THE URBAN-BROOKINGS TAX POLICY CENTER

THE TAX REFORM PANEL REPORT: "BLUEPRINT FOR CHANGE?"

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BILL GALE, Moderator

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C O N T E N T S

P R O C E E D I N G S

MR. GALE: We're fortunate to have Rosanne Altshuler, who was the senior economist on the panel. In her day job, she is a professor at Rutgers, and will first explain the details, the "nuts and bolts" of the report to all of us.

Then we will turn to the panel members. We're very fortunate to have Bill Frenzel and Charles Rossotti here to discussion why they did what they did, and at that point, then well open up the floor for questions, if anybody has any, and then to jump-start the evaluation of the panel's ideas, Kevin Hassett, Gene Steuerle and I will each talk about a few minutes on the major themes or points that we want to emphasize, and then, again, we'll open the floor for questions.

So we have a lot to talk about this morning, appreciate that you're all here, and let me just mention the notebooks that you've received have some background material on tax reform and the agenda. They also have bios for the speakers, so I won't spend a lot of time doing that.

So without further ado, let me turn the podium over to Rosanne.

MS. ALTSHULER: Thank you, Bill. Thank you for inviting me to present the panel's report. I look forward to hearing comments from the panelists that will be up here later on.

Just to start off, this report is the product of the work of nine distinguished members, who all brought very different perspectives to the project. I've learned a huge amount from the nine members of the panel and I'm especially honored to be here today with two panelists that I learned quite a great deal from and were two of my favorite panelists.

What I want to do today is just the facts. I want to go through the report and there's a lot in the report, so it's going to take me a little bit of time. I hope I don't go too over as far as time is concerned.

I also might have to start speaking really fast. We're starting with the current system here.

The report starts by making the case for reform and that case was very easy to make. The current system is complex, it's unfair and it's inefficient, and we thought that this illustration did a good job of illustrating that. Let me give you our starting point because I think this is really important. We had some constraints that we worked with.

The executive order directed the panel to recommend options that would make the tax code simpler, fairer, and more conducive to economic growth while recognizing the importance of home ownership and charity in American society.

We limited our evaluation or we were limited to reforms of the individual and corporate income tax system. You will not hear me talking today about the estate tax or the payroll tax. We talked about income tax reform, corporate and individual.

We had some additional constraints. Revenue neutrality. This was a tough one. We had to be revenue neutral, and I'll talk more about that in a second.

And then the panel made a decision, this summer, to repeal the alternative minimum tax. So that was another constraint that we were working with. The executive order also asked us to distribute the tax burden in an appropriately progressive manner, so we had distribution as a constraint, and we had also simplicity as a constraint, but it was a constraint that we took especially seriously.

We took all of them seriously but simplicity was one that was always in the forefront of our talks, of our deliberations.

The decision was made to use the administration baseline. That projects 17.4 trillion in federal, individual and corporate income tax revenues over the next ten years.

Interesting, we looked at the CBO projections and that level of revenue was within approximately one percent. It's important to understand what the administration baseline is and what's in it. It assumes that the 2001 and 2003 tax cuts will be made permanent. It's the policy baseline, so it also assumes that the president's proposals are enacted, and so it assumes LSAs and RSAs would be enacted. That's important for our effective tax rate calculations. It's important for the whole exercise.

It also assumes that the AMT patch will expire as scheduled after the 2005 tax year.

I don't think I have to spend a lot of time talking about the AMT with this crowd. Repealing the AMT would cost us $1.2 trillion over the budget window that we were working with. So we started $1.2 trillion down. As you can see, the graph shows the incredible growth in the reach of the AMT over this period.

An interesting table that's in the report gives an idea of the cost or the implications of repealing the AMT. So the question here is what rates would be required for revenue neutrality, if we were to repeal the AMT. Okay.

And so the first bars on the left give—this is for married filing jointly—it gives the tax rate schedule, current law, 10, 15, 25, 28, 33, 35. If we were to repeal the

AMT and remain revenue neutral, Treasury estimates that we would have to increase—we'd have an across-the-board increase of 11 percent in those tax rates. 11 percent.

You can step back for a second and say, well, would you really increase the bottom two rates? Well, let's say we just increased the top four brackets. That would be an 18 percent increase. So just repealing the AMT, we'd have the top rate for married filing jointly, would be 41 percent doing the exercise that I just went through with you.

Another constraint that we were working with was revenue estimation. This was a tough one. We had to score all of our proposals and Treasury Department's Office of Tax Analysis, who we worked with very closely and who were absolutely fantastic in responding to our numerous requests and changes in requests, and what if we did that and what if we did this.

They did all of our, quote, unquote, scoring. Our proposals were scored using conventional scoring techniques and I think Washington is starting to understand what conventional scoring techniques mean. These are not static revenue estimates. These are micro dynamic. They do take behavior into account. But they hold the growth of the economy fixed.

We constrained ourselves to be revenue neutral using conventional revenue estimating techniques but we also asked Treasury to do a macroeconomic analysis of our options. So we did a dynamic analysis and the results of the dynamic analysis are discussed in the report and the appendix goes through the models that Treasury used.

They used three standard economic models. They're the same models that are used in the academic literature and by the staffs of the CBO and the JCT.

As far as the distribution of—everybody keeping up with me so far? As far as the distribution of the tax burden is concerned, the first question that we had to ask ourselves is what does "appropriately progressive" mean?

Well, the panel decided to design reform options that remain relatively close to the current distribution of tax burdens. Okay.

The report is absolutely chock-full of distribution tables. The tables show the distribution of—mostly the focus was on the individual and corporate income tax burden and we have tables for 2006, 2015. We have in the appendix over the whole budget period. We have the incidence assumptions that were used by Treasury or described in the report and we have tables in the appendix that change some of the incidence assumptions to do somewhat of a sensitivity analysis.

I don't know how many people have made it through the appendix yet.

It's time to move to my discussion of the plans. So what I'm going to do is mostly spend time going through the common elements of the plans and then I will talk a little bit about the two different plans that were recommended.

So the way I'm going to do it, though, instead of having a whole section of common elements, is I'm going to start by talking about the simplified income tax plan, and then I'm going to tell you that the other, more fundamental reform option, takes most of the household provisions.

I'll tell you which ones that we don't take in the second plan.

Again, I hope this is useful. What I've done is I've gone through the report and I've just gone through all the provisions, just to give you the facts, you know, what's in the report.

So what did we do? We started by repealing the AMT. Then we created something called the family credit. People were calling us up yesterday, looking at our form, saying, Where's the standard deduction? Well, there is no more standard deduction. We consolidated the standard deduction, personal exemptions, the child tax credit, and the head a household filing status into a single family credit, which I'll show you how that's calculated. It's very simple. The eligibility rules are straightforward, and the next credit, the work credit, keys off of that family credit.

So there's one family credit, a big consolidation effort, and a lot of information in the appendix about these credits. The work credit.

This consolidates the EITC and the refundable child tax credit into a single work credit, and I should say here, I should have put it on the slide, the work credit is a refundable credit that phases out. The requirements for claiming the family credit are the foundation for the work credit eligibility. Simplicity was a goal here.

One of our goals was to reform the credit in such a way that it would be easy for individuals to have the IRS calculate the credit for them by simply checking a box, and write the rules in such a way that taxpayers would want to do that.

I have some information about ages, and I don't think I'll have time to go through all of those details, but we'll have the slides and we can flip back to them later. But we did go through the details in the report.

The family credit's very important, so I have a whole slide on it here. It provides a tax benefit comparable to the current system. It also replicates the 10 percent tax bracket. There's no longer a 10 percent tax bracket. I'll get to the tax brackets at the end of this section of the talk. Very easy calculation.

First you figure the base amount of the family credit, so for a married couple that's $3,300 and then you add an amount for each child, that's $1500 each, a child is defined similarly for the work credit, and then for each dependent that's $500 each, and this is a credit, you subtract the credit from taxes due. Okay.

As far as the home credit, what we've done—I think everybody's familiar with what we've done here. I could probably just skip right over it. Yes, there's a limit, there's a credit. We've replaced the deduction for home mortgage interest with a credit, 15 percent of interest paid on a principal residence. We now have a gap that varies by region. So the amount of the mortgage interest eligible is based on average regional housing costs. These are FHA amounts. The panel limit is 125 percent of the median sale for each county, which results in current limits between about 227,000 and 421,000.

There is transition relief over five years. The next figure here, chart, graph, whatever you want to call it, is very interesting. It's in the report. It shows the percent of taxpayers who pay interest and receive mortgage interest tax benefits under current law and under the tax panel's plans. Under current law—this is stratified by income—if you go to the right, you look over all taxpayers. About 54 percent of taxpayers who pay interest, receive mortgage interest benefits, under our plans that number goes up to about 84 percent.

So the idea here was to make this benefit available to all taxpayers, to even out this uneven benefit that's in the current code.

On charity, I think I'm going to let Charles talk in more detail about this, but we have now—there's no more itemized deduction, there's no more standard deduction, there's no more figuring out, should I itemize, should I not itemize.

Everybody gets an above-the-line deduction for charitable contributions that exceed one percent of income, and then we have a bunch of other important charitable giving reforms. Just to hit some high notes, we require information reporting for large charitable contributions.

We have some rules on gifts—or recommendations on gifts of appreciated property. We recommend improving rules for value and gifts of property to charities. Then allowing taxpayers over age 65 to make tax-free distributions directly from IRAs to qualified charitable organizations. Better oversight and governance of exempt organizations.

Should I hit something else? Keep going. Okay. Health insurance. Probably you could all pass a test on this one too. What we're going to do here again is make a more uniform benefit but it also has a limit.

Just starting in the middle, the—well, let's start at the top.

We're going to allow a deduction for the purchase of health insurance in the individual market. This is obviously for people that don't have employer-provided health.

So the limit would be 11,500 for families and 5000 for single. Where'd we get this limit? It's the FEHB amount, which is also approximately the same—so this is what conversation gets, this is what your congressmen and women get. It's also approximately the same as the national average annual amount projected to be spent on health insurance premiums in 2006. Those numbers turned out to be about the same.

We are going to limit the exclusion for employer-provided health coverage. That limit is going to be the same as the deduction limit, 11,500, and the Treasury gave us an estimate that this will increase the number of insured by approximately 1.6 million people.

Continuing with the household provisions, the idea of the panel was to start with the broadest possible base, redesign and rationalize provisions that they wanted to keep in the code, so that's home ownership, health, charity, and just present a plan that would make people think about what they wanted to add back into the code.

We repealed the deduction for state and local taxes, reformed the tax preferences for higher education by having the family credit cover some full-time students, and permitting tax-free saving for education costs. I'll get there in a second. Also eliminated tax-free fringe benefits except for certain in-kind benefits that would be provided to all employees at the workplace.

Again continuing through. Simplify the tax treatment of Social Security benefits. I learned an incredible amount about the tax code. I shouldn't really admit that, but—I was an expert coming in but the tax code is huge. Social Security benefits wasn't anything that I looked at. But I would have to say that that was the most shocking thing to me, was looking at the calculation of the taxation of Social Security benefits. I couldn't believe it when I saw how complicated that calculation was.

We have a more straightforward deduction, and I won't go through the specifics but it removes the marriage penalty in the provision, it indexes the thresholds for inflation, and taxpayers above the threshold would include—to be above the threshold, you'd have to have 44,000 income, if you're married it's between fifty—they'd be taxed on between 50 and 85 percent of benefits.

That form is so much simpler than the current form. So this was something that was extremely important for us and it was not one of the easiest things that we were able to do.

Everything was hard. Some things were harder than others; our savings package. People are probably familiar with this, we've been talking about it in a couple of our hearings. We now have three simple consolidated accounts. Save at Work, Save for Retirement, and Save for Family, and those names are trademarked and copyrighted.

Save at Work. They're supposed to be easy to remember, and I have no short-term memory, and even I can remember them.

Save at Work. These are the employer-provided plans. We would create uniformity for employer-provided defined contribution plans and we would add the autosafe features that the Brookings Institution and the Tax Policy Center has done a very good job in educating us all about.

I won't go through each of those. I think that if you're in this audience, you know a little bit about them. People have been asking us about the limits. We'd use the current 401(k) contribution limits.

The next two have different limits. This is the Save for Retirement. This is outside of your employer-provided retirement benefits. So it creates a new account that combines all the current retirement savings accounts that are not provided by employers. A lot of simplification here.

There's a very good chart in the report that shows how we are consolidating and rationalizing and simplifying all these plans. $10,000 of contributions per individual account, per year. That's Save for Retirement.

Save for Family. We had very interesting testimony, we went across the country, some of you followed us, which we really appreciated, and we looked at the patchwork of savings incentives for medical expenses, education, et cetera. Well, I guess I could say it was—it's complicated—"mess" is maybe the wrong word. But very, very complicated.

This is one plan, $10,000 in contributions, one thousand can be withdrawn each year without penalty, so we don't have to get into hardship determinations. We have made the saver's credit refundable and I should point out at this point that this is a package. This was supported by the panel because it was a package. If you pull any of these provisions out, you're likely not to get unanimous support.

We want this to be viewed, they want this to be viewed as a package. So there'll be a refundable saver's credit. This would phase out. With income there's only two phase-outs left in the tax code, one for the work credit and one for the saver's credit. They both are credits that are aimed at lower-income individuals.

As far as financial income is concerned, the idea is that we want income to be taxed only once at the U.S. level in this case. We'd exclude a 100 percent of corporate dividends, paid out of income that was taxed in the United States.

