THE BROOKINGS INSTITUTION

MEMO TO THE PRESIDENT:

TAX REFORM'S CHALLENGES AND OPPORTUNITIES

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Welcome:

LEONARD BURMAN, Director
Urban-Brookings Tax Policy Center
Urban Institute

CHRIS BERGIN
President and Publisher
Tax Analysts

PANEL ONE: SETTING THE STAGE

Moderator:

LEONARD BURMAN
Director, Urban-Brookings Tax Policy Center
Senior Fellow, Urban Institute

Panelists:

ROBERTON WILLIAMS
Principal Research Associate
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CHRIS BERGIN

President and Publisher
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WILLIAM GALE
Vice President and Director
Economic Studies Program
The Brookings Institution;
Co-director, Urban-Brookings Tax Policy Center

JOHN BUCKLEY
Chief Democratic Tax Counsel
House Ways and Means Committee

PANEL TWO: TAXES AND THE SAFETY SECURITY NET

Moderator:

DEBORAH SCHENK
Marilynn and Ronald Grossman Professor of Taxation
New York University School of Law

Panelists:

FRED GOLDBERG, Partner
Skadden Arps Slate Meagher & Flom

LEONARD BURMAN
Director, Urban-Brookings Tax Policy Center
Senior Fellow, Urban Institute

PANEL THREE: TAXATION OF CAPITAL INCOME

Moderator:

ROSANNE ALTSHULER
Rutgers University;
Incoming Co-director, Urban-Brookings
Tax Policy Center

Panelists:

PAMELA OLSON, Partner
Skadden Arps Slate Meagher & Flom
Former Assistant Secretary for Tax Policy
U.S. Department of the Treasury

LILY BATCHELDER
Associate Professor of Law and Public Policy,
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PANEL FOUR: ENERGY TAXES

Moderator:

CHRIS BERGIN
President and Publisher
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Panelists:

DAVID WEISBACH
Walter J. Blum Professor of Law, and Kearney
Director of the Program in Law and Economics
University of Chicago Law School

MARTY SULLIVAN
Contributing Editor, Tax Analysts

GILBERT METCALF
Professor of Economics
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Closing Comments:

WILLIAM GALE
Vice President and Director, Economic Studies

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P R O C E E D I N G S

MR. BURMAN: Welcome to the Brookings Institution. This is a conference that's co-sponsored with the Tax Policy Center and Tax Analysts. I'm glad to see you all here. I was wondering whether people would show up for a conference about tax reform when other things are obviously on the front pages of the newspapers. But even though it might seem like a strange time to be talking about ax reform after the meltdown, I think tax reform is going to be more important than it ever has been -- the financial problems of our government which already looked pretty bleak 6 months ago are now getting close to the crisis point. We're going to need a tax system that's actually capable of raising revenue necessary to finance the government without it going into bankruptcy.

Besides the monster deficits, there are a number of factors that are going to make tax reform I'd say inevitable because logically they are although the political process always can surprise us, but certainly makes tax reform important, at least the expiration of the Bush tax cuts at the end of 2010 and the ever-looming and ridiculous alternative minimum tax.

I'm delighted that we've been able to put together an outstanding panel of experts, and I should point that Ben Harris is the one who did all the work of getting everybody together, who will be talking

about things that we might do both small and large to deal with our fiscal problems.

I'm going to ask you to please turn your cell phones, iPhones, Blackberrys and whoopee cushions to vibrate. You didn't realize there's actually a small group -- never mind. We don't this enough, but I'd like to thank the funders of the Tax Policy Centers who have been incredibly generous in allowing us to do things like this. They're listed on our website and we're enormously grateful to them. And also want to thank besides Ben Harris the other co-organizers of the conference, Bill Gale, Roseanne Altshuler, and of course our co-sponsor Tax Analysts and Chris Bergin who I'll turn the microphone over to.

MR. BERGIN: Thank you, Len. Good morning, everybody. Like Len and on behalf of Tax Analysts, I would want to welcome you to what I expect to be a stimulating series of discussions throughout today. Thank you all for coming. And my special thanks to Len Burman, Bill Gale, the Tax Policy Center and its wonderful staff for partnering with us on this event. Thanks also to the Brookings Institution for hosting us in this great facility.

As I think most of you know, Tax Analysts is the publisher of many fine print and online products, so I'd also like to thank our customers for helping us with co-sponsoring this today. As one of our main missions, it is to provide forums both inside our publications and outside or

publications for debate about key issues of tax policy. That's why we frequently hold roundtable discussions with policy experts throughout the year and why we sometimes partner with the Tax Policy Center on conferences like today's.

Let me also mention that Tax Analysts will publish the papers that result from today's conference. And as Len mentioned, considering these times, I think the timing of this conference is just about right, and I'm sure that like me, you are all eager to get started. So thank you again for all coming and let's move to our first panel.

MR. BURMAN: The first panel is Setting the Stage and we're going to talk about the prerequisites for tax reform, what the candidates have proposed, and what we should do about it and what we likely will do about it. To start off I'd like to introduce Bob Williams who will talk about President-elect Obama's tax and stimulus plan.

MR. WILLIAMS: About 15 months ago at a Tax Policy Center conference, then Senator Obama proposed his tax plan. The world was very different then. We had unemployment at 4-1/2 percent, the economy was growing at a 4 percent rate, subsequently upgraded to 5 percent, credit markets seemed to be doing just fine, and CBO was projected a cumulative budget deficit of $343 billion over the coming decade. That's the budget situation as of January 2008, just 11 months ago. We had a budget deficit for the first 4 years of the 10-period, 2008 to

2011, but then we were expected to go into surplus. That's a result of the expiration of the Bush tax cuts. Just 8 months later CBO redid those numbers and said we're going to be in deficit the whole time, $2.3 trillion over the 10-year period. If we assume as both campaigns did during the election that the Bush tax cuts would be extended in their entirety, the situation looks a lot worse. We have numbers of a $7.4 trillion deficit over that period. Then if you take into account what's happened over the last couple of months, who knows where we are.

So we're in a very different situation than we were when now President-elect Obama proposed his tax plan. Unemployment is at 6-1/2 percent, actually it's 6.7 percent announced this morning and it would be a lot higher than if three-tenths percent of the workforce hadn't dropped out of the labor force; 500,000 job losses last month and they increased the estimates for the previous months by 200,000. So we're in a very bad downward spiral on the employment side. The economy is clearly in recession. NBER announced it formally this week. The credit markets have all but collapsed. And as I said, a $2.3 trillion cumulative budget deficit before we take into account the bailouts and the stimulus plans, and $7.4 trillion if we assume current policy, that is, if the Bush tax cuts are fully extended and -- AMT.

So what will President Obama do? His staff has said he will pursue both the stimulus plan and his tax cuts, ignore the deficits at least

in the short-run. So we're going to ask today what he's proposed to do during the campaign. We don't know which of these things he'll pursue, but I'm going to go very quickly through the pieces of his tax plan as proposed during the campaign. We'll talk about a couple of things, both the details of the individual proposals, the revenue costs of each one, and then the distributional impact.

First, his campaign plan. He was going to partially extend the Bush tax cuts, extend them for everybody but the rich, and his view of rich was $250,000 a couple, $200,000 if you're single, increase the top tax rate on dividends and capital gains from the current 15 percent to 20 percent, actually for dividends that would be a tax cut after the Bush tax cuts would expire. He would create a number of new refundable tax credits and expands in existing credits. He would permanently -- the AMT. He would make the estate tax permanent so it would not disappear in 2010 as it is currently scheduled to do. Nor would it revert back to 2001. It would just be made permanent at the 2009 level. And he would close corporate tax loopholes to gain some revenues to help pay for all this.

Let's go into some detail of that. First, partially extending the Bush tax cuts. That amounts to extending the bottom four tax rates up through 28 percent, maintaining the child credit at its $1,000 current level, maintaining marriage penalty relief. Returning the top two tax rates to their pre-2001 levels, 36 percent and 39.6 percent. Restore -- that's the

phase-out of the itemized deductions and personal exemptions with higher thresholds to make sure you didn't hit people with incomes below $250,000, the nonrich, protect the middle class by -- a very expansive definition of the middle class. And raise the top tax rate on dividends and capital gains as I said before from 15 to 20 percent.

That would reduce revenues by $950 billion relative to current law. A quick aside here, current law says we let the Bush tax cuts expire as they're scheduled to do and we let the AMT bite the way it's currently scheduled. We do not continually maintain the higher exemption level we now have. Current policy says that we extend the Bush tax cuts for everyone and that we patch the AMT year after year. So they're very different baselines. This is relative to the current law baseline assuming the Bush tax cuts disappear, so we see a large tax loss because the tax rates are lower for the bottom end of the distribution. This raises marginal tax rates for people at the top end, not a low, from 35 percent to 39.6 percent, tack on -- and that's another little more than a percentage point, but we're pushing well into the 40 percent range for people at the top end if you tack on state taxes as well.

He would create and modify a number of refundable tax credits. The advantage of refundable tax credits of course is they reach to the bottom end of the distribution. People who don't pay taxes get benefits from refundable credits or they do not get benefits from the

nonrefundable credits. Under current law, about 38 percent of tax units pay no federal income tax. If we create all these refundable credits and make some new ones, that would raise that number to 48 percent. Nearly half of all tax units would pay no federal income tax if the Obama tax plan were fully put into place. What pieces were there? There was a making work pay credit, 6.2 percent of the first $8,000 of earnings, about $500 per person, phased out for higher-income people. A universal mortgage credit, 10 percent of their first $8,000 of mortgage interest for people who don't itemize their deductions. Expand the saver's credit. Reach further down the distribution and make it somewhat larger. Create the American opportunity credit. Replace the Hope college credit for the first 2 years of college, raising the maximum amount to $4,000 and making it refundable which makes it available to people at the bottom end. Make the child and dependent care credit refundable. Right now it's not refundable so it's not available to people at the bottom end of the distribution who don't pay taxes. And make it larger. Increase the maximum credit rate to 50 percent. And expand the earned income tax credit in a few ways. Make it larger for families with three or more children. Make it larger for childless workers. And extend the threshold for married couples. That's another $1.25 trillion of revenues spent on that. Very progressive because it does go to the bottom of the distribution. All of these phase-outs that are not available to people at the top of the distribution. It's spreading the wealth

as Joe the Plumber found out on the rope line. But it's spreading it in a way that may well help people at the bottom end. It does raise marginal tax rates for some people in some ranges. It lowers marginal tax rates for other people in other ranges. Research by Jeff Rohaly at the Tax Policy Center suggests that more people would see their marginal tax rates go down under this plan than would have seen marginal tax rates under the McCain plan which is supposed to be less spreading the wealth.

Other new tax cuts, exempt seniors with incomes below $50,000 from paying any income tax. That's a $70 billion cost. Extend and index the AMT patch permanently. That's $1.2 trillion. Make permanent the estate tax at 2009 levels, $3-1/2 million exemption and a 45 percent tax rate. That loses another nearly $300 billion.

Business tax credits. Make permanent a couple of the credits in place now, the R&D credit and the renewable energy production credit. Another $150 billion. And a whole bunch of revenue raisers which I've put intentionally in small print because they're unintelligible to me. We don't know how much they cost. We didn't try to estimate. We took the campaign's number of $924 billion as a gain in revenue from closing loopholes and from taxing some incomes at higher rates.

So where do we stand? Add all those pieces together and it's $2.95 trillion worth of revenue less relative to current law. If you tack on the interest, the debt service on that amount in addition to deficits, that

raises it to $3.5 trillion over a 10-year period. Fairly expensive in a time when we don't have a lot of money to spend.

It also ignores the fact that Senator Obama also proposed a health plan which I'm not going to talk about at all today, but that would cost another $1.6 trillion over 10 years and the cost would be rising. The cost in 2018 would be more than twice the cost in 2010 and would continue to rise in the future because health costs rise and the expenditures through refundable credits for health insurance would get much larger.

How the tax plan works in the fiscal situation, 10-year deficit would rise to over $6 trillion. The health plan pushes it up more toward $8 trillion. In the economic downturn, obviously bailouts and stimulus plans make things even worse. So a bad fiscal situation to start off with and would make the bad fiscal situation even worse. One caveat on this. We don't talk at all about the spending savings that now President-elect Obama had promised. We're not sure what they are, they certainly weren't specified, and anyhow we're not spending people, we're tax guys.

The plan would increase progressivity. It cuts taxes a lot from lower- and middle-income households. A very broad definition of middle income. I'm happy to be part of the middle class again. Struggling, but I'm there. It turns out a lot of us think we're in the middle class. Eighty-five percent of people classify themselves as middle class,

something on the order of that. It raises taxes on the very top end. Five percent might be expansive. Throughout the campaign Senator Obama was saying he was going to cut taxes for 95 percent of working Americans, 95 percent of families with children, roughly 95 percent of everybody. It actually raises taxes on that very top end. And the measured effect as I've indicated depends on the baseline. If you look against a current policy baseline, he actually would raise some money by our estimate of about $600 billion over 10 years but that starts off by losing the trillion dollars -- extending the Bush tax cuts and making the AMT patch permanent.

Distributionally this is what happens what I've got here spread out here. The first five blocks or the five quintiles, the bottom 20 percent and then up through the middle and top 20 percent. You'll see the bottom in 2009, all but the top quintile would see an increase in their after-tax income. I think that's a good measure of what's going on. At the very bottom, at the bottom quintile, of course, 20 percent would have nearly a 6 percent increase in after-tax income. If you're up at the very top end, these two little blocks over on the right side, if you're in the top 1 percent you'd lose somewhat around 7 percent of our after-tax income, and if you're in the top one-tenth of 1 percent, that means you've got more than $2.7 million a year. If you're an executive who flies in private jets instead of driving cars to Washington, they're worse off.

In 2012 the numbers change but this is note is against a current baseline where the Bush tax cuts disappear. Relative to that everybody is better off because he extends the Bush tax cuts unless you're at the very top end because those are the people for whom he's going to raise taxes and go back to the old levels. If we measure against current policy, that is extending the Bush tax cuts and patching the AMT, you'll see this green bar will show the top end loses after-tax income.

Across types of households. In 2009, heads of households do best also because they're poor and they would benefit from a lot of the refundable tax credits. The elderly actually are worse off mostly because they get no tax cut, but they would see an increase because of corporate taxes reallocate similar to them. If we go to 2012 against current law, everybody is better off, but again you see the same pattern, heads of household because they're poor do better, tax units with children do somewhat better.

That was then. This is now. Stimulus will dominate the tax plan. Stimulus comes first. The tax plan will come second. We don't know which pieces of the tax plan will go. Fiscal austerity is totally off the table. We can spend anything we want because first things first, we got to take care of the economy. Tax increases seem less likely now. There's talk of pushing them off instead of imposing higher taxes in 2009. Push

them off a little while. And then somewhere down the road we'll return to fiscal sensibility if and when the economy recovers.

That sets the stage. Bill, I guess you're up to do more.

MR. GALE: Are there any questions? Bob just gave you a very thorough and perhaps sobering overview of where we are and what to expect. My discussion is going to be a little more thematic, a little less in the numbers, a little less focused on specific tax rules and more on the conceptual mix if you will among the various tax issues.

I see three sets of tax issues. One is the stimulus as Bob mentioned. The second is what I've called the Obama agenda and what I mean is what he came up with September 2007 and October 2007 when he spoke at the Tax Policy Center, that is, if the economy wasn't imploding, what is it he said he would like to do. The third set of issues are sort of why people think the Tax Policy Center is sometimes a pest. It's really exciting to think about a new world and a new agenda and a new administration and a new everything, but there are these kind of nagging issues that won't go away and we need to focus on them as much as we focus on the exciting new stuff so I'll talk about that as well.

I want to mention there are not three separate issues. Creative policymaking will find a way to create interactions between these things. So the stimulus package could be used to address some of the agenda issues. Bob mentioned that fiscal austerity is off the table now but

we all know we need to come back to it. There might be a way to tie a fiscal package now, a stimulus now and an increase in the deficit now, with a medium-term or longer-term effort to bring the deficit back in line.

Likewise, energy and climate change is a big issue for Obama and energy taxes are a potential source of long-term revenue that I'll come back to in a second and Gib will talk about later. Lastly, tax reform, fixing the structure of the system, is not independent of getting the revenue levels right. If we need to raise revenue levels, it'll be much harder to do that if we have an inefficient, complicated, unfair system than if we have a system that actually works. So there are key interactions between all of these, but I think logically or conceptually it's easier to talk about them one at a time and we can come back to the interactions in the questions and answers.

So taxes and the stimulus package. I think there's a fairly strong consensus that the stimulus needs to be big and it needs to be more than a sort of one-shot deal, it needs to be on a sustained basis. There are two reasons, maybe a third reason. One is it's looking like we're in increasingly dire times just in the real economy alone. On top of that you've got the financial markets kind of teetering on the edge and so a large stimulus can help both of those issues. The other issue is it's not clear where else the stimulus is going to come from. The rest of the world is not going to pull us out of this. There aren't various sectors in the U.S.

that are doing well that could pull the poor sectors out. The "Washington Post" had an article this morning that said retailers across the aisle were reporting drops in sales so it's sort of like everything is dropping simultaneously. That's comforting if you're a student of historical business cycles because that's how business cycles used to work. The bad news is we weren't so good at getting out of those business cycles and the turbulence in the economy in the last 30 to 40 years has often had some sectors rising while other sectors are falling. We don't see that right now. So that leads me to think at least we need an even larger effort on the fiscal side.

In thinking about what might be in a stimulus package it sounds kind of nuts but certainly not the crazies thing you will hear in Washington in the last year or the next year, it's hard to figure out how to spend $500 or $700 billion. It's going to take some effort to come up with ways that are not ridiculous. If I'm Jay Leno or David Letterman, I can't wait to see the list of spending ideas that come out because some of them are going to be ridiculous. But I think having said that, infrastructure investment can address, and those is one of those interaction issues, a deep social need, it can address energy technology, it can help the economy in the short-run and the long-term, and so I think that's probably high on everyone's list. State and local government assistance I think is important in a downturn. This is probably understood in this room but it

may not be understood other places, state and local governments face balanced budget rules and in a recession when their revenues fall they need to cut spending to keep the budget in balance. That's exactly the wrong response from a macro perspective. We don't want state and local governments cutting spending now. We want them boosting spending and getting resources into the economy. So aid to state and local governments would probably have a marginal propensity to spend of about 1. Unemployment payments the same thing for similar reasons. It's harder for me to think of good tax stimuli that will have bang for the buck that is the same magnitude as these three spending options. It's easy to think of some bad stimuli. For example, it is almost silly to say, but a capital gains tax cut would not do much good right now given that the market has fallen as much as it has, but I predict you will hear proposals for capital gains tax cuts.

Rebates are a more serious issue. My sense is that the recent ones have not worked all that well. There is an element of wanting to give people cash and let them use the cash, but in terms of dollars spent versus stimulus effect, I think it's fair to say that most studies suggest that rebates have a lower bang for the buck than these spending options. And I imagine that Obama will push some of the proposals that Bob laid out as part of the stimulus package and that's of a more mixed potential benefit. So I think taxes ultimately will be part of a stimulus

package but I think there's a big potential for silly policy here on both the tax side and the spending side and so that's something to keep an eye out for.

Let's turn to the Obama agenda. We have a session later today on energy taxes so I just want to highlight. I think there's widespread agreement among economists and among policy analysts that the right way to go here is either a carbon tax or a cap and trade system. This is not Yogi Berra saying when you come to a fork in the road, take it. Either of these systems would have similar economic impact. There are differences in administration and policies, et cetera, but either of these systems relative to the current system where we subsidize a variety of targeted energy subsidies would be far better than that. Specifically, they would raise the cost of putting carbon into the atmosphere. They would automatically encourage alternative energy sources. This is not a point that is understood in Washington or even outside the Beltway. You don't need to specifically subsidize every alternative energy source. As long as you tax the bad energy sources you are giving implicit subsidies to the good energy sources. Obviously they would reduce environmental damage, they would improve our energy security, and they would actually raise revenue as opposed to subsidies which cost money, and as Bob noted and we will come back to, that is not an unimportant consideration right now. So I think where we need to go on this is pretty straightforward,

and maybe Gib disagrees and we can find out later, but I think that that's a pretty simple one conceptually.

Health care is a little messier and taxes are an important role in health care, but they're not the complete story. In energy they are a very big part of the story, in health care they're a big part but not as big. There's a whole medical side of health care that needs to be reformed that we had a conference on here a couple weeks ago. But the tax side on health does not help. Basically we had this open-ended firm level deduction for health insurance expenditures. That's regressive, it's expensive, and encourages the overconsumption of health within the insurance package.

There are several alternatives. You can cap the deduction. You can convert the deduction to a credit and give it either to the firm or to the worker. John McCain proposed the last, to give it to the worker. Interestingly, my former colleague Jason Furman who is now on the Obama team proposed the same thing. Len, Jason and others have the Tax Policy Center that lays that out. I personally think there's a lot of logic to that last proposal and I don't think the McCain campaign explained the virtues of that very well in the campaign and I think that if you are looking for a bipartisan base to start talking about health care reform, that might actually be the bipartisan base that could be used.

Saving. Right now we want everyone to spend like mad for the next couple of years and then we want them to stop immediately and then save like mad forever more. So I'm not quite sure that saving is going to be a big push right now but it should be when we get through this and we get back a couple years. Obama endorsed the automatic IRA which is Retirement Security Project here has supported. He's endorsed changing incentives for low-income households, converting the saver's credit to a flat-rate match. I'm happy to note that the President's Panel on Tax Reform supported a similar proposal. And another thing which I don't think is explicitly in the Obama platform but would be a logical extension of that would be to reexamine all of the deductions for saving, and just like the deduction for health care is open-ended and regressive and expensive, giving a deduction for contributions to IRAs and 401(k)s is not open-ended, there's a limit, but it's regressive and it's more expensive than it needs to be because it gives bigger subsidies at the higher end and it's less effective than it could be because it gives bigger subsidies at the higher end to people who are more likely to shift their assets rather than to lower-income households who are more likely to actually increase their savings by contributing. So we could restructure those deductions in the same away I mentioned that we could for health insurance and I think that would be a big help. Peter Orszag, John Gruber and I have a paper on that from a couple of years ago that lays out exactly how that would work.

Simplification. One of the interesting things in Obama's tax platform that Bob didn't mention, I think maybe the only thing, is Obama has supported a return-free filing system for a limited group of taxpayers based on an experiment that was run in California a couple of years ago. I think that's good news. I think that would be a good way to move the tax system. We've seen in California that it works, that people like it. The bad news is that you can't enact all these refundable tax subsidies that Obama wants to have and still have anybody left in the system who could actually use the return-free filing system. The cost of getting a tax system that's simple enough that the IRS can fill out your tax form, the cost of that is you can't have all these specialized individual subsidies. So there's a tension there. I can guess which way it will go because of the first item because I said this frequently, but it is really ironic, we have these enormous debates over tax policy, huge disagreements about who should pay, how much people should pay, what should be taxed, et cetera. There is only one issue that everyone right, left, center, old, young, moderate, extreme, agrees on and that's that the tax system is too complicated. So you'd think if the system worked, a system of analysis and advice and input and political calculation worked, we would get a simpler tax system, but every year not only do we not get a simpler tax system, we get a more complicated tax system. I don't understand the dynamics behind that, but as much as things have changed and we're in a new era and yes we can

and everything is different, I'm guessing that simplification will lose out again to the other things people want to do in tax policy and that when it's all said and done at the end of 2009 we will have a more complicated tax system than we do now. That's where we stand in terms of the Obama agenda. It's a new era. Democrats control the White House and the Congress. It's very exciting. There are a bunch of ideas on the table. The economy is in a mess which is horrible but is another opportunity for good policy.

Now I want to talk about again the things that make people hate or find annoying tax experts and that is we still have all these issues that have been conveniently ignored and I just want to highlight three or four of them. One is the expiration of the Bush tax cuts and I know Obama has a proposal there. He wants to extend most of them and eliminate or at least let expire the high-income tax cuts. This in itself is an enormous fiscal policy issue. It's gotten buried under the table because both campaigns used as a baseline the assumption that the Bush tax cuts were extended. We can talk about why they did that, but anyway it's 2 percent of GDP. That's three times the cost of fixing the Social Security system over time. So we can fix the Social Security system and still have money left over to extend two-thirds of the Bush tax cuts. So if we think Social Security is a big huge issue that costs a lot of money, we should

think that this whole set of issues around the extension of the Bush tax cuts are a big issue, big funding.

One way to think about this is if you're going to have permanent tax cuts you have to talk about permanent spending cuts and the question is how big would those permanent spending cuts have to be. One way to do it is what I did here. Let's say we're not going to take the spending cuts out of Social Security, Medicare, and Medicare, not because we don't need to cut those in the long-term, we do, but exactly because we do need to cut them anyway, we can't also cut them to fund the tax cuts. So let's take them off the table. Let's take defense and homeland security off the table because we're still fighting two wars and this probably isn't the best time to do that. Let's take net interest off the table because as Len alluded to, we don't want the federal government defaulting on its interest payments especially now. And so that leaves the rest of spending, everything else the government does. You would have to cut that by half to pay for a 2 percent of GDP reduction in revenues. Of course you could raise other tax revenue sources, but if we're talking about spending cuts, that's the magnitude of the cut that's being evolved here. It's been sort of shoved under the table as an issue and I think it needs to be brought out as a first-order issue.

The second issue is the AMT, everybody's favorite whipping boy. While I won't go through this in great detail, as you know, it was

originally intended to close loopholes, now it's hitting people who have egregious behavior like having a lot of kids or living in states that have high taxes and actually paying those taxes, and that's not what it's meant to do obviously. To make it worse, it's not even covering the loopholes anymore because of changes in the rulings on capital gains under the AMT. Obama proposes what's called a patch which gives you a sense of the temporary duct tape nature of the proposal. We really need to address this issue. We need to rid the tax system of this cancer and we need to raise our revenues honestly. I don't see us doing that in the next couple of years, but when we start thinking about serious tax issues again, that's on there.

Lastly, Bob ended on a down note so I get to end on a down note too. I'm actually going to end up an up note. I'm just heading down right now. Everyone understands that cyclical deficits are different from structural deficits and everyone understands we're going to have a really big cyclical deficit for the next couple of years. That doesn't mean that structural deficits are not an issue. They are. We have big ones already, but big cyclical deficits are going to come on top of that, and when we get through this cycle we're going to have enormous structural deficits to deal with. Spending is projected to rise to 27 percent of GDP within the next 20 years. That's a gradual rise. That's without all the stuff we've been talking about in terms of stimulus. And there's a tendency to think of this as that's

just Medicare and Medicaid and we just got to fix the health spending thing and we'll be done. If I can convince you of any one thing about the long-term fiscal situation, it's that's the rest of the budget matters too. In the last 7 years, the long-term fiscal gap has risen by 7 percent of GDP. That's an enormous, enormous amount. The tax cuts were 2 percent of that, but then there's all this other stuff too. You could do a lot of damage in the short-term to the long-term fiscal outlook. We can fix Medicare and Medicaid and we could still be in this bind for other reasons. So once we get through this cyclical issue, we really, really need to pay attention to the long-term issues. I don't see how we get there with spending cuts alone so if we raise existing taxes, we need to reform the system first to broader based lower rates so we can actually raise the rates some if we need the increased revenue. Energy taxes we're going to talk about. Carbon taxes I think are a first-order issue and we're going to talk more about this in a different session, but the value-added tax is an obvious candidate here.

So that's the end of the depressing part of the talk. I just want to close on an upbeat. As Rahm Emanuel said recently, a crisis is a terrible thing to waste. Yes, there's a crowded agenda. Yes, we have enormous deficits. But this is a huge opportunity for everyone involved to get some good policies going. It seems like Congress and the administration are much more open to changes. The gridlock of the past seems to be out. And in an area when Congress can just give $700 billion

to the Secretary of the Treasury and say spend this, there are lots of opportunities for creative and good policies, so I hope we'll see some of that over the next couple years. Thank you.

Our next speaker is John Buckley from the House Ways and Means Committee which we know is the source of all tax policy wisdom in the world.

MR. BUCKLEY: I think my role today is to provide the view from the Hill is what the program suggests and I think the view from the Hill is cloudy in the short-term but I think if you step back and look at some of the long-term issues that have been discussed earlier the picture becomes quite clear.

In the short-term, congressional action is really all event driven. We've seen enormous events occur in the last several months. I truthfully engaged in speculation after the 2006 election as to what might happen in the next Congress and I actually was in a position to in part influence that. My speculation was quite wrong. I think really the speculation now what might happen next year is premature. You have to wait. The Obama team is still putting its plans together. It's entertaining I believe but not necessarily an activity that I spend a lot of time on at this moment.

