

**The Scouting Report – Fix the Tax System  
Live Web Chat with *Politico* Chief Lobbying and Influence Writer Jeanne Cummings and Brookings Vice President of Economic Studies William Gale  
December 3, 2008**

**12:30 Jeanne Cummings-Moderator:**

Hi everyone and welcome to today's edition of the Scouting Report. I'm Jeanne Cummings, and I will be your moderator for today's chat. I'd like to welcome William Gale, Vice President and Director at the Brookings Institution.

**12:31 Jeanne Cummings-Moderator:**

Let's get things started with a question we received via e-mail. Do you think a second fiscal stimulus should be issued? If so, what form should it take?

**12:31 William Gale:**

The need for a fiscal stimulus is undeniable. Recent efforts can't be pushed much farther: the Fed Funds rate has already sunk to 1 percent and can't sink much lower. Investments in U.S. infrastructure should be a crucial part of the stimulus package. Other major components should be aid to states to help with Medicaid funding and general budget expenditures and further extension of unemployment benefits.

**12:31 [Comment From John]**

Can Obama achieve his tax goals?

**12:33 William Gale:**

Obama has a very ambitious agenda, for both tax policy and other areas of economic policy. There is a thought that the deficit will prohibit activist legislation, but my view is that the Administration and Congress both view, correctly, that the economic situation and financial crisis is a bigger risk than the short-term deficit and so will act aggressively. So, in short, yes he can!

**12:35 Jeanne Cummings-Moderator:**

The recent runoff election in Georgia, however, highlights one of Obama's greatest challenges -- Republicans will still have enough votes to block some Obama initiatives. They will be under enormous pressure from the business community to block any tax increases and may have the political muscle to do so.

**12:35 [Comment From Marc Grossman]**

I agree that a stimulus pkg is needed, but it needs to be handled correctly. Not like the ridiculous bailouts that have been mismanaged and are only serving big business.

**12:37 William Gale:**

You're absolutely right. Both the size and structure of the stimulus package merit attention. In terms of size, it needs to be quite large--estimates have ranged from \$500 billion over two years to up to a trillion dollars. In terms of structure, it needs to focus on things that will stimulate the economy, get people spending and get people back to work

or let them keep their jobs. The best options are infrastructure spending, aid to states and local governments, and Unemployment benefits. Tax rebates have not worked well, nor would things like capital gains tax cuts.

**12:38 [Comment From Ian]**

What will happen when the Bush tax cuts expire in 2010?

**12:40 Jeanne Cummings-Moderator:**

If Obama has not been able to pass his tax plan by then, those tax cuts are likely to expire. In some ways, this could be the best scenario for the Democrats. They could go into the 2010 mid-term elections without having a single vote on raising taxes but likely with a claim that they reduced taxes on middle income households. After the election, the Bush tax cuts would expire -- again without the Democrats having to cast a single vote.

**12:40 [Comment From Sarah]**

I'm still a bit confused about Obama's tax plan how can he reduce tax on all the people making less the 250 thousand? How can he pay for all the other stuff he wants to do?

**12:42 William Gale:**

The short answer is that right now, he can't, and he isn't trying too. The immediate concern is to stimulate a teetering economy with a very fragile financial system. Almost any policy that does that is going to raise the deficit further. In the medium and longer term, options like spending cuts, carbon taxes (or the revenue from selling permits in a cap and trade system), or other taxes like a value added tax will needed to close the large and growing gap between federal spending and revenues.

**12:42 [Comment From Jeff Lord]**

Hi Bill - A month or so ago, an academic testified at a House hearing that the federal government should eliminate the tax deferral for 401(k)s in favor of an entirely new system. Chmn George Miller initially seemed to support the idea, but appears to have backed away. Do you think fundamental changes to 401(k)s are needed? And even if you don't think so, do you think the Obama Admin will support dramatic changes to 401(k)s? Aren't traditional DB plans at many companies (and for many local and state employees) suffering as much as DCs?