There's going to be an overlap here with our business provisions, with the territorial tax proposal that I'll get to in a second.

What would happen here is corporations would notify shareholders regarding the proportion that can be excluded.

If you're receiving dividends from a fully domestic corporation, all of their earnings generated within the United States, that's a 100 percent dividend exclusion.

If you're receiving dividends from a multinational corporation, you get an exclusion to the extent that U.S. corporate tax was paid on the income out of which the dividend was paid.

Let's see. 75 percent of capital gains received by individuals on sales of corporate stock would be excluded, if that corporate stock was held for more than a year. So these are very pro savings, pro growth plans.

Gains on properties other than corporate stock would be taxed at regular rates. We would increase the exclusion on gains of housing. More stringent rules for life insurance annuities and deferred compensation. I won't get into the details there, but there would be grandfathering of existing arrangements.

Finally, on the individual side, we have gone from six tax brackets down to four. You will file as—if you're married you can file as single. Most of the marriage penalties are removed.

You can see that the brackets are twice as big for married and unmarried. So you can file as married, you can file as single. If you're single, obviously you'd have to get married to file as married. But you're welcome to do that, and it would be simple.

You wouldn't need to talk to your tax accountant first, and people wouldn't say to you, "Why did you get married this year and not wait until next year?" or something like that.

And you'd never have to explain to people what a marriage bonus or penalty is. But that actually is not true. You'd still have to have some idea of what that is. Let's move to small business, to business income taxation.

This is a very interesting part of this plan in that it recognizes, explicitly, that businesses of different size face different problems and different compliance burdens when they're trying to figure out their taxes.

For small businesses, this would have to be welcomed by—well, we think it would be welcomed by small businesses, and Charles can talk more about this. A business with receipt of less than one million. We would simplify recordkeeping because you would basically be taxed on what I guess is called the checkbook method, cash method accounting. Immediate write-off for all purchases except for land and buildings, and then in terms of compliance, there'd be segregated business accounts with information reporting and credit card sales information reporting.

So this is again a package for small business that I think is attractive. Midsize business, very similar. This is receipts of more than a million and less than ten million.

They would report on the same cash basis as small businesses, but there'd be exceptions for the purchases of new equipment and the cost of inventory. There wouldn't be immediate expensing for all.

A simplified depreciation system. Again, I don't have time to go into that. As far as large business is concerned, all large businesses with receipts of more than 10 million would be taxed at the business level. This includes LLCs, partnerships and S corporations. The tax rate would be lowered to 31.5 percent. Remember, we're working with a lot of constraints and this is a nice reduction in the corporate tax rate, and there were all sorts of other attractive provisions.

More uniform treatment of business income. Just like on the individual side, there was a quote, unquote, cleaning of the base. We wanted to start over again. We want to look closely at the special provisions and special deductions that go into the codes, so we eliminated all tax preferences other than accelerated depreciation and we got rid of the crazy and kooky corporate AMT.

On international, we recommend territorial with expense allocation rules that are reasonable and make economic sense.

I'm happy to take questions on international.

As far as the—I'm finishing up—I think I'm actually going to be on time, Bill. I'm finishing up the simplified income tax and I'm flashing up here, just for a second, the sum of the many distribution tables. This is 2006 law at 2006 cash income levels. You see the distribution of the percent—oh, I see—the percent of income tax paid should be on the Y axis and it didn't show up there. And you can see that pretty much kept the distribution the same.

I mean, it's almost exact when you do it by quintiles.

That's for 2006 and this is for 2015, and I guess there are about a 100 distribution tables in the report, and it's not fun when you find a typo in one and you've copied it into all of the others. One of my sleep deficits is due to that.

Let me move on. So that is an overview of the simplified income tax plan. Wasn't trying to make it the most—you know—entertaining talk. I just wanted to give you the facts, so that you didn't have to read through the entire 300-page report.

Let me move to the other plan that was recommended by the panel. The panel endorsed two plans, as I'm sure everybody realizes, and both plans, they unanimously said are better than the current system. As an overview, this is a blended tax structure that would move the current tax system towards a consumption tax while some elements of income taxation. How does it do this? It's an x tax, with a tax on financial income at the individual level; okay. It combines a progressive tax on labor income and a flat-rate tax on interest dividends and capital gains at the individual level, with a single rate tax on business cashflow. Okay.

It's a consumption tax with some income tax elements. We had these common elements that carried through to both plans. I think a very strong point of the report.

Same provisions as the simplified income tax plan with the following exceptions. There's a 15 percent tax on interest dividends and capital gains earned outside of the savings plans, because those savings plans that I described are carried over into the growth and investment tax plan, and maybe Bill or one of the other commenters can go through and add up how much savings can be put into these plans per family. It's a huge amount.

Save at work plans are Roth style here, and the tax rate schedule, 15 percent, 25 percent, 30 percent. Three tax rates here with the top rate being at 30 percent.

Businesses would be taxed, business cashflow. So it's receipt from sales minus purchases from other businesses, minus wages and compensation. That gives you taxable business cashflow and you just put a 30 percent tax rate on that. Expensing. There's full expensing.

There's a consumption tax. Consumption tax requires expensing to be consumption taxes. This would ensure that the after-tax return on investment is the same as the pretax return. You have an effective marginal tax rate on new investment of zero. Okay. Normal returns, the effective tax rate on normal returns is zero.

We eliminate interest deductibility because allowing both expensing of new investments and an interest deduction would give us negative effective tax rates. So it would be a net subsidy to new investment. This is a package. You don't take expensing without the denial of interest deductibility, although it could happen.

[Laughter.]

MS. ALTSHULER: Cashflow would not include amounts received from returns on financial assets. That's out of the system. This is what we call an R-based system; out of the system. That means that there's no deduction for financial payments, interest in dividends, no longer, so there's no deduction there out of the system.

Losses are carried forward with interest. They really should be fully refundable but those of us that have studied the tax policy towards losses know that there are always special games that can be played when you give full refundability.

So we have losses carried forward with interest, that's new, and there's a special regime for financial institutions, which I would be quite happy not to discuss.

So they get interest deductions and they're going to be taxed on their interest income.

I was hoping to run out of time just before that line. Cross-border transactions. You can either go with an origin-based tax or a destination-based tax. We chose a tax base, a destination-based tax. So the tax base is domestic consumption wherever it's produced, which, in shorthand means that exports would not be taxed, and imports would not be deductible.

To get to a domestic consumption base you do something called border adjusting.

So exempting exports from the tax base and including imports is called border adjusting the tax base and that's what gives you a destination-based tax, and all countries that run VATs use a destination-based tax, except for there's always the case of Japan, that nobody really understands.

So I think that they're destination-based. They are subtraction method and everybody else is credit invoice.

Interesting. There are implementation advantages of doing the border adjustment, of picking a destination-based tax. It solves the transfer pricing problem. The base is domestic consumption. So there's no incentive to overcharge or undercharge for sales with related parties. They're just out of the tax base.

And then it also limits tax avoidance by closing the system. Using domestic consumption as a base prevents U.S. businesses from structuring transactions with foreigners to avoid U.S. taxes just because you've closed the system down.

When you talk about a fundamental tax reform, you want to talk about transition relief. Transition relief was scored, was, is part of the plan. Border tax adjustments, by the way, is not part of the—we took that money and put it aside. We did not spend that money. That's not in the slides. That was just an oversight on my part.

On transition relief, again, we thought about this, the panelists thought about this carefully. Transition relief would be provided to avoid short-term disruptions and permit gradual adjustments to cashflow taxation.

We would not attempt to put taxpayers in exactly the same place under the current system, because as Bill Frenzel would say, then you may as well have the current system, I would say. So we're not, we didn't do full transition relief, but there would be relief and this is in the chapter, I believe it's chapter seven, describes transition relief for the growth and investment tax plan, the GIT, and the relief would be provided for interest deductibility, on the other side of that, the taxation of interest income, depreciation and border tax adjustments.

There's a long discussion about thinking about transition relief, providing more generous relief results of course in smaller efficiency gains, and there are some substantial efficiency gains according to the estimates in the report for this tax.

Again, distribution. Well, if you just look at the quintiles, it's pretty much dead on. That's for 2006, and this is for 2015, and I hope everybody feels like they know the plans now, can answer questions. That is it.

[Applause.]

MR. GALE: Thank you, Rosanne. Let's get hooked up here. It took the panel upwards of a year, it took Rosanne 30 minutes, and we're going to ask our two members to take 15 minutes each. I'll just introduce them real quick.

Bill Frenzel has the unique distinction of being the only person to have served on the Social Security reform panel and the tax reform panel. So we're not sure what you're doing next but we'd like to hear about that as well.

Charles Rossotti is at the Carlyle Group and of course is former commissioner of the Internal Revenue Service.

So why don't we start with Bill and then we'll turn to Charles.

MR. FRENZEL: Thank you very much. Rosanne, that was a real tour de force. I think I want my vote back.

[Laughter.]

MR. FRENZEL: That was a really wonderful job. I'm going to begin at least a little differently, because those of us who are a little slower of wit than ever grasp the substance. I'm going to tell you more about how we tried to proceed. We started from the standpoint that any idiot can produce a better tax code than the one we've got. The problem is we have several 100 million idiots in the United States who all have a little different idea of how they might want to do it.

So to get some kind of consensus is extraordinary difficult.

Now the process that we go through is terribly difficult, and if you're nervous about any feature of our report, don't worry, this is just sorta the opening cannon and Fort Sumter's got a lotta days left to defend itself.

We go to the secretary, the secretary to the president, the president to the Congress maybe. The Congress maybe does something. Maybe contemplates its naval for a couple years and works it out. While we're doing this, people like this conference will get together, have ideas on tax reform, many other good institutions, university and think-tank are producing wonderful work on tax reform, and who knows where the process will lead.

This commission did not think that we were writing on tablets of stone, but, rather, that we were trying to get the process started in a rational way from which others could proceed, others who have a higher pay grade could figure out how they really wanted to go.

Remember, we do comprehensive tax reform in this country on about a 20 year basis. '69 was the first one that I can remember. I wasn't here. '87 was the next one. And who knows when this one might come to fruition?

One of the interesting things was at least in '87, the public polled a high degree of irritation at the tax code. That is less true today. So for demagogues to whip the country up, saying that we need tax reform, it's far more difficult today, and I think it makes the process much more difficult for the president and for the Congress.

Rosanne has told you the conditions under which we labored, and all of them made our job much more difficult. The two that you might not think about a lot are that we had to use the president's baseline and Treasury data for all of this stuff.

We were, after all, reporting to the secretary, who was reporting to the president, and Treasury is full of competent thoughtful people. On the other hand, we don't all make the same assumptions when we structure our models, and sometimes we would go to Treasury and say these figures are goofy, what the hell are you doing?

And sometimes they would tell us and sometimes we would understand what they told us.

[Laughter.]

MR. FRENZEL: And one other terrible restriction now is the federal open meeting law. I'm not going to go into it here because it causes me to froth at the mouth. But that was terribly difficult.

We also wanted to be, to make our report be a tax report, but obviously, if you live around here and you're working on taxes, you can't be blind and deaf to political things that are happening, and so as we worked, we had to worry about whether a president could recommend this, whether a Congress could accept it.

A lot of rules of thumb were thrown out, such as here's one that everybody will hate. Let's recommend it and then the Congress can be heroic when they amend it out.

I don't think we followed that rule very closely. We had conflicts. All of our directions—growth, simplicity and fairness, are in conflict with one another. And we decided, as Rosanne suggested, that fairness is what fairness is now. Not courageous, not smart, and probably not fair. Nevertheless, that's the way these kinds of proposals have engaged ever since I've been involved in any kind of tax law around here, and you can see, even with those fudged figure there being exactly even, you will have people saying you are paying off the rich, or you aren't giving the rich enough incentive, or you're stomping on the poor or whatever.

So to protect our own sanity and get going, we said we'll try to duplicate the burden tables that are in existence.

For simplicity, for most of us that wasn't the biggest driver that we were interested in, but we realized, if you're going to get the public behind the bill, it may, for a lot of people, be the only driver. And so we had to focus on that with great intensity.

Finally, the growth factor, which I think most of us were most interested. You are restricted of course by budget neutrality and by the burden tables, and so forth.

We had special problems. We had the AMT. We had to eat 1.3 trillion over ten years. That was more than a mouthful. In 1987, the Congress tried to solve a problem of lowering personal rates by diverting personal liability over to corporate liability, and we didn't think we ought to be doing that, and so we didn't have that particular plaything to work with.

We also, because we are revenue neutral, we didn't have a lot of money to buy transition.

Now Rosanne has told you that we put some small transition numbers in there, but the easy way to do it is to buy off all the aggrieved policies. We did much of that in 1987. We really have done almost none of it this year.

And the same is true when you switch to a new system of taxation. Rosanne gave you little hints about how difficult it is to move into our second recommended plan because it's going to be a very bumpy road.

We had trouble with financial institutions, that you can expect. We had a lot of trouble with interest, particularly in the second plan. We had trouble with border adjustment. More than that, we had, still had trouble with Treasury on its estimates, and so forth.

We also decided that we didn't have to be exactly precise in our revenue neutrality and, you know, as you look down the road and you estimate revenues and expenses, you either got to be goofy or stupid if you think you're going to be anywhere near right.

And so we said we don't have to be exactly right. We used one-half of one percent. We might just as well have used 10 percent, in my judgment. Government work is like horse shoes. If you're close, that's pretty good. Probably better than usual.