I think one thing you can say however is the dynamics in the Congress are going to be quite different going forward than I think they

have been since probably 1994. You will I believe see much closer coordination between the congressional majorities in the new Obama administration, going back very much to what I believe occurred with the Clinton administration and the Democratic congresses in the first session. It may be a more sober group on Capitol Hill given there are still many people who remember the lessons of 1994 and fiscal responsibility is not necessarily widely rewarded at the election book so unfortunately that lesson is still there and may interfere.

I also think you're going to see a much closer coordination with Treasury and the administration. I was very surprised when the Democrats came back in power. I hadn't been paying a lot of attention over the previous 12 years, but at that point I expected to be dealing with Treasury just the way we always dealt with Treasury in the past regardless of party affiliation and I found that that was not correct. I had not been correct when the Republicans controlled Congress. There really has been a breakdown in the relationship between the Treasury department and the Congress and I believe that is going to change, and one of the goals of many people including myself is to change that dynamic. To some extent that means less freedom for people like me but I think it will result in better policy.

Let me just comment slightly on what was said previously before I talk about the long-term picture for tax reform. I think Bill was

right. Spending will be a much larger part of the stimulus package than taxes. I probably would disagree with his characterization that you're going to see a lot of boondoggles. I believe this country has underinvested in infrastructure for an extraordinarily long period of time and a lot of money could be spent fairly quickly and fairly wisely addressing those unmet needs.

I think tax policy becomes increasingly less effective in terms like this. We saw what happened to the rebate. It might have slightly increased consumption for a month or two. Bonus depreciation and expensing, they're useful incentives but not many companies either have access to credit markets or consumers for the products that would be produced with the new investment. We are already seeing indications that current law regarding tax benefits are less effective. The low-income housing credit, the renewable energy credits that Congress just enacted increasingly are going without customers because there's not the sufficient tax liability among the investors to use those credits. That's particularly true since the financial industry was the large investor in projects assisted with those credits. In some respect, the Section 382 ruling that Treasury did, did more damage to the renewable energy credit programs and the low-income housing credit problems than anything else. Wells Fargo was one of the largest purchasers of wind energy projects and low-income housing credit projects. My feeling is their appetite for those items has

been sated for the foreseeable future. The more I look at this the more all things interact.

On health care, just protecting my own job, let me strongly disagree with Bill and his statements about health care. I don't think John McCain's proposal has any prospect of forming a bipartisan coalition in the Congress. I'm speaking now from the House Democratic standpoint. I believe as tax lawyers we all focus and I believe overfocus on the impact of the employer-provided health care exclusion on health care in this country. I believe that the most cost-effective way of providing health care is group plans, and right now that exclusion is the price for group coverage, the type of coverage that most people in this room enjoy. The administrative costs for group coverage are tiny compared to the individual market and without creating a viable mechanism for group coverage you could easily dramatically increase the administrative health care costs in this country. Medicare has one of the lowest administrative costs. Viewed in isolation you can say that the exclusion is a bad idea but unless you replace it with a mechanism to create viable group coverage for individuals you have potentially increased and not decreased costs in the health care sector.

Now let me go back to the long-term because it's always much easier for somebody in my position to talk about the long-term rather than the short-term because it may be wrong, but it will take a while for

people to understand where you're wrong. I always like to say that my feelings about tax reform are summarized by a quote from Winston Churchill. He once said that you can always count on Americans to do the right thing after they have tried all the other options, and I think if you look at our tax system, we have tried all the other options. We have a system that has very serious structural and fiscal problems. They are problems that I believe are so large that they can only be handled in the context of a major look at our tax system. On structural issues, the AMT that was discussed previously is a very large one. On the business side, we have high corporate tax rates but a very narrow corporate base. Our corporate receipts as a percentage of our economy are relatively low compared to other countries. Our tax rates are relatively high. I believe that that's not good for long-term economic growth and businesses look at marginal rates when deciding where to locate businesses.

It's easy for me to pick those two items because they are the focus of the tax reform bill that was introduced by Charles Rangel last year. Also I think if you look in the long-term, tax reform is going to be in the context of an individual income tax system. I think I simply would say that the Reagan administration in 1984 was correct. They analyzed every one of the various alternatives to an income tax and decided I believe quite correctly that an individual income tax is the only viable major source of revenue for this country. The only alternative system that has I think

even much intellectual basis to it is the idea of a hybrid system using a value added tax to replace part of the income tax. I think if you look at it for more than a few minutes you begin to understand how unworkable that would be. It would actually I believe dramatically increase the complexity and obtrusiveness of our tax system. You could remove the tax return filing requirement for 100 million Americans but you'll substitute a claim for a refund from 120 million Americans. I spent 2 years trying to develop such a system for then Ranking Member Sam Gibbons. By the time it was over with the combination of rebates to take care of the inherent regressivity of the VAT coupled with a tax rate, you remove a very small fraction of people from the return system, you only have to look at the experience of the rebate earlier this year. There will be 20 million additional tax returns filed this year to claim the rebate. That's difficult enough for the IRS to handle on a one-term basis. A hybrid system would essentially make that a permanent increase in filing requirements across the board. On the corporate side it would add one more tax for businesses to comply with.

Finally met me say something that is obvious to me but it's not always -- politics will play a large part of the tax reform plan. I also however believe that politics should play a large part of the tax reform plan. In our society, politics are a very inefficient way of expressing the will of the people, but it is the only way we have. A tax reform plan

designed without regard to politics will not last long. Almost all of my education in tax law came while working for the United States Congress. You all literally have financed my education in taxes. I came with very little background. But in my first year law school class I had a professor who was very proud of his experience as a Peace Corps volunteer in Latin America and he drafted a tax reform plan for that country and the country enacted it. The professor recurrently would go back to the tax reform plan as he tried to get us interested, largely unsuccessfully, in one income tax system. It was a plan designed without regard to politics. It eliminated many of the things like health care subsidies that just simply don't belong in a tax system. It simplified the law by choosing rough justice over complicated individualized relief measures. In the middle of the first semester of law school the professor announced that regrettably the law was repealed, and it not only was repealed, it was repealed retroactively as if the thing had never come law. You have to be realistic when you're looking at tax reform. You can repeal benefits for housing and health care and things like that only if you provide replacement benefits. You can get rid of many individualized relief measures only if you somehow prevent constituents from availing of their constitutional rights to petition their legislatures for redress, it is a part of our system and it's the part that makes it interesting among the technical details to me, but it will be a part that will play a large role in the tax reform debate. Thank you.

MR. BURMAN: I want to thank everyone on the panel. I'm glad that we reached agreement. I should ask Bill whether he wants to respond to anything John said or if anybody else on the panel wants to say anything before we throw this out to the audience for questions.

MR. GALE: Not so much to respond, but maybe elaborate. I certainly agree with what John said, let's specify a bunch of points that I think we actually agree on. You can't throw people into the individual market without a viable way of getting health insurance so under the current individual market you couldn't just move people in there and expect gains. You would see big, big losses. So I agree that reform of the individual market or extension of the group market somehow to individuals would matter in assessing tax reform. But if you want to keep the group market the way it is, you could still reform the open-ended deduction that firms get. It's not completely open-ended, but you could still reform that by making it a fixed credit per worker, for example. There are ways to limit it and cap it and give better incentives that leave it at the firm level and keep the group market in tact but remove the regressivity, reduce the expense, et cetera.

SPEAKER: I think probably Bill and I are closer than you might think. I think the most important thing to do is maintain the viability of the group market. I'm not an insurance expert and I guarantee you that I'm not an economist either, but I doubt that there is much one can do to

really mandate changes in the individual market to get the effect of the group market. I just don't think there are any reforms of the individual market that can't be avoided by the companies in how they market their policies, to whom they sell the policies. So I think the most important thing here is maintaining a viable or even expanding the group market, but is from somebody who's obviously enjoyed the benefits of the group market (inaudible)

SPEAKER: President-elect Obama actually did propose something that would do that. He had the insurance exchange and he said that the credit was only available for insurance purchased the exchange or through employers, that could be a very effective pooling mechanism.

SPEAKER: I understand -- increase in the administrative cost just from individual -- if you look at administrative costs from individual polices for small employers to major employers, there's this dramatic differential in cost.

SPEAKER: But a lot of that is actually due to risk rating in the market and the exchange there wouldn't be -- it would be community rated so --

SPEAKER: No, I'm talking about (inaudible) not -- I'm not taking about rating. I'm talking just pure --

SPEAKER: But actually when you look at the loading costs -- if you look at the loading costs in insurance, I think --

SPEAKER: Let's put it this way, I'm a tax lawyer and (inaudible) out of my league.

SPEAKER: The big things as far as I understand it are marketing and risk assessment and risk assessment wouldn't be a factor if there was community rating. And the other thing is there are 45 million people without health insurance so you need to think about something to do for them.

SPEAKER: I don't disagree about the need to expand health care coverage. I just believe doing that has to maintain the current group market or we have a net loss. But again I'm well beyond any (inaudible)

MR. BURMAN: Let's throw this open for questions and comments. If you have a question, please actually make it a question, and identify yourself. This is being webcast so people won't know who you are unless you say. Yes? And also wait for the microphone.

MR. KING: I'm Arnold King .

MR. BURMAN: Please identify yourself.

MR. KING: Identify myself?

MR. BURMAN: I'm sorry.

MR. KING: I'm Arnold King and I have a couple questions. Obama had talked about are you familiar with Obama's point on he going

go give rebates to individuals doesn't pay any taxes? And two, the alternative minimum tax, isn't the alternative minimum tax like an accounting and finance standpoint and how (inaudible) is going to change and what plans or alternatives is Obama administration to do about the alternative minimum taxes is concerned?

SPEAKER: The question is about the credits and the AMT. Obama has proposed a patch to the AMT, that is what happens to the AMT is it's not indexed for inflation and so every year the real income level that gets exposed to the AMT increases. So over time if we didn't change the system, eventually everyone would be on the AMT and it would be the tax and not the alternative tax.

So what the patches do is temporarily raise the exemption to keep people off the AMT and I believe his proposal was to raise the exemption and then index for inflation. Is that correct?

SPEAKER: He's going to set it at the 2007 level and index it going forward.

SPEAKER: So it's a partial solution in the sense that it keeps -- it doesn't let the AMT create more damage than it's currently doing but it doesn't deal with the longer-term structural issues, A, the existence of the AMT, B, we're relying on the AMT for a lot of revenue over the next decade and a lot of people don't think we're actually going to

get that revenue so our budget forecasts are even worse than they look on paper. So it's not a real solution but it's a partial solution.

SPEAKER: I actually should probably point out that I don't know what President-elect Obama ever actually said what he was going to do about the AMT. When we did our analysis of the presidential candidates' tax plans we said we would make up things that the candidates weren't specific about and the campaign never objected to our saying that that was what they were going to do.

SPEAKER: In general. In general. Occasionally --

SPEAKER: I hope Congress has that same flexibility next year.

SPEAKER: The candidates said that the AMT was a serious problem and that something should be done about it and --

SPEAKER: One measure of the ineffectiveness of the AMT though is that there were 3,000 people with over a million dollars' worth of income who didn't pay regular income tax last year. The AMT caught a 1,000 of them.

MR. BURMAN: Next question?

MR. SULLIVAN: Marty Sullivan with Tax Analysts. Hi, John. It's a question for -- I think it's mostly for John. I'm fascinated every time I hear that the Congress is going to have a $700 or $500 billion stimulus package on the president's desk by January 21. Could you explain how it

is possible for the U.S. Congress to put together $500 to $700 billion of outlays before the president's even in office especially since you don't have -- you may not have the cooperation or technical support of the Treasury staff?

MR. BUCKLEY: Having participated in a one weekend process that enacted a $700 billion bailout bill, let me assure you it's possible. Again I think we're kind of speculating on things that we know not a lot about and it is I think quite possible if the will is -- and the Obama administration will not be officially in place but there are consultations going on all the time, if there is a desire and a need to do something that quick, I believe Congress can do it. They're quite capable of doing it.

SPEAKER: Will the 111th Congress already be sworn in?

SPEAKER: Regretfully they come back on the 3rd of January.

SPEAKER: I should point out that everything people say is on the record.

SPEAKER: I'm talking about my vacation plans and nothing else.

MR. LOBEL: Marty Lobel. I wanted to focus attention on something that Obama has been hammering on and you guys haven't mentioned at all which is the tax gap and the shifting of taxes or jobs and income abroad and what its impact is likely to be on our tax policy. The

Permanent Investigation Subcommittee estimated there's close to $3 trillion worth of evaded taxes of our transfer pricing system. Do you think there's any chance of raising revenue by dealing with the multinational corporate taxes?

SPEAKER: There are two aspects I think to your question and one is enforcement of our current taxes and Congress always is more than willing to do it. It's a very difficult thing to do legislatively I believe. I do think that international tax rules will be looked at. They were a large part of Chairman Rangel's tax reform bill last year. It will be looked at going forward and that's --

SPEAKER: Actually I have a question. Do you actually understand the proposal limiting deferral and Senator Obama or President-elect Obama's plan? Is that the same as yours?

SPEAKER: I feared that you probably have spent more time studying -- than I so I don't know.

SPEAKER: Can I just follow-up? Is there any consideration or do you think there will be any consideration of a dramatic change in our tax policy by going to for example combined reporting or the unitary system so as to avoid all the transfer pricing? Is this the kind of a crisis that will engender that kind of reform?

SPEAKER: To do that you would need -- it's nothing we could do by ourselves. You would need the structure of other countries

being part of that agreement I think. I mean, I think -- I don't know a lot about state and local taxes, but they use unitary but I think it's through common agreement among the various states how to split the income up. For one country to impose a unitary system without coordination with other countries I think creates problems.

SPEAKER: Tax Analysts ran a conference in which we had -- I forget what his title was but he was from the E.U. and he said that the E.U. with the exception of U.K. and Ireland was most likely to develop some sort of a unitary tax concept and from an economic standpoint I believe it's probably a lot more efficient.

SPEAKER: I think you're saying the same thing I am. The E.U. is not much different than our various state jurisdictions. They've worked together and they can do that. I'm just saying it's not easy for us to impose unitary without having similar relationships with other countries that are part of that arrangement.

MR. BURMAN: Next question?

MR. HEFLIN: My name is Jay Heflin . I'm with Congress Now. Mr. Buckley, the press corps on Capitol Hill has been told that Ways and Means is going to start hearings in January that will likely focus on tax policy. I'm wondering is the -- bill going to be the basis of those talks and will Obama's tax plan be any part of those talks?

MR. BUCKLEY: I keep finding out things that I don't know so I don't know where your rumor came from.

MS. NELSON: Susie Nelson. I was just wondering if people could comment on the suggestions for a payroll tax holiday as part of the stimulus, the political possibility or the desirability.

SPEAKER: I'm sorry. I couldn't hear the question.

SPEAKER: Payroll tax holiday.

SPEAKER: Payroll tax holiday as an economic stimulus.

SPEAKER: I don't think we've ever done that. It seems like there would be huge administration challenges to --

SPEAKER: Presumably it would be straightforward because the employers could just stop withholding, but the difficulty is it's the same as a tax rebate and that would presumably have the same effect, putting money in the pockets of people and hoping they'll spend it and history suggests they don't particularly now when people are saying will I hold my job. I think they do what the money is stick it in the bank and not spend it. So as a stimulus it's probably not a great idea.

SPEAKER: I just think there would be accounting --

SPEAKER: There may be accounting issues we'd have to deal with.

SPEAKER: Accounting challenges for the Social Security Administration and for --

SPEAKER: That's another story.

SPEAKER: -- dealing with people with multiple jobs and so on.

SPEAKER: Right.

MR. BURMAN: Joe?

MR. MENRICK: Joe Menrick. A question for John mostly, but others may want to comment. John, you mentioned problems with integrating a value added tax with the income tax for purposes of eliminating the obligation to file. I wonder if you intended your comments to suggest that there was no role for a value added tax in filling up the fiscal gap going forward. And if in fact that was your intention, do you have any bright ideas about what other sorts of revenue we might conceivably use.

MR. BUCKLEY: My intention was to say exactly what I said and that is a value added tax will not be part of a revenue neutral reform of our tax system. And to replace a portion of the income tax with a value added tax will increase the complexity and intrusiveness of our overall system. It is a wonderful way to raise revenues in addition to what we're currently collecting and one of the -- and that's what the other developed countries essentially do. They have a value added tax on top of corporate and individual income taxes and payroll taxes that are at least as robust

as ours. I'm not speculating on that part of it, I'm just saying those who suggest it is a hybrid form, it's just not a workable structure.

MS. POPLIN: Carolyn Poplin from the Center for American Progress. This is for Mr. Buckley. I was a little bit late but I heard you say that the McCain health care was sort of dead. Is it very different from the Widen-Bennett "bipartisan" plan which I think is very much alive and is an individual obligation to purchase health insurance?

MR. BUCKLEY: I'm speaking from the perspective of the House Democrats and I don't --

MR. POPLIN: Widen is a Democrat.

MR. BUCKLEY: I said House Democrats. I think in the House, and I think this is going to happen across the board, is that there will be great reluctance to take tax measures that undercut group coverage and I believe that many will view the Widen approach as doing that and this -- I mean, maybe I've learned lessons from 1994, I mean, the last time we did it the most important argument against health care reform was the feeling that people felt a threat to their current coverage and that I think is going to drive the debate. We want to extend coverage. We want to do that desperately. But if you do it in a fashion that creates the threat to current coverage, it's just not -- I don't think it's viable.

Now obviously there are others that disagree with me and again let me again say I'm really way out of my league here when we get

into the discussion of health care issues. I mean, I think there's been a long debate about value added taxes giving competitive trade advantages and most economists would say not. I think to some extent the answer is they do because the other countries have used those taxes to in effect create nationalized health plans and take the cost off the employer. So they do -- in those countries they rebate the cost of their health care when they export a product and they impose the product of the cost of health care when they import the product. Economists will tell you and I will say it so they don't have to say it, that it all gets washed out in current rates, but that means we have a weaker currency to reflect that. And this goes back to the value added tax. There are so many things that are in the mix here.

SPEAKER: There's actually -- there's another argument an economist would make about health insurance which is that even though employers nominally write the checks, it's the employees who pay for it in the form of lower wages. If you believe that then health insurance per se doesn't create a competitive disadvantage. The way in which reliance on a VAT might help with trade is if it reduces reliance on -- reduces other economic inefficiencies.

MR. KING: Arnold King again.

MR. BURMAN: I'm going to try to hold it to one question per person if you don't mind. There's somebody in the back there.

MR. VAUGHN: Thanks. Martin Vaughn with Dow Jones News Wires. John, I want to follow-up on your comment about the appetite for renewable energy tax credits and low-income housing tax credits drying up and I wondered if you could discuss that in a little more detail. I guess my understanding is that the short-term problem is that the bank investors, the financial investors, don't have -- I mean they have losses likely this year and next and so that's the reason that there's no appetite now. Treasury's Section 382 guidance complicates that for future years by taking a lot of those tax liabilities off the table. And the question is if you could confirm that or discuss that a little more, but the question is, is it likely that Congress is going to restructure those credits so that they'll be viable -- more viable in the next several years?

MR. BUCKLEY: Let me go first to what's happening -- at least my view of what's happening and that is that the credits like the low-income housing credit, the new markets credit, and the renewable energy credits, typically have relied on financial services companies as investors and that makes a lot of sense. I mean they're in the financial intermediation business so buying credits with the interest rate -- essentially interest rate return makes sense to them. I think two-thirds or so of low-income housing credits in the past were bought by a combination of Fannie Mae, Freddie Mac, Citibank, Bank of America, and one or two other major corporations. I think Wells Fargo was a big

participant in that in the renewable energy credit. So the pool of investors is -- to say shrunken is an understatement. And then with the 382 ruling it does have -- and it may not be a big role, but it does have the role of taking new bank acquires out of the market because of the ability to use pre-acquisition losses.

If I'm right and if it is as serious a problem as has been portrayed to me, I think you could well see Congress looking at those issues. I use that only as an example as to why taxes -- and it's a hard think to say at the Tax Policy Center, that taxes in these circumstances are no longer as -- perhaps as efficient in economic growth as is spending programs which is I think what Bill said.

MR. GALE: Yes.

MR. CLUMPNER: Jim Clumpner -- faculty of Princeton. Just a follow-up on that, a technical question, is that 382 change an ongoing revenue loss is that a one time? Is this a new tax expenditure that will continue to lose revenues over time?

SPEAKER: The regulation is permanent.

SPEAKER: (inaudible)

SPEAKER: Yeah, I think there's enormous concern about -- John mentioned and I think I said something about it, that we're moving toward -- on the corporate side we have a narrow base, high rates relative to other countries, and on the individual side there are many more

proposed refundable credits. I think there's widespread agreement among tax policy experts that a broader-based lower-rate system is the right way to go. I say that hearing in my head John's very astute comment that if you don't politics into account in reforming the system, the reform is not going to last very long. But I still believe in my heart of hearts that a broad-based low-rate system is better than the one we have right now.

SPEAKER: And let me say I agree with you and that's kind of the thrust of what Charles Rangel has attempted to do on the corporate side in this tax reform plan.

MR. BURMAN: Henry?

SPEAKER: I'd like to challenge you a bit on what seems to be the emerging consensus that shovel- ready public works will result in rapid spending but rebates to individuals will simply be saved. The historical evidence is just the opposite. It's that public works have spent out remarkably slowly and now all of a sudden there seems to be this deep faith that this time we're going to get it right. My understanding is that with respect to rebates there's a pretty strong consensus that something on the order of 60 percent of them get spent over a year or 18 months. Compared to the spend-out rate on public works, that's breathtakingly fast. So I'd like to ask you to justify the dissing of tax cuts for individuals and the embracing of spending on public works as counter-stimulus measures.

SPEAKER: I'll grab that one. On the rebate side, I think there's some evidence that the 2001 rebate worked fairly well. There's sort of the 20 percent spending, 30 percent debt reduction, 30 percent saving and whether that's 70 percent net spending if you take into account debt reduction is spending or 40 percent is a religious question, but two-thirds of it went to stuff that ostensibly could push the economy forward. That was a rebate that was in the context of a long -- at the beginning of a long-term tax cut. I think if you look at the recent rebate you're going to find much less -- the one enacted earlier this year, you're going to find much less of a stimulative impact. There's actually a graph that John Taylor showed in the "Wall Street Journal" a couple of weeks ago that was very telling on that point and there's other evidence.

On the infrastructure side, you're certainly right about the historical mistiming of infrastructure investment, sort of getting it too late in the cycle. But everything I've seen about the current economic situation suggests that there's a lot of time between now and the end of the downturn and so one of the good things about having a long, deep, horrible recession is we might get the timing of the infrastructure investment right this time. And I think there's a lot of increased awareness of the fact -- this fact, this mistiming fact, in a lot of efforts to -- currently to identify things that could happen relatively quickly. And also the -- in the models that -- the macro models that various places that use,

infrastructure spending tends to just have a bigger bang for the buck than rebate spending in part because it's investment and it stimulates related investments. But it's an open question. It's not something that -- while I feel strongly in my heart of hearts that a broad-based low-rate system is the right tax system to have, I feel less certain that rebates are wrong and infrastructure is right. It's more a question -- a call of judgment. And part of it also is juts the magnitude. I don't know that we want to give multi-hundred-billion-dollar rebates and we got to come up with other ways to spend the funds. I can't say I'm right and you're wrong. I just -- that's how I think about it.

SPEAKER: I'd only add one other point to that. One thing that may differentiate the infrastructure issue now is a lot of state and local governments are shelving projects that are close to being actually underway. In Virginia they're saying we're going to stop this project right now even though they're breaking ground so it sounds like they may be able to do things faster than they have historically. Whether that proves true is another question, but certainly from a political perspective you'd say that to get the money now whether it's true.

MR. BURMAN: There's a nice connection into the next session where we're going to talk about what a great idea value added taxes are, vouchers for health care, and refundable tax credits. Thank you to the panel.

(Recess)

MS. SCHENK: Thank you. I'm Deborah Schenk, from NYU Law School, and it's my pleasure to moderate the next panel.

As the preceding speakers made clear, there are clearly interactions between taxes and the other problems that are facing our country. And this panel addresses the interactions between taxes and the social safety net.

For a long time it's been clear that taxes not only raise revenue, but they also deliver government benefits. And that's what this panel is addressing.

As Bill Gale mentioned, this is a time for creating policy making, and not silly policy. And in that vein, I view this panel as somewhat substances and form, although not substance over form.

First, we'll hear from Len Burman, who will offer a proposal that pairs health care reform with tax reform -- and important idea, because health care is obviously such an important part of the social safety net.

And then we'll turn to form, and Fred Goldberg, who's going to advocate refundable credits as a delivery mechanism for government benefits.

And after we hear these two presentations, we'll open the floor up again for questions and answers.

Len?

MR. BURMAN: Thank you very much, Deborah.

I was really glad that John gave such a nice lead-in to this panel by talking about what a great idea a value-added tax was.

(Laughter)

This is actually -- this is a proposal which -- talk about the background for this. The background for this paper was actually George Ian (ph) at the University of Virginia asked me how could we get tax reform. And my first answer was, "Move to a different country."

(Laughter)

But then I tried to think about how we could repeat the trick we had in 1986, where we were able to convince people that to adopt policies that had winners and losers -- which always seems like the biggest challenge -- and the secret was to come up with another source of revenue that people didn't understand that they were paying.

(Laughter)

Of course, you know, since I put together this paper, which was originally written, I guess, last March, the entire economy has melted down, and the financial system is a shambles. And you would think that that would make the kind of big thing that I'm talking about even less likely. But I've actually convinced myself that, in fact, this is actually the ideal solution to our current economic crisis. Because we've got an economic meltdown right now. We have to deal with that.

We've got short-term budget challenges, which were illustrated very nicely in Bob Williams' slides that were showing that, you know, giant deficits in the short-run, phasing up to giant deficits over the next 10 years. And then, of course, over the very long term, we realize that if we don't change policy we become Argentina -- which seems to create an imperative for policy.

And there of, of course, a number of other factors involved, like the expiration of the Bush tax cuts which will require some action by the end of 2010. The fact that the income tax is just a total mess, that people perceive it to be unfair, pointlessly complicated -- which undermines voluntary compliance, makes it hard to comply even if you want to, if you can't figure out what your tax liability is. And also implies that the tax system -- the income tax is just not going to be a plausible mechanism for financing our growing government needs over the next 10, 20 or 30 years. There are also rising concerns about economic inequality. Up until about last year, the share of income earned by the top 1 percent of taxpayers had risen to a point that it hadn't reached in the eve of the Great Depression. And thinking about that now, I realize that I probably should have considered that as a leading indicator for what might come next. I did get a phone call from a reporter who said, "Well, now that the economy is in a tailspin, doesn't that mean that all of the concerns about economic inequality will be eliminated, because rich people are no longer rich?"

And I said, “Yeah. I guess it’s true that measured economic inequality is going to be reduced, but the ideal way to do that would be to bring up people from the middle, rather than slam down the people at the top.”

So, the solution that I outlined in my paper is that we would enact a value-added tax to pay for health care. And talking about a new tax right now seems like -- ”Well, that’s not a great idea. We’re in a recession, and taxes -- ” -- you know, the standard recipe for dealing with a recession is you cut taxes, you don’t raise them, and you certainly don’t create new ones.

But -- if you said a value-added tax was going to take effect in a couple of years, and the rate was going to go up steadily as it phased in over time, that would be like a 10-year economic expansion program. Every year you’d want to spend money to avoid the tax increase in the future. And it would deal with our long-term budget problems.

Okay. So, what are the requirements for this grand, unified reform of our tax and health care system?

First of all, we need to be able to control spending. The largest growing, the fastest growing source of spending for the government, and the one that really creates the big problems over the long term is Federal spending for Medicare and Medicaid -- that is, for health care.

The CBO has these long-term projections, and by the year 2040 or so, spending on Medicare, Medicaid and Social Security comprise about 18

percent of GDP -- that is the historical average of total taxes collected at the Federal level.

We need to figure out a way to reduce that spending level.

One of the concerns people have about the current tax system -- and I think it's exacerbated by some proposals to create more refundable tax credits, like Fred's going to talk about -- is that a lot of individuals don't owe income tax. And the concern is that from their perspective, Federal government programs appear to be free.

So another concern for reform, I would argue, is that lower and middle-income people should be responsible for a share of government spending.

A third concern -- and this is raised by rising economic inequality -- this was a big theme of President-elect Obama's campaign, and I imagine it will be a theme of his administration -- is that we need to maintain or improve progressivity. The tax system is one way of mitigating economic inequality.