**12:44 William Gale:**

The financial meltdown has reopened longstanding discussions about the best way to set up a pension system. There are some changes that we should be pursuing, regardless of the financial meltdown -- creation of automatic IRAs (for people who don't have access to 401(k) plans or DB plans), making the savers credit refundable (so people with low income can actually benefit from it) and changing the credit to a flat rate matching payment that goes into people's accounts directly (rather than as a tax deduction that encourages spending).

**12:46 William Gale:**

I don't think the Administration will try to dissolve 401(k)s. I do think that changes in 401(k)s could be beneficial. First, making the choices more automatic in terms of enrollment, saving levels, investment allocations. Second, converting the deduction for the contributions to flat rate matching contribution to the account. Third, getting investors to focus on **\*\*generating income in retirement\*\*** rather than asset accumulation per se. In brief, the last point is that people should be buying more annuities, as they go through the life cycle, and not waiting till age 65 to buy them. This will be a big push, I think, now that the market has fallen 40% and people remember that stocks are risky.

**12:47 William Gale:**

DB plans are clunky and are unlikely to be revived per se, but many of their features -- like automatic enrollment and like the focus on retirement income provision rather than asset buildup -- will translate compellingly to a 401k world, after the crash.

**12:47 [Comment From Marc Grossman]**

Again, I agree with what you are saying. The previous stimulus pkg had little if any affect whatsoever.

**12:48 [Comment From Sarah]**

How will president-elect Obama be able to offer true tax help to small business owners?

**12:51 Jeanne Cummings-Moderator:**

Obama has suggested many ways to help small businesses, but the major chunk of his plan is embedded in his tax policy. According to the president-elect, most small businesses earn less than \$250,000 -- which means that they would fall into his category for tax cuts and under his promise never to face a tax increase. The Congress also addressed this income issue recently when it increased the government insurance on bank accounts to \$250,000. That proposal was a response to small businesses seeking greater protection in the difficult economic times and it was aimed at discouraging them from taking money out of the bank and splitting up their accounts to ensure they qualified for government backing.

**12:52 William Gale:**

And the best thing that can be done for small business is to get the economy as a whole going again. We need generalized stimulus right now, not targeted subsidies.

**12:52 [Comment From Brett]**

Obama and Senate Finance Committee Chairman Max Baucus have said they want health care reform to be the first priority after stimulus. What tax policy changes do you expect to make the cut in their efforts and will it do anything toward a greater goal of reforming the broader tax system?

**12:54 William Gale:**

Right now, firms get tax deductions for the health insurance they provide to their employees and employees do not pay taxes on this. This results in expensive, regressive, open-ended policies that encourage gold-plated health insurance plans and leave low-

income households out of the loop. A better strategy would be to convert the deduction to a fixed credit -- say \$5,000 for a married couple -- for the purchase of health insurance. This would save money, raise health insurance coverage rates, be progressive and so on. Both R's and D's have supported this idea in various guises recently.

**12:54 [Comment From Ian]**

Should we get rid of or at least modify the mortgage interest deduction when the housing market recovers? It seems highly distortive to me.

**12:57 William Gale:**

Obviously, this is NOT the time to do anything that reduces house values. However, when the crisis passes and the housing market is stabilized, I would support converting the MID (which is regressive, expensive and open-ended and encourages purchases of oversized houses with oversized loans -- that is, is very similar in structure and effect to the health insurance deduction) to a fixed first-time home buyers tax credit, refundable, of say \$10,000. This would save money, be less regressive, and would actually encourage home ownership (the MID does not do that, it mainly raises land and house values). But, I must emphasize, now is not the right time to do this!!

**12:58 Jeanne Cummings-Moderator:**

Back on health care, the plan promoted by Bill is pretty close to the one John McCain had included in his campaign platform. Voters didn't warm up to it in large part because they are very leery of tinkering with the employee-based health insurance system. That's one reason Obama repeatedly told voters that his health care reforms would not replace the current system.