Now Rosanne told you about the two suspects that we declared guilty, some who we flushed out of the docket. We looked at a national sales tax. We decided that was unwanted [?]. We looked at a VAT in several iterations and decided that we weren't quite ready for that. We were having enough difficulty with our consumed income tax or our x tax, or whatever we call it. That posed enough of a problem.

I'm going to conclude by talking about the prospects, in a couple of pieces. I assume, because the president appointed us, that he is going to produce some plan and send it onward to the Congress. When you look at the prospects for next year, it does not stimulate you to bet the rent money on the fact that we're going to enact tax reform next year. I hope we do. I think it's possible. But perhaps handicappers—Nick the Greek might say it's unlikely.

For us, that's okay, if it doesn't work next year. We think our framework is a wonderful one for future reference, and if tax reform could occur in the next year, the year after, or the year after that, our report, we believe, will still be helpful, as will all the other commentary and other reports as well.

With respect to how the plan is treated in Washington when it gets before the Congress, I think to me, obviously, the hardest sell is going to be the corporation. They are getting a little bit of a rate cut; they're getting a good deal of simplicity in our program. But they got the best of all possible worlds right now. The largest of them are not paying, at least I believe most of the smart ones, are not paying at the rates specified as our maximum rates. They are finding ways, that every time a bill comes before the Congress, that they can get a little extra push. The Fisk bill, or what do we call it now?

MS. ALTSHULER: ETI.

MR. FRENZEL: The ETI bill is a perfect example of piling on. If you didn't get a couple hundred million out of that bill, you should certainly fire your lobbyist because everybody else did.

Now if you have those wonderful opportunities, you may not like something like this. You're doing better in this game, and I think we need to expect that and I think somewhere along the line we have to appeal to corporate managers and owners on some kind of a higher basis, that they may not do as well as they thought they were going to do in the short term. But maybe some of this will lead to long-term advantage for all of us.

Charlie.

MR. ROSSOTTI: Okay. I think you can all see why we really enjoyed having Bill Frenzel as part of our working group, not only because he has participated in some of the other reforms of income tax as well as other programs, but, you know, he keeps us all recognizing we have to have a sense of the absurd when we deal with taxes. And we also should note that Brookings is a big contributor here to this, because they not only contributed Bill Frenzel but Gill Gale, and all the other research that you did certainly informed what we were doing.

I, for the second time in my life, seem to have wandered back into tax territory. I never have been a tax expert. You know, I was in business most of my life. Somehow, I ended up as IRS commissioner, finished that three years ago, done with the tax business, and then, to my amazement, I get called by the White House, would serve on this tax panel, and I thought, gee, why do I want to do that? You know, I thought I was finished with this.

I finally decided to do it, really, for one main reason, which is that I agree with the assignment, the way it was set up by the president, and the assignment, as I read it, was tax reform. That's what it was about. Tax reform means that you're going to recommend a better, more sound system for collecting the government's revenues. You know, sound means that, as we say in the report, that it's, you know, efficient, it's reliable, and it distorts activities throughout the country as little as the tax code can, which is another way of defining it's exactly the opposite of what we have now, which does all of those things very, very badly, and I certainly became aware of that in my life as both a business person and as a tax commissioner.

So if there's a chance to really do tax reform, I thought that was a good thing to do, and I learned who the other panelists were, I realized that they were people who had the same idea, not exactly of course, but basically the same commitment to doing tax reform.

And that's what I think we did. I think tax reform, as I just described it, is a doable assignment. It's not an easy assignment, and certainly politically, you know, there's all the hazards that we know about. But it is doable. It's not asking you to take nine months and invent a cure for cancer or boil the ocean.

You know, it's confined to something that—

MS. ALTSHULER: It's close.

MR. ROSSOTTI: No; not actually. I think it's a confined thing, if you think about it correctly.

What it does mean, though, there's obviously—I mean, you know this from Rosanne's great briefing. There were a couple things that we were not asked to do as part of this. One of them is basically to resolve, you know, the two endless questions that are endlessly debated, and should be endlessly debated in a democracy, which is whether you should have more or less tax revenue as a percentage of the GDP, or whether the tax revenue that is produced should we done more or less progressive.

You know, as soon as our report—actually, before our report was out, we got an editorial from the New York Times that said, well, the panel did a good job but it's useless because they had the wrong assignment. The right assignment is they should raise more revenue and they should not have been given the guidance that the president's tax cuts should be made permanent, neglecting the fact that the congressional baseline, which does not make the tax cuts permanent actually raises the same amount of revenue within one percent, which just shows how confusing the whole thing is today when you have multiple interacting provisions that end up with the same result, whether you have a permanent or not permanent tax cuts.

The point is that I think if you believe that we need more revenue in the system, over time, to pay for whatever you believe we need to do in the government, you still I think should, if you're thoughtful, realize you have to have a sound foundation to actually raise that revenue, which we absolutely do not have today with the current tax system, the way it works.

On the other hand, we also got a comment the same day from some folks at the Cato Institute, said, well, they did a good job but, you know, the problem was that they didn't cut the tax rates enough.

Well, you know, this is the same thing in reverse. You know, if you believe that you need less revenue and you're going to have dynamic effects on the economy, the easiest thing in the world to do with any of these proposals is take the same proposal, which is a more sound system and just cut the tax rates a little bit. You don't have to be, you know, doing a lotta work to figure that out.

What's hard, I think, is to actually come up with a system with whatever level of revenue is that does it in an efficient way, which is what tax reform is all about.

The second big endless discussion is as Bill and Rosanne both alluded to, is how progressive should it be? Is it progressive enough? Or it is too progressive?

You know, who pays how much tax is something that should be debated in the political environment, and it will be. You know, we simply agreed, as Bill said, that we would focus on tax reform, you know, maintaining, as the president directed, an appropriate progressive system which basically means that we kept pretty much the same distribution tables.

Actually, if you look at it more carefully, you will see that it is actually slightly more progressive at the very end. What you find out is when you do it by quintiles, you don't get the full insight because so much of the tax is paid by the top 20 percent, that to really understand you have to go a little bit deeper, which is why you have the one, five and ten percent numbers, and just because of the way it came out, it's slightly, slightly more progressive. That was not so much an intent as just a fallout.

On the other hand, the people in that top one percent are going to get some very big long-term benefits. So I'm not feeling sorry for them.

So those were the things that we didn't have to do. So what did we do?

Well, I think that from my point of view—and Bill and I have debated this a little bit—I actually do think that simplification is the most important thing, by far.

And I say that not—you know, simplification has a little bit, the word has a little bit of the air of sort of it's nice to have, who cares, okay? And that's actually fostered, that implication is fostered by the focus on, well, we have a, you know, a 30-line form instead of a 70-line form. You know, that's nice. I mean, we've cut the number of lines on the form. But, you know, does that really matter?

It's a much, much deeper issue than that, much deeper issue, which I hope that some of you who are really thoughtful about the tax system would really focus on.

Why is it deeper? Because the resources and the impact on behavior in this country of the system is immense. There are two big numbers that people will use and that I think, you know, I used at the IRS. One of them is it costs $140 billion a year for compliance costs. Time and money, if you monetize the time at a reasonable number, you come out to 140 billion that people are spending, which if you—you can compare it to a lot of things. That's more than taxpayers spend on higher education in this country, as an example, and it's way bigger than most of the other costs in other countries.

The other big number is the tax gap, the amount that's not collected, that should be. That's—and I'll use round numbers—300 billion. Now as a lot of you are analysts, as I was once in my life, you tend to be suspect of big numbers like that, especially when they're round numbers, 143, hundred—two questions immediately come up. A, are they real numbers or just something that somebody throws out to get attention?

And B, could you ever do anything about them? Trust me. I spent five years on this. They are real numbers. You know, we did a lotta work at the IRS, in research, on both of those numbers, when I was there, to get better numbers, and although they haven't completed all the work on the business side, for at least on the individual side and for—they are accurate and if there is anything about them that is inaccurate, they are more likely to be understated than overstated because, for example, in the tax gap, there hasn't been any real study of what the noncompliance is in the whole flow-through entities, all the S corps and partnerships which have trillions of dollars of money flowing through them, and there's really no idea how much noncompliance there is in those. None.

Okay. There hasn't been any study for any time, that's been meaningful. So if you add up those two numbers, we're talking about, if you want to call it this way, in round numbers, $450 billion per year of friction in the system. You know. And when you consider the income tax combined collects about—we were only dealing with income tax—$1.3 trillion, you're talking about something that is really huge.

Now can you do something about that? Yes, you can do something about that and part of it is the tax code. The other part is there's got to be some resources for the IRS but they're not unrelated issues.

So let me just finish up by summarizing what I think is broadly called simplification and also some implications for compliance, and I think that the real point here is that in this proposal, in the simplified income tax at any rate, it's much more profound impact, much more profound impact than just how many lines on the 1040 form are cut.

First of all, there's—just if you want to talk about the level of forms, there's a lot more forms than just the 1040 front page, and there's a table in there, there'd a diagram that shows you all the complexity of all the forms, how they are in the system and how they get reduced dramatically under the simplified income tax. So just in a visual sense, you can see it that way.

But let me just quickly run through some things that I think are important from the simplification standpoint and Rosanne did an unbelievable job covering the whole outline. So I'm just going to hit, without describing them, some of the key points. All of the provisions that affect basically families, which affects every individual taxpayer, all the various provisions, and there's at least four of them, four different ones now that are consolidated into this family credit.

A tremendous amount of confusion, cost, and resources are devoted just to those things and a tremendous amount of obscurity over how they actually work, really consolidated dramatically into the family credit.

For those of you concerned about the low-income people, and I hope we're all concerned about the low-income people, there is a provision that has grown over the years, the earned income credit, and then was a second provision, child credit, that does a lot to distribute income supplements, if you will, to working families.

But it's extremely complex and again has a whole array of different definitions in the current code. Those are very, very thoughtfully integrated with the family credit under this proposal, to the point where, really, somebody who fills out that one page family credit thing, which is the essence of simplicity, just listening to your children and your other dependents, can check a box and have the IRS calculate it.

Or they could have themselves do it in a much simpler way, very, I think, important progress in terms of making that provision actually work.

The whole concept of itemizing versus standard deductions. You know, if you think about it, the idea of a standard deduction is, well, it's simple, you just put the standard deduction. Except that for a lotta people, you first have to figure out whether you should itemize in order to figure out whether you should itemize or you should use the standard deduction.

You know, it's not a great thing to have to do anything two ways to figure out which one is better. Gets rid of all that. There is no such thing as itemizing. It also allows us therefore, to have in a very simple way, I think, and a very reliable way, to allow everybody that makes a charitable contribution over a one percent threshold to claim it, and of course now only the 35 percent who itemize claim it.

Without getting into the details, the whole issue of savings plans is remarkably complex in today's tax code. You all know that. Rosanne explained it. There are more tax code provisions, names, that have gotten into the public vernacular that you can imagine. You know, SEPS, 401(k)s, 529's, all of these things. Even professional planners have a hard time trying to figure out what these things really are.

They're all consolidated into three types of plans that are available to everybody and I think provide an opportunity for most people to save up to the levels that they would want to, in a way that they can understand.

And it also, by the way, interestingly, eliminates under our recommendations, some less well-known but very significant provisions that are, in effect, sort of backdoor provisions that allow unlimited savings but for a very small number of people.

Those two are the so-called inside buildup of cash value insurance plans and deferred executive compliance. Of course I'm here speaking against interests, cause, you know, I have some pretty good interests in some of those but they'll be gone. The AMT. I don't have to say anything about the AMT.

You know, the idea of having two parallel tax systems at both the individual and the corporate level, you know, is the opposite, and I defy anybody, really, to figure out, you know, without—you know, you can run a computer program and figure out how all these things interact.

But to really understand how does the AMT interact with my various deductions, with the phase-out of itemized deductions, the phase-out of my personal exemptions, no one can really figure it out at individual level and people even get confused at the aggregate level because the baseline that Treasury uses, which has permanent tax cuts, ends up coming out the same as the baseline which doesn't have permanent tax cuts.

I mean, how much more do you need to say? All phase-outs in this are eliminated with the exception of the two refundable credits, which you have to have a phase-out for just because they're income supplements. That's the savings credit and the work credit. But those are the only phase-outs that are left in the system.

Social Security, people that are getting Social Security, you know, it's almost like a little income tax system by itself now. As Rosanne mentioned, that's extremely simple. Small business. Roughly, almost 98 percent of the businesses in this country have less than a million dollars of gross receipts.

I struggled with this when I was a small business. I struggled with it when I was at the IRS. I think, you know, in terms of compliance burden, and it isn't just the slogan, it really is a much, much heavier burden on small business because you inherently have the issue of, you know, not just copying off your 1099 or your W2 but figuring out your net income that's inherent in having a business.

98 percent of those businesses are—I think it's around 23 million businesses, have less than a million dollars of gross receipts. Under this proposal, I mean, I would be able to stand up my opinion to any small business owner and say this is good for you.

[Start side 1B.]

MR. ROSSOTTI [continuing] accounting, with very minor exceptions. Everything except land and buildings is written off. It's very, very simple. The schedule C form, which is the business form, is really—you can see it in the report, it's one page and not even a full page, in terms of impact on small business.

And for medium size up to 10 million, it's just slightly more provisions, but not a whole lot. It keeps the same thing pretty much in force. And then for the larger businesses over 10 million, of course they're inherently more complex, but the clean tax base does provide simplification.