Another concern is relatively high marginal tax rates. In the last panel, Bill and others -- Bill and John -- talked about high marginal tax rates on corporate income, 35 percent tax rate, even though revenues were relatively low. That's a higher rate than applies in much of the rest of the world. And conservatives, in particular, are concerned about high marginal tax rates on individual income, as well. So an ideal reform would reduce those rates, too.

And, finally, we'd like to improve our long-term fiscal situation, without exacerbating the recession.

So the solution is a phased-in value-added tax to pay for health insurance. The idea is that the value-added tax would finance all Federal medical expenditures -- that is, for Medicare, the Federal portion of Medicaid -- actually, for all of Medicaid -- the State Children's Health Insurance Program, Veterans health programs. And the value-added tax would be set so that it raised enough revenue to finance those programs.

Now, in the version that outline in the paper, I assume that the VAT would pay for the entire cost of all those programs. And if you did that, the value-added tax would be about an 18 percent rate, assuming an impossibly broad base and 100 percent compliance.

If I were a fair tax person, I would just stop there. But, in fact, you know, the impossibly broad base and 100 percent compliance probably isn't feasible. So the rate would probably have to be higher. I mean, alternatively, you could have some kind of income testing for benefits, as well.

But the basic idea is that the VAT would pay for all of these Federal health care programs. And the idea of pairing the value-added tax with a new entitlement for health care is that even though a value-added tax is regressive -- that is, low-income people spend a larger share of their income than high-income people do, the combination of a VAT and health

insurance is actually progressive. Say, for a middle-income person, getting a health insurance policy is worth $12,000 for a family, would be worth way more than what they would be paying in value-added taxes. The idea for this actually came about as a result of a conference we had at Brookings a year ago, when we were talking about the role of capital income taxation. David Weisbach (ph) talked about an "x-tax," which a lot of people -- what the idea of x-tax is, it's a progressive consumption tax. But a lot of people perceive that as complicated. The rates tend to be very, very high. And the question is, is there another way that you could increase reliance on consumption taxation and maintain progressivity, as well?

And the answer is what's done in the rest of the developed world, which is using the value-added tax as a way to finance an expanded social safety net. The combination of a VAT and health care is actually progressive. Now, there are people who are left out. Low-income people who are currently covered by Medicaid wouldn't be getting anything out of the health insurance entitlement. Well, how you do deal with them? One way would be to do the kind of thing that Michael Wright's (ph) talked about, which is have a refundable income tax credit that would be paid to low-income people to offset their VAT liability.

The advantages of a VAT is that it would be a relatively efficient revenue source. Since the VAT rate would be tied to medical spending, everyone would have an incentive to buy into cost-control measures.

I think this is an enormous advantage of tying a value-added tax to Federal spending for health care. Because right now, people think of programs like Medicare and Medicaid as "free." They're being paid for by the government. They also -- they're not very much aware of the cost of the exclusion for employer-sponsored health insurance. And that means that anything that the government might do to limit the costs of those programs can produce a hue and cry of opposition from people who are mostly concerned about the loss of benefits.

Well, if a value-added tax were tied to health care, then if health care costs continued to grow faster than the rest of the economy, the VAT rate would have to increase. And everybody would be paying the value-added tax. So it deals with the concern that so many people aren't paying income tax now.

And that would create pressure to lower government spending on those programs -- which I think could be an enormously valuable measure.

The other part of the proposal is income tax reform, with rate cuts. If the Federal government were paying for all of health care through a value-added tax, it would save something like $600 billion in spending that was otherwise being financed through general revenues. It saves the general

revenue portion of -- the general revenue financing for Medicaid, the general revenue portion of Medicare, which is larger than a lot of people thing, and about $200 billion of annual income tax expenditures on the exclusion for employer-sponsored health insurance.

So the consequence is that Federal income tax rates could be cut dramatically. The top rate could be cut at least to 25 percent for both individual income and corporate income tax rates.

It would also allow payroll tax cut, because part of the payroll taxes go to pay for Medicare. And it would bolster the Social Security Trust Fund. Because if you got rid of the exclusion for employer-sponsored health insurance -- another think John Buckley thought was a great idea -- if you got rid of the exclusion for employer-sponsored health insurance, then there would be something like $80 or $90 billion of additional revenue going into the Social Security Trust Fund from that.

Now, the effect on the States is kind of complicated. It would save them a lot of money if they weren't paying for Medicaid. It would reduce their -- there's been a lot of focus on the effects of rising Medicare and Medicaid costs on the Federal budget, but the rising costs for Medicaid which, by the way, increasingly is just going to pay for long-term care, as the baby-boomers are aging, and more people are going into nursing homes, that's a huge obligation for the Federal and State governments through the

Medicaid program -- that that is the largest long-term risks for State governments, and they would no longer be on the hook for that.

So -- and it would broaden State income tax bases for the same reason it broadened the Federal income tax base, because there would no longer be exclusion for employer-sponsored health insurance. So the States would just love the idea of a Federal value-added tax.

No, actually, that's not true.

(Laughter)

The thing they might object to is that it obviously would have interaction effects with State sale taxes. There are enormous complexities involved with integrating a value-added tax with State sales taxes. I don't resolve those. I will point out that Charlie McClure (ph) is leading a project specifically on that issue. I think in February he's planning a conference on ways to integrate a Federal VAT with State sales taxes. And he believes that that's something that's possible.

The other thing about my proposal is that it would involve broadening the base of the income tax. And one of the things I would do which would also make the States happy is I would get rid of the State and local tax deduction because, arguably, they wouldn't need it anymore, because they'd be saving so much money from Medicaid that they could use that to offset the effect of the lost State and local tax deduction.

So the other part of this is a broad income tax reform. And the nature of the income tax reform which I outlined in the paper is similar to proposals that have been made by Bill Gale. It's not dissimilar from the proposal made by Michael Gratz (ph), except that in my system I wouldn't have the 100 million people not obligated for income taxes, because I think that would be a mistake, and it would feed into the concerns about so many people who are outside of the income tax system.

Instead, what I would do would be to simplify the Federal tax system enough so that most people didn't have to file a return. There would be final withholding by employers.

And the basic idea is that there would be a two-rate individual income tax system. The 15 percent rate, which would apply from the first dollar of income up to -- I haven't actually, I haven't worked out the exact revenue-neutral thresholds, but up to $80,000 or $100,000 of income. And then a second rate of 25 percent beyond that.

The standard deduction, personal exemptions and other subsidies would all be converted -- they'd either be eliminated, or they'd be converted into refundable tax credits. This is actually the way in which this syncs with what Fred's talking about.

The basic idea is instead of personal exemptions and standard deductions, that people would have an allowance, a refundable tax credit,

which would be an allowance for themselves and for their children. And that would replace the standard deduction and the personal exemption. The advantage of doing that is that that allowance is basically just cash. It doesn't depend on your income. And it could just be similar to the Gratz (ph). This could be either mailed to people in the form of a rebate, or it could be -- he proposes that the money go into something like an ATM card, particularly for low-income people, that they could use to help finance consumption over the course of the year.

The advantage of this system is that if the first dollar were subject to the 15 percent rate, and most income were subject to the 15 percent rate, you could do exact withholding for almost everybody -- except for the people in the higher bracket.

Deductions that were preserved under this system would instead be converted into credits which would be -- so, let me see. I'm getting ahead of myself here. First we'll talk about -- the interest and dividends would be subject to withholding at a 15 percent rate. Higher-income people would actually file a return, and they would pay taxes on the additional amount. Wages and salaries would be subject to withholding at a 15 percent rate. If we preserve the mortgage interest deduction, which is probably a political necessity, the deduction would be converted into a 15 percent refundable tax credit, which would be paid directly to the lenders, or paid to the individuals as a voucher which they could transfer to the lenders.

Charitable contributions would, instead of a deduction for people in the 15 percent rate, there would be an automatic credit that would go to charities -- 501(c)(3)s. The UK actually does something like that right now.

There are a number of other conforming changes that would be made. But the basic idea would be to simplify the tax system enough so that almost nobody would have to file a tax return.

Now, John talked about the fact, well, if you've got this rebate -- and this is very similar to what Gratz (ph) was proposing -- that the Federal government would have to send people checks at the end of the year. But the nice thing about the proposal, and the thing I find, actually, appealing about Fred's proposal to turn deductions into credits -- is that that would make it clear that the purpose of whatever paperwork requirement there was to get the tax credits paid at the end of the year would clearly be to get the subsidy from the government, and it wouldn't be part of tax preparation. Tax preparation, itself, would be very, very simple. And basically the idea is that income less deductions for most people is just taxed at a 15 percent rate, and for most people, that could be done directly through withholding.

So this solves everything. (Laughs)

(Laughter)

There are a few reasons why it might not happen.

(Laughter)

One is that the government is kind of busy with other things right now. There's an unwillingness of politicians to deal with losers and, of course, there would be the perception that some people would end up paying more under this system.

There is -- George Yen (ph) wrote a wonderful article, a depressing article, about the polarized political environment, and how dysfunctional the political system is. As Bill mentioned and Bob mentioned, President-elect Obama has a laundry list of goodies, and the insistence on more progressivity, and that would make it harder to simplify the tax system along the lines that I propose.

But then again, I mean, the reason we got the '86 tax reform was, in part, because Ronald Reagan gave a really good speech. Obama probably gives better speeches than Reagan did -- and nobody thought the tax reform act of '86 could happen, either.

(Applause)

MR. GOLDBERG: I'm revealing my age here. I have no idea how to use this machine.

(Laughter)

My general technical incompetence.

(Pause)

It's a treat to be here today. I will hearken back to a lesson I was taught shortly after I became the IRS Commissioner. Actually, it was a long-time

colleague at the time, Chris Cox (ph), who was then a Member of Congress. And he said, "Fred, remember one thing. They can set the hearing. They can make you show up. But once you start, you've got the mike."

(Laughter)

So, as we will see, I'm going to deviate slightly from the topic I was assigned.

(Laughter)

The way this program is structured is that this morning we're talking about taxes and social safety net. This afternoon we're talking about taxes and capital taxation, and taxes and energy policy. And those are two very different ways to think about the tax system. One has to do with social welfare, the other has to do with economic policies that in some ways nears the new approach the Joint Committee is taking to what used to be referred to as "tax expenditures." But it's a useful framework.

Before starting, I'd like to talk about the 2008 campaign -- death and near-death experiences on the road to tax reform. A number of speakers have alluded to Senator McCain's proposal which, at least in my view, was a stunted version of a very coherent way of thinking about health reform. I think he was probably terrorized by Republican orthodoxy from going as far as he should have gone. But it included an important set of ideas.

So here's the debate.

"I'm going to cut 95 percent of your taxes, and I'm going to make affordable health insurance available to everybody. That guy is going to tax your health insurance benefits for the first time in the nation's history, and give you a meager and mere -- indeed miserly— $5,000 that will not begin to permit you to purchase health insurance. And, adding insult to injury, you don't even get the credit, it goes straight to those insurance companies."

That is not a fair debate. I think you can predict pretty quickly, it's going to win.

The issue is whether that debate will have a meaningful impact on the ability to at least consider the role of refundable credits, and the absurdly regressive distortionary nature of employer deductions and worker exclusions for health care.

There were a couple of near-death experiences. Senator Obama's initial proposal on payroll tax increases -- in addition to being maybe the worst policy proposal in the last 20 years -- really makes it harder to debate the role of tax increases -- payroll tax increases -- in dealing with very difficult problems. Fortunately, as he displayed over and over again, he was facile enough to move to a revised policy that kept the kernel of the notion, but did so in a way that people understood was perhaps rational for two reason: one, the rate increases were significantly reduced; two, they were deferred to when we actually need the money.

Senator Clinton -- and this, I should confess at the outset, this is a topic I have been working on for 15 years -- for whatever reason was giving a speech about children's savings accounts, "baby bonds." She had proposed a $500 refundable credit, a very laudable proposal. She slipped, and called it a $5,000 credit. John McCain pounced 13 hours later, and the proposal was never heard from again.

And I think one of the lessons is, we asked for informed, thoughtful, out-of-the-box, innovative debates and ideas from our Presidential candidates, and that is merely an invitation to slaughter. And I think that we need to wonder how that's going to work.

Anyway, I'm going to talk about three topics relating to social welfare and the tax law.

The first is replacing social welfare deductions and exclusions with refundable credits.

The second is building a platform for universal lifelong savings.

And, third, in continuing the due deference to John Buckley, to talk about yet a third way to think about value-added taxes.

Let's start with refundable tax credits, and look at where we are from the social welfare context.

This chart shows the what one thinks of as tax expenditures for health care, for thrift, for home ownership, for charity and for education. It doesn't cover the earned-income tax credit, which relates to work.

There's something very important about this list. And what's important is, health care really matters to all of us. Thrift is a virtue, thrift is something that we as a people care a lot about. Home ownership, that's the American dream. Charity is a deeply imbedded part of our collective persona. And education is opportunity. And tax theorists, tax administrators, tax policy folks can say, "Oh my God, why are you doing all of this through the tax system?" And that's maybe a fair question. If you're a pure tax guy, a pure Hague-Simons (ph) advocate -- whatever -- the answer is, "This is really stupid."

But I think it's important to stay into the fact that these are really core shared values. And as John was saying, if you don't take that into account, you kind of are going to miss the reality of what's going to unfold down the road.

Now, I'm not saying these are good or bad. My personal view is they are reality, so I want to start from that reality and figure out how to make it work better. But if you could convince Congress to repeal all of these, go for it.

But what's important is the current form of subsidy. And the current form of subsidy consists of deductions and exclusions from income. The alternative form of subsidy -- or incentive, you can call it whatever you wish -- is a refundable tax credit.

Now, the historic framing of this issue is as follows.

"Deductions are a giveaway to the idle and abusive rich. Why are we doing this?" To which the answer is, "Refundable credits are simply another misguided, ill-informed, welfare program for the poor."

And that's the framing of the debate.

That is not a constructive conversation.

Now, I'm going to refer at the top of this slide to this article. And even though I am one of the co-authors, I can say with no shame or embarrassment that it is truly, truly an extraordinary article.

(Laughter)

And, indeed, one of the co-authors, Lily Batchelder of NYU is here today. Peter Orszag, of current and even greater fame in the future, was the other co-author. And the reason I know it's extraordinary is it proves -- it proves -- that a refundable credit is more efficient than deductions. And it talks, for example, about this guy, Pigeoux -- Pijoux? -- I don't know, but anyway, the reason I know it's extraordinary is that half way through the process of writing it I realized I did not understand a word of it.

But let me tell you what I do understand -- and this is very personal. I've got five kids, and I really love my kids. And every one of them is choosing a career in the public sector, or is choosing a career as a workers rights attorney, or is choosing a career managing a non-profit organization.

So let's take my second kid, Ben.

Ben is a teacher in the Montgomery County public schools. I'm one of those rich lawyers. And the government pays 35 percent of my mortgage interest deduction. On its better years, our government pays 10 percent of son Ben's mortgage interest deduction.

How do I look him in the eye? How do I say, "Oh, this is fair because my ownership of my home confers three-and-a-half times the social welfare that your ownership of your home confers."

This has nothing to do with rich people or poor people or anything else. It has to do with the tax law's judgment that there is a collective social benefit in home ownership. And I believe the collective social benefit of home ownership is as applicable to my sons Ben as it is applicable to me. And the same thing applies to his charitable contributions. The same thing applies to his savings. The same thing applies to his efforts at continuing education. The same thing applies to his health care.

So I really don't understand the Pigeoux (ph) models. But I do understand that if this is about social welfare, a refundable credit is the only plausible answer.

It does other things, too. I compensates for the annual accounting period. In all of these tax policy discussions, a lot of what the Joint Committee is doing now, I think we lose sight of the fact that the tax system requires an annual accounting period. It's the only thing that works.

Well, in the system we have, just do the math on what happens to a person with $40,000 -- a family with $45,000 of income every year, and a family that has $15,000 of income in year one, and $75,000 of income in year two. We are hobbled by the fact that we have to leave within an annual account system.

And a refundable credit deals with that distortion. The fact is that more than 85 percent of all families have positive income tax liability over their lifetimes. And tax policy people who think about lifetime incomes understand that we should not be blinded by the annual accounting period.

Third, it is counter-cyclical. The nature of the credits, the amount of the credits effectively operate in a counter-cyclical fashion from a macroeconomic standpoint. And, again, all of this stuff is proved in the Lily-Peter paper that I got to sign onto, and you ought to read it, because it makes a very convincing argument. This is a subset of the fact that our tax system is uniformly fails to take advantage of counter-cyclical policies. The NRL rules that have been talked about before.

The notion that you pay taxes when life sucks and you get that money back when life is good is absurd. And we do too much of that.

The other point to make is this can be done on a revenue-neutral basis. Let's reference to the paper that he and others did set a 28 percent rate, or maybe on the savings, that I believe was a revenue-neutral credit.

You could do this revenue neutral. So instead of a 35 cents on the dollar from Uncle Sam, maybe I have to live with 28 cents from Uncle Sam. Instead of living 10 cents from Uncle Sam, my son Ben gets 28 cents. It feels like a pretty good place to be.

There are challenging technical and administrative issues -- particularly there are complexities in health care and savings contexts, because there are so many of them. But on the other hand, it's an opportunity for simplification.

The comments before -- I don't know whether it as Bill, or Len -- somebody was saying -- or John -- we all talk about simplification but it never happens. I think it never happens because we start in the wrong place.

I believe that we should accept things like home mortgage interest deductions, and charitable contributions, and government subsidized or incentivized savings. So the issue is we don't get to simplification because we can't get rid of them. The issue is getting to simplification -- conditional simplification. Within the context of those provisions, can we simplify? And I believe that a refundable tax credit system is an opportunity to achieve a lot of that.

Second concept -- universal lifelong children's savings accounts. Simple. Tax credit of 500 bucks for every kid at birth or some age. That account must remain in place for that child's entire lifetime. The goal is quite

simply to create a universal platform. This is about the plumbing, not about the dollars.

Now, why would we do this?

One reason is that everything else we have tried has failed. It's done good work, and there are probably more people saving than otherwise would be saving. But prior to what is going on in the economy right now, more than 20 percent of all Americans were un-banked. More than 20 percent of all Americans lived in asset poverty. More than 40 percent of all African American families lived in asset poverty. And we need to figure out some other way to deal with that challenge.

The hypothesis is: build it and they will come.

And the data is out there. The IDA experiments that have been going on, some of the income experiments that have been going on. UK went to this kind of a program a number of years ago. The preliminary data -- it's only about three years' worth -- says that in low-income zip codes, the 250 Pounds that comes from the government is matched to the tune of 500 Pounds by private contributions to the accounts established for those low-income kids.

And the theory is that you look at Social Security, you look at the earned-income tax credit, you look where they started, and you look where they are now, and the big challenge from a legislative standpoint is to get structures in place.

This is like a social welfare infrastructure project. You go overnight -- or over a generation -- from 20-plus percent un-banked to everybody banked. You go to a system where you have these accounts, and you build those accounts -- which I believe is clearly a legitimate government function along the lines that the interstate highway system or any sort of other infrastructure. Churches will help build on it, local communities will help build on it. Families will help build on it. The government can help build on it.

The refundable savers credit is terrific. But when 20 percent of the people don't even have a bank account, where's the money going to go? Auto IRA is terrific, but if people don't have accounts, where's the money go? And this is a plumbing project. This is an infrastructure project. It is the only one of the three things I'm talking about that costs any money.

The cost at 500 bucks, 4 million kids a year, that's about $2 billion, rounded up to $3 billion a year -- that's a lot of money, but that is nothing compared to every other number we've seen on the screen today.

It is absolutely doable. The current IRS/FMS infrastructure, plus the financial institution structure -- today -- says you could do this next year. And it is a pretty inexpensive investment for the potential upside.

Replacing the payroll tax with a VAT to fund our social safety net. I believe this is the last, best and maybe only hope for avoiding fiscal catastrophe.

Demographics -- we are on cruise-control, absolutely cruise-control, to spending 25 percent of gross domestic product, or more. In short of grotesque policies, this is going to happen. It's baked. We're all here. You could have a Fiscal Sanity Commission that would set and re-set the rates to make long-term balance in the face of policy changes, demographic changes and economic trends. This is a lot of what Len was talking about.

I think a comment worth making is that one of the criticisms of a VAT or a consumption tax is that it's regressive. To which the answer is: compared to what?

It is a significantly more progressive levy relative to the payroll tax, and it is a significantly more progressive levy relative to what then-Senator Obama's first proposal was on payroll taxes. And certainly, if integrated properly with the income tax, it will be a dramatically progressive levy relative to where we are now.

Some random observations.

Very slight increases in that VAT rate, relatively speaking, could let us be Ireland. A significant cut in corporate rates -- perhaps also funded by base broadening.

One of the problems I have with President-elect Obama's campaign on this exporting of jobs and this whole discussion is it's a little bit like saying, "I want to stop gravity." And that a far better policy approach is, "I want to

be gravity." I want to have a tax system that says, "Everybody wants to be here because we are the biggest, best, most lucrative tax shelter in the world. Because at the margin, the rates of working in the United States are better than working anywhere else." And I think that kind of sucking the jobs in is probably a little bit better than trying to keep them from going offshore.

You could use a paltry portion of that revenue to fund the paltry cost of universal lifelong savings accounts. You could do other health care reform with it. You could do other good things with it.

And this "do other," to me, is mission creep. And the issue is whether that mission creep is a policy opportunity, a political opportunity or why it won't happen at all.

Some more observations -- it's border adjustable. I don't even pretend to understand the economics argument. When I was at Treasury, I used to hear them. They always explained it. And after they left it was like I'd eaten a Chinese dinner, I couldn't understand. "Okay, yeah, I got it." But maybe -- it's sort of like Roth IRAs and Traditional IRAs are the same thing. They prove that to you and they leave, and you don't understand why that could possibly be the case.

But I do believe border adjustability matters. It matters a lot. And it is a benefit to our competitive position.

If you do the VAT to replace the payroll tax, you answer one of the standard objections: “Why should we add yet another tax system to our current regime?”

One answer is that if you use it to replace the payroll tax you have created no net new taxes. And there are those who think, well, the payroll tax, the smoothest running machine we have -- at least when I was in Treasury and looked at surveys, the fact was that payroll tax was the most hated levy among all small business. They hate it.

And, again, I’ve got to go back to my kids. You know, “Daddy, what happened to my paycheck?” Right?

I was standing in line at DMV some number of years ago, and two young women were talking about -- the got, they had their first jobs. And they said, “I’m not getting paid anything like what these guys promised me? What’s going on here?”

Well, a part of the withholding, obviously, is you’re paying your tax. But you start to talk about, “Well this -- ” -- ”What’s this FICA person? Who’s he? Why does he get all that money?” And there is, I believe, a political virtue in linking the two because, well, I’ve got to pay extra price, and some kind of cost when I buy a TV or something. Yeah, that’s pretty abstract at the end of the day. But, baby, that pay check goes up, I’m a happy camper.

Plus, you know, if you're buying TVs you can say, "Hey, grandma, this is for you, baby," because you're paying for part of her health care.

And I think that it's also, as Len mentioned, something of a response to Madison's comment about tyranny of the majority. There is a view that many of us have that everybody should pay something in taxes because that is a social compact. It ought to be progressive, it ought to based on ability to pay. But the income tax system is inexorably moving towards a world where, during any given year, 38 percent, 40 percent, 45 percent -- you know, we're pushing over 50 percent. I think that's fine -- given the practical uses that are being made of the tax system.

But I think a national value-added tax responds to that concern, and it links very closely two notions: what are we paying, and what is our obligation to the elderly and those who need the support of Medicaid? I think that's a fair question to ask, and we all ought to participate in those answers.

Just mechanically, folks would maybe want to think about taking a page from FDR. When the payroll tax started, there was a one-year holiday on income taxes. One could think about those kinds of gimmicks to make this thing work a little bit better.

But at the end of the day, the three things I've talked about -- converting to refundable tax credits, which is done on a neutral basis and isn't rich versus poor, this giveaway, that giveaway or anything else -- it is a

principled position, based on notions of efficiency, notions of accommodating annual accounting period, and notions of being counter-cyclical.

Creating a universal plumbing, a platform for savings is a relatively -- microscopically -- inexpensive venture in the context of everything that's going on, and I believe it is the only way -- the only way -- to begin to address issues of inequality, asset inequality, the only way to begin to address issues of asset poverty. And it is absolutely easy to do.

And I think that we will have failed if we don't get to a new degree of freedom by picking up a new form of revenue in the form of value-added taxes. My personal view is that the most logical place to deal with the revenue is to replace the payroll tax -- for reasons I've indicated.

But if we do none of these, we will have failed.

Thank you very much.

(Applause)

MS. SCHENK: So those were both great presentations, and I'm sure you have a lot of comments and questions. So we'll take comments and questions from the floor.

Wait for a microphone, and when you get it, please state your name before you speak.

Down here in the second row.

MS. WAYMAN (ph): Thank you. Carol Wayman from the Corporation for Enterprise Development.

My question is for Fred -- as you're pulling your mic on.

The question is, the earlier panel really talked about savings in the context of retirement only. And when you're talking about your children, or my children, or kids at birth, retirement just seems so far away.

I wonder what the uses of the children's savings account are, if it's just retirement, or you can use it for other things? And then how that would work.

MR. GOLDBERG: From my vantage point -- and I should add a couple people (inaudible), yes I was and am a Republican -- the theory here is to build the platform. I would require that that money stay in that account literally -- literally -- forever.

What it does is it begins to create an architecture where you can build other programs. It's like sidecars, for those who do ERISA work. You could have a 529 account hanging underneath it for saving for education. You can have a special account dedicated to a first-time -- you know, to cover a down payment on a first-time house.

One of the interesting things in the UK context is the number of folks who would call the primary provider of this service, of setting up these accounts, and say, "Can Johnny's daddy get a hold of that money?" "No."

"Good, keep the son of a bitch away." "Can I put this money aside and have it used only so Johnny can buy his first-time home?" "Sure."

And so the theory is that existing financial architecture -- if you look at what financial institutions can do -- the difficulty of opening up an account, post-Patriot Act, is astonishing. We don't see it, but if you go out there with folks who are currently un-banked, it is so difficult for them to get into the financial system.

And the theory behind this proposal is once you've created the architecture, once you've said, "Okay, everybody's got an account," they can hang whatever they want to hang underneath it. It can be for health care, it can be -- if we keep HSAs, it can be HSAs. It can be IRAs. You can use it whatever you want.

So this is not to address those issues, this is to create the infrastructure that makes it possible to take advantage of those opportunities.

MS. SCHENK: Just to be clear, Fred -- in response to the question -- the $500 would never actually be used for the child.

MR. GOLDBERG: It's there, and it's stuck.

MS. SCHENK: Right.

MR. GOLDBERG: That's it.

And, indeed, the person then has that compounded asset to pass along to their children or other folks, or charity, wherever they care to pass it on. The plumbing has to be permanent.

Getting into the system is a killer, in terms of opening accounts. Getting out is easy: “Thank you very much. I’ve got my money. I’m gone.” And you can’t get back in again, so it is locked up. That piece is locked up forever. The government has little or no say over what other -- you know, what sidecar accounts are hanging underneath. That’s up to a lot of other people.

MS. SCHENK: And did I just understand you to say that the money could be transferred at death?

MR. GOLDBERG: Yes.

MS. SCHENK: Other questions?

Mm-hmm? In the middle?

MR. AGA (ph): Onoke Fue Aga (ph) a question. I mean, on the three reform policies, which ones are the most expensive? It could be one, two or all of them.

And the other question, on a flat tax, what do you think about a (inaudible) in the foreseeable future?

MR. GOLDBERG: On the three proposals?

MS. SCHENK: Yes -- do you want to prioritize them?

MR. GOLDBERG: It’s hard, because I’ve been dealing with children’s savings accounts issues for 15 years. And I believe deeply it’s the only way to break what I think is very troublesome as a social matter.

I think refundable tax credits is so obviously the right thing to do.

But, at the end of the day, we are bankrupting ourselves -- absolutely bankrupting ourselves. And I believe the only plausible way to deal with that issue is through introduction of a different kind of revenue source in the form of value-added tax.

So you will not let me choose my first child. You will not let me choose my second child. I'd pick the value-added tax.

MR. AGA: And the —

MR. GOLDBERG: In terms of your question about a flat tax -- one, no I don't think it's viable. And, personally, I don't think it's a good idea.

MS. SCHENK: Len, did you want to comment?