**12:59 William Gale:**

Interestingly, the leading Democrat who has supported this proposal is Jason Furman, a key member of Obama's team. I think there is a difference between a partisan campaign and the need to find solutions that are bi-partisan and effective when governing. I would not be surprised if there was an effort to make this type of reform a cornerstone of a bi-partisan effort to reform health care.

**1:00 [Comment From Larry]**

Do you think closing the corporate loop holes in the tax system will cost our economy even more?

**1:01 William Gale:**

There is broad consensus among tax experts that broadening the tax base (i.e., removing loopholes) and reducing tax rates is the right way to reform the system. Right now, we have a narrow tax base, with lots of loopholes/exemptions/deductions/etc. A broad base, low rate system taxes everything at the same rate, removes incentives to avoid or evade taxes, is fairer and can generate significantly more revenue than the current system.

**1:02 William Gale:**

That's all a long way of saying that reducing corporate loopholes in conjunction with lowering the rate would be a good direction for tax policy to move.

**1:02 Jeanne Cummings-Moderator:**

Shifting our focus a bit, what do you think about taxing or capping carbon emissions?

**1:03 William Gale:**

Certainly the right strategy is to make it more expensive to use and emit carbon, which is the source of global climate change problems. This could be accomplished via a direct tax on carbon emissions or via a cap on carbon emissions, with the government selling permits to pollute. The two approaches are equivalent in economic terms and would produce wide-ranging benefits. Fortunately, the cap and trade mechanism for taxing carbon was supported by Senator McCain during the presidential election, and continues to be supported by members of both parties, making this reform politically safer than in the past.

**1:03 [Comment From Dave]**

What is your position on HR Bill 25 which is the FairTax Bill? It is endorsed by 81 House members and 9 Senators? It is simple, efficient, equitable, and backed up by in depth research. Mike Huckabee talked about it in his campaign, but no one has mentioned it again. Imagine getting 100% of your paycheck and getting taxed on what you consume and not on what you earn.

**1:06 William Gale:**

The short answer is that the so-called FAIR TAX is not a good idea. The 23% rate that is supposed to hold is based on bad calculations. I have written extensively on this, won't bore you with details here. The tax is probably not enforceable at the rates that would be required, especially when state sales taxes and reasonable amounts of evasion are added in. The whole thing is based on faulty premises or misleading statements -- like the example that people get to keep all of their pay check. Yes, they do, but they still pay the same amount of taxes, they just pay it when they buy the good instead of when they earn the money. There are numerous other deceptions that advocates have employed like claiming that the price level will fall (it might, but if it did, wages would fall too so there would be no net gain). In short, not a good direction for tax policy, and even worse, a very deceptive campaign put forth by its advocates.

**1:08 Jeanne Cummings-Moderator:**

Just one more thought -- I don't think I'd want to be one of the politicians who voted to eliminate the home mortgage deduction that many take each year. Not only would it wipe out plenty of rebate checks, it would probably do even more harm to the housing industry.

**1:09 [Comment From Joe Peters]**

In a paper with Orszag and Gruber you suggested to increase equity we could eliminate the inequitable tax preference for IRAs and 401(k)s and replace it with a flat 30 percent

government retirement savings match. Do you see any hope this type of fundamental reform in the Obama administration?

**1:11 William Gale:**

I am pleased that someone has read the paper! That proposal is what I was alluding to above. I think it makes sense, and I think people might be ready to think about enacting it. The broader issue is that one of the forgotten ways to reform the tax system is to restructure deductions -- see the discussion of mortgage and health and saving deductions above. I think this will catch on soon because the existing deductions are extremely expensive, very regressive and largely don't achieve the goals they are aimed at achieving. So, I think it is a real possibility that legislation moves in that direction.

**1:13 [Comment From Joe Peters]**

I had no choice; my professor made me read it. :)

**1:13 Jeanne Cummings-Moderator:**

Let's shift directions one more time. How should we think about the budget deficit in a recession? Does it matter?