Now, you know, Bill said maybe you don't want a clean tax base if you can figure out how to slip something in. But the fact of the matter is all of that complexity, for all of these special provisions, is very significant for everybody combined.

I mean, from the government and from the legal and accounting side, every one of those provisions is like a tax code in and of itself. They have regulations, they have rules, and they have compliance issues. At one point at the IRS—and we were able to reduce this during my term—but at one point a quarter of the audit resources of the IRS that were devoted to large corporations was spent on one provision which was the R&E credit.

And I can tell you, I was in the technology business myself, in the software business for 28 years, and I can tell you exactly how we treated the R&E credit, if we did get it. Is we did all the R&E we wanted to, and at the end of the year we told the tax department find what you can and see what you can get for us. It had nothing to do with decisions on what kind of R&E we did, and, you know, if you really talk to anybody at the executive level in the software business, I think, if they were honest, they would tell you the same thing.

You might have to put them under oath, under penalty of perjury, but that's what they would say.

All of those provisions do take time and money to administer. They really don't really help you most of the time in investment decisions for the same reason that I mentioned on the R&E credit because basically nobody's ever sure whether they're going to be there.

You're making a decision. You know what the tax rate's going to be. You don't know what this other stuff is going to be. So it really doesn't, in most cases, influence you.

A very significant simplification by getting rid of all those. On the international side, I think, you know, it's always going to be complicated.

But under the simplified income tax, and Rosanne was instrumental in designing these provisions, you know, it really basically says we're not getting any revenue anyway from the global income reach. We're just not getting—in fact we may be getting negative revenue because, well, you can manipulate the tax credit that you're using to shelter domestic income. So get rid of it, forget about it. Just tax domestic income, permanently exempt foreign income, and the tax credit system becomes tremendously simpler, without actually losing any revenue.

Depreciation. A simpler system with only four categories of depreciation. For small businesses, those that do depreciate, for example, buildings or the medium-size businesses, it's really incredible simple. There's just four categories. Almost all the assets are going to fall into one category with just a single account that you can use, and a 30 percent declining balance, and similarly for the other schedules.

And for the larger businesses, you would still keep the asset records but you have only four categories and you get less need to argue about which asset goes into which category.

On the compliance—and I'm just going to go through these very quickly—there are some very, I think, important provisions that would help on the compliance side here, to make sure that people actually pay, you know, what is on the books, and would aid in that process.

The whole simplification of the family and work credit provisions, by itself would make a difference because there's just a lot of wasted resources, basically, trying to interpret rules about how these things work now and they would be incredibly simpler under the current system.

For small businesses, and we know that small businesses do have—there is a significant compliance problem with some small businesses, which is actually very unfair to the majority of small businesses cause they're paying—they're at a competitive disadvantage for the people who are not complying.

In addition to the simplification which eliminate a lot of argument about potential technical issues, which are basically a waste of time in my opinion, there are two reporting provisions here that I think would be extremely important, namely, the requirement that there be a separate bank account. Most people have a separate bank account anyway. But a separate bank account with some summary reporting to the

Small Business and to the IRS at the end of the year, and also the credit card, you know, so much business now goes through plastic, that credit card companies would report again to the taxpayer as well as to the IRS, a summary of payments through those businesses.

It's not a foolproof system but I can tell you, it would be a big advantage because, right now, all you have is the information that's on the tax return, and, you know, so you could look at deductions but you don't have any information about what's not on the tax return.

Now you would have some information that would at least point in that direction.

I think on the charitable contribution side there were $17 billion of overstated charitable contributions. Most of those fell into two categories, people just putting them on, that didn't exist, and secondly, overvaluing property that's other than cash, and there are some provisions which Rosanne mentioned there, for reporting, which would not be burdensome.

They would only be limited to the larger value items.

The international provisions. There's always going to be difficulty on transfer prices and things of this kind for international business but nevertheless, going to the territorial system would at least greatly simplify the whole tax credit system and, frankly, would eliminate some of the gamesmanship that could go on.

Conforming the tax rules for all legal forms of business, for large business, is both a simplification, a very significant simplification but also a compliance issue, because if you look at most of the tax shelters, or a lot of the tax shelters that were marketed and were proposed, they involved the use of the partnership form, you know, to move income and losses around.

Having a simplified system, where every large entity is taxed the same way at the corporate level, would simply things, eliminate for the individual the need to get these complicated K-1s, for example, on your individual returns, and of course is it not a tax increase because they would actually pay a slightly lower corporate rate than individual rate, and if they did distribute dividends, if they were domestic they would be tax-free.

Let's see. Those are I think just some of the things. There's more, I think, on the compliance side. The only other thing I would say is on the politics. You know, I'm not an expert on politics. I think Bill summed it up well. The one thing I would say is if you read the initial commentary in the media, and you know, I'm not complaining about the media but it's just that there's really not a lot of focus on what the substance of any of this is, or even necessarily accurate reporting.

Immediately jumped to the question of who's going to be—you know—Where's the battle going to be, and who's going to be against it?

You know, frankly, it doesn't take a great deal of work or a lot of intelligence to figure out that if, you know, you limit the mortgage deduction, that people that are living off that deduction might be against it. You know.

I mean, how smart is that, and how much information is there reported in that? I think the danger here is that this all becomes a self-fulfilling prophecy because the only thing people hear about is, you know, is whatever this controversy is over one or two provisions.

And that's why I think the people, like you in this audience, have a huge role to play in this, you know, almost really regardless of how exactly how the next steps of the politics play out. I don't know at the present, what the secretary's going to do and the president's going to do.

But as Bill said, you know, we feel like tax reform is something that has to happen at some point or should happen at some point. If it doesn't happen next year, maybe it'll happen the following years, and you folks are the intellectual leaders that can, you know, really report on the substance of this, and recognize, if you look in this book, you'll see in the back that it has a large panel of different kinds of taxpayers, a lot of—one of the more interesting tables in the whole thing, is it's got more than usual, a sample of, you know, various taxpayers in the 25 percent bracket, the median, the 75 percent, top 5 percent, low tax states, high tax states.

What you find out is they're going to all pay about the same way. Even the people in high incomes, in the high tax states. When you net it all out, yeah, they might lose the mortgage deduction, some of it, or they might lose a state tax deduction, but the other aspects, the elimination of the phase-outs, the alternative minimum tax, they end up in the same place, you know, pretty much, very, very close to within a small percentage.

You know, that has never, to my knowledge, been reported in any press story that's come out so far. I really say that you folks have a chance to do a real service by reporting accurately.

I don't mean to say you're going to agree with all—you know, it'd be a miracle, if all of you agreed with every provision, you know, and I'm confident there are improvements that could be made.

But at least to analyze it from a substantive standpoint as opposed to just leaping to the obvious thing, which is what some people won't like it if they lose a particular deduction. How smart do you have to be to figure that out? Let me stop there.

MR. GALE: All right. I see there are no questions so we'll—

[Laughter.]

MR. GALE: We need a mike up front, I think.

First question to Len Berman, and please state your name and affiliation, please keep it short and please be sure you have a question.

MR. BERMAN: I'm Len Berman. I'm Bill Gale's senior research assistant. [Laughter.] That was actually—we did an article once where I was listed that way. I'm co-director of the Tax Policy Center and Bill lets me play with him.

I want to start by saying I really admire what you guys have done, but I also have to say that I agree with the New York Times.

Charles, when you left the Treasury, we were running surpluses, and the new guy couldn't just carry the ball. We immediately started running deficits. And, you know, if you look at the administration's own projections, by 2010 we're running—the tax cuts are $300 billion. That's their estimates; not CBO's.

That's like 10 percent of revenues and your proposal would actually reduce revenues further from that, for good reasons, and that your plan had—I counted at least five different plans to reform the tax system.

I just wonder why there wasn't discussion. I understand you couldn't recommend it, but at least discussion about a plan that would be better suited to the demographic emergency that we know is coming after 2010.

MR. ROSSOTTI: My answer—that wasn't our assignment. I mean, I would claim simply that if you want to raise more revenue for the reasons that you say, you think that's the solution, you know, that's a good debate to have and it's going to go on. But no matter what level of revenue you want, you need a sound system to do it. We don't have a sound system to do it.

So I'm not debating that issue, and, you know, it will be debated. But I don't really see that it's a sound statement to say that you should not fix the system that collects the revenue just because you want more of it. That's my answer.

MR. FRENZEL: I have a similar answer, Len. You saw our charter, and the president asked us to come on a tax panel to do something, and laid out these restrictions, and I guess if we didn't like the restrictions we probably should have declined service on the panel because we couldn't go forward. All of us thought that it was worthwhile to build, or to provide a set of ideas from which tax reform might flow.

So that's why we are where we are. Why did we have a variety of plans, or rather, two instead of one? I guess we felt both of them were worthy of discussion and we were acutely conscious of the fact that other decision makers were going to process these things, and we saw some important elements, and in our plans there are some differences.

In one plan we have no tax on dividends. In another plan, we have a 15 percent tax on dividends. What we were trying to show is that you could leave the burden tables in stasis and still have a variety of ways to simplify the code and make it a little more [inaudible].

So that's all we're trying to do. As we kick the snowball down the hill, we have no idea, knowing whether it's going to get to the bottom or not, and part of that's up to you.

MR. ROSSOTTI: Len, let me just add this. I mean, if you thought, if you believe, if I believe, okay, we absolutely have to have more revenue, you know, I mean we need whatever it is, 10, 15, 20 percent more revenue, I would still say fix the system that collects the tax you have, and then, if you want to add another tax like a VAT, or you simply want to increase the rates to collect more revenue, you've got to at least know what you're doing.

I mean, to be honest with you, if you try to take the current system, just leave it in place and add a VAT on top of that to collect more revenue, you know, which may at some point be something that somebody wants to do, but you did it today with the current tax code the way it is now and with the IRS [the way] it is now, you would have, instead of 140 billion of compliance costs and 300 billion of a tax gap, you would just—all you would do is be increasing that even more, to a more astronomical level.

I mean, the system is in no shape to administer this plus another tax.

So even if I agreed with you a 100 percent, I would still say do this, okay, and get it done, and temporarily suspend or don't suspend, keep debating whether you want more revenue but at least fix the system that collects the revenue you have. That's a practical issue.

MR. CHAPOTON: My name is Buck Chapoton with Brown Advisory. Let me ask, on the savings accounts, I assume those are Roth IRA type savings account, no deduction going in and—

MS. ALTSHULER: Yes.

MR. CHAPOTON: I don't mean—I mean just a Roth approach.

MS. ALTSHULER: Save for family and save for retirement.

MR. FRENZEL: The two individual ones, the save for family and save for retirement are. The safe at work is the 401(k).

MR. CHAPOTON: Right. I'm sorry. I'm dealing with the individual [inaudible]. Well, two questions. When we talk about revenue neutrality, isn't a whole lot of the revenue loss from that type of plan beyond the budget window?

I assume you're talking about a 10 year revenue neutrality?

MR. FRENZEL: There is; yes.

MR. CHAPOTON: So that's one question that sort of worries me. I must say, I like a lot of what I hear, I'm quite impressed with how far-reaching it's been. But that aspect of it bothers me, and isn't that alone, on the individual side, a big move to a consumption tax or consumed income tax? So I guess those two points are related to me.

MR. ROSSOTTI: Well, I think that, you know, we were trying to get some estimates of how much revenue might be lost, you know, in the next ten or twenty years, but, you know, we really couldn't get any numbers on that.

There obviously would be some. But I think it would be also the case that it is a move to allow people to save more, which is one of the things that we hoped would be accomplished by this plan.

MR. CHAPOTON: Really, my point is somebody's got to pay for that and it seems to me we're making we're our children and grandchildren pay for it. I mean, everybody would like a tax system that produces more savings, obviously, but I'd feel better about it if we—I mean, pretty soon we will have no tax at the individual level, basically no tax on savings, and so that somebody's going to have to pay for that and I think it's going to be my granddaughter.

MR. ROSSOTTI: It's not clear how much—I mean, it's not clear whether there would be more revenue lost in the second ten years, how much more, we couldn't get any numbers on that, you know, and even for the first ten years it's pretty tough to—we start getting out ten years, to make these projections.

But I get back to my point. You know, if we could get it revenue neutral for ten years and simplify the system, this won't be the last time we take a look at this, you know, at this tax code.

MR. FRENZEL: Yeah. I feel the same way. What we've told you is going to happen in ten years is pretty ambitious of us, to believe that that's going to come true anyway, and the numbers beyond were not available to us. So we said here's the best we can do for now. What did we say? Between 14,000 and 15,000 amendments since 1987. Probably be twice that many in the next ten years.

If we clean it up well now, we'd get a lot more amendments of course. So we don't know what's out there and they'll need another group like us, only much smarter.

MR. ROSSOTTI: But I think there's an important point that really should be stressed, is that yes, we've got some expanded limits on these plans compared to now, but we also—and this is where the package point comes in. There's a significant amount of revenue that is basically allowed to be deferred, tax-free, between insurance, through insurance plans and executive comp plans. I mean, those are big numbers and it's obviously very limited to a small number of people, and that's part of the package, which is to eliminate that.

And I don't know whether that's, you know, when you get to the second ten years, I mean any time you have provisions that are essentially unlimited provisions, people are going to figure out more ways to make use of those provisions.

So I don't know where we'd be ten years from now, if we kept those provisions in there, allowed people to take advantage of those and essentially put as much money as they want away, tax-free.

