UNITED STATES OF AMERICA

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PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM

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FIRST MEETING MINUTES

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WEDNESDAY,
FEBRUARY 16, 2005

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

PRESENT:

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

WITNESSES:

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

PANEL STAFF AND DFO:
JONATHAN ACKERMAN, ROSANNE ALTSHULER, TRAVIS BURK
BENJAMIN GETTO, MARK KAIZEN, JEFFREY KUPFEr

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

(10:02 a.m.)

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

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

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

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

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

I think you know that this is a matter of extraordinary importance to the President and to the country. The President is committed to major tax reform, to real tax reform, to something more than just moving the boxes around, to finding what the opportunities are here to make the tax code fairer, simpler, and more growth-oriented.

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

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

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

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

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

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

But I don't know any time in American history where a more talented, distinguished, or dedicated group of people from the private sector with prior experience and many cases in the public sector have been brought together to focus on a major public policy issue. And I don't know any time where there is a combination of a President so dedicated to use the results of a talented, distinguished private citizen group to advance the public policy objective of a code that is fairer, simpler, and more growth-oriented.

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

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

I really think this is an historic opportunity. I commend you. I really commend you from the bottom of my heart for taking on this tough assignment. And I pledge that we at Treasury will be at your service, be available with the Office of Tax Analysis, Office of Economic Analysis, and the resources of the IRS as well that you can draw on to help you in your deliberations.

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

Thank you very much.

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

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

SECRETARY SNOW: Thank you very much

CHAIRMAN MACK: Thank you very much.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

We welcome input throughout the process. At the same time, we will also be requesting comments on specific topics in connection with the first stage of our work; that is, defining the problems in the tax code. Today we're making our first request. We ask that interested parties submit comments to the panel about headaches the taxpayers, both individuals and businesses, face because of the existing system; second, aspects of the tax system that you believe are unfair; third, specific examples of how the tax code distorts important business or personal decisions; and, fourth, goals that the panel should try to achieve as we evaluate the existing tax system and recommend options for reform.

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

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

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

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

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

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

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

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

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

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

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

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

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

I think it is important that the committee have a working relationship that is able to work in a bipartisan, nonpartisan fashion. This is the task of this committee. And I look forward to working with you in a cooperative fashion to meet the challenge that this committee is facing.

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

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

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

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

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

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

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

And here is a senior partner in a law firm that specializes in tax work. So if they don't do their own, how much more difficult is it for the average citizens to comply?

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

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

CHAIRMAN MACK: Thank you very much, John.

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

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

It is an important job. And we are all I think glad to be here. I am pleased and flattered to be picked for this illustrious group. I don't think any of us sought this chore, but it has come our way and we'll do the very best we can with it.

With that, Mr. Chairman, I yield.

CHAIRMAN MACK: Mr. Rossotti?

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

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

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

While there are many objectionable features in the current tax system and the chairman and vice chairman mentioned some of them, one of the worst of them in my view is that honest and diligent taxpayers, who are, fortunately, the majority in this country, pay a great deal extra to make up for the minority who cut corners and don't pay what they owe.

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

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

Thank you, Mr. Chairman.

CHAIRMAN MACK: Charles.

Liz Ann Sonders?

MEMBER SONDERS: Thank you, Mr. Chairman, Mr. Vice Chairman.

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

There are obviously a lot of routes you can take to making tax code simpler, fairer, more pro growth. And I think the simplicity is the most obvious one and, arguably, the most simple one. For lack of a better word, it's pro growth. And I am also a big fan of having been a market participant and an observer of investors for a long time, I'm a believer in the growth of this economy.

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

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

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

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

And we are the engine of growth globally, but we also have become very much a consumption economy versus the rest of the world that is more of a savings economy. Hopefully this process will help to ease some of those imbalances. And I am very much looking forward to the next six months.

Thank you.

CHAIRMAN MACK: Thank you, Liz Ann.

Mr. Tim Muris?

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

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

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

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

Thank you.

CHAIRMAN MACK: Thank you.

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

MEMBER POTERBA: Thank you, Mr. Chairman.

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

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

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

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

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

CHAIRMAN MACK: Professor Garrett?

MEMBER GARRETT: Thank you, Mr. Chairman.

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

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

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

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

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

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

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

As a country, we face an enormous deficit of $500 billion entitlement programs that are in trouble. And I think as we go about our job, we have to keep that in mind as we look at provisions.

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

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

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

CHAIRMAN MACK: They will.

MEMBER GARRETT: Full comments. [attached]

CHAIRMAN MACK: Right. That they will be.

Professor Lazear?

MEMBER LAZEAR: Thank you, Mr. Chairman.

I have been a professional economist, like

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

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

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

CHAIRMAN MACK: Thank you, Ed.

And thank you for indulging us in our opening comments. This may come as a surprise to you, but this is really the first time that we as a group have been together. And it's really the first time for many of us who have had the opportunity to hear the points of view expressed by each of the panel members this morning. So again I thank each of you for your comments.

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

Fred, we look forward to your presentation this morning.

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

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

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

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

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

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

The death tax was added three years later. And, again, you were talking about one percent on estates above $50,000 with a maximum rate of 10 percent on estates above $5 million, which in today's terms is about $87 million. Again, in the beginning, essentially it was a tax focusing on issues of dynastic wealth.

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

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

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

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

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

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

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

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

In order to fund Social Security, President Roosevelt and the administration and Congress enacted payroll tax withholding in 1934. Well, if you were paranoid, you would think this was all preplanned. But what that did is that laid the foundation for probably the most important development in the income tax, which was from class tax to mass tax.

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

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

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

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

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

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

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

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

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

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

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

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

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

Under President Kennedy, individual rates were reduced from about 90 percent to 70 percent. Corporate rates were reduced from 52 to 48 percent. President Kennedy was the one who proposed and caused to be enacted the investment tax credit. Depreciation lives were reduced from about 19 years to 12 years. Keogh retirement plans for the self-employed were enacted.

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

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

So you have President Kennedy in 1960 in his first speech talking about we can use the tax code to do good. We've got to get the system off the backs of productive workers. We've got to use the tax system to promote investment and economic growth. And in 1969, let's start thinking about reform.

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

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

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

About 40 percent of all potential taxpayers with positive income in any given year pay no income tax. But there is a difference here. They don't pay income tax because the personal exemption or standard deduction has gone up. They don't pay income tax because the earned income tax credit, the child tax credit and other special provisions.

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

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

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

(Laughter.)

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

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

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

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

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

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

The importance of inflation in driving the revenue structure of the tax system cannot be overstated. In 1972, Social Security benefits were indexed. The house continues to grow. Oh, there appears to be a crack in the foundation, but we will get back to that momentarily.

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

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

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

In many respects, the most important

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

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

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

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

We're not going to expand the system through rate increases. We're not going to expand revenue through lowering personal exemptions or the standard deduction. What we are going to do is we're going to find this little piece and go after it. We're going to find that little piece and go after it. We're going to find another little piece and go after it.

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

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

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

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

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

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

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

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

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

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

It is worth noting that deductions are of little or no benefit to the 40 percent of taxpayers who don't owe taxes. A family of 4 with family income of about $40,000 gets no benefit from a charitable contribution deduction, gets no benefit from a mortgage deduction, gets no benefit from a deductible contribution to an IRA. And one answer is, well, they don't pay taxes. That's the way it goes.

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

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

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

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

Senator Moynihan wrote a great piece about how we get inured of these things. It is hard. We can't describe or capture what that 10,000 figure means. The notion that you are changing the tax system 10,000 times since you did your '86 Act reform, broadened the base, reduced rates, and kept it simple, it just defies description.

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

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

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

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

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

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

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

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

There is a distinction between promotion and removing barriers. We talk about incentives. I think there are many instances in the tax law where you are not providing an incentive. You are removing a barrier to constructive economic activity.

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

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

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

The income tax has failed and in my view is likely unable to adapt to the world around us in terms of global competition and capital flows, the same with respect to financial derivatives. Financial derivatives were nothing before 1990. Now they're $200 trillion. Derivatives make a hash of the traditional building blocks of an income tax system.

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

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

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

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

The first lesson is the challenge of how you think about the income tax. Is it to raise revenue or is it to do social policy and provide industrial policy? That is the perennial struggle we have had since 1960.

The second is that the lesson of tax reform in '69 and the lesson of tax reform in '86 is a cautionary note. They didn't last long, and they didn't do much.

The third question is, there is a world around us that we cannot control. And that world around us, whether you are talking capital markets or you are talking global trade, is and will change how we have to think about how we raise revenue.

Thank you very much.

CHAIRMAN MACK: Thank you very much for the history lesson. I think it was fascinating to walk through. There were a number of items that you went through, some of which you really gave emphasis to, the phase-in/phase-out.

Identify a couple of other areas. In some respects, you may have in your last comments -- the purpose of the code, thinking about what we are trying to accomplish, the lessons of the '69 and the '86 Acts. But, again, some other areas that are similar, say, to the phase-in/phase-out in concept that we ought to focus on?

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

Second, I --

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

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

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

One can imagine, for example, tax credit proposals if you stay with the current income tax system focused on prefunding entitlement responsibilities.

You know, the talk now is about Social Security private accounts. And you may or may not like that policy, but there are other ways, additional ways, in which you can create an asset base on a more universal asset base. So effectively you're prefunding future entitlement obligations through the tax system. That's another thing that one could think about. So I think they interrelate in those respects.

I think there is a lesson here. Things grow. They get bigger. I mean, you could look at Social Security. When it was enacted, 50 percent of the workers and the benefits didn't kick in until after you were expected to die. And now you have a very different system.

If you look, the Earned Income Tax Credit was intended to reduce the marginal rates. It's now a refundable credit that goes way beyond that.