MR. BURMAN: Right. I was actually just going to say what Fred just said. I mean, the problem with the flat tax is, well, first of all, the complexity in the tax system is not because we've got more than one tax rate. The complexity is because of how hard it is to measure income, and complexity created because of subsidies run through the code, and all the tax credits, as well. We could simplify a lot through the kinds of measures that Fred was talking about.

But the other problem with flat tax is that it would inevitably be extremely regressive. Some of the proposals are aimed at taking care of people with low incomes. But since a flat tax inevitably means high-income people get a big tax cut, anything that's revenue-neutral means there would be a

huge tax increase in the middle. And that's why it's politically a non-starter.

MS. SCHENK: In the very back.

MR. BRADY: Hi. My name's Peter Brady.

So the question is about the deductions for savings, or moving to credits. And I was wondering if they applied to both defined-contribution plans and defined-benefit plans? Or just defined-contribution?

And the reason I'm asking this, Fred, is you're very interested in raising your own taxes, and I just wanted to know if partners in law firms could still do a self-DB and shove a hundred grand in there and get a deduction, or if it turned to a credit.

MR. GOLDBERG: You know, one of the most important reasons not to permit the Bush tax cuts to expire early is I'm already 61, and in four years I could care less.

But I would integrate it with qualified plans, 401(k) -- I would integrate all of this, would be my answer.

MR. BRADY: Okay, how would you do refundable credits for the defined-benefit plans?

MR. GOLDBERG: Matching contributions. Well, it's hard. You'd have to run it through the saver's credit. The individual would file a return -- right? And you'd show —

MR. BRADY: Would you actually tax accruals on defined-benefit plans, then?

MR. GOLDBERG: No, no. No.

MR. BRADY: Okay, so there still would be a big —

MR. GOLDBERG: Understand -- you know, you're not going to solve on this point.

The point Len is sort of, you know, talking about -- so how are you going to do this? As I've said, I think the savings -- the group savings pieces are harder, health care is harder.

But I think you can find surrogate ways to get at it. You're not going to solve all of the issues.

A wealthy person, high-income person currently, arguably is better off because otherwise you will be taxing that inside buildup at 35 percent whereas, from my dear son Ben, you would otherwise be taxing that inside buildup at 10 percent?

How do you fix that? My answer is: you can't.

MR. BRADY: (Off mike. Inaudible)

MS. SCHENK: The mic, please?

MR. BRADY: Just to clarify what I think Len said, the accrual would be included in income for the employee -- for DB plan?

MR. GOLDBERG: I don't think they do that. That's not what —

MR. BRADY: Not the accrual, the new benefits -- the equivalent of the contribution that the employer puts into the plan, would it be considered income to the individual?

MR. GOLDBERG: I would view it -- under current law it's an exclusion, it would stay an exclusion. But the value is -- right? -- there's an implied tax —

MR. BRADY: Right now, the treatment of DC and DB is equivalent.

MR. GOLDBERG: The way you would have to do it is you would treat the contribution as taxable income and give a flat-rate credit -- right?

MR. BRADY: On DBS.

MR. GOLDBERG: Right.

MR. BRADY: Okay.

MS. SCHENK: In the back, on the other side.

MR. KLUMPNER (ph): Hi. Jim Klumpner again.

One element that is in common with both of your proposals is using consumption taxes to fund safety-net programs. But I do take John Buckley's political concerns very seriously.

How would you react to changing your proposals and having the consumption tax not based on the VAT but, instead, based on pollution excise taxes?

MR. BURMAN: The idea -- we're going to talk about carbon taxes this afternoon. The carbon taxes, or Cap-and-trade, or something like that, is

a potential revenue source, obviously -- a potentially significant one. And there's a lot to recommend it.

There's probably not a lot of money left over after you deal with the distributional effects of imposing those taxes, or you deal with the transition issues. Although maybe Gib will disagree with me on that.

But I don't think you could fund much of -- you might be able to fund a portion of the social safety net through environmental taxes, but I think there would still be a need for substantial other revenues.

I mean, we're talking about, in the case of health care, you're talking about, you know, maybe a trillion dollars of obligations, Federal obligations, each year. And you're not going to get that from a carbon tax.

MR. GOLDBERG: I think there is a virtue in numbers. The rest of the world has figured out how to make a value-added tax work reasonably well. And I think that there is a virtue in harmony. That's not to say you shouldn't deal with this other issue.

But I just think the administrative -- sort of the consistency, cross-border consistency, to some extent, is a great virtue from a political standpoint.

And all of us have referred to Professor Gratz and, you know, this thing about getting 100 million folks off the tax rolls.

My view, at the end of the day, is we are going to continue to use the tax system and will increasingly use the tax system to deal with social welfare policies. It is an extremely efficient delivery system. I mean, I see Mort in

the audience probably cringing at the thought of using the tax code this way. But I think the reality is that we lose sight of how extraordinarily -- what an extraordinary national resource the tax system is as a financial institution. It's getting money in and getting money out.

And I think the reality is we're going to keep using it that way.

On the other hand, you know, we think of the payroll tax as a piece of cake, but small businesses hate it. And if the political trade is get rid of the payroll tax, do this tax instead, and somebody said, "Oh my God, you're going to have to pay so much more for what you buy," and you're telling Joe Sixpack, or Joe the Plumber, maybe, "No, no, no, Joe -- but your taxes went up. Your paycheck just went up -- " -- I think that is an arguable political calculus that arguably works.

SPEAKER: (Off mike. Inaudible)

MR. GOLDBERG: I think they're offended because the money seems to be just taken. It is an administrative pain, in terms of dealing with workers. Some of them like to keep the money and spend it on the business and they get real unhappy when the IRS comes in and chases them for it, and there's personal liability for it.

It just sets people off. I can't explain to you why.

And this is survey data that's 20 years ago now, maybe? So I can't really tell you. But that's at least what I think the data would show.

I think the argument -- we've got payroll taxes, we've got income taxes, we've got estate taxes, we've got certain kinds of excise taxes, we've got gasoline taxes. And now we're just going to add another one.

You know —

SPEAKER: Why would they object less to a VAT than to payroll taxes?

MR. GOLDBERG: Oh, I think they'll object a lot.

(Laughter)

SPEAKER: So, basically, they're just whiners.

MR. GOLDBERG: They're -- but, you know, but you got to pay attention to the whiners, because they've got all the votes. So it's —

MR. BURMAN: So the advantage of a VAT to pay for health care is that it's -- particularly for small businesses, health care is a huge problem. And, you know, if you want to provide health insurance to your workers you're at enormous risk if somebody gets sick and your premiums go through the roof.

MR. GOLDBERG: And whichever -- if you can sell that, you've got my vote.

I think that we can't -- one of the things that happens in tax policy is that my "best" becomes the enemy of everybody's "good." And I think that's one of the things we've struggled with in dealing with tax reform for a long time.

The whole issue about dividends, and double-taxing corporate income, Treasury had an elegant proposal to achieve something pretty close to a good answer. And Bill Thomas said, "Forget about it. Just tax them at 15 percent." And that was an accommodation -- a rough-justice accommodation.

And so in this case, I think given the stakes of finding how are we going to deal with that 25 percent of GDP bogey, I think that if I sit here and say, "Len, you gotta replace the payroll tax and forget about it. Gratz says you gotta get 100 people off the tax rolls or forget about it," and you say, "It's gotta be for health care or forget about it -- " -- you know, we'll be here in 10 years talking about the same thing.

And I think what, for at least for some of us, is so encouraging about President-elect Obama's approach is that he at least kind of let's you think, well, maybe that's not going to happen again. And I think that -- so, if you can get 49 votes, you've got mine, man. And, that's -- you know, that's the political process.

MS. SCHENK: Mort? Right here.

MR. KAPLAN: I'm Mortimer Kaplan.

You referred to Franklin Delano Roosevelt's one-year tax holiday.

MR. GOLDBERG: Yes.

Mr. KAPLAN: And I was wondering how far you intended to go?

Because, you remember, about that holiday, it was to take the Beardsley Ruml plan to put us on a pay-as-you-go basis. And we used to pay our taxes -- I don't think of it as paying taxes at the time -- but it used to put the taxes after the fact. You know, for the year of 2008, you'd pay it in 2009. And Beardsley Ruml wanted to go pay-as-you-go.

So what do you want to do?

MR. GOLDBERG: Ahh -- this is actually -- the whole history that Mort is referring to is fascinating. When Roosevelt did two things, not one thing. The one thing that people know that he did was to get to Social Security. The other thing that Roosevelt did was, prior to his time as President, only the top third of all Americans paid an income tax. And as part of this whole effort, he went from a tax on the top third to an income tax, ultimately, on virtually everyone. And part of the deal was to get all of this to happen, he had a one-year holiday.

Now, it's a little bit tricky, because he was going to a pay-in-the-future, to a pay currently through withholding.

And, Mort, again, my answer to that question would be I would do whatever it takes to get the law enacted. I just think structurally we're so messed up here. Refundable credits is just a much better structure. Savings is a hard one. That's not one I've spent a lot of time one. I think Bill and the Brookings folks have.

But just structurally, it's so wrong to say I'm paying 35 percent of my health care costs, and 15 percent of the person pushing carts around Skadden, ARPs' health care costs. It just isn't -- you can't swallow that. So you've got to fix the structure.

All of our IRAs and -- I mean, we have made a pact with the Devil, I believe, over the last 25 years, in savings policy. And the answer is we cap them. So the rich don't get IRAs, and they don't get Roth IRAs, and they don't get all this stuff.

And the deal is, none of them are refundable.

Well, I believe that is a pact with the Devil. Because I think that our system needs to be more inclusive, and it needs to deal with all those folks who aren't otherwise paying tax.

So, to me, creating a tax-credit platform is a structural change, savings platform, is a structural change of the first order.

And I believe that we cannot survive on the income tax. I believe we will destroy our economy. And I believe we will destroy lots and lots of individuals in the process.

So, whatever price you have to pay to get to a value-added tax is a price that I would be willing to pay. And if the answer is you get your payroll tax repealed this year, and you don't start doing your value-added tax till next year, I'd take that deal in a heartbeat.

If you're doing it in the health care context, if the government has to pick up the tab currently for the kind of costs you're talking about, but we put the value-added tax in place next year -- again I think you make the deal. There's no principle here at all. None -- other than getting to the structure you care about.

MS. SCHENK: Bob?

MR. WILLIAMS: Bob Williams of the Tax Policy Center. A question for Len.

You suggested that the VAT would be a way of constraining health care costs, because people would say, "If I spend more, my VAT's going to go up."

I don't do that in the restaurants when I go -- did I misinterpret that?

MR. BURMAN: Yes, you misinterpreted it.

MR. WILLIAMS: Okay, can you clarify?

MR. BURMAN: The basic thing is that there are things government could do that are fairly sensible to limit health care costs, and all of those sensible things have got lobbies against them.

So we can require computerized medical records -- the doctors hate that, because they have to spend money on it. And you could invest in standards of care. Again, you know, doctors object because they think they know things that goes beyond what science knows.

There are some procedures that might be viable, with a low probability, and they have enormous costs. They don't make any sense.

Again, you know, the ethic in the United States is, "Do whatever it takes." If you've got insurance, you've got an entitlement to anything that might be efficacious -- even if would cost, you know -- even if the expected cost for saving a life is tens of millions of dollars.

So the idea is that if the Federal government is paying for health care, and the value-added tax rate is related to what the Federal government is paying for health care, then politicians could say, "Okay, we're going to do things to lower -- we're going to do things to lower your value-added tax rate." You know, we're going to get rid of relatively inefficient procedures. We understand that some people might object to it, but we have to do it because, you know, we can't have this rate continuing to go up. That's the theory.

MR. WILLIAMS: The same sort of thing goes on, if I think there's a probability I'm going to need this service, the way, with my insurance, I buy insurance that covers things -- even though there's a small probability I'm going to cover it, I'm willing to pay the cost, because the cost to me is very small.

Isn't that the same kind of thing again?

MR. BURMAN: Yes, well, for one thing, I think a lot of people don't really perceive the connection between what they're paying for health insurance

and what they're getting, because they -- you know, I said earlier that I thought people paid for health insurance through lower wages. And that has to be true on average. But I don't think on an individual basis people see a connection between the premiums they're paying -- the premiums their employers are paying on their behalf, and their compensation.

I really think actually one of the biggest advantages of President Bush's proposal and Senator McCain's proposal is that for the first time employers would actually be reporting to employees what they were paying for health care. I think it would be a good idea to require employers to do that anyway, without any reform. Because, they'll say, "Oh, my gosh. You're paying $12,000 for health insurance for me? And I could get some of that in higher wages?" It might have a salutary effect. But I think insurance does create a disconnect. And also one of the problems with insurance now is that insurance doesn't cover certain things. People get sick, and then they yell and scream, there are stories in the newspaper, and they end up getting covered anyway.

MS. SCHENK: Fred, did you want to comment?

MR. GOLDBERG: Yes, well, I just wanted to ask -- in your version of your proposal, would the Federal government's payment of health care costs replace employer-provided insurance?

MR. BURMAN: Employers could still provide insurance -- and I assume the large employers would continue to do it, because it's a relatively -- you

know, as John said, it's a very efficient way of providing care. The credit, or voucher or whatever would be transferable to employers. So instead of the employer-sponsored -- instead of the exclusion you have now, employers would say -- employees could say, "I would like for the insurance to be provided through my employer," and then transfer the subsidy to them to pay for it.

Small and medium-sized employers might provide insurance, as well. My guess is that they would do it through something like the Insurance Exchange, something like the Federal Employees Health Benefits Program, where they could buy it and get group rates for it. And individuals would be able to buy insurance on their own and use the voucher to pay for that.

MS. SCHENK: Other questions?

Rosanne, here in the -- ?

MS. ALTSHULER: Rosanne Altshuler, Tax Policy Center.

The President's Advisory Panel on Tax Reform put together a proposal to use the VAT to buy down the income tax rates. And that proposal was not recommended because the Panel wanted to be -- to only have unanimous recommendations put forward. But that plan was included in the report, and was, you know, has the analysis from the Treasury Department.

We would actually become Ireland if we were to follow a plan like that.

One of the reasons why we couldn't get unanimity on that plan was the money-machine argument. And I hate to even bring it up.

But I want to just throw that out to both of you: how do you fight that type of an argument?

MR. BURMAN: So I think actually having the value-added tax dedicated to paying for health care actually turns the money-machine argument on its head. Because, in fact, people would see there was a connection between government spending and the tax rate that they would be paying.

So the money-machine argument is that value-added tax is a relatively painless tax. If you, you know, put in a 5 or 10 percent VAT it would generate a whole lot more revenue for the government, and that would finance a whole bunch of additional spending.

My argument is that if the VAT was actually dedicated to pay for health care then, in fact, people would see a connection between what they were paying for goods and services and the generosity of the program that was being provided by the Federal government. Not everybody agrees, but that's the way it would work.

And there's no guarantee, either, that the VAT would remain the only source of financing for health care. You could legislate that, but the gasoline tax was supposed to be the source of financing for highway infrastructure, and there -- other spending is coming out of general revenues. But that's the theory.

MS. ALTSHULER: And how would you respond to the argument that once the VAT is in place it could be used to finance other than health care?

MR. BURMAN: My argument is that actually the rate would have to be so high just to cover health care —

(Laughter)

-- that there wouldn't be money left over.

MR. GOLDBERG: I guess the -- I agree with Len's analysis. I think the answer to your question is that's life in a democracy, because it is explicit. And if folks know that it's going to cost some more to buy a TV or, you know, go, do, whatever they're going to buy, and we choose collectively to make that choice, I think that's a fine choice. That's also why I would link it to something very specific.

I as doing some research a while back on this question, and I've concluded that the Wall Street Journal is a leading supporter of this proposal. Unfortunately, they're in denial.

And what you do is you go back and you look at all of the articles, editorials, out of the Wall Street Journal

"in praise of -- " -- in praise of Ireland, in praise of all of these Eastern European countries -- and they just absolutely laud these low rates.

Well, there is a hundred percent correlation between those countries that are praised and those countries that have a value-added tax.

And there was an editorial -- I don't know whether it was right before or right after the election -- where the Wall Street Journal said, "Maybe we should think about a value-added tax." And I think that the business community just made a horrible miscalculation during the Bush administration and when the Republicans controlled Congress, to not recognize the obvious.

We are going to be spending 25 percent of GDP -- best case -- for the next 30 or 40 years -- period. No, we're not going to grow out of it. No, we're not going to reform immigration policy enough to let us grow out of it. No, people aren't going to start dying younger, they are going to live longer. So forget about it.

And I think that there was an opportunity to craft something back then that business community said "We're not going to do."

And I think the result is going to be a less favorable configuration going forward. But I'm not sure if you need to bet -- I don't know what kind of percentage you need on a VAT to get the corporate rate down to 25 percent or 20 percent if you combine it with base-broadening, but it can't be a lot.

MR. BURMAN: I should also point out that we won't become Ireland. Because Ireland can be Ireland because Ireland's small. If we lowered our rate —

MR. GOLDBERG: Well -- because Ireland's Ireland. Right, we won't become Ireland. But, you know, the direction.

MR. BURMAN: But, you know, in 1986, when we lowered our rates, everybody around the world did, as well.

MR. GOLDBERG: Mm-hmm.

MS. SCHENK: In the front, there. You need the mic.

(Pause)

MR. GOLDBERG: Rosie, the other answer to your question is we'd need a money machine.

(Laughter)

MS. RUFFING (ph): I'm Kathy Ruffing, and I have a question, actually a request for clarification on Len's proposal for a value-added tax to replace the payroll tax.

Do you mean to restrict that to the Medicare payroll tax? Or would that also encompass the Social Security payroll tax?

Now, that's a program where the benefits are tied to earnings and where, arguably, the issues are different.

MR. BURMAN: In my outline, the Medicare payroll tax would be eliminated, because that program would be subsumed in this just general health insurance program -- but not the Social Security payroll tax. So there would still be a 6.2 percent tax.

MR. GUTTENTAG: I'm Joe Guttentag. I'm one of the older people here.

Why should I not be worried that I'm living on my savings, on which I've paid income tax. And now you're going to switch to a system where I'm going to have to pay a substantial amount of tax again under the value-added tax.

So should Mort and I be concerned about this?

(Laughter)

MR. BURMAN: Mort and Joe ought to be concerned.

One of the concerns about a value-added tax is that when you impose it it's effectively a lump-sum tax on old capital. Everything you've saved up is now worth less because you're got to pay more for goods.

That's considered a drawback but, in fact, the older people actually have run up all of these obligations for social services, and they haven't produced any way of paying for them. And this is actually an ideal way to have you contribute.

(Laughter)

One of the misconceptions about a VAT, though, is that it's thought to be a burden on old people generally. And, in fact, that's not true.

Most old people -- not Mort and Joe, but most of them -- rely primarily on Social Security for their income. Social Security is indexed. So if a VAT produced higher prices, Social Security benefits would increase, as well.

So when we did -- in another paper, with Jane Gravelle and Jeff Rohaly, I looked at the distributional effects of a VAT. And, interestingly, old people,

as a group, are less hurt by a VAT than younger people, because so much of their income comes from this indexed source. It's only the well-off ones, who have completely ignored these long-term obligations that they've foisted on the rest of us —

(Laughter)

-- that would end up having to -- (laughs).

MS. SCHENK: Any other questions?

In the very back.

MR. BURMAN: Emil would have to pay more, too.

MR. SUNLEY: Well, I'm retired.

You make the argument on deductions and credits, which is an old debate. It's clear that if you just replace deductions and credits you can adjust marginal tax rates and pretty much get the average distribution the same. And, indeed, there would be a lot of pressure, if you shifted from deductions to credits, to provide greater reductions in marginal tax rates at the top so the average distribution is the same.

And I suspect, Fred, that if you looked at those earning over a million dollars -- partners in major law firms -- their mortgage interest savings relative to their income is a lot less than the mortgage interest savings of your son relative to his income, even though the marginal rates are different.

But suppose I switched from deductions to credits, and then I adjusted marginal rates to on average get the rates -- the average burdens roughly the same. Basically, you're shifting the burden, let's say, among the high-income people, those who have huge deductions -- let's say, give a lot of charity, maybe some mortgage interest -- from those people to those high-income people who are relatively low in their deductions relative to that income class.

But I think we should keep separate the distributional issue from whether deductions or credits make more sense in the context. Because I think sometimes this issue -- and this is an old debate. I mean, we got -- you know, your child-care credits, instead of exemptions, back in the '70s. I mean, this is not a new debate.

But the one group that always come in and is most concerned about this type of proposal is the charities. Because even if, on average, the tax savings was still the same for charity, low-income people give to church, and health insurance people give to opera, or to the universities or whatever. And there's a tremendous shifting of where the charitable deductions might go -- even if, on average, the total amount of charitable giving was unaffected.

MS. SCHENK: Do you want to comment, Fred?

MR. GOLDBERG: Yes.

I mean, you know, I think there are lots of these questions, but I simple cannot get past the fact that the government pays 35 percent of the first million dollars on my mortgage, and pays 10 percent on my son's hundred -- I just can't sleep with that.

And the fact that I choose to give to the opera, and the Federal government subsidy of what I choose to give to the opera is going to drop from 35 cents on the dollar to 28 cents on the dollar, and the fact that what the person caring for my mother chose to give her money to the church -- it doesn't bother me a damn bit.

MR. BURMAN: I'd actually like to make a plug for a paper we just posted on Tax Policy Center website. Eric Toder and I, and Chris Geissler from Brookings did an analysis of the distribution and interaction effect among tax expenditures. And it actually answers the question about -- the overall tax expenditures are pretty regressive, that they're worth much more as a share of income at the top with the exception of refundable credits -- although the share declines for very, very high-income people.

And Rosanne Altshuler, actually independently, did another analysis that also looked at the distribution of certain tax expenditures.

MS. SCHENK: I hate to cut it short, but we're at 12 o'clock.

So I'll thank both of the panelists for a fascinating discussion.

(Applause)

And Bill -- don't get up. Bill Gale has a word for you.

MR. GALE: Okay, I happen to be an expert on lunch as well as taxes, so let me share my wisdom.

There are two lunch lines out here. There are drinks and stuff back in that corner, in the hallway.

We're going to take a break until 12:30 or so, when our lunchtime speaker, Bill Dauster is here.

So, get your lunch, come on back in, and at 12:30 we'll start up again.

Thanks.

(Recess)

MR. GALE: Thanks. We heard from John Buckley at Ways and Means earlier this morning. Now we have the privilege of hearing from Bill Dauster who's the General Counsel of the Senate Finance Committee. I love reading the descriptions of what people on the Hill work on. Bill's areas of expertise include health, tax, international trade, welfare, and social security. So that would -- that's probably the union of all of the expertise in this room, and having to deal with all of those on a day-to-day basis I'm sure is quite an accomplishment. Bill has also worked on the Budget Committee, and the Labor and Human Resources Committee. He's worked for Senator Feingold, worked on Senator Wellstone's Exploratory Committee. He's also been in the White House on the National Economic Council. So he's been in the center of a lot of debates on tax and other issues, and we're very happy to have him here.

On one timing note, we're going to probably wrap this up by 1:15 and accelerate the schedule of the day a little bit. If we end early and you don't want to leave until the previously arranged time, you're welcome to sort of sit in your seat for 15 minutes at the end of the day. (LAUGHTER) Anyway, with that let me welcome Bill and to say we're very happy to have you here. Thank you. (APPLAUSE)

MR. DAUSTER: Thank you, Bill, for that very kind introduction, and thank you for the opportunity to speak here today. One of my life's jobs has been to be the guy who states the obvious things. As the publisher, Alfred Doff , once said, "An economist is a man who states the obvious in terms of the incomprehensible." (LAUGHTER) I'm that kind of guy. So let me start by acknowledging the obvious fact that I am not Larry Summers, I'm not Jason Furman, and for those of you who came here today because of a line on the Website, earlier in the week at least, that listed the luncheon speaker as a "representative from the Obama economic team -- invited --" you are now discovering perhaps to your horror the importance of reading the parenthetical and fine print. I am in no way connected with the Obama economic team. I am not one of the geniuses down there. I don't speak for my employers, the Finance Committee, either. And I am not like the other presenters here today, one of the Michelangelos of tax policy. I am the luncheon speaker. (LAUGHTER) I'm hoping that you have here, with some of you still with

lunch in your hands, reached that part of your day when you're feeling as Mark Twain did about Michelangelo when he was touring Italy and he wrote, "I used to worship the mighty genius of Michelangelo, but I do not want Michelangelo for breakfast, for luncheon, for dinner, for between meals. I like a change occasionally." I am that kind of change. Change you can digest, too. (LAUGHTER) So I hope that I have now prepared you to be slightly underwhelmed. Now let me return to the obvious.

Buckminster Fuller said, "Everything you've learned in school as obvious becomes less and less obvious as you begin to study the universe. For example, there are no solids in the universe. There are no absolute continuums. There are no straight lines." That's what he said. Washington is that kind of place. For here nothing that is solidly true is truly solid. Nothing continues as we expect it to, and there is no straight line between where one stands and the correct policy result. By this time in today's program, many of you have reached the obvious conclusion that America desperately needs some tax reform. Alas, there is no straight line between that conclusion and our enacting a correct policy result. So where does this year's tax policy path lead us? We're in one of those momentous times that makes me think more and more of Woody Allen's speech to the graduates where he wrote, "More than any time -- any other time in history, mankind faces a crossroads. One path leads to despair

and utter hopelessness; the other to total extinction." Let us pray that we have the wisdom to choose correctly. (LAUGHTER)

And so in economic times like these, we're destined to think as Yogi Berra suggested when he said, "When you come to a fork in the road, take it." So, when faced with economic times that we have these days, a new President and a new Congress will first and foremost address the economic times that we face these days. And thus, first out of the box we can expect economic recovery legislation. And I'd expect that stimulus bill to include significant tax components. Those of you who have been following along know that the mantra of Washington stimulus talk -- and it was presented on this very stage as well -- has the trio of timely, targeted, and temporary at its heart. And last, in terms of tax law, each of those three criteria leads slightly away from simplification. So we're likely to start this year with a step towards tax "complification," albeit perhaps a temporary step.

I think of that tax stimulus legislation as sort of the crack of the sounding of the starter gun for the race to extend President Bush's tax cuts as well. Moths are drawn to the light, night follows day, and republicans seek to extend Bush tax cuts. (LAUGHTER) I can't blame them. Those who seek orderly process may hope to see a systematic addressing of tax policy, but more likely republican senators will seek early to seize the initiative, capitalize on the economic conditions, and force

votes on extending those Bush tax cuts. And that leaves the not-so-dirty-little secret that most democrats are happy to extend most of those tax cuts, too. Democrats favor extension, for example, of the middle-income tax rates, marriage penalty, tax relief, the child tax credit, and the child independent care credit for a few. So one must ask for how long Congressional democrats would feel comfortable voting “no” on amendments that would extend those tax cuts. Just mark me down as expecting that Congress will early on extend a lot of those middle-income tax cuts.

Then there’s the energy subject, which we’ll deal a little bit more later, too. The author, Albert Camus, said, “Nobody realizes that some people expend tremendous energy merely to be normal.” The same can be said of America’s economy. Americans expend tremendous energy merely to run our economy in its normal fashion. In other words, Americans are energy gluttons. The President-elect has spoken about moving energy tax legislation -- or energy legislation -- early in the administration, and I would expect that energy tax incentives would play a part in any such effort. Alas, this is not simplification either. Now I can imagine some steps that could have simplifying effects to them. I’d personally like to see an energy tax incentive that would be more source-neutral, encouraging deployment of energy or conservation sources that

achieved energy consumption efficiencies without picking winners or losers explicitly. A touch changes we could bring in their own complexity.

And then there's healthcare. Albert Schweitzer said that, "Happiness is nothing more than good health and a bad memory." (LAUGHTER) I am just thankful to be a happy man, at least as far as I can recall. But tens of millions of Americans are not happy with their healthcare these days, and you can't blame them. If you think that the tax code needs reform, you should see the healthcare system. So President-elect Obama has cited healthcare reform as a priority item in times of economic uncertainty. And Chairman Baucus has made it clear that the Finance Committee is pressing ahead vigorously to move healthcare reform next year. I raise healthcare in this tax conference because reforming healthcare could well involve reform of the tax exclusion from employer-based health insurance premiums. I understand that you actually did discuss that a little this morning, too, so I'm not coming out of the blue. Yes, President-elect Obama did make clear in the campaign his opposition to eliminating the current tax exclusion. But in his healthcare white papers, Senator Baucus has said that more targeted reforms of the exclusion might make the incentive more equitable and reduce spending in the healthcare system. One option for reform would be to cap the amount of the healthcare premiums that could be excluded. You could cap the tax exclusion based on the value of health benefits, or you could

cap the exclusion based on a person's income, or you could do both. No matter how we address it, mark me down as feeling that it's likely the exclusion gets debated as part of the healthcare reform this coming year. That's true if for no other reason than Willie Sutton's famous remark, as you may recall the bank robber when asked why he robbed banks, replied "Because that's where the money is." But speaking of money, as George Bernard Shaw once said, "Lack of money is the root of all evil." And if we do address economic recovery legislation -- middle-class tax cuts, energy tax incentives, and healthcare reform -- then as Senator Everett Dirksen said, "Pretty soon it adds up to real money."