You know, whether that would end up losing more revenue, or how much it would lose compared to what we get by having these Roth style IRA plans.

That's why I think it is important to look at this as a package. I would not personally, and I think several of our panelists, would not have supported these savings plans, if it weren't for the package aspect, and that we were going to eliminate these other backdoor methods, notwithstanding the number of participants in these backdoor methods.

MR. GALE: Tom.

MR. : I guess the panel makes a very persuasive case, that in the 19 years since the '86 tax reform act, there's been a lot of tax deform, and I was wondering if the panel considered any institutional changes, that if you were to get one of your proposals enacted, that the same thing would not happen, starting in year one.

MR. FRENZEL: We, or I personally believe that it will happen. People don't run for Congress on nothing. They run on something, and it's usually to help their friends in some way or another, or do good things for the republic, and those translate into lots and lots of tax changes.

I felt it was a little bit above our pay grade to try to bulletproof a tax system against amendments in the future, and in fact not even any Congress can bind itself against future action. I didn't think this was quite worthy of the status of a constitutional amendment, so I would much rather see us taking on tax reform on a decennial basis or something in the future. But I think the point you make is right—there'll be endless amendments.

MR. GALE: Jason and then Mike.

MR. FURMAN: Jason Furman, Center on Budget and Policy Priorities, NYU. One question we asked a lot in the Social Security debate was the cost of doing nothing versus the cost of the president's plan.

In taxes, if we did nothing, we'd have higher tax revenues a couple years from now, but we'd have, I think, probably a much less simple, much less efficient tax code than what you have. Political realities are I can't predict whether tax cuts should be extended but just taking current law, they wouldn't be extended at all, political reality is my guess is some would be extended, some wouldn't.

So the question is why should I think that the economic benefits of your proposals, in terms of simplification, compliance, reducing some distortions, outweigh the economic costs of passing a tax law, should increase the deficit? And one other small note.

The one percent number you use, I think it's a little bit misleading. If you do an apples-to-apples comparison of administration to administration, where there were not the tax cuts, it's 4 percent. Or CBO, with and without, it's 4 percent. It's only when you sort a crosswalk the two that you get one percent, and four percent is, in our world, a really, really big number. I mean, it's larger than the Social Security deficit that we spent a whole year talking about. So I wouldn't minimize that there's difference between these baselines.

MR. FRENZEL: Say the question again, would you.

MR. FURMAN: The question is why should I think that these tax reforms—even if I grant that they're simpler and more efficient than the current system, are better than doing nothing, where doing nothing means having a higher level of tax revenues but collecting them less efficiently.

MR. FRENZEL: Do you think that's what it means? Do you think doing nothing means more tax revenue?

MR. FURMAN: That's what the law that's—the question is why is your tax reform better than the law that's on the books today.

[Simultaneous conversation.]

MR. FURMAN: The law that's on the books—this isn't the 1980's. The 1980's, revenue neutrality had an unambiguous meaning. Today it doesn't. It has a controversial meaning and the panel took one interpretation of revenue neutrality. If you followed the law on the tax books—we didn't pass another tax plan for the rest of time—tax revenues would go up.

MR. ROSSOTTI: They'd go up I guess because you're assuming that 50 million people would pay the AMT or something; you know.

MR. GALE: He's talking about the expiration of the Bush tax cuts. The question is if we were to enact one of the panel's proposals, that would be doing two things. One is accepting a new current law baseline that incorporates the Bush tax cuts that have already been enacted and the ones that have been proposed, like [inaudible] hadn't been enacted, and then changing to your—

MR. ROSSOTTI: But it also has the assumption that you're going to collect 1.3 trillion.

MR. GALE: No, I understand that, but Jason's question is why we should think that the combination of those two would be economically—

MR. ROSSOTTI: My answer is that, you know, frankly, if you want to take this framework and adjust the rates, so you collect 4 percent more, you know, you can do that in a flash, okay, I mean, if that's what you think. It's a different debate, it's a question of—I mean, the question is because you want to endlessly debate whether you should have 4 percent, plus or minus revenue, should you leave a mess of a tax system in place, because that's more important, that 4 percent.

My answer is if you think you should get 4 percent more revenue, fine. Pass this plan and adjust the rates to get 4 percent more revenue, which you can do without even, you know, thinking about it twice. That's a political debate you can come up with.

[Simultaneous conversation.]

MR. FRENZEL: [inaudible], you know, if we didn't think it was worth doing, we wouldn't have accepted the charge. The charge included the president's baseline. We tried to live with it the best way we could and produce the best plan that we could.

MR. FURMAN: It's obviously, it's going to be politically difficult to extend all the tax cuts, so why don't we wait till 2011, see where everything settles and then do your reform, locking in the 2011—

[Simultaneous conversation.]

MR. FRENZEL: [inaudible] if you employ a tax commission composed of you and me and a couple a friends in here, and I suspect not a lotta people would pay attention.

MR. GALE: Maya.

MS. MacGUINEAS: Thank you. Maya MacGuineas, New America Foundation. First, I'd just like to compliment you on a report which I think has a lot of great ideas in it. My question is really about the $300 billion tax gap. Are there estimates—this may be in the report—I failed the first test of actually being able to download the report, so I am not finished reading it. But—

MR. GALE: The Tax Policy Center Web site has the report.

MS. MacGUINEAS: I finally got it. I'm just a little behind. But are there estimates of what the tax gap would be under the two proposals? And I was wondering, assuming that there are not, if you could pull out the provisions, just talk a little bit about the provisions that would be best at decreasing the tax gap, because I think that's an interesting part.

MR. : I went through, I don't think I ought to repeat them, I went through a list of about six or seven items in my remarks. But I think, you know, the reason that there's no estimate in there is it's really tough to make estimates. You know, it's hard enough to make estimates of what it is now, how much it would change.

So we didn't have the resources to do that. I could just tell you, from experience, that they would materially provide an opportunity to reduce that tax cut.

Now I will say this. Okay. Just changing the tax code by itself is a necessary step and it would help, but if you don't also do some things to provide some resources for the IRS to modernize its systems and to increase some of its compliance staff, you know, you really won't get the impact that you need.

I mean, just the tax code itself will make a difference, but mostly what it does is it provides an opportunity to address the tax gap. It doesn't necessarily close it all by itself.

MR. GALE [?]: Let me follow up on that real quick. Why didn't the proposal recommend more resources for IFS enforcement?

And just between you and me, we won't tell anyone—how much would the tax gap fall?

[Laughter.]

MR. ROSSOTTI: Well, we did call attention to the tax gap but, again, our assignment was to deal with the tax code, not with IRS resources. I think there are some very important things that would help on the compliance side, even with the resources they have now. You know, at the end of my term, I wrote a report that some of you may have seen, that dealt with what could be done about the tax gap, you know, and how much it would cost in terms of additional IRS resources, which are very modest, and of course that was before we had this tax reform.

So I'm not going to give you exact number, but I could tell you, you could make a material dent—actually, I would say probably it would be more important to get more of a dent than what the difference is between these policy baselines.

MR. FRENZEL: Well, in the 1980's, we relentlessly gave the IRS more money and then we asked, as a result, we added a great deal more revenue that we asked "Buck" Chapoton to collect for us, and he would rush out and hire a whole bunch of sociology majors from Texas A&M and then we would say, How come we didn't get all that money in we planned to get in?

[Laughter.]

MR. FRENZEL: So if there are estimators out there who believe that they could tell you what a given amount of money devoted to the IRS will develop in terms of extra revenue, I got to tell you, that may be the guy that designed the levee in New Orleans.

[Laughter.]

MR. GALE: Larry, in the back.

MR. HAAS: Hi. I'm Larry Haas from MS&L. I have a question about capital gains. I remember the discussion, in '86. Capital gains differential and getting rid of it and how central that was to fairness and simplicity. People shouldn't be shifting income in inappropriate ways, to kind of get advantage of a lower rate, and also it's just not fair that you earn income a certain way and you get one rate, you earn income in a certain way, you get a different rate.

Even if you concede the point that there's some savings incentive that's very valuable, something I'm skeptical of—but even if you concede that point, with the rates so much lower, even today, than they were before 1986, why is a capital gains differential, which you're proposing, worth the cost in simplicity and fairness?

MR. ROSSOTTI: Well, let me just make sure you understand what the proposal is, because it's a little more—first of all, the capital gains exclusion applies only to gains on corporate stock where there's tax paid at the corporate level.

So a lot of the gains you're talking about, all other kinds of property would have the same rates of tax as ordinary income. So the only place there's a preference, an exclusion, is on gains from sale of corporate stock where there is a corporate tax paid at the corporate level.

MR. HAAS: It isn't conditional, though, on the corporation actually paying tax. Right?

MR. ROSSOTTI: Well, no, it's not conditional on the corporation paying tax, but if you understand what we have also done in the—this is why it's a package—

Mr. HOSS: Right.

MR. ROSSOTTI: On the corporate side, we've really eliminated, you know, a lot of the things that could be used ordinarily, you know, under today's schemes, whether they'll get through or not, you know, Bill mentioned—but the cleaning up of the tax base would eliminate, really, a lot of the vehicles that are currently used to, you know, pay very low rates of tax at the corporate level.

As far as simplicity, it's the essence of simplicity. If you get a gain on corporate stock, you take 25 percent of it and put it on your income, and that's all there is to it. It's much simpler than today's system that has multiple rates and much—I mean, for all gains, except corporate stock, there is no difference, just like '86, and for corporate stock you just take 25 percent of the gain and put it in as income, and, you know, there's nothing really complicated about that.

MR. HAAS: Could you just address, then, the question of fairness, which is a carve-out for a certain type of a gain as opposed to the way people, you know, earn income in other ways.

MR. ROSSOTTI: Well, the point is that the—you can argue with it, but the point is there is a tax. The tax is at the corporate level, you know, and it's paid at the entity level as opposed to the individual level. That's all. I mean, it's not that it's not paid. I think the other point is take a look at the distribution tables. You can go to the top one percent of taxpayers, under this plan, who have a substantial amount of capital gains income, and they're actually paying slightly more tax under this proposal than they are under the current system.

MR. FRENZEL: We were enthusiastic about investment income, savings, paying off capital, and my guess is that if we hadn't had so much of a burden of alternate minimum tax, we would have whacked away at it a good deal more than we did.

And yeah, is there a bias in there towards saving—you bet.

Now other forms of appreciation are also sheltered. For instance, I suppose the most commonly appreciated asset is a person's home. We preserved the $500,000 exemption and added another hundred to it, and then indexed that. So we think we're protecting the average American's most important asset that is likely to appreciate. We didn't fool with artworks and so forth; beyond our—

MR. ROSSOTTI: Just to go to this, if you look at page 137 of the report, just as an example, that shows the distribution of the federal income tax burden under the simplified income tax and under the current law, for the top one percent of taxpayers, which is people with over $400,000 of income, and which have a substantial percentage of capital gains, they would actually increase their share of the tax from 33.9 percent of 37.3 percent.

Now how can that we, you know, because when you add up everything that goes into it, including the rates, the capital gains rate on nonstock property and everything else, that's what it is.

MR. GALE: All right. And if you recall, the tax reform panel report was originally scheduled for July 31st, it got delayed and then it got delayed again. So in the spirit of tax reform, we will delay the start of the third panel this morning and take a few more questions here. I've got a question here, then Howard, and then back there.

MS. BATES: Jenny Bates from the British embassy. I'd like to ask a question about the international component of your proposals.

If I've understood correctly, the movement to territorial would apply under both the plans that you've put forward. I'd be interested in your thinking behind that, at least a little bit more, how you got to that part of the proposal, and in particular, how it interacts with other elements of the corporate tax side, cause I think if I understood what you were saying Rosanne, what looks like potentially quite a significant tax cut, on the face of it, for multinational corporations, might not actually prove to be that, given how interactive some of the other bits of your proposal.

But I'd be interested in the thinking behind and how it interacts with the rest of the plan.

MS. ALTSHULER: I'll let you answer and I'll follow up.

MR. ROSSOTTI: Okay. I think that what we really concluded was that while we supposedly have a worldwide tax system in the U.S., it really doesn't work. I mean, it just doesn't work. I mean, there are so many ways that you can use tax planning to avoid paying income earnings. In fact it actually may work in reverse, this is really a deceptive point, but where, you know, the crediting system can actually be used to actually shelter U.S. income.

So essentially we went to a system that, you know, is more like what you see is what you get, where, you know, you just exempt dividends from foreign operations completely, you don't have any foreign tax credits, then, against that, except for mobile income, and, you know, you have some expense allocation rules and you end up with, you know, really about the same revenue with a lot less complications.

Rosanne.

MS. ALTSHULER: I think Charles has said it. It's an incredibly complicated part of the law. We collect very little revenue. The multinational are very good at generating negative effective tax rates by deducting expenses in the United States and then having, through the crediting—through the foreign tax credit, they're able to bring that money back at a zero percent rate.

So I'm not saying that every multinational is in this position and that every multinational will be better off. But there are negative effective tax rates out there and one of the points that Charles made, repeatedly, is that there's an unfairness, that you have different corporations of different size able to generate, you know, more a favorable rate for themselves.

I don't know if you want to follow up on that, Charles.

MR. ROSSOTTI: Well, I mean, if you actually look, you know, and for public corporations, you can look in the 10Ks and see what the actual tax rates are, you know, that are paid, both, you know, on U.S. earned income. They're wildly variable, wildly variable, you know, and largely, you know, in significant part, because of how the fund income works and how the tax crediting system works as well as some of the other tax preferences in the code.