These may be good things. I'm not saying they're good or bad. But things tend to grow. And I think one of the lessons from tax reform acts is if you just kind of cut the shrubbery back, it's going to grow back to where it was.

You may say, "That's okay. Maybe tax reform is like Thomas Jefferson. We need a revolution every 12 years or 15 years. Strip the thing back. Make it simple. But don't delude yourself. It's going to be back in 15 years." And maybe that's the best you can do and that's okay.

I think that the world around us suggests that there are ways to do sector-based reform of the income tax. If you think about sort of the whole hodgepodge of savings provisions, you could dramatically simplify those rules on a revenue-neutral basis. If you think about raising revenue from enterprise income, you could radically simplify those rules on a revenue-neutral basis.

So there are ways to work through these pieces, but the only thing I really come away with is I think you are better off thinking big than thinking little.

CHAIRMAN MACK: Thank you very much. I hope I didn't get you in trouble with that question.

MR. GOLDBERG: It was inevitable.

CHAIRMAN MACK: We will move down to this end of the table first, Jim, if you have got a question you would like to pose.

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

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

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

Now, that doesn't mean that you give up on an income tax, but I think it means you think very differently about an income tax. And it's going to differ between whether you're talking about the corporate sector, where there are shortcuts that you take analogous to the passive loss rules, or whether you're talking about individuals whose principal source of income is their own investments.

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

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

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

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

You focus mainly on individual taxes, which is terrific, but I wondered if you could say something about corporate income taxes and complexity. In particular, is it worth all of our time that businesses and the IRS spend in compliance on corporate income taxes when it is such a small part of our income and when we could get those taxes from individuals, who, after all, are people who get the money from corporations?

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

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

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

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

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

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

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

MEMBER LAZEAR: You mentioned in your comments when you were talking about the 1986 tax reform that the basic philosophy associated with this was to broaden the base but to keep the rates low. And in some sense, we seem to have failed on both counts because the base is not clean, nor have we succeeded in keeping the rates low over time.

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

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

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

You look at the list of savings

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

Sometimes there are virtues in choices. Sometimes there are virtues in no choices. There is a very large virtue in my world of letting the person decide.

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

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

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

VICE CHAIRMAN BREAUX: Thank you very much, Fred, for an excellent presentation and really putting it in an historical perspective as to where we have been and how we have gotten there.

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

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

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

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

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

MR. GOLDBERG: The trouble is getting deep here, Senator. I think it's impossible. I think the notion of we're going to get rid of everything we have and start over is a waste of time. I don't think you should bother thinking about it.

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

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

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

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

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

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

Second, you can do base broadening and say, "What am I going to do good with all of the base broadening I have done?" Get rid of state and local tax deductions or get rid of the rules on employer-provided health care. And good luck.

But you can broaden your base and buy some good things or you can think about the tax system in sort of discrete sectors. What can I do with respect to all of this stuff out there on savings? What can I do out there with all of this stuff relating to how we tax corporations? What can I do about my international tax piece? If you want to get into the estate and gift tax, what -- and sort of think about them as sectors.

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

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

CHAIRMAN MACK: Thank you very much.

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

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

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

MR. GOLDBERG: I urge you not to minimize that. You could make it a lot harder depending upon how far you're willing to go. If you do it all within the current context of the income tax, it's going to be 10 to 15 years at the outside if you find some other ways of restructuring the income tax, you may be 20 years, 20-30 years, which is a long time. I mean, that's a good amount of time.

MEMBER FRENZEL: Thanks very much.

MEMBER ROSSOTTI: Fred, great presentation.

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

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

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

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

MEMBER ROSSOTTI: I understand. Thank you.

MEMBER SONDERS: Fred, terrific presentation, very helpful. Thank you.

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

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

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

MR. GOLDBERG: You looking for -- well, no. I mean, I have been through these issues about dynamic scoring and about -- there's a lot of confusion about revenue estimates. Revenue estimates are dynamic today in the sense that they assume changes in behavior.

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

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

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

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

I think it is an absolute deadlock certainty that properly done tax reform will increase economic growth. That is a certainty. I think the risk in trying to go beyond that obvious proposition, which is true, to saying, "Well, gee, I am going to give myself credit for an extra 50 basis points on GDP every year of growth," I think it runs some risks because I'm not quite clear how sure anybody can be on that number. And you move that number a little bit and you move your revenue numbers enormously.

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

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

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

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

MEMBER MURIS: Right.

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

I think that, again, fairness and distribution are exceedingly important. I think those who argue that the tax system has become more regressive are wrong. I think that the data suggests it has become more progressive.

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

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

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

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

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

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

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

CHAIRMAN MACK: Again, unless someone has got a burning question that they have got to follow up, because of time, I think we need to move on.

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

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

(Laughter.)

CHAIRMAN MACK: Thank you.

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

And I think, Professor Kaplow, you are going to go first.

MR. KAPLOW: Yes, I am.

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

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

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

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

When our taxpayer arrives in the second period, the retirement years, during the interim, there will have been earnings on that savings, the return, the interest, or whatever form it might take, that will be received. And the taxpayer, being retired, all that remains is to consume. So the taxpayer will consume both the principal of what was saved along with the return or interest on that savings.

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

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

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

In the second period, when our taxpayer is retired, all that would remain to be taxed would be the return on savings, which would be interest in a simple example.

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

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

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

How might you implement this form of consumption tax? In the old days, it was discussed, that trying to keep track of how much each person consumes at each point in time might be rather difficult as an administrative matter, but it has been observed that one way one could implement a consumption tax -- and it's the way that has been most talked about in recent decades -- is to define the consumption tax base by starting with something like the current income tax base or a theoretically pure income tax base and simply subtracting the change in wealth.

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

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

What would happen? Savings would be untaxed when they were earned. Any accrual, as it happens, would also be untaxed. However, when it was withdrawn for consumption, every bit of it would be taxed, in this case for the first time. So that's the basic operation of a personal cash-flow consumption tax.

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

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

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

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

How can we appreciate this intuition? It follows from accounting identities, but to really grasp it, consider a tax that is going to be at 25 percent. What if it were a 25 percent consumption tax? Well, individuals obviously could consume 75 percent as much as they could consume in each period as in a world with no taxes. However, they chose to allocate across periods.

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

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

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

Well, let's stick within period one for a minute and imagine our taxpayer is choosing between apples and oranges. The income tax, whether you spend it on apples or oranges, will be taxed in the same way, obviously.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

If you put these departures toward heavier taxation of capital together with an earlier laundry list of departures toward consumption tax treatment of capital, then that is probably that we are between an income tax and a consumption tax, probably closer to a consumption tax than a pure income tax, but that varies over time as different tax reforms have been enacted.

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

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

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

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

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

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

Thank you.

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

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

In preparing comments about tax reform and tax policy, I often feel like everything has been said and everyone has said it over the past 20 years. So I wanted to start off with a little bit of a different tack before I turn to my overheads. And that is I want to quote from Yogi Berra and Winston Churchill, two names that you don't often hear in the same sentence, because I think that it provides the right context for my comments.

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

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

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

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

The most obvious issue is the tax base,

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

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

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

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

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

And a fifth issue is actually the level of revenue. I didn't put this on this overhead because you have already been tasked to do a revenue-neutral reform, although I endorse all of Fred Goldberg's comments in regard to the entitlement issue.

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

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

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

The implication of this is that comparing the actual system to a system that only exists on paper is fun but is not likely to be very informative about what happened if you actually aimed to hit that system. So we need to think about real world comparisons between the current system and alternatives.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Some save a little.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

All right. What about economic growth? Well, again, in theory, there is no doubt that a consumption tax, a well-designed consumption tax, can be more productive in terms of long-term growth than the current income tax.

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

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

In addition, converting to a consumption tax could actually blunt some of the savings incentives that are in the current income tax. I'm not a huge fan of all of them, I think low and middle income households, they tend to work fairly well. It would be a more promising way to raise saving and growth by encouraging things like automatic escalation or contributions and automatic enrollment than by trying to switch to a consumption tax.

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

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

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

One of the ways where consumption taxes are decidingly inferior to income taxes is in dealing with unstable tax systems. So if you are moving the tax rate up and down over time, if you think of that as a prototypical tax change going back and forth, that has a much bigger effect on the return to saving investment in a consumption tax than it does in an income tax.

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

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

Let me conclude. The income tax might be a big house, it might be a messy house, it might be a jumbled community, but I don't think you should tear it down. I think you should try to rebuild it.

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

If a consumption tax is added on in addition to that, that is one thing. That is a way to broaden the revenue base and look forward to paying for entitlements in the next 50 years, as has been discussed. But if we eliminate the income tax and go to a consumption tax, we're making a huge change in the biggest tax system in the history of the world.

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

Thank you.

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

We now move to Stephen Entin. Steve?

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

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

If you have ever been scrambling in terror to fill out your income tax at 11:00 P.M. on April 15th trying to get to the post office before it closes, you know that taxes can be very stimulating indeed.

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

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

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

I would like to toss out some ideas about what income is and what isn't. These have repercussions when you consider what is fair and how the economy works. I think we need to get them clear.

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

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

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

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

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

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

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

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

We have heard that the income tax does tax people. The more that they work and produce, the more that they save and earn because of the graduated rates. And we have seen that the income tax hits saving and investment harder than consumption, which simply encourages consumption by penalizing saving.

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

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

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

So we have four layers of potential tax on saving versus one on consumption except for those bizarre few federal excise taxes that probably ought to be canned.

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

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

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

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

Economically most of the burden of the taxes on corporations and businesses and savers ultimately hit people in their role as workers because they are less efficient and they are paid less as a result. Savers can always choose to switch to consumption. Consumption is nice, too. But when they do, workers lose their jobs.

