenue neutral basis with a national sales tax, and a business transfer tax.

The national sales tax base is substantially the same as in the Fair Tax proposal. The business transfer tax is very similar to the USA tax proposal.

The tax would also have in it as an integral part a rebate which would protect the poor in America from the sales tax up to the poverty level, and in the case of married couples, a little bit more, to prevent a marriage penalty.

The business transfer tax is basically a tax imposed on businesses, whether corporate or not corporate, on their gross receipts from the sale of goods, and allows them to deduct the purchase of goods and services from other businesses.

It's a border-adjusted tax so that exports are not in the tax base, and imports are in the tax base. It is, therefore, a destination principle consumption tax, as is the sales tax.

Both the BTT and the sales tax are destination principle consumption taxes. They're both neutral between savings and consumption. They're both neutral among types of investment. They're both neutral between capital and labor. And they're both neutral between foreign produced and U.S.-produced goods.

The current income tax doesn't enjoy many of those characteristics. It's an origin principal task, so it encourages producers to locate outside the United States. We're seeing more and more of that going on now.

It encourages headquarters to locate outside of the United States. Both production of goods and increasingly services are being located outside the United States.

It's also biased against savings and investment. This is a point that has been widely understood by the economics profession for a long time, and is one of the major reasons why we have such a low savings rate in the United States.

It also reduces the ability of the American businesses to compete, and reduces economic growth in the United States.

The current income tax also, of course, treats different kinds of business activity very differently, and leads to lots of microeconomic inefficiencies.

The Fair Tax tax proposal would be revenue neutral using joint committee methodology of approximately an 8-1/2 percent rate on each tax. I'd be glad to go through the details of that with the Commission. That work was most recently done by Gary Robbins at Fiscal Associates.

The best plan would promote economic growth. It would do so because it would reduce the tax bias against work, saving and investment, by reducing marginal tax rates. It would also increase the level of savings and investment in the United States, which would increase the capital per worker, increase productivity, increase output, and increase the well-being, the material well-being, of virtually every American.

It would make U.S. businesses more competitive, both because of the effect on investment, but also because for the first time we would not longer have this huge relative price differential between U.S.-produced goods and foreign-produced goods.

Today our tax system basically taxes U.S. producers very heavily, both through income and payroll taxes. And then it imposes virtually no tax on foreign produced goods that are imported into the United States.

And we also tax American business activity abroad. By moving to a territorial destination principle consumption tax, we no longer have that relative price differential.

You will sometimes hear economists say, well, if we go to a destination principle consumption tax, it won't have any effect, because currencies will adjust. In fact, if we put in a BTT or a sales tax, the currency will appreciate to counteract any advantage that American producers have.

The flaw in this reasoning is that they say if you put in a 20 percent BTT or a 20 percent sales tax the currency will appreciate 20 percent, equal and offsetting. If that's true, then we'll have a 20 percent increase in the wealth of every American relative to foreigners. So instead of having no effect, we would have a 20 percent wealth increase of the American people..

The problem is, that can't happen. Investment flows, capital flows, dominate, not the trade flows. So we'll have a very pronounced impact on the competitiveness of American workers and American businesses to preserve high-paying bluecollar manufacturing jobs in the United States.

I wanted to take just a second and show you this graph and show that the manufacturing as a share of the overall economy has been dropping hard and continues to drop. One of the reasons for that is, we rely so heavily on an income tax that both taxes savings and investment and reduces our competitiveness. But also because it is not border adjusted. We're the only OECD country that doesn't rely heavily on destination principle consumption taxes, and it's had an impact on our competitiveness.

We are now down to the point where we have approximately 13 percent of our economy being manufacturing. Similarly we have ever increasing trade deficits. Now they're approaching six percent. And that would not matter if that capital inflow was being used to fund higher investment.

We shouldn't target a specific trade deficit amount. But if the trade deficit and the corresponding capital surplus is being used to fund current consumption it's a problem. And if you look at this, our private fixed investment as a percentage of GDP has been basically flat at about 15 percent for a long time.

So all this money coming into the United

States is not being used to fund higher investment. It's being used to fund consumption. We're in effect mortgaging our future.

And we're not increasing the investment and the capital per worker and the output of American workers and businesses.

This chart is somewhat instructive. It's similar to the Fair Tax in that a married couple with two children would not pay sales tax on spending up to $25,000. This is based on the federal poverty level plus an adjustment because the poverty level for two people that are married is not twice the single person.

This protects poor people from paying any sales tax whatsoever.

One thing that I think people do not look at, we talk about distribution, this proposal would increase the pie. It's a positive sum game. It would increase the size of the economy 10-15 percent.

And I think when you come right down to it, the most important thing is, are we going to have a proposal that makes the American people, on average, a lot better off on an after tax basis, in terms of their after tax income, or their after tax ability to finance consumption.

This proposal and the Fair Tax and a few others would dramatically improve the well-being of virtually every American, tax lawyers perhaps excluded. My partner and I will have to find something else to do.

The effective tax rate here shows that it's progressive, and this is because of the rebate. It's actually negative effective tax rate for people spending under the poverty level, and then the tax rate gradually grows as someone spends more and more.

So the proposal is progressive. It would be radically more simple, I can explain it to my 12 or 15-year-old, which is something I can't do about the current Internal Revenue Code.

It would reduce the intrusiveness of the system where we have to report virtually everything about our lives to the federal government, and increase privacy.

It would also make housing more affordable. It would enable you to purchase your home with pretax interest, which is something the president mentioned was important.

And it shares a similar analysis with the Fair Tax, similarly with charities. Most people today give to their churches, synagogues, or whatever with after-tax money because they don't itemize. Under this proposal you could give with pretax money, and that would be true of all Americans.

With that I'll just conclude. There is a lot of additional information about more technical questions, transitions and that sort of thing, I'd be glad to address either now or later, if the panel were interested.

CHAIRMAN MACK: Again, thank you both for your presentations.

And John, I'll turn to you first.

VICE CHAIRMAN BREAUX: Thank you, Mr. Chairman.

And thank both of you. I know that you are both extremely dedicated and very, very active in your concepts.

Let me just throw out two of the problems, among others, that I have with the concept. Number one is the compliance issue. You have suggested, Mr. Wright, a national sales tax figure at about 23 percent. I've heard others say that if it's going to be revenue neutral, that's not even close. It's got to be about 30 percent or more.

And I think there are only 10 countries in the entire world that have had a national sales tax above 10 percent, and none of them have it today because of the compliance factor. So that's one concern.

The second concern, and Mr. Burton you've talked about it, is progressivity. Because there are an awful lot of folks on the other side of the issue who say that if you have a national sales tax, and in order to make it progressive you're going to have to complicate it with rebates or tax credits or exemptions, and if you don't do that, it becomes so nonprogressive that it's not in keeping with what our charge is as a panel, and what has been the history of this country.

So those are my two concerns among others.

MR. WRIGHT: Now I'm on? The 23 percent is an average. It's what's in the legislation today. We have had the bill scored by a broad spectrum of economists, and that's their number, not ours.

I would also suggest that the height of the tax rate - please don't shoot the messenger. We're telling the American public what the federal government is costing them when we say 23 percent. If it seems high, well, that is the cost of government.

If we want to have a lower rate, we should discuss that with our congressmen and senators.

But the end of the story is, that is a rate which I can give you academic papers on at some length the number of people who have scored it and come up with that rate.

There are certainly a couple who stand up, one of whom was at your first meeting, who disagree with us on that.

Compliance? Senator Breaux, we're reducing the number of filers by 80 percent. We're concentrating the collection of this money with about 80 percent of that collection coming from less than 15 percent of the retailers.

We're taking the kind of tax forms that have to be filed from extremely complex - the Earned Income Tax Credit form alone - from extremely complex to one simple form that's uniform across the country which is a sales tax return form, which my company in Houston, Texas filed for many years with absolutely no problems. They are the simplest form, they are the irreducible minimum.

It also is the lowest possible marginal tax rate which means less incentive to cheat. There is less profit that comes from cheating.

So the stories you've heard on compliance have not taken into account the Fair Tax as written.

MR. BURTON: In the interests of time, let me just address some of the distributional questions.

Basically this proposal is - both proposals are fair to poor people. They don't pay any appreciable tax under the proposal, which is more than you can say under the current system.

In addition the proposal is progressive, and as spending goes up, people pay more tax.

I think probably the most important point is that virtually everyone would be better off under either of these proposals. And the reason for that is that they will cause such dramatic improvement in economic growth and increase the size of the pie.

But the bottom line though is that I think it probably is true that they are not as steeply progressive as the current system. They are somewhat less progressive. But you have to ask yourself, does it really bother you whether or not you're going to tax the most affluent a little bit less - not a lot less, but a little bit less - if they're not spending their money on themselves?

And you have to change your paradigm, the way you think about it. Because if they're not spending it on themselves, they're saving it and investing it and using it to produce factories that employ people, or they're giving it to charity.

I mean that's really where the, quote, lack of progressivity comes from is the fact that these people are spending it on either building factories or investing it in businesses to employ people or they're giving it to charity.

CHAIRMAN MACK: Bill.

MR. FRENZEL: Actually, my questions are similar to John's relating to the rate that is required to replace income on a one-for-one basis. I suppose all those will be subject to putting the yardstick on them.

You both are convinced that that rate is a revenue neutral rate?

MR. WRIGHT: Not only are we convinced, we'd be happy to supply you with a ream of academic studies that agree with our quoted rate.

MR. BURTON: The consumption base is much broader than the current income tax base. The current income tax base is shrunken so much by the exclusions, deductions and credits that by moving to a comprehensive consumption base you broaden the base, a lot.

MR. WRIGHT: If we could get the PowerPoint back up through the magic of electronics, there's the chart or the progressivity. That's a family of four. The current system is the red line. The Fair Tax is the blue line. And it would not be dissimilar for the BEST Tax.

MR. FRENZEL: Okay, well, we will try to find out about that.

Under your system, Tom, do the states collect the taxes and remit them to the federal government?

MR. WRIGHT: That's correct, sir, and we pay them one-quarter of one percent for doing so. And that's their election. If they elect not to do that, they can have a state next door do it, or they could have the federal government come in and do it for them. I suspect they won't choose the last option.

MR. FRENZEL: Okay, and do you anticipate the federal government will audit the state collection?

MR. WRIGHT: I certainly do, which reduces the number of audits of the federal government down to an irreducible minimum of 50 plus Puerto Rico.

Obviously, there will be, rather than hundreds of millions of individual tax returns going into the federal government, we'll have maybe 14 to 20 million sales tax returns going into the state government, which the state governments will keep up with.

MR. BURTON: The states do a very effective job. I have collected and deal with the Texas State sales tax authority. They are quite efficient, quite effective, and very good with padlocks if you don't pay your taxes.

MR. FRENZEL: They're all very good at that.

MR. BURTON: Yes, sir, they are.

CHAIRMAN MACK: Thank you.

MS. SONDERS: I want to talk for a minute about health care.

Tom, you didn't talk about it with any kind of specificity, and David, you have a little slide in the appendix that talks about health care. And your points are absolutely valid that in a perfect world you have - the fact that employer-provided health-care does not incentivize either the user or the producer of this to economize in any way, but that's under a perfect world.

And some of the criticisms of a national sales tax, particularly for low-income people under catastrophic circumstances is that they are going to be forced to pay an extensive amount of tax for something that is sort of out of their control. And I wonder how you accounted for that, whether it's in distribution tables or otherwise?

MR. BURTON: Well, I think it's difficult to imagine a more bizarre means of delivering health care than we have in this country today. If you think about it as a marketplace where basically the people using or providing a service have no incentive to economize, and the people that provide it basically have to pay whatever the other person pays.

It would be as if your employer said, go buy whatever kind of car you want, and then the car company can sell you whatever options you want, and we'll pay for it. And then the tax systems has this huge tax expenditure in place to encourage that kind of market.

And then we wonder why we're up to spending last I heard it was 13 percent or 14 percent of GDP on health care. It's my understanding that we now spend nearly as much by government, and it's going to get worse as the European countries do.

And then we have massive private health insurance costs as well, which is reducing the competitiveness of our businesses, including most obviously the automakers.

We need to address the question. And part of that is reforming how we tax it. We would entirely untax poor people. If we want to subsidize poor people's medical care additionally we can adjust Medicaid on the spending side.

But we need to change the way we deliver health care in this country or it's going to be terribly destructive of the economy. I mean when you think about 14 percent, that is a vast amount of money that we're presently spending, it's more than any other industrialized country on the planet, and it's driven by the tax system.

MR. WRIGHT: I have nothing to add other than the fact that I was forced into supplying health care for my employees at Wright Marketing Communications in order to hire employees competitively. And there will be little change under the new system for that - for other employers not to have to have that to be competitive in their hiring practices.

CHAIRMAN MACK: Ed.

MR. LAZEAR: Let me ask you a question a little bit about the BEST tax work. In that version you have a split between something that looks like a modified VAT, and something that looks like a retail sales tax.

And then in the Fair Tax proposal you have only a retail sales tax.

And the question would be, why do you choose one over another? Is there some argument that you somehow get less distortion, or some different distributional effects by splitting it in that particular way? It seems like it's more of a collection device, and I'm wondering if you could go through the rationale for it.

MR. WRIGHT: Want to start with the grassroots guy and then go to the technical guy?

Under any sort of VAT, and I do want to distinguish the Fair Tax from a VAT or any kind of a comprehensive consumption tax or anything else of that nature, you're hiding part of the federal government in the cost of goods and services, and in particular, you're hiding it in what the American consumer pays for domestically manufactured products.

Under the Fair Tax we're saying, enough of this obfuscation. Put the cost of government in front of the American public one time.

MR. BURTON: As a matter of economics, they're both flat rate destination principal consumption taxes, and therefore have virtually identical economic effects. It's an administration choice, and a perception choice.

Under the best plan businesses will write checks, and consumers will pay at the retail level. Although the best plan does require that the BTT portion of it be reflected on receipts so that people are at least aware that that is going on.

Administratively it would be different. There are those who might argue that dividing it has certain administrative advantages. I'm not necessarily one of them. I think that the primary reason is perception, and the economics of the two plans are virtually identical.

CHAIRMAN MACK: Charles.

MR. ROSSOTTI: Mr. Wright, in terms of the retail sales tax, I presume that businesses that were buying supplies or other things at retail would not have to pay the retail sales tax; is that right?

MR. WRIGHT: Yes, that's correct.

MR. ROSSOTTI: So that would be implemented how, so that they would know so that if I walk in and I'm buying for business I'm exempt from the retail sales tax?

MR. WRIGHT: Today in Texas when I went in to purchase my children's birth announcements from a printer, I said to them even though they dealt with me all the time in my company - this is mine, it's personal, I'll pay the tax.

Otherwise when I walk in there, when I buy it for resale, I of course have a retail sales tax license in the State of Texas, and did not pay the tax by proving that I had that license, and then I billed it back up to clients.

MR. ROSSOTTI: I mean, given that the tax would be 23 percent, do you perceive any problem with people who might be a little less honest than you are, saying I'm here to buy a refrigerator for my business, and I don't need to pay this 23 percent.

MR. WRIGHT: We are Americans. We are liberty minded. We hate taxes as much as any society has on this planet. This is not perfect. People will cheat, as they do today. The comparison that I would give you is how much less cheating there will be under the Fair Tax than the army of 18 million nonfilers that we have today to begin with.

Yes, ma'am.

MS. GARRETT: Mr. Wright, I also want to ask you about compliance. I share John and Charles' concern about compliance under retail sales tax. And what's interesting, of course, if you do a credit invoice tax, if there is noncompliance at the retail level you don't lose the entire tax. That's one of the reasons a credit invoice is used.

What was the thinking behind your group's decision to use a national sales tax at this level, something we don't' see in any other country, rather than doing the same thing through a credit invoice case?

MR. WRIGHT: Well, we would certainly love to see Congress make it easier for us to have a lower rate by spending less. This would be a good idea. It would make it much easier to get this across.

But the point is, we're looking for transparency, transparency to the American public. And when you reduce the number of collectors over the current income tax system, when you have 80 percent fewer, 90 percent fewer forms, when you have 80 percent of the sales taxes collected by only 15 percent of the consumers, yes, there will be cheating, yes it will happen.

Will it be on the scale that we have with the current system? Absolutely no.

MR. BURTON: I'd like to add something if I might.

The studies that look at comparative

compliance rates at the state level between sales taxes and income taxes show that the sales taxes are better complied with.

Also, if you look at the European literature, there's an entirely new means of cheating in a VAT that doesn't exist in a sales tax, and that is manufacturing false input credits, and false export credits. And they have big problems with people manufacturing those input credits.

Americans, especially American public finance experts, tend to be relatively naïve about how you can cheat the VAT, and Europeans aren't. You can cheat the VAT in many ways that you can't cheat a sales tax.

So I think the compliance rates are likely to be virtually the same under a sales tax and a value-added tax. In fact the Europeans all call their VATs sales taxes. There is a huge similarity in terms of what's going on there.

MR. POTERBA: How would each of your plans treat the taxation of financial services, bank return and insurance companies?

MR. BURTON: Both the Fair Tax and the BEST tax tax financial intermediation services, and in the case of the BEST tax it's an integrated, between the BTT and the sales tax, and in the case of the Fair Tax it's just the sales tax.

And basically it divides the interest rates into components, and you have the pure return to capital, which is not taxed, and then you allow the credit for bad debts against the sales tax. And then the difference, say a free checking account or something, is subject to tax by the sales tax.

And it's all administered by the financial institution. With financial intermediation sold to consumers, it is subject to tax under both proposals.

MR. POTERBA: This does create a new administrative issue for the financial institutions, which is trying to allocate the component of what they're selling, which is just the return to capital versus the service flow which they're providing.

MR. BURTON: It does, but for anybody familiar with what the financial institutions have to deal with today, which is literally billions of 1099s, original issue discounts, capital gains, and so on down the list, mark-to-market, the list is very, very long.

What they have to do in the case of the Fair Tax is child's play.

CHAIRMAN MACK: Let's see, where to begin.

I find myself with many of the concerns that have already been raised, but I also find myself intrigued with what you all have presented in the sense of, I can kind of imagine how Americans feel about how their activities are influenced by the present income tax, both at the state and the national level.

It does influence the way we live, how we invest, the decisions we make. So I find your proposal very intriguing.

One of the other questions, though, which I think Senator Breaux kind of touched on was this notion that if this is such a great idea, why haven't other political entities around the world pursued it? And I think that we've all heard comments that either six or ten nations have tried it in the past, all of which have dropped it. I guess those were probably with rates above, say, let's say 10 percent.

But there is a kind of unique aspect to the American system which I don't think exists elsewhere, in that we have states that have had in place a sales tax, and the collection of that sales tax, whereas other entities have not, other political entities have not.

So I guess I'm both asking the question

and maybe answering it myself, but I want to give you all the opportunity to address this notion that one of the reasons that we shouldn't pursue this is because nobody else has done it, and it hasn't worked elsewhere.

MR. WRIGHT: You quite correctly point out that two of the largest economies in the world use sales taxes - Texas and Florida, with which you are intimately familiar.

The errors made in other countries can typically be characterized by adding a sales tax to an existing income tax system.

There has never been, with one exception in recent history, where they repealed all other taxes and put on a sales tax. England at the end of the Napoleonic Wars repealed the hated tax to finance the war with Napoleon, as Parliament promised, which led to only having consumption taxes at that point, indirect taxes in England. And it led to the largest economic expansion in the history of the English empire.

So consumption taxes of a type have been very successfully used throughout history. They generally expand the economy in which they're applied. They help the civil liberties of the individuals.

And they supported democracies and free governments.

This is not an idea that does not have serious historical precedent.

MR. BURTON: I guess I would say that a sales tax is a uniquely American way of having a consumption tax. We have it in 45 states. We're very familiar with it. It's not rocket science.

But the United States is very much behind the rest of the world in terms of relying heavily on consumption taxes. Every other OECD country relies heavily on consumption taxes. United States does not. And it certainly contributes to some of the economic difficulties we've been experiencing.

CHAIRMAN MACK: If you were to take the portion of the sales tax that is used to eliminate the payroll tax, if you took that out, what's the dollar relationship or the percentage? The rate drops to what?

MR. BURTON: The payroll tax roughly accounts for one-third of the revenue, and therefore, one-third of the percentage points on the rate. I guess one way of looking at that is that the combined roughly 17 percent is lower than the Fair Tax primarily because of the fact it doesn't repeal payroll taxes, either Social Security or Medicare.

Now, revenues today are way down. I mean they're down to just under 16 percent of GDP. And consumption accounts for about 85 percent of GDP. So I think a Fair Tax is very nearly revenue neutral at 23 percent. There's relatively little doubt about that.

But the estimate was just done on the best plan, using joint committee methodology. So that - which is wrong. The joint committee methodology overstates the required rate, because of a number of things, but the most important being is it doesn't take into account economic growth effects at all.

If we passed either of these plans, you'd see the economy grow 10 to 15 percent of GDP within a decade, and that would show up in revenues. And I think those of you who have grappled with federal budgets for a living know how important economic growth is to the bottomline numbers.

And this will have economic growth effects like we haven't seen in our history.

MR. WRIGHT: An editorial comment.

CHAIRMAN MACK: Quickly.

MR. WRIGHT: Yes, sir. By repealing the payroll tax we move from a narrow regressive payroll tax to a broad progressive sales tax to fund Social

Security, certainly much more fair to low income Americans than what we have today.

Last but not least, it is the repealing of that payroll tax that gives such tremendous advantages in housing and in charitable giving within the Fair Tax.

CHAIRMAN MACK: Again, thank you both very much. And we're going to recess for a lunch break, and then we'll start back up at 1:15.

Thank you all.

(Whereupon, at 12:28 p.m. the aforementioned matter went off the record, to return on the record at 1:20 p.m.)

CHAIRMAN MACK: All right, I think we'll go ahead and get started with our afternoon panel. Can you hear me out there? Okay, good.

Our next panel is going to be making presentations for reform of the existing code. We have John Podesta, president and CEO of Center for American Progress; Paul Weinstein, COO and senior fellow, Progressive Policy Institute; and Chris Edwards, director, tax policy studies, Cato Institute.

And again, I welcome all three of you. Chris and I spent a few years working together a few years back.

Paul, we're delighted you're here.

And John, again, thank you so much for coming and being part of this. And I think we'll start with you, John.

MR. PODESTA: Okay, thank you, Mr. Chairman. I think my mic is on.

I am the president of the Center for American Progress. American Progress is a nonpartisan research and educational institute dedicated to promoting a strong, just and free America that ensures opportunity for all.

We believe that as Americans we're bound together by a common commitment to these values. Even more we believe that America is prosperous and strong when we provide opportunity to the middle class, and have a system that rewards work and is open to all.

That's why we're here, Mr. Chairman, because laws --

CHAIRMAN MACK: John, hold on just a second here. Something happened to your microphone.

MR. PODESTA: Thank you. It's working? Okay.

So while it's clear that our nation must have a tax system that guarantees the financial integrity of the United States government, it must also honor the moral integrity of the American people.

And that's why I want to go through the principles behind our plan. Our belief is in fairness and opportunity; our belief that in a democracy there is no excuse for a tax system that can only be fully understood by professional accountants and a handful of lawyers, although I count myself as one of those lawyers.

These values have the underpinning of the American Progress plan, a progressive approach to comprehensive reform of our federal tax code.

Why comprehensive reform? Because the 21st century economy requires a modern tax system. Our economy is increasingly driven by jobs requiring advanced skills. Human capital is just as important as physical capital, if not more so, in today's economy.

A tax system that rewards incomes from wealth at the expense of work and skill flies in the face of the fundamental economic change that we're experiencing in the 21st century. Yet this is exactly the tax system that our nation has today.

As a result of the tax code changes, championed by the administration during the first term, middle income workers today can easily find themselves paying taxes on their wages at a rate that is double or even triple the 15 percent rate that millionaires paid on their investment tax.

I'm going to leave this chart up for a little while, and I really ask you to focus on it. Consider a cook at a high school cafeteria preparing school lunches for our kids making $25,000. That taxpayer is currently paying a marginal federal income tax rate of 15 percent. Add the payroll tax of 6.2 percent for Social Security, 1.45 percent for Medicare. That worker will face a cumulative 22.65 percent tax on their wages.

Add to that the 6.2 percent their employer pays on their behavior for Social Security, 1.5 percent for Medicare, that worker is then paying 30 percent in total.

Or consider a married couple, say a nurse and an office worker, making $85,000 a year. They would be paying approximately 40 percent of their income in federal taxation.

This of course is significantly higher than the marginal tax rate that's being paid by capital income on millionaires which is now just 15 percent. We don't think that's fair. We believe that America can do better than that.

With comprehensive reform we can reward work instead of wealth, and in the process strengthen the middle class.

With our plan for progressive tax reform, approximately 70 percent of U.S. taxpayers would actually receive a tax reduction, a tax cut. For those under $200,000 it would be approximately $600.

Yet a time when the federal government is floating in a sea of red ink, our plan also generates about $500 billion more than compared with the president's policy. I know the instructions that the commission is under, and maybe we could get back to that. But we think that more revenue needs to be raised.

I'd note that our revenue and distributional estimates come from the Urban-Brookings Tax Policy Center, and were generated with their state of the art microsimulation model.

As I said, at a time of massive federal deficits it's important to be cautious about how much revenue any comprehensive reform would raise. We've tended to be conservative on all this. For a full description of our plan you can go to our website at AmericanProgress.org.

Let me turn to how our plan works. First, it puts fairness first. Each source of income is taxed the same. In other words we tax wealth according to the same rate schedule as ordinary income or wages.

We reduce the dependence on the regressive payroll tax. The plan will remove the employee side of the Social Security payroll tax, and remove the cap on the employer side.

So we've integrated the payroll and the federal income tax.

We enhanced the take home pay of lower income taxpayers by reducing the marriage disincentive of the EITC, while expanding eligibility for the child tax credit.

We reformed the estate tax, though its opponents have I think misrepresented to some extent the impact of the estate tax, it in fact remains the most progressive of federal taxes. It's only paid by people making multi millions of dollars, or with wealth of multi millions of dollars. It affects less than two percent of the population.

Our plan increases the exemption, so it reforms the estate tax. It increases it to $2.5 million per individual. It thus exempts virtually every small business owner and farmers and ranchers whose assets are subject to the estate tax.

In making the tax system fairer, we also want to make it simpler, and more user-friendly. We do this in a number of ways, first by reducing the number of brackets to three, with three rates at 15, 25 and 39.6 percent. Where those rates kick in is included in our slide.

Our plan eliminates tax loopholes that now allow corporations and wealthy individuals to avoid paying their fair share of taxes. And we eliminate the Alternative Minimum Tax.

The AMT I think is something that really will add great complexity as we move forward in the tax code with now millions up to 30 million Americans having to fill out their taxes twice if you will because they become subject to the AMT; almost a third of taxpayers by 2010.

Unlike the flat tax and the value-added tax or a national sales tax, our plan does maintain the current deductibility of charitable giving, home mortgage interest, state tax deductibility, and other deductions in their current form.

We think there is room enough to both raise the revenue that we talked about without eliminating those valuable deductions that serve important social interests.

In addition with progressive tax reform we will be able to offer tens of millions of Americans new opportunities to save and create wealth for their retirement. We do that by replacing the current deduction-based retirement savings tax incentive with a across-the-board 25 percent refundable tax credit, which gives new incentives for people, particularly at the mid- and bottom end of the scale to save for their retirement.

And we encourage long-term savings by, for people making under a million dollars annually, by exempting a portion of the capital gains on assets held at least a year. For assets held more than five years, they'd receive a 50 percent exemption, which encourages long-term savings I would add.

As I mentioned most taxpayers will receive a tax deduction. For those earning under $200,000 it averages $600, and we've supplied you and the staff with a distribution chart.

Since I raised the question of retirement security, I'd also like to point out that to maintain our full commitment to financing Social Security our plan would dedicate a portion of general revenue to the Social Security Trust Fund. By raising more revenue overall than the current system, and dedicating 2.25 percent of gross GDP per year to the Social Security Trust Fund, we solidified the financial status of the Social Security system.

Further, our plan protects this revenue by including a number of safeguards. We've actually tried to create the real lock-box for Social Security in our plan, and hopefully, you'll give that some consideration.

At the Center for American Progress we're convinced that we could have a tax system that's fair, simple, that fosters growth, and that reduces the fiscal deficit by creating that tax system. But creating that tax system will take honesty and courage.

Though this panel is charged only with reporting revenue neutral options to the Treasury Department, I think - I would just urge upon you to - I think it's incumbent upon you, even as you create revenue-neutral platforms for this, to think about the fact that we now have a structural deficit that next year will be about $430 billion a year. Even in the out years, with current projections, we're looking at, if there is any fix to the AMT, of upwards of $3-, 4-, perhaps $500 billion, and in the next decade, we're going to five percent GDP structural deficit.

So we need a platform that is going to be able to meet the needs of the American people, and ultimately that is going to require us to raise some revenue.

Thank you.

MR. WEINSTEIN: Thank you, Mr. Chairman. I appreciate the opportunity to be here, and also the privilege of being on the same panel with a former boss of mine, John Podesta, who I've actually written a book on, Management in the Executive Branch, and I often cite his role as chief of staff as one of the exemplary jobs in the history of the White House; it was excellent. And as I said, I'm pleased to be here.

My name is Paul Weinstein. I'm with the Progressive Policy Institute. PPI is a nonprofit research organization that's dedicated to a third-way approach to tackling the problems facing our country - third way and practical. And that's really where we tried to focus in our tax reform plan. And we focused on trying to reform the current system in a realistic and politically feasible way.

America's tax system, as everyone here knows, because that's why we're here, is both unfair and overly complicated. A slight majority of

Americans seem to think that it's better to go to the dentist than it is to pay your taxes.

Look at a recent poll by AP and IPSOS: 70 percent of Americans think the federal tax system is too complicated. Another 54 percent of Americans, according to an NBC poll, believe that the system is actually rigged against them, and that some people are not paying their fair share.

So the tax code clearly is too complicated. Why? Well, there are too many redundant tax breaks in there for individuals: 16 different IRA type accounts, five college tax breaks when you actually are just going to school, not including the account that you're given when you're trying to save for college; four incentives to raise kinds; multiple definitions of what a child is; different phase-outs for all these different types of plans and tax incentives.

Since 1986, according to one study, more than 84 new tax laws have been enacted. Why? Well, quite honestly, as Congress and the President develop new tax ideas, many of which are quite good, they don't necessarily remove the ones that are already on the books.

Number two, tax compliance is costly.

According to an internal memorandum of the Department of Treasury, the total cost of tax compliance is $115 billion a year. I don't know if that is really accurate or not. A lot of these numbers sometimes are thrown around. But if you want to go in political circles and do a 20 percent cut in that, a 50 percent cut in that, that amount is still incredibly significant when you think about it.

Finally, assuming the President is baseline, assuming current policies remain consistent, according to Gale, Orszag and Shapiro, about 80 percent of households, including a majority of households in every income quintile, will end up worse off as a result of current tax policies.

So when we started at PPI, we wanted to develop what would our goals be for tax reform? Well, first, we wanted to make a system that was more generous. In particular we wanted to provide tax relief for what we considered the pillars of middle class aspiration: owning a home, saving for retirement, raising your kids, going to college or sending your kids to college.

Second, we wanted to reduce confusion. I mentioned the types of multiplicity and redundancy in the tax code.

Three, try to treat everyone the same wherever possible. Quite honestly the number of phaseouts and different rules and these different types of incentives are problematic. Many people aren't able to take advantage of these different incentives. There is so much confusion around the EITC. There have been charges of both underuse and some people claim overuse.

We want to try to eliminate those phaseouts where possible, basically the hoops in the tax code.

Fourth, streamline the code. Eliminate or consolidate existing breaks. Require taxpayers to do less paperwork. Try to get as many people using the easy form as possible.

And finally, deficit neutral. As your commission has been charged with, finding a plan that is basically revenue neutral.

So our plan is basically a family-friendly tax reform. It creates four super-incentives from 68 different existing deductions, credits and other tax breaks. The four are a college tax credit, a home mortgage deduction for all, a family tax credit (that's a single family tax credit) and a universal pension.

The college tax credit is a $3,000 refundable tax credit which roughly covers the cost of - just a little bit less - but the average costs of tuition at public schools, just tuition, and a third of the average of private tuition. It's good for the first four years of college, and two years of grad school.

It eliminates five existing breaks. It's available to any student who wants to attend an accredited college or university more than half time.

It contains no phaseouts, unlike the current system. And the credit goes directly to the students.

A home mortgage deduction for all. This basically puts the home mortgage deduction above the line, and makes it available for anyone who actually owns a home. We estimate that more than 10 million Americans would benefit by this, going above the line. And then most of the benefits would go to those with incomes of less than $50,000, making this a very pro-middle class proposal.

Third, a family tax credit, available to families with incomes of up to $120,000, this proposal would eliminate 200 pages of code. It would combine three tax incentives, all three very important tax incentives, the EITC, the child credit, and the child and dependent care credit, into one credit, again, above the line and fully refundable.

It would provide a maximum credit of 3,500 for a family with one child; 5,200 for two children; and $7,000 tax credit for a family with three children.

It is capped at three children, in part because of budgetary constraints.

A universal pension. Under this proposal we would take the six different IRA-type accounts and combine them into one account. We're not talking about 401(k)s here, we're strictly talking about the IRAs. 401(k)s would work in partnership with this proposal.