So this is just a way that, you know, it's a perfect example of really making things more transparent. I mean, you know, recognizing reality. We're not actually taxing foreign income, you know, and having a complicated provision on the books that doesn't really work is not a good idea.

MR. FRENZEL: We recognized the EU criticisms of our tax system which benefits themselves, and the Fisk [inaudible] and EPI rulings of the WTO. So we thought we'd give your lawyers a chance to work on some different kinds of problems.

MS. ALTSHULER: I think we also think it's a great starting point for a debate, starting with the territorial. There's going to be a lot of debate about the treatment of royalties, the treatment of expense allocations, and this is really a starting point. Do we want to subsidize multinationals that are heavily involved in R&D? And maybe as a country we do. But the starting point is recognizing that that's exactly what's going on, implicitly, in the code.

On the growth and investment plan, I think that we decided that a destination-based system is the best in terms of—is better than an origin-based system in terms of implementation, and to do that, you end up with what is essentially a territorial, what you call a territorial system.

Remember that at the business level, it is a consumption tax, so you need to kind of approach the questions from that perspective. It is a consumption tax and then you ask yourself, do you want to be destination based? Origin-based? What will be the treatment of international cross-border transactions?

MR. GALE: Howard.

MR. GLICKMAN: I'm Howard Glickman with Business Week. On the consumption tax, you almost proposed an x tax, but in the end I guess decided not to, and I wonder if you could talk a little bit about why you decided to impose some tax at the individual level on capital gains and dividends.

MR. FRENZEL: You've got sort of the wrong people here. Because of the open meeting law, which we were obliged to follow, we had to work in groups of less than a quorum, and Charles and I were involved in plan one, and we were not involved in plan two, where they made that suggestion. But I think if you—

MR. : We tried to get good people but the only people—

[Laughter.]

MR. FRENZEL: When you're talking to the junior varsity, you get—

[Laughter.]

MR. FRENZEL: But if you'll look at the report, you will see that they first studied what might be a complete consumption tax. What they wound up with were some skewed burden tables, that they were pretty sure couldn't possibly pass muster with any kind of observers, but particularly people in the Congress who were concerned about fairness, and therefore they added back in the taxes and, you know, we, I must say our poor staff was at work night and day, endlessly tweaking break points, and where you change the rates, what levels of income and so on, to get the thing to come out even, and that was one of the things that had to be done, was to do that, and so we don't call it a consumption tax, or an x tax. It's a broken investment tax, I think would be [inaudible].

MR. GALE: That's a really bad name, by the way. If an income tax taxes income, what is [inaudible]?

[Laughter.]

MR. FRENZEL: We couldn't afford [inaudible].

[Laughter.]

MR. KLEIN: Bob Klein from Ernst & Young. My question really follows up from the question that was just asked. Maybe Rosanne could comment on it. Being a former research director in Michigan, and having experience with the single business tax, I think I recognize a value-added tax framework when I see one, but the report's very careful and the panel's been very careful today in avoiding calling what is being proposed, its second version, as being a value-added tax. It's very close to a value-added tax. But the statement was made, is that the U.S. isn't quite ready yet to discuss the value-added tax.

Any thoughts about why we're ready to talk about the second option but not ready to talk about value-added taxes? I think your answer about the progressivity may be a little bit of insight into the issue.

But any other comments about why we're not quite ready to deal with the VAT directly, and related to that, will the WTO view the new system as a VAT system from an international perspective?

MR. FRENZEL: I'll start and Charles can come at it later. This was one of the situations where we have a political ear and a political eye looking around as well as a tax ear and eye, and the American public has not been terribly friendly to a multiple tax system, and the thought sort a sends shivers through the body politick who think that you're going to have an income tax and a VAT, which would enable policy makers to ratchet both of them up following each other, and there's a real paranoia out there about that.

The second point is one that Charles made occasionally too, and that is that you suddenly lay on the IRS a double burden of administering the crummy old income tax, plus a new crummy old VAT tax, and how they were going to be able to do that.

We were not quite sure and neither were they, and I think it's fair to say that the Treasury always made a terrible face whenever we suggested that that was the direction we were going.

Those are some of the reasons. Charles may have some more.

MR. ROSSOTTI: Well, I think basically, you know, again, as Bill said, we weren't as intimate, either of us, involved in the second panel. I mean, the idea was to present options to the president and one of them, by direction, was an income tax. We came up with the simplified income tax. The other flavor of tax is something that's more like a pure consumption tax, and, you know, that panel considered all the different ways of doing that, recognizing it also had to be progressive, because that was also under the directions.

So that's where you came out. I mean, that's kind of the thinking process.

MS. ALTSHULER: There's a very nice analysis of adding a VAT to the U.S. system in the report, I believe that's in chapter eight, and what the VAT does is it takes the simplified income tax that these panelists worked so hard on, and adds a very well-thought-out VAT on top of that, and the Treasury Department did a lot of work scoring that for us.

So I think that that chapter could be a very important part of the debate, going forward, and I, for one, am glad that that chapter is in the book.

MR. FRENZEL: Incidentally, if you read that chapter carefully, you will see that we suggested that the national sales tax, we really didn't want for now. It doesn't mean that some time in the future it may not rise from the grave. The VAP, on the other hand, we used the other term, "not quite ready" or whatever. But, yeah, this is something that might be used. Lots of people have suggested it eventually as an add-on tax to take care of Len's [?] problem and some of these other questions. Maybe people will want to do that.

We sort a left that one half-alive.

MR. ROSSOTTI: Basically, I think that if you were of the opinion, which I know some people are, many people are, look, you know, we're just not raising enough revenue, whichever baseline it is, plus or minus 4 percent, just not enough, you know, to fund what we think in the government. It's a reasonable conclusion you can come to.

You know, it's fine to talk about it theoretically. You can't escape the fact that if you want a certain amount of revenue, you actually have to collect it, and people have to pay it.

You know, it's not just a matter of passing, you know, policies. You have to actually do it.

We are not administering and collecting the taxes we have on the books today at an acceptable level and it's going to get worse if you just do nothing.

The compliance costs and the price gap are huge. The rate of change in the tax code, the complexity adds to that, IRS resources are a problem, lack of modern computer systems are a problem.

If you really felt that you wanted more revenue, what I would do is I would do something like the simplified income tax. I'd provide a little bit more resources, including the compliance features. I would provide a little bit more resources, which I describe in my paper, it's not part of this report, you know, and you would do two things.

One is you would collect more revenue, I can't say exactly how much, but you would collect more revenue at a more efficient level, and you would provide, if you needed it, a foundation to collect even more revenue by doing one of two things, either by raising some of the rates and, you know, if you start at a 33 percent rate level and you want to go up, it's a lot easier, because you're collecting a certain—it's a lot easier to go up from that level than it is from if you start at a higher level.

Or if you really felt that you needed to do something more, you could institute a VAT, which would be the other option, as Bill said, on top of the income tax, because that is the combination that most of the European countries have, but you would have at least a sound system, you know, to administer, and that's what I would do, if I thought that we needed more revenue, which is a decision that could be made politically at some point.

MR. GALE: All right. Thank you on behalf of all of us. I'd like to thank all three of you, literally, for your service to the country and especially for your appearance and comments here this morning. It's been fascinating. Thank you.

[Applause.]

MR. GALE: We're going to move around a bit and continue with the third set.

[Pause.]

MR. : We have a distinguished panel to provide commentary on tax reform.

Gene Steuerle is well-known as the father of tax reform. It's a little known fact that as a primary school student, he actually outlined the Internal Revenue code of 1954.

And Bill Gale and Kevin Hassett are critics at large of the tax system. Kevin's skyline tax rate system, that made the prescient observation that affected marginal tax rates, looked exactly like the New York City skyline before September 11th. That chart is actually in the tax reform panel's report, although without attribution to Kevin, and Bill Gale had an article in 1997, which is in your packet, that basically had all of the major reform proposals in it, and it just took eight years for the president to call a panel and for the panel to make the recommendations.

So with that, Bill or Kevin.

MR. GALE: Kevin.

MR. HASSETT: Oh, I get to go first.

MR. : Yeah, Kevin, you go first.

MR. HASSETT: Okay. Well, thank you very much. I think as you start to get older, as say, Bill is, that you go to graduations, and one of the neat emotional experiences of going to a graduation is you look out and you see like the Little League coach and the person who taught the kid in choir, and all that kind a stuff, and you se this great kid in front of you and the people that all collectively contributed to that kid's graduation and the kid becoming an adult.

And I have the same kind of feeling today, because I look out and I see all these people who testified before the panel, and people who taught us very important things, like Gene's work on how to do housing right, and so on, that had a big impact on the panel.

And so for me I actually feel—it's a little bit of an emotional time, because when I look at what the panel did, you know, I think that they really did make an effort to identify the things that everybody who looks at the literature and things about things ought to concede are true, and then try to build a system around that.

MR.   : It really makes you want to cry, doesn't it?

[Laughter.]

MR. HASSETT: I love you, man!

But they also did more than that, and they really made, I think, an accomplishment that reflects the contributions of the panelists that just spoke, that they went from the academic theories and evidence about what works to practical solutions that seem to me to have been, at times, really quite inspired.

And so I'd like to spend my brief time talking a little bit in more detail about one of them that I thought was particular clever, that reflects, you know, I think the genius of the panel that was assembled, and that's the way they treated housing.

And then after that, what I'd like to do—we were talking about the thing being dead. I think Novak wrote that in the paper this morning.

And I'd like to talk a little bit about the scenario where it actually is not dead. So could it be that this is what's going to happen, and then after that, I'll hand it off here to Bill, I guess you're next, or Len. Gene. Sooner or later I'll get it right; there's only four of us up here.

Okay. So let's talk about housing. I've been spending a lot of time sort of getting ready maybe to do an academic paper on taxation in the housing market and one of the things that motivated this was both the knowledge that the panel was going to make a report that likely was going to do something to housing, and the observation that Joe Stieglitz and I were at his event at Swarthmore College last weekend, and Joe said something like, well, we all agree you shouldn't tax housing but do we really want to—or subsidize housing, but do we really want to do that right at the top of a real estate bubble, take it away. You know, isn't that gonna cause a crash and isn't there a big financial risk from that?

And there's some disagreement in the literature about whether, if you take away the mortgage interest deduction, it has a big effect on housing prices. But after looking at the literature and thinking about it very carefully over the last few months, I became convinced—and this is before I saw the panel report—that the high-end estimates about what the effect on prices ought to be were probably the ones that were correct, and that the papers that were saying that there wasn't going to be a big effect were likely incorrect.

And there's actually kind of a very simple intuition for why, in the end, I think that's true, that allows you to think about what the scale of the effect is going to be, and intuition goes like this. The thing about the housing market is that there's new housing construction that responds to prices, and the new housing construction ought to drive the price of structures down, if there's a big increase in supply, and if the new housing construction slows down, then it ought to have an effect of increasing the prices of old houses, say, in the future.

And so for structures, you could expect that if you tinker with the tax code, that maybe what would happen would be the home builders would be really upset but the prices wouldn't move that much.

And that argument has been made, but the problem is that it doesn't really apply to land, and so for land, you know, there's a little bit of, we can, you know, start having people who work in D.C., live in Leesburg or something, but mostly land is in fixed supply, and so you would expect to see pretty much capitalization into the price of land, of the mortgage interest deduction, and land's share of the typical residential property is maybe 40 percent. And so if you think that maybe counting the state contribution, there's like a 40 percent net benefit for a wealthy person who buys a house for the mortgage interest deduction, then, you know, multiply the two, maybe you'll get about a 16 percent reduction in prices. That's what you ought to expect, even if you're a real optimist about like how bad the homebuilders are gonna suffer, and so that those prices will adjust a lot.

And in the end, there were some arguments about why you shouldn't see that effect. But I didn't think that they really held water, once you really analyzed them closely.

But then comes the report, and the report noticed something very interesting, that the numbers really—I sort of intuited them but never quite knew how severe they were. But one of the numbers that I found most interesting in the report was that 54 percent of people who pay interest on a mortgage actually get some tax benefit. You know, it's about half.

And this leads to something else that you learn, if you read the literature on mortgage interest deduction, which is the mortgage interest deduction, today, has no effect on home ownership.

And so, you know, there's been a lot of talk in the Republican Party about an ownership society and how we need to subsidize ownership, and because people own a home, there are sociologists who talk about the positive effects on that, there's fewer divorces and things like that.

So you can say that it's probably a good idea to have people own homes but what we got now doesn't do that and the reason is that it's a deduction if you don't itemize, then you'll get the benefit, and so what they did was they moved it to being a credit.

And if you move it to being a credit, then basically what you do is you reduce the subsidy for rich people because the credit's I think 15 percent, if I remember right, so instead of getting, say, the 35 or 40 percent, if you add the state tax you're getting 15 percent, and it's capped, so that you no longer are creating a big tax incentive for McMansions.

But then there's the 50 percent of people that weren't getting anything before, that suddenly, they actually have a reduction in their user cost of a home.

And one of the interesting things that you see in the literature is that this latter point could actually have a big effect on prices, because—Manke [ph] was the first to write a paper on this, but they found that you could really do a good job predicting home prices, home price movements, if you knew how many new entrants into home ownership there were in a given year.