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

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

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

A neutral tax would not tax corporate income twice. It would be taxed at either the corporate level or the shareholder level. And I agree it really should be passed through to the shareholder.

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

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

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

These things have a different point of collection, but they really are on the same tax base. They all treat saving neutrally versus consumption, all employ expensing instead of depreciation, and with appropriate adjustments for interest passthrough. All are territorial. All have the same basic tax base.

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

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

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

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

If you are going to be constrained to a

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

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

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

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

So even if they are collected on

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

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

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

Fred mentioned that we have broadened the base to preserve the rate structure. And so we have gotten some revenue by phasing this and that out. But when you phase out this or that, you change the effective marginal rate because earning an extra dollar means changing your taxable income by something more than an extra dollar or losing part of a credit. Marginal rate structures adjusted for phaseouts look like the Manhattan skyline.

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

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

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

And the simple, clearer neutral tax would be seen to be fair. Everyone would be filling out the same, fairly simple tax form. And there would be not much on there that people could duck with. And people would know that their neighbors were paying their fair share, too.

The stability and transparency, Mr. Chairman, I am glad you brought that up. Only people pay taxes. Businesses and things don't pay taxes. Taxes are best levied on individuals.

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

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

For example, in a consumption-based system, pensions are not a tax expenditure. They're the normal treatment. The current treatment of saving would be the outlier. In the income tax, the pension is listed as a tax expenditure because you're intending to tax saving and the returns immediately in an income tax and putting in the bias. In the unbiased system, it is the norm. It is not a tax expenditure.

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

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

Thank you very much.

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

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

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

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

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

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

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

And, as Bill Gale pointed out correctly, negative assets, borrowing and interest, need to be included and incorporated as one moves in these directions, which we have not done consistently.

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

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

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

But I think it is interesting to observe that in other countries in the world, where mixed systems are the norm, typically a VAT and an income tax, many of them engage in more aggregate redistribution leveling of income through the fiscal system than we do. A few engage in less. And they are at many different points along the spectrum.

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

CHAIRMAN MACK: Yes. Go ahead, Bill.

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

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

But I understand this isn't your task right now. Your task is do revenue-neutral reform. But I think in doing revenue-neutral reform, you could do the nation a huge service by setting up a tax base that then could be used to finance whatever entitlements we eventually would like to have.

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

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

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

CHAIRMAN MACK: Mr. Entin?

MR. ENTIN: If you had two taxes, if there was a prospect of a second tax, I think people would be more afraid that you were going to have a net increase in taxes and that if it would bring on substitution, that they would resist the opportunity for Congress to have two taxes to raise, rather than just one. I think it would be scary.

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

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

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

You have to weigh the fairness of punishing people the more that they work and produce versus the kindness we would like to show to people who are low-income. We would like to relieve them of some of the cost of providing for defense and the common good. But that is kindness, not fairness. And fairness is a proportional tax.

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

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

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

So, rather than putting on a second layer of tax, I would suggest you simply move more toward the consumption base than the existing structure.

VICE CHAIRMAN BREAUX: Thank you.

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

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

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

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

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

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

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

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

MR. GALE: I am sorry?

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

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

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

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

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

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

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

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

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

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

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

There would be many intervening years during which the prospect that any money you saved, rather than consume now, you would be paying the tax on now. And you would be paying the tax on the day the VAT went from zero to 15 percent or whatever it might be would have a tremendous adverse incentive effect, one that we would not want to contemplate or to realize.

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

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

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

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

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

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

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

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

So some of this is going to be handled by itself by the market if you went to the pure saving deduction, tax it when you take it out kind of tax system.

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

MEMBER FRENZEL: Thank you.

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

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

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

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

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

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

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

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

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

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

MR. ENTIN: If you looked at what happened in Russia after they got rid of some really bizarre, very high tax, narrowly based taxes and moved toward a flatter rate tax, where it simply was not worth trying to evade the system, their revenues did much better. There is something to that.

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

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

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

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

MEMBER SONDERS: We have talked a lot

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

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

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

MR. GALE: Sure. Thank you.

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

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

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

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

Tax expenditures tend to have this upside-down structure that if you absolutely looked at them as spending programs, they would look ridiculous because they are giving the biggest benefits to high-income households, the smallest benefits to low-income households because you deduct the payment at your marginal tax rate.

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

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

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

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

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

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

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

Unless you have decided whether you are viewing the tax base as something that looks more like consumption or something that looks more like the broad-based income tax definition, you will not know, for example, whether a pension plan is a tax expenditure that ought to be eliminated or normal treatment that ought to be expanded.

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

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

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

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

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

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

MR. GALE: Sure.

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

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

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

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

We are not sure just how much saving and investment have been harmed and capital formation has been harmed by this. But given the several trillion dollars that the capital stock is today and given the size of the tax rate I have described to you, you would expect several trillion dollars in additional plant and equipment structures to be built over roughly a five to ten-year period. We get an indication of that from previous times we have changed depreciation schedules and capital gains rates and so forth.

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

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

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

Now, since the capital stock is already approaching eight to ten trillion, I think having several trillion dollars more expected in investment over a decade is not at all unusual in an assumption.

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

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

MR. GALE: Thank you.

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

MR. MURIS: Thank you.

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

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

Fred's history started at World War I,

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

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

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

So we need to be very careful. If tax changes of that magnitude don't show up in growth trends, we need to be real careful about claims about tinkering with this saving account or that depreciation provision is going to create trillions of dollars of growth.

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

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

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

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

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

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

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

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

We also know from days of old, of centrally planned economies that were wildly inefficient but did have high growth rates. So it is worth keeping in mind that probably what we care about is economic efficiency, how much the tax system is contributing towards subtracting from social well-being.

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

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

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

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

5 percent larger and grow to a normal rate from that.

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

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

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

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

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

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

But I think an economy like ours, for those who are compliant with withholding at the source, we can probably also get them to send W-2's, 1099s, and the like, and make sure it doesn't get lost in the shuffle.

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

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

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

The evasion issue here is pretty straightforward. The taxes collected at a single spot at the retail sale. And there is no third-party withholding. So nobody knows that the sale took place unless the government is actually standing right there.

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

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

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

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

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

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

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

So it will be possible. I don't know if you can write regs to close this, but let me come back to that. You will have massive avoidance or evasion because it's not clear whether it's legal or not by having all inflows characterized as finance and all outflows characterized as non-finance.

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

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

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

I think some of these questions have highlighted some of the possible difficulties with that pure consumption tax when we bring it into the real world. There are political difficulties, which we don't have to worry about because we're not a political group.

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

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

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

MR. KAPLOW: It partly relates to Jim's question. I mean, there are some sectors. So going back to an earlier discussion about avoidance and evasion, if we think of the cash economy, the cash economy is a disaster under all systems. And that's the same entities that aren't reporting the income are also probably not paying payroll taxes, are also not reporting on the sales because if they reported one, they may well be caught on all. And although there are ways one can get at that better and worse, that basically is not an area one can make much progress on.

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

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

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

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

I think in terms of difficult --

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

(Laughter.)

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

And I, frankly, don't know enough about either of them to opine confidently except that they strike me that they are really important tails that could well wag the tax reform dog here. I would encourage you to pay attention to them, either in the income tax or in a consumption tax system.

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

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

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

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

It is perfectly all right if you are going to keep a business sector tax to have a VAT type for most industries and then leave the financial sector the way it is and just keep your boundary conditions clean because you can have a neutral tax under either type of situation and you can have two neutral taxes side by side, one for one sector and one for the other, again as long as you are careful, and still handle the financial sector. But it has to look very much like the current tax system.

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

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

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

MR. GALE: It is a really good question.

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

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

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

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

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

MR. KAPLOW: They are people, too.

MR. ENTIN: They are people. They have a

peculiar outlook on the world, however. Consumption is less likely to fluctuate, even in a downturn, than would investment spending. Investment spending goes through the big cycles. So in a sense, the consumption base is a stabler base given whatever happens in the economy than is an income tax base.

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

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

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

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

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

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

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

I think there is a sense in which many of the forces in a fairly one to one way would migrate from one to the other and, for better or worse, play themselves out in a similar fashion.

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

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

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

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

You would have a lot more investment in

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

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

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

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

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

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

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

If you have different situations in particular industries, where elasticities of this and that may vary, you may get some situation. In the VAT, for example, if the financial sector is exempt, you may get a distinctive twist in the relative competitiveness of the manufacturing sector versus the financial sector. And there may be some shuffling of resources.

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

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

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

Now, I'm already going to pay tax on it before I leave the house because it's collected at my household level. But now that I have taken my after-tax income to the store, whether I buy an import or I buy a domestic product, I have already been taxed on my income. So in a sense, it's implicitly but not explicitly border-adjustable.

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

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

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

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

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

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

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

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

If you went to a neutral tax system, you would probably see a little bit of a bump up in manufacturing, a little bit of reduction in the service sector until that adjustment was completed and then trend growth and both.

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

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

CHAIRMAN MACK: That was quite an ending to that, Steve.

Bill, do you want to?

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

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

And I'm a card-carrying economist. Therefore, I agree with Steve that border adjustability is not an issue. But I understand that is not a compelling argument to the millions of people that think it is. And I would encourage you to actually have a session that goes through this and tries to nail it down.

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

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

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

We can also ask, since we're talking about an integrated system, how does the taxation of corporations relate to that of individuals and so forth, when you then get corporations that are foreign-owned but located here, the question of how we are going to take any reform that we apply within our borders and apply either to foreign corporations operating here or to U.S. investment abroad, which is the international dimension of the system, those are things we want to worry about getting right that can have effects.

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

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

MR. ENTIN: I do apologize. None of us answered the other half of your question, which was, what happens to American firms working abroad vis-a-vis other firms abroad and they are trying to impose our tax rate structure on them when their competitors abroad don't face our tax rate structure?