Now lack of money is not a reason to forego doing what we need to do to confront the economic crisis. As President Franklin Roosevelt said in the run-up to World War II, "If one's neighbor's house is on fire, one doesn't haggle over the cost of the garden hose to put out the fire." Said Roosevelt, "I don't say to him before that operation, neighbor, my garden hose cost me $15. You have to pay me $15 for it." But one can also pretty well predict, but by late next year, there's going to be renewed alarm with the prospect of trillion dollar deficits over multiple years. And one may have looked at CBO's or looked at OMB's estimates of the deficit in the last couple of months; there's already close to, in those last two months, the deficit for the entirety of last year. Now I was here in 1987 and 1990 and remember addressing the deficit in a bipartisan way.

And I was here in 1993 and I remember addressing the deficit in a partisan way. The partisan way sort of lost us the Congress the next year, so I have a personal preference for working out our deficit future in a bipartisan way. Now a lot of people find budget summits unpleasant. They can take a great deal of time and a great deal of effort, but there's a silver lining to that, too. A budget summit might also be the venue for genuine tax reform. Doing tax reform along with deficit reduction can increase the chances that more people feel that they are winners from the result of that budget summit.

So far, some of you may have noticed, I mention a lot of things, but I haven't discussed climate change legislation yet. Ambrose Bierce defined weather as, "The climate of the hour, a permanent topic of conversation among persons whom it does not interest, but who have inherited the tendency to chatter about it from naked, arboreal ancestors whom it keenly concerned. The setting up of official weather bureaus and their maintenance and mendacity prove that even governments are accessible to suasion by the rude forefathers of the jungle." Now Ambrose Bierce, of course, wrote before the current understanding of climate change, but I bring up that debate because should Congress enact climate change legislation, it has the potential to be one of the biggest tax reform pieces of legislation of all, sucking in and redistributing a trillion dollars in revenues in a decade. So far I've been in denial about the

climate change bill. Once again to quote Mark Twain -- and he's been quoted by other, more prominent, politicians recently -- "Denial ain't just a river in Egypt." The political perils of the bill are just too many for me to get my mind around how we enact it. But if we do, there would be an opportunity for tax reform.

But now I am getting to the point where prediction about even a moderately distant future is becoming fanciful. It may have happened earlier in the speech actually. We need to guard against the Washington norm, to expect as John Sladek once said, "The future according to some scientists will be exactly as the past, only far more expensive." That is probably not true, just as it's probably not true what Dan Quisenberry said, that "The future is much like the present, only longer." What is more likely to be true is what Paul Valery once said, that "The trouble with our times is that the future is not what it used to be." And so for those reasons and more, that's why I'm serenely glad that the President-elect has chosen to surround himself with so many people who are truly geniuses. Thank you. (APPLAUSE)

MR. GALE: All right. Thank you. We don't have like a response from the opposition. (LAUGHTER) But we would be delighted to -- well first, Bill, thank you very much. I wish I had a quote to pull out to respond, but I don't. Although the Yogi Berra quote was used earlier today, so -- it's okay. We'll have you as a first speaker next time so you

can set the stage. Anyway, questions, comments, thoughts, for our speaker?

MR. FORMAN: Hi. Jon Forman, University of Oklahoma. I was curious what the Senate side response might be on lowering corporate tax rates or corporate integration? Anything like that under consideration?

MR. DAUSTER: I guess I don't have to stand up, do I?

MR. GALE: Right!

MR. DAUSTER: I think that those items will be considered as well on the Senate side. The Chairman of the Ways and Means Committee is a leader on that. We want to acknowledge John's work and the Chairman's work on the House side. I expect that we'll look at it, too. There is a growing feeling that our corporate tax rate is not -- is being more and more systemically evaded and that there are -- that a fundamental reform would make good economic sense to maintain our competitiveness internationally. So I think that people will look at it. I don't think it is a big enough thing to drive itself along on its own, but it could become part of another tax, larger tax experience. And I don't know how to predict when that would come up, but I think it will be looked at some more.

MR. GALE: Bob. The mike is coming.

MR. WILLIAMS: Bob Williams with the Tax Policy Center. The Congress comes back two and a half weeks before the President gets inaugurated. Do you anticipate any activity in that period, and if so, what?

MR. DAUSTER: Ah, alas. How can I say this in a way that would be favorable to the Congress? (LAUGHTER) Next question. I think there will be an attempt to move to the auto rescue package. I don't have the feeling about me that there is a sixty-vote consensus to get to that package. We will also in the Finance Committee are trying to move a rather modest set of pension provisions along, but we've encountered some objections on trying to move that. And as you get towards the end of the lame duck -- and this is a doubly lame duck since it's the second duck -- things become less and less productive, and more and more bitter, and therefore, one would probably do best by predicting modest achievements -- if that last word could be actually used in the sentence.

QUESTIONER: Thinking about the future being just like the present only longer sets up my question which is that you predict that the economic recovery plan will include tax cuts that will be targeted and temporary and timely. Well, on the temporary front, there hasn't been a great history of tax cuts expiring on schedule, so what is it about this package that you think might lead tax components to actually be temporary and expire in a year or two?

MR. DAUSTER: That's a fair question. Had we acknowledged sunsets where they exist, the answer in the first instance would be if we don't limit it to just temporary items, then we are acknowledging that we wish to immediately take on the question of permanence of the 2001 tax cuts. And I don't think that there is a desire to do that in -- it isn't the first choice in addressing the stimulus because they really don't take effect for a couple of years. But the permanence issue doesn't have to be addressed for a couple of years. So I think that the attempt will be to try and focus the package that we can get out on things that are reasonably well understood, could be passed with broad consensus, and could be enacted pretty quickly in the January range. And that would make the first choice of planners to be to postpone if possible the larger debate of permanence. Whether we can achieve that is kind of an open question.

MR. GALE: Let me follow up on that. Larry Summers, who actually here uttered the temporary, targeted, timely, recently changed it to speedy, sizeable, and sustained. (LAUGHTER) So that's point one. Point two is we had a discussion in the earlier session about the relative efficacy of some spending options versus tax options in terms of bang for the buck in terms of stimulating the economy. And so can you talk at all about what Finance is thinking about in terms of what would be the best

way to stimulate, what would be the early wins that you'd want to get on this?

MR. DAUSTER: I think that there is a reasonably broad consensus that the stimulus package should include tax and spending components; that there would be middle-income tax components, there'd be some business components, there would be infrastructure components -- not necessarily tax, it could be spending. There would be aid to states, most probably through the federal match in Medicaid. That there by then could well warrant another unemployment insurance extension. Those kinds of items are probably in the broad consensus. There, of course, will be other things, but I would see that as sort of the starting point.

As to the question of do we need to address this through tax solutions or through spending solutions, I think this is a symptom of the type of question that in Washington, the A or B question, is almost always best answered yes. But in a circumstance like this, we'd probably do well to try both and try a lot of different things.

MR. GALE: Yes, Henry.

QUESTIONER: There will be a strong temptation, since the fiscal stimulus package assuredly will pass and be signed, to lard it with a number of other provisions. In fact, one could imagine every member trying to get his or her favorite item into this bill. I wonder if you could give

us your view on what the likely freight on this train will end up being and the wisdom of trying to add other items to it?

MR. DAUSTER: The question is, I guess, generally should everyone grab the first train out of this station? And our first response I guess should be that yes, there will be other trains leaving before the end of the Congress, and I think that we can say that with some credibility. I think you've predicted a likely and not surprising reaction that many will try to add on pretty much everything. I think the immediate response after the "don't worry, there will be other legislation," is that really we want to get something done quickly because we will need to address the economic emergency that's going on now. If we make it more and more heavily burdened with other, more controversial issues, that's going to slow down this bill, and we have to show some achievements at the very beginning. And I think that -- I'm hopeful that we'll be able to prevail with that kind of reasoning, at least in the beginning of the Congress. That should last us, you know, two or three weeks, and then we're going to be back with the more difficult environment.

QUESTIONER: You mentioned the difficulty of getting your hands around climate change legislation, by which I take it you meant comprehensive climate change legislation. But you'll recall that the Finance Committee's energy tax bill a couple of years ago did include a modest beginning on carbon-capture tax credit, which while it would not

have eliminated the carbon emissions issue, it would have made a start. It wouldn't have made us energy independent, it would have made a start. And had it been passed, would have gotten the tax regulations, the Treasury regulations, in place which a future Congress could have expanded if they had the sense of urgency and emergency. Is that still on the agenda for Senator Baucus?

MR. DAUSTER: Yes, I guess so, and I thank you for the non-rehearsed endorsement of our previous product. (LAUGHTER) I do think that those sorts of things are doable, and we'll continue to push at them. And I can see those being in sort of the middle-run talk about energy efficiency legislation. But I have -- the one that I have sort of the mental difficulty with is the sort of climate change writ large where you try and raise the cost of energy generally through capping its availability, which is implicitly going to be -- republicans will call that the tax increase, and it sort of -- although there will be substantial tax cuts that go with it, it's still -- it's fraught with political peril.

MR. BURMAN: I wanted to quote -- to use a quote, too.

MR. GALE: For purposes of the Web situation --

MR. BURMAN: Len Burman, Director of the Tax Policy Center.

MR. GALE: Thank you.

MR. BURMAN: So Emperor Nero who said, “Fire? What fire?” (LAUGHTER) That has basically been Congress’s attitude towards long-term budget problems, and the question is that -- I mean, obviously dealing with the short-term economic collapse is an imperative right now, but does that make it more or less likely that Congress would actually deal with it -- deal with what everybody knows the elephant in the room, the long-term bankruptcy of the government, or will they just use that as an excuse to do nothing?

MR. DAUSTER: Fair question, Len. The a --

MR. GALE: That’s a hard one to answer “yes” to.

MR. DAUSTER: Yeah, it’s terrible, yes. I can’t say “no” though, can I? I think of -- we in the Congressional branch tend to be something of lagging indicators in a way. You could think of -- when people often recognize as unemployment rates lag the change in growth in the economy, we tend to lag unemployment rates, right? So, when unemployment rates change, we’re going to get more interested in the economic crisis that is, in fact, happening now. And so, I see us lagged responding to that. Then following that, I think that there will become greater awareness of the fiscal situation. You and I can add up the numbers and see that they’re coming to be as large as they’re looking to be, but they haven’t appeared in newspapers and print that way, and therefore, gotten people to call their Congressmen and Senators and say

"You know, those are significant numbers." And so I expect that we will address it, but we will address it after we have gone through this current fiscal -- through the economic emergency. And also, I think we'll address it second because people will be averse to wanting to talk about any substantial tax increases or spending cuts in the economic emergency itself, and for good, you know, economic policy reasons. So for both the political building reason and because of the economic reasons, I expect that we'll address it starting late in this coming year. But probably can't wait too much longer after that before people do begin to feel it pretty strongly.

MR. GALE: Congress has made a consistent policy on this; they will always deal with this next year. (LAUGHTER)

MR. METCALF: Gib Metcalf. You talked a bit about climate change. The other big issue out there is energy and oil security, and with oil now trading at roughly $45 a barrel, we've really cut the legs out from under a lot of our efforts to think about replacing oil. I'm just curious what the new Congress might be doing there. I'm glad to know the windfall oil idea is sort of off the table, but is something like an oil security charge a possibility or some other kinds of policies?

MR. DAUSTER: I do believe that we will do a good deal of incentives to try and encourage alternative production, alternatives sources of energy. I think there are decent prospects for café standard

improvement for trying to improve the fleet of automobiles, especially if we're going to be extending recovery funding to them. I recall, however, -- and your question asks something about what is in effect increasing the cost of energy -- and I recall in 1993, a new Vice President named Al Gore wanted to increase energy costs, and he proposed a BTU tax. And it ended up being converted into a rather modest increase in gasoline taxation, but yet it was still very roundly criticized and difficult to sustain. So I have modest hopes about any effort to explicitly increase the cost of energy. It's -- times have changed since then, and you make it implicitly a strong argument that there is -- people are incurring costs by using energy that's imported from unstable political regions, and we're not explicitly paying for those costs. So there is an argument for there being some recognition of the economic security costs of our energy habits, but addressing it explicitly is a politically very difficult thing to do.

MR. RUBIN: Richard Rubin at *CQ*. There seems to be a broad consensus that something has to happen on the estate tax during 2009. How do -- given everything else that's going on that has to be dealt with, how do you create the legislative breathing room for that? And then also, how do you reconcile the Baucus position and the Obama position?

MR. DAUSTER: Yes. (LAUGHTER) No, it is -- I think you're exactly right that there is a high probability that we'll want to address the estate tax, if for no other reason than a policy reason that it

goes to zero faster than the other stuff and, therefore, you miss an opportunity if you didn't address it 2009. I think there is a consensus feeling that reform is more likely than repeal. The Baucus position, for those of you who may not have been following this closely, is that he wants to get as much repeal as possible, but he wants to only do as much as is possible. So the consensus then leads you to something like the 2009 levels of estate tax, you know, give or take going forward. Your -- the more difficult question that you asked is well, where is the legislative breathing room to do that? And I don't have a quick answer for that. But you could see it becoming part of the mix of responding to likely amendments about tax cuts. Last time I checked, Senator Kyl is still interested in the subject, and others will bring it up if we don't bring it up. So there will be pressure for us to move towards addressing it, perhaps at the same time that we address other 2001 permanence issues.

MR. GALE: Let me use my prerogative to toss in a question. Senator Baucus came here a few weeks ago and gave a very impassioned talk on healthcare reform --

MR. DAUSTER: I'm terribly off message, aren't I?

MR. GALE: No -- he wanted to push healthcare reform aggressively in the next Congress. So the question is -- given everything that healthcare goes through Finance and Ways and Means as does tax policy, -- sort of a two-part question; you can't answer "yes" -- one is will

healthcare reform -- will healthcare push back, you know, tax reform, push tax reform off the agenda? And the other question is alternatively, could you envision -- you talked about this briefly, but talk about it more -- as sort of the big summit that deals with, you know, spending cuts, tax reform, health reform, and maybe social security, you know, put it altogether and solve it at once.

MR. DAUSTER: Throw it all in -- I think there is a risk as -- I don't know if anybody else shared that feeling. When you mention all those things together, it begins to feel like it's almost too much to try to do at one time, and so it makes me a little nervous. There is logic to linking healthcare reform with some tax efforts. The President-elect, after all, talked about using the taxes from the $250,000 and up individuals to help to pay for healthcare reform. So there's -- and as I mentioned, there is the employer exclusion as nexus -- links between those two issues. Never try to make one of those Greek words plural. But I think that in the short run, I think you have to take the President-elect at his word that he thinks that the top priorities are going to be dealing with the economic emergency, and seeing energy legislation and healthcare legislation as contributing to the addressing of that economic emergency. And so I would see those as happening in the short and medium run first, and that more fundamental deficit reform and tax reform probably coming in a step further down the road. If we try to ball them all up together, doing healthcare reform or

waiting to do healthcare reform until we cut the global deal on deficit reduction, then we are postponing it well into the end of the year at the earliest. And I had more optimistic hopes, along with my boss, for moving healthcare legislation earlier than that.

MR. GALE: Yes?

MR. VAUGHAN: Martin Vaughan with Dow Jones Newswires. Bill, when you talk about middle-class tax cuts possibly being part of the stimulus, what form would you expect that to take? How would it be different from the rebates, which have been criticized as not giving the bang for the buck that they were supposed to give this year? And do you expect it would be accomplished through -- could it be accomplished at the employer level through withholding changes?

MR. DAUSTER: Thanks, Martin. Those are very intelligent questions, but as George Mitchell once said, “The First Amendment guards my right to say anything I want, but it doesn’t say that I have to say.” And I think that a general response is probably the best one, that there -- I acknowledge what you’re saying, and your question is right. But there were some who were uncomfortable with the effectiveness of the rebate, although you did see some positive effect in the second quarter growth numbers, which I think you can partly attribute to those. And, therefore, I think that there will be people looking for alternatives to that, and you’ve mentioned one that’s possible. I think it’s too early to give an

intelligent answer about how we'll address that, but I do feel confident that there'll be an individual component of the package.

MR. GALE: I want to put you on the spot with one more question, and then we promise we'll put you out of your misery here. It's 2008. It's December 2008. The economy is a wreck. A new administration is coming in, a new Congress. We have democratic control of the White House and both houses of the Congress.

MR. DAUSTER: So far I like this question.

MR. GALE: Okay, so far, just -- now that I've got you just where I want you. Okay. Suppose that we invite you back four years from now, in December 2012; what do you think currently you would say then about what happened in the ensuing four years, what the major legislative accomplishments were, what the failures were, and what the prospect for the country is going forward?

MR. DAUSTER: Well, seeing as I will not remember this event as well as some of the others of you here, I'm going to be praying that you won't have remembered it either. And I'll say, "You'll remember when I was here four years ago, and I told you --" (LAUGHTER) and then fill in the part where I'll describe what actually happened. I will be thankful to God and to the political process that I will still be able to come to an event like this in the first instance. If we can -- if you're still interested in hearing from me in four years, then I've attained a certain level of success

and longevity. But it is just too difficult -- it is too uncertain to be able to talk about intelligently. All I know is that what I'll be talking about is something that I haven't thought of yet, and it will be different. Something will have come up in the intervening years that will be completely different. And that is why I thank you for asking that question so that I can now say, "You know, something's going to come up that will be completely different than what I just said." So now I can say, "I said it four years ago."

MR. GALE: That's great. All right. Well, let me say it myself. Thank you very much for a very interesting and entertaining talk. Thank you. (APPLAUSE)

START OF PANEL THREE

MR. GALE: Okay, we're going to switch to a session on capital taxation with Rosanne Altshuler, Pam Olson, and Lily Batchelder.

Something that we had no idea might happen has just come up as Bill was saying. We're going to take a 5-minute break and start again in 5 minutes.

MS. ALTSHULER: Hi everyone. We're going to try and get started in about 2 minutes or less.

Hello, everybody. I'm Rosanne Altshuler, Co-director of the Tax Policy Center, and we're going to get going again on this session, on capital income taxation.

The new administration as we know has an opportunity to reconsider the taxation of capital income, and in this session we're going to focus on the corporate income tax and the estate tax. Given that the estate tax is set to expire in 2010 only to return again at 2001 levels in 2011, it really makes sense to consider its reform. And on the corporate income tax side, the current economic situation forces us to think very carefully about the impact of taxes on economic activity, and how and whether the tax policy towards corporations can actually stimulate the economy. Even before the economy turned, corporate tax reform I would argue had been actively debated. As globalization continues to intensify competition, corporate tax reform I would predict would be something that we'll discuss during the next four years.

So, without further ado, let me quickly introduce our speakers and then turn to these topics. You have their impressive bios in your handouts so I won't do long introductions, but I will do a short one. Pam Olson, who will be the first speaker, is a Partner at Skadden Arps and was former Assistant Secretary for Tax Policy at the Department of Treasury. And Lily Batchelder, who's going to talk to us about the estate tax, is a Professor at NYU Law School. So let's get started.

MS. OLSON: Thank you. It's great to be here. I'll start with a story. A city slicker visiting a farm asked the farmer why his cow had no horns. So the farmer began to explain, "Well, you see, there are different

reasons why cows don't have horns. Some breeds have no horns. The Angus and Red Poll breeds, for example, have no horns. And some cows don't have horns because their horn buds were removed when they were calves. But that cow over there? That cow doesn't have horns because it's a horse." (LAUGHTER) I'm a farm girl. So I won't make the city slicker's mistake. But I'm a lawyer by training, and I see a lot of economists in the room with whom I've worked, and I'd say that asking a lawyer how to tax capital might bear some relationship to asking the city slicker to explain the difference between a horse and a cow. With that caveat, let me begin.

To paraphrase Einstein, "Perfection of means and confusion of ends seems to characterize the U.S. corporate tax system." We perfected the double tax on corporate income, save for the S Corporation, in the Tax Reform Act of 1986, and we've been suffering the consequences ever since. The perfection of the double tax contributed significantly to the dot.com-turned-dot.bomb meltdown of 2000 to 2001, and it has contributed significantly to the financial crisis we face today. How? Well, the perfection of the double tax system in the 1986 act was fundamentally anti-equity and pro-leverage. And those anti-equity features pervade the Internal Revenue Code, perfection of means, confusion of ends.

Let's take a quick look at the anti-equity features and the distortions that they cause. First, the most obvious problem is that the tax system -- is that the system taxes income earned in corporate solution twice, first at the corporate level and then again when it is distributed to shareholders as dividends or as capital gain when they sell the stock. Prior to the 2003 act, that brought the top tax rate on corporate income distributed as dividends to nearly 60 percent, and created a mighty incentive for all sorts of core corporate managers to claim that it was much more efficient for them to keep the profit and reinvest it than to distribute it as dividends. I've gotten in trouble for saying this before, but Warren Buffett can keep my money and reinvest it. From the rest of them, I want a return. (LAUGHTER) The lower tax rate on capital gains made methods of delivering capital gains to shareholders, such as stock redemptions, a much more efficient means of distributing excess cash to shareholders. Purely coincidentally, I'm sure, it furnished the stock used to cover the stock options issued to those corporate managers, thus avoiding the dilutive effect of having to issue more stock. After a run through the legislative sausage factory, President Bush's 2003 proposal to eliminate the double tax became a 15 percent tax on dividends and capital gains, reducing the top rate on corporate income to about 45 percent. That reduced the distortion significantly, but the 15 percent rate will sunset

in 2010, if it isn't repealed before then, putting the top tax rate back to about 60 percent and re-incentivizing all those corporate shenanigans.

That's not the end of the extra tax for equity. There are some cases where a double tax just isn't enough. If a corporation owns stock in another corporation, it is entitled to a dividends received deduction, but it gets only a partial deduction if it doesn't own 80 percent of the stock. Thirty percent of the dividend is subject to an additional layer of corporate tax. Certain industries, insurance for example, suffer further limits on their dividends received deduction.

There is also no reduced rate for corporate capital gains. So if a corporation sells stock in another, the gain is taxed at the full 35 percent rate. Capital losses are subject to restrictions. For example, they may be unusable against ordinary income; that can make it difficult to recognize them. Witness the special pass in the Emergency Economic Stabilization Act for banks that might otherwise never have been able to recover the real losses they suffered on the worthlessness of their investments in Fannie Mae and Freddie Mac preferred stock. There are escapes from the corporate level tax, for S-Corporations, partnerships, LLCs, and sole proprietorships, but distort investment decisions and discriminate among similarly situated tax payers for no apparent reason. It makes no sense to have a system that prefers investments based on the form of entity, or lack thereof, in which the business operates. There are

those who seem to believe that the “S” in S-Corp stands for “small business.” It does not. Some very large businesses operate as S-Corporations. Operating as an S-Corp requires only that the entity be sufficiently closely held to use Subchapter S. If it is, it can avoid the double tax, paying tax merely at the shareholder level while its competitors must pay tax at both levels. In one U.S. industry, two of the largest competitors are a closely held S-Corp with a single-level tax, and an employee-owned company that pays the double tax because it has too many employee shareholders to qualify as an S-Corp. Now you can probably guess which set of shareholders is the wealthier. The point is not to cut off the escapes from the corporate system and tax all business income at 45, or gasp, 60 percent. But the distortions have no logical underpinning, even for those who would levy higher taxes than the current system on wealthier individuals and the system must be rationalized. Moreover, we should do so before the 15 percent rate on dividends expires in 2010 or is repealed.

Debt is an easy means of eliminating some of the double tax on corporate income because interest is deductible at the corporate level and taxed just to the recipient. Consequently, by substituting debt for equity, the top tax rate on corporate income can be reduced from 45 or 60 percent to a top rate of 35 percent. Interest income may, in deed, fall entirely outside the U.S. tax base if it is held by a tax exempt organization,

such as a pension plan or an endowment fund, or if it is paid to a foreigner. Generally speaking, the code imposes a 30 percent withholding tax on payments of dividends and interest to non-U.S. taxpayers. That 30 percent withholding tax is eliminated, however, if the interest payment qualifies as portfolio interest. It then leaves the country, and the U.S. tax base, scot free. Even for non-portfolio interest, our income tax treaties often reduce interest withholding rates to a greater degree than dividend withholding rates; in some cases, exempting treaty countries' residents' interest income from U.S. withholding tax altogether. Although treaties often reduce the 30 percent withholding rate on dividends, with a few recent exceptions, non-exempt dividends altogether. The first of the recent exceptions is the Income Tax Treaty with the United Kingdom, which was signed in 2001 and exempts from withholding dividends paid to U.K. shareholders who have owned more than 80 percent of the voting power of the paying company for the previous twelve months. Given that dividends represent income that has already been taxed at the corporate level, while interest represents income that has not, the disparate withholding tax treatment of dividends and interest is peculiar. Payments on equity must bear a double level of tax, while payments on debt may escape with none. The logical corporate response is, of course, issue more debt.

And that's not the end of the anti-equity, pro-leverage bias in the code. Another perfection of the 1986 act was limitation on tracking and net-operating losses. If there was need of proof that it can be dangerous to turn to a lawyer for advice on designing a tax on capital income, that may be obtained by observing that the code's current NOL limitations were the product of an American Law Institute report. Section 382 limits the use of net-operating losses whenever there is a greater-than-50-percent-ownership change within a three-year period. If the requisite shift has occurred, the use of NOLs is limited to the equity value of the company on the date of the shift, multiplied by the tax exempt interest rate on that date. Given the near obliteration of many companies' equity value in the last few months, the freezing of the debt markets, and the need to raise equity capital or be acquired, 50 percent shifts are likely and likely at a time when the mechanical operation of the rule will have devastating effects.

And Congress really perfected the anti-abuse part of the anti-trafficking provision. The statute provides Treasury a broad grant of regulatory authority, but it otherwise provides no out for lack of tax avoidance motive, and no out for the fact that business operations continue in tact. It compels the reduction of equity value for equity contributions that occur within two years of the ownership shift, the concern being that the contributions might have been made for the

purpose of increasing the equity value on which the limitation would be calculated. That isn't policy. That's insanity. But the bias against equity and for debt should be remedied is a view shared by economists from both sides of the aisle and by business leaders. There is also agreement that the pro-leverage code may have played a key role in creating the current economic crisis. President-elect Obama's senior economic advisor, Jason Furman, said "Disparity between debt and equity financing encourages corporations to finance themselves more heavily through borrowing. This leverage, in turn, increases the financial fragility of the economy, an effect we are seeing dramatically today." McCain advisor, Doug Holtz-Eakin, wrote that the tax system is "subsidizing leverage." And Gregory Mankiw, formerly President Bush's Chair of the Council of Economic Advisors, recently wrote "Because interest payments on corporate debt are deductible for corporate income tax calculations, this capital income is taxed only once. This asymmetric treatment of debt and equity finance induces companies to issue more debt than they otherwise would, increasing leverage and the economy's financial fragility." Similarly, the CEO of FedEx wrote in the *Wall Street Journal* that "Our national policies actively encouraged all this debt. The United States has a completely uncompetitive tax structure in general, and it has a particularly onerous tax structure for firms that are asset-intensive."

The anti-equity, pro-leverage sections of the tax system are not the only things in need of repair. Internationally, through our high rates, we are competitively disadvantaging American businesses. While we once led the world in lower corporate rates, we now find ourselves with corporate rates 50 percent higher than the OECD average, and foreign governments continue to lower their corporate rates. While working on anti-inversion proposals at Treasury, I learned that it was possible to strip income into Sweden. Sweden! At the same time we've larded the code with special deductions and credits that reduce the effective rate, things like the manufacturing deduction and R&D, just two of many examples. Some would like to believe that a tax rate 50 percent higher than our major economic trading partners doesn't matter. Some of those same people believe that a 3 percent reduction for manufacturing creates a powerful incentive. Based on what's going on in the global economy, I think it's a safe bet that they're wrong.