Americans of all income levels could participate, which is unlike current law. We'd have a $3,000 contribution limit. When every American began working on their first paycheck they would get a $500 stake-back refund, rebate, a stake back into government to open a UP with.

We'd have a refundable credit for contributions by low income workers.

And portability. One of the biggest problems we face now with retirement plans basically is that half or more than half of Americans actually withdraw their money when they switch jobs. This is primarily among younger workers.

Under this plan you would have to at least opt out of the system. That is, if you had a UP when you went to work, you'd give them your UP number, and when you left that job that money would immediately flow into your UP account, sort of eliminating the temptation of pulling that money when you're basically handed the check.

There are a number of benefits, but let me try to summarize quickly here what we think they are, the main ones are. This is $436 billion in new net tax relief for these four areas: college, home ownership, families and retirement.

We take 68 tax provisions, move them into four, reconfiguring $2.5 trillion in tax incentives. It simplifies the code, eliminates a number of phaseouts, multiple definitions. And we eliminate 200 pages of the code just for the family tax credit.

It reduces the number of itemizers because we make all of these above the line. It makes the code more progressive by closing a number of special interest breaks, and using them for benefits that are a benefit for all Americans. And it's deficit neutral.

On the final four pages, and I won't go into all the details on this, I'll let people think about these things, but here essentially are the offsets, a suggested list of offsets. Some of these people may feel comfortable with; some they won't. The beauty of this is, you can replace these with other ones.

Primarily these offsets come from two sources. One, the college tax credit for example, consolidating the number of existing education credits. Then additional funds on top of that come from a number of special interest incentives to be eliminated.

That's the case for all four of these proposals which you'll see in these four pages.

I'd just like to close by saying that I applaud the commission for the work that they're doing. This is not an easy task. Quite honestly, I think though that the time has come for tax reform, and that we need to take action, especially in light of both the increasing complexity of the code, and also our deficit situation.

Thank you.

MR. EDWARDS: Thank you very much. And

thanks for having me testify. I certainly commend the panel for having such a wide-ranging set of hearings. We certainly all agree that the current tax code is in desperate need of reform.

Today and tomorrow the panel is going to hear a lot of plans to replace the income tax with a consumption based tax system, like the Hall-Rabushka flat tax. I strongly support moving in that direction.

There is no doubt that a consumption-based system would be far better for economic growth than the current system, because of the favorable treatment of savings and investment. And consumption taxes are intrinsically simpler, intrinsically simpler, than income taxes.

My proposal for a dual-rate income tax would be major reform in itself, but it would also be a way, a method to move toward a flat neutral consumption tax like Hall-Rabushka.

The dual-rate income tax system would be simpler, it would treat taxpayers more equally, and it would promote growth with lower marginal tax rates. There would only be two individual tax rates of 15 and 27 percent, and the corporate tax rate would be sharply cut from 35 percent to 15 percent.

For individuals the rate structure would integrate with the Social Security payroll tax to create a consistent marginal rate on earnings. The higher 27 percent rate in my system would kick in where the current payroll tax kicks out at $90,000, creating a consistent marginal tax rate.

Itemized deductions would be eliminated. Middle income families would see a big cut in their marginal tax rate from 25 and 28 percent currently down to just 15 percent. The top individual rate on savings income, income from dividends, interest and capital gains, would be just 15 percent.

That builds around the current tax cuts enacted in 2003 that reduce the divided and capital gains rates.

Savings vehicles such as IRAs would be retained.

This chart shows the dramatic reduction in marginal tax rates that would be possible under a dual-rate tax system. By eliminating deductions and credits affecting the middle class, the middle class would get a sharply reduced marginal tax rate.

The next chart sort of shows the same thing. It shows the combined marginal rate of the payroll tax and income taxes currently, and again, there would be a sharp reduction in the marginal tax rate.

For corporations the tax rate would be cut sharply from 35 percent to 15 percent. The treatment of dividends and interest would be equalized. Essentially dividends and interest would be taxed at both the corporate level and the individual level, but just at the low rate of 15 percent at each level.

President Bush has called for a revenue neutral reform, and I've suggested some base broadeners that the panel could look at to compensate for the sharp reduction in the corporate tax rates.

But I would caution the panel that the panel should avoid looking at any base broadeners for the corporate that are anti-investment as were enacted in the 1986 tax reform.

I'd also point out that looking at a sharp corporate tax rate cut, the dynamic feedback effect from a corporate rate cut would be large. A Joint Tax Committee report in March that looked at the dynamic effect of a corporate rate cut and an individual rate cut found that the effect on GDP growth would be much bigger from a corporate tax rate cut.

With the dual rate tax structure it could also incorporate tax expensing as under the Hall-Rabushka flat tax plan, and the territorial premium for international investment.

So again, the dual rate tax system would sort of be a halfway movement through the Hall-Rabushka tax system.

On simplification, the dual rate tax system would eliminate itemized deductions. All taxpayers would take the standard deduction. And for corporations the low tax rate would greatly cut incentives for tax avoidance and evasion.

Tax compliance costs multinational corporations, as you've heard, from previous hearings, and I think you're going to hear about tomorrow. The rules on corporations are complex, not just because the rules are complex, but because we have a high statutory rate, corporations put a huge amount of effort into creating corporate tax shelters.

If you sharply cut the corporate rate, the corporate taxes would be simplified, and corporate executives would spend their time making good products and not hunting for tax shelters.

On fairness the dual rate income tax would greatly increase horizontal equity, in other words, people with similar incomes would pay similar amounts of tax, but 95 percent of households would pay tax at a low 15 percent rate. For folks at the bottom end, the dual rate tax system would retain the earned income tax credit and personal exemptions would be greatly expanded.

On economic growth, marginal tax rates on all income sources would be cut, and any economist will tell you that marginal tax rates are crucial to reducing the so-called dead weight losses of the tax system, in other words, with lower marginal tax rates we cut the waste generated by the tax system.

Global tax competition I think is crucial to consider in this round of tax reform. There is a global corporate tax revolution going on. The average statutory corporate tax rate in the 30 nations of the OECD have fallen from 38 percent in 1996 to just 30 percent by 2004.

We've got currently the second highest corporate rate in the industrial world. The United States has to respond to this global tax competition. I think that corporate tax cuts around the world will continue in the years ahead, because especially for medium and small countries around the world there are just compelling interests to continue cutting your corporate tax rates to get inflows of investment. And the United States has to respond, I think, to what's going on elsewhere in the world.

Looking at the data on global investment, there is about a trillion dollars of foreign direct investment, or corporate investment, that flows across borders every year. We want that investment to come in our direction, and that's why I put a corporate tax rate cut as the centerpiece of my tax plan.

Corporate tax rate cuts are not just about making businesses more competitive; they're about helping American workers. High corporate tax rates mean smaller inflows of investment, which means lower wages.

The Economic Report of the President last year expressed this point succinctly. It said, quote, "In the long run much of the burden of capital income taxes is likely to be shifted to workers. The reason is that such taxes reduce investments which diminishes the capital stock. Workers are less productive when they have a smaller capital stock to work with and earn lower real wages."

And that's why we need a corporate tax rate cut.

And to conclude on that point, international competitiveness is much more important today than when the United States last looked at major tax reform in 1986. Multinational corporations are increasingly responsive to taxes both with regard to the real investment flows as well as the movement of paper profits across countries.

There is an interesting New York Times story on Sunday looking at large U.S. pharmaceutical companies. Apparently large U.S. pharmaceutical companies actually earn most of their profits in the United States but for tax reasons they report most of their profits abroad, with purely legal tax mechanisms.

The reason of course is that the United States has such a high statutory tax rate. Pharmaceutical companies apparently report a lot of their profits in Ireland. It has a 12 percent corporate tax rate. We need to respond to this I think by sharply cutting the corporate tax rate. Everyone would be winners. Those profits would move back into the United States. That would help the U.S. fisc. It would allow us to lower tax rates and make the system more efficient. And like I said, it would be good for workers.

So that's why I put a corporate tax rate cut as the centerpiece of the dual rate tax plan. And

I think not only for the plan I proposed but any tax reform that this kind of looks at and Congress may move ahead with. I think a corporate tax rate cut has to be a centerpiece of tax reform.

And I'll close there. And I'd be happy to answer any questions.

MR. POTERBA: Let me pick up on an issue that follows from Chris' recent remarks. The challenge in what you're doing of course as always is to finance the things that we'd like on the tax expenditures.

In paying for the family friendly reform, one of the things you mention is raising money by changing corporate shelters for highly mobile foreign income.

What do you actually have in mind with respect to the corporate income tax there? And what are the particular proposals that you would embrace for the foreign income?

MR. WEINSTEIN: Well, that's obviously based on the Joint Committee on Taxation's proposal from their report in January, so that's what it's referring to.

If you're asking more generally what do we do on the corporate side, our first approach was to do something on the individual side. We're now working on a piece on corporate tax reform as well. We're looking basically at ways to try to sort of close the loopholes there, and either bring down the rate or try to direct incentives toward more research and development and investment.

That's one of our big concerns there, and that's why we're looking at that particular approach.

MR. POTERBA: Okay, but so essentially what you're doing on the financing side is just to work through the Joint Committee's list.

MR. WEINSTEIN: Some, some are there and some are not. That particular one is from the Joint Committee on Taxation. Some of them are from repeals of certain things that were passed in last year's 2004 act. Some are from CBO. There are a number of things, and I'm happy to provide the committee with some of those more specific sites.

MR. MURIS: I know we've got a lot of people on at a time, so let me have the other two panelists if they could briefly respond to this.

We've heard a lot of testimony about the benefits, in terms of economic growth of a tax more on consumption and less on savings. And both of you make some bows in that direction, one more than the other.

And I'm curious as to whether what you proposed -- one of the things we're asked to do is to sort of start over again, and we're allowed to do options. Is what you propose based on the realities of the current system on the one hand, or a disagreement with the idea that the tax code should be heavily weighted toward taxing consumption.

MR. EDWARDS: If I understand your question, yes, I strongly support movement toward a consumption-based system. And I would be delighted if Congress were to in one swoop rip up the income tax code and replace it with something like the sales tax or the Hall-Rabushka system.

What I propose is sort of a halfway step to get partway there by having provisions that are favorable to savings, and by reducing marginal tax rates.

Your question went to economic growth. I recently surveyed the literature, and basically, with a revenue-neutral reform, if you were to replace the current income tax code with a consumption-based system like the Hall-Rabushka flat tax, you'd perhaps get in the long run a U.S. GDP that's up to about 10 percent higher. That's with a revenue-neutral reform.

I also propose that the federal government cut spending substantially. And if you were to cut spending at the same time as reforming the tax code, the boost to GDP would be much greater.

But with a revenue-neutral reform, you're looking at a GDP over the long term maybe 10 percent larger.

MR. PODESTA: Well, first of all, I think you have to look at the consumption tax in the context of two issues. One is, I think that replacing the income tax with a consumption tax is a political nonstarter in this country. Whether the American public would accept consumption tax at the rates that one would need to replace the income tax at the 23, 27, 28 percent I think is highly dubious from a practical political perspective.

But I think it also fails on a substantive perspective in terms of the progressivity that you get out of that system. It tends to shift, again, taxation away from the wealthiest Americans and onto the backs of the middle class, and I think it also has an interesting distributional effect. It ends up, if you think about when people save money and when people spend money, you're burdening the young and the old at the expense of people in the middle years, which I think will strike most people as in its own way unfair, apart from the distributional effect from increasing taxation on the middle class at the expense of the wealthy.

So I think there is the potential for some -- for example, we in a separate proposal we put out with respect to health care, we have a small more progressive value-added tax used to pay for universal coverage. So I think that we're not opposed to it ideologically, conceptually. But I think it has to be narrowly targeted. I think the distributional effects have to be considered.

I would make probably the same criticism of Chris' plan. And I think for all of us coming forward, we've done that. I think that a distributional chart of the proposals that you're looking at putting forward as a proposal should go through a rigorous analysis of who's winning and who's losing under that system.

We've obviously tried to construct a system that really where the sweet spot is at the heart of working Americans, where they have incentives to save, but they also have a lower overall tax burden from the perspective of federal taxation.

MS. GARRETT: One question for all of you. As you know one of the problems in the current tax system is the tax penalty on second earners and couples, often the working woman, sometimes called the marriage penalty.

I wondered what your plans did with respect to that. I know Mr. Podesta's plan deals with the EITC, but I didn't notice anything else. I think Mr. Edwards' plan would deal with it with your thresholds on the rates.

And then finally one very quick question for you only, Mr. Weinstein. Your college tax credit has the advantage of getting rid of phaseouts and combining credit so it's simpler that way.

But then you have a requirement that the student commit to summers of service. And I wondered how that squared with simplicity, and why we were having the IRS check into what our students were doing in the summers?

MR. PODESTA: Very quickly on our side, by eliminating the employee portion of the Social Security tax, particularly for two income working families, we give a very substantial benefit in that regard. And then that's adjusted in the rates.

But most two-couple working families would receive a tax cut under our proposal.

MR. WEINSTEIN: On the EITC we too in our plan do try to deal with the marriage penalty in that case, equalizing it there.

Regarding the college tax credit, yes, there is a two summers service requirement. There's been a long tradition at my organization, a commitment to national service, rights and responsibilities. Quite honestly, also, it's a little bit of a way of holding some of the costs down in the proposal.

If you want to be more generous and get rid of it, you simply have to basically find some more offsets. It just affects the take-up rates. Currently about 55 percent of Americans take up rate for the current existing college tax benefits. And on this plan I think we're assuming up to about 70.

So basically you have to assume much higher if you were going to do that without the service requirement.

MR. EDWARDS: To eliminate marriage penalties you basically have to make sure that the standard deduction for couples is twice singles. You make the rate bracket for the higher rate kick in at double the point for singles.

I do that in my plan so it would eliminate marriage penalties. But your question also goes to the broader issue of the horizontal inequities in the tax code. People of similar incomes paying substantially different amounts of tax.

By eliminating deductions and credits in general, you're moving toward a horizontal equity in the system.

MR. ROSSOTTI: Chris, I wanted to ask a question on your corporate tax, you were focusing on the corporate rate. Was your statement to get the rate down, was that a statement of what you would like to see as an objective, or were you actually saying that that is something that your plan would achieve on a revenue-neutral basis?

And I wasn't clear where the revenue was going to come from, to get there?

MR. EDWARDS: Right. The numbers are, my individual plan is revenue neutral based on a run by the Tax Foundation microsimulation model.

On the corporate side if you completely eliminated the deduction for employee health insurance, for state and local taxes, and you excluded interest from the tax base, like under the Hall-Rabushka plan, that would make up for about 75 percent of the revenue.

And I'm suggesting, but I don't know precisely, that under a dynamic score a substantial corporate tax cut like that would probably produce feedback effects I'd guess on the order of 20 or more percent.

MR. ROSSOTTI: But on interest, what would you do for financial institutions if you deducted?

MR. EDWARDS: Financial institutions would need special rules. Like under any consumption-based tax system, like the Hall-Rabushka plan or the national retail sales tax, you would need special rules for financial institutions.

MR. ROSSOTTI: What do you do for companies that are now all becoming combined, such as General Electric and many others? They're essentially all financial institutions at heart.

MR. EDWARDS: Right. Well, you would probably have to require them to file different returns for the different parts of the business.

MR. LAZEAR: Mr. Podesta, you prefaced your comments by saying that human capital was a very important part of the economy, and I certainly agree with that.

So I was wondering, when you think about lowering the marginal rates on the middle class, one of the hopes would be that by doing that you'd stimulate lower income individuals to want to invest in human capital and thereby get into the middle class.

Are you aware of any evidence on this that would suggest that those kinds of effects might be significant, given the kind of plan that you have in mind?

MR. PODESTA: I am happy to provide some studies that back up that notion. Robert Solow testified in a meeting that we had to that effect. But let me get back to the Commission with some particulars.

MS. SONDERS: I think it was only you that had it in one of your slides here with capital expensing. And I think the comment was just that the dual-rate structure could incorporate.

I wanted just quick comments from all of you. Assuming the other proposals therefore maintain current depreciation and not move to expensing.

MR. EDWARDS: What I see set up for the corporate tax system is sort of a structure that you can take and leave different pieces of. And I suggested that the dual-rate system, you could incorporate capital expensing nicely. Because one of the concerns about full capital expensing under the current code, if corporations also get an interest deduction, is that they'd essentially get too much deduction. You'd essentially be subsidizing investment at the margin.

Under a system like the Hall-Rabushka where you eliminate the deduction for interest expense, capital expensing would work really well. It would be much simpler than depreciation, and it doesn't -- and expensing is superior economically because it doesn't distort investment at the margin.

MR. WEINSTEIN: Your assumption is right about our plan. We are however looking on our separate sort of corporate effort to look at expensing, whether or not we should move increasingly to it and how to basically pay for it. It's really an issue again of cost.

There are some definite economic advantages towards moving to immediate expensing of plant and equipment and other investments that are related to production. We're looking at it.

MR. FRENZEL: John, I'm a little foggy as to our mandate with respect to Social Security. It looks like it's a fairly important element in your plan.

Tell me again how your plan works, and how important it is to the overall structure of your plan.

MR. PODESTA: Well, one of the things we wanted to do in integrating the payroll tax and the income tax, and to create a more progressive tax platform, was to anticipate what would this do to the financing of Social Security.

We've lifted the cap, the $90,000 employer side cap on Social Security taxation, but it still makes up for some shortfall in revenue going into the trust fund. So we dedicate a percentage of income tax into the Social Security trust fund, and require a three-fifths vote to overcome that.

We think that gives a steady stream of income and closes about half the gap, the so-called 75-year gap on Social Security.

MR. FRENZEL: Okay, but employees no longer pay?

MR. PODESTA: The employee portion would no longer be paid by the employee; that's correct.

MR. FRENZEL: Okay, what happens to the self-employed?

MR. PODESTA: Well, half of the tax would -- they're paying both sides of it at this point. The employee and the employer side.

MR. FRENZEL: But to get to your --

MR. PODESTA: Half if it would be

eliminated.

MR. FRENZEL: To get to your desired progressivity, this is a very important part of your plan.

MR. PODESTA: Yes. Well, it provides a substantial amount of why there is tax relief, particularly on low wage workers and middle income workers, that's correct.

MR. FRENZEL: Thank you.

VICE CHAIRMAN BREAUX: Well, I want to thank all three of the panelists. John, thank you. We've talked about your ideas, and I appreciate the effort in bringing down the rates to three rates. It's certainly a simplification. And some of the other suggestions certainly guarantee some progressivity on what we're trying to accomplish.

Paul, I liked the concept of the savings account. You're talking about one single savings account. It seems to me that one of the problems on savings is that there are such a multitude -- what did you say, 16 different ways for Americans to save -- and that's very confusing.

I mean if you could maybe just give me a little bit of elaboration on it, can we get it down to one universal savings account? It'd be a lot simpler, and hopefully more people would understand it and participate it if we did. But can you really do that?

MR. WEINSTEIN: Well, you can. You have to make some choices. For example, you're going to have to choose between whether or not you want to keep the Roth or the traditional tax-deferred plan. You'd have to make a choice. Or you could offer one account that lets you choose up front, which one you'd want to do. There are some complications of that.

VICE CHAIRMAN BREAUX: What kind of restrictions would you have on what would qualify for a savings, that has to be used for retirement, education, health care or most anything that's legal, for instance?

MR. WEINSTEIN: Well, no, right now we would basically limit it to what traditionally what IRAs are now allowed to be used for: education, home ownership, emergencies, obviously, of some kinds. Health care, we haven't really tackled whether or not you'd allow it for that. But it's something we might have to look at.

VICE CHAIRMAN BREAUX: One final question, Chris, thank you. I'm trying to figure out why I don't like your proposal, and I can't quite figure it out.

So the dual-rate you get them down to, the rates, the individual rates to 15 and 27 percent. And in order to guarantee progressivity, I mean I guess you would not support any kind of a value-added tax in addition to the two rates, would you? Can you comment on that?

Because some people have said, look, we believe in a value-added type of tax, but in order to guarantee progressivity we think that you ought to have still some type of an income tax on earned income.

MR. EDWARDS: In my plan -- I mean you've got to remember though that folks at the upper middle and at the high end have a lot of deductions under the current system that I would eliminate. I was just looking at the distribution yesterday of the mortgage interest deduction and the state and local tax deductions. They are very skewed to the high end.

The biggest chunk, the biggest group of folks, the biggest amount of dollars for the state and local tax deduction is from $100-200,000. So I'm saying get rid of those deductions and lower the rate to 27 percent.

I would not support any kind of value-added tax in addition to an income tax. I think plans in all due respect to Michael Graetz who I guess testified this morning, I think plans like that are very dangerous for the United States.

I think we have a uniquely strong and powerful economy because we don't have the value-added taxes that Europe has on top of their income taxes. So I strongly recommend against any kind of additional add-on tax to the income taxes.

VICE CHAIRMAN BREAUX: I thank all three of you.

CHAIRMAN MACK: A couple of questions.

Chris, let me just start with you. This is probably more of an economic question as opposed to a specific tax.

Have you given thought to what would happen in, let's say, the residential real estate market as a result of the elimination of the tax treatment?

MR. EDWARDS: During the '90s when there was a lot of discussion about the Hall-Rabushka system, there was a huge amount of economic studies looking at what would happen to the housing industry because that system would repeal the mortgage interest deduction.

I guess I have sort of a mixed view on

that. Some folks think that there would be a radical drop in housing values because the mortgage interest deduction is capitalized partly in the cost of housing.

But on the other hand, you know, many folks own their home outright. They don't take the mortgage interest deduction. So the mortgage interest deduction is only one component of housing values in the United States.

And one of the arguments actually for mortgage interest deduction is that it increases the home ownership rate. I don't know whether that is true, because other countries like Canada and Australia and I understand do not have the mortgage interest deduction, and their home ownership rates are almost as high as they are here in the United States, at something like 65 or a higher percent.

So I think if tax reform went ahead in a time period certainly like the last few years when housing values have been going through the roof, I don't think that we'd really notice the effect of the tax code change. Because housing values are tending to rise over time anyway.

CHAIRMAN MACK: John, let me raise a question with you on the corporate side. If you said it, I apologize, I forgot what the rate was. But I think a broader question would be, A, do you believe that it is important to bring the corporate rate down for competitive purposes?

B, how far do you think you need to get it in order to be competitive?

And C, how would you pay for that reduction?

MR. PODESTA: Well, let me start by saying that our plan doesn't address that issue. But in listening to Chris, there may be one shocking revelation here, which is, I think the notion of lowering the corporate income tax by broadening the base is not a bad one, and maybe is one that the Commission should consider.

Where I think I would disagree with him is, how do you pay for that? How do you make that revenue neutral? It seems to me that where you want to start is in the complexity of the corporate tax code.

I would start with the deductions for ceiling fans from China, and from Bermuda offshore tax credit, et cetera, try to create a more level playing field across the corporate landscape, and then try to reduce the rates.

We have in one recent study 80 of the largest corporations in the country paid no income tax; 28 paid no income tax over the course of three years. So I think there is room to broaden the base on the corporate side and lower the rate, but I wouldn't do it on the backs of homeowners, people who are trying to create charitable deductions for their churches and public institutions in the country.

So how you pay for it is as important, I think, as trying to get the rate reduction down.

How far to take it? It seems to me that's to some extent the question of how much revenue can you pick up by closing loopholes and broadening the base.

CHAIRMAN MACK: If there are no further questions, again, thank you, all three of you, for your participation, and we'll go to the next panel then.

Our next panel will present views on alternative proposals for reform. And I understand that these three presentations will be five minutes each. And we have Jim Baker, chairman of Baker & Company, LLC; Edgar Feige, professor of economics emeritus, University of Wisconsin, Madison; and Roland Boucher, chairman, United Californians for Tax Reform.

And Mr. Baker, why don't we start with you?

MR. BAKER: Chairman Mack, Vice Chairman Breaux, members of the panel, it is my honor to come before you to address an issue of major importance to our country, the reforming of our tax system.

The president has made federal tax reform a priority of his administration with the goals of simplifying federal tax laws, reducing compliance costs and burdens, sharing the burden in an appropriately progressive manner, promoting long run economic growth, and encouraging work effort, savings, and investment.

As a small business owner and consultant, I understand that the reformation of our tax code will strengthen our nation's competitiveness in the global marketplace. I therefore want to thank the members of this distinguished panel for your willingness to be of service to our nation to perform this important duty of determining what ideas and suggestions move forward to the Department of the Treasury and the President perhaps.

Today I come as an advocate for the Transform America Transaction Fee, which is a new idea that has been offered in the form of a legislative bill, H.R. 1601, which would charge the Department of the Treasury with studying the proposal and creating a comprehensive report detailing its feasibility while noting the implications for implementation.

This is an idea that could generate the revenue necessary to run our government by collecting a fee on transactions that occur in our economy, and doing so in a way that meets all the goals that have outlined in the order that created this panel.

The fee would apply to retail and wholesale sales, business to business purchases, and financial or other transactions, including intermediate exchanges, with payers becoming liable for the fee at the point of control.

Importantly the fee could be assessed in a number of ways as a percentage of the transaction, or on a fixed tier or progressive basis. And as proposed the fee would not apply to cash transactions of less than $500; to wages and salaries from employers; or to savings-related transactions.

The major features of this plan is that it speaks to the power of the idea, in that it's simple. It eliminates federal taxes as we know them: income, corporate payroll, corporate profit, and capital gains taxes would no longer exist.

As a result of these changes the burden and costs of complying with the existing tax code would be drastically reduced, a burden that impacts both individuals and corporations alike.

The mechanism that would exist in its place would be transparent, with the fee being applied being a known commodity. It does not require complicated rules to determine what the amount due actually is.

The plan is fair in that it shares the burden of providing revenue widely, including the capture of underground economic activity and foreign transactions, thereby enabling the fee needed to achieve revenue neutrality to be 0.4 percent.

That's based solely on applying the fee to the $750 trillion that moves annual through our Federal Reserve Banking system.

It's flexible. The rate charged can be structured so that no single class of wage earners or economic sectors would be unduly burdened by the levying of this fee on their transactions.

If for example the manufacturing sector of our economy was facing particular strains, the fee rate could be temporarily adjusted to compensate for their difficulties.

The fee could also be structured progressively, in the sense that lower income wage earners would not be unduly burdened. Such a progressivity can be accomplished by recognizing the correlation between the amount of a transaction and the income of individuals.

Important, by varying the applicability of the fee, the important policies such as the promotion of home ownership and charitable giving could still be implemented.

It positively impacts our economy. The transaction fee lowers tax and compliance costs while providing policymakers with the availability of tools to promote economic goals.

Individuals that make $40,000 a year would actually bring home $40,000.

With these cost enhancements, firms will be able to undertake new projects and find a supply of labor ready to work. It would discourage short-term trading in favor of long-term investing.

And for the small business sector of our economy, the sector that SBA estimates is responsible roughly 75 percent of our net new jobs, it would free that system up. It would lower business costs and model cost, and the burden of complying with existing codes.

Entrepreneurs would be free to do what they do best: responding to marketplace needs through the identification and satisfaction of customer needs.

In conclusion, the transform American transaction fee idea holds tremendous promise for achieving the goals of the President's initiative and for a more competitive America. It will accomplish the basic purpose of the tax system, raising necessary revenue to fund the operations of our government.

It will share the burden widely with one scenario for revenue neutrality requiring a rate of less than one- half of one percent.

It will provide flexibility needed by policymakers to promote goals and to address segments of our economy that have particular concerns.

It will promote economic growth through its cost-lowering and burden-lessening effects, thereby freeing the important small business sector of our economy to focus on job growth and innovation.

And finally as proposed in the current legislation it offers a thoughtful methodology for its enactment that would allow our government to have in place a system to address our national priorities. It is an idea, panel members, who's time has come. I look forward to learning more about the recommendations the Panel will submit to the Secretary, and I thank you for this unique opportunity to testify.

CHAIRMAN MACK: Mr. Baker, thank you. And Mr. Feige, we'll go to you.

DR. FEIGE: I want to thank the Panel for giving me this opportunity to testify to propose what I call the automated payment transaction tax, or for short, the APT tax.

It's a radically different proposal than any you have considered. And I should begin by acknowledging that I'm under no illusions that the Panel will support or adopt this kind of radical change immediately.

But I think it is time to begin to think about different ways about thinking about taxation, ways rooted in the information age rather than in the industrial age.

The key points to the proposals are as follows. The panel has well established all the difficulties of our current tax system. So the best news I have to offer in my proposal is it would entirely eliminate state, local and federal corporate, personal income taxes, capital gains taxes, sales taxes, gift and estate taxes, and it would replace them with a very simple flat tax rate on all transactions. That's the entire plan. It is very simple to understand.

We would eliminate all deductions, all exemptions, all credits, all exclusions, and adopt a zero tolerance policy on all forms of tax expenditures. The effect of this is to eliminate opacity of the current tax code and place the political burden of providing for public goods on the expenditure side of the budget, which I believe is more transparent.

We would assess and collect the tax payment at source, namely, when payment is made through the electronic technology of the modern banking payment system. Tax currency is also taxed. Currency is the major medium of exchange for the underground economy. And I would also tax currency as it enters and leaves the banking system through ATMs or over the country.

The cost savings involved -- and I challenge opponents of this plan to match whatever objections they have to the plan against the decided benefits, which I would argue the elimination of our current system could save our government and our taxpayers roughly $825 billion every year. That's made up of approximately $300 billion in distortion efficiency costs; another roughly $200 billion in compliance costs; and another $325 billion estimated innovation costs.

The simplicity and transparency of the plan: it eliminates all filing of all information and tax returns. It eliminates record-keeping since taxes are automatically assessed and collected at the source of payment, that is, whenever any financial institution that permits debiting or crediting to its accounts, we have one line of software that links that account to a government taxpayer's account.

That is how the tax is implemented, and every time a transaction is made, a fixed flat percentage is immediately transferred in real time to the government.

It's essentially the electronic financial equivalent of a highway easy pass -- no toll booths to go through, no returns to file. It is instantly assessed and automatically collected.

And I should say it's completely private, because the government only gets to know how much is in your taxpayer account, it does not know what transactions generated the payments to you. So there is total privacy involved here.

It's also very transparent, because at the end of the year every taxpayer knows precisely how many dollars they paid to the government, because this will be the only form of taxation. Except I should say I have not included local property taxes in this proposal because I think they should be retained.

And I also have tried to avoid the confrontation over Social Security by not including Social Security payments in my revenue-neutral calculations.

It's fair, and it's equitable. Every free market transaction, every voluntary transaction between two consenting parties, is taxed at exactly the same rate, and yet the tax is highly progressive even though it's a flat tax, because the tax base is so highly skewed in the direction of the wealthy.

It's administratively easy -- we now only monitor financial institutions to be sure that line of software is not tampered with, rather than 100 million taxpayers. Compliance costs of $200 billion annually are virtually eliminated.

It promotes efficiency in growth, because the inefficiency of a system, just one moment if I may, rises exponentially with the tax rate. What I'm talking about here is designing a system with the lowest conceivable marginal rate on the broadest conceivable tax base, all transactions.

It shifts the burden away from wealth producing activities, that is, positive sum activities, to wealth redistributing activities, zero sum activities. And it can be viewed as a public brokerage fee to pay for the provision, maintenance, and use of the monetary, legal, and military and political institutions that facilitate and protect free trade.

It's revenue neutral. I can calculate that as you'll see in the appendix. This will amount to a six-tenths of one percent tax on every transaction paid equally by the buyer and seller. We're talking about a marginal flat tax rate of three-tenths of one percent on every transaction.

And that takes into account that transactions will fall by 50 percent as a result of the tax.

CHAIRMAN MACK: Mr. Boucher, I apologize for pronouncing your name incorrectly when I first spoke.

MR. BOUCHER: Am I connected now?

Thank you very much for inviting us here. The United Californians for Tax Reform has been involved in the tax reform movement for the better part of 14 years. And we've primarily concentrated on simplicity and lowering rates.

My name is Roland Boucher, and I'm chairman of the United Californians for Tax Reform. And in putting together this presentation our board, just the three of us, spent weeks agreeing on which proposal specifically we were going to give.

This is not easy stuff, and you've got a lot of people to satisfy. But it really comes down to the President, doesn't it?

The proposal we have before you today is extremely simple. We are not asking to change the world but only asking that the income tax be changed in a very modest way. The president suggested that we maintain the deduction under the proposals, maintain the deduction for mortgage interest and charitable contributions.

By implication that means that the other itemized deductions were on the table. And we've chosen the largest other one left over, which is state and local taxes. And we're going to show you how on a revenue-neutral basis we can reduce the taxes on the

American people to 20 percent maximum, with one other minor modification having to do with the personal exemption.

We will show that we have simplified the tax code, and we made it fair, or no less unfair than it is now. We promote economic growth. Our transition costs are essentially nothing. And we are revenue neutral, and we can show that too.

We have seven key points in our proposal. One, eliminate all deductions for state and local income sales and property taxes. Retain all other deductions including home mortgage interest and taxable charitable contributions.

We eliminate all personal and dependent exemptions, but we fold them into the increased standard deduction of $7,950 for single taxpayers and $15,900 for joint tax filers.

So those who file today in the short form will have no effect whatsoever. They'll pay the same taxes they're paying now.

We retain the maximum tax rate of 15 percent for income from qualified dividends and capital gains. We don't have to touch that to remain revenue neutral.