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

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

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

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

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

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

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

(Whereupon, at 1:09 p.m., the foregoing matter was adjourned.)

University of Southern California
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Opening Statement

Federal Tax Reform Panel

Elizabeth Garrett*

February 16, 2005

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

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

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

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

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

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

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

IRET Institute For Research On The Economics Of Taxation

IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

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

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

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

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

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

• ***The Inflow-Outflow Tax***[1] <ftp://ftp.iret.org/pub/InflowOutflowSum.PDF>, which we view as the optimal neutral tax system.

• ***The Economics of Taxation and the Issue of Tax Reform***[2] <ftp://ftp.iret.org/pub/EntinNewOrl-2003.PDF>, a handbook on the way in which taxes affect the economy, the concept of marginal tax rates and a non-distorting tax base, the anti-saving, anti-investment features of the current income tax, and the advantages of neutral taxation.

• ***Reforming Taxation: Attributes of a Good Tax System and Principles to Guide Reform***[3] <ftp://ftp.iret.org/pub/ADVS-183.PDF>, some basic facts on the purposes of taxation, and the nature of income, fairness, and efficiency that should be understood in order to develop a good tax system.

• ***Renew Bonus Expensing To Keep Recovery Strong***[4] <ftp://ftp.iret.org/pub/ADVS-173.PDF>, showing the sensitivity of investment to tax treatment.

• ***The End of Tax Expenditures As We Know Them?***[5] <ftp://ftp.iret.org/pub/BLTN-84.PDF>, which warns that what is an anomaly under the income tax, and may have been branded a tax expenditure, may be the highly desirable norm under a consumed-income or consumption tax (example, all pension and retirement plans).

• ***Tax Incidence, Tax Burden, and Tax Shifting: Who Really Pays the Tax?***[6] <ftp://ftp.iret.org/pub/BLTN-88.PDF> which demonstrates that all taxes are paid by individuals, that taxes on corporations and capital income in general are largely shifted to labor by depressing saving, investment, productivity, and wages, and that graduated tax rates on the upper income result in lower incomes across the board.

• ***Phase-outs Increase Tax Rates and Tax Complexity***[7] <ftp://ftp.iret.org/pub/BLTN-71.PDF> which calculates the adverse impact on marginal tax rates of many tax provisions that means test deductions, credits, and exclusions.

• ***Taxes and the Good Society***[8] <ftp://ftp.iret.org/pub/TaxesGoodSoc.PDF>, which is a discussion by the late Dr. Norman B. Ture, one of the country's leading tax experts, on the basic concepts of tax fairness, neutrality, and the purpose of taxation in a democratic society.

What is the current system?

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

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

Why tax reform? Income, growth, and jobs.

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

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

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

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

Correcting flaws and avoiding errors.

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

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

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

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

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

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

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

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

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

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

Framework for thinking about tax reform.

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

1. Raising revenue to pay for government goods, services and activities; and

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

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

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

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

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

Four key criteria for tax reform.

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

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

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

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

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

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

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

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

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

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

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

Simplicity. The complexity of the current tax system imposes enormous compliance costs on taxpayers and enforcement costs on the government. Most of the complexity in the current tax code stems from its arbitrary definition of taxable income, its effort to impose non-neutral taxation of income from capital, and its taxation of income from foreign sources offset by a tax credit for foreign taxes paid.

There is no conflict between simplicity and neutrality. Neutral tax systems that are not biased against saving and investment are inherently simpler and fairer than non-neutral ones. Systems that restrict taxation to income earned domestically are likewise simpler than systems that tax global income with a credit against foreign taxes paid. For simplicity, the tax system should be territorial, levied on income earned within the country.

However, the very simplest tax systems, those that would have businesses collect all taxes without income earners or consumers seeing what is taken or having to do any work would be a violation of visibility.

Simplicity should not be an excuse to remove large numbers of people from the tax rolls or to eliminate periodic tax filing. Some small amount of effort by the citizens in paying tax is a fundamental requirement of a tax system that informs the citizen-voters about what government is doing, enabling them to fulfill their civic responsibility in a democratic society.

The current tax code fails all four tests.

The current tax code violates neutrality by taxing some income at higher rates than other income, in particular by falling more heavily on income used for saving and investment than on income used for consumption. It hides significant revenues from the voters in business taxes, and it exempts tens of millions of people from the income tax rolls. It masks the cost of government. It encourages people to attempt to shift the cost of government goods and services to others. It is enormously complicated. It punishes real economic effort and treats many taxpayers very badly.

Let me take a moment to make clear what the income tax biases against saving and investment consist of. At the federal level, there is usually one layer of tax on income that is used for consumption, but there are at least four layers of possible tax on income that is saved (Chart 1).

1) Income is taxed when first earned (the initial layer of tax). If one uses the after-tax income to buy food, clothing, or a television, one can generally eat, stay warm, and enjoy the entertainment with no additional federal tax (except for a few federal excise taxes).

2) But if one buys a bond or stock or invest in a small business with that after-tax income there is another layer of personal income tax on the stream of interest, dividends, profits or capital gains received on the saving (which is a tax on the "enjoyment" that one "buys" when one saves). The added layer of tax on these purchased income streams is the ***basic income tax bias against saving***.

Chart 1 Multiple Taxation of Saving
One Tax on Consumption, Four Taxes on Saving

Layer 1– Tax on Earnings

Income is taxed when earned. If it is used for consumption, there is usually no further federal tax.

Layer 2 – Personal Income Tax on Returns

If the income is saved, the returns are taxed as interest, dividends, capital gains, or non-corporate business profits.

Layer 3 – Corporate Income Tax

If the saving is in corporate stock, the corporate tax hits the income before it is either paid out to shareholders or reinvested to boost future earnings.

Layer 4 – Transfer (Estate and Gift) Tax

Another tax on already taxed assets.

(Similar taxes at the state and local levels increase the multiple taxation.)

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Chart 2 Multiple Taxation of Corporate Income

	(a) Retained Earnings, Pre 2003 Act	(b) Dividend Payout, Pre 2001 Act	(c) Retained Earnings and Dividends, 2003 Act
1) Corporate Income	$1.00	$1.00	$1.00
2) Corporate tax at top rate	$0.35	$0.35	$0.35
3) After-tax corporate income: Either retained, raising stock price (columns (a), (c)), or paid as dividend (col. (b), (c))	$0.65	$0.65	$0.65
4) Individual income tax at top rate (dividends as ordinary income, retained earnings as capital gain)*	$0.13 (tax rate 20%)	$0.2574 (tax rate 39.6%)	$0.0975 (tax rate 15%)
5) Total tax	$0.48	$0.6074	$0.4475
6) Total tax rate	48%	60.74%	44.75%
7) Income left to shareholder	$0.52	$0.3926	$0.5525

** Top corporate rate excludes corporate surtaxes, and top individual rate ignores phase-outs of exemptions and deductions and taxation of Social Security, which may push effective top tax rates higher than statutory rates. Retained earnings are assumed to trigger a long-term capital gain with a maximum rate of 20% or 15%. Short-term gains are taxed at ordinary tax rates.*

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3) If the saving is in corporate stock, there is also the corporate tax to be paid before any distribution to the shareholder, or any reinvestment of retained after-tax earnings to increase the value of the business. Whether the after-tax corporate income is paid as a dividend, or reinvested to raise the value of the business and create a capital gain, corporate income is taxed twice — ***the double taxation of corporate income***.

4) If a modest amount is left at death (beyond an exempt amount that is barely enough to keep a couple in an assisted living facility for a decade), it is taxed again by ***the estate and gift tax (the "death tax")***.

State taxes compound these biases.

The anti-saving and anti-investment biases in the income tax retard growth. The maximum combined federal corporate and individual income tax rates on dividends could exceed 60 percent before the 2003 tax reductions, and they are still are nearly 45 percent today (Chart 2). That is before state and local taxes, and is on top of the tax on the income that was used for the saving. Estate taxes and the generation skipping tax can still raise the total tax burden on income going into a taxable estate to between 80 and 85 percent. The tax disincentives to save and invest, and to work, train, and take risks, lead people to under-save and over-consume, and to work less and play more.

It has long been assumed that high graduated tax rates and added layers of tax on income used for capital formation would do little economic damage, would harm only the wealthy, and would provide significant income redistribution. In fact, income redistribution was the main justification for the "Haig-Simons" definition of income that inspired the concept of taxable income in the current income tax. Professor Simons, at least, admitted that the tax was not economically optimal, and that it would damage saving and reduce output. His disciples seem to have forgotten that consequence, and are living in a state of denial.[14]

It has become apparent, however, that most of the taxes that seem to fall on those who supply physical capital, intellectual capital, or special talents to the production process may actually be shifted to ordinary workers and lower income retirees in the form of reduced pre-tax and after-tax incomes. Even for labor, the optimal (additional) tax on the normal returns to capital is zero.[15]

Capital is far more sensitive to taxation than is labor (Charts 3 and 4). Savers can easily switch to consumption, a satisfying alternative, or send capital abroad. Many workers, by contrast, have to work to make ends meet, or work hours that are set by their employers. (The self-employed or the upper income, who can afford to retire or take time off, have somewhat more flexibility as to hours worked.) Therefore, a given tax rate imposed on labor and capital has a far greater impact on the quantity of capital than the quantity of labor offered to the market. The relatively large reduction in the in the stock of capital depresses productivity and demand for labor, which lowers wages and employment. The work force bears the economic burden of taxes on capital (Chart 5).