Our international tax rules further distort investment decisions. The code taxes on a worldwide basis, but with a credit for taxes paid on foreign income and with the tax deferred until the income is repatriated to the U.S. unless it is Subpart F income, which is subject to tax currently. A practical effect of this structure, worldwide tax imposed upon repatriation, is that U.S. companies may invest abroad and be taxed in the same manner as companies based in that locale or based in other

countries without a worldwide system. Another practical effect of this structure is that it can cost a company 35 percent in federal income tax to reinvest its foreign profits in the U.S.; what Bob Pearlman, formerly of Intel, referred to as the “35 percent investment tax credit to keep my money offshore.” That doesn’t make a lot of sense. One way to fix the system would be to tax corporate income on a territorial basis or by exempting dividends from foreign subsidiaries. Either would be comparable to the frameworks of many of our trading partners. Such a change would have the advantage of allowing U.S. companies to continue to compete abroad on the same basis as their foreign counterparts. Its disadvantage is that it adds pressure to the transfer pricing system. Another alternative would be to tax the income when it is earned without regard to when it is repatriated. That would minimize the transfer pricing concerns. It would, however, significantly disadvantage companies competing in lower tax jurisdictions, which at this point is most of the world with potentially disastrous effects for U.S.-headquartered companies. It would also be unlike the framework of any of our trading partners. Avoiding the potential disaster would require significantly reducing the corporate tax rate. Charlie Rangel’s off to a good start, but he’s going to have to go a lot further.

We need to have a real debate on reform of our tax system. Thus far, most of the energy has gone into debating expensing as a

means of exempting the normal return on capital. That, in my view, has been a waste of energy. Expensing may eliminate some of the distortions of the tax system, but will cause its own unless we eliminate the deductibility of interest. Given the revenue scoring system, it will cost significant tax revenues, making tax rate reductions all the more difficult. It also doesn't seem to matter to most of corporate America because expensing does not affect financial statements. So, expensing is a high-cost reform, offering little real benefit to the recipients. I've been advised that tax rates matter less if the tax system permits expensing; a point that does not make sense to me. But then I'm a lawyer, not an economist, and perhaps some of the economists in the room can correct me later on this afternoon. Expensing exempts the tax on the normal return on capital; that is the risk-free rate. The vitality of our system and of our economy stems from the constant search for the extra-normal return. Trading lower rates for expensing with higher rates is not a trade I would consider. Expensing is, of course, a bedrock of a value-added tax, and I would say that we should be considering a value-added tax, but not as a replacement for the corporate income tax.

Finally, as we consider the tax on capital, we should look carefully at the tax treatment of housing and whether it contributed to the current financial crisis. I am certain that no one will want to touch real estate given the condition of the market. But if and when things settle

down, if we can look at the incentives dispassionately, it would be worthwhile for economists to review the Tax Reform Panel report's proposals on housing, and to model the effect on housing market values if individuals at the lower end of the income spectrum were given an incentive to buy housing that the current system does not provide them. Can we afford to consider this? Can we afford not to?

I'm going to close with another story. A gentleman notorious for the money he lost betting on horses and having trouble repaying his debts went to his neighbor to ask him for financial assistance, explaining that his wife was very sick and needed surgery. He needed help covering her medical expenses. After much discussion and contemplation, the neighbor said, "How do I know if I give you the money that you won't go lose it on the horses?" "Oh," the man replied, "I've got the money for the horses." (LAUGHTER) Thank you. (APPLAUSE)

MS. BATCHELDER: Okay. I feel a bit like this is the Wizard of Oz, to just know to put this up. So the topic I'd like to talk about today is one that, I think, we're going to have to deal with in the next roughly a year, which is estate tax reform. And the reason we have to deal with it is this: That this year we have a $2 million exemption and a 45 percent rate. Next year it rises to $3.5 million or $7 million a couple. The following year the estate tax disappears entirely. And then the year after that it comes back to life and has a $1 million exemption and a top rate of 55 percent.

So this obviously creates a lot of complexity, tax planning incentives, some fairly morbid incentives as well. And I think, and some of the prior discussions suggested, that no one seriously thinks we're going to let this unfold, and I certainly hope we don't. The silver lining is, though, that this means and gives us an opportunity to rethink the taxation of gifts and bequests more generally. And so what I want to do today is provide a little bit of background on wealth transfers, on the existing estate tax system, and talk about a few reform options.

Just to cut to the chase, I want to make three main points. The first is that inheritances magnify economic disparities and are probably the largest contributor to the relatively low levels of intergenerational economic mobility that we have. The second is that the estate tax is actually very critical for the fairness of our tax system as a whole because it mainly burdens high-income heirs as opposed to donors. And otherwise, all inherited income would essentially be taxed at a zero rate and a much lower rate, of course, than income from labor and savings. And finally I want to talk about how we nevertheless could improve the estate tax by either simplifying the law and/or more ambitiously, replacing it with an inheritance tax.

So I want to start by giving some background on wealth transfers. Lek Khitatrakun and I have done some estimates on who receives gifts and bequests generally, which I will refer to as inheritances.

And this line shows that they're distributed very unequally. So about the bottom two-thirds of the income distribution receives about -- in general, receives bequests that are under $50,000, but that's only about one-eighth of the value of bequests received. And then the top 1 percent of -- sorry, this isn't income distribution, this is the bequests received distribution -- which is sort of that dark place of the pie and the striped ones, they generally inherit over $1 million, sometimes well over $1 million, and they receive about a quarter of bequests received. These are some very rough estimates of the average amount that people inherit over their lifetime, and this also shows that inheritances are contributing substantially to economic disparities. So this is grouping people by their economic income over their lifetime -- sorry, their annual economic income, which includes their annual AGI or income that we think of, plus the annuitized value of any inheritances that they receive over their remaining lifetime. And what it shows is that for people with economic income under about $200,000, they generally receive roughly comparable amounts of inherited income. But for people with more than that, they receive much larger amounts of inherited income.

Our -- the last part I want to make before sort of moving on to the current tax treatments -- I'll go back here -- is that inheritances significantly contribute to and present a major barrier to intergenerational economic mobility. The U.S. sort of contrary to our perception actually

has fairly low levels of economic mobility relative to other developed countries. And some factors that you would think of like the correlation between parent and child IQ, personality, schooling, those all contribute to these barriers. Some estimates suggest that they account for about 30 percent of the correlation between parent and child income. But inheritances the estimates suggest are the single largest factor contributing to this. They account for, according to some estimates, about 40 percent, so more than all of those other factors combined. And I want to pause and emphasize what this means. It means if we want to begin sort of further breaking down a hereditary class structure in the country where people's economic outcomes depend on the family they're lucky enough to be born into, the single best way to do this would be to think about inheritances and trying to have them distributed more broadly. So I think all of this means that it's an important issue how we tax inheritances. And from a fairness perspective, we might actually want to think about taxing them more heavily than other kinds of income rather than as we will see less heavily.

So there are currently three major buckets of provisions that affect the taxation of inherited income relative to income from labor and savings. The first is, of course, the estate tax system. Last year it was estimated to raise about $26 billion. The second is stepped-up basis, which last year was estimated to cost on the order of $26 billion. And the

final is the income and payroll tax exclusions for inherited income from their basis. Some people would argue that these aren't really a tax preference; that these are compensating donors for the fact that they aren't able to deduct gifts and bequests that they make. I would argue the better view is that they are a tax preference; that generally the income tax is trying to allocate tax burdens based on a measure of how much people can personally choose how to spend so that it doesn't allow deductions for personal expenses. And so on that theory, you should have gifts and bequests that or may come out of after-tax income, and the fact that these receipts are not included in the income tax or payroll tax base of the heirs would be a tax preference. The net result of all of this is that effectively we have a zero rate on inheritances. We have no income or payroll tax. We have the estate tax and we have stepped-up basis, which is essentially a negative tax rate.

This is an overall effect, so what I want to get into now is the estate tax system, specifically, and who it's burdening. These are estimates of the average 2009 estate tax rate on all inheritances received by the economic income of the heir. And the first point I want to make is that it's important to know and think about the fact that the estate tax is actually a relatively efficient tax and predominately burdens heirs. I can go into some more discussion about this in the Q&A, but the efficiency of facts of the estate tax system and who it burdens very much depends on

why the donor accumulated the wealth that is ultimately transferred. And if they did this to benefit their heirs specifically, then it's a relatively inefficient tax and the burden falls more on heirs, but a fair amount on donors as well. On the other hand, if the donor was saving for other reasons, for instance saving for retirement, saving because they liked being wealthy, then the estate tax turns out to be an extremely efficient tax and very much falls on heirs, almost entirely. The empiricalistic evidence somewhat surprisingly finds that most wealth transfers actually fall into this second category, which means that the tax is relatively efficient, it predominately burdens heirs. It also means that this traditional tension we think of in tax policy of trading off fairness and efficiency doesn't necessarily exist in the context of the question of whether we should increase wealth transfer taxes.

So returning to this chart, it assumes, contrary to existing practice, that the burden of the estate tax system is on heirs. Most distributional estimates today assume that it falls on donors. Generally I think because of lack of data, not a sort of deeply held conviction that that's the right analysis. If you allocate the burden to heirs, you see that it's a very progressive tax. So heirs with economic income of under about $200,000 bear essentially no estate tax burden. Heirs who receive inheritances of less $2.5 million bear very little estate tax burden. And it partially offsets the existing tax preferences for gifts and bequests

received within the income and payroll taxes. So what I've done here is show what the average estate tax rate is on inherited income, which is the dark bars, and then the average income tax rate on income from work and savings. And what you see is that for most people -- people up to about $500,000 of economic income -- pay much lower rates on their inherited income than income from work and savings. Above that it appears that because of the estate tax, that they pay higher rates on inherited income, but that's not necessarily true either because this is not including stepped-up basis, and it also isn't including the payroll tax.

So the final point I wanted to make is that the current system, even though I think it actually has a lot of advantages, is not perfect. It is very complex, which I will go into briefly later, for reasons that aren't necessarily -- don't necessarily need to be part of the law. Its effects are not terribly transparent because nominally it is imposed on the donor. And it's also relatively imprecise at the individual level. So even though it's strengthening the fairness of the tax system as a whole, for individual heirs it can operate somewhat unfairly. So this chart is showing that about two-thirds of people that inherit more than $1 million, which would be over in this area, most of them inherit in this range of $1 million to $2.5 million, about two-thirds of those bear no estate tax burden. Meanwhile about a third of heirs who inherit less than $1 million do bear an estate tax burden. And this later category only accounts for about 4

percent of revenue, but the point remains that the estate tax does end up to some degree burdening some low-income, low-inheritance heirs, while much better off heirs are not burdened.

So I want to -- let's talk about a few different reform ideas. The first one is that we will need to smooth the rate structure over time. And President-elect Obama, as was discussed earlier, has proposed making permanent 2009 law, which we estimate would raise about $17.5 billion next year. But this proposal of making it permanent would actually lose about $280 billion over 10 years because so many of the years to come after that the estate tax would have raised a lot more revenue with its $1 million exemption. This shows that if we adopted a different baseline, we could actually raise significantly more revenue from the estate tax. So if we made 2008 law permanent instead, we would raise about 50 percent more. If we made 2011 law permanent, we would raise about three times as much.

The other portion of sort of sticking with the estate tax system of reforms that we could enact if we stuck with that scenario is a package of simplification measures. So I won't necessarily go through these in detail right now, but it would make sense to allow spouses to carry over their lifetime exemption. When they don't do so, when they don't make -- when the first to die doesn't use up their lifetime exemption, that's a major tax loss, and it's a trap for the unwary. There are also

significant differences in the tax treatment of gifts and bequests that we could narrow or eliminate through all these different measures. And the biggest one is, of course, stepped-up basis, which we could think about replacing with carryover basis or realization. And then finally the big political issue that often comes up with the estate tax is the tax treatment of family businesses. And I think there are ways that we can improve the relief provisions that exist. Generally right now they create incentives to invest in family businesses, and transfer wealth through the form of family businesses when a donor or their heirs actually don't want to do so; and so one possibility is to eliminate the incentives and disincentives by permitting deferral at a market interest rate to the extent that the liquid assets of the estate are not sufficient to cover the estate tax liability. I should emphasize, though, that I only think this is a good idea if we really adopted a market rate of interest.

The other option I want to talk about briefly is even more ambitious, and that would be to replace the estate tax system with an inheritance tax. And currently, the inheritance taxes are actually much more common cross nationally. There are a variety of forms of inheritance taxes, and so I'll talk about one possibility, which is sort of a hybrid of -- these three darker bars are all inheritances taxes. And the specific proposal that Lek and I have modeled is this one in blue where you would have -- each heir would have a $1.9 million lifetime exemption; then

amounts over that would be included in the income tax base and subject to an additional 15 percent tax. And this would be revenue neutral, relative to 2009 law, which is the currently discussed proposal for how to smooth the rate structure going forward. But, of course, you could raise a lot more revenue if you wanted if you used lower exemption levels.

I think this has four advantages. The first is that the only way you can really deal with the individual level in equities that I discussed that are part of the estate tax is by shifting to an inheritance tax. So this shows that this proposal that we've modeled is roughly distributionally neutral in aggregate, but at an individual level it's very different. So if you take all of the people, all of the heirs that are burdened by the estate tax currently, all of the heirs that would be burdened by this inheritance tax, only about 30 percent are burdened by both of them. So they have fairly different effects at an individual level. Overall about 30 percent of the dollar burden would fall on different heirs. Even among the heirs that are burdened by both taxes, they pay fairly different rates under the two regimes. So this is just plotting; each of these little dots is an heir and their average estate tax rate versus their average inheritance tax rate.

The other advantages of an inheritance tax are that in my view it improves incentives. It creates incentives to give to lower inheritance individuals, lower income people. For a bunch of reasons I think it would be simpler. And finally, it's more transparent. Estate tax

opponents have generally railed the estate taxes and successfully argued that it's an unfair, double tax. It's burdening the frugal, hard-working, generous donors who are sort of ruthlessly taxed straight when they die. And in doing so, I think they've really exploited some misconceptions about the estate tax. The first is that it's actually not donors that are predominately burdened by the estate tax. And also many people aren't aware that inherited income isn't included in the income tax base. I think an inheritance tax would make this situation more transparent; and sort of make more transparent that the wealth transfer tax system isn't a double tax, but is really the only tax that we're imposing on people who inherit extraordinary large amounts. And in doing so I think it would make the public able to make a more informed choice about how we want to tax inherited income relative to income from labor and savings, and also maybe reinvigorate support for taxing inheritances in the first place.

(APPLAUSE)

MS. ALTSHULER: Well thank you, Lily and Pam, for excellent and informative talks, and for teeing up some great topics for debate. So let's go to the questions. Again, identify yourself and ask a question in the form of a question please. So, let's start over there.

QUESTIONER: Arno King. Yes, Pam, I had a question, okay? How did the 1986 tax reform come about and how did it play a role in the economy today and yesterday? And also, what's the possibility of

getting a lower corporate tax rate back? And Lily, where's the difference between -- where to put our -- to we get an estate tax as far as Obama is raising concern?

MS. ALTSHULER: Let's just go one question at a time and we'll direct that question to Pam.

MS. OLSON: Okay. The 1986 act put it firmly in place a double tax system, so a tax at the corporate level, treating the corporation as a separate entity, and then treating the individuals, their shareholders, as something a completely separate taxing unit. Prior to the '86 act, there were some very minor forms of integration, but the 1986 act got rid of those and did some things like repealing something called the General Utilities Doctrine, so pretty clearly put in place the certainty that there would be a tax at both levels. And the only way to get out of that was either to move into S-Corp form, which would allow you to be taxed just at the shareholder level, or to issue a lot of debt and sort of self-help yourself out of the corporate tax system. But otherwise, it pretty clearly isolated the corporation as a separate entity, bearing a separate level of tax from the shareholders.

MR. WEISBACH: David Weisbach, University of Chicago. I have a question for Lily, which is that chart you gave on the distribution of inheritances and claim that that shows that there's an increase in equality because of inheritances. I guess I just didn't understand that and

wondered if you could respond? Which is don't we need to know whether inheritances are more concentrated than other income? Suppose I earn 100, you earn 50. I inherit 70, you inherit 60. Is it more equal or less equal? All you've got is a 70/60 there without the 150. I don't know how to even think about it without knowing what the other income is distributed as.

MS. BATCHELDER: Yeah, that's a really good point, and it does really make a difference. I think it depends on what kind of economic disparities you're interested in. So it is the case that by income, inheritances rise and rise fairly dramatically with income. As a share of income, you're right, they actually decline somewhat. So just to sort of reiterate, if you're higher income, you inherit a lot more, but the percentage of your income that you tend to receive in inheritances is smaller.

MR. SUNLEY: Emil Sunley. With all the problems of taxing interest, is the easiest solution just to deny any deduction for interest? Would that work well internationally, too?

MS. OLSON: Well, we could certainly look at that possibility. In looking at some of the tax reform things that I looked at while I was at the Treasury Department, my conclusion was that it was not a sensible way to go because of the fact that all the other countries of the world do allow an interest deduction, and because -- you could assume that interest

rates would eventually adjust to take into account the fact that it was, you know, you'd match it with not taxing it at the recipient level, I assume. And so you could assume that interest rates should adjust down to reflect the fact that the interest wasn't taxed. But I think interest rates are in many ways set internationally today and not just domestically, although some of the disparities we're seeing in interest rates around the world today perhaps leave that open to question. But if, in fact, interest rates are set on an international market, then it becomes hard for us to say we're going to eliminate the deduction, not tax interest at the recipient level, and assume the interest rates will adjust accordingly. I'm not sure that we can count on that happening. But it's certainly something that could be considered.

MS. ALTSHULER: I think, Howard, you had a question? And then there's some more. We'll get to everybody. No problem.

MR. GLECKMAN: Howard Gleckman at Tax Watch. And I'm curious about Pam's argument that the pro-leverage provisions of the code are to some degree responsible for the current economic crisis. And I actually wonder if Rosanne and Lily agree with that?

MS. ALTSHULER: I'll turn it over to you.

MS. BATCHELDER: I think it's hard to say. I don't think it's helped. And I don't think that necessarily the home mortgage interest deduction is a major contributing factor because we've had it in place for

so long and it's common cross nationally. But I think there'd be a difficult time explaining a direct causal relationship because these parts of the tax code have been in place for so long, but it certainly does contribute to overleveraging.

MS. ALTSHULER: I'm actually going to agree with Lily. It's something that I want to think more about. But it's not clear to me that we could call it a cause, but I'm very glad that Pam started her talk on this topic and brought it up. But I can't -- I'm not sure.

Bill, since you're right there, and then we'll go -- Bill wants to respond. Oh, waiting for the microphone.

MR. GALE: Thanks. Bill Gale at the Tax Policy Center. I want to take Pam's side on this. I agree that the interest deduction features have been a long-standing feature of the tax code. But if you go back to about a year ago or year and a half ago, whatever, there was a big question of how could a collapse in the subprime market, which is not that big, bring down the entire system? And the answer is basically -- you can think of it is -- if you're basically -- if you're standing around on two level feet and someone pushes you a little bit, you basically don't topple over. You may wobble, but you don't fall down. If you're standing on one foot, leaning over the edge of a cliff and someone pushes you, you go tumbling down to your death. And what the tax deduction did was let -- encouraged leverage in a way that sort of got people sort of right there at the edge,

and then the subprime collapse, which in a $14 trillion economy, is not that big a deal, turned into a big deal because the financial system was so leveraged. And so I think there is a case to be made that the tax treatment of debt did contribute significantly to the -- not to the impulse, but to the response to the impulse.

MS. OLSON: I want to note that Marti Sullivan in the *Tax Notes* issued 29th of September of this year has a chart that shows the dramatic increase in the ratio of mortgage debt to GDP in the United States from 1995 to 2000, going from 47 percent to 81 percent. We saw a similar significant -- not as large, but a significant -- yeah, I guess almost as large -- significant increasing in the leverage ratios of the major U.S. investment banks from 2001 to 2007. Now, of course, at the same time we also had reductions in interest rate. And so there was obviously an incentive to borrow because of the reduction in interest rates as well. But there's been a really significant skewing of the use of leverage just in the last few years.

MS. ALTSHULER: I think we could keep going on and on, but let's get to some of these other questions. Right there.

MR. LEVY: Alex Levy with Senator Schumer. Lily, you indicated that one of the aspects of the estate tax, the existing estate tax, needs reform in section 6166; that's all those tax preferences for farms and small businesses. But I wasn't aware of any empirical evidence that

really anyone's taking advantage of those to an extent that it's leading to sheltering of income in family businesses. Most of that I've seen from building on others, no one's really, really qualified for those. And also, I -- a second, smaller question is you didn't discuss the estate taxes impacting or contributing to charitable giving, and do you think that the inheritance tax scheme that you suggest would be a less powerful incentive?

MS. BATCHELDER: So under liquid assets and family farms, I feel like there's a bunch of issues there. So the first is that I think there's very limited evidence that anyone is selling the family business in order to pay the estate tax. There was a *New York Times* study and an American Farm Bureau study finding that no evidence of a single family farm that had been sold to pay the estate tax. There certainly are some businesses and some estates that are taking advantage of these provisions, but I think the biggest risk in terms of not having an optimal policy or approach to this is the political one. That as long as theoretically one can imagine a scenario where a family business is going to have to be sold to pay the estate tax, that is trotted out and used against the estate tax system. So to the extent that we can come up with a non-distortive policy that eliminates even the theoretical possibility, I think that would be helpful.

On charitable giving, the estate tax system actually tends to increase charitable giving, which is interesting because it's reducing

people's income so there is an income effect, but the substitution effect of the fact that charitable giving is excluded from the estate tax base results in a net increase in charitable giving. Some estimates are sort of on the order of 10 percent. I think it's possible that an inheritance tax would be not as effective in that respect to the extent that right now really the only way that you can shelter income from the estate tax is by giving to a spouse, which most people give all of their estate to their spouse if they're the first to die, or giving it to a charity. Under an inheritance tax, you could also give it to people that you wouldn't otherwise give as individual heirs. The problem with that is that it doesn't appear that people's giving patterns among individuals are all that responsive to tax rates. There's really very weak evidence in general on this. But there is a -- part of the issue with estate planning is that so much is interpreted symbolically by one's heirs into the estate, so people tend to give identical amounts to all of their children, regardless of their economic circumstances. And a lot of people think that's because -- and I've talked to some estate tax lawyers who have said that they counsel all their clients to do so because after you're dead, you don't really want your kids then starting to think, oh, did my parent love me less. So in that sense I think these choices are relatively inelastic and charitable giving would probably stay about the same.

MS. ALTSHULER: David.

QUESTIONER: Given that statement that you just made about people willing, wanting to give their money equally to kids, seems to me that what's behind a lot of what you're speaking about is your intergenerational mobility. Is there any evidence whatsoever that Americans are interested in achieving some more, greater equality in intergenerational distribution of income? I mean, if you asked -- you went out and asked the typical American, "Should the government get 40 percent of any dollar that I gave to my kids" is an appropriate exercise of government authority? They would say no. That would be my guess 98 percent. So what evidence is there that Americans actually want to use the tax system in this manner? Or are you just imposing -- I didn't say you, but imposing a view that is not generally accepted? In other words, is the estate -- I would say the estate tax is just an opportunity to legally take more money from those who have a lot of it.

MS. BATCHELDER: I think a lot of it depends on the framing of the issue, and I think that's what I was trying to get at. But nobody likes to be taxed, any tax they hate. So, of course, they're going to hate an estate tax that if it's going to affect them and reduce the inheritance of their kids. But the question is sort of how to allocate taxes fairly. And I think if it is framed as I think is sort of empirically the reality, that we're taxing income from inheritances, estates from inheritances, at much lower rates than income from work. I can't speak to the polling data,

but I think probably one of the more widely shared values in the U.S. is equal opportunity, and is the idea that you should be able to sort of make of yourself and be rewarded based on your own efforts and not on your family background or race or religion or whatever else it may be. And so I think to the extent that we are actually privileging that source of privilege within the tax system, that could be something that people would be amenable to -- but again, I think you would need to really phrase it as a tradeoff between taxes on labor and taxes on receipts from inheritances.

MR. FORMAN: John Forman. I must say, I'm wowed by what Pam said because I think it's really important to think about how the economy works and how the tax system encourages us to buy houses instead of machinery, equipment, and great jobs. But my question is actually for Lily --

MS. BATCHELDER: You got the wow and I get the question!

MR. FORMAN: -- and forgive me, that's kind of a twofer, but -- but Lily, given where you seem to be coming from, why would you tax inheritances at a 15 percent rate? Why wouldn't you just treat it like any other income and tax it all the way up to 35 percent or 39.6 percent? I'd be inclined to do that. I'm just curious where intellectually you get to just sort of saying 15 percent. Was that just modeling considerations or revenue-neutral considerations or what? What do you really think?

MS. BATCHELDER: Sorry, I must have been unclear, but the idea was to include them in income and then subject them to an additional 15 percent rate, which you can think of as a proxy for the payroll tax. You could think of as a proxy for the fact that we aren't taxing it through gains and they'd otherwise be taxed at a 15 percent rate. But it would -- so the modeled proposal was the first $1.9 million that you inherit is tax free; after that you include it in your income tax base, so it's taxed up to 35 percent, depending on where you fall in the income spectrum and 15 percent above that.

MS. ALTSHULER: A different kind of wow! David in the back.

MR. WENTWORTH: David Wentworth. Pam, you make a cogent argument why the taxation of equity should substantially change. This is more or less a political question. I wonder, given all the things we've heard earlier today and all the things we all know just from the business we're in, if there's any political liability of the kind of restructuring that you argue needs to take place?

MS. OLSON: Yes, I think there's significant political liability, and I hope that eventually we can get to the point where we can look at it a little more logically and a little more objectively and move in a positive direction. But I'm not particularly sanguine about us being able to put the political rhetoric behind us to be able to do so.

MS. ALTSHULER: I'm going to ask a couple of questions now if that would be okay. I think we have the time. So I'm going to start with Pam and just a couple of follow up questions. And I know I've asked you this before, and maybe the answer's changed, but it would be how much further does Rangel have to go? How low does the tax rate have to be for us to end deferral and have that not be a disastrous policy in your view?

MS. OLSON: The answer is I don't know how far it has to go, but I think that we probably have to look at something close to a 20 percent rate. Given where rates are in other parts of the globe, I think we'll probably have to look at something close to 20 percent before we could go up to a worldwide system without deferral.

MS. ALTSHULER: I think when I asked you that two or three years ago it was 25 percent, and I think that just told you how much other countries have lowered their rates.

Another follow-up question is you mentioned turning to the VAT as a revenue source. What would you do with your VAT? Would you buy down rates, would you use a payroll tax?

MS. OLSON: Well, I think you use part of it to reduce corporate rates. I think that one of the things that we ought to be looking at seriously is a complete revamp of our mechanism of paying for the social security because in reality what we have is a pay-as-you-go system

where we collect a little bit more than we need right now, but soon that's going to change. We're not actually setting anything aside in the way of assets that are going to satisfy the people who are paying in now, thinking that at some point they're going to get social security. Obviously, there's some growing healthcare liabilities out there as well, even based on just trying to cover Medicare and Medicaid without thinking about the proposals to expand coverage further. So there are lots of uses to which it could be put, but I think that one good way to use it would be to buy down the corporate rate to make us more competitive on an international basis, and then to also look at using some of it for social security and/or healthcare.

MS. ALTSHULER: I think it's really interesting how times have changed when we can have a conference and people will think seriously about a VAT in many of the different sessions. It's interesting.

Can I ask you one more question? And then I'll turn to Lily, unless there's other questions? Okay, we'll go back to you, David, also. The next question is apparently the U.K. is thinking of going territorial. I'm not sure how close they are right now. I know it's something that they've talked about. So I guess that would leave us and Japan with worldwide systems. So if we were to adopt a territorial system, would you like to do that as all other countries do it, or would you like to have our own homegrown territorial system where we'd do something like have

allocation rules? I'm not going to say which types of allocation rules, but maybe one or two.

MS. OLSON: Well, I think there's a definite benefit to using some of the models that have been used in other countries to the extent that they've been found to be workable, so I think it would behoove us to look at what other countries have done and have found successful. We might want to make some changes to it. Transfer pricing, of course, if we move to a territorial system does become a big concern. And some of the transfer pricing disputes that we have going on right now I don't quite understand because they're not between the U.S. and low-tax jurisdictions, they're just disputes between countries. And so there's work that needs to be done in sorting out who gets to tax what, regardless of how you look at the system, whether it's a territorial or a worldwide or we stick with our current system.

MS. ALTSHULER: And I'll follow up with another question, sorry! What about instead of having allocation rules, just saying 95 percent of the dividend repatriated wouldn't be subject to tax?

MS. OLSON: I think I might be on the record supporting that, yeah, in another setting.

MS. ALTSHULER: Now let's see if we have some -- there's a question back there. David, you've asked one, so I'm going to have another.