We replace the 25 tax rate with a 20

percent rate and eliminate the 28, 33 and 35 percent rates.

We retain all other tax code provisions, including adjustments to gross income from IRA contributions, alimony payments. And we retain the tax credit including the child tax credit.

So we made a very minimal change to the tax code.

The benefits. We will reduce the number of tax brackets from six to three. That's self evident as a benefit.

We reduce the number of taxpayers who would claim itemized deductions from 40 million to under 10 million. This is true because we've reduced the value of the itemized deduction by two things. We've made the standardized deduction larger, and we've removed roughly 40 percent of the itemized deductions.

Withholding is now easier to compute. Withholding is a bear for retired people, because your income is at the mercy of the market. You can't predict it.

And so just by minor changes, we are helping out the persons who have to try to figure out how much should I withhold, or how much quarterly payments should I make?

Record keeping will not be necessary for most taxpayers, because there are 130 million tax filers; there are only going to be 10 million using the form; the other 120 million are going to have a very easy time of it.

We would reduce the disparity in the federal tax burden for taxpayers at the same income level. Now this is probably the thing that causes the most consternation among the people that we talk to, the taxpayers. They don't like the fact that they are afraid, in fact, they really believe that another person making the same amount of money is paying a different amount of tax..

That comes about strictly because of the itemized deductions, child credit, and so forth. It has nothing to do with the basic tax code.

We reduce the disparity of federal tax burdens between taxpayers in different states. If I live in state A, which should I pay less or more taxes than someone in state B? These are fundamental fairness issues. They go to the heart of people believing in the tax code.

If you can't make it fair in these very simple ways, then it's pretty tough to get people not to try to cheat. Because if they think they're being cheated, they'll cheat back.

We raised taxes from no taxpayer who now claims the itemized deduction, the standard deduction.

Administrative ease, well, not only do the taxpayers save a lot of time and trouble, the employers would be saving a lot of time and trouble in figuring out how much to withhold. A simple tax table, with a single 20 percent rate above that tax table, would be all that was required to file your taxes, and it would reduce the number of errors that the taxpayer makes.

Now, California has already changed their tax filing system, in terms of the reporting -- or the filing -- the filing system by doing essentially that. And I'm sure it is helping.

We reduced the number of taxpayers who claim the itemized deductions, so the IRS is going to have the ability (maybe this is a bad thing to say) the ability to look at four times as many tax returns in the brackets in which the cheating takes place.

We lower the top marginal rates by 50 percent, nearly 50 percent, from 50 to 20 percent -- I'm sorry, from 35 percent to 20 percent. We reduce therefore the disincentive to work. We reduce the marginal tax rate for small business.

I had a small business. I became a corporation; I was still a small business. And let me tell you, when you're paying half of your income, half of your profit, to the federal government, you have to borrow sometimes to make those payments. And that is not exactly helpful to small businesses.

Thank you very much.

CHAIRMAN MACK: Thank you very much.

Any questions from the panel?

Turn on your microphone.

MS. GARRETT: (First seconds off-mike 2:33:05) those of us in California are aware of the Alternative Minimum Tax. And I wondered what your proposal did with respect to the Alternative Minimum Tax.

MR. BOUCHER: We didn't do anything directly, but we did reduce the number of people who would have any business filing it by a factor of three.

Also, we have studied many many tax proposals. Our computer programs can analyze tax codes fairly quickly. We must have done 100 of them for this meeting, because we look at other people's proposals too. And we've done over 1,000 since we started.

What we've done in California is, we've got six bills introduced and most of them passed. There's one floating there now with capital gains, to make it simpler so that one of the things the federal government can do, not only let people file without itemized deductions, but remove the restrictions on the short tax form so that most people can use it.

Now, we've done that in California. And I say it's self-evident that a six-page set of instructions is better than a 125-page set of instructions. I think at one time we figured out there would be a enough paper to go from LA to New York, it would be six inches deep, with the amount of paper we spend making tax forms.

Now, six pages is still a lot of paper. But it's not as bad as 125 pages.

MR. ROSSOTTI: Mr. Boucher, I just wanted to ask, how you had estimated that you could get the rate down to 20 percent? In other words is there anything more to it than what's here?

MR. BOUCHER: Well, we were as surprised as you are. We for years had been doing this on the basis of throw all the itemized deductions out. But since the President wanted to keep two of them, well, we kept them.

And I ran this about 12 times before I showed it to the board. What happens is, when you get rid of that itemized deduction for state and local taxes, you pick up $73 billion.

MR. ROSSOTTI: Per year?

MR. BOUCHER: A year. That's twice as much -- these, by the way, these are 2001 figures, because the latest, we use the IRS data. To take the IRS data from 1304, document 1304, which has it $2,000 and $5,000 increments, all the way up to $1 million. We put that in our computer so that when we run the tax code, we have the actual data from the IRS in there that we can pull things out of the actual data. So that's how we do it.

And when we pull that data out, when we remove that one tax element, and then recalculate, and the computer fills the tax code out, which is better? You'll take whatever gives you the least tax. If you do the figures, single, married, independently, should you itemize or not itemize, then we go ahead and run the code.

And when we get through, it drops the tax rate. The top three tax rates disappeared, and we came in with 21.4 percent at the top rate.

MR. ROSSOTTI: And this is supposed to be revenue neutral, right?

MR. BOUCHER: That's all we run is revenue neutral.

Now we also decided, well, if we're going to get to 21.4, why don't we take it down to 20? So we looked at, what if we got rid of the personal exemption and popped that into the standard deduction.

It was taking away from the itemized.

MR. ROSSOTTI: I wonder if it isn't private if you could send the staff here the model which shows how that works?

MR. BOUCHER: Absolutely. We've run a lot of cases. We'll run cases on anything you want us to run it around.

MR. ROSSOTTI: No, just the one that shows how you got it down to 20 percent, that's all.

MR. BOUCHER: Okay, no problem.

VICE CHAIRMAN BREAUX: I just wanted to thank all three of the panel members. We got your material. We'll be looking at it very carefully. And thank you for your time; appreciate it very much.

CHAIRMAN MACK: Welcome gentlemen.

We have three panelists that will be presenting again some other alternative proposals:

David S. Miller, partner with Cadwalader, Wickersham & Taft LLP; David A. Hartman, chairman, Lone Star Foundation; and Mr. Norman G. Kurland, president, Center for Economic and Social Justice.

And Mr. Miller, why don't we start with you.

MR. MILLER: Mr. Chairman, and panel members, my name is David S. Miller. I'm a partner in the law firm of Cadwalader, Wickersham & Taft.

I thank you for inviting me to speak today. I'm going to present to you a progressive system of mark-to-market taxation.

Under my proposal public companies, private companies with $50 million or more of net assets, and individuals, married couples earning $1.6 million or more or having $5 million or more of publicly traded investment property would mark to market, that is, would be treated as if they had sold and repurchased their publicly traded property in derivatives each year, and would pay tax on any appreciation or could deduct any loss, without actually selling the property.

The proposal would affect only the top one-tenth of one percent of the wealthiest and highest earning individuals and married couples. All other individuals and small companies would remain under the current realization system.

Under the proposal corporations would be subject to tax on their mark-to-market gains at the current 35 percent rate, and their mark-to-market losses would be fully deductible.

Individuals' mark-to-market gains would be taxed at the 15 percent long term capital gains rate. Qualified dividends would also benefit from the 15 percent rate, and interest and other ordinary income would be taxable at the current 35 percent rate.

Individuals' mark-to-market losses would be fully deductible against current or prior mark-to-market gains and other capital gains, and losses could offset 43 percent of ordinary income, or could be carried forward indefinitely.

The first advantage of a mark-to-market system is that it generates significant additional revenue without raising rates or imposing new taxes. For example, if a mark-to-market system had been in place in 2004 it would have generated over $2.2 billion of additional revenue from the two founders of Google alone. Over a 10-year horizon, the proposal would generate hundreds of billions of dollars.

To satisfy the president's objectives for tax reform I would use the revenue to first repeal the Alternative Minimum Tax, and then either eliminate the tax on investment income for low income families, or else expand 401(k) plans for all Americans.

The proposal would dramatically simplify the federal tax law. It would eliminate the Alternative Minimum Tax, and eliminate tax planning and a slew of anti-abuse rules for mark-to-market taxpayers.

Under a mark-to-market system there is no need for the straddle rules, the short sale rules, the wash sale rules, the constructive ownership and constructive sale rule, or the capital loss limitations.

All of these rules prevent abuse of our realization system. But mark-to-market taxation measures economic income, and it is abuse proof.

Because mark-to-market taxation is abuse-proof, the proposal would eliminate a number of the most prominent tax shelters for mark-to-market property. For example, loss generators are impossible under a mark-to-market system. Tax losses arise only if the taxpayer has in fact suffered an economic loss.

The proposal uses the incidence of tax to enhance progressivity. Large corporations in the wealthiest one-tenth of one percent of households would mark-to-market their publicly traded property in derivatives. Their tax rates would remain the same, but their incidence of tax, and therefore their tax burden, would increase.

Most taxpayers would remain on the realization system. Their tax burden would not change, but the Alternative Minimum Tax would be repealed.

The proposal restores fairness to our system. Under current law wage earners are subject to tax when they receive cash wages, but large investors can avoid virtually all tax on their appreciated assets by hedging their risk with derivatives, and borrowing against their positions indefinitely.

In this case they can receive cash without tax, and if the estate tax is repealed, these taxpayers will never pay cash on the appreciation in their assets.

The proposal eliminates this loophole, prevents deferral of tax to the very wealthiest of taxpayers, and helps ensure that all taxpayers, wage earners and investors alike, pay their fair share.

The proposal eliminates the inefficiencies of our tax system, and enhances liquidity in the capital markets. It eliminates the locked-in effect which discourages taxpayers from selling their appreciated property, and the lock-out effect, which discourages taxpayers from repurchasing securities that were sold at a loss.

And the proposal, perhaps the only proposal presented to you, would tax complex financial instruments economically, and prevent taxpayers from using them to reduce their tax.

The proposal encourages work effort, savings and investment, by repealing the Alternative Minimum Tax, eliminating tax on the investment income of low income taxpayers, and it complements the president's progressive indexing proposal for Social Security.

The proposal would also conform the tax law to GAAP. Under the proposal when the securities and derivatives of corporations increase in value, and they report the earnings to their shareholders under GAAP, the corporations would be required to pay tax on these earnings.

This is the law in the United Kingdom, and it should be the law here, too.

To summarize, a progressive system of mark-to-market taxation achieves all of the president's tax reform objectives. It simplifies, it enhances progressivity, it eliminates the Alternative Minimum Tax, it retains home mortgage and charitable donation deductions. It closes loopholes and eliminates tax shelters. It encourages savings and investment.

Most importantly it is revenue neutral, and it does not raise rates, deny deduction or impose new taxes.

Thank you.

MR. HARTMAN: I appreciate the opportunity to appear before you today in order to present the recommendation of the business transfer tax for comprehensive reform of the federal tax code.

I'm David Hartman from Lone Star Foundation, a public policy institute which conducts state and federal fiscal studies.

The business transfer tax is a subtraction method value-added tax, commonly referred to as the VAT -- we'll refer to the business transfer tax as BTT -- which is consumption based by expensing fixed investment; border adjusted by taxation of imports and crediting of exports; replacing three-quarters of the federal tax code, and superseding all income and wealth taxation other than the individual social insurance taxes.

The BTT base is determined for commercial activities as all revenues, less export sales and less purchases of goods and services, including fixed investment for expensing, adding back all imported purchases equal the commercial base, and include as proposed governments and not-for-profits tax on all employment expenses plus all imported purchases.

The BTT would supersede the following federal taxes: individual income taxes, corporate income taxes, employer social insurance taxes, estate and gift taxes, and custom duties.

The BTT single tax rate necessary for tax revenue neutrality is 17 percent rate. Or, alternatively, for tax burden neutrality, 18.2 percent. Here we need to note that both rates provide found money from taxing net foreign trade. The 18.2 percent provides funding for either transition or debit reduction at the present tax burden on U.S. citizens.

The BTT prevents regressivity. It provides rebates to all citizens of the BTT on family-based covered level income, charitable giving, and home mortgage interest rate.

It taxes income above poverty level

proportionate to consumption, and it terminates capping employer social insurance but retains the federal match of individual contributions.

I'd like to address misconceptions about the business transfer tax. Border adjusted taxation via the business transfer tax or any VAT is not protectionism. It only equalizes the competitive hurdles for U.S. producers.

VAT taxation was not the cause of runaway welfare spending in Europe. It was due to adopting VAT taxes in addition to, rather than in replacement of, income taxation, as is proposed herein for the VAT.

Border adjusted taxation, I want to particularly emphasize this, because we have a trade in goods hemorrhage, and we are virtually destroying our manufacturing sector by how we tax.

Border adjusted taxation is the only realistic basis for equalizing prices to end the trade deficit hemorrhage and the manufacturing crisis.

So in summary, the BTT addresses the principal U.S. economic problems. The manufacturing crisis is addressed by border adjusted taxation. The saving and investment deficit is addressed by consumption taxation.

Outsourcing of services is addressed by border taxation. Relocation of corporations will be stopped by ending corporate income taxation. Declining labor income shares will be remediated by exemption investment in order to secure greater economic growth and greater productivity of labor.

Increasing growth of all incomes will result from all of the above BTT remedies, and you will terminate the complex and inefficient income tax code with simpler, broadest base, providing the lowest rate from the BTT.

It's proposed that the BTT would be phased in over three years by a third per year, and simultaneously sunsetting the present code by a third a year.

There is the alternative. We'd do better to replace the corporate income first, because it would have more effect on returning of flight of corporations.

However, one has to bear in mind that it would put people under the combined business taxation that previously were not taxed as corporations. So they need to get the benefit of the personal income tax reduction to not complain.

In the appendix of supporting information, which there apparently is not time to present, but I would urge you to particularly look at the evidences of the manufacturing crisis which we're in utter denial on, and the consequent economic effects that it caused that would be cured by this approach to taxation.

And I might finally say that I didn't agree with much that I heard about the retail sales tax nor credit invoice VATs. The experience with both of these show that they have been limited in what you can cover with them. They're virtually too transparent politically, whereas the business transfer tax, where it can be made apparent by putting it on invoices to include the 17 percent business transfer tax, would be actually the easiest to secure the biggest base in my estimation, and that's what required to give you the lowest marginal rate.

Thank you.

CHAIRMAN MACK: Thank you, Mr. Hartman.

And now, Mr. Kurland. Please pass the computer.

MR. KURLAND: Thank you, Mr. Chairman, for the opportunity to speak to you today on the President's request that we reform the tax system.

I represent the Center for Economic and

Social Justice which is founded on these propositions, that expanded capital ownership should be, is a missing ingredient in all the nations of the world as a fundamental objective of citizenship, and it has to be part of the tax system.

Two, that there should be limited economic power of the state.

Three, that we must restore the just or the free and open market system for determining what the just price is, the just wage, and the just profit.

And four, a restoration of a private property.

Now these are the four pillars of what we call "the just market economy" or "the just third way" -- not just "the third way," but "a just third way."

Our proposal is designed to transform the federal tax system to accelerate private sector growth, balance the budget, and make every citizen a capital owner.

Who owns America today? Ten percent of Americans own 90 percent of all directly held corporate equity, while the remaining 90 percent split 10 percent of the individually held stock.

There are statistics showing that the top one percent of Americans have more household financial assets than the bottom 95 percent.

What can we do about that? Our tax reform is based on what we call capital homesteading, which would promote growth creation for all Americans. So that the incremental growth in the economy can be built into the American people from the day of birth to the time of death.

So we're talking about creating not just a personal savings account. We call it the capital homestead account, taking off from Lincoln's ideas that 160 acres of land should be made available to propertyless people in the past.

The U.S. economy adds new plant and equipment, new rentable space, and new physical infrastructure in both the private and public sectors at a rate of about $2 trillion a year. That's the annual growth ring. Roughly $7,000 per man, woman and child in America.

We finance that growth in ways that don't create new owners in the process. And basically it's because of a half complete thought of how to finance new capital formation.

Harold Moulton in 1935, who was the president of Brookings Institution, wrote a book called The Formation of Capital in which he said that it made no sense for people to reduce their consumption incomes in order to become owners of capital. Why? Because it reduces the feasibility of the project itself not to have customer power to buy the resultant goods and services that are added.

Now some people talked about human capital. Well, human capital, this is almost -- this is a contradiction in terms, because capital are things, and we shouldn't be talking about human things. And if we want to see what increases the productivity of our economy, 90 percent of the productivity growth according to very excellent studies is attributable to technological change and systems changes.

And so these are capital, and these are the kinds of capital that are added in ways in the corporate sector through standards of feasibility so that capital is not added unless it is procreative, unless it will pay for itself. So we'll talk about precisely what we're talking about, how do we create an ownership society.

The President is absolutely right in elevating that. And that makes us different than any other economy on the globe. We don't have to copy people. George Mason, before the Declaration of

Independence was signed, said that one of the fundamental purposes of government was to enable people to have the means of acquiring and possessing property, Section 1 of the Virginia Declaration of Rights, before the Declaration of Independence.

And we had Adams and Jefferson and Daniel Webster talking about the fact that if we want to have a political democracy it is absolutely vital that people had a property stake.

You had Popes who issued encyclicals indicating that if you wanted to remove the class struggle between the workers and the owners, enable people to become owners.

In my time I will have very little time to go into this, but there is a book that is downloadable free from our website which goes into detail, and I've also submitted a statement for the record. But as Senator Breaux has probably heard from Senator Long on these, I worked with Louis Kelso when we first met with Senator Long, and he became the champion.

Hubert Humphrey was a champion of the ideas of building ownership. Ronald Reagan gave speeches about industrial homesteading. We just call it capital homesteading. Walter Reuther, who I worked for before, before Louis Kelso, was beginning to talk about, this is the new, this is the new game plan for working people. John D. Rockefeller III wrote about this, and of course, President Bush.

Let me just touch on the basic points, and the details you can find in the subsequent slide.

What is the purpose of a tax system? It's to yield the revenues to pay the legitimate costs of government.

Another purpose of a good tax system would be to make sure that it maximizes the production of wealth in a competitive global economy. We want to minimize the need for redistribution, and this includes the Social Security system. And our proposal would move the revenue, once you see what our specific proposal is, it would generate $3,000 of capital credit per year for every man, woman and child from the time of birth, so that by the time someone reached 65, they would accumulate roughly, under our projections in the book, about $200,000 of capital assets.

Because we would make dividends deductible at the corporate level and taxable at the personal level, except for that used to pay off leveraged acquisitions of stock, they would be getting about a 15 percent rate of return, or $30,000. So a husband

and wife could retire on $60,000 of second incomes, incomes from capital over and above whatever else they could earn from any other source.

And during that period of time they would accumulate roughly $780,000 of dividend incomes on the basis of getting $3,000 credit each year to acquire the growth.

And then lastly this is to create a level playing field, and to create new capital owners, without violating the property rights of owners of existing capital. We have proposals for inheritance taxes, but essentially it's to get the - to have corporations pay out their earnings fully through dividend deductibility, so they are required to find another source of financing their growth, and that would be through the issuance of new shares through the capital homesteading accounts, and the Federal Reserve, the section 13 of the Federal Reserve Act, would be the means by which they begin to modify the growth of America.

Thank you very much.

CHAIRMAN MACK: Questions?

VICE CHAIRMAN BREAUX: I just have one, Mr. Kurland.

You're recommending it would be a single one rate?

MR. KURLAND: Yes.

VICE CHAIRMAN BREAUX: And what would that be?

MR. KURLAND: It would be a single rate above the poverty line. So I heard the Fair Tax people; I'll take their numbers.

Because frankly the Fair Tax proposals are not that different from our proposals as to what would be taxed and what would not be. We'd eliminate the payroll tax; we'd allow the corporations to eliminate their corporate taxes by paying out their earnings except for depreciation and for operating reserves.

But otherwise pay it out, issue new shares. We would, on the inheritance laws, we would not tax the estate. We would allow the capital homesteader to accumulate a million dollars of assets to encourage those with billions of dollars in their estates to spread it out as broadly as possible to other capital homesteaders.

VICE CHAIRMAN BREAUX: Okay, thank you.

MR. POTERBA: Mr. Miller, two questions on the mark-to-market plan.

The first is, it would seem as though in a year when the stock market is substantially down, like

2001, that this plan could induce a lot of downward volatility in federal revenues, and one could go into an experience where there is a very pronounced drop, sort of like what happened in California in the late '90s as it became very sensitive to the state revenue structure to capital gains.

I'm wondering if you've done any calculations or simulations about these things?

And the second is related to the loss, the loss carry-backs that you allow, so that a loss this year can be carried back against previous gains? In the UK experience do we know anything about the extent to which the losses are ultimately, you know, recoverable against past gains? Or how many people end up in a position where they now have an unrecovered loss that is carried forward and waiting for future gains?

MR. MILLER: I'm afraid I can't help you on either one. One, I have not done modeling of the effect in a downturn. And number two, I don't know enough about the UK system to tell you whether they get refunds for their losses, or what their carry-back system, how their carry-back system operates.

MR. FRENZEL: Mr. Miller, when you're marking to market, would you deduct for inflation in that year?

MR. MILLER: You could. That certainly could be a component. Obviously, indexing for inflation is in a sense fair. You have to balance that against revenue. It would be consistent with my plan to do so.

MR. FRENZEL: Thank you.

MS. SONDERS: Mr. Miller, let me just stay with this for a minute. When you talk about mark-to-market valuations on publicly traded securities and derivatives, I've spent 20 years on Wall Street, and we know that there are plenty of public securities where the ability to get a valuation is pretty easy, but certainly many times publicly traded doesn't necessarily mean actively traded, and some of these more thinly traded derivatives, what the ability is to come up with a valuation, and what the administrative cost associated with that would be?

MR. MILLER: Well, you're right, for really publicly traded stocks it would just completely be a matter of looking it up in the *Wall Street Journal*. For complex derivatives and thinly-traded stock, I would do two things. One, I would allow taxpayers to use their GAAP valuations for income tax purposes.

Number two, for taxpayers that are not reporting under GAAP, I would put the responsibility evaluation on the investment banks that either structure or are counter parties to the derivatives. The IRS would approve of methodologies, would audit only those methodologies.

I would allow taxpayers to rely on the valuations given to them by their counter parties as long as they do so in good faith.

CHAIRMAN MACK: Any other questions?

If not, I thank the panel. We have one more panel to go. We're still waiting for some members of that panel to arrive, so we will take a break for the next few minutes.

Thank you.

(Whereupon, at 3:05 p.m. the above-mentioned matter went off the record, to return on the record at 3:17 p.m.)

CHAIRMAN MACK: We have three of the panel members already with us. This is our last panel for today. This will be on the Flat Tax.

And we're going to hear testimony from Robert Hall, a senior fellow at the Hoover Institution; Stephen Moore, president, Free Enterprise Fund at the present; Richard Armey, co-chairman, Freedom Works -- I love that title; and Steve Forbes, again, we hope that he is on his way. And of course that's a name that people recognize, president and CEO of Forbes, and editor-in-chief of Forbes magazine.

So with that I think we'll go to Mr. Hall.

MR. HALL: Well, thank you, Mr. Chairman.

I'm delighted for this opportunity to talk about the Flat Tax, and I will also be talking about the X-tax, which is a close relative to the Flat Tax, which was created by David Bradford.

Let me start by saying what the Flat Tax is, and to do that, let me just show you the individual tax return which would be filled out by all wage earners. And it is an individual wage tax. So the personal part of this tax system, the part that individuals generally come into contact with and fill out a form, is just on wages. And I'll explain the reason for that as we go along.

It's important to understand that this does not claim to be a personal income tax. It is what it says it is, it's an individual wage tax. And it's very simple. You report on line 1 wages and salary and retirement benefits, so it's wage-type income, lines 1 and 2. Then there is a personal allowance, a generous personal allowance. And the numbers here should be thought of as illustrative. This is really a toolkit for tax reform, and various alternative combinations of things like the marriage penalty, the degree of progressivity, are controlled in part by the personal allowance.

Then there is a dependents allowance, so that's similar to the existing tax system.

And that takes you to taxable compensation, the difference between total earnings and the exemptions, the allowances. And then a tax of 19 percent.

We also would view this as having a withholding system as at present, so this would be actually when it's filed, it would just be a mop-up of the actual tax versus the withholding. Withholding of course in this system would be very simple, so this would be just something that happened at the end of the year to take care of what was basically deducted during the year.

All right, so this accomplishes enormous simplification at the personal level. And replaces great complexity of taxation at the personal level.

It does so in two ways. One is, it's a very simple tax structure. It's an allowance and then a 19 percent tax on top of the allowance.

It also reveals something very important about this system and related systems that I think this panel should take very seriously, and that is the benefits of dealing with business taxation at the source rather than at the destination.

So business income is taxed in the system, but it's not taxed on this form. When business income reaches individuals, it's already been taxed. And teaching people about that principle is one of the most important goals of tax reform, and it's an area where we've made some progress.

We cut the business tax rates on dividends and capital gains two years ago. I think it was a very important step in the direction of proper tax reform. And we showed that it could be done. And we need to do more of that.

Okay, so that takes us to the other half of the tax, which is the business tax. And the business tax is a very close relative of the value-added tax. It uses the same efficient principles of taxation that the value-added tax does.

And its only difference from a value-added tax, if you're familiar with how that works, is that in line 2(b) a business is allowed a deduction for the wages and salaries it pays. If you eliminated 2(b) this would be exactly a European-style value-added tax at a 19 percent rate.

You might ask, well, why not do it that way? What is the matter with the European system? Why don't we just copy a very successful institution that exists in Europe?

And the answer is, going back for a minute to form one, form one introduces progressivity in the tax system that is unattainable if you were to capture everything on the business tax. Because the business tax doesn't know of any deductions, what exemptions an individual should be given. You can't make it progressive. It's really the same tax system, but by shifting the tax on earnings away from the business and toward the individual, you can make it progressive.

So this solves the one problem that really stands in the way of the adoption of the value-added tax in the U.S. as a comprehensive replacement for personal business taxes, which is, it's not progressive.

Europeans have struggled with that problem, and they've done all kinds of things that are bad. They've introduced differential rates, they've put a progressive income tax on top of the value-added tax, which is a serious mistake.

The right way to do it is to make it progressive; make the value-added tax progressive, and that's what this tax design does.

Okay, so what are the benefits of this? One of the expenses, if we can go back for a second to the business tax, and this is inherited from the standard value-added tax, is, on line 2(c) there is a deduction for purchases of capital goods -- plant and equipment.

That makes it a consumption tax. So the standard value-added tax, the European value-added tax, is a consumption tax. That's a highly desirable form of tax. It gives the right incentives for capital formation.

This tax system, these two forms together, are the essence of simplicity. But it's not just simplicity achieved for its own sake; it's simplicity directed toward having an air-tight comprehensive low-rate consumption tax.

It's very easy to administer. It's vastly easier to administer than the current income tax because it taxes business income at the source.

I think that ought to be the litmus test for successful tax reform is, does it tax business income at the source. Do you have Form 1099s or do you not?

The IRS has to process more than a billion Form 1099s every year. That is completely wasted effort. There is no social benefit whatsoever in doing that. Because all that business income could be taxed at the source.

If the tax has already been paid, before it goes to the family, you don't need to worry about the family's receipt of it. You don't have to have a Form 1099. So the abolition of the Form 1099s, which is a complexity that greatly burdens the IRS and individual taxpayers as well, not to mention the institutions that have to issue them, is just an enormous improvement in the administration of the tax system, and it's done as part of a system that achieves very basic goals of efficiency, consumption tax principle, and simplicity.

The 19 percent rate duplicates, or more than duplicates -- I haven't done these calculations -- Rabushka came to me after he saw these slides and said, you're underselling. Of course he often accuses me of that. And he said, it's 19 percent actually the, according to his calculations, the revenue neutral rate would be less than 18 percent currently.

So this works.

And many many people -- this as you know has been around for a long time, and in fact, many people now have investigated, even some from a hostile point of view -- and there's very strong agreement that a rate in this region will be revenue neutral.

Okay, now turning for a moment to the X-Tax, the X-Tax has the same structure, has the same tax forms, it has the same principle, business taxation at the source. It's very simple. The only difference is, the personal tax has more than one bracket.

For example you could have a 12 percent bracket and a 25 percent bracket, with the higher bracket starting at $60,000 just as an example. And that will achieve a different distribution of the burden of federal taxes.

Now that's something of great concern to everybody, certainly to me. And the added flexibility from another bracket could take you a long way toward dealing with this question of just where that burden should be allocated.

In particular, if you wanted to duplicate the distribution of the burden of the current personal income tax, you would want to have a second bracket. So just to illustrate what that means, the blue line is the Flat Tax, and the red line is the X-Tax. Notice first of all the Flat Tax is not flat.

Many, many, hundreds of critics have said, you've mislabeled this. The Flat Tax is not flat. It's a zero tax for a long way, and then it starts up at the 19 percent rate.

Well, that's Rabushka's fault. He invented the name. And you can blame him for that. The Flat Tax is what it is, that is, it has one rate where it imposes a rate, and then it has many who are not taxed at all. That's why it's progressive.

The X-Tax, you can see, the red line, puts a lower burden in that middle area from 40 to 60, which contains a lot of taxpayers, and then puts a higher rate. It has a crossover point, and then for higher-income taxpayers because of the higher top bracket rate it collects more revenue.

So I just throw that out to say that there are design principles here that could be adapted to whatever decision is made about the distribution of the burden, and you could keep the -- is that it? Did I get five minutes? Does that go off at five minutes?

Okay. So --

CHAIRMAN MACK: Take another minute or so.

DR. HALL: The only other thing I wanted to talk about was just very quickly what could you do that would be incremental steps toward the Flat or X-Tax? We did a very important one already. We moved in the right direction. The president made the right choice, which is business taxation at the source, cut not the business taxation of dividends but the personal taxation of dividends. Very, very important step.

The next step is, not 15 percent but zero. That would be the efficient form.

So we need to carry on with steps like that, and we need to simplify the personal tax.

There are many things we could do not, especially as the AMT is taking more and more of a bite, particularly the state and local income and property taxes. This would be a very good time to take that step, because they are not deductible under the AMT, and therefore, the number of people who would be affected is unusually small right now.

So there are lots of things that could be done incrementally to achieve this basic framework of a business tax that taxes business income at the source, very simple, the personal tax only on wage income. The two together constitute a simple, efficient consumption tax.

Thank you.

CHAIRMAN MACK: Stephen, do you want to go next?

MR. MOORE: Sure.

Thank you, Senator Mack and Senator Breaux, for inviting me to speak here. This is a great honor for me to be with Professor Hall and my old boss, Dick Armey. Dick, it's great to see you again.

What I wanted to talk a little bit about this afternoon just for a few minutes is the idea of how we could get to a flat tax in a politically achievable way.

You all know about the dysfunctions of the tax system. You've been studying that for the last several months. Mr. Rossotti, you might be interested that I have on my wall in my office, I have one of these old Peanuts cartoons, where Snoopy used to sit on the doghouse and type out a message. And it says, Dear IRS, please take me off your mailing list.

And I think that's the way a lot of Americans feel about the tax system today.

(Off-mike comment.)

So I worked a bit with Dick Armey back in -- when did we, what was it early '90s? I think so.

MR. ARMEY: '93 and '94.

MR. MOORE: -- when Dick Armey first embraced the Flat Tax, and caused an incredible political sensation with that idea. And I really commend Dick for taking that issue on.

I became more and more convinced as we were debating the Flat Tax that the political obstacles to getting that in place were nearly insuperable, because of all the special interest groups that were mounted against it.

So this idea that I came up with, and one of the things you learn in Washington is that there is no such thing as a new idea, but this was the idea of why don't we have something very similar to what Professor Hall just outlined, but essentially make it optional to workers so that they could opt in to the Flat Tax if they wanted to have the Flat Tax, but if they felt that they wanted to stay in the current system that they would have the option of doing that too.

So in a way, rather than having an Alternative Minimum Tax, which we have right now, the idea behind this is, why don't we create essentially an alternative maximum tax, which would be the Flat Tax rate that Professor Hall talked about.

And so let me just talk about why I think this might be the bridge that gets us to a flat tax. And first talk a little bit about the political barriers that we face in terms of trying to get to a flat tax.

Milton Friedman, a number of years ago, had a very famous article in the *Wall Street Journal* called "Why We Will Never Have a Flat Tax." And the point that he made in that article was that the political opponents are all lined up with huge bankrolls of money ready to spend to try to defeat the Flat Tax. And we saw that right away -- we saw a little of that when Steve Forbes, who will be here in a few minutes, ran for president in 19 -- I think it was in 1996, when he was searching in New Hampshire, the housing groups ended up spending millions of dollars to try to discredit the Flat Tax, you remember with all those ads that they were running against him that were mostly lies, but they were very effective in terms of bringing Steve Forbes' numbers down.

So there are political obstacles. And the first obviously is that you have these well-funded special interest groups who want to protect the loopholes that they've invested in in the current tax system.

The second is that many Americans feel a fondness to many of these sacred -- what I call the sacred cow deductions in the tax code, like the mortgage interest deduction and the charitable deduction, just to mention two.

A third problem with the Flat Tax in terms of having it implemented in an easy way is that when we got involved in the Flat Tax, we came up with this wonderful plan. And then we realized, wait a minute, there are really important and expensive and complicated transition costs to moving from our current system to the new system.