Chart 3 Effect of Tax On Desired Capital Stock

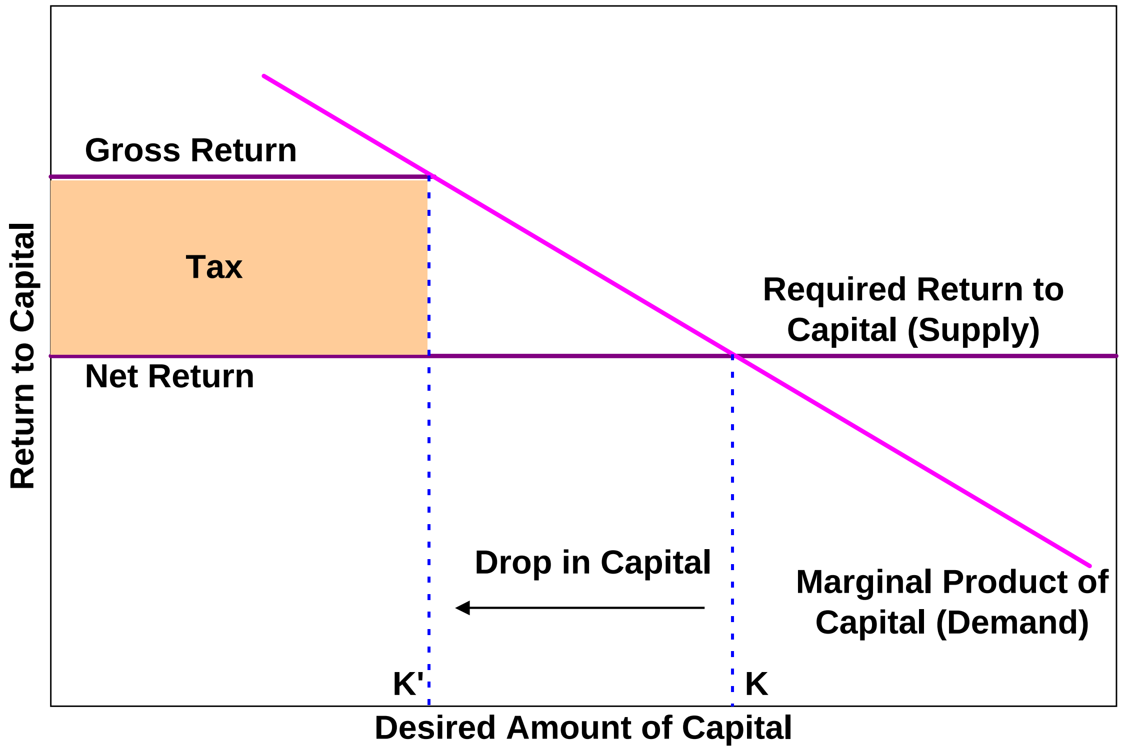


Chart 4 Effect of Tax On Labor

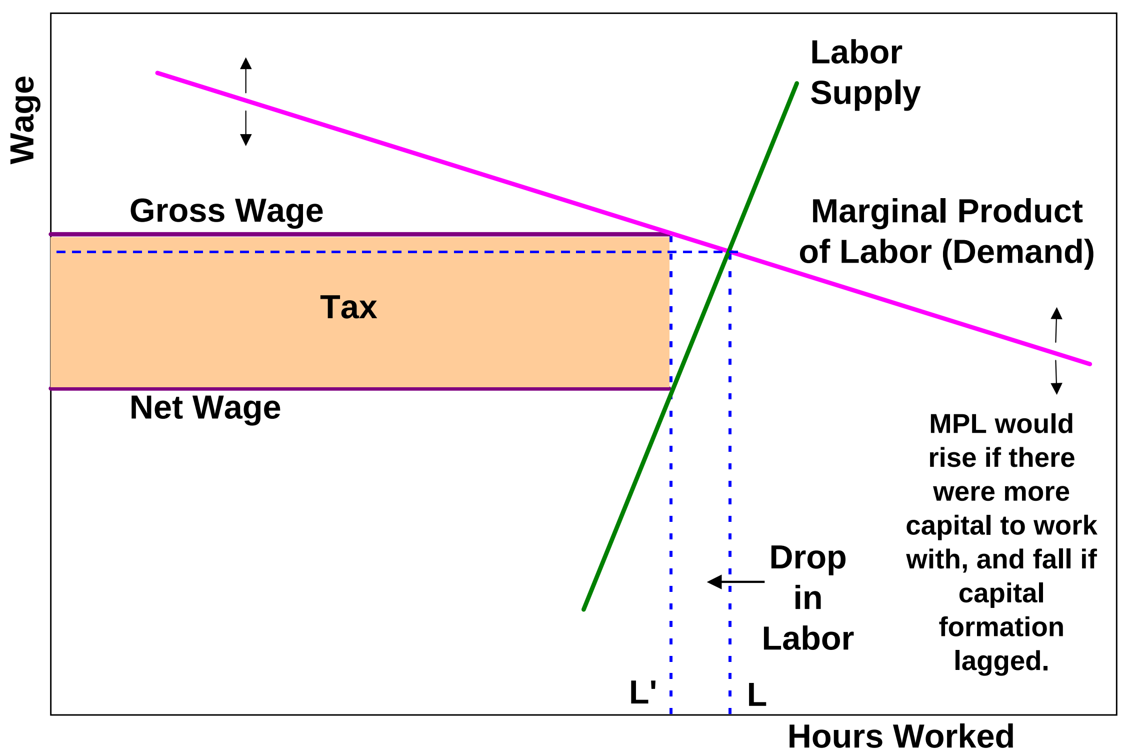
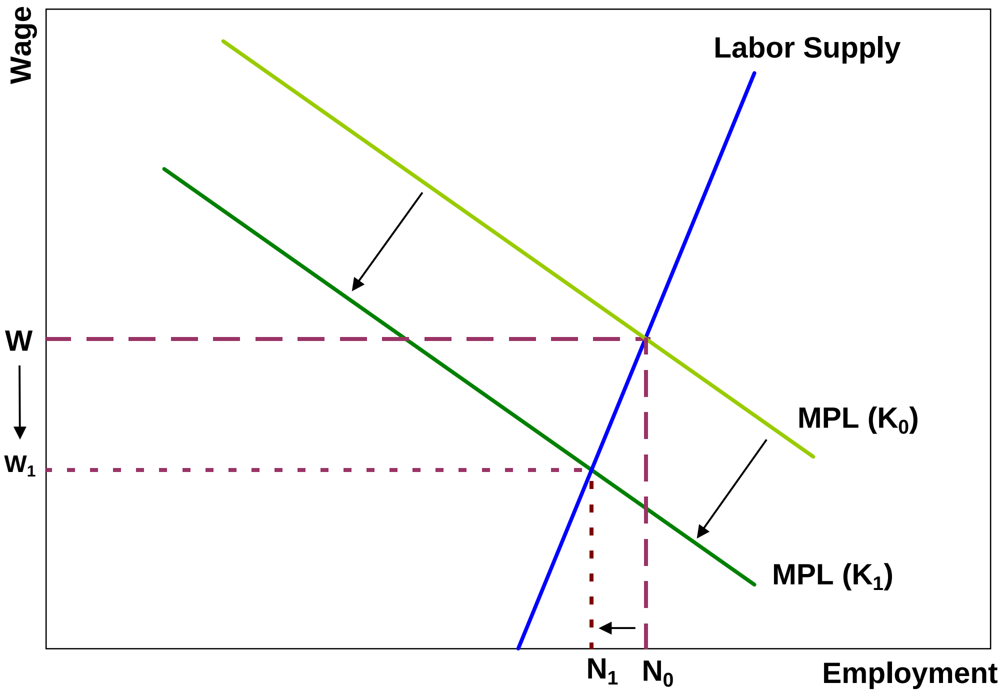


Chart 5   A Smaller Stock Of Capital Reduces Wages



Consider a small trucking company with five vehicles. Suppose that the rules for depreciating trucks for tax purposes change, with the government demanding that the trucks be written off over five years instead of three. The owner has had enough business to run four trucks flat out, and a fifth part time. He is barely breaking even on the fifth truck under old law. It is now time to replace one of the trucks. Under the new tax regime, it does not quite pay to maintain the fifth truck. The owner decides not to replace it, and his income is only slightly affected. But what happens to the wages of the fifth truck driver? If he is laid off, who bears the burden of the tax increase on the capital?

Consider another example, involving human capital, specifically, medical training. Suppose the imposition of a progressive income tax were to discourage the supply of physicians by inducing some doctors to retire, by causing others to work fewer weeks per year, and by dissuading people from applying to medical school. One result would be fewer jobs available and lower levels of productivity and incomes for nurses and support staff in medical offices and hospitals. Another would be a rise in the price of health care for consumers (including the government).

Neutral taxes can be best at satisfying the four key criteria for a good tax system.

<u>Neutrality and Growth.</u> Neutral taxes are, by their nature, more favorable toward growth than income taxes. Neutral taxes eliminate the income tax biases against saving and investment, and have flatter tax rates to avoid punishing people who work, save, and produce more output and income. Eliminating the estate and gift tax removes one layer

of tax bias. Another layer is removed by taxing corporate income either at the corporate level or at the shareholder level, but not both.[16] For full neutrality, the basic income tax bias against saving and investment must be corrected by granting all saving the same treatment as is given to pensions or IRAs, either by deferring tax on saving until the money is withdrawn for consumption (as in a regular IRA), or by taxing income before it is saved and not taxing the subsequent returns (as in a Roth IRA). The two methods are equivalent if the tax rate is the same over time (Chart 6). Either method is a boon to savers. Putting away $1,000 a year from age 20 to 70 at historical stock market yields is a saving deferred account yields $400,000, but less than $250,000 under ordinary income tax treatment (Chart 7).

President Bush's 2001 and 2003 tax reforms have gone a long way toward achieving the goal of tax neutrality. They provide for elimination of the estate and gift tax in 2010. They reduce the double taxation of corporate income by taxing dividends and capital gains at a reduced rate of 15 percent. However, the death tax returns in 2011, and the tax relief for dividends an capital gains expires at the end of 2008. At the very least, these steps should be made permanent.