And so if you had a big demographic group of people who were, say, 30 years old, and at the age where they're first going to buy a home, then that would really drive up prices because you get kind of like a ripple effect, where the new entry comes and then they buy the house, so maybe big up the price for the $100,000 home, and that person gets 110, but then they want to buy a $150,000 home, and it goes all the way up.

And so you get pretty big price effects from getting a big wave of new entrants. So I'd have to say that I have no idea what would happen to prices if we switched to the treatment that you guys have proposed because there'd be so many things working in different directions.

And then there's also the five year grandfathering, and so on.

So I think that if we really wanted to get rid of the subsidy for home ownership, which is one of the big distortions in the tax code, sometimes the estimates from the models of the benefits of tax reform really get a lot of their "bang for the buck" out of removing the subsidy to home ownership, especially in Bill Jorgensen's [ph] models, where "bang" is an understatement for what kind of power you get from this.

And then if you combine the fact that they're doing that, and then they also have integration on the corporate side, which is taking us from this world where we used to have, perhaps, too high a tax on corporate capital and too low a tax on residential capital, well, then by lowering it here and reducing the subsidy here, then you've really gone a long way towards leveling the playing field and basically just increasing the allocational efficiency of the economy.

Net, I would guess that you'd still have to get a reduction in housing prices out of this proposal and the intuition is just that suppose we didn't change housing at all but did go to expensing at the corporate level. Well, that's going to draw capital into the corporate sector and away from housing anyway.

And that's sort of why we're doing it. so it's still got to be going down but I don't think it's going to be anything near the scale of what it would have been, if you just had a wholesale repeal, because all these new people who are suddenly getting a subsidy where they didn't, and the other neat thing is—and this is a distributional justice kind of thing—it's got to have a much more powerful effect on home ownership than the current system, because at the margin, the people who really might not have enough money to buy a home, it might be a "big deal" for them to get the credit.

So the reason I want to talk about it in detail is that I think if you look at the report, you see a whole bunch of things that are that well thought out, and so I'd actually have to say that I have a hard time justifying opposition to the collective thing, and I would imagine that most people would, that you could find this thing or that thing that you don't like.

But really, it's so much better than where we are now, that it would seem like it'd be irresponsible, I think, to oppose it as a collective.

So how might it actually become law, and, say, next year? What's the scenario? I don't know what the odds are but you could combine the fact that the alternative minimum tax is disproportionately harming people in democratic states because of the state and local factor, and so hopefully there are Democrats who want to do something about the AMT, with the fact that I think there's going to be a very strong intellectual support for what the panel's done, and great respect for the work that they've accomplished.

And if you add to the fact that there's one more thing on the table that Jason pointed out, and that it'd be very, very easy to take this plan and tinker with it a little so that it's revenue neutral, relative to current law, and still come out way ahead from current law.

And so it seems like there are enough chips on the table, where if we're in good-faith bargaining on Capitol Hill, we could find something where you could get 80 votes in the Senate, because if the Republicans were willing to give a little bit on having current law, maybe let current law be the baseline rather than tax cuts extended, and then the Democrats, you know, basically would be given some on the way capital tax maybe is treated in this thing, that you could see that this is really where the sweet spot should be for tax reform.

I think that '86 is the current historical highlight of the tax reform agenda but this panel starts off something that could be significantly better than '86, and I'd just like to thank you guys for accomplishing that.

I don't think that anyone could have expected that you would have been able to and I hope that the good scenario ends up being, you know, history, after next year.

MR. : Now the brains behind the tax reform act of '86, Gene Steuerle.

MR. STEUERLE: I wouldn't say that, especially with people like "Buck" Chapoton and other people sitting in the room.

Let's imagine that we had a somewhat dysfunctional family and the kids didn't study at home and the meals were basically made out of fat and sugar, and the grass is about a foot high in the yard.

The house is never cleaned and so everybody in the house gets sick all the time. And at the same time, let's also suppose this family doesn't earn enough to pay all its bills. It spends a lot of money and doesn't earn very much.

And so we set up a commission to tackle this family's problems, and the commission proposes that the kids study, the meals be made nutritious, the grass be cut and the house be cleaned. It doesn't really say anything about the inadequate work efforts or the overspending of the parents.

Well, then the question is are we happy with what this commission suggested for the family? I'd suggest, for the most part, I agree with Bill Frenzel. I think we should be happy with what it did, even though we're fair to comment on what it did not do. I think both those—

[Start tape 2A.]

MR. STEUERLE: [continuing] because the things they did suggest that have to be done are things that, indeed, have to be done.

My opinion on this subject, as well as a variety of other functions, is that our government itself is dysfunctional now, but it's not just dysfunctional in the tax system. It's dysfunctional in the Social Security system. It's dysfunctional in the way it treats health care. It's dysfunctional in the way we handle emergencies.

And we've got a lot of problems to solve, and it's somewhat dangerous, I think, to attack too much those people who attempt to solve one or two or five or ten or twenty of these problems because we're not solving a lot of the other ones.

I mean, we have a lot of work to make our government more functional.

I should be clear. By the way, when I say our government's dysfunctional, I don't mean it's dysfunctional on average, and this is always a tough issue to discuss.

You know, the tax system probably does collect revenues, decently, and probably better than most countries, and, you know, Social Security does work in protecting the old, relative to not having a system, but at the margin, for what we're doing with these systems every year, the additional amount we're spending for these systems, the additional amount we're collecting, it's very dysfunctional.

We're not really solving additional problems. We're often creating them. And there are a variety of areas where I think this commission proposed thing that are good and that we need to think of as policies in and of themselves.

Kevin discussed housing policy. I mean, forget about tax reform or forget about any other budget reform. Think about housing policy. Is this a good movement in housing policy?

Mind you, the tax code is the principle component of our housing policy as a nation, and so this reform commission proposed a major change in housing policy.

I would say yes, it did. By contrast, the reform they propose with what the press picks up—the reform they propose, almost unambiguously, encourages more home ownership. It doesn't encourage necessarily greater values of homes to be purchased, but it almost unambiguously encourages more home ownership and makes that more neutral. That's not a headline we pick up.

Or let's take the charities. I have charities calling me on the phone all the time now talking about the charitable provision, and do you know what they're fighting over? They're saying, well you know, we're not sure we can accept a one percent floor. We think it has to be one-half of one percent.

And I say to them, have you read the literature? The literature shows that the floor almost causes no negative effect on charitable contributions. The extension of the charitable deduction to non itemizers, almost unambiguously increases charitable contributions. Here you have a proposal that almost unambiguously increases charitable giving. Why do you want to fight over such small items?

And on top of that—and this is just something that bothers me—it seems to me that our different sectors of the economy, if we're professionals, we have some obligations, at times, to go beyond our narrow special interest. For charities to say they don't care about whether this system is administrable or not—I'd love to get, by the way, from any of you who have it, these numbers on noncompliance, because I'm dealing with people on the Hill right now on it.

You know, as to the level of noncompliance we have in the current system. See, that's not an issue for charities. The noncompliants are people who cheat with overvaluation of gifts or claim cash contributions that IRS can't administer.

Say that's not an issue for the charitable sector, to me, is sort of a denial of their fundamental professional obligations. I'd even extend that to the home builders.

The home builders should at least say this expands home building even though we're worried a little—maybe we're worried a little bit about building at the top.

Or let's go on to some, a couple other areas. Let's mention health policy. I mean, if there's anything that is extraordinary bad in the current in the system, it's this open-ended subsidy for health insurance. At the margin, for the additional amount we're spending, we're increasing the number of uninsured, and I think, I'm not sure, I think that may be behind the number that Rosanne just had as a little footnote in one of her slides, said that the proposal would increase the number of insured people, because if you cap the subsidy, it reduces some the price growth in health care.

Some of that cost growing is leading a lot of small employers and low-income people not to buy health insurance. So here's something that probably unambiguously increases the number of insured people in society as opposed to our current policy, which at the margin, is spending more and more to increase the number of uninsured. It seems to me that's a worthy policy as a matter of health policy.

Forget about what you think about the rest of tax reform or what you think about everything else.

So I very much applaud what the commission has done in a great many of these areas. Now I have two criticisms, and they've really already come up in the questions and answers, so I'm not going to spend a lot of time on them.

Given that I think the government is so dysfunctional at so many areas, and given the partisan nature of the way we're wrangling over even making improvements, that I think most of us would say, at least most of us who are analysts would say almost unambiguously make the world a little better than it would be now.

I think it was probably a mistake for the commission to put forward two proposals. I understand all the academic reasons why you might want to do it.

I think if they have a second proposal, it should have been sort of like the VAT. You know, here's what some people are discussing, we haven't solved all the problems, and I don't think the commission, by the way, solved all the problems on going to a full-blown consumption tax, and if you prefer to do a little bit of self-promotion, if you look at what the tax policy center put out or has done in the last session we had, with a lot of people examining different aspects of going to a full-blown consumption tax, you'll see there are a lot of big compliance issues that remain in that system.

And by the way, I'd also remind you that in a full-blown consumption tax, you still have all the low- and middle-income people in an income tax, because in food stamps and earned income credit, and temporary assistance for needy families, and all these other systems, their income plays out.

So they're still in an income tax system where you've got to measure income and consumption at the same time.

So I think it probably was a mistake to put forward two plans. I think that gives Congress an excuse for saying, hey, we've just got a lot of ideas here, we don't have to have a baseline from which you go.

The way reform I think worked—the reason I think '84 reform was actually partly success, was we set up a baseline. You know, we set up that first draft. We got support from both the left and the right, that this was better than the current system, and it set up a baseline, and by trying to set up two baselines, I think it leads us, a little ambiguous.

And the second criticism I have is with the saving account proposals. I like a lot of the simplifications in the various saving account proposals, but "Buck" Chapoton was entirely right.

There is a huge, huge revenue drain down the road when you allow people to put aside $10,000 each year in each of three different types of accounts, so I guess it adds up to about, at least $30,000 per year per family. It's quickly possible to put aside a few million dollars in these accounts.

And let me give you another just example on what this does in terms of equity.

And the notion that some economists put forward, that a backloaded savings incentive is the same as a frontloaded is basically incorrect, because with the frontloaded system—and this is something David Bradford who advocated an x tax would have argued—the frontloaded system, if you get big gains from the system, the government shares in them, at least at the point at which you consume.

With a backloaded system, the government doesn't share in the gain. So let's compare two people putting money in a Roth IRA. Or $10,000 in Roth IRA type saving account. So you put 10,000 in, you invest and you get 2 percent because you're a modest risk-averse person, or maybe you're just a bad investor.

You get 2 percent a year and you withdraw that money after 40 years. Well, you've got 10,000 in there. You've got about $10,000 of capital income that avoided tax. You've withdrawn $20,000 consumption.

If you're like me and you tell your kids, with whom I try to help finance Roth IRAs, I say take your $10,000, don't touch it, give it to your kids, because Roth IRAs you can go through two generations, as an inheritance, and you get 7 percent real in the stock market. You've got, at the end of 80 years, $2 million. That's just for one $10,000 investment. You've got $2 million that you can withdraw, tax-free, and not have to pay any tax.

So there's enormous equity issues in going to backloaded systems versus frontloaded systems, as well as the fact that a backloaded system really does have enormous revenue cost over the long run. I think the notion that, well, we couldn't figure out the ten or [inaudible] is incorrect. There are just enormous revenue implications to that type system, in addition to all sorts of games you can play.

And finally, when you have both frontloaded and backloaded systems, which the panel proposes, that's very complicated because then every single taxpayer has to go through this debate over which one's better and which one's worse, depending on what their tax rates are going to be in the future versus today and what the current and future Congresses are going to do. It's a very complicated calculation. So for a commission that was promoting simplification, I think that was perhaps it's biggest mistake.

But let me end there. I really think that all in all, that the commission did a marvelous job in a lot of areas. Every time I read some of the details, even little things like giving little interest credits on capital equipment that's expensed, which is enormously important for new businesses, I find little things that they did do with it, I'm very impressed, and I think this should be, especially the first plan they put forward, should be a baseline from which we proceed, dodging some of the errors that I might—or quibbles I might have.

MR. : Thanks, Gene.

Bill.

MR. GALE: All right. Thanks. I want to echo the sentiments, that this is a very creative, thoughtful, serious, substantive report. I really like the idea that they didn't just pull a proposal off the shelf, they really thought about this stuff in creative ways, and came up with kind of different ideas, put them together in interesting ways. There's a lot of emphasis on how the various parts of the tax system relate to each other, that is, they take the system part seriously, so Rosanne's discussion of expensing and denial of interest payments, Charles Rossotti's discussion of combining the tax treatment of dividends with the territorial treatment, with the closing down corporate shelters, that integrated stuff is really central to tax reform, and by emphasizing simplification, by emphasizing the integrated aspect of things, they've done what politicians can't do or are unwilling to do, which is take a step back, focus on the big picture, broaden the scope of the public debate a little bit, and I think the debate would be greatly enhanced if it started from this document, rather than it starting from the usual stuff we hear.

I should also say Kevin and I have been doing tax panels a long time. When the president first announced the idea of a tax reform panel, I said this is a joke, this is a complete waste of time. Kevin said no, no, no, this is serious, this is really important.

I think Kevin is absolutely right on the serious, substantive report.

MR. HASSETT: You've never said that before.

[Laughter.]

MR. GALE: I know. I've never actually said anything nice about tax policy in the Bush administration either; so this is a first.

I don't know if it's going to go forward. I'm not going to talk about the politics, except to say that tax reform is always a long shot but sometimes it happens, and maybe the stars are aligned the right way.