And it turned out when we started actually trying to write the transition law, the transition rules into law, we were almost writing a whole new tax code just to deal with all these complexities of the transition cost.

A fourth is what I call the winners and losers problem that when you have a system as Professor Hall has just outlined. There is no question that it's great for America. It will grow the economy. It will vastly simplify the system. But in the short term it will create people who are winners in the system because it's a revenue neutral system, but it will also create people who will have to pay more taxes.

And one of the things we've found in tax bills in the past is that the people who are going to lose are going to make a lot more noise than the people who are going to win. So that winner-and-loser problem is a big one.

Another problem that arose was this allegation that the flat tax would be a big tax increase on middle income people. And at some point, as many times as I've debated this issue, and they cite you, Mr. Hall, as having at one point in your career having said that this would be a tax increase on the middle class. And that became a problem with the Flat Tax as well.

And finally I would just simply make the case that Americans like choice. They don't like being forced into something new. They like -- this is one of the sort of characteristics of Americans that we like to have the freedom to choose. And that's why what I'm now going to describe to you I call the "freedom to choose flat tax."

Now let me just spend a couple minutes describing how this would work, and it's really very simple.

First you would establish a Hall-Rabushka-Dick Armey-Steve Forbes style flat tax system, very much like Professor Hall just described to you. It would be essentially a 20 percent flat tax rate on businesses and workers, or if you wanted to separate it, a 19 or 18 or 17 percent, that would be fine as well.

Second of all, it allows every worker and business owner to choose whether they want to be in the new system or the old system.

I wanted to make point about this, and that is that one of the problems of doing this optional flat tax that I think is a big problem is that if you do this, and you allow people to have a permanent choice, then you will have a gaming of the system. People might go back and forth from one year to the other.

And so the way, I think the best way to get around that problem is simply to say that every American is sort of grandfathered in to the current tax system. Once they decide to move into the Flat Tax, then they're there for good. So you can't move back and forth. You have a one-time opportunity to move into the next tax system, and then you're there for good.

And I would basically say for new workers you just put them immediately into the Flat Tax system, so that over time you'll have 50 percent and then 60 percent, 70 percent, and then eventually hopefully you'll have 100 percent of people who've opted into the flat tax.

Fourth point is that there are no transitional rules under this system that I just set up. In other words, your job could be so easy on this tax reform commission, you could just amend the tax code with one simple provision, which would simply say that every American now has the opportunity to opt in to the Hall-Rabushka type of flat tax. You wouldn't have to write one word of transition rules, because this obviates the need for any transition rules.

This would replace the Alternative Minimum Tax with essentially what we would have now would be an alternative maximum tax.

And one last point I'll make on this, something you might want to consider, is, one way you could do this is you could actually integrate the payroll tax into the system if you wanted to. And the way you could do that is you could create essentially a 25 percent rate on your flat tax, and then you would give every American a dollar for dollar tax credit for every dollar of payroll tax they paid.

What this essentially would do would be to create a flat rate, 25 percent, combined payroll and income tax rate. It would make, in terms of your income distributional analysis, it would look a little better, because lower income people would pay even less tax this way, and higher income people would pay a slightly higher rate. So that's one thing to consider, a variation of the plan, is to integrate the payroll tax.

Since I just have two minutes left, I'll just make a couple of other quick points about some of the objections. I should say that about 10 years ago I wrote an article in The Wall Street Journal outlining this idea. And the Journal called me at the end of the year and they said, we had more response on this article than we had on any other article we've written since Dick Armey had proposed the Flat Tax, I think on the pages of The Wall Street Journal in 1993 or '94.

So it clearly caught the public's attention, this idea of having the freedom to choose. But there were a number of objections that were raised, and I'll just quickly go over what those objections are.

One, probably the biggest objection that I heard is that this is a gimmick. This isn't a real tax plan, this is just a gimmick to give people the freedom to choose. You can't have two parallel tax systems.

And as I got involved in doing more research on this, one of the things I discovered was that the Hong Kong tax system, which is a flat tax -- Hong Kong has often been held up as sort of the paradigm that every country should strive for with their 15 percent flat tax. Well guess what, Hong Kong's 15 percent flat tax is an alternative tax system. They have a very complicated tax system just like we have in the United States. And what they did was they also created this alternative system.

Now the reason nobody knows that is because, lo and behold, almost all the workers immediately opted in to the flat tax system, so that they essentially -- they never repealed their old tax system, they just rendered it irrelevant.

Finally is the idea of the revenue loss issue, that if you give people the choice they are going to decide which one gives them the lower liability, and therefore you can't possibly do this tax system on a revenue neutral basis.

And I just would make a couple of responses to that. Number one, it probably is true in the short term. But if I'm right that over the course of the next five to 10 years people will automatically opt into this system, then that revenue loss is going to be a temporary problem.

Second of all, and this is something I would just urge you all as a panel, regardless of what tax plan you adopt, it is so critical to not just look at the, what we call the static analysis of these plans, but the dynamic analysis. And if you put into place anything like the Dick Armey-Steve Forbes-Professor Hall Flat Tax system it will be so powerful for the economy that I believe, and I think a lot of economists agree, that you are going to have a Laffer Curve effect, and you are going to produce more revenues not less.

Thank you so much for listening.

CHAIRMAN MACK: Steve, thank you for your comments.

And Dick, we'll now turn to you. Welcome, good to see you again.

MR. ARMEY: Thank you, Mr. Chairman. And

let me just thank you for the invitation to be here. I am here as the chairman of Freedom Works, a grassroots public policy organization of some 700,000 enthusiastic people.

I take no pride of authorship in the Flat Tax. The Flat Tax was created by Professors Hall and Rabushka in 1984. I merely rediscovered it and presented it in the form of a legislative bill for consideration of the Congress in 1994.

What I did throughout the fall of '93 was search for the right tax system. I pretty much did then what you're doing now. I reviewed all the options available to me, and I juxtaposed every option against what I would call tax fundamentals. And I got very fundamental about this.

I started with the proposition that there is only one legitimate reason for the tax code, and that is to raise money. Any purpose to which you put a tax code beyond that, I consider to be a corruption of the code.

I then further made the observation that all taxes are paid by people, and all taxes are paid out of their income in the year in which they earned that income. And any way you levied taxes other than that I put in a category of deceptive government practices, in an effort to do nothing more really than hide the cost of the tax from the people who pay the tax, or what I like to call, given my dispositions, "government corruption."

I use the word, by the way, corruption very purposefully. Corruption to me is simply taking a tool that is designed for one purpose and putting it to another purpose.

The two principal corruptions of the tax code that cause confusion, complexity and enormous compliance cost, heartache, headache and back break, are one, the effort to use the tax code for income redistribution. I said enough about that, I consider that illegitimate.

And then the other of course is social engineering. I always like to illustrate the point by bringing out that the current tax code has in it a home mortgage deduction to encourage you to buy your home, and then a marriage penalty to live in it out of wedlock.

These things to me are just audacities on the part of government. And the audacity always eventually results in lies, and of course, the great lie that underlies so much of the American tax code as we know it today is the false dichotomy between earned and unearned income, which is basically a slick way of saying that earnings from property are not legitimate earnings. And this gives you a chance of course to justify double taxation, earnings of capital earnings and consider yourself morally and intellectually superior for the effort.

I think you're probably picking up a tone in my voice, that I not only am contemptuous of the existing tax code, but of an awful lot of what passes for thought that underlies it.

So what I look for in 1993 was a tax code that was, first, simple, direct and honest. That led me, and obviously it had to be a tax code where the taxes were levied on income. That's the only honest way, and I knew it could be direct, and I knew it could be simply done.

Also the tax code should be neutral with respect to savings, investment and consumption. What amuses me so much of the discourse on tax reform is while many, many people like myself lament the fact that the existing tax code is punitive to the two economic activities of savings and investment, there is a consistent tendency for a lot of these critics to say, well, the correction for that is to write a tax code that is punitive to consumption.

And I always want to remind people of Adam Smith, 1776, the sole end and purpose of all economic activity is consumption. To the extent that the government intervenes in the affairs of commerce, it should do so on behalf of the consumer.

Why would you want to discourage consumption? I've got to tell you quite clearly, I enjoy consumption and intend to do it as much as I can for as long as I can.

But at any rate, that is just one of the little amusements about the current debate as far as I can see.

Now the fact of the matter is I also adopted for myself what I consider to be a unique American definition of fairness. Because I hear so much about "fair share." And that, by the way, is in an empirical quagmire today, in terms of, if you want to juxtapose most positions about fairness against the statistical facts of the distribution of tax burden, you would find a good deal of schizophrenia in the debate.

But to me it's uniquely American to say that the correct definition of fairness is to treat every person exactly the same as every other person. And treat every dollar exactly the same as every other dollar, irrespective of whether you earned it through your capital holdings or your labor holdings. Both are essential to the productive process, and both are a contributor.

So that, of course, again brought me to the Flat Tax. As I then determined in my mind that there was no other honest, simple and direct way to write a tax code than the Flat Tax, as done by Hall and Rabushka, I then bent myself to the tax of putting it in legislative language.

That immediately put me into a quagmire called politics. And I immediately realized the need to make concessions. So as I wrote the tax bill, I'm sorry to sit before, I'm a bit ashamed to say, I made two concessions to politics.

The first concession was, I continued the practice of withholding tax. The problem with withholding tax is it is the means by which most people have a burden of taxes disguised from them, to wit, I sit down once every month with my wife, and we joyfully pay our bills, cuss the gas company, cuss the mortgage company, cuss the electric company, and cuss even Sears and Penny's.

But even without the power of the state to coerce me to do so, I do in fact pay those bills.

What I don't do at the first of the month is write a check to the government and cuss the government. Now in my own peculiar case I find good opportunities to do so without that prompting. But I do think. Now what really broke my heart is my son, David, who I poured my love into teaching him all his life, came to me one day happy that the government was good to him. Dad, he said, they gave me a $350 tax refund. That broke my heart. He thought he had something good coming from the IRS, and everybody knows as you know, the Panel knows, there is nothing but evil that comes from the IRS.

So the fact of the matter is, withholding is a form of government by disguise that does disguise the cost of government from people who pay the cost of government. Any time you think the government is free, or that you undervalue, under-measure the cost of government, you are of course tempted to do the most unholy of all things, which is vote for more government.

And so I consider it a tragedy, a tragic concession on my part that I continued withholding.

Withholding of course further complicates the matter because it plays right into the hands of the demagogues. Once you do personal withholding and collect labor taxes, taxes on labor at their source, then of course in order for uniformity and reducing the cost of the government and so forth you then continue the practice of the corporate or the business tax, and tax capital earnings at their source as well.

That means if you avoid double-taxation, the person who receives earnings from capital, as a distribution of after tax earnings, is then accused of being a person who doesn't pay his share of taxes, which of course we know has been alleged of my friend, Steve Forbes, constantly throughout all the debate.

But the fact of the matter is, double-taxation of capital earnings is counterproductive to the performance of the economy, and it is fundamentally unfair.

Now, my own preference would be to collect all taxes at the point where they come. Do away with withholding, and tax dividends and interest. But since we decided to tax at the source, we then of course do not tax the distribution of after-tax business earnings.

The other concession I made, which is probably even more egregious than this, was, I accepted the notion that a Fair Tax system where everybody is treated exactly the same as everybody else must be progressive. This is oxymoronic.

The fact of the matter is we do accept the notion of the personal exemption. It has been a great comfort to a lot of people to know that we have been fair about this. But the fact is because you have a generous personal exemption, the rate must be high.

I was a member of Congress when I did this. I had to pay attention to politics. I would implore you to take the Flat Tax in its purest form and do not make these horrible concessions that I made. Do away with withholding tax. Make Milton Friedman happy. Show him there is a redemption for what he calls the worst idea he ever had.

And just don't get caught up on this silly notion of progressive. What's fair is to treat everybody exactly the same as everybody else. And I think one of the things that we ought to do is set an example in the tax code of the United States that we Americans believe in this definition of fairness, and we have the courage of our convictions.

So I'm asking you to be, each and every one of you, a better person than I was. But I know you're all capable of doing that.

Thank you. As Bill Archer says, that's not hard to do.

CHAIRMAN MACK: Thank you, Dick.

Steve, I introduced you before you came in. So we're delighted that you're here, and we're looking forward to your comments.

MR. FORBES: Thank you very much, Mr. Chairman.

I tried to practice politics, and obviously it did not work out, which is why I'm here today.

Perhaps it's fitting that we meet in the basement of this building in a project like this, especially with the National Transportation Safety Board, because the tax code itself is a wreck.

So thank you for having me here. I think there are two basic needs that need to be addressed on federal tax reform, and my colleagues I think have done a very good job on it. And that is, the complexity of the code, and the overall burden imposed on the economy by unnecessarily high rates that come out of that complexity.

As we all know, there is not a human being alive today who knows what's in the tax code. I love to point out that Abraham Lincoln's Gettysburg Address is 270 words, defining the character of the nation. America's Declaration of Independence - 1,300 words, the Constitution - 5,000 words, held us good for 200 years, the Holy Bible which took several thousand years to put together - 773,000 words. And the federal income tax code, with all of its rulings and attendant regulations - 9 million words and rising.

So if you look at that first slide, it just graphically illustrates it.

As Senator Breaux well knows, since 1986 when we last attempted to simplify the tax code, we did not kill the beast. We left the beast in place, like a movie with a beast coming out of the swamp. The monster coming out of the swamp. It came back again.

As the Senator has pointed out, the code has been amended 14,000 times since then. And since 1986, next slide, it has grown by some 3 million words.

There we go. This thing doesn't seem to work. Three million words.

And when taxpayers reach certain thresholds, they now have six thresholds instead of two as we had two brackets in '86. Now we have six, and probably it's about 386 when you factor in the fact when you reach certain income tax thresholds you are required to give back some of the deductions you were given.

And the whole abomination of the Alternative Minimum Tax, which as your Vice Chairman has rightly pointed out should be called the compulsory maximum tax, God help you if you take those deductions.

A typical taxpayer filing a 1040 today spends 67 percent more time doing it than they did in 1986. As you know, the AP poll shows that seven out of ten Americans now think the tax code is too complicated, even though half the American people theoretically don't even pay income tax.

So it's so bad that even tax professionals can't cope with the beast. Twenty year ago President Reagan did sign the Tax Reform Act of 1986. The tax shelter industry suffered a heavy loss, but the beast returned, and within a few years we had a new array of abuse of tax shelters.

The nice thing about the Flat Tax is that it would eliminate the possibility of setting up complicated tax avoidance schemes. The thing would just be too transparent, too simple, to hide tax liabilities.

The Flat Tax would end all the clutter. You could literally fill out the thing on a single sheet of paper or on a postcard. Under my proposal for a Flat Tax we would be lowered to 17 percent. There would be generous exemptions for adults and for children. A family of four would pay no federal income tax on their first $46,165 of income.

Millions would be removed from the federal income tax rolls altogether. There would be no tax on Social Security benefits, no tax on personal savings. It would zero out capital gains. No more death taxes. No taxation without respiration.

Taxpayers would have a choice. I think they should have a choice, since people always focus on what they're going to lose. They could opt for the new flat tax, or they could file under the old system. This type of dual system is being used successfully in Hong Kong, and people could see for themselves which one is better. Give people a choice.

On the corporate side, same thing, 17 percent rate, full expensing for business investments. If you have a loss, you carry it forward.

As Steve and others have pointed out, a low tax rate would set off an economic boom, not only by letting people keep more of what they earned, but by lowering barriers to risk taking. High rates are a barrier to risk taking.

And as we know, every time in American history that the tax burden on the American people has been reduced, better paying jobs were created, new businesses were created, incomes went up, and the standard of living improved.

But that's not all. Lower taxes also drove, and this is the amazing thing, and what I don't understand why liberals don't understand it, is lower taxes also drove government revenues up, not down. The Kennedy tax cuts of the 1960s, government receipts went up and the economy boomed, even though rates were reduced across the board by over 20 percent.

We saw the same thing from the Reagan tax cuts of the 1980s, and even in 2003 with the reduction on capital gains, dividend, tax, and personal tax rates, receipts today are up almost 10 percent. The thing works.

So another thing I hope we address and not get caught up in is this whole thing of static revenue, static analysis on the impact of taxes. God I wish we had gotten rid of this thing when Republicans took over 10 years ago. It is an absolute absurdity. The idea that taxes have very little impact on incentives, as you well know, rebates are just a one shot, don't have a long term impact on the economy, but rate cuts do.

And every time they score these things, they are invariably wrong. When they raised the capital gains levy in '86, they said revenues would go up. Wrong. Tax receipts lunged.

When in 1997 when rates were cut from the capital gains tax rate was cut from 28 percent to 20 percent, critics said, revenues would be hurt. Revenues actually went up even though rates were reduced.

So I hope when you do your reforms, look at the real world, not the crazy world of Washington, D.C.

So in conclusion Mr. Chairman, this monstrosity of a tax code that we have today has created a monstrosity of a problem. Like every big problem it requires a big solution. We should have learned from the experience of 1986 that fiddling around the margins won't do the trick. A simpler, fairer flat tax will do it.

We already know the thing works, because of what's happened in Hong Kong, Russia, Lithuania, Latvia, Estonia, Ukraine, Slovakia, Romania, Serbia and Georgia. Even The Economist magazine for crying out loud, which trashed the thing when I ran 10 years ago, had a cover story suddenly discovering the virtues of the Flat Tax.

Other nations are actively considering the thing. So my question is, what are we waiting for? Especially at a time when the rest of the world, particularly India and China, are determined to catch up with us.

I thank the committee for hearing this truncated version of my testimony. I think the situation is clear. We have to do it because it's right, it's fair, it's honest, it reduces political corruption, but also will make us enormously more competitive in a world that is determined to catch up with us.

Thank you very much.

CHAIRMAN MACK: Steve, thank you very much.

And I will now turn to Ed for the questions.

MR. LAZEAR: I actually have two questions if you will allow me.

The first one is I guess for both Steves. Steve Moore actually stated this very clearly. When you talked about the system that Hong Kong used, if you have a system with choice that allows individuals to choose whether they're going to go into one tax system or another, obviously they're going to choose to go to the system that costs them the lowest amount.

As a result in order to keep things revenue neutral, what you have to do is, you have to raise tax rates. Now that's kind of self-fulfilling in the sense that that's going to drive people even further into the new system.

So perhaps that's what people meant by saying it was a gimmick. My guess is that you view that as a positive feature of the plan rather than a negative one, but I'd like you to comment on that.

I'll just ask the question of Bob as well, and then you both can answer.

Bob, the second question was that in your system I assume that payroll taxes would not be deductible at the level of the employer? And if that were true, would that cause a distortion in terms of the use of capital versus labor? Or would you argue for some kind of deductibility of the payroll tax?

Thanks.

MR. MOORE: Well, you raised the question that's asked the most about this idea of making the tax plan optional. And I'd just make a couple of observations.

One is, I hope that if we can get this right, if your panel can get this right, we're talking about a tax system not for five or 10 years, but for 100 years. And one of our frustrations, whether it's dealing with Social Security reform or health care reform or tax reform, is, we always let these transition issues interfere with us getting to the Promised Land, the Garden of Eden of where we want to be.

And so to some extent this plan of making it optional, where, and remember, once you move into the new system you're there for good. So you can't keep going back and forth and gaming the system. But the idea would be over the next five to 10 years you would move towards a system where virtually everyone would then be in the Flat Tax, and there would be no more, you know, going back and forth.

A second point that I'd like to make is that when you look at the high costs of the tax system right now, and you've probably heard from a number of witnesses in your past hearings about the huge complexity costs.

I remember when I was working for the Kemp commission a number of years ago, we talked to a huge number of small business owners who said, you know, my

-- the cost -- the cost that I have of just figuring out how much taxes I owe is greater than my tax liability, which is really the essence of an inefficient tax system when it costs you more to figure out what you have to pay than what you actually pay.

And so the point I'm making is, and there have been some studies that indicate that the average American pays about $500 just to figure out what their income tax burden is. Well, if that's the case, there are a lot of people who would be willing to pay up to $500 more in taxes just to be able to fill out the Steve Forbes or Dick Armey style flat tax.

Interestingly enough, and you may, Mr. Rossotti, be familiar with these statistics, but Americans are a nation of procrastinators when it comes to taxes. And so a lot of Americans are waiting until the last week, about half of Americans, you probably know these statistics better than I do, wait until the last week to do their taxes. And a good proportion of Americans are up until midnight on April 15th doing their taxes.

So if you tell them, you can have this postcard return, I think a lot of people would just voluntarily move into it regardless of what the other system would cost.

Finally, I think the point that Steve Forbes made is so essential, that if you have a low rate tax system of 18, 19 percent, this would be such rocket fuel for the American economy, especially as, you're right, we're competing with India and China right now. And if we bring our tax rates down like this, I am convinced, you will have such an enormous impact in terms of revenues that it will wash out the impact of people trying to reduce their taxes by choosing from one to the other.

DR. HALL: The question was the deductibility of the payroll tax at the employer level? The general principle guiding that is that anything of value that the employer pays that's to the benefit of the worker is, in general, deductible to the employer, and taxable to the worker.

That would, for the employer's side, that would include the payroll tax deduction. So although it's not identified literally in there, it would be one of the things that is considered part of compensation.

I should say that the Hall-Rabushka plan does not try to deal with the Social Security side of the federal tax system. But it's something I'm currently thinking a lot about, especially on the health side. And there's a lot more to be done there as we look into the rest of this century.

The issue of financing of health care is going to be very central.

CHAIRMAN MACK: Ms. Sonders.

MS. SONDERS: I want to stay on this idea of making a flat tax optional.

And take it a little bit further to go back to your example on Hong Kong. On the revenue neutrality issue, was that a guideline in place when they established the optional tax code, and then related to or not related to that, what was the timeframe under which we essentially rendered the existing tax code neutral, and how legitimate is that as a guide for us?

And then as it relates to the issue of making this optional, Mr. Armey and Mr. Hall, what your views are since we obviously know the Steves' views on this, what your views are on this sort of optional attachment to this.

MR. ARMEY: Let me say, I think the option helps with the transition costs. And I'm always proud to let Americans be free to choose.

The fact of the matter is, I'm also

confident if the choice is between my good idea and the government's bad idea, that Americans will choose my good idea.

But the fact of the matter is, I don't know how quickly it happened in Hong Kong, but it will happen very, very quickly I think, because I have been amazed at the number of people over the years since 1994 who took the occasion right after filling out their income taxes to quickly do the calculation on the Flat Tax postcard. And said, I'm better off with a flat tax, even if I don't have my mortgage deduction, even if I don't have a lot of these fictions of this. The fact of the matter is, most people find that it's not only simple, more convenient, one they can file with a greater degree of confidence and sense of security, but also one in which they actually have a lower tax rate than when they go to the complexity.

So I think there would be a rapid movement if you indeed went to my system of one rate, no personal exemptions, remember if you will, that there would not be such things as earned income tax credit, child tax credit, and so forth. These items of income redistribution wouldn't be there.

The fact of the matter is that most

energetic opponent of a flat tax has been H&R Block. H&R Block does not make a living filling out taxes for rich people. It makes its living acquiring income transfers out of the current tax code for poor people.

Those transfers would not be there, and therefore, you would think that people at the lower income spectrum would be more likely to stay with the old code, because the old code actually pays them money rather than taxes them.

So you would have to have some kind or reconciliation against that whole process. The fact of the matter is, the corruption of income redistribution has become so much of our tax code that just correcting that would be a major problem in transition.

MR. FORBES: Concerning Hong Kong, they put in their tax system in 1947, and thankfully, I don't think they even looked at revenue neutrality. They just put the bloody thing in.

And it's really an active hybrid system. They have a progressive code from two percent to 20 percent. They have a handful of deductions. And they have a flat of what they call a standard rate of 16 percent.

You have a choice each year of picking the lower one. It's the exact opposite of our Alternative Minimum Tax. You get to choose which one is the lower one, and it's there for everybody every year.

Only about one percent of the tax filers go for the 16 percent flat rate; most end up with a rate from the two to 20 ending up being less than 16, but they pay about 21 - 25 percent of the tax receipts.

So it's an active system. We probably wouldn't want to have that here. We'd probably have a time limit where you could make a choice, and then we'd phase the thing out. But in terms of -- let me make a comment on revenue neutrality. Borrowing from our former president, you should define what revenue neutrality is.

If you believe a new system is going to provide a dynamism for the economy, factor that in, and don't go for the zero sum that if you have a tax cut it's lost forever. It just is so preposterous. Experience shows it's preposterous. And if you get caught up in that, we're going to be stuck in this thing forever.

And I think also in this town we've got to get away from the notion that what's good for Washington is good for the country. Even if there is a deficit (this is heresy to say it) I say do it if it helps the nation.

And remember in the 1980s the national debt went up $1.7 trillion not because revenues were lacking -- they grew in the 1980s as we know. But the national wealth, the net worth of the nation, went up $17 trillion. And there's not a business person who wouldn't trade one dollar of debt for $10 of equity. So if it's good for the country, making us more competitive, getting more Silicon Valleys going as the Steiger tax cut of 1978 started to do, do it. And don't worry about whether Washington can get its own act together. Let the nation get its act together, and I think they will be the better off for it.

MR. MOORE: Just two quick points in addressing your question.

One is, I hear it said all the time, well, we can't have an optional flat tax. That would create two tax systems in America.

Well, as you all know, we have two tax systems now. We have the current tax system, and we have something called the Alternative Minimum Tax. So there's nothing new about this. This would simply give people a choice where they could pay the lesser of the two rather than the greater of the two right now. I do view this as a transitional issue.

And one other thing I would just urge your panel to do, Senator Mack, and that is, Steve Forbes is exactly right that over the last 10 years you've had an enormous number of countries that have adopted flat taxes. Russia's I think is, what, 13 percent, Steve? And if you look -- there was an article in The Wall Street Journal just a couple of months ago -- Russia's tax revenues are way up under this 13 percent flat tax system, way above what they had when they had 60 and 70 percent tax rates.

So it would be very instructive to look at Latvia and Estonia and Russia and these other countries, and look what happened with their tax revenue collections once they put in place a flat tax system.

MR. FRENZEL: I have only one question of Congressman Armey.

Dick, if it took you 20 years to recognize the folly of your apostasy, how are we going to learn it in six months?

MR. ARMEY: Well, here I am. I've bared my soul. I've confessed before you.

These are difficult things. And I had to wrestle with them. I was about to mention one of my friends in Congress, but since he's running for governor of his state I won't mention his name. But he is distressed over the fact, and he argues correctly that the American people are distressed over the fact that we have now come to the point where about one-half of the adult population of the United States today do not pay taxes.

And in fact a very large share of those people who do not actually pay -- I'm talking income taxes -- actually receive money back in the forms of these things.

Certainly you can't call that fair. And the champions of all these concessions to the bottom end are the same voices that you hear constantly haranguing the higher income Americans because they don't pay their fair share.

So first of all you have an awful lot of inane tax discourse in American public policy discourse, and secondly, as an economist, one of the things we always try to avoid is the free rider syndrome. But if you bear no costs of government, indeed, you are earning part of your living off of government, your natural impulse is to vote for more government.

And of course as Steve Forbes pointed out, during the '80s, revenue to the United States Treasury doubled, but the deficit went up because people were voting for more government.

So you get yourself caught up I think in a false set of signals. Remember, in the free market transactions which are rational, the greatest signal mechanism that leads to rational choice is the price. A clearly discerned price is the evidence by which you make a rational decision.

When you've hidden the cost, and indeed, disguised the cost as if it were a benefit, as these redistribution gimmicks do at the lower end, then what you have then is irrational consumer choice and the fundamental question of how large the government should be.

CHAIRMAN MACK: We have a number of panel members to ask --

MR. FORBES: Just one point on that in terms of people not paying income tax, they still have to file a tax return each year and go through that rigmarole which is good for H&R Block and others. But also, I think the American people as a whole don't realize, even if they don't pay federal income tax, even if Dick Armey's son may get a refund that he already had paid in and didn't realize it, everything you do now gets taxed.

People don't realize, when you turn on the electricity, you get electricity taxes. You turn on the water you have utility taxes. You drink your coffee in the morning, you've got the sales taxes. You drive to work, you've got the tolls. You have gasoline taxes. You want to complain to the government, you pay the three percent Spanish-American War excise tax.

Everything you do gets taxed. You want to get married, we all love families, but we tax you for the privilege. Property taxes, everything. And so if the American people are educated to the fact that they may not pay income tax, but by golly, everything they do gets tolled and taxed, I think there would be support for this thing.

CHAIRMAN MACK: Let me again state that we have a number of panel members that haven't asked a question, and I think if we could, let's try to keep our responses short. It's interesting coming from a former Senator who could speak unlimited, but we just have a limited amount of time.

John?

VICE CHAIRMAN BREAUX: And keep our questions short as well.

Thank you all very, very much. Congratulations for the extensive work that you all have done in this area. Many of you have made a career, obviously, of this project.

I was going to start with the assumption that I presume that all of you were supportive of the concept of reasonable progressivity in the tax code, but I heard from Congressman Armey that probably is not a safe assumption.

But my concern is that -- (You've heard these arguments.) My concern is that a person whose income is only dividends, capital gains, and interest buildup would pay no income tax at all under this system. If you believe in reasonable progressivity, how do we sell that? How is that handled?

How do we sell that? How is that handled? When I tell people back in Louisiana, where the average income is about $28,000 that someone who is a multimillionaire with only dividends and interest and capital gains is not paying any income tax.

MR. ARMEY: But the fact of the matter is, when Steve gets his dividend income, he's getting the same thing that I get when I get my paycheck. He's getting his after-tax earnings.

VICE CHAIRMAN BREAUX: Is your paycheck

that big?

MR. ARMEY: No. But the point is, and this is where such rhetorical innovations as earned versus unearned income confuse people.

The dividends and interest are the distribution of after-tax earnings of what it is he owns. But what your people, who you're talking about, they've developed the expectation that he ought to pay twice while I only pay once, because what he provides gives him unearned income, and I earn my income.

And it's a prejudice against him. And it's not fair. He's a decent man, he doesn't deserve this treatment.

But the fact of the matter is, that is a major job. Now one way I propose to do that, do away with withholding tax, and then collect the tax then at its receipt. Do away then with corporate business taxes, and tax the distribution of business earnings at its receipt. And then of course they don't have that problem.

Because then he's got to sit down at his breakfast table at the end of every month, write out his check to the government, in a custom the same way I have to, which is good for him. I want him to have that privilege.

MR. POTERBA: As we have looked at flat tax type plans, I think we have realized that the transition is really a critical part of all this. But if one could design things de novo you might do something different than where we start from.

Steve Moore, you've suggested the optional flat tax is one way to work through the transition. I guess my question for the rest of the group is, in thinking about the transition, do you have advice for us in going down the root of trying to handle the preexisting basis and assets that have already been built up.

What do we do with the interest contracts that have already been sort of structured? And any broad thoughts on how best to try to manage some of these transitional issues?

MR. ARMEY: I think most of your most difficult transition issues are going to be on the business side. Because under the Flat Tax, for example, capital expenditures are expensed. But you have the existing depreciation schedules in inventory, and you couldn't just sort of lump drop them in in that first year. I could, but then I only need one vote, see, you guys need a lot more than I do.

So I think that one of the things that I think there is a greater tolerance and capacity to cope with, and extended transition in these complex issues in the business world than there is in the private sector. The other thing is, I think quite frankly you might have to, as you contemplate this, anticipate a higher rate in the first two or three years of the tax application to cover the transition, and then with the anticipation of phasing it down to a lower rate later.

But we've spent a lot of time working on that, too, and we have a backlog of work. It is difficult. It is complex. I'm not prepared to describe it now, but we'd be happy to share what we have with you.

MR. MOORE: There is another, one quick possibility just to think about is you make the effective day of the new tax system 2008 or 2009 so that people have two or three years to sort of prepare for the new tax system which minimizes -- it doesn't totally eliminate the transition problems, but it gives people some time to adjust.

MR. POTERBA: Would you worry, though, if you did that, that people would not invest before 2008?

MR. MOORE: Well, that creates problems

too.

MR. FORBES: But I think having that choice, one, in terms of the interest side, most people would refinance very quickly if you took care of the interest side.

And on depreciation, because you'd have several years of going with old or new, I think those who may have accumulated depreciation may make the conscious choice that going with the new would still be better off than trying to recover the old.

And in business all the time you have writeoffs. You're seeing it in the telecoms now. Most of that stuff is worthless that they're carrying still tens of billions on their books.

So if you have a date certain that the thing is going to happen, and make it five years, most appreciations run often five to seven years, if you have a five-year period of choice, or seven-year period of choice, I think 99 percent of that goes by the wayside, and the advantages of being able to expense immediately overwhelms anything you're going to worried about that you have on your balance sheets.

And the markets would recognize that very quickly too.

CHAIRMAN MACK: Tim.

MR. MURIS: I may have heard Mr. Armey being relatively soft compared to Mr. Forbes. I just wanted to follow-up on the transition rules.

Did I misunderstand you, Dick, that you would allow some -- you would have a higher rate because you would allow people to not have to write off some of these costs?

MR. ARMEY: I would want to get as quickly as I could to where capital expenditures and inventory just is expensed, because of the simplification. If you look at business inventory and depreciation are two of your greatest complexities.