The President's proposed expansion of the neutral treatment of saving in his lifetime saving accounts and pension reforms is a step in the right direction. The analogous treatment of investment is to allow immediate expensing of investment instead of lengthy depreciation. Depreciation understates business costs, overstates income, and overtaxes investment. Chart 8 shows, for example, that the value of the depreciation allowance on a seven year asset at three percent inflation is only 85 cents. The allowed tax cost of a building that must be written of over 39 years is only 37 cents. The erosion of the value of the allowed claims for cost by time and inflation greatly understates business costs, and the damage is worse the higher the rate of inflation. Assets have to be able to earn more to cover the added tax. Those that cannot never get built. Workers never get to work with these assets, and their wages suffer.[17] It was a mistake to allow the 50 percent expensing provision in the 2003 Tax Act to expire at the end of 2004. The next chart shows the effect of the 30 percent and 50 percent expensing provisions in the 2002 and 2003 tax cuts. They were the major reason why equipment spending and economic output bottomed out and then took off in 2003 and 2004 (Chart 9).[18]

There are several types of neutral tax systems. They include a cash flow or saving deferred income tax[19], a national retail sales tax, a value added tax (VAT)[20], a returns exempt Flat Tax[21], or some combination. They all either defer taxes on saving or exempt the returns to arrive at a saving-consumption neutral tax base. They all eliminate multiple taxation of corporate and individual income and of estates.

An individual cash-flow tax is collected from individuals based on their earnings less their saving, which equals their spending on consumption goods and services. The Flat Tax uses the Roth IRA method to achieve the same end result. A retail sales tax is collected by retailers based on the consumption spending of individuals, which is that part of their earnings not devoted to saving. Value added taxes are collected in increments throughout the production process by businesses based on sales less investment expenses;

Chart 6 Equivalence Of Saving Deferred And Returns Exempt Tax On Saving; Contrast With Ordinary Income Tax

Tax Treatment	Saving Deferred	Returns Exempt	Ordinary Income Tax
Pretax earnings to be saved	$100	$100	$100
Tax on saving	0	20	20
Amount saved	100	80	80
Is interest on inside build-up taxed?	No, 7.2% reinvested	No, 7.2% reinvested	Yes, 5.76% reinvested
Account after 10 years	200	160	140
Tax due on withdrawal	40	0	0
After-tax spendable balance	160	160	140
Cost to saver of ordinary tax treatment			20 (= 160 – 140) (a third of the interest)

Illustration assumes 7.2% pre-tax interest rate, 20% tax rate, and 10-year investment.

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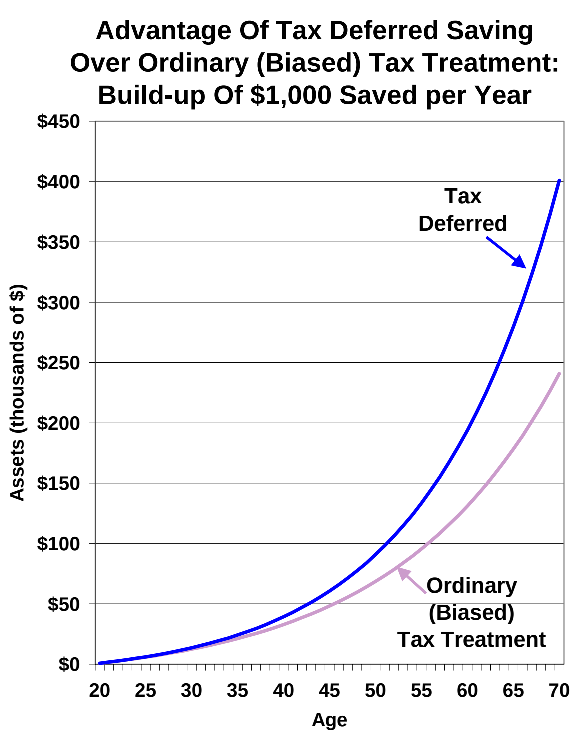
Chart 7 Advantage Of Tax Deferred Saving Over Ordinary (Biased) Tax Treatment; Build-up Of $1,000 Saved per Year



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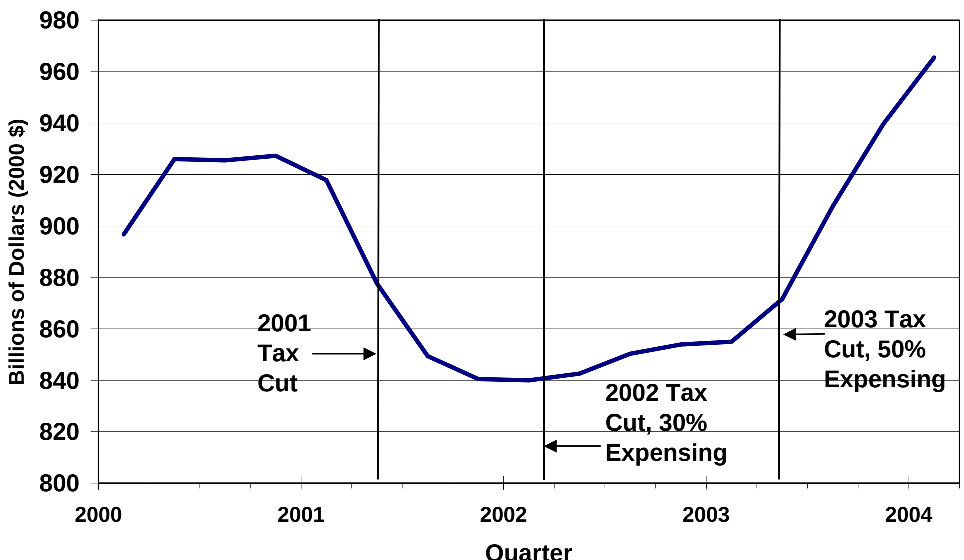
Saving from age 20 onward, under tax-deferred system and ordinary "double taxation" (assume 7.2% interest rate, 20% tax rate).

Chart 8 Present Value of Current Law Capital Consumption Allowances per Dollar of Investment Compared to Expensing (First-Year Write-Off)

Asset lives:		3 Yrs	5 yrs	7 yrs	10 yrs	15 yrs	20 yrs	27.5 yrs	39 yrs
Present value of first-year write-off of $1 of investment:		$1.00	$1.00	$1.00	$1.00	$1.00	$1.00	$1.00	$1.00
Present value of current law write-off of $1 if inflation rate is:	0%	$0.96	$0.94	$0.91	$0.88	$0.80	$0.74	$0.65	$0.55
	3%	$0.94	$0.89	$0.85	$0.79	$0.67	$0.59	$0.47	$0.37
	5%	$0.92	$0.86	$0.81	$0.74	$0.60	$0.52	$0.39	$0.30
Assumes a 3.5 percent real discount rate, 3-20 year assets placed in service in first quarter of the year, 27.5 - 39 year assets placed in service in January.									

Institute for Research on the Economics of Taxation (IRET)

Chart 9
Real Private Investment - Equipment And Software And 2001, 2002, and 2003 Tax Cuts



Data Source: BEA NIPA Table 5.3.6, line 9

Institute for Research on the Economics of Taxation (IRET) sales less investment equals national income less saving, which again equals the amount spent on consumption of final goods and services. (The Flat Tax may also be thought of as taxing capital income at the business level with expensing, like the VAT.) In other words, these taxes all have the same fundamental tax base.

Some writers make artificial distinctions among saving-consumption neutral taxes, referring to them as consumption taxes if they are of the sales tax or VAT variety, and as saving-deferred or saving-exempt income taxes if they are of the cash flow type or Flat Tax, as if to imply that they generate different incentives to save or consume. In fact, the point of collection of the taxes does not change their common nature; they are all saving-consumption neutral taxes on people's incomes (properly defined).

Each of the types of neutral taxes has the potential to accommodate a single low tax rate on income, and to eliminate the alternative minimum tax and the estate tax. The systems all have expensing instead of depreciation (or equivalent non-taxation of investment outlays), and no separate taxation of capital gains. Each is territorial, and can substantially reduce the confusing treatment of foreign source income that cripples American businesses operating abroad.[22] Many of the major sources of complexity in the current tax code would be gone.

Under all of the neutral tax systems, the costs of buying and operating equipment, factories, commercial buildings, and residential real estate, would all be lower. With a lower tax hurdle, several trillion dollars of capital investment that is just not sustainable under current tax law would become possible. Investment would boom for a decade or more, productivity would rise at a rapid clip, and wages would match the gains.

If the GDP were to be ten percent higher under the new tax regime, it would raise incomes for middle income families by about $4,000 to $6,000 a year. Everyone would gain. Labor would gain most of all. Capital formation boosts productivity and wages. Every dollar of additional GDP made possible by additional capital formation yields about 50 cents in higher after-tax wages, about 30 cents in higher federal, state, or local tax revenue, requires about 15 cents to replace the capital as it wears out, and returns about a nickel to the savers and investors.

The United States would be a magnet for capital intensive industries furnishing higher paying jobs. Starting a new business would be far easier, because one could concentrate on running the business instead of figuring out tax forms. One could put one's money to work expanding a business instead of paying insurance premiums to keep the business in the family in the event of one's death.

<u>Neutral taxes and visibility.</u> Visibility means that the voting public is well aware of how much the government is costing them. Among the various neutral taxes, those collected from individuals are more visible, and those collected by businesses are less visible. Some neutral tax plans have recommended very large exempt amounts. Visibility requires that, excepting the very poor, as many people as possible pay tax so that, as voters and consumers of government services, they will be aware of what government

costs, and realize that government is not a free good. Neither simplicity nor fairness should be used as an excuse for exempting tens of millions of people from tax.