I want to touch on two things that Kevin and Gene said, and then talk about the report itself.

On the mortgage stuff, it's interesting to note that under the simplified income tax proposal, the effective tax rate on housing goes down according to their estimates, and that has to be, I think, the fact that all these non-itemizers are now getting the deduction. So it's quite possible that it does encourage home ownership and I agree with Kevin's comment about the price effects and all that.

I just want to say one more thing about the mortgage deduction. I do not think there should be geographic variation in the deduction. We don't have geographic variation in the capital gains exception for housing, even though all the same arguments would tell you that you should.

You know, the costs of rearing a child or buying health care varies by region. We don't allow regional variation for that. I understand the political reasons why you might put it in there. Two of the commission members are from California. But I don't think there's any economic justification for regional variation in the mortgage credit.

MR. HASSETT: It would also be a lot easier for us to model if you got rid of that.

[Laughter.]

MR. GALE: That's true. On the Roth IRA stuff, I want to echo Gene's comments and just add that it can't be good for the employer-provided pension system to be raising the IRA limit from four thousand to ten thousand for people with income up to 150,000, or something like that, and raising it from zero to ten thousand for people above 150,000. A business owner with a spouse and two kids could shelter 60,000 a year in the two Roth vehicles that are being discussed and as was discussed earlier, a lot of businesses have relatively small revenues. It's not really obvious why that owner would then want to have a pension plan and have to deal with all that.

So that part of the plan I really don't like. It sort of sticks out as a sore thumb. On the other hand, I love the automatic 401(k), the refundable saver's credit. I'd like to suggest that those provisions could be decoupled from the Roth IRA stuff.

All right. Having said that, I like the ideas in the report better than the report itself. All right? And let me just highlight three issues. The growth effects, which are very big in the report relative to economic estimates that are out there, are not really documented very well.

We know there are three models but we don't know much about the models. I'd like to know more about where those growth effects are coming. They're much bigger than the AER article by Altig, Auerbach, et cetera, et cetera.

The distributional effects. I didn't realize this until this morning. But one reason that they look so good is that the baseline has repealed the estate tax in it, which means all the income shifting that can go on when you repeal the estate tax is happening in the baseline.

It also has RSAs and LSAs as Rosanne mentioned, of either, I guess 5000 or 7500; 5000 in the baseline. And it's got the whole set of 2001, 2003 tax cuts made permanent.

We have not done that as a society. But it's not as surprising to me that the proposals are distributionally neutral relative to that as it would be for current law.

But the other issue I want to raise is that the distributional measures that are used are also not the preferred measures. Changes in percentage of taxes paid gives you very misleading numbers when you're looking at people close to zero or people that have negative numbers.

I don't think anyone wants to say a tax cut from 2 to $1 is the same as a tax cut from 200,00 to $100,000, and a tax cut from one to negative one is a tricky thing to think about.

And percent of taxes paid is also not a meaningful measure when the revenue level is changing. Let me give you an example, why. Suppose you take our current system and you abolish it and you just have a system where the richest guy in the country pays one dollar in tax. All right.

If you looked at share of taxes paid in that system, you'd say, whoa! the rich are paying a 100 percent of all taxes. That's way up from the current system. All right. But in fact the rich guy's got the biggest tax cut of anyone in the proposal I just suggested.

So share of taxes paid is a very misleading thing when revenue levels change and the response would be, well, we're revenue-neutral, but A, that's on a 10-year basis, not a year-by-year basis, and B, it's relative to a baseline that doesn't exist.

So I'm concerned about the distributional numbers. I know the Tax Policy Center's going to do more on this, but let me just highlight that. I'm not saying the distribution numbers are wrong. I'm just saying I don't feel comfortable accepting them, given what I know so far.

Finally, let's talk about the revenue neutrality issue. Gene's example, metaphor of the dysfunctional family is not a good one, and I'll tell you why in a second.

And the report is just not good on this. The first bullet of the executive summary says the single most important function of a tax system is to raise revenue. All right. And then the next 290 pages have no revenue numbers in them. All right.

Rosanne said there are dozens of distributional tables. There are no revenue numbers. That's a problem.

The mere fact that they don't want to tell us what the revenue numbers are makes me want to know what the revenue numbers are.

[Laughter.]

MR. GALE: We hear that the revenue and structure are separate issues. Yes, that's true, but if that's the case, then why not start it from current law; okay. Why not replicate current law?

I mean, you could say we're going to design a structure that replaces one percent of GDP in revenues, and you can design this beautiful elegant structure, and say this is a great structure, and everyone can agree it's a great structure.

But if you ask is it a replacement for the current system, the answer is no, you can't fund government with this beautiful elegant structure.

So we need to think about the revenue level. If we're thinking about replacing the existing system, we cannot avoid thinking about the revenue level.

The proposal rightly excoriates the sales tax people because they essentially understate—they have built into their proposal a $7 trillion cut in government spending and that's why the 23 percent sales tax that you hear is nonsense, okay, because it changes spending relative to current law.

Well, the proposal changes taxes relative to current law. So the same criticism applies there. And, for example—well, let me come back to this.

I think that you'd have to raise tax rates by over 20 percent to get the system they proposed, raising the same amount of revenue in 2015 as current law. I can explain that calculation if you want; but let me move on.

One is assuming the tax cuts are permanent is a gigantic assumption. The president's told us Social Security is in crisis. Making the tax cuts permanent costs three times as much as Social Security, fixing Social Security over the next 75 years.

Second, the report notes that there's a change in the revenue profile over the ten year period. It makes it sound like—well, it says the revenue profile is flatter in the proposal than it is in the Bush policy baseline. But if it's revenue neutral, that means it's got to raise more revenue now, or 2006, 2007, and less revenue than the Bush baseline in 2015. That has two concerns.

One is with a Republican Congress where 90 percent of Republicans have signed a no new taxes pledge, actually saying that the proposal raises revenue in the next couple years would be an interesting thing to know, if it's true. I don't know if it's true; but it looks like it is.

But then going out in the future, whatever we thought we were raising in 2015, even under the Bush baseline, we're raising less than that. So it's making the long-term revenue problem even more difficult, and that's before thinking about Roth IRAs, and which are these big backloaded cuts, and it's before thinking about the indexation of the threshold for Social Security.

Now all my information here is from Jason, so correct me if I'm wrong. But currently, the threshold for taxation in Social Security is fixed in nominal terms. The panel would index that. That would cost an enormous amount over the next 75 years and it would make the Social Security and Medicare situations worse.

Now if you're just looking at a 10-year revenue window, that's not an issue. But if you're looking, you know, longer term, it's a very big issue. There are other concerns on the consumption tax side. But I really don't think—well, they haven't addressed the revenue neutrality issue because the numbers just aren't there. I really think the report could have been more coherent and clearer on the revenue side.

Now what Charles Rossotti said is right. We can all bump up the rates to get the revenue back to current law, but doing that would raise, for example, the 33 percent rate to 39.6, which by odd coincidence, is where it was raised in '93, and I don't think the administration wants to go forward with something like that.

So this is a big issue. We're talking about 4 percent. That's not really the right way to look at it. It's about 20 percent of corporate and personal income tax revenues that are at stake here and I like the structure of what was suggested, with the notable exception of the Roth IRAs, but I can't get away from thinking about this as replacing the current system, without having a discussion of do we want to enact a tax cut that's three times as big as a Social Security shortfall and actually bigger than that because of the issues I just mentioned.

MR.   : Thanks. Now we're a little bit over but I'd like, with your indulgence, to maybe take 10 minutes for questions, comments. Questions. No comments. Anybody have a question? It must have been really clear.

MR. GLICKMAN: Howard Glickman, again, with Business Week. There's been a lot of criticism of the Roth type IRAs, and I wonder how important are they to the structure of this new tax system. What if they were just traditional IRAs, with all the other changes?

MR. GALE: Well, it's not just a change from traditional to Roth. It's a vast expansion in the limits for almost everyone, and that creates the sheltering of long-term revenue issues and, you know, very few households are going to be able to contribute to the limit, and the ones that do are extraordinary high income and wealthy households.

I mean, you can basically shovel, like I said, 60,000 a year into these things, and over a decade—for a family of four.

MR.   : Should be 80,000.

MR. GALE: I'm not sure if you can give the retirement contribution for the kids. I think you have to have wage income to actually do the retirement one, but you don't have the family—

MR. : I mean there are other issues we even have in current law which is—again, we have phase-outs. Now this plan only has two phase-outs. But you start having phase-outs on the basis of income. People build up enough income within tax-free accounts, you still need to have reports to government on what that amount is. Maybe you're not going to tax it for income tax purposes, but you'd probably need to, at some point, figure out whether you're—you know, if I've got a couple million dollars in an account, should I qualify for food stamps?

And we say no, we're not going to report them. I mean, so there are just all sorts of issues that come along with this backloaded system.

I mean, you could probably live with—I mean, if you really just want to give small savers an exemption, you know, give them a thousand or two thousand dollar, or three thousand dollar for exemption for interest and dividends, and just be done with it there. But once you've built up this game plan, that you can do within the Roth IRA system, I'd say you not only create a lot of problems revenue-wise but you're complicating the tax system enormous, which goes against the whole simplification idea of this proposal.

MR. : I just wanted to clarify one thing too. What I understand as being the most important substance of your criticism of Roths, is that if you're saying that you're revenue neutral, but you've frontloaded a bunch of revenue from past ten years from now into the first ten years, then you're kind a cheating.

And so there's this debate of like whether the Roth structure, or the other structure is better, and, for me, I'm indifferent between the two. But it is true that you need to be honest when you're laying out where the revenue's coming from. So it could be the ten—this is one of those ten year budget is unacceptable kind of points.

MR. : Roth IRAs essentially do to the tax system what Social Security and Medicare do to the expenditure system. You know, you make all these promises for the future and you don't worry about how you're going to fund it.

MR. SANDALOW: HI. David Sandalow from Brookings. In 2004, a conservative Republican governor of Maryland imposed a new tax on the people of Maryland. He proposed it, it passed very quickly to widespread bipartisan acclaim in that state. It was a pollution tax, a tax on any home that was connected to a public water or sewer system.

And I wonder if the lessons of that were, should have been considered by the tax commission.

Kevin, you've written about a much more consequential pollution tax, the carbon tax, and its potential for offsetting changes in corporate double dividend taxation and Bill Gale, you've written about environmental taxes as well.

Should these pollution taxes be part of the dialogue on fundamental tax reform, going forward, and if so, how do you make that happen?

MR. : I mean, that was actually a part of—it's the same answer to the question I asked in the last panel, which is it's outside their mandate. They were only allowed to look at income taxes. It's certainly true that looking at environmental taxes is something that we should be doing as a way to—you know, for various reasons. But they couldn't do that under the mandate; isn't that right?

MR. : Any other questions? In the back. Joel. This is Joel Friedman from Center on Budget and Policy Priorities.

MR. FRIEDMAN: Hi. Joel Friedman from the Center on Budget and Policy Priorities. Gene, you've written a lot on the unified child credit and that whole approach.

I just wondered if you'd comment on the structure in the simplified plan and how you think it meets those, some of the criteria you laid out before.

MR. STEUERLE: Yeah. We actually tried to spin a couple numbers. My colleague, Adam Carosa [ph], you see a number of reports in the back of this book, that actually, a number of items that were close, I think, to what the panel came out on, and we're trying to run the numbers to see exactly how they match up.

Actually, they did even a couple things beyond what we did, that I thought was pretty nifty, which was their way of folding in the debate over the educational subsidies into these credits.

We struggled, Adam and I struggled with, well, you've got this one credit that goes to age 17, and one goes to 21, and so on and so forth, and, you know, no matter where you cut the age cutoff, you ended up creating a lot of winners and losers and I'm guessing that they have some winners and losers too. But it's at the margin that I'm not bothered. But what they did also did is they folded in the educational things by saying, okay, we'll go ahead and give these credits to people who are up to age 20, I think it was—up to age 20—we'll do that in exchange for getting rid of some of these educational subsidies over here on the other side.

Of course then they also had some of the educational subsidies folded into their saving account proposals, which, again, outside of the level of the backloading, I actually think actually provide some simplification.

So that extra interaction, I thought they actually did some fairly neat things. I haven't actually run the numbers, to tell you, you know, that there's some group that I'm really concerned about. But I generally agree with Charles Rossotti. I think simplification is a major item and I'm personally willing to live with, you know, a number of winners and losers along the way to simplification.

I should also say that they got in the same bind we did, which was, I think ideally, because of marriage penalties, are the reasons.

I would have liked to have a flat credit that just doesn't phase out at all. I think if you're going to adjust for family size, it's legitimate for millionaires and it's legitimate for smaller families. You want to tax millionaires more, or raise their tax rate, you know, you have an extra [inaudible] the family, it does lower your ability to pay. But when it came to things like the earned income credit, you try to flatten that out all the way, and you end up having these enormous revenue consequences we have trouble dealing with, and I'm sure it's exactly what—I can just see the staff sitting down and struggling through the exact same numbers.

MR. : With that, I also wanted to thank the panel for what they did, and even if Novak is right, and this isn't going anywhere right now, just starting a national dialogue on tax reform and working towards a system, and the tax system is broken and we need one that works to deal with these demographic emergencies.

This is a tremendous start. I think it would have been a pretty lame report if it hadn't produced anything that we could have criticized, and thanks to the tax reform panel and to the panelists here.

Thank you.

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