But I also would be willing in order to prevent this from being dumped in one year to have a transition period of a short period of time. I'm talking about two to three years where you might have a temporary higher rate if that makes the transition more acceptable.

One of the things I was acutely aware of when I did my work on this was, I was in the Congress. And you don't have a thing unless you have 218 votes in the House and 51 or 60, depending on dispositions at the time, votes in the Senate. And you don't get those unless you respond to the criticisms you have. That's what for example I made what I thought was an unholy concession to the income redistributors and their Holy Grail of progressivity, and I am still personally humiliated by myself having done so.

But to have tried to put the Flat Tax together without that concession would have been from a parliamentary point of view so unrealistic that I would hardly have deserved the position I had at the time I did it.

MR. MURIS: Could I ask Mr. Hall if he has any comment on the transition issue?

DR. HALL: I was afraid you would.

Jim Poterba put me up to thinking through all these topics in 1996. And I developed a complicated matrix of the central transition issues.

It's something that really requires great care. I would certainly indicate that if you were going to endorse a very sudden shift to something like the Flat Tax, that you would want to study that very seriously.

I think I'm a believer, certainly having watched the politics of this, of saying, well, there are some steps that could be taken that are going to get us closer that don't have major transition problems. We've already done some of that, by the reductions in rates on dividends and capital gains.

This idea of having some type of choice, of course we have choice now, the government gets to make a choice with respect to the AMT. One possibility that has been discussed quite a bit is trying to shape the AMT into becoming ultimately the Flat Tax. And I think that's a very good idea.

One of the great benefits there is, you're already starting with a tax that has fewer deductions. So I think that would be good.

I don't have -- my posture here, you can tell, is very much to say, here is the ideal system. I know that it's not politically viable. I'm not a dreamer in that respect.

But let's know what would be really good. And do what we can to get there. So I haven't tried to develop a very complicated transition plan, and I'm prepared to comment on that as it happens, and I'm very happy to see it happen. But it's just not been my role to solve all those complicated problems.

I'm happy that there are tax designers who are serious about that.

MR. MURIS: There was a British scientist in 1917 who said we can solve the U-boat problem by heating the ocean, and when he was asked how he was going to do that, he said he didn't do details.

DR. HALL: Thank you very much.

MR. FORBES: Actually, excuse me, just one quick comment on the transition. If you go immediately to a low rate such as 17 percent, then by definition the value of that unused depreciation is cut in half, and the value of it. And if you have a few years, a handful of years of people having a choice, I think the thing is minimized.

I don't think we need to get caught up in details on that, because 99 percent is taken care of with choice, a couple of years, and the fact you've sharply reduced the value of the depreciation. And on interest everyone is going to refinance just as they did with mortgages a couple of years ago.

CHAIRMAN MACK: Beth.

MS. GORDON: Yes, I wanted to follow up on John's question about progressivity. I wish my students were here to hear Dr. Hall, because when I teach the Flat Tax, the hardest thing always to teach them always is, it's not flat, and it need not be flat.

So that was very helpful to me. I'll make them listen to these comments. And I think that the demand for a zero bracket, even in the Flat Tax, represents that many people do not believe all dollars are equal, and many people have a vision of equality that says you treat similarly situated people the same, and somebody with $45,000 of income, somebody with $250,000 of income, somebody with $750,000 of income may not be similarly situated. So it's just different visions of equality that I think may be driving this.

And I guess what I wanted to get from the members of the panel other than Mr. Armey -- because I think he's articulated his vision of progressivity, or his view of it -- I wonder what you would say with respect to the appropriate level of progressivity? The Flat Tax as it's currently articulated has two brackets.

One of the hardest things, I think, for those of us who believe in progressivity, and the President instructed us that we should come up with progressive options, is to figure out what is the right level of progressivity. How steep should the rates be? We've had lots of different rates.

What's your intuition? What sorts of value judgments and other kinds of issues should we confront as we think about the appropriate level of progressivity, even in the Flat Tax?

DR. HALL: Strictly, that is a two-bracket, for your class and here, we can call it the two-bracket as opposed to the N-bracket tax.

I was very comfortable in 1981 when we launched this idea that we got it about right. One of the things that I think of here is that it's not strictly a question of the distribution of the burden. It's a question of being realistic about what high income people do when they're embedded in a tax system.

And just as we know that a sales tax system will founder if it gets much above 10 percent, I think that almost any type of tax system that tries to impose taxes in the 30, 40, 50 percent range generates just huge burdens associated with the fact that the high income taxpayers and their advisers can always stay one step ahead of the government. We've seen so many examples of that.

So a lot of it to me is beyond the question, just the abstract question, of what's the fair distribution of the burden, into this question of what are the realistic upper limits of what high income taxpayers pay.

And so those were the factors that led me to feel comfortable.

Now one thing that we haven't come to

grips with is that the distribution of income and wealth in the United States is much more uneven today than it was 20 years ago. There's been a big trend towards -- you see that. I've been doing some work recently showing just how much better off college graduates are today relative to high school graduates than 20 years ago, and it's really amazing.

So I think we need -- and one of the reasons that I'm more of an X-Tax guy now -- is that I think we need to recognize that that has some counterparts in where the tax burden ought to lie. So I feel that if I really had to pick today, I'd probably pick a three-bracket X-Tax setup.

I wouldn't set the upper tax rate, though, above 25 percent. And so with that constraint, I would think about what is a fair distribution.

But again, I guess to back up to what I said earlier, my main role is to provide a way of thinking about a very straightforward well designed tax system and sort of throw it out and let the political process ultimately make use of it.

So what the original designer has to feel about this is probably not too important. What really matters is, can these ideas get across about the structure of it to give us an efficient simple tax system that really works?

MR. MOORE: One of the things about the tax system, and this seems pretty self-evident, but I think a lot of times Dick Armey's former colleagues in Congress forget this, is that an ideal tax system is meant to make poor people rich, not rich people poor.

And we get so involved in the whole issue of fairness that I think some of the big losers in the tax system are poor people. Let me explain what I mean. Dick Armey was talking about this issue of taxation of capital versus taxation of labor. And oftentimes we treat capital and labor as if they are in conflict with each other, sort of the old Marxist idea that we've got the owners of capital and we've got labor.

Well, there is some very interesting research that I'd be happy to present to you, Senator Mack, that shows that about 95 percent of the gains from capital don't go to the owners of capital, they go to labor, because of course --

(Off-mike comment.)

MR. MOORE: Right. And so the perfect example is a computer. And you've probably all see this data, that if you take two equally skilled workers, and one of them is working with a computer in front of them and the other one isn't, that person with a computer is likely to be paid 10, 15, $20,000 more a year.

So the pro-capital aspects of what we're talking about have huge benefits for lower-income labor folks.

All of that said, I don't have any problem with the way that Hall and Rabushka set up their system, with a fairly generous zero bracket. I think that is probably the best way to deal with the progressivity issue, other than doing what Dick Armey said at the beginning is, keep the Flat Tax totally pure. Don't provide any exemptions, and deal with all the income redistribution issues through the spending side, which is what you said at the beginning, that the idea of the tax code should be to raise revenue, and if we want to redistribute, do that through the spending programs.

MR. FORBES: If you get above a certain tax rate, you get the kind of code we have today, because it doesn't work. The AMT is an example of it. We have all these exemptions in there, and people felt they were taking too many exemptions, so we put in the Alternative Minimum Tax.

On capital gains, we tax capital gains in this country still, but we don't allow you to reduce the losses unless you can offset them with gains. But you can't take a raw loss on your personal income tax return above, I think, $3,000 a year. That's preposterous. If you want to tax capital gains, then by golly, you should be able to deduct all the losses, because the fact of the matter is, most new businesses fail within five years of inception.

And in terms of progressivity, I make the concession, $46,000 for a family of four. If that isn't generous, I don't know what is. A family of six, you have four kids, it's over $63,000 is not subject to federal income tax.

And the idea of the exemptions was initially that you should have some money, some income, not subject to tax, so you can meet your basic minimal needs. That would seem to be a very simple way to do it.

And the fact that you can have people with equal incomes having disparate tax liabilities shows that that's a very unprogressive system. It should be fairly simple as you can in this world, the more you make, the more you pay.

So I think Steve made a very good point on poor people. The way people rise up is by having the ability to get more productive tools, by being able to accumulate capital.

Remember, the biggest source of capital in this country is not venture capitalists, it's not Wall Street, it's people taking first or second mortgages on their houses, increasing first mortgages or taking a second mortgage is the biggest source of startup capital for new businesses.

So people get it where they can. They just don't -- I think too many of us observers or academics or whatever don't realize that people strive to get ahead. And that's why no names are always rising up to become the big names. Whoever heard of Bill Gates 25 years ago?

MR. ROSSOTTI: Well, first I just want to say, Mr. Armey, that notwithstanding your views about the IRS, I do want to thank you. A long time ago, my first month in office, I visited you in your office in Texas, and you offered to help me anyway I could, notwithstanding your feeling about the agency that I was running. So I appreciate that.

MR. ARMEY: May I make a point? And I've made this point for all these years as I've traveled the country.

The employees of the IRS get a bum rap.

Congress passes a tax code that is impossible, and then tells these people, go out there and enforce it.

And I'd like to remind people, the last time somebody gave me an impossible task I got damn cranky trying to do it. So I hope you will appreciate that I don't really think you're evil.

MR. ROSSOTTI: I know that.

MR. ARMEY: It's just that what you do is evil.

MR. ROSSOTTI: I know that. And you made that very clear to me my first month, when you were kind enough to let me visit you in your office.

But I did have two more kind of specific questions for Professor Hall. You made the point right in your first chart that the idea was, and you said this was very fundamental, that for business income that it would be taxed once at the source, and therefore, wouldn't have capital gains or dividend taxation at the individual level.

So I'm trying to understand -- just use an example that one of the previous panels raised. Recently there was a big IPO where Google founders got about $4 billion worth of stock, which, I don't know how much of it they sold, but if they'd sold a substantial amount they would have had a big capital gain, which under your plan as I understand it would not be taxed then or ever, but yet, I'm not aware that under this flat tax that at the corporate level Google would have paid any significant amount of tax, given their -- they would have paid some, but nothing close to what that capital gain would be.

So I'm trying to figure out, where does your principle come in that would have been taxed once at the business level? I could give other examples, but just using that one.

DR. HALL: Well, Google is a subchapter C corporation, and the market value it achieved then, and even more since then, is the capitalization of its after-tax income. So the capital gain of course would have been even larger if Google were not taxed.

So there's been a huge implicit taxation representing the present discounted value of its future earnings, all of which will be taxed. Google will pay huge (does today) huge taxes, and would pay huge taxes under the Flat Tax.

MR. ROSSOTTI: But if you just look at the taxes that are actually paid, as I understand it, as of a certain point, the people who had the gain on the stock wouldn't have paid anything, because that would have been capital gains. But Google wouldn't have paid anything either, or at least not anything significant in comparison with that transaction.

DR. HALL: Correct on the second, but wrong on Google. Google as a corporation is paying a lot of tax, and would pay a lot of tax under the Flat Tax. The capital gain is the capitalization of its after-tax income. So if there were no tax, then the capital gain would have been much larger, so the principals of Google got a smaller capital gain as a result of the fact that Google itself will be taxed as a business.

MR. ROSSOTTI: So your view of their tax is not that they paid anything to the government, but that they got, you know, let's say $6 billion instead of $10 billion?

DR. HALL: Right, and the government will gradually collect the remaining $4 billion.

MR. FORBES: The professor is right about discounted value of future cash flow, future earnings. It's similar to an IRA or a 401(k), you defer it today because you're going to pay it down the road.

So this idea that it's a timing issue, therefore it's bad -- we do it all the time, but we don't recognize it.

MR. ROSSOTTI: Okay, well I won't -- the

second thing is, I was just wondering what you were going to do on your business level tax for, let's say, financial incomes or financial institutions, if you will. Is that going to be considered their revenues? Let's say a bank or any kind of a financial institution, their interest income, under your proposal, in business, would be included in their income, but their interest expense would not?

DR. HALL: The taxation -- all tax systems struggle when you get to financial institutions because of the way they bundle financial services with interest payments.

Conceptually -- I'm not sure I can beyond this conceptually -- but conceptually what you want to do is to say that when a bank provides a deposit management services bundled with just paying a depositor a lower tax rate, a lower interest rate, then conceptually you'd want to separate those two transactions, and forget the financial part, which is not part of the Flat Tax, but count the value added that was generated by the financial services.

So just strip away the financial part of it, and leave the substantive part, the service part, and then tax that.

Of course that's easy to say but hard to execute.

MR. ROSSOTTI: But just even at the conceptual level, though, I wasn't clear. Pure financial income, receipts, would not be part of the income that would be taxed at the business level?

DR. HALL: Right. For a financial institution, if you looked at Form 2, the revenue that would be reported would be the revenue representing their sale of financial services, not their full financial income.

MR. ROSSOTTI: So their total financial income, pure financial, it would just be passed through, ignored?

CHAIRMAN MACK: Let me move to a different subject. We've heard a lot over a period of time that we were both trying to understand the present code and today as well about the notion of border adjustability. And I'm starting I guess from the assumption that the Flat Tax is, most people would say it's not border adjustable.

Which leads to, is that an important issue from your perspective? Again, there are many economists that say that if you border adjust, it really doesn't make any difference, that the exchange comes into play and so forth.

So give me a sense about what your thoughts are. Steve Forbes, I think maybe we'll start with you, what your thoughts are with respect to this issue of border adjustability, and if you think it is important, how would you go about it with respect to the Flat Tax.

MR. FORBES: Well, in terms of the corporate tax, I've always believed that we should do what most countries do, that if you earn the money outside the country it should not be subject to U.S. tax, and we'd avoid the situation that came up in the tax bill last year when we suddenly discovered that $600 billion of profits are sitting in cash -- sitting outside this country, because we tax it at 35 or 40 percent rate when you include state taxes. They try to find ways to shelter it.

But suddenly you have a one-year 5-1/2 percent rate, and suddenly tens of billions, companies have announced that tens of billions are going to be brought back here at home.

The Irish don't tax profits of Irish companies, their profits here in the United States. So in terms of territoriality, I think we should go with the rest of the world.

MR. ARMEY: Border adjustability would be a real problem in the tax code. First of all, it again, it introduces from my point of view a corruption.

If the singular purpose of a tax code is to raise money, then you don't compound and make it more complex by trying to use it to correct your balance of payments.

But the problem is, the biggest reason why our balance of payments is always out of whack is, we're the richest nation in the world, and we buy more from abroad than what poor nations can buy from us. And a Flat Tax is going to make us even more richer.

So the fact of the matter is, as we become more prosperous under the Flat Tax world, and more people are more prosperous across the spectrum of our society, we're going to import more from abroad.

And until international nations share our level of prosperity, they will cry.

So again, I've always cautioned people to have a more expansive view of international finances. The fact is we always have a balance of payments, because our capital accounts make up what we see as the deficiencies of our current accounts.

Final point: I've never figured out why we should feel bad when we take real products from the

French, the Europeans, the Italians, and whomever, and we give them nothing but money. I say it's a heck of a deal. We ought to do it as much of it as possible.

MR FRENZEL: We give them promises.

MR. ARMEY: That's right.

CHAIRMAN MACK: Any other comments?

MR. MOORE: I guess I would disagree a little bit with my professor who taught me economics, Dick Armey, on this.

I do think that the ideal tax system would be something you heard from earlier today, what David Burton talked about, which would just eliminate the - which would just create a straight consumption tax, trade in the corporate income tax for a value-added tax, trade in the personal income tax for a national sales tax.

I think the problem that you have in this country with respect to trade, and you see this right now with even some Republicans and many Democrats talking about a 25 percent tariff on China and so on, well, the biggest reason I think that we have this trade -- to the extent we do have a trade deficit -- is because we do have -- we do put our exporters at a 10 to 15 percent disadvantage because of our tax code.

Now, I happen to think politically what

we've been talking about on this panel of moving towards a flat tax is probably the first big step to tax reform. But ultimately I'd like to scrap the income tax system entirely, and let's have a tax system that treats our trade values just as other countries do. Because we're really about the only industrialized country that doesn't have a border adjustable tax system.

CHAIRMAN MACK: Okay, well I think --

MR. FORBES: By the way, to back up Dick Armey's thing on trade, in North America we've had trade deficits for about 350 of the last 400 years. And looking around us I don't think we've done badly with that kind of sinning. I think -- if I were a dictator I'd ban trade numbers. They're just mischief.

CHAIRMAN MACK: All right, well thank you all for your participation. Thank you, panel members, for an excellent day.

We are now adjourned.

FROM THE AUDIENCE: (Off-mike) talked about taxes and that kind of thing, and yet we really haven't talked about the entity that creates rules, imposes rules and judges rules, which is the IRS, against the (inaudible) American public (inaudible) billions of hours to do taxes, and yet we're not going to do anything about that entity? I think something has to be done. It hasn't been talked about here.

CHAIRMAN MACK: And the reason it hasn't is because we are operating under a directive, an executive order, that has really defined what our responsibilities are. That's not one of them.

It doesn't mean it's not an important issue, but that's not one of our areas to pursue.

FROM THE AUDIENCE: You are without authority over the IRS.

CHAIRMAN MACK: Right.

(Whereupon, at 4:48 p.m., the hearing was adjourned.)

UNITED STATES OF AMERICA

PRESIDENT'S ADVISORY PANEL ON
FEDERAL TAX REFORM

EIGHTH MEETING

THURSDAY
MAY 12, 2005

The Panel met in the National Transportation Safety Board Auditorium, 429 L'Enfant Plaza, S.W.,, Washington, D.C., at 9:30 a.m., Connie Mack, Chairman, presiding.

PANEL MEMBERS PRESENT:
THE HONORABLE CONNIE MACK, Chairman
THE HONORABLE JOHN BREAUX, Vice Chairman
THE HONORABLE WILLIAM ELDRIDGE FRENZEL
ELIZABETH GARRETT
TIMOTHY J. MURIS
JAMES MICHAEL POTERBA
CHARLES O. ROSSOTTI
LIZ ANN SONDERS

WITNESSES:

KENNETH W. GIDEON	Partner, Skadden, Arps, Slate, Meagher & Flom, LLP; Former Assistant Secretary of the Treasury (Tax Policy) and IRS Chief Counsel
JAMES R. HINES, JR.	Professor of Business Economics and Research Director, Office of Tax Policy Research at the University of Michigan Ross School of Business
R. GLENN HUBBERD	Dean, Columbia Business School and Russell L. Carson Professor of Finance and Economics
EDWARD D. KLEINBARD	Partner, Cleary, Gottlieb, Steen & Hamilton
DAVID J. SHAKOW	Professor of Law, Emeritus, University of Pennsylvania; Director, KPMG, LLP
STEPHEN E. SHAY	Partner, Ropes & Gray
ALVIN WARREN	Ropes & Gray Professor of Law and Director of the Fund for Tax and Fiscal Research at Harvard Law School

A-G-E-N-D-A

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

9:35 a.m.

CHAIRMAN MACK: Good morning, everyone.

I believe we'll go ahead and get started. Our first panel member this morning is going to be with us via satellite. And we will be hearing from Glen Hubberd, Dean, Columbia Business School and Russell L. Carson Professor of Finance and Economics.

And this panel or this discussion will be Perspectives on Business Tax Reform.

And, Glen, if you are there and are ready, we look forward to hearing from you.

MR. HUBBERD: I'm ready. Thank you very much, Senator.

CHAIRMAN MACK: Good. We see you, and please proceed.

MR. HUBBERD: Okay. Good.

Well, thank you. And Senator Breaux, and members of the panel. And I do have some slides as well. And I just wanted to set up some issues. I don't know, if who is doing the slides could start on page 2.

There are some big picture goals of tax reform that I think lead right to the hearing you're having today on business taxation. First is the reason that we're here, which is improving living standards. And I think most of the work that's done by economists would suggest that fundamental tax reform could improve our standard of living, that is annual incomes, by as much as 9 percent. I'll come back to that number.

Second, reducing complexity and wasteful tax planning, which is in the business tax code is principally in the international tax area and in the measurement of depreciation and capital gains and tax shelters.

The third element that I think is critical is, obviously, maintaining tax fairness. And I tee these up for this morning because in truth the elephant in room, if you will, for tax reform is capital income taxation and business taxation. That is the source of the problems that are effecting living standards, it is the source of the much of the complexity in tax planning and games to get around it have hurt tax fairness.

If you'd go to the next slide, please.

Rather than talking with you about very specific prototypes, which I know many on your panels will do, I just wanted to suggest from a perspective of what economists have looked at for some time is a family of prototypes that might be a good place for you to end up. And I think it's really in two parts.

One is to think of not as separate corporate tax, like we have today, but a general business tax system that has as its base sales, less what I purchased from other firms, less the compensation I pay my employees and less a portion of capital spending: Under an income tax that a portion of capital spending would be depreciation, under a consumption tax that would 100 percent expensing which in my view would be a better way to go. I think that's a larger stimulus to business investment.

Now, note here that whether or not we think about fundamental income tax reform, and it's something that would have depreciation in this mix, or fundamental consumption tax reform with expensing we would not have an interest deduction like we have under current law. Okay.

The household tax would be just on compensation. So individuals would not pay tax on interest, on dividends, on capital gains. So in this "good place to end place" we have a system that would be neutral for saving and investment decisions, we would tax all income once and only once, whether it's business income or wage income. And I would note, and we can come back to this if you'd like in questions, it's important not to let the best be the enemy of the good because the distinction between income and consumption tax reform is actually not that large. Both of these fundamental reforms would be a big advance of where we are.

If we go to the next slide, please.

What I've said so far may sound a little bit like motherhood and apple pie, so I wanted to point out some very specific good outcomes that come as a consequence of business tax reform.

One, I think any business tax reform that you should consider as a major prototype for reform should not tax capital income twice and no taxation of investor returns, and no tax distinction between debt and equity. You all know from your experience in policy, from business and economics that the artificial distinctions between debt and equity in the tax code have lead to large distortions of business decisions, and indeed in some places to some of the corporate scandals that we have seen. So one very good outcome is we don't under tax reform double tax investor returns and we don't try to discriminate between debt and equity.

A second feature that may seem like a

wrinkle but I view as a necessary part of tax reform of either of the prototypes I outline for you is territorial tax system. That is unlike current law. We would not tax the income that multinationals earn abroad. And the reason for that is simple. Fundamental tax reform would have, by not double taxing returns, any additional taxation on dividends. One kind of dividend, of course, is a dividend paid from a controlled foreign corporation back to its parent here. Symmetry would suggest that we not tax that.

The third good outcome as a consequence is that these tax reforms could offer a very large stimulus to business investment, particularly if you go the route of the consumption tax and expensing, which would at least be my own advice to you in your deliberations. That is very important for the U.S. economy in particular, and I think for the world economy as well.

If you go to the next, please.

There are also some big challenges in tax reform, some of which may be bigger than you think and others, I would argue, smaller than you think. One thing that's critical is the tax treatment of interest. And here I've talked about prototypes that would disallow interest deductions but not tax interest income. That will clearly generate the need for discussion in the business community.

I would also advise, which you know quite well, that it's the maintenance of interest deductions that makes it hard for us to give broad base relief for saving. Because with the presence of interest deductions we can also get tax arbitrage opportunities.

Under this tax treatment of interest will also be a need to think about the taxation of financial institutions, as I know you're already doing.

Special provisions are a challenge. There are some industries that exist, frankly, to sell products tax favored under current law. Tax reform would diminish that. And make no mistake about it, you will hear from those industries.

But the third and perhaps largest point on this slide is I know you will spend a lot of time thinking about transition and transition costs. I would invite you if you have a chance, to take a volume Kevin Hassett and I edited for the American Enterprise Institute that suggests transition costs for tax reform may be overstated, and in fact cold turkey transitions to tax reform may be less problematic than some think. In particular tax reforms that would be cutting dividend and capital gains have all been very positive effects on asset that values can offset some of the other costs of tax reform.

Just quickly going to the next slide, I know that you are talking about business tax issues today, but one cannot avoid the nexus between the business tax reform and the household tax reform here. And I just want to make sure that it's clear, as I'm sure it is to all of you, that when we give this extra benefit for capital income, that is stopping the double and multiple taxation and we're also pursuing revenue neutral tax reform, the one truism of economic supply is which there is no such thing as a free lunch. And broadening the tax base will require some offsets. Two that would appear to me to most logical would be capping, limiting in some way the state and local deduction on federal returns and further limits on the home mortgage interest deduction for high income people.

I think it's possible if we do this to also eliminate the separate alternative minimum tax, which also would have simplification benefits.

But another household tax challenge I'll raise with you, if you go down the route of tax reform and you maintain a home mortgage interest deduction, you're going to have some kinds of debt where you have a deduction in taxation and other kinds with no deduction, no taxation and that, to put it mildly, is a challenge.

To go to the next slide, sometimes economists talk in terms of broad big picture without any notion of whether we can proverbially get there from here. The answer here is I think we can. I think we have already started. I think President Bush's agenda on cutting marginal tax rates, on reducing taxation of saving and investment and the attention now being paid in the Congress to AMT reform, all of this is pointing in the same direction.

I think it is possible even in tax reform to focus on distributional considerations. That is, not only revenue neutrality which you have set as a goal for yourself, but to make sure that while we're cutting marginal tax rates we don't offer net tax cuts for high income taxpayers as a group. I think that is possible through some of the deduction limitations that I mentioned before.

And just to close in that regard if you

look at the next slide, the compromise it seems here if one didn't want to go all the way with what I was suggesting, is perhaps a more schedular system with lower but not zero-tax rates on returns to savings. And then the tension between depreciation, less favorable for investment but less costly than expensing.

Just to tie all of this together on the closing slide, how do you start? It starts in either two ways you could approach this discussion in your deliberations.

One is to start with a benchmark for fundamental tax reform. I tried to set up a business tax model for you briefly this morning.

A second, and to me, almost equally productive discussion would be for you to start as a cleanup discussion. And one way you might do that is to, say, start with a broad based tax system like the alternative minimum tax and ask yourself how that can be fixed; that is getting rid of some of the onerous provisions, cutting taxes on capital within that model and get the tax reform that way. Either way there is no such thing as a free lunch. And I think the education process that you're involved in with the business community of seeing there are big gains from tax reform, but we will also have to accept some offsetting tax changes is important.

Thank you very much for the time. And I would welcome and look forward to any questions you have.

CHAIRMAN MACK: Glenn, thank you very much.

Jim, you want to start?

MR. POTERBA: Glenn, thanks very much for joining us.

You mentioned on the household tax challenges that if we move toward various reforms of the kind you consider, we might end up with bifurcated debt markets with some things being deductible and some not. Do you see that as raising problems the structure of the debt markets per see? You mean there will be things which were treated differently for the investor side, but maybe you could elaborate a little bit more on the concerns you have there and how if at all you'd think about trying to remedy those problems?

MR. HUBBERD: I apologize. I heard your words, Jim, three or four at a time all cross.

MR. POTERBA: Okay. As when I've been simultaneously translated. I will try speaking slower and louder.

You mentioned the problem of bifurcated debt markets, which as I understand it is that investors would be taxed in different ways on ostensibly the same financial instrument in the marketplace. Do you have any advice on thinking about how the market might respond to that circumstances or to best minimize the impact of these issues?

MR. HUBBERD: You raise a very important question, Jim. And in the tax reform if you went the route that I suggested this morning and you insisted on maintaining the home mortgage interest deduction in its present form, you would have some markets. For example, the market for business debt that would have a tax exemption at the individual level because there's no deduction, no taxation. But the market for home mortgage instruments and securities collateralized by home mortgage instruments would have taxables. You would have the full deduction.

There are ways to deal with that. Equilibrium prices, of course, would adjust in those markets. An alternative might be to go to some other mechanism than an home mortgage interest deduction to subsidized housing. But if you insist on keeping a full home mortgage interest deduction, I don't see a way around having these two types of debt.

MR. POTERBA: Okay. Great. Thanks very much.

CHAIRMAN MACK: Tim?

MR. MURIS: Glenn, it's nice to see you, even if you've been invisible. It's nice to see you again, Glenn, even at a distance.

Given the transmission problems, let me ask a very short question.

Can you elaborate on what you and Kevin said about transition costs and why you think cold turkey is really reasonable?

MR. HUBBERD: Thanks, Tim. If I understand your question it's about why I think transition costs are small?

MR. MURIS: Yes.

MR. HUBBERD: Is that --

MR. MURIS: That's close enough.

MR. HUBBERD: Okay. I mean here's the basic argument. Normally when economists have thought about the transition to tax reform we look at things like the movement from depreciation to expensing as reducing the value of old capital, which is a cost, a transition cost of tax reform and as we move from a depreciation regime to a new regime. Offsetting that in tax reform is the reduction in dividend and capital gains taxes. I believe, and this is controversial in the economics profession, but I believe that a significant fraction of those taxes are capitalized in asset values. And so a permanent reduction in dividend and capital gains taxes would be good for the stock market and then indirectly good for investment. That would offset some of the transition costs.

If you did not believe that, if you don't believe in tax capitalization, then you should take these transition costs much more seriously. And there are some plans that have been put out there, including some very detailed work by the late David Bradford on how to do transition.

Transition raises difficulties because when you keep multiple tax systems in place for a time, you raise tax arbitrage opportunities as well as complexity.

MS. GARRETT: Yes. Hi. Thank you.

I wanted to talk a little more about the distributional concerns. You talked a bit about how we ought to think about the high income. With the very low income and EITC or some kind of relief like that is a way to deal with possible regressive effects.

I always find it more challenging to think about the sort of middle quintiles whose income is wholly compensation and who are also burdened by the payroll tax and other tax on compensation. And I wondered if you had any suggestions or views about those distributional concerns? Again, the sort of lower middle class people whose income is purely compensation and who are also burdened by the payroll tax.

MR. HUBBERD: Shortly just to go through the pieces you mentioned. Certainly for higher-income people I think it is possible to use limitations on deductions to make sure that an average tax rate is not matching the marginal tax rate cut that economics would suggest you want.

For low income individuals I think you're right, any of these reform proposals could use very generous exemptions or EITC type systems to deliver whatever subsidy the political process deems appropriate.

For middle-income people I think one has to be careful about focusing on just a static analysis. Because if you believe the goals of tax reform are to raise productivity and wages, those accrue to all in society including middle-income families. And certainly many middle-income families in the saving that they do for retirement and other purposes would benefit from reductions in capital taxations.

I would be very surprised if the Treasury or the JCT in doing distributional tables for you couldn't produce distributional tables for reforms like this that pretty much match the distribution of current law.

MR. ROSSOTTI: Professor Hubberd, you noted under your concerns at the top of the list the treatment of financial interest income and more broadly the whole financial sector. And I'm just wondering under your concept, you know you eliminate interest deductions and I guess the consequence of that is you also eliminate taxation on dividend income or interest income and financial institutions. So what happens to the financial sector then?

For example, any financial institution that pretty much makes its earnings on the spread between interest income or financial income and interest, is that just not taxed at all under that concept or what would happen?

MR. HUBBERD: No, not at all, Mr. Rossotti.

You raise a big question because financial institutions are now a very large fraction of value added. And if you break them down into parts, you spoke of a particularly plain vanilla example of lending. There I think tax treatment is pretty straightforward because you can focus on spreads and separate profitability from risk bearing. More complicated, perhaps, is income earned in the securities business. But there have been virtual treatises in recent years on either the income tax version of this or the consumption tax version of how to treat this.

We have made big changes, say, since the time of the ALI Treasury studies in the early 1990s. So I think this is one where we can do tax reform without worrying that we're leaving financial institutions out of the net. This would not be an excuse to get rid of taxation of financial institutions.

MR. ROSSOTTI: Just summarize quickly then how you would do it if you're not giving the deduction for interest, you're not taxing interest income or dividend income, where do you then capture that income?

MR. HUBBERD: Well, simply, if we you start with your example on net lending, you would tax margins. So you'd be taxing lending spreads, not the gross flows of interest deductions and interest receipts.

In securities transactions you would be trying to measure the value added.

Here it's important how you structure the prototypes because you want to make sure you don't have a prototype that makes it easy to relabel a goods transactions as a financial -- I'm saying you know well there are some prototypes for tax reform that leave wide open recharacterizing, say, the sale of a durable good as a financial transaction. Others do not leave that wide open. So again there's been considerable thought in recent years on these, and I think it is possible to get at these with at least no more complexity than under current law, which for financial institutions is incredibly complicated.

MR. ROSSOTTI: On a related issue on your implicit move to a territorial system on the international tax. How do you avoid having multinationals essentially move all of their intellectual property income, their financial income, whatever, can be moved which they're already doing to a considerable extent to offshore locations with little or no tax and then just repatriating the net back, whatever they want to, tax-free through dividends?

MR. HUBBERD: Well, your question as I understood it was about how do you keep intangibles of multinationals from moving abroad in a territorial system. You know, keep in mind, again something you know very well, and for many multinationals we're already pretty close. In other words, the notion that U.S. multinationals typically operate in low-tax jurisdictions for the bulk of their business is not -- principally in high-tax countries, it's not as big of a deal perhaps as your questions suggestions.

I think it's important to consider, as I'm sure you are, how you're treating within the U.S. the taxation of the production of the tangible capital. As we talked about expensing for fixed capital investments, the question is how are you treating the generation of tangible capital, the tax treatment of R and D and so on.

Current law, of course, also puts pressure on multinationals to relocate, in some sense, pieces of what they do. I don't see a sea change here. But I say territoriality of what's implied by tax reform is really like a dividend exemption system. I mean, that's what we need here.