Neutral taxes and simplicity. Neutral taxes are inherently simpler than income taxes. Picture the current stacks and stacks of tax forms that a parent, a small business owner, a saver, a retiree, or a low income worker receiving the EITC must fill out. Think of the worksheets that govern the taxation of Social Security benefits and the phase-outs of deductions, exemptions, and credits. Think of Schedule D, and of having to list dozens or hundreds of stock trades. Think of the dozens of depreciation schedules and the complexity of recapture on Schedule C.

Think about the rules relating to how much you can put into what kind of pension plan or IRA or education account, when and how much you have to start withdrawing, and what happens to you if you miscalculate. Try to figure out the foreign tax credit form without computer assistance. Picture doing it all over again if you run afoul of the alternative minimum tax (either the individual AMT, or, if you are a corporate tax officer, the corporate AMT, which taxes corporations more heavily when they are suffering reduced earnings in a recession, or trying to grow rapidly and increase employment). Try to plan sensibly for the estate and gift taxes without a tax attorney on your payroll and an insurance broker on call.

Now picture throwing that all into the waste basket. Under neutral taxes, even those that are collected from individuals, the filing would be a relative snap. There would be no vast array of credits and exemptions phased in or phased out. There would be no list of stock trades, no Schedule D, no separate calculation or peculiar taxation of capital gains. There would not be dozens of different pension arrangements; all saving would either be tax deferred without rules and limits, or would have been done after-tax with no taxation of the subsequent earnings.

There would be no depreciation schedules and no keeping track of different rules for different machines and buildings over many years; investment in machinery, buildings, land, resources and research would be deducted dollar for dollar in the year it was made. There would be no foreign income and foreign tax credit offset to compute, and less need for the IRS to rely on information from foreign banks or businesses to enforce U.S. tax law. Tax treaties would relate only to the accurate allocation of costs between parts of a multinational business.

Picture a tax system in which the individual tax forms fit on two sides of a sheet of paper, nearly all the numbers were provided by one's employer, bank, broker, or credit card company, and it only took a day to do.[23] Alternatively, picture a Fortune 500 business sending in a tax form that weighed one pound instead of one hundred. Picture fifty thousand tax accountants and IRS agents lining up to teach math in grade schools across the country.

Neutral taxes and fairness. It is clear that neutral taxes are fairer than income taxes, if one understands the nature of income. Income is the payments that people receive for contributing to the production of goods and services by working or making capital available. Except in rare cases, people are paid in proportion to how much they add to the value of output. If income is proportional to effort and one's contribution to the economy, then a flat rate proportional tax, with no tripling up of taxes on saving and investment, is arguably the fairest tax.

Kindness and charity urge that the poorest citizens be relieved of the requirement to share in the cost of government. Neutral taxes can be made progressive via rebates (if the tax is levied on businesses) or by a personal exempt amount or even multiple tax rates (if levied on individuals), but that should not be carried to excess. Income support programs are best handled outside the tax system as explicit payments by federal and state agencies other than the Treasury.

Nonetheless, neutral or "consumption-based" taxes can be made progressive to the degree that is deemed desirable. It is not necessary to double or triple tax saving and investment to have a progressive tax. That was the main rationale for the income tax in the 1930s, but we know better today. We can have a fair and charitable neutral tax and still enjoy the added growth of jobs and income that the correct treatment of saving and investment creates.

Neutral taxes encourage investment in education, and encourage highly skilled people to keep working and to keep employing others. Spending a hundred thousand dollars on schooling, and losing four to eight years of paychecks, is a major sacrifice. The reward is a higher level of skill and income, compressed into a shorter working life. Graduated tax rates and the lack of a deduction for investment in education penalize such people. A flat or flatter rate neutral tax system would end that discrimination.

Bear in mind that growth generates a higher level of income across the board, and is a good thing for everyone. It is hardly fair if a misguided effort to redistribute the pie causes the pie to shrink, and it is worse than a crime, it is a blunder if such efforts hurt the poor the most.

Budget and distributional concerns.

Count the gains from growth in determining the budget impact of tax reform. The potential for faster growth of jobs and incomes should allay concerns that tax reform might force a choice between higher short-term budget deficits and tax increases for some taxpayers.

As saving and investment increase, productivity and the taxpayer's income will grow faster for a decade or more and be higher by increasing amounts over time. When we look at how tax reform affects a family or individual worker or taxpayer, it is not enough to apply the new tax code to last year's income because neither the economy nor the taxpayer will behave the same way after tax reform as before.

The taxpayer will enjoy lower interest rates on mortgages and student loans as the tax burden on saving is reduced. Although reduced taxes on saving may not instantly lower the tax of a twenty-year-old who has not yet begun to save, it will lower taxes on that worker as he or she accumulates assets over a working lifetime, and leave that worker many tens of thousands or even hundreds of thousands of dollars better off by age 65, and far more secure in retirement. Whatever happens the first year, people will enjoy a lifetime of benefits from a pro-grow tax reform, and it is the lifetime benefits that matter.

As for the federal budget, there are many benefits, short term and long term. People would immediately have less incentive to shelter their existing income from tax, and the Treasury would see some revenue offset to any net tax reduction even before any rise in economic activity and income. In addition, of course, national income would grow faster, right from the start. An extra point on the growth rate would add a cumulative extra half trillion dollars to federal revenues over seven years.

There would also be gains on the spending side of the budget. More people working, and working at higher paying jobs, would men a natural reduction in claims for income support payments. In light of the great benefits of reform to the economy, the population, and the budget, it would be wise to forge ahead, regardless of the transitory budget consequences. If the transitory costs to the Treasury are of real concern to lawmakers, they can best be addressed by restraining the growth of federal spending to accommodate the tax reform.

Conclusion

Tax reform is not about shifting the tax burden to someone else, eliminating individual tax filing or making it painless, eliminating millions from the tax rolls, eliminating all deductions, eliminating the IRS, or eliminating competition from foreign companies or countries.

Tax reform is not just an indiscriminate "broadening the base and lowering the rate."[24] It is about getting the tax base right and setting rates that cover the amount of government that people want to have.

Tax reform is about raising revenue in a manner that does less damage to the economy than current law, and that better informs the public what it is paying for government so that voters can make informed decisions about how much government activity they wish to support. Get tax reform right, and we will have a better economy and a better government.

Endnotes

1. Stephen J. Entin and Norman B. Ture, "The Inflow Outflow Tax: A Savings Deferred Neutral Tax System," 1998, <ftp://ftp.iret.org/pub/InflowOutflowSum.PDF>.

2. Stephen J. Entin, "The Economics of Taxation and The Issue of Tax Reform," IRET Paper, April 24-27, 2003, <ftp://ftp.iret.org/pub/EntinNewOrl-2003.PDF>.

3. Stephen J. Entin and Lawrence A. Hunter, "Reforming Taxation: Attributes Of A Good Tax System And Principles To Guide Reform," *IRET Congressional Advisory*, No. 183, January 19, 2005, <ftp://ftp.iret.org/pub/ADVS-183.PDF>.

4. Stephen J. Entin, "Renew Bonus Expensing To Keep Recovery Strong," *IRET Congressional Advisory*, No. 173, May 6, 2004, <ftp://ftp.iret.org/pub/ADVS-173.PDF>.

5. Bruce Bartlett, "The End of Tax Expenditures As We Know Them?" *IRET Policy Bulletin*, No. 84, June 13, 2001, <ftp://ftp.iret.org/pub/BLTN-84.PDF>.

6. Stephen J. Entin, "Tax Incidence, Tax Burden, And Tax Shifting: Who Really Pays The Tax? " *IRET Policy Bulletin*, No 88, September 10, 2004, <ftp://ftp.iret.org/pub/BLTN-88.PDF>.

7. Michael Schuyler, "Phase-Outs Are Bad Tax Policy," *IRET Policy Bulletin*, No. 71, January 16, 1998, <ftp://ftp.iret.org/pub/BLTN-71.PDF>.

8. Norman B. Ture, "Taxes and the Good Society," Lecture by Norman B. Ture, Delivered at Center for Economic and Policy Education, Saint Vincent College, September 13, 1995, <ftp://ftp.iret.org/pub/TaxesGoodSoc.PDF>.

9. See note 11.

10. Bruce Bartlett, *The End of Tax Expenditures As We Know Them?, op. cit.*

11. Such issues were not considered in 1986, and the results were not good. The Tax Reform Act of 1986 was often described as "broadening the base and lowering the rates." Although this is sometimes offered as a definition of a sound tax reform, it misses many basic points. In fact, the 1986 Act was a major disappointment. It lowered personal tax rates at the margin, which was a good step toward economic efficiency. However, it sharply raised tax rates, at the margin, on new saving and investment, which increased the income tax bias against those activities. It did so, in the guise of base broadening, by removing provisions that mitigated the multiple layers of tax imposed on income from saving and investment. The Act eliminated the investment tax credit, lengthened asset lives for cost recovery purposes, ended the capital gains differential, imposed or tightened income and contribution limits on tax deferred retirement savings plans, and introduced passive loss rules on real estate that depressed returns in that sector for investors who were not active managers of their properties. The minor efficiency gains that came from canceling a few peculiar tax breaks for certain other activities in no way made up for these across-the-board increases in the taxation of capital.

In effect, the Tax Reform Act of 1986 moved the hybrid tax system in the direction of a purer broad-based income tax. The Act paved the way for the stock market crash of October 1987, and led to weakness in investment in plant, equipment, and real estate that, along with two payroll tax increases in 1988 and 1990, set the stage for the recession of 1991-92. The 1986 Act also removed several million people from the income tax rolls, making them less concerned about the cost of government and less interested in controlling federal spending and tax rates in the future.