MR. LOBELL: Hi, I'm Marty Lobell. And I've really tried to behave myself, Pam, but the last comments about territorial have driven me beyond the point of endurance.

MS. ALTSHULER: That was the idea!

MR. LOBELL: Every IRS commissioner who's ever testified before Congress said the transfer pricing system is impossible to police. Marty Sullivan has written a series of articles pointing out the deliberate effort by the multi-national corporations to shift profits offshore. Cayman Islands is the third largest banking center in the United -- in the world. Does that make any sense? Of course not. What we have to do -- and I heard your comments about the downside of going to a unitary or a formulary apportionment system -- is we either have to go towards that as the EU is now doing. You were at the conference the tax analysts had where the commissioner from the EU said "Everybody but the U.K. and Ireland were going to a unitary system or moving in that direction." Or we have to say we trust the corporate executives who have to sign under oath what their profits are and impose a flat tax on the amount of profits they say they declared worldwide. That's the only system where we're ever going to be able to protect our domestic manufacturers from the multi-nationals because the multi-nationals who don't pay taxes are competing against the domestic companies who have to pay taxes. The effective tax rate -- and we had an article about this in *Tax Notes* -- for foreign income

is 4 percent, and yet every time you talk to a territorial person, they say, "Oh, we have to pay a 35 percent tax rate." Well, if they do, they ought to fire their accountants. (LAUGHTER) I mean, how do you expect -- you've already admitted -- how do you expect to enforce the transfer pricing system when the IRS -- everybody here will admit -- is underfunded, understaffed, and overwhelmed. I mean, the classic example was I was at the Permanent Investigation Subcommittee Hearing on the UBS situation, and I was sitting behind an IRS official, and when the UBS official said, "Oh, we're prepared to turn over 19,000 accounts that appear to violate U.S. law." And the guy looked at his cohort and said, "Oh shit, now what do we do?" I mean that's the situation that we face because the scheme that you're proposing is an invitation to fraud. Now I've made my speech --

MS. ALTSHULER: I think I'll let Pam respond at this point.

MS. OLSON: That wasn't a question, really, was there a question in there? I'm not sure. I think I just heard a Marty Lobell usual diatribe. (LAUGHTER) So maybe I'll start responding by saying first of all, Marty, I did not advocate a system. I did not advocate in my paper a territorial system. So, let's start by getting you off your soapbox, okay? Now that you're off your soapbox, let's start also by looking at number one, my dealings -- I've dealt with a lot of corporate tax payers around this country, and I have not found any of them engaging in fraud. Do they try

to minimize their taxes? Absolutely, it's their obligation to shareholders. It's also their obligation to their customers. It's also their obligation to their employees. They don't do better by paying the government more.

The third thing is transfer pricing is very difficult to enforce. The tax authorities tend to make it worse by virtue of the fact that they don't do a very good job of focusing their resources. So for example, if we're spending a lot of resources trying to decide whether the U.K. gets to tax it, or France gets to tax it, or the U.S. gets to tax it, or Germany gets to tax it, or Japan gets to tax it, and that is where a lot of our transfer pricing disputes takes place, then are we really doing a good job of using resources? Sure we're bringing more money back into the U.S. Treasury by doing so, but it's not in that situation a corporation that's trying to minimize its income by going to the Cayman Islands -- and no, there aren't a lot of manufacturing facilities in the Cayman Islands, and I don't think there's a lot of banking operations going on there that aren't just the headquarters for operations somewhere else where they're actually paying tax at an appropriate corporate rate. So, you know, the corporation in that instance is a stakeholder. It doesn't care whether it's taxed by the U.K., or Germany, or France, or Japan, or the U.S. It just needs to know which one. And there's a whole lot of dispute going on as to who gets to tax them, and a whole lot of resources that get put into that, including in

particular resources by the various taxing systems of this world. So we could start by moving in the right direction by getting rid of some of that.

In terms of moving to a formulary system, do I think we should look at that? Absolutely I think we should look at that, but given the fact that among the 50 states in this country, we've been unable to come up with a formulary apportionment system that we can agree to even here. I'm not the least bit sanguine that we'd be able to make that work on an international basis.

MS. ALTSHULER: And I think I'll follow up with that. Formulary apportionment -- and I'm stealing one of Pam's lines from a slide she gave me -- is no panacea. There are certainly problems with that, and one of the things that I know Pam has brought up is what type of income are we going to be apportioning? It's going to have to be income from intangible assets, and it's going to have to be passive -- what are we going to do with passive income? And there are all sorts of opportunities to fool around with the system and to move sales centers if you're just going to be looking at sales. Or to -- if you're going to have capital in the mix, there's different ways of insourcing and outsourcing. Harry Grubert and I have a new paper on this. So the answer's not necessarily there either. So I'll end it there and let's move to Fred who has a question.

QUESTIONER: Just as a point of personal privilege and as a former IRS commissioner, I never testified that transfer pricing was

inadministerable, and in deed, my own view is that while it is difficult, it is far from impossible. I'd like to ask Pam if she could maybe clarify what she was saying before. You seem to think there was some relationship between transfer pricing issues and marginal tax rates on business enterprises, and that somehow lower rates would help with that issue. Could you explain that again please?

MS. OLSON: Well, I think if you lower rates, you give less of an incentive for anybody to move income somewhere else. So if I've got the same corporate rate here as there is in Ireland, it doesn't make a whole lot of difference whether I'm operating here or in Ireland.

QUESTIONER: So there's this -- so what you're saying is a structural fix would be the best way to deal with transfer pricing. Have everybody suck their income into the United States.

MS. OLSON: That's right, structural, right.

MS. ALTSHULER: That's another benefit of lowering the rate.

MS. OLSON: Right.

MS. ALTSHULER: I had one question for you, Lily, and then I think we can move on. One of your policy reform proposals was let's do some simplification. And I'm just wondering to what extent will that simplification increase revenues and decrease tax padding? It didn't scream out to me that those simplifications would do a lot in terms of

taking money away from estate tax lawyers. Another way of saying decrease tax planning.

MS. BATCHELDER: Well, some of them I think are actually extending tax planning to everyone. So the concept of making the spousal deduction or exemption carry over is a really obvious estate planning technique that a lot of people don't take advantage of. So you end up with these very differential tax rates that I think are unfair, and it would sort of make sense to just change the default. Some of them would raise revenue. Some of them would lose revenue. I would generally be in favor of sort of a revenue-neutral simplification package and to the extent possible distributionally neutral. So you're really making sure that you're better targeting, if we're going to stick with the estate tax, the amount transferred, but not necessarily changing the net worth overall.

MS. ALTSHULER: Well, I just want to thank everybody and we'll move on. Thank you.

(Applause)

MR. BERGIN: Since this is a later panel, I'm going to switch things up just a little bit. We have two presentations. I'll make some opening remarks, and then I'll introduce the first presenter, and when that's done I'll return back up here and introduce the second presenters so that we can keep our attention spans in check.

In case anybody forgot from this morning, I'm Chris Bergin with Tax

Analysts. If I can beg your indulgence for one second, I'd like to actually personally thank the Tax Analysts staff that helped put this conference together. I know they worked hard. I watched them.

As some of you may remember or at least I hope you remember, I used to write a column for *Tax Notes Magazine* every week. One of the things I loved to write about was politicians. Let's face it; they're just easy. For example, politicians apparently believe that Americans have two rights that you can't find in the Constitution: first, that the value of our houses should always go up and, second, that what we pay for energy never should go up. I made that point in a column 12 years ago.

My point now, well, I don't want to sound like I'm running for office, but it's time for a change because what we've been doing for decades clearly isn't working now. That is why I'm thrilled to be here with a distinguished panel of speakers because they're going to talk about change. They're going to talk about bold solutions to longstanding problems. While change will involve some pain, I would suggest it won't come close to the pain our country is now experiencing -- as the magic screen goes down, which is a signal.

So let me get right to the first part of our panel discussion. First to speak is Tax Analysts own Marty Sullivan. Marty has a Ph.D. in Economics from Northwestern University and has served as an economist of the Joint Committee on Taxation at the Treasury Department and in the

private sector, and I'm proud to say for the last 10 years has written for Tax Analysts.

Marty.

MR. SULLIVAN: Thank you, Chris, and good afternoon, everybody. It's great to be up here and be part of this excellent conference on tax policy.

During the presidential campaign, Barack Obama set a goal. He said he would like to cut domestic gasoline consumption by as much as we now currently import from the entire Middle East and from Venezuela.

Well, that's a lot of gasoline. That's 54 billion gallons a year. It is, in fact, more than one-third of all the gasoline that we currently consume.

So you can see that on this chart which begins in 1970 and goes through Department of Energy projections for 2019. The red dot is where we are now. The green dot is where President-Elect Obama wants to get in 10 years.

As you can see, this would be the largest cut in gasoline consumption since that 1978, that little thing over there, 1978 to 1982 period when gas prices doubled. That decline was 13 billion gallons a year. So we have to ask ourselves, how can President-Elect Obama achieve this ambitious goal?

Well, members of Congress are going to have lots of suggestions to subsidize their favorite technologies such as ethanol or biodiesel or hybrid

tax credits. But to save 54 billion gallons of gasoline a year, we really should not be asking ourselves which technology.

So what should we be asking instead? Well, I'm an economist, and as an economist I'm not just concerned about goals. I'm concerned about the costs of achieving those goals.

So if you think like me, you're going to ask the question, how can we achieve this monumental task at the least cost to the economy? That is what's the most cost-effective policy available? Well, tax credits for alternative energies can achieve environmental objectives, but they have costs which will be especially large if we're trying to do these unprecedented shifts in gasoline consumption.

The least cost solution to our gasoline problem, the least cost solution to achieving this goal is a gas tax, and when I say a gas tax I mean a significant increase over the 18.4 cents a gallon that we currently have. Only a gas tax appropriately assigns costs and then lets the market decide the most efficient way to respond to those higher costs. It's a policy option that will best preserve jobs, productivity growth and competitiveness.

Now I know what you're all thinking, which is the politics of a gas tax are very tough, and that's true. But just because the politics of a gas tax are tough is really no reason, especially for a group like this, to dismiss it. We can phase the tax in over many years, and we can and we should

rebate the entire amount to individual taxpayers. I think it's time to free the gas tax from its political exile and bring it back into the forefront of the political debate.

Now also during the campaign, candidate Obama said that he would like to see one million plug-in-hybrid electric vehicles on the road by 2015. To do this, he proposed a $7,000 tax credit similar to the tax credit or the limited tax credit that Congress passed this October.

Plug-in hybrid electric vehicles are an exciting new technology. These vehicles can get up to 150 miles per gallon.

So what's wrong with a tax credit for such a wonderful technology? Well, the problem is with that approach government is singling out one particular technology in favor of all the others when there are lots of other promising technologies out there. For example, we have natural gas vehicles. We have hybrid vehicles that don't plug in, that get 50 miles per gallon.

There are high-tech innovations in internal combustion engines such as variable valve and lift mechanisms. There's direct injection. There are turbo chargers. There are more fuel-efficient transmissions. There's reduced tire resistance, rolling resistance on tires. There's more efficient aerodynamic design, and the list goes on, and who knows what else American ingenuity is cooking up right now.

I don't mean to bore you with that list, but I do think we need to be

aware that there are a lot of other things going on than the few technologies that you hear members of Congress talking about.

My point is that tax credits should not be designed around particular technologies, but they should be designed around goals. In this case, our goal is to save a lot of gasoline. All technologies that cut gasoline consumption should get the same subsidy per gallon of gasoline saved. Tax credits should be technology neutral.

In my paper, which I wrote for this conference, I show you how to construct a technology-neutral tax credit, and I think that would be a vast improvement over current law.

But this whole approach of providing tax credits for alternative technologies is fundamentally flawed even if you could produce a tax credit which was technology neutral. The tax credit approach puts the economy in a straight jacket. It's like Novacaine. It deadens the pain.

And, the problem is that it suppresses the most natural of market responses from taking place. When we provide subsidies for fuel-efficient vehicles, we are subsidizing driving rather than allowing the true costs of driving to be passed on to producers and to consumers. That shifts the market away from the most efficient solution which does include fewer cars and less driving. It also draws resources away from the rest of the economy in the form of tax dollars, reducing the productive output of the less fuel-intensive portions of the economy, and reducing output and jobs

overall.

In contrast, the gas tax is technology neutral, and it lets the market respond to higher gas costs with adjustments that are less burdensome to the economy. Those adjustments will come in the form of a wide array of new technologies and a wide array of new approaches to conservation.

Now tax credits for alternative vehicles are inferior policies under any circumstances, but they make absolutely no sense in the presence of mandated fuel efficiency standard, our CAFE standards under current law. Under CAFE standards, if one vehicle model improves its fuel efficiency, that only invites less fuel efficiency somewhere else in the motor vehicle fleet. So if we are able to get a million 150 mile per gallon plug-in electric hybrid vehicles onto the road, that's only going to make more room for auto makers to produce less efficient, more profitable vehicles elsewhere in the fleet. The net result of the plug-in hybrid tax credit is no increase in overall fuel efficiency.

The combination of tax credits and CAFE standards creates a tangled mess of incentives, so one of them has got to go.

So which one should go? Well, CAFE standards are superior to tax credits because they are technology neutral, and moreover CAFE standards act like a tax on cars, and that's economically superior to a subsidy for cars because, as I have said, that tax is going to reflect the true economic cost of driving.

So my conclusion, my policy recommendation for President-Elect Obama is he not propose a tax credit for plug-in hybrid electric vehicles, and, quite the contrary, Congress should repeal all of the existing tax credits for plug-ins and other hybrids.

And, since this is a conference on tax policy, on tax reform, I would like to point out that would simply the tax code and it would eliminate the unfairness and the inefficiency that arises because not every has $7,000 of income tax liability to utilize that credit.

Being politically realistic, I will mention that if we cannot bring ourselves to repeal tax credits for alternative technologies we should try to reform them to make them technology neutral, and we need to get those vehicles that are eligible for tax credits out of the CAFE calculation, out of the CAFE standards.

I only have one slide, so I'm going to keep pointing to it.

Now I hope I've convinced you that CAFE standard are more efficient and better economic policy than tax credits and you shouldn't have both at the same time.

But how do CAFE standards stand up against the gas tax? Well, that's an easy one to answer because a lot of economists have done work in this area, and it's a consensus view among economists that a gas tax is more efficient than CAFE standards. I'll give you four quick reasons why.

CAFE standards only increase the fuel efficiency of new vehicles. It

takes 14 years for the American motor vehicle fleet to turn over. So if you're going to use CAFE standards to achieve reductions in gasoline, it's going to take a little bit of time.

CAFE standards are prone to loopholes which allow manufacturers to not increase their fuel efficiency.

CAFE standards do not encourage the scrapping of less efficient older gas guzzlers. We all have our favorite old car that gets about eight miles to the gallon in our garages. Well, if there was a higher gas tax, you would have an incentive to get rid of that. You do not have an incentive under CAFE standards.

Finally, CAFE standards suffer from what is known as the rebound effect, which is when your car is more fuel efficient the marginal cost of driving goes down, so you drive more. We really don't want a gasoline-saving policy which actually encourages more driving.

And the gas tax doesn't have any of these problems.

So, unfortunately, while there's a lot to recommend a gas tax to us from an economic perspective, there's really not much to recommend the gas tax from a political perspective. Those of you who are old enough, nobody here, who are old enough or schooled enough to know their history from the 1970s, there were three serious attempts to cut the gasoline tax in the 1970s, and all three attempts were soundly defeated.

But there's no reason for total despair about the prospects for a gas

tax. In October of 1982, President Ronald Reagan there would have to be a palace coup before he would ever approve a gas tax. Well, one month later, there was an election, and he sort of sent out the signals that he would approve it, and then he signed it into law a couple months after that. So even Ronald Reagan can go for a gas tax increase.

Of course, the younger folks here also remember President Clinton's five cents a gallon increase in 1993.

Now during this year's campaign, candidate Obama shot down both Hillary Clinton's and John McCain's proposal for a gas tax holiday. He called it a gimmick. A lot of people thought it was a good political idea, but he survived, and he became President. That's the kind of leadership we're going to need if we're going to have significant increases in gasoline consumption.

So how can we make a gas tax more politically palatable? Well, my idea is that we counteract the effect of this highly visible gas tax increase with a highly visible gas tax rebate. We should put the proceeds, all the proceeds of this tax into a dedicated trust fund and rebate all of those funds to individuals on a quarterly basis, so it's more immediate. A quarterly $100 check, preferably at the beginning of each quarter, would make a 50 cents a gallon gas tax increase a little bit easier to handle.

Because a gas tax is regressive, Congress should provide proportionately larger gas tax rebates for low income people. I think that's

no surprise to anybody. We should certainly do that, but that's not enough. There's a disproportionate burden on rural drivers versus city dwellers, and I think the politics dictate that we give proportionately larger rebates to rural drivers over city drivers.

Even normally anti-tax conservatives should be in favor of a gas tax. After all, it's an externality-reducing tax. It's not your normal type of tax. It is an efficient alternative to government regulation, and once a gas tax is in place government can step aside and let the markets determine the most efficient way to respond to the full cost of gasoline consumption. A gas tax is a market solution to the problem and to the externality problems of gasoline.

And, current circumstances add another reason for a gas tax hike. A gas tax provides an incentive for the whole economy to search for ways to save gasoline. CAFE standards put the entire burden on car manufacturers and their new car customers. For years, Detroit auto makers have discussed the idea of getting rid of CAFE standards and replacing them a gas tax. They recognize it would be a benefit for them, but it would also be a benefit for the whole economy, and I think it deserves some serious attention.

Finally, let me give you one last reason for a gas tax: OPEC. That great oil cartel often has trouble maintaining discipline within its ranks, but to the extent it can control the price of oil, it is reasonable to expect that

the price that producers charge will fall in response to a higher gas tax. So, in the long run, a significant part of a gas tax increase would not be paid by Americans, but it would be paid by the governments of producing nations like Saudi Arabia, Venezuela, Russia and Iran. And, who can complain about a result like that?

Thank you.

(Applause)

MR. BERGIN: Thank you, Marty.

Our next idea will be presented by our remaining two speakers, and I will introduce them in the order in which they will speak.

Gilbert Metcalf is a Professor of Economics at Tufts University and a Research Associate at the National Bureau of Economic Research. He is also a Research Associate at the Joint Program on the Science and Policy of Global Change at MIT. He does research in taxation, energy and environmental economics.

David Weisbach is the Walter J. Blum Professor and Kearney Director of the Program in Law and Economics at the University of Chicago Law School. He was a consultant to the President's Commission on Tax Reform in 2005. His current research focus is on issues relating to climate change and energy taxes.

Gil. And, Marty, I'll bring back your glasses.

MR. METCALF: Well, thank you. It's a pleasure to be here today,

and I will start the present, and then David will come up and correct everything I've said incorrectly, that I've said that's incorrect.

So our topic is carbon pricing in the Obama Administration. Let me just start by defining some terminology. Carbon pricing can refer to cap and trade which we've already talked a little bit about today. That's one way in which we can put a price on carbon emissions. Another is a carbon tax which explicitly puts a price on emissions.

A second definition is while I will be talking, David and I will be talking about a carbon tax or carbon cap and trade, we really mean more generally a tax on greenhouse gas emissions. Fifteen percent of greenhouse gas emissions are non-CO2: methane, sulfur hexafluoride and other gases. But just the generic term, I'll use carbon.

The last point I'll just make as an introductory comment is that we really should think of this very distinctly from Marty's discussion on raising the gas tax. You shouldn't be thinking about this as two ways to get at the same goal. Carbon policy is really about industrial sector emissions, industrial fuel use and electricity generation. It's really not a lot about transportation.

If we had a $50 per ton CO2 carbon tax, which is a pretty steep tax to start with, but it is a tax. It's a level of pricing that we would need if we wanted to move towards a goal of 80 percent reduction in carbon emissions by 2050, President-Elect Obama's stated goal. That would

raise the price of gasoline by about 45 cents.

So the real action is not going to be in the transportation sector. But if we care about energy security, if we care about oil imports, then that really speaks to Marty's proposal.

Okay, so why do we want to use a carbon price? Well, the simple answer from an economist is that it is a cost-effective way to achieve a given level of reductions in greenhouse gas emissions. If we look at the trading program that was set up under the acid rain program under the Clean Air Act amendments of 1990, this reduced the cost. It's estimated this reduced the cost of SO2 emissions cuts by about a half compared to a command and control regulatory approach. This is studies done by groups including researchers at MIT.

A market-based approach is a much less cumbersome and potentially, hopefully, less contentious regulatory instrument. There's been some talk in recent weeks about using the Clean Air Act to regulate carbon dioxide and perhaps through the concept of an endangerment finding.

I find this quite worrisome. I think this could really tangle us up in a both regulatory and legal process that could really impede our moving to making real significant cuts in carbon emissions. I think there's really good reasons not to go down the regulatory road but really to use a market-based approach. It has worked well in the SO2 program. It's

worked well with some caveats in the European Union with the emission trading scheme, and it's something that we could certainly do here.

So what are the issues? I'll talk in terms of a carbon tax rather than cap and trade because this is a tax conference, but the concepts and issues are similar for both.

What do we tax?

What's the base?

What's the price?

What's the tax rate?

What kind of revenue are talking about and what do we do with that revenue that we collect?

So just for those of you who aren't aficionados of climate change, just a little bit of background information: Energy-related fossil fuel combustion accounts for about 80 percent of greenhouse gas emissions in the United States. These are particularly easy to bring into the tax base. You've got a series of other gases. The technical term is forcing. The degree to which they contribute to raising temperature in the atmosphere is they are significantly more powerful.

Let me just turn off my phone. Somebody is trying to call me. It's my son.

They're significantly more powerful, but there's much less of them in greater, in aggregate amounts. But it is important to bring these into the

system to the extent that it's possible because what we find is that it is, some of these other gases, the non-CO2 gases, it turns out, can be quite easy to get quick and significant reductions in, so that it can really bring down the aggregate cost of meeting any emission reduction goal.

So where do the emissions come from? About a third from electricity production, 93 percent of the coal that we mine in this country goes to electricity. Over half of our electricity comes from coal.

Transport is about a quarter, but, as I noted before, I think this is where we will see the least impact in terms of reducing carbon emissions through transport.

Then in the industrial sector, it's about 12 percent, but here we have significant areas in which we can achieve reductions.

In terms of the tax base, the jargon here is we can levy the tax upstream or downstream or a cap and trade system. Downstream would be to levy the tax at the point where fuels are being consumed or chemicals are being used in factories. This is a particularly inefficient to go about collecting the tax. It is much more efficient to go to the source of where the carbon, focusing on carbon, where the carbon comes out of the ground or where it enters the country, imported.

One of the good things about dealing with CO2 emissions is that there's not a whole lot of process change, things that you can do that if you have a barrel of oil that gets imported. There's not a whole lot that

you can do that reduces the carbon emissions coming from that barrel of oil. There is carbon sequestration, and we do have to think about that, carbon capture and storage. But just for thinking about process changes, there really isn't much you can do.

So whether you put the tax on the oil where it comes into the country or at the refinery or at the pump at the gasoline station, you really get the same effect. So you might as well pick the point where it is most cost-effective and most administratively efficient to collect it, and that's the upstream level is the place to do that.

For our non-energy, the for the non-fossil fuel greenhouse gas emissions, we're talking 20 percent of the non-energy emissions, non-energy carbon fossil fuel emissions, the other 20 percent of these other gases and some non-energy use of carbon dioxide.

David and I have another paper where we sort of go through these sources and conclude that you can collect about half of that remaining 20 percent which means we can get up to about 90 percent of total greenhouse gas emissions at a reasonable administrative cost. Here, what you're doing is you're trading off greater comprehensive coverage by broadening the base against higher administrative costs of doing that.

So for natural gas, we have about 400,000 gas wells in the U.S., but almost all that natural gas goes through about 500 natural gas processors, and nearly all of this gas is processed. This is natural place to collect the

tax. If you collect the tax there as well as the roughly 55 import points, pipelines and LNG facilities, you capture all of the natural gas.

Similarly, for coal, we have less than 1,500 coal mines in the United States. They're all paying taxes right now for the Black Lung Tax. So this is a logical place to collect the tax.

You could collect it at coal-burning electric utilities. I think there are really two reasons to prefer the coal mine approach. The first is that some coal is being used in industrial use, and we do want to capture the emissions from that coal-burning.

The second is that there's a fair amount of methane that gets produced in the production of coal, coal bed methane. At high gas prices, there's an incentive to collect it and sell it, but at low gas prices there isn't. So you would want to make sure that the coal bed methane is brought into a carbon tax to give them the incentive to capture and put it into the pipeline system.

Finally, for oil, we have 149 refineries. That's a sensible place to put the tax there.

The next question is what should the tax rate be? Well, what we know from PAGOO is that you should set a tax equal to the marginal damage of emissions. What we have drawn here are a couple of distributions of estimates of what the marginal damages are. You see they range from a negative $25 per ton of carbon to a positive $125. It's a

huge range. The reality is we simply don't know what the marginal damages are.

The approach that's generally taken is to say, well, scientists tell us that we should be looking to avoid more than a 2 degrees Celsius increase in temperatures and, to do that, we should be looking to stabilize emissions between carbon concentrations in the atmosphere between 450 and 550 parts per million.

To do that, we're going to need a trajectory along the lines of what the President-Elect is proposing. So we should start with a tax rate perhaps in the $20 per ton range and then ramp it up over time. That starts us with about $100 billion per year in revenues, potentially.

One of the impediments to any energy tax is that it is regressive particularly as you look at this, using an annual income approach. And so, this table simply shows what the burden on households of a carbon tax would be as a fraction of disposable income. This includes both direct increase expenditures on fuels as well as the higher cost of food, clothing and other commodities because of the cost of fuel in producing them. What you see is that for low income households, the burden is about 3.5 to 4 percent of their income, and it falls to less than 1 percent of income for the highest income deciles.

So our proposal is that we should do a carbon tax. It should be revenue neutral. We should not be using this to expand the size of

government. We should not be expanding the fiscal burden during a recession, and we argue that we should make this distributionally neutral.

There was talk this morning about somebody asked whether we should use a carbon tax to pay for reducing the payroll tax. Well, you could do that, and that would be one way to achieve the distributional neutrality.

The last point I'll make and then I'll hand it over to David is that one of the interesting things about a carbon tax is that you actually have regional neutrality to a large extent with this tax because the rural areas where people are driving more tend to be areas where they are heating with natural gas, not using air conditioning. In more congested areas where they may driving less, you see more heating with electricity and, in some areas, more use of air conditioning. So what I found in work with Kevin Hassett and Aparna Mathur at AEI, we found that there is regional neutrality on a distributional grounds there.

With that, let me turn it over to my co-author.

I was going to give it to you. Do you want to do it? I'll do it, okay.

Last point I'll make or the first point David would have made if I had gotten off the stage is should we go with cap and trade or a carbon tax?

Clearly, there's a lot of political momentum for cap and trade, and Obama has come out for fully auctioning the permits, which I think is important. Four arguments here for favoring a carbon tax:

The first is we can put a carbon tax into place much more rapidly than we can a cap and trade system. CVO has a report last year that talks about this in greater detail. We're already 15 percent above our emissions in 1990. Globally, we're 25 percent above where we were in 1990. To the extent that we feel like we really need to get moving on this, we can do it more quickly with a carbon tax.

Second, a carbon tax is more efficient than cap and trade. There's been a great deal of research looking at when you take into account the uncertainty over the cost of reducing carbon emissions, is carbon capture and storage going to work, are plug-in cars going to come online, are we going to get breakthroughs in battery technologies, all these things. There's tremendous uncertainty, and the modeling that's been done is pretty unequivocal that a carbon tax is much more efficient than a cap and trade.

It also leads to lower price volatility. We've seen price volatility in the SO2 program, the NOX Trading Program in the United States, the European Union emission trading scheme. If you're an electric utility trying to plan a 50-year long-live power plant, you would like some sense of what the price of carbon emissions is going to be so that you can do some rational planning. I think the lower price volatility has a lot to be said for it.

There's also an issue that what we're seeing is that with a carbon

tax, and there are politicians in this room who can say this with more authority than I can, but taxes go through the Senate finance Committee and the Joint Committee on Taxation, Ways and Means. If we really want to do a revenue-neutral reform, where we're shifting the form of taxes rather than raising taxes and spending it, then running it through a tax-writing committee is a way to ensure that kind of discipline to make sure that it's revenue neutral. If we run it through the committees that will be overseeing cap and trade legislation, the incentive there, presumably, is to spend it on projects that are under their committee domain.

And, finally, and this one I really turn over to David, is the issue of border tax adjustments.