VICE CHAIR BREAUX: Dean Hubberd, John

Breaux. Thanks for being with us.

It seems that looking at your proposition, I mean I see a lot of dessert but I don't see any spinach. An I'm kind of wondering. I mean, everything that's out there sounds great but you know where's the heavy lifting on that?

MR. HUBBERD: Well, actually that's what I was pretty careful to try to point it out. And I love spinach, not just desserts. Economists are pretty good talking about spinach.

The spinach is clear. Let's take the business side.

The reason that you can do the relief on the investor level on capital taxes and moving to expensing in this is you are giving up interest deductions. While you're not taxing interest income, the value of an interest deduction under current law is substantially greater than the tax you're collecting on interest because so much interest is going to de jure or de facto exempt entities. That's a big piece of spinach.

Now it's not net spinach for capital because it's going elsewhere for capital taxation.

At the household level this spinach that avoids giving large tax cuts for very high-income people is the limited deductions. So in particular if you wanted to eliminate the AMT as part of this and still keep the tax-burden, I would urge you to think of eliminating the state and local tax deduction on federal returns as well as limiting the home mortgage interest even more for high-income tax payers. That's a fair amount of spinach.

The hidden spinach, if you will, is really that there are some businesses who draw their breath from the current tax codes treatment of capital, and you can rest assured that those businesses and institutions will not be happy with tax reform.

VICE CHAIR BREAUX: Thank you. Appreciate it.

MR. FRENZEL: Thank you very much, Glenn.

You mentioned that there would be a stimulus to the economy from expensing, particularly on slide 4. We've already discussed that it's expensive and if we do that, we may have to forego some other desirable reform.

Can you give us an idea of the nature and amount of stimulus we might expect since growth is one of our primary goals?

MR. HUBBERD: Well, let me take the two pieces of your question. Certainly the primary part you asked about. What expensing does is reduce the user cost of capital for investment. And in some recent work, Kevin Hassett and I found that moving to expensing could raise the equilibrium capital stock sufficient to raise consumption for workers about three percent per year. That is not a three percent growth rate change a year, but a level. Think of it as an annuity. That could be a very, very big number indeed.

The additional gains from tax reform come from the reduction in tax on dividend and capital gains that could also effect dividend values and the cost of capital.

I'd like to push back a little on your question about how expensive this is. It's a question of how economists look at it versus how Washington looks at it.

In Washington there's a budget window of a finite number of years, five or ten. Moving from depreciation to expensing is, all you know well, just about the time-value of money. And if depreciation allowances are close to riskless, that's like the risk-free interest rate. So the actual difference between depreciation and expensing is pretty modest over a very long horizon, even though on looking at five or ten years it might appear to be quite large.

MR. FRENZEL: Thank you.

MS. SONDERS: Hi, Glenn. Nice to see you again.

Let me carry on with Bill's question. You know, your opinions are well documented and well known on the impact that an elimination of taxation on capital would have on the stock market. Now, we obviously went part of that way through the reduction in tax rates in 2003. But I wondered what your opinion would be on the effect, particularly on the stock market, in an environment where there was full elimination of that taxation?

MR. HUBBERD: Well, first of all, and for the 2003 experiment it's hard to know what the market price because you weren't legislating a permanent cut. You were legislating this phase out and people like to guess will this be permanent, won't it be permanent, will tax reform happen or not. The best guess that I gave at the time was that if you would have eliminated all dividend and capital gain taxes and people believed that was permanent, you might have had an effect on the market on the order of 80 percent of asset values, which would be smaller than a full capitalization effect but still something clearly noticeable.

Others who believe that there's no tax capitalization would suggest even larger cost of capital effects than I might believe, but smaller asset price effects. There's range of studies that have tried to document on both margins and an excellent recent review paper by Alan Auerbach and Kevin Hassett on that point.

CHAIRMAN MACK: Glenn, I'd like to focus on the suggestion and something I believe strongly in as well, the notion that there should not be double-taxation. And under the proposal or the comments you made, basically what we have is by the tax I guess being collected at the corporate level, you have no individual taxation on dividends, savings, capital gains. That, obviously, causes a political problem.

So I think my question to you is is there another way to accomplish the objective of only taxing that income once as opposed to the way that you have described it this morning?

MR. HUBBERD: Well, it's an excellent question, Senator.

The reason that I think many economists have focused on this set of prototypes as opposed to deductions and the business level and then taxation at the individual level is because so many individuals, either by the law, by tax planning or by practice just don't pay taxes at the individual level. So if your goal is to tax not more than once but at least once, then I think you're going to have to do it at the business level. If that was the political concern that you were raising.

I think from the prospective of the business community this should still be seen as a plus, Senator, because the cost of capital for investments and the values of firms could still be higher under this set of prototype for tax reform. But I think if you tried to do it by deducting interest and dividends and then taxing everything at the individual level, you would find yourself with a pretty large revenue hole.

If your political question was how do you get some progressivity back in capital taxation, you could approach that by giving credits. In other words, you could give a fixed rate credit for taxes paid at the individual level and then still collect some extra tax for high income people at the individual level. I would urge you not to do that. The tax benefits all occur at the margin. And if you think wealthy people are the marginal players in capital markets, which I do, then you've done very little for efficiency.

CHAIRMAN MACK: I appreciate that.

Any other questions that the panel would like to raise at this point?

Glenn, we know you have a tight schedule and we greatly appreciate both your presentation and your responses to our questions.

Thank you very much.

MR. HUBBERD: Thank you, Senator. And thanks for the accommodation.

CHAIRMAN MACK: Okay. You're more than welcome.

Our next discussion this morning will be on the integration of corporate and individual tax systems.

And we have with us this morning Alvin Warren, Ropes & Gray Professor of Law and Director of the Fund for Tax and Fiscal Research at Harvard Law School.

And Kenneth W. Gideon, partner at Skadden, Arps, former Assistant Secretary of the Treasury and IRS Chief Counsel.

Welcome to both of you.

And, Mr. Warren, why don't you begin.

PROFESSOR WARREN: Thank you. And good morning.

So yesterday you heard a lot of different plans. My role this morning is to return to income tax principles and to talk about integration of corporate and individual income taxes. And I'd like to address two questions:

First, why should corporate and individual taxes be integrated;

And secondly, how can it be done?

The basic fact here, as Senator Mack indicated a moment ago, we have a system of double-taxation. And so that's the first part of the answer as to why should corporate and individual income taxes be integrated. Taxable corporate income that is distributed to taxable shareholders is taxed twice; once when earned by the corporate and again when received by the shareholder as a dividend. This system of double taxation creates four different kinds of incentives.

First, it creates incentives for individuals to invest outside of corporations to avoid the double tax.

Second, it can create incentives for corporations to issue debt rather than equity because interest but not dividends are deductible.

Third, it can create incentives for corporations to retain, rather than distribute, corporate earnings. And that incentive depends particularly on the relationship of corporate and shareholder tax rates.

And finally, it can create incentives for corporations that are going to distribute earnings, to distribute them as capital gains rather than as dividends, particularly if they're taxed at different rates.

So on the one hand we have a system of double-taxation. On the other hand, not all corporate income is subject to double taxation. Some is taxed only once at the investor level, and here you can think about corporate earnings that are distributed as deductible interest to taxable lenders. There's no tax at the corporate level because of the deduction for interest.

A different example is that some corporate income is taxed only once, but at the company level. And here you can think about corporate earnings that are taxed to the corporation but are distributed as dividends to exempt or foreign shareholders where there is no double-taxation because there's no investor level taxation.

And finally some corporate income is taxed at neither the corporate nor the investor level. An example here is corporate earnings distributed as interest to exempt or foreign lenders.

So our current system is one which sometimes we have double-taxation, sometimes we have single-taxation, sometimes we have no taxation. And for those in the auditorium who are corporate tax lawyers, there are even cases of triple-taxation today which I won't go into unless you want to discuss it later.

So the basic idea of integration is that corporate income should be taxed once, but only once to reduce these kinds of tax induced distortions. There are really three practical methods for accomplishing corporate tax integration.

First of all, shareholders could receive a credit when they receive dividends for corporate taxes that have been paid with respect to those dividends.

Secondly, the shareholders could simply exclude dividends that have been taxed at the corporate level, or;

Thirdly, the corporations could deduct

dividends as they do today, take a deduction for interest.

Now the basic idea of the shareholder credit, as I said, is the shareholder receives a credit for corporate taxes paid with respect to earnings distributed as a dividend. It's important to focus on what the result of a shareholder credit is. The result is that the corporate tax is no longer a separate tax. The corporate tax is simply a withholding tax with respect to distributions to investors. So there's not a separate tax, it functions like a withholding tax just as we have withholding on wages that everyone is familiar with.

We can show this with a simple numerical example. Just take a corporation earns $200. The corporate tax rate is 30 percent, so the corporation pays 60 in corporate taxes, has 140 left which it distributes equally to 2 shareholders, A and B, whose tax rates are 25 percent and 35 percent. So we have one shareholder whose tax rate is lower than the corporate rate and one shareholder whose tax rate is higher than the corporate rate.

Somehow my slides got out of alignment when they put on this computer but I think you can follow it here.

Each shareholder received $70 in cash after the corporate taxes. But just as you don't pay taxes simply on your cash wages, you pay taxes on your cash wages plus the amount that's been withheld, each shareholder would pay taxes on $100. So there'd be a preliminary shareholder tax of 25 percent and 30 percent, but each shareholder would receive a credit, just like a credit for withholding on wages of $30. So that shareholder A would receive a refund of 5, a $30 credit against a $25 tax. And shareholder B would pay additional taxes of 5 because a $30 credit would only cover $30 out of $35 of taxes due.

So each shareholder would be in the same position as if the dividends had been taxed to that shareholder at the individual rate. Shareholder A ends up $75, the 25 percent rate has been applied to shareholder A. And shareholder B ends up with $65, the 35 percent rate has been applied to shareholder B. So under this system the corporate tax simply becomes a withholding tax and is no longer a separate tax.

The major alternative practical method for integration is a shareholder exclusion for dividends. A shareholder simply excludes dividends already taxed at the corporate level. The result here is somewhat different. Corporate earnings are now taxed at the corporate rate, not at the individual investor's rate. So in our previous example when those dividends are distributed to shareholders whose tax rate are 25 percent and 35 percent, the 25 percent and 35 percent rate don't come into play. Each shareholder simply keeps $70, and so dividends have been taxed, corporate income has been taxed at 30 percent.

So the major tax policy decision in designing an integration system to eliminate double-taxation and tax all corporate income once but only once, is do you want corporate income taxed at the individual's tax rate, in which case you want a shareholder credit system, or do you want corporate income taxed at some other special rate in which case you would want a shareholder exclusion.

You could also have a corporate deduction for dividends which would eliminate the corporate level tax. But there's a caveat with respect to this system. Without a withholding tax simply deducting corporate dividends would automatically extend the benefit of integration to tax-exempt and foreign shareholders. Remember our distribution of corporate income to a tax-exempt shareholder, the only tax now is at the company level. If you gave a deduction at the company level, you'd eliminate any tax on that corporate income. So unless you want to automatically extend the benefit of integration to foreign shareholders and other exempt shareholders, a corporate deduction for dividends is not really practical.

If you coupled withholding with a corporate deduction for dividends, you've essentially recreated the shareholder credit method.

Any of these integration systems involve a series of important policy questions:

How can the shareholder credit or exclusion be limited to income taxed at the corporate level?

Should the benefits of integration be extended to foreign investment or investors?

Should the benefits of integration be extended to tax-exempt investors?

And how closely should the integration method be aligned to the treatment of debt to prevent distortions?

Let me just mention two recent developments. As you all know, in 2003 in the United States the tax rate on dividends was reduced to the preferential rate on capital gains. This can be thought of as a partial step toward a dividend exclusion as originally proposed by the President.

On the other hand, as enacted the lower shareholder rate applies even if income was not subject to the corporate tax. So this particular method does not really integrate the two taxes because there's no connection between what goes on at the two levels.

Finally, several important trading partners of the United States have in recent years replaced their longstanding shareholder integration systems with exclusion systems in order to avoid some European judicial decisions prohibiting discrimination against investment involving other EU countries.

So let me just close with three conclusions. The basic idea of integrating individual and corporate income taxes is that corporate income should be taxed once but only once to reduce distortions.

Secondly, the principal design decision raised by integration is whether corporate income should ultimately be taxed at shareholder or corporate rates. The first answer would suggest a shareholder credit, the second a shareholder exclusion.

Finally, under either approach the shareholder credit or exclusion should be available only for income that was actually taxed at the corporate level.

Thank you.

CHAIRMAN MACK: Thank you.

Mr. Gideon?

MR. GIDEON: Thank you very much for the opportunity to appear here. I am here to talk about the comprehensive business income tax proposal. This proposal originally appeared in 1992 when I was Assistant Secretary of Treasury. It's set forth in much more detail in this book than I'll be able to go through in a few slides this morning, but I will try to give you the highlights.

CBIT's objective was to tax all business income only once and to eliminate economically inefficient current corporate tax law distortions. In other words CBIT had a somewhat broader goal than just integration per se, which would have dealt only with the double-taxation of corporate equity capital. In other words, and the distortions it addressed were the current structures favoring of corporate debt over equity finance, the favoring of the noncorporate over the corporate form and its favoring of corporate retentions over distributions. The goal was to promote simplification and fairness by taxing corporate and noncorporate business entities using a single set of rules.

Under CBIT income of almost all business entities, in other words whether they're corporations, partnerships, whatever the form of organization would be measured and taxed at the entity level. Very small business measured by gross receipts would be excluded because there's some problems at the lower end in really pulling apart kind of proprietor income and other pieces.

There would be no investor level tax on distributions. Distributions of business income, whether business or interest, would generally not be taxed when received by investors.

Losses incurred at the corporate level do not pass through equity holders. Unused losses could be carried over at the entity level.

There would be no business level interest deduction, although the corollary is that interest received in the hands of the recipient wouldn't be taxed either.

Your staff and I put together this simplified chart of the effects of CBIT. And I won't go through all of these, but I'd just ask you to look at current law versus the comprehensive business income tax. And what you see is that whereas you get differences in treatment of equity income in current law, you do not get that -- in other words, everything is treated the same in a CBIT system. And that's one of the major sources that the economists tell us of the kind of welfare gains that would result from such a system.

And the other point I'd note is that there is currently some preference, as Professor Warren mentioned, for dividends in the current system. In the next chart which actually appeared in the CBIT report in 1992 that was not true. Again, I won't pause to go through this chart, other than to simply say it's important that you focus on the fact that you always must keep in mind not only the domestic concerns which were really focused in the first chart, but keep your eye on the ball of what's happening to foreign holders and to tax-exempt holders. And that's the reason I wanted to include this chart to make sure that there was focus on that as well.

Again, comparing what happens in current law. There's differing treatment of corporate and noncorporate business entities. In CBIT everything would be the same except for the very smallest businesses.

In current law there's a different treatment of corporate debt and equity. In CBIT corporate distributions, both dividends and interest are excluded.

Similarly, corporate and noncorporate equity is distinguished in current law and in CBIT that would not be the case.

In 1992 we did an extensive analysis of the welfare gains that would be brought about by enacting a CBIT system. And we thought they would come from: Improved consumption choices by the allocation of resources; improved corporate borrowing policy; improved corporate dividend payout.

I think that one thing that would have to be done if you were seriously considering this proposal today... is those estimates are old. They were not against the system. And, they would need to be updated. Having said that, I think that I and others still feel there would be significant and important welfare gains from adopting a CBIT system.

One of the things that CBIT does that's different, as has been mentioned, is that CBIT does try to take into account corporate tax preferences. And essentially CBIT would only give these exclusion benefits, if you will, for income that has in fact been taxed once at the corporate level. So one of the things about CBIT that differs a little bit from the current dividend relief structure, is that it attempts to take into account preference income, keep track of it and not basically have any income get through the system without being taxed at least once.

There are a couple of options for how to deal with that. The first option is to include in the investment, that income in the investor's income, and tax it at the ordinary rate.

The second is to tax distributed preference income at the business level.

Option one is probably better from an economic efficiency standpoint. Option two is easier to do.

CBIT uses an excludible distributions account to keep track of what's in fact been taxed. I won't go through all the anti-abuse rules that are up there... that you would probably need to kind of guard the system, but just be aware that there would be a need to do that.

One of the biggest concerns we had when we were looking at CBIT at the time was the international concerns. In other words, in a sense the U.S. tax on distributions is the currency we use to trade in tax treaties, the reciprocal concessions are getting that. And if we're basically not -- if we're going to distribute corporate income kind of free of tax to all holders, one of the problems is that there is going to be some loss of leverage in that system. And it will require substantial adjustments in our treaty system.

Financial intermediaries. That's a concern. I can't say that we thought that we had completely addressed in the CBIT proposal we had. I think that one of the interesting questions is what the behavioral response is going to be. Indeed, one of the things you'll see in the original Treasury study about implementing CBIT generally was the suggestion of a longer phase in. And part of the reason for that, for a long phase in of CBIT, was the notion that there were going to be fairly serious behavioral changes that were difficult to estimate. And so you might want to kind of see where you were in terms of how the market responded to such fundamental changes in the rules.

Let's just sum up some of the market impacts and transitions.

The interest rate on CBIT debt: It would be tax-exempt to holders, therefore it ought to be a little lower, you would think, than the taxable interest rate.

By virtue of the fact that corporate distributions would be exempt, state and local debt would lose -- in other words, it wouldn't be taxed, but it would lose its favored status. And you may need some transitional rules to avoid those kinds of difficulties.

One of the things I think you have to address is what happens if you combine CBIT with other proposals, for example, expensing as was addressed here this morning. I think that what you should recognize is that you are effectively not taxing capital income if you do that. In other words, I'm not making a normative choice that that is a good or a bad thing so much as I'm saying you should be conscious that that is the impact of combining CBIT with a proposal like expensing.

I think that there are other arbitrage concerns, as I've noted on the slides. And since I've gone over a bit, I want to just thank you for this opportunity to present CBIT. And I think Professor Warren and I would be delighted to answer any questions you have.

CHAIRMAN MACK: Thank you very much.

And I'll turn to Senator Breaux.

VICE CHAIR BREAUX: Thank you very much, gentlemen, for your comments and the presentation. I think that, obviously, the concept of taxing things only once has a great deal of merit and we've been tinkering around with how to get there for a long time.

My question -- is pretty much a broad question -- is if we do this, what are the costs associated with it and how do we pay for this? And one of the requirements of the Commission, obviously, is to be revenue neutral.

Professor Warren and Mr. Gideon, well if we enacted your recommendations, how much would we have to find in terms of revenues to pay for the expense of doing that or do you think it would not be a cost, or whatever?

MR. GIDEON: I think that the first thing you'd need to do is get proposal like CBIT reestimated under the current base. CBIT actually raises an awful lot of money. And if you look at that more complicated chart I had, I think you see the reasons why. And that is that an awful lot of money is getting through the system untaxed. In other words, if you have corporate earnings that were offset by interest deductions, if those are going to tax-exempt institutions, if those are going to foreign countries there is zero-tax on that. Under a CBIT system you're going to get a level of corporate tax on that.

So at the time these estimates were done back in '92 we thought you would actually raise enough money out of CBIT you could lower the corporate rate. So in a CBIT proposal there is some kind of internal generation, if you will, simply from that shift in the base.

VICE CHAIR BREAUX: Professor Warren?

PROFESSOR WARREN: I would agree with that. You know, this is a question that should be put, I think, to economists and revenue estimators.

But I would say that it is important to remember that we're not simply talking about eliminating the double-tax, which would of course cost something. We're also talking about trying to tax all corporate income once, some of which is not taxed at all today. So it's hard to get a specific answer to the question without working through all of the details in terms of how you would accomplish the various subparts of that.

VICE CHAIR BREAUX: I appreciate it. Thank you.

MR. FRENZEL: Thank you.

Ken, it's nice to see you again after such a long time.

MR. GIDEON: Nice to see you again, Mr. Frenzel.

MR. FRENZEL: I thought I heard you say that in the application of CBIT the states and municipalities who now issue tax-exempt bonds would not be able to do that anymore?

MR. GIDEON: No. Their status would be unaffected, it's just they would have less relative advantage because they would be competing essentially on the same playing field with corporate debt because it, too, would not be taxed when distributed to holders. In other words, in effect, if you will, that since interest would have been taxed at the corporate level, the distribution out to holders of corporate debt would not be taxed. So their comparative advantage would be eliminated.

MR. FRENZEL: Thank you for clearing that up. I must have old ears or something.

Why wouldn't we solve the problem or what revenue would we miss if we simply exempted the dividends from taxation entirely to individuals?

MR. GIDEON: Well if you look at this book, there is a dividend exemption proposal in it as well. And it is kind of the milder form. What it misses that CBIT gets, though, is what we were just talking about. In other words, leverage creates kind of a situation in which substantial corporate earnings can get through the system with nobody paying tax on them. Because if you are deducting the interest and you are paying it to a tax-exempt or to a foreign person, there will not be any level of tax on those corporate earnings. Whereas, in CBIT which is kind of a step beyond simply dividend integration, if you will, then you will get a level of tax on those business earnings that are distributed.

MR. FRENZEL: Great. Do you agree, sir?

PROFESSOR WARREN: I do agree with that. But I would go further and say that this raises a -- I don't know if you want to call it a tax policy or a tax philosophical issue -- which is if you're going to have an income tax system do you want this segment of income, capital income earned through corporations taxed at a different rate from all other income earned by individuals? If you simply exempt dividends, and that means there's one tax rate that applies to that kind of income, that's the corporate rate. And that's certainly one approach.

The alternative approach would be to say that what we want is the same tax rate to apply to all income earned by individuals. If you're going to do that, you can't accomplish that by an exemption. You've got to somehow pass through the taxation to shareholders. You can eliminate the double-tax with a credit, but then you would apply the shareholder rate.

So I think that's an important philosophical or tax policy issue in designing a way to eliminate the double-taxation.

MR. GIDEON: And to just focus a little more on that, Professor Warren wrote an important study or he was the reporter for an important ALI study on a imputation system which is how you would accomplish that. I think that?s for another day I would still think that the right way to do this is to capture the income at the corporate level and then worry about how you credit it at the individual level. But CBIT basically adopted the approach that we would essentially tax corporate income at a schedular single rate. And it didn't matter what the holder's income tax level was, and it's an important question Professor Warren is raising.

Imputation does raise significant problems of complexity in order to bring it about, but it's a fair point.

MR. FRENZEL: Thank you.

MS. SONDERS: Thanks, gentlemen.

I have a question for both of you on expensing. Professor Warren specifically how to incorporate into your system, an integrated system? And then, Mr. Gideon, hoping you could expand a little bit more on the arbitrage opportunities that would exist under those circumstances.

PROFESSOR WARREN: You could simply have expensing at the company level and still have shareholder credit integration. It seems to me that's an entire separate question. You could have a cash flow type tax at the company level. So it seems to me that the two questions are completely independent; what kind of integration you want to have and whether or not you want to have expensing or depreciation.

MR. GIDEON: Yes. And I would agree with that answer. In other words, I think that expensing is a separate concern. I think that when you move to expensing, particularly in a proposal like CBIT, what you should recognize that you've done is you're effectively not taxing capital income in that circumstance.

And the arbitrage concerns I have really are the arbitrage concerns that Glenn Hubberd was raising this morning. In other words, if you're going to have a world in which some debt is getting CBIT treatment, that is that the interest is not deductible at the corporate level but it's exempt at the recipient level, whereas you're going to have other debt that isn't like that, you worry about people trying to play off those two systems against one another to the detriment of revenue. And that's really the point of a lot of the second two bullets on my concerns list is that you do have to focus on, to the extent you're going to preserve a mixed system for the treatment of debt, what those arbitrage opportunities might be.

MR. ROSSOTTI: Professor Warren, I just wondered if you had developed any analogous thought, I can understand you doing it on dividends to avoid the double-taxation, but it wouldn't deal with the issue of say interest income that's received by tax-exempt or people with tax-exempt accounts or tax-exempt pensions never paying any tax on that. And did you ever develop any analogous way of dealing with that problem? Because you point was you want to tax it once but only once, so now we've got a whole stream of interest income that's never taxed. Did you develop any clever idea on how to deal with that problem?

PROFESSOR WARREN: I don't know how clever it was. But in the American Law Institute report that Ken referred to, we did address this question. And if you remember earlier on in my discussion I said if you take a deduction system and add withholding to it, it really reproduces shareholder credit or investor credit system so that you could get to the result that you're talking about by simply introducing withholding on interest payments. And then deciding how much of a credit you wanted to give the investor who had provided debt capital.

And so the lender there would be in exactly the same position as the shareholder under a shareholder credit integration system.

MR. ROSSOTTI: So they wouldn't receive the full interest? They would receive a portion of the interest?

PROFESSOR WARREN: Sure, because it would be withholding.

MR. ROSSOTTI: Yes.

PROFESSOR WARREN: And then you'd have a tax policy question of whether or not you wanted to make some of that, or all of that, or none of that available to them as a refund. And you could do that not only for tax-exempt lenders, but you could also do it for foreign lenders.

So I think there is a mechanism, a technical mechanism, that's relatively straightforward that would allow you to treat equity just like debt for these purposes. The question would be whether or not that's what you'd want to do. But I think it's perfectly possible.

MR. ROSSOTTI: One follow-up here.

Mr. Gideon, on your CBIT you mentioned that you hadn't fully developed how to deal with financial intermediaries, I guess. But just as far as you did go, how would you deal with financial intermediaries or financial businesses of all sorts where basically they're making their money on the spread on the spread between their interest income or their financial income and their interest? What would be the treatment under your CBIT plan for those?

MR. GIDEON: Well, one question is how valid is that presumption in the current world if you look at, particularly, banking institutions and then a substantial shift to fee income, that was one of the things that we were actually concerned about.

I think that the best way to say this is that you will simply have to deal explicitly with financial intermediaries and decide how you're going to apply these rules to them. But it may very well be that they have incentives that would lead them in other directions.

I don't think the CBIT study, to be honest with you, is going to help you a lot on that point.

MR. ROSSOTTI: Yes.

MR. GIDEON: It was a question that we thought about, we identified the issue but I don't think we came to firm conclusions --

MR. GIDEON: -- about how to respond to the question. And I also think the goalposts have moved since we looked at it.

MS. GARRETT: In our April statement we tried to emphasize that we wanted to make sure that we really went after simplification. Often people talk about that, but in the end what comes forward is complex because they want to be fair or you want to avoid distortions, etcetera.

And as I was listening to Al's answer to Charles' question and as I read through Ken's presentation, one of the things you think about is, well that's pretty complex. CBIT's particularly complex it sounds like.

And I just wondered if you could address that sort of complexity trade-off with avoiding distortion or getting the answer right, and is it something that we should be so concerned about when we're talking about corporations as opposed to individuals? Right? You might have a different dynamic?

So that's my main question. I just want to ask one really quick question, though, because in answer to Liz Ann and then also on one of the slides of Ken, am I to understand that if we went to a system of expensing, even kind of keeping an income tax system, and I understand that's a hybrid system, your recommendation to us is to eliminate the interest deduction. If you go to expensing, then the right answer is to eliminate the interest deduction as well, that that has to go hand-in-hand? So that's just a quick question to make sure I'm clear about the arbitrage and the right answer, and then the complexity is the larger?

MR. GIDEON: Well, I would say that I think CBIT is an alternative that you should seriously consider. And if you did that, you would eliminate the interest deduction to the extent set forth there. I mean, that hedged carefully, and for a reason. Because I think it's important that you look at the report and what was considered in it so that you can understand what you're doing. But in general I think that a CBIT like system, and I think that Al is right, you could do the same things in an imputation system, both of those, by eliminating the difference between the treatment of debt and equity, I think would have important efficiency gains.

In other words, people would quit making decisions in the world that I live in of tax planning based on the distinctions in treatment between those two things. And that is likely to be a more economically efficient kind of answer.

Secondly, I actually don't think that CBIT is complicating. I think that CBIT is dramatically simplifying. Indeed, I think Al's objection might be that it's too simplifying in the sense as compared to imputation leaves you with essentially a schedular rate on corporate income. But I think that if you compare it particularly to the current system, I think you'd be way ahead in terms of simplification terms.

PROFESSOR WARREN: So simplification, like most things in tax law, are complex. Because it depends what you're comparing it to.

So I mean take the current double-tax. All of these arbitrary distinctions between debt and equity, for example, that leads to all sorts of transactions. And so should we count that as complexity? I would say so. There are all sorts of resources being wasted by people in law firms and investment banks to dream up transactions that make no sense except for the tax law. The government has to spend all sorts of resources to try and police them, and so on.

My own personal view about this is that if you integrated either way; either with the shareholder credit or with the shareholder exclusion and you didn't try to be too fancy, you'd end up with a lot simpler a world than we have today. And let me just give you one example.

Today with the double-tax system, corporate tax shelters are always beneficial for the corporation. Because if you can win and reduce your corporate tax rate, that's a real gain. On the other hand, if you have a shareholder credit system and all the corporate tax is a withholding system, the stakes are much lower. There's much less of an incentive to go out and do corporate tax sheltering, because all it's doing is reducing the withholding tax, not the ultimate tax.

So, you know, these things are complex. All I can give you is my general reaction. But I'm confident that we could make either one of these systems more complex than current law, but I'm also confident that we could radically simplify, I agree with Ken, current law by integrating the two taxes.

As between the two of them, Ken and I may disagree here a little bit. I would say that they share the major complexity, and that is the major complexity is making sure that either the shareholder credit or the shareholder exclusion is limited to income that's actually been taxed at the company level. So the President's 2003 proposal, as it eventually came out of the Treasury Department, was gloriously complicated in order to prevent people from playing games, even though it was a shareholder credit. I thought it went much too far in complexity in terms of trying to get it right.

The shareholder credit has to have some sort of protection, too, but I would just say they both share that. I would urge you to think about the major difference between the two of them being, as I said, this tax policy or philosophical question as to whether or not there should be a single rate that applies to all of an individual's income including capital income or into corporations, or whether or not there should be a separate schedular rate that applies to corporate income.

MR. MURIS: Let me ask you both to step back a second and answer this big picture question. There's been a lot of support for a long time to end double-taxation, and it hasn't happened. And I'll throw out three possible reasons and I'm sure maybe you can come up with others. But I'd like your view on it.

One, maybe there is some respectable support that I don't know about for double-taxation.

Second, a lot of these problems of getting from where we are now to where we want to be are complex and there's reasonable disagreement, and no one way to do it can coalesce support.

Or, third, maybe there's just failure in the political process. But maybe there are other reasons, and if you could comment on that, both of you?

MR. GIDEON: I think that is a tough question. But I do think that one of the kind of political realities is that there was never much of a constituency to push this because the benefits are diffuse. In other words, if you think about it corporations were never all that enthusiastic, because to the extent you eliminate the double-taxation, then it's a lot harder to explain to your shareholders why you're retaining that income. And so, you know, if you talk to people, you never got a lot of enthusiasm from corporate leadership for a proposal like this.

The benefits, on the other hand, I mean it's a problem of kind of dealing with tax legislation generally. In other words, the benefits here are cross-economy benefits. They are, we think, are big time efficiency gains. And on the other hand, it's hard for anybody to say "Gee, that's really good for me, go do that." And so I think that's really been the issue. And it's often the issue in achieving fundamental reform.

PROFESSOR WARREN: I agree with everything that Ken said. I would just add, I think this is the kind of issue that moves through the U.S. tax legislative process only when a major political figure makes it his or hers and is really willing to stand up for the principle. And in the past, although both Republican and Democratic administrations had integration studies and proposed them, my own personal evaluation was that there was never the level of support from the political leadership that would be necessary to carry it through.

MR. POTERBA: Thank you both for your

really clear and wonderfully helpful testimony here.

Al, I wanted to pick up on the 2003 legislative proposal issue that you raised and link that back to the discussion of trying to tax the preferred income and making sure that one can actually trace these things through.

Is your sense that sort of the 2003 original proposal just went too far in trying to do the tracing and keep track of everything, and that one could make do with a much simpler structure that would get most of the way there, but not all the way there? Or was this something where it was somehow misplayed in the way the political process and the media understood the proposal so that there really aren't problems here? Or are there real issues here that we have to worry about?

PROFESSOR WARREN: Okay. So let's back up and address and identify the issue. As Ken put it, the issue is that a corporation may have income that it hasn't paid taxes on and that it's going to then distribute it to the shareholders. And at that point the shareholders shouldn't get a credit or an exclusion for something that hasn't been taxed at the company level. How do you prevent that?

Well, there are really two approaches. One approach is for the company to say we're not distributing income that hasn't been taxed, so we should withhold it. And then the shareholder gets the exclusion of the credit.

The second approach is for the company to say we're now distributing income that hasn't been taxed and we'll tell the shareholders that so they'll have to pay taxes on it.

The first approach puts an additional burden on corporations but is incredibly simplifying for investors because they can think every dividend they've received has been taxed, and they don't have to worry about it.

Both approaches have been used around the world. The Europeans have tended to use the first. The Australians pioneered the second.

The President's 2003 proposal went down the second route and said that we're going to do is have a system that if we distribute untaxed corporate income, we need to keep track of it and notify the shareholders. Well, if you're going to do that there's a lot of complexity because there may be, what tax lawyers like to call streaming. There may be some shareholders who would be able to take advantage of untaxed income more than others.