12. This framework owes much to the work of IRET's founder, the late Norman B. Ture. See his papers: "Taxes and the Good Society," *op. cit.*; "Restructuring The Federal Tax System" *IRET Policy Bulletin*, No. 65, December 15, 1995, <ftp://ftp.iret.org/pub/ BLTN-65.PDF>; and "Federal Tax Policy and the U.S. Economy: Policy Options for Improving Both," March 13, 1997, <ftp://ftp.iret.org/pub/FedTaxPol-Improv.PDF>. For an overview of a model tax system that Dr. Ture proposed based on these principles, see Stephen J. Entin and Norman B. Ture, "The Inflow Outflow Tax — A Saving-Deferred Neutral Tax System," *op. cit.*.

13. For more on the biases against saving in the current income tax, see Stephen J. Entin, "The Economics of Taxation and the Issue of Tax Reform," <ftp://ftp.iret.org/pub/EntinNewOrl-2003.PDF>; Stephen J. Entin, "Fixing The Saving Problem: How The Tax System Depresses Saving, And What To Do About It," *IRET Policy Bulletin*, No. 85, August 6, 2001, p. 15 ff, <ftp://ftp.iret.org/pub/BLTN-85.PDF>. Also see David F. Bradford and the U.S. Treasury Tax Policy Staff, *Blueprints for Basic Tax Reform*, 2nd ed., revised (Arlington, VA: Tax Analysts, 1985).

14. Any justification of the comprehensive or broad-based income tax and the additional corporate and death duties must rely on significant non-economic social benefits, because these taxes impose high economic costs, including reduced incomes across the board. The usual social benefit assumed for the income tax is that it may be used to reduce income inequality. However, redistribution lowers total income, especially labor income, and the process can hurt those it is designed to help. Early advocates of using the broad-based income tax for redistribution, such as Professor Henry C. Simons, acknowledged some of the costs.

Simons admitted that the income tax is not economically ideal. He reasoned that, since the rich save more than the poor, taxing saving more heavily than consumption would be "progressive". Simons also favored making the marginal tax rate structure graduated (higher tax rates imposed on incremental taxable income as it exceeds specified levels) to further increase the progressivity of the system. The pure Simons definition of income did not allow for a corporate tax in addition to the individual income tax, however, because that would have been an additional layer of double taxation.

Professor Simons was well aware that the twin distortions of the tax base and the rate structure inherent in the income tax could lead to a drop in saving, investment, and national income. In his magnum opus, *Personal Income Taxation*, (Chicago, IL: University of Chicago Press, 1938), Simons wrote:

> The case for drastic progression in taxation must be rested on the case against inequality — on the ethical or aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly evil or unlovely...
>
> The degree of progression in a tax system may also affect production and the size of the national income available for distribution. In fact, it is reasonable to expect that every gain, through taxation, in better distribution will be accompanied by some loss in production...
>
> [I]f reduction in the degree of inequality is a good, then the optimum degree of progression must involve a distinctly adverse effect upon the size of the national income... (Simons, pp. 18-20.)

Simons took seriously the possibility that saving and investment would suffer from his policy prescription:

With respect to capital accumulation, ...the consequences are certain to be significantly adverse... [I]t is hardly questionable that increasing progression is inimical to saving and accumulation... That the net effect will be increased consumption ... hardly admits of doubt." (Simons, pp. 21-23.)

Simons's remedy was not to do away with progressivity, but to offset its effect on saving by running federal budget surpluses. The assumption that the government virtuously would run large budget surpluses to make up for the anti-growth consequences of a biased and progressive tax system has proven to be utterly naive. Furthermore, a budget surplus cannot make up for the adverse effects that high corporate or individual tax rates and unfriendly capital cost recovery allowances have on the present value of after-tax cash flow from an investment, a calculation that any business school graduate will undertake in deciding on the feasibility of an investment project. Thus, even an offsetting budget surplus would not prevent a reduction in the equilibrium capital stock from a reduction in the marginal return on investment.

Professor Alfred Marshall, who bowed to the general acceptance of progressivity, nonetheless favored a more neutral graduated tax on consumption over a graduated tax on income: "[T]here is a general agreement that a system of taxation should be adjusted, in more or less steep graduation, to people's incomes: or better still to their expenditures. For that part of a man's income, which he saves, contributes again to the Exchequer until it is consumed by expenditure." (Alfred Marshall, *Principles of Economics*, Eighth Edition (1920), Philadelphia, PA, Porcupine Press, reprinted 1982, p. 661.)

As Marshall pointed out, one does not need to adopt a non-neutral income tax to achieve progressivity. Saving-consumption neutral taxes can be made progressive as well. In fact, it is not necessary to have graduated tax rates to achieve progressivity. A tax which exempts some amount of income at the bottom, and imposes a flat marginal tax rate on income above that amount, is progressive, because the average tax rate will rise with income. A graduated consumption-based tax is not as economically efficient as a flat rate consumption-based tax, because it increases the tax penalty at the margin the more productive an individual becomes and the more effort he or she makes. Nonetheless, it is far more efficient than a graduated income tax.

15. Several studies in the economic literature illustrate that neutral treatment of capital income would raise the after-tax income of labor, in present value terms, even if labor must pick up the tab for the lost tax revenue. That is, a tax on capital is effectively shifted to labor. For a further discussion of tax shifting and the literature on optimal taxation of capital, see Stephen J. Entin, *Tax Incidence, Tax Burden, And Tax Shifting: Who Really Pays The Tax?, op. cit.*

16. The Treasury issued a report on corporate individual tax integration in 1991, and there is a long literature on these mechanisms. Most other developed countries use one approach or another to mitigate double taxation of corporate income, and have lower corporate tax rates as well.

17. For a further discussion of the merits of expensing, see Entin, *The Economics of Taxation and the Issue of Tax Reform, op. cit.*, <ftp://ftp.iret.org/pub/ EntinNewOrl-2003.PDF>. Also David Bradford, *Blueprints for Basic Tax Reform, op. cit.*.

18. See Stephen J. Entin, "Renew Bonus Expensing To Keep Recovery Strong," *IRET Congressional Advisory*, No.173, May 6, 2004, <ftp://ftp.iret.org/pub/ADVS-173.PDF>.

19. A tax on income less net saving, in which all saving is tax deferred in the manner that current law allows for limited amounts of saving in an ordinary IRA, 401(k), or pension. This type of tax is also called an inflow-outflow tax, a consumed income tax, an individual cash flow tax, or an expenditure tax.

For a full description, see *The Inflow-Outflow Tax*, *op. cit.*, <ftp://ftp.iret.org/pub/
InflowOutflowSum.PDF>.

20. Value added taxes include European style credit invoice method VATs, goods and services taxes or GSTs (as in Canada and Australia), subtraction method VATs, and business transfer taxes.

21. A returns exempt tax does not allow a deduction for or deferral of current saving, which must be done on an after-tax basis, but it does not subsequently tax the returns on that after-tax saving. It is the method used for Roth IRAs.

22. All the major saving-consumption neutral taxes would lead to international tax simplification because all are territorial. That is, they are imposed on economic activity within the United States, and not on economic activity conducted by U.S. residents elsewhere in the world. The present global income tax requires U.S. residents to report income from around the world, and then to file for a foreign tax credit to avoid double taxation. Moving to a territorial system, not only for businesses but for individuals as well, would provide great simplification for taxpayers and would reduce administrative and enforcement costs for the IRS with little revenue consequence. It would also greatly enhance the competitiveness of U.S.-based multinational firms that must compete with foreign firms whose home countries have territorial regimes and lower corporate tax rates than the United States. It would be expected to raise exports of intermediate goods and services of multinational businesses to their affiliates abroad, and lead to more demand for the research and management functions of the U.S. parents.

Sales taxes and VATs are generally imposed on imports and remitted or not levied on exports. This feature is called border adjustability. The border-adjustable form is natural because sales taxes (and the final layer of the VAT) are collected at the point of final sale to consumers. With border adjustment, any purchase, whether domestic or foreign in origin, triggers the same tax at the cash register. Consumed-income taxes and the Flat Tax are not explicitly border adjustable, because they are collected from individuals as they earn. However, these taxes fall on income before it is used for consumption, and so the tax falls on income used to buy a domestic good or an import. The tax is not levied on foreigners buying U.S. exports. These taxes may be thought of as implicitly border adjustable. Border adjustment and territoriality are different concepts.

23. A simple neutral individual cash flow tax might arguably be considered the optimal tax system. An example is the Inflow-Outflow Tax expounded by the late Norman B. Ture at the Institute for Research on the Economics of Taxation. It is levied only on individuals, and is therefore the most visible tax system. In it, people would defer tax on saving and investment (including tuition invested in human capital), and deduct any income they transfer to others (as gifts or as taxes). Thus, charitable gifts, payroll taxes, and taxes paid to state and local governments would be deductible (and recipients of transfers would report the receipts as taxable income if it exceeded exempt amounts).

Saving would be deducted from taxable income. Withdrawals from saving would be added to income. One's bank or broker would give one the required amount to enter on the tax form. There would be an exempt amount to protect the poor, and, ideally, a single (flat) marginal tax rate on all other income, which would minimize all other distortions of economic activity. Investment in inventories, equipment, and buildings for one's business would simply be expensed. The I-O tax would fall on virtually the same tax base as a national retail sales tax, but would be more visible to the taxpayer/voter, and would do a better job of "costing out" government. See *The Inflow-Outflow Tax, op. cit.,*
<ftp://ftp.iret.org/pub/InflowOutflowSum.PDF>.

24. We do not want another Tax Reform Act of 1986. See note 11 and *Reforming Taxation: Attributes of a Good Tax System and Principles to Guide Reform* op. cit., <ftp://ftp.iret.org/pub/ADVS-183.PDF>,