(Applause)

MR. WEISBACH: Thanks for staying around. I'm the last speaker of the day, and we still have a crowd here.

I'm going to talk about border tax adjustments. Those of you that were around in '93 and remember the energy tax know that this is one of the most difficult issues in an energy tax, how to deal with this. We have some initial thoughts on it. I'm not sure we have any sort of final answer on it, but we'll put forth our thoughts.

One thing I should say is that what we're imagining in this proposal is to unilaterally impose a U.S. carbon tax, and there's an issue as to whether that's even a smart idea at all or whether we should wait for

whatever treaty we get. I don’t have a very good priority.

The question is whether imposing a tax unilaterally is, number one, a good treaty negotiation strategy, whether leading and then hoping other people follow and, if they don’t follow, maybe backing away is better than waiting and having everyone do it at once? I’m not sure I know the answer to that. We’re proposing here a unilateral tax.

The other question is if we’re eventually going to have a treaty, is starting early on emissions reductions now a better thing to do? That is can we reduce our overall cost if we start now? The answer to that seems to be, pretty clearly, yes.

So we’re imagining a unilaterally imposed U.S. tax. I should note that’s what the Lieberman-Warner system debated last summer was going to be, a cap and trade system but imposed unilaterally.

The question is, in that context, what do we do about imports of carbon-intensive goods? I’m sorry, I don’t have a bullet point on there, but we’ll start by saying that principles of free trade indicate that we should have border tax adjustment.

So imagine a producer in foreign country and a producer in the United States, and we have a price on carbon. If they don’t have a price on carbon, their production will be lower. Their production costs will be lower, and it would like they have a comparative advantage. But the only reason they have a comparative advantage is because they’re imposing

costs on the rest of the world. Right? They're imposing an externality, and we don't think that's consistent with the notion of free trade.

If you will, in economics terms, the notion of comparative advantage requires the price reflect marginal cost. If they don't have some kind of carbon price, their price doesn't reflect true marginal cost of the good, and so a border tax is a way to ensure that trade occurs on the basis of comparative advantage and not something else. Politically, also, border tax adjustment, as you know from the '93 experience, seems to be fairly necessary.

So there's good economic arguments, good political arguments for border taxes. The question is how to actually make them work, and that's where all the problems are. There are really two big problems. One is legal, and one is implementation.

The legal problems are very difficult, and after spending a lot of time studying the issue I can say that I don't know whether a border tax adjustment on a carbon tax would be legal under the WTO rules. I don't think anyone knows that. There is a lot of articles on this, speculation on it. I don't think anyone really knows the answer.

There are two points here. One is that a unilateral tax with border tax adjustments is less likely to be WTO legal than a multilateral regime. So one flaw with the unilateral proposal is it's less likely to be upheld by the WTO.

The second point is that taxes are more likely to be border tax adjustable than the exactly equivalent permit system, and the reason why is there are some specific provisions in the WTO for border tax adjustments but nothing like that for a property rights regime like a permit system is. So one argument in favor of taxes is it might be that you have a better of chance of it being upheld as WTO legal.

If it is legal, there's still the terribly difficult problem of how to implement border tax adjustments. We're all familiar with border tax adjustments in a VAT where a VAT is imposed on the full price of a good. So all we need to know for the border tax adjustment is what it sells for. It's quite easy to do the border tax adjustments.

With an energy tax, like a carbon tax, the border tax adjustment would be on the carbon content of the good. It's not something you can directly observe. So if steel is produced in Korea, there will be emissions because of the energy used to produce that steel. But when the steel is sold into the U.S., you don't know what those emissions are. You don't know what the carbon price should be on that imported piece of steel. So there's no easy way to implement a border tax adjustment on carbon, unlike in a VAT.

How do we get around this? We have a couple ideas of ways to get around this, really three ideas which are up there. Actually, the last bullet point is part of this implementation issue.

The first one is to focus on goods only with substantial carbon content. Most of what we import, a lot of what we import really doesn't have any significant carbon content, but it has some. Instead, if we focus on carbon-intensive goods, and there's really five we're going to highlight in a second, we can reduce the administrative burden quite significantly while still capturing most of the carbon that's imported into the United States.

The second idea is instead of trying to impose a border tax adjustment based on the actual emissions in the foreign country, we're going to look to comparable products in the United States, figure out what those emissions are, and we have that data, and impose a border tax adjustment on that basis with the caveat that if a foreign producer were to be able to prove to the governing authority in the United States that their emissions were actually lower, they could essentially prove out of the system. That would allow us to have data to impose a border tax as well as, hopefully, get around WTO challenges that we're imposing a tax that's higher than appropriate, given the emissions that were created in producing that product.

It's not a perfect system. Administratively, it would still be quite difficult, but better than trying to figure out what the emissions are in foreign country on a country by country basis, on a product by product basis which would be very difficult.

The last idea we have to simplify the system is to use a combination of origin and destination basis systems. The idea would be that if a foreign country has a carbon price there, we don't need a border tax adjustment. It's only for countries importing to the U.S. that don't already have a carbon price.

Here's our next slide which has some data on this. This is the five most intensive carbon goods that are imported into the United States. The other one, the sixth one, would have been refined oil. We import very little refined oil. So the six most carbon-intensive goods that we consume, and these are five of them: steel, aluminum -- that's really actually all ferrous and nonferrous metals -- chemicals, paper and cement.

Then what's surprising about this chart is who's on the chart. If you look at the top importer in the United States, four of these five is Canada. We're not talking China here. So if you're thinking about border tax adjustments for imports for carbon-intensive goods, you should not be thinking of China. A lot of what we import from China is apparel and electronics which is not carbon-intensive.

All right, Canada. We've got Trinidad and Tobago. Canada is second, by the way, and the only one that isn't first. China shows up in a few places here, Ukraine. Most of these countries, and Brazil is down there on aluminum, most of these countries are already signatories to the Kyoto Treaty, the Kyoto Protocol -- sorry -- so that a lot of these countries,

we wouldn't have to worry about border tax adjustments for under the combined origin/destination system. Again, it's only for these carbon-intensive goods and only from countries that are not signatories or that do not impose a carbon price.

So it looks like the system might be manageable. For the few goods where we would actually have to impose a border tax adjustment, we would use the U.S.-based production system rather than whatever they're doing foreign in order to enable us to have data. We think it's feasible. We think it's economically justified, but at the end of the day this is a difficult problem. It's not clear there's any great solutions.

All right, so our conclusion is that we should have a market-based rather than a command and control system, so some kind of carbon price. It should be revenue neutral and distributionally neutral, and that should be a tax, not a cap and trade system.

We can get 80 percent of U.S. emissions quite easily with less than 3,000 taxpayers. We can get 90 percent with not all that many more taxpayers. So we have a comprehensive upstream system with a limited system of border tax adjustments.

Thanks.

(Applause)

MR. BERGIN: I'm going to use my prerogative here and ask the first question because there's an 800-pound gorilla in the room. I don't

know where it is, but Marty referred to it a couple times. So I'm going to ask all the panel members.

This question is rather simple. Does a carbon tax or an increase in the gas tax have a chance in this town?

MR. METCALF: Let me start with that because when we were putting together the presentation, talking about a carbon tax, I thought this is really sort of going out on a limb. But then I heard Fred's and Len's proposals this morning, and I began to think we're kind of middle of the road.

But more seriously, you know five years ago we would not have thought that we would see a cap and trade bill coming to the floor of the Senate, being reported out of committee. So I think things have fundamentally changed.

Then when you look at the need that we're going to have over the long run for revenue, I think that this really does have to open up all kinds of options that previously had been off the table.

MR. BERGIN: Marty?

MR. SULLIVAN: I was just going to say if the public can be educated that this would be a redistribution of wealth from Middle Eastern countries to Americans, they might be a little more widely accepted.

And, I think if conservatives could understand that this is not your normal tax, but this is a way of reducing government regulation, this is a

smart way to go.

MR. WEISBACH: The carbon tax, by the way, is not about the Middle East really. I think you made that point. So coal and natural gas are almost all. We import almost none of that. So it's really all U.S. producers that would bear the burden on that which is the real political problem. It's what killed the BTU tax with coal to my understanding.

MR. BERGIN: Okay. I'll open it up to the audience. Please, again, state your name when you get a microphone. I saw that hand first.

QUESTIONER: Thanks. I'm Bennett Minton .

Marty, a gas tax, I understand I go to the gas station, it costs more than it did yesterday.

For a carbon tax, it's very abstract. How much are you raising the price of my Prius?

MR. SULLIVAN: I don't know about the price of the Prius. Well, the price to produce the Prius, a $15 per ton CO2 tax would raise the price of a new car about 1.5 percent. For every $20 per ton CO2 carbon tax, it's going to raise the price of gasoline about 18 cents.

QUESTIONER: Bob Williams, the Tax Policy Center.

What, if anything, did we learn from the run-up in oil prices and the consequent fall we've see in the last year that helps inform this debate?

MR. METCALF: Well, one thing we saw when gas got to $4 a gallon, people began to make really substantial changes in driving. We

saw driving drop off. We saw public transit rates go up. I read in the Globe yesterday that even though the price of gasoline has dropped off, people are still sticking with public transit. Now some of that may be that the economy is in the tank too.

It's clear that if you have a significant and what is perceived to be a long-run increase in the price of energy as opposed to, oh, it's going up but it's going to come right back down, then you will get really significant changes in behavior.

MR. BERGIN: Anybody else?

QUESTIONER: Arnold Caine .

You say that CAFE standards are more efficient than a gas tax, but yet you're saying that a market standard is a solution to the gas tax problem. I mean which one is it? How can we be sure of that?

MR. METCALF: We do know that. I think the question was about CAFE standards versus a gas tax and why is a gas tax more efficient.

It's just very striking when you think about it, especially in the backdrop of everything that's happened to the auto makers now. Everybody is pounding on the auto companies. Everybody is beating on them and saying they should be producing more fuel-efficient cars.

But if you think about it for a minute, we put the entire burden of fuel efficiency on the auto makers. We don't ask or incentivize, if that's a word, anybody else to reduce their fuel consumption. And so, if you think

about it, why isn't the whole economy provided with an incentive and placing the burden?

So I think when you think about it, it's almost self-evident that a gas tax is more efficient than putting the entire burden on new cars.

MR. BERGIN: Okay, I'm coming around. In the back here.

QUESTIONER: David Bardine .

Both panels are recommending a form of tax in which the revenue is rebated. There's no net increase to the Federal Treasury. So I want to know, are there any models where that's already been done?

When you look at any of the other countries in the world which have cap and trades ahead of us, they're better Kyoto people than us non-Kyoto. Are any of them rebating?

When you look at our own supposed model of the acid rain, SO2, NOX, we don't have any rebate there. We don't give the electricity consumer. What's the experience on rebating that might make it credible to the conservative that Marty mentions or anybody else, any taxpayer, that those rebates are really going to happen and work?

MR. METCALF: There is evidence of that.

MR. SULLIVAN: Oh, there is?

MR. METCALF: Yes. Well, first off, the previous cap and trade programs have given the permits away for free. So this is a fundamental difference.

Of course, for the SO2 program, it really didn't matter because we were talking about assets that were valued at about $8 billion a year. So we weren't talking significant money like we are now.

The first significant carbon and energy taxes that were related to climate change happened in Scandinavia back in the early nineties, and those revenues were used to lower personal and corporate income taxes. There is evidence that that can be done and has been done.

MR. WEISBACH: Right. The big E.U. program, though, the European trading system for Kyoto, that was a given away system. There was nothing to rebate there. They gave away the permits.

MR. SULLIVAN: And there's another example which is British Columbia has a carbon tax in which they rebate all the proceeds. In fact, I stole my idea from them. They have a dedicated trust fund for that and all of that. There's a treasurer in charge of that trust fund. If he doesn't rebate all of the money, his salary is reduced by 10 percent. It's pretty strict.

MR. BERGIN: That's a good idea.

John, I'm coming around.

QUESTIONER: John Samuels with GE.

This is a question for David or Gil on what the international experience has been with carbon taxes and, in particular, have any of the countries that have adopted them implemented border adjustments

effectively or even tried?

MR. WEISBACH: The existing carbon taxes are almost all quite low and quite narrow, all enacted almost more than a decade ago. So there's not a lot of international experience with carbon taxes. They're almost all Scandinavian.

The U.K. has a small system called the Climate Change Lobby which is just a few years old now, and it's a relatively narrow base. There's nothing in the world like what we're proposing.

QUESTIONER: Were they considered at all in Europe before the cap and trade systems were adopted?

MR. METCALF: That was what Europe wanted to do in the 1990s. Economists and policymakers were quite interested in going the carbon tax route. You may recall that there was opposition by European countries to the notion of trading at Kyoto, which the U.S. pushed.

The reason they ended up going with cap and trade rather than a carbon tax was that the rules of the E.U. require unanimity on fiscal policy, which a tax is, but they require only a majority for regulatory policy, which cap and trade was deemed to be.

MR. WEISBACH: I'll just point out that in the E.U. systems, the E.U. trading system covers only about 40 percent of their emissions. What we're proposing here gets 90 percent. So it's really a different kind of thing than what they're doing in Kyoto.

QUESTIONER: Bill Gale, the Tax Policy Center.

Two questions: One is on the revenue neutrality and distributional neutral aspect of this. There's no inherent reason why a carbon tax needs to be that. There's nothing in the economics of it. It's just I gather you're proposing it to grease the political wheels. If so, then I kind of have the same response as I do to people who talk about substituting the value added tax for part of the income tax, which is we're going to need revenue from somewhere, and if we use up all our new revenue sources on the revenue-neutral stuff, then we don't have any ammunition left. So your comments on that is one question.

The second question relates to the cap and trade versus carbon tax where you talked about the volatility of the price as an issue in the cap and trade system, but I wonder if that's not true in the tax system too. Namely, if you have a tax, as we all know, we're all tax experts. We all know if you have a carbon tax, you're going to have constant beating to reduce the tax.

The cap and trade system has this very nice incentive effect that the people who own the permits don't want to get rid of the system because the permits are valuable. So it becomes sort of self-enforcing in a way.

And so, I wonder if you could comment on that aspect of the two options too.

MR. SULLIVAN: So, on the second question, my answer on that

one is three letters, AMT.

Why have we not been able to get rid of the AMT? Because we need that revenue. I think that's a large reason why we have not solved the AMT problem. So, with a carbon tax, it can raise a substantial amount of revenue which we will need in the overall fiscal basket, and that creates some momentum to keep this tax and to fight the pressures to lower it.

MR. METCALF: This is an argument to try to disentangle getting a carbon tax in place from concerns about the growth of government and big government, all the arguments you can raise against the VAT. We simply want to disentangle that.

But I certainly have no philosophical problem with saying: Well, we have these real fiscal needs coming down the road. So let's look at the whole array of tax instruments we can put in place, and let's use a carbon tax as an additional instrument to help us reach these goals.

That was the idea behind that.

MR. WEISBACH: It's really more intellectual about how to think about the system rather than what Congress actually does.

MR. SULLIVAN: On the issue of revenue neutrality, of course, it is arbitrary we've chosen that. The only thing I can say to that is, as I studied the history of the issue, it is so difficult to enact a gasoline tax. The only realistic chance, it seems to me, is if it's revenue neutral. If you ask it to do more that's politically uncomfortable, it will never survive.

But you're right. It has nothing.

Some people say if you dedicate the money to road-building, the road-builders' lobby and the state and local governments would be politically in favor of that. So maybe that's a politically easier path for a gas tax.

MR. BERGIN: Which is the tax that's easy to raise on a nonrevenue-neutral basis?

MR. SULLIVAN: A secret tax.

QUESTIONER: Roseanne Altshuler, Tax Policy Center.

I think the border tax adjustment issue is a very important one, and I'm so glad to see that you've dug in deep on that.

You didn't mention anything about export rebates. I assume we'd have to do that. There's a difficulty in that you would give an export rebate if you're exporting to a country that doesn't have a carbon tax, right?

There's this real incentive to set up distribution centers, and it's the same way on the way in. We're going to have to trace how those products go through from one country to another.

MR. WEISBACH: I can imagine a system if every country had the same, the origin within carbon pricing world and destination outside that. Then wherever the consumption takes place, there's going to be the tax. So putting a distribution center in the Caymans won't help you if the product is ultimately consumed in Canada.

QUESTIONER: But now I have to know that they're going to Canada.

MR. WEISBACH: No, you don't because Canada has a tax on the import, right. So you don't have to know it, right.

Now the problem is, of course, you don't have the data. So maybe the Canada import tax is totally different than our export rebate because you don't really know the emissions from each one. So there are imperfections in the system, and surely there would be some gaming. But if the system were used universally, I don't think you have that problem.

QUESTIONER: Does that mean we'd give an export rebate on all exports? We wouldn't have to worry about where they're going because what you're saying is where they're ultimately consumed they're going to be taxed.

MR. WEISBACH: No, because if you give a rebate on an export to Canada, and they don't have the border tax coming in, then you'd begin with tax, right. So you have to know where it's going, and that is, yes, a big administrative --

QUESTIONER: So this is a problem?

MR. WEISBACH: Yes, well, it's an administrative problem. It's not an avoidance problem, right. As long as the place of consumption is where there's a carbon price, it will be imposed. But, yes, we didn't intend to have an export rebate.

I should note, by the way, that the Warner-Lieberman bill doesn't appear to have that, and most bills that I know of that have border tax adjustments on imports don't seem to have the export side, which raises a real WTO legality problem, a real economic problem. I'm baffled as to why that's the case, but it seems to be.

QUESTIONER: It makes it harder with the WTO?

MR. WEISBACH: Yes, but we intend to have a border tax rebate on exports.

MR. SULLIVAN: I'd actually go in a slightly different direction. We haven't completely sorted this out. I think we have this sort of hybrid origin destination approach.

To me, where we ought to be heading is an origin approach, ultimately, where the major, not every country in the world, but the major carbon-emitting countries have some sort of carbon pricing policy or a proxy for it. The reason for that is that there's a greater incentive for the countries to put the policies into effect if the revenue stays in their own country. So I think that's where we ought to end up.

MR. WEISBACH: I didn't mention it. That's one of the reasons why we would do this, right. If you have a full destination system, then there's no advantage to China joining a treaty because they don't get the money for goods that are consumed in the U.S. regardless, right. The combination origin and destination creates the incentive for China to join

the treaty, and that's actually the reason why we wanted to have this combination in addition to administrative simplicity.

MR. METCALF: Roseanne, we're talking about steel and cement here. Intangibles don't have a carbon content, so they won't be shipping them through tax havens.

MR. BERGIN: I'm going in circles, so I'll try to get everybody.

QUESTIONER: My questions, I guess, deal with the efficiency of some of your schemes. Gil and David, as I understand it -- I don't know -- 80 percent of emissions almost get immediately reabsorbed out of the atmosphere and into some system. What you're concerned about is actually how much carbon ends up in the atmosphere rather than how much is reabsorbed in the trees and so forth. So shouldn't an efficient tax system provide subsidies for the owners of assets that reabsorb the carbon out of the atmosphere? Shouldn't I get paid for my trees that I plant in my back yard?

And, Marty, I was trying to -- I assume your gas tax is really a tax on petroleum, not just transportation use but also utility and industrial use.

MR. SULLIVAN: Right.

QUESTIONER: And I was trying to, from your little chart, figure out what kind of tax level you would need to get down to the Obama goal. My quick, real quick and dirty look, it looked like $600 a barrel or $15 a gallon or something like that, maybe, taking the '78 experience.

I don't know if you've done any calculations along those lines, that you can correct me and tell me what that might be. But if that's the case, you're talking $1.5 trillion of tax revenue or something, given your numbers up there.

Given the externality, I mean putting a $15 on each gallon of gas, is that an appropriate measure of the externality that we are incurring by the consumption of that gasoline? Perhaps you can just remark.

Then what does that say then about the appropriateness of President-Elect Obama's goal?

MR. SULLIVAN: I just used the President-Elect's goal to illustrate and for narrative purposes. The correct economic answer, as you're pointing out, is to find out the externality costs of using gasoline which would be a combination of greenhouse gas emissions, and that might be 25 cents a gallon or 10 cents a gallon or 50 cents a gallon depending upon the social price of carbon.

Then if you had a distribution of the energy security costs of gasoline, it would look like that one. They were all over the charts. But again, I think you're talking 25 or 50 cents a gallon.

And, you add the two together, and you get something between 50 cents and $1 a gallon perhaps. I think we're talking in that ballpark. Then you'd have to know the elasticity to figure out the quantity response there.

So I agree with you. Perhaps President Obama's goal, it may or

may not be consistent with the externality costs and the elasticities that are implied.

MR. METCALF: Kent Small and Ian Perry have estimated externality that we should raise the price of gasoline by about $1 a gallon to capture all the externalities from using -- all, everything, congestion, road congestion, accidents, all these sorts of externalities, highway pollution.

MR. WEISBACH: Carbons sink, so a lot of the sink is the ocean, right. You don't have to worry about that. It's happening anyway, right.

The rest of it, you're talking deforestation or aforestation or reforestation, and the question is what you do about that. The science is complicated because it depends on where you plant the trees and what kind of trees you plant. So it's complicated.

You can either have a tax on deforestation if you can get the science right, and we can observe deforestation quite accurately with satellites right now. We can actually count individual trees, although the science of what type of tree and where you plant it still needs to be worked out. Or, you could have a credit for reforestation.

What did we do in our paper? I don't remember.

MR. METCALF: We have an offset. We allow agriculture, land use to opt into the system. So the issue is not so much the -- technically and sort of scientifically, absolutely, we should be allowing credits for things

that contribute to absorption of CO_2. The real problem is figuring out what's additional, what's actual incremental action that would not have taken place otherwise, and this is a very, very difficult thing to sort out.

MR. BERGIN: I'm coming, Lynn, I promise. There's two right here.

QUESTIONER: Hi. Derrick Dorn with Senator Jeff Bingaman.

My question is for Marty. I tend to share the moderator's skepticism that a gas tax will be on the horizon anytime soon particularly because we currently use that revenue stream for the Highway Trust Fund which is nearly bankrupt. So it's going to have to be raised anyway.

So short of raising the gas tax for climate to combat greenhouse gas emissions, I'm wondering if you have thoughts on what we can do to the current subsidies either for vehicles or non-vehicles and kind of make sense of them in a way kind of for the time until we can get the gas tax of your nature passed.

MR. SULLIVAN: I share the moderator's skepticism about the possibilities of a gas tax.

Well, I think we need, we're going to have tax credits for alternative technologies, and as much as possible they should be technology neutral. I've heard about some proposals for I think they're called feebates for new cars where it would be a sliding scale based on miles per gallon, and I think proposals that move in that direction, which don't pick and choose technologies. If you get 150 miles per gallon, whether you use rubber

bands or you use hydrogen or you use wood-burning stoves, however you do it, you should get a larger tax benefit.

MR. BERGIN: In the interest of full disclosure, I should point out that the moderator is also very skeptical about targeted tax credits.

QUESTIONER: Alex Leamey.

Bear with me for a second because this may sound like mishagoss at first, but a lot of farmers and ranchers we've heard from are very concerned that a carbon tax would be particularly burdensome on them because of the flatulence of their cows and cattle that emit methane.

MR. BERGIN: It's burps really.

QUESTIONER: Burps, burps.

MR. SULLIVAN: You got the wrong end.

QUESTIONER: All right.

MR. METCALF: He has all the facts.

QUESTIONER: Be that as it may, how would the plan you're proposing deal with the burps and the particular burden on these farmers and ranchers who have a very small margin.

MR. METCALF: So this is just cattle. It's not horses. It's not pigs.

It's just cattle, and it's pretty constant per head of cattle with one. We actually don't include them, but what you could do is you could have a head tax on cattle that takes into account their lifetime burping. I say this only partially humorously because you can change their diet to reduce the

enteric fermentation. So you could have a head tax that reflects sort of the average releases, methane releases, but then allow a reduction for better practices, better dietary practices.

MR. WEISBACH: I think the big thing with the farmers is the manure, and so spread manure doesn't have anaerobic fermentation, but their manure pools do. It produces methane. And so, I think you've definitely got to worry about that, the methane from anaerobic fermentation and manure.

MR. METCALF: Big feed lots.

MR. WEISBACH: I'm sorry?

MR. METCALF: You should include the big feed lots.

MR. WEISBACH: Yes, exactly. They're causing a cost on the rest of the world. They should pay the tax.

MR. METCALF: And they can capture it, and it becomes cost-effective with a carbon tax for them to capture it and sell it, the methane because that methane, you can burn it. It's a natural gas.

MR. SULLIVAN: Okay, I'm not going to burp anymore.

MR. WEISBACH: You don't have a ruminant. It's not the same.

QUESTIONER: I was really proud that we'd gotten through almost the entire day with no B.S.

MR. BERGIN: Who are you, by the way?

QUESTIONER: I'm Chris Bergin with Tax Analysts.

I'm Len Burman with the Tax Policy Center.

I also have a problem with that. Obviously, a carbon tax, at least in the short term, would be as devastating to the coal industry, and that's at least a political problem. What do you do about that?

MR. BERGIN: I'll let you handle the hard ones.

MR. SULLIVAN: We can have a transition fund. So Congressman Larsen, in his bill, has a 10-year transition fund. We're really talking about a generation of workers that will have to transit out of this industry. That's who we care about really.

So I think there's sort of two things. One is transition assistance. It's clear that a carbon tax or cap and trade, this is a tax on coal. It's absolutely true.

But the other thing is that this provides an even greater incentive to solving the carbon capture and storage issue. It's unfortunate with FutureGen. The funding with that got derailed last year. The future of coal is really a future of coal in which we capture and store the carbon.

QUESTIONER: I actually just remember that I had a proposal for this. I was talking to Terry Dinan the other day. A strategic coal reserve, keep on mining the coal and just put it some place until you figure out how to burn it without putting more CO2 into the atmosphere.

MR. SULLIVAN: Can I just say I think we should give massive subsidies to coal miners, their families, to West Virginia, to southern Ohio.

The economics of this are we want to impose the tax. How we spend the revenue is sort of a separate issue. It's sort of like the stimulus plan. It's free money. It doesn't matter.

I think it has to be devoted to political relief. Otherwise, we're never going to get anywhere, and I don't see what the problem is with targeting that relief to these sectors which will be devastated. I have no problem with that.

MR. WEISBACH: Just staying on coal, right, it really is a tax on coal. If you burn all the remaining reserves of oil and natural gas, you still get away with reasonable climate change. The problem is if you burn all the remaining coal you're in deep trouble unless you have some kind of carbon capture system. So it really ends up at the end of the day, 100 years from now, being about coal.

MR. BERGIN: Anybody?

QUESTIONER: Dennis Zimmerman, American Tax Policy Institute.

My question is a bit related to Len's. Right now, the major tax on this tax base are the state severance taxes. Are there likely to be interactions there? Are they likely to push back in a way that we have to include those in your distributional considerations about the revenue collected?

MR. METCALF: That's a good question. I don't know the answer to that, but that becomes part of the political calculus also, presumably.

MR. BERGIN: All right. If I could think of a burp joke, I wouldn't use it.

I'm going to ask Len to come up here for a second, but before he does I'd just like to give this wonderful panel a round of applause.

(Applause)

MR. BURMAN: I want to thank the panel. I want to thank all of the speakers who came in today for this conference. One of the amazing things about being in the Tax Policy Center is you can say, well, we think it would be fun to do this conference, and we get the best people in the country to come and talk.

Obviously, I want to thank Chris because he's always enthusiastic about joining in on these. We've participated in conferences that he took the lead on. This was, I think, one where we took the lead, but he was actually planning on doing something very similar. So we had coincident interests.

There are a couple of people who actually make things happen when Chris and Bill and I actually have good ideas that we couldn't possibly follow through with. Larry Hoss, who's standing at the back of the room, I think actually did a lot to follow through on Chris' part of this, Ben Harris who followed through on Bills' part of it and Renee Henley . Basically I wouldn't be involved in these things unless I could sort of commit to doing things that are enormously time and intellectually

engaging and then pass it off to Renee to actually make it happen.

Finally, I want to thank Leah Puttcammer and Joy Falzaronno who have been walking around with microphones, helping to check people in, doing everything else that makes one of these conferences happen. I think the logistical challenges of these things are much bigger than most of us can imagine, and the fact that it seems to go seamlessly is a testimony to their hard work.

I'd also like to thank Wendy Lewis from Tax Analysts. There's a beautiful poster outside that's like the classiest thing that's ever been associated with a Tax Policy Center-related event. I suspect she might have been part of that. Also, the communications staffs at both the Brookings Institution and at the Urban Institute.

Thank you all very much for staying to the end, and thank you to the speakers.

(Applause)

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