So there are two questions. One is which of these two methods would you think is preferable, and secondly haven chosen one or the other, how do you trade off exactitude against simplicity?

My own personal view about this is that the first method is preferable. We should do everything we can to make reporting as easy as we can for individual shareholders who are, even if it's easier, are going to make all sorts of mistakes. So a shareholder should assume anything he or she gets has been taxed at the corporate level. That means corporations have got to withhold. That's the cost there. I think they're able to bear that burden. That wasn't a decision that the Administration made in 2003.

That said, do I think that the complexities that the Treasury had in 2003 were well intentioned and well motivated? Absolutely.

Do I think that they probably went a little too far in trying to get it exactly right even though it was complex? Probably. And what we ended up with is, of course, worse. What we ended was a system in which the shareholder gets the benefit whether or not there's been any corporate tax paid.

Ken may have a different view.

MR. GIDEON: No. I actually agree with Al. And I agree with the choice of basically taxing preference income when distributed. And my reasons are really kind of tax administration reasons.

In other words, I have a wonderful study that we've learned in kind of excise taxes in the United States. We kept moving the point of collection further back because we could more dependably get the tax. And we now tax gasoline at the refinery gate for that reason. And I think that, frankly, it's a lot easier from a tax administration standpoint to get this at the corporate level than it's going to be to get it at the individual level. I mean there are significant reasons, equity arguments that can be made for doing it the other way. But this is one where I would come down for administration and simplicity.

MR. POTERBA: Ken, could I just ask a follow-up? You mentioned that you thought that a transition to a CBIT could well be done slowly with a long phase-in period of some sort. Could I just ask both of you if you see arbitrage opportunities or other problems that would arise with doing some sort of phase-in like that? And how should we think about the optimal link of a phase-in?

MR. GIDEON: I think the problem is that

anytime you have two systems and you have people who do what I do in the world, you will have arbitrage opportunities.

The concern that lead us to a longer phase-in for CBIT was simply this: We thought then that there would be powerful behavioral responses to CBIT, and I'll tell one anecdote to illustrate this.

While I wasn't around in office at the time of the '86 Act, I was there in 1989 which was in time to explain to Senator Bentsen why everybody has missed the corporate revenue estimates as badly as they had. And the reason was that there was a huge behavioral response that was unanticipated in making subchapter S corporate passthrough elections. And part of the problem is when you make big changes, you are predicting behavior. And with the best of intentions the revenue estimators may not get that exactly right.

PROFESSOR WARREN: I mean I basically agree with that. I mean, the shorter transition is better because it eliminates arbitrage. On the other hand, it may be expensive. The good thing about arbitrage during a transition period is it's limited, so it may be a tolerable cost.

MR. GIDEON: Yes. I think this is

essentially a political decision in which you are balancing the problems of having two systems coexist against the problem that you may not have guessed right about what the impact of the new system would be.

CHAIRMAN MACK: Ken, it's been mentioned a couple of times I think by you that in essence we need to understand that if we add expensing to CBIT, we are not taxing capital income?

MR. GIDEON: Yes, I think that's really the net effect is that you've essentially turned this into a kind of a corporate consumption tax, if you will. Because I think, you know I'm not an economist and others who are could probably be more elegant about this, but it's my understanding that basically the combination of what we were doing in CBIT plus expensing would effectively leave kind of capital income untaxed in the system.

CHAIRMAN MACK: Good.

Any other questions?

Again, thank you very much. And I would reflect what Jim said that your presentations were terrific and the responses were right on target. So thank you very much.

Our next discussion this morning will be on a topic we've already heard a little about, and that is business tax simplification. And we're delighted that David J. Shakow, Professor of Law, Emeritus, University of Pennsylvania is with us. And also Edward D. Kleinbard, partner Cleary, Gottlieb, Steen & Hamilton.

We're delighted to have both of you with us this morning.

And, Mr. Shakow, you want to begin?

PROFESSOR SHAKOW: Thank you very much. I'm here to present today some of the conclusions that we reached in a reporters' study of the American Law Institute that I worked on in late 1990s. I have to say at the start, this was a reporters' study so that it does not reflect the views of the American Law Institute.

And what I'm going to say today is going to have three simple, I think, parts. One is that just as publicly-traded entities under current law are all taxed the same way, no matter how they're organized for local law purposes, so privately-held entities should all be taxed the same way.

Number two, that the way that they should be taxed is through a passthrough system such as the partnership system that we have.

And number three, which is also important, that for many simple closely held entities the partnership tax structure should be simplified in a way that is similar to the S corporation system that we have under current law.

Under current law businesses that are not sole proprietorships are generally taxed in one of three ways:

As so called C corporations, meaning that they're separately taxed and we just hard a lot about that from Professor Warren and Mr. Gideon;

Second, as S corporations;

Third, as partnerships.

And those last two forms as passthrough forms. Passthrough forms means that their owners are taxed directly on the income entity.

Since the IRS has allowed limited liability entities to be taxed as partnerships there's been a movement towards using the partnership form for small businesses.

The partnership tax rules provide substantial flexibility. Partnerships have a lot of ability to vary the ways they operate and the tax law has to follow along with that. This allows the tax with the flexibility that's in the tax law to probably tax many kinds of different transactions. However, the flexibility of the partnership tax rules has also allowed them to be used in the past for tax abusive transactions, and what has meant in terms of the development of the partnership tax law is that we are left with a very complex set of rules to deal with the partnership structure.

Complicated partnership tax rules apply to simple partnership transactions, not just to complicated ones. That is to say the sale of a partnership interest, a very straightforward transaction, redemptions of partners, transfers of partnership property to a partner all require complicated calculations to determine according to the code the precise way that they should be dealt with.

Now the second point on this slide I think is very important, and as an academic and academic emeritus, I'm only sorry that I can't present with a study above anecdotal evidence, although I think the anecdotal evidence is clear.

There are 2.5 million partnership forms filed every year. I can tell you as a former teacher of partnership tax that the issues I refer to on this slide, just the sale of a partnership interest and the need under the code to decide how much of the loss that is recognized is capital, how much is ordinary; those calculations at the level of teaching to law students who are interested in tax law and want to practice it in the future, when you get to these issues their eyes occasionally glaze over. These are difficult, complicated calculations.

It's extremely hard to imagine that the 2.5 million entities that file as partnerships under the tax law are observing these rules. And this is not a matter of any kind of intentional or explicit tax avoidance. This is a matter that these rules are devilishly complicated. And for most practitioners I strongly suspect, and this is based on as I say anecdotal evidence of speaking to people and never getting a contrary answer; when you get to the level of the standard common partnership, these rules are simply ignored out of ignorance. And that's a very important factor in terms of deciding what does it mean to simplify the tax law. To have complicated rules that people not out of any bad motive are ignoring, is a very troublesome situation. And that effected us in our study, and as I say, we're only sorry that it was essentially too expensive and complicated to prove something as subjective as this.

So what did we come up with in our ALI

study? We tried to deal with the situation in a number of ways. We accepted Congress' distinction between publicly-traded entities and other entities. We originally thought we might go into this in more detail. It seemed clear that this was an appropriate distinction to draw.

Under the code no matter what its form, a publicly-traded entity is taxed as a C corporation with, under the current law, the double-taxation structure. Publicly-traded entities are free to choose whatever form for state law purposes they want to choose. The tax law does not interfere with their choice of form. Because no matter what form they choose, they're going to be taxed the same way.

So we said let's extend that to privately-held entities. Let's say for all privately-held entities they will all be taxed the same way. And at that point we had the choice, and you'll be hearing more about this this morning, what road should we choose? The decision to choose one road is very important. We opted for the passthrough structure. We felt that way some of the issues about what tax is going to be applied are conceptually solved, and also because we were not prepared, although others are, to take sole proprietorships and tax them as separate entities. We knew that the sole proprietorships, the individuals who were running their own businesses, were going to be taxed directly on their income. We felt that the passthrough structure was most consistent with that.

So in the passthrough structure we started with the partnership rules under current law. The study itself goes into more detail on this, but it's not relevant this morning. We continued to use the complicated partnership rules because the partnership structure as a business matter is a flexible structure and, therefore, the tax law has to be flexible to deal with it.

But we concluded that entities owned solely by domestic individuals who divide all their income and losses in a straightforward manner; you get 20 percent, you get 30 percent. We're not saying one kind of income goes to one person, one kind of person goes to another person which for business reasons may be appropriate in a regular partnership. But when you're dealing with a partnership with a straight up kind of division of income where all the owners are domestic individuals, so we're not dealing with tax entities of any sort, in that situation we said you can be governed by a simpler set of rules. And we started out to figured out what that set of rules should be.

We ended up with a set of rules that's remarkably similar to what the S corporation rules are today. And I say that as kind of an intellectual matter, it was a fascinating study. We did not say well we've got these two systems now, partnership/S corporation; let's use one for the complicated one for the sample. We started with our set of assumptions as to what was needed for a simpler set of rules. And for reasons that I think are not always the same as the reasons the S corporation developed, we ended up with a set of rules that's pretty much the same as the S corporation rules.

And that is the proposal that we came up with. As I say, the basic elements are familiar to us, but the crucial element that privately-held entities should be taxed the same way is one that does not exist under current law and which we felt and feel continues to make the structure as a practical matter on a day-to-day basis complicated.

Transitional issues are clearly important, but obviously you have to take the first step of choosing this route before you get to the transitional issues.

This slide goes through a number of possible transitional alternatives. I don't think they're any different in our situation from what they are in a standard transition case. The basic question is if you have an entity now that is not taxed in the way it's going to be taxed, how do you get from one to the other? And choices would have to be made if you could take that first step.

And finally, we throw out at the end but this is not essential to what I've been talking about today, if you really want to go further along the route of single-taxation, at least another structure that could be considered is to tax owners of publicly-traded entities simply on the change of value of their ownership interests and not worrying about taxing at the entity level. But I put this in at the end. That's not essential to what I really wanted to focus on this morning.

What I want to focus on this morning is, as I said, the need to tax all privately-held entities the same way. The choice we think is the proper one, is to use a passthrough structure. And third, to provide a simplified method for closely held entities that are owned solely by individuals, domestic individuals.

Thank you very much for the opportunity.

CHAIRMAN MACK: Thank you.

Mr. Kleinbard?

MR. KLEINBARD: Good morning. Thanks very much for giving me this opportunity to talk with you concerning about how we might go about simplifying and rationalizing the income tax rules applicable to operating or investing in a business.

At the outset, I really want to commend this panel for its fortitude. By my count you're mid-way through your eighth hour of listening patiently to speakers urging different tax reforms on you, each presented with its own memorable acronym. In this respect, I have to also plead guilty. Because I've packaged my suite of business income tax reforms under the umbrella name of the Business Enterprise Income Tax, which I refer to as the BEIT which seemed to me to be particularly appropriate for a tax proposal.

Unlike many other witnesses, however, I am here to urge on you a set of proposals that will, if enacted, go a very long way to putting me and others of my ilk out of business by largely eliminating the role of tax considerations in business planning.

The BEIT does so by replacing current

laws, multiple elective tax regimes with a single set of rules for each stage of the life cycle of a business. Choosing the form of the business enterprise, capitalizing the enterprise and selling or acquiring business assets or entire businesses. So how do I do that?

Well, the BEIT has four components to it. The first, and here obviously I part company with David, is to tax all businesses at the entity level. So a partnership, unlike current law, would be taxed as an entity. I would, obviously, contemplate having micro business exceptions, which are covered in the appendix.

Second, and this might seem kind of a small point for grand tax reform plans, I would adopt true consolidation principles for affiliated enterprises. And I'll talk about why that in fact is desirable.

The third, I would get rid of the tax-free reorganization rules, the tax-free incorporation rules and I would treat all transfers of business assets or the acquisition of a company into a consolidated group as taxable asset transactions.

I would impose a rate of tax on those transactions, however, what I call tax neutral. That is, the tax rate will depend on the depreciation period that the buyer gets in respect to the nature of the particular asset so that the sum total of the present value of the benefit to the buyer and the cost to the seller are equal. And by doing that, I'll see to it that assets in fact migrate to their highest and best use.

And finally, and sort of most importantly, I include still another acronym, the uniform cost of capital allowance, what I call the COCA, which is a different way of approaching integration.

We heard this morning about ways of approaching integration through disallowing interest expense. We've heard about ways of getting to integration by providing shareholder credits on equity or dividend exclusions on equity.

What COCA represents is a third way. And that is a uniform deduction for all capital of whatever label to the issuer, uniform inclusion rules for all investors so that we get rid of a debt equity distinction, but we do so in ways that I think are materially superior to the prior two approaches that have been more extensively developed in the literature.

Going quickly through the four prongs of

BEIT.

The first, one tax system for all business enterprises. That's been discussed in another context already over the last two days. It's a feature of CBIT, it's a feature of the Flat Tax. And the idea is that a business enterprises ought not to have tax rules that distinguish the tax results depending on the cleverness with which you choose your form of organization at the beginning. Whether you are clever enough to choose a partnership or a corporation, the results should be the same from a tax point of view.

Again, separate rules for micro firms.

By taxing business entities rather than trying to pass all the characteristics through to investors, you get a much cleaner results, particularly for publicly-traded firms where the problems of figuring out who owns what share of what on stock that trades everyday is just impossible.

True consolidation principles seems, as I said, like a very silly point. Because we have consolidated returns. And the answer is that only people who don't practice tax law believe that we have consolidated returns. In fact, we have an extraordinarily complicated system that is difficult to describe. I can only give you anecdotally one example: The leading treatise on the taxation on consolidated returns, which itself is several volumes long, has a single chapter that is 300 pages long devoted to how to treat the taxation of sales of assets between affiliated companies. A 300 page chapter on that one topic, as to which you would think there should be no discussion. It's all in the consolidated group. Who cares?

My approach: I have a choice. I could either read the 300 pages and understand them or propose a new regime in which it wouldn't matter. And I went with plan B. So that's how my mine works. It's who cares? It's one big pot, which is just how you all think of what consolidation means.

Tax neutral acquisitions. Again, the idea here is we get rid of tax-free reorganization rules, we get rid of tax-free incorporation rules, we tax all transactions as assets sales. And the amount of tax to the seller is keyed off to the depreciable life of the assets to the buyer so that we have different tax rates for different depreciation schedules.

The result is kind of a similar to a tax-free organization rule, to a completely tax-free world for the transfer of assets, but it's much cleaner and it gets rid of enormous numbers of corporate tax shelter opportunities.

This morning's newspaper -- well, not your newspaper, my newspaper, the Daily Tax Report has a article, had a new case called Santa Monica Films that dealt with the abuse of high basis that somebody tried to get a double-deduction by importing it into a partnership. This gets away from all of that.

Finally, COCA. Well, the idea of COCA, as I said, is to replace our different treatments of debt and equity, which is the fundamental source of instability in our taxation of financial instruments and replaces that with a single uniform deduction to investors, single set of inclusion rules for investors. The result is both an integration type result and it is a result that replaces the current laws' inconsistencies with an internally consistent and comprehensive proposal.

It is unlike CBIT. It is comprehensive in that it answers the question how do we tax derivatives, which are an enormous part of the financial markets today.

From the point of view of an issuer, all that COCA means is that you deduct a fixed rate, which I would propose would be set as a percentage above one year Treasuries, of your financial capital that's invested in your enterprise.

It turns out when I thought about how am I going to figure out what is my financial capital, that the great thing is that balance sheets turn out the balance. And so instead of worrying about the right side of the balance sheet, I just worry about the left. And I say I take the sum total of my tax basis, my investment in assets, and I give a deduction for that. That's becomes the issuer's deduction for the financial capital that the issuer has hired to use in its business.

From the investor's point of view, I have a somewhat more complicated set of rules. But the basic theme is the same. I have minimum inclusion rules in which all investors would pick up the same COCA rate applied to their basis in their investments. So if you have $100 invested in stock and it's 5 percent COCA rate, you would pick up minimum of $5 a year of income regardless of whether there were actual distributions.

I believe that companies would in fact change their distribution policies to accommodate that.

And I would urge that your contemplate applying this rule in order to make sure that we in fact collect the one level of tax which I'm trying to move for financial capital to the holders, that you would impose it on the tax-exempts as well as taxables.

I then have a little tax on homeruns called the excess distribution tax. So if you, unlike me, hit a homerun on one of your investments, you pay an extra tax of 10 or 15 percent.

And then I have rules for losses that basically unpeel the layers of the onion and reverse prior income inclusions.

The consequence of the COCA regime is that an issuer gets COCA deductions regardless of the form of the financial capital it issues.

It means that I am out of work for creating contingent, convertible, euro denominated, S&P linked notes because if the only reason for those to exist is tax, they won't exist anymore.

Interest rates should adjust to it.

And then from the point of view of investors, they have an instrument in which they're picking up time-value of money return.

From the point of view of the fisc, we're getting a regime in which we have gotten away from the deferral mechanisms that people employ and the curse of the realization requirement.

And that's it in a nutshell.

CHAIRMAN MACK: Did you take a breath? Very good.

Jim, start with you.

MR. POTERBA: And let me ask about the consolidation issues, because this is the first time that the panel has actually heard about tax issues which may have been announced --

MR. KLEINBARD: Can you just talk a little louder for me?

MR. POTERBA: Sure.

MR. KLEINBARD: I'm older than I look.

MR. POTERBA: Yes. This is the first time our panel has heard about issues involving consolidation. So I want to just get a little bit more clarity on some of the issues there.

MR. KLEINBARD: Yes.

MR. POTERBA: There are two pieces to my question. The first is, is there any reason that the consolidation reforms that you described need to be part of BEIT or could they parachute in as a stand-alone reform with other reforms that one might consider? You know, if we'd put you in the panel with CBIT, could one do CBIT plus consolidation reforms?

And second, do you have any idea of whether the net revenue effects of the consolidation reforms you described would be positive or negative?

MR. KLEINBARD: Let me deal with the second first. Obviously, I have neither the skills nor the data to do revenue estimation, you know. There is no reason on God's earth to believe, however, that an improved consolidation regime, net of the dead weight costs of getting rid of all the consolidated tax return specialists, is going to be a revenue loser.

Turning to the first question -- Jim, do you want to just -- I'm sorry. Just repeat the first part of the question again for a second?

MR. POTERBA: IT sounded as though the consolidation --

MR. KLEINBARD: Oh, the parachuting. I'm sorry.

MR. POTERBA: Parachuting with other reforms.

MR. KLEINBARD: It hurt my feelings so much that you would take only part, that I suppressed it.

But, yes --

MR. POTERBA: That's a small bite of the

apple.

MR. KLEINBARD: You can, but you can't take just that. Because the idea of the true consolidation is that the assets -- that you no longer care about the corporate identity of the subsidiary when you buy a target subsidiary. Today all of our rules exist for the purchase of dealing with the off chance that you might resell that subsidiary and we have to keep track of inside basis and outside basis. So you can't, in fact, take the consolidation rule without taking my other rule about acquisitions. Those two really have to go together so we have a consistent regime for acquisitions. And those two you could take out and use somewhere else while I cry myself to sleep.

MR. MURIS: I'd like to give our professor a chance to respond to the practitioner's comments on his plan, particularly about taxation at the entity level.

PROFESSOR SHAKOW: Well, as I indicated in my earlier statement, although we did not consider it a slam dunk, to decide to go through a passthrough structure rather than the entity tax structure. And so I don't want to misrepresent that we felt that it was clearly you had to go one way rather than the other. But I think that we opted in the end for the passthrough structure for the reasons I suggested earlier. That first of all, in terms of sole proprietorships, or Ed's small entities, at some point you're going to tax people on their business directly. We felt that the publicly-traded versus nonpublicly-traded line was a very clear line. I don't mean from a lawyer's standpoint whether every entity you can put on the right side of the line. But what I meant is that when you talk about publicly-traded, you think you have a pretty good idea for the most part of the kinds of entities you're dealing with and the kind of business organization that you have to worry about. You're talking about entities that are really going to be in the public eye and that are going to have all sorts of other considerations non-taxed that will lead them to cross the line.

Once you're not on the publicly-traded side, we felt it would be best to treat everything together one way. As I said, you don't have to worry about feeling uncomfortable with the tax rate. And you don't have to feel uncomfortable that there is some other entities that aren't taxed as entities. Some other businesses, the sole proprietorships let's say that aren't taxed as entities that there's another line which is a more morphed line that you have to worry about crossing one way or the other for tax advantage and for tax planning purposes.

MS. GARRETT: Professor Shakow, my question was the same. So let me pressure you just a little bit on it. Because it seems to me that sometimes it's very difficult to tell unless you knew what a public company was and a nonpublic company, particularly at some levels of being big, right? We know a lot of really large important consequential closely held companies as well.

So I wanted just to pressure you a little bit further. Why isn't it the case, particularly if we take the last panel and we integrate in some way, why isn't it the case that you'd rather make the distinction on the basis maybe of size, right? I mean, take a size of gross receipts and change your treatment depending on whether you're talking about a big active business or what seems to be a more mom and pop kind of small business that you might not want to use the same rules for?

PROFESSOR SHAKOW: The other test that exists in terms of, let's say, gross proceeds for some measure of profits or some measure of employees; there are all sorts of measures like that. Those sorts of measures we felt would end up not giving you as clear a line because of the different types of companies that you're dealing with.

There's no question that there are very large important entities that are taxed as passthroughs. There are very large sub S corporations. There are enormous cooperatives. There are partnerships that are much larger than almost any C corporation you're dealing with.

So there's no question that that issue is there. However, I think we're not uncomfortable, as the previous panel suggested, with the structure in which ultimately the tax is determined at the level of the owner. After all, that is the integration push. And so to view that and to start out with that as the norm and not worry about how you're going to translate the tax at the entity level to the proper tax rate at the owner level seemed to us as a practical matter when you're dealing, as we were, with privately held entities with the vast bulk -- large numbers of entities for whom an explanation would be needed as to how you're going to go from one level of tax to the second level tax, even though ultimately it's all going to be zeroed-out, it seemed to us net that the simpler rule would be the passthough rule.

MR. ROSSOTTI: Just to turn around and ask the question a little bit differently. I definitely like the idea of being able to allow, you know, most of the partnerships not to have to cope with all the complexity that was designed for the abusive kinds of transactions. But I just wonder, leaving aside whether you require people to report or pay tax at the entity level or individual, leaving that point aside, would it be appropriate as you've studied this, as I look at your chart, to allow all partnerships below a certain size without having to worry about exactly who their owners were? I mean, you drove it by whether they were domestic individuals who divide their income a certain way. I mean, could you go even simpler and just say, "look if you're a partnership below a certain size as measured by, let's say, gross receipts, you can use these similar rules?" Or would that in some way get you back into trouble that lead to these rules in the first place?

PROFESSOR SHAKOW: Yes. We were not comfortable with that. Our reasoning was, I think, or let me say "our," so let me just put it on my shoulders.

I think my feeling would be that when you cover entities whose owners are domestic individuals and entities that do not have any special rules for allocating income, you are covering a very large number of entities. And our concern, I think, was that if you expand the scope of that rule beyond that, you raise all sorts of other issues that make it very difficult to imagine that you'll feel comfortable in the end with the simple rules that we wanted to apply.

MR. ROSSOTTI: Okay.

PROFESSOR SHAKOW: Granted that different individuals could be at different tax rates. We felt that was appropriate.

MR. ROSSOTTI: Okay.

PROFESSOR SHAKOW: We felt everything else made us uncomfortable.

MR. ROSSOTTI: Okay.

PROFESSOR SHAKOW: And we're covering so many entities, let's leave it at that.

MR. ROSSOTTI: Okay.

MS. SONDERS: As you know, and you mentioned in terms of number of hours, we spent a good deal of yesterday, all of yesterday, talking about full-blown reform options.

I have a question that really isn't about integration. It's more about compatibility. And as you think about your various proposals taking it outside the business world, what do you think in terms of a full-blown reform, say a move towards a consumption based system or a national sales tax or a flat tax, where do you see the best compatibility under those set of limits and keeping the answers in a broad sense?

MR. KLEINBARD: Well, I approached the question, frankly, from the opposite direction which is I designed the COCA to be an income tax system. If you're going to a de facto consumption tax, that means that you are exempting the return to capital from tax. You don't need the apparatus of the COCA system particularly to accomplish that. You could do the consolidation and tax mutual acquisition rules as a part of the business tax reforms within the cash flow tax system. But COCA effectively would drop by the wayside.

COCA is an attempt to come up with the first comprehensive set of rules for the full panoply of financial instrument in an income tax environment. But the others would still, I think, have merit in a consumption tax environment.

MS. SONDERS: I think our proposal also kind of started out with the assumption that there would be an income tax. So you'd really have to see what type of alternative tax systems were created as to whether these issues would even arise. And if so, at that point I think I'd have to answer the question with more of a specific model in mind.

MR. KLEINBARD: I should add that I saw in the original brief for your panel a fundamental tension between consumption tax on the one hand and preserving the mortgage interest deduction on the other. I mean, as other panelists have indicated, if you have a world in which returns to capital are tax-exempt and there was a mortgage interest deduction, I will lever up my house to the hilt and buy tax-exempt assets with it. So the bite tries to respond to that in an income tax world it's a very tough question what are you going to do with the mortgage interest deduction in a consumption tax environment.

MR. FRENZEL: And just following up on that, if you had your druthers -- first of all I presume you did COCA because you expected us to be operating in an income tax environment for the future.

MR. KLEINBARD: Yes, sir.

MR. FRENZEL: If you had your first choice, would you find merit in a consumption tax?

MR. KLEINBARD: This is a very tough question. And I have deep in the appendix -- I actually have a couple of slides on why I believe in an income tax.

And the fundamental differences, as Glenn Hubberd indicated, between an income tax and a consumption tax are not gigantic. They go to, at least in an ideal state, whether the pure time-value of money is taxed or not. And that doesn't sound like a very exciting issue. But there are some profound implications from that.

First is that to get a consumption tax that is as progressive and raises as much revenue as an income tax, you're going to need nominally higher rates for the consumption tax. You may view it as an income tax equivalent. Nominally higher rates and you're going to work a lot harder to deal with the progressivity issue.

In an income tax environment you don't have that problem. What an income tax really means if it's functioning correctly is that over a lifetime you taxed my wealth once. And in a consumption tax world you haven't necessarily taxed my wealth once because--unless you're going to tax a death as a consumption event, which seems unfair.

Taxing my wealth once seems to me perfectly okay. I understand the efficiency argument, but there's more to the way a society works than economic efficiency. And if you want to ask the question -- I think the greatest economist I ever met was Jimmy Breslin. And he said there are only three things that matter, you know. A really good job, a job that gives you satisfaction as well as an income. A confidence that things are going to be better for your kids than they are for you. And a sense that we're all in it together.

And I've always felt that the consumption tax just fails that. And I realize that, you know, in the scheme of things an income tax is going to hit me because of my personal situation more than the consumption tax will. And that's okay with me. I think that's the right trade for America.

VICE CHAIR BREAUX: I want to thank you both, gentleman.

Mr. Kleinbard, thank you for your presentation. I mean, you made the point about having to read all of these sections and becoming very frustrated. I've concluded that if we could require every single member of Congress to read the entire Internal Revenue Code at one sitting, we would have a tremendous amount of support for simplification. Perhaps we ought to try and make that happen. So thank you very much.

Mr. Shakow, I was very interested in the passthrough concept. And I think you see how popular that concept is with the utilization of LLCs, limited liability corporations, which are just exploding. I mean, I think it's probably doing more than just increasing in popularity. Can you comment on that? Is that an indication of how that might work if it was advanced into a different degree?

PROFESSOR SHAKOW: Yes. Well just this morning I reviewed again the data on tax filings of different entities. And it just reminded me of how things have changed since the IRS made clear that limited liability entities can be taxed as passthroughs.

I think that that is a reflection of the comfort people feel with the passthrough structure as long as the state non-tax issues that are involved with business organizations can be dealt with unrelated to the federal tax issues. And that I think was a motivating factor in the proposal we came up with. And so I'd agree with the thrust of your question.

MR. KLEINBARD: I apologize. If I just interject the thought that it's difficult to overstate how many so called corporate tax shelters in fact are LLC tax shelters or partnership tax shelters. And it's difficult to overstate the crises in the administration of the international tax system of the United States in particular that's the result of limited liability companies, disregarded entities, passthroughs of various kinds.

If you look at the list of the IRS tax shelter list of listed transactions they've come up with, a dozen or more are basically transactions that are the result of partnership misallocations of income that took advantage of very technical rules or the use of disregarded entities in ways that were not anticipated by the drafters of these hundreds of pages of code to which, Senator, you referred.

VICE CHAIR BREAUX: What's the danger? I mean, I don't want to spend a lot of time on it, but what's the danger of this, of the passthrough?

MR. KLEINBARD: Well, the danger is not passthrough per se. The danger is the difficulty of allocating income accurately as members enter and leave a passthrough, is the first problem.

And for example, the case that was in today's Daily Tax Report is an abusive transaction, according to the tax court in which Credit Lyonnais put in a property that was worth nothing, had a high basis, high investment cost and purported to be a partnership and then sold its partnership interests three weeks later. And people claimed that the benefit of that high -- that built in loss twice, it's a misallocation of what we call the inside basis and the outside basis, and it's the shifting of that back and forth as investors come and leave in preprogrammed transactions.

And the other issue, of course, is that it means that every rule in the Internal Revenue Code has to be vetted under dozens of different permutations. Because you say I have a rule here that works for corporations. Now what happens of instead of a corporation, it's a partnership? What happens if instead it's two corporations together form a partnership? What happens if it's this form of organization? What if I make this special allocation?

Every substantive rule has to work for every conceivable permutation. And the fact is they don't all work.

VICE CHAIR BREAUX: Thank you.

CHAIRMAN MACK: This question may be the result of eight hours of sitting here or it may be my family's connection to baseball. But I was curious as to why a homerun tax?

MR. KLEINBARD: It's strictly necessary. It accomplished two things from my point of view.

The first is it's a bit of a soak up tax to deal with the preference point that CBIT deals with in its more complex fashions through all these EDA type things. To the extent that there are income that's been under taxed somewhere in the system, the homerun tax makes up for that.

And second, it just goes to revenues and fairness, you know. I don't think it's completely out of the question to expect people who have extraordinary gains to chip in some of that to help finance government.

CHAIRMAN MACK: In most cases a homerun is pretty obvious in the sport.

MR. KLEINBARD: Yes, sir.

CHAIRMAN MACK: Is it obvious in the circumstances that you're talking about?

MR. KLEINBARD: Yes. Because the fundamental differences -- one of the big problems which you heard about yesterday, which is absolutely true, one of the fundamental problems with the income tax system is its over reliance on the realization system. You know, not until somebody actually sells a security, a taxable event. COCA deals with that by having these rules that require a time value of money component, an interest like component to be included in income every year.

So the homerun component is the excess over a pure time value of money returned. So it's mechanically very simple to determine.

CHAIRMAN MACK: Thank you very much.

Unless there's some other questions, that would conclude this panel. Thank you both.

MR. KLEINBARD: Thank you.

PROFESSOR SHAKOW: Thank you.

CHAIRMAN MACK: And our last panel this morning is on international income taxation. And our two panelists are Mr. James R. Hines, Jr., Professor of Business Economics and Research Director, Office of Tax Policy Research at the University of Michigan Ross School of Business. And Mr. Stephen E. Shay, a partner, Ropes & Gray.

We're delighted that you're both here.

And Mr. Hines, I believe we'll begin with you.

PROFESSOR HINES: Thank you very much.

My colleague, Steve Shay, pointed out to me before we started that international seems to go last. We're of the firm belief that it's very important, however, and that the last shall be first in some substantive sense.

Let me give you a quick refresher for members of the audience on the current U.S. tax regime.

The United States taxes the worldwide incomes of American individuals and corporations. And what that implies is that dividends received from foreign subsidiaries of U.S. corporations are subject to U.S. tax. Less one get too concerned about that, you are entitled to claim foreign tax credits for foreign income taxes paid. And U.S. tax obligations are generally deferred until dividends are repatriated. So in certain income that is earned abroad and kept abroad is not subject to U.S. tax until it comes to the United States.

There's a special regime for 2005 which Congress in its legislative wisdom enacted last year, but that's just a one time regime.

Why does the United States tax foreign this way? Is there any justification for such a system? There's a very popular justification that I wanted to address because I think it's widely held, and I think it's honestly a misconception, which is the capital export neutrality concept, which is the notion that income should be taxed at the same total rate that's foreign plus domestic rate wherever it is earned. So in a system like that if the United States has a 35 percent corporate tax rate, if you earned money in a 35 percent corporate tax rate jurisdiction, you would be subject to no additional U.S. tax. Whereas, if you earn money in a 20 percent tax foreign jurisdiction, you pay 20 percent to the foreign government and 15 percent to the U.S. Government, and then you're subject to the same tax rate everywhere.

It's got a certain intuitive appeal that scheme. And the appeal is that it seems as though market considerations rather than taxes would determine the allocation of investment and other economic activity. And, in fact, there's a common claim out there that taxation of the ilk by the United States would promote global efficiency because you take taxes out of the equation in determining where investment would go.

I would quickly note that the same logic, the logic that says that this is good for efficiency, actually says that it's not good for the United States. That the logic in support of capital export neutrality is one that says that U.S. national interests would best be served by taxing foreign income, permitting only a deduction for foreign taxes paid, which the United States does not do and I'm not aware of any major capital exporting country that does that. Because it's not a good system. But that tells you something about the logic.