**1:15 William Gale:**

The deficit certainly does matter in the long run – it reduces national saving, it can push up interest rates, and it passes along unsustainable debt to our children. Unless the new administration and Congress are willing to suggest truly massive cuts in Medicare and Medicaid, Obama will face pressures to raise new revenue. A sensible set of structural reforms would aim to combine the fiscal responsibility and progressivity of the Clinton years, without the complexities of targeted subsidies, and the lower marginal tax rates of the Bush years.

Even with this reform other revenue sources are also likely to be needed. A carbon tax or "cap and trade" system could raise considerable revenue. Alternatively, a value-added tax could be added as a complement to the current system, not a replacement. A VAT set at 10 percent, a low rate relative to most industrialized countries, could raise an additional 4 to 5 percent of GDP in revenue if the tax base were kept fairly broad.

**1:16 William Gale:**

We received an interesting response from an earlier part of the discussion. Will post it now:

**1:17 [Comment From Marc Grossman]**

Doesn't it have to matter, but maybe in a different light? Basically, not so much in the short term, but moreso the long term. We have to consider that and the ways the reduce the deficit once we've stabilized.

**1:17 Jeanne Cummings-Moderator:**

Responding to Bill's deficit comments...In addition to creating new revenue lines, Obama is talking about cutting spending. That, I believe, will be among the most interesting

things to watch in the coming year. It seems to me his Honeymoon ends the day he draws blood and upsets a constituency that backs the targeted government program. He can't do it all by eliminating antiquated military weapons systems.

**1:18 William Gale:**

In response to Marc, yes, and it would be ideal to consider the short-term and long-term at the same time but it may be too complicated to do so politically.

**1:18 Jeanne Cummings-Moderator:**

We have time for just a few more questions, so send them in quickly.

**1:18 [Comment From Joe Peters]**

Speaking of your old colleague Peter Orszag, he will be the new budget Director. He and President-elect Obama promised to through the budget line-by-line....but can that reasonably expected to produce much savings?

**1:20 William Gale:**

The Administration seems clear that they want to look for spending cuts, in part to help the long-term budget picture and in part because wasteful spending undermines support for government and all of the good things it can be doing. It will be a challenge -- quite a big one. But I think Obama picked the right guy for the task and I think Peter will do an excellent job on a very tough assignment, one that has eluded even very committed budget directors for decades.

**1:23 Jeanne Cummings-Moderator:**

Bill, just to follow on your comments with a question: The big challenge for Obama will be getting Congress to pass those cuts. Is there any evidence that the appropriators that reign on Capitol Hill will climb aboard Obama's cost-cutting agenda or will this be a knife fight between the Hill and the White House -- as usual?

**1:26 William Gale:**

This is the key question. I think that if the issue is framed narrowly --e.g., we are going to cut spending on programs, x, y, and z -- the effort will fail, because the opponents of cutting x, y, and z will object strenuously and no one has a lot to gain. However, and this is the key point, if the spending cuts are part of a broader package, that addresses tax revenue, tax structure, social security, perhaps Medicare, then I think the package as a whole can have enough good things that everyone will on balance find it passable. To be clear, this would need to have R support as well, so look for a broad, bi-partisan package. Bill Thomas, the former Republican Congressman from California, used to describe this strategy as "solving the problem by making it bigger" and I think that is what we will see -- a big, broad fiscal package that has a lot of very good and necessary and "it's about time" things in it.

**1:27 Jeanne Cummings-Moderator:**

Great observation, Bill.

That's about all the time we have. Thanks for the terrific questions and to Bill for fielding so many of them.

**1:28 Jeanne Cummings-Moderator:**

Don't forget to check out next week's chat, Wednesday at 12:30. We'll have Martin Baily on hand to discuss rebuilding financial institutions. Thanks everyone!

**1:28 William Gale:**

Let me add my thanks to everyone as well. We are going to need a lot more conversations like these to make headway on the really difficult problems facing the country.