The actual U.S. system, of course doesn't correspond to capital export neutrality. We have a hybrid system in which foreign tax credits are limited. There are extremely complex rules about that. And the U.S. taxation of unpatriated foreign income is deferred, as I mentioned earlier.

As a result of those two features the U.S. system distorts a whole host of business decisions, including investment, R&D spending, financing and I listed a number here. I could have added more, but for the limitation of the slides size. And these distortions are not of trivial magnitude, that it's certainly relevant to the revenue that we're raising. That because we have the system that we do, we wind up changing business decisions and not in a way that enhances productivity and therefore income.

Would it be better for the United States performance system to correspond to capital export neutrality, to remove the limitations on foreign tax credit claims and to tax foreign income upon accrual? And in a word I tell you no. And the reason is that taxing U.S. investors at the same total rate, regardless of investment location, actually would not promote either global welfare or national welfare and matters would be even worse if foreign taxes were merely deductible.

The reason is that there are other investors in the world. Not everybody's from the United States. And American companies compete with Germany companies and French companies and Dutch companies and Italian companies and everybody else. And so because you're in a competitive world environment, it changes the way you should think about these things.

The logic of capital export neutrality assumes that the United States is the only country in the world that does any investing, and that's simply wrong. American firms, because of our regime, are subject to higher total tax burdens than their foreign operations -- then are firms from many other countries. Tax differences cause them, therefore, to be outbid in foreign acquisitions and encourage American firms to outbid foreign competitors in other acquisitions. So the tax regime itself is influencing the direction of investment and the nature of investment.

To put it differently, we have a tax system where taxation of foreign income is determined on the basis of ownership. If you're an American and you own a British operation, that changes your taxes. It's not the same as if you were French and you owned that same British operation. And so it has the predictable affect of distorting ownership. If you tax on the basis of ownership, you will distort ownership, and that is what the system does.

Now you might ask, well how important is that? The problem is that ownership and control is very important to business productivity.

I want to take an aside and talk about the realities of foreign direct investment because I think there's a lot of misunderstanding about this, too.

What is foreign direct investment? This is foreign direct investment. It is firms from rich countries buying firms in other rich countries. That is the vast majority of foreign investment in our world.

I have a statistic on this slide that in 1999, the last year for which we have comprehensive data, 57 percent of the gross product of American firms investing abroad are in G7 countries. And, by the way, the United States is the biggest G7 country. So it's the littler G6. That's well more than half of the gross products for American firms.

Foreign direct investment is an American company buying a British company. That's what foreign direct investment is. There is a tiny amount of plant and equipment investment in China and Bangladesh, and places like that. But that is a drop in the bucket. That is nothing as far as the tax system goes concerning foreign investment.

If you contemplate tax reform, international tax reform for the United States, the vast majority of the impact of that reform is going to be on American firms and whether or not they acquire a German firm or they are outbid by a French company acquiring the same German firm. That's what it's about.

The actual movement of plant and equipment is tiny. It's foreign direct investment and the taxation of foreign income is really about determining the returns to people who have acquired and operated other foreign companies. The same is true in the United States.

I have another statistic that in 2001 96 percent of foreign direct investment in the United States represented acquisition of American companies, not adding plant equipment, you know, Toyota building a new plant or something like that; that's not what foreign direct investment is about. Of course, there's a little bit of that. You know, you hear newspaper stories and so on. But it's a tiny amount.

So when you think about the tax system and the incentives it creates, the thing to think about is what incentives does it create for ownership of business enterprises and the operation of business enterprises, and the financing and all the other things that go into operating a business enterprise?

Would exempting foreign income from taxation reduce U.S. prosperity as some, I think, believe it would? No, I don't think so. And the reason is that the current U.S. tax system distorts the ownership of business enterprises and thereby reduces the productivity of American firms abroad, and it reduces the productivity of foreign investors in the United States. And because it does that, what the tax system does is it reduces the returns to what are called fixed factors in the United States; the things that have to be here and the things that have to be here is primarily labor. So ultimately the cost of the business distortions, and this is true of business distortions at large, by the way, it's not just international; because of the business distortions in the tax system wind up taking the form of lower wages for American workers, primarily. And it will also wind up lowering return to capital. But the main impact will be on lowering the demand for labor and therefore wages in the United States.

Exempting foreign income from taxation would not cause plant and equipment to flee from the United States, because plant and equipment don't really move that much. What really moves is the ownership of business assets. And so what exempting foreign income from taxation would do is to rationalize the ownership of business assets by putting the United States in a position similar to that of the major countries with which we compete.

And domestic productivity, I should add, is enhanced by treating foreign taxes as a cost of doing business, which the current system doesn't do a good job of, and not imposing added home country tax burdens merely because a foreign operation is owned by a U.S. entity, which is what the system does also.

What about equity? Is it fair to permit a company to earn a lot of money in a zero-tax foreign location and not pay any taxes when somebody else who earns the same amount of money in the United States would have to pay taxes? The thing to think about there is that it's a lot harder to earn money in a zero-tax foreign location because you're competing with German investors who don't pay tax to Germany on their foreign products and they want to earn money in a zero-tax foreign location, too. So it's really an apples to oranges comparison to think about -- you know, it's akin, I think, to the municipal bond type case where it's true that you save -- you don't have to pay taxes on your municipal bond interests. But it's also true that there are a lot of people who want to get municipal bonds, and therefore the rate of interest is a lot lower.

So there are different methods of exempting foreign income from taxation. I think they have their attractions, and we can talk about some of the details. And there are considerations that have to do -- you have to be careful about income and expense allocation rules and transition rules in such a change.

Thank you.

MR. SHAY: Thank you. I'll just observe at the outset that I was invited to speak. These are my personal views based on 25 years of practice as an international tax lawyer with a brief stint in the Government during the period of the 1986 Act as the international counsel at the Treasury.

My theme is really taking the same topic at the opposite end from Jim's. I'm not an economist. I'm a practicing tax lawyer. But the theme of what I have to say is at some level very simple, and I believe very consistent with almost everything else you've heard; and that is with respect to an income tax system, and I only have one comment about a consumption tax that I'll come to at the end, once you move away from taxing income relatively equally, the more exceptions you have, the elections you have, the more complexity you'll have and the less revenue you'll have. It's as simple as that. If you can keep that in mind in everything you do, your outcome, your product will be I think simpler and more effective.

The first observation, the taxation of foreign income directly effects U.S. tax base. What Jim just mentioned about investment, I'm not really in a position to speak to. I'm not an economist. But the one thing I would say is a lot of the world I deal in is not a world of market. It's a world of moving assets within a single taxpayer. There are no market constraints.

Second, if foreign income is taxed at a lower combined effective rate, by combined I mean foreign and U.S. rate, than U.S. income, then taxpayers will shift income and assets that are shiftable the tax ownership of which is shiftable to the lower tax rate environment. And that can be by moving risk. The big thing today in transfer pricing is we try and shift risk to foreign entities that are lower taxed. We shift intangibles.

The last bullet I think I would caveat now a little bit in light of what Jim said. Reduced taxation of foreign income subsidizes U.S. investment in low-tax foreign countries. He's saying it's real investment, and I guess I stick with the statement. But I think part of what I'm talking about is shifting tax ownership. And they do get the benefit of that in some respects.

And the big question all of this, the big question when you come to cross-border income is whatever you're doing for economic activity outside the United States, you have to say why are you not doing it for the taxpayer in Des Moines. And that's where I fundamentally differ with Jim's comment about the equity of the guy who earns a $100 here and a guy who earns a $100 in a zero-tax jurisdiction.

We have a foreign tax credit system because we tax all foreign income. Our current system is deeply, deeply flawed. Two fundamental reasons.

We allow the foreign tax credits to be used as between categories of income; high taxes can be used to offset low-tax foreign income.

Low foreign tax income is very easy to manufacture under today's rules. This is completely fixable, if you have the courage to do it.

We treat royalties not subject to foreign tax as foreign income.

We easily permit giving into low-tax foreign earnings.

And our foreign taxes can also be used as credits to offset U.S. tax on what really economically -- I shouldn't say economically. On what most of us would think is U.S. income that we treat as foreign income under the current rules. The leading example of that is if I sell inventory property outside the United States, if I pass title outside the United States, we call it foreign. I can credit foreign taxes against it. If I pass title in the United States on exactly the same sale, we call it domestic. I can't use foreign taxes against it.

For somebody like me and a number of other people who have spoken, that's like candy in the candy shop. We just go in and reach in and take it. Thank you.

Unlike Ed, I am not at all worried about being employed. I am a little worried about being employed by the same firm and the same clients after I'm finished.

And that takes me directly to my next slide. Basically it's very simple what I do, and my colleagues do. I try and cause foreign taxes on foreign income to be reduced below the U.S. rate. The same techniques I've referred to work against foreign income tax systems as work against our own. Then we defer the U.S. tax on income that I can get to be subject to a lower rate than the U.S. rate. Then we use transfer pricing to shift income to those companies. And right there I've got a lot of untaxed foreign income that I then, because of our current rules of deferral, I will not repatriate until I've got a reason to that overcomes a repatriation tax.

When I do bring it back, the last bullet, I cross credit foreign taxes that I do have somewhere, and I only bring back enough that I can offset the U.S. tax on with excess credits. I think somewhere there is a study that indicates the U.S. tax rate on foreign income that's repatriated is somewhere in the three percent lower range. This is why.

This tax planning has been rewarded by favorable court decisions, congressional passing of the Homeland Dividend Relief Act. It's been referred to before. All those untaxed earnings I'm going to spend most of the remainder of my 2005, or a good portion of it, once the IRS is finished coming out with its guidance on Homeland Dividend, which so far the day before yesterday's release was 71 pages. The prior release was 100 pages. I expect another 100 pages by May 20th. To keep it simple, I'll be working through how we can bring those untaxed earnings back at an effective rate of no higher than 5.25 percent. Once again we thank the Congress.

From where I sit, it's to me hard to justify taxing foreign income more favorable than U.S. income. There is no question that we should allow a credit for foreign taxes. Nothing I say should be taken as indicating that we as a country do not value international trade investment, need international trade and investment. There are serious trade-offs here. The trade-offs are:

One, we are going to raise taxes, we have to raise taxes. "Raise," I mean collect taxes from a tax base. The observation I'm making here is nothing more than when you think about foreign income, it really isn't that different from the other categories of income you've been dealing with throughout this process. If you're going to tax income, if you're going to create any category and give it a lower rate of tax, you're going to have to defend that lower rate environment, you have to be sure it goes for what you want and you're going to have to deal with me. And before you're done, I'll be glad to give you one more free day of my time, look at anything you've come up with and I'll tell you how we game it. Unless you tax comprehensively.

The whole theme you've been hearing is the more comprehensively you tax, the better off the system is going to be. You will have lower rates and you will have more ultimately efficiency. There are legitimate arguments about efficiency in the international context, and I don't pretend to give you a definitive answer. I think these are serious and deserve a lot of thought and consideration. But my bias is overwhelmingly to take a "prove it to me" attitude, prove it to me that the efficiency gains are going to be achieved, are going to outweigh the equity considerations, the substantial complexity to defend any major rate differential and the inevitable wasteful tax planning.

I've only discussed at a very high level two alternatives for reform. They are possible if you do have a broader base and lower effective rates. Because at the end of the day you just can't -- you don't want to have U.S. taxpayers if they are, as I'm going to suggest, be taxed currently on foreign income, you don't want it on a much higher rate than the rest of the developed world. This is not a let's out tax Americans suggestion. It is let's get a system that we can actually work in the real world.

One approach then is expand current taxation to control foreign corporation earnings subject to a foreign tax credit with limits on cross crediting.

You will not find a single multinational taxpayer came in and tell you they like this, unless they see a broader purpose to having a broader tax base and a more efficient tax system.

You could alternatively exempt active foreign business income. So I wouldn't rule out exemption, per se. But it has to have borne some level of foreign tax or else I will push income into that environment.

I think my time is up.

I'm just going to skip to consumption tax, one consumption tax observation at the end.

If U.S. tax shifts to a pure consumption tax system, just recognize that we then would be the outlier. No major country does not tax business income. And as a result you have to recognize there are going to be major behavioral effects.

One good news, that's not on this slide, is foreign companies will probably want to move their income here until their home country imposes current taxation of U.S. income, which they will do. They will do what I'm proposing going the other direction. Because we will be the tax haven from an income tax perspective.

Secondly, foreign countries will have no reason to have income tax treaties with the United States because treaties are reciprocal reductions in source taxation, we're not going to tax their people, why should they reduce their tax on our businesses? We have nothing to offer.

Finally, my last bullet on this page is conjectural, but I would think foreign countries if they want revenue and are willing to take the burden on new investment, could well increase taxation of U.S. company's foreign business operations.

Thank you very much.

CHAIRMAN MACK: Senator Breaux?

VICE CHAIR BREAUX: Well, I thank you, Mr. Chairman.

And thank you two panel members. It's been a real good discussion of different viewpoints on the same issue, which I think is always very helpful.

Mr. Shay, I take it, I mean your presentation I basically agree with many of the points that you made.

Mr. Hines, my concern is quite frankly that if companies have an opportunity to move to a low-tax or a no-tax jurisdiction, that's going to be a huge incentive for them to either buy businesses or move their operations overseas. But I would ask Mr. Shay, other countries that do not tax worldwide income of their business, there's a lot of them that would, I guess, do what Mr. Hines is recommending here, that you only tax your territorial income. And it seems that they're not moving out of their countries. Can you comment on that? I mean, the feeling I have is that U.S. companies are just going to move overseas. But the countries that have a territorial tax base only, don't see that, do they?

MR. SHAY: Well, actually I'm not going to comment on that because I think you have to look at the data on that. I mean, you look at the Netherlands, which is a classic territorial system, who are the big companies there? Phillips, Shell a couple of others. But after you go on the second hand, you're not going to recognize any of their names. But that's anecdotal and I really don't mean -- I emphasize in everything I'm saying look at the data. Look at the data. Look at where the income flows are. They are not where real investment is. They're in the Cayman Islands. They're in the Netherlands. Disproportionate to the real assets that are there.

But in response to your question, there is no question. A number of other major trading partners do have forms of an exemption system. They live with it. They raise their tax base notwithstanding that. Their tax planners do the same things I'm talking about vis- à-vis their system. They collect much more of their overall revenue base from value added taxes. They have other sources of income. That's observation one.

Observation two, we had an industry that from 1986 from the '86 Act until 1996 was not exempted from current taxation on the foreign income for a large portion of their income, and that was the banking and financing industry because interest was not exempted for what we call Subpart F. That industry then went into Congress in 1997 and said why are we being treated differently. And they got what's known as the Act of Finance Exemption to Subpart F.

It's hard to complain with the argument they made why are we being treated differently. But as I see the U.S. banking industry between 1986 and 1996, it did not disappear. It did not move to the Netherlands. So I just think that there's got to be real data somewhere on this. It's not at all clear to me that we're going to lose our base by taxing worldwide income provided that, and this has been throughout my slides, it really makes sense if we broaden our business tax base, take away loopholes, reduce rates so that the differential, if there is a differential; most tax rates in the European countries outside of Ireland -- Ireland is 12.5 percent. Most tax rates are at the lowest, in the high 20s. I think there's one 28 percent going up into the mid and higher 40s. If you can get your business tax rate to a range that's in between 30 and 25, which is huge. That's a huge thing. But if you get there, at that point I think a lot of the sort of the "sky is falling" concerns, it's hard for me to believe that they'll be accurate.

But again, I'd look at data. I'd run models.

I frankly have one major concern, and that is that you have to report by the end of July. I think that the task in front of anyone trying to redesign the U.S. tax system deserves much more time. I hope that's a start of a longer thoughtful exercise. And I hope you folks are able to do what the 9/11 Commission did, which is keep the public and the politicians honest after you deliver your report.

VICE CHAIR BREAUX: Jim, why don't you go ahead. I'd like to hear --

PROFESSOR HINES: Sure. The question was directed at Steve Shay, although let me weigh in.

There are a lot of data that bear on this question, certainly. You know, take Germany and France which are two major capital exporting countries that in essence wind up exempting foreign income from taxation. There's plenty of economic activity in Germany and France, and I'm not aware of concerns about that.

The issue is does the home country

taxation of foreign income influence the pattern of business activity of ownership, business ownership? And the answer is yes, we have quite a bit of data about that.

And in terms of the consequences, it's always hard to know the alternative, you know what the world would have looked at had the United States exempted foreign income from taxation, say, in the '86 Act. And so it's hard to point to that experiment because we didn't get to see it. However, what our theories tell us anyway is that what you should see if you have distortionary business tax system is a slow erosion in living standards. You don't know why wages went up by only half a percent one year rather than one and a quarter percent. You don't know that they would have gone up more. But in fact if you have distortionary system, that's what's going to happen is that you just have this slow erosion or much slower growth than you otherwise would have had.

MS. SONDERS: I guess, James, this question is largely for you. I'm going to one of your slides that talks about the reduction of productivity of businesses located in the United States and in turn reduces a return to labor.

And then, Stephen, in addition you talked about any move to that kind of structure would require a tremendous amount of data on the benefits from a productivity standpoint.

So I guess the question goes back to whether or not you have done any specific studies that would quantify the benefit from a productivity or other efficiency perspective to put somebody like, you know, the gentleman to your right a little bit more at ease about this possible structure?

PROFESSOR HINES: Well, thank you. And I have. So together with Mihir Desai, who I know who testified before you when you had your San Francisco meeting, we've calculated the effective tax burden on outbound U.S. investment at about $50 billion a year, the economic burden. Not the revenue collection. And that calculation implies that the return to labor -- U.S. labor is about two-thirds of the economy. And so two- thirds of the cost of that, you know, would take the form of lower wages, lower return for U.S. labor, lower wages, so that's $33 billion a year.

MR. POTERBA: Let me start, Stephen, with a question for you. When you described your concern about consumption taxes and thinking about the business tax side and the foreign tax side there, is that a concern that applies primarily to something like a retail sales tax? If one thought about a CBIT of the kind that we saw discussed in two previous panels, does that raise the same concerns you have about the consumption tax?

MR. SHAY: It's easiest to see in the case of a retail sales tax. I think at the end of the day the question that you're going to want to ask about whatever system you have, I think of a CBIT, if I understand it correctly and I've not spent time with it basically since the early '90s when it first was proposed, I think it's still an income tax if I understand it correctly. And so at that point it's hard for the treaty partner if that's the nature of the question, to say that we're not taxing and we would indeed be taxing the income of their enterprises in the United States.

MR. POTERBA: So then I guess the specific issue if we did CBIT plus expensing, we would say that's a consumption tax? And does that step trigger the concerns?

MR. SHAY: Well, I think the reality is it is a consumption tax, we know that. Our treaty partners have shown that they're not entirely stupid, although they bided their time on the fisc before they attacked it - - or on the DISC, I should say. And so it's really a question of at what point is somebody is going to say the emperor wears no clothes. They would be completely entitled, I think, to say that such a fundamental change we're going to terminate our treaty. Under the terms of the treaty, I think that would be permitted because it would be a fundamental change in the nature of the understanding at the time that the treaty was entered into.

So if they choose to. Now whether they choose to is going to depend on their own calculus. So it's a little bit of at what level are you asking me. Are you asking me substantively? Yes, I have that concern. Are you asking what would happen in the real world if international diplomacy? It would be more complicated than that.Okay.

MR. POTERBA: Okay. But let me also ask both of you. I mean, are there issues? I know that you're headed in different directions with your desired proposals here. But starting from where we are if we were to move Jim to something which was sort of a simple territorial structure, Steve if we were really to try to do worldwide at a somewhat lower rate, are there transitional issues that would be particularly important for us to worry about in thinking about how we get from here to there?

PROFESSOR HINES: Certainly. It all depends on the nature of the proposal that you adopt. And for example, you know, there's a way of implementing territorial taxation which is border cash-flow-taxation. Your permit a deduction for funds leaving the country and you tax everything coming back in the country at full rates. And that in essence will wind up exempting foreign income from taxation, but do so in a way that avoids some arbitrages and so on.

If you were to enact something like that, the key transition issue would be you have to give taxpayers deductions for their existing unrepatriated earnings and profits abroad or else you'd really be subjecting that stuff to double-taxation because you haven't given them the deduction in the first place.

The short answer is yes, there are transition issues. But I agree with some of the previous speakers, I don't think they're all that complicated once you think them through.

MR. SHAY: I'm still trying to figure out Jim's comment on the prior earnings. The earnings that are already abroad if you're going to move to exemption, the hard question is do you give them the benefit of the new rule or do you hold people to the deal at the time they kept those earnings abroad on the understanding they'd be taxed on their way home.

One of the biggest difficulties, frankly, in my view is the homeland giving them relief, is it was done before you guys have concluded your work. Because a classic way to get a very difficult set of new rules in place is to provide transition relief. And if I were you, I would be hoping that for whatever reason a lot of low-tax earnings are not repatriated so you have something to work with. If you move either to exemption, which is going to hurt key taxpayers -- in terms of transition let's be clear. Jim and I can very closely start to converge if you can persuade me that exemption is offered in a way that is going to -- where the income will have some either foreign tax or a surrogate that's going to discourage the kind of planning I'm talking about. Having said that, I have very low confidence that you can do that, which is why my bias is overwhelmingly towards current taxation. And my lack of confidence is from five years in the Government trying to design these rules and 20 years working around the rules.

But you can imagine convergence. But if you go to exemption, there are people today as has been said who are better off with the current rules than they would be under exemption. Because they are using the cross-crediting, that I've referred to, to essentially reduce U.S. tax and U.S. income. If you go to exemption with anything like a principled mechanism, including one I disagree with very strongly, namely the Joint Committee proposal because it has no requirement of a foreign tax on what's being exempted. But they, the current Joint Committee proposal, would tax royalties currently, foreign interest currently. Most royalties today can be functionally exempt from U.S. tax through cross-crediting. So you are going to need to deal with transition whichever of these approaches you take because of the craziness of the current rules.

MR. MURIS: I want to thank both of you for really terrific presentation. I'm tempted to tell my wife I heard this heard panel on international taxation, but she would, I'm sure, remind me that I get excited about attacking arcane rules of budget baseline. So I probably won't.

But I'm also tempted to, given that this sort of confessional nature of Mr. Shay's comments, to ask him how he feels about going to work each day. But let me leave that aside, too.

And let me ask Professor Hines a question as a fellow academic, this is a hard question for an academic to assess himself. But where do your comments fit within the literature, the academic literature, not any sort of public literature and where are you in that divide? How well are they accepted?

MS. POTERBAL: Can I just interject. He is the academic literature.

MR. MURIS: Well, Jim told me there wasn't much, but there might be some more. But if there's not, that would be sufficient answer.

PROFESSOR HINES: Well, my coauthors have written some papers, too.

I'm kidding. Your staff person, Rosanne Altshuler is a significant fraction of that literature as well, I might add.

There's been a significant change in the academic literature in the last 10 or 15 years on this subject. And the traditional capital export neutrality notions, the defense of systems of foreign tax credits like the U.S. system, has -- that is much less popular now than it was, say, in the 1960s or 1970s.

In terms of where the literature is currently, I do think it's -- the economic's literature anyway is sympathetic with what I was telling you. Of course, there is as there always is, variation. But what we know -- I don't think there's any disagreement in the literature on the following: That ownership of business assets around the world is highly responsive to taxation. That the financing of business assets if highly responsive to taxation. That dividend repatriations are highly responsive. That, you know, you just can't miss it. You see all of that.

Ireland gets a lot --Ireland's got a different situation than other countries. Why? For a number of reasons. But partly it's got a very low-tax rate. Now it's a small country and it's unique. And, you know, it's not like the United States. But that we know from the literature.

The question is what are the implications for U.S. tax policy? And the idea that U.S. tax policy should be designed as though we're the only country in the world, is just -- that can't be the right way to think about this. And it's that insight, I think that pushes you to the idea that when we're an outlier in the world, it's not in our interest and it's not in anybody else's -- an outlier in the sense of imposing a heavier tax regime on foreign income than other countries do.

MS. GARRETT: Thanks. I also want to thank you and all the panel. And also to our staff who I think put together a terrific set of panels today.

I've been reading some tax sheltering literature, some of the academic literature. And there is in that literature recommendations for greater tax conformity as a way to deal with tax shellers, broadening the base, lowering the rates. And as I listened to your presentations I found myself thinking about the international tax implications of that, about which there is not much written, at least that I have found.

It sounds to me like it goes in the direction that Mr. Shay recommends with the taxation of worldwide income, no deferrals, those sorts of things. So I take it your reaction may be determined by your reaction generally to taxing worldwide income not having deferral. But I want to first get your reaction to that. But then secondly, are there any other international tax ramifications to such a move or any things that you would recommend that we look at to learn of those things? As I say, I haven't found that in the literature that I've been reading.

MR. SHAY: Well, just one starting point

is today the U.S. international tax rules start with U.S. tax accounting. We apply the U.S. Subchapter C corporate tax regime to countries to our foreign corporations, controlled foreign corporations that are entirely outside the United States.

This morning I was on the phone with a Dutch lawyer before coming over here explaining why dividends from a Swiss company to a Dutch company of U.S. real estate assets would give rise to a U.S. tax.

So one question is does it make sense or is there some way to apply either financial accounting, generally accepted accounting principles to income of foreign corporations that are controlled by U.S. persons that are operating entirely outside the United States? That has been done.

There is one set of rules, the interest capitalization rules, where there's been some effort to do that with respect to earnings and profits of foreign corporations. Very, very little. And so that is viewed as a potentially very attractive place to simplify international taxation. That's one side of the argument.

The other side of the argument is that if you go that route, if you don't do it across your whole tax base, then already you have a division and I go back to work on arbitrage. And that's nontrivial, but maybe you could get beyond that. Because as Al Warren said earlier, I mean in respect to giving on integration, we can't be perfect here. The other concern is use of financial accounting as a tax base. That is not what it's designed for. I think a lot of work needs to be done before we move in that direction, and there certainly are a number of people who have looked at it who have raised questions as to whether you're going to get some pretty fundamental problems doing that. I am not fully -- I'm not conversant enough with that to give you my view on that. I just say I do recognize if you're going to tax international income currently, boy it would be a lot easier if you could start with the local accounting principles if we got ourselves comfortable that we would be defending that distinction vis-à-vis when it comes into the U.S. and closer to the local tax base. That would make your credit system a lot easier. So I have a lot of sympathy for that. But everything else, most of what we talked about, it would need a lot more work before I give you my view.

PROFESSOR HINES: I agree that the book tax conformity discussion is very absent on the international side. And it's distressing that it is so. And it does seem a natural extension of it to say oh well, you know if we want book tax conformity, then we would want to include foreign income, you know, dollar for dollar and therefore tax it. And I believe what the exercise illustrates is what's wrong with thinking about things that way.

If an American company earns a $1 million in Ireland, Ireland has a chance to tax it. They can set whatever rate they want. They can enforce their tax laws. They choose to set a lower rate than the United States, and that's their decision. I mean, there are countries that have a zero-tax rate. Small, very small countries do that. They're sovereign entities and that's what they have chosen to do.

And you know, on Steve Shay's slides, you know, if Des Moines wanted to do that, that's fine with me, too. If they want -- you know -- we have fiscal federalism. Every state gets to pick its own thing.

So the same for international. So a dollar earned abroad that is taxed already at whatever rate the local government chooses to set is something different than a dollar that is earned in the United States.

MS. GARRETT: But don't you restore that

with credits?

PROFESSOR HINES: You can. Yes. The question is -- yes, if you have a credit system you can deal with it with credits. But there's a question do you want to deal with it with credits. That's the question or do you say that, you know, these countries have their own systems and they've chosen to make trade-offs that are different than ours, and we respect that. And so the income is taxed that way and it's taxed for other countries who invest in Ireland that way. And so it would be the same for us.

MR. ROSSOTTI: Mr. Shay, I just wondered what would you suggest if we went to your preferred solution, but U.S. based corporations, what would be a comparable way of thinking about for foreign corporations that were operating in the U.S? I mean, we obviously can't tax them on a worldwide basis, but we do have the same issues of those corporations finding ways to do business here, sell their products here and you know report income wherever they feel like reporting it. Is there any comparable concept that you have for dealing with that segment?

MR. SHAY: Well, I think there are two questions. One is if you don't do something about that, you are retaining a different disparity, namely

U.S. owned and foreign owned vis-à-vis the U.S. market, and that's what prompted the wave of expatriations that was dealt with in modest fashion in the 2004 Act and that one of your earlier panelists, Mr. Taylor, basically criticized the failure to strengthen the U.S. source pools effecting U.S. income earned by foreign owned groups.

And I shared the view that you -- and say in my slides, actually, that you would need to improve those rules. One proposal has been to strengthen the so- called anti-earning stripping rules, the rules that permit the foreign owned groups to earn U.S. income with deductible tax-free, essentially deductible interest.

The criticism of that approach is that to be effective you are running hard against, and we already do in our existing rules, so called nondiscrimination provisions of the U.S. -- of our treaties. The difficulties with those provisions is they are applied extremely formalistically. And so the question is should you say there's a discrimination if you deny a deduction for interest when it's paid to somebody not being taxed on it when you're comparing it with allowing the deduction for somebody who is taxed on it? I mean, clearly those are apples and oranges. But the nondiscrimination provisions of the treaties have been historically looked at with such a formalistic view, that people argue this would be discriminatory. I don't think it necessarily -- I mean I don't think it is discriminatory to tighten those rules.

In a substantive way I worry about how we deal with the treaty issue, but it seems to me it can be dealt with.

So I'm answering yes I think you do need to look at those rules. Yes, we do need to if you're going to make U.S. resident taxation of foreign income more tightened, you're going to have to tighten on the inbound side as well.

When you go to expatriation, that is a more difficult issue. And the question essentially is at that point, if you are taxing U.S. companies on their worldwide income, why doesn't that encourage people to own non-U.S. companies, and it will if companies have a material portion of non-U.S. activity if the other foreign countries don't adopt similar rules, and lt's assume for at least in the short term they won't. Although my own personal view is that if you look out five or ten years, the direction Europe is going is very much to move to a single tax system against -- you know, with a lot of struggle. But the European Court of Justice is doing it whether they like it or not. And I think that is going to push in directions that are going to let -- they are already allowing fewer and fewer low-tax environments within the EU. What they're going to do about Ireland, I don't know. That's their big political question. But you can anticipate they may move in this similar direction vis-à-vis non-EU activity if they're going to tighten up the EU marketplace the way I think it's going to go.

But that's projecting a little too far ahead. In the meantime you have to think about anti-expatriation issues. And no economist will ever want to hear that because that involves putting some nature of restrictions on ownership, as Jim was saying. I mean, that's a real issue. That's a very real issue, and one that needs to be addressed in connection with thinking about this.

The answer to that is that if you do broaden the base and you bring your rates down, you're relieving pressure on that. And my own judgment is, and just watching is happened, is I would have thought if that were such a big issue, we would have been there already long ago. And so my confidence is that I don't think if your rates are within some range of sort of the general rates, that that is going to prove to be a big problem. If it were, then you'd have to address it.

MR. ROSSOTTI: Just one follow-up?

CHAIRMAN MACK: Sure.

MR. ROSSOTTI: Just for Mr. Hines. I thought you did a good job of explaining what foreign direct investment is all about. But it leads me to this follow-up question, is that if, as you pointed out, that a lot of the issue is an American firm and a German firm investing in the U.K., to use your example, if the U.S. did have Mr. Shay's proposal and it was completely taxed on a worldwide basis but if we brought the rate down to where it was below the U.K. rate or at least equal to the U.K. rate, wouldn't that just neutralize the issue because there would be no extra tax? And, you know, the American firm and the German firm investing in the U.K. would be paying the U.K. rate both of them, and in fact the U.S. had this worldwide tax would be academic at that point. Excuse me. Not academic, but neutral at that point.

PROFESSOR HINES: Thank you for that correction.

MR. ROSSOTTI: Yes.

PROFESSOR HINES: Two thoughts on that. The U.K. has a 30 percent corporate tax rate, so we would have to get down to 30 percent.

MR. ROSSOTTI: Right.

PROFESSOR HINES: And I agree that at one level it would neutralize it. Insofar as the U.K. is concerned, it's a big world out there and they're not all the U.K.

MR. ROSSOTTI: Right. But in any given country? I mean, your point was most of it is in the G7 countries.

PROFESSOR HINES: Yes.

MR. ROSSOTTI: And so we know what those rates are. It's a limited number. To the extent that the U.S. rate was equal to or less than in anyone of those countries, that rate, it would neutralize the issue in that country?

PROFESSOR HINES: It wouldn't neutralize the issue insofar as investment, say, equity financed investment going into those countries. I agree.

The U.S. system would still create -- it still has a lot of kooky features with the foreign tax credit limit currently that would nonetheless cause problems even in that -- even if the U.S. rate were 30 percent and the U.K. rate is 30 percent, we have a lot of -- there are a lot of odd features in the U.S. tax system that still will cause distortions and still cause costs even in that case.

MR. ROSSOTTI: That's probably a little deeper into --

CHAIRMAN MACK: Actually, that was the question I was going to raise, so I think we'll just end it at that point. And thank both of you for your presentations this morning.

And I, too, want to say on behalf of the panel and those of you who participated, I want to thank our staff for the work that they did in the preparation of this two days of hearings.

Thank you all very much.

(Whereupon, the meeting was adjourned at 12:33 p